INTERGOVERNMENTAL FISCAL TRANSFER IN NEPAL: LESSONS DRAWN FROM THE INTERNATIONAL PRACTICES

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Abstract - Nepal hastransformedits governance system from the unitary to a federal democratic republic after the promulgation of The Constitution of Nepal on September 20, 2015.On the basis of constitutional provision, the modality for the intergovernmental fiscal transfer (IGFT) system (i.e. from federal level to provincial and local level) yet to be further clarified. However, the first federal budget 2017-18 has allocated the fiscal equalization grant and special grant to the local level and newly formed Intergovernmental Fiscal Management Act 2017 has provisioned the revenue sharing modality and natural resources revenue sharing modality among the different tiers of government. The objective of this article is to review the intergovernmental fiscal transfer (IGFT) system in Nepal and to suggest the appropriate IGFT model and need variables based on the international practices and national need. This study has adopted the descriptive and analytical method based on the qualitative data. Regarding the issue, the study suggests that- the equalization grants should be transferred on formula basis. In the initial phase of the new governance system, fiscal transfer formula should be research based, very simple and clear. The variables used in formula should be relevant, non-disputable and selected on the basis of national context and availability of the data. Relevant database of the newly established provincial and local governments should be developed accordingly and the fiscal transfer formula should be amended periodically which will serve more the constitutional spirit of fiscal equalisation. Moreover,specific and clear guidelines should be formulated to implement the matching and special grants as well.

Keywords - Intergovernmental fiscal transfer, revenue sharing, vertical fiscal imbalances, horizontal fiscal imbalances, federal government, state government, local government,

I. INTRODUCTION

Intergovernmental fiscal transfer is a major source of sub-national government revenue in most of the federal countries around the globe. No clear modality is available regarding the intergovernmental fiscal transfer around the world. It depends up on the political, social and economic situation of the country. Literatures on fiscal federalism consider the intergovernmental fiscal transfer as the mechanism to reduce vertical and horizontal fiscal imbalance and to minimize the disparities among the different tiers of governments

The newly promulgated Constitution of Nepal 2015 has provisioned 7 provincial and 753 local governments including rural municipalities and municipalities. It has not provisioned the clear modality for the intergovernmental fiscal transfer from the central government to provincial and local governments. However, it has provided some guidelines regarding the different types of grants.The constitution has provisioned a Natural Resource and Fiscal Commission to assess the modality and amount of the transfers to the lower government. As per the revenue assignment modality presented in the constitution, most of the revenue generation power is centralized at federal government whereas expenditure responsibilities to the provincial and local level government are very high. As per the constitutional provision, the central government collects around 80 percent of tax revenue and 90 per cent of the total revenue. The sub national governments have to depend upon the federal transfers in order to perform their expenditure responsibilities assigned by the Constitution. Federal parliament has recently passed the Intergovernmental Fiscal Management Act 2017 which has provisioned the revenue sharing modality of VAT and excise duty on domestic production and revenue from natural resources.

This study has adopted the descriptive and analytical method and based on qualitative data. It has analysed the intergovernmental fiscal transfer system adopted in present transitional phase of fiscal federalism in Nepal and recommended some guideline and suggestions by examining the lessons learned from the selected federations. It is hoped that the recommendations will be useful for the government in establishing the appropriate intergovernmental fiscal transfer model in federal Nepal.

The paper is divided into six sections. It begins with a brief introduction. Section two discusses the theoretical principles of intergovernmental fiscal transfer. Section three includes the conceptual framework of intergovernmental fiscal transfer. Section four discusses the practices of intergovernmental fiscal transfer across the selected federal countries like Australia, Brazil, Canada, India, South Africa, and Switzerland. The intergovernmental fiscal transfer system in Nepal is critically analysed in section five. The last section includes conclusion and recommendations of the study.

II. PRINCIPLE OF INTERGOVERNMENTAL FISCAL TRANSFER

The most crucial part of intergovernmental fiscal transfer is concerned with the impact on policy objectives of the governmentthat depends upon the formulation of transfer system and operational part of the transfer fund.IGFT is neither basically good nor basically bad; it depends upon the transfer mechanism and efforts of fiscal transfer on basic outcome regarding the allocative efficiency, equitable distribution and macroeconomic stabilization. The IGFT differs from country to country according to their conditions and objectives. An experience of transfer system from different countries has drawn the common sense argument that transfershould be for the efficient service delivery, need based with sufficient resources and having flexibility in decision making. In order to fulfil these conditions, transfer must be designed properly and central government must be accountable for the outcome (Bird & smart, 2001). Shah, Rajaraman, and Rezende, (2008) have identified six broad objectives for Intergovernmental fiscal transfer (IGFT).They are: 1) To fill for the vertical fiscal gap, 2). To provide solution for the fiscal disparities with the help of equalization transfer, 3).To set national minimum standards, 4).To provide Compensation for the spillover benefit, 5).To impress local priorities and 6).To make negotiation towards the less infrastructure development and to create macroeconomic stability in poor area. A good transfer systemshould be:with clear objectives, reflecting sub national autonomy, providing revenue adequacy and responsiveness towardsthe need of sub national government. In addition, it should be equitable (fair) in distribution of revenue, transparent in grant distribution and efficient in resource allocation. Transfer mechanism and grant formula should be predictable, simple and clear.Likewise, it should be affordable in programs of sub national government and accountable for the result (Shah, Rajaraman, & Rezende2008). The major objective of IGFT is to address vertical and horizontal fiscal imbalances amongthe layers of government. Vertical fiscal imbalance means difference between expenditure and revenue from own sources in various layers of government.However the horizontal fiscal imbalance appears among the sub national governments which have different capacities, different need and priorities. It is also called regional inequalities. Usually, verticalfiscal transfer is determined on the basis of expenditure requirement and need for making provision of minimum services of the sub national governments. But, horizontal fiscal imbalances are addressed by providing the vertically determined fund among the sub national governments by adopting the equity and efficiency principle (Hajra, Rakhe, & Gajbhiye 2008).

Nevertheless, Shrivastava (2011) argues that the initial transitional phase of fiscal federalism has had two different interlinked stages. First stage includes structural changes like reorganization of the country, division of resource and responsibilities among the different levels of government and establishment of institutional bodies for the settlement of upcoming vertical and horizontal imbalances. Secondly, redesigning the administrative structure and designing of intergovernmental fiscal transfer model would have to be on place. The case applies for Nepal as she is continuously working under these processes and this study is hoped to be helpful in this regard.

III. CONCEPTUAL FRAMEWORK

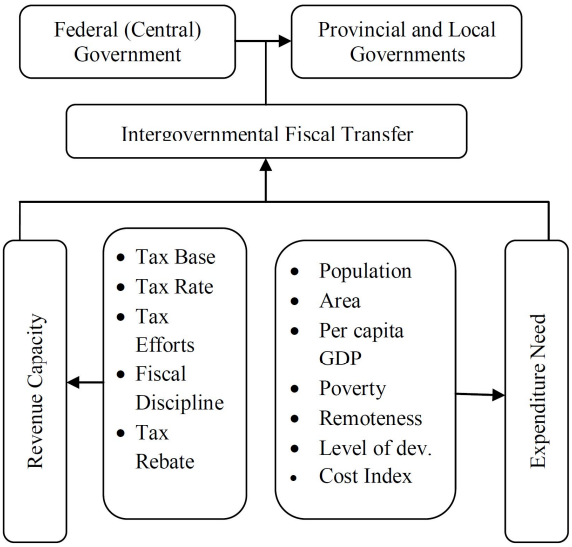


Fig. 1:Conceptual framework of intergovernmental fiscal transfer

As the objectives of fiscal transfer is to address the fiscal imbalances, the transfer system should be based on revenue capacity and expenditure need of the sub national governments. It is because the verticle and horizantol fiscal imbalances among the subnational governments are generated because of unequal revenue sources and demand for the services. Hence, as mentioned in the conceptual framework (given in fig. 1), the revenue capacity of the sub national governments should be determined by these variables: tax base, tax rate, tax efforts, fiscal discipline and tax rebate. Likewise, expenditure need of the sub national governments should be determined by these variables: population, area, per capita GDP, poverty, remoteness, level of development and cost index.

IV. PRACTICE OF INTERGOVERNMENTAL FISCAL TRANSFER IN SELECTED FEDERAL COUNTRIES

4.1 Australia

Australia has become a federation in 1901 with six separate British colonies came together and established a commonwealth and became a state.The

Australian federation today comprises the federal government, six states, two internal self-governing territories, and some 720 local governments. The federation was formed by coming together of six-self governing British colonies in 1901 (AG, 2017,& chhetry,2017). The major tax revenue is Goods and Service Tax (GST) which is same like the value added tax. It is collected by the commonwealth government and distributed to the different states as the fiscal transfer.Commonwealth Grant Commission (CGC) is an organizational body to determine amount and mechanism of fiscal transfer every year in Australia.There aremain two types of transfers to the State/Territorial governments: i) General Purpose Payments-GPPs (Equalization Transfer) ii) Special Purpose Payments (SPPs). The formula used for the grant transfer is: The amount of grant to a state = (state's per capita share of total grant pool + expenditure needs + revenue needs + needs for specific purpose payments.) The CGC calculates "state relatives" in consideration with the revenue capacity and expenditure need of the state governments. "State relatives" are decided by the revision made every five years for forty-one expenditure and eighteen revenue categories.(Bird& Tarasov, 2004, Library of Parliament, 2005,)

The major composition of the transfer pool of GPP (around 97%) is covered by revenue from the Goods and Service Tax (GST) of commonwealth government.However, the major factors of revenue capacity and cost disabilities are given in table 1. Next, there are three types of Payments for Specific Purposes (PSP): National Specific Purpose Payments (SPP), National Partnership Payments (NPP) and National Health Reform Funding.Under the PSP, healthcare, schools, skill development, disability services, housing etc.are the important sector for transfer. Similarly, SPP is provided on a case by case basis according to the appropriateness and NPP is an activity based funding and allocated on per capita basis (Panta, 2017).

Table 1: Factors Affecting in Australian Transfer System

Factors affecting revenue bases	Factors affecting expenditures
✓ Gross State Product (GSP) per-capita (i.e., GSP + Population) ✓ Payrolls of large business (wages and salaries) ✓ Value of commercial or industrial land ✓ Value of mining production	✓ Share of Australian population ✓ Proportion of ✓ population aged 65 years or over ✓ Proportion of population who are indigenous (Aborigines) ✓ Proportion of population residing in remote areas ✓ Proportion of population enrolled in government schools ✓ Proportion of population enrolled in government schools ✓ Proportion of population with low income ✓ Relative average weekly earnings ✓ Relative lengths of roads

Source: (Rangarajan & Srivastava, 2004, Panta, 2017)

4.2 Brazil

Brazil is a federal democratic republic under a presidential system. The President is both the head of state and the head of government administered by the cabinet of ministers. The country is a three-tier federation which includes 26 states,a federal districtand more than 5,500 municipalities. According to the 1988 Constitution, states and municipalities are independent units of the Brazilian federation (BG, 2017, Chhetry, 2017).

Industrialized product tax and income tax which are administered and collected by the federal government are taken as redistributive tax in Brazil. Municipalities have received 67 percent of revenues out of their total revenue from the federal and state government.The intergovernmental fiscal transfer system in Brazil includes 4 major mechanisms including (i) revenuesharing, (ii) mandatory or legal transfers, (iii) compensatory transfers, and (iv) discretionary grants. There are four types of transfer under the revenue sharing- (i) state participation fund (FPE), (ii) municipality participation fund(FPM), (iii) sharing of tax on circulation of goods and services(ICMS), and (iv) sharing of natural resources revenue (NRR).

FPM is a non-matching and unconditional transfer which is provided as per the fixed coefficients for each state. The percentage distribution to the state is- states of north, north-east and central west: 85% and states of south and south-east: 15%. Similarly, distribution percentage of regions is- north : 25.37% , north-east : 52.46%, central west: 7.17%, south: 6.52and south-east: 8.48%.The share of FPE amount to the state and region is determined on the basis of previous year adjusted for inflation and GDP growth (75%) as a transfer pool and the factors considered in determining the share(weight) of individual state by using the coefficient is- (i) Size of the state (5%) , (ii) Direct proportion of population shares and inverse of the per capita income of state (95%).FPM is an unconditionalnon-matching , mandatory, transfer. As per the constitutional provision, it is provided to capital cities on the basis of a formula based on the direct proportion of population size and inverse of per capita income of the respective state: 10%, large non-capital cities with more population (based on criteria of population and per capita income): 3.6% and rest of the municipalities on the basis of formula with criteria of population size: 86.4%.

The share of discretionary grant is determined by the political decision. These grants may be matching as well as non matching and it consists of less than two percent of the total transfer in Brazil. Likewise, compensatory nature transfers are provided by two ways- First type relates to exports of industrial goods. Which mandates sharing with the states of 10 percent of the revenues from the federal selective and the second type relates to the exports of primary and semi-manufactured products.Transfers for the education and health care system are managed

through the legal transfer, which is regulated by the specific laws. The major variables that have been using in Brazilian fiscal transfer system are per capita income, health, education and per capita royalty (Arvate, Mattos, & Rocha, 2015, (Sen, K.T, Amarnath, H.K, Dash, B.B, Gupta, M & Kumar, S.2014, Pant, 2017).

4.3 Canada

Canada federation composed of 10 provinces, 3 territories, and about 3,700 municipal governments. Autonomous provincial and municipal governments share with the federal government unrestricted access to all the major tax sources. They are authorised for raising a high proportion of their own revenues (GoC, 2017, Chhetry, 2017).Canada has a long and complex history of fiscal transfer system. Presently,there are four types of intergovernmental fiscal transfer among the federal and provincial governments: i) Canada Health Transfer (CHT), ii) Canada Social Transfer (CST), iii) Equalization Payments (EP), iv) Territorial Formula Financing (TFF) (Table 2).Canada Health Transfer and Canada Social Transfer arebased on equal per capita transfer system and used to reduce the vertical fiscal imbalances. These transfers are unconditional transfer and fiscal transfer amount under these criteria is determined by the federal government and these transfers CHT and CST are provided to the provinces with autonomy to spend with some certain principles, criteria and conditions of health and social sector as provisioned in respective acts and regulations.

Theequalization payment transfer is used to reduce the horizontal fiscal imbalances among the provincial governments. This transfer is also an unconditional open-ended fiscal transfer.

It is based on per capita income, tax capacity and national average level of tax and focuses on the representative tax bases regarding the different revenue sources. In this system every revenue sources and tax are taken individually. Initially, this system was used for 33 revenue bases which were included revenues, royalties and user charge. But the system was amended in 2007 and only five revenue sources like personal income tax, consumption tax, property tax and natural resources are in practice. Territorial Formula Financing (TFF) is an unconditional grant which is provided to three territorial governments to address the activities based on public service delivery like hospitals, schools, other infrastructures and social service for the large number of small and isolated communities. The formula for this transfer is

TFF = (Expenditure Need – Revenue Capacity). Where expenditure is determined on the basis of large area, extreme weather conditions and small population(Srivastava,2004,Srivastava, 2011, Rangarajan &Virkola, T. 2014, Pant, 2017).

Table .2The Transfer Systems and Indicators Used in the Transfer Formula in Canada

S. N	Transfer	Nature	Factors determining the transfers
1	Equalization Grants	Unconditional Block Grants	Population, average tax rate of the provinces, per-capita standard tax base and individual province's tax base
2	Canada Health and Social Transfers (CHST)	Specific purpose Grants	Normative/Standard expenditure needs on health and social services. Predetermined tax point transfers, tax bases of the individual province and highest tax base, Population
3	Territorial Formula Financing (TFF)	Unconditional Block Grants	Expenditure needs (large area, extreme weather conditions, small population), own source revenue.
4	Health Reform Fund	Earmarked	----------

Source: Dafflon, 2014 as cited by Panta, 2017

4.4 India

India is a democratic republican federal country. The country has a three-tier federal structure with 29 states and 7 centrally administered territories -2 of which have legislatures. Below the state governments, in urban areas there are 96 municipal corporations, 1,494 municipalities, and 2,092 smaller municipalities. There are 247,033 rural local bodies, of which 515 are at the district level, 5,930 at the block level, and 240,588 at the village level (GoI, 2017, Chhetry, 2017). Fiscal transfer from central government to states in India is based on the recommendations of the national finance commission and grant transfers are also provided by the Planning Commission and the central ministries in India. The status of Finance Commission, Planning Commission, National Development Council, Inter-state Council and State Finance Commission are defined by the constitution. Each Finance Commission is established normally for five years and it develops the fiscal transfer criteria. In Indian federal system, there is vertical as well as horizontal imbalance. The vertical fiscal imbalance is solved by means of fiscal transfer from central to state governments. The population criteria is a appropriate means for deciding vertical fiscal transfer which gives equal per capita transfer to all states. Some other criteria adopted by the various fiscal commissions are capacity distance, area, index of infrastructure and fiscal discipline. Table 3 presents the criteria based transfer of central taxes to state governments in India for five recent finance commissions (Srivastave, 2011)

Table 3: Criteria-based sharing of central taxes with states in India: four recent Finance Commissions

Criteria	Relative Weight (Percent)				
	10th	11th	12th	13th	14th
1. Population	20.0	10	25.0	25.0	17.5
2.Distance/Capacity	60.0	62.5	50.0	47.5	50
3. Area	5.0	7.5	10.0	10.0	15
4. Index ofinfrast.	5.0	7.5	-	-	
5. Tax efforts	10	5.0	7.5	-	
6. Fiscal discipline	-	7.5	7.5	17.5	
7. Fiscal capacity			47.5		
8. Demographic					10
9. Forest cover					7.5

Source:(Panta2017), Reports of various Finance Commission, Government of India.

In the same way, another important transfer system in India is a Gadgil formula approach which has been using by the Planning Commission. This formula is used to determine the share of state government in the plan transfer. This formula has been changed time to time and current formula is referred to as the National Development Council (NDC) revised Gadgil formula. According to this formula 30 percent of total fund is allocated to special category states and rest of 70 percent is distributed to general category states by using the criteria with relative weight. The variables uses in Gadgil-Mukherjee formula are: population, per capita income, tax efforts, fiscal management, national objectives and special problems. (Srivastave: 2011)

4.5 South Africa

South Africa is a democratic republican country with three-tier system of government. The President is the executive authority and elected by the Parliament. The country is composed of 9 provinces, 8 metropolitan municipalities, 44 district municipalities and 226 local municipalities (SAG, 2017, Chhetry, 2017). South Africa has been broadly adopting two types of grant- equitable share grant (80%) and conditional grant (20%).Equitable share grant consists ofprovincial equitable share (PES) transfer and local government equitable share (LGES)transfer. PES formula based transfer system consists of six components which are: education, health, poverty, economic activity, institutional and basic. The formula for Provincial equitable share(PES) for province i,(Gi)= Ei + Hi +Bi +Ii +Pi +Ri ((Alam & Vazquez 2015, Pant 2017).

The local government equitable share(LGES) grant transfer with the size determined by the yearly budget for the basic services. This grant is also a formula based grant. The formula for the LGES grant is: LGES = BS + I + D-R ± C

Where, BS = Basic Services Component, I = Institutional Component, D = Development Component, R = Revenue Raising Capacity Correction Component, C = Correction and Stabilization Factor.

Table 4: The weight of the different component of transfer formula in South Africa.

S.No	Component	Weight (2013)
1	Education	51
2	Health	26
3	Basic	14
4	Institutional	5
5	Poverty	3
6	Economic Activity	1
	Total	**100**

Source: Alam and Vazquez (2015)

The major determinant factors for the LGES are:Poverty, access to service, basic services, quality of services, population growth,municipal size, projected own revenue of wealthier local governments and poor local governments and population. (SALGA, 2012, Pant 2017)

The National government provides four types of conditional grant- supplementary grant, financing for specific program of national interest, specific purpose in-kind grant for special programme and grant for disaster management for the basic services to achieve the uniformity among all citizens (Panta, 2017).

4.6 Switzerland

Switzerland has a federal government, 26 cantons and around 2889 municipalities. Cantons are highly independence and they have permanent constitutional status. All cantons are equal in status but they are different in terms population and area. They have own constitution, parliament, government and court. One of the most significant features regarding assignment of responsibilities is that residual powers are vested in cantons rather than confederation(Srivastava, 2011, Chhetry,2017).The Swiss fiscal equalization transfer consists of three main types of transfer- revenue equalization, expenditure need equalization and cohesion fund. The revenue equalization transfer is provided on the basis of resource potentiality of the canton. The indices of revenue potential are calculated on the basis of eight major communal taxes of the last three years. They are-personal wealth tax, income, corporate Capital tax, corporate profits tax, tax on wage (TDS), immovable property tax, capital gains tax and motor vehicle tax. The expenditure need equalization transfer is a vertical transfer system. It is transfer from the federal level to cantonal level.

Table 5: Expenditure Needs Equalization Transfer Formula in Switzerland

Expenditure Needs	Variables	Weights (%)
Geo-topographic	✓ % of people living above 800 m altitude	33
	✓ % of productive land greater than 1080 m altitude	33
	✓ Population Density	16
	✓ Population of Commune less than 200 residents	16
Socio-demographic	2/3) of socio-demographic transfers	
	✓ % of social aid to population (denotes poverty)	42
	✓ % of people above 80 years to population(denotes old age)	25
	✓ % of foreigners to population	33
	1/3) of socio-demographic transfers	
	✓ Number of residents	35
	✓ Workplaces in proportion to surface	38
	✓ Workplace in proportion to population	27

Source: (Dafflon, 2014).

The variables used in the formula and weights are: under the geo-topographic- percent of people living above 800 meter altitude- 33%, percentof productive land greater than 1080 meter altitude- 33%, population Density- 16%, population of Commune less than 200 residents- 16% (Table 5). Under the socio-demographic 2/3 of socio- demographic transfer the weights are: percent of social aid to population (denotes poverty)- 42%, percent of people above 80 years to population(denotes old age)- 25%, percent of foreigners to population- 33% and under the 1/3 of socio-demographic transfer the weights are- umber of residents- 35%, workplaces in proportion to surface- 38%, workplace in proportion to population- 27% (Dafflon, 2014, Pant, 2017)

There are two types of transfers. They are a federal level transfer and the transfer from rich cantons to the poor cantons. The federal level transfer covers 60% of the transfers. The federal cost compensation is a vertical transfer which addresses the fiscal needs of cantons on the basis of disparities in geographic and topographic situations of mountainous and rural cantons. The objective of Cohesion fund is to facilitate the transition to the new fiscal framework and those cantons which have lost some of their fiscal capacity. This transfer is financed 75% by the federal level and 25% by the strong cantons(Virkola, 2014).

V. INTERGOVERNMENTAL FISCAL TRANSFER IN NEPAL

Fiscal federalism is a major aspect of economic development of the developing country like Nepal undergoing federalism. Since, Nepal is in the initial stage of designing fiscal federalism model, one of the important aspects of which is, the development of IGFT framework. Consequently, formulation of appropriate model of fiscal federalism to run the economic activities in such transitional phase needs serious consideration. In this background, present constitution has made some provision of functional power, responsibilities and revenue assignment among the federal, provincial and local government. The five schedules of power and functions include exclusively federal, provincial and local government functions and concurrent functions of federal-provincial and federal-provincial-local functions.

Kelly (2011) concludes that grants transfer system in Nepal during the unitary system was ad hoc and dominated by the categorical grants in determining the annual grant pool. It was highly complex. International best practices would announces for the simple and formula based transfer system for both capital and recurrent grant. Similarly, Subedi (2013) also concludes that intergovernmental fiscal transfer in Nepal was not predictable. The formula based transfer system hadbeen using only for the block grant provided by the Ministry of Finance (MOF) to local bodies (LBs). Distributive pool provided by the MOF was ad hoc in nature. LBs were highly dependable on central government grant. There was a lack of appropriate criteria and transfer formula for line agencies regarding the fiscal transfer.

Under the unitary system, the grant allocation methodology to the local bodies was:

$Y=a+bX$ (Total grant = Minimum grant + Additional grant)

Where,

a=Minimum grant

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

The local level expenditure need was based on 5 variables comprising (i) population, (ii) weighted poverty, (iii) area, (iv) weighted cost, and (v) weighted tax effort. The weight for these variables was different in the cases of VDCs, municipalities and DDCs. In the case of VDCs, the weights were fixed as population (60%), area (10%), and weighted cost (30%). Similarly in the case of municipalities weights were given to population (50%), weighted poverty (25%), area (10%), and weighted tax effort (15%). On the other hand, 40% weight was given to population, 25% for weighted poverty, 10%to area, and 25% for weighted cost in the case of DDCs (LBFC, 2015).

Sharma, Raghunandan, and Devkota, (2015) analyze that there are huge fiscal imbalances and development/economic inequalities among the provinces. The variances on population, area, HDI and per capita income and the variances on vertical fiscal imbalances among the provinces seem to be contrasting.Thus, regional inequality between the provinces is another challenge ahead. Horizontal

imbalances and economic disparities can be seen huge in current federal structure. In such background they have suggested to address above inequalities between the provinces, National Natural Resources and Fiscal Commission should work out the grant transfer formula to equalize vertical and horizontal imbalances among the provinces in Nepal in new governance system.

Recently the Government of Nepal has promulgated two Acts related to IGFT: (i) Intergovernmental Fiscal Management Act (IGFMA) 2017 and National Natural Resource and Fiscal Commission (NNRFC) Act 2017. The article 6.1 under the Schedule 3 of IGFMA has the provision of establishing a Federal Divisible Fund (FDF) in order to divide the VAT and excise duty on domestic production among federal, provincial and local government. Further, the sub-article 2 has made the provision of dividing the total amount of the FDF comprising 70, 15 and another 15 percent among the federal, provincial and local government respectively.

Table 6: Sharing of VAT and Excise duty of domestic production in Nepal (%)

Revenue Heading	Central government	Provincial governments	Local governments
Value Added Tax (VAT)	70%	15%	15%
Excise Duty on Domestic Production	70%	15%	15%

Source: Intergovernmental Fiscal Management Act 2017, Government of Nepal

Similarly, Article 7 of the Act has provisioned that the Government of Nepal will establish a Federal Divisible Fund in order to share the royalty collected from natural resources among the federal, provincial and local governments as per the following modality:

Table 7: Sharing of Royalty Collected from Natural Resources in Nepal (%)

S. N.	Royalty Heading	Gov. Of Nepal	Related Province	Related Local Government
1.	Mountaineering	50	25	25
2.	Electricity	50	25	25
3.	Forest	50	25	25
4.	Mining and mineral	50	25	25
5.	Water and other	50	25	25

Source: Intergovernmental Fiscal Management Act 2017, Government of Nepal

Present constitution has provisioned the four types of grants like equalization grant, conditional grant, matching grant and special grant. To make recommendation on the grant allocation to the various tiers of the government, the Constitution has provisioned the National Natural Resources and Fiscal Commission. The NNRFC has to elaborate the various components of the constitutional provisions. Although the fiscal transfer provided to the local governments has significantly increased under federal structure, local governments again will have to depend heavily on the central government to meet their expenditure responsibilities. The fact is clearly reflected in the first budget of 2017/18 after federal set up. Out of NPR 1,139 billion total budget, NPR 232 billion (i. e. 20 percent) is allocated for the local bodies including provinces through two types of fiscal transfers- fiscal equalization and conditional grants. The variables used for the fiscal equalization grant are population,level of development and cost adjusted area of the local governments.

CONCLUSIONS AND RECOMMENDATIONS

Revenue assignment modality presented in the present constitution has centralized most of the revenue generation power at federal government whereas most of the expenditure responsibilities are assigned to the provincial and local level government. As per the constitutional provision, the central government collects around 80 percent of tax revenue and 90 per cent of the total revenue. This situation creates the significant vertical fiscal imbalances among the levels of governments.Newly promulgatedIntergovernmental Fiscal Management Act 2017 provisioned the modality of the sharing of VAT and excise duty on domestic production among federal, provincial and local government and the first budget of 2017/18 after federal set up, two types of fiscal transfers including fiscal equalization and conditional grants are provided to the provincial and local governments as a transitional arrangement. Thus, to address the problemthe paper suggests that in the initial phase of the new governance system, fiscal transfer formula should be research based, very simple and clear. The variables used in formula should be relevant, non-disputable and selected on the basis of national context and availability of the data.

The common major variables used in the fiscal transfer formula in selected federations are- Population, Area, per capita, Tax effort/capacity, expenditure need,Education, Health, Poverty, Fiscal discipline, Index of infrastructure etc. On the basis of experiences from the international practices and study carried out at the national level, this study suggests that the intergovernmental fiscal system in Nepal also should be based on the revenue capacity and expenditure need of the transfer receiving governments. Regarding the revenue capacity the variables canbe used are: tax base, tax Rate, tax efforts, fiscal discipline and tax rebate. Likewise, the variables for estimated expenditure need could be: population, area, per capita GDP, poverty, remoteness, level of development and cost index. Use of these variables for the fiscal transfer depends up on the availability of the data for the required field. Relevant database of the newly established provincial

and local governments should be developed accordingly and the fiscal transfer formula should be amended periodically which will serve more the constitutional spirit of fiscal equalisation. Moreover, specific and clear guidelines should be formulated to implement the matching and special grants as well. Last but not least, weightage of the variables in transfer formula can be suggested only after the data analysis which is beyond the scope of this short study.

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