

The National Natural Resources and Fiscal Commission: A Custodian of Federalism in Nepal

Strengthening Constitutionalism in Nepal



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Foreword

This note on the National Natural Resources and Fiscal Commission (NNRFC) has been produced by Niti Foundation — a Nepali not-for-profit public interest organization that accompanies locally-led policy reform, in partnership with the National Endowment for Democracy. Valuable insight for this note has been received through Niti Foundation’s engagement with the NNRFC under USAID’s Public Financial Management Strengthening Project.

Fiscal and natural resource federalism are two important pillars of Nepal’s federal system. The NNRFC’s role as custodian of fiscal and natural resource federalism makes it a critical actor to mitigate Nepal’s historical centripetal inertia and thus ensure the realization of the 2015 Constitution’s federal vision. This note was commissioned for the purpose of reflecting on the strategic contribution of the NNRFC to support constitutional commitment towards federalism.

This note explores: 1) the constitutionally mandated responsibilities of the NNRFC; 2) the challenges the Commission faces in fulfilling this role; and 3) three strategic roles that the NNRFC can assume, as custodian, interlocutor, and a knowledge leader in regard to Nepal’s fiscal and natural resource federalism.

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We hope that this note is a useful baseline for further conceptualization of the significance of the NNRFC in maintaining and strengthening democratic federalism in Nepal.

Abbreviations

CA	Constituent Assembly
IFA	Intergovernmental Fiscal Arrangement
IFR	Intergovernmental Fiscal Relations
LLRC	Local Level Restructuring Commission
MoF	Ministry of Finance
MuAN	Municipal Association of Nepal
NARMIN	National Association of Rural Municipalities in Nepal
NNRFC	National Natural Resources and Fiscal Commission
NPC	Nepal Planning Commission
PSC	Public Service Commission
SNG	Subnational Government
UNDP	United Nations Development Programme
USAID	United States Agency for International Development

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1. Introduction

The 2015 Constitution imagined an independent commission, the National Natural Resources and Fiscal Commission (the 'NNRFC' or the 'Commission'), with a permanent structure to deal with matters of fiscal and natural resource federalism. In the first Constitutional Assembly (CA),¹ the Constituent Assembly Committee on Natural Resources, Economic Rights and Revenue Allocation recommended the creation of two separate commissions, one each for fiscal and natural resources affairs. However, so as not to create 'too many' constitutional bodies,² the second CA agreed to merge these ideas and establish the NNRFC in its current form.

On the fiscal side, the NNRFC oversees issues like the assignment of fiscal responsibilities, deciding on the framework for the intergovernmental fiscal architecture, and the creation of a knowledge base on fiscal federalism.³ The goal of fiscal federalism is to enable the newly created subnational governments — provincial and local — to enjoy their constitutionally devolved rights and formulate their own independent policies and programs rather than merely acting as decentralized outlets or implementing agencies of the federal government. As such, while operationalizing the expenditure and revenue assignment and deciding on inter-governmental grants and borrowing limits, the NNRFC is expected to do so in a just, and impartial manner among the 761 governmental units, in line with the spirit of federalism, and in a way that results in an efficient use of public funds.

On the natural resources front, the Commission is concerned with harnessing and conserving natural resources available to all levels of government. Specifically, the NNRFC is mandated to 'set bases for the determination of shares of governments in investments and returns, in the mobilization of natural resources'.⁴ Further, the Commission is required to engage in research on disputes that may arise in the course of distribution of natural resources as well as the environmental impact of these distributions and provide suggestions to governments.⁵ These components of natural resource federalism are a unique and critical addition to the Commission's scope of work given the vital role that natural resources play in national economy and society.

The NNRFC, as an institution, is still evolving. It was established with a permanent secretariat in 2017. Commissioners have been appointed in phases, albeit not without some controversy. While these are formative years for the Commission, and the political-economic context of federalism that it operates in is

1 The first CA was set-up in May 2008 for a two-year period and was dissolved in 2012 after it failed to deliver the Constitution. The second CA was constituted in Jan 2014 and the Constitution was promulgated in Sep 2015.

2 The 2015 Constitution establishes 13 constitutional bodies.

3 The Constitution of Nepal 2015, art 251.

4 *ibid*, art 251(h).

5 National Natural Resources and Fiscal Commission Act 2017, ch 4. A copy of the Act is available at: <https://www.lawcommission.gov.np/en/wp-content/uploads/2021/01/National-Natural-Resources-and-Fiscal-Commission-Act-2074-2017.pdf>.

still emerging, there are early signs of challenges that lie ahead. The foremost of these is for the NNRFC to locate itself within the broader contours of Nepal's fiscal federalism architecture given the fuzzy outline of its role in the Constitution. The Constitution imagines the NNRFC as an independent technocratic agency that balances the uneven fiscal powers of the three tiers of government, helping to maintain productive inter-governmental relations.

There are specific expectations and values that provide the location of the NNRFC in the Constitution. First and foremost is the expectation that it plays an independent and impartial role to ensure the distribution of national resources among all 761 governments in a fair and just manner. This is a critical role because the success of federalism depends not only on the various governments' ability to deliver public services like education, health, or public security but also on the capacity of the new constitutional dispensation to successfully foster stronger and more regionally balanced economic growth. Towards this end, the NNRFC has attempted to envision its location and has been met with several challenges along the way.

The NNRFC, like all constitutional bodies, can perform its role effectively and impartially only with adequate autonomy, appropriate capacity and resources, and multi-partisan support. However, the constitutional authority of the Commission has been diluted by both subsequent law and practice. This has threatened to effectively make the Commission subservient to the executive government in Kathmandu. Moreover, the Commission's dependence on employees of the federal government for technical support might influence the Commission's capacity to be impartial. In any case, there is an acute need to enhance the technical ability of the Commission in effective data management and sectoral expertise.

In order to fully assume its potential, the NNRFC has to play a multi-dimensional role within the framework provided by the Constitution. These roles, broadly grouped into custodial, interlocutor and knowledge leadership roles, are essential for the effective implementation of fiscal and natural resource federalism in Nepal. Against this backdrop, this note explores the institutional formation of the NNRFC, the rationale for its design, and challenges to its independence. It also explores a way forward to strengthen the NNRFC in line with its constitutional vision and mandate. The note recommends that a strategic direction forward for the NNRFC is to take a maximalist approach in delineating the scope of its work.

2. The NNRFC in the Constitutional Imagination

The NNRFC was established with a mandate to be directly responsible for designing and implementing two important pillars of federalism — fiscal federalism and natural resource federalism — in a way that is insulated from the centralizing politics of Kathmandu. Indeed, the disproportionate capacity of the state to generate revenue and the state’s historical lack of concern for sharing resources justly to benefit the entire population has resulted in uneven development. These imbalances were one of the key drivers for the demand for federalism to begin with.⁶ Against this backdrop, the promotion of more balanced and inclusive economic development must be at the heart of the NNRFC’s vision and mission.

To this end, the NNRFC has been created as a powerful and autonomous body. The goal of doing so is to maintain impartial and just fiscal and natural-resource relations, independent of partisan politics, while also acting as a counterbalance to the disproportionate power held by the federal executive. This is reflected in the institutional design of the NNRFC, which seeks to ensure its independence and impartiality. The chairperson and its members are appointed by the Constitutional Council, which has representatives from all branches of the government — the executive, legislative and judiciary — as well as leader of the opposition party.⁷ This is to ensure that members appointed to the Commission are of the highest integrity and stature for universal acceptance, and further ensure that political differences do not affect their tenure. The appointed members are precluded from appointment to other government services after their service on the Commission,⁸ and their salary and employment benefits are not voted on in the Parliament.⁹ Moreover, as constitutional body and by nature of its function, the NNRFC can operate in equidistance from all three levels of government.¹⁰ By assuming an important responsibility in the division of fiscal and natural resources among the 761 constituent units of the federation, the NNRFC has a critical role to ensure the smooth implementation of federalism in Nepal.

2.1 The NNRFC’s Fiscal Responsibility: Counteracting the State’s Centripetal Bias

Fiscally, the NNRFC has a particular responsibility to play to counteract the centralizing tendency of Nepal’s fiscal federal design and practice. The Constitution has a centripetal bias with strong unitary features in its fiscal federal design. This, in conjunction with the legacy of centralized governance and

6 Astri Suhrke, ‘Restructuring the State: Federalist Dynamics in Nepal’ (April 2014) Chr. Michelsen Institute.

7 The Constitution of Nepal 2015, art 284.

8 *ibid*, art 250 (8).

9 *ibid*, art 250 (7).

10 While the law has identified the federal Ministry of Finance as the Commission’s liaison institution, this does not prevent the NNRFC from functional cooperation, coordination and communication with subnational governments, other federal institutions such as line ministries, the central bank, and institution outside of the government including the media and other constitutional bodies.

development planning during the transition period, has created an obstacle to effective decentralization throughout the early years of federal transition.

While under the erstwhile unitary system the central government had sole authority over the income and expenditure of the state.¹¹ In the changed federal context resources must be shared with subnational governments commensurate with their share of expenditure responsibility. However, by constitutional design, there is a disproportional assignment of expenditure and revenue to different levels of governments. Major revenue sources are within the control of the federation whereas the expenditure burden for service delivery and development is shared proportionately by all 761 governments. While the centralization of revenue sources is seen in other federal countries — this generally emerges for economic and administrative efficiency — it nevertheless creates vertical and horizontal fiscal imbalances.

The vertical fiscal imbalances arise from the disproportional revenue and expenditure assignment across different levels of governments. Thus, for example, in 2018, while local governments accounted for 23 percent of the total government expenditure, their own source revenue was estimated to be between 2 – 3 percent.¹² In fact, the World Bank estimates Nepal's vertical fiscal gap to be highest amongst the federations of the world. Overall, 80-85 percent of the fiscal gap at subnational level is likely to be required to be met through intergovernmental fiscal transfers.¹³ The only way subnational governments can balance their expenditure against their resources is through the vertical transfer of resources.

Moreover, the differences in revenue capacities and expenditure needs among the subnational units give rise to horizontal imbalances. Province 1, Bagmati, and Lumbini, for instance, historically contribute significant shares of national income by virtue of the many urban centers and industrial hubs within these provinces. Karnali and Sudurpaschim provinces, on the other hand, only contribute 0.24 percent and 1 percent to national income respectively.¹⁴ This uneven distribution of revenue results in differing level of dependence on federal grants and fiscal transfers.

The huge vertical and horizontal fiscal gaps among federal and subnational governments mean that fiscal transfers — at least at the present stage of federalization — must be the major sources of revenue for the provincial and local governments. Indeed, if Nepal's subnational governments are to effectively carry out their functions of public service delivery and development as stipulated by the Constitution, and provide a similar minimum standard of service to citizens in doing so, they must have a fair and balanced share of national fiscal resources. The constitution-makers designed the NNRFC as an independent institution to ensure this. The NNRFC plays a central role in the determination of revenue sharing. Fiscal resources are distributed via unconditional and conditional grants, the sharing of tax and non-tax revenue and royalties from natural resources, and allowing for subnational borrowing from internal market or the federal government to fill their fiscal deficit in a particular year.¹⁵ The NNRFC is to make decisions on revenue distribution based on the revenue raising capacity and expenditure needs of each of the subnational governments. The federation, which holds the majority of revenue streams, is required to comply with the Commission's revenue sharing recommendations.¹⁶ Taking key decisions concerning the distribution of state revenues out of the hands of the federal executive is fundamental to the NNRFC's envisioned function, thus making the Commission an important institution to lessen central domination in the new federation.

11 The Local Self-Governance Act 1999 had provided some revenue-collection powers to the local bodies (VDC and municipalities).

12 The World Bank, 'Fiscal Architecture for Federal Nepal' (2017) Nepal Development Update Report, September 2017; Achyut Wagle, 'Fiscal Imbalances in Nepal's Federalism: An Empirical Analysis' (2019) NRB Economic Review.

13 The World Bank (n 12).

14 Wagle (n 12).

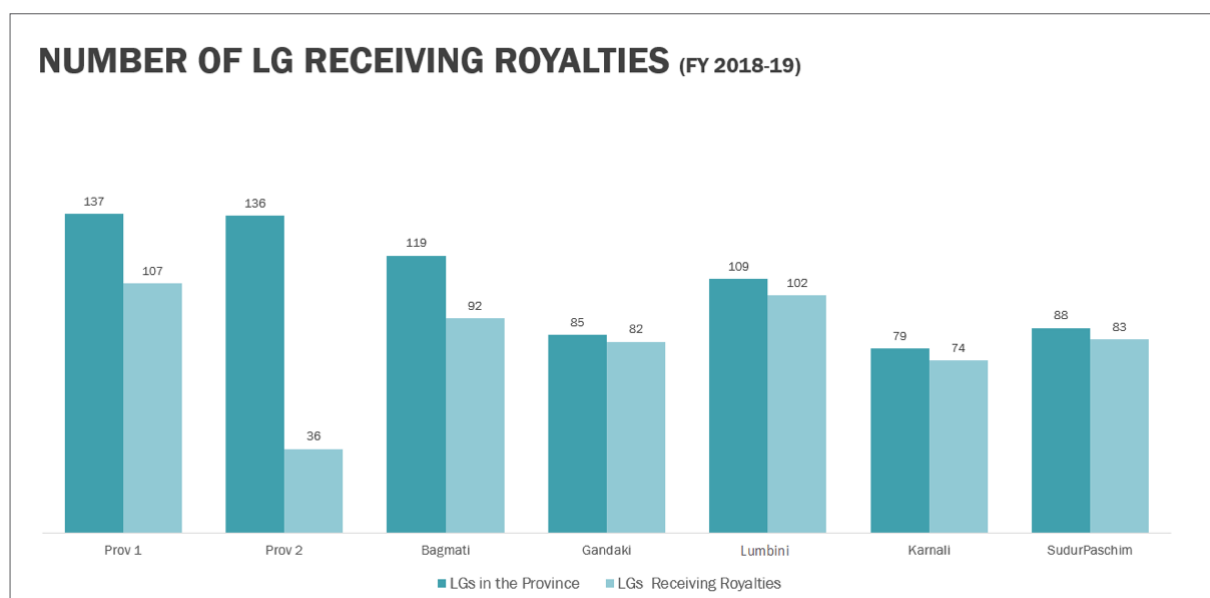
15 The Constitution of Nepal 2015, art 60, 251.

16 *ibid*, art 60(3).

2.2 The NNRFC's Natural Resource Responsibility: Promoting Economic Utilization and Incentivizing Conservation

The NNRFC is also entrusted with the crucial responsibility of overseeing critical aspects of natural resource governance in the federal context. Like fiscal federalism, natural resource federalism is based on the premise that devolving executive and legislative authority is more likely to improve accountability, as governments closer to the people can better assess and respond to the needs and preferences of users, and therefore, determine optimal level of economic use and sustainability of natural resources. However, given the uneven distribution of the country's natural resource endowment and the political jurisdictions of the subnational governments, allowing all government units to manage natural resources would inevitably result in friction from some resources-rich governments enjoying disproportionate benefits while the costs are borne by many, if not all. For example, as shown in Figure 1 below, the number of local units receiving natural resource royalties varies considerably across provinces.¹⁷ In 2018-19, while the local units in Bagmati received Rs. 5.80 million in natural resource royalties on average, in Madhesh the amount was a meagre Rs. 0.37 million. The amounts in other provinces — Gandaki (3.50 million), Lumbini (2.30 million), Province 1 (2.30 million), Sudur Paschim (0.83 million) and Karnali (0.59 million) — also varied greatly. Indeed, overall, there are significant regional differences in economic opportunities and availability of natural resources.

Figure 1: Number of Local Governments Receiving Royalties (FY 2018-19)



In addition, the potential for free riding among the subnational governments can damage natural resource conservation efforts and has the potential to plant seeds of conflict over benefit sharing and ownership rights. To help prevent this from occurring, the NNRFC has been created as an impartial third-party to anticipate, enquire and resolve natural resource-based disputes among the governments. The NNRFC has been tasked to resolve any potential natural resource distribution-related disputes arising between the federal and provincial governments, between individual provincial governments, between the provincial and local governments, and between individual local governments. Further, the Commission

¹⁷ Author's calculations based on National Natural Resources and Fiscal Commission, 'First Annual Report of National Natural Resources and Fiscal Commission 2018-19' (2019), available at: http://nnrhc.gov.np/uploads/resources/2020-01-21/annual_report_final3.pdf

is constitutionally mandated to take on a central role in determining the basis of distribution of natural resource royalties among different governments. It is also required to determine the basis on which shares of investment and returns from natural resource royalties for all federal units are allocated.¹⁸ Finally, both the Constitution and the NNRFC Act require the NNRFC to remain watchful for the potential negative externalities of natural resources extraction and to develop ways to mitigate them by conducting environmental impact assessments and providing recommendations to the government on natural resource protection.¹⁹ The NNRFC thus has the dual responsibility of promoting the appropriate economic utilization of natural resources while also incentivizing conservation efforts. Like with fiscal federalism, the role of the NNRFC is particularly critical given the reluctance of Kathmandu-based political institutions to devolve authority to subnational governments.

¹⁸ *ibid*, art 251.

¹⁹ *ibid*, art 251(2).

3. Critical Reflection

The NNRF faces several challenges in executing its roles. These challenges are manifested both outside the Commission — that is, through the political processes shaping broader constitutional implementation and the Commission's independence — and inside the Commission — through its institutional formation, structuring, and the need to build its technical capacity. These internal and external aspects are also interrelated. The note explores these challenges by grouping them under two themes: (1) constitutionalism and independence; and (2) bureaucratic structure and technical limitations.

3.1 Constitutionalism and Independence

While political federalism has largely been instituted via elections to representative institutions across all three tiers of the new federal structure, administrative and fiscal federalism have yet to be fully instituted. These processes have been characterized by inertia in the devolution of functional powers to subnational governments, the lack of transition plans to guide administrative and fiscal devolution, as well as encroachment on the mandates of key institutions, including the NNRF, by federal legal frameworks and federal government practice.

There was an intense debate in the Constituent Assembly to ensure that the independent status of the NNRF was maintained. The record of the Constituent Assembly Committee on Natural Resources, Economic Rights and Revenue Allocation shows that this was in response to the call from the 'pro-federalist' committee members who feared that the lack of such a body would inevitably lead to the implementation of a form of fiscal federalism that would strongly favor the federal government, which in turn would be detrimental to the independence of newly created subnational units.²⁰ However, despite this intention of the constitution-makers and establishment of the NNRF as an independent entity, the NNRF's scope of work and power in practice have been curtailed by subsequent laws and actions of policymakers at the federal level. The conservative formation of the laws required to implement fiscal federalism have severely diluted what was imagined by Constitution, namely an independent NNRF that acts as a neutral referee among governments across all levels in Nepal's federal polity.

In operational terms, the independence of NNRF is maintained through the definition of its responsibilities in the Constitution itself. However, in some cases, the wording of the Constitution's text has created room for varying interpretations of the Commission's specific roles. Constitutional and federal experts have questioned the propriety of limiting the constitutionally defined scope of the Commission and identify this as a matter that needs to be presented before the constitutional bench of the Supreme Court. One such vague and contentious issue is whether recommendations made by the NNRF on

²⁰ For review of the Constituent Assembly, see Kanak Mani Dixit, 'The Life and Death of the Constituent Assembly of Nepal' (2012) 47 *Economic and Political Weekly* 35-41; Surendra Bhandari, 'Constitution Making and the Failure of Constituent Assembly: The Case of Nepal' (2012) 11 *Ritsumeikan Annual Review of International Studies* 1-40.

the quantum of fiscal transfers are a legally binding constraint on executive governments, especially the federal government. Presently, the Commission and the federal government have posited varying interpretations on this question.

In addition, the federal executive has failed to formulate regulations related to two laws — the Natural Resource and Fiscal Commission Act 2017 and Intergovernmental Fiscal Arrangement Act 2017 — that directly operationalize the provisions of the Constitution and determine the Commission's scope of work. The regulations are necessary to facilitate the everyday working procedures of the NNRF, for example, by clarifying the procedure for hiring external experts and setting-up protocols for how the Commission communicates with subnational governments.

Further, subsequent laws that have sought to unbundle and clarify the role of the Commission have reduced its working territory. For example, Article 60(3) of the Constitution authorizes the NNRF to decide on the volume of all four types of grants — equalization, conditional, special, and matching.²¹ Despite this, currently, conditional grants continue to be determined by federal line ministries to fund sectors that the Constitution has devolved to subnational governments. For example, basic and secondary education, which is clearly an exclusive power of local government is being funded via conditional grants, enabling the continued practice of centrally allocated funding. This has also prevented local or provincial governments from exercising their constitutionally provided power to hire or transfer teachers and has required them to use funds from other sources if they want to implement any education programs beside those designed by the federal government.

Moreover, many centrally designed schemes — like *Janata Awas Yojana* (People Housing Program) or *Sana Khanepani Yojana* (Small Drinking Water Projects) — have been designed by federal line ministries with funding transferred as conditional grants directly to local governments for implementation (i.e., not through inter-governmental fiscal transfers as recorded in federal budget). This effectively renders local governments as mere implementing units of the federal government. This practice, where transfers are made as conditional grants, are contrary to the Constitution's provision and prevent the Commission from taking a holistic view of fiscal transfers to subnational governments.

Similarly, key fiscal institutions like the Ministry of Finance or the National Planning Commission have encroached on the NNRF's turf. The Intergovernmental Fiscal Arrangement Act 2017 (the IFA Act 2017) has provided power to operate special and matching grant to the National Planning Commission (NPC), a unit of the federal executive, and not the NNRF.²² Although the amount of these grants compared to overall quantum of fiscal transfers is very low, the fact that they have been kept within the NPC, which is directly supervised by the federal government, is against the Constitution. In addition, these two windows — matching and special grants — of fiscal transfer can always be used as a lever by the federal government to influence the decision-making of subnational governments, possibly against their will, and provide undue power to the federal government vis-à-vis other governments. Likewise, the MoF has also issued investment guidelines that explicitly set the rules for investment in infrastructure projects, requiring that they be done jointly with provincial and local governments. According to the constitutional mandate, these guidelines should have been devised by the NNRF. This type of attempt by the federal government to gain an upper hand on matters related to fiscal federalism run counter to the Constitution's design, defy the conception of an independent fiscal body to decide on the rules on the matter and undermine the overall norms that the Commission is seeking to institutionalize with regard to intergovernmental fiscal transfers. Given its relatively newer status and limited space, the Commission is not in a place to resist these attempts by the federal government. There is also additional danger that the government may respond to any assessment made by the Commission that is contrary to the federation's

21 The Constitution of Nepal 2015, art 60(3).

22 Intergovernmental Fiscal Arrangement Act 2017.

own views or actions by reducing the Commission's allocated budget or even withholding data crucial to the functioning of the Commission.

3.2 Bureaucratic Structure and Technical Limitation

The NNRFC is a five-member committee, headed by a chairperson, with each serving for a predetermined six-year period from the date of their appointment. The leadership has only recently taken shape with the appointment of the chairperson in 2019 and three of four member-positions filled in 2021, after four budget sessions and fiscal-transfer rounds were completed. In the absence of a full cohort of commissioners, the NNRFC's core tasks have remained unfulfilled. While having fewer members lowers the political capital necessary for the Commission when making structural decisions that could bring about major changes, or makes it easier to decide on contentious issues, collective decision-making lowers the risk for individual members and presents a collective conscience of the Commission. This helps to increase the Commission's credibility. The delay in the appointment of commissioners has thus severely undermined the Commission. This is incredibly significant as increasing demands are placed on the NNRFC by federal, provincial, and local governments to take a more assertive leadership role in institutionalizing fiscal federalism.²³

In support of the five commissioners, the NNRFC has a permanent secretariat, which was established in 2017. This is staffed with public service personnel from various technical and administrative service backgrounds. The idea behind the establishment of a continuing Commission with a permanent secretariat was to ensure more substantive engagement with all relevant information and data. More importantly, it was thought to foster conducive relationships and coordination between the Commission and the agencies and governments it is required to work with to oversee and monitor the implementation of its recommendations.

In the early years, prior to the appointment of any commissioners, the NNRFC secretariat played a critical role, establishing basic rules for equalization grants and revenue sharing and making recommendations regarding intergovernmental transfers based on ad-hoc fiscal transfer formulas, which were incorporated into the annual budget and grant distributions by the Ministry of Finance. Since their appointment, the NNRFC's commissioners have taken over the decision-making process. However, in the subsequent years, bureaucratic and technical limitations have meant that there have only been marginal changes regarding the fundamental structure of the grant system/framework, little refinement of data, and limited alteration to the weightage formulas. Indeed, without swift and strong technical support from a well-equipped and resourced secretariat, wide sweeping change is difficult for the commissioners to achieve.

Limited staffing is one of the largest obstacles facing the NNRFC. Indeed, at the time of this study, only 45 of 73 positions in the Commission were filled. Moreover, there is frequent churn of employees among the positions that are filled (particularly among the high-level bureaucrats), which undercuts the Commission's administrative stability and institutional memory, and is also a serious problem.²⁴ This occurs partly because some government employees agree to serve at the NNRFC as stop-over arrangements in order to secure a posting based in Kathmandu. But more importantly, technical employees are sourced from respective ministries (e.g., revenue cadre from the Ministry of Finance, forest officers from the Ministry of Forestry, etc.) and their career prospects are perceived to be better at the respective ministries than at the NNRFC, resulting in limited professional incentive to continue serving at the Commission over longer periods of time.

23 Yanki Ukyab and George Varughese, 'Nepal's new Natural Resources and Fiscal Commission' *Nepali Times* (13 February 2019), available at: <https://www.nepalitimes.com/latest/nepals-new-national-natural-resources-and-fiscal-commission>; UNDP 'Policy note for the federalism transition in Nepal' (2019).

24 National Natural Resource and Fiscal Commission, 'First Strategic Plan of National Natural Resources and Fiscal Commission' (2021).

The NNRFC Secretariat is supposed to be housed by technical staff to support the Commission's work. Currently all staff positions in the Secretariat are filled by federal public service employees, although there is a provision in the law that enables the NNRFC to hire personnel from outside of the government. The NNRFC Act 2017 allows the Commission to obtain expert service 'if the human resources employed within the Commission is unable to perform any work that the Commission is required to perform'.²⁵ While external support is necessary, no regular experts have been hired by the Commission, except for the purpose of conducting a few minor studies on an ad-hoc basis; this is despite the provision being mentioned in the NNRFC's annual plan, with a corresponding budget allocation for this in the past two years. Whereas some engagement of career bureaucrats in the Secretariat is essential because they will have full access to all necessary data and information across government, these personnel should be complemented by people from outside the bureaucracy who have the technical knowhow and skills more compatible to the work of the NNRFC. Overall, limited expert policy advice available to the Commission, a Secretariat beset by rapid turnover of senior bureaucratic staff, intergovernmental resistance, and the absence of a full cohort of commissioners have all caused major obstacles to the implementation of the Commission's strategic initiatives.

The international community has provided important technical assistance during these formative years and is willing to continue to do so. Recently, USAID, UNDP-Nepal and The World Bank have provided technical assistance in various aspects of fiscal federalism — including fiscal gap analysis and understanding of international practices on natural resources federalism. Despite this external assistance, the NNRFC needs more technically sound and administratively apt support from the Secretariat. Accessing this support is possible with changes to the Commission's current organizational design so that the traditional structure of government agencies can create a flexible space to accommodate external expertise to be hired for differential periods and perks than regular public service personnel. Over the next few important formative years, the NNRFC should seek to leverage further assistance to build its technical capacity.

25 National Natural Resources and Fiscal Commission Act 2017, s 5.

4. Strategic Direction Ahead

The drafters of Nepal's Constitution imagined a significant role for the NNRFC in defining the contours of the federal structure of the country, and indeed, the constitutional text itself has lent strong legitimacy and power to the Commission. However, for the NNRFC to assert these powers and establish itself as a credible agency in the implementation of federalism, it must assume three interrelated roles — as custodian, as interlocutor, and as knowledge leader — all of which are critical in attaining the goals of fiscal and natural resource federalism.

4.1 The Custodial Role

In its own documents, the NNRFC has defined its constitutional role to be 'the custodian of fiscal federalism' in Nepal.²⁶ However, a clear and coherent articulation of what the custodian role signifies — beyond reiterating provisions of the Constitution and implementing laws — has yet to be done by the Commission. The custodian role implies concern not only for what the NNRFC does in itself, but also in managing the ecosystem of fiscal federalism. The NNRFC cannot afford to limit itself to allocating fiscal resources and remaining passive to the ways in which other actors are responding to its resource allocation decisions. Rather, the Commission should actively enquire and act upon the fiscal and political incentives of the governments and design a fiscal transfer system that can produce equitable local and provincial economic prosperity. Fiscal decentralization is after all 'the empowerment of people by the [fiscal] empowerment of their local [and provincial] governments.'²⁷

For the Commission to properly engage in the above articulation, this note argues, a maximalist approach to the unbundling of the Commission's constitutional mandates is required. In effect, determining the totality of the role of NNRFC requires an examination of not just the *de jure* rules codified in law, but may need to rely on *de facto* rules created by virtue of practice. This includes a requirement not only that the NNRFC negotiate with other actors about its role but also that it establish conducive working relationships with them. This will also support the creation and nurturing of an ecosystem where many participants can come together and contribute to the goal of empowerment and prosperity through fiscal federalism. The ecosystem can support the upholding of constitutionalism, production of knowledge, and conservation of the environment. The ecosystem can also support building a body of research, researchers, datasets, and a community of knowledge creators. It should actively promote both knowledge producers and users in the realm of fiscal and natural resources federalism. If we use the banking system as an analogy, in the fiscal federalism setting, the Commission, and not other financial institutions, ought to act like a central bank. While a central bank produces

²⁶ National Natural Resource and Fiscal Commission (n 17).

²⁷ Jorge Martinez-Vazquez, 'Running with the Fiscal Decentralization Bahl, Proceedings' (2005) 98 Annual Conference on Taxation and Minutes of the Annual Meeting of the National Tax Association.

some services on its own, its primary role is to ensure the adequate provision of banking services by overseeing the overall banking system. There are plenty of openings provided by the Constitution to amplify its role, and the NNRFC should seize these and take initiative to operationalize them.

In performing its custodial role, the Commission can also promote accountability by performing a fiscal watch dog function and oversight over fiscal policymaking in the country. By performing tasks which are part and parcel of the custodial functions — like analysis and assessment of the technical soundness of fiscal policy, costing of governments' service delivery, forecasting to ascertain the macro-fiscal consequences of budget bills including debt sustainability, and recommending actions to maintain fiscal discipline and transparency — the Commission can nudge governments towards greater accountability. The Commission can demand accountability from all levels of governments — both in fiscal affairs and natural resources related issues. For example, many local governments rely on fiscal transfer from the federal government to fund their education service delivery. They might not spend the money in a judicious way to achieve results. Minimizing such phenomena, which public financial theorists call the 'flypaper effect', is another responsibility of the Commission. This is in line with the goal of the Commission to support vertical and horizontal fiscal imbalance across governments, as well as the constitutional mandate to find ways to meet the expenditure needs of all governments and reform revenue collection. The Commission is partially already doing this through the use of various performance indicators which guide the determination of the quantum of grant allocations to the subnational governments.

4.2 The Interlocutor Role

Nepal's model of federalism can be described as cooperative federalism.²⁸ The Constitution requires that the 761 federal units maintain the relations between them 'on the basis of cooperative federalism'.²⁹ Further, it calls for the 'develop[ment] and expand[ing] of harmonious and cooperative relations between the Federal Units by way of sharing of responsibilities, resources and administration between them'.³⁰ The most cited constitutional provision regarding intergovernmental relations states that 'the relations between the Federation, States, and Local level shall be based on the principles of cooperation, co-existence and coordination'.³¹ These constitutional provisions provide the broad contours for intergovernmental relations while the subsequent laws set out specific rules that guide practice of the relationships. The arrangement for cooperation, coordination and coexistence has gradually evolved over the last few years to respond to legal, political, and administrative challenges. However, an examination of governments' actions and activities reveals that governments are low in confidence towards each other and mutual trust is lacking.³² While there are alternative mechanisms for intergovernmental coordination in general and the management of fiscal relations in particular (e.g., the Inter-Provincial Council and the Inter-Provincial Fiscal Council, and the Provincial Coordination Council), all of these mechanisms have the federal government at their core and often became a forum to vent political disagreements.

In addition to the above, the overlapping nature of power distribution — particularly through the expansive list of concurrent powers, assigned to all three levels of government — has complicated the devolution of functional power. Since the clarity of functional roles provides the bedrock of fiscal federalism, the lack of clarity has muddled the transition towards federalism and by extension created friction in intergovernmental relations. Moreover, the confusion over distribution of powers among three tiers of government favors the federal government. The overlapping jurisdictions among the

28 The Constitution stipulates 'Cooperation, Coordination and Coexistence' as principle guiding the intergovernmental relations, see: the Constitution of Nepal 2015, art 232.

29 *ibid*, art 50(1).

30 *ibid*, art 51(a)(2), art 51(b)(6).

31 *ibid*, art 231(2).

32 Khim Lal Devkota, 'Intergovernmental Fiscal Relations in a Federal Nepal' (2020) International Center for Public Policy, Andrew Young School of Policy Studies, Georgia State University.

three tiers potentially create gaps through which the federal government can intrude on the powers of provincial and local governments.

In this context, by acting as an additional interlocuter for the relationships among governments — both horizontally among governments of same level and vertically across different levels of the federation — the NNRFC can be effective by virtue of its constitutional roots and its formal independence from the federal executive. The NNRFC Act allows the Commission ‘to coordinate and cooperate with various constitutional bodies, the Government of Nepal, government agencies in local and provincial level or public agencies as needed’.³³ As part of its interlocuter role, the NNRFC can provide a platform to conduct intergovernmental consultation, bargaining, and dispute settlement. It can thus help enhance understanding and mutual respect of the roles and responsibilities of each government with the principle of shared rule and self-rule. This way, the NNRFC can also help develop effective relationships and improve the ability of governments to meet mutual expectations by clarifying what responsibilities each government can perform better, and by determining their share of the national resources pie in accordance with their functional responsibility.

The NNRFC can play a crucial role in interpreting the extent of governments’ functional roles and responsibilities, as this forms the basis for the Commission to assess fiscal gaps and make recommendations. The interlocution role can aim to optimize utilization of resources in way that bring efficiency in resource generation and public spending. This includes proactive participation in determining national basic minimum standards, advocating policy and programmatic harmonization across different levels of government, and ensuring adequate and timely information sharing and regular communication in the fiscal federalism ecosystem.

In addition to these, given the centralizing tendencies within Nepal’s fiscal federalism, the NNRFC can use its position to proactively seek to help and advocate for the subnational governments’ rightful demands. After several occasions of non-compliance with its recommendations, in June 2021, the NNRFC issued a public notice citing concern over the decision by the Ministry of Finance to issue guidelines on equalization grants, which included the provision to ‘[redetermine] the amount of equalization grant in case of adverse fiscal conditions brought about by disasters or other conditions’. The right to decide on the volume of the equalization grant constitutionally lies only with the NNRFC, and therefore, this action by MoF is encroachment on the NNRFC’s turf. Similarly, the Commission can engage in advocacy to settle the rightful role of each level of government as well as of the NNRFC. For example, pursuing the generation and dissemination of better data to inform decision-making regarding fiscal transfers is part of the Commission’s advocacy for equalization of revenue-raising or expenditure capacity. The Commission can also collaborate with the local government associations, Municipal Association of Nepal (MuAN) and National Association of Rural Municipalities in Nepal (NARMIN), in advocacy initiatives.

In order to execute the above role and gain clarity regarding its relations with provincial and local governments, the NNRFC needs to look far beyond these immediate stakeholders and must seek to build an alliance of like-minded institutions including other constitutional bodies. This alliance building role (as part of its interlocuter role) requires the NNRFC to expand its reach and relation with non-governmental actors like civil society groups or community-based organizations, media, and academia. Each of these actors have a unique role to play in supporting the Commission and creating alliances for the institutionalization of fiscal federalism in Nepal under the leadership of the Commission. For example, there is limited knowledge of fiscal federalism within the media and it is thus covered only minimally in news and analysis. The NNRFC could, therefore, orient and train media-personnel on issues of fiscal federalism as well as on the constitutional role of the NNRFC and any threats to such role. This is likely to increase and improve media coverage of fiscal federalism and the activities of the NNRFC, thereby spreading the message to a wider population. This is important, because as a constitutional body, the

³³ National Natural Resources and Fiscal Commission Act, 2017, s 7.

NNRFC ought to be able to connect directly with citizens and the community. This connection would enable better understanding of the context and help educate citizens on fiscal federalism. It would also provide a feedback loop to the Commission on its own activities and decision-making. At a basic level, for the Commission, this engagement could take the form of training local representatives on fiscal federalism, making presentations on the ongoing progress of intergovernmental transfers, distributing information and communication materials on the Commission's work, and so on. Doing so will enhance the Commission's standing and credibility with the public.

The NNRFC has begun performing some of these interlocution roles. For example, the Commission has begun the process of intergovernmental coordination and cooperation as far as intergovernmental fiscal relations (IFR) are concerned. Most of the NNRFC's IFR actions concern the technical aspects of intergovernmental fiscal transfers like feedback on grant transfers or revenue sharing formulae; approaches to decisions on sharing royalties from natural resources; ways to improve subnational spending and raise revenue collection. To perform these actions, NNRFC has used both formal and informal communication channels. Formally, the NNRFC organizes various events — face-to-face and (recently) virtual — where local government representatives and bureaucrats participate. Annually, the NNRFC organizes a residential event where it invites the provinces' finance secretaries and asks them to present on the financial situation in their respective provinces. The NNRFC also submits an annual report to all seven provinces and makes an extended presentation on the report to the provincial chief, chief ministers, ministers, and other top government leadership. Informally, members of the Commission maintain relations with key local and provincial political leadership, who also act as information channels. These forums have become important platforms to exchange views on various fiscal issues, identify challenges facing local and provincial governments in their mutual relations or with federal government agencies as well as to discuss potential solutions. Although it is difficult to quantify, the issues raised in such forums will feed into the NNRFC's internal discussions and decision making. For subnational governments, such formal and informal forums have become platforms to share their viewpoints and grievances with the NNRFC.

Given that the NNRFC maintains arm-length relations with all 761 governments, it can deal with them on equal footing. This will support the Commission in performing its responsibilities under its interlocutor role. Currently, the main channel of communication between the Commission, and subnational governments and other federal agencies is through official and private contacts within the federal Ministry of Finance, as the latter was designated as the liaison agency for the Commission. In addition, the NNRFC meets with the President, the finance minister, and several legislators, which helps build institutional relations. Yet, as the relationship between the Commission and the executive government is not clearly defined, challenges remain. For example, there is debate on whether the Constitution has endowed the Commission with the authority to enforce compliance with the rules it creates. There have been instances where recommendations made by the Commission have been defied by the federal government.³⁴ Although this matter was overshadowed by the COVID-19 pandemic, it requires serious deliberation and clarification going forward. The failure to address these issues will only decrease stakeholder confidence in the Commission, thereby impeding the Commission in the performance of its roles, including its interlocutor role.

4.3 The Knowledge Leadership Role

It is mostly history and politics and not economics that have shaped the development of the fiscal federalism architecture in Nepal. In the early days of the federalism discourse, much of the debate was limited to the number or names of the provinces. There was limited deliberation and attention paid to assessing the fiscal or economic viability of subnational units and so there was very little knowledge creation and debate on what the fiscal ecosystem ought to look like. Moreover, even after the adoption

³⁴ National Natural Resource and Fiscal Commission 'Bittiya Samanikaran Anudan Sabandhama Dhyanakarshan [Notice regarding Financial Equalization Grants]' (2021), available at: <https://bit.ly/3HOfK1V>.

of the 2015 Constitution, the Local Level Restructuring Commission (LLRC) was constrained and unable to consider important fiscal and economic indicators — like revenue potential or ability for economic self-reliance, service delivery spillover, natural resources endowments, access to marketplace, and local economic conditions — as bases when determining how the erstwhile local administrative units would be restructured into the new local governments.

Against this backdrop, the NNRFC's attempt to establish a rules-based framework for intergovernmental fiscal arrangement encounters severe limitations. While the current approach of resource allocation is a clear break from the past where the allocation of resources and programs were used as a lever to maintaining centralized power in Kathmandu, intellectual and informational input is sorely required to implement fiscal and natural resource federalism in a way that the Constitution has imagined. Technically, the approach and methodology that the Commission uses to determine the formula that shapes the vertical and horizontal quantum of fiscal transfer is key. Any arbitrary manipulation in the formula or an approach that unfairly benefits one government or another must be avoided. The Commission cannot make a satisfactory framework for fiscal transfers, for example, without understanding actual expenditure needs and revenue capacity.

These challenges need careful attention, both in terms of technical substance and political viability. In the short term, the NNRFC can meet and overcome these challenges through the engagement of local experts. These experts can bring trust, political and contextual astuteness, and relational skills, which are essential to prepare for and navigate the diverse set of stakeholders and engage in the necessary local interlocution that will lead to a contextually relevant output that incorporates technically sound assessments and is strategically communicated. Moreover, the NNRFC must initiate knowledge leadership to gain institutional credibility through a high level of technical competence. It is worthwhile mentioning that the Public Service Commission (PSC) has, over the years, established itself as perhaps the most trusted and credible constitutional body in the country — something that is credited to its perceived impartiality and technical soundness in what it does — i.e., recruitment of public service personnel. The knowledge leadership role is thus an important way for the NNRFC to establish itself as a credible constitutional body.

5. Afterword

The NNRFC remains the only constitutional commission exclusively entrusted to independently deal with the matter of fiscal and natural resource federalism. To execute this mandate, the NNRFC was constituted as an independent body to neutralize the effect of the centralized design of the fiscal federalism architecture. The NNRFC has both implementing authority as well as rule-setting powers in matters of fiscal and natural resources federalism. Despite this, the Nepali state's centripetal bias, the bureaucratic formation of laws, and organizational structure have severely diluted the constitutional imagination of the NNRFC to the detriment of its independence and efficacy. This has also affected the Commission's capacity to perform its custodian, interlocutor, and knowledge leadership roles for proper implementation of fiscal and natural resource federalism.

In this context, strengthening, empowering, and enabling the NNRFC to assume the role of custodian, interlocutor and knowledge leaders is imperative for proper implementation of fiscal and natural resource federalism, as well as other pillars of federalism — like political and administrative federalism — which are dependent on effective fiscal decentralization. To the Commission's advantage, it has legitimacy by virtue of being an independent constitutional body. Despite this, only a high degree of technical competence will help it gain credibility as it executes its functions and seeks to secure its place in the federal structure. Currently, the role of the Commission is set by de facto practice as much as by de jure legal provision. The role of NNRFC in facilitating intergovernmental relations has not been practiced to its full extent despite constitutional and legal mandates to do so. The Commission further faces challenges in navigating the strong centripetal bias in Nepal's federal design. Irrespective of these challenges, however, there is no alternative but to organically build an institution that conforms to the broad constitutional framework and political culture of federal Nepal.



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