Financial Management of the Small Municipalities of Nepal: Sustainability Issues

Mahesh Baral

Follow this and additional works at: http://digitalrepository.unm.edu/nsc_research

Recommended Citation

This Article is brought to you for free and open access by the Nepal Study Center at UNM Digital Repository. It has been accepted for inclusion in Himalayan Research Papers Archive by an authorized administrator of UNM Digital Repository. For more information, please contact amywinter@unm.edu.
Financial Management of the Small Municipalities of Nepal: Sustainability Issues

Mahesh Baral
University of Trento, Italy
maheshbaral@hotmail.com

Paper prepared to present at the Third Annual Himaliyan Policy Research Conference at Madison (October 16, 2008)
Abstract
Due to the centre dominated intergovernmental fiscal relation; the decentralization efforts of Nepal remained incomplete even after 9 years of the implementation of LSGA. The financial health of Nepalese local governments, particularly small municipalities is vulnerable as they are going to lose a big chunk of resource called LDF in near future and so far no substitute for it is prescribed or recommended. Many researchers have argued that the proper implementation of property based tax could replace the LDF but there are many concerns and several barriers with such tax system. Firstly it has limited scope to improve the financial health of those municipalities and secondly there are many obstacles: tax culture of the local people, weak institutional capabilities, absence of proper database, untrained human resource and rampant corruption are few of them. Nevertheless, the municipalities have distinct comparative and competitive advantages, which should be explored and implemented accordingly.

Key Words: Revenue Assignment, Expenditure Assignment, Intergovernmental Transfer, Borrowing
1. General Introduction

1.1. Introduction

3915 Village level government units named as Village Development Committees (VDCs) are the lower level government institutions in Nepal, whereas 58 semi-urban towns and other cities are characterized by the umbrella term 'Municipalities': the capital city, Kathmandu is Metropolitan Corporation, four other big cities are Sub-Metropolitan Corporations and there are 53 municipalities. The general perception of western cities doesn't apply to Nepalese municipalities because these cities lack the basic urban services and infrastructure, are heavily influenced by urban poverty and are heavily polluted.

Articles 138, 139 and 140 of the Interim Constitution of Nepal, 2006 have provisioned and briefly outlined the modality of local governance for the country but it failed to give concrete basis for it. In the case, the Local Self Governance Act, 1999 (LSGA) is the basic law that deals the local governance system in Nepal. The LSGA has basically followed the principle of subsidiary to allocate the different roles to the different tires of government. The elected representatives of the local people are authorized to serve their voters or tax-payers for the betterment of the society and the people.

The LSGA has devolved different sectors to be taxed by the municipalities and different responsibilities to be fulfilled by them. The internal resources, intergovernmental transfer, external grants and the borrowing are the sectors of resources for the municipalities. The composition of internal resources is around 65.3 percent of total income that is hugely covered by Local Development Fund (LDF), a tax collected by the central government by 1.5% of the total invoice of import through the custom offices and distributed among the municipalities, which is not the sustainable source of income. The reason is, as per the conditionality of Nepalese membership to WTO, LDF (34.5% of total revenue of the municipalities) should be
abolished by 2011. Hence the Nepalese municipalities are about to lose a big chunk of their resources. In addition to that, as Nepalese municipalities are suffering from a huge rate of population growth due to internal migration: the expenditure responsibility is increasing very rapidly.

Municipalities

Municipalities in Nepal are basically small towns surrounded by rural villages and most of them are district headquarters. However all district headquarters are not recognized as the municipalities and there are many districts with more than two municipalities on it. So, it could be concluded that the government is recognizing those towns as a municipality, who fulfil certain requirements set by the LSGA.

Due to the urbanization process of Nepal and due to the internal migration trend, municipalities are getting more importance and are more focused for development activities. Some 21 percent people live in the urban centres in the present-day Nepal but in accordance with a UNDP/ADB report, half of the population of Nepal will be living in urban areas by 2035 AD (Devkota, 2005).

1.2. Methodology Used and Limitations

The study is basically focused on the sustainable financial management of the Nepalese municipalities. The municipalities focused on this study are quite young municipalities which were granted the municipality status some 12 years ago. Although to study comparatively, the data of some other municipalities (such as Bidur municipality) has also been analyzed. As these are the new municipalities with short history of operation, the people living there are reluctant to pay tax and user charges and hesitant to go for municipal services because they were not used to pay for such services before. The study is basically focused on the
municipalities who don't have strong financial resources and are very weak in institutional capabilities as well.

In the case study basis, two municipalities (Ratnanagar and Bidur) have been selected on different basis and different competencies: both are small municipalities with the population below 50000 inhabitants but Ratnanagar is a young municipality based on Terai region however Bidur Municipality is not that young, a municipality from hilly regions and not that far from the capital city Kathmandu. According to their geographical location; they have different comparative and competitive advantages. The table 1 given in the annex shows the basic information about those two municipalities including the financial as well as expenditure part of them.

Key persons from the municipalities, the ministry, political parties and from civil society including municipal association of Nepal have been interviewed. Local residents and the possible tax payers have been interviewed with focus questions especially related with their tax culture. The secondary data is obtained from the report published jointly by GTZ/udle and GoN, MLD. Additionally, the population census of 2001 and living standard survey conducted by Central Bureau of Statistics were also reviewed during the study.

2. Principles and Policies of Local Development

The LSGA has outlined following basic principles and policies of local self governance:

(a) 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.

3. Brief history of local (self) governance in Nepal

The history of decentralization goes hand in hand with the history of Nepal or even before that. There were the practices of allocating various rights or devolving many functions to the society even some 1600 years ago. Grama, Tala, Dranga of Lichivi reign (a regime which is believed existed in Nepal during 1100 to 1400 AD) could be the best example of such institutions. Since then, the decentralization process continued in Nepal, though the increments and curtailments had gone side by side with different successors or rulers and with different regimes until Nepal took its steps toward modernization.

Nepal entered to the modern era after it sacks the family rule of Ranas (a family that ruled the country for 104 years) and enjoyed democracy in 1950. In the process of creating democratic foundations to the nation, two different acts: the Municipality Act of 1953 and the Village Act of 1956 were enacted. The premature political system of the country again faced another setback in the year 1960 when the then elected government was scrapped by the King, who took the political power that lasts for next 30 years. The political move was claimed to establish an indigenous political system that shoots with the soil: hence decentralization was considered as priority agenda. Previous Acts were replaced by the Town Panchayat Act of 1962 and Village Panchayat Act of 1962, respectively. In the course of time various (to be more specific: eight) studies were conducted to strengthen the decentralization process, various
recommendations were prescribed, most of such recommendations were enacted, different institutional arrangements and changes were made.

After the restoration of multi party system in the country in 1990 and after the enactment of the Constitution of the Kingdom of Nepal, 1990: effective decentralization was emphasized to strengthen peoples' participation in the development. Although, by mentioning it on the directive principles of the state policy, the responsibility was given to the elected parliament to enact proper law. The DDC Act, VDC Act and Municipality Act were endorsed and people chose their representatives to these bodies through elections. There were many concerns regarding these Acts which lead to form The High Level Decentralization Coordination Committee on the chairmanship of then Prime Minister. The Committee diagnosed different problems and urged to rewrite the statute, which was the turning point and the foundation for enactment of the Local Self Governance Act, (LSGA) 1999.

4. Main Characteristics of Nepalese Local Self Governance

4.1. Application of the Principle of subsidiary

There is a movement throughout the world to move the decisions that affect people closer to those affected (McLure Jr., 1998). The first fundamental step in the design of a system of intergovernmental fiscal relations should be a clear assignment of functional responsibilities among different levels of government (McLure, ...).

The local level governments of Nepal are supposed to provide those goods and services to the people that could be more perfectly delivered if it is done at the local level. It could be observed that the power sharing between central and local level governments have their own characteristics and international practices are not totally followed. There are various reasons for it and [t]here is no absolute best way for deciding which level of government should be
responsible for particular public services (McLure, ... ). One of the main constraints is the institutional capacities of the local governments to handle the responsibilities. Additionally, in the course of time, the central government's unwillingness and hesitation to handover the line agencies to the local government make the decentralization movement of Nepal incomplete, even after many years. This is due to the improper design of fiscal decentralization because if systems are not designed with forethought, however, decentralization can instead create serious problems. The transition economies find themselves midway in the process, and mistakes are already being made (Bird, 1995).

4.2. Prioritization of the assignments
The local level governments are supposed to conduct their assembly meetings annually with the wide participation of the local people in the presence of civil society and media. Such assembly is the authority that identifies the sector to be taxed, fixes and changes the tax rate and approves the audit reports. In addition to routine administrative functions, the assembly approves the annual budget that is the priority paper of the projects to be operated for the coming year.

4.3. Resource Sharing
The Interim Constitution of Nepal and LSGA has provisioned for the sharing of the national resources between central government and local level governments but it is unsolved agenda for many years as the previous constitution of Nepal also have directed the country in same direction. Since the enactment of then Constitution in 1990 it remained a complicated task for many years and always the local level governments are found weaker in the negotiation process. Even though there are some challenge-funds for the well functioning local governments but many of them are deprived from adequate resources from the centre that is heavily influenced by the political power structures.
4.4. Investment Gap

Subnational governments may have unequal capacity to finance public services because of regional differences in income, as well as differences in access to easily taxed bases, such as natural resources (McLure Jr., 1998). During the decentralization process of Nepal, even though various sectors have been devolved and could be taxed by the local level governments, the scope of local revenue mobilization is less than the expenditure assignment, which created strong financial imbalance. Fiscal imbalances are worrisome because they draw resources away from investment and, when deficits persist, lead to a buildup of government debt and a consequent servicing burden that can become unsustainable and can threaten macroeconomic stability (IMF, 1999). This is more painful in the transition phase of the country when the country needs huge amount of capital investment to build basic infrastructures and upgrade the level of services delivered to the people.

4.5. Unfunded Mandates

The budget system in Nepal is known as the line item budgeted. It is divided on the expenditure topics and has very limited mobility to shift from one topic to another. Though the LSGA have assigned various roles to the LGs, due to the shortage of financial resources, many of such responsibilities are whether remained unfunded or never come to the priority list of the LGs. For example, a VDC is free to run a primary school in the mother language of the majority of the people living there but the VDCs can't run such type of schools due to the lack of resources. In the same way, the LGs are assigned to preserve the local culture, traditions, scripts, languages, historical places, architect, and monuments but the task is seldom funded properly. Such unfunded mandates may yield dissatisfaction to the local people for not respecting their culture and rights.

In addition to that the central government has devolved various unfunded mandates to the LGs and the LGs are in pressure to implement those tasks without resources. The management of
the street lights could be the best example. The central government had handover the responsibility to manage the street lights to the municipalities but failed to handover the resources to them. The municipalities are now heavily indebted in electricity bills due to the street lights and a strong conflict is going on between the municipalities and the electricity authority. The municipal roads could be the next example of heavily unfunded mandate to the municipalities. The government handed over the municipal roads to the municipalities without giving the resources.

4.6. Institutional Framework and Constraints

The institutional capability of the municipalities is weak in various ways. They are not well supported by proper database, technology, financial resources, infrastructure and human resource. So, the powers and responsibilities given to them are rarely functioned properly. Additionally, for almost 5 years, the local governments are deprived from the elected leadership of the people.

The revenue mobilization is the weaker part of the local governance in the absence of elected representatives and the local governments in Nepal are charged for rampant corruption within their system. In one side they are deprived from trained and competent menpower in the other side the role of private sector and civil society is also neglected.

5. Expenditure Assignment (Sectors Devolved to the Local Governments)

The LSGA, basically following the principle of subsidiary; devolved various roles and responsibilities to the local government units. In addition to that, the central government devolves various responsibilities to the local government through annual budget as well. The major sectors devolved to the municipalities of Nepal by the Act are as follows:

Drinking water
Education
Public health services
Language and culture
Agriculture
Tourism and cottage industries
Infrastructure and transport
Sports
Irrigation
River and soil erosion control
Forest and environment protection
Human resource development
Implement the cooperative movement
Records keeping
Disaster management
Various programs of social security
Private sector promotion and development
Promote peoples participation

6. Revenue Assignment (Sectors devolved for Resource Generation)

The trend toward fiscal decentralization and the transfer of some revenue-raising and expenditure authority from central to lower-level and subnational governments is, in part, a political reaction from below against the long years of extensive central control (Bird, 1995). Although, the LSGA has devolved various responsibilities to local and municipal level governments, such responsibilities should be supported by proper revenue capabilities. If subnational governments are responsible for expensive social services such as health and education, the pressure on subnational revenues will be much greater and the conventional
The LSGA, to perform the job mentioned above, has devolved various sectors of revenue to be taxed by the local governments. The scope of such resources could be classified as follows:

- House and land tax
- Land revenue tax
- Market shop tax
- Vehicle tax
- Entertainment tax
- Rent tax
- Advertisement tax
- Business Tax
- Commercial Video Tax

Different service charges:
- On sanitation, drainage and sewage
- Entrance charges for tourist points
- Charges for gardens and for picnic
- Different types of fees
- Licensing fees of different equipments
- Approval fees
- Recommendation fees

Income through selling of different things
- Natural resources like sand and boulders
- Forest products
- Products of public ponds and garden
- Central grant
- Borrowing power
7. Current Financial Picture and the Envisaged Problems

Currently there is a huge gap between revenue assignment and expenditure assignment in the municipalities. Firstly the municipalities are failure to mobilize internal resources as it is supposed to be done due to various reasons; secondly the rate of revenue increment can’t cope the rate of expenditure growth. Though the size of the revenue is also growing in incremental way, but it failed to fulfil the growing expenditure needs.

Furthermore the Nepalese municipalities are not getting LDF by the year 2011, which is the 34.5 percent contributor of the overall revenue of the municipalities due to the membership of Nepal to WTO, because it is one of the major precondition of any member country that imposing any tax should have rational and in fact, local development fee does not stand in this rationale (Chhetri, 2002).

Additionally the rate of population growth in the municipalities is quite high (about 6.1% in the case of Bharatpur municipality) then the national average (2.24%). This is basically due to the internal migration from the village to such cities. Such migration and population growth is leading to develop the municipalities in unplanned way and furthermore it is contributing to the growth of slums. People in the rural villages want to migrate to the city centres to enjoy the better services like health care, education, access to information and communication etc. Consequently the revenue assignment is getting bigger and bigger day by day.

In addition to that, due to the various awareness and advocacy campaigns and political and social movements; the bargaining power of the people has been improved and they are demanding more services in the right based way. Due to the various political changes in the
past decade, and due to the promises made in different political fronts, the local people are demanding more and prompt municipal services and it is contributing the growth of expenditure assignment more rapidly.

8. Possible Answers of the Problems

The reluctance of the central government to handover its line agencies to the local government and as the local governments were not financially empowered; it is widely accepted and believed that Nepal never tried to decentralized in true way and Nepalese municipalities were not exception to it. Mr. Romanath Oli in his interview opines that: in one hand the horizon of responsibilities has been increased but in the other hand the sectors devolved for taxation are not strong enough to manage them. He also argues that as municipalities are still very weak on financial autonomy, the concept of self governance adopted by Nepal has flaws on itself (Oli, 2001).

To solve the problems explained above, various researchers have suggested that effective implementation of the house and land tax or integrated property tax could be the best solution. Additionally, the other financial tools such as: redesigning of intergovernmental transfer system and facilitation for borrowing from internal and external resources could be adopted. I have tried to analyze the possibilities of those three options separately and highlighted the major policy changes we need to bring to let the system work. Additionally, I also have analyzed the other possible and potential resources that could help fulfil the gap between revenue and expenditure assignment.

8.1. Implementation of the House and Land Tax or Integrated Property Tax

Property (House and Land) Tax and Integrated Property Tax

The system of tax the government levies from the people by certain percent of the total property they owned on the valuation of it at the beginning of the fiscal year is called property
tax. For the purpose of property tax, not only the house and land but also the vehicles, shares, bond, ornaments, cash, bank balance etc. be evaluated (Aryal, 2001). In other words, for the purpose of property based tax, not only the house and land but also all the other property (cash and kind) will be evaluated and the tax is levied by certain percent on it. Normally, the property is evaluated in the price index of the beginning of every fiscal year and could be different year by year.

LSGA don't define what is integrated property tax but according to definition given by Regulation of LSGA, "Integrated property" means the lands within municipal area and physical structures such as wall, building, godown, shade, garage etc. built thereon (Rule 2 (e). For the purpose of integrated property tax, in addition to the evaluation of land, building and other property, all the physical infrastructures such as compound wall, shades, warehouse, garage etc. will be evaluated and the final amount is taxed by a certain percent as prescribed by the law and regulation.

According to LSGA, the Nepalese municipalities are immune to implement whether house and land tax or the integrated property tax in their respective territory. So far majority of the number of municipalities have adopted this tax system but the big municipalities are still hesitant to follow it as they fear that they may loose the amount of money they are mobilizing through the house and land tax if they adopted it. It is believed that the integrated property tax is scientific and by implementing it, the municipalities could broaden their tax horizon. It is calculated on the municipality basis and many researchers criticise it as a flaw because if a person has two set of property in two separate jurisdictions of the municipalities, the concerned person could twice enjoy the threshold facility.

Rationale

The development in the local level brings various changes in the local level and the values of the property will also be raised. Hence, if the people want their locality be developed or the
price of their property to be raised, they should also contribute in this process by paying house and land tax (Aryal, 2001).

Regulatory Framework

The annual council meetings of the Municipalities are authorized to fix the rate of house and land tax or integrated property tax that is based on the valuation of the property. By evaluating the tax rate of the property, it could be observed that the tax rates are fixed on the progressive way. Theoretically the valuation of the property that falls below the threshold are exempted from the tax and the tax rate get higher and higher as the valuation of the property gets bigger and bigger. In the case of Bidur Municipality, no such exemption has been made although the tax rate is fixed in the progressive way. The table 2 given in the annex shows the general tax rates decided by the government based on the valuation of the property.

Contribution

Municipal taxes especially the property based tax (land and house tax) could be one of the sustainable taxes but it needs sound database system and efficient operation at municipal level (Mahat, 2002). Although the house and land tax or the integrated property tax is considered as one of the major lifeline of the municipalities whether in the present context or in the absence of LDF; the real contribution of it on the municipal own source resource is not that encouraging. According the data of Fiscal Year 2005/006, the house and land tax or the integrated property tax has contributed the own source revenue only by 8.02 percent.

Table 3 and 4 given in the annex show the comparative chart of Ratnanagar and Bidur municipality explains that the property based tax is not that strong to support the financial burden of the municipality. In the case of Ratnanagar, it contributes by 13.14 percent that is much above than the national average but it is much more poor in the case of Bidur
municipality as the property based tax contributes to the own source revenue of Bidur municipality only by 6.26 percent.

The Tax Culture

Mostly people in Nepal ask for municipal services for free of cost; this is partly because most of the citizen need further awareness / education programme and partly because our municipalities provided with municipal services free of cost in the past (Mahat, 2002). The local people or the possible taxpayers are reluctant to pay such taxes because they were not used to pay these taxes and during the study, it is also noted that the municipalities failed to translate the importance of such taxes in the mindset of the local residents. Most of the members participated in the focused group discussion during the study opined that they are penalized by declaring their locality as a municipality.

The local people have many questions and concerns regarding the house and land tax or the integrated property tax and very few of them were found aware about the total system of this tax: who decides the tax rate, how much they need to pay and when etc. Although the encouraging factor is that, they are keen to know the system especially the evaluation process of their property. Additionally they are also interested to know the offer or the subsidies on tax amount if they declared their property by themselves.

Many of them were having dissatisfaction on the process of taxation in the local level, particularly on the process of house and land tax. They were with the view that although the valuation of their property may be bigger enough to be taxed but the productivity of it is negligible. In other words their property may meet the parameters of the tax system to be taxed but the real income of it is so low, if they are taxed on it, they will loose their property; sooner or later. According to them, due to the Nepalese culture, the house and land they have is their
inheritance property developed through generations and due to its market value it could meet the taxing parameters but as it is not generating economic benefits, it would be injustice to tax them.

The next concern raised by them is the process of fine or penalty for not paying the tax in time. They were found interested to know the scheme of waiver of the penalty on it. They were with the view that the municipality should announce the scheme of waiver of penalty and fine and should encourage the people to pay tax. They suggested that once the client starts paying tax, the continuation of it is highly possible.

Furthermore the participants who are willing to pay tax were raising the concerns of their pileup amount of tax. Even though they are ready to pay it, they can't clear the backlog at once. They demanded the system of payment in instalment basis.

Problems for Effective Implementation

There are different problems on effective implementation of the house and land tax or the integrated property tax. Various of such problems are related with the municipalities themselves. Few of such problems and barriers could be described as:

Institutional Capabilities: most of the municipalities are not capable enough to mobilize such tax from the point of view of institutional competencies. They don't have trained men power to implement these taxes, additionally they don't have technology and mechanisms such as computer software etc. to calculate those taxes.

Data Source and Database: lack of proper database could be the other problem of municipalities to implement such tax system. In addition to the number of households, they don't have additional data regarding those houses and land. Additionally, even if they have some data regarding it, that is not updated and compiled at all.
Awareness among the people: we already discussed the level of awareness among people and the concerns raised by them. It is observed that massive level of awareness campaign is necessary to educate the possible tax payers by the municipalities. Door to door program could be more effective on this connection.

Tax Culture: tax culture among the people could be another hurdle to implement the house and land tax effectively. The municipalities need to convince their taxpayers that how differently the municipal services are being provided, in how many ways they are being benefited from those services and why the municipality want the people to contribute in the process.

It should be a difficult question to answer that what would be the real picture if the property based tax is mobilized in maximum capacity? The present data structure don't support to find an answer of the question however by comparing the number of household and analyzing it with the tax rate with few assumptions; we could generate some ideas. However we can say for sure that even in that case the property based tax can neither substitute the LDF nor it will be the major contributor of them in the near future.

8.2. Intergovernmental Transfer

If we compare the expenditure assignments with the revenue assignments of the local governments in Nepal, we found large gap between them. The gap must be filled in one of two ways: by giving local governments more revenue raising powers or by revenue transfers from the central government to the subnational governments (Bahl, 2000). Taxing local lobbying activities under the revenue-sharing scheme is one of the effective ways to promote fiscal reconstruction. In this policy scheme, some of the tax revenue should be returned uniformly to the local governments involved (Ihori, 2004).
Main transfers and shares

As the internal revenue mobilization of local governments in Nepal is very weak: they are largely dependent on intergovernmental transfer and other available financial tools. The intergovernmental transfer is roughly about 75 percent of the total income of the local governments of Nepal, however in the case of municipalities it is about 60 percent.

In general, the intergovernmental transfer in Nepal could be broadly divided on two categories - grants and revenue sharing. The local governments receive three types of grants- 1) Administrative Grant, 2) General Purpose Block Grant and 3) Conditional Grant. The various types of revenue are being shared by central government and local governments and it has both top-down and bottom up approaches. The transfer system between central government and local governments is channelled through Ministry of Local Development.

Main reasons for using transfers

Funding the expenditure assignment of the LGs could be the main reason of using transfers in Nepal. Without such transfer, the LGs can't perform their responsibility in proper way. The Interim Constitution also recognizes the intergovernmental transfer as the means of financial source to the LGs and recognizes them as the shareholders of the central treasury.

Normally the expenditure assignment between central government and local governments creates vertical imbalance of revenue distribution. The local governments normally have more responsibility but not adequately supported that create imbalance between central and local governments and to address this problem, the intergovernmental transfers is essential.

In addition to that, balancing the disparities between different local government or the horizontal imbalance is also a strong reason for the transfer because some LGs are financially strong where the others don't have strong financial basis and the capacity of mobilizing local resources is also different among them. The intergovernmental transfer could be best solution to manage such disparities.
Method of transfer and main allocation principles

In general, the local governments receive three types of grants - 1) Administrative Grant, 2) General Purpose Block Grant and 3) Conditional Grant. By its name, the administrative grant is utilized to manage recurrent costs, such as salaries and allowances of the centrally deputed officials, and supplementary salary of the locally recruited staffs. The local governments have no discretionary power to utilize this fund according to their priorities. The general purpose block grant is unconditional and the local governments are immune to use it according to their priorities by following their own budgetary and audit regulations. The local governments also receive conditional grants to construct infrastructures by following specific guidance provided by the central government.

The general purpose block grant could be different among different LGs on the basis of various factors. The distribution of such grant is carried out on the basis of set formula in one hand and on the level of performance of the LGs on the other. Hence, it could also be categorized as the formula based and the performance based grant system. The system or the formula is in operation since few fiscal years and based on the different indicators such as: human development index, population, geographical area and the cost factors. According to the Local Bodies Fiscal Commission Report, 2004, the weight to these factors has been divided as: 50, 20, 20 and 10 percent respectively.

Although we have developed formula based grant system, the size of the transfer is principally determined by the parliament because the amount of money to be transferred is fixed through the annual budget. Basically the expenditure assignment of the LGs is the decisive factor to determine the size of the budget to be transferred and it is influenced heavily by the political commitment. The policy shift announced through the annual budget could be other influential factor for the transfer.
The conditional grant is distributed on demand and priority basis. The concerned department of the government carry out the need assessment and other necessary analysis and finalized the budget. The Department of the central government not only provide necessary resources for such projects but also the proper guidelines and indicators to be followed. The LGs have to be accountable and to report the concerned Department for the progress made and the Departments and National Planning Commission through their own channels monitor them. Nevertheless, the most important part of intergovernmental transfer in Nepal is the practice of revenue sharing between central government and LGs. The one most important source of money to the LGs is the share of royalty they receive upon the exploitation of natural resources, such as: from hydropower power, mines and from timber industry. The revenue mobilization and sharing authority is also distributed among LGs and it circulates to both directions: top-down and bottom up. The DDCs in the intermediate level and the VDCs and Municipalities at the lower level share the resources they have mobilized with each other. For example the DDCs are entitled to get 25% of the Land Revenue or Land Tax collected by the VDCs or the municipalities whereas the VDCs and municipalities get 35-50% of the earning of DDCs from the commercial utilization of the raw materials (sand, stone, boulders etc) and recyclable waste. The DDCs also share 35% of the royalty they receives from mines, timber industries, tourist entry fees and the money they get from hydropower plants with VDCs and municipalities.

8.3. Borrowing

As per the law, the local governments of Nepal are competent to burrow from banks, any organization and institutions by fulfilling certain conditionality set by the law. However, according to the legal provision and general practice, the municipal borrowing should be utilized for capital investment but not for recurrent cost.
Legal Provisions for borrowing

The LSGA, 1999 has provisioned the municipal and local borrowing and set the conditions to be fulfilled to exercise the power. According to the LSGA, The Village Development Committee (VDC), Municipalities and District Development Committees (DDC) are immune to borrow from different lenders to fulfill the investment gap between expenditure assignment and revenue assignment. According to the Sec. 148 of LSGA, the Municipalities could raise the loan from a bank or any other organization according to the policy approved the Municipal Council.

Although the local bodies (Governments) of Nepal are immune to mobilize the loan from banks and any other organizations, the international borrowing should be channeled through the consent of Central Government. The Sec. 263 of LSGA states that the Local Bodies should get prior approval of Nepal Government to establish contact with foreign governments, international organizations, diplomatic missions and international non-governmental organizations.

Regulatory Framework for the Borrowing

According to LSGA, during the course of burrowing, the Nepalese local governments should fulfill certain requirements. First of all, the local governments should approve the burrowing policy and modality by the annual Council meetings. After fulfilling such conditions, the local governments could utilize their moveable or immoveable property as the collateral for burrowing. In addition to that, the local governments, in the guarantee of the central government could burrow money from those sources without giving any collateral. In case of international borrowing and getting money from any international organization the local government should get consent from the central government.
What has been done so far!

Even though the Nepalese local governments are immune to burrow from a bank or from other institutions, there are very rare cases of such burrowing. Particularly, burrowing is tough in the case of small Municipalities for various reasons. It is believed that borrowing should be used by the larger subnational governments in developing countries, and they should be given an incentive to make more use of this source (Bahl, 1999). In the case of big cities, in the project basis, there are few examples of international burrowing, particularly for infrastructure development project but it is rarely replicated in other local governments.

The two main features of the municipal borrowing in Nepal are: municipalities get loans from the Town Development Fund (TFD), a non-commercial source; and the size of the loan operation is very small (about 2 per cent of total revenue) (Shrestha, 2002). Town Development Fund (TDF) was established as a specialized public finance institute which lends to local authorities for infrastructure investment in the form of loan or grant ... TDF in principle, finances the bankable projects of the municipalities (Mahat, 2002).

Problems for burrowing and scope to improve

The pay-back capacity of the local governments is very weak in Nepal as they don't have reliable source of income. Next hurdle on this process is the lack of proper lending institution and agency. Nepal has adopted market economic policy and the government can't force any bank or financial institution to invest in any particular sector. Institutional worthiness of the Nepalese local governments is very weak and the bank and financial institutions are hesitating for lending money to these institutions. The market is shy with them as the level of corruption in these institutions is believed as quite high. In addition to that, the political uncertainty and fragile political situation is creating confusion and some time problems in the local level. The central government is not willing to work as a guarantor in municipal burrowing and most of the local governments don't have reliable property that could be used as collateral.
9. Other Options

Apart from the above mentioned three major options to fulfil the gap between revenue assignment and expenditure assignment of the Nepalese municipalities; few other municipalities have proved that they are not totally dependent on LDF and regular sources of resources however they can generate resources from other sources as well. Bhaktapur is an example who is generating 38 percent of its total revenue through tourist entry fee (Udle, 2006).

Some of the municipalities have their different comparative and competitive advantages based on their culture and tradition. For example, the municipalities of eastern part of Nepal could raise significantly big amount of money from taxes on Hatt Bazar but that is not possible in western part of Nepal.

Public private partnership (PPP) could be one of the models to provide municipal services to the people and there are already few good examples of effective implementation of it.

Dhangadi municipality, a middle level town in the far west, has successfully implemented vegetable market under the built-operate-transfer (BOT) modality of PPP ... Kathmandu Metropolitan city has signed management contract of Gangabu bus park with the private party and this has saved a big amount of operation cost of the metropolitan city (Mahat, 2002).

Professional tax is considered as another potential source of revenue of the municipalities however the scope of professional tax in small municipalities is not that high in comparison to the big municipalities. Because of the production sector and service sector industries are mostly located in the big cities, professional tax could be one of the major contributors to them provided that it is mobilized effectively.

Local governments of Nepal are considered as the stakeholders and shareholders of the revenue generated through the exploitation of natural resources. In this connection, the
municipalities with high potentialities of exploitation of natural resources could be benefited from such resources.

Additionally, experience sharing and replicating the best practices could be another useful tool for the municipalities. Further more local Governments must actively participate in civic networks to communicate and learn from each other so as to strengthen local capacity. Geographic and regional similarities can be emphasized so than sharing information is productive (Handley, 2008). Utilized technology to share best practices and models for other grantees, is a next step that will help promote effective balance and change in the system (Handley, 2008).

Conclusion
Although the LSGA have promised to devolve proper responsibilities and resources to the Nepalese local governments, the revenue part was inadequately and poorly designed, which produce huge resource gap between expenditure and revenue assignments. The problem is much more complicated in the cases of Nepalese municipalities and particularly to the small municipalities (with limited competencies) as they are going to loose LDF; the single largest contributor of the total resources; in the near future. Even though the problem was identified since Nepal got the membership to WTO: nothing has been done concretely to substitute it. Many researchers have stressed the role of integrated property tax or house and land tax in the context of the absence of LDF, but it is not likely that property based tax system will significantly support the small municipalities to fulfil their resource gap: though it's role can't be underestimated. Additionally, the barriers that could hinder the effective implementation of the tax system should be identified and solved separately. In addition to that, as different municipalities have different comparative and competitive advantages and competencies, such advantages should be explored and mobilized. Finally, as we are in the stage of redesigning of
the state and governance system; the intergovernmental fiscal imbalance should also be analyzed and solved in the proper way.
Reference


McLure, Charles E., Jorge Martinez-Vazquez, *The Assignment of Revenues and Expenditures in Intergovernmental Fiscal Relations*.


Shrestha, Manoj (2002), *An Overview of Intergovernmental Fiscal Relations in Nepal*, Andrew Young School of Policy Studies, Georgia State University.
Annex

Table 1
Comparative Chart of Ratnanagar and Bidur Municipality of Nepal

<table>
<thead>
<tr>
<th>Heading (FY 05/06)</th>
<th>Ratnanagar</th>
<th>Bidur</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue</td>
<td>31,732,000</td>
<td>32,995,000</td>
</tr>
<tr>
<td>Own Source Revenue</td>
<td>9,774,000</td>
<td>9,835,000</td>
</tr>
<tr>
<td>Contribution of property based tax</td>
<td>13.14%</td>
<td>6.26%</td>
</tr>
<tr>
<td>Local Development Fee</td>
<td>4,824,000 (26.08%)</td>
<td>7,176,000 (21.93%)</td>
</tr>
<tr>
<td>Total Expenditure</td>
<td>31,732,000</td>
<td>32,995,000</td>
</tr>
<tr>
<td>Current Expenditure</td>
<td>5,300,000</td>
<td>8,263,800</td>
</tr>
<tr>
<td>Capital Investment</td>
<td>25,227,100</td>
<td>22,320,450</td>
</tr>
<tr>
<td>Number of Employees</td>
<td>66</td>
<td>48</td>
</tr>
<tr>
<td>Population</td>
<td>44,551</td>
<td>22,317</td>
</tr>
<tr>
<td>Total Revenue Per Capita</td>
<td>712.26</td>
<td>1478.49</td>
</tr>
<tr>
<td>Own Source Revenue Per Capita</td>
<td>219.39</td>
<td>440.70</td>
</tr>
<tr>
<td>Total Expenditure Per Capita</td>
<td>712.26</td>
<td>1478.49</td>
</tr>
<tr>
<td>Current Expenditure Per Capita</td>
<td>118.96</td>
<td>370.30</td>
</tr>
<tr>
<td>Capital Investment Per Capita</td>
<td>566.25</td>
<td>1000.17</td>
</tr>
<tr>
<td>Employees/000 Population</td>
<td>1.48</td>
<td>2.15</td>
</tr>
<tr>
<td>Local Development Fee Per Capita</td>
<td>108.28</td>
<td>321.54</td>
</tr>
</tbody>
</table>

Source: GTZ/udle (2007)

Table 2
Tax Rate Chart

<table>
<thead>
<tr>
<th>Tax Ceiling</th>
<th>Tax Rate</th>
<th>Amount of Tax</th>
<th>Total Tax</th>
<th>Total Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>= or &lt;1000000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1000000</td>
</tr>
<tr>
<td>Additional 1000000</td>
<td>300 (Rs.)</td>
<td>300</td>
<td>300</td>
<td>2000000</td>
</tr>
<tr>
<td>Additional 3000000</td>
<td>0.05%</td>
<td>1500</td>
<td>1800</td>
<td>5000000</td>
</tr>
<tr>
<td>Additional 5000000</td>
<td>0.25%</td>
<td>12500</td>
<td>14300</td>
<td>10000000</td>
</tr>
<tr>
<td>Additional 1000000</td>
<td>0.5%</td>
<td>50000</td>
<td>64300</td>
<td>20000000</td>
</tr>
<tr>
<td>Additional 2000000</td>
<td>1.50%</td>
<td>300000</td>
<td>364300</td>
<td>40000000</td>
</tr>
</tbody>
</table>

Source (Aryal, 2001)
### Table 3
Comparative Chart

<table>
<thead>
<tr>
<th>Heading [FY 05/06 (In %)]</th>
<th>Municipality Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own Source Revenue to Total Revenue</td>
<td>65.38 %</td>
</tr>
<tr>
<td>Depending in LDF in Total Revenue</td>
<td>34.54 %</td>
</tr>
<tr>
<td>Contribution of Property Based Tax in Total Revenue</td>
<td>8.02 %</td>
</tr>
</tbody>
</table>

Data Source: GTZ/udle

### Table 4
Comparative Chart

<table>
<thead>
<tr>
<th>Heading [FY 05/06 (In %)]</th>
<th>Ratnanagar</th>
<th>Bidur</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own Source Revenue to Total Revenue</td>
<td>36.88</td>
<td>45.76</td>
</tr>
<tr>
<td>Depending in LDF in Total Revenue</td>
<td>21.93</td>
<td>26.08</td>
</tr>
<tr>
<td>Contribution of Property Based Tax in Total Revenue</td>
<td>13.14</td>
<td>6.26</td>
</tr>
<tr>
<td>Current Expenditure incurred from Own Source Revenue including LDF</td>
<td>54.85</td>
<td>79.03</td>
</tr>
</tbody>
</table>