

Intergovernmental Fiscal Transfers System in Global and Nepalese Context

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LETTER OF RECOMMENDATION

This thesis entitled “**INTERGOVERNMENTAL FISCAL TRANSFER SYSTEM IN GLOBAL AND NEPALESE CONTEXT**” has been prepared by Jayanti Sharma under my supervision. I hereby recommended this thesis for examination by the Thesis Committee as a partial fulfillment of the requirements for the Degree of Master of Arts in Economics.

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APPROVAL LETTER

We certify that this thesis entitled **“INTERGOVERNMENTAL FISCAL TRANSFER SYSTEM IN GLOBAL AND NEPALESE CONTEXT”** submitted by Jayanti Sharma to the Central Department of Economics, Faculty of Humanities and Social Sciences, Tribhuvan University, in partial fulfillment of the requirements for the Degree of MASTER OF ARTS in ECONOMICS has been found satisfactory in scope and quality. Therefore, we accept this thesis as a part of the said degree.

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LIST OF ABBREVIATIONS

AFC	Average Fiscal Capacity
CA	Constituent Assembly
CLGF	Commonwealth Local Government Forum
DDC _s	District Development committees
EFC	Effective Fiscal Capacity
FFC	Federal Finance Commission
GST	Goods and Service Tax
HDI	Human Development Index
IGFR	Intergovernmental Fiscal Relation
IGFT	Intergovernmental Fiscal Transfer
LB	Local Bodies
LBFC	Local Bodies Fiscal Commission
LGFC	Local Government Financial Commission
LSGA	Local Self Governance Act
MCPM	Minimum Condition and Performance Measures
MoF	Ministry of Finance
MOLD	Ministry of Local Development
NRB	Nepal Rastra Bank
OLS	Ordinary Least Square
SFCLB	Secretary of Fiscal Commission and Local Bodies
SNG	Sub National Government
SPC	State Planning Commission
UNCDF	United Nations Capital Development Fund
VAT	Value Added Tax
VDC _s	Village Development Committees

Chapter I: INTRODUCTION

1.1 Background of the Study

A growing number of countries have adopted fiscal federalism in an effort to improve the performance of their public sector. The underlying theme of the reforms is restructuring the public sector and improving its efficiency. In the context of fiscal policy, the reforms entailed decisions in identifying the optimal distribution of functions and powers between the federal and sub-national governments. This process introduces specialization of functions and changing the very relationship between the government and the citizen-voters in important ways. Understanding federalism as a larger concept will help facilitate the understanding of fiscal federalism. This is because federalism is the operational context within which fiscal federalism is situated. Federalism refers to a political system where there are at least two levels of government. In such cases, there is the juxtaposition of two levels of power of a central government otherwise called the federal government and other states labeled variously as states, regions, republics, cantons or unions (Moges, 2003).

Federalism is derived from the Latin word “foedus” meaning covenant. It is a political concept in which a group of members are bound together by covenant with a governing representative head. The term is also used to describe a system of the government in which sovereignty is constitutionally divided between a central governing authority and constitutional political units (like states or provinces). Federalism is a system in which the power to govern is shared between national state governments, creating what is often called a federation (Akindele&Olaopa, 2002). It is a political theory that is divergent in concept, varied in ecology and dynamic in practice. It has to do with how power is distributed or shared territorially and functionally among the various units in a federation. Federalism is a system in which the lower levels of government are represented in the central government and its institutions. Pursuing the federal structure involves both decentralization of decision-making power and representation of regional units at the national level. This process influences the allocation and distribution of economic resources across regions and economic agents.

Fiscal federalism derives its nature and characteristics from constitutional provisions as well as the state of economic development, the pattern of income and resource distribution, and the institutional capacity of the system. The constitutional provisions define the framework within which decision-making would be exercised and establishes the vertical and horizontal structures that find meaning within the prevailing socio-economic environment of the system. The vertical structure defines the assignment of fiscal decision-making power between the federal and lower tiers of government. The horizontal structure outlines the nature of interaction across cross-sections of government levels. This aspect addresses how regional governments interact to each other especially when there are externalities and spillovers.

The theory of fiscal federalism addresses three issues related to fiscal decision-making: assignment of responsibilities and functions between the federal government and the regional governments, the assignment of taxation power and the design of inter-governmental transfer (subsidy) of fiscal resources coupled with provisions about the borrowing windows to sub-national governments. These factors give rise to a third issue of the relative size of the public sector in the national economy. It is therefore the dynamics of these processes and public policy choices that ultimately shapes the performance of the fiscal sector and its impact on the national economy.

An important aspect of the exercise of fiscal federalism is the assignment of fiscal functions to the federal and the sub-national governments and the appropriate means of financing these responsibilities. The theory of fiscal federalism does not provide a clear-cut separation of fiscal responsibilities that would promote economic efficiency and resource distribution. The broad thrust of normative theory is that expenditure responsibilities in areas of macroeconomic stabilization and redistribution functions should remain within the domain of the federal government whereas allocation functions should be assigned to lower levels of government (Oates, 1999; Shah, 1999; Musgrave, 1983). The argument is based on the reasoning that lower levels of government have limited capacity and policy instruments to provide stabilization and redistribution functions. Due to the nature of the responsibilities, the federal government usually assumes macroeconomic stabilization and income redistribution functions and make sure that regional governments would not take measures that are not compatible with such functions. Moreover, there are functions such as national

defense and foreign affairs that have national public good character and hence usually assigned to the central government.

INTER-GOVERNMENTAL FISCAL TRANSFER

A financial transfer from a central authority to a subsidiary in a federal system or to a member of a fiscal transfer union among member governments of an economic community is known as fiscal transfer.

Inter-governmental fiscal transfer means transfers of funds from one level of government to another. Intergovernmental fiscal transfers are a dominant feature of sub-national finance in most countries. They are used to ensure that revenues roughly match the expenditure needs of various levels of sub-national governments. They are also used to advance national, regional and local objectives, such as fairness and equity, and to create a common economic union. The structure of these transfers creates incentive for sub-national, regional and local governments that affect fiscal management, macroeconomic stability, distributional equity, allocational efficiency, and public service delivery.

The logic of centralizing revenue collection is generally stronger than that of centralizing expenditure responsibilities all over the world. The share of social sector expenditure in total spending is very high in modern welfare states and these responsibilities are usually heavily borne by constituent unit governments with some federal assistance. In this background, virtually every country faces the problem of fundamental imbalance between expenditures and revenue. Therefore, the need for intergovernmental fiscal transfers arises to close the budgetary gap. No simple and uniform pattern of transfers will be suitable for all circumstances. (Prasad, 2016)

There are two types of intergovernmental fiscal transfer:

1. Conditional grants: conditional grants are sometimes called specific purpose grants. The central government specifies the purposes for which the recipient government can use the funds. Such a grant is often used to address concerns that are highly important to the centre but are considered less so by the sub-

national governments. Examples are projects with inter-regional spill-over effects. Within conditional grants, there are several types:

- a) **Matching Open-Ended Grants:** For a unit of money given by the donor to support a particular activity, a certain sum must be expended by the recipient. For example, a grant might indicate that whenever a local government spends a dollar on education, the central government will contribute a dollar (or fifty cents) as well. With an open-ended matching grant, the cost to the donor ultimately depends upon the recipient's behavior. If the local government's expenditure is vigorously stimulated by the program, then the central government's contributions will be quite large and vice versa.
 - b) **Matching Closed-Ended Grants:** To put a ceiling on the cost borne by the central government, the Centre may specify some maximum amount that it will contribute. This is called a closed-ended matching grant. This mechanism is used by most countries due to concerns of budget control. In some countries, the total sum of matching grants is limited by the government selection mechanism.
 - c) **Non-Matching Grants:** In this case, the central government offers a fixed sum of money with the stipulation that it be spent on a specified public good. The recipient government is not required to match the contribution of the central government.
2. **Unconditional Grants:** An unconditional grant places no restrictions on the use of funds. In effect, it is a lump-sum grant to the recipient government. The main justification for central government to give unconditional grants to states/provinces and localities is that such grants can be used to equalize fiscal capacities of different local governments to ensure the provision of minimum (or reasonable) level of public services. In most countries, the equalization grants are transfer made from central government to sub national government (e.g., Canada, Australia, Japan, Korea etc.), while in Germany, the equalization transfer is made from states with above-average fiscal capacities to states with below-average fiscal capacities. In other countries, unconditional equalization grants take the form of a general revenue- sharing.

Fiscal transfer based on discretionary or negotiations are undesirable. The formula-based distribution is regarded as a sound transfer system. Formulas should not be too complex and desired degree of inter-jurisdictional equalization can be built into such a formula (Bird, 2002).

Nepal is practicing a unitary form of government since a long period of time. This system hasn't been able to achieve the aimed objectives and rapid development in the country. It has been unable to address the will and aspiration of the Nepalese people. Nepal is a hub culture society. People of various languages, ethnic groups, cultures, and traditions are the resident of Nepal. Their practices, traditions, cultures and languages are in the verge of extinction. So, federalism has been felt the only solution for their preservation and protections. The Constituent Assembly (CA) in its very first meeting held on May 20, 2008 formally declared Nepal a Federal Democratic Republic. In conformity to this declaration, the Interim Constitution was duly amended and elections have been held for the positions of the president and vice-president. Unlike declaring the country, a republic, the federal state structure cannot be formed by mere agitation and declaration. The first Constitutional Assembly (CA) became unable to declare Nepal as a federal state with new constitution.

Second CA became success to bring new constitution and declare Nepal as a federal state having seven provinces on 20 September 2015. As of 20 September 2015 Nepal is divided into 7 provinces. They are defined by schedule 4 of the new constitution by grouping together the existing districts. Two districts however are split in two parts ending up in two different provinces. In addition, the government currently shares five types of revenue with the DDCs. In FY 2013/14, DDCs received NRs. 1.66 billion from the government. The headings of revenue sharing are: land registration fees, mining, forest, hydropower and mountaineering. As per the new constitution, land registration fees will be shared with the provinces and local governments (Village Municipality and Urban Municipality). However, the rest of the revenue will be shared with all the three governments (central, provisional and local). In FY 2014/15, the government collected NRs. 356 billion revenues from different headings such as customs duty, value added tax, corporate income tax, personal income tax etc.

1.2 Statement of the Problem

In the context of Nepal, the motivation for adopting federal system of governance comes from both relatively slow growing economy where opportunities do not expand fast enough and the feeling of exclusion from various groups. It is hoped that adoption of federal governance will help to accelerate the pace of economic growth to expand the opportunities. It is necessary to underline the fact that calibrating policies and creating institutions to accelerate the inclusive development of the economy must complement the creation of federal governance system for the stability and sustainability of the federation. This study focuses on some vital problems for their scientific answers. Some appropriate questions for the problems have been listed as follows.

- How Inter-Governmental Fiscal Transfer System (IGFT) is practice in global context?
- How inter-Governmental Fiscal Transfer System in practice in Nepal?
- What is the scenario of income and expenditure of Local bodies in Nepal?

1.3 Objectives of the Study

The general objective of this study is to study the intergovernmental fiscal transfer system.

-) To study Inter-Governmental Fiscal Transfer System (IGFT) in global context.
-) To study intergovernmental fiscal transfer system in Nepal.

1.4 Significance of the Study

The rationale behind this study is to make knowledge and provide general information about the intergovernmental fiscal transfer system. This study may be significant to concerned individuals for their respective study, writing, publication, policy making etc. From this study it is hoped that the reader will get adequate and authentic information about the structure of IGFT.

1.5 Limitations of the Study

This study has some limitations as which are listed below:

-) The research or study is based on secondary data.
-) This study may not reveal the exact fiscal condition. As it is based on data from old decentralized fiscal system.
-) Due to lack of time and resources, there may be some lacking in the research report.
-) There may be technical errors while doing calculations related to research.
-) The research is for academic purpose.

1.6 Organization of the Study

The study has been divided into six chapters:

Chapter 1: Introduction

This chapter contains background of study, statement of problem, objectives of study, significance of the study, limitation of the study, and organization of the study itself.

Chapter 2: Review of Literature

This chapter consists of theoretical and empirical literature reviews on related topic.

Chapter 3: Research Methodology

It includes selection of the geographical region for the study, research design, nature and sources of data, data collection methodology, and tools and techniques.

Chapter 4: Intergovernmental Fiscal Transfer System in Global Context

It includes analysis of IGFT in global context.

Chapter 5: Intergovernmental Fiscal Transfer System in Nepal

It includes analysis of IGFT in Nepalese context.

Chapter 6: Conclusion and Recommendations

This chapter consists of summary of the study, conclusion of findings and recommendations of the study.

Chapter II: REVIEW OF LITERATURE

2.1 Theoretical Review

Intergovernmental transfers are the dominant source of revenues for sub national governments in most developing countries. The design of these transfers is of critical importance for efficiency and equity of local service provision and fiscal health of sub national governments (Litvack, 1998).

2.1.1 Federalism

Federalism is a political organization system which pursues the purpose to connect the existence and independence of the majority of political unities with a synthesis of these unities to a higher unity. As a result, federalism is the freedom of narrower territorial and personal communities within the scope of a whole. Federalism serves the creation of unity in diversity; it operates towards an integration of what is different in the common. Federalism allows a solution of national conflicts in countries with a multinational structure. Via federalism, the subsidiarity principle is realized most clearly in the area of allocation of competences.

The fundamental aims of federalism are:

-) Safeguarding of diversity and different identities,
-) Protection of specific features of every minority community,
-) Protection of the individuality of every nation, the federal state or the region.

2.1.2 Fiscal Federalism

The basic foundations for the initial theory of Fiscal Federalism were laid by Kenneth Arrow, Richard Musgrave and Paul Samuelson. Samuelson's two important papers (1954, 1955) on the theory of public goods, Arrows discourse (1970) on the roles of the public and private sectors and Musgrave's book (1959) on public finance provided the framework for what became accepted as the proper role of the state in the economy. The theory was later to be known as "Decentralisation Theorem" (Ozo-Eson, 2005). This framework identifies three roles for the government sector. These are correcting various dimensions of market failure, maintaining macroeconomic stability, and redressing income inequality. The central government is responsible for

the correction of market failure and maintenance of macroeconomic stability, while the sub national governments and the central government are jointly responsible for redressing income inequality (Ozon-Eson, 2005). Each tier of government is seen as seeking to maximize the social welfare of the citizens within its jurisdiction. This multi-layered quest becomes very important where public goods exist, the consumption of which is not national in character, but localized.

Oates (2008) has said - “The political theories make out the case for federalism on the basis of freedom and representation, safeguarding group identities and ensuring security and stability through bargains. On the other hand, economic theories of federalism focus on creating multilevel public sector governance systems to improve efficiency. The traditional approach or what has come to be known as the first generation theories of economic federalism implicitly assume that governments are “benevolent” and are “custodians of public interest” and they seek to maximize social welfare and therefore, are responsive to the preferences of the people, The new approaches to fiscal federalism or the second generation theories consider the assumption of benevolent governments unrealistic and take that agents within the governments (bureaucrats and politicians) have their own objective functions operating within the constellation of incentives and constraints depending on the given fiscal and political institutions. They model the inter-governmental behavior in terms of principal-agent relationship, underline the importance of hard budget constraints and focus on the importance of competition – both vertically between different levels of government and horizontally among different units within the same level to enhance efficiency in the delivery of public services.

This principle, which Oates (1972) has formalized into the “Decentralization Theorem” constitutes the basic foundation for what may be referred to as the first generation theory of fiscal decentralization (Oates, 2006; Bird, 2009). The theory focuses on situations where different levels of government provide efficient levels of outputs of public goods “for those goods whose special patterns of benefits are encompassed by the geographical scope of their jurisdictions” (Oates, 2006). Such situation came to be known as “perfect mapping” or “fiscal equivalence” (Ma, 1995; Olson, 1996). Based on the preceding, the role of government in maximizing social welfare through public goods provision is assigned to the lower tiers of government.

The other two roles of income distribution and stabilization are regarded as suitable for the central government.

Four Pillars of Fiscal Federalism

Boex has said “There are four pillars of fiscal federalism. They are a) expenditure responsibilities, b) revenue assignments, c) intergovernmental fiscal transfer, d) Sub-national borrowing”.

A. Expenditure responsibilities

There is no one best way for deciding which level of government should be responsible for the provision of particular government services. The adequacy of any assignment has to be judged in terms of how well it achieves the goals or objectives set up by the central government in its decentralization strategy. Commonly accepted objectives of fiscal decentralization include an efficient allocation of resources via a responsive and accountable government, an equitable provision of services to citizens in different jurisdictions, and macroeconomic stability and economic growth. The activities of government should be separated into three sectors such as macroeconomic stabilization, income distribution and resource allocation (Vazquez et al., 2006). Macroeconomic stabilization can be obtained through high employment and price stability, which is possible, only by central government. It is because sub-national governments have no power to print money and often have limited power to borrow money and there is no much effect on microeconomic stability by sub-national governments due to their limited jurisdictions. Moreover, the distribution system means the equitable distribution of income. These functions are also theoretically assigned to the central government, because it is difficult to manage by sub-national governments and are likely to distort the geographical allocations of economic resources.

Under the federal system, a significant legislative authority is provided to the lower levels of governments. Decentralized expenditure responsibilities to the different levels-federal, state and local of the government is one of the major tasks of fiscal federalism. It is concerned with which expenditure responsibilities should be assigned to each level of government and which should be shared between different levels?

The expenditure assignments are the base of fiscal decentralization. It is the first step in designing an inter-governmental fiscal system. Without role and responsibility, there is no need of revenue. The functions should be assigned on the basis of principle of efficiency. Revenue assignment without solid expenditure assignment would weaken the decentralization process. Therefore, expenditure assignment is the first step in designing an intergovernmental fiscal system (Martinez, 1994).

B. Revenue assignments

The two main issues of fiscal federalism are tax assignment and revenue sharing. We shall assume that the allocation of resources between the two sectors has been concluded and that the concern is with how to raise a given sum of revenue and shared the proceeds between the various tiers of government. An important question the study seeks to address from the onset is whether revenue generation should be centralized or decentralized? For convenience, let us assume that all revenues are generated from taxes. There are three distinct options here, namely, to collect all taxes centrally; to allow sub national governments to collect the taxes; or to assign taxing powers to each and every tier of government (Tanzi, 1995; Taiwo, 1999).

Central collection of taxes tends to be consistent with the pursuit of the distribution and stabilization functions of government, and also the provision of national public goods, all of which are assigned to the central government. This system is also likely to generate economies of scale in tax administration and prevent revenue loss due to the mobility of taxpayers from one locality to another if such taxes were collected locally. The system is also desirable when considerable weight is attached to tax uniformity across jurisdictions. On the other hand, a decentralized system of tax collection would be more likely to make spending decisions at the grass root level more compatible with available resources. It could, therefore, promote accountability and responsibility as well as the efficient provision of local public goods. This system can also encourage fiscal autonomy and tax competition among localities. Tax assignment considers the levels of government that should tax what and how, thereby providing various levels of government with revenue they can control. It has four main attributes, namely, power to legislate and set rates, fiscal authority over tax bases, the administration of the tax, and the right to revenue collected (McClure, 1995; Vincent, 2001).

For fiscal federalism to succeed there must be fiscal authority over changing the tax bases allocated the different tiers of government. In practice, however, limited autonomy is given to the lower tiers of government in this area so that a uniform rate of taxation can be maintained across the country (Vincent, 2001; Aigbokhan, 1999). As a guide, equity (consistency of revenue means with expenditure needs) and efficiency (minimizing resources cost) criteria suggest that the following principles be used for the assignment of tax bases.

-) Progressive and redistributive taxes should be centralized, such as personal income tax and corporate income tax;
-) Taxes suitable for economic stabilization, such as import duties, should also be centralized;
-) Taxes on mobile factors of production such as gains taxes should be centralized;
-) Residence-based taxes, such as sales/excise and retail taxes are best suited for states;
-) Benefit taxes/user charges are usually assigned to the level of government that provides the services such as toll gate levies, hospital and education fees, and motor licenses;
-) Taxes on immobile factors of production, such as land and buildings (property taxes) are assigned to local governments;
-) Taxes on natural resources should be assigned to the central government, for the sake of administrative efficiency and uniform practice since the major projects in the field often involve big transnational corporations.

In order to improve the financial base of local government, it is required to increase revenue which includes both taxes and innovative ways to mobilize local assets and community resources. It requires strengthened financial management and accountability systems in local governments. This includes robust, independent regulatory bodies and strengthening of downward accountability which will promote transparency and combat corruption (CLGF, 2009). Moreover, the vertical fiscal gap and vertical fiscal imbalance is arisen if there are inappropriate assignment of

responsibilities, centralizing of taxing powers, pursuit of beggar-thy-neighbor (wasteful tax competition), and lack of tax room at sub national levels due to heavier tax burden imposed by the central government (Shah, 2006).

Table 2.1 Conceptual basis of expenditure assignments

Expenditure category	Service responsibility	Provision of service	Comments
Defense	F	F	Benefits/costs are national
Foreign affairs	F	F	Benefits/costs are national
International trade	F	F	Benefits/costs are national
Environment	F	F	Benefits/costs are national
Banking and currency	F	F	Benefits/costs are national
Internal commerce	F	F	Benefits/costs are national
Immigration	F	F	Benefits/costs are national
Airways/ railways	F	F	Benefits/costs are national
Industry and agriculture	F,S,L	S,L	Significant interstate spillover
Education	F,S,L	S,L	Transfers in kind
Health	F,S,L	S,L	Transfers in kind
Social welfare	F,S,L	S,L	Transfers in kind
Police	S,L	S,L	Primary local benefits
Highways	F,S,L	S,L	Some roads have interstate spillover, others are primarily local
Natural resources	F,S,L	S,L	Promotes a common interest
Notes: F= Federal, S=State, L= Local			
Source: Adapted from Anwar Shah, 1994			

Table 2.2 Conceptual basis of tax assignments

Tax type	Determination of		Collection and administration	Comments
	Base	Rate		
Customs	F	F	F	International trade taxes
Corporate income	F	F	F	Mobile factor
Resources taxes	F	F	F	Unequally distributed
Personal income	F	F,S,L	F	Redistribution, mobility, stabilization
Wealth taxes	F	F,S	F	Redistributive
Payroll	F,S	F,S	F,S	Social program
Value added tax	F	F	F,S	Admin. Costs stabilization
Sales tax	S	S,L	S,L	Higher compliance costs
“sin” taxes alcohol, tobacco	F,S	F,S	F,S	Health care shared responsibility
Gambling, lotteries	S,L	S,L	S,L	State and local responsibility
Motor fuels effluent charges	F,S,L	F,S,L	F,S,L	Tolls on road use/ by extent of pollution
Congestion toll	F,S,L	F,S,L	F,S,L	Tolls on road use
Parking fees	L	L	L	Local congestion
Business tax	S	S	S	Benefit tax
Excises	S	S	S	Immobile base
Poverty	S	L	L	Benefit tax, immobile
Land	S	L	L	Benefit tax immobile
Betterment	S,L	L	L	Cost recovery
Poll tax	S,L	S,L	S,L	Non distorting
Source: Adapted from Boadway, Roberts and Shah, 1994				

C. Intergovernmental Fiscal Transfer System

Shrivastava (2002) has said “Inter-governmental fiscal transfer is the third pillar of fiscal decentralization. It has many names such as grants, subsidies, subventions etc. The inter-governmental fiscal transfers are important tool of public sector finance in both industrial and developing countries in three major reasons. First, the central government will have opportunity to raise more revenue and maintain good relationship with the sub-national governments and on the other hand, sub-national governments will have advantages to deliver quality services as required by the people in transparent and efficient manner. Second, in most cases, there are considerable differences in revenue-raising capacity between sub-national governments. If they were fully autonomous to mobilize revenue and solely depend on their own revenue, richer jurisdiction would be capable to spend 26 more on public service as compare to the lower income jurisdiction. This kind of situation has both equity and efficiency implications in service delivery process of sub-national government. Therefore, in order to support lower income jurisdictions, central government makes fiscal transfer to bridge the gap of resources to support local economic development. Third, resource transferred from central to sub-national level helps to address the national priorities areas such as health, education, sanitation, drinking water etc. through the initiation of sub-national government. It is more helpful to promote equity and efficiency of sub-national governments and be supportive for poverty reduction agendas at grass root level”.

The way of intergovernmental fiscal system organization varies from country to country. These differences partly reflect historical and geographical characteristics of each country, the degree of heterogeneity of the population and the extent of government intervention in the economy. Given the diversity, how questions of inter-governmental structures and functions are resolved in practice will often differ from country to country (Bird, 1990). Although the diversity complicates broad generalization, reference to the experiences of other countries is often the only guide available. Despite its limitations, such experience may provide useful lessons in assessing the potential strengths and weakness of intergovernmental fiscal systems in any country (Bird & Vaillancourt, 1998).

There are four questions that must be answered with respect to intergovernmental functions and finance in any country:

1. What does what? This questions is about assignment of functions between levels of government
2. Who levies what taxes? This questions is about revenue assignment
3. How to resolve the imbalances between revenue and expenditure of sub-national governments? This question has to do with vertical imbalances between levels of government.
4. How to adjust for the differences in capacities and needs among different governmental units at the same level of government? This question is about horizontal imbalance or equalization.

Fernando (2010) says the “piggybacking” approach may be appropriate to the tax sharing to sub-national governments. From the theoretical point of view, the asymmetric decentralization relates to a transfer of different “dosages” of fiscal powers, authority and responsibility in different local governments taking into consideration the conditions and requirement for each particular country and local development. There are inherent tradeoff between central government control and local flexibility.

Types of Intergovernmental Transfer System

A number of alternative types of transfer that could be considered for the design of a system of intergovernmental transfers include:

-) Revenue sharing: local governments could be allowed to keep a percentage of certain national revenues collected within their territories, such as the personal income tax. These revenues can be distributed on “derivation basis” (i.e., they stay in the jurisdiction where they are collected) or else they can be distributed on a per capita basis or other criteria or even formulas. Because revenue sharing does not give local governments discretion over either the tax rate or base, revenue sharing is considered a type of intergovernmental transfer.
-) General purpose (unconditional) block grant: a general purpose or unconditional block grant is a grant allocated on an annual basis that has no

strings attached. A formula is often used to allocate unconditional block grants among local governments. Due to the unconditional nature of this grant type, it provides local governments with a substantial amount of policy discretion. Grants issued for equalization purposes are most often general purpose unconditional grants.

-) Conditional grants: the name of this grants already suggests that conditions are imposed (by the central government) on the use of this grant. Conditions can vary greatly from case to case. A sectoral block grant (also called categorical grants) is a conditional block grant that comes with the condition that the funds must be spent on a specific sector (for example, education); however, local governments maintain full control over how to spend the funds within each sector. However conditional grants may be justified in order to promote national policy priorities or to prevent suboptimal funding of particular local government activities.
-) Matching grants: matching grants are conditional grants which require a specific contribution by the local government in a particular expenditure area. For example, the central government may provide a matching grant of one dollar for every dollar that a local government spends on schoolbooks from its own revenue sources (or general allocation transfers). Matching grants can be designed in a variety of ways and for a variety of purposes. Matching grants can be defined for very specific purposes or for broader purposes; the rate with which the central government matches local government contributions can be increased or decreased depending on the central government's desire to stimulate spending in a particular policy area; and matching grants can be open-ended or capped at a maximum for each local government.
-) Cost reimbursement: the central government could implement a grant scheme in which it fully or partially reimburse local government for certain approved cost. Again, this mechanism restricts the discretion of local governments and should be used with great caution. However, reimbursement schemes are recommended when a central government relies on local governments to implement central government policies (i.e., to fund tasks that fall outside the

realm of functions to be devolved to local governments as part of the decentralization program).

- J) Ad hoc or ex-post grants: in some cases, the distribution of grant program is left to their discretion of an agency within the executive branch, such as the office of the president or the ministry of finance or in some cases to the discretion of parliament. Ad hoc disbursement gives the public officials an opportunity to “buys” favors and provides politicians an opportunity to wield their influence to the benefit of their constituents. This practice hardly ever results in an allocation of resources in accordance with the principles of sound fiscal management. Another relatively common practice, with similar inefficient results, is for the Ministry of Finance to forgive subnational governments budget loans that were incurred during the year, essentially turning budget loans into ex-post transfers.

The design of intergovernmental fiscal transfers: types and mechanisms

Any mechanisms intended to transfer funds from one government to a set of others will entail three policy choices:

1. How to determine the total amount of resources to be distributed?
2. How to allocate that resource pool across all eligible sub national governments and?
3. If and how to restrict the way the transfer funds can be used?

Appropriate design of a transfer system should consider each of these design features systematically. While each of these features is discussed below, the transfer instruments chosen, in fact, reflect all of them simultaneously.

1. Determination of the transfer pool

The size of the transfer pool can be determined in three basic ways. First, pools based on a predefined portion of national revenues in the current or recent fiscal year can provide an increased degree of certainty to sub-national authorities that they will, in fact, receive the transfers. This approach can also ensure a growing source of revenues for sub-national government if the pool is tied to buoyant revenue sources

such as income tax. The potential downside is that, by inflexibly dedicating a proportion of national revenues to sub-national governments, the center will lose some control over macroeconomic fiscal policy. Whether this proves to be a problem depends on the volume of resources being committed to sub-national governments relative to the overall size of the national budget and how sub-national governments use the resources.

Second, aggregate transfer allocations may be linked depending on the spending plans of sub-national governments. The overall level of grant financing for approved projects can be determined on the basis of the size of those projects planned for by the sub-national governments. Alternatively, the allocation may be intended to provide transfers of a certain allowable amount to eligible individual recipients of particular types of programs such as social welfare. These transfer pool can either be closed-or open-ended. Closed-ended pools set aside a maximum amount of funds available for distribution, and not all the needs to be distributed if an insufficient number of approved plans are submitted. Open ended pools are determined on the basis of all approved spending and can potentially be unlimited. Such a design feature can be risky for a central government trying to keep its overall spending level under control and balancing a variety of competing demands for funds. This helps to explain why they are much less common in developing countries.

Third, a common way of determining a transfer pool is through annual budget decisions. This approach gives the central government maximum flexibility to respond to national fiscal conditions. Such ad hoc allocations, however, can create uncertainty for subnational governments, making them vulnerable to fluctuating economies and the vagaries of political negotiation. Serious local fiscal problems can arise if subnational governments plan expenditures based on transfers received in previous years and the parliament unilaterally decides to cut transfers substantially in the current fiscal year.

2. Allocation of funds among sub-national governments

A number of approaches are used to allocate the transfer pool across eligible jurisdictions. First, tax-sharing transfers return to a particular sub-national government all or some portion of a central government tax collected within its geographical jurisdictions. Such transfer can be elastic in terms of their growth if the tax being shared has significant growth potential; however, they are usually counter equalizing since sub-national governments with larger tax bases will derive greater amounts of transfer funds. Thus, these types of transfers are based on sub-national fiscal capacity and are not good instruments for redistribution across sub-national jurisdictions. In some cases, such as the people's republic of china, the bulk of sub-national resources are derived from tax sharing.

Second, transfers allocated on the basis of an objectively defined formula are increasingly popular because they meet some of the key evaluation criteria. Specifically, they are transparent for the recipient governments and one limitation of formula-based transfers commonly faced in developing countries is the lack of timely and adequate data required to implement the allocation formula. In addition, there is sometimes a tendency to try to meet too many objectives with a single transfer program, and so many indicators are added to the formula that its overall effects are not clear.

Third, cost sharing transfers reimburse sub-national governments for expenditures on particular priority activities that are deemed worthy of subsidization. Such grants can be either total or partial cost sharing (matching). The former reimburse the sub-national jurisdictions for the full costs associated with allowable services, while the latter requires jurisdictions to contribute some minimum portion of total costs from their own resources, e.g. to correct or an inter jurisdictional spillover or to meet some equity goal, the budgets of recipient governments can be distorted in undesirable ways.

Finally, some transfer allocation mechanisms depend on ad hoc decisions of the granting authority in determining how much of the transfer pool each jurisdiction receives. Such mechanisms may create great uncertainty on the part of transfer

recipient since they do not know how their grant will be allocated or how much they will receive. They also open the door to arbitrary, subjective, nontransparent allocations that may work against broader public sector goals. Some major federal systems, such as Argentina, use a fair degree of nontransparent criteria in their transfer programs.

3. Degree of sub-national spending autonomy and the transfer instruments

A final policy choice in transfer design concerns the degree of autonomy enjoyed by recipients' sub-national government jurisdictions in using the funds from transfer instrument. Greater sub-national autonomy also means that the central government has less control over how the funds are spent. A number of commonly used mechanisms are:

First, general-purpose allocations give a sub-national government full autonomy over the use of transferred funds. A recipient jurisdiction can allocate the money for whatever purpose it desires and for either labor or non-labor inputs. Such transfers are closest to the spirit of full devolution of spending powers advocated by proponents of decentralization.

Second, sectoral limited block allocations permit the recipient government to choose how funds are to be used, but only within a particular sector. These transfers are particularly relevant where the government determines that significant benefits external to the spending locality are associated with particular activities such as health.

Finally, specific-purpose transfer can be highly restrictive in how the funds are spent. Restrictions may apply to choices between labor and non-labor inputs and or for particular spending plans. Thus, a capital development project grant may have to be spent according to the provision of the project plans submitted by the local council and approved by a central ministry.

Shotton (2010) has said "Moreover, there are several kinds of Centre-local fiscal instruments. The major purposes are to shut the vertical gap, to minimize the horizontal gap by equalizing across SNG, to compensate for spillovers and

externalities, to encourage SNG expenditure in national priority areas, to build SNG capacity and encourage SNG performance and to help remove political discretion, patronage and corruption. The main types of IGFT instrument are share of a national tax (share maybe distributed to SNGs by area of derivation or a formula base system), unconditional block grants based on formula for general SNG expenditure like administrative and development, specific (conditional) grants which is more or less tied on specific service, cost reimbursement for delegated functions, targeted transfers for national priority programs and on.

Inter-governmental transfers target four principal objectives:

1. Correcting vertical fiscal imbalance: transfers are used to fill the gap between revenue raising capacity and needs.
2. Implementing federal public policy through local governments: transfers make it possible to achieve the same result as, for instance, a minimum standard imposed by regulations, while leaving local governments more freedom in the choice of instruments.
3. Compensating for jurisdictional spillover: local government units providing services to people living in other jurisdiction (and thus not carrying the fiscal burden) must receive the adequate compensation. The rationale for transfer is both equity and allocative efficiency.
4. Reducing horizontal fiscal imbalance and harmonizing tax burdens: transfers means bringing in additional resources to government units with a lower fiscal capacity or too heavy a revenue effort.

It is important to recognize that any intergovernmental transfer program whether or not explicitly designed to help equalize the resource base of sub-national governments, will have re-distributional implications. This is true because all transfer programs involve a flow of resources from Centre to sub-national government such that, under most scenarios, some localities will be made better off relative to others. Thus, it is important to consider the full range of intergovernmental transfer in analyzing the overall re-distributional effects of transfers, not just programs specifically defined as equalization or re-distribution mechanisms.

Guidelines for Intergovernmental Finance

-) Clarity in objectives, consistency of design with objectives and singular focus
-) Simplicity, objectivity and transparency of allocation criteria
-) Incentives for fiscal prudence and competitive service delivery and results based accountability to citizens
-) Autonomy, independence in designing programs and flexibility in use of resources
-) Revenue adequacy and responsiveness
-) Predictability
-) Fairness: entitlements vary inversely with fiscal capacity and directly with fiscal needs; one size does not fit all- urban vs. rural, large vs. small
-) Affordability
-) Proper Assessment: to ensure periodic review and assessment

The problems of fiscal federalism and their solution

- 1) Vertical fiscal imbalance: It must be decided which level of government in the federation will perform the specific functions required to meet societal preferences. Vertical fiscal imbalance refers to a disproportionate alignment of these revenue sources vis-à-vis expenditure obligations by level of government. That is, one sovereign level of government often tends to possess relatively superior revenue (mainly tax) sources to finance its spending function as contrasted to the other sovereign level. Such imbalance normally follows a pattern whereby the central government holds the superior fiscal position, while sovereign state governments and their local tax government offspring possess inadequate tax sources to finance their spending responsibilities. This primarily results from the dominant use of progressive income taxes by central government-leading to an income-elastic tax structure.

Various intergovernmental fiscal instruments may be used to solve the vertical fiscal imbalance problems. These are:

-) Income tax credits: A central government personal income tax credit for taxes paid to state (or to state and local) governments, will provide

an incentive for these governments to develop their own tax system to a satisfactory point.

) Income tax deductions: A central government personal income tax deduction for taxes paid to state (or to state or local) governments will provide incentive for these governments to develop their own tax systems.

) Unconditional grants: Under this approach, central government would provide no-strings-attached grants to state governments help to alleviate their revenues shortages. These grants would preserve the discretion of the recipient sub-national governments to spend the funds as they see fit.

- 2) Horizontal fiscal imbalance: when fiscal imbalance occurs between different units of government at the same level of government in a federation, it is known as the problem of horizontal fiscal imbalance. For example, considerable differences exist in the distribution of economic resources among the various states. This means the sources of taxation, when converted to a per capita basis, differ among the states. Thus, per capita income, wealth and sales (three primary tax bases) take on an interstate dimension and result in horizontal fiscal imbalance among the various states.

Admittedly, one advantage of decentralized fiscal decision making by state and local governments is the fact that a particular revenue structure can be adapted to the unique resource characteristics of a given state or locality. Nonetheless, since resource endowment is the ultimate source of governmental revenue collection capacity, a given state or community enjoying considerable income-and wealth-producing ability and strong sales base is capable of providing either a greater per capita output of public and quasi-public goods than a resource-poor- jurisdiction, at the same revenue effort, or the same output of such goods at a lower revenue effort than the poorer jurisdiction.

Various intergovernmental fiscal instruments may be used to solve the horizontal fiscal imbalance problem. These are:

1. Unconditional grants: central government may provide “no-strings-attached” grants to relatively poor states, or to relatively poor state and local, governments. Or a state could provide such grants to the poorer governments within its jurisdiction.
2. Conditional and block grants with variable matching formulas: while not ideal, grants of this type, from the central or state governments, nonetheless do supply funds to the poor state.
3. Interstate redistribution resulting from progressive central government income taxes: A central government, by imposing progressive income taxes, tends to collect higher per capita tax amounts from the wealthier, as opposed to the poorer states. Thus, even with a proportional per capita expenditure incidence across the states, an income redistribution effect favoring the poorer states would result from the tax side of the budget.

D. Sub-national Borrowing

Public debt and borrowing traditionally has been as an important source to finance long-term infrastructure projects because it enhances intergenerational equity. Such type of intergenerational sharing enables local government to undertake the large scale infrastructure investments.

2.2 Empirical Review

2.2.1 International Context

Dillenger and Webb (1999), in their paper concerning fiscal management in Colombia, observe a problematic case of decentralization trial. Because of the defective design of decentralization, Colombia has experienced some weakening of macroeconomic performance especially in the last decade. The decentralization has led to some problems, both in maintaining fiscal balance at the national level, as resources are transferred to sub national levels, and in preventing unsustainable deficits by the sub national governments. The problems have appeared because national government interference prevents departments from controlling their costs and because sub national governments have come to expect debt bailouts. Briefly, the fiscal problems of the national government in the 1990s mostly originated on the spending side for items not related to decentralization. The requirement to share all revenues with the sub national governments meant that the national government could not balance the budget just by raising taxes. The continued increase in transfers to the municipalities made the problems of the center worse.

According to Islam (2007) intergovernmental fiscal transfers are dominant features of the finances of sub-national governments in most countries. A key feature of South Africa's intergovernmental fiscal relations system is that revenue powers are less decentralized than expenditure responsibilities. Therefore, notwithstanding South Africa's relatively decentralized government structure, an important gap exists between the expenditure responsibilities of sub-national governments and their revenues (Amusa & Mathane, 2007).

The wide variations in resource endowments and per-capita income levels of sub national governments in South Africa mean that many sub-national authorities lack adequate fiscal capacity in meeting their constitutional mandates (Amusa & Mathane, 2007). This vertical imbalance makes transfers by national 32 governments to provincial and local governments inevitable (Durham & Verwey 2012). For this reason, intergovernmental fiscal transfers form an important cornerstone of South Africa's IGFR system. The following Table provides an indication of the division of the available revenue raised nationally between the three spheres of government.

Table 2.3: Division of nationally raised revenue (2009/10 to 2015/16)

Percentage share	Outcome			Revised estimate 2012/13	Medium- term estimates		
	2009/10	2010/11	2011/12		2013/14	2014/15	2015/16
National departments	50.0%	48.1%	47.0%	47.0%	47.6%	47.9%	47.5%
Provinces	42.5%	43.7%	44.6%	44.2%	43.5%	43.2%	43.2%
Local governments	7.5%	7.3%	8.4%	8.8%	8.9%	9.0%	9.2%

Source: Adapted from National Treasury, Budget Review (2013:111)

From Table 2.3 it is evident that national and provincial governments receive the largest portion of more than 40% respectively, while local governments receive the smallest share of less than 10%. The reason for this is that local governments fund the majority of their spending through charges and taxes they collect themselves (National Treasury 2013).

Akinlo (1999) examined the fiscal responsiveness of state governments to formal intergovernmental flows in aggregate, and according to central government assistance schemes. The research was conducted using the 1980 data for 19 states in a cross-sectional analysis. The conventional constrained maximization model was used with a Simple Linear Ordinary Least Squares (OLS) technique. The variables incorporated in the model include: per capita federal funds, statutory grants, non-statutory loans, population growth rate, population density, geographical area, total federal funds, level of education, recurrent expenditures, capital expenditures, developmental expenditures and non-developmental expenditure. The key findings of the research reveal that the state government fiscal expenditure was stimulated by grants. Total federal funds have a highly significant effect on developmental expenditure. This suggests a high level dependence of the state governments on the federally allocated revenue.

Ekpo and John (1996) used the Nigerian data to study the fiscal operations in Nigeria from 1960 to 1990, using a historical (political economy approach). The study covered ten states namely; Anambra, Bendel, Cross-River, Lagos, Ogun, Kano,

Kaduna, Plateau, and Rivers. Their findings show that state government depends on the federally allocated revenue before the economic crisis of 1979\80, suggesting some evidence of centralization. The study also revealed that fiscal federalism in Nigeria is more influenced by non-economic factors such as the agitation for more states.

2.2.2 National Context

According to the LSGA, local government (VDC, Municipality and DDC) have some revenue raising powers, but the local revenue base is limited and stagnant. Due to the lack of sufficient fund to meet the assigned expenditure, there is a high degree of dependency of DDCs and VDCs upon central government transfers (representing 75% of 36 total LG revenues) is very high. On the other hand, the local government expenditures are small in scale as compare to central government. It is accounted that only four % of total public expenditures is mobilized by local government in Nepal. Central transfers to DDCs have been mainly channeled down through sector ministries to their deconcentrated departments. The fiscal decentralization policy is now to switch to “devolved” funding through a mix of conditional and unconditional grants to the DDCs themselves – but implementation is stalled because of the current suspension of local elected bodies (UNCDF, 2004)

The issues associated with fiscal decentralization namely expenditure assignment, revenue assignment, and estimation of expenditure needs, fiscal gap, and intergovernmental fiscal transfers have been analyzed (Ligal et al., 2004b). The study has broadly focused on revenue assignment, assessed resource gaps, and suggested some measures for minimizing the fiscal gaps of the local bodies in the country. The overall objective of the study is to design revenue assignment to local bodies namely VDCs, Municipalities and DDCs, identify potential tax and non-tax areas of local bodies, estimate total revenue along with expenditure needs quantify resource gaps in relation to expenditure requirement and suggest modalities of intergovernmental transfer to address the resource gaps among local bodies.

The service delivery and its effectiveness and revenue mobilization pattern of the local government in Nepal have been reviewed and analyzed (Adhikari et al., 2004). This study has just shown total approved budget, total expenditure and gap between

two annual aggregate of two fiscal years 2001/2002 and 2002/2003. At the same time, internal revenue mobilization pattern of Jhapa, Parbat, Sindhuli and Surkhet districts of the same fiscal year has been revealed. Besides, he has also depicted internal income and recurrent expenditure of some municipalities such as Khadbari, Biratnagar, Bhimeshor, Kamalamai, Butawal, Hetauda, Narayan, Nepalgunj, Dasarathchanda, and Mahendranagar. Moreover, he has also presented the figure of internal income of some VDCs of Morang and Kaski districts in the same fiscal year (2001/02 and 2002/03). The total conditional and unconditional grants transferred by the central government to DDCs, Municipalities and VDCs of the same two fiscal years are analyzed. It is also mentioned the support received by Tanahu, Rupandehi, Kailali and Surkhet DDCs from Development partners (various donor communities). However, the study report could not analyze the correlation between internal and central grant of local government properly. It has just presented the reflection of the financial position of local government in general of two fiscal years

The study on assessment of Village Development Committee Governance and the use of block grants have principally focused on how the large amount of money transferred to VDCs from central government as block grants are spent on reducing poverty and achieving the millennium development goals (Inlogos, 2009).

The study on the Assessment of Fiduciary Risk in Local Bodies, (LBs) Public Expenditure Financial Accountability in Nepal has identified the key areas and the degree of fiduciary risks in managing public finance by LBs in Nepal (NAREC, 2009). The has 38 analyzed the existing status of fiduciary risks by all sampled local bodies- DDCs, VDCs and Municipalities, to overview the final audit process in LBs how far the process has become able to explore financial irregularities and LBs response on those aspects, and to provide recommendations on various aspects (policies, systems and procedures and capacity) of local bodies to improve public expenditure management capacity and to reduce fiduciary risks on the basis of analysis.

The study “Nepal’s Fiscal Federalism Model in the New Constitution: Agenda for Amendments” reviewed the modality presented in the new constitution on the natural resources, economic rights and revenue allocation and recommended some amendments. The study finds that the fiscal decentralization initiatives have not been

successful in minimizing the political, social, economic, regional and ethnic inequalities inherent for nearly 240 years of a unitary system of governance in Nepal. The study recommends: VAT and income taxes will have to be collected concurrently at both the central and sub-national levels. Other taxes including excise duties will have to be collected by the sub national governments which will support the expenditure responsibilities of the sub-national governments adequately in federal Nepal. A Federal Finance Commission (FFC) and the National Planning Commission will have to be constituted at the central level to make national level development plans and to make recommendations for additional grants and loans. A State Planning Commission (SPC) and a State Finance Commission can be established in each state to prepare state development plans and to deal with the transfers to be made to local bodies (Prasad, 2016).

In Nepal, the central government collects the major part of taxes and the collected taxes are distributed in a prescribed manner in Nepal. Some taxes are assigned to collect by local bodies which constitute a small portion of local taxes. There is high disparity in tax collection. The central development region collects around 80 per cent of total revenue which includes the contribution of custom duties. Even if custom is taken out, the share of the central development region will be high. The concentration of tax collection will have to be neutralized in federal Nepal. The local governments in Nepal have a weak revenue base relative to their expenditure responsibilities. The expenditure of local level at VDCs, DDCs and municipalities is very small in comparison to total government expenditure. In the fiscal year 2013/14, expenditure of the local level was only 8 per cent of total government expenditure (LBFC, 2015). The revenue generated by the local levels is not sufficient to meet their expenditure responsibilities. In the fiscal year 2013/14, the share of local body's revenue was only 12.1 per cent of total revenue collection of the government (LBFC, 2015) local governments in most federations have a weak revenue base relative to their expenditure responsibilities. Therefore, the local governments highly depend on transfer.

Chapter III: RESEARCH METHODOLOGY

3.1 Selection of the Geographical Region for Study

For this study, IGFT practice in decentralized Nepal with the reference to global context has been chosen due to its wider theoretical and empirical perspective.

3.2 Research Design

This is the fundamental type of research rather than applied research. It is both quantitative as well as qualitative research which portrays the trend and practice of IGFT in Nepal with special reference to international practice. Through qualitative analysis, the research attempted to examine the strength and weaknesses of different countries' IGFT practices to show the pathway for Nepalese IGFT model ahead, which is still in its initial phase.

3.3 Nature and Sources of Data

The study is based on secondary data such as Economic Survey, MCPM Report, Budget Review of Nepal and other countries, UNCDF Report. The necessary information and data have been collected from Ministry of Finance (MoF), Central Bureau of Statistics (CBS), Nepal Rastra Bank (NRB), Secretary of Fiscal Commission for Local Bodies (SFCLB), District Development Committees (DDC).

3.4 Data Collection

The secondary data collected from various sources were sorted, tallied and computed using Microsoft Excel for qualitative analysis purpose.

3.5 Data Analysis Tools

This paper uses tabular presentation, component bar diagram, which give the clear illustration of facts about the study subject which were further analyzed by using theoretical and empirical perspective.

Chapter IV: INTERGOVERNMENTAL FISCAL TRANSFER SYSTEM IN GLOBAL CONTEXT

This paper provides an overview of the intergovernmental fiscal transfer system in eight major industrial and developing countries, with special reference to the design of equalization transfers. The countries selected are the Canada, Australia, the United States, Germany, India, Brazil, Nigeria and South Africa. Most of these countries have relatively developed formula-based transfer systems, and represent the major varieties of transfer systems adopted in the world.

4.1 Canada

Canada is a federation of ten provinces (British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick, Nova Scotia, Prince Edward Island, New Found land) and two territories (Northwest Territories and Yukon). The specific purpose transfers from the federal government to the territories are similar to those from the federal government to the provinces. But for equalization transfer the territories receive more than the provinces on per capita basis as the equalization scheme reflects the greater needs and costs that arise as a result of the territories remoteness and sparse populations.

The transfer of funds from higher to lower levels of government has been an important aspect of the Canadian federal system since confederations. At the time of confederations, custom and excise duties constituted the principal revenue sources of government. Because the constitution Act 1867 restricted the provinces to the direct taxation, a system of grants and statutory subsidies were established to compensate for lost revenue. In addition to cash payments, close-ended per capita grants were instituted. The federal government also assumed the provinces existing debts and made special grants to New Brunswick and Nova Scotia. These special grants were subsequently enhanced and also extended to the few Prairie Provinces.

Currently, there are three major programs of federal transfers to the provinces.

1. Canada health transfer
2. Canada social transfer

3. Equalization and territorial formula financing

Canada health transfer: It is the primary federal contribution to the health care in Canada. Between 2013-14 and 2014-15, aggregate cash transfers to the provinces and territories are increase by 6 per cent. However, 2014-15 is the first year in which CHT cash is distributed on an equal per capita basis to all provinces, even though that program design change had been announced in budget 2007. As a result, Alberta and Northwest Territories experience substantial growth in their CHT entitlements (37.8 per cent and 45.2 per cent respectively), while most other provinces and territories experience increases of less than 4 per cent.

Canada social transfer: It is a transfer to provinces in support of social services and has been distributed on an equal per capita cash basis since 2007-08; aggregate cash transfer is increase by 3 per cent in 2014-15. As Canada's population is expected to increase by 1.2 per cent during that year, per capita entitlements will rise by 1.8 per cent. Differentials in aggregate entitlements reflect differences in provisional and territorial population growth. The fastest growth is anticipated in Alberta at 5.3 per cent, and the slowest in Nova Scotia, at 1.4 per cent.

Canada equalization program: Canadian equalization program uses a national average standard as the basis for equalization. The basic calculation for the equalization formula is that of a province's tax capacity. Tax capacity is calculated as the amount of per capita revenue which a province could raise by applying the national average tax rates to its tax bases. The tax capacity of each province is then compared with the amount of per capita revenue that could be raised if the province has a standard (five province average) per capita tax base. A province whose per capita tax base is below the standard receives an equalization payment equal to the difference between the province's tax capacity and the standard tax capacity, multiply by the province's population.

This program equalizes have- not provinces up to the national average- only those provinces that were below the national average are affected by the program – and is paid for out of general federal revenues. Provinces whose tax capacities are above the

national average – then have provinces- are not equalized down. Thus, the system does not fully equalize tax capacities across all provinces.

Currently, there are 30 revenues sources for this program. The main sources include personal income taxes, corporate income tax, secession duties, general sales taxes, gasoline taxes, motor vehicle license fees, alcoholic beverage taxes, forestry taxes, oil royalties, natural gas royalties, sales of crown leases and reservations on oil and gas lands, other oil and gas revenues, metallic and non-metallic mineral revenues, water power rentals, other provincial taxes and miscellaneous provincial revenues.

4.2 Australia

The Australian Federations comprises the federal (Commonwealth) government, six states, two self-governing territories and over 700 local governments, which vary significantly in size, population, geography and economy. The IGFT on Australia is perhaps the most pertinent to Canada because its economy is similarly structured and it too has a formalized fiscal transfer aimed at equalization. In the fiscal year 2012-13, the federal government in Australia budgeted \$90.4 billion in total payments to the states, equal to 24 percent of federal government spending or 5.8 percent of GDP. Roughly 80 percent of this funding is in the form of untied grants, which provide general discretionary funding to the Australian states. The remaining funding from the federal government are largely special purpose payments, which have specific purposes linked to the use of the funds. Equalization Evolves in Australia is just like Canada, Australia does not have a formal constitutional requirement for equalization.⁷ Section 96 of the Australian Constitution provided for the federal government to “grant financial assistance to any State on such terms and conditions as [federal] Parliament thinks fit”. According to Stephen Kirchner, Section 96 of the Australian Constitution was intended as a safety net to assist states that encountered financial difficulty. Beginning in mid-1970s, there was a move away from fiscal need towards a principle of equalization by the Australian federal government. In its 1993 report, the Commonwealth Grants Commission, which administers the system of equalization in Australia, introduced the principle of “full” fiscal equalization. The Commission defined the principle of “full” fiscal equalization quite similar to Canada: “The principle of fiscal equalization is that each State should be given the capacity to

provide the same standard of State-type public services as the other states, if it makes the same effort to raise revenues from its own sources and conducts its affairs with an average level of operational efficiency”.

Equalization in Australia

There is a key difference between the two equalization programs in addition to the existence, or not, of a constitutional mandate. Payments to the Australian states are based on assessed fiscal capacity on both the revenue and expenditure side of state budgets. In other words, both the spending and taxing of the Australian states are considered in determining equalization. Canada, on the other hand, only assesses the taxing or revenue capacity of the provinces in calculating equalization. The Commission responsible for equalization attempts to identify and quantify factors outside the control of the states that influence their expenditure requirements and revenue raising capacity. This is distinct from their actual expenditures and revenues. It is this assessment of both expenditure needs and revenue raising capacity that makes the Australian approach to fiscal equalization unique internationally. Like Canada’s equalization program, the process of identifying and quantifying the factors that determine equalization grants in Australia is extremely complex. A wide range of factors are taken into account including population size, age, and structure, per-capita income, the impact of geography on costs, the presence of indigenous peoples, English fluency, and the capacity of various tax bases. Indignity is the single largest source of equalization on the expenditure side while mining revenue is the main source of equalization on the revenue side. Interestingly, Australia does not assess fiscal need in calculating equalization. According to Kirchner, it is not uncommon for Australian states with strong fiscal positions (budget surpluses or low debt levels, for example) to receive equalization funds from states with weaker fiscal positions.

GST and Equalization in Australia

The Australian federal and state governments agreed in 1999 that the distribution of revenue from the new GST - similar to Canada’s GST - that was collected by the federal government would be based on fiscal equalization principles. In return for the GST revenue, the states agreed to abolish a number of inefficient state-level taxes such as taxes on financial account transactions. This marks a material change in the

equalization program in Australia. Whereas the amount transferred to the states under the previous system was largely determined by political decisions of the federal government, the amount available for equalization is now determined by the amount of GST revenue. Competition between the states for revenue through the equalization process is now a zero-sum game because the equalization pool is determined, in part, by the size of the GST revenues. In addition, the GST rate and the base upon which it is levied can only be changed with the agreement of state governments and the federal parliament. Each state receives a per-capita share of the GST revenue plus an offset amount that reflects different expenditure and revenue needs and capacities relative to the average of all the states. On average, GST revenue that is linked to equalization makes up around 25 percent of state government revenues. The federal government's special purpose payments to the states are included in this assessment on the assumption that revenue available to the states from most sources is fungible.

4.3 United States of America

The US federation encompasses the federal government, 50 states and more than 87,000 local governments. Each state has its own constitution. In cases of conflict between the national and local laws, the former prevail. The United States has a bicameral national Congress where legislation needs to be sanctioned by both houses. Each state elects two representatives to the senate. Unlike Canada and Australia, the United States has no formal system like Equalization to transfer resources from prosperous states to less prosperous ones. As the Canadian-born Chris Edwards, Director of Tax Policy Studies at the Cato Institute, explains, however, the United States has developed a hugely complex financial relationship between the federal government and the states through the Grants-in-Aid system.

Grants-in-Aid Federal Transfers to the State

The US system has grown steadily for more than a century as the federal government has become involved in an increasing array of state and local activities. Currently, there are more than 1,100 federal aid programs for the states, with each program having its own rules and regulations. Grants-in-aid are a key mechanism that the federal government has used to extend its power into state and local affairs. Grant programs are subsidies from the federal government that are accompanied by federal

regulations designed to micromanage state and local activities in funded areas. Most federal aid is distributed by formulas, which are based on such factors as state populations, income levels, and poverty levels. Medicaid funding, for example, is distributed based on each state's average personal income compared to the US average. Thus, poorer states generally receive more grants. The US federal government is expected to spend a little more than \$561 billion in 2014 on aid to the states, making aid the third largest item in the federal budget after Social Security and national defense. Some of the major federal aid programs are in the areas of education, health care, housing, and transportation. From the beginning, many aid programs required states to match federal funds on a dollar-for-dollar basis. Unfortunately, matching requirements have induced excessive state spending and continuous program expansion. Federal aid has also prompted the growth in state bureaucracies, partly because aid programs have often required that states set up new agencies to oversee spending in the prescribed activities. There was initial resistance to the expansion of federal aid, but it was politically difficult for states to opt out of new aid programs because, if they did, their residents would still have to pay federal taxes to support federal aid spending in other states. There is no overall plan to the system; instead, it has grown in an ad-hoc manner over many decades. The number of Grants-in-Aid programs rose from 15 in 1930 to 132 by 1960. The largest expansion of federal granting during this period was the 1956 law authorizing the building of the interstate highway system. However, it was during the 1960s that federal aid really exploded. Under President Lyndon Johnson, aid programs were added for housing, urban renewal, education, health care, and many other activities. The number of aid programs quadrupled from 132 in 1960 to 530 by 1970.

The number of aid programs soared from 653 in 2000 to 1,122 in 2010. Federal aid spending is expected to reach \$561 billion in fiscal year 2014, of which \$286 billion are health grants and \$275 billion are non-health grants. Federal aid programs range from the giant \$267 billion Medicaid to hundreds of more obscure programs, such as a \$15 million grant for Nursing Workforce Diversity, a \$116 million grant for Boating Safety Financial Assistance, and a \$125 million grant for Healthy Marriages. While most aid programs are project grants, most aid spending is on formula grants. That is because many of the largest aid programs, including Medicaid, are formula grants. Under formula grants, legislation spells out how much funding each state receives

based on factors such as state income and population. The states are often required to match some portion of the federal government's aid with their own funding. Problems with Aid to the States are eight major problems with the US approach, ranging from spurring wasteful spending to inconsistent matching between state grants and financial needs to reducing policy diversity at the state level to expanding both Federalism and Fiscal Transfers. In many critical ways, the Canadian approach is superior and certainly more transparent than the US approach to transfers between the federal and subnational levels of government. Put differently, the lessons for Canada from the United States with respect to fiscal transfers seems largely to be what to avoid rather than what to adopt as a means to reform. Indeed, there appear to be clear lessons for the United States showing ways of simplifying and improving their system of transfers to the states based on the Canadian model.

4.4 Germany

The German federations include the federal government, 16 states and over 11,500 local governments, which are regulated by state legislations. It provides a clear example of cooperative federalism: a strong role of the federal government, as evidenced by extensive concurrent spending responsibilities, and authority to issue framing legislation in many areas assigned to the states. At the same time, through the upper chamber of parliament (Bundesrat), the states collectively have veto power over federal legislation that affects them. The members of Bundesrat are appointed by the states.

A defining characteristic of the German tax system is that it is largely a system of joint taxes. The three main taxes, namely the personal and corporate income taxes and the VAT are joint taxes. This means the federal, state, and local governments have shared rights. According to Blankart, these taxes are legislated at the federal level (rates and tax base) by the Bundestag (federal assembly) and the Bundesrat (federal council). The revenues from these three sources are divided between the federal government and the state and local governments.

Dividing the Revenue

The division of tax revenues in Germany takes place through a five-step process, which is informative about the mechanisms for equalizing revenue capacity .First, the

German constitution requires that personal income tax revenues are allocated to the federal, state and local levels in the following percentages: 42.5%, 42.5%, and 15% respectively. The corporate income tax is divided 50-50 between the federal and state governments.

The second step ensures that personal and corporate income taxes are allocated to the appropriate state. Personal income tax revenues, for instance, are allocated to states based on the residence of individuals. Corporate taxes are paid to states based largely on the location of employees in the company. This process is simply meant to ensure that states receive the proper allocation of the revenues raised jointly.

The VAT is distributed in two steps. First, one quarter of VAT revenues are retained by the federal government. The remaining three quarters are divided into two parts:

- 1) 75 percent is paid out to the states on a per-capita basis, and
- 2) the remaining 25 percent (of the three quarters) are distributed to states deemed “poor” based on the difference between personal and corporate tax revenues raised per capita in the state compared to the national average.

The third step incorporates transfers from well-off states to the less well-off states. These transfers are unique because they are between states (horizontal transfers). They are federal only insofar as they are determined by federal law. A state is defined as well-off if its effective fiscal capacity (EFC), measured by its total actual tax revenues, is larger than what the state would receive with an average fiscal capacity. The average fiscal capacity (AFC) of a state is defined as the total tax revenue of all states weighted by their population. This system is similar to Canada’s system of equalization, although it is much less complicated and therefore more transparent.

The fourth step in the process is to provide certain poor states with a secondary federal equalization payment. These payments are made to states that remain under a prescribed threshold of AFC compared to EFC after the transfers from step three. In other words, when states still lack the fiscal capacity required after receiving a transfer as outlined in step three, they become eligible for a supplemental payment.

Finally, there is a special secondary federal equalization transfer that is provided to states whose economies are simply too small and poor to reach parity in the calculations outlined above and/or those still suffering from the financial burden of the former communist regime.

Note that all allocations and transfers from one to five above are untied and non-earmarked, which means the states are free to use them at their discretion. The federal government is not allowed to use (or misuse) federal transfers for any micromanagement of the states. This is an important limit to federal power in Germany. The German federal transfer system is, therefore, fundamentally different from the United States' Grants-in-Aid system and programs of other countries such as Canada that use tied grants (in Canada, there is both the Canada Health Transfer and the Canada Social Transfer)

4.5 India

The Indian federations include 29 states, seven territories and a very large number of urban and rural governments. It is a bicameral democracy; the members of the upper house are elected by their respective states. The federations are characterized by wide disparities in ethnic, religious and socioeconomic characteristics. This has favored a strong centralizing role of the federal level of government (the Union).

A notable feature of transfer system in India is the existence of multiple channels. The Constitution provides for the appointment of the Finance Commission by the President of India every five years to make an assessment of the fiscal resources and needs of the Center and individual States. Based on these, the Commission is required to recommend the shares of personal income tax and union excise duty and grants-in-aid to the States. However, with development planning gaining emphasis, the scope of the Finance Commissions was restricted to cover the States' non-plan requirements in the current account. The Planning Commission became a major dispenser of funds to the States by way of both grants and loans. In addition to these two channels, various Central ministries give specific purpose transfers with or without matching requirements.

As a way of bridging the fiscal gap, the Indian Constitution provides for revenue sharing from the central taxes and grants. As per article 280 of the Constitution, it is the Finance Commission that is authorized to recommend the proceeds of the revenue sharing and the grants to the states. There is also the Planning Commission which gives plan assistance by way of grants. While the Finance Commission orders unconditional grants, the transfers of the Planning Commission (which is mainly concerned with development projects) are substantially conditional. Various central ministries also give specific purpose transfers for various central schemes with or without matching requirements. In India, the central government is authorized to provide grants to state governments for any purpose, whether that purpose is under federal government jurisdiction or not. Accordingly, the central government could also spend on areas on which it has no legislative authority. It is the Planning Commission that plays a great role in supplementing funds for the state plans and also in providing funds for several schemes, sponsored by the union government ministries, which are carried out by the state level administrations. The last form of transfer is criticized for its conditionality (which will affect local autonomy) and for its being discretionary. However, it takes important share of the planning assistance for it accounts for 40% of the total plan assistance and 14% of total current transfers.

A. Finance Commission Transfers

The first transfer of the commission is revenue sharing. This is a mechanism where the states are entitled to claim a certain portion of the proceeds from all the central taxes. It is only in 2000 that the Constitution, through its 80th amendment, entitles the states to claim revenue sharing from all central taxes but before that it provides only for personal income tax and union excise duties. One reason for amending the Constitution in this regard is because the federal government began to pay more emphasis on revenue sources which are not subject to revenue sharing and a disincentive on effectively handling those taxes which are subjects to the revenue sharing.

Revenue sharing is a dominant form of transfer to the states within the Finance Commission transfers. In the year 2005, the twelfth financial commission has recommended the distribution of 30.5 percent of the net proceeds of central taxes

to be distributed among the states. In the year 2010, the recommendation of the thirteenth Finance Commission to devolve 32% of the net proceeds of the central taxes was accepted by the central government expected to last until the year 2015. After assessing and determining the amount that should be devolved to the states, the Finance Commission first devolves the shared revenue from the central taxes to the states. It is only after apportioning the shared revenues among the states that the commission would go on to devolve grants-in-aid if there are post devolution budgetary gaps. The apportioning is made through grant formulas. The percentage share of the grants-in-aid by the Finance Commission is much less than the same of the revenue transfers through tax sharing. It is also experienced that the proportion of tax shares to total financial resources recommended by the Finance Commission has been increasing while that of grants-in-aid has been constantly declining.

It is submitted that with tax devolution accounting for nearly 90 percent of the revenue transfers ordained by the Finance Commission, the grants-in-aid have lost their teeth as an equalizing and disciplining instrument. On the other hand, the special category states obtain more than 80% of the transfer of the Finance Commission in the form of grants. The Finance Commission adopts transfer formulas that are meant to play an equalization function. While the Finance Commission transfers tend to have an equalization effects taking account of differences among states in population, per capita income (to determine the taxable capacity of the states), area, economic and rural infrastructure needs, and tax efforts; Planning Commission transfers for specific purpose projects tend to defy equalization effects.

It is submitted that the Finance Commissions transfers are much more equalizing than the Planning Commissions because the criterion of per capita income disparities is much more equalizing than the population criterion. The Finance Commissions formula weights income disparities much more heavily than the Planning Commissions formula (62.5 versus 25 per cent, respectively); and the Planning Commission weights population more heavily than the Finance Commission (60 versus 10 per cent, respectively). The element of backwardness is also included in the tax devolution to serve as an equalization factor although it

is criticized as being not specifically targeted to fiscally disadvantaged states. However, it could be said that the formula of the Finance Commission is pursuing more than an equalization objective because tax effort and fiscal discipline are also in the formula. Equalization has been further blunted by the fact that the parliamentary resolution requires the commissions to use the 1971 population figures in the transfer formula whenever it is used for interstate distribution to provide an incentive for population control.

The criticisms against this stipulation are whether it is proper to incorporate population planning policies in the transfer system and if it is proper there remains a problem for those states with increased population not because of more fertility rates but because of increase in the migration rates in to the states and effective measures in reducing mortality rates. This as it may, the gap filling methodology of the Finance Commission is criticized for two grounds. First, it is criticized that the methodology does not take in to account the fiscal disabilities or expenditure needs of the low income states that resulted the existing interstate difference in expenditures to perpetuate. Second, the gap filling methodology creates perverse incentives in that it leads to negative incentives to tax effort and expenditure economy. In effect, states showing large deficits in their budget get rewarded while those that manage their finances better suffer. It is because of such problems that it is argued that the transfer system lacks both equity and incentive although there are different attempts being undertaken to rectify that.

B. Plan Commission Transfers

Unlike the Finance Commission, the plan commission is not established by the Constitution of India and it is argued that this commission is one of the many instances that reflect the central dominance in the country and that greatly undermines and overlaps the jurisdiction of the constitutionally mandated organ—the Finance Commission. It is pointed out that around 30% of the revenue flows from the union budget to the states are dispensed for state plans through the Planning Commission. These transfers are made through devising a formula that may be modified by the National Development Council, which is chaired by the Prime Minister and is composed of higher officials from both the central and state governments and members of the Finance Commission. Some argue that since

both the state and the union officials are represented in the Council that approves the rules based on which the Planning Commission makes the award for plan assistance for the states, it has the merit of transparency.

The transfer is divided in two parts. First, 30 percent of the fund is reserved for the special category states. The 70 percent fund of the commission is reserved for the general category states which are apportioned between the states based on a formula the variables and the weights of which is 60% to population, 25% to per capita GSDP, 7.5% to fiscal management, and the remaining 7.5% percent to special problems. The fiscal transfers in India have witnessed various problems. First, the multiple institutions with overlapping jurisdictions have blurred the objective of the transfer. Second, accommodating different purposes has complicated the transfer formula. Third, the system is not well designed to achieve equalization and to ensure minimum service levels in the states. Finally, it does also have a disincentive effect on fiscal management in the states.

4.6Brazil

Intergovernmental fiscal transfer in Brazil can be classified into two categories

1. Tax transfer or Revenue sharing based on Brazilian constitution
2. Specific purpose transfer

1. Revenue sharing: Brazilian constitution provides strict criteria for revenue allocation among the different levels of the government. It is mandatory for unions to apply atleast 25 percent of all tax revenues on education. Major programs for revenues sharing are described below.

a) State participation fund: The allocation criteria under State Participation Fund are as stated below.

-) Federal government deposits 21.5 percent each of income tax and industrial product tax in a special fund.
-) From special fund 85 percent is kept aside for the distribution to the states in the north, north-east and centre- west region.
-) Remaining 15 percent is allocated to the south and southeast region
-) The fund is released within the given deadline.

- b) **Municipal participation fund (FPM):** Municipal participation fund is created through 22.5 percent of federal income and industrial product tax. About 12 percent of the FPM funds are allocated to state capitals and municipalities with population greater than 400,000 and 6 percent of remaining fund is set aside for the Municipal Participation Reserve Fund to be allocated for large municipalities. Remaining fund is allocated to the municipalities based on the formula that varies directly with population and inversely with per capita income. Beside FPM, municipalities receive certain proportion from rural property tax (50%), payroll deductions of income taxes of municipal employees (100%), tax on gold by origin (70%), revenues from crude oil based on the value of production (2.3%) and hydroelectricity and mineral taxes by original (50%).

2. Specific purpose transfer: It is classified into four categories

- a) **Non-constitutional transfers:** it complies with specific laws other than the constitutional provisions.
- b) **Conventions or negotiated transfers:** which are not based on laws but on negotiation for the support of some priority areas such as regional development, agriculture, health, education etc
- c) **Special investment funds/ projects:** this type of transfer is related with the projects that are undertaken by the state and local governments on behalf of the federal government.
- d) **Transfer made through government agencies:** it is mainly from the ministries of planning, education, finance, urban development and health.

4.7 Nigeria

The bulk of revenue collected by the federal government goes into federal account which is shared between the federal and the other levels of government. This includes the proceeds of Value Added Tax (VAT). In Nigeria, the national assembly makes the provision for the distribution of public revenue:

-) Between the federation and the states

-) Among the states of the federations
-) Between the states and the local government councils
-) Among the local government councils and
-) Grants or loans and the imposition of charges upon the consolidated revenue fund of the federation or imposition of charges upon the revenue and assets of the federation for any purpose notwithstanding that it relates to the matter with respect to which the National Assembly is not allowed to make laws.

Federal account funds are distributed uniformly across states. This works against more populous states. A huge derivation premium benefits only few states. About one-third of all allocations from the Federal Account to states reflect derivation premiums most of which is received by the four main oil producing states regardless of their performance in terms of service delivery and human development indicators.

The allocation disregards local revenue capacity of individual states. About 2.5 percent of the fund is distributed proportionally to local revenue efforts. However, it works as a penalty to poorer states that have fewer opportunities to increase their revenue collection.

It can be inferred that practice of intergovernmental transfers in Nigeria is still metamorphosing and there are still rooms to accommodate the concerns of all tiers and regions of the federation.

4.8 South Africa

In South Africa, allocations for unconditional grants, also known as equitable shares are formula based taking into consideration population per province and per municipality, school going children, access to health care, poverty incidence, economic output per province and so forth. Equitable share allocations are mandated by the Constitution. They are also termed block transfers and they provide broad support in a general area of provincial and local government expenditures (such as education, health and roads) while allowing recipient spheres of government discretion in allocating the funds among their expenditure responsibilities. Equitable share allocations provide budget support with no strings attached in a broad but specific area of provincial and local government expenditures. In South Africa,

matching grants are not used even though there are grants that are designed to mimic the latter. Supplementary grants such as the infrastructure grants to provinces (IGP) are transferred to provinces to supplement equitable shares for infrastructure development. This is a classical example of a non-matching conditional transfer which provides a given level of funds without provinces matching, as long the funds are spent for a particular infrastructure purposes.

Matching grants in South Africa will not be economically viable to implement especially at the provincial sphere of government which on average receives 97 per cent of its revenues through fiscal transfers. To limit transaction costs, it will be worthwhile for the national government to finance a specific programme directly. There is fiscal space for South Africa to start experimenting with matching grants at a local government level which generates on average about 94 per cent of its own revenue. National government can use matching grants as incentive to amplify service delivery. However, caution should be taken as matching requirements can place a burden for certain municipalities with limited fiscal capacity. In South Africa other conditional grants are used to bring about changes in the way government services are delivered in the short to medium term. Transitional, capacity building and support grants are as a result of structural adjustment within provincial and local governments. The financial management grant, local government restructuring grant, and municipal systems improvement grant are an example of such grants. These grants fund additional functions assigned to sub-national government for policy or capacity reasons or because the function has been inherited. There are also grants that address backlogs and provincial disparities in the distribution economic and social infrastructure that has been inherited. Health revitalization and infrastructure grants to provinces are an example. Some conditional grants such as the provincial and municipal infrastructure grants are also formula driven taking into consideration infrastructure backlogs per province or municipality. Other grants finance natural disasters; disaster relief grant is an example. The way South Africa is funding most of the disasters which affect provinces and municipalities are ex-post. This requires that an affected area be declared a disaster area, special funds be appropriated and then be transferred. Given the changing climate conditions, the government should consider coming up with an ex-ante strategy of risk financing natural disasters.

In South Africa conditional transfers are reviewed yearly with the promulgation of the Division of Revenue Act which comes with amended grant frameworks and classifications. Classifications specify the conditionality of grants, whether they are specific-stand-alone grants or supplementary grants. Allocations for other grants as are discussed through the budget process and decided in the vertical division part of the annual budget within the context of the three-year MTEF (National Treasury, 2013). Apart from the conditionality attached, these transfers normally form part of the equitable share and appear on the budgets of the sphere of government concerned. Some grants are transferred as block grants to recipient government. The central hospitals and most of the professional training and research grants are examples of block grants. On other instances, some grants are appropriated in the budgets of the national transferring departments but fund service delivery in provinces or municipalities. Usually the national department imposes conditions in the transfer and administration of the grant. Imposed conditions are hard and enacted. Failure to comply with the conditions of the grant will result in either the withholding of some or all funds earmarked for a province or municipality

Table 4.1: Equalization arrangements for IGFT in international context

Country	Equalization arrangements
Canada	Federal transfers: equalization scheme based on formula (adjusted from time to time) assessing provincial revenue capacity in terms of a representative set of provincial taxes and non-tax revenue sources against a middle-range five province standard and providing unconditional grants representing 42% of all transfers.
Australia	Since 2000, the federal government has collected a goods and service tax (GST) that funds general purpose payments to the states. Allocation is based on the calculation of revenue capacity and expenditure needs from comparison of 18 revenue categories and 41 expenditure categories.
Germany	Primarily interstate transfers (62%): equalization through an interstate revenue pool to which rich Lander pay and from which poor Lander draw according to a formula; plus, federal transfers (38%): federal supplementary payments of 1.5% of value added tax(VAT). The primary per capita distribution of the shares of the Lander of a portion of the VAT also has an equalizing effect.
India	Federal transfer: based on recommendations of independent finance commission recommending share of federal taxes and distribution of unconditional and conditional grants to fill gaps in state revenue, taking account of differences among states in population, per capita income, area, economic and rural infrastructure needs and tax effort. However, planning commission transfers for specific projects tend to counter equalization effects.
Brazil	A revenue sharing fund of the states and revenue sharing funds of the municipalities are derived from revenue sharing of three main federal taxes: personal income taxes, corporate income taxes and the selective VAT. The distribution of these among the states and municipalities is mainly based on the redistributive criteria, but horizontal inequalities in the distribution of fiscal resources remain highly significant.

Nigeria	Federal transfers assigned by the national assembly with distribution among states based on criteria specified in the constitution: population, equality of states, internal revenue effort, land mass, terrain, rural road/inland waterway, potable water, education, health, and at least 13 percent based on derivation (to reflect resource revenue). The appropriate allocation of revenues from natural resources remains highly contentious. The emphasis upon equality of states (40% transfers) has meant that because of large differences in the size of the states per capita revenue have in fact varied sharply.
South Africa	Federal transfer: based on the recommendations of the independent Finance and Fiscal Commission to meet the constitutional requirement of “equitable” division among provinces and municipalities. The commission has developed a formula taking account of specific factors of demography and economic activity.

The above table shows the arrangements for equalization transfers which varied from federations to federations and these are set out in the summary form.

Chapter V: INTERGOVERNMENTAL FISCAL TRANSFER SYSTEM IN NEPAL

The government of Nepal has adopted policy of developing local level programs based on decentralization principle by catching the spirit of Local Self-Governance with a target of ensuring people's maximum participation in country's governance process. As envisaged by the new Constitution of Nepal, initiatives have been taken to make the democratic practices efficient from local level for delivering the fruits of democracy among the people. The Government of Nepal, as per the constitutional provision to transform the local bodies into a robust institution through merger of their current structure by taking population, geography and infrastructure into consideration, has constituted a commission to propel the tasks of delineating the boundaries and identifying the number of village government (*Gaunpalika*), municipal government (*Nagarpalika*), and special, protected and autonomous areas. Currently, services are being delivered through 75 District Development Committees (DDCs), 217 Municipalities and 3157 Village Development Committees (VDCs).

Government of Nepal has been providing grants to all DDCs based on criteria that include population, cost of development, geographical area and Human Development Index. But, until recently, it was providing equal amount of Rs. one million, as unconditional grant to the VDCs. Some correction was however made in fiscal 2065/66 and a crude formula taking into account of population and area of the VDC along with the cost index of DDC was used to transfer funds to the VDCs.

With a view of initiating a formula based grant distribution system MoLD constituted a Committee to design a formula for distributing block grant to District Development Committees (DDCs). The Committee recommended an interim formula, which has been adopted by MoLD for distributing grants to DDCs since FY 2003/04.

Table 5.1: IGFT mechanism in Nepal

Design features	Nepal
Allocation criteria	Formula: Based on 1) population, 2)land area, 3)HDI, 4) cost index + performance adjustments according to the results on the performance measures.
Adjustments mechanism of the grants	MCs + adjustment of the grant according to the performance (+ up to 30% extra and minus up to 20% if performance is poor)

Source: LBFC (2015)

GON provides both administrative and development grants to DDC. Administration grants to DDC are determined based on the administrative liability of the central government. LSGA 1999 and the regulation clearly mention about the types of personnel central government has to depute at the DDC and the types of personnel DDC can recruit locally. All the liabilities of the centrally deputed personnel plus the liability of VDC Secretaries plus some administrative expenses are borne by the central government. Development grants to DDCs constitute of both specific purpose conditional grants and the general purpose unconditional grants. The bases for determining such conditional and unconditional grants are, however, until recently, determined on an ad-hoc basis without assessing the need of the respective DDCs. DDCs receive recurrent grant from the Center to meet their administrative expenses. The purpose of this grant is to enable the DDCs to meet salary cost of staff deputed from the center, staff hired by the DDC, welfare fund contribution of the staff so hired and salary cost of the VDC secretaries. Up to fiscal year 2002/03, the MoLD used to specify the amount allocated for each purpose. With effect from 2003/04, DDCs are, however, given the discretion of budgeting funds required for this purpose out of the recurrent grant provided to them by the center. Capital grant is provided to DDCs to enable them to execute development activities in the district. DDCs have the sole discretion on the use of capital grant for the purpose they wish by following the planning and budgeting procedures as set out in the local self-governance law.

Prior to fiscal year 2003/04, capital grant to DDCs was provided as the development grant. Center is also providing the DDCs with funds to implement projects in different sectors. These include rural drinking water and sanitation, local infrastructure and rural road projects, construction and rehabilitation of large and local level suspension bridges, and development programs based on people's participation. Starting from fiscal year 2004/05, the DDCs have been given full authority regarding planning including selection of the projects and allocation of funds from the conditional grants. The MoLD has been using an interim formula for the distribution of block grant to DDCs with effect from fiscal year 2003/04. District area, rural population in the district, level of human development and transport cost factors are considered while determining the size of block grant to DDCs. In the interim formula, the available divisible pool of the grant is divided by giving a weight age of 50 percent to the human development index whereas 20 percent weightage each is given to the rural population and cost factor of the district followed by 10 percent weight age to the area of the district. Besides the allocation of grants based on the above mentioned formula, DDC also receive annual conditional grants for initiating development activities especially in drinking water, irrigation and rural roads. On top of such grants, DDC also receive performance grants based on the performance of the DDC in fulfilling Minimum conditions set for such grants. LGCDP since last fiscal year is continuing such topping up on grants to those DDCs that met the minimum conditions set for the purpose.

5.1 Fiscal transfer system in VDCs

The Center followed the practice of providing every VDC with an equal amount of Rs. 500,000 per annum in the form of block grant until FY 2007/08. This approach does not take into consideration the expenditure needs of VDCs lying in different geographical locations, with varying population size and area. On per capita basis, the existing practice tends to favor the VDCs of Hills and Mountain districts, which are less developed and remote but have a lower population. Considering this problem, since FY 2008/09 the Center has started providing block grant to VDCs with a range of minimum of RS 1.5 million to maximum of Rs. 3 million on the basis of a formula that takes into account of the VDC level population, cost and area. While doing that, it

took population census 2001 data for VDC population and the district cost indexes same for all VDCs in the district.

The current scenario of intergovernmental transfer in Nepal is guided by the political or electoral theory of public expenditure which explains that trend in public expenditure depends on electoral preferences of politicians. The transfer scheme has not been systematic and effective. The ministry of finance directly provides fiscal transfer as a grant to DDCs, municipalities and VDCs. The current grant allocation methodology to the local bodies is:

$$Y = a + bX \text{ (Total grant = minimum grant + additional grant)}$$

Where,

a = minimum grant (VDC 1.5 million, MNCs 3.0 million and DDC 4.0 million)

X = Explanatory/expenditure need variables used in grant distribution such as population, area, poverty, etc. (X applies only in additional grant)

B = Coefficient of expenditure need variables

Intergovernmental fiscal transfer in Nepal has not been systematic and effective. It is highly influenced by the political domination theory. The ministry of finance directly provides fiscal transfer as a grant to DDCs, municipalities and VDCs irrespective of their human development situation, development status and expenditure need. Therefore, clear modality needs to be explored.

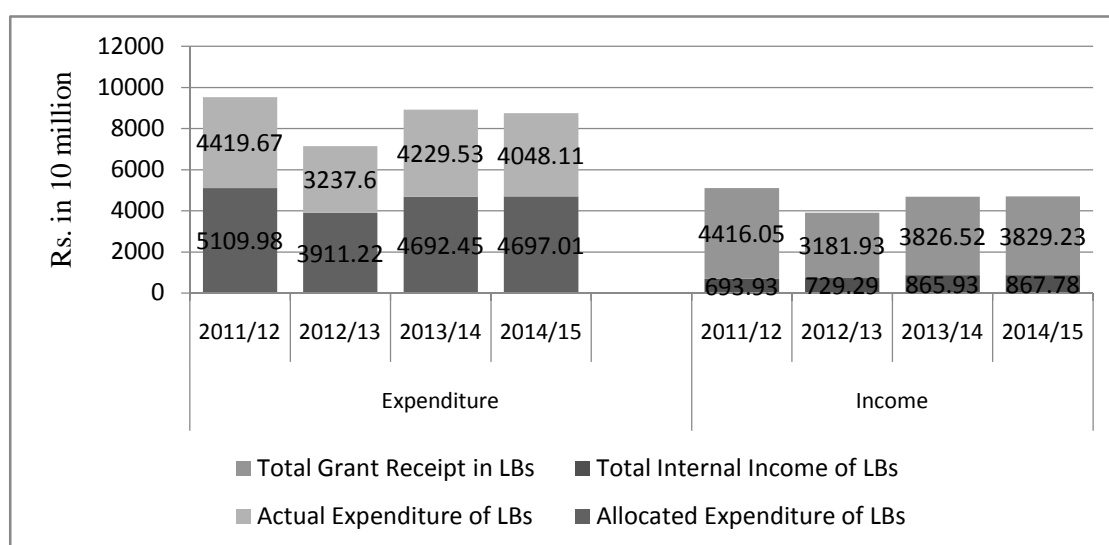
Table 5.2: Income and Expenditure of Local Bodies

(Rs. in 10 millions)

Description	Fiscal Year				
	2011/12	2012/13	2013/14	2014/15	Average
Total Internal Income of Local Bodies	693.93	729.29	865.93	867.78	789.23
Total Grant Receipt of Local Bodies	4416.05	3181.93	3826.52	3829.23	3813.43
Total Income of Local Bodies	5109.98	3911.22	4692.45	4697.01	4602.67
Share of Internal Income in Total Income (%)	13.58	18.65	18.45	18.48	17.29
Share of Grant Receipt in Total Income (%)	86.42	81.35	81.55	81.52	82.71
Growth rate of internal income of LBs (%)		5.10	18.74	0.21	8.02
Growth rate of grant receipt by LBs (%)		-27.95	20.26	0.07	-2.54
Allocated Expenditure of Local Bodies	5109.98	3911.22	4692.45	4697.01	4602.67
Actual Expenditure of Local Bodies	4419.67	3237.60	4229.53	4048.11	3983.73
Actual Expenditure as % of Allocated Expenditure	86.49	82.78	90.13	86.18	86.40

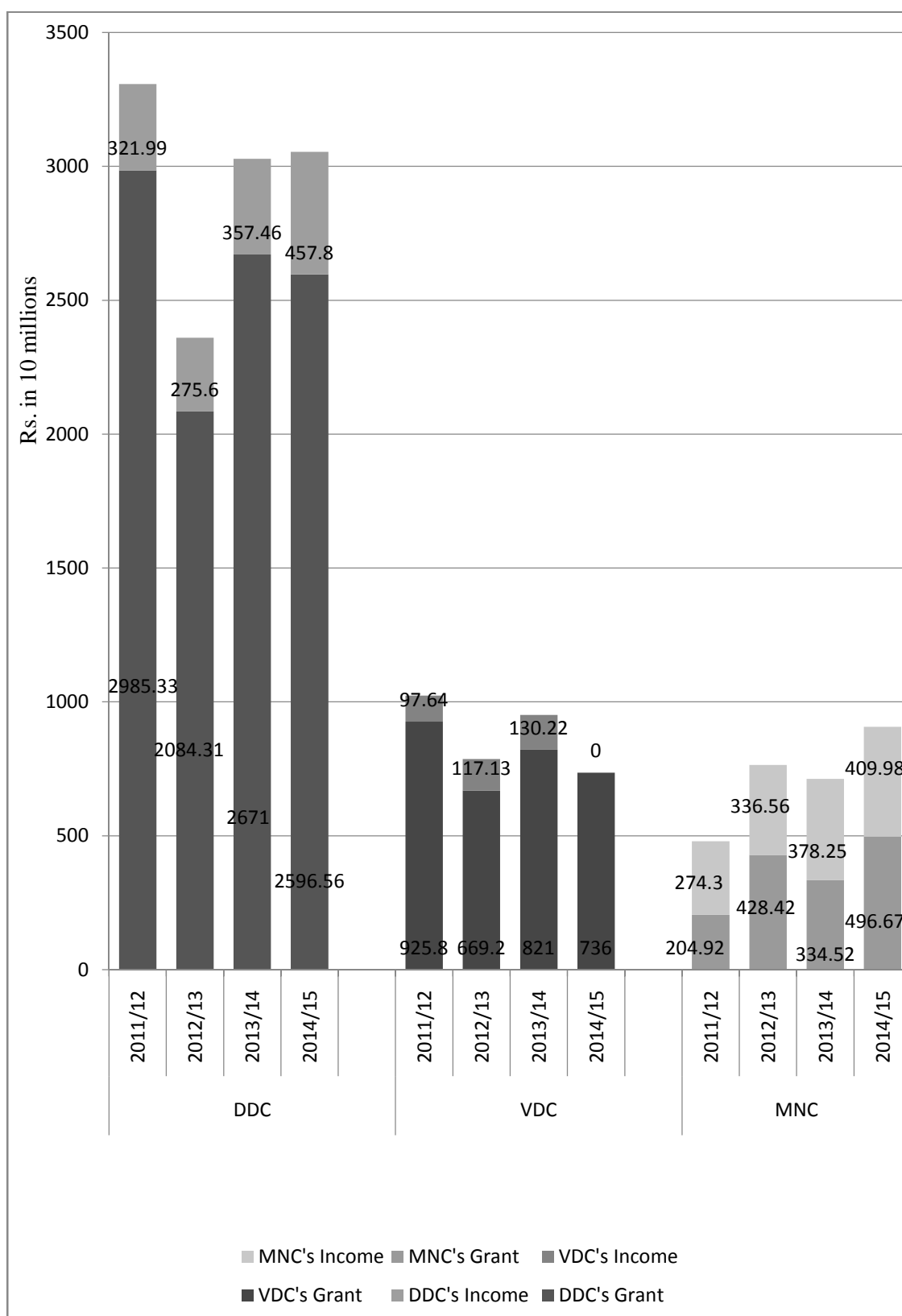
Source: Economic Survey 2015/16, Ministry of Finance, Government of Nepal

Figure 5.1: Trends and Composition of Income and Expenditure in Local Bodies



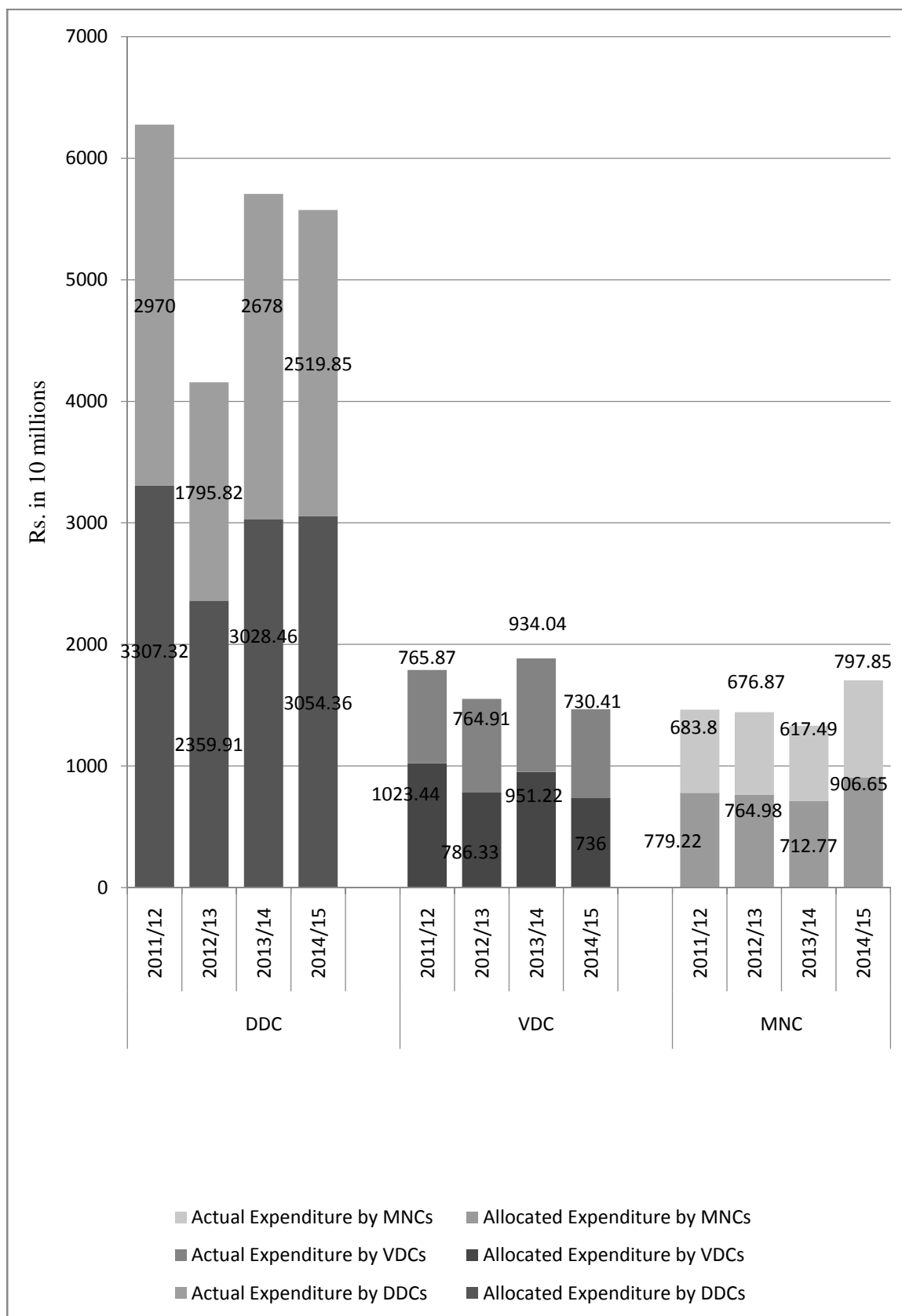
Source: Economic Survey 2015/16, Ministry of Finance, Government of Nepal

Figure 5.2: Composition of External and Internal resources in Local Bodies



Source: Economic Survey 2015/16, Ministry of Finance, Government of Nepal

Figure 5.3: Allocated and Actual Expenditure of Local Bodies



Source: Economic Survey 2015/16, Ministry of Finance, Government of Nepal

5.2 Government Grants to Local Bodies

Tasks mainly in the sectors like development of local infrastructure, social security, social mobilization and empowerment, poverty reduction, environment friendly development, social service delivery at local levels, local good governance including reconstruction subsequent to the earthquake and infrastructure are being carried out through local bodies in line with the spirit of decentralization. The government of Nepal has been providing the major chunk of its expenditure in the form of grants to local bodies for their failure to mobilize their own internal means and resources to meet their desired goals. The status details of resource mobilization of local bodies are as follows:

5.3 DDC Grants

District Development Committees are provided with grants for providing economic, social supports and empowering people thereby supporting in poverty reduction through institutionalization of inclusive development that is based on the needs and demands of local people with their own direct involvements while utilizing local skills, labor, means, and resources. The government of Nepal provided nearly Rs. 29.85 billion grant to the DDCs in FY 2011/12 while such grants stood between Rs. 21 billion and Rs. 26 billion in the fiscal years from 2012/13 to 2014/15. Towards DDCs' internal sources and revenue disbursement sides, the income stood at Rs. 4.57 billion in FY 2014/15 while such income remained close to Rs. 3 billion in fiscal years from 2011/12 to 2013/14. During this period, the DDCs have spent about 80 to 90 percent of their total allocated fund. Enhancing internal resource mobilization capacity is apparent since the contribution of the grants hovers around just 85 percent to 90 percent.

5.4 Municipal Grants

Municipalities are being provided with recurrent and capital grants with the objective of reducing poverty and attaining socio-economic development through the development of physical infrastructures thereby strengthening their service delivery mechanism. Towards recurrent side, tasks such as institutional development, economic and administrative strengthening, resource mobilization and coordination, environment and sustainable development related policies, formulation, coordination,

monitoring and evaluation together with setting an appropriate weighing system for grant disbursement are being carried out while on capital grants front, physical infrastructure works are being performed. The government of Nepal had provided grants of Rs. 5.04 billion in FY2011/12 while such grants stood at Rs. 4.28 billion in FY 2012/13, Rs.3.34 billion in its immediate subsequent fiscal year and Rs. 4.96 in FY2014/15. Grant of about Rs. 4 billion was mobilized through municipality's internal resources and revenue disbursement in FY2014/15 while such grants ranged from Rs. 2.74 billion to 3.78 billion between FY 2011/12 and FY 2013/14. During this period, internal resources contributed about 40percent to 60 percent to total expenditure while other expenditures were covered by the grants.

5.5VDC Grants

The government of Nepal has been disbursing grants to VDCs in order to institutionalize local peoples' need based development initiatives through the utilization of local skills, labor, means and resources. The government of Nepal had provided grants of Rs. 9.25 billion to VDS in FY 2011/12 while such grants dropped to Rs. 6.69 billion in its succeeding fiscal year 2012/13, Rs. 8.21 billion in FY 2013/14 and Rs.7.36 billion in its subsequent fiscal year 2014/15. Likewise, Rs. 970million was mobilized through their internal resources and revenue disbursement in FY 2011/12 while their internal resources rose to Rs.1.17 billion and Rs. 1.30 billion respectively in its two consecutive subsequent fiscal years. The internal resources of VDCs contributed from10 percent to 15 percent to its total expenditure.

The amount garnered through local bodies' internal resources and revenue disbursement totaled nearly Rs. 7 billion in fiscal years 2011/12and 2012/13 while such amount grew to 8.65 billion in FY2013/14. This seemed to have contributed about 13-19 percent to the total expenditure. During this period, the government of Nepal has provided grants from Rs.31 billion to Rs. 44 billion to the local bodies.

CHAPTER VI: CONCLUSION AND RECOMMENDATIONS

6.1 Conclusion

Intergovernmental transfer programs serve multiple often-interrelated purposes, three of which are particularly important. First, they help to cover subnational fiscal imbalances, supplementing inadequate local own-source revenues to improve the ability of subnational governments to meet their expenditure responsibilities. Second, they can be used to meet national redistribution objectives, helping to offset fiscal capacity and fiscal gap differences among subnational governments. Third, they can be used to encourage local expenditures on particular goods and services that exhibit positive spillovers or are considered to be basic needs that should be distributed less unequally than the ability to pay for them.

The institutional arrangement and the responsibility for fiscal transfer and their respective equalization differ from country-to-country as enlisted below.

-) In case of Canada, the provinces and territories have extensive revenue sharing powers, sharing income and consumption tax bases (among others) with the federal government. State and local taxes account for nearly half of the total tax revenue. The provinces are also assigned revenue from non-renewable natural resources. As a result, the aggregate vertical imbalance is low compared to other federations. There are significant horizontal imbalances. These are addressed by formula based transfer intended to equalize revenue capacities and through block grants for health and social services
-) In India, transfers are based on criteria set every year by an ad hoc independent finance commission. The commission has traditionally set transfers based on broad equalization objectives but also to fill ex-post resource gap. Capital transfer and loans are decided by union through its planning commission, in line with the objects of successive national plans.
-) In USA intergovernmental fiscal transfer take the form of Block or special purpose transfers reflecting allocative as well as distributional purposes.

-) In Germany, intergovernmental fiscal transfer is mainly horizontal, involving redistribution of shared revenue among states on the basis of indicator of respective needs.
-) In case of Australia, most taxation powers are concentrated at the federal level, which accounts for over 80% of total tax revenue. The resulting large vertical imbalance has facilitated extensive use of conditional grants reducing the states autonomy and accountability in areas of their responsibility. There are also substantial equalization transfers funded by VAT revenue. The system which is administered by the independent commonwealth grants commission aims to address the differences in revenue capacities and spending needs of the states.
-) In case of South Africa vertical imbalance exist due to the centralization of major taxes at the central level and the delegation of responsibility for implementing most of the expenditure obligations to the sub-national level. Horizontal imbalance at the provisional level are present but probably to a smaller degree compared to developing economies.
-) In case of Nigeria also there exist major vertical imbalance due to the federal government spends between half and two thirds of its resources on capital expenditure and one third of expenditures for state and local government. Not only vertical imbalance is existing in Nigeria but horizontal imbalance.
-) In case of Brazil intergovernmental transfers finance the bulk of local government spending, these are broadly structured as revenue sharing mechanism largely unconditional but also conditional for a small part.

Meanwhile in the Nepalese context, there is the modality of two-tier system in LBs, with village and municipal bodies as the lower tier and district bodies as the higher. The VDCs serve as local governance units in rural areas and Municipalities serve the same purpose in urban areas. The District Development Committees (DDCs) function as middle tier units between VDCs/municipalities and the central government. The government has been providing different types of grants to the LBs. Of them, general purpose grants, also known as block grants, are the only grants that the LBs can spend in their discretion within the limits specified by the law. The block grants are also divided into two: basic entitlements and additional grants. The additional grants,

which are much bigger in size compared to minimum grants, are being formula-based. Currently, different sets of criteria and weighing system are being applied for the allocation of grants to the LBs. Population, area and weighted cost index form the basis of allocation of grants to VDCs, whereas population, area, weighted poverty and weighted revenue effort are the criteria for the municipalities. In case of DDCs, the allocation criteria are population, area, weighted poverty and weighted cost index.

Formula-based grants system is regarded as one of the achievements in fiscal decentralization. Before the system was in place, the government used to allocate grants to the LBs, specially the DDCs and municipalities on arbitrary basis. As a result, the transfer system lacked the elements like equity, predictability, objectivity, transparency etc. With the introduction of the system, there has been marked improvement in the transfer system of the government. Because of this, on the one hand, transfer system has been relatively objective and transparent, on the other; equity aspect is also being taken care of to a considerable extent.

At present the Government of Nepal, as per the constitutional provision to transform the local bodies into a robust institution through merger of their current structure by taking population, geography and infrastructure into consideration, has constituted a commission to propel the tasks of delineating the boundaries and identifying the number of village government (Gaunpalika), municipal government (Nagarpalika), and special, protected and autonomous areas. These local government bodies would adopt the policies and programs for local level for the purpose of local self-governance and ensuring maximum people's participation in country's governance process.

In this context, the Local Government Financial Commission (LGFC) is responsible for regulating the use of government grants, sub-national borrowing and IGFT assisting in fiscal independence of Local Bodies (LBs) and accessing the performance of these LBs. According to LGFC assessment, most of the LBs have been able to perform well on but about one-third of the total VDCs have not been able to achieve success at desired level mainly due to the problem of excessive regular expenditure need, unproductive investment, grant reliant revenue source which need to be resolved by broadening the capital expenditure, increasing internal revenue,

transparency in governance, performance-based evaluation system to allocate grants to the local government and proposed federal government by the central government.

6.2 Recommendations

Many developing countries have continued the decentralization process and reformed their intergovernmental fiscal system over the decades. At the same time, large infrastructure demand at the Sub national level has continued. As a result of these two trends, IGFT legislation is likely to figure high on the policy agenda. In developing IGFT legislation, experience of other countries offers valuable lessons though solutions of other countries experience also highlight potential pitfalls in the design of ex ante and ex post IGFT frameworks. Thus, it is recommended to develop the IGFT framework with the mixture of both: country's specific need and the standard global practices in federal countries.

Optimum utilization of available financial instruments by making the economy vibrant is a must to achieve sustainable economic development. Aside from generating revenue potentials through revenue collection authority, the government should also focus on efficient expenditure assignment framework in proposed 7 State federal structure of Nepal for their viable functioning. For example, resources for the large projects that can bring effective changes in development context should be the policy framework for program implementation for all tiers of governments. The local, federal and central government all can participate in these projects through organized, cooperative, efficient and transparent mobilization of financial instruments, public debts, public expenditure, sub-national borrowing and IGFT with constitutional (budgetary obligation such as tax and expenditure authority and responsibilities of different tiers of government) and institutional framework. The task for utilizing available resources optimally via result oriented development projects still remain a challenge which need to be solved in order to develop Nepal under new federal structure in order to fulfill the aspirations of citizens. Therefore, the federal structure of Nepal should be developed in a way such that the IGFT system, revenue collection and expenditure mobilization and overall fiscal federalism can be optimally operational and sustained by all independent yet competing governmental units.

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APPENDICES

Appendix 1: Income and Expenditure Details of Local Bodies

(Rs. in 10 millions)

Description	Fiscal Year			
	2011/12	2012/13	2013/14	2014/15
1. District Development Committee (DDC)				
Grant received from Government	2985.33	2084.31	2671	2596.56
Net Income	321.99	275.6	357.46	457.8
A) Internal Resources	178.04	136.94	186.4	209.64
B) Revenue Disbursement	143.95	138.66	171.06	248.16
Allocated Expenditure	3307.32	2359.91	3028.46	3054.36
Actual Expenditure	2970	1795.82	2678	2519.85
2. Municipality (MNC)				
Grant received from Government	204.92	428.42	334.52	496.67
Internal Resources and Revenue Allocation	274.3	336.56	378.25	409.98
Allocated Expenditure	779.22	764.98	712.77	906.65
Actual Expenditure	683.8	676.87	617.49	797.85
3. Village Development Committee (VDC)				
Grant received from Government	925.8	669.2	821	736
Internal Resources and Revenue Allocation	97.64	117.13	130.22	0
Allocated Expenditure	1023.44	786.33	951.22	736
Actual Expenditure	765.87	764.91	934.04	730.41

Source: Economic Survey 2015/16, Ministry of Finance, Government of Nepal

Appendix 2: Government Grants to Local Bodies

(Rs. in 10 millions)

Description	Fiscal Year						
	2011/12	2012/13	2013/14	2014/15	2015/16	Average	% of Budget
1. District Development Committee (DDC)							
Recurrent Grant	230	133.68	137	127.3	136.96	152.99	1.77
Capital Grant	361	309.79	195	207.4	230.49	260.74	2.98
Total	591	443.48	332	334.7	367.46	413.73	4.76
2. Village Development Committee (VDC)							
Recurrent Grant	769.2	512.65	664.4	579.4	663.44	637.82	8.59
Capital Grant	156.6	156.6	156.6	156.6	141.74	153.63	1.84
Total	925.8	669.25	821	736	805.18	791.45	10.42
3. Municipality (MNC)							
Recurrent Grant	60	94.14	115	378.8	506.56	230.9	6.56
Capital Grant	11	11	0	36	123.01	36.202	1.59
Total	71	105.14	115	414.8	629.57	267.1	8.15
4. Local Development Fund (LDF)							
LDF Capital	190	123.7	195.68	200.43	234.63	188.89	3.04
LDF Recurrent	40	39.97	64.32	61.12	108.73	62.828	1.41
Total	230	163.68	260	261.55	343.37	251.72	4.45
Grand Total	1817.8	1381.55	1528	1747.05	2145.58	1724	27.78

Source: Economic Survey 2015/16, Ministry of Finance, Government of Nepal