



Comments

on the Report of the Preliminary Draft of the Constitution
by the Committee on
Natural Resources, Economic Rights and Revenue Allocation

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The views and opinions expressed herein are those of the author. Comments should be directed to Alexander.Wegener@interpublic-consultancy.de.

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1. Introductory remarks on sub-national finance

This comment on the proposal of a constitution as submitted by the Committee on Natural Resources, Economic Rights and Revenue Allocation was prepared by Dr. Alexander Wegener (Berlin, Germany) to support the drafting of a constitution for Nepal.

The comment paper is structured as follows:

- First, three guiding questions on public finance are formulated based on commonly accepted design principles of intergovernmental fiscal relations,
- Second, some observations and comments are given relating to the overall design, structure and content of the draft, and
- Third, commentaries are given article by article, paragraph by paragraph, and, where necessary, proposals for rephrasing are given.
- Fourth, some examples of public finance related constitutional articles are presented based on the German federal system.

1.1 Three guiding questions

A key mark of public finance is the ability for a public body to control its own finances. A key issue is how finance is distributed between levels of government and administrative levels. Three basic questions that allow a first assessment of a public finance system:

- Who does what?
This question is asking which levels of government and which administrative levels are responsible for which tasks (expenditure assignment).
- Who levies what taxes, user charges and fees?
This question is asking which levels of government and which administrative levels are responsible for the setting of taxes and tariffs (decision-making authority) and which levels of government and administrative levels are responsible for the collection of these taxes, user charges and fees (collection authority).
- How are imbalances in funding requirements (expenditures) and funding options (revenues) resolved?
This question is asking whether there is, and if, which form of vertical imbalance in expenditure needs and actual revenues is existent and how these imbalances are equalised (equalisation mechanism)

The last question already addresses a crucial issue in public finance that touches the overall normative role and function of levels of government within a state. In a perfect world, each level of government should have sufficient funding sources to cover its funding requirements. However, given the very different design of revenue assignment and functional assignment, most countries in the world have to ad-

dress the problem of vertical imbalance.

In the past – prior to the rise of decentralisation policies – the existent vertical imbalance allowed central or regional levels of government a rather tight control over local government, and usually the control was both in terms of functions, and in terms of finance:

- Typically, unitary states, and other state constructions that can be classified as highly centralised for historical reasons, clearly regard local government as “creatures of state” and local governments may only perform those functions that were explicitly transferred to them.
- Decentralised states, often federal, in which the core of policy development and executive, operational service delivery is not on the central level, local government enjoys often specific rights. The most common right is that local governments are responsible for all functions and tasks that are of local concern. This is the operational expression of the idea of local self-government.

1.2 What is institutional symmetry for?

The institutional symmetry between decision-makers, beneficiaries and the funding body is a cornerstone for a decentralised local government finance system. The more decentralised, regionalised or even federalised a state is structured the more important is the design of a sub national finance system according to this institutional symmetry.

The institutional symmetry reflects three relationships between users and beneficiaries, the decision-makers, and the funding body.

Principle of congruence

This principle demands that a local government body should be responsible for those tasks which are used by or benefit mostly the local residents in its administrative boundaries. There should be a spatial identity between decision-makers and user or beneficiaries.

Decision-makers, beneficiaries (users) and responsible funding bodies should be located in the same spatial area (institutional symmetry)

Principle of connectivity

This principle demands, that decision-makers that decide on an issue that affects budgets should also be responsible to fund this decision by their own means. For example, a federal government should not decide on a law, which incurs costs on sub-national governments without accompanying funding.

Principle of fiscal equivalence

This principle demands, that the beneficiaries of locally produced services should also pay for these services. In consequence, this principle demands that local services should be funded by the local community. The community is set up by natural and legal persons. By that principle, it becomes evident, that funding for local government should be balanced between all beneficiaries of the local government, citizens and businesses.

Regarding the tax assignment among different tiers of government, international experience suggests that some taxes are better suited for sub national governments than others. International lessons provide a number of economic rationales of taxation in a federal setting (McLure 1983 and Ter-minassi-

an 1997). Maintaining efficiency is often emphasized for the assignment of local taxes. This is because decentralizing tax systems can often interfere with the efficiency of nationwide economic integration. Commonly emphasized criteria are as follows:

- Local taxes should be independent from national policy goals such as income redistribution objectives and economic stability.
- The local tax base should exhibit low mobility between jurisdictions.
- Benefit taxes and user charges are appropriate to local taxes.

Figure 1: Design principles of local and sub-national taxation

Local Authorities	Citizens and Residents	Businesses
Local revenues need to be adequate to meet the cost of the services and infrastructure they are intended to finance.	The framework for local taxation needs to be simple, transparent and easy to understand.	The local tax system needs to be fair and equitable in both design and administration.
Local revenues need to be buoyant (the tax base should grow automatically when prices rise, population grows or the economy expands) to meet expanding demands for service delivery. Revenue collections need to be stable and predictable to facilitate planning and budgeting. Collection and administration costs need to be minimized.	The local tax system needs to be fair and equitable in both design and administration. <ul style="list-style-type: none"> • Everyone should pay something. • The tax burden should be proportionate to ability to pay (vertical equity). • Taxes should be applied consistently for individuals at the same income level (horizontal equity). • Intensive users of municipal services should pay more (benefits principle). Local revenues should enhance accountability and strengthen the social contract at the local level.	<ul style="list-style-type: none"> • All enterprises pay something. • Similarly situated businesses pay similar taxes. Local taxes need to support a conducive business environment. <ul style="list-style-type: none"> • Taxes should not distort economic activity (efficiency). • Taxes should minimize barriers to enterprise development, especially for small and medium-size enterprises.
Local revenue autonomy and flexibility need to be reinforced.	Local taxes need to be linked to services provided.	Local taxes need to be linked to services provided.
Tax instruments need to be politically acceptable.	Compliance costs for taxpayers need to be minimized.	Compliance costs for taxpayers need to be minimized.

after Sarzin 2007

In addition to the aforementioned efficiency criteria, economic principles, such as national equity, administrative costs, and fiscal needs are important for developing countries (Boadway, Roberts, and Shah 1994). Thus,

- Sub-national engagement in perverse redistributive policies, using both taxes and transfers, should be restrained.

- Rules to allocate tax revenue among jurisdictions, restricting tax evasion and avoidance, will be required.
- Revenue means should be matched as closely as possible to revenue needs.

2. General comments on the underlying assumptions

In general, the report of the committee on natural resources, economic rights and revenue allocation for the preliminary draft of the Constitution published by the Constituent Assembly is in some aspects very detailed, much more detailed than in any other federal constitution world-wide.

A rather obvious assumption in the report is that the federal government is the most powerful level in the proposed state structure of a federal level, provincial level and local government level.

Key messages are:

- **A constitution should not make detailed provisions for central, provincial and local levels of government. Rather, a constitution should express and define the underlying principles for public finance.**
- The proposed articles and paragraphs are largely unsuitable to form a chapter on Public Finance in a federal constitution. Some of the articles are better to be part of a Law on Budget Principles, and some issues are even subject to regulations rather than to be content of a law. The mixture of technical aspects, fundamental principles and details must be divided that only the key principles, the fundamentals of public finance and intergovernmental fiscal transfers are laid down in the constitution.
- Most of the proposed articles refer to technical and administrative issues, but not to key principles of the state, principles of coordination between levels of government and rights and duties of these levels of government. Many of the articles are too specific to be part of a constitution, but too general to form the basis of "normal" draft laws.
- There seems to be a major misunderstanding of the role and function of a constitution compared to other legislative decisions and administrative decisions following laws. There should be a clear hierarchy in terms of constitution, laws passed by Parliament and regulations providing guidance based on laws issued by line ministries. This hierarchy seems to be absent. There should be a hierarchy of legal terms used in Nepali and official translations (i.e. Act, Law, regulation, ordinance, decree, etc.), as well as for other terms (such as tax, fee, user charge, etc.).
- **Revenue assignment should not become subject to political majorities, but should be designed to fund the functional assignment.**
- In combination with the list of revenues assigned to various levels of government, it is rather obvious that **neither provincial nor local governments will have sufficient funds to deliver the functions assigned to them**, making them heavily dependent on federal government policy decisions and administrative behaviour. The proposed revenue assignment leaves the provincial government with little power in practice, and their scope of activities is rather small compared to the federal level. The approach in the draft is predominantly centralistic and leaves very few and rather small discretionary power to provincial and local governments.

- The **budget process is described vaguely**, while a number of crucial issues are not mentioned (borrowing, deficits, audit, democratic control, disclosure, parliamentary process).
- The **proposed unitary accounting system is a set back** compared to the existing Local Self-Governance Act of the early 1990s, which requires municipalities to introduce accrual accounting.

3. Comments on the proposal

This chapter discusses proposal made in the report. To ease reading, the unofficial translation of the articles is being repeated for each of the paragraphs. The comments refer to the articles

- 5 "Distribution of Economic Rights (see section 3.1 on page 5)
- 6 "Budget Formulation" (see section 3.2 on page 6)
- 7 "Distribution of Sources of Revenue" (see section 3.3 on page 6)
- 8 ""National Consolidated Fund" (see section 3.4 on page 7)
- 9 "Finance Bill" (see section 3.5 on page 7)
- 10 "Expenditure from the National Consolidated Fund" (see section 3.6 on page 8)
- 11 "Expenditure Charges on the National Consolidated Fund" (see section 3.7 on page 8)
- 12 "Estimates of revenue and expenditure" (see section 3.8 on page 9)
- 13 "Appropriation Act" (see section 3.9 on page 9f.)
- 14 "Supplementary Estimates" (see section 3.10 on page 10)
- 15 "Votes on Account" (see section 3.11 on page 10)
- 16 "Special provisions for revenue and expenditure" (see section 3.12 on page 11f.)
- 17 "Votes of Credit" (see section 3.13 on page 12)
- 18 "Contingency Fund" (see section 3.14 on page 12)
- 19 "Act relating to financial procedure" (see section 3.15 on page 12)
- 20 "Meaningful distribution of revenue" (see section 3.16 on page 13f.)
- 21 "Budget of Provincial Governments" (see section 3.17 on page 16f.)
- 22 "Budget of Local Governments" (see section 3.18 on page 18f.)
- 23 "Management of Account of Revenue and Expenditure" (see section 3.19 on page 19f.)

3.1 Article 5: Distribution of Economic Rights

The proposal makes the federal government the most powerful level. This in contrast to many other federal state system, in which the regions or provinces have larger powers and share those with local governments.

3.1.1 Article 5, paragraph 1

Current Proposal:

(1) The distribution of economic rights among the different level of governments shall be as set forth in List 1. Economic rights that do not fall under the jurisdiction of any government, shall be deemed under the jurisdiction of central government.

In combination with the list of revenues assigned to various levels of government, **it is rather obvious that neither provincial nor local governments will have sufficient funds to deliver the functions assigned to them**, making them heavily dependent on federal government policy decisions and administrative behaviour. The revenue assignment is in sharp contrast to the principles of institutional symmetry which would seek to balance functions with own source revenues.

3.1.2 Article 5, subsequent paragraphs

The provisions made do not allow local self-governance or provincial self-government. There is no distinctive mentioning of the principle of subsidiarity, in contrast, all functions and tasks are assigned to the federal (central) level if not specified in the list 1 or the constitution.

The proposal is in contradiction to ideas of decentralisation and local self-governance and will result in a very powerful federal government overruling provincial and local governments.

The smaller provisions on local or provincial discretionary authority (for example paragraph 5, 9, 12, 15 for local governments) are guiding in the right direction, however, with all the powers allocated to the central level, they will remain without any larger importance in creating true local self-governance.

3.2 Article 6: Budget Formulation

Current Proposal:

(1) The budget of federal, provincial and local governments shall be formulated so as to strengthen effective management of the entire economic system, transparency and accountability.

(2) The framework of budget, time to present the budget, and the relation with the federal budget management shall be as prescribed by federal law.

The two paragraphs are too vague to guide the budget process. It not even said which period a budget should cover and under which principles a budget should be prepared. See, as a proposal, chapter 4 for some ideas.

This article will not be able to ensure proper and transparent budget formulation under democratic control.

3.3 Article 7: Distribution of Sources of Revenue

Current Proposal:

The federal, provincial and local governments may impose tax and collect revenue from the sources as set forth in List 2.

Provided that, the federal government shall specify the sources that are not in the list of any level of government.

No tax shall be levied and collected by the federal, provincial and local governments except in accordance with law.

The list 2, which allocates various already existing sources of revenue to levels of government, suffers from several key problems that cannot be accepted in a constitution:

- The revenue assignment to provincial and local governments will be not enough to fund their assigned task. Thus, the list is violating all principles of public finance theory and best practices derived from decades of decentralisation.
- The revenue assignment is much too detailed for provincial and local governments, as the underlying assumption is that the federal government alone may invent and implement new taxes. Therefore, the provincial and local governments are doomed to sustain from the mentioned revenue titles without having a chance to change the revenue sources.
- The shared revenues, as shown in list 2, are not mentioned in the constitution.

The constitution should include provisions which types of income are assigned to local governments (i.e. land-based taxes) and which taxes are to be shared between federal and provincial government and which taxes are subject to supplements by provincial and/or local governments. The allocation of revenues should follow the cost of service delivery of assigned tasks.

The proposed revenue assignment is violating ideas of local self-governance and public finance theory in federal state structures.

3.4 Article 8: National Consolidated Fund

Current Proposal:

Except for the revenues of religious endowments, all revenues received by the Federal Government of Nepal as set forth in Table two, all loans raised on the security of revenues, and all the money received in repayment of any loan made under the authority of any Act and any amount received by the Government of Nepal shall as be credited to a Government Fund to be known the Consolidated Fund.

No comments.

3.5 Article 9: Finance Bill

Current Proposal:

Any Finance Bill shall be introduced only as a Government Bill. Finance Bill means a Bill concerning any or all of the following subjects

- (a) the imposition, collection, abolition, remission, alteration or regulation of taxes,*
- (b) the preservation of the Consolidated Fund or any other Government fund, the deposit of money into and the appropriation or the withdrawal of money from such funds, or the reduction, increment or cancellation of appropriations or of proposed expenditures from such*

funds,

(c) the regulation of matters relating to the raising of loans or the giving of guarantees by the Government of Nepal or any matter pertaining to the amendment of the laws concerning financial liabilities undertaken or to be undertaken by the Government of Nepal,

(d) the custody and investment of all revenues received by any Government fund, money acquired through the repayment of loans, and the grant of money, or audit of the accounts of the Government of Nepal, or

(e) matters directly related to sub-clauses (a) to (d),

Provided that a Bill shall not be deemed to be a Finance Bill by reason only that it provides for the payment of any fees such as license fee, application fee, renewal fee, or it provides for imposition of any penalty or imprisonment, or by reason that it provides for the imposition of any tax, duties or fees by a local authority.

The article denominates certain draft laws as financial bills but without saying why there should be a special title for these laws, because there is no specific procedure assigned to these finance bills.

3.6 Article 10: Expenditure from the National Consolidated Fund

Current Proposal:

No expenditure shall be incurred out of the Consolidated Fund or any other Government fund other than the following.

(a) money charged on the Consolidated Fund,

(b) money required to meet expenditure under an Appropriation Act,

(c) advance money authorized by an Act required to meet expenditures, when an Appropriation Bill is under consideration, or

(d) expenditures to be incurred in extraordinary circumstances under a Vote of Credit Act which contains only a description of expenditure

This article is regarded as redundant if the word and legal content of the term "budget" would have had defined in the proposed constitution.

3.7 Article 11: Expenditure Chargeable on the National Consolidated Fund

Current Proposal:

The expenditures relating to the following matters shall be charged on the National Consolidated Fund :

(a) the amount required as remuneration and benefit to the President and Vice-President,

(b) the amount required as remuneration and benefits and pension payable to the Chief Justice of Nepal and other Judges of the Supreme Court,

(c) the amount required as remuneration and benefits payable to the following officials -

(i) the Speaker and Deputy Speaker of the Legislature- Parliament,

(ii) the Chief Commissioner and Commissioners of the he Commission for the Investigation of Abuse of Authority,

(iii) the Auditor General,

(iv) the Chairperson and members of the Public Service Commission,

- (v) *the Chief Election Commissioner and other Election Commissioners, and*
- (vi) *the Chairperson and members of the National Human Rights Commission.*
- (vii) *the Chairperson and members of the National Financial Commission.*
- (viii) *the Chairperson and members of National Natural Resources Commission.*
- (ix) *Other Constitutional Commissions*
- (d) *the administrative expenses of the Supreme Court, the Commission for the Investigation of Abuse of Authority, the Office of the Auditor General, the Public Service Commission, the Election Commission and the National Human Rights Commission,*
- (e) *all charges relating to debts for which the Government of Nepal is liable,*
- (f) *any sum required to be paid under any judgment or decree of a court against the Government of Nepal,*
- (g) *any other sum declared by law, including grants to be provided to provincial and local governments and expenditure, to be chargeable on the Consolidated Fund.*

Typically, a budget would include next to the federal institutions, agencies and offices also the expenses of each and every line ministry (which seem to be absent and being referred to as Appropriation Act). It might more comprehensive and consistent to have one budget showing all planned revenues and expenditures rather than to have an artificial split between the National Consolidated Fund and a separate Appropriation Act.

3.8 Article 12: Estimates of revenue and expenditure

Current Proposal:

- (1) *The Finance Minister shall, with respect to every fiscal year, present before the Legislature-Parliament annual estimates including the following matters*
 - (a) *an estimate of revenues,*
 - (b) *the money required to meet the charges on the Consolidated Fund; and*
 - (c) *the money required to meet the expenditure to be provided for by an Appropriation Act.*
- (2) *The annual estimate to be presented pursuant to clause (1) shall be accompanied by a statement of the expenses allocated to each Ministry in the previous financial year and particulars of whether the objectives of the expenses have been achieved.*

3.8.1 Article 12, paragraph 1

The paragraph outlines the duties of the Minister of Finance in the presentation of the budget and the preliminary figures - i.e. estimates on revenues and expenses.

What is missing in the proposal is a procedure in the decision-making of the budget itself.

3.8.2 Article 12, paragraph 2

No comments.

3.9 Article 13: Appropriation Act

Current Proposal:

The money required to meet the expenditure to be provided by an Appropriation Act shall be specified under appropriate heads in an Appropriation Bill.

A budget should always include income and expenses. There is no need to have two acts (laws). The budget should be one annual law only, showing estimated income and estimated expenses. The budget plan must be balanced.

3.10 Article 14: Supplementary Estimates

Current Proposal:

(1) The Finance Minister shall, in respect of any financial year, present supplementary estimates before the Legislature-Parliament, if it is found -

(a) that the sum authorized to be spent for a particular service by the Appropriation Act for the current fiscal year is insufficient, or that a need has arisen for expenditure upon new services not provided for by the Appropriation Act for that year, or

(b) that the expenditures made during that fiscal year are in excess of the amount authorized by the Appropriation Act.

(2) The sums included in the supplementary estimates shall be specified under separate heads in a Supplementary Appropriation Bill.

3.10.1 Article 14, paragraph 1

This article cannot be accepted. No government may incur expenditures that are higher than the budget (illegal). Therefore, a supplementary budget after exceeding the budget is already illegal, the supplementary budget must be passed in advance of possible higher expenditures (see also the critical comment to article 16!).

The constitution should only provide provisions for the definition and the procedure of a supplementary budget.

3.10.2 Article 14, paragraph 2

This paragraph is of technical nature and should be deleted.

3.11 Article 15: Votes on Account

Current Proposal:

(1) Notwithstanding anything contained in this Part, a portion of the expenditure estimated for the financial year may, when an Appropriation Bill is under consideration, be incurred in advance by an Act.

(2) A Vote on Account Bill shall not be submitted until the estimates of revenues and expenditures have been presented as aforesaid and the sums involved in the Vote on Account shall not exceed one-third of the estimate of expenditure for the financial year.

(3) The expenditure incurred in accordance with the Vote on Account Act shall be included in the Appropriation Bill

The article is obsolete if a general clause as proposed in this paper (see comment to article 16, paragraph 2) is introduced.

3.11.1 Article 15, paragraph 1

See comment to Article 16, paragraph 2

3.11.2 Article 15, paragraph 2

Proper budgeting always needs forecasts. Delayed budget submission to Parliament cannot be justified by poor preparation, but by political disputes on spending only. The article and this paragraph allows too much freedom for federal government to by-pass sound public finance policies and should be deleted.

3.11.3 Article 15, paragraph 3

See comment to previous paragraph.

3.12 Article 16: Special provisions for revenue and expenditure

Current Proposal:

(1) Notwithstanding anything contained in this part, if, due to the especial circumstances, the estimates of revenue and expenditure for the forth coming financial year is not introduced before the Legislature-Parliament until the end of current financial year, the revenue may be collected pursuant to the Fiscal Act of the Current Financial Year.

(2) If the circumstance is occurred as stated in clause (1), The Finance Minister shall, by explaining the reason thereof, not exceeding one-third of the total expenditure of the current financial year, present a Bill before the Legislature-Parliament to authorize for the expenditure of forth coming financial year.

(3) The amount of expenditure made pursuant to clause (2), shall be included in the Appropriation Bill.

(4) Notwithstanding anything contained in this Constitution, the Bill introduced at the Legislature-Parliament pursuant to clause (2) may be discussed and passed on the same day.

3.12.1 Article 16, paragraph 1

Revenue collection is not legally based in the annual budget, but in taxation laws and other regulations. Therefore, there is no need to underline the right to collect revenue in case of the non-existence of a budget in a new fiscal year. The paragraph can be deleted.

3.12.2 Article 16, paragraph 2

It might be better to reduce the spending to operational expenses to secure the ongoing work of the administration except entering new obligations. It would be not wise to have a fixed sum (such as one third).

In case that a budget has not been passed in time at the beginning of a new fiscal year, the government is entitled to expenditures that secure the ongoing work of public bodies and legally binding expenditures.

3.12.3 Article 16, paragraph 3

See previous comment.

3.12.4 Article 16, paragraph 4

Parliamentary procedures should be regulated in the standing orders of Parliament and are not be laid down in the constitution. The paragraph may be deleted.

3.13 Article 17: Votes of Credit

Current Proposal:

Notwithstanding anything contained elsewhere in this Part, if owing to a local or national emergency due to either natural causes, a threat of external aggression or internal disturbances or other reasons, and it is impractical or inexpedient in view of the security or interest of the State, the Finance Minister may present a Vote of Credit Bill before the Legislature-Parliament giving only a description of the proposed expenditure

This article is highly disputable, as it would allow government to by-pass the formal budgetary process. The justifications given in the article are too vague and may be misused. Instead, an ordinary budget management always offers options in cash flow management. Even extraordinary events must not result in non-transparent budget behaviour. The article should be deleted and be replaced by regulations on supplementary budget.

3.14 Article 18: Contingency Fund

Special funds do not need to be regulated in the constitution. What should be regulated, however, is the right to establish special reserve funds on the federal level and whether these special funds have the right to borrow.

Federal government may create by law special reserve funds for a limited time period. Special reserve funds must show in the budget. Special reserve funds must not take loans.

3.15 Article 19: Act relating to financial procedure

This article refers to the interchangeability of budgeted expenditures and is of technical nature. Regulations on budget flexibility should be generally regulated in a Public Finance Law or/and in detail in the annual budget law. There is no need to have such a provision in the constitution.

3.16 Article 20: Meaningful distribution of revenue

3.16.1 Article 20, paragraph 1

Current proposal:

(1) Federal government shall make an arrangement for meaningful distribution of its revenue, collected from its sources, among central, provincial and local governments

The proposed article (1) is rather meaningless, because the term "meaningful" allows far too much discretion for the federal level to determine the amount and the criteria for allocation to both provincial and local level.

It is recommended to formulate:

Federal government must ensure appropriate funding to provincial and local governments for delivery of tasks assigned to provincial and local governments.

3.16.2 Article 20, paragraph 2

Current proposal:

(2) An independent Financial Commission shall be constituted so as to recommend the financial transferrable amount to be received by provincial and local governments

The proposed article (2) establishes a Financial Commission to "recommend" the gross fund available for intergovernmental fiscal transfers. Although it might allow to increase legitimacy, the article does not tell anything about the composition (especially the power of provincial and local levels) and the decision-making authority of that commission, as it will "recommend" only. **Revenue assignment should not become subject to political majorities, but should be designed to fund the functional assignment.**

Further, the proposed commission will not have any decision-making rights, and the representation within this commission remains unclear. The proposed commission reveals that the underlying basic principle of revenue allocation will be not based on needs, nor will the the own sources of revenue of both provincial and local governments sufficient to fund their assigned tasks. This is a severe problem and gives federal government strong power which are usually not to be found in a federal state.

There is no need to have the establishment of such a commission to be in the constitution anyway. The commission, if needed, should be established through law. This law should precisely regulate

- the size of the commission,
- the members of the commission,
- the rights of provincial and local governments towards that commission and within that commission
- the decision-making authority of that commission,
- the rights of that commission towards Parliament.

3.16.3 Article 20, paragraph 3

Current proposal:

(3) The central government shall distribute a financial equity grants to the provincial and

local governments on the basis of need expenditure, and capacity and efforts to revenue collection.

The proposed paragraph (3) deals with equity grants to provincial and local governments which should be allocated based on "need", "capacity" and "efforts" in revenue collection. The paragraph suffers from two key assumptions: First, the paragraph assumes that "backward regions" and "local government" will not have sufficient funds to provide "general standards", indicating a poor revenue assignment for sub-national governments in general. Further, equity grants seem to be distributed by federal government only, leaving the provincial governments without any responsibility to ensure appropriate funding of local governments within their boundaries - and thus also telling much about the poor revenue assignment to provincial levels. Finally, it seems that the equity grants are additional - typically, equalisation mechanisms do not provide additional funds, but are about supplements provided to some public entities financed through charges on others.

In addition, the notion of needs, capacity and efforts in the constitution would make impossible any improvement of the design principle of equalisation. Given economic growth and demographic change, the three criteria might not be appropriate for the future. Therefore, they should not be mentioned in the constitution to avoid the necessity for permanent constitutional changes.

Again, if the recommended paragraph 1 is accepted, there is no need to mention equalisation in the constitution anyway.

3.16.4 Article 20, paragraph 4

Current proposal:

(4) Provincial governments shall, from the grant as provided by the central government, and collected revenue from its sources, distribute a financial equity grant among the local governments, as determined by law, on the basis of need of expenditure, capacity of revenue and efforts to collect revenues.

Similar to the paragraph 3, the paragraph 4 provides some information on how provincial governments should establish an equalisation systems between local governments based on the same criteria. The comments on the criteria remain the same, please refer to the previous section.

The paragraph 4 will establish a second equalisation system, and will suffer from the same problems as mentioned above. There should be only one equalisation scheme, and therefore, the constitution must only provide information whether there should be

- an equalisation system between provinces and/or
- an equalisation system between local governments within one province, or
- an equalisation system between all local governments throughout the country.

3.16.5 Article 20, paragraph 5

Current proposal:

(5) The federal government shall make an arrangement to distribute other grants (conditional grant, supplementary grant or grants for other purposes) provided via National Consolidate Fund

This paragraph empowers the federal government to have intergovernmental fiscal transfers and may

include both conditional and unconditional grants. It seems that the federal government should have authority to provide these grants to both provincial governments and local governments. Federal government may thus contradict provincial policies, if there is no participation of the provinces in the design, amount, and conditions of these fiscal transfers. There should not be any unconditional grants from federal level to local level, otherwise the provincial level has little or no political function.

3.16.6 Article, 20, paragraph 6

Current proposal:

(6) The distribution of revenue among the central, provincial and local governments shall be transparent.

This paragraph is obsolete, it does not provide any information but the notion of transparency of revenue distribution across levels of government. More important are issues such as

- whom to decide
- whom to participate (provinces, local governments)
- what to redistribute
- according to which criteria

are not mentioned.

Any fiscal transfer to any level of government must be rule-based, transparent and according to defined criteria.

3.16.7 Article 20, paragraph 7

Current proposal:

(7) While enacting Acts relating to revenue distribution, national necessity, autonomous of provincial and local governments, services to be delivered by governments to the people of province and local level and economic rights provided to them, capacity to collect revenue, assistant to provide for development, regional imbalance, poverty and inequality, deprivation, emergency work, and assistance to provide for temporary needs etc shall be included.

This paragraph refers to a design principle of the state. Therefore, articles such as "Nepal is a federal, democratic and social state" should be stated at the beginning of the constitution to underline the general importance. Based on these design principles, a number of provisions proposed would be become obsolete. What is missing, however, is the notion of the principle of connectivity in the constitution. This is a must for any federal state and reflects the main problems in states that rely on decentralised service delivery, but do not know this principle. Therefore, the constitution should include the following provision:

(Principle of connectivity) No level of government may allocate or transfer tasks to any other level of government without full funding of the respective task.

3.17 Article 21: Budget of Provincial Governments

A constitution should not make detailed provisions for central, provincial and local levels of government. Rather, a constitution should express and define the underlying principles for public finance.

The comments of the article 21 refer to the current proposal only. It should be noted, however, that there should be only one article for all levels of government regarding financial transparency and budgeting.

3.17.1 Article 21, paragraph 1

Current proposal:

(1) Provincial government may, among the list of federal government, subject to existing laws, impose surcharges. The detail provisions regarding the policy and fundamental base to prescribe the rate of such taxes shall be as determined by the federal laws. The governments at different level shall not introduce double taxation.

The paragraph allows provincial governments, not local governments, to have surcharges, while the federal government reserves all regulatory rights, including the determination of tax basis, and presumably tax assessment procedures.

The third sentence of the paragraph prohibits double taxation. While there is a enumerated list of revenues in the annex, this sentence may be understood as a fundamental right to invent new taxes, if there is not already a tax existing that taxes the same tax base.

No rights are given to local government which is not acceptable for a federal state.

3.17.2 Article 21, paragraph 2

Current proposal:

(2) The provincial governments shall collect taxes on the basis of their revenue capacity and base of taxation. In the case that the provincial government are unable to secure such amount, no grant or compensation from the federal government is provided

This paragraph just regulates that low capacities in tax collection and coverage must not be used as an argument by provincial governments to claim additional funding from central (federal) government.

This regulation is not a key issue to be placed in a constitution. Instead, **the constitution should be limited to define public finance and to lay down principles of revenue assignment and fiscal transfers only.**

3.17.3 Article 21, paragraph 3

Current proposal:

(3) Responsible provincial financial authority shall present provincial budget to the Provincial Legislature stating estimates of revenue for every financial year, necessary amounts to be charged on Regional Consolidated Fund, and expenditure from Appropriation Bill.

The paragraph just regulates that there must be a budget on the provincial level, that this budget must

be approved by provincial elected bodies. In addition, the paragraph deals to some extent with budget forecasting for revenues and expenditures.

The provision is repeated for other levels of government. In a constitution, this provision is too detailed to be included as a constitutional clause, but there is no provision on public finance in general.

3.17.4 Article 21, paragraph 4

Current proposal:

(4) The Appropriation, Supplementary Budget, Vote on Account, Votes of Credit and other especial provisions relating to revenues and expenditure shall be as determined by law

The paragraph regulates that amendments to the budget - in case of economic problems or unrealistic forecasts - have to obey to procedures according to law without any further explanations.

This should not be regulated in the constitution, as this would limit the subsequent law-making to the issues and topics as defined in this paragraph only. It is more restricting future decision-making processes than it enables future decision-making on these matters.

3.17.5 Article 21, paragraph 5

Current proposal:

(5) Every provincial government shall have a Fund to be known as Consolidated Fund. All the revenue collected from the sources stated in List 2, grant to be received from federal government, loan and sum received from other sources shall be deposited to this Fund.

The paragraph requires provincial governments to have one fund only to avoid shadow budgets. However, the details are not required in the constitution. The issue is to avoid any shadow budget, therefore the paragraph should read:

Federal government, provincial governments and local governments may have one fund only. The fund is to be named General Fund.

The rephrasing is valid for all levels of government and not only for provincial governments.

3.17.6 Article 21, paragraph 6

Current proposal:

(6) Only the responsible financial authority of province shall, subjects related to taxes, appropriation, financial responsibility, audit and other related issues under the jurisdiction of provincial government, introduce in the Provincial Legislature as a Provincial Financial Bill

The paragraph takes away from Parliament the most important right: The right to prepare budgets, including the setting of taxes.

This paragraph is totally incompatible with the concept of democratic governance.

3.17.7 Article 21, paragraph 7

Current proposal:

(7) No tax by a provincial government under its jurisdiction shall be imposed in contrary

with national financial policy, flow (movement) of goods, capital, service and labour, and neighboring provinces.

The paragraph wants to reduce the tax setting authority of that level of government. While it may be reasonable to prohibit double taxation (not to be misunderstood with shared taxes or supplements on existing taxes of other levels of government!), the notion of

- national financial policy
- flow of goods, capital, service, labour, and
- potential impact on neighbouring provinces

is by far giving much too much power to the federal level. Any tax will always affect at least one of the aspects mentioned.

The taxation powers of each level of government must not reduce the taxation power of other levels of government.

3.17.8 Article 21, paragraph 8

Current proposal:

(8) If a provincial government shall have to formulate deficit budget, it shall have to present the sources to recover the deficit as well, as determined by federal law.

Each level of government and each public body is responsible to have balanced budgets. No other level of government shall have the duty to take over debts occurred on other levels of government. There should be no restriction on sub-national borrowing, however. Therefore, the paragraph should read:

Sub-national levels of government, provincial governments and local governments have the right to borrow on their own risk.

Any type of borrowing is limited to capital expenditures only.

The two proposed paragraphs avoid:

- that current expenses (consumptive expenditures) are funded through debts;
- that bailouts promote moral hazard in deficit spending and excessive expenditures.

3.18 Article 22: Budget of Local Government

Again, there is no need to have all levels of government separately mentioned in the constitution. Instead, there should be one chapter on Public Finance only.

3.18.1 Article 22, paragraph 1

Current proposal:

(1) Every local government shall have a local Consolidated Fund. All the revenue collected from the sources stated in List 2, grant to be received from federal and provincial govern-

ments, loan and sum received from other sources shall be deposited to this Fund.

Please refer to 2.2.1 for comments.

3.18.2 Article 22, paragraph 2

Current proposal:

(2) The local governments shall collect taxes on the basis of their revenue capacity and base of taxation. No grant or compensation shall be given if they are unable to collect taxes

Please refer to 2.2.2 for comments.

3.18.3 Article 22, paragraph 3

Current proposal:

(3) A representative of local government shall present the income and expenditure for every financial year to the council of the local government and shall approve it from the council.

Please refer to 2.2.3 for comments.

3.18.4 Article 22, paragraph 4

Current proposal:

(4) No tax by a local government under its jurisdiction shall be imposed in contrary with national financial policy, flow (movement) of goods, capital, service and labour, and neighboring provinces or local governments.

Please refer to 2.2.4 for comments.

3.18.5 Article 22, paragraph 5

Current proposal:

(5) If a local government shall have to formulate deficit budget, it shall have to present the sources to recover the deficit as well, as determined by federal and provincial laws.

Please refer to 2.2.5 for comments.

3.19 Article 23: Management of Account and Revenue Expenditure

3.19.1 Article 23, paragraph 1

The article refers to similar coding and classification of revenue titles and budget items. This is usually organised through a chart of accounts and subject to a law, there is no need to have this regulation in a constitution.

Current proposal:

(1) There shall be the similar classification of statement of revenue and expenditure of federal, provincial and local governments. Other provision in relation to this shall as determined by the federal laws.

It is recommended that there should be a law on public finance defining terms rather than to fill the constitution with technical issues.

3.19.2 Article 23, paragraph 2

There is absolutely no need to have the same accounting system on all levels of government. An accounting system should be adopted that supports the primary functions of a distinctive level of government. Local governments do invest in infrastructure, they own assets and they provide services, while central government predominantly redistributes funds, especially in a federal state. Given these different functions, different accounting systems suit more the distinctive needs of the various government levels. Cash based accounting not suitable for local government.

One of the main benefits from introducing accrual principles into government finance is the recognition of all assets, both financial and non-financial, and liabilities of a government unit. Such recognition will, among other, strengthen the unit's accountability, its asset and liability management, and its making and buying decisions. In contrast, cash-based accounting does not allow an analysis of non-financial assets, and cash-based accounting has no information on uncollected receivables and current liabilities.

Because accrual accounting provides much more information than cash based accounting, there is no problem for accrual accounting systems to provide the information cash based systems operate with (i.e. National Statistics, etc.).

Current proposal:

(2) The federal, provincial and local government shall adopt the same accounting system. The manner and system of this shall be as determined by the federal laws.

The proposed unitary accounting system is a set back compared to the existing Local Self-Governance Act of the early 1990s, which requires municipalities to introduce accrual accounting.

3.19.3 Article 23, paragraph 3

Current proposal:

(3) It shall be the duty of provincial and local governments to follow the classification of revenue and expenditure and accounting system.

There is no need to have this regulation in a constitution, and the current approach to have standardisation through the Local Bodies Financial Regulations (LBFR) is the appropriate approach. The content of the regulation addresses technical issues that should be organised in regulations based on one law (Public Finance), which itself is based on the constitution.

3.19.4 Article 23, paragraph 4

Current proposal:

(4) If a provincial government does not follow the prescribed classification of revenue and expenditure and accounting system, the federal government may prohibit the grant to be provided until the provincial government follow it.

Similar to the previous comment, conditions under which grants are distributed are to be regulated in the annual law on intergovernmental fiscal transfers based on the budget (law). There is no need to have this issue regulated in the constitution.

3.19.5 Article 23, paragraph 5

Current proposal:

(5) If a local government does not follow the prescribed classification of revenue and expenditure and accounting system, the provincial government may prohibit the grant to be provided until the local government follow it.

See previous section for comments.

3.19.6 Article 23, paragraph 6

Current proposal:

(6) Budget shall be presented by including the estimates of expenditure making division of current and capital part.

In no constitution in the world reference is made on how to prepare budgets. This should be content of a Law on budgeting.

3.19.7 Article 23, paragraph 7

Current proposal:

(7) If it is necessary to obtain a loan to recover losses, an analysis should also be presented if it is going to impact on the entire financial system.

Although the content of the proposed regulation is well understood, there is no need to have this feature of deficit budgets and sub national borrowing in the constitution. Again, this aspect should be content of a Law on budgeting.

3.19.8 Article 23, paragraph 8

Current proposal:

(8) The management of loan to be received by provincial and local government shall be as determined by the federal laws (for instance Financial Responsibility Act).

See previous comment.

4. Proposal for a chapter on Public Finance

a) Principles of budgets

- all levels of government have independent budgets and are responsible for their budget only, including authority and responsibility for sub national borrowing
- all revenues and expenditures have to be included in one budget for one or more years, separated by years
- if a new budget is not approved at the beginning of a new fiscal year, the government is entitled to

have expenditures for maintaining the work of the administration and to fulfill legally binding expenditures

- the government may not exceed the total approved spending. Changes requires Parliament approval.
- the annual statement of accounts have to be verified by the General Auditor
- federal government loan taking needs approval by Parliament

b) Principles of revenue assignment

- principle of connectivity
- principle of subsidiarity
- definition of taxes, shared taxes and supplements to taxes other levels
- taxes assigned to federal government
- types of income assigned to levels of government

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