

# Ethnic and fiscal federalism in Nepal

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## 1. Introduction

Multiparty democracy was introduced in Nepal in 1990 after a popular uprising led by the Congress party and the United Left Front, a coalition of communist parties. After the victory of the people's movement in April it was decided to make a new democratic constitution, and throughout the year there was a struggle between the political leaders and the monarchy on the contents, including the powers of the king. The outcome was a compromise between the different political forces, the main elements being multiparty democracy within a constitutional monarchy. For further details on the democratic transition see in particular Hutt (1991), but also Hachhethu (1994) and Whelpton (2005).

Ethnic issues were raised in the process, but never became major issues in the drafting of the new constitution. Still the constitution states that "Nepal is a multi-ethnic, multi-lingual, democratic, independent, indivisible, sovereign, Hindu, Constitutional monarchical kingdom", according to Hutt (1991). Hutt concludes that communal groups had been granted only minor concessions, and the demands of terai (plains) organizations had been largely ignored. These conclusions were drawn already in 1991, but in retrospect his conclusions appear to explain the subsequent political and military developments in Nepal.

Multiparty democracy was established soon after, with the first election taking place in 1991. The new democratic rule gave room for a free press and a thriving civil society, including ethnic based organizations. NEFIN (Nepal Federation of Indigenous Nationalities) has been the main representative of the hill Janajatis (ethnic groups), while the terai ethnic groups and castes have been represented by a regional political party, the Sadbhawana Party, see Gellner (1997) and Lawoti (2005) for discussions of the development of ethnic based politics after the democratic transition. NEFIN has been represented by a Kathmandu-based academic elite, especially Harka Gurung, Om Gurung and Krishna Bhattachan. Bhattachan (1996, 2000 and 2003) has been the strongest proponent of ethnic autonomy and federalism. Bhattachan and co-author Pyakuryal warned already in 1996 that ethnic violence would be the result if the state did not place the "ethnic paradigm" at the center of all state activities. The

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recent ethnic conflicts in terai, as well as the continued demands for autonomy by different ethnic organizations indicate that they were, or became, right<sup>1</sup>.

At the same time the Maoists developed a policy for ethnic autonomy, probably as a strategy for political and military support from different ethnic groups. At their First National Conference in 1995, prior to the civil war that was initiated in 1996, they announced an "Ethnic Policy in Nepal", according to Sharma (2002). This was a 14-point platform, where one issue was "Right to autonomy on regional, district and local level should be given ... where [an] ethnic community has majority". In 2001 they proposed nine autonomous regions according to Sharma: Seti-Mahakali, Bheri-Karnali, Tharuwan, Magarant, Tamuwan, Tamang Saling, Newar, Kirant, and Madhesh, where the names indicate their ethnic base. Tharuwan is the western part of terai, where the Tharus constitute the traditional population. Madhes is the eastern part of terai, which historically has been occupied by castes and ethnic groups that migrated from India, and are termed Madhesi people. The term Madhesi sometimes includes the Tharu people. Regional autonomy based on ethnicity is still the demand of the Maoists after they entered mainstream politics by participating, and winning, the April elections.

To conclude, the democratic revolution in 1990 gave room for ethnic policies in Nepal led by NEFIN representing the ethnic groups of the hills, the regional Sadbhawana party of terai, and the Maoists. As a result of the Maoist insurgency, the second people's movement in 2006, the agreements between the Maoists and the democratic parties, as well as the removal of the monarchy, there is now room ethnic issues that were not incorporated in the 1990 constitution. The newly elected Constituent Assembly will decide on the federal structure of Nepal. This report hopes to give inputs to the discussion, based on experiences from other countries. Section 2 focuses on experiences with ethnic federalism in other countries, while section 3 discusses the problems of fiscal federalism.

## **2. Ethnic based federalism**

### **2.1 General perspectives**

Around the world, ethnicity is one of the most frequently cited sources of instability and conflict within states. Intra-state conflicts between different ethnic groups, or between ethnic minorities and the state, are much more common than inter-state conflicts today. It is therefore crucial to find institutional devices which can ensure democratic participation from the whole spectrum of ethnic groups within a state while and at the same time managing ethnic tension to prevent violent conflict, instability or state disintegration. In search of such devices, federalism has become a popular formula for theorists and policy makers alike. Federalism has been a

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<sup>1</sup> See Hatlebakk (2007) for a socio-economic analysis of the terai conflict.

central issue in the constitutional deliberations after the transition in Nepal, and is in contemporary debates even mentioned as an institutional solution in deeply divided societies such as Iraq and Sri Lanka.

The main reason for federalism's popularity is that it enables the state to combine self-rule with shared rule. A state is defined as federal when its authority and sovereignty is divided between a central level of government and regional units at lower tiers of government. This division of power must be accompanied by shared power, i.e. the regional units should be represented at federal level. Federal systems includes a range of slightly different institutional designs, but a minimum common denominator of federations is that the sovereignty and representation of the regional units are *constitutionally guaranteed* (King 1982).

In Nepal, most proposals for ethnic autonomy come close to what is defined as an ethnic federal system, where the borders between the regional units should match the boundaries of relevant ethnic or linguistic communities. Although support for federalism as a tool of ethnic conflict mitigation is generally strong among political scientists, the idea of ethnic based federalism is highly controversial. In the following, we will therefore present the ongoing debate about ethnic versus purely territorial federations, and thereafter identify the key challenges in two existing ethnic federal systems, Ethiopia and India. The section will point out the relevance of this debate to the current discussions on ethnic federalism in Nepal.

A major argument in favor of ethnically based federations is that the country's ethnic subdivision ensures that the various ethnic groups will form a local majority in one or more of the subunits (Kymlicka 2006). In this way, minorities may feel a sense of security and be enabled to promote own culture and identity. It is assumed that when the demands of self-determination are met and the culture of the groups is assured, the source of inter-ethnic struggles is undermined and instead intra-ethnic competition is likely to occur.

Those who are against ethnic federal subunits would counter the above argument by claiming the exact opposite: When ethnic groups have their own subunits, instability and the pressure for secession are likely to increase. When the group is endowed with resources, legitimacy and an independent power base, people's loyalty will be to the regional subunit rather than to the federation as a whole, thus undermining the existence of the dual loyalty, which is essential to the unity of the state (Fearon and Laitin 1996; Brubaker and Laitin 1998, Duchacek 1987). There is also a practical problem in the creation of ethnically homogenous regions, which is very relevant for Nepal. Ethnic homogeneity is hardly possible in any territory in multi-ethnic states, due to the diversity and mixture of peoples across ethnic boundaries. Therefore, new minorities are likely to be created within the subunits, who are in danger of being victimized, intentionally or not (Adeney 2000). On the other hand, by creating

ethnically heterogeneous subunits it is possible to prevent national minorities from becoming local majorities (Elazar 1987).

It is today a consensus across social sciences that ethnicity is a constructed and not inborn social phenomenon, and that it is frequently mobilized and strategically used in pursuit of power and scarce resources (Barth 1994). When a system is structured along ethnic lines, it is likely that a mobilization of even dormant or non-salient ethnic identities will take place, spurring groups which originally did not see themselves as separate ethnic units into ethnic political mobilization. Ethnically based systems are thus likely to freeze the originally fluid identities, which in turn may lead to sharpened ethnic divides, making life difficult for minorities within the ethnic subunits (Smith 2000).

## **2.2 Experiences from other countries**

Analyses of the real experiences with ethnic federalism, however, tell us that it is not only the *institutional arrangements* (for example ethnic versus non-ethnic federalism) which determine the performance of federal systems, but also the *context* in which these arrangements are implemented. The following brief account of the federal systems of India and Ethiopia illustrates this. India became a federal state as a result of de-colonization, while Ethiopia was turned into a federation after the fall of the military-Marxist government of the Derg in 1991. The two federal states struggle with some degree of instability, both in terms of localized ethnic conflict and secessionist movements. They are facing “sons of the soil” movements questioning the fundamental rights of members of competing ethnic groups and continued claims of further subdivision and separate statehood for new ethnic groups. Separatist movements are operating in Kashmir and the Punjab in India, and partly also in Oromiya in Ethiopia. But the Indian federation is still cited as a successful federal system, and an example of how federalism has contained claims from ethnic groups to secede (Adeney 2000). Ethiopia is probably the only federation in the world which has asserted the universal right of all ethnic groups within its borders the right to govern them selves. In the Ethiopian Constitution of 1995, ethnic groups have the right to self-determination, including the right to secession. However, the Ethiopian system is marked by an overzealous central government, and local ethnic conflicts are rife, particularly in ethnically mixed areas.

In the academic analyses of the Indian federation, three reasons are given for the Indian success. Firstly, in Indian politics there is generally no incompatibility between claiming an ethno-regional and national identity. Thus, it has been possible to maintain an overarching identity in addition to the ethnic one. Secondly, India’s huge diversity, the many crosscutting cleavages within and between subunits and ethnic groups, like religion, language, caste and

tribe, are preventing the cultural and social divisions to cumulatively reinforce each other, allowing for flexibility and shifting alliances both between individuals and groups (Manor 1996).<sup>2</sup> Thirdly, the resilience of the Indian federal system is by many explained by the strength of its parliamentary democracy (Adeney 2000; Sharma 2003; Stern 2003). Regular elections and the spread of democratic ideas has led to increased political activism among the wider population, including marginalized groups (Dalits, other low castes, and Muslims), but has also enhanced the legitimacy of the central government and made it possible to justify a strong centre, securing the unity and efficiency of the federation.

The Ethiopian federation represents in many ways the opposite of the Indian experience. The fundamental principle of the Ethiopian political system since 1991 is loyalty to a separate identity, the ethnic one, as superior to an overall national identity. Ethnically based organisations and parties are consistently favored. Ethiopia's major societal cleavages are partly crosscutting and partly overlapping. But the ethnic divisions seem to absorb most of the controversies along other conflict lines. This means that conflicts between subgroups within the federation are channeled into ethnic lines, thereby "ethnicizing" social and economic cleavages. Ethiopia's introduction to parliamentary democracy in 1991 has not given ethnic groups a real chance of influence. The ruling party is using its access to the state's resources to enhance its position and undermine the opposition, and its centralized party apparatus is intervening in regional affairs, undermining the federal division of power. Needless to say, this creates conflicts, ethnic or other, and the state has no credibility as a neutral broker. The Ethiopian federation seems therefore to lack what India has: the political space for national in addition to ethnic identities, crosscutting cleavages, a functioning democracy, and a legitimately strong central state, all reducing the Ethiopian federation's chances of creating a sustainable accommodation of ethnic diversity.

### **2.3 Implications for Nepal**

One of the lessons that can be drawn from this brief analysis is that there is no clear cut answer to the question whether ethnic federalism by itself promotes or undermines democracy and stability in multi-ethnic states. But the Indian case shows that there is a symbiotic relationship between federalism and democracy: The federal subdivision of the state would probably not have managed to facilitate Indian unity if it had not been a democracy, while the well-functioning democracy is made possible by the empowerment of regional states and minorities in the federation. In contrast to this, the illegitimate centralization of power and the lack of

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<sup>2</sup> The problems of religious communalism and clashes between Muslims and Hindus and the growth of the Hindu-nationalist BJP indicate, however, that there is a ground for mobilisation on religious divides which set aside other unifying or crosscutting identifications.

democracy in Ethiopia are undermining the federal division of power, and the federal subdivision along ethnic lines is exacerbating ethnic conflict. It is thus clear that democracy and federalism must co-exist in order for federalism to have a stabilizing and reconciliatory effect. Nevertheless, when it comes to stability, the experiences of both federations illustrate the intrinsic problems of ethnic federalism: the danger of a never ending process of state demands from more and more ethnic groups. Unless claims for separate statehood are accompanied by a high degree of flexibility from the central government to change sub-federal borders, there is a danger of increased and continued ethnic tension. It also shows that unless ethnic subdivision is supplemented by a strong protection of minority rights, it is likely to lead to increased discrimination of sub-ethnic communities. Based on these conclusions, the Constituent Assembly of Nepal should carefully consider the following recommendations:

- The Constitution should facilitate the consolidation of a deep-rooted and inclusive democracy, involving all segments of society, including various ethnic groups and castes.
- It should enhance a political system which permits the expression of various cleavages in society (class, caste, urban/rural, religion etc), not only the ethnic one. Nationally based, and not only ethnically confined parties, should be allowed and encouraged.
- The constitution should include flexible and transparent procedures for the creation of potentially new federal sub-units.
- It should ensure a strong protection of minority rights and universal individual human rights, by asserting that all citizens within the various federal units, not only the indigenous ones, should have the right to employment and property.
- The Constitution should carefully balance the rights of federal units with those of the central state. A strong and legitimate political centre is a precondition for the rule of law and a genuine protection of the rights of all citizens of Nepal.

### **3. Fiscal federalism**

In this section we first present one possible federal partition of Nepal to illustrate some problematic fiscal implications. We then go on to discuss tax and redistribution systems based on theory and experiences from other countries, in particular India.

#### **3.1 A federal partition based on government revenues**

As much as 81% of government revenues in Nepal were in 2004/05 from the four districts of Kathmandu (42%), Parsa (24%), Morang (8%) and Rupandehi (7%). The three latter (terai) districts contain respectively the cities of Birgunj, Biratnagar and Bhairawa. The industries in these areas generate custom revenues (in particular Parsa), VAT and income tax, which are the

main forms of taxation. The next top revenue collecting districts are Lalitpur (2%), Chitwan (2%), Sindhupalchoc (1%), Jhapa (1%), Dhanusa (1%), Banke (1%), Makwanpur (1%), and Kaski (1%), with the four latter containing the cities of Nepalgunj, Janakpur, Hetauda and Pokara. In total these 12 districts contributed 94% of all government revenue. The remaining 63 districts contributed only 6% of the revenue. Irrespective of the ultimate partition into federal states, Nepal will face a challenge in redistributing government revenues from the few wealthy districts to the majority of poor districts.

Let us illustrate the challenge by presenting one possible partition. For alternative proposals see Rimal (2007), who also presents details on the ethnic composition of the districts as well as some of the proposed federal states. We find it reasonable to base a state around each of the four major income-generating centers of Kathmandu, Birgunj, Biratnagar and Bhairawa. The first (Tamang-Newar) state may cover the hill-mountain districts of the present central region, which includes Kathmandu, Lalitpur and Sindhupalchoc. The second (Madhes) state may cover the Madhes region from Hetauda to Saptari, and includes Janakpur. The third (Kochila) state may cover Sunsari, Morang and Jhapa. The fourth (Tharuwan) state may cover the western terai from Chitwan to Kanchanpur, and includes Nepalgunj. Note that the western terai state suggested here covers a large geographical area, and it might be an alternative to make a separate state with Nepalgunj as the headquarter, but we have to keep in mind that Nepalgunj contributes with only 1% of the government revenue, which implies that this state will be relatively poor.

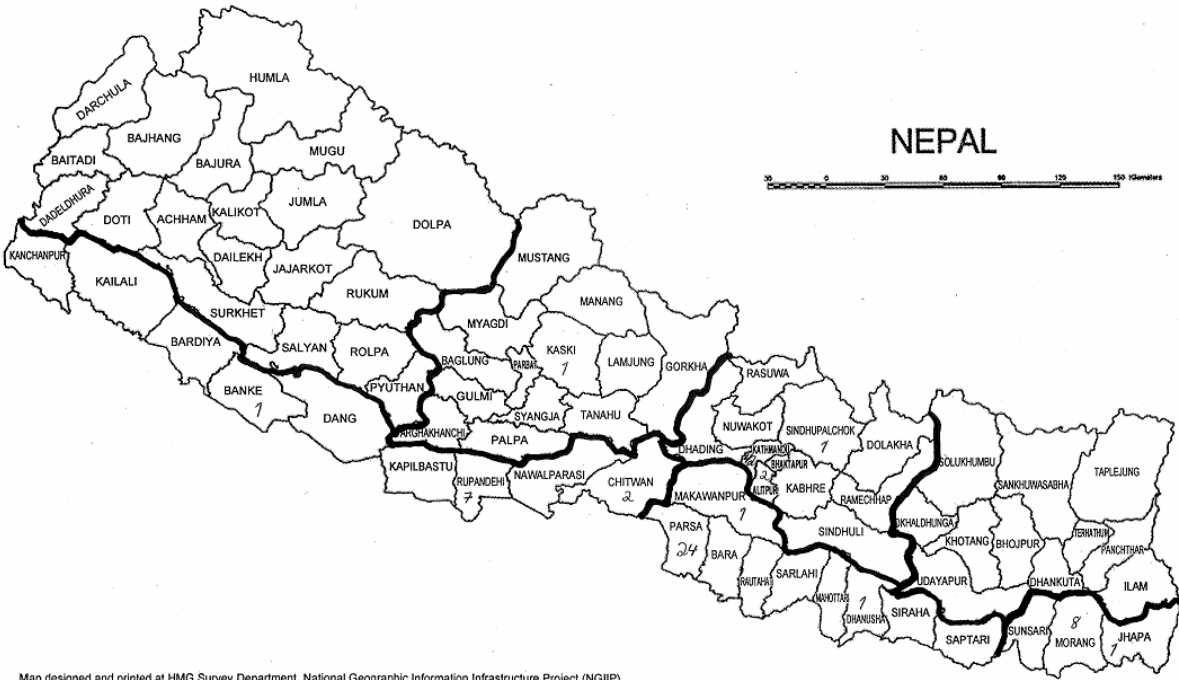


Figure 1. A partition of Nepal into federal states, based on government revenue

Among the 12 top revenue districts only Kaski is left, and it seems reasonable to form a fifth state with Pokara as the headquarter covering the hill-mountain districts of the western region. We are now left with the eastern hill-mountains that may become the sixth (Kirat) state, and the mid-western and far-western hill-mountain districts that may become the seventh (Mahakali-Karnali) state. Both these hill states will have practically no government revenues. The states suggested here, as well as the 12 revenue generating districts with their contributions to the government revenues, are depicted in Figure 1.

The problem with the proposal presented here, which applies to most proposals, is that the eastern hill state, and in particular the western hill state will be very poor. And if the western terai is split with an additional headquarter in Nepalgunj, this state will be poor as well. Now we believe that Nepalgunj has a potential for industrial development, so a pro-active government may decide to create a separate state in the west consisting of the five western-most (Tharu) districts. But still we are left with the poor hill states. The hope of the political leaders may be that that these states will develop the hydro-power sector. However, government revenues from existing power-plants are limited, and we cannot see that this sector will solve the financial situation of these hill states. The most obvious solution will be to link the hill districts with the adjoining terai districts as in the present regions. However, this appears not to be a feasible solution in the present political climate.

### **3.2 Reallocation between states**

The need for redistribution of government revenues, and thus the risk of political conflict, will depend on the actual partition of the country into federal states. As described, most proposals end up with poor states in the eastern and western hills, and potentially a poor state in the western terai. As a consequence, redistribution between, and within, states will be necessary. Nepalgunj, and surrounding districts, will need funding from either the central government in Kathmandu, or from a state-government in Bhairawa or Birgunj. Similarly, the poor hill districts will need funding from either the central government in Kathmandu, or from the state government, which in turn will need funding from Kathmandu.

A federal state will meet many of the same problems of taxation and redistribution as a unitary state. Additional specific problems and potential benefits may arise from the federal structure itself, see Bardhan (2004) and Singh (2007). In general, a federal structure is beneficial if local conditions vary from one region to another. As local needs vary the local government may be in a better position to implement necessary policies. However, as Bardhan points out, this requires that the local government actually pursue the interests of the local population, and not the local elite.



Another potential problem is that local governments may decide on very different tax- and redistribution schemes. In India they have even taxed inter-state trade, which implies that each state will produce less of the goods and services for which they have comparative advantages. In the Nepali context this would mean that hill districts may have to pay tax on rice imported from the terai. Similarly, the federal states may decide on different tax rates between states, and between commodities and services within states. In both cases people may adjust to these tax differences by moving economic activities to other states, or between sectors within states. This means that the states may compete on tax rates, and it means that the tax-structure may lead to inefficient production of goods and services. There are many examples of this from India, where the federal fiscal system is being reformed, see Singh (2007).

Nepal should attempt to avoid the mistakes done in India. The tax-system should be as simple, and broad, as possible. Most economic activities should contribute to the government's provision of public goods, and tax rates should as a general rule be uniform across sectors and states. As taxes are collected at the local level, it is wise to let the local government keep a share of the taxes to give incentives to create a broad tax base, and to effectively collect taxes. In addition, there is need for a simple redistribution scheme, where the poorer states get additional funding from the centre. There will also be need for a redistribution scheme within states, where the poorer districts receive funding from the state government. Finally, it is essential that the local bureaucracy and politicians are accountable to the voters. This would mean regular local elections, and the authority by the central government to legally intervene whenever the local government misuses its powers.

#### **4. Conclusions**

The new constitution should facilitate a deep-rooted and inclusive democracy where all minorities are protected. Irrespective of the final partition, there will be a number of ethnic minorities within all federal states. A thriving and inclusive local democracy is necessary to secure the interests of all local peoples and not only the local elites. Furthermore, the constitution should secure the interests of groups defined along non-ethnic cleavages such as class, caste, urban/rural and religion. To the extent possible each federal state should include an economic center. This is hard to implement given the regional economic structure of Nepal, and a relatively strong national government is necessary to redistribute financial resources to the poorer states in the eastern, and in particular, the western hills, and possibly also the western terai. The national government should also unify the tax- and redistribution system to avoid tax competition and inefficient adjustments to the fiscal system.

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