Policy and Advisory Technical Assistance (PATA)

For

Strengthening Subnational Public Management

Revised Draft Midterm Report

September 2017

Acronyms

ACA	Additional Central Assistance
ADB	Asian Development Bank
AMS	Audit Management Software
BBL	Building By-Laws
BMIS	Budget Management Information System
BMPS	Budget Monitoring and Planning System
BPS	Building Permit System
CAGR	Compounded Annual Growth Rate
CB	Capacity Building
CBS	Central Bureau of Statistics
CBT	Capacity Building and Training
CCEA	Cabinet Committee on Economic Affairs
CEE	Centre of Excellence for Evaluation
CGAS	Computerized Government Accounting System
CGC	Commonwealth Grant Commission
CIS	Citizen Interface System
CNBV	National Banking and Securities Commission
COA	Chart of Accounts
COSO	Committee of Sponsoring Organization of the Treadway Commission
CPSU	Central Public Sector Undertakings
CRR	Cash Reserve Ratio
DCC	District Co-ordination Committee
DDC	District Development Committee
DEA	Department of Economic Affairs
DEAS	Double Entry Accounting System
DFID	Department for International Development
DoIT	Department of Information Technology
DSS	Decision Support System
DTCO	District Treasury Comptroller Office
DY	Deputy

ED	**Executive Director**
EIS	**Executive Information System**
FAA	**Fixed Assets Accounting**
FAR	**Fixed Asset Register**
FC	**Finance Commission**
FCE	**Fiscal Capacity Equalization**
FCGO	**Financial Comptroller General Office**
FFC	**Fiscal and Financial Commission**
FGD	**Focused Group Discussion**
FMAS	**Financial Management and Accounting System**
FMIS	**Financial Management Information System**
FRBMA	**Fiscal Responsibility and Budget Management Act**
FRL	**Fiscal Responsibility Law**
FRMB	**Fiscal Responsibility & Budget Management**
FRS	**Functional Requirement Specification**
FY	**Financial Year**
GDP	**Gross Domestic Product**
GESI	**Gender Equity and Social Inclusion**
GIDC	**Government Integrated Data Centre**
GIS	**Geographic Information System**
GoI	**Government of India**
GoN	**Government of Nepal**
GST	**Goods and Services Tax**
HEE	**Horizontal Equity Equalization**
HFI	**Horizontal Fiscal Imbalance**
IA	**Internal Audit**
IBRD	**International Bank for Reconstruction and Development**
ICF	**Internal Control Framework**
IDA	**International Development Association**
IECCD	**International Economic Cooperation Coordination Division**
IFAD	**International Fund for Agricultural Development**

IGAFFR	**Intergovernmental Agreement on Federal Financial Relations**
IGFM	**National Planning Commission**
IGFMD	**Intergovernmental Fiscal Management Division**
IGFT	**Intergovernmental Fiscal Transfers**
IMD	**Internal Management Division**
IMS	**Inventory Management System**
INTOSAI	**International Organization of Supreme Audit Institutions**
IOR	**Intimation of Repayments**
IP	**Internet Protocol**
IPO	**Initial Public Offering**
IPSAS	**International Public Sector Accounting Standards**
IPT	**Integrated Property Tax**
IPTS	**Integrated Property Tax System**
IT	**Information Technology**
KMC	**Kathmandu Metropolitan City**
LAPAC	**Local Authorities Public Accounts Committee**
LBFC	**Local Bodies Fiscal Commission**
LDO	**Budget Guidelines Law of Brazil (Lei de Diretrizes Orçamentárias)**
LMBIS	**Line Ministry Budget Information System**
LMBIS	**Line Ministry Budget Information System**
LSGA	**Local Self Governance Act**
LSGFR	**Local Self Governance Financial Regulation**
M&E	**Monitoring and Evaluation**
MARS	**Municipal Administration and Revenue System**
MC	**Minimum Conditions**
MCPM	**Minimum Conditions and Performance Measures**
MIIP	**Municipal Infrastructure Improvement Project**
MoF	**Ministry of Finance**
MoFALD	**Ministry of Federal Affairs and Local Development**
MTB	**Medium Term Budget**
MTBF	**Medium Term Budgetary Framework**

MTEF	**Medium Term Expenditure Framework**
MTF	**Master Trust Funds**
MTFF	**Medium Term Fiscal Framework**
MTPF	**Medium Term Performance Framework**
NAMS	**Nepal Audit Management Software**
NBC	**National Building Code**
NEPSE	**Nepal Stock Exchange**
NFC	**National Fiscal Commission**
NNRFC	**National Natural Resources and Fiscal Commission**
NPR	**Nepali Rupee**
NRB	**Nepal Rastra Bank**
NSSF	**National Small Savings Fund**
NUDS	**National Urban Development Strategy**
OAG	**Office of Auditor General**
OECD	**Organization for Economic Cooperation and Development**
OMO	**Open Market Operations**
OMS	**Office Management System**
OPEC	**Organization of the Petroleum Exporting Countries**
OSR	**Own Source Revenue**
PAC	**Public Accounts Committee**
PATA	**Policy Advisory and Technical Assistance**
PBG	**Performance-based Grants**
PEF	**Public Expenditure Framework**
PEFA	**Public Expenditure and Financial Accountability**
PFM	**Public Financial Management**
PFMRP	**Public Financial Management Reform Strategy/Program**
PIC	**Program Implementation Committee**
PIS	**Personnel Information System**
PM	**Performance Measure**
PMS	**Payroll Management System**
PPA	**Multiyear Plan of Brazil (Plano Plurianual de Acao)**
PRI	**Panchayati Raj Institutions**

PSIAS	**Public Sector Internal Audit Standards**
PSU	**Public Sector Units**
RBA	**Risk Based Audit**
RBIA	**Risk Based Internal Audit**
RMIS	**Revenue Management Information System**
RMS	**Revenue Management System**
SGST	**State Goods and Service Tax**
SLR	**Statutory Liquidity Ratio**
SNG	**Subnational government**
SPC	**State Planning Commission**
SPMP	**Strengthening Subnational Public Management Program**
SPV	**Special Purpose Vehicle**
SRS	**System Requirement Specification**
SWAP	**Sector Wide Approach**
TA	**Technical Assistance**
TDF	**Town Development Fund**
TSA	**Treasury Single Account**
UN	**United Nations**
UNCDF	**United Nations Capital Development Fund**
UT	**Union Territories**
VAT	**Value Added Tax**
VDC	**Village Development Committee**
VFI	**Vertical Fiscal Imbalance**
WMS	**Waste Management System**

Contents

Executive Summary

The new Constitution of Nepal has introduced a federal system of governance, where the main structure of the Federal Democratic Republic of Nepal will be of three levels i.e. the Federation, the State and the Local. The Constitution has given powers to all three levels of the government to enact laws, prepare budgets, and mobilize their own tax resources. The Constitution has now assigned a larger functional, semi judicial and fiscal authority, and provided new mandates to elected subnational governments. While the decentralization under the new federal structure will increase the financial and decision-making powers of the subnational governments and their discretion over expenditures, it also creates greater responsibilities for effective delivery of public goods and services as well as opportunities for greater accountability towards citizens by the local government (LG) officials and civil servants.

While most LGs have been established following local elections in the recent months, state governments are not yet in place pending elections, currently scheduled for November 2017. The previous LGs have been restructured with the District Development Committees (DDCs) converted to District Coordination Committees (DCCs) and municipalities and nearly 4,000 Village Development Committees (VDCs) restructured into 753 metropolitan and sub-metropolitan cities, and urban and rural municipalities. Although most LGs are in place, they are not fully operational due to the lack of proper infrastructure, adequate human resource, and clear operating rules and regulations.

The Policy and Advisory Technical Assistance (PATA) for Strengthening Subnational Public Management (SSPM) in Nepal is an Asian Development Bank (ADB) support to the Government of Nepal (GoN) for developing a fiscal decentralization framework in line with the provisions of Nepal's new constitution and policy recommendations for operationalizing the framework. The main objective of PATA is to carry out a comprehensive assessment of the reform priorities through detailed and operationally relevant studies, and provide actionable policy recommendations to the GoN for operationalizing fiscal federalism and improving the public financial management (PFM) systems at the lower tiers of the government. The PATA findings are expected to enhance (i) the readiness of the GoN to adapt to fiscal decentralization under a federal structure, (ii) increase the knowledge of GoN in setting up the required institutions to operationalize fiscal federalism and to ensure that the new powers entrusted with subnational governments are exercised in a judicious manner and (iii) eventually improve the capacity and effectiveness of GoN to deliver public goods and services through the new structure of subnational administration in a transparent, accountable and inclusive manner, meeting the demands of the citizens of Nepal.

The studies under the PATA provide the international best practices and recommendations which are customized to Nepal's context. The key building blocks of fiscal federalism are: (1) revenue mobilization at the subnational level, (2) revenue sharing among different tiers of governments, (3) subnational borrowing – establishing borrowing arrangement for subnational government, (4) subnational level expenditure allocations (public sector budgeting), and (5) establishment of PFM systems to increase transparency and reduce fiduciary risks at subnational level.

A critical aspect of fiscal decentralization is that state and LGs have revenue-raising powers through taxation. The component on **improving revenue mobilization** looks at the revenue potential of the subnational governments, ways to improve own source revenue mobilization through appropriate tax policies and laws within the ambit of the Constitution and how to improve tax administration systems that are based on information technology (IT) and good governance principles. To ensure that the expenditure of each level of government matches with the corresponding revenues, there needs to be fiscal transfers to address vertical and horizontal imbalances among federal, state and local levels of government. The component on **intergovernmental fiscal transfers (IGFT)** deals with the institutional setup, modality and quantum of fiscal transfers from federal government to the subnational government both in the form of tax sharing and grants.

The subnational level is also given borrowing powers by the Constitution independent of the federal government. The **subnational borrowing** component of this study provides a framework and roadmap for on-lending and borrowing as well as debt management in line with the key principles of overall fiscal discipline. The fourth component of this study looks at the ways for **improving expenditure allocations**

and public sector budgeting at the subnational level, which is essential for effective planning and allocation of scarce public resources to meet the country's short and long-term objectives in building capital and social infrastructure. Multi-year outcome based budgeting frameworks are assessed in the context of subnational government under the federal structure.

The components of revenue mobilization, IGFT, subnational borrowing and public sector budgeting are closely interlinked from the perspective of fiscal equalization. Thus, when expenditure exceeds revenue, state and LGs borrow or depend on transfers from the federal government.

All the above four components can be effective in a PFM system only when there is improved transparency, proper monitoring and control over the flow of public funds, and a well-guided IT infrastructure to streamline the process and institutional arrangements for effective delivery of public goods and services as well as investment. Hence, the fifth and final component of PATA is on **improving transparency in PFM** and reducing fiduciary risks at subnational level which is further sub-divided into (A) Internal audit and internal control, (B) Technical Audit[1], and (C) ICT and MIS.

The following section provides a summary of the key findings and highlights the recommendations under each component. Where possible, the recommendations are substantiated with frameworks, outlines, and guidelines as applicable in the main report.

Chapter I: Improving Revenue Mobilization

The quality of fiscal decentralization in Nepal, guided by the provisions of the 2015 Constitution, depends on the assigned responsibilities and resources to the subnational governments (SNGs). Key gaps identified based on an as-is assessment are as follows. First, the assignment of revenue sources considered together with expenditure responsibilities to the SNGs clearly indicates a large vertical imbalance. A correction of this gap through large fiscal transfers would affect the quality of decentralization as the SNGs would be highly fiscally dependent on federal transfers. Second, there is also a large horizontal imbalance amongst the subnational jurisdictions due to heterogeneity of areas, population sizes, economic bases and availability of natural resources. To increase their autonomy, it is therefore vital to ensure that assigned tax and non-tax revenue sources are exploited to their full potential by the SNGs. In this process, they would face transitional and medium to long term challenges.

After examining the constitutional provisions in Nepal, the economic principles underlying efficient taxation, best practices of other major federations, the past revenue performance of erstwhile LGs and central taxes that have now been assigned to SNGs, a set of policy recommendations in regard to the assigned revenue sources is provided and prioritized according to importance and timeline of implementation.

Recommendations

The key recommendations are given in three parts: Overall, tax by tax and non-tax sources of revenue

a. Overall recommendations:

In all, nine taxes have been assigned to the SNGs namely: agro-income tax, vehicle tax, property tax, house rent tax, business tax, land tax, advertisement tax, entertainment tax and house and land registration fee. In each of these cases, it is recommended that "Model" Acts and Rules should be made by the federal government during the transition period. This would facilitate the immediate implementation of the assigned taxes by the SNGs who would be free to adopt these acts and rules as these are or in a modified form. Instead of having one Act for all the SNG taxes, as was done under the LSGA 1999 for the LG taxes, it is recommended that at the minimum, Acts and Rules should be made for three groups of taxes:

- Exclusive or largely exclusive to state governments (SGs)- Vehicle tax, agricultural income tax
- Exclusive to LGs - Property tax, House rent tax, Business tax, Land tax (land revenue)

[1] Technical Audit component will be discussed under the draft final report.

- Taxes under common jurisdiction of SGs and LGs - House and land registration fees, Entertainment tax, Advertisement tax.

Furthermore, a full-fledged revenue department at the level of SGs and LGs would need to be developed supported by an institutional framework. This would provide means of undertaking evaluation of revenue performance, designing a compliance strategy and providing an IT infrastructure. A strategy should also be put in place for a process by which correction of vertical and horizontal imbalances is undertaken in a dynamic perspective.

b. Tax by tax recommendations:

Agro income tax is the only tax assigned exclusively to the SGs. Further, vehicle tax can be utilized as largely exclusive to the SGs.

- **Agro-income tax –** Since agriculture is an activity characterized by low income generation and high volatility, its revenue potential is limited. In addition, there are issues such as lack of administrative capacity at the SNG level, absence of relevant database, difference in agricultural income tax rate (lower) vis-à-vis central income tax rate (higher) potentially resulting in tax evasion by overstating agricultural income and understating non-agricultural income. In order to address the problem of low potential revenue, initially, commercial and plantation crops may be taxed.

- **Vehicle Tax –** It is efficient that it is levied and administered by the SGs rather than the LGs since an efficient vehicle tax requires common tax rates and definitions across the entire state. Further, rate differentiation between privately owned vehicles (one-time levy) and vehicles used for commercial purposes (annual tax) may be maintained. Since the newly formed states would initially not have the necessary capacity, officers from the federal government with experience of administering this tax may be deputed to states.

Four taxes are exclusive to the jurisdiction of LGs namely, property tax, house rent tax, business tax and land tax (land revenue).

- **Property Tax –** Major recommendations relate to building of institutions at the federal and local level for assessing property values according to market trends. Further, tax rate can be made ad valorem or according to type/use of the property and it should be linked to municipal services provided within the jurisdiction for the relevant properties. A differentiation between residential and commercial property may also be made. The experience of existing LG officials can be initially utilized in the collection and administration of property tax.

- **House Rent (HR) Tax–** In case of house rent tax, there is a risk of understatement of rent by both landlord and tenant. Existing experience of administration of HR tax should be utilized. Also, existing LSGA law may be adopted and clear distinction may be made between rented property for residential and commercial use.

- **Business Tax –** It should ideally be taxed on the basis of business income. Considering administrative difficulties, turnover may be taxed to begin with. Also, rate must be low because business income is being taxed at the federal level as well. Moreover, local tax paid should be deducted from the Central Income tax.

- **Land Tax –** Land used for urban plants, floriculture, exotic plants with export potential etc. may be taxed at higher rates and land used for subsistence agriculture may have to be exempted.

For the remaining three taxes, it is recommended that the higher tier of government namely, the SGs should make laws to ensure common rates and definitions. SGs may allow the LGs to collect and retain a part of the revenues. However, until the SGs are formed, model laws can be prepared by the federal government as indicated earlier. According to available information, the federal government has prepared guidelines and an indicative framework for making these Acts. The following recommendations pertain individually to these taxes

- **Advertisement Tax –** The advertisement tax rates may be differentiated according to mode of advertisement – traditional means (display boards, newspapers, radio and television etc.) and modern means of advertisement such as broadcasting services.

- **Entertainment Tax –** A distinction can be made in defining the tax base between traditional means of entertainment like theatres and cinema halls vis-à-vis modern means of entertainment like broadcasting services, internet etc. Tax rate should be ad-valorem applicable on the price of entertainment service.

- **Land and house registration Fees –** A system of benchmark values according to area characteristics which needs to be revised periodically reflecting trends in market value may be developed. Also, the link between property tax and land and house registration fees may be utilized. Lower rate may be applicable for female ownership.

c. Non-tax revenues:

Apart from fees and service charges, there are three major sources of non-tax revenues for the SNGs namely: forests, water (hydro power) and minerals. It is the NNRFC which has the responsibility of determining the respective shares of the federal government, SGs and LGs as provided in the new constitution. It is argued here that proper sharing of non-tax revenues from these sources has the potential of correcting both vertical and horizontal imbalances in Nepal.

Prioritization and time lines

Immediate/short term:

- Model Acts and Rules should be made by the federal government immediately
- Appointment of revenue officials at the SG and LG levels should be immediately made by the concerned governments once they are formed.
- Developing mechanism for tax assessment for facilitating registration, filing of returns, and provision of information

Medium term:

- States shall develop their own tax laws by adopting or modifying the central ‘model’ laws. The following shall also be undertaken:
  - Development of administrative infrastructure and revenue bases (tax and non-tax) in states and municipalities/ rural municipalities
  - If rates differ across LGs within a state, determine floor rates at the state level
  - Training of revenue officials
  - Making ‘tax effort’ or ‘revenue effort’ a criterion in revenue sharing formulae for both central to state revenue sharing and central/ state to local revenue sharing (E.g.- from Indian Finance Commissions)
  - Use of incentive structure applied to revenue officials
  - Setting up a suitable institutional mechanism for compilation and collation of fiscal data including revenue data at the SNG level

Expected value added

The expected value to be delivered upon implementation of the above recommendations are

- Application of economic principles and international best practices
- Gradual increase in SNG autonomy
- Reduction of vertical and horizontal imbalances
- Basis for balanced economic development and minimum acceptable standards of public and merit services across jurisdictions

Implementation risks

In the process of implementation, the key overall risk is that of revenue inadequacy at the subnational level. This arises due to the fact that the assignment scheme under the 2015 Constitution has only assigned those taxes to the SNGs that have historically been exploited by the local levels under LSGA 1999 with two exceptions of vehicle tax and agricultural income tax. The history of revenue experience for other local taxes indicates low tax base and low revenue capacity. Therefore low tax bases in relation to expenditure responsibilities would engender considerable dependence of SNGs on central transfers affecting the quality of fiscal federalism. Other common constraints are weak administration and inefficiency reflected in lack of IT system and staff capacity, and possible pressure for tax exemptions when state laws are made. A suitable implementation strategy including strategy for overcoming perceived challenges and risks in implementation is provided.

Chapter II: Intergovernmental Fiscal Transfers

Subnational governments have higher expenditure assignments and lower resource base, which necessitates the fiscal transfer both vertically and horizontally. In most countries IGFT is a dominant feature of subnational finance as it ensures that revenues roughly match the expenditure needs of subnational governments. There are two broad categories of transfers from the federal government to the subnational governments: Tax sharing and Grants.

The main challenge for a country that is transitioning from a unitary to a federal government structure is the determination/apportionment of the vertical transfer between tax sharing and grants. Under the unitary system the LGs have been receiving as many as eleven types of grants including: MCPM grants, performance based grants, recurrent grants, conditional grants and unconditional grants.

After studying the existing IGFT practices prevailing in Nepal, needs for addressing vertical and horizontal imbalances under the new federal structure, and international best practices, the following key recommendations are provided:

- **Establishment and Strengthening of NNRFC**

For efficient functioning of NNRFC, a detailed structure has been proposed in the report. The structure comprises additional recommendations which relate to divisions, sectoral divisions and subdivisions of NNRFC.

Due access to reliable, accurate and adequate sources of data should be granted to the commission. Agencies with relevant data should be ascertained and made responsible for providing timely information to the commission which would be essential for formulating measures of expenditure needs and fiscal capacity.

Further, financial autonomy should be given to NNRFC. With regard to resources, subject/sector **specialists** such as economists, geographer, demographer, sociologist, etc. should be deployed to make the commission more capable to determine and develop norms, criteria and indicators of revenue distribution and make the transfers more transparent and rational.

- **Suggestions on IGFT Act**

Measures should be taken to strengthen the IGFT Act, which is yet to be enacted. With regard to revenue distribution, the share of the state and LG should be gradually increased based on their expenditure needs and spending capacity which will mature eventually in the long run. Also, the royalty collecting power with regard to mining and use of forest resources may be given to the states since the responsibility of protecting and preserving such resources vest on them.

- **Strengthening of Performance Based Grants System (PBGS)**

PBGS, which is currently in practice in Nepal, creates linkages between the transfers from federal government to subnational governments and the performance/capacity of the LGs to absorb and manage fiscal resources. The PBGS in Nepal should entail to the following basic minimum conditions containing: a. Generation of own source revenue in a steady manner (at least a certain % more than previous year); b. There is no unresolved adverse opinion from OAG; c. Plan and budget has been prepared and approved, *and d.* Achieve a minimum of certain % of expenditure across all untied funds within the 4th quarter of the financial year.

Additionally, further assessment should be made on qualitative set of performance measures classified into themes such as: a. Planning and budgeting; b. Sector specific performance such as health or education (e.g. enrolment rates and/or specific outputs such as level of students passing exams with certain quality, etc.); c. Project execution and service delivery; d. Accounting, financial reporting, and audit, and e. Transparency and accountability.

- **Mechanism for Unconditional Grants**

The practice of distributing the unconditional grant in two types, that is, **formula based grant** and **fixed grant** may be continued. However, the ratio of distribution and parameters considered for formula may be reviewed. At present, population, weighted poverty, area and weighted tax effort is considered in the formula.

Also, for the purpose of giving the unconditional grants, performance parameters may be drawn and subnational governments may be classified in two and three tiers (2 for state and 3 for local).

Therefore, the states may be classified as SG1 and SG2 and local as LG1, LG2 and LG3 on the basis of their performance (parameters for which will be ascertained, e.g. progress in education, health, etc.). The following is an illustration of the share of ratios and parameters to be designed for unconditional grants:

Subnational government category	Share of Unconditional grant		Parameter for formula
	Formula Based (%)	Fixed (%)	
SG1	70	30	Population, weighted poverty, area and weighted tax effort
SG2	60	40	Fiscal gaps
LG1	65	35	
LG2	55	45	
LG3	45	55	

Note: The above percentage ratios and parameters are illustrative only

The aforesaid recommendations have been detailed in the main report.

Chapter III: Subnational Borrowing – Establishing borrowing arrangement for subnational government

Regarding the as-is assessment of subnational borrowing, the team identified the following key gaps and risks that currently exist in Nepal:

- **Overall subnational borrowing**
  - Fiscal responsibility legislation is absent
  - There is no system of issuer rating for debt
  - Only one credit rating agency is existing in Nepal
  - Banks are not in a position to lend funds to LGs
  - Planning of expenditure is required to be strengthened
- **Town Development Fund**
  - Accrual basis of accounting not being followed at TDF
  - Non-performing assets (NPA) recognition by TDF policy is required to be strengthened
  - Manpower with relevant technical and financial expertise is required at TDF

On the basis of these, the following **recommendations** are made:

Enactment of a Fiscal Responsibility and Budget Management Legislation (FRBM) for ensuring fiscal discipline - Borrowing is a tool which when used effectively can yield beneficial results to the development of the country. However, if not managed effectively, debt burden at the state or LG level could take decades to settle. Therefore, at the on-set of this transition while subnational governments are being formed, it is critical that the institutional development and borrowing mechanisms should be adopted with utmost responsibility and care. One such mechanism would be to enact a FRBM for the federal government.

The PATA team suggest an FRBM Act to be enacted which will ensure that the fiscal discipline is maintained. Additionally, it is also suggested that a Joint Fiscal Responsibility and Budget Management Council be established which will perform both ex-ante role - providing independent forecasts on key macro variables like real and nominal GDP growth and ex-post monitoring role.

Restructuring TDF for development of borrowing by the state and LGs- The existing legislation allows TDF to function as a financial intermediary, but in the absence of sufficient legal provision the role of TDF as a financial intermediary has been subdued.

The PATA team suggests the strengthening of the existing TDF Act to make TDF an autonomous independent organization, under the umbrella of MoF, run by a team of professionals drawing on a steady source of operating funds, having greater capacity to engage in a wide range of economic development activities than acting on the strength of borrowing and grants from the federal government.

Establishment of seven branches of TDF (under the central TDF) at the state level is recommended for meeting the financing needs of the states and various LGs within the boundary of a particular state. All TDF branches should be independent of each other but should work under the guidelines and control of the existing central TDF, which has the necessary expertise and knowledge of lending to LGs in Nepal.

However, the 7 branches (at each state) may not be established at once. Although the establishment of branches has been suggested as a medium term goal (see roadmap in subsequent section in Chapter 3), the eventual procedure of setting up branches shall be based on the actual demand of loans which may vary from state to state. Therefore, it is suggested that an assessment of actual demand of loan be conducted and branches of TDF be established accordingly in a phased manner. Until the time there are any branches set up in a state, the borrowings can take place through the central TDF.

Further, establishment of a strong credit rating environment is also necessary for subnational borrowing to thrive in developing countries.

ICRA Nepal is the rating agency in the country. However, there are no statutory requirement of maintaining the issuer rating. Only in case of IPO or Right Issue, the rating is mandatory for the transaction. The PATA team suggests that the credit rating agency in Nepal, drawing upon the experiences of its international partner, should undertake an exploratory exercise to evaluate the credit quality of TDF, states and municipal entities in Nepal, with a view to explore the feasibility of expanding the horizons of its rating operations. This will help the bond market in Nepal to have a noticeable growth in terms of issuers and investors, instruments, and volume of transactions.

The above recommendations are elucidated in detail in the main report.

The expected results and value to be delivered are:

- Transparency in fiscal policy objectives
- Fiscal discipline
- Government debt maintained at prudent level
- Stability in fiscal policy making process
- Optimal usage of subnational resources and public assets ensuring value for money
- Reduction in revenue deficit and containment fiscal deficit

The **challenges** envisaged for implementation of the above recommendations are as follows:

- Adequate fiscal data needs to be collated for assessing the fiscal health of subnational governments which should be the basis for setting any debt limits.
- Mechanism needs to be put in place between the MoF and NRB for ensuring adequate coordination between fiscal and monetary policy of the government.
- As a top down approach is advocated in setting fiscal targets, monitoring the adherence to targets will be a very difficult task.

- Timely implementation of the project by the subnational governments without cost overruns will need to be ensured.
- TDF needs to get the requisite amount of capital and debt for on-lending to subnational government
- TDF needs to have requisite trained manpower for effective evaluation of the projects and its monitoring for implementation and timely repayment of debt
- Implementation of internationally accepted accounting standards and policies and keeping pace with the changes in the global markets are necessary.
- Preparation of all the budgets of subnational governments is needed to calculate their fiscal status

Chapter IV - Improving Expenditure Allocations and Public Sector Budgeting

An as-is assessment was carried out from policy, institutional and operational perspectives to understand the current budgetary processes, PFM reform initiatives, and the changes that are underway, relating to implementing budgetary processes i.e. MTEF, MTBF and outcome budgeting at subnational level in Nepal. This was supplemented by an analysis of the budget data of the GoN of the last 5 years.

The **key gaps** identified from this review are:

- High levels of budget outturns
  - Trends show overestimation of expenditure / shortage of release of funds / underutilization of budgeted allocation
  - Underestimation of non-tax revenue receipts
  - Revenue expenditure is highly overestimated with regards to the use of goods and services, interest and services on foreign and internal loans, and subsidies to public corporations and private enterprises
  - Actual grants received are much lower than those estimated
- Lack of proper prioritization
  - Lack of proper prioritization among projects/ programs leading to spending in non-priority areas
  - Prioritization has not touched upon the new and upcoming projects
- Limited implementation of MTEF and MTBF
  - Implementation of MTEF only in principle with lack of multi-year perspective and linkages with annual budget
  - Incorrect sequencing of PFM reforms, i.e., introduction of MTBF happened after implementation of MTEF and no initiatives for MTFF and MTPF are yet to be in place
- Inadequate performance
  - Performance issues and lack of GoN's conformity with the conditions necessary to be fulfilled for receiving grants
  - Divergence between plan and actual implementation of programs/ projects
  - Lack of proper performance monitoring mechanism

Based on the as-is assessment, the gaps identified and review of international practices, recommendations on implementing MTEF, MTBF and outcome budgeting have been suggested with prioritization based on timeline of implementation.

The **short-term recommendations** (<u>to be implemented in the next 6 months</u>) comprise drafting of:

(I) Financial procedures for states and LGs including strengthening of public accounting norms and standards that require accrual accounting and reflect international accounting standards
(II) A budget calendar for states and aligning it with the calendars of LGs, and
(III) Guidelines for operationalizing a consolidated fund at states and LGs

The **medium-term recommendations** (to be implemented between 6 and 12 months) proposes the GoN to:

(I) Suggest:
   a) Principles for projection of revenues and expenditure for states and urban and rural LG
   b) Framework for mapping of sectors with ministries at subnational level
   c) Prioritization framework for fund allocation by the national and subnational governments
   d) Framework for integrating annual budget with MTEF and MTBF

(II) Draft:
   a) Fiscal Responsibility & Budget Management (FRBM) Act for the federal, state and LG and enact the same
   b) Budget guidelines and MTEF and MTBF guidelines for states and urban and rural LGs
   c) Guidelines to prepare three-year rolling plans using Medium Term Expenditure Framework (MTEF) and annual plans for states and LGs
   d) Costing guidelines for existing and new programs for states and LGS
   e) Guidelines for the preparation of outcome-based budgeting for states and LGs
   f) Guidelines for providing performance measures and targets aligned with national and local goals and priorities

The **long-term recommendations** (to be implemented beyond 12 months) encompass actions for the GoN including:

(I) Suggesting structure and functions of:
   a) State fiscal commission
   b) Costing secretariat

(II) Operationalizing ICT systems for states and LGs

(III) Sequencing MTEF implementation in stages (MTFF →MTBF →MTPF)

The **expected value** to be delivered through implementation of these recommendations include:

- Institutionalization of fiscal federalism
- Efficient allocation and use of public resources
- An effective budgetary process linked to performance

Implementation **challenges and risks**:

- Implementation of MTEF, MTBF and outcome based budgeting at the subnational level (state and LG) is a challenge given the capacity constraints and resource gaps of the subnational level bodies.
- With states yet to be formed and the LGs being at different levels of maturity, some of the relatively less equipped subnational bodies will require a longer time frame and focused capacity development support compared to those with higher degree of modernization and capacity.
- A "one size fits all" approach may give rise to unprecedented risks and make the implementation of these performance based budgeting approaches ineffective.
- A phased approach may be adopted for implementation of MTEF, MTBF and outcome based budgeting at the subnational level. Highly advanced subnational governments may be targeted in the first year, moderately advanced ones in the second year and relatively less advanced ones beyond the second year
- It is critical to link performance of the budget preparation and execution agencies i.e., the degree of their application of the recommended budgeting tools (MTEF, MTBF and outcome based budgeting) with the levels of budget approvals or grants (in the form of incentives/ punitive measures) to ensure proper planning and utilization of funds.

Chapter V – Internal Audit, Internal Controls and Internal Control Framework

A lot of powers have been put into the hands of the subnational level of government by the constitution. They have been given financial autonomy and the freedom to choose the areas (health, education, infrastructure, etc.) in which they want to spend their income (including own resources as well as grants). However, to effectively manage this responsibility, it is important that they have strengthened internal controls in place and a pro-active Internal Audit (IA) Department at the subnational level.

The **key gaps** identified by the team were as follows:

- Shortage of human resources coupled with inadequate regular capacity building resulting in lack of competency
- Traditional / archaic internal audit practices and procedures being followed
- Limited coverage of scope of IA and follow up audit observations.
- Independence of IA being compromised.
- Effectiveness of IA has also been less than desirable
- Organization structure of IA under federal structure is not yet implemented
- Audit is not guided by any specific Internal Audit Standards
- RBIA Manual has been prepared under SPMP-I but has not yet been implemented.
- Weakness in maintenance of records has been observed. Financial reporting is merely a regulatory compliance requirement rather than management tool.
- Bank reconciliations and reconciliation of program and financial reports not done.
- Weak HR controls is observed illustrated by no job description provided, lack of organizational structures, no formal training policy resulting in competency and accountability gaps
- IT controls have been observed as there are no back-ups and lack of access controls

The **major recommendations** of the team are as follows:

- Recruiting required resources and continuous capacity development of IA staff
- Modernized audit processes, e.g. risk based approach, in conduct of audit needs to be institutionalized.
- Modern tools such as Audit Management Software should be used for audit efficiency and effectiveness.
- Broader coverage of internal audit to include efficiency of operations and program effectiveness.
- A decentralized institutional structure of internal audit at the subnational level reporting to the governing body (e.g. council) to ensure independence. Scope and structure ingrained in the legislation.
- Training of Trainers (ToT), piloting, handholding is suggested for implementation of risk based audit and AMS.
- Internal Control Framework (IFC) needs to be developed and followed to institute a robust control system in the subnational level which has been provided as a part of the annexures.
- To ensure that controls exist, is adequate commensurate to the nature and size of the organization, is functioning effectively and functioning throughout the period. The management should conduct periodic control monitoring tests.

These changes will improve the accountability and transparency at the subnational level, effective, streamlined and standardized audit processes and strong internal controls. Also, with strong internal control system transparency, accountability will be enhanced ensuring reliable financial statements being prepared, compliances with regulation and smooth operation of activities, prevention and detection of frauds and errors decreasing fiduciary risks at LGs.

Based on the above recommendations:

- A concrete structure would come up for conducting IA in LGs.
- Legislative strengthening will ensure enforceability of IA and hence improve the effectiveness of IA.
- AMS will benefit the IA department to track observations and actions and also help the external auditors.
- A suggested ICF is provided so that LG can refer to the relevant control measures in accordance with the nature, size and activities of the particular LG.
- Internal control assessment checklist based on the control objectives is provided for reference.

However, the government will be facing the following implementation challenges and risks:

- IA in public sector is being carried out traditionally therefore there will be resistance to change to modern approaches and tools such as RBIA and AMS.
- Availability of competent IA staff at LGs, especially at remote rural municipalities, is a serious matter of concern.
- Resources at LGs to institute modern system like AMS will be a challenge.
- Further control of AMS system, periodic upgrading, hosting and maintaining among 7 state governments and 753 LGs is a challenge.

Chapter VI – Information and Communication Technology (ICT) and Management Information System (MIS)

Operationalizing of ICT systems could play a transformative role in ensuring accountability, transparency and efficiency in the allocation and utilization of funds at the subnational government level. Implementation of Municipal Administration Revenue System (MARS) in LGs in a well-planned and phased manner, which was earlier piloted in Kathmandu Metropolitan City, can support the GoN's efforts to strengthen digitization and automation of both the revenue and the expenditure side of the financial statements of the LGs; help streamline effective planning and monitoring of budget process and fixed asset management; and improve delivery of services at the LG level.

The MARS replication strategy presented in this study discusses ways to customize the MARS based on tax structure, service delivery needs, infrastructure constraints and capacity of different types of LGs and eventual integration of all municipal functions and workflow into a single web-based platform to provide efficient and automated services to the citizens of 753 LGs**.**

This component primarily identifies key implementation constraints such as poor or lack of connectivity of ward offices and municipal center, lack of technically competent resources, lack of basic infrastructure like electricity in remote wards, poor or no internet connectivity and lack of computers and basic infrastructure like modem, optical fibers, servers, etc. The study also identifies lack of technical competence of workforce with regards to e-governance systems, IT skills to handle hardware and software operations and lack of expertise on accounting and related skills. Customization issues, data migration, change management and integration problems hamper putting a robust system in place.

The team suggests a phase-wise implementation of MARS at the LG level so as to make the system more effective and acceptable provided that adequate political commitment is made to rollout MARS across the country. A comprehensive capacity building plan for the workforce would be required including training needs analysis to understand the requirement of each type of LGs, training the trainers and finally trainers training the end users. This will ensure the capacity building program to be effective. Since the existing infrastructure will vary from one level of LG to another, a thorough assessment should be conducted to identify LGs where the existing infrastructure needs a radical revamp and subsequently a roadmap for improving the connectivity and infrastructure should be prepared. The recommendations also speak about the technical assistance that shall be required for smooth implementation and sustainable operation of MARS.

A team should be formed which will provide end to end support for successful implementation of MARS to cover areas like capacity enhancement of workforce, system customization and localization, data migration and conducting pilots. Finally, the team suggests an appropriate communication strategy through which the implementing agency would be able to educate the end users about the benefits of MARS and integration of MARS with existing systems should be carried out.

Background

The Federal Democratic Republic of Nepal, is a landlocked country in central Himalayas in South Asia, bordering China and India. Nepal has a diverse geography, including fertile plains, subalpine forested hills, and 8 of the world's 10 tallest mountains, including Mount Everest, the highest point on Earth. Kathmandu is the nation's capital and largest city. It is a multi-ethnic nation with Nepali as the official language.

The new Constitution of Nepal has introduced a federal system of governance at three levels i.e. the Federation, the State and the Local.[2] The revenue powers and functional assignments under a decentralized system have been indicated in the Constitution, which provide devolution of powers across tiers of federal government in a bottom-up manner rather than a top-down approach under a unitary government.

Nepal is currently in a state of transition and the new structures are in the process of being setup. The relationships among these structures, both horizontally as well as vertically are also being redefined. Decentralization of power and transition to a federal system of governance under the new Constitution exert strong pressures on government performance to meet citizens' needs (the demand side) and to provide effective goods and service delivery (the supply side). Decentralization tends to redefine interactions between local leaders and their constituencies. New regulatory, administrative and financial decision-making powers over procurement, expenditures, and delivery of goods and services by the elected LGs have a greater impact on local economies. Conversely, decentralization creates opportunities for greater accountability to citizens. Accountability is about the obligation of the government officials and the civil servants to accept responsibility for their activities, and to disclose the results in a transparent manner. This requires necessary controls to be put in place as per predefined processes and reporting systems to ensure that the discretion entrusted with decision making bodies is exercised in a judicious manner.

The transition from unitary to federal structure has necessitated the GoN to undertake a series of reforms in terms of political, legal, organizational, administrative and operational matters, which are at various stages of implementation. The challenge for the GoN is to put in place the necessary processes, policies and institutions at the subnational level for smooth transition to a federal structure while facing various constraints in technical and human resource capacity.

The Asian Development Bank (ADB) is providing (PATA) for Strengthening Subnational Public Management (SSPM) in Nepal. It has been guided by the requirements of the new Constitution and the Government of Nepal's ongoing work in unbundling the Constitution in order to (i) develop an operational framework for the fundamental building blocks of fiscal decentralization/fiscal federalism in line with the federal structure under the new Constitution and (ii) expand the public financial management (PFM) reforms at the subnational government level building on the reforms initiated under Strengthening Public Management Program (SPMP).

The main objective of PATA is to carry out a comprehensive assessment of reform priorities through detailed and operationally relevant studies, and provide actionable policy recommendations to the Government of Nepal for operationalizing fiscal federalism. The assignment involves policy advisory on 5 key components of fiscal federalism relating to (i) improving revenue mobilization at the subnational level, (ii) revenue sharing among different tiers of government, (iii) subnational borrowing, (iv) improving subnational expenditure allocations and (v) improving transparency in PFM and reducing fiduciary risks at subnational level.

[2] The word "province" is also used interchangeably with "state".

Genesis of the report

The structure of this midterm report is as follows:

Executive Summary – A summary of the report including brief background, overview of the project and component wise key findings and recommendations

Background – An understanding on the social, political and economic condition of Nepal, a look into PATA project, its components.

Component 1

Chapter I -Improving revenue mobilization

Component 2

Chapter II – Intergovernmental Fiscal Transfers

Component 3

Chapter III – Subnational Borrowings

Component 4

Chapter IV -Improving expenditure allocations and public sector budgeting

Component 5

Chapter V – Internal Audit, Internal Control and Internal Control Framework

Chapter VI - ICT and MIS

Each chapter of the report has been structured in the following sections

Introduction
As-is assessment
Constitutional provisions
Gap analysis
International experience
Policy recommendations
Implementation strategy
Perceived challenges and risks in implementation

Acknowledgement and Bibliography

Annexures

Chapter I
Component 1: Improving Revenue Mobilization

1. Introduction

Nepal is making a transition to a federal system of governance under its new Constitution which was promulgated in 2015. Under this Constitution, Nepal will have three tiers of government: Federal, State and Local. This transition involves creation of a second tier of government consisting of 7 states.

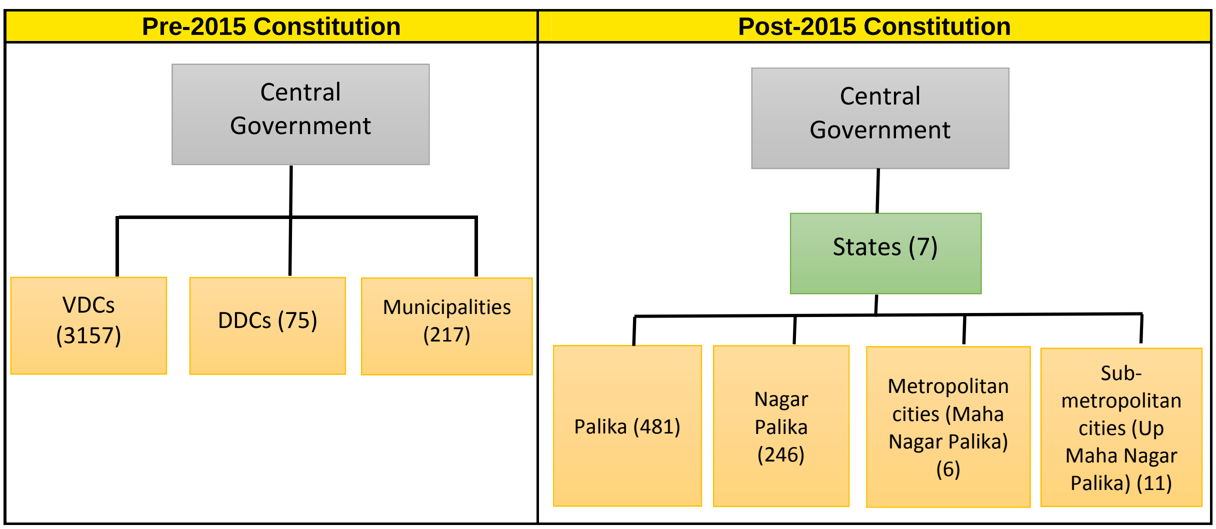
The Constitution has assigned expenditure responsibilities and revenue sources to the subnational governments. Most of the key revenue sources remain with the federal government while expenditure responsibilities of the newly created subnational governments are relatively larger. The resultant gap will have to be met by transfer of resources by the federal government to the subnational governments. As the system evolves, the subnational governments will have to develop and utilize revenue sources assigned to them. There should also be a search for new taxes, further review of assignment of taxes, and adequate revenue sharing arrangements to increase the degree of fiscal autonomy of the subnational governments.

1.1 Structure of Subnational Governments

Implies significant horizontal imbalance

Prior to the 2015 constitutional arrangement, local level governments consisted of Village Development Councils (VDCs), District Development Councils (DDCs) and municipalities. These have been recast as depicted in Chart 1. Nepal has, at the local level, 75 DDCs, 217 Municipalities and 3157 VDCs. These LGs will be recast into 753 local level governments consisting of 6 metropolitan cities, 11 sub-metropolitan cities, 246 urban municipalities and 481 rural municipalities. Thus, while the second tier of government will be completely new, the third tier of government would also be completely reorganized.

Chart 1: Structure of Government in Nepal: Pre and Post 2015 Constitution[3]



Source: EY Team

Note: As per latest available information, two sub-metropolitan cities (Birgunj and Biratnagar) have been upgraded to metropolitan cities, taking the total number to 6. However, the data illustrated in Annexure 1 Tables A1 and A2 is based on the old structure where there were 13 sub-metropolitan and 4 metropolitan cities.

Elections have already being held for the Palikas and Nagar Palikas in 6 states. LG elections in states 3, 4 and 6 were concluded in May 2017 in Phase 1. In Phase 2, elections were held in 35 districts of states 1, 5 and 7 on 14 June 2017. According to the Election Commission, preparations are underway for LG elections to be conducted in state 2 on 18 September, 2018[4]. The Election Commission intends

[3] Refer to Annexure 1 for details on (a) the list of documents that was referred by the team (List A) and (b) list of officials that the team has consulted during the course of drafting this chapter (List B).

[4] https://thehimalayantimes.com/nepal/vote-counting-concludes-in-76-local-bodies-in-province-number-7/

to conduct the state level elections by October 2017, the national assembly and legislative elections by November 2017[5]. In fact elections to states are due to be completed before 21 January, 2018 under a Supreme Court Ruling[6].

1.2 Nature of decentralization in Nepal under the new Constitution

Under the new Constitution of Nepal the focus is on devolution rather than de-concentration or delegation which are other alternative forms of decentralization.

In the literature on fiscal federalism, alternatives to centralized governments are qualitatively differentiated in terms of options relating to de-concentration, delegation, devolution. De-concentration relates to shifting of decision making powers to federal government officials that are located outside the capital. Delegation refers to shifting of service delivery responsibilities to semi-autonomous bodies or NGOs that are fully accountable to the federal government. Devolution refers to transferring service delivery responsibilities along with substantive decision making authority to subnational governments who are primarily accountable to the local constituency. The 2015 Constitution of Nepal clearly has taken the option of devolution where, decision making authority for assigned subjects have been devolved on elected state and local legislatures who would oversee the functioning of governments under their respective jurisdictions. De-concentration and delegation to some extent can still be carried out for responsibilities left with the federal government. The essence of change in Nepal is therefore about devolution and not about the first two options. In the case of devolution, two issues needs to be examined. First, whether the assigned functional responsibilities are in accordance with principles that would ensure efficient service delivery through accommodating local or state level preferences, linking assigned tax and non-tax revenues to the principle of subsidiarity and the benefit principle to the extent possible and taking into account inter-jurisdictional externalities and spillovers. In the context of the link between revenue and expenditure assignments one needs to implement the benefit principle in determining tax rates and user charge. Second, depending on externalities which may be inter-state or inter LG jurisdiction, principles of full or partial cost recovery and where full recovery is not advocated, degree of desired subsidization needs to be determined. In the case of education for example, primary and secondary education are associated with considerable degree of externality and as such education is classified as a merit good where full cost recovery is not advocated. Since, many of the benefits of education spillover across jurisdictions benefiting the nation as a whole, subsidization flowing from the federal to the lower tier of government can be justified and local and state governments need not determine user charge or fees aimed at full recovery of costs. In the case of health also large externalities are associated and similar considerations apply. In both cases however, a significant role of subnational governments is justified in order to accommodate local preferences reflecting medium of instruction, nature and extent of course coverage etc. But, minimum desirable standards to be achieved across jurisdictions may still be determined by the federal government. These are clear cases where concurrent jurisdictions are justifiable. But responsibilities of each tier should be delineated. Similarly, a high degree of cost recovery would be justified in the case of services where benefit is largely contained within the jurisdiction. For example, local roads, local amusement parks etc.

1.3 Potential issues to be addressed

In this chapter starting with an as-is assessment, the main constitutional provisions are highlighted relating to revenue assignment to the subnational governments, emphasizing the nature of transition and the ensuing issues. In particular, there seems to be an *a-priori case* of high vertical and horizontal imbalances. While the horizontal imbalances depend on the ground conditions relating to the new

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https://thehimalayantimes.com/nepal/june-28-polls-in-province-2-to-be-deferred/

[5] http://www.business-standard.com/article/news-ani/nepal-s-election-commission-starts-preparation-for-three-tier-election-117070401387_1.html

[6] The ruling states that all three tiers of the elections must be held and the requisite structures must be put in place well before January 21, 2018 as the transformed parliament will automatically dissolve after the deadline. “It is mandatory to hold all three tiers of elections including local, provincial and federal level election by January 21, 2018 in order to fully implement the Constitution of Nepal,” states the apex court ruling http://mofald.gov.np/en/nepal-nagarpalika-gaupalika-list.

structure of subnational governments relating to their size, population, economic base etc., vertical imbalance arises mainly due to the assignment scheme. Unless the assigned revenue sources are fully utilized and effectively supplemented by a scheme of fiscal transfers where autonomous transfers are large and discretionary transfers from the federal government are limited. There is an apprehension that the subnational governments would become highly fiscally dependent on the federal government, adversely affecting the quality of devolution. The anticipated gaps have been analysed and the binding constraints on utilization of assigned revenue sources, a suitable implementation strategy and perceived challenges and risks in implementation in the ensuing sections.

2. As-is assessment

Prior to the 2015 Constitution, Nepal had only two tiers of government namely a federal government and an elaborate structure of LGs. Even the LGs were administered largely by the federal government officials for about a decade and a half since LG elections could not be held. In terms of revenue assignment, most important taxes from the revenue view point were with the federal government. Although the LGs were assigned a large list of tax sources, very limited amount of revenues were collected.

The essential feature of the 2015 Constitution is to insert a new tier of government at the state level. Furthermore, the erstwhile LGs have been transformed into a re-organized set of LGs. In this chapter, the revenue performance of the federal and local taxes raised by the federal government and LGs according to the scheme of assignment prior to the new constitution has been reviewed. However, the analysis is organized in a manner so as to facilitate an understanding of the revenue features of the central and subnational taxes under the new constitution.

2.1 Revenue performance of central taxes

Taxes assigned to the federal government account for an overwhelmingly large share of tax revenues currently raised by the GoN

The main central taxes are as follows:

1. Individual income tax
2. Corporation tax
3. Customs duties
4. Excises duties
5. VAT

Table 1 shows that taxes on income, profits, and capital gains currently contribute about 24% of the central taxes. Adding these direct taxes, including taxes on payroll and workforce to VAT, excise and customs duties, which have been assigned to the federal government, together these account for nearly 92% of the current central tax revenues. Two taxes, viz., vehicle tax and property tax together accounting for about 4.3% of current central taxes stand assigned to the subnational governments. There is residual category of current central taxes consisting mainly of (i) taxes on specific services (foreign employment, health and education), (ii) tax on use of goods (use of infrastructure, road maintenance etc. and infrastructure tax) and other taxes (registration fee and owner certificate charge). These taxes, if continued, would also go to the federal government since these are not mentioned in the subnational lists. Tables 2 and 3 show that property tax and vehicle tax also show high growth and buoyancy comparable to the taxes assigned to the federal government. This indicates that although their share is low, these can be further developed by the subnational governments.

Table 1: Relative shares (%) of major taxes assigned to the federal government in Nepal

Fiscal Year	Taxes on income, profits, and capital gains*	VAT excl. imports	VAT on imports	Excise duty	Customs and other import duties**	Taxes on payroll and workforce	Property tax (annual property tax and house and land registration)	Vehicle tax	Residual group
2010-11	23.3	12.6	22.2	14.9	20.2	0.4	2.0	1.7	2.7
2011-12	24.2	12.3	21.2	14.2	20.5	0.7	1.7	1.8	3.4
2012-13	24.8	10.9	21.2	14.0	22.0	0.7	2.1	1.7	2.7
2013-14	24.2	11.0	21.4	14.5	21.8	0.8	2.1	1.6	2.6
2014-15	24.2	11.1	20.5	15.0	21.0	0.8	2.6	1.8	2.9

2015-16	27.1	11.8	17.3	15.6	19.5	0.8	3.1	1.7	3.1
2016-17 RE	24.4	11.1	21.4	15.2	19.2	0.8	2.8	1.5	3.6
2017-18 BE	24.4	11.1	21.4	15.2	19.2	0.8	2.8	1.5	3.6
*includes remuneration tax, house rent tax is not excluded; **includes customs and other import duties, taxes on exports and other taxes on international trade and transactions									

Source (Basic Data): Budget Speech Annexures, various years

Table 2: Growth rates of currently raised major central taxes (%, y-o-y)

Fiscal Year	Gross taxes	Taxes on income, profits, and capital gains*	VAT excl. imports	VAT on imports	Excise duty	Customs and other import duties**	Taxes on payroll and workforce	Property tax (annual property tax and house and land registration)	Vehicle tax	Residual group
2011-12	19.5	24.1	16.5	14.2	14.0	21.5	119.1	0.4	25.4	47.2
2012-13	22.4	25.1	9.3	22.4	20.7	31.2	20.9	48.8	13.8	-3.3
2013-14	20.5	17.8	20.8	21.4	25.3	19.4	30.2	24.9	15.2	19.3
2014-15	13.9	14.0	15.3	9.2	17.9	10.1	19.5	40.9	27.1	24.4
2015-16	18.3	32.5	25.3	-0.1	22.9	9.8	11.8	39.9	12.5	27.7
2016-17 RE	25.5	12.9	18.7	55.2	22.1	23.7	27.8	11.7	10.7	46.7
2017-18 BE	26.0	26.0	26.0	26.0	26.0	26.0	26.0	26.0	26.0	26.0
*includes remuneration tax, house rent tax is not excluded; **includes customs and other import duties, taxes on exports and other taxes on international trade and transactions										

Source (Basic Data): Budget Speech Annexures, various years

The relationship between nominal GDP growth and revenue growth of individual taxes is captured in the respective buoyancy estimates. Tax buoyancy indicates percentage change in tax revenue relative to a one percent change in nominal GDP. Table 3 shows tax-wise buoyancy of currently raised central taxes. Overall central taxes have shown an increase in buoyancy from 1.3 in 2013-14 to 3.0 in 2015-16. In 2015-16, tax on income, profits and capital gain has shown inordinately high buoyancy exceeding the value of 5. Excise duties have also shown high buoyancy of 2.3 and 3.8 in 2014-15 and 2015-16 respectively. The residual group also shows a relatively high buoyancy in these two years.

Table 3: Tax-wise buoyancies of currently raised central taxes

Fiscal Year	Gross taxes	Taxes on income, profits, and capital gains*	VAT excl. imports	VAT on imports	Excise duty	Customs and other import duties**	Taxes on payroll and workforce	Property tax (annual property tax and house and land registration)	Vehicle tax	Residual group
2011-12	1.7	2.1	1.4	1.2	1.2	1.8	10.1	0.0	2.2	4.0
2012-13	2.0	2.3	0.8	2.0	1.9	2.8	1.9	4.4	1.3	-0.3
2013-14	1.3	1.1	1.3	1.3	1.6	1.2	1.9	1.6	1.0	1.2
2014-15	1.8	1.8	1.9	1.2	2.3	1.3	2.5	5.2	3.4	3.1
2015-16	3.0	5.4	4.2	0.0	3.8	1.6	1.9	6.6	2.1	4.6
2016-17 RE	2.2	1.1	1.6	4.8	1.9	2.0	2.4	1.0	0.9	4.0
2017-18 BE	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
*includes remuneration tax, house rent tax is not excluded; **includes customs and other import duties, taxes on exports and other taxes on international trade and transactions										
Note: For calculating buoyancy, nominal GDP growth forecasts for FY16-17 and FY17-18 were calculated by using annual real GDP and CPI inflation forecasts for these years from Asian Development Outlook (April, 2017), ADB The revenue trends of years prior to 2010-11 are given in Table A3 to A5 of Annexure 1										

Source (Basic Data): Budget Speech Annexures, Various years

2.2 Revenue performance of taxes currently raised by LGs

Revenue trends with respect to taxes currently collected by LGs, viz., DDCs and municipalities have been examined. Listed below are some of the major taxes currently collected by these LGs:

1. Vehicle tax
2. Business tax
3. Land and house registration fee
4. Property tax
5. Entertainment tax
6. Tax on commercial video
7. Advertisement tax
8. Land Tax (Land revenue)

Table 4: Growth of taxes raised by LGs (%, y-o-y)

	in million NR				Share in total local level tax income (%)			DDCs and municipality taxes and internal income of VDCs as % of current central tax revenues
Fiscal Year	tax income of DDCs (1)	total tax income of municipalities (2)	internal income of VDCs (3)	total income (1 + 2 + 3)	tax income of DDCs	total tax income of municipalities	internal income of VDCs	
2010-11	669.2	769.9	904.0	2343.2	28.6	32.9	38.6	1.32
2011-12	823.7	927.2	976.5	2727.4	30.2	34.0	35.8	1.29
2012-13	800.6	1277.5	1171.3	3249.4	24.6	39.3	36.0	1.25
2013-14	669.2	1527.1	1302.2	3498.5	19.1	43.6	37.2	1.12
2014-15	1324.0	1852.9	896.5	4073.4	32.5	45.5	22.0	1.14

Source (Basic Data): Sthaniya Nikaya Vittiya Sthiti Vishleshan", various years, LBFCS, GoN

Based on Table 4, the following two observations can be made

1. The share of Municipalities in total local level tax income has increased significantly from 32.9% in 2010-11 to 45.5% in 2014-15 partly reflecting the conversion of several VDCs into Municipalities. During this period the share of VDCs internal income declined from 38.6% to 22.0%.
2. The total local level tax income as a percent of current Central tax revenues has gradually declined from 1.3 in 2010-11 to 1.1 in 2014-15.

At present Nepal has a governance structure wherein the taxation powers primarily lie with the Central Government. The Local Self Governance Act (LSGA) 1999, Local Self Governance Regulations (LSGR) 2000 and Local Self Governance Financial Regulation (LSGFR) 2007 have defined the local revenue assignment and its operational details. These are summarized in Table 5.

Table 5: Taxation powers of LGs as per Local Self Governance Act (LSGA) 1999

Level of governance	Taxes
VDCs	House and land tax, land revenue (Malpot), local market tax/shop tax (Haat Bazaar tax), vehicle tax (registration, renewal and lump sum), entertainment tax, Bahal Bitauri tax (the taxes on small infrastructures built and maintained by VDCs or municipalities and used by small business holders) based on rent tenancy, advertisement tax, business means tax, commercial video tax, natural resource utilization tax and other taxes like collection and savings tax
Municipalities	House and land tax or integrated property tax, land revenue (Malpot), local market tax/shop tax (Haat Bazaar tax), vehicle tax (registration, renewal and lump sum), entertainment tax (collected from cinemas, video halls, cultural show halls, magic shows and circus), Bahal Bitauri tax (the taxes on small infrastructures built and maintained by VDCs or municipalities and used by small business holders) based on rent tenancy, advertisement tax, business means tax (on industry, trade, profession or occupation), commercial video tax, and other taxes like collection and savings tax and enterprise tax.
DDCs	Tax on use of infrastructure (roads, paths, bridges, irrigation, ditches, ponds) constructed or maintained by them, tax on business use of natural resources (wool, turpentine, herbs, worn and torn goods, stones, slates, sand and bone, horn, wing, and leather of animals except those are prohibited), tax on export from district, tax on re-usable products and tax on re-cycling and re-usable goods. can also levy non-taxes as charges and fees for services

Source: Uma Shankar Prasad (2015), 'Nepal's Fiscal Federalism Model in the New Constitution: Agenda for Amendments'

Notes:

In case of taxes levied by the VDCs, the bases are defined and fixed by LSGA 1999. The rates are defined by LSGR 2000 except Haat Bazaar and shop tax that can be defined by Village Development Council

In case of taxes levied and collected by the municipalities, the base and rate determination is according to the LSGA with a few exceptions but the rate caps are prescribed by the federal government

The DDC at the first tier has been given the power to define tax bases and rate caps

LGs have experience in administering house and land tax, business tax, land tax (land revenue), entertainment tax, advertisement tax and vehicle tax. They do not have experience in administering agricultural income tax.

2.3 Concluding observations

Preliminary analysis indicates that the existing revenue sources, tax and non-tax, that are currently being used for realizing revenues by the GoN and the LGs have been assigned to the three tiers of government, namely federal, state and local, such that a relatively large share of the tax revenues will remain with the federal government. However, the share of federal government would be marginally reduced as some of the tax revenue sources would be re-assigned to subnational governments. Furthermore, shares in two specific taxes, namely, VAT and excise duty are being earmarked for sharing between the three tiers of government. Thus, the current central tax revenues can be divided into two parts: (a) tax revenue sources to be retained by the federal government, (b) tax revenue sources to be assigned to the subnational governments. In addition, the subnational governments will have access to other tax and non-tax sources assigned to them. As per constitutional provisions, there are no taxes listed in the two concurrent lists, viz., Schedule 7 and Schedule 9. . However, there are four taxes which are commonly listed between state and LGs, that is, under Schedules 6 and 8 respectively. In the case of non-tax revenues, each tier of government has been allowed to levy fees and service charges according to their functional responsibilities.

3. Constitutional Provisions

3.1 Assignment of Revenue Sources

Revenue source assignment implies significant vertical imbalance

Schedules 5, 6, 7, 8 and 9 of the Constitution respectively provide the list of powers including those of taxation of the Federal government, the state governments, concurrent powers between the Federal and the state government, powers of LGs and concurrent powers of all the three tiers of governments.

The Constitution divides powers relating to tax and non-tax sources of revenue amongst federal, state and LGs. Details of taxation powers at each level of government are given in Table 6. There are no new taxes in the three Schedules listed in Table 6 as compared to the current situation. However, there is a re-assignment of existing taxes currently being levied by the federal government under GoN Acts or by the LGs under the LSGA Act, 1999. Important taxes from a revenue viewpoint such as customs duty, VAT, excise duty, corporate income tax and individual income tax have all been allocated to the federal government. For the new tier of the government namely, the state governments, there is only one exclusive tax namely, agro-income tax. Agro-Income tax has not been levied under the Income tax Act by the GoN so far. If the states exploit this source of tax, revenue from this would constitute an additionally compared to revenues raised under the existing taxes. There are four taxes where the powers to levy the tax are commonly listed in the state and the LG schedules that is in Schedules 6 and 8 respectively. These are vehicle tax, entertainment tax, advertisement tax, and land and house registration fees. In the local list, there are four exclusive taxes namely, property tax, house rent tax, business tax, and land tax (land revenue).

Table 6: Distribution of taxation powers amongst the Centre, State and LGs as per the New Constitution

Centre –Schedule 5	State – Schedule 6	Local Level– Schedule 8
Custom Duty	Vehicle Tax (Savari sadhan kar)	Vehicle Tax (Savari sadhan kar)
VAT	Entertainment Tax (Manoranjan kar)	Entertainment Tax (Manoranjan kar)
Excise duty	Advertisement Tax (Vigyapan kar)	Advertisement Tax (Vigyapan kar)
Corporate Income Tax	Land and house registration fee (Ghar jagga registration shulk)	Land and house registration fee (Ghar jagga registration shulk)

Individual Income Tax	Agro-income tax (Krushi ayama kar)	Property tax (Sampatti kar)
Remuneration Tax		House Rent Tax (Ghar bhaal kar)
		Business Tax (Vyavasay kar)
		Land tax (land revenue) (Bhoomi kar, (Malpot))

Source: Constitution of Nepal, 2015, Translated by Nepal Law Commission

The division of non-tax revenues amongst the Centre, State and LGs according to the new Constitution is given in Table 7. Except for passport and visa fees, other non-tax sources are commonly listed in the three lists. However, service charge, fee and penalties pertain to services provided by the respective governments and therefore they will have different revenue bases. Royalty from natural resources and tourism fee which is listed in the concurrent list (Schedule 9), would be on the same revenue base but will be shared between the different tiers of the government.

Table 7: Distribution of non-tax revenue sources amongst the Centre, State and LGs as per the New Constitution

Centre – Schedule 5	**State – Schedule 6**	**Local Level – Schedule 8**
Service charge and fee	Service charge, fee	Service charge and fee
Penalty	Penalty	Penalty
Tourism fee	Tourism fee	Tourism fee
Passport fee		
Visa fee		
Schedule 9 (Concurrent list) - Service fee, charge, penalties, royalty from natural resources, tourism fee		

Source: Constitution of Nepal, 2015, Translated by Nepal Law Commission

LGs have some experience of administering taxes and utilizing non-tax sources

As already noted, under the new Constitution, the revenue raising powers of the federal and LGs have been assigned in terms of five schedules. These are delineated in Schedules 5 to 9. The Constitution has assigned specific tax and non-tax sources to the subnational governments. Schedule 6 specifies revenue sources for the states and Schedule 8 for the LGs. Schedules 7 and 9 relate to concurrent matters between federal and state governments and amongst federal, state and LGs respectively. Since a number of revenue sources are either common across different schedules and/or are listed in the concurrent schedules, a framework is needed to resolve potential conflicts in these matters.

Sources of Non-Tax Revenues for the Subnational Governments

Details of non-tax revenue sources are given in Table 7. Conceptually, a distinction can be made between non-tax revenues that arise due to provision of services and ownership of assets by the subnational governments. These are in the form of user fees and charges etc. or return on the assets in the form of interest receipts, dividends, sale of asset etc. The other kind of non-tax revenue arises from royalties linked to ownership on natural resources. Three sources of such royalties or other forms of non-tax revenues such as sale of products (timber, non-timber) are water resources, minerals and forests. These are listed under Schedule 9, which lists the concurrent powers between the three tiers of the government. In the case of service provision or returns on assets, the non-tax revenue can be delineated according to jurisdiction without much ambiguity. These are discussed in detail later in this report. In the case of shared powers, particularly water resources, which is linked to hydel power and irrigation, forests and minerals, sharing arrangements need to be put in place. In Nepal's case, traditionally such sharing arrangements have been in practice for a long period. The overall revenue potential of these main non-tax revenue resources have been estimated in a recent study (2012) entitled 'Design and Implementation Plan for a System of Fiscal Transfers in Federal Nepal'[7]. These estimates are based on the inputs provided by Nepalese experts in the respective fields.

[7] Srivastava, D. K. "Key Elements of a New Fiscal Regime in Federal Nepal."*Ottawa: Forum of Federations, www. fo rmf ed. org/pa st/ Nep al key el eme nts*. Vol. 28. 2011.

In this study, the sharing arrangements recommended by Pandit and Shrestha (2009), which is based on traditional arrangements and other relevant considerations if Nepal moves to a three-tier government structure, have been provided in Table 8.

Table 8: Proposed distribution of natural resource royalty in percentage (Pandit and Shrestha, 2009[8])

NR Royalty source	Center	Province	Local/community
1. Custom duty of any products	100	-	-
2. Land revenue	25	25	50
3. VAT on NR products	60	40	
4. Water royalty	40	30	30
5. Forest products	25	25	50
6. Wildlife and national parks	33	40	27
7. Minerals	40	30	30
8. Hydro-power royalty	40	30	30
9. Tourism	-	33	67
10. Earning from hydropower	100	-	-
11. Sand and gravel	-	33	67

Source: ICIMOD presentation to CA member in April 2009

These shares can be compared with recommendations of a recent Committee on Inter-governmental fiscal arrangements, set up by the Ministry of Finance on which a Bill on Inter-governmental fiscal arrangements has been proposed. These shares are given in Table 9.

Table 9: Apportionment of royalty from natural resources (in %)

Sl.no.	Particulars	Government of Nepal	Related State Level	Related Local Level
1	Mountain Climbing	85	10	5
2	Electricity	85	10	5
3	Forest	85	10	5
4	Ores & Minerals	85	10	5

Source (Basic Data): Intergovernmental Financial Management Bill

Notes:

1. In case any Natural Resource falls under the jurisdiction of a single state & Local Level only then the amount payable to such State & Local Level will be deposited to the reserve fund of that State & Local Level
2. In case any natural resource fall under jurisdiction of two or more State & Local Levels then the amount of royalty to be received by each state & local level shall be determined on the basis of effected area & deposited to the reserve fund of related States & Local Levels.

Clearly, the recommendations given in Table 9 reflect a relatively large share of the federal government. It is notable that local communities were also entitled to a share in these non-tax revenues under the traditional arrangements as they participate in the maintenance of relevant resources and also depend on these resources. Recommendation is that these shares should be finalized only when the relevant stakeholders, particularly the state governments and the LGs come into existence. Finally these shares would be determined by the NNRFC after detailed studies and consultations with the relevant stakeholders.

3.2 Key links with expenditure responsibilities

At the subnational level required resources cannot be assessed independent of the expenditure assessment and the methods of financing of the resultant gap between assessed expenditures and assessed revenues. A low degree of revenue autonomy of the subnational governments would affect

[8] Pandit, Bishnu H., and Him L. Shrestha. "Natural Resources and Revenue Sharing in the New Federal System of Nepal: A Proposed Model." The Initiation 3 (2009): 38-48.

the nature and quality of fiscal decentralization that is being attempted in Nepal through a new model of fiscal federalism under the 2015 constitution.

The extent of revenue mobilization needed depends on expenditure needs. At the moment expenditure is being analyzed in terms of procedures rather than assessment of actual expenditure needs. In due course this assessment should be undertaken for effective revenue mobilization and appropriate design of fiscal transfers. For this purpose, Table 10 gives the expenditure responsibilities of the state governments and Table 11, those of the LGs. The central expenditure responsibilities and expenditure items in the concurrent lists are given in Annexure 1, tables A6 and A7.

Table 10: Expenditure responsibilities of the state governments (Schedule 6)

Item No.	Expenditure item
1	State police administration and peace and order
2	Operation of banks and financial institutions in accordance with the policies of Nepal Rastra Bank, cooperative institutions, foreign grants and assistance with the consent of the Centre
5	State civil service and other government services
6	State statistics
7	State level electricity, irrigation and water supply services, navigation
8	State universities, higher education, libraries, museums
9	Health services
10	Matters relating to the State Assembly, State Council of Ministers
11	Intra-State trade
12	State highways
13	State bureau of investigation
15	State Public Service Commission
16	Management of lands, land records
17	Exploration and management of mines
19	Use of forests and waters and management of environment within the State
20	Agriculture and livestock development, factories, industrialization, trade, business, transportation

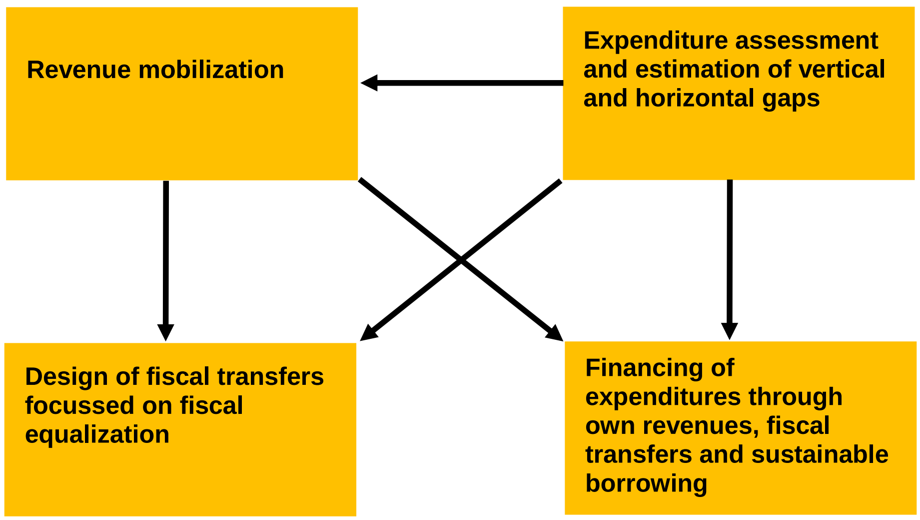
Table 11: Expenditure responsibilities of LGs (Schedule 8)

Item no.	Expenditure item	Item no.	Expenditure item
1	Town police	13	Agriculture and animal husbandry, agro-products management, animal health, cooperatives
5	Management of the Local services	14	Management of senior citizens, persons with disabilities and the incapacitated
6	Collection of local statistics and records	15	Collection of statistics of the unemployed
7	Local level development plans and projects	16	Water supply, small hydropower projects, alternative energy
8	Basic and secondary education	17	Disaster management
9	Basic health and sanitation	18	Protection of watersheds, wildlife, mines and minerals
10	Local market management, environment protection and biodiversity	19	Protection and development of languages, cultures and fine arts
11	Local roads, rural roads, agro-roads, irrigation		

Item no.	Expenditure item	Item no.	Expenditure item
12	Management of Village Assembly, Municipal Assembly, District Assembly, local courts, mediation and arbitration		

The link between revenue mobilization and expenditure responsibilities and other critical elements of managing decentralization are illustrated in Chart 2. In the subsequent discussion, the application of the benefit principle which links expenditure needs and revenue mobilization are also explained.

Chart 2: Achieving fiscal equalization: linking revenue mobilization, assessment of expenditures and its financing



Source: EY Team

The expenditure needs for each of the state governments and each of the LGs have to be estimated separately. Such an assessment depends on the functional assignment of expenditure items for these two tiers of government. There is however, provision for concurrency in many functional responsibilities between federal, state and LGs as well as state and LGs. For a healthy working of a fiscal federal system, clear demarcation of the functional responsibilities of each level of government is needed and all cases of ambiguity need to be resolved. Once clearly demarcated, a reliable expenditure assessment exercise can be undertaken.

As such expenditure financing can come from three sources namely own revenues, fiscal transfers and borrowing consistent with sustainability requirements. Some part of the expenditure, particularly capital expenditure, which may lead to creation of an asset with an expected return when the asset is in service will directly contribute to non-tax revenues.

The gap between expenditure need as assessed and assessed own revenues would need to be filled up by fiscal transfers. These fiscal transfers would have to take into account both the aggregate gap for all states considered together (vertical dimension) and state wise gaps which would be different for each state (horizontal dimension). This relationship is depicted in the Chart 2 above[9].

The role of benefit taxation and where relevant the implications of considerations arising from externalities and benefit spillovers with respect to assigned revenue sources to the subnational governments have been discussed later in this report (Table 37). For example, in the case of vehicle tax the benefit principle is applicable for maintenance of subnational and local roads. The benefit of a

[9] Also Table A6 and A7 given in Annexure 1 relates to expenditure powers of federal government and concurrent expenditure assignments for all three levels of government in Nepal respectively (also see Table 10 and 11 for expenditure assignments for state and LGs).

house and land registration fees is in the nature of the value of certification provided by government to the purchaser of the property. The beneficiary is clearly identifiable and the benefit principle is applicable. If the cost of providing the registration service in the case of land and house is clearly quantifiable from the general budget, the benefit principle can be fully applied. Such quantification is quite difficult in practice because costs of maintaining IT systems etc. and administrative costs are often shared across various services provided by the government. Table 12 provides illustratively, critical links between functional assignment and revenue dimensions for items in state and local lists.

Table 12: Linking functional assignment with revenue aspects: Selected Expenditure Responsibilities

#	Selected Expenditure Items	Link with Revenue Dimension			
		Nature of good	**Most suitable* method of recovering costs**	**Suggested combination of financing****	**Comments**
List of responsibilities exclusive to states (Schedule 6)					
1	State police administration and peace and order	This is a state level public good	It is ideally financed by state level taxation and fiscal transfers to the extent that there is inbuilt inadequacy in state level taxation. For this service, state taxes should be considered together rather than individually.	This is a case of pure public good. Only penalties for offenses etc. can be used as contribution from the non-tax side	Cost should be fully recovered by the combination of state taxes and fiscal transfers from federal to state governments taking into account, both vertical and horizontal dimensions of transfers
2	Operation of banks and financial institutions in accordance with the policies of Nepal Rastra Bank, cooperative institutions etc.	This is very largely a private good except for general administrative support at the state level	Cost should be recovered from the beneficiaries of the services provided by the banks, financial institutions and cooperative institutions within the local jurisdiction	In the administration of foreign grants and assistance, costs should be recovered from the general state level tax revenues as it is a part of state level administration	The related costs are recurrent in nature and should be recovered through current revenue resources rather than borrowing
3	State civil service and other government services	This is a pure public good at the state level	It is ideally financed by state level taxation and fiscal transfers to the extent that there is inbuilt inadequacy in state level taxation. Individual taxes cannot be linked to this service. All state taxes should be considered together	This is a case of pure public good and one to one linkage between individual taxes with specific administrative departments is not possible	Cost should be fully recovered by the combination of state taxes and fiscal transfers from federal to state governments taking into account, both vertical and horizontal dimensions of transfers
4	State level electricity, irrigation and water supply services, navigation	Electricity, irrigation and water supply are private goods in nature.	Variable cost recovery and annualized capital costs should be considered in fixing relevant tariffs.	At least variable costs should be nearly fully recovered from the beneficiaries of the service	This sector requires considerable capital cost which may be financed through investment based on borrowing and surpluses generated by relevant state level organizations.
5	State universities, higher education, libraries, museums	These are cases of merit goods with considerable externality	In higher education, recovery should be partially made through relevant fees but a degree of subsidization supported by state budgetary resources is justifiable.	Perceived degree of externality in higher education is lower than primary and secondary education.	Benefit spillover since usually other state citizens can also avail of education facilities in one state

6	Health services	This is a case of merit goods with considerable externality	Costs can be recovered through a combination of hospital charges and support by general budgetary resources (taxes and fiscal transfers)	This will be combination of non-tax revenues and budgetary resources	Suggested recovery rate from hospital charges should be less for basic and primary health services and more for tertiary and specialized services.
7	Use of forests and waters and management of environment within the State	Forest, water resources, and environment have externalities that extend beyond local, state, and sometimes national boundaries.	This can be part financed by user charges including sale of timber and non-timber resources of state level forests and similarly for water resources.	Usually, externalities justify subsidization, dependence on general budgetary resources and transfers from higher tiers.	International experience in many developing countries show high dependence on general budgetary resources and low rates of recovery through tariffs and user charges.
List of responsibilities exclusive to LGs (Schedule 8)					
1	Town police	This is a local level public good.	This should be financed by local level taxes and fiscal transfers from higher tiers.	there may be some recovery from traffic fines etc.	Nearly 99% should be financed through general local level budgetary resources. No tax by tax linking is possible.
2	Basic and secondary education	This is a service characterized by a high degree of externality and some benefit spillover. It is a merit good.	Cost should be partially recovered through fees but should largely be supported by general budgetary resources	Usually, cost recovery is justifiably limited to 5 to 20%	International experience shows that the degree of implicit subsidization is often very high in the range of 90% plus. In India, many studies have characterized these as high merit/ Merit-1 services[10]
3	Local roads, rural roads, agro-roads, irrigation	Roads are local public goods. Irrigation is a private good but with benefit spillovers.	In the case of roads, some recovery can be made through tolls etc. But these may be able to recover a very small portion of the recurrent cost.	Roads involve both, investment and maintenance. Both costs should be taken into account in determining cost recovery ratios.	International practices show that at the local level, the recovery rate tends to be negligible and dependence is almost entirely on general budgetary resources.

Source: (Basic data) Constitution of Nepal, 2015, EY team

In Section 5, the broader principles of linking revenue sources with expenditure responsibilities in the context of international experience are given in Table 19. In this case, a large number of federal responsibilities are also covered.

3.3 Mobilization of subnational revenues in Nepal

In spite of a large number of tax and non-tax sources under the pre-2015 Constitutional provisions, the revenues raised by the existing LGs have been quite limited. This could partly be due to the fact that the tax bases relating to these taxes were narrow and partly because for most years, the LGs were run, not by elected representatives but by officials nominated by the federal government and were also subject to frequent transfers and often did not have local roots.

10 Srivastava, D. K., et al. "Budgetary subsidies in India: Subsidising social and economic services." *National Institute of Public Finance and Policy* (2003).

Comparing the revenue sources listed under LSGA, 1999 with the new scheme of assignment of revenue sources, the following two observations can be made:

a. LGs can focus on the 8 tax items listed in Schedule 8 of the Constitution subject to the arrangements worked out w.r.t. the items commonly listed with the state governments.

b. The transition to the new scheme of revenue assignment should be straightforward since there are no new taxes. However, the power to levy the tax at the state and local level will have to be finally derived from relevant legislation passed at the state and the local levels. Until elections are held at the state level, transitional arrangements for the levy of local taxes may have to be made by the federal government.

GoN is introducing a bill for operation and management of local level governance to enable LGs to function in the transition period. This would enable the elected assemblies of rural municipalities and municipalities to start functioning almost immediately after the local level election process is completed.

This Act would provide some clarity regarding taxes and the related features of corresponding tax bases as also revenue items that are commonly listed and/or concurrent between the states and municipalities/ rural municipalities. It is notable that urban and rural LGs (municipalities) have been treated symmetrically in their revenue raising powers. Accordingly, the rural municipality/ municipality would be entitled to levy and collect the taxes as listed in Table 13. The characteristic features of the tax base are also described in this table. The transitional arrangements are being proposed to enable the rural and urban municipalities to utilize the following taxes constitutionally assigned to them.

Table 13: Key features of tax bases relating to subnational taxes as per the Draft Bill for operation and management of local level governance

Name of tax	Key features of tax base
Integrated property tax/ House and Land tax	(a) Can be levied only on house and land under the ownership of single person within the area of the rural municipality/ municipality (b) Size, type, composition and use of the house and land and status of the productive utility of immovable property (c) living standard, financial status and spending capacity of the citizen (d) The prevalent market price and depreciating value of the immovable property (e)Other bases deemed appropriate by the assembly
Land Tax (Land Revenue)	Utility of the land
House Rent Tax	On any individual or institution who has rented out in full or part, the house, shop, garage, go-down etc.
Business Tax	On the basis of capital investment and financial transaction of any trade, business or profession
Rent or Tenancy Tax	On weekly bazaar, market and shops constructed
Herbs, Scrap and wildlife Tax	on wool, herbs, hay grass, scrap goods and for the commercial use of the bones, horn, feather, skin etc. of dead or killed wildlife other than wildlife prohibited by the prevalent law

Source (Basic Data): Draft Bill for operation and management of local level governance (DFID translation)

Since these are transitional arrangements, the state and LGs, once the duly elected representatives are in place, can enact their own legislations w.r.t. the items covered in the GoN Act as also w.r.t. any items that the subnational governments have powers to levy the tax or raise non-tax revenue that are not covered in the GoN Act.

In the case of commonly listed and/or concurrent powers, this Act provides for a distinction between the following cases:

a. Tax rate is determined by the state and collection is done by the municipality/ rural municipality
b. Rate is determined and collection is made by rural municipality/ municipality
c. Where part of the tax/ fee rate is determined and collection is made by the state and for another part, rate is determined and collection is made by the rural municipality/ municipality

d. Rate is determined and tax is collected as provided by the GoN
e. Tax is determined and collected by the state: There is no pure example of this. The case that comes closest is that of vehicle tax, where except for specified vehicles, for all other vehicles, state can levy the tax, determine the tax rates and collect the taxes.

Table 14 describes different tax and non-tax items that fall under these categories:

Table 14: Cases for tax and non-tax powers commonly listed and/or concurrent between the state and LGs

	Tax and non-tax powers commonly listed and/or concurrent
Case (a)	(1)House and land registration fees
	(2)Rate of natural resources including stones, pebbles, slate, sand etc. to be determined by the state and collection by the rural municipality/ municipality
Case (b)	(1)Advertisement tax (2)Entertainment tax
Case (c)	(1)State to determine rate and collect tax w.r.t. vehicles other than horse cart, rickshaw, auto rickshaw and e-rickshaw; Rural municipality/ municipality to determine and collect tax w.r.t. horse cart, rickshaw, auto rickshaw and e-rickshaw
	(2)State to determine tourism fee w.r.t to trekking and tourism tariff; Rural municipality/ municipality to determine and collect entry fee to heritage sites like park, garden, museum etc.
Case (d)	(1)Mountaineering fee and entry fee to national park and wildlife reserve

Source (Basic Data): Draft Bill for operation and management of local level governance (DFID translation)

In the case of revenue items commonly listed in the federal, state and LG lists or under concurrent jurisdiction, a provision for revenue sharing has also been made in this Bill. The revenues are to be collected and deposited according to the source of the revenue by setting up of a fund at the state level. Under the guidance of a Revenue Sharing Determination Committee, the sharable revenues between states and rural municipalities/ municipalities is to be done by reference to the following principles:

1. Basis of origin of revenue
2. Revenue collection cost
3. Service provided to the people by the state and by rural municipality/ municipality
4. Poverty, local regional imbalance and inequality minimization
5. Other basis of income

Since the overall objective of fiscal transfers is to achieve equalization of standards of important services and to engender balanced economic development across jurisdictions, these considerations are useful as a starting point. These should further be supplemented after deliberations at the NNRFC to accommodate effects of incentives/ adverse incentives. For example, the use of collection cost as a factor implies that higher collection costs would lead to higher share in revenues would result in inefficient collection of taxes with the same amount of revenues being collected by incurring higher collection cost. Suitable normalization would be required in this case to weed out the implied adverse incentives. Similarly, the use of tax/ revenue effort as a criterion would provide a suitable incentive for the concerned governments to increase their revenue with an increased revenue effort.

To enable the subnational governments to start functioning as soon as they get constituted, the GoN has allocated certain initial funds in the FY2017-18 Budget.

3.4 Estimating Potential Revenue for Subnational Governments: Some Preliminary Observations

Estimating potential subnational revenues at this stage is constrained by paucity of data and various discontinuities with respect to some of the available data. One of key recommendations is setting up of suitable institution mechanism for the compilation of fiscal statistics covering subnational tax base, tax revenues and other aspects of finances for building up a sound basis for related research and future policy interventions.

At this stage, estimating potential revenue for the subnational governments is constrained by a variety of considerations. Some of these are discussed below.

1. As the taxes assigned to subnational governments would be subject to new laws where tax bases may differ due to changes in definition and the tax rate structure might also become different, it is difficult to utilize the past experience of tax revenues to estimate the potential for the future.
2. Except for a few taxes, it is also difficult to construct a relatively longer term history of the existing taxes relevant for the subnational governments.
3. Change in classification of data over time, that is, from 2009-10 to subsequent years
4. Extreme variations in annual buoyancy estimates which may partly be due to the nature of the tax; for example, in the case of property tax, extreme shifts in buoyancy is generally observed which may be due to periodic revisions in ratable values, circle values etc.
5. There are clear structural breaks in the Nepalese economy that would affect buoyancy estimates if the estimation is over a longer period. Two years which represent such structural break are due to the global economic and financial crises in 2008 and the disruption caused by the recent earthquake in Nepal in 2015.

Given these constraints, a buoyancy-based estimation of potential/ projection for two taxes has been attempted, subject to a variety of limitations. In this case, it is estimated year by year buoyancies but averaged them to take out the individual year volatility. The sample period was too small to utilize any trend-based method. The two taxes are the vehicle tax and the property tax for which tax revenue history from the federal government accounts is utilized. The trends reflected by these are considered as close proxies to the potential tax base of these taxes that are now entirely with the subnational governments. Some recent attempts have also been made to partly examine the revenue potential at a micro level in Nepal using selected case studies of certain municipalities.

Table 15: Potential revenue estimates: selected subnational taxes

Sr. no.	Title	Value
1	Average GDP growth (%) during 2011-12 to 2014-15 (4 years)	11.6
2	**Average buoyancy during 2011-12 to 2013-14 (3 years)**	
A	Property tax	2.02
B	Vehicle tax	1.46
3	**Growth numbers obtained using average buoyancies (%)**	
a	Property tax	23.5
b	Vehicle tax	17.0

In million NRS.

Sr. no.	Entry/ Fiscal Year	2015-16 Budget actual	2016-17 Projection	2017-18 Projection
1	Nominal GDP*	2,248,691.1	2,510,380.3	2,802,523.4
2	Property tax**	13,149.4	16,236.6	20,048.5
3	Vehicle tax**	7,104.8	8,311.2	9,722.5

* for nominal GDP, average growth of 11.6% was applied on 2015-16 value to obtain projections for the two subsequent years
**for property tax and vehicle tax, growth rates obtained from average buoyancy estimates were used to obtain projections for 2016-17 and 2017-18

Source: Union Budget Speech, various years

In the current estimation, the benchmark buoyancy values are based on the limited available relevant data and these should be considered only broadly indicative. Over the medium term, a buoyancy of 2 for property tax and 1.5 for the vehicle tax can be achieved and sustained. Accordingly, estimated average growth for the medium term for revenues from the property tax could be 23.5% and that from vehicle tax could be 17% (Table 15). This is based on a nominal GDP average growth assumption of 11.6% on average for the medium term.

For paucity of data, it has not been possible to estimate revenue potential for other taxes. The agricultural income tax may only be utilized to a limited extent because of resistance from the farmers and locally active political parties. However, it may be applied on selected commercial crops and plantations in some of the states particularly the southern states where most of the farming activities are concentrated.

Because of differences in geographical features and distribution of economic activities, where major state-wise differences are observable, a state-wise and tax-wise micro approach for estimation of revenue potential is advocated. An example of such a micro-level approach for municipalities is evident in a recent study by Support for Development Initiatives Consultancy Pvt. Ltd. (SDIC) in collaboration with UNCDF entitled “Revenue Improvement Action Plan (RIAP)”. This study provides a revenue projection by source, tax and non-tax, for the three years FY2018-20 for the municipality of Byas and other VDCs attached to it[11] as per Local Level Restructuring Committee report. Initially the “total potentiality” of each revenue stream (tax and non-tax) was estimated. This may be interpreted as the total revenue that would accrue to the jurisdiction assuming full compliance of existing tax base and application of existing or moderately higher tax rates. Further a RIAP has been drawn with recommendations related to administrative reforms and mobilisation of new sources of revenues such as street light fees. Based upon the acceptance and implementation of the RIAP, the revenues for FY2018 are projected as a certain percentage of the “total potentiality” of each revenue stream. For example 50% of the “total potentiality” of house rent tax amounting to NRs 5.5 million is expected to be achieved in the first year, i.e., FY2018 as compared to actual revenues of NRs. 264,420 in FY2016. Further, for the next two years revenues are projected to grow by a certain percentage per annum. These growth rates are based upon the historic revenue growth rate, the area and population of the municipality and its annexed area, and the estimated contribution of RIAP to increased revenue collection due to increase in tax base. Own source revenue of Byas is expected to grow by 41% on a y-o-y basis to NRs 66.5 million in FY2018 as compared to an annual growth of 29.8% over the period FY2014-2016.

A recent LBFC Report has also provided a framework for projection of tax revenues for subnational governments. Their suggested framework separately for state and LGs are summarized in the tables 16 and 17.

Table 16: Projection of Tax Revenue of State Government: Suggested Framework

Tax (1)	Base (2)	Tax coverage percentage (3)	Rate (4)	Revenue (2X3X4)
House/land registration fee	Selling value of house/land			
Vehicle tax	Number of vehicles			
Agricultural income tax	Income from agricultural sector			
Educational service tax	Fees			
Stamp duty	Number/ Value of taxable documents			
Taxes on gambling/lottery/casino	Entrance fee			
Total				

Source: Study on Revenue Mobilization of State and Local Level, LBFC (2016)

Table 17: Projection of Tax Revenue of LG: Suggested Framework

Tax (1)	Base (2)	Tax coverage percentage (3)	Rate (4)	Revenue (2X3X4)
Land revenue/ land tax	Quantity of land			

[11] According to the Local Level Restructuring Commission’s report submitted in March 2017, whole or parts of seven VDCs are included in Byas municipality.

Tax (1)	Base (2)	Tax coverage percentage (3)	Rate (4)	Revenue (2X3X4)
House/ land tax	Selling value of house/ land			
Entertainment tax	Number of seats in Cinema hall and entrance fee			
Business tax	Number of trade and business house			
Hoarding board tax	Number of hoarding board of different sizes			
Rent/ Tenancy tax	Size and value of public property			
Taxes on operation of boat, rope way, cable car	Number of travellers on boat, rope way and cable car			
Taxes on cart, tom-tom and animal	Number of cart, tom-tom and animal			
Total				

Source: Study on Revenue Mobilization of Province and Local Level, LBFC (2016)

Given the paucity of fiscal data at the subnational level in the context of the new constitutional arrangements it would be important to setup a suitable institution mechanism for the compilation of relevant fiscal data including revenue related data so that meaningful research and analysis can be conducted to provide inputs for future policy interventions. Recommendations to this effect are included in section on recommendations relating to capacity building.

It should also be noted that micro-level studies conducted for municipalities or other erstwhile local levels using past revenue performance data would have limited relevance to guide as to the revenue potential of the newly organized subnational governments. First, any evaluation of such past data based on micro studies, would reflect old tax structure including rates, definitions etc. It is not known at this point of time as to what would be the legal provisions with respect to the taxes assigned to the newly established LGs. Second, it is difficult to utilize the revenue performance of one municipality/ set of municipalities, as a guide to the revenue potential, for another set in the newly established jurisdictions of the LGs because of changes in the area covered and tax bases. Third, the very purpose of establishing new LGs is to ensure development of economic bases and infrastructure etc. in these areas. This would fundamentally change the revenue potential of the tax bases.

4. Gap Analysis and associated risks

4.1 Identified gaps and related risks

A successful transition to an efficient system of fiscal federalism, with a three tier structure of government, requires recognition of key gaps that can constrain the effectiveness of transition and then find and suggest the relevant means by which these gaps can be overcome. The most important gap in making this transition is the lack of institutional capacity, particularly since the state governments do not exist at present. Major gaps identified and recommendations as to how to overcome these gaps to facilitate the transition process are summarized. In this context, the associated risks with respect to each identified gap have also been identified (Table 18).

Table 18: Gap analysis and associated risks

Sr. no.	Problem	Recommendation	Risks associated
1	**No Legal Basis in the absence of state governments**	**Federal government can provide "Model" Acts and Rules for taxes to be levied by states and LGs. States/ LGs can adopt the Model Act as it is or after modification** E.g.- In India, while introducing GST, the federal government provided a model law for SGST for the state governments which they could adopt as it is or with modifications	If Model Acts and Rules are not in place, newly formed states and the reorganized LGs would have to undertake drafting of laws themselves and given their limited capability in the beginning, this would further delay the transition to a fiscal federal system
2	**Issues of common jurisdiction between state and LGs** *Four taxes have common jurisdiction*	**State governments to provide common laws with common definitions and mostly uniform rates**; in selected cases (advertisement tax and entertainment tax), LGs may exercise their autonomy for determining rates; rate variations to be minimized	In the absence of such mechanism, there is a possibility of duplication of taxes or double taxation. It may lead to potential conflict between states and LGs in such cases
3	**Deficiency in fiscal autonomy at the subnational level**	**Proposed revenue sharing options determined on a tax by tax basis.** VAT and excise revenue sharing in the short-run. In the long-run a generalized revenue sharing may be better as tax by tax volatility is evened out (E.g. in India, tax by tax sharing was replaced by a generalized tax revenue sharing)	High dependence on federal government for resources to meet their needs
4	**Lack of buoyancy in revenue sources assigned to subnational governments**	**Focus on developing tax bases with relatively high revenue potential**, for e.g.- vehicle tax, property tax and house and land registration; **long-run-** search for new subnational taxes like congestion tax	Inefficient allocation of limited administrative capacity over tax and non-tax sources
5	**Lack of administrative capacity**	**Deployment strategies and capacity building** (i) Deployment of officials dealing with tax administration on deputation or on permanent basis at the subnational level (ii) Training of revenue administration officials at the subnational level	Subnational governments would be unable to exploit the available revenue sources to full extent
6	**Imbalances in distribution of tax bases across jurisdictions**	**Where tax base is weak, non-tax sources could be relied on;** supplemented by equalization transfers from federal government to state and LGs and from state governments to LGs	High degree of horizontal imbalance
7	**Limited own- revenue sources**	**Incentive structure for augmenting own-revenue sources** **(a)** Incentives to subnational government officials but on objective basis **(b)** use of tax effort in the revenue sharing formulae for *inter-se* distribution of central revenues and grants among subnational governments **(c)** development of economic activities which will augment the existing tax bases	Inadequate and uneven standards of services across subnational jurisdictions Insufficient resources to finance the expenditure needs and provision of public services to the residents

Source: EY Team

4.2 Concluding observations

The implementation of a genuine fiscal federal system requires subnational governments to have adequate own revenue sources to meet the preferences/needs of their residents and take into account, their different resource endowments and physical and geographical characteristics. The fiscal federal system in Nepal needs to be qualitatively different from the highly centralized features of the unitary government. The key issues that need to be addressed to successfully implement the fiscal federal system are as follows:

1. **High degree of centralization of revenue sources:** According to available estimates, majority of tax revenues would come from taxes assigned to the federal government. This would give rise to a large vertical imbalance in raising resources and would call for a significant volume of transfers to resolve the vertical imbalance.

2. **Potential conflict in common and/or concurrent tax and non-tax items:** The common tax items between the state and the local level are vehicle tax, entertainment tax and advertisement tax. Similarly, the common items in non-tax revenues among all the three tiers of government include service charge and fees and tourism fee.

3. **Large horizontal disparities:** Most of the tax bases in Nepal are concentrated in and around Kathmandu and the borders between Nepal and India. Moreover there is poor connectivity between other states and Kathmandu. The challenge is to incentivize equitable economic growth and provision of public and merit services.

4. **Estimating revenue potential:** No state level GDP data is available. To deal with this issue, district-wise data will have to be aggregated according to state boundaries to construct indicators of economic activity that can represent relevant revenue bases for different tax and non-tax sources of revenue. Only limited information on assessment of economic potential of natural resources (water, forests and minerals) and their distribution according to subnational jurisdictions is available. However, for such exercises, there is considerable dearth of data at present.

5. **Deficiency of capacity at the subnational level:** In the initial years, states and the newly formed LGs would lack the capacity of making laws, formatting rules to levy the taxes assigned to them, administering the taxes and exploiting the own non-tax revenue sources.

5. International experiences

5.1 Revenue Assignment: First Principles

Genuine fiscal autonomy is critical to ensure consistency with the benefit principle

The normative basis of assignment of revenue sources to subnational governments is considered in the literature often in terms of the First and Second Generation theories of Fiscal Federalism. In the First Generation theory, reference is made to the well-known Musgravian (1959) branches of Public Finance namely, macro-stabilization, income redistribution and resource allocation. This is often supplemented by the application of the 'benefit principle'. The benefit principle advocates that taxes should be paid by residents of that jurisdiction who benefit from the supply of public goods financed by such taxation. The Second Generation theory refers to considerations that include other non-economic elements such as accountability, administrative feasibility and tax autonomy of subnational governments (Oates, 2013). The Second Generation theory components do not exclude the First Generation theory components but only supplement those (Bird, 2011).

As Mclure (2000) has argued, for effective fiscal decentralization, subnational governments must control their "own" sources of revenue[12] i.e. they should have genuine fiscal autonomy. This would also be consistent with the benefit principle. They should not be under the financial control of the federal

12 The term "subnational" is used to describe all levels of government below the national level. "Second-tier" is used for the highest level of subnational government-- the states of the United States, Australia, and Brazil, the provinces of Argentina and Canada, the laender of Germany, and the oblasts of the new republics of the former Soviet Union--and "local" is used for all governments below the second tier.

government[13]. Thus, there is a need to resolve the issue as to which revenue sources can and should be assigned to subnational levels of government and how these assignments are to be effected. The 'revenue assignment problem' is closely linked with the 'the expenditure assignment problem'. It is this link that makes the application of the benefit principle possible.

Stabilization and income redistribution are largely federal government responsibilities

In the Musgravian framework, the stabilization and the income redistribution objectives are largely to be served by the federal government. It is in the context of the resource allocation objective that both federal and subnational governments play a key role. The taxes commonly thought to have the most powerful stabilizing effects are the corporate income tax and the progressive individual income tax--the former because profits fluctuate more than general economic conditions and the latter because of the stabilizing effects of graduated rates (including tax-free amounts)[14] This suggests that these two taxes should be assigned to the federal government.

The distribution function is also commonly assigned primarily to the Federal government for the following reasons. First, subnational attempts at redistribution may not be successful, and they are likely to distort the geographic allocation of economic resources. Progressive taxation may drive out capital and high-income individuals. This will make an apparent progressive tax in effect become regressive. In the literature, it is noted that the long-run incidence of property taxes levied on mobile capital by one subnational jurisdiction may be on immobile factors, land and labor, rather than on the owners of property[15].

Even if subnational taxation achieves some redistribution within a given subnational jurisdiction, interpersonal inequalities may persist across jurisdictions. These are best addressed by national policies. In some cases it may be better to use intergovernmental grants to address differences in average income levels in various subnational jurisdictions than to use taxes and transfers to individuals[16].

The assignment of the individual income tax to the federal government for stabilization purposes does not mean that subnational governments should not use proportionate taxes on the income of individuals. For example, income and corporation tax are levied at both federal and state level in the USA.

The third function of governments is efficient allocation of resources. Policies of subnational branches of governments should be permitted to differ in order to reflect the preferences of their residents. **Decentralization** of taxing and spending power allows subnational governments to tailor schemes that match the demand of their constituency which ultimately **will increase efficiency because LGs have better information about their residents' needs** than the federal government.

Application of Benefit Principle

Tax payments should reflect costs and benefits of public services. Among the best examples of benefit-related taxes are those levied on motor vehicles and motor fuels and used for the construction and maintenance of roads and highways. To the extent possible, services provided by government should be financed by user charges and fees. Each level of government should be assigned taxes that are related to the benefits of its spending. Thus, proper assignment of taxes that are related to benefits depends on the assignment of expenditure functions. The federal government should be responsible for expenditures having benefits that extend across subnational boundaries or that are characterized by economies of scale not realized at the subnational level in the provision of goods and services.

This implies that subnational governments must have enough "own" revenues to finance the services they provide. If a subnational government legislates and collects its own taxes, protected by meaningful constitutional safeguards of its right to do so, it clearly has a source of own revenues.

[13] Much of the discussion of this paper is more appropriate for a federal system of government than for a unitary system. None-the-less, interest in tax assignment is not confined to federations. It is necessary that, under either system, the central government have a real commitment to devolution of power if tax assignment is to be meaningful.

[14] Progressive taxation takes a percentage of income that rises as income rises; regressive taxation takes a percentage that falls. Proportionate taxation takes the same fraction of income at all income levels.

[15] See Mieszkowski (1972). Note that this analysis of the incidence of a tax levied by one jurisdiction is conducted holding the tax policy of other jurisdictions constant; see McLure (1977) and the discussion of section III.

[16] See Sewell (1996) and literature cited there.

Subsidiarity in taxation

It is commonly accepted that expenditure responsibility should be assigned to the lowest level of government that simultaneously reflects the geographic scope of benefits of public services and achieves economies of scale; this is commonly called the principle of subsidiarity. A similar principle can be evoked in the area of tax assignment: a given tax should be assigned to the lowest level of government that can implement it (or for which it can be implemented) and for which it is not inappropriate[17]. Compliance with this principle is important to minimize the tendency towards vertical imbalance, which exists because subnational governments have difficulty implementing many taxes, but higher levels of government can implement almost any tax that a lower level of government can implement.

In conclusion, it can be said that in the assignment of revenue sources in the 2015 Constitution in Nepal, income redistribution and macro-stabilization objectives are satisfied but the application of the benefit principle and the principle of subsidiarity requires that fiscal autonomy of the subnational governments should be increased in due course. The conceptual basis of assignment of tax is given in in Table 19. In this, F, S and L respectively stand for federal, state and local responsibility.

Table 19: Conceptual basis of tax assignment

Type of Tax	Determination of Base	Determination of Rate	Collection and administration	Comments
Customs	F	F	F	International trade taxes
Corporate income	F	F	F	Mobile factor, stabilization tool
Resource taxes, resource rent (profits, income) tax	F	F	F	Highly unequally distributed tax bases
Royalties, fees, charges, severance taxes, production, output and property taxes	S,L	S,L	S,L	Benefit taxes / charges for state-local services
Conservation charges	S,L	S,L	S,L	To preserve local environment
Personal income	F	F,S,L	F	Redistributive, mobile factor
Wealth taxes (taxes on capital wealth, wealth transfers, inheritances, and bequests)	F	F,S	F	Redistributive
Payroll	F,S	F,S	F,S	Benefit charge, e.g. social security coverage
Multistage sales taxes (VAT)	F	F	F	Border tax adjustment possible under federal assignments, potential stabilization tools
Single-stage sales taxes (manufacturer, wholesale, retail)				
Option A	S	S,L	S,L	Higher compliance cost
Option B	F	S	F	Harmonized, lower compliance cost
"Sin " taxes				

[17] Similarly, Musgrave (1983, p. 11) notes that the assignment rules he suggests "place narrower constraints on the lower levels of government, so that the latter might be accorded prior claim on the use of taxes suitable to them." The notion of subsidiarity in taxation was introduced to the EU with the Maastricht Treaty amendments to the Treaty of Rome (Article 3B). Subsidiarity requires that Member States should be able to determine their own fiscal policies unless those policies have negative spill-over effects on the entire Union. The Commission of the European Communities (1991, p. 7) explained that subsidiary requires that "Member States should remain free to determine their tax arrangements, except where these would lead to major distortions." See also McLure and Weiner (forthcoming).

Type of Tax	Determination of Base	Determination of Rate	Collection and administration	Comments
Excise on alcohol and tobacco	F	F	F	Health care shared responsibility
Betting, gambling	S,L	S,L	S,L	State and local responsibility
Lotteries	S,L	S,L	S,L	State and local responsibility
Race tracks	S,L	S,L	S,L	State and local responsibility
Taxation of "bads "				
Carbon	F	F	F	To combat global/national pollution
BTU taxes	F,S,L	F,S,L	F,S,L	Pollution impact may be national, regional or local
Motor fuels	F,S,L	F,S,L	F,S,L	Tolls on federal/provincial or local roads
Effluent charges	F,S,L	F,S,L	F,S,L	To deal with interstate, inter-municipal or local pollution issues
Congestion tolls	F,S,L	F,S,L	F,S,L	Tolls on federal/provincial or local roads
Parking fees	L	L	L	To control local congestion
Motor vehicles				
Registration, transfer taxes and annual fees	S	S	S	State responsibility
Driver's licences and fees	S	S	S	State responsibility
Business taxes	S	S	S	Benefit tax
Excises	S,L	S,L	S,L	Residence-based taxes
Property	S	L	L	Completely immobile factor, benefit tax
Land	S	L	L	Completely immobile factor, benefit tax
Frontage, betterment	S,L	L	L	Cost recovery
Poll	F,S,L	F,S,L	F,S,L	Payment for services
User charges	F,S,L	F,S,L	F,S,L	Payment for services rendered

Source: Anwar Shah, The Reform of Intergovernmental Relations in Developing and Emerging Countries, Policy Research Paper No. 23, World Bank, 1994

5.2 Revenue Assignment: Case Studies

The revenue assignment provisions and related issues with respect to five federal countries namely Australia, India, South Africa, Canada and Germany has been reviewed.

A. Australia

Structure of Government:
LGs do not have a direct relationship with the federal government

Australia's federal system is entrenched in the Commonwealth Constitution. There are 6 states (and 2 federal territories) and 571 "local government areas" or councils. The number of municipal-level governments recently fell from 869 in 1980 to 571 following merger policies initiated by several states. LGs are not explicitly recognised by the Constitution. LGs have no direct relations with federal authorities but depend directly on state and territory governments which have their own constitution and LG Act. Consequently, the status, names (cities, shires, county councils, districts, towns, etc.), roles and responsibilities of LGs differ from state to state.

Assignment of Revenues:
There is a high degree of vertical imbalance but GST revenue is fully assigned to the state governments

Taxation powers of the Commonwealth and the states are defined in the Constitution as well as in the intergovernmental Agreement on Federal Financial Relations (IGAFFR) agreed with the Council of Australian Governments (CoAG) in 2008. Australia has a highly centralized tax system where more than 82% of national revenue is collected by the centre through controlling and determining major revenue bases such as Customs duties, PIT and CIT, VAT, and Excise duties. The remaining 18% is collected by state (from tax bases such as payroll tax and stamp duties, land use and natural resource tax, motor vehicle tax, Gambling tax, and Royalty from resource extraction) and LGs (from tax bases such as property tax, and Parking fees and charges).

Subnational government revenues (inclusive of tax and other revenues only) represents 8.5% of GDP (Table 21). State revenues mostly comprise of property-related taxes (i.e. around 34% of states' tax revenue, including land property tax and financial and capital transactions), payroll taxes (33%) and motor vehicle (14%). States have the right to set their own tax rates and bases for the taxes they control. The only tax for LGs is the land property tax (shared with the states).

All states except one collect royalty revenue from mining activities in their state. The majority of royalties are calculated and collected based on the value of minerals produced (only two states collect royalties on the basis of mining profits). In 2013, average royalties represented 8% of states' own-source revenue but these revenues are very unevenly distributed among the States. Other major sources of revenue for LGs include the sale of goods and services, interest income, dividends, fines, developer charges, contributions, other capital revenues, etc. Over a quarter of total LG revenue comes from user charges. In the context of Nepal, non-tax revenues do have the potential of increasing the revenue autonomy of the subnational government. They also have a capacity of providing an inbuilt equalization of resources. This is so because sources such as water (hydel power), forests, and minerals are areas where non-tax revenues can be high and their distribution is such that many of the poorer and low population regions in Nepal have a high share in these sources of non-tax revenues. This is a case where the NNRFC would need to take explicit account of the low revenue autonomy given to the subnational governments through taxes and therefore they should try to balance it partially through the use of natural resources.

Table 20: Revenues of the Commonwealth Government and Subnational Governments: Australia

Revenue by Type	% GDP		% General Government (same revenue category)		% Subnational Government	
Subnational data			Local data only			
Total Revenue (2013)	15.3%	-	45.1%	-	100%	-
Tax revenue	5.1%	-	18.6%	-	33.3%	-
Grants and Subsidies	6.8%	-	-	-	44.4%	-
Other revenues	3.4%	-	-	-	22.2%	-

Source: OECD/UCLG (2016), Subnational Governments around the world: Structure and finance.

To partially address vertical fiscal imbalance, the Commonwealth provides ongoing funding to the States to assist with the cost of their service delivery. According to a 2001 Agreement between the Commonwealth and state governments, the entire revenue from GST is distributed amongst the state governments on the basis of relativities worked out by the Commonwealth Grants Commission.

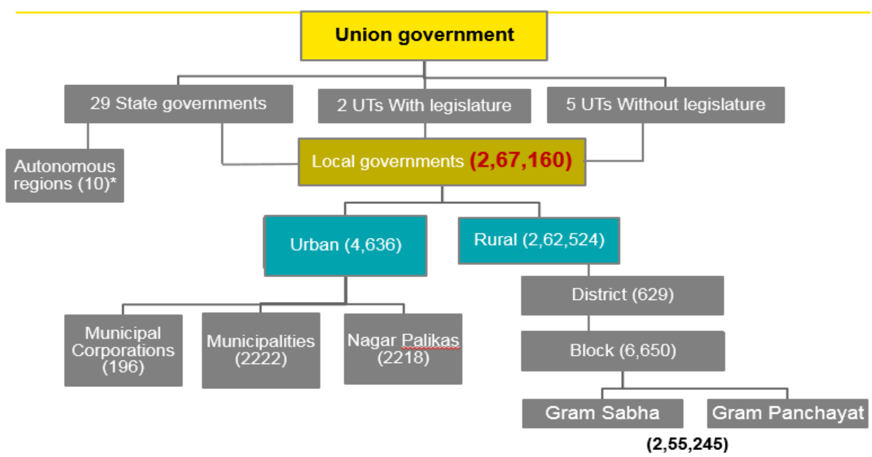
B. India

Structure of Government:
LGs are constitutionally recognized but assignment of revenue powers depends on the state governments

India has a multi-layered structure of government. The structure of government in India consists of a federal government, twenty-nine states, two Union Territories (UTs) with legislatures, five Union

Territories without own legislatures, several autonomous regions within states, a three-tiered structure of rural LGs, and three levels of urban LGs. The urban LGs are divided into three categories namely, municipal corporations, municipalities and Nagar Palikas. There are three types of rural bodies also. But they are arranged in a vertical structure. These are district panchayat, block panchayat and gram panchayat. Together these are referred to as the Panchayati Raj institutions (PRIs). This structure is illustrated in Chart 3.

Chart 3: Structure of governance: India



Source (Basic Data): Second Administrative Reforms Commission, fifth report, April 2009

LGs were given a constitutional status through the 73rd and 74th amendments to the constitution. The 73rd Constitutional Amendment Act, 1992 came into effect from 24th April 1993. Article 243 G Part IX of the eleventh schedule of the Constitution of India gives the detailed list of functions to be performed by PRIs. States having a population not exceeding 20 lakh have been given the option of not having any Panchayat at the intermediate level.

Relative Revenue Powers:
States have a high degree of fiscal autonomy even prior to fiscal transfers

Assignment of taxes between federal and state governments is governed by the items listed in the Union and State Lists under Schedule 7 of the constitution. For details refer to Annexure 1 - Table A8. There are no taxes listed in the concurrent list.

After the introduction of GST, selected constitutional articles (e.g. Art. 92C), have been amended through one hundred and first amendment to the constitution dated 8th September 2016[18].

The effect of these changes has been to abolish the service tax, and Union excise duties and sales taxes except on the specified petroleum products. The central sales tax and entry taxes have also been abolished. The GST has been introduced from the 1st of July 2017. The post-GST revenue position of the centre and states will only be known in due course. In the event of revenue loss, the state governments have been guaranteed compensation by the federal government for a period five years. The GST rates have been fixed in a manner so as to be broadly revenue neutral. From a revenue standpoint, from this long list of taxes only the following taxes are significant for the Union government: customs duties, income tax, corporation tax, Union excise duties, and service tax. In the State list, the following taxes have been important from a revenue stand-point: sales tax (state VAT), motor vehicle tax, stamp duty and registration fees, state excise duties, and electricity duty. Prior to GST, the relative share of own tax revenues in the combined tax revenue of the federal and state governments is summarized in Tables 21 and 22.

[18] Refer to Annexure 1 – Table A9 for details

Table 21: Taxes Raised by Federal and State Governments: Position before and After Revenue Sharing (% share in total taxes – five year average)

Five year periods	Taxes raised by Federal government	Own taxes of state governments	Net central taxes after transfer to states	State taxes including share in central taxes
FY2001 - 2005	61.0	39.0	44.6	55.4
FY2006 - 2010	64.7	35.3	47.6	52.4
FY2011 - 2015	60.7	39.3	43.5	56.5
Source: Indian Public Finance Statistics, 2015-16, Ministry of Finance, Government of India				

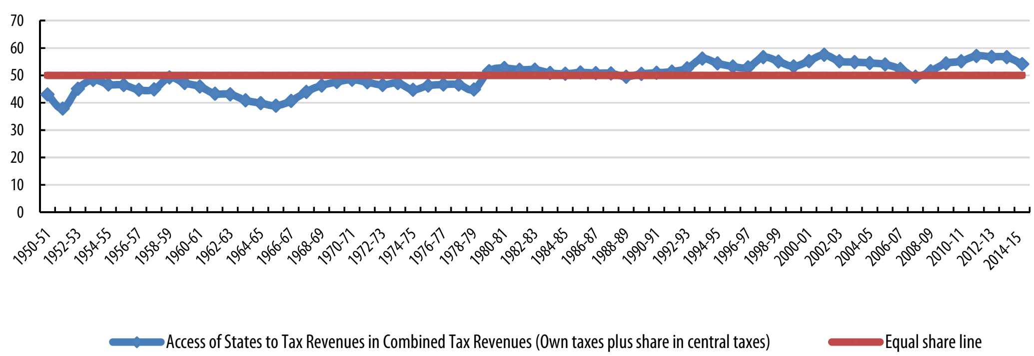
Access of the states to the overall tax revenues is determined by the sum of state's own tax revenues plus their share in central taxes. In terms of assigned revenue powers, states raise just a little less than 40% of the combined taxes. After receiving a share in central taxes, states' share has gone up to close to 56% in recent years. In Table 22, respective shares in terms of averages over selected periods are given, covering the total revenue receipts.

Table 22: Share in resources: Centre and states (percentage)

Share of centre and states in combined revenue receipts (%)				
Five year periods	Centre's revenue receipts before transfers	States' revenue receipts before transfers	Centre's net revenue receipts after devolution and grants to states	States' net revenue receipts after receiving devolution and grants from the centre
FY2006 - 2010	64.6	35.4	39.1	60.9
FY2011 - 2015	61.9	38.1	36.3	63.7
Share of centre and states in combined revenue receipts (%)				
	Centre's capital receipts net of net loans from centre to states		States' capital receipts including net of loans from centre	
FY2006 - 2010	64.8		35.2	
FY2011 - 2015	67.4		32.6	

Source (Basic data): IPF statistics and RBI

Chart 4: Relative Access of States to Tax Revenues



Source (Basic Data): Indian Public Finance Statistics, various issues

As shown by Chart 4, this share has been below the line of equal access (50 percent) prior to 1980-81, close to this line during 1980-81 to 1988-89, and marginally above this line 1989-90 onwards. It can be said that post-transfers, access to tax revenues to the states is broadly evenly balanced. This has been a long-term trend. In recent years, the share of states has marginally increased in the combined tax revenues.

Taxation Powers of LGs

LGs can be assigned taxes by the State governments from within the State list taxes

The 73rd Constitutional amendment act adds a sub clause (bb) to Article 280 of the Constitution. According to this sub clause, the Central Finance Commission, in addition to other stipulated duties, shall also make recommendations to the President regarding the measures needed to augment the then Consolidated Fund of a State to supplement the resources of the Panchayats in the State on the basis of the recommendations made by the Finance Commission of the State.

There are a few glaring limitations in this framework. The 29 subjects mentioned in the 11th schedule[19] only give power to the LGs to take decisions but not to legislate. The State Finance Commissions' recommendations are not mandatory in nature. It is completely up to the State Governments to devolve or not to devolve, functions, functionaries and resources on the LGs as per the constitutional scheme. The 29 items are handled by different state ministries and are not in the hands of the Minster of Panchayati Raj and Rural Development.

The 73rd and 74th Constitutional Amendment Acts have favoured devolution of financial powers (through creation of 11th and 12th Schedules vide which functional and fiscal powers have been devolved to them) upon the LGs institutions. However, the two schedules by themselves do not contain subjects of 'revenue resources' except by way of incidental receipts. The taxes, duties, tolls and fees to be levied by them and assigned to them and the grants-in–aid to be given to them are left to the discretion of the state governments.

Thus, in India, rural as well as urban LGs derive powers of taxation only out of subjects specified in the state schedule as given in Appendix A10. Each state government can authorize the LG specific revenues sources under articles 243H and 243X of the constitution. As such, the assigned resources to the LGs may differ from state to state. In India, the jurisdiction of LGs is entirely within the control of the state governments. This leads to considerable inter-state heterogeneity in the standards of locally provided services. The framework in Nepal may prove to be more conducive in achieving equalization in the standards of locally provided services.

A State Finance Commission has to be constituted at least once in every five years to review the financial position of the Panchayat and to make suitable recommendations to the Governor as to the principles which should govern the distribution between the state and the panchayats relating to both sharing of taxes and grants. It can also recommend measures to strengthen the financial position of the panchayat bodies and deliberate on any other matter referred to it by the Governor.

C. South Africa

Structure of Government:
South Africa is a quasi-federal country

South Africa is a quasi-federal country as it is a unitary state with some federal features. The 1993 Interim Constitution increased the number of provinces from four to nine. The integration process also resulted in a reduction of municipalities from more than 1000 before 1990 to 830 just after 1993 and further down to 278 following the 2011 municipal elections. Urban areas have metropolitan municipalities (category A). In primarily rural areas, a two-tier organisation consisting of district municipalities (category C) and local municipalities (category B) exists. The latter share authority with the district municipality.

Assignment of Revenues:

In South Africa, there is a high degree of vertical imbalance. Provincial tax revenues account for less than 1% of total tax revenue and around 0.2% of GDP. The bulk of provincial tax revenue is derived from motor vehicle licenses, with some revenue being derived from casino (gambling) taxes and liquor licenses. Few provinces are collecting all the revenues possible from the limited existing tax sources at their disposal. Municipalities collect local taxes and exercise total control over their tax base. The principle tax is property tax. District municipalities do not collect property tax with significant disparities in the municipal tax bases.

Municipalities raise an important share of their revenue in the form of charges, in particular user charges for water, sanitation, electricity and refuse removal services. The share of these revenues is low in rural

[19] Article 243 G Part IX of the Constitution of India containing the list of functions to be performed by Panchayati Raj Institutions

and poor municipalities. Table 23 gives the share of subnational governments revenues, tax and non-tax, in general government revenues, their own total revenues and as a percentage of GDP.

Table 23: Revenues of the Commonwealth Government and Subnational Governments: South Africa

Revenue by Type	% GDP		% General Government (same revenue category)		% Subnational Government	
Subnational government data			Local government data only			
Total Revenue (2013)	20.8%	8.2%	56.5%	22.1%	100%	100%
Tax revenue	1.5%	1.3%	5.3%	4.4%	7.4%	15.4%
Grants and Subsidies	14.9%	2.6%	-	-	71.3%	31.8%
Other revenues	4.4%	4.3%	-	-	21.3%	52.9%

Source: OECD/UCLG (2016), Subnational Governments around the world: Structure and finance.

Fiscal transfers are overseen by the Financial and Fiscal Commission (FFC). The FFC has argued that increasing provincial tax powers would strengthen accountability at the margin. Provincial governments can propose new taxes through the Provincial Tax Process Regulation Act of 2001. A province may, in terms of this Act, propose any tax not strictly prohibited by the Constitution. Section 228 of the Constitution permits provincial taxes, levies and duties other than an income tax, a VAT, general sales tax, rates on property or customs duties. It also authorizes provinces to impose a flat-rate surcharge on the tax bases of any tax levy or duty imposed by national legislation other than the tax bases of CIT, VAT, rates on property or customs duties.

The most fiscally buoyant and constitutionally compliant revenue source for provincial governments would be provincial surcharges on PIT and/or surcharges on the fuel levy. The constitutional requirement, however, of any surcharge on the tax base of a national tax has been interpreted to mean that a province cannot impose a surcharge as a percentage of the national tax liability due (i.e. a surtax). Rather, the province must design its surcharge as a tax on the underlying income or activity that occurs within its borders. Thus, a province cannot automatically ‘‘piggyback’’ on a national tax.

Section 229 of the Constitution confers substantial tax powers on municipalities including property rates, user charges and other taxes, levies and duties, if authorised by national legislation. Various legislations support Section 229 in the regulation of a municipality’s own revenues:

- The Municipal Property Rates Act (MPRA) of 2004 regulates LG’s ability to impose property rates
- The Electricity Act of 1987 and the National Water Act of 1998 govern service charges and tariffs specific to the sector
- The Municipal Fiscal Powers and Functions Act (MFPFA) of 2007 regulates all municipal taxes (excluding property rates), including a municipality’s ability to apply a surcharge on a tariff and the various “smaller” taxes. Importantly, Section 5 of the Act allows for a municipality or a group of municipalities or organized LG to apply for a new tax.

In practice, however, there is wide variation in the ability of municipalities to generate their own revenues (as illustrated in Table 24 below). Consequently, many municipalities (especially rural and district ones) are highly dependent on intergovernmental grants received from the national Government.

Table 24 : Share of Municipal revenue sources in total revenues of municipalities in South Africa

Revenue sources	**2015**	**2016**
Property rates	13%	13%
Service charges	36%	37%
Interest earned	5%	5%
Grants and subsides	26%	26%
Others	20%	19%

Source (Basic Data): Statistics South Africa

D. Canada

Structure of Government:
Provinces have a large share of revenues

Canada is divided into ten provinces and three territories. The relatively larger provinces in terms of population are: Ontario, Quebec, British Columbia, and Alberta. In terms of area, two other big provinces are Manitoba and Saskatchewan. Nova Scotia, Newfoundland and Labrador, Prince Edward Islands and New Brunswick are referred to as the Atlantic Provinces. Northwest Territories, Yukon and Nunavut are the three territories. Most of the population in Canada is concentrated in the provinces sharing their borders with the US.
At the local level, Canada has a system of municipalities that are based in a city, town or district. Municipal governments are responsible for areas such as libraries, parks, community water systems, local police, roadways and parking. They receive authority for these areas from the provincial governments. Across the country there are also band councils, which govern First Nations communities. These elected councils are similar to municipal councils and make decisions that affect their local communities. Together, in Canada, at the state or regional level, there are 10 provinces and three territories and at the local level, there are 3805 municipalities.

Assignment of Revenues

Revenue assignment to the provinces covers both direct taxes and indirect taxes. There is mixed picture as to how these taxes are raised. The harmonised sales tax (HST) is levied and collected by the federal government on behalf the provinces. Otherwise, there is a mix of provincial sales tax (PST) or Goods and Services tax (GST). The GST tax base is concurrent in the sense that it is also levied by the federal government.

Table 25: Provincial GST/PST/HST Rates 2017

Province	GST	PST	HST	Provincial Tax Information
Alberta	5%	n/a	n/a	Alberta Tax and Revenue Administration
BC	5%	7%	n/a	BC Consumer Taxes
Manitoba	5%	8%	n/a	Manitoba Retail Sales Tax
New Brunswick	n/a	n/a	15%	New Brunswick Taxes
Newfoundland	n/a	n/a	15%	Taxes in Newfoundland and Labrador
NWT	5%	n/a	n/a	NWT Taxation
Nova Scotia	n/a	n/a	15%	Information for Nova Scotia Taxpayers
Nunavut	5%	n/a	n/a	Nunavut Taxes
Ontario	n/a	n/a	13%	Ontario HST
PEI	n/a	n/a	15%	PEI HST
Quebec	5%	9.975%	n/a	Quebec GST and QST
Saskatchewan	5%	6%	n/a	Saskatchewan Provincial Sales Tax
Yukon	5%	n/a	n/a	Yukon Taxation

Source: https://www.thoughtco.com/canadian-sales-tax-rates-510599

The Canadian provinces also have access to income taxes. Tax collection agreements enable different governments to levy taxes through a single administration and collection agency. Income tax base is also concurrent for the federal and provincial governments. The federal government through the Canada Revenue Agency collects personal income taxes on behalf of all provinces and territories except Quebec and collects corporate income taxes on behalf of all provinces and territories except Alberta and Quebec. Among non-tax revenue sources, resource royalties are particularly important for the provinces. Canada has a very elaborate system of fiscal transfers consisting of equalization transfers, grants for health and education and other grants.

Provinces in Canada raise about half of the combined federal and provincial taxes. They have a relatively larger share in taxes on goods and services than in taxes on income. They account for the entire tax revenue on payroll taxes and property taxes whereas the federal government has access to the entire revenue from taxes on international trade and transactions as given in Annexure 1 - Table A11).

In terms of raising non-tax revenues, provinces have a larger share amounting to nearly three-fourth of the combined non-tax revenue. An important source of non-tax revenues for the provinces is resource rent, particularly oil and gas royalties (refer to Annexure 1 - Table A12 for details).

E. Germany

Structure of Government:
In Germany, LGs do not have a direct relationship with the federal government.

The German federal system, set up by the 1949 Basic Law, reformed in 2006 and again in 2009, is based on the principle of co-operative federalism. The three-tier system of subnational governments includes, below the Länder (states) level, a LG level composed of 295 rural districts (Landkreise) and 107 district-free cities (Kreisfreie Städte), and at the lower level, municipalities. There are 16 Landers and 11092 municipalities. While LG status is constitutionally guaranteed, they are governed by their state. Their organizational structure may differ from state to state. Several districts and municipal merger policies were carried out by the states over the last few decades, and more recently, in state Saxony-Anhalt for example. Overall, the number of German municipalities has decreased by one-third between 1990 and 2016.

Assignment of Revenues:
There is a relatively low level of subnational tax autonomy, the Federation having almost exclusive power to legislate on tax bases, rates and sharing arrangements

The Basic Law sets out detailed fiscal provisions, in particular the assignment of exclusive and shared taxes, intergovernmental transfers as well as equalisation principles between the federal government and the states. It also includes specific arrangements relating to municipalities although LG financing is established by the states. The 2009 Federalism reform (Föderalismus reform II) modified some financial arrangements. SNG (Subnational government) financing is based mainly on tax revenues, whose share in SNG revenue, public tax revenue and GDP is significantly above the OECD average. However, there is a relatively low level of subnational tax autonomy, the Federation having almost exclusive power to legislate on tax bases, rates and sharing arrangements.

The SNG tax system is based on shared and own-source taxes. States represent around three-quarters of SNG tax revenue. In 2013, shared taxes accounted for around 55% of all SNG tax revenue. Most of states' tax revenue comes from shared taxes, essentially the PIT, CIT and the VAT. Their own taxes include inheritance tax, vehicle tax, real estate purchase tax, lottery tax, beer tax, etc. States have little control over own taxes, with the exception of real estate purchase tax. Main local shared taxes (around 40% of local tax revenue) are the PIT and tax on interest, and marginally the VAT. Own source tax includes the local business tax (41% of local tax revenue) and the property tax (13% of local tax revenue amounting 0.4% of GDP, one of the lowest levels of the OECD). Shared taxes are part of the formula-based fiscal equalisation system between states defined by the Equalisation Law, 25% of states VAT revenues being used for equalisation. At the local level, each state is in charge of its own equalisation mechanism.

Table 26: Revenues of the Federal Government and Subnational Governments: Germany

Revenue by Type	% GDP		% General Government (same revenue category)		% Subnational Government	
Subnational data			Local data only			
Total Revenue (2013)	20.6%	7.8%	46.2%	17.4%	100.0%	100.0%
Tax revenue	11.3%	3.0%	49.3%	13.2%	54.8%	38.9%
Grants and Subsidies	5.5%	3.1%	-	-	26.6%	40.3%
Other revenues	3.8%	1.6%	-	-	18.5%	20.8%

Source: OECD/UCLG (2016), Subnational Governments around the world: Structure and finance.

Besides tax equalisation, there are horizontal equalisation transfers to states, aimed at reaching equal public services in all regions. States with lower-than-average fiscal capacity are compensated through federal transfers. In addition, specific transfers are made to reflect certain needs of the states, to finance joint tasks or for specific purposes. At the local level, there is no direct federal grant to LGs, only state grants. They represent a significant source of revenue and comprise general, compensation, investment and specific grants.

Other revenues, in particular user charges and fees paid by local citizens and corporations as users of local public services, are a significant source for SNGs, especially for LGs.

5.3 Concluding observations

In conclusion, the cross country analysis discussed above indicates varied fiscal federal systems across countries. While in India, Canada, Australia and Germany, LGs depend on state/provincial governments for their revenue powers, in South Africa, LGs depend largely on the national government for these powers. In Germany, the Federation has almost exclusive power to legislate on tax bases, rates and sharing arrangements. In Nepal, although the LGs can enact laws, the process of making such laws will be provided under the state law. Further, no tax can be levied and collected at the local level except in accordance with the state law.

Similar to the current situation in Nepal, in Australia, South Africa and Germany there is a high degree of vertical imbalance requiring high dependence on fiscal transfers by subnational governments. In contrast, in India and Canada, states/provinces have an almost equal/larger share in national revenues.

Canada has an elaborate system of fiscal transfers consisting of equalization transfers and grants. In Germany also, a formula-based fiscal equalization system determines revenue sharing between the federal and state governments. Moreover, there are horizontal equalisation transfers to states, aimed at reaching equal public services in all regions and other specific purpose transfers. India also has an evolving system of fiscal transfers. In the absence of an appropriate fiscal transfer framework, the Government of Nepal in its latest budget, has provisioned fiscal transfers for the local bodies thereby helping the LGs in carrying out their expenditure in the transition period. Eventually, after the state governments are formed, an elaborate system of transfers, possibly like in India, with federal and state finance commissions, will have to be developed. A proposal to set up a revenue sharing determination committee to prepare the basis of revenue sharing between the state and LGs is indicated in the bill for 'Operation and Management of Local Level Governance.

6. Policy Recommendations

Assignment of revenue sources for the subnational governments under the Constitution of Nepal, broadly satisfies the principles of revenue assignments except the principle of revenue adequacy. GoN, at least for the time being has decided, as per the available information on IGFT Bill, to share the revenues from VAT on domestic sales and excise duty revenues with the SNGs. The relevant shares are to be specified in the IGFT Act. Thus, GoN has decided for revenue sharing under a Federal Government Act and for tax-specific revenue sharing rather than generalized revenue sharing.

Revenue needs of the subnational governments should be viewed in light of highly uneven economic development across the regions, highly centralized collection of tax and non-tax revenues and highly uneven distribution of tax bases and base of non-tax revenues.

In the context of revenue mobilization at the subnational level, state governments and where required LGs would have to enact the necessary laws, create institutional capacity, and prepare administrative procedures to exploit the revenue resources assigned to them. The federal government can facilitate this process in the period of transition. Article 59 (2) provides that, "The Federation may so make necessary policies, standards and laws on any of the matters enumerated in the Concurrent List and other areas of financial powers as to be applicable also to the States"[20] [Translation of Nepal Law Commission].

While the state and LGs, as they are autonomous in matters assigned to them, would be free to make changes in the laws prepared by the federal government, such laws initially made at the federal level can still serve as benchmarks for the states. Policy recommendations are in two parts: (a) tax by tax recommendations and (b) overall recommendations with prioritization and timelines (Table 27)

[20] http://www.lawcommission.gov.np/en/documents/2016/01/constitution-of-nepal-2.pdf

6.1 Tax by tax recommendations

Table 27: Tax by tax recommendations

1. Agro-income	
Legal basis	State level law. **[A]:** Until state legislature is formed, a Model Act and related Rules may be made by the Federal Government may be kept ready for the consideration of the state assembly which may adopt it as it is or with modification.
Gaps and associated risks	Lack of administrative capacity and relevant database. Difference in agricultural income tax rate vis-à-vis Central income tax rate opens up opportunities of tax evasion. If agricultural income tax is lower, there would be a tendency to overstate agricultural income and understate non-agricultural income. Potential revenue is likely to be low because of low and volatile nature of the tax base. Agricultural growth tends to be lower than non-agricultural sectoral growth on average.
Binding constraint	Politically difficult to levy an agricultural income tax. In the current Central Income Tax Act, although provision to tax agricultural income was there, but so far this tax has not been levied.
Other constraints	Nature of tax base is inherently volatile because of agricultural incomes being subject to output- price cycles.
Framework for Solution	Initially commercial and plantation crops may be targeted. Since agricultural output and incomes are subject to output price cycles clear provisions should be made to deal with the inherent volatility of this revenue source. Inherent volatility of this tax base should be recognized.
2. Vehicle Tax	
Legal basis	**[A]** as above Furthermore, this tax until now was levied by the federal government. It is a tax on vehicles and therefore affects the movement of people, goods and services. It is efficient that it is levied at the higher level of the subnational government that is the state level. Only for some traditional types of vehicles, whose mobility is generally limited to a local area, it can be levied by LGs.
Gaps and associated risks	Lack of administrative capacity. Interstate differences in tax rates may lead to vehicles being registered in jurisdictions with relatively lower rates.
Framework for Solution	Officers from the federal government with experience of administering this tax may be deputed to states. Rate coordination amongst states should be undertaken. Rate differentiation between privately owned vehicles (one-time levy) and vehicles used for commercial purposes (annual tax) may be maintained.
3. Property tax	
Legal basis	Local level law. **[B]:** Until LGs are in place, a Model Act and related Rules may be made by the federal government may be kept ready for the consideration of the LGs which may adopt it as it is or with modification.
Gaps and associated risks	Potential for underestimation of rateable value of property. For properties being used for both commercial and residential purposes, there is built-in incentive to declare its main use as residential if it has a lower effective tax rate.
Framework for Solution	Existing LG officials have experience in collection of property tax. At the federal level and local level, institutions should be created to assess property values according to market trends. The tax rate can be made ad valorem or according to type or use of the property. The rate of the tax should be linked to municipal services provided within the jurisdiction for the relevant properties. There is also a need for differentiating between residential and commercial property.
4. House Rent Tax	
Legal basis	Local level law. **[B]** as above
Gaps and associated risks	Understatement of rent charged both by owner and tenant.

Framework for Solution	Use existing experience for administering the tax. Adopt existing LSGA law. Distinction may be made between rented property used for residential use and commercial use.
5. Business tax	
Legal basis	Local level law. **[B]** as above
Gaps and associated risks	Understatement of business income. Low revenue potential if levied on basis other than income.
Framework for Solution	Ideally, taxed on the basis of business income. Due to administrative difficulties, turnover may be taxed. Rate must be low because business income is being taxed at the federal level. Local tax paid should be deducted from the Central Income tax.
6. Land Revenue (Land Tax)	
Legal basis	Local level law. **[B]** as above
Gaps and associated risks	Land revenue and agricultural income tax are examples of double taxation.
Framework for Solution	Land used for subsistence agriculture may have to be exempted. Land used for urban plants, floriculture, exotic plants with export potential etc. may be taxed at higher rates.
7. Advertisement tax	
Legal basis	Common jurisdiction. **[C]:** It would be ideal for the state legislature to make this law. Until state legislature is formed, a model law made by the Federal Government may be kept ready for the consideration of the state assembly which may adopt it as it is or with modification. State government may allow the LGs to collect and retain the revenues and may give a share to the states. This would ensure uniformity of rates and definitions and collection can be more efficient.
Gaps and associated risks	Difficult to assess the commercial value of an advertisement. Inherently low buoyancy as many advertisements continue to produce value to the advertiser for long years but difficult to charge tax again and again.
Framework for Solution	Rates may be differentiated according to mode of advertisement – traditional means (display boards, newspapers, radio and television etc.) and modern means of advertisement such as broadcasting services.
8. Entertainment tax	
Legal basis	Common jurisdiction. **[C]** as above
Gaps and associated risks	Difficult to assess the commercial value of an entertainment.
Framework for Solution	A distinction can be made in defining the tax base between traditional means of entertainment like theatres and cinema halls vis-à-vis modern means of entertainment like broadcasting services, internet etc. Tax rate should applied to the value of entry ticket making it ad-valorem.
9. Land and house registration fees	
Legal basis	Common jurisdiction. **[C]** as above
Gaps and associated risks	Potential underestimation of declared value of sale with the concurrence of buyer and seller.
Framework for Solution	Need to have a system of benchmark values according to area characteristics which needs to be revised periodically reflecting trends in market value. Utilize link between property tax and land and house registration fees. A lower rate would encourage declaration of correct values. Lower rate may be applicable for female ownership.
10. Common observations for all taxes	
Legal basis	Model laws should be prepared for three groups of taxes:

	a) Exclusive/largely exclusive for state governments (Agro-income tax and vehicle tax) b) Taxes under exclusive jurisdiction of LGs (Property tax, house rent tax, business tax, land tax (land revenue)) c) Taxes under common jurisdiction of state governments and LGs (Entertainment tax, Advertisement tax, Land and house registration fees) Taskforces should be set up by MoF, GoN to prepare these model laws. Until state legislature is formed, a model law made by the Federal Government may be kept ready for the consideration of the state assembly which may adopt it as it is or with modification. State level law. Collection can be done and revenue retained by LGs.
Gaps and associated risks	Lack of administrative capacity
Binding constraint	Low revenue potential of taxes assigned to subnational governments creates no effective difference in the degree of de-centralization and makes states dependent on central transfers which will adversely affect the quality of fiscal federalism in Nepal

Source: EY Team

6.2 Possibilities of new taxes and related considerations

If new taxes are identified for the subnational governments, it is only through a constitutional amendment that such a tax can be assigned to the subnational governments. If a tax is introduced without such an amendment, it would become part of the residual list and under the residuary powers of the federal government, it will become a central subject. Since most of the revenue yielding taxes that presently exist in Nepal have already been assigned to the federal government, almost all of the conventional tax areas are already covered. Only one group of taxes in modern economies is not covered, namely, environmental taxes. However, in the design of environmental taxes, because of externalities involved, it is generally not recommended that they be levied at the subnational level. One exception is congestion tax, which can ideally be levied in crowded municipal areas in order to discourage congestion, particularly in specified hours.

There is also the possibility of levying cesses on top of central taxes which can be earmarked for subnational governments. These can be levied both on direct and domestic indirect taxes. Furthermore, if a constitutional amendment is in any case required and based on available evidence, it is straightforward to conclude that the revenue potential of the existing assignment scheme will result in a high degree of vertical imbalance in favour of the federal government and that this is bound to affect the quality of fiscal autonomy of the subnational governments in Nepal, some of the revenue yielding central taxes, such as the domestic VAT can be assigned to the states. To begin with, at least a good share of revenues from this tax and possibly the personal income tax should be shared with the subnational governments under recommendations of the NNRFC.

6.3 Overall recommendations: prioritization and timelines

In terms of prioritization of recommendations and timelines, Table 28 summarizes recommendations.

Table 28: Prioritization of Recommendations and Timelines

Timeline	Recommendations
Immediate	▸ "Model" Acts and Rules with respect to following should be made by the federal government during the transition period **Group (a): Exclusive or largely exclusive to state governments** (1) Vehicle tax (2) Agricultural income tax **Group (b): Exclusive to LGs** (1) Property tax (2) House rent tax (3) Business tax (4) Land tax (land revenue) **Group (c) Taxes under common jurisdiction of states governments and LGs** (1) House and land registration (2) Entertainment tax (3) Advertisement tax ▪ Entry fee to heritage park, garden, historical and archaeological heritage, and museum to be determined and collected by municipality/ rural municipality ▪ Appointing revenue officials in municipalities/ rural municipalities by partly absorbing revenue officials in existing municipalities, DDCs and VDCs
Short-term	▪ Model law to be made by the federal government for: 1. Vehicle tax (other than those covered by municipality/ rural municipality) 2. Agricultural income tax ▪ Appointment of revenue officials at the state level ▪ In drafting laws, use ad valorem rate as far as possible as compared to specific rates
Medium-term	▪ States to develop their own tax laws by adopting or modifying the central 'model' laws ▪ Development of infrastructure and revenue bases (tax and non-tax) in states and municipalities/ rural municipalities ▪ If rates differ across LGs within a state, determine floor rates at the state level ▪ Training of revenue officials ▪ Develop mechanism for tax assessment for facilitating registration, filing of returns, and provision of information ▪ Make 'tax effort' or 'revenue effort' a criterion in revenue sharing formulae for both central to state revenue sharing and central/ state to local revenue sharing (E.g.- from Indian Finance Commissions) ▪ Use of incentive structure applied to revenue officials ▪ Setting up a suitable institutional mechanism for compilation and collation of fiscal data including revenue data at the subnational level
Long-term	▪ Correction of vertical and horizontal imbalances in own revenues ▪ Development of new subnational taxes, e.g. – congestion tax

Source: EY Team

7. Implementation strategy

Key components of the implementation strategy can be considered in two parts: (

a) Initiatives by the federal government to facilitate the subnational governments in the transition period while building up their institutional capacity and

(b) A step by step roadmap for building institutional capacity at the subnational level.

7.1 Central initiatives for sub-national governance

a. Transitional Revenue Provisions:

GoN has made initial revenue provisions for the subnational governments

The elections for the LGs are about to be completed. Most of the Palikas and Nagar Palikas would be in place during FY2017-18. In FY2017-18 Budget, allocations for the subnational governments have been made under the following heads:

1. Grants to LGs

2. Fiscal Transfers
   a. For Palika/ Nagar Palika
   b. States

This has been necessitated because NNRFC has not been constituted yet.

The FY2017-18 Budget has allocated Rs. 225.05 billion i.e. 17.6% of the total budget as grants to local level (i.e. fiscal transfers for Palika/ Nagar Palika), of which Rs. 148.63 billion is allocated as equalization grant and Rs. 76.41 billion as conditional grant. As the state government has not been formed yet, an allocation of Rs. 7.14 billion as transitional arrangement through equalization grant (i.e. fiscal transfer to states) has been made.

In the Budget Speech, the Finance Minister observed that to enable the LGs to select and implement respective development programmes and actions, the GoN is providing required resources in the FY17-18 Budget. Furthermore, a new category of transfers under the title 'Fiscal Transfer' has been introduced to provide a strong foundation for the working of the federal system of governance according to the new constitutional provisions.

The Budget Speech also observes that NNRFC has not been constituted yet, for overseeing the financial transfers including revenue distribution and distribution of grants. Apart from an overall amount being earmarked in the federal budget, it has also been distributed across the LGs according to the "equalization principle", using population, development status and cost adjusted area as the relevant factors.

It has been ensured that the different types of LGs namely, rural municipality, municipality, sub-metropolitan cities and metropolitan cities, receive grants within a reasonable range such that the grants received by a LG is neither less than a specified threshold nor it is higher than a certain limit. These limits are given in Appendix tables 13 and 14. In addition to the equalization grant, certain conditional grants have also been allocated to the LGs.

b. Proposal for Revenue Sharing

Initiatives by the GoN for facilitating the establishment of a fiscal federal system are:

1. Bill for operation and management of local level governance
2. National Natural Resources and Finance Commission (NNRFC) Bill
3. Inter-governmental Financial Management Bill

Tax Sharing

The IGFT initiative has proposed certain revenue sharing arrangements for specified taxes and non-tax revenues. These proposals may be taken as transitional arrangements until NNRFC is constituted. The two major indirect taxes namely customs duties and sales tax/ VAT account for more than half of total central tax revenues that are currently raised. It is useful to divide VAT into two parts: VAT on domestic sales and VAT on imports. VAT on domestic sales is nearly one-third of the total VAT revenue. An idea currently being discussed is to introduce revenue sharing between federal and subnational governments. If this revenue sharing is on specified taxes rather than sharing all central taxes, as far as indirect taxes are concerned, GoN may exclude customs duties and VAT on imports from such a pool. In this case, the sharable pool will consist of nearly 26% of the central tax revenues (refer Table 1).

c. Enabling Subnational Levy of Taxes:

Federal Initiatives are required at least for a transitional period

To enable the subnational governments to work in the transitional period, the GoN has assured that Bills on Budget Accountability and Central Financial Procedures will be tabled into the Legislative-Parliament in this fiscal year. The disintegrated information technologies in the field of public financial management at various agencies will be integrated. It has also been provided that fiscal transfers from Federal to States and Local Level and recording and reporting of revenue management of three tiers of governments will be managed through a suitable accounting system.

In this study, the main revenue related challenges for the subnational governments are examined. As noted, the state governments have limited assignment of exclusive revenue sources and no experience of administering these taxes or using the non-tax sources. Beyond the transitional arrangements, the state governments will have the responsibility to bring out the necessary state-level legislations for the levy of taxes under their exclusive jurisdiction and where required, for the taxes which are commonly listed in state and LG jurisdiction. In the transitional arrangements, the federal government would be coming up with certain ideas as to how to deal with revenue items that are common between state and LGs. In exploiting these, the role of each government needs to be clearly spelt out. However, once the state governments are in place, they can finalize the arrangements in consultation with their own LGs.

7.2 Preparing "Model" Central Acts and Rules for Subnational taxes

Although no new taxes have been proposed in the Constitution, post-Constitution, neither the LSGA 1999 nor the central Acts relating to taxes assigned to the subnational governments would be valid. To provide a legal basis to the levy of subnational taxes to facilitate their levy as soon as the subnational governments are in place, the federal government can prepare "model" Acts or legal basis for the levy of these taxes. The subnational governments would be free to adopt these "model" acts as they are or with modifications. In due course, they may come up with entirely new tax legislations. This also provides an opportunity for a new design of the subnational taxes.

According to Schedules 6 and 8 of the constitution, 9 taxes have been assigned to the subnational governments. These can be divided into three categories: (a) taxes exclusively assigned to state governments, (b) taxes exclusively assigned to the LGs, and (c) taxes where taxation powers are commonly listed between state and LGs. These taxes are listed in Table 29.

Table 29: Taxes assigned to the subnational governments

Taxes exclusive to the state governments	Taxes exclusive to the LGs	Taxes where powers are common between state and LGs
Tax on agricultural income	Property tax, house rent tax, business tax, land tax (land revenue)	Land and house registration fee, entertainment tax, advertisement tax, vehicle tax

Source: Constitution of Nepal, 2015

Under Article 198, state assembly can impose a tax through a 'Money Bill' with respect to items listed in Schedule 6, 7, and 9. Article 203 provides that no tax in a state can be levied except in accordance with law.

Under Article 226, the Village Assembly and Municipal Assembly can make laws with respect to items listed in Schedules 8 and 9. Furthermore, as provided under clause 2 of this article, the process of making laws under clause (1) of this article shall be as provided under the State law.

It is desirable both from a practical and an economic viewpoint that taxation laws even for taxes exclusively assigned to the LGs should not differ across LGs. First, the LGs would have limited legislative capacity. Second, any excessive rate differentiation or differences in definition of tax bases may encourage unhealthy tax competition across jurisdictions. As discussed earlier in this Report, Nepal being a small country, there is a case for avoiding undue variations in state and LG tax rates and other features so that these differences do not lead to economically inefficient movement of factors and resources. An interstate platform for discussing and resolving these issues might have to be worked upon. Article 251 (i) of the Constitution mandates the NNRFC 'to do study and research work on possible disputes that may arise between the federation and the states, between states, between a state and a local level, and between local levels, and make suggestions to act in a co-ordinated manner for the preventions of such disputes'. Article 234 provides for the constitution of an 'Inter-State Council' to settle political disputes arising between the federation and a state and between states. This council could potentially undertake the task of harmonizing tax laws and resolving related conflicts[21]. Articles 233 and 235 also relate to co-ordination between three tiers of the government. These provisions could be applied to taxation powers which are common between state and LGs. In case of conflict with respect to such powers, the state law will prevail as per Article 228 which provides that no tax is to be levied and collected at the local level except in accordance with the state law. Furthermore, under clause (2) of this article the local level may levy tax by law on matters falling within its domain while remaining consistent with a) national economic policies, b) carriage of goods and services, c) capital and labour

[21] A similar mechanism has been provided for India under the Article 263 of the Constitution

market, and the d) neighbouring states or local level bodies so as to ensure a genuine common market and coordinate policies. It is therefore desirable that, once the state governments are elected taxation laws are made at the state level for all the taxes assigned to the subnational governments so that definitions are common across local jurisdictions and excessive differences in the tax rate is also avoided. At least, at the state level, 'model' laws can be prepared which can be adopted by the LGs with or without modification.

But there is a practical difficulty that the elections for the LGs have been held and Palikas and Nagarpalikas would start functioning ahead of the state assemblies. Therefore it would be ideal for the federal government to make 'Model' laws for the taxes under the subnational jurisdiction as a transitional arrangement. Once the state assemblies are in place they may continue with the same Act or modify it. A good precedent exists in the Indian context of introducing GST, where the federal governments has provided a 'model' law to the state governments for the imposition of SGST at the state level. Under Article 232 clause (7), the following is provided: During the continuance of the Central rule, the Central Parliament may make laws with respect to any matter enumerated in the List contained in Schedule-6. Such laws shall continue to exist until repealed by other laws made by the concerned State Assembly.

Article 236 provides for the establishment of a common market throughout Nepal so that through taxes or otherwise no fiscal barriers are made to obstruct free movement of goods across jurisdictions.

It may be noted that the Constitution has provided for exclusive jurisdictions for some taxes to the states, for some to the LGs, and there are some taxes that are placed in both state and local lists. It would not be appropriate to make just one Act for all these taxes as was done under the LSGA. The nature of taxes are different for states and local levels as also for those that are commonly listed in the two lists. It was argued that a minimum of three sets of laws are needed. It may be even better to possibly have one Act for one tax. This enables for providing detailed definitions, descriptions and corresponding Rules and makes the administrators answerable for revenue performance Act by Act. Framing of Model Acts and Rules requires specialized legal and technical expertise. This should be done by MoF/ MoFALD in collaboration with the Ministry of Law.

With respect to the taxes commonly listed under the state and LG jurisdiction, some agreed mechanism needs to be evolved to clarify the scope of respective jurisdictions. Some discussions and proposals are under discussion in this regard. Accordingly, for each tax under common jurisdiction, the following details (Table 30) as specified in the draft inter-governmental financial management bill may be of relevance.

Table 30: Subnational taxes under common jurisdiction of state government and municipality/ rural municipality (proposed in inter-governmental financial management bill)

Tax	Relative Jurisdiction/provision
Vehicle tax	States to levy vehicle tax on all vehicles determine the rate and collect the tax, except the following LGs to levy vehicle tax on horse cart, rickshaw, auto rickshaw and e-rickshaw
House and land registration Entertainment tax	Law to be made and rate to be determined by the state Collection to be done by the municipality/ rural municipality
Advertisement tax	Rate to be determined and collection to be made by municipality/ rural municipality
Tourism fee (Non-tax source of revenue)	State to determine and collect trekking and tourism tariff Entry fee to heritage park, garden, historical and archaeological heritage, and museum to be determined and collected by municipality/ rural municipality

Source: Inter-governmental financial management bill

With respect to transitional provisions, article 296 clause (4) provides that "The legislative power of the State Assembly in respect of matters set forth in Schedule-6 shall, upon the commencement of this

Constitution, be vested in the Legislature-Parliament set forth in clause (1) until the State Assembly is formed. Any law so made shall be inoperative in relation to that State after one year of the date of formation of the State Assembly set forth in this Constitution".

Some initiatives so far undertaken at the central level in terms of drafting model laws for the subnational governments are of two types: one by MoFALD[22] and one by LBFC. MoFALD has come up with a document that provides model law/procedures for making and presenting subnational budgets which makes reference to estimation of revenue etc. in the budget. But they did not come across any model acts for these specific taxes assigned to subnational governments. At the LBFC a document has been prepared that provides a framework for preparing model tax laws. This description indicates the basis components of such model tax laws including the need to define tax bases, tax rates exemptions etc. (Framework of model act for LG[23]). But actual model tax laws have not been prepared.

7.3 Developing principles and tax codes for subnational taxes

The authority to levy taxes had first been provided to Village Panchayats through the Village Panchayat Act 1962. Similarly the District Panchayat Act 1962 and the Nagar Panchayat Act 1962 gave powers to the Districts panchayats and the Municipalities respectively to collect taxes. The Local Self Governance Act (LSGA) 1999, Local Self Governance Regulation 2000 and Local Self Governance Financial Procedures Act 2007 promulgated by the Government provided the various types of revenue collection responsibilities to the local level and their operational details. These taxes include but are not limited to Vehicle tax, property tax, entertainment tax, advertisement tax, house rent tax, business tax etc. Thus there exists a single Act through which all these taxes are levied.

The 2015 Constitution allocates the following 9 taxes to the Subnational level:

1. Vehicle tax
2. Entertainment tax
3. Advertisement tax
4. Agro-income tax
5. House Rent tax
6. House and Land registration fees
7. Business tax
8. Land tax (land revenue)
9. Property tax

The policy options for enactment and collection of each of the above taxes are discussed in the previous sub-section. Ideally, considerations are different for each of the three groups of taxes as mentioned in Table 29, and hence there should be three different acts. Eventually decisions may be taken state by state and the practices may differ.

Recommendations for the design of major subnational taxes as proposed in the new Constitution of Nepal are given below. The best practises and principles for designing each of the below mentioned tax is given in detail in Annexure 1 – Table A16.

1. Motor vehicle tax (Common jurisdiction)

As part of the transition the existing motor vehicle tax structure may be continued with some modifications. For private vehicles a one-time tax may be levied while for commercial vehicles the annual vehicle tax may be continued. A one-time levy on private vehicles internalizes the spill over costs for the private vehicle owner who may find an annual vehicle tax too burdensome to comply with. A commercial vehicle owner on the other hand would have a higher spill over cost entailing a higher one-time levy, which commercial vehicle owners would prefer to evade as their income is earned at periodic intervals. Thus for commercial vehicles an annual vehicle tax coupled with enforcement would be more suitable. Nepal currently levies tax at specific rates. To simplify the tax, a modal category may be

[22] Draft Finance Act for local governments prepared by MoFALD is attached as Annexure 1 – Table A15.

[23] Final report "Study on Revenue Mobilization of Province and Local level" (2016), LBFC November 2016.

determined such that the tax rates for other categories are determined as a proportion of the modal category rate. Any form of exemptions except those given to vehicles used for emergency purposes and including those given to government vehicles may also be abolished since these vehicles also create an equivalent amount of externality. The administrative costs too would be lowered as classification complexities and the incentive to misclassify reduces.

2. Land and house registration fee (Common jurisdiction)

It is desirable to keep the tax rate for land and house registration fee low. Revenue buoyancy would come from making it ad valorem and providing a mechanism by which property values are periodically reassessed. If a shift in ownership to bring about a better gender balance is so desired, a lower rate on property registered in the name of women members of the household may be levied. Differentiation should also be made between owner occupied, rented and commercially used properties and between land that remains unutilized vis-a-vis that which is utilised for economic activities.

3. Agro-Income tax (State's jurisdiction)

This is the only tax exclusively assigned to the state governments under the new Constitution. In many countries this tax base has remained underexploited due to political considerations and cyclical nature of agricultural income which depends upon output and price cycles. Currently the Income Tax Act, 2000 exempts agricultural income from tax. In Nepal, income from subsistence agricultural activities may have to be exempted. First focus may be on plantation and commercial crops.

4. Business tax (Local jurisdiction)

The ideal base for the business tax should be income generated from the business. However LGs may find it difficult to administer such a tax. A practical option would be to use turnover of a business within the LG jurisdiction or fixed license fee which may be revised periodically.

5. Property tax and Land revenue (Local jurisdiction)

The Government may continue with the existing tax rate structure applicable to the integrated property tax by borrowing from the Council tax in UK, the element of proportionality in tax rates across different bands. Thus only the modal category rate would need to be revised on an annual basis. Alternatively, it may continue with the existing progressive ad valorem rate structure applicable to the land and house tax which may also be preferable to specific rates although property tax revenues may then potentially rise and fall with the property market. The rate of the tax should also be linked to municipal services provided within the jurisdiction for the relevant properties. The tax base should be defined to include only immovable properties and its value may be determined on the basis of rental value rather than capital value since this is easier to estimate. A conscious effort should be made to avoid any form of double taxation. In the case of land revenue, the existing system collection may be continued.

A brief summary of the various taxes assigned to the subnational level are given in Table 31. Specifically it provides the features of the existing tax base in Nepal, international experience, desirable objectives to be aimed at while designing the tax, applicability of benefit principle to the tax, recommendations with respect to Model Acts and Rules to be enacted by the Federal/State/LGs and key aspects of intergovernmental coordination, wherever applicable.

Table 31: Tax-wise principles and recommendations

1. Vehicle Tax (VT) (Savari sadhan kar) - Common jurisdiction	
Features of existing taxes	Currently VT is levied by both Federal Government and LGs. The rates are fixed on a specific basis depending upon the type of vehicle and whether it is used for personal or commercial purpose.
International experience	**UK:** A one-time tax is levied based upon the CO_2 emission level of the vehicle. Along with other taxes on fuel and vehicles, London has experimented with a congestion charge. **India**: VT structures across most states have two features in common: a) A one-time ad-valorem levy on sales price of privately owned vehicles based on the life of the vehicle where life may be defined as 10, 15 or 20 years depending upon rate of wear and tear and b) an annual fixed rate VT levied on commercial vehicles varying according to the type of vehicle.
Desirable objectives	VT will likely be largely levied by the state governments particularly on all the motorized vehicles whereas VT on some traditional vehicles like horse or bullock driven carts may be assigned to the LGs.
Applicability of Benefit Principle	The Benefit principle is applicable in the case of VT since the tax is levied to cover the cost of development and maintenance of state-level roads. The beneficiaries of this service are both commercial and private vehicle owners and hence both should be taxed. In the case of commercial vehicles, the benefit of the service provided by the transporters eventually passes on to the consumers who purchase or utilize the transported goods/services. Thus the tax burden too should be similarly passed on to them. Despite being a clear case of applicability of benefit principle, a one-to-one relationship in practice is hardly ever maintained.
Recommendations	• Rates should be determined in line with the Benefit Principle. • Rate differentiation may provide an incentive for vehicles to register themselves in lower rate jurisdictions. It would be ideal to have common tax base definitions and rates across all states through a common Central Model Law to begin with. • In determining rates a distinction should be made between privately owned vehicles and vehicles meant for commercial use. • Privately owned vehicles may be subjected to a one-time life tax where life may be shorter in hilly and mountainous regions compared to plain areas. A higher rate may be applied when the vehicle comes for re-registration after the completion of its first life. • Commercial vehicles may be subjected to an annual tax; in determining the rates, distinction is often made according to technical characteristics of the vehicles such as size, capacity etc. For some categories of commercial vehicles the tax can also be ad valorem. A modal category may be determined such that the tax rates for other categories are determined as a proportion of the modal category rate. Any form of exemptions except those given to vehicles used for emergency purposes and including those given to government vehicles may also be abolished. • To protect environmental interests older vehicles may be subjected to higher tax rates both in the private use and commercial use categories since they carry a higher environmental load.
Key aspects of intergovernmental coordination	This tax has so far been administered by the Department of Transport, Government of Nepal and their existing staff and administrative apparatus can be assigned to state governments temporarily. The LSGA had also provided VDCs and municipalities the authority to levy VT.
2. Entertainment Tax (ET) (Manoranjan kar) - Common jurisdiction	
Features of existing taxes	Currently Municipalities and VDCs may levy ET at the rate of 2% to 5% of entrance fees on means of entertainment such as cinema halls, video halls and cultural show halls, permitted within their jurisdiction. Tax may also be levied on circus and magic shows, video, cable etc. used for commercial purposes.
International experience	**India:** ET is being levied at the Municipal level on movie tickets, and on digital platforms such as broadcasting services, DTH Services, Pay TV Services etc. The rates are generally ad valorem in nature and vary from state to state. Any form of ET levied at the state level has been subsumed under the GST.

Desirable objectives	In many countries ET has proved to be a revenue buoyant source for LGs.
Applicability of Benefit Principle	The benefit of entertainment goes largely to citizens of the concerned jurisdiction although entertainment services can also be equally enjoyed by visitors from other jurisdictions. The relevant cost incurred by the government may relate only to the maintenance of general law and order. However, law and order is a public good, the benefit of which is shared not only by consumers of the specific entertainment service but by all citizens of the jurisdiction and also visitors. It may therefore not be possible to establish a one to one link.
Recommendations	The tax should generally be ad-valorem linked to price (entry fees) to be paid for availing the entertainment service. A distinction can be made in defining the tax base between traditional means of entertainment like theatres and cinema halls vis-à-vis modern means of entertainment like broadcasting services, internet etc.
3. Advertisement Tax (AT) (Vigyapan kar) - Common jurisdiction	
Features of existing taxes	At present Municipalities and VDCs can levy AT, defined in specific terms that varies according to size, on signboards, stalls, globe boards etc. that are placed on junctions, public places under their jurisdiction.
International experience	**India:** It was being levied at the state level on advertisements (except newspaper ads) before being subsumed under the GST.
Desirable objectives	In many countries AT has proven to be a revenue buoyant source for LGs.
Applicability of Benefit Principle	The benefits from advertisements are largely commercial in nature reflecting profits of suppliers advertising their good/services. Government may incur costs in maintaining public roads/sites which are used to put up advertisements. In other cases, it is difficult to measure the value of benefits derived and hence apply the benefit principle. The revenues earned should be added to the general tax pool.
Recommendations	A distinction can be made in defining the tax base between traditional means of advertisement like signboards, stalls etc. vis-à-vis modern means of advertisement such as those through broadcasting services, internet etc.
4. Land and house registration fee (LHRF) (Ghar jagga registration shulk) – Common jurisdiction	
Features of existing taxes	Currently the federal government is entitled to levy a LHRF with rates being fixed annually under the Finance 'Act'. The prevailing rate in urban areas is 4% while in rural areas it is 2% on the value of the property. The government had introduced a system of minimum value in 1982-83 and it was decided to levy registration fees on the value of the property concerned as declared by the seller or the minimum value fixed by a committee that represented the LGs and various related organizations of the national government.
International experience	**India:** A system of one-time levy of LHRF as well as stamp duties is applicable on transfer of land or property. While the former is specified on a fixed basis, the latter is specified as a percentage of the sale price of land/building. **Estonia:** Real property transfers are subject to a transfer fee, which is calculated as a rate times the value. The rate is a fixed amount for properties over a minimum value, and a sliding scale taxation system exists for properties of lower value. **Poland:** Three transfer taxes or fees are levied on the property value: stamp duty, notarial fee, and title registration fee. Both the stamp duty and the notarial fee are levied at a percentage of the reported sales price. The Land Title Registry collects a fee, which is a percentage of the reported price, to record the new ownership title.
Desirable objectives	Rates for this tax should not be kept too high otherwise they provide incentive to undervalue land and property implying tax evasion. It is important to ensure uniformity in tax rates across local jurisdictions within a state or even across states so that there is no incentive to register a property in jurisdictions other than where the property is located.
Applicability of Benefit Principle	The benefit principle is applicable as the benefit of the value of certification is provided by government to the purchaser of the property who is also clearly identifiable. If the cost of providing the registration service is clearly quantifiable from the general budget, the benefit principle can be fully applied. Such

	quantification is quite difficult in practice because costs of maintaining IT systems etc. and administrative costs are often shared across various services provided by the government.
Recommendations	• States may make the necessary law so that tax base definitions and tax rates remain uniform across jurisdictions within a state. • Since it is desirable to keep the tax rate low, revenue buoyancy comes from making it ad valorem and providing a mechanism by which property values are periodically reassessed. • It is important to have a mechanism by which circle rates and annual ratable values are objectively assessed. Sometimes it is useful to keep a lower rate if the property is registered in the name of women members of the household to encourage shift in ownership pattern and bring a better gender balance. • Value of property depends upon available infrastructure and future growth potential of relevant areas.
Key aspects of intergovernmental coordination	The Federal Government can set up an institution within the mechanism such that a suitable committee is setup for periodic reassessment of commercial or rateable value of properties since this requires technical expertise and linking of investment in infrastructure etc. with property values. It will be economical to have one federal institution with branches in different states so that techniques and methodologies can be commonly shared.
5. Agro-income tax (AIT) (Krushi ayama kar) – State's jurisdiction	
Features of existing taxes	Currently the federal government has the power to levy AIT but has chosen to exempt it. As per the Income Tax Act 2000 agricultural income derived by a person from sources in Nepal other than income from an agriculture business derived by a firm, company, or partnership is exempt.
International experience	**India:** States like Assam and Kerala levy it on plantation and commercial crops. It is also levied on commercial crops in Sri Lanka.
Desirable objectives	This is the only tax exclusively assigned to the state governments. In many countries this tax base has remained underexploited due to political considerations and the cyclical nature of agricultural income which depends upon output and price cycles.
Applicability of Benefit Principle	Farmers often utilize irrigation, subsidized seeds, fertilizers and pesticides, agricultural training programs and advisory services provided by the government. Costs incurred in providing these results in benefits to the farmers who consequently earn agricultural income. This income can then be taxed according to the benefit principle with respect to farmers located in a specific jurisdiction.
Recommendations	The rate of AIT may make reference to the benefits enumerated above. However usually, AIT rate may not be tangibly different from non-AIT rate. If it is lower, it can give rise to possibilities of evasion due to overstatement of agricultural income in total income. The benefit principle is hardly ever applied in practice. In fact, exemptions etc. are given from the concerned tax for poorer and marginalized farmers as well as with respect to crop failures. Income from subsistence agricultural activities may have to be exempted. At first focus in Nepal may be on plantation and commercial crops. In India, this tax base has been assigned to the state governments but its utilization has been very limited.
Key aspects of intergovernmental coordination	This tax is part of the existing Income Tax Act, but has not been utilized so far. Federal and State governments should coordinate in the administration of this tax to minimize tax evasion exercised by using agricultural incomes as a vehicle for evasion if they are taxed at a lower rate.
6. Property tax (PT) (Sampatti kar) – Local Jurisdiction	
Features of existing taxes	An integrated property tax (IPT) is levied on the capital value of land, house or building as determined by the local valuation committee in lieu of the house and land tax, and land revenue in Nepal. LGs have the authority to fix rates of the IPT within the minimum and maximum limits given in Local Self Governance Regulations 2000. The rates are specific and the structure progressive.

International experience	**UK:** PT is levied at the local level by the name Council Tax. It operates by placing every house into one of eight bands (A to H): the higher the band, the higher the PT paid. Each band reflects a range of estimated market values of houses in 1991.The ratios between the PT charged for each band are set centrally, but the overall level of PT is set locally. **India (Delhi):** PT is levied on the annual value of the building, which is determined by the formula: Annual Value = Covered Area x Base Unit Area Value x Multiplicative Factors. **Slovakia:** The value of the base for the property transfer tax is specified by a price decree of the Ministry of Finance. When property is transferred, administrators can choose the higher of the reported sales price or the assessed price. The assessment is done by appraisers. **Armenia:** In Armenia the real property transfer tax is a percentage of the declared value or official price, whichever is greater.
Desirable objectives	LGs have had experience in levying IPT or the house and land tax. The value should be kept proportional to the value of the property and low enough to incentivize compliance.
Applicability of Benefit Principle	The benefit to the property owners results from government's expenditure on maintaining roads around the property, maintaining law and order, providing basic amenities such as water, electricity etc. The value of property responds to development around the property. Furthermore, such development also crowds in various commercial activities, further increasing the value of the property. The benefit accrues to owners both of houses and commercial property. Application of the benefit principle is justifiable in the concerned jurisdiction. However, often such development activities are provided not only by the concerned LG but also state or national government in case the state/national highways pass through such areas. For these reasons, recovering full costs of the relevant services provided by the LGs may not be justified. In any case, it is difficult to quantify the relevant cost from the overall budgetary costs because administrative services etc. are often commonly shared.
Recommendations	Conscious effort should be made to avoid double taxation. The tax rate can be made ad valorem or according to type or use of the property. The rate of the tax should be linked to municipal services provided within the jurisdiction for the relevant properties. This tax should be limited to immovable property.
7. House Rent Tax (HRT) (Ghar bhaal kar) – Local Jurisdiction	
Features of existing taxes	Municipalities and VDCs are empowered to levy a rent tax on the amount of rent in cases where any house, shop, garage, go down, etc., is rented wholly or partially in their jurisdiction. The rent tax may be levied at a rate not exceeding 2%. Rent tax may also be levied by Municipalities and VDCs on shops constructed, operated or supervised by Municipalities/VDCs. The rate may be determined based on the size, type, design, construction and structure of the house and area covered by the house. The rates are specific and progressive.
International experience	In most international jurisdictions rental income is taxed at the national level as part of personal income. In Rwanda, for example, rental income tax is levied by LGs. The rates are progressive and higher for commercial properties than for residential properties.
Desirable objectives	This is a source of revenue which has been exploited by the existing LGs in Nepal but its contribution has been negligible.
Applicability of Benefit Principle	Same observations as in case of property tax apply
Recommendations	Distinction should be made between rented property used for residential use and commercial use.
Key aspects of intergovernmental coordination	If house rent is taxed this tax should be deducted from the Nepalese Income Tax Levy to avoid double taxation.
8. Business Tax (Vyavasay kar) – Local Jurisdiction	

Features of existing taxes	Municipalities/VDCs are empowered to levy a BT on specified industry, trade, profession or occupation. Minimum and maximum rates for each category of profession are fixed in the Local Self-Governance Regulations, 2000.
International experience	In **Canada** provinces impose corporate income taxes, capital taxes, and payroll taxes on businesses. Most states in the **United States** impose corporate income taxes, most also impose retail sales taxes that fall to a considerable extent on businesses. **Germany** levies a local value added business tax. In **Brazil** local BT is levied on the gross receipts of independent professionals and firms in the service sector, although some important services, such as communications, finance, and transport, are excluded. **South Africa** levies a regional services council levy. **Kenya** employs a system of business licenses wherein the cost of business licenses may be determined on the basis of the type, size, and location of the businesses. **Tunisia** levies a low-rate gross receipts levy. This tax, imposed mainly in urban areas, is levied at rates and on a base which is generally established by the Federal Government.
Desirable objectives	Business tax has been exploited by the existing LGs in past but its contribution to overall tax revenues has been minimal.
Applicability of Benefit Principle	The benefit to the business owner is due to maintenance of law and order and other benefits derived by the property owners as already discussed in property tax above. It may also be noted that law and order is a public good and it is difficult to quantify its benefit to one business/ property vis-à-vis others.
Recommendations	The ideal base for the business tax should be income generated from the business. However LGs may find it difficult to administer such a tax. A practical option would be to use turnover of a business within the LG jurisdiction. Rate must be low to incentivize compliance.
Key aspects of intergovernmental coordination	It is best for states to make model laws and rules which their LGs can adopt in its original or modified form at least initially. To ensure better buoyancy in this tax source, in the revenue sharing formulae from state to LGs, tax effort with respect to this tax and similar other taxes can be used as a criteria.
9. Land tax (land revenue/LR) (Bhoomi kar, (Malpot)) – Local Jurisdiction	
Features of existing taxes	Municipalities and VDCs are authorized to levy LR. On the recommendation of the municipal council, GoN specifies the land subject to Bhumi Kar. For the purpose of land revenue, land is divided into four categories, viz. Abal, Doyam, Seem and Chahar. Land revenue rates are fixed on the basis of the type and productivity of land. These rates fixed within the minimum and maximum limits given in the Local Self-Governance Regulations need to be approved by the municipal council.
International experience	**India:** LR is also levied at the state level based upon the type of land. In certain states such as Karnataka, while the tax is administered by the State the collection authority is given to the local levels.
Desirable objectives	This is a traditional tax on land. Over time its contribution to revenue has fallen drastically in most countries. Ideally LR should be levied on income generated from land. However since agricultural income tax is separately defined it would be useful to make a distinction between the two to avoid double taxation. In local areas land may be classified according to type of use and level of productivity.
Applicability of Benefit Principle	Same observations as in case of agricultural income tax apply in the context of application of the benefit principle to land revenue levied in rural municipalities. In the case of LR applicable to municipal or urban lands, same observations as discussed in the case of property tax apply.
Recommendations	Land used for subsistence agriculture may have to be exempted. Land used for urban plants, floriculture, exotic plants with export potential etc. may be taxed at higher rates.
Key aspects of intergovernmental coordination	It is best for states to make Model Laws and rules which their LGs can adopt in its original or modified form at least initially. To ensure better buoyancy in this tax source, in the revenue sharing formulae from state to LGs, tax effort with respect to this tax and similar other taxes can be used as a criteria.

Source: EY Team

7.4. Roadmap for building institutional capacity

Critical to the future fiscal performance of subnational governments in Nepal under the Constitutional arrangements would be allocation of resources for establishing a suitable institutional capacity. Aspects of institutional capacity relating to revenue mobilization are discussed in detail in this section.

Building up of the institutional capacity for revenue collection is a subject where subnational governments will have to start from the very beginning. Five critical components of institutional capacity building can be considered for this purpose, which are interlinked:

a. Setting up revenue administration and progressively developing this capacity

There has to be a state level civil service which may address normal administrative work at the level of state governments and LGs with provision for deputations and assignments between posting in state and local administration. In addition, there may be local level service cadres specific to each LG. Most of the senior positions in the revenue departments at the state and local levels should be manned by qualified people preferably drawn from state service cadres. A moderate vertical hierarchy can be developed for overseeing the performance of the revenue department. In the initial stages in Nepal, some of the senior positions may be filled up by revenue officials from the federal government on deputation or assignment and from retired revenue officials of the federal government who may be inducted in advisory capacities.

Separately a comprehensive audit strategy supported by an IT infrastructure should be put in place to ensure that expenditures incurred on these initiatives remain consistent with accepted norms and produce expected outcomes.

b. Setting up a detailed compliance strategy

The key components of tax compliance strategy covering both voluntary compliance and enforced compliance are detailed in a separate section (section 8) in this study. These components include required interface with tax payers and tax authorities including facilitation and education.

c. Setting up an incentive structure separately applicable both to administrative staff and tax payers

Improvement in revenue performance can be encouraged by setting up suitable incentive structures. These incentive structures can be made applicable to a) overall government at the state and local levels, b) revenue administration officials, and c) tax payers. In the first category, incentive schemes should include linkage of revenue performance to fiscal transfers covering both revenue sharing and grants. In the case of revenue sharing, tax effort can be used as a factor in determining the specific share of a state amongst all states (federal to state level transfers). A similar strategy can be adopted with respect to transfers from the state to local level and federal to local level. Incentives to revenue administration officials may include rewards in the form of increments, promotions and prizes for comparatively better revenue performance measured on objective grounds. Tax payers can be encouraged to improve their compliance through a variety of schemes such as lottery based rewards, rewards in the form of tax rebates or explicit prizes etc.

d. Setting a robust training programme for both staff and tax payers

Revenue officials need to be trained in terms of specific details with respect to each tax under their jurisdiction, aspects and technical details of assessment, cases where exemptions apply, developing forms of returns and other registration details etc. Such trainings can be organized at the state level for state government officials and LG officials in the state for whom common training programmes may be formulated. In addition, at the LG level, specific training programmes for local taxes may be organized.
There should also be training of revenue officials at the federal level under auspices of a central institute in which specialized revenue training programmes may be organized where international expertise as well as local expertise may be invited to provide such trainings.

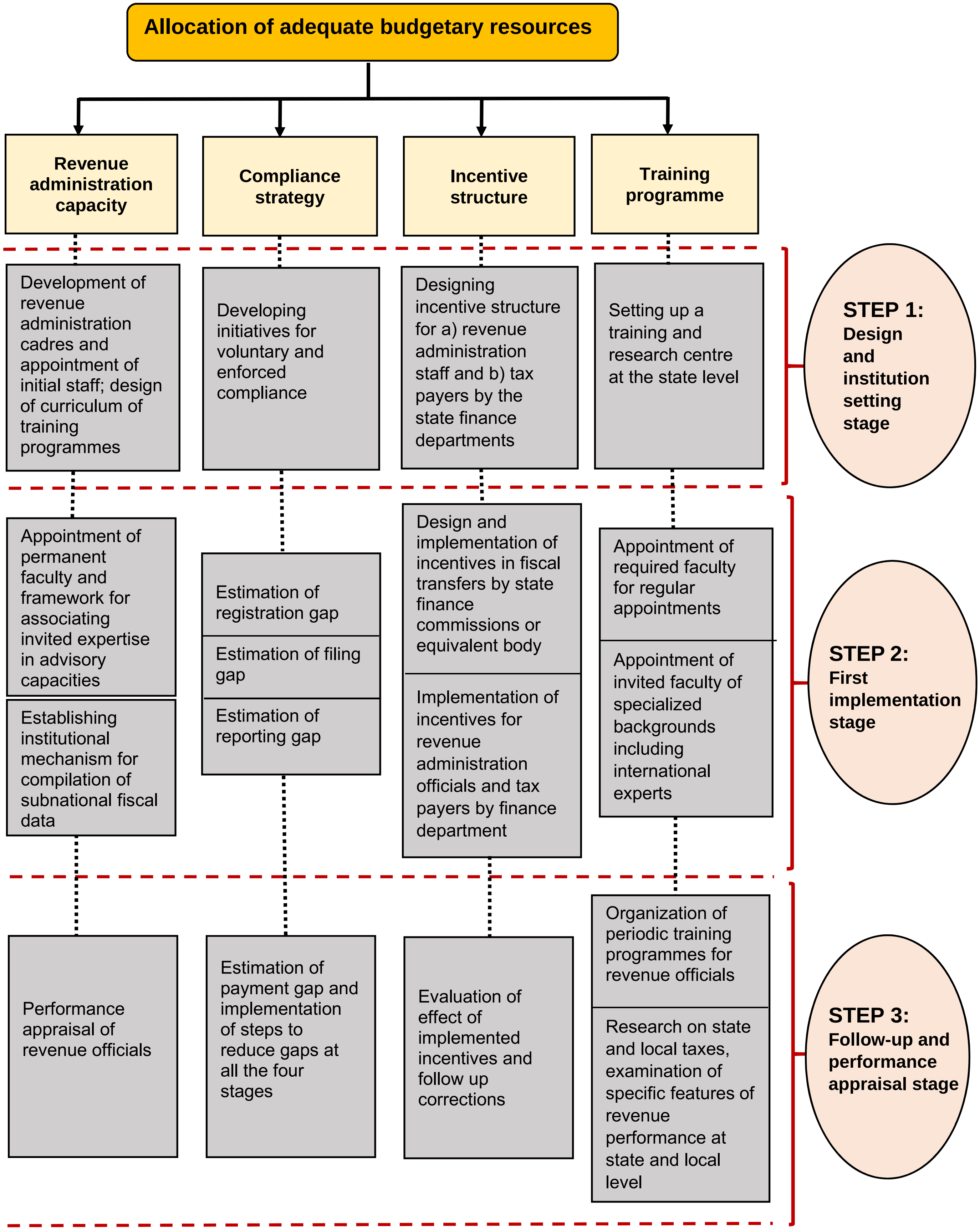
e. Setting up a suitable institutional mechanism for compilation of subnational fiscal data

As discussed in the section on estimation of potential tax revenue, there is a need for an institutional mechanism for compilation of fiscal data in the new constitutional framework which may be utilized by researchers and federal, state and LGs for assessing the performance of revenue sources assigned to them as also with respect to other fiscal dimensions. This mechanism needs to be established primarily at the state level with branches at the LG level. In this institution formats for compiling and keeping data by the concerned departments should also be developed. An institution would also be needed for compiling state level macroeconomic and sectoral data. Ideally for each state a state statistical commission should be established to undertake these responsibilities. The state level institution can compile both the state level data and collate the local level data for inter-LG comparisons. In addition there has to be a framework for comparisons of inter-state and inter-LG fiscal performance which would be required by the NNRFC, policy makers and researchers both national and international at large. This mechanism can be setup at the federal level.

Flow chart 5 provides a visual road map for institutional capacity building for revenue collections.

In the case of property tax and house and land registration fees, revenue depends on the value of the property at the time of registration and the annual rateable value of the property for property tax. These taxes require periodic assessments to reflect changes in market value of properties. Sometimes it is useful to have a specialized institution that conducts research on how property values have changed in the past and how these may change in future. An institution of this kind can at first be setup at the state level to conduct research relating to the relationship between market forces and property value including rental value changes according to commercial and non-commercial areas, making distinction between rural and urban areas and other economic characteristics.

Chart 5: Road map for institutional capacity building for revenue collections



Source: EY Team

8. Perceived challenges and risks in implementation

8.1 Major revenue side risks in implementing the decentralization program

A successful transition to an effective decentralization of governance in Nepal through devolution faces several critical risks which need to be overcome. In the context of revenue mobilization, some of the key binding constraints can be divided into two parts: overall and tax specific. In this section, the overall risks were discussed. The key overall risk is revenue inadequacy. This arises due to the fact that the assignment scheme under the 2015 Constitution has only assigned those taxes to the subnational governments that have historically been exploited by the local levels under LSGA1999 with two exceptions of vehicle tax and agricultural income tax. The history of revenue experience for other local taxes indicates low tax base and low revenue capacity for the locally assigned taxes as discussed in chapter two. In the case of agricultural income tax also, due to a variety of considerations including political considerations, it has not been exploited even by the federal government despite having the power to do so under the present income tax act. Therefore low tax bases in relation to expenditure responsibilities would engender considerable dependence of subnational governments on central transfers affecting the quality of fiscal federalism. Other common constraints are weak administration and inefficiency reflected in lack of IT system and staff capacity, and possible pressure for tax exemptions when state laws are made. Major revenue side risks are identified below:

1. **Institutional Deficiency Risk**: To successfully administer assigned revenue sources, necessary institutions need to be in place to ensure that laws are made, corresponding rules are defined and these laws and rules are implemented effectively to finally collect revenues. Institutional capacity is also needed to assess revenue performance. Deficiency in setting up appropriate institutional infrastructure would lead to sub-optimal performance.

2. **Inadequate Revenue Assignment Risk**: If the current revenue assignments prove to be inadequate, there would either be excessive dependence on central transfers or substandard provision of vital services. If the quality of fiscal decentralization is unacceptably low, the entire experiment may fail.

3. **Deficient Revenue Mobilization Risk**: Revenue mobilization is a dynamic concept. One gains new experience and builds on past experience as the system evolves. If sufficient learning by doing does not happen, even the limited assigned resources will remain sub-optimally exploited.

4. **Deficient Compliance Risk**: Compliance depends on both administrators and taxpayers. There are well-recognized compliance risks which have been discussed in detail in Section 8.3.

5. **Inadequate Inter-governmental Coordination Risk**: Excessive rate differentiation across states and across LG jurisdictions is not desirable as it leads to unhealthy tax competition and inefficient movement of capital and resources.

6. **Excessive Federal Intervention Risk**: Given the initial position of the federal governments, there would be a strong tendency for the central ministries to continue to dominate, particularly in the areas of common or concurrent jurisdiction. Such attempts would lead to non-fulfillment of the objectives of decentralization. It might be economically inefficient as well, making it difficult to change the status-quo, characterized by extensive inter-regional inequalities in development, per-capita income and access to critical services like health and education.

7. **Inadequate Tax Base Augmentation Efforts**: Tax bases are not static. They need to be nurtured in order to progressively yield higher revenues even when rates are unchanged. Tax bases develop in general through better economic performance of the concerned area.

8.2 Assessment of the binding constraints relating to recommendations

In this section, critical binding constraints and strategies to overcoming these are explained.

Table 32: Resolving binding constraints for effective revenue mobilization at the subnational government

	Binding constraints	Strategies to overcome these constraints
1. Subnational taxes		
	Low tax base for assigned taxes	Institutional capacity building: Out of all assigned taxes, focus should be prioritized to taxes with relatively high revenue potential such as vehicle tax, land and house registration fees and property tax
	Weak tax administration	This can be progressively overcome by setting up a revenue service and launching compliance improvement programmes including training infrastructure and setting up of suitable IT systems. This should be provided the highest priority to initiate revenue mobilization as mentioned in the previous section
	Lack of suitable mechanism for compilation of fiscal data at the subnational level	This can be attended to by setting up state statistical organizations for which necessary budgetary allocations should be made as a top priority as soon as the state governments are setup.
2. Tax specific constraints		
Property tax	Lack of adequate database for property ownership at the municipal level.	This should be overcome by setting up a dedicated revenue department for administering this tax and setting up of an institution for linking property values to market forces and providing for periodic assessment of circle values according to area and type of property. GIS-mapping and spatial planning tools can be utilized to update the property databases in municipalities.
Land and house registration fees		
Agricultural income tax	Political opposition and opposition by farmers, vulnerability to cyclical changes in prices and Output	Initial focus should be on commercial crops and plantations
Non-Tax revenue-user fees	No historical utilization of this source of revenue for any tangible contribution to overall subnational revenues.	Determination of rates of user-fees to perceived benefits and tax payer education.

Source: EY Team

8.3 Developing a compliance strategy

Given that the revenue sources assigned to the subnational governments have limited revenue potential ensuring highest possible compliance from the very beginning is necessary to utilize these limited resources to the full capacity.

Given the limited revenue assignments to the subnational governments in Nepal, it is important to realize their full potential by keeping compliance at highest possible levels right from the beginning. Compliance strategies should also be put in place at the federal level because full realization of potential of central taxes would facilitate fiscal transfers to the subnational governments. Eventually required current expenditures in critical areas such as health, education and infrastructure would be largely financed by own revenues and fiscal transfers. For this purpose the critical elements in determining and improving compliance in detail as discussed below has been reviewed.

Total tax compliance can be seen as the sum of voluntary compliance and enforced compliance. These can also be broadly viewed as ex-ante compliance and ex-post compliance. Ex-ante compliance refers to compliance activities of the tax payers and the tax department before the tax is paid. Ex-post compliance refers to their compliance activities after payment of taxes, filing of returns and submission of information in prescribed schedules.

Voluntary compliance depends upon tax payer characteristics such as their general education and awareness, understanding of tax laws and appreciation of the role of taxation in the providing public and merit goods. It also depends upon institutional features such as the legal framework and the system of collection and collation of information including third party information. Voluntary compliance is affected by the perceived efficiency and transparency of the tax collection departments in particular and that of the government in general.

Enforced compliance arises after returns have been filed and taxes have been deposited. Enforcement activities may relate to computer and desk based scrutiny of tax returns, collation of information submitted by tax payers with third party data, identification of arithmetic errors, instances of unintended underpayment, cases of default and fraud and follow up actions including audit, inspection and legal and penal actions.

Both forms of compliance are interdependent. Perception of an effective enforced compliance mechanism leads to improved voluntary compliance. High level of voluntary compliance leads to lower cases of defaults requiring penal actions.

The structure of key collection costs are detailed in Table 33.

Table 33: Structure of collection costs

<table>
<tr><th rowspan="2">Establishment costs</th><th rowspan="2">Common Endeavour Costs</th><th colspan="5">Tax payer focused costs</th></tr>
<tr><th>Ex-ante (before payment of tax)</th><th colspan="4">Ex-post (After payment of tax)</th></tr>
<tr><td>Building</td><td>Third party information</td><td>Registration facilities</td><td rowspan="6">Automatic computer based checking
• Calculation errors
• Claims for excess deductions
• Under-reporting of tax base</td><td rowspan="6">Manual scrutiny
• Calculation errors
• Claims for excess deduction
• Under-reporting of tax base</td><td rowspan="6">Selected audit
• Desk-based
• Field-based</td><td rowspan="6">Universal Audit
• Desk-based
• Field-based</td></tr>
<tr><td>Equipment</td><td>Cross verification of transactions</td><td>Filing of returns</td></tr>
<tr><td>IT infrastructure</td><td>Facilitation of tax payers in dealing with departmental processes (registration, filing of returns, payment of tax)</td><td>Payment of taxes</td></tr>
<tr><td>Others</td><td>Counselling</td><td>Other departmental services</td></tr>
<tr><td></td><td>Training and education</td><td></td></tr>
<tr><td></td><td>Departmental and sponsored research</td><td></td></tr>
</table>

Source: EY Team

The compliance gap can be decomposed into the following:

1. **Registration gap:** This implies failure to get registered with the tax authority for purposes of assessment and payment of taxes.
2. **Filing gap:** This arises when a registered dealer or entity is required to file a return according to prescribed periodicity but fails to do so in one or more periods.
3. **Reporting gap:** This arises when a registered dealer or entity is required to file information along with his returns or independently from time to time but fails to do so or provides incomplete, inconsistent or false information.
4. **Payment gap:** This arises when even after registering with the tax authority and correctly declaring the tax, the tax payer fails to make timely and correct amount of payment.

Compliance is adversely affected if the tax rates are relatively high, the tax structure is highly disaggregated, and the tax laws are highly complex. These features relate to the design of the tax and are subject to policy based reforms. When the tax rates are high, given other things, the benefit to the taxpayer of avoiding or evading tax is also very high. The more complex is the tax system, the higher is the likelihood that tax assessments can be subjected to legal disputes. Incurring expenditure on legal advice would involve private compliance costs but may still be incurred if a net tax saving is expected. The cause of compliance is served more effectively when the tax system is simple and the tax rates are low. A large reduction in higher rates of personal income tax with the adoption of the flat tax in Russia, for instance, appears to have improved compliance. This argues for minimal exemptions, which also eases administrative costs. Policies can also be calibrated to compliance problems. In this context, often, a low rate with limited exemptions and royalties in the case of the Extractive Industries are recommended. Choice of thresholds may also take into account compliance considerations. Simple tax rules are evidently better for effective compliance. Given the wide and complex circumstances that tax laws need to address and the multiple objectives that policy serves, the advantages of simplification can however, be over-stated.

Eventually for each tax, tax potential should be estimated and compared with the actual tax revenues. The gap between the two i.e. excess of potential over actual tax revenues is referred to as the revenue gap. Further research which would feed into building an effective compliance strategy would require detailed analysis of the tax wise revenue gaps and by minimizing risks associated with each tax so that the tax gaps may be progressively reduced by improving compliance. At this stage the following steps may be followed to improve revenue performance and reduce revenue gaps.

1. Tax-wise risk-matrix parameters relating to registration, filing, reporting and tax-payment should be estimated.
2. In selecting cases for audit, higher weight should be given to the revenue gaps relating to those taxes whose contributions to the total tax-gap is relatively higher.
3. Supporting research may be undertaken to enhance quality of policy decisions and assess their revenue impact
4. Communicating analytical findings of tax-gap studies and risk-imbalances to the administrative and field staff
5. Strategies for increasing voluntary compliance should be reviewed periodically particularly in taxes and states/local levels with high tax revenue gaps

Involuntary non-compliance may arise both due to (a) inadequate information, (b) excessive complexity of tax laws, and (c) unintentional errors. Taxpayers may be unaware of the provisions of the tax laws and they may make unintentional errors in interpreting the law, keeping records and in the calculation of their tax liabilities.

Voluntary Compliance

Voluntary compliance involves both costs and efforts on the part of the taxpayers. Their willingness to undertake these efforts is often strengthened by making them appreciate the role of the taxes that they pay in the context of the broader role of the government. In order to promote such understanding, many governments have now launched early education programs.

a. Early education programs

Several countries are developing tax awareness programmes at schools or at higher stages of education for providing an understanding and appreciation of the role of the tax system. When the potential taxpayers understand that taxes paid by them are meant for their own benefit in the form of provision of public goods like courts and general administration and merit goods like health and education, they are motivated to become self-compliant. Some of the country initiatives in this context are listed below.

- Austria has developed an education at schools programme in which schools across Austria receive educational visits by tax officials focusing on providing core awareness of future responsibilities for tax and customs compliance.
- Canada has developed an online course to help individuals to understand the fundamentals of the Canadian tax system and to show them how to file a basic tax return.
- Chile has started early tax education at schools with the collaboration of educational ministries and other government agencies. The Chilean tax education programme targets children from age 6 years. Commencement at this age is intended to provide basic understanding, during the early cognitive period.
- Korea, with a view to developing a culture of compliance based on informed understanding has launched an education campaign targeting general public as well as opinion leaders.
- In India, the Tax Administrative Reforms Commission has suggested several initiatives for outreach and education of taxpayers.

b. Administrative facilitation of compliance: Use of Information Technology

Many tax departments are now increasingly using information technology for administrative facilitation of compliance. These technologies include web-based portals for registration, filing of return and other information as well as for payment of taxes. This often requires developing an interface of the tax department with the banking and the financial sectors. Some of the electronic devices commonly referred to as Electronic Fiscal Devices (EFD) include electronic cash registers, electronic tax registers, electronic fiscal printers, electronic signature devices, and sales control devices. These are increasingly being used by the tax payers. These initiatives are proving to be more cost effective compared to traditional contact and response methods. In this process, not only administrative costs are reduced but there is also a significant reduction in the private costs of compliance by facilitating various compliance related processes including registration, filing, reporting and paying. Some important recent country initiatives in regard to technology assisted filing and other compliance aspects include Austria where the voluntary use of an electronic Standard Audit Tax File submitted annually is being promoted to more than 2 million company taxpayers. In India, the Tax Administrative Reforms Commission has recommended a strategy for providing information tools including automation of website, e-learning videos and call centres to make understanding of compliance easy.

In a survey-based study by Casey and Castro (2015), the main conclusion is that the implementation of EFDs can only be effective if it is part of a comprehensive compliance improvement strategy that clearly identifies risks for different segments of taxpayers and envisages implementing a set of measures to mitigate these risks. It also observes 'the deployment of fiscal devices cannot by itself achieve meaningful results, whether in terms of revenue gains or permanent compliance improvements.'

c. Promoting effective record keeping

Voluntary compliance becomes easier for taxpayers who develop the habit of keeping relevant records. In order to inculcate this habit, some countries have initiated programs to facilitate record keeping by taxpayers. For example, Canada has implemented a Books and Records Review Program (BRRP) programme primarily focusing on SMEs in traditional high cash based industries namely, construction, restaurant and food services, and retail businesses. Australia has also developed a record keeping strategy that incorporates education, supporting products and a graduated approach to enforcement to encourage compliance behaviours particularly for new businesses. In Singapore, grants for accounting software are provided.

d. Working on Behavioral Aspects

Behavioural aspects include optimization errors and intrinsic motivation relating to feelings of shame, guilt, pride, patriotism and social norms. There is significant interdependence amongst motivations. Reducing deterrence, for instance, weakens extrinsic motivation to comply. Attitudes differ significantly both across and within countries. This heterogeneity in motivation should be taken into account in planning a strategy to promote voluntary compliance.

e. Relationship Management

Managing relationships particularly with taxpayers is important for effective compliance management. Some advanced tax departments have introduced an ‘enhanced relationship’ (or ‘cooperative compliance’) with key taxpayers. This involves maintaining a close communication between the tax department and the taxpayers.

f. Incentives and sanctions

Voluntary compliance can also be increased by designing suitable incentives such as providing rewards through a lottery system for customers, making sure that they obtain a receipt for their purchases. Sometimes penalties are also used for this purpose. Australia has introduced a new civil penalty regime (promoter penalty laws). These new penalties deter the promotion of tax avoidance and evasion schemes by placing promoters of unsustainable schemes at risk of a significant monetary penalty when they expose their clients to scheme penalties.

Enforced compliance

a. Cross-matching of Data

Cross-matching of information by bringing together on a common platform information submitted by taxpayers and information obtained from third parties can provide an effective enforcement mechanism. Typically a taxpayer generates vast spectrum of information across numerous agencies in connection with personal or professional requirements.
Third party data can be categorized as under:

- Data set provide by government agencies such as regulatory bodies and other departments
- Commercially available database such as banks, telephone department and power utilities
- Data set requisitioned by tax department for tax administration purpose

Third party reporting encourages compliance by increasing the probability of false reports being detected, with an important role for financial intermediaries. Internationally, information provided by financial institutions is central to information exchange that reveals cross-border evasion.

Exchange of relevant information between federal and subnational governments might prove to be beneficial in improving compliance at both levels in the context of at least some subnational taxes. For example, vehicle tax, agro-income tax and business tax.

b. Audit and Inspection

Audit is known to be a significant deterrent weapon in the armory of the tax authorities. Audit is a costly activity as it requires going into considerable detail for identification and quantification of cases of default, fraud, non-payment, and underpayment of due tax liability.

All of these compliance strategies may be difficult to implement in one go at the subnational level. Top priority can be given to: (1) allocation of adequate budget for revenue administration and for related IT infrastructure, (2) designing and implementing from the very beginning tax effort and revenue performance in federal to state and from state to local fiscal transfers and (3) Setting up registration facilities in the case of taxes where tax payers are required to register with the relevant authority and measurement of corresponding registration gap.

Chapter II

Component 2: Intergovernmental Fiscal Transfers

1. Introduction

This component is aimed at providing guidelines for the implementation of inter-governmental fiscal transfers (IGFT) in Nepal within the broad framework of the new Constitution (Government of Nepal, 2015) based on theoretical principles and international practices. The study reviews the pre-Constitutional (As-is) situation, and scans though the international practices relating to theoretical and practical aspects of the types, modalities, formulae and indicators of different intergovernmental transfers. The study is a desk review, based on various documents from government and non-government sources (published and unpublished) were studied. In the process, the study team had useful interactions with the concerned officials of the Government of Nepal.

2. Pre-2015 Constitution (As-is) Situation

Prior to the new Constitution, Nepal followed primarily a unitary system of governance with a Central Government and different types of local bodies (LBs): 75 District Development Committees (DDCs), 217 Municipalities and 3,157 Village Development Committee (VDCs).

The unitary format has remained intact despite the attempts to establish local self-governance through the Decentralization Act, 1981 and Decentralization Rules, 1984, and the Local Self-Governance Act (LSGA), 1999. For example, the LSGA sought to "make provisions conducive to the enjoyment of the fruits of democracy through the utmost participation of the sovereign people in the process of governance by way of decentralization," and to "constitute local bodies for the development of the local self-governance system". Accordingly, the LSGA devolved 16 categories of expenditure responsibilities to the DDCs, and 11 categories of responsibilities to the VDCs and Municipalities to make the LGs capable and efficient in local self-governance. (Government of Nepal, 1999).

2.1 Revenue assignments

The revenue assignments to the LGs as per the LSGA are as in Table 34. While the major sources of revenues, VAT, excise, income tax, international trade taxes, are with the central government, the LGs have only the minor own sources of revenues such as the house and land tax, vehicle entrance tax, business tax, service charge and fees. The VDCs also impose the natural resource utilization tax. Municipalities can also levy rent tax. Thus, the revenues of LGs comprise own revenues, tax sharing and transfers from the center. Besides, little effort is made by the LGs to improve the tax collections.

As typical of a unitary governance system, the self-governance principle is hardly followed for the LGs and there is not enough autonomy in the expenditure and taxing power. The LGs have very little control over their expenditures as over 90 percent is met by the allocations from the central line ministries and departments. With respect to the own taxes the LGs have little discretion over the determination of the tax bases and rate structures as they are set by the central government.

Table 34 Distribution of Tax Powers and Sub-National Tax Assignments under LSGA 1999

Central Government	DDCs	Municipalities	VDCs
Taxes on business income (public, private and joint venture enterprises)	Natural resource tax on commercial utilization (3550 % should go to VDCs and Municipalities)	House and land tax	House and land tax
Tax on income from individuals,	Taxes on infrastructures like roads, bridges, etc.	Land revenue or land tax	Land revenue or land tax (25 % goes to DDC) Shop and market (haat) tax
Interest taxes	Service charges (guest house, library, city hall,)	Vehicle tax	Vehicle tax
Capital gain tax	Local development fees	Entertainment tax (cinema hall, video hall and cultural show halls)	Entertainment tax (cinema hall, video hall and cultural show halls)
Property tax (Registration fees (	Other prescribed service charges	Rent and tenancy tax including rent tax on property rented	Rent and tenancy tax
Taxes on goods and services	Licensing and renewal fees (Panighat, water course, boating, tunings and fishing)	Advertisement tax on sign board, etc	Advertisement tax on sign board, etc
VAT	Recommendation fee and other fees as prescribed	Business/enterprise tax on prescribed industry, trade, profession or occupation	Business/enterprise tax on prescribed industry, trade, profession or occupation
Excise taxes on cigarettes and li	Sales revenue (sand, stone, wood swept by river, etc)	Commercial video tax	Commercial video tax
Tourism fee	Fines	Integrated property tax	Natural resource tax on the commercial exploitation
Motor vehicle tax	Tax sharing	Service charges on utilities, public facilities, etc	Other taxes as prescribed
Air flight tax	Registration fee (transaction of house and land)	Entrance charges (tourist places, parks, gardens, towers, etc)	Service charges (sanitation, drainage and sewerage, solid waste management, performing magic and circuses)
Contract tax	Royalty (mines, petroleum products,	Parking charges	Entrance charges (tourist places, parks, gardens, view towers,
Taxes on international trade (import and export duties)		Other charges and fees (valuing immovable property, approval, recommendations, etc)	
		Building permits	
		Fines	

Source: Acts relating to Central taxes and non-taxes, MoF, IRD, DOC, and Local Self Governance Act, 1999

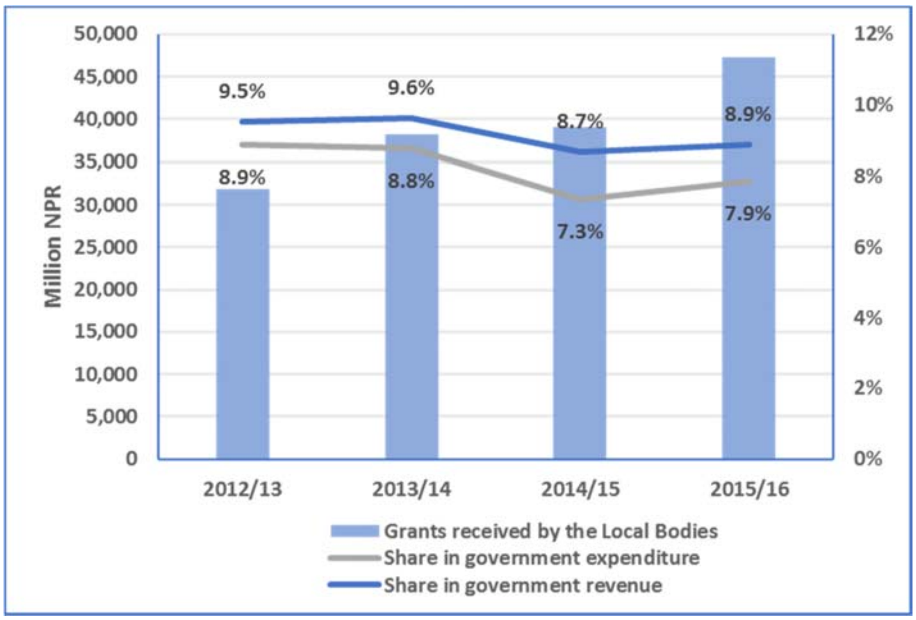
2.2 Own Sources of Revenue

The own revenues of the LGs is just about 2 percent to total national revenue. It could meet not more than 19 percent of their local expenditure assignments. The expenditure of LGs is more on minor infrastructure such as irrigation channel, water supply, primary school buildings, village roads etc.

Table 35 Significance of own source revenues and expenditures of LGs

				(NPR million)	
		2012/13	2013/14	2014/15	2015/16
Government expenditure		358,638	435,052	531,558	601,016
Government revenue		333,927	396,885	450,413	531,411
Own source revenues (OSR) of LGs		7,293	8,659	9,574	11,067
Share of OSR in combined revenues		2.1%	2.1%	2.1%	2.0%
Grants received by the LGs		31,819	38,265	39,047	47,290
Share of grants in combined government revenue		9.5%	9.6%	8.7%	8.9%
Share of grants in government expenditure		8.9%	8.8%	7.3%	7.9%
Sources:					
Government of Nepal (2016/17) Economic Survey, Table 2(a), Ministry of Finance, Ministry of Federal Affairs and Local Development and Local Bodies Fiscal Commission Secretariat					

Figure 1 Grants received by the LGs and their share in government revenue and expenditure



The grants received by different categories of LGs are as in the following table.

Table 36 The income and expenditure details of the LGs

				(NPR million)	
	Description	2012/13	2013/14	2014/15	2015/16
1	**District Development Committee (DDC)**				
	Grants Received From Nepal Government	20,843	26,710	26,720	27,180
	Internal Resource and Revenue Disbursement	2,756	3,575	4,578	4,103
	Total Allocated Fund for Expenditure	23,599	30,285	31,298	31,283
	Real Net Expenditure	17,958	26,780	25,199	23,330
2	**Municipality**				
	Grants Received From Nepal Government	4,284	3,345	4,967	12,060
	Internal Resource and Revenue Disbursement	3,366	3,783	4,100	6,964
	Total Allocated Fund for Expenditure	7,650	7,128	9,067	19,024
	Real Net Expenditure	6,769	6,175	7,979	10,450
3	**Village Development Committee (VDC)**				
	Grants Received From Nepal Government	6,692	8,210	7,360	8,050
	Internal Resource and Revenue Disbursement	1,171	1,302	897	0
	Total Allocated Fund for Expenditure	7,863	9,512	8,257	8,050
	Real Net Expenditure	7,649	9,340	9,340	8,010
	Summary				
	Gross Internal Revenue of Local Bodies	7,293	8,659	9,574	11,067
	Total Grants received by the Local Bodies	31,819	38,265	39,047	47,290
	Total Income of the Local Bodies	39,112	46,925	48,621	58,357
	Share of own source income of Local Bodies in their Total Income	19%	18%	20%	19%
	Source: Ministry of Federal Affairs and Local Development and Local Bodies Fiscal Com				

Even the low expenditure assignments of the LGs could not be met with their meagre own resources, there is significant vertical fiscal imbalance VFI)[24]. Measured as a ratio of own source revenue to total revenue including the transfers and grants received (Martinez-Vazquez & Boex, 2001), the VFI in Nepal stands at about 80 percent (table 3), which is rather high as compared the existing federal countries, requiring significant vertical transfers from the central government to the SNGs.

2.3 Tax sharing

Currently, most of the transfers from the central government to the LGs are in the form of grants, and very few are through tax sharing.

The tax sharing system exists between the central government and DDCs and between DDCs and VDCs. The central government shares the revenue with DDCs, from land and house registration fee (5 to 90 per cent depending on the amount of collection), royalties from mines (50 per cent), royalties from forest (10 per cent), royalties from the hydropower generation plant (10 per cent) and tourist entrance fees (30 per cent). The DDCs are mandated to share with VDCs and Municipalities, up to 35 to 50 per cent of the earnings from the charges on the commercial use of raw materials and recyclable wastes, and from the sale of sand, stones, wood swept by rivers, etc. But the tax revenues being not significant the tax sharing is not adequate.

2.4 The Grant system

The grant system is fairly developed. Basically, there are three types of grants: 1) Administrative grants, 2) General purpose Block grants, and 3) conditional grants. The first two types of grants are referred as Development grants.

[24] VFI is a measure of the broad correspondence between the expenditure responsibilities assigned to each level of government and fiscal resource available to them to carry out those duties.

The DDCs receive administrative, block and conditional grants. The administrative grant includes salaries and allowances for the central staff at the DDCs, supplementary salary and allowances for the other staff, welfare fund contribution for the DDC staff and salary and allowances for the VDC secretary. All this grant forms about 25 percent of the total administrative grants. The general block grant is around 33 percent. In addition, the DDCs receive the road grant and suspension bridge grant.

Currently, only a nominal share of about 15 percent of the grants is based on formula. The rest of the budget has been distributed randomly regardless of the size of districts and need-based variables such as population, geographical area, poverty, per capita income and cost. The grant formulae differ for DDCs, VDCs and municipalities as follows (Table 37).

Table 37 Current Formula of Grant Transfer from Central Government to Local Bodies

Indicators	VDCs	Municipalities	DDCs
Population	60	50	40
Weighted poverty		25	25
Area	10	10	10
Weight cost	30		25
Weighted tax effort		15	

Source: MOFALD (2012)

As part of the recurrent grant system, the GoN also provides municipalities with sectoral conditional project-based block grants. Among them, only capital grants from MoFALD are formula-based and other grants are conditional. Although the municipalities' block grants are in principle unconditional, in practice certain conditions are kept into the provision of these grants. Total transfers to the municipalities increased from NPR 1,350 million in 2006-07 to NPR 9,730 million in 2015-16, the average annual growth being 29 percent. The rest of the unconditional capital grant is channelized for the minimum grant based on the provision of LSGA. The weighted cost and poverty indices have been used for allocation to DDCs, VDCs and Municipalities, as the proxy of equalization purpose. However, it has been realized that these indicators are not adequately supporting and balancing of the remoteness and backwardness regions.

Besides the unconditional grants, there are numbers of conditional grants that are transferred from the center to divisible pool fund of LBs, like roads, suspension bridges, drinking water, and sanitation, maintains of canals, etc.

2.4.1 MCPM grants

An important component of the grant system has been the minimum conditions and performance measures (MCPM) system which is based on the concept of performance-based grants system (PBGS) developed in the year 2000. Basically, the MCPM system was introduced to monitor the performance of the LGs. The system is also used as a tool for grant allocation to the LGs. Under the MCPM system, the LBFC annually assesses the performance of LGs, and recommends adjustments (rewards/penalties) in the grants to local bodies. For the assessment purpose, two sets of indicators[25] are used – minimum conditions (MC) and performance measures (PM). The MCs ensure that critical functions such as approval of annual budget and programme on time of the LGs are discharged. PMs attempt to measure the extent to which the LGs have succeeded in accomplishing the tasks/results in key performance areas. The GoN annually adjusts the grants to be provided to LGs based on the MC and PM assessment and those LGs that meet the MC and score high in PM are provided with additional capital grants.

Nepal has been adopted MCPM for the purpose of make effective local governance as a tool of measuring mechanism of local bodies. The basic laws related to MCPM are Local Self-Governance Act, 1999, Local Self-Governance Regulation, 2000, and Local Bodies Financial Administration Regulation, 2007, MCPM is functioning[26]. The functions and activities of local bodies are directed by these laws. In addition to these laws the works, actions and activities of LBs are also guided by various regulations, work procedures and directives. The additional unconditional capital grant for local bodies is provided on the basis of result obtained through the assessment MCPM tool incorporates a system of providing assistance to local bodies grants The system has undergone changes over the last one decade. Currently, the performance based grant system, in the case of DDCs, is applicable for the block grants (non-sectoral capital grants). The system is based on two components: (1) The DDCs get certain basic entitlements as central government grant, which is allocated independent of the MCPM scoring; and, (2) in addition to the basic minimum entitlement, additional capital grants to the DDCs are allocated based on MCPM assessment. In the case of VDCs, all the central government grant is provided on formula basis. If the VDCs comply with certain MC, they will receive a topping-up grant. PMs is introduced for VDCs from FY 2014/15 only. have not yet been introduced for VDCs.

There are 15 MCs and 62 PMs Indicators, of which five of the PMs related indicators are suspended until elected representatives are in place. Likewise, the system is applied for Municipalities as well from FY 2008/09. In case of VDCs, only the assessment of MCs is done, and the VDCs are being evaluated for the second year. The LBFC carries out the assessment through independent evaluators. For this, separate manuals have been developed for the assessment of DDCs, Municipalities and VDCs, which define both the indicators and the assessment procedures, among others. The number of MCs for VDCs is gradually increasing from year to year. The assessment manual has undergone regular changes since its elaboration in 2004. However, it was decided in 2008, to keep the manual stable for some few years to ensure sufficient awareness and to consolidate the achievements from the system, hence the changes have been minor.

Table 38 The Minimum Conditions Indicators LB-wise

S.N.	DDC indicators	VDC indicators	Municipality indicators
1	Annual Budget and program approval	Annual Budget and program approval	Annual Budget and program approval
2	Annual progress appraisal	Annual progress appraisal	Annual progress appraisal
3	Annual and quarterly progress report	Grant utilization and accounting	Annual and quarterly progress report
4	Internal audit and VDCs final audit	Final audit	Account operation of Municipality Fund
5	Account operation of District Development Fund	Inventory management	Tax and record of internal revenue source
6	Information and record management	Social security program	Audit and irregularity rectification
7	Final audit and record of irregularities	Personnel management	Assets management
8	Inventory management		Building construction and design approval
9	Personnel management		Publication of revenue and expenditure details and tax rate
10			Personnel management

Table 39 The Performance indicators used for MCPM grants

	Thematic areas	Remarks
DDC	Planning and Budget Management Resource mobilization and financial management Budget release and program implementation Monitoring, Assessment Communication and Transparency Organization management and work responsibility	Thematic areas-5 Total number of indicators-46
Municipality	Local governance Financial resource mobilization and management Plan and program management	Thematic areas-5 Total number of indicators-40

	Thematic areas	Remarks
	Organization and HRD Urban basic resource management	
VDC	Formulation of participatory village development program, Target group program Release and expenditure status Publication of income and expenditure statement Implementation of social security program Personal record database, VDC profile Citizen charter, Public audit, public hearing Internal resource management	Thematic areas-13 Total number of indicators-100

Table 40 Eligibility for additional grants under MCPM

	Performance rating and conditions	Reward/ sanction	Staff incentives
1	3 topmost DDCs/Municipalities 1 top VDC in each district	20% addition in grant	First DDC/ Municipality – NPR 300 thousand Second DDC/ Municipality-NPR 250 thousand Third DDC/Municipality- 200 thousand
2	Top 25% DDCs/ Municipalities/VDCs (First category)	15% addition in grant	NPR 125 thousand for DDCs & Municipalities
3	Second top 25% DDCs/Municipalities/VDCs (Second category)	10% addition in grant	NPR 100 thousand DDCs & Municipalities
4	Third 25% DDCs /Municipalities/VDCs (Third category)	10% deduction in grant	
5	Last 25% DDCs/Municipalities/VDCs (Lowest category)	15% deduction in grant	
6	MC met but failed in PM (DDCs/Municipalities/VDCs)	20% deduction in grant	
7	MC not met (DDCs/Municipalities/VDCs)	Lose all formula based grant	Note- In case of VDCs, DDC makes decisions

2.4.2 Administrative grants

The Municipalities also get the administrative grants that forms about 20 percent, general purpose block grants to the tune of 60 percent and the remaining 20 percent for specific purposes. The VDCs get about NPR 500,000 each year uniformly as equalization grant, of which they spend about 25 percent in administration. However, the present grant system is not predictable, follows the incremental rule, hardly equalize the fiscal capacity differences, and no scientific method of distribution is used. Thus, there is scope for improvement in the grant system.

In summary, the central government exerts firm control over the local body government finances: firstly, by not devolving enough expenditure powers; and secondly, through the different grants and tax sharing, and through various line department grants.

3. Constitutional Provisions

The new Constitution 2015 is poised to change the situation by creating a federal structure with three layers of governance: the federal, state, and local levels. Although it has drawn up provisional boundaries for seven states yet their names are to be decided by their eventual assemblies and a commission has yet to fix their final boundaries.

"In the federal structure, local levels have been transformed to 479 village municipalities, 248 Municipalities, 13 sub-metropolises, 4 metropolises and 75 district coordination committees. Such bodies have been delivering services and performing development works as transformed local level entities." (Government of Nepal, Ministry of Finance, 2017, p. 73). Subsequently the government added two more District Coordination Committee by splitting Nawalparasi and Rukum districts in two states. Now the number of LBs are: 488 village municipalities, 11 sub-metropolises, 6 metropolises, altogether 753 local levels, and 77 district coordination committees. The LBs have also been given a constitutional position, as 'Gaon Palika' in rural areas and Municipality in urban areas. In the new set up, 'Gaon Palika' will replace the present local institution of VDC while existing institution of Municipality will remain the same. Moreover, the presence of existing DDC is replaced with District Council (DC). The constitution mandate of DC is to coordinate between Gaon Palika and Municipality.

The constitution of Nepal provides for division of the revenue and expenditure functions between the federal and state governments. Schedules 5, 6, 7, 8 and 9 enumerate, the federal, state, concurrent I (federal and state governments), local level governments, and concurrent II (federal, state and local governments) powers, respectively. The residual powers will rest with the federal government. The distribution of tax and non-tax powers as per the new Constitution is given in (Table 41). Except for agro-income tax there are no new taxes as compared to the present situation.

Table 41 Constitutional division of revenue powers between the three levels of government

Schedule 5 - Centre	**Schedule 6 - State**	**Schedule 7 - Concurrent (Centre and State**	**Schedule 8 - Local**	**Schedule 9 - Concurrent (state and Local)**
<u>Tax Powers</u>				
Customs duty	Vehicle tax		Vehicle tax	
VAT	Entertainment tax		Entertainment tax	
Excise duty	Advertisement tax		Advertisement tax	
Corporate income tax	Agro-income tax		Wealth tax	
Individual income tax	Tourism tax		House rent tax	
Remuneration tax			Business tax	
			Land tax (Land revenue)	
			Property tax	
Centre – Schedule 5	**State – Schedule 6**	**Schedule 7 - Concurrent (Centre and State**	**Local – Schedule 8**	**Schedule 9 - Concurrent (state and Local)**
<u>Non-tax powers</u>				
Service charge and fee	Service charge and fee	Industries and Mines	Service charge and fee	Service fees, charge
Penalty	Penalty	Water supply and sanitation	Penalty	penalty
Tourism fee	House and Land registration fee	Tourism	Tourism fee	Tourism
Passport fee		Utilization of natural resources		Royalty from natural resources
Visa fee				
Source: Constitution of Nepal, 2017				

Constitutionally the LBs have been empowered more revenue assignments than before. Currently the local governments are generating revenues from the property tax, house rent tax, fees on registration of houses and land, land tax, business tax, service fees, tourism fees, etc. All these revenues are now included in the exclusive lists of constitution. Further, in the concurrent list, service fees, penalty, tourism fees, natural resource fees, etc, are included.

However, as before, most of the important sources of revenue such as income tax including payroll tax, VAT, excise duty, customs duty, and other special taxes yielding over 82 percent remain with the federal government while expenditure responsibilities of the newly created subnational governments are relatively larger. Only a few of taxes such as land and building registration fee, house rental income, tourism tax, and vehicle tax are assigned to province and local level are assigned to local and province (Constitution, Schedule 6 and 8). In the local list, there are four exclusive taxes namely, property tax, house rent tax, business tax, and land tax (land revenue). The revenue potential from the taxes that are shifted from the federal list to the SNGs form not more than 5 percent of the total revenues, and their total OSR is likely to go up from the present 2 percent of the total government revenues to be about 7 percent[27].

Table 42 Additional tax potential provided to SNGs by Constitution

(NPR 10 million)

	2015/16	2014/15
Rental Income tax	33.6	26.6
Building land Registration fee	131.4	93.8
Tourism	14.1	9.5
Vehicle tax	71	63.5
Total	250.1	193.4
Out of total tax (%)	51.9	41.1

There are four taxes where the powers to levy the tax is concurrent between the state and the local governments: vehicle tax, entertainment tax, advertisement tax, and land and house registration tax. **The concurrent powers can be source of conflict. It is not clear as to the demarcation of the tax levying power between the state and local governments. The following aspects of the concurrent taxes need to be attended:**

- **(i) which government will determine the rate structure,**
- **(ii) whether there will be a dual rate system,**
- **(iii) which government will collect the revenue,**
- **(iv) whether the state government will administer and collect the tax and distribute the proceeds to the local governments,**
- **(v) whether the local governments would administer and collect the revenues and retain part of the revenue and credit the rest to the state government, etc.**

These modalities need to be clearly specified. Therefore, there is a need for an independent grievances redressal body.

Table 43 Common revenue sources of the federal, Sate l, and local level governments under the New Constitution.

SN	Heads of Revenue/Taxes	Federal	Provincial	Local	Schedule/Notes/Remarks
1.	Customs	FR			(Sche.5)
2.	Excise duty	FR			(Sche.5)
3.	Value added tax (VAT)	FR			(Sche.5)
4.	Corporate Income tax	FR			(Sche.5)
5.	Individual/Personal Income tax	FR			(Sche.5) In English Version[28] Individual word is used
6.	Remuneration tax	FR			(Sche 5)
7.	Passport Fee	FR			(Sche 5)
8.	Visa Fee	FR			(Sche 5)
9.	Tourism Dastur (*charge)/**Fee	FR			*In Nepali version paryatan dastur is mentioned, In English version **Tourism fee is mentioned.

[27] The dominance of the central government in the fiscal power distribution reminds Anwar Shah's observation about the central perception: "Giving money and power to sub-national governments is like giving whiskey and car keys to teenagers" (Shah, 2004).

[28] Ministry of Law, Justice and Parliamentary Affairs, GoN.

SN	Heads of Revenue/Taxes	Federal	Provincial	Local	Schedule/Notes/Remarks
					In Schedule 6 only word Paryayat (Tourism) is used; it is not clear where it is tax or fee.
10.	Service Fee Charge^	FR	PR	LR	In Nepali version ^Shulk and Dastur both words are used. In English version only charge the word charge is used.
11.	Penalties & fines	FR	PR	LR	Local governments can impose only fine
12.	Land and House Registration Fee^^		PR	LR	(Sche 6 and 8)
13.	Vehicle Tax^^^		PR	LR	(Sche 6 and 8)
14.	Entertainment tax		PR	LR	(Sche 6 and 8)
15.	Advertisement Tax		PR	LR	(Sche 6 and 8)
16.	Tourism (only mentioned tourism)		PR		In Nepali version only word Tourism@@@ is mentioned, no word tax (kar) is not mentioned. In English version only word Tourism is mentioned.
17.	Tax in agriculture income		PR		(Sche 6)
18.	Local tax***			LR	(Sche 8)
19.	Tourism fee			LR	(Sche 6 and 8)
20.	Business Tax			LR	(Sche 8)
21.	Land Tax (land revenue/malpot)			LR	Including malpot collection
22.	Royalty received from Natural Resources	Concurrent	Concurrent	Concur rent	(Sche. 9(6)

Source: The Constitution of Nepal, Arranged by the Study Team

^^ This head is also included under local tax under the jurisdiction of local level,

^^^ This head is also included under local tax under the jurisdiction of local level

***includes Property tax, house rent tax, fee on registration of houses and land, vehicle tax,@@@ Under Schedule 6, it is required to be specify what to be imposed and collected tax or fee.

As the system evolves, the sub-national governments will have to develop and utilize revenue sources assigned to them**. There should also be a search for new taxes, further review of assignment of taxes, and adequate revenue sharing arrangements to increase the degree of fiscal autonomy of the sub-national governments.** As for the expenditure assignments, it is presumed that much of the expenditures incurred by the line ministries are going to be devolved to the state and local governments. In fact, as a transitional arrangement through Budget for FY2017/18, the GoN has devolved the development functions to the local level.

4. International Experiences

4.1 Transfer Policy for Reducing Fiscal Imbalances

The inadequacy of resources to meet expenditure functions makes the subnational government dependent on the federal government and this dependency is likely to continue even with the new Constitution, if proper transfer system is not in place from the beginning. The central tax revenues need to be shared between the three levels of governments.

Inter-governmental transfers are the dominant sources of revenues for sub-national governments in most developing countries. Central transfers finance 85 percent of sub-national expenditures in South Africa, 72 percent of provincial and 85 percent of local expenditures in Indonesia, 67 to 95 percent of state local expenditures in Nigeria and 70 to 90 percent of expenditures in less prosperous states in Mexico. The design of these transfers is of critical importance for efficiency and equity of local public services provision and the fiscal health of sub-national governments.

The basic objectives of IGFT should be correcting the VFI to enable the SNGs to meet their assigned expenditure functions and correcting the HFI by equalizing the fiscal capacity of SNGs to attain uniform service provision among the residents through equalization transfers. In addition, IGFT can be an effective tool for achieving national priorities and national standards of public services; improving fiscal efficiency of SNGs in terms of revenue mobilization and expenditure management by stimulating them through performance based grant systems; and, accomplishing macroeconomic stabilization by influencing the overall activities of the SNGs. A summary of the better practices are as follows (Table 44).

Table 44 Summary of the principles of transfer policies

Objective	*Grant Design*	*Better Practices*	*Practices to Avoid*
Fiscal Gap	Reassign, tax base sharing	Canada	Deficit grants, tax by tax sharing
Regional fiscal disparities	Fiscal capacity equalization	Australia, Canada, Germany, Denmark, ECA	General revenue sharing with multiple factors
Setting national minimum standard	Block transfers, conditions on service standards	Ex-Indo. roads and education, Chile, Brazil	Conditions on spending
Benefit spillovers	Matching grant	S. Africa teaching hospitals	
Influencing local priorities	Open-ended matching	Canada social assistance	Ad hoc grants
Stabilization	Capital grant with upkeep Anwar Shah, requirements	Political and WpoorldlicByanrkisk guarantee	Stabilization without upkeep

Source: (Shah, 2004)

4.2 Vertical Fiscal Imbalance (VFI) and Vertical Sharing Options

As mentioned above, the VFI is the gap between own revenues and expenditures of each level of government. It is a structural issue and might arise by design. Generally, the expenditure responsibilities assigned to the sub-national governments would require larger share of revenue resources. The raising of taxes, however, must be largely centralized for efficiency and economic reasons. Thus, a large part of the VFI is by design.

VFI is justified on the basis of the following reasons. Firstly, the Central government functions are such that they basically serve the 'national' interests as opposed to the narrower State interests. The functions like defense, border security and integrated planned macroeconomic development do require huge resources. Secondly, the Central government needs to meet the equity objectives through the tax policy and expenditure policy. The horizontal fiscal equalization needs greater access to revenue sources. "A centralized fiscal policy is tantamount to an insurance contract where the higher level government promises to even out income variations across regions that result from regionally asymmetrical shocks" (Spahn, 1995). Thirdly, certain national taxes such as income tax and manufacturing tax require a centralized uniform administration. Also, the centralized tax administration reduces scope for needless 'tax competition' among the sub-national governments.

At the same time, there are certain arguments for minimizing the VFI. Firstly, there is the accountability argument. If the central government collects most of the revenues, and provincial governments collect less but spend more, it requires vertical transfers from the center to the provinces. This may reduce the accountability of the provincial governments. Secondly, a large VFI makes the Central government financially very powerful and the provinces to be weaker. Moreover, it is observed that "when centralized control is exercised through the vehicle of financial transfers instead of direct provision of services, the lines of responsibility for each level of Government are blurred." (Grewal, 1975).

Apart from the intended VFI, there could be other undesired components of VFI caused by several factors: such as

1) The nature and extent of actual fiscal autonomy;

2) Conflicting or uncoordinated federal and State priorities (for example, education, agriculture, social welfare, infrastructure expenditures);
3) The shortcomings in the existing revenue sharing arrangements;
4) Political conflicts.

More than the tax revenue sharing, tax power sharing could also cause VFI. It depends upon the degree of discretionary change to tax rates or tax bases required for generating additional revenue. This point can be illustrated by contrasting two governments one of which (Central Government) raises its revenue from progressive income taxation and the other (say, a State Government) from sales tax. In a period of high inflation accompanied by correspondingly high increases in money incomes, but little growth in output, the Central government would experience high and automatic growth in its tax revenue without having to increase the rate of tax or broaden the tax base while the State's revenue would remain static.

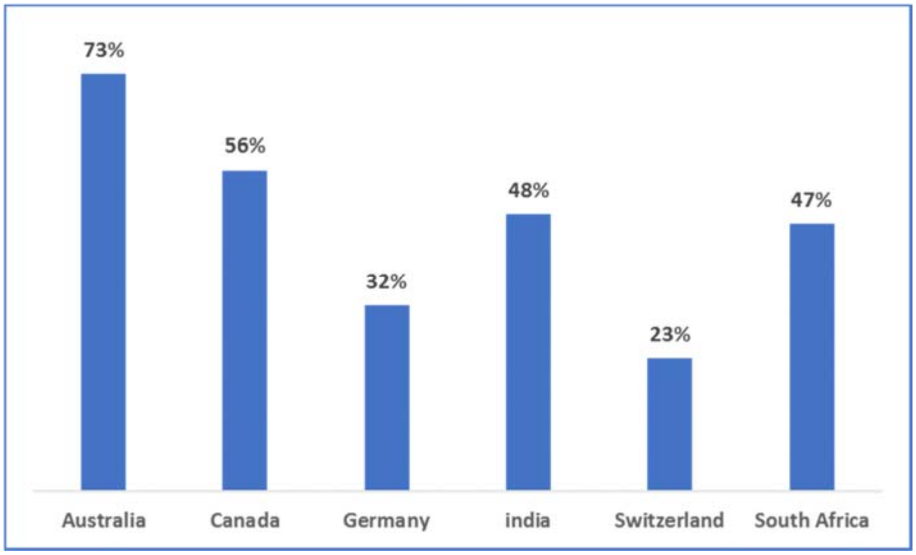
The basic idea in correcting the VFI is that 'government at each level can command the financial resources necessary for them to carry out their expenditure responsibilities'. Among the countries that adopted the federal systems, it is a well-known feature that the VFI is mostly in favor of the federal government. The basic idea in correcting the VFI is that 'government at each level can command the financial resources necessary for them to carry out their expenditure responsibilities'.

It is well acknowledged fact that the Australian Federation has one of the largest VFI. Nearly 73 percent revenue accrues to the Commonwealth government, while its expenditure responsibilities form about 55 percent. The states collect 25 percent of revenues but spend about 39 percent of the total. The local governments collect only about 5 percent of revenues and spend 7 percent of expenditure. Thus, the states and local governments rely very heavily on Commonwealth government for funds. In terms of direct program spending, the commonwealth spends about 54 percent of the total, leaving 46 percent for the combined state and local governments. In the case of the constituent six states in the Australian federation, the revenue share is 29 percent with 41 percent expenditure responsibility and in the case of local governments, the revenue share is just 3 percent and expenditure share is about 5 percent.

In Canada, the VFI is comparatively less as the state government collect 53 percent of the revenues and spend about 63 percent of the combined expenditure. The VFI is more of structural in the sense, the more productive and fast-growing revenue sources are allocated to the federal government while the expenditure functions allocated to the states such that the expenditures will grow faster. In other words, the problem lies in the allocation of revenue resources itself. Such high structural VFI necessitates increasing transfers from the federal to subnational governments. State and local spending is a much larger proportion of the total. Looking at the individual components of spending, one sees that only in the area of social services is the federal government dominant – and then with approximately 36 percent of the total delivered by the state and local governments.

In India, the central government has the power to collect tax and non-tax revenues to the extent of 68 percent of the total combined revenue collections. However, the states undertake nearly 67 percent of the combined expenditure functions. Thus, the required extent of transfers would be about 32 percent. In the case of Germany, the amount is determined by taking into account the needs and capacity of subnational governments. In India, the distributable pool is prescribed as a fixed proportion of the total central government tax revenues. Fiscal federalism in Switzerland can be characterized in terms of overall fiscal restraint and minimizing the centralization of fiscal power. The VFI in 2001 appears to be about 25 percent.

Figure 2 VFI in selected federal countries



In the case of Nepal, the pre-new Constitution VFI of the Local Government is over 80 percent during the four years 2012 to 2015.

There are two ways of bringing down the VFI in Nepal: **(a) Amend the constitution to give more tax powers to subnational governments**; e.g, in Nepal, pay roll tax can be assigned to local level and consumption based excise duty can be assigned to the Province in future and **(b) provide sufficient vertical transfers from federal government to state governments, and from state governments to local governments.**

In Nepal, the constitution does not specify which taxes to be shared between which level of governments and to what extent. It shows that the discretion to determine the vertical and horizontal tax sharing is left to the NNRFC**. The first task for the NNRFC therefore, is to have an idea as to what is the extent of VFI going to be between the federal and states and states and local governments** with the existing constitutional division of revenue resources and expenditure functions[29]. There are three approaches to fix the size of the vertical transfers:

a) As a share of SNGs from federal government revenues,
b) On the basis of cost reimbursement, or
c) On an *ad hoc* basis.

The vertical share should be fixed in such a way, the sub-national governments should be able to meet their assigned expenditure functions. There are two options to reduce the pre-devolution revenue gaps at the federal, state or LG level**:**

(a) One way is to completely reduce the fiscal gaps of the SNGs to zero. This may result in wider fiscal gap at the federal level, which can be met through new borrowings. In this case, the vertical share should be made equivalent to the aggregate of subnational fiscal gap.

(b) Alternatively, the fiscal gaps of the federal and state governments can be kept at equal level (see Error! Reference source not found. **for determination of the vertical share), and allow the sub-national governments, especially the state governments, to go for**

[29] Nepal's expenditure need is analysed and assessed in this Report (under the heading Assessment of Expenditure and Gap Analysis).

borrowing. This is a policy issue. In this case, the vertical share should be determined in such a way that the fiscal gaps at the national and sub-national level are equal.

A part of the VFI is a policy issue over the desired degree of dependence of SNGs on the federal government. As and when the VFI policy changes, the part of the VFI that is consciously built can be corrected to a manageable level by re-assignment of revenue and expenditure responsibilities between the two governments.

4.3 Transfer Options: Tax sharing vs Grants

Once the vertical share is determined, decision needs to be taken as to how much should be the tax sharing and how much should be the grants.

Basically, there are two broad channels of transfers from the federal government to the subnational governments: Tax sharing and Grants. The issue to be resolved is how to apportion the vertical transfer to be channeled through tax sharing and grants.

The merits of tax sharing are as follows:

- Firstly, the transfer amount through tax sharing is in line with the productivity and growth of the central taxes unlike the grants which are usually not linked to tax revenue collections. Therefore, tax share being a fixed percent of the tax revenue collections of the federal government would mean the subnational governments can be assured of reasonably growing amount.
- Secondly, transfers through tax sharing could reduce uncertainty for the subnational governments. Subnational governments can be fairly sure of the amount of revenue they are going to get and accordingly make suitable spending plans in advance.
- Thirdly, although the federal government collects the taxes, the bases for the central taxes lie within the states. Therefore, state governments do get a feeling of re-claiming a portion of the central tax.

The disadvantages of tax sharing could be:

- The federal government might be lax in collecting the taxes being aware that the revenue need to be shared.
- Transfers in the form of grants give flexibility to determine the form, method of transfers with and without certain conditions. Conditional grants, matching grants etc. gives control over the expenditure management of the subnational governments.

4.4 Tax sharing Options

The transition to the federal system in Nepal might require introduction of tax sharing between the federal and subnational governments. Tax sharing or tax devolution could be either by way of tax power sharing, tax revenue sharing, or tax base sharing. In Nepal, as in many countries, the division of tax powers is already done in the constitution. **However, there is room for tax base sharing especially, with respect to the VAT. For example, the tax on rental income earned from the property other than income from house rent (which is already assigned to local level) and pay-roll tax. Similar fine tuning may be required in the tax power and tax base sharing to bring down the VFI from a very high level to certain manageable level. This can be done by re-examining the division of tax powers.**

Although transfers through tax revenue sharing is not explicitly mentioned, Article 60 (2) and Article 60 (3) can be interpreted in favor of using tax sharing as a method of equitable distribution of collected revenue and, as recommended by the NNRFC.

The international experience shows that tax sharing is a popular method of federal transfers. In Australia tax sharing was undertaken for three different purposes at different times: The first was the sharing of the payroll tax revenue; the second was when states stopped collecting excise duties on tobacco and alcohol products by a court order and the Commonwealth government replaced the revenue; and third when goods and service tax was introduced in 1999, the revenue was transferred to the states as a measure of compensating their revenue losses. Australia assigns the entire revenue received from the goods and services tax to the states on the basis of an equalization or "relativities" formula. States' equalization payments are reduced by an amount proportional to the share of the goods and services tax they receive.

In Germany, all broad-based taxes, such as individual income tax, corporate income tax, and VAT, are shared. The revenue from individual income tax is shared by the federal government (42.5 percent), states (Länder) (42.5 percent), and municipalities (15 percent). Corporate income tax and capital yields taxes are shared equally by the federal government and the Länder. The VAT is distributed between the federal government and the Länder on the basis of legislation approved by the Bundesrat (the national legislature representing the Länder). Municipalities are required to remit 15 percent of their business tax revenues to the federal government and Länder (Fisher 1997).

4.4.1 Tax sharing: all taxes vs tax by tax

An issue pertaining to tax sharing that needs attention is whether the sharing should be from all the taxes collected by the federal government or should it be only from selective taxes. International experience shows that the tax sharing from all the tax revenues collected by the federal government is better than sharing specific tax revenues because experience shows that selective tax-wise sharing biases tax policy over time as federal governments invariably tend to focus more on those taxes which they do not have to share. This issue has been well-discussed in the literature. For example, Bird and Smart conclude "On the whole, the best way to provide both some degree of stability to local governments and some degree of flexibility to the federal government is to establish a fixed percentage of all central taxes (or current revenues) to be transferred as is (more or less) done, for example, in Colombia and Argentina. Sharing specific national taxes is less desirable than sharing all national taxes because experience shows that it biases tax policy over time as federal governments invariably tend to increase more those taxes which they do not have to share. Sharing all taxes also ensures that the ''pain'' as well as the ''gain'' of cyclical variations in central revenue is shared." (Bird & Smart, 2002, p. 900)

In India, initially, the Indian Constitution provided for the sharing of only two central taxes with states. Article 270 permitted mandatory sharing of the net proceeds of income tax levied and collected by the Union with the States. This position continued until the 80th Amendment of the Constitution in 2000 which provided for sharing of the proceeds of all Union taxes and duties with the states. However, certain sources such as the Central sales tax, consignment taxes, surcharges on central taxes and earmarked cesses are kept out of the divisible pool.

In Germany, the main taxes (VAT, income tax) are shared among all three layers of government. The vertical distribution of shared taxes is as follows: the income tax (including wage tax) is allocated to the Federation, the Länder and local governments at the ratios 42.5 percent; 42.5 percent; and 15 percent. The final withholding tax on interest and capital gains is shared at ratios 44 percent; 44 percent; and 12 percent. The corporation tax is shared among the Federation and the States in equal parts. The shares of income taxes are relatively stable since they emanate from provisions in the Constitution. The share of VAT however is subject to federal legislation (with the participation of the Länder) and may significantly vary over time in response to VFI that may emerge on the expenditure side. For the year 2009 the shares were Federation: 53.9 percent; Länder: 44.1 percent; and municipalities: 2.0 percent respectively. The distribution of tax revenues includes reducing the revenues of richer states in favor of the poorer ones. The local share of income taxes is basically by origin (residence principle), with a formula allocation of taxes on corporations. VAT is principally allocated on a per capita basis although up to 25 percent of the Länder share is apportioned with respect to the lack of revenue-generating capacity of a State.

In Nepal, the report recommends sharing of revenue from all taxes. This will simplify the sharing process and it will reduce biases in federal tax administration and collection. Apart from the pitfalls of selective tax by tax sharing mentioned above, the determination process is also going to be complex.

In some countries, the tax base sharing is in vogue. Tax base sharing could be when the federal and state governments tax the same base with different rates. This has become common especially in the case of value added tax or goods and services tax as in Australia, Canada, and India. For example, in Canada, Australia and more recently in India, the introduction of Goods and Services tax (GST) from July, 2017 provides for sharing of the GST base between the federal and state governments. With this, the current arrangement regarding tax devolution may undergo changes with the introduction of the unified. **In Nepal, it is preferable to share the VAT base between the federal and state governments.**

As regards the methods of determining the vertical share there are three ways to determine the total transfer amount through tax sharing to be: (i) as a fixed proportion of federal government tax revenues; or (ii) on an *ad hoc* basis, that is, in the same way as any other budgetary expenditure and (iii) through negotiations. **Till the federal fiscal administration is stabilized, it is preferred to determine the vertical share on *ad hoc* basis. Later, when the functioning of the states are stabilized and the fiscal capacities are clearly established, the vertical share determination can be based on more rational methods.**

4.4.2 Tax Reform for better Vertical Resource Sharing

An important step towards reducing the VFI could be reforming certain tax structures so that the tax revenues of the subnational governments can be automatically enhanced without any federal government intervention. Once such tax reform could be that of the value added taxation.

Revenue sharing requires firstly, to introduce a comprehensive value added tax combining the customs, excise-duty, value-added tax, passport fee, visa fee, tourism fee, service charge, fee and penalty collected by the federal government; house and land registration fee, motor vehicle tax, entertainment tax, advertisement tax, tourism, service charge, fee and penalty of the State taxes; Secondly, to prescribe a single or a few common rate structures for all goods and services – tax rate to be levied by the center and that by the states; and, thirdly, to specify the tax collection mechanisms. Once a comprehensive VAT is introduced, the sharing of revenues could be roughly 7 percent for states, 15 percent to local bodies, and 75 percent to central fund. To make subnational governments more autonomous, access should be given in VAT. The other taxes that can be considered for reform could be the house and land registration fee, house rental tax, entertainment tax and advertisement tax and vehicle tax.

For further analysis and recommendations on this aspect refer to component I “Improving Revenue Mobilization”.

4.5 Designing horizontal tax sharing

The horizontal tax shares are usually determined on the basis of a formula comprising three kinds of criteria for horizontal sharing are used: criteria representing the need factors, criteria representing the equity factors and those representing the fiscal effort and fiscal management. Usually, certain proxy variables are selected as representing each of these basic criteria, and the revenue share of the lower tier government is determined as $Si = \Sigma\ \beta i.\ Xi$ where Si = the share of i^{th} state /local government; Xi = selected criteria variable suitably proxied; and βi = appropriate weight.

India

With regard to use of horizontal sharing formula, one of the best experience is that of India. In India three phases are discernible in the *inter se* distribution of tax shares among States. In the first phase that lasted until the Seventh Finance Commission, separate formulae were recommended for the distribution of *inter se* shares of States in income tax and Union excise duties. Recommendation of a uniform formula for the *inter se* distribution of income tax and Union excise duties by the Eighth Finance Commission marked the beginning of the second phase which lasted till the Tenth Finance Commission. The Eleventh Finance Commission marked the beginning of the third phase with full convergence in the distribution formula when all the Union taxes became shareable with States. In the distribution of income tax, the first seven Commissions assigned an overwhelming weightage to population ranging from 80 percent to 90 percent and the residual weightage ranging from 10 to 20 percent was assigned to the factor representing the contribution of the state to the central revenues. Eighth Commission assigned a weight of 22.5 percent to the inverse of per capita income of States and 45 percent weightage to the distance of the per capita income of a state from the highest per capita income while reducing the weightage to population from 90 percent to 22.5 percent and retaining the weightage to contribution at 10 percent. The Eighth Commission, again for the first time, adopted a common formula for the distribution of 90 percent share of States in income tax proceeds and the States' share of Union excise duties. The Tenth Finance Commission had done away with the contribution factor. The shift in the different components in the formula for *inter se* distribution in favor of equity was carried forward by the subsequent Commissions.

Some of the Finance Commissions also considered other factors with specific weights – index of backwardness, distance of per capita income, income-adjusted total population, etc. The Seventh Finance Commission increased the weightages assigned to equity. The Tenth Finance Commission for the first time assigned weights to efficiency parameters in the distribution formula. That Commission assigned a weight of 10 percent to fiscal self-reliance as measured by the share of own revenues in total revenue expenditure of a State. The Tenth Commission also inducted disability factors represented by area and infrastructure distance into the distribution formula for the first time. The Commission assigned a weight of 5 percent each to these factors. Since then, the successive Commissions have been assigning weights to area. The introduction of elements of equity in the distribution formula was by and large welcomed.

The recommendation to reduce the weightage given to population to 10 percent and to assign a weightage of 62.5 percent to per capita income distance had resulted in the reduction of shares of high income and middle-income States in tax devolution. This evoked a sharp reaction from these States, even though the Commission assigned a combined weightage of 12.5 percent to tax effort and fiscal discipline. The contention of these States was that the better performing States were being penalized under the dispensation of the Finance Commissions and that this was creating a moral hazard for States to remain profligate and not to improve their fiscal situation. Though a need was felt to reward the States for better performance, it gathered momentum in the wake of the recommendation of the Eleventh Finance Commission according higher weightage to equity. The Twelfth Finance Commission increased the weight to population from 10 percent to 25 percent and reduced the weight assigned to distance of per capita income from 62.5 percent to 50 percent. Further, the Commission doubled the weightage assigned to efficiency parameters like tax effort and fiscal self-sufficiency.

The criteria used by the Finance Commissions in the formula for the horizontal distribution of tax shares across states can be broadly grouped under, a) factors reflecting needs, such as population and income measured either as distance from the highest income or as inverse, b) cost disability indicators, such as area and infrastructure distance and c) fiscal efficiency indicators, such as tax effort and fiscal discipline. While the weightage assigned to population has declined considerably, weightage assigned to income distance and efficiency factors has increased considerably in recent years.

Table 45 Evolution of Devolution formula: Criteria and weights

Finance Commission	Population	Area	Index of infrastructure	Percapita GSDP distance from a selected benchmark	Fiscal discipline	Tax effort	Demographic change	Forest cover
11th FC	10	7.5	7.5	62.5	7.5	5		
12th FC	25	10		50	7.5	7.5		
13th FC	25	10		47.5	17.5			
14th FC	17.5	15		50			10	7.5
Source: Various Finance Commission Reports, Government of India								

The criteria used with justifications are as follows.

1. Population: Ensures equal per-capita transfers
2. Distance: Indirectly facilitates fiscal capacity equalization
3. Area and Infrastructure: Bring in cost considerations

4. Fiscal discipline and tax effort: Incentives for better fiscal performance
5. Demographic change: Takes into account the population change
6. Forest cover: Bings in environmental considerations.

Germany

In Germany, as regards the inter-state horizontal equalization, it is carried out among the states themselves without interference of the federal government (although based on a federal law requiring the consent of the Bundesrat, the States' national assembly). The Federation complements the system through asymmetrical vertical grants. If the sub-national sharing is tax by tax, then the formula should also be tax by tax.

4.5.1 Horizontal tax sharing for Nepal – broad guidelines

The horizontal tax revenue sharing in Nepal can also be formula based. The sharing should be from all the central tax revenues to avoid the pitfalls of tax by tax sharing. The shares should be determined on the basis of equity as well as efficiency factors. However, since the fiscal efficiency and fiscal prudence of the states are yet to be known, the determination of the horizontal shares can be based more on equity and need factors.

Till now information is available only on certain structural factors such as area, population, forest cover, infrastructure, level of development. Suitable proxies need to be identified as also the weights for each factor. By and large, the choice of the factors, proxies and weights will be guided by intuition of the NNRFC and policy priorities.

Over the years, however, it is possible to adopt more scientific methods of determining the shares. One such method would be to identify the fiscal gap. The fiscal gap is the difference between own source revenue (OSR) and the expenditure. In the case of Nepal, we attempted to estimate the likely state-wise fiscal gaps as follows. Assuming that the total income (OSR + grants) of each DDC is equivalent to its total expenditure, and aggregating them across the constituents DDCs, estimates of fiscal gaps for each of the seven states are obtained as in Table 46. The fiscal gap is quite high, the mean being 80 percent. It varies from 69 to 90 percent but not statistically significant. It supports the observation that in Nepal the VFI is quite high.

Table 46 State-wise Fiscal gaps derived from the constituent DDCs for 2015/16

(NPR million)

State	Total Grant	Revenue share	Own Source Revenue (OSR)	Total Revenue	Grant+Total Revenue	Fiscal gap	Fiscal gap as percent of expenditure
State 1	1,066	325	327	652	1,718	1,391	81
State 2	797	185	163	348	1,145	982	86
State 3	1,213	675	844	1,519	2,732	1,888	69
State 4	725	330	267	597	1,321	1,055	80
State 5	984	257	450	707	1,691	1,241	73
State 6	656	75	106	181	837	731	87
State 7	509	36	64	100	609	545	90

Source: Local Bodies Fiscal Commission (LBFC), Report on Financial Status Analysis of Local Bodies, 2017
Assumption: Total expnditure = Total Income

It is important to analyze what factors cause the fiscal gap. Some factors are structural in nature, such as the area, population, and the composition of income, extent of backwardness, poverty, literacy, infrastructure etc. These factors are common for all the states. The second set of factors are effort factors – the effort in raising the revenues. Some states put more effort and some states put less effort. A composite index can be developed that combines the factors, for example a linear weighted sum or average. The vertical revenue share is distributed according to the composite index.

An important drawback of this method is the arbitrariness in identifying the factors, difficulties in choosing the right proxies and quantifying them, and objectively assigning the weights before combining them into a composite index. Utmost caution is needed as the resultant share pattern could be highly sensitive to even small alteration in quantifying the factors.

A more refined procedure could be to express the fiscal gap as a linear function of all possible factors and estimate the function through regression method on cross-section or panel data as suggested by Sarma (Sarma, 1997). The advantage of this method is: Firstly, it is possible to objectively identify the relevant factors or their proxies. For example, if variations in urbanization (share of urban population in total) is not relevant for variations in fiscal gap, its regression coefficient tends to become statistically insignificant. If on the other it is responsible for variations in the fiscal gap, then the regression coefficient will be statistically significant. The final regression will contain only those factors which are significant, implying that those are the factors responsible for the size of the fiscal gap. Of course, caution needs to be exercised in properly identifying the fiscal gap, properly identifying the factors, properly specifying and quantifying the proxies and properly estimating the regression. An important advantage of this method is that the weights of the factors emerges as regression coefficients. What is more, through a more refined weighted least squares method is used, the resultant weights reflect the relative importance of the factors. The estimated fiscal gaps can be used to derive the horizontal shares for each state. The development of the method in more detail is given in (Sarma, 1997). The regression (more specifically the weighted least squares regression) can be estimated based on the cross-section data of the 7 states. The estimated fiscal gaps of the states can indicate the size of the tax shares.

4.6 Options for Grants

The other broad channel of IGFT is grants. With the transformation to federal system from the unitary system, with the changes in the tax assignments to the subnational governments, and with the provisions to share the tax revenues, one can expect that the needs for grants could be smaller than earlier.

International experience shows that although the type and nature of the grants differ depending upon the country's situations, there are certain common features regarding grant systems. For example, virtually, all federations have certain equalization grants. In addition, there are grants with conditions that induce the subnational governments to meet national objectives. The following are the types of grants are provided to SNGs in different countries.

4.6.1 General Purpose Unconditional Bloc grants

In the case of unconditional grants, no restriction is imposed on the use of funds. It is a lump sum amount of money provided to the subnational governments. In most cases this grant is provided for equalizing fiscal capacities to ensure that a minimum standard and level of public service is provided to its citizens. Unconditional grants, are the best for promoting autonomy of the states and local bodies and inter-jurisdictional redistribution. They are also termed 'block grants' which simply augment the recipient's resources.

However, experience with the general purpose unconditional grants show that these grants are prone to a phenomenon referred to as the 'flypaper effect'. It implies that grants to local governments tend to result in more local spending than they would have had the same transfers been made directly to local residents for political and bureaucratic reasons.

Since tax sharing is going to be a significant transfer, the unconditional or Bloc grant can be reduced to some extent. An amount of 10 percent of the revenues is suggested for the pool of unconditional grants. (Policy Research and Development Nepal, 2009).

4.6.2 Conditional / Specific Purpose grants

Conditional grants are specific purpose grants or categorical grants, wherein the federal government specifies the purpose for which the recipient local body can use the funds. "In comparison with taxation, intergovernmental grants are likely to create the impression of zero political costs for the recipient government, and thereby result in a loss of accountability and efficiency. If, however, grants are given for specific purposes and carry with them at least some obligations towards the government which gives them, accountability is comparatively enhanced. Thus, on the criterion of accountability, specific purpose grants should be ranked higher than general revenue grants, which in turn are superior to taxation." (Grewal, 1975).

Conditional grants can be matching or non-matching. In the case of conditional matching grant the federal government asks local bodies to match certain portion of the expenses on specific programs as a condition to receive the grant.

Canada

A good illustration of a simple but effective output-based grant system is the Canadian Health Transfers program by the Federal Government of Canada. The program has enabled Canadian states to ensure universal access to high-quality health care to all residents regardless of their income or place of residence. Under this program the federal government provides per capita transfers for health to the states, with the rate of growth of the transfers tied to the rate of growth of GDP. No conditions are imposed on spending, but strong conditions are imposed on access to health care. As part of the agreement to receive transfers from the federal government, the states undertake to abide by several access-related conditions. In Switzerland, the equalization system was introduced in 1938 in the form of conditional grants that varied according to the tax capacity of the cantons. **In Nepal, efforts can be made to introduce conditional transfers for health and education and to some extent for drinking water too; specify the conditions in terms of program outcomes and link the grant to the achievement**.

4.6.3 Matching Grants

Certain grants may incorporate matching provisions – requiring grant recipients to finance a specified percentage of expenditures using their own resources. The matching grant, for instance, will be provided for infrastructure projects based on feasibility and cost of projects. Factors such as project's impact, availability of financial, physical and human resources required to implement the project, and the project's importance will also be taken into account while extending the matching fund. The matching grant could be open-ended or closed-ended. Open-ended matching grant is a type of grant in which the federal government does not impose a limit on the matching funds. Closed ended conditional matching grant is such a grant for which the federal government puts a maximum ceiling on the cost to be borne to finance a particular service.

Matching requirement encourages greater scrutiny and local ownership of grant-financed expenditures and is helpful in ensuring that the grantor has some control over the costs of the transfer program. Matching requirements, represent a greater burden for a recipient jurisdiction with limited fiscal capacity. However, matching transfers may distort local priorities and be considered inequitable as richer jurisdictions can raise matching funds more easily. But the latter problem can be offset, if desired, by varying matching rates with jurisdictional wealth and the former may be the desired outcome when the transfer is intended to e.g. internalize spillovers or achieve overriding national policy objectives.

4.6.4 Equalization Grants

Adapting the federal system with decentralization of expenditure and revenue raising invariably creates different fiscal capacities across regions, making it impossible to provide comparable levels of public services at comparable rates of taxation. This is so because, to provide a given level of public goods and services, different states require different amounts of expenditure per capita, for the following reasons:

(i) differences in the composition of the population across regions need different types of public services;
(ii) differences in the cost of providing a given level of public services, due to different wage costs, transportation costs, population densities, and other factors differ across regions; and
(iii) differences in the regional preferences for public goods and services; and,
(iv) different tax bases per capita across regions generally requiring different tax rates to generate comparable levels of revenue per capita.

There are two broad types of fiscal equalization: Fiscal Capacity Equalization (FCE), and Horizontal Equity Equalization (HEE). Fiscal Capacity Equalization (FCE) is the traditional interpretation, widely used in Canada, Australia, Germany and Switzerland. This model, calls for transfers from lower level jurisdictions (states) with high per capita income and low per capita needs to those of opposite characteristics. The Horizontal Equity Equalization (HEE) is an alternative view which seeks to apply the rule of horizontal equity (the equal treatment of individuals in equal positions) across the fiscal operation of states and does so on a nationwide basis. The fiscal treatment given by lower level jurisdictions should be the same for individuals in equal positions, independent of the jurisdiction in which they reside. Usually the FCE grants are easier to determine and are more popular.

Across the OECD, fiscal equalisation transfers average around 2.5 percent of GDP, 5 percent of general government spending, and 50 percent of intergovernmental grants. (OECD, 2014).

Australia

Australia introduced a formal system of horizontal fiscal equalization in 1933 to compensate states/territories, which have a lower capacity to raise revenue. The objective is full equalization which means that, each of the six states, and the Australian Capital Territory and the Northern Territory would have the capacity to provide services and the associated infrastructure at the same standard, if each state/territory made the same effort to raise revenue from its own sources and operated at the same level of efficiency. At present, only GST revenues are distributed to achieve equalization.

The equalization grants seek equalizing fiscal capacity, not fiscal policies of the states. Nor do these grants are expected to result in the same level of services or taxes in all states, nor do they direct that the states must achieve any specified level of service in any area, nor impose actual budget outcomes. The principle is that each state should be given the capacity to provide the average standard of State-type public services, assuming it: (a) operates at an average level of efficiency; and, (b) makes the average effort to raise revenue from its own sources. The Commonwealth Grants Commission is entrusted with the task of developing state relativities based upon the above principle for use in grant allocation. These relativities are defended in open adversary proceedings by the Commission, and a final report is presented to the Commonwealth cabinet for review. The cabinet occasionally revises the recommended relativities based on its own view of relative fiscal needs. Following this review, a final determination is made in the Annual Premiers' Conference.

Canada

In Canada, as a federal system of government, there is also a commitment to fiscal equity within the Canadian economic union. Fiscal equity is an extension of the principle of horizontal equity to federal systems of government: individuals in similar economic circumstances should be treated in a like manner by state government, regardless of province of residence. If different states are able to provide different levels of NFBs to their residents, the principle of fiscal equity will be violated.

In Nepal, Article 60 (4 and 5) of the new Constitution provides for distribution of fiscal equalization grants to the state and local governments, on the basis of two main criteria: expenditure need and revenue capacity.

4.6.5 Performance-based Grants (PBGs)

Another category of grants that can be useful are the PBGs. PBGs can be used towards providing subnational governments with tangible incentives to improve their overall institutional, organizational and functional performance, thus making the grant more effective, efficient and responsive as a strategy for the delivery of public goods and services. By linking the level of funding that subnational governments receive in the form of fiscal transfers to their performance, such grants can provide incentives to improve their activities such as revenue collection, planning, budget execution, accountability, financial management, and good governance in general.

India

In countries such as India, the PBGs take the form of incentives under the Fiscal Responsibility and Budgetary Management (FRBM) system. Under this, states are required to keep the fiscal deficit and revenue deficit under certain limits, failing which they attract certain penalty which is then distributed among those states that manage the deficits within limits. There could be other types of PBGs

4.6.6 The Minimum Conditions and Performance Measurements (MCPM)

In Nepal, the PBGs already exist in the form of MCPM. The MCPM is a performance-based system providing incentives to improve local governance, financial management, participation, revenue mobilization, planning, and budgeting, service delivery, among others. As such, the importance of the system is being increasingly realized by the GoN and development partners (DPs). The government believes that MCPM system has helped promoting accountability at the local level and ensuring basic local service delivery. The fact that GON has included its own funding from the grant system and expanded the original pilot to a nation-wide system is a strong indication of major trust in the overall system. Additionally, there is a solid belief that it has enhanced level of compliance of the LGs with respect to many legal and policy provisions as contained in the MCPM assessment manual. It has also assisted the government to identify capacity gaps of the LGs. Because of this, the multi-donor funded Local Governance and Community Development Program (LGCDP) has also regarded the MCPM as a major tool for its implementation and has been providing funds to the LGs based on the MCPMs results. In Indonesia, MCPM is used to improve the institutional, organizational and functional performance of SNGs in the name of Local government Performance Evaluation System. In Ethiopia, it is known as Woreda (City Government Benchmarking System).

MCPM grants are based on an objective evaluation of LBs and a measuring rod to assess their accountability, transparency and responsiveness. This on one hand encourages the local bodies to improve their performance by recognizing their good undertakings and on the other helps to tie up grants with their capacity that will enable capable local bodies to acquire additional grants. Along with this it will assess their strengths and weaknesses and improve their performance by minimizing weaknesses. It has been mandatory to fulfill the minimum conditions for measuring performance.

The considered opinion has been that MCPM should be promoted and strengthened as this has proven to be an effective tool to safeguard fiduciary risk of local government finance. However, the system should continue to focus on public financial management and good governance. There is of course, a need for sharpening of the system within its existing objective and limitations. For example, it can be examined if it can also accommodate sectoral or other functional objectives as well. At the same time there is need to see that it does not get overloaded and the system should continue to focus on its core objectives and principles. Hence, it is important to keep the system simple and possible to manage. One aspect of the MCPM that needs attention is to link the system with capacity building of local bodies. Another concern is regarding the timing of assessment. It is observed that the system has not been able to produce assessment-results and subsequent announcement of the grants before the planning session of local bodies starts. The MCPM grants should be continued with these changes; like simplification of assessment process so that it is less time consuming and for a time being (until enhancement of capacity by them in a defined level) applying only MC for village municipalities..

4.6.7 Capital Grants

Federal governments have two reasons to be interested in what state and local governments do in financing infrastructure. First, some local infrastructure projects may involve significant externalities, second, some such projects may constitute essential elements of national development programs, and third, some of the capital projects may be part of the overall national development plans and therefore need federal government interventions and plan-related grants.

4.7 Broad Principles for designing the grant formula

In general, the grant formula has to identify the elements that appropriately reflect the objectives and indicators or proxies for measurement for example as in Table 47.

Table 47 Principles for grant formulae

Grant objective	Criteria to be used
Provide grants for the expenditure needs and regional cost differences	Population; Indicators of physical factors influencing costs of service provision, eg., land area, population density, and urbanization; Measures to reflecting concentration of high cost population eg., the percentage of families living below the poverty line, the percentage of people on pensions, the percentage of school aged children, etc.;

	Indicators of infrastructure needs, eg., miles of paved highways, percentage of households with access to adequate water supply, infrastructure needs to support economic development, etc.
Equalize local body income or fiscal capacity	Level of average income, or size of tax base; Amount of money that could be raised if all appropriate tax bases were subjected to normal (average effective) rates.
Provide incentives to increase revenue	A measure of tax effort and management performance; Maintenance of a level of revenue mobilization.
Achieve a balance between revenue capacity and expenditure needs	Defined standards of expenditures for desired levels of service, link minimum expenditure requirements with assigned tax revenues; Interpolation of historical expenditure figures.

Formula grants are administratively demanding to manage the system. A responsible unit to maintain the database and manage the system is considered necessary. To assess efficiency and effectiveness of the system, or identify issues for revisions, grant systems need to be monitored and tracked continuously.

In Nepal, under the unitary system, different formulae are used for horizontal distribution of grants from federal government to local bodies. **Under the federal system similar formulae are to be designed taking into consideration factors such as population, area, population density, ratio of population below poverty line, urbanization, backwardness, state of economic and social foundation, possibility of revenue collection, effort to collect taxes, fiscal discipline of the state/local level are included.** Sharing the revenue on the basis of formula, it would be transparent, predictable and out of political interference. The effect, consequences and their compensation also should be considered during revenue sharing on the basis of formula.

4.8 The Transfer Designing and Monitoring Institution – The NNRFC

For federal fiscal transfer management, Part 26 (Article 250) of the constitution provides for the establishment of independent constitutional body, namely, the 'National Natural Resources and Fiscal Commission' (NNRFC) to look after the fiscal matters and the management of natural resources.

The NNRFC would consist of a chairperson and a maximum of 4 members with a tenure of 6 years, who are not members of any political party at the time of the appointment. Expertise, experience, and integrity are the criteria for selection and appointment as a chairperson or members. A measure of impartiality and objectivity is assured by the security of tenure and assured remuneration. Conflict of interest is sought to be curbed through prohibiting their further employment in the government.

As per Article 250 of the constitution, the NNRFC is designated to manage the IGFT that addresses vertical and horizontal imbalances between federal and subnational governments. Further, as per the constitutional mandate the federal government shall devise formulae based on certain parameters for distribution of various grants including the fiscal equalization grants to province and local level entities. Article 251 lists out the functions in detail (**Error! Reference source not found.**).

The functions specified for NNRFC more specifically cover the following aspects of the transfer system:

1. The methods to reduce the fiscal imbalances – vertical and horizontal
2. Types of transfers needed, tax sharing vs grants,
3. Design the formulae for determining the tax devolution shares,
4. Types of grants – unconditional, conditional, matching, equalization, capital grants,
5. Methods of implementing and monitoring the transfer system in line with the relevant Constitutional provisions.

The NNRFC should be reasonably autonomous and powerful. It is also necessary to have dispute resolving and grievance redressal body. Since it is likely that many issues and disputes may be arise in relation to usage of natural resources. The composition and the capacity of NNRFC should be suitable to perform all these assignments.

Most countries that adopted federal systems invariably have dedicated institutions to manage the federal fiscal transfers and relations. The mandate, scope of work, duration of existence, duties and functions of such commissions differ across the countries. For example, Australia has independent and permanent Commonwealth Grant Commission (CGC). India and Pakistan have constitutional temporary and expert based Commissions. South Africa has independent, advisory, constitutional, and permanent commission. In Australia, the scope of commission is limited to the revenue collected from GST. The scope of transfers in Canada is broader and it includes health transfer, social transfer, equalization and territorial formula financing and associated equalization functions. In India, the primary duty of the Finance Commission is to make recommendations regarding the distribution between the Union and the States of the net proceeds of taxes, and the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund as well as the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Municipalities. The main duty of the Fiscal Finance Commission of Africa is to provide proactive, expert and independent advice on promoting a sustainable and equitable IGFR system to the Government, through evidence based policy analysis to ensure the realization of our Constitutional values. Accordingly, the organizational structure also differs across the countries.

Australia

Australia runs a lean Commission, comprising of a Chairperson and 3 members, all are experts and not representing any stakeholder interest. The Secretariat is headed by a full time Secretary, under whom two branches (Branch A and B) operate, each headed by an Assistant Secretary. Branch ‘A’ deals with three sections, namely, the Revenue and Business Management, and sections that deal with ‘Economic Development & Education’, and ‘Health & Roads’ respectively. Branch B also headed by an Assistant Secretary, has four sections, dealing with ‘Capital and PTEs’, ‘Data Management’, ‘Location & Justice’ and Welfare & Transport’ respectively.

South Africa[30]

In South Africa the Fiscal Finance Commission, contains 9 members including Chairperson and Deputy Chairperson. The Secretariat of the Commission has four divisions: Commission Secretary, Finance, Corporate Services and Research and Recommendations Programme. The Executive Management Committee (EXCO) is chaired by the Chairperson/Chief Executive. EXCO is committed to principles of transparency, accountability, efficiency and effectiveness, and the practical application of these principles to enable delivery of the constitutional mandate. The commission in South Africa makes recommendations for equitable distribution of national resource among the national, provincial and local government spheres of government, each recognized by the constitution. The commission’s recommendations are not binding but they serve as a basis for national, provincial and local government consultations and legislation for distribution of resources. The FFC mandate is related to the equitable share concept established in the constitution. The national parliament is obliged under the constitution to make an equitable distribution of national resources between the three spheres of government, determine an equitable share of each province in the provincial share and provide grants to provinces and local governments. The constitution makes it obligatory for the parliament to consult FFC and consider its recommendations.

India

In India, once the Commission is constituted, there exist set procedures to enable the Commission to function smoothly. The Commission is delegated the powers of a department of the government and in exercise of these powers, in its first meeting it approves a simple set of rules of business, which covers how the Commission is to meet, its consultation and internal protocols. The Commission has a list of sanctioned posts, which has settled down through practice and comprises of a Secretary, an economic adviser, 2 Joint Secretaries, 4 Directors, 3 Joint Directors, 3 Deputy Directors and 8 Assistant Directors. The Commission also has space for full time consultants.

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[30] The Annual Report 2016/17, Finance Fiscal Commission, South Africa, www.ffc.co.za

Internationally, in the time of designing the structure of the Finance Commission, the issues of professionalism that implies fairness and equal treatment, free sharing of information, striving for quality and time management are significantly considered and addressed.

4.8.1 Guiding Principle of Designing the Structure

On the basis of the Constitutional provisions, provisions mentioned in NNRFC Bill submitted by the GoN and taking into account the international practices, a suitable operational structure of the Commission for Nepal should have the following features:

- First the commission should be lean, supported by well-qualified staff to handle the wide range of duties with minimal administrative workload and cost as well.
- Second, the Chairperson and members must focus on the core functions rather than a day to day duties,
- Third, ensure the stability and continuity of human resources through stable service tenures and avoiding frequently changing provisions.
- Fourth, ensure high quality of database management and research capability through open arrangement of competent professionals and expert from the market as well as availability within government/public services.
- Fifth, the Commission must be well equipped to undertake outreach activities and provide time and resources for capacity building of the next generation of inter-governmental fiscal actors.

In relation to Nepal, the broader approach and structure of NNRFC as permanent institution, numbers of members, tenure of members, qualification and eligibility for the appointment of chairperson and members as well as functions, duties and powers of the NNRFC is provisioned by the Constitution. **This Report proposes an operational and administrative structure of the NNRFC (table 10).**

Table 48 A suitable operational and administrative structure for the NNRFC

Major Attributes	Description	Basics/Provision	Justification
1. Broader Component/ Divisions	Divide in two divisions: (i) Natural Resource, (ii) Fiscal Arrangement	Both will be led by the Chairperson on support of the Secretary as an Administrative Chief.	Because of the nature of work area is different, both area needs different specifications and the matter of expertise.
2. Sect oral Divisions	Comprising both broader components the Divisions will be: (i) NR Policy, Research/Analysis, Distribution and Management Division (Led by NR Advisor and supported by Policy Analyst) (ii) Economic Research and Analysis Division (Led by Economic Advisor), (iii) Fiscal Policy and Transfer Division (led by Joint Secretary who has the experience on fiscal policy and management), (iv) Data Collection , Management & Monitoring Division (Led by Data management Expert) (v) Internal Management Division-IMD (Led by Joint Secretary)	By policy matter the divisions will be led and looked after by the members; each divisions, except internal management division, at least one subject specialist expert will be deputed as staff employee. Operational and day to day work of will be led by the Joint secretary.	1/ Create the sectorial divisions under the broader components keeping in mind the nature of works and provincial arrangement**;** **2/Depute full time consultant at least in the area of economics, finance, natural resource management, demography, geography, data management, sociology and human development as assign the work in concern Divisions**

Major Attributes	Description	Basics/Provision	Justification
3. Sub Divisions	(i) NR Policy, Research, Distribution and Management (proposed sub divisions -Policy Review and Research (Led by Research Associate) -Distribution (Under Secretary) --Coordination and Dispute settlement (Led by legal advisor-Undersecretary) (ii) Economic Research and Analysis Division - Research (led by Research associates with supports of Research assistants) -Budgetary Analysis of Federation and provinces (led by under Secretary Finance) (iii) Fiscal Policy and Transfer - Policy Review -Revenue Sharing and Grant/Transfer for provinces -Revenue Sharing and Grant/Transfer for provinces for Local levels (iv) Data Collection & Management Division -Data Collection, -Hardware -Software and procedures (Each to be led by IT Associate of such component) -Reporting & Monitoring (v) Internal Management Division-IMD As per the nature of work and their break downs (however the sub divisions under IMD may less or more as per the internal management norms in other regular agencies; such as Finance/Accounting, Internal audit, Procurement, Human Resources, Legal, Public Relation).	Create up to 3 subdivisions within the Division as per requirement). Each sub division will work for one or two provinces as pert the decision of the Commission on the basis of nature of works in relation to Provinces. The subdivisions will be led by the Under Secretary level employees as well as others as required as per the nature of job.	Create the sub divisions under the sectoral divisions keeping in mind the matter of addressing provincial relationship and their concern to harmonies and coordinate with federal level.

Notes:

1. The Organogram can be developed based on proposed Organizational Structure showing the authority and line staff.
2. The proposed structure of the NNRFC has been designed under hybrid approach with proper mix of sector wise specialist and regular staff from the Government services that help to make it more coordinative and competitive; the works should be divided in broader approach that related to the NRs and fiscal and financial; divisions and sub divisions can be divided accordingly, and the Divisions will be led by the specialist and regular high level staff as per the nature of job (The is proposed accordingly)..

5. Policy Recommendations with detailed implementation steps and framework

Based on the PATA team's assessment of the present scenario in Nepal and discussion with the stakeholders the following recommendations are suggested in relation of the intergovernmental fiscal transfer suitable for implementation in Nepal.

The recommendations are as follows:

Recommendation 1: Suggestions for NNRFC

(a) Facilitate effective and accurate data collection

For the effective and efficient functioning of NNRFC, the commission should have access to reliable, accurate and adequate sources of data. Concerned agencies should be ascertained and made responsible for providing timely data to the commission, which would be essential for formulating measures of expenditure needs and fiscal capacity.
Therefore, commission should have power to collect data and seek reports from government agencies.

(b) Financial autonomy of NNRFC

Financial autonomy of NNRFC is very important. If the commission has adequate resources at its disposal to carry out its functions and has the authority to execute its budget without recourse to approval from the MoF, it will enjoy autonomy in its budgetary decisions and would be able to function effectively and efficiently.

(c) Deployment of subject/sector specialists

Subject/sector specialists such as economists, geographer, demographer, sociologist, etc. should be deployed to make the commission more capable to determine and develop norms, criteria and indicators of revenue distribution and make the transfers more transparent and rational.

(d) Relationship between GoN and NNRFC

The bill should suggest the coordinating ministry that would provide a link between the GoN and the NNRFC. The consulting ministry should be determined as per the nature of functions. Since most of the functions are related to fiscal matters, MoF may act as the nodal point between the two.

(e) Capacity Building

The Commission should be well equipped to undertake outreach activities and dynamic living organization by providing time and resources for capacity building of the next generation of inter-governmental fiscal actors.

(f) Deployment of manpower

There should be clarity about the approach for deployment of human resources/employees, i.e. whether the commission will have separate service or whether the employees will be deployed by GoN. From the perspective of development of professionalism, expertise and independency for fair and free recommendations separate service may be more effective.

(g) Proposed structure[31] of NNRFC

The structure of the commission should be lean and efficient with support of well-qualified staff to handle the wide range of duties that will reduce administrative workload and cost as well. The Chairperson and members should focus on the core functions and not day to day administrative duties. The stability and continuity of human resources should be ensured through stable service tenures and avoiding frequently changing provisions. Also, high quality database management and research capability should be ensured through open arrangement of competent professionals and expert from the market as well as availability within government/public services.
Following structure of NNRFC has been suggested (as per Constitution of Nepal) below.

Major attributes	Description	Constitutional Provision
Apex Body	Board of Chair and Members (5 members including chairperson)	Article 250.1

[31] The structure has been designed based on the constitutional provisions of Nepal and the discussions that were undertaken with concerned representatives of the GoN

Recommendation 1: Suggestions for NNRFC		
Appointment[32] and tenure	By the President on the recommendation of the Constitutional Council (CC) for 6 years	Article 250.2
Vacancy	In the circumstances of (in case of), the Chair/Member: i) submits resignation in writing to the President, (ii) attains the age of 65 years, (iii) a motion of impeachment is passed against the him/her (under Article 101) (iv) is removed from office by the President on recommendation of the CC on grounds of inability to hold office and discharge the functions due to physical or mental illness, (v) If dies.	Article 250.4
Remuneration	-As provided for in the Federal law, -Shall not be altered to their disadvantage, so long as they hold office,	Article 250.7
Functions, duties and responsibility	Mainly: (i) recommending on the grant distribution, (ii) revenue sharing and taxation matters, (iii) determining the extensive grounds and measures, regarding the distribution of revenue, (iv) conducting research and studies with regard to making a basis for distribution of conditional grants, (v) reviewing the bases of revenue distribution and (vi) facilitating and assisting to the GON on settlement of disputes.	Article 251.1
	To recommend on fiscal equalization grant to provide to local level by the Province and about the basis and criteria of providing conditional grant to local level by the Province. To facilitate and assist to the GON on settlement of dispute raised between federation province and local level of the distribution of revenue	
Rights	NNRFC may: - Acquire advisory/consultative services (from constitutional bodies, government office and public organisations), - Take expert view/services (personal and institutional) - Form any task force or committee for a specific purpose, (TOR as defined by the Commission), - Establish coordination and cooperation with the Ministries of GoN and other agencies, - Get cooperation regarding the information, description and assistance from any agencies or authorized person, - Take decision regarding the work segregation of the Commission	
Additional recommendations by the PATA team on structure of NNRFC		
Broader Component/ Divisions	Since nature of work is different the commission can be broadly segregated into two divisions: (iii) Natural Resource, (iv) Fiscal Arrangement Both the divisions will be led by the Chairperson with the support of the Secretary as an Administrative Chief	.
Sectoral Divisions	The above broad divisions can be further divided into the following sections/divisions: **(i) NR Policy, Research/Analysis, Distribution and Management Division** *(Led by NR Advisor and supported by Policy Analyst)*	

[32] Required qualification (as per the article 250.6 of the Constitution of Nepal): (a) having gained expertise upon being active for at least twenty years in the field of natural resources or fiscal management, economics, law, management, after holding a bachelor's degree in the relevant subject from a recognized university, (b) not being a member of any political party at the time of appointment, (c) having attained the age of forty five years, (d) being of high moral character.

Recommendation 1: Suggestions for NNRFC		
	(ii) Economic Research and Analysis Division *(Led by Economic Advisor),* **(iii) Fiscal Policy and Transfer Division** *(led by Joint Secretary who has the experience on fiscal policy and management)* **(iv) Data Collection & Management Division** *(Led by Data management Expert)* **(v) Internal Management Division** *(Led by Joint Secretary)*	
Sub Divisions	Proposed sub-divisions are as follows: **(i) NR Policy, Research, Distribution and Management** -Policy Review and Research *(Led by Research Associate)* -Distribution *(Led by Under Secretary)* --Coordination and Dispute settlement *(Led by legal advisor-Undersecretary)* **(ii) Economic Research and Analysis Division** - Research *(led by Research associates with supports of Research assistants)* -Budgetary Analysis of Federation and provinces *(led by under Secretary Finance)* **(iii) Fiscal Policy and Transfer** - Policy Review -Revenue Sharing and Grant/Transfer for provinces -Revenue Sharing and Grant/Transfer for provinces for Local levels **(iv) Data Collection & Management Division** -Data Collection, -Hardware -Software and procedures *(Each to be led by IT Associate of such component)* **(v) Internal Management Division** As per the nature of work (however the sub divisions under IMD may less or more as per the internal management norms in other regular agencies; such as Finance/Accounting, Internal audit, Procurement, Human Resources, Legal, Public Relation). An organogram for the NNRFC will be recommended in the draft final report.	

Recommendation 2: Possible suggestions for IGFT Act
Based on the constitutional provisions and discussions with the officials representing the GoN, the following suggestions are made:
Revenue distribution
VAT and Excise Duty VAT and excise duty will be imposed and collected by the federal government and deposited in a federal divisible fund; thereafter, it will be distributed among three levels of government. The ratio of distribution should be provided in the legislation. **The share of the state and LG should be gradually increased based on their expenditure needs and spending capacity which will mature eventually in the long run.** **Royalty from natural resources** Previously, as per the Local Self Governance Act (LSGA) 1999 (sec 220) and its regulation, royalty collected by the GoN (federal) was distributed to the DDCs as per: 1) Royalty on hydro-electricity- 50% (out of this amount 12 % for the DDCs where the power house is located and rest was divided to all DDCs of the concern Development Region) 2) Royalty on Mining- 50%, to the concern DDCs, 3) Royalty on Mountaineering- 30%, to the concern DDCs 4) Royalty on use of forest based resources- 10%. to the concern DDCs **The PATA team suggests that the royalty collecting power with regards to mining and use of forest resources may be given to the states since the responsibility of protecting and preserving such resources vest on them.**
(b) Formation of Intergovernmental Fiscal Council
The major role of the council would be to consult and coordinate the matters of intergovernmental fiscal arrangement with the three levels of governments. The federal law should mention the scope of work of the council in detail along with the process of coordination and consultation for effective, transparent and timely functioning of the council.

Recommendation 3: There is a need for reducing the VFI. This can be achieved either by amending the constitution to give more tax powers to subnational governments; or by providing sufficient vertical transfers from federal government to state governments, and from state governments to local governments.	
Existing practice	The more productive taxes are all in the central list. The SNGs do not have significant revenue yielding taxes.
International experience	There should be a further review of assignment of taxes. Many countries have taxes whose bases are taxed by both the federal and provincial governments.
Explanation of the recommendation (elaboration)	With the present constitutional division of tax powers, the major revenue yielding taxes are in the central list, while the taxes and non-taxes in the SNG schedules are not so revenue productive. This will lead to high and growing vertical imbalances and eventually to high dependence of SNGs on the central transfers.
Rationale	While central transfers are desirable to some extent to keep the balance, too much dependence of SNGs on central government is against the principles of federation.
Desirable objectives to be achieved	Therefore, devolving some more tax powers to the SNGs is desirable to reduce their dependence on the center.
Implementation steps	Attempt should be made to find new sources of taxation and find ways of dividing the productive tax bases, for example sharing of the VAT

Recommendation 3: There is a need for reducing the VFI. This can be achieved either by amending the constitution to give more tax powers to subnational governments; or by providing sufficient vertical transfers from federal government to state governments, and from state governments to local governments.	
Timelines for implementation	**Short term**

Recommendation 4: Determine a fixed portion of all the revenues collected by the federal government to be devolved to the state and local governments.	
Existing practice	So far there is no such practice in Nepal of sharing a fixed proportion of the revenues collected by the federal government. This should be taken up by the NNRFC.
International experience	VFI is usually tilted towards federal government. However, Switzerland and Germany are exceptions, with 25 percent and 45 percent of revenues accruing to federal governments. In Australia tax sharing was undertaken for three different purposes at different times: for payroll tax revenue; compensating for revenue loss on account of abolition of excise duties; for revenue loss due to introduction of GST. To reduce the VFI, the federal government in Australia provides funds to the states to support funding for service delivery. During 2013-14, these transfers accounted for 25 percent of federal expenditure and around 40 percent of states revenue. In Canada, the VFI is comparatively less as the state government collects 53 percent of the revenues and spend about 63 percent of the combined expenditure. In Germany, all broad-based taxes, are shared. In India, the 80th Amendment of the Constitution in 2000 provided for sharing of all Union taxes and duties with the states. The determination of the vertical share depends upon the country specific circumstances and conditions.
Explanation of the recommendation (elaboration)	There are two ways of determining the vertical share. One way is to make good the fiscal gaps of the sub-national government. In this case, the vertical share should be made equivalent to the aggregate of subnational fiscal gap. This might leave a significant fiscal gap at the federal level which needs to be met through new borrowings. Alternatively, the fiscal gaps of the federal and state governments can be kept at equal level, and allow the sub-national governments, especially the state governments, to go for borrowing. This is a policy issue. In this case, the vertical share should be determined in such a way that the fiscal gaps at the national and sub-national level are equal. This requires a policy of allowing the SNGs to borrow from the market, the feasibility and viability of which, is to be examined.
Rationale	Minimising the vertical imbalances.
Desirable objectives to be achieved	Performance of SNGs as per the economic right assigned , delivery of services in time as desired quality

Recommendation 4: Determine a fixed portion of all the revenues collected by the federal government to be devolved to the state and local governments.	
Implementation steps	The vertical share of the tax revenues has to be arbitrary to begin with and gradually will have to be fine-tuned over the years by taking into account other economic policies.
Timelines for implementation	**Short term**

Recommendation 5: The Report recommends sharing of revenue from all the central taxes and not tax by tax sharing. This will simplify the sharing process and it will reduce biases in federal tax administration and collection.	
Existing practice	Most of the federal countries rely on tax sharing as a viable method of federal fiscal transfers.
International experience	In USA, India, and other countries, the horizontal shares are determined using certain criteria. These criteria represents the need and efficiency and capacity factors. The need factors are proxied to represent the need for making the backward state catch up with the other states. These factors are level of development (percapita income distance, population density, backwardness, etc). The efficiency factors are the tax effort, fiscal discipline, etc. The capacity factors are the percapita income, area related factors and so on. Each of these factors are assigned certain weights, determined either intuitively, or based on scientific observation over time as to the importance of the factor in influencing fiscal status.
Explanation of the recommendation (elaboration)	**Across** the world, it is normal practice for the higher level of government to take steps towards horizontal fiscal equalization.
Rationale	States with higher needs should get higher share. States with better fiscal performance should be rewarded. States that are inherently backward need to be helpful. The factors to be taken into account, and the weights reflecting the importance will have to be determined by the transfer management institution, which in this case is the NNRFC
Desirable objectives to be achieved	Reducing the horizontal fiscal imbalance among the SNGs.
Implementation steps	1. The proxy variables needs to be selected at the first instance in order to calculate the transfer. 2. Although the proxy variables can be numerous, viz. Area, Population, Index of infrastructure, per capita gross domestic product and distance from a bench mark, Fiscal discipline, Tax effort, Demographic change, Forest cover; herein can consider the below mentioned proxies for calculations since under the head existing practice above, these 3 proxies are mentioned: (i) Population (ii) Area (iii) Weighted cost

Recommendation 5: The Report recommends sharing of revenue from all the central taxes and not tax by tax sharing. This will simplify the sharing process and it will reduce biases in federal tax administration and collection.	
	3. For each state, select proxy variables for representing the three categories, quantify them, prescribe the weights for each proxy and work out the tax share as $S_i = \Sigma \beta_i . X_i$ where S_i = the share of the state (or local government); X_i = selected criteria variable suitably proxied; and β_i = appropriate weight.
Timelines for implementation	**Short-term**

Recommendation 6: Design suitable formulae for horizontal tax revenue sharing between the state and local governments by taking into account factors representing need, efficiency and equity for the lower level governments.	
Existing practice	There is no practice of revenue sharing between center and states at present.
International experience	In USA, India, and other countries, the horizontal shares are determined using certain criteria. These criteria represents the need and efficiency and capacity factors. The need factors are proxied to represent the need for making the backward state catch up with the other states. These factors are level of development (percapita income distance, population density, backwardness, etc). The efficiency factors are the tax effort, fiscal discipline, etc. The capacity factors are the percapita income, area related factors and so on. Each of these factors are assigned certain weights, determined either intuitively, or based on scientific observation over time as to the importance of the factor in influencing fiscal status.
Explanation of the recommendation (elaboration)	Across the world, it is normal practice for the higher level of government to take steps towards horizontal fiscal equalization.
Rationale	States with higher needs should get higher share. States with better fiscal performance should be rewarded. States that are inherently backward need to be helpful. The factors to be taken into account, and the weights reflecting the importance will have to be determined by the transfer management institution, which in this case is the NNRFC
Desirable objectives to be achieved	Reducing the horizontal fiscal imbalance among the SNGs.
Implementation steps	1. The proxy variables needs to be selected at the first instance in order to calculate the transfer. 2. Although the proxy variables can be numerous, viz. Area, Population, Index of infrastructure, per capita gross domestic product and distance from a bench mark, Fiscal discipline, Tax effort, Demographic change, Forest cover; herein can consider the below mentioned proxies for calculations since under the head existing practice above, these 3 proxies are mentioned: (i) Population (ii) Area

Recommendation 6: Design suitable formulae for horizontal tax revenue sharing between the state and local governments by taking into account factors representing need, efficiency and equity for the lower level governments.	
	(iii) Weighted cost 3. For each state, select proxy variables for representing the three categories, quantify them, prescribe the weights for each proxy and work out the tax share as $Si = \Sigma\ \beta_i.X_i$ where S_i = the share of the state (or local government); Xi = selected criteria variable suitably proxied; and β_i = appropriate weights.
Timelines for implementation	**Short-term**

Recommendation 7: Unconditional grants from federal government to states can be kept at moderate level since significant vertical and horizontal sharing of tax revenues are suggested as also different types of equalization, conditional, matching and capital grants.	
Existing practice	Unconditional grants are about 20 percent now can be reduced to 10 percent.
International experience	In most cases, this grant is provided for equalizing fiscal capacities to ensure that a minimum standard and level of public service is provided to its citizens. They are also used to meet the administrative needs of the SNGs.
Explanation of the recommendation (elaboration)	Once tax sharing is introduced perhaps the amounts used for the general purpose grants can be reduced.
Rationale	Unconditional grants give the discretion to the local governments to spend as per local needs rather than on those activities that are dictated by the federal government. Unconditional grants being fixed amounts to each of the states, they are discretionary.
Desirable objectives to be achieved	Fine-tuning the fiscal equalization.
Implementation steps	The NNRFC needs to take into consideration the economic background of each of the states and determining the level of grants. There can be no set criteria for the unconditional grants and entirely based on the judgement of the recommending institution.
Timelines for implementation	**Medium term**

Recommendation 8: Grants for health and education as also other social welfare activities can be designed as specific purpose conditional grants	
Existing practice	At present the conditional grants to local governments are more for physical infrastructure.
International experience	In Canada and Germany as also many other federations, significant specific grants are given for health and education functions of the subnational governments.

Recommendation 8: Grants for health and education as also other social welfare activities can be designed as specific purpose conditional grants	
Rationale	Better social development
Desirable objectives to be achieved	Equitable access to health and education services
Implementation steps	Determine the parameters to measure output and outcomes Baseline and data gathering mechanism to be agreed upon between the various levels of governments Formula to link incentive to achievement in improvement in the measured parameters
Timelines for implementation	**Medium term**

Recommendation 9: Work out Fiscal Equalization Grants to be given to the State and Local governments.	
International experience	Fiscal equalization transfers is the top priority in several federal countries: Australia, Canada, and Germany.
Explanation of the recommendation (elaboration)	Adapting the federal system with decentralization of expenditure and revenue raising invariably creates different fiscal capacities across regions, making it impossible to provide comparable levels of public services at comparable rates of taxation. This is so because, to provide a given level of public goods and services, different states require different amounts of expenditure per-capita, for three reasons.
Rationale	Encourage fiscal discipline among states
Desirable objectives to be achieved	Fiscal discipline
Implementation steps	The Australian principle and method seems most suitable to provide services and the associated infrastructure at the same standard, if each state/territory made the same effort to raise revenue from its own sources and operated at the same level of efficiency. The equalization grant will be from all the revenues, tax and nontax and without any conditions. The State-wise shares will be worked out on the basis of per capita relativities of income, population, and such other factors.
Timelines for implementation	**Medium term**

Recommendation 10: Continue the MCPM grants with selective modification in changed perspective	
International experience	Performance based grant system exists in countries like India.

	In Indonesia, MCPM is used to improve the institutional, organizational and functional performance of SNGs in the name of Local government Performance Evaluation System. In Ethiopia, it is used as City Government Benchmarking System and its national name is Woreda.
Explanation of the recommendation (elaboration)	The considered opinion has been that MCPM should be promoted and strengthened. However, the system should continue to focus on public financial management and good governance. There is of course, the system is based on valid and reliable data including the district cost index (DCI) and weighted cost factor. Another concern is regarding the timing of assessment. It is observed that the system has not been able to produce assessment-results and subsequent announcement of the grants before the planning session of local bodies starts. The MCPM grants should be continued with these changes. So the key suggestions are: • Review of MC and PM indicators in changed context, • Simplification of assessment process and making it less time consuming, • For a time being (until enhancement of capacity by them in a defined level) application of minimum conditions only for village municipalities, • Develop the system of updating the DCI periodically as per the geographical variance in price inflation, • Reviewing and fine tuning the weighted cost factor to effectively support higher-cost local levels, • Use only the rewarding provision for the time being (2-3 years) in case of village municipalities; that means ignore the punishment of grant deduction provisions in initial period.
Rationale	This has proven to be an effective tool to safeguard fiduciary risk of local government finance.
Desirable objectives to be achieved	A need for sharpening of the system within its existing objective and limitations.
Implementation steps	For example, it can be examined if it can also accommodate sectoral or other functional objectives as well. At the same time there is need to see that it does not get overloaded and the system should continue to focus on its core objectives and principles. Hence, it is important to keep the system simple and possible to manage. One aspect of the MCPM that needs attention is to link the system with capacity building of local bodies.
Timelines for implementation	**Medium term**

Recommendation 11: There is a need for an independent grievances redressal body	
Existing practice	So far there was no need for such a grievance redressal mechanism in the unitary system.
International experience	In India the Inter-State Council, in Australia the CGC act as grievance redressal institutions, in case of any conflicts between the federal and provincial, or among the provincial governments.

Recommendation 11: There is a need for an independent grievances redressal body	
Explanation of the recommendation (elaboration)	There exist some taxes common between different Schedules. Such Concurrent tax powers can be source of conflict. It is not clear as to the demarcation of the tax levying power between the state and local governments. (i) which government will determine the rate structure, (ii) whether there will be a dual rate system, (iii) which government will collect the revenue, (iv) whether the state government will administer and collect the tax and distribute the proceeds to the local governments, (v) whether the local governments would administer and collect the revenues and retain part of the revenue and credit the rest to the state government, etc.
Rationale	The tax power demarcation between the federal, state and local governments need to be clearer.
Desirable objectives to be achieved	
Implementation steps	The NNRFC can have a wing for the redressal of the grievances arising between and among the three layers of government. In addition to support the implementation and coordination of intergovernmental fiscal activities and minimize the grievances and conflicts, through the federal law make clear the scope of work of the council in detail along with the process of coordination and consultation for effective, transparent and timely functioning of the **Intergovernmental Fiscal Council** (proposed by IGFT Bill presented in Legislative Parliament by the GoN). The proper and timely communication regarding the grievances and their nature to the Inter-State Council (formed under the chairship of Prime Minister, Article 234) will be more supportable to make necessary policy intervention regarding the redressal of grivances.
Timelines for implementation	**Short term/Medium Term**

Recommendation 12: Consider the degree and scope of economic right given by the constitution to Province and Local level and share the revenue and transfer the resource as grant accordingly that can minimizes the expenditure need gap	
International experience	The share of expenditure among the federal governments level mainly depends on the provisions made by the Constitution. In Switzerland, Germany and Canada, the Centrals spend 30 t0 40 percent[33]. This percent in Australia, India, South Africa and Mexico varies in between 45 to 60 percent (Anderson). In Nepal as per the massively assignment of the expenditure rights to the Local and Province this share can be limited to 30-40 percent in ling run.

[33] Adhikari, CM, Sanghiya Nepalko Artha rajniti (Political Economy of Federal Nepal, 2071 PP13,

Explanation of the recommendation (elaboration)	Consider the economic rights while making arrangement of revenue sharing and grant transfer Consider the social and human development related variables while designing the granting formula (e.g.HDI), Make provisions of review and reconcile the expenditure and revenue right in line with capacity enhancement of the SNGs and narrow down the fiscal gap, Allocate special grants to those local levels and provinces which are relatively in bottom level of social and infrastructure development. Base on the analysis, *as per the nature of economic rights of local level provided by the Constitution, enhancement of their capacity of spending and expansion in demand of services and development it may be expended near to 35 to 40 percent. The spending share of province still to be reconciled based on the economic rights given by the Constitution and the nature of work to be done in regional and district level that cover the area more than one local level. Tentatively it can be estimated to be between 15 to 20 percent.*
Term	Medium and Long
Rationale	Equitable and balanced distribution of resources
Desirable objectives to be achieved	To minimize the Vertical and horizontal Fiscal imbalance
Implementation steps	Categories the local levels as per their development, infrastructures and social status, As per the category of the local level give different weightage while defining the formula (give more weightage in are where infrastructure is poor and in comparison to population density is lower and area is wider). Periodically review the expenditure right and revenue potentials and capacity and revise the resource sharing.

Chapter III

Component 3: Subnational borrowings - Establishing borrowing arrangement for subnational governments

1. Introduction

Under the new federal structure in Nepal, the development of states, LGs will largely depend on their ability to generate revenues and rational allocation of expenditures. However, due to vertical and horizontal fiscal imbalances, not all states and LG will be able to generate the same level of revenues. This is where borrowing comes into the picture as it becomes a necessity at the subnational level when the government is not able to meet the expenditure needs through fiscal transfer and own source revenue.

Subnational borrowing is a crucial component of a sound system of intergovernmental fiscal relations because it provides state and LG access to credit which is much needed for the modernization of public infrastructure especially in developing countries. Establishing a sound framework for subnational borrowing is of critical importance for assuring that state and LGs are able to contribute to development of infrastructure as capital markets develop.

The ultimate efficiency of decentralized government finance rests on the benefit principle, which requires that the costs of public services be covered with taxes paid by those who benefit from these services. However, if current tax receipts were spent toward capital projects from which benefits can be derived for many years ahead, such as a new road or a water treatment plant, the benefit principle would be violated in an inter-temporal sense across time periods. Unless corrected, this “inter-temporal spill over” of benefits would lead to the under-investment in public infrastructure. This is because current residents might not be willing to pay the full cost of the project while receiving only a fraction of its benefits, while the remaining benefits would accrue to future generations.

Debt financing has the potential to rectify this situation by spreading the costs of building a facility over the entire period during which the benefits from this investment are received. For service facilities whose costs are fully recovered from user fees, borrowing brings a clear improvement by allowing governments to charge appropriate prices for their services. For instance, while funding a public sewer extension from recurrent local resources may prove impossible, borrowing could help put in place a sustainable, fee-financed project that is more cost effective and safer than private provision alternatives (e.g., private septic tanks).[34]

In many developed economies, a primary avenue for subnational infrastructure development is government borrowing. There is consensus among public finance experts that government spending on recurrent goods and services should be met by revenues from taxes and other recurrent revenue sources. Moreover, the “golden rule” for government borrowing states that it is proper for governments to borrow for capital projects (Musgrave, 1959). As discussed above, the ability of subnational governments to borrow is an important part of an efficient system of intergovernmental fiscal relations on normative grounds.

In light of the above the following sections discuss the as-is scenario in Nepal, constitutional provisions, gaps observed by the PATA team, recommendations and implementation framework for subnational borrowing.

[34] Subnational borrowing - International Studies Program Andrew Young School of Policy Studies Georgia State University

2. As-is Assessment and Gaps identified

2.1 As-is scenario in Nepal

The following points denote the current scenario relating to subnational borrowing in Nepal.

1. The present government borrowings are at around 27% of the GDP. There is thus, ample scope for increase in borrowing.
2. At present, amid limited resources available for spending, the lack of efficient organizational management of the municipalities has resulted in larger portion of spending in recurrent revenue expenditure and a little is left for capital spending. The experience of 58 municipalities with about 30% of spending being of recurrent nature shows that expenditure is clearly skewed to recurrent expenditures (and primarily salaries) and only about 70% allocated in capital investment. The situation has deteriorated over years resulting in even larger gaps in infrastructure financing. Therefore, there is a need search for alternatives or additional options for mobilizing resources for investment for infrastructure development. Current borrowing of LGs comprise only 0.85% of municipal total revenue (or 3% of municipal internal revenue) in average. There is ample scope for municipalities to borrow the amount subject to fulfilling the FRBM requirement. [35]
3. The following table[36] gives an overview of revenue and expenditures of 58 municipalities in Nepal (NPR million)

Table 1: An overview of revenue and expenditures of 58 municipalities

Municipal Revenue	FY2008-09	FY2009-10	FY2010-11	FY2011-12	FY2012-13	FY2013-14
Local Tax	632	582	770	905	1,556	1,123
Service Charge Fees & Fines	644	619	755	625	964	1,263
Property Rental	98	124	107	125	178	205
Other Revenue	73	84	28	73	99	67
Total OSR	**1,446**	**1,409**	**1,659**	**1,728**	**2,797**	**2,657**
IGFT and other transfers	4,944	6,071	6,521	5,873	4,853	4,476
Total Revenue	**6,390**	**7,480**	**8,180**	**7,601**	**7,650**	**7,133**
Transfer share	77%	81%	80%	77%	63%	63%
Municipal Expenditures	**FY2008-09**	**FY2009-10**	**FY2010-11**	**FY2011-12**	**FY2012-13**	**FY2013-14**
Current expenditures	1,949	2,295	2,688	2,582	2,572	2,356
Capital expenditures	3,181	3,745	4,385	4,212	4,197	3,844
Total Expenditure	**5,130**	**6,040**	**7,073**	**6,794**	**6,769**	**6,200**
Revenue surplus	**1,260**	**1,440**	**1,107**	**807**	**881**	**933**
Capital expenditure share	62%	62%	62%	62%	62%	62%

4. The following table[27] illustrates the projection of infrastructure financing gap of the municipalities (NPR in billion).

Table 2: Illustration of projection of infrastructure financing gap of municipalities:

Financing of Investment Need	FY2015-16	FY2018-19	FY2021-22	FY2024-25	FY2027-28	FY2030-31	Total
Revenue Surplus	1.35	0.72	0.71	1.76	3.62	6.96	34.38
Total IGFT	20.59	26.14	37.37	52.01	72.8	102.56	783.56
Market Borrowing (Capacity Constraints as 25% of Revenue Surplus)	0.34	0.18	0.18	0.44	0.91	1.74	8.6
Total financing available	22.28	27.04	38.26	54.21	77.33	111.26	**826.54**

[35] Final Report – Municipal Finance Framework for the National Urban Development Strategy (NUDS) of Nepal

[36] Draft report – Designing a Framework for Subnational Government Financing through Borrowing- UNCDF

Financing of Investment Need	FY2015-16	FY2018-19	FY2021-22	FY2024-25	FY2027-28	FY2030-31	Total
Total municipal investment requirement							**2,329.92**
Scenario 1: 60% of physical target							1,397.952
Scenario 2: 75% of physical target							1,747.44
Scenario 3: 90% of physical target							2,096.928
Financing gap							
Scenario 1: 60% of physical target							571.412
Scenario 2: 75% of physical target							920.9
Scenario 3: 90% of physical target							1,270.388

The projected financing gap has been arrived at by assuming 15% growth of recurrent expenditure, 11% growth of OSR, and 12.5% growth of IGFT based on estimated amount for 2015/16.
Further, the above estimates are based on the 58 old and 159 new municipalities. However, the above may not hold good for the current structure of 753 LGs.

5. Year-wise data analysis showed that there were fiscal surpluses of NPR 40.64 billion in FY 2013/14, NPR 21.99 billion in FY 2014/15 and NPR 31.45 billion in FY 2015/16.

Table 3: Overall financials of GoN for the past 5 years (figures in NPR. million):

Description	FY2017-18 BE	FY2016-17 RE	FY2015-16 A	FY2014-15 A	FY2013-14 A	CAGR (%)
Revenue & Grant	802,223	656,162	524,783	450,023	410,864	18
Expenditure	1,138,707	823,654	493,337	428,033	370,226	32
Budget Surplus (-)/ Deficit(+)	336,484	167,493	-31,446	-21,990	-40,637	-
Net Financing	-233,748	-135,844	-15,905	33,327	26,274	-
Surplus(-)/Deficit (+)	102,736	31,649	-47,351	11,337	-14,363	-

The following are observed from the table above:
a) In the three years from FY2013-14 to FY2015-16, there has been budget surplus, indicating that receipts (revenues and grants) have exceeded expenditure. The surplus mainly pertains to the lack of implementation of budgeted capital expenditure.
b) Similarly, during the years FY2013-14 and FY2015-16, there has been fiscal surplus.

6. At present, there are no statutory requirement for maintaining issuer rating except for IPO or right issue.

7. Presently, borrowing by the GoN is not based on the GDP of the country. There is no fiscal responsibility legislation (e.g. FRBM Act) to ensure fiscal discipline and to mandate the levels of targeted revenue deficit or fiscal deficit in Nepal.

8. NRB as the central bank of Nepal decides various issues pertaining to borrowing, the debt market and debt sustainability at the central level. Namely, it undertakes the following activities:

a) NRB prepares the public debt issue calendar annually. In the budget the MoF decides the borrowing requirement, which for the previous fiscal year was projected at an external borrowing of NPR 195.72 billion and domestic borrowing of NPR 111.0 billion. The 21st amendment to the Debt and Guarantee Act, 1968 passed on November 14, 2016 has revised the ceiling of total outstanding external borrowing to NPR 700 billion from the previous ceiling of NPR 500 billion as allowed by the 20th amendment. With respect to domestic borrowing, a new act called Providing Mandate to Raise Domestic Debt Act is passed every year. As per the act, up to NPR 111 billion domestic borrowing is allowed to be raised for the fiscal year 2016-17.

b) NRB can raise the above debt in the following forms:
- Treasury Bills (91/182/364 days). Generally auctioned on Monday or as the need arises
- Development bonds with minimum maturities of 3 years and up to 15 years
- Citizen Saving bonds for the medium term
- Foreign employment bonds for the medium term (to attract funds from persons outside Nepal)

c) There is an Open Market Operation Committee chaired by DY Governor (Public Debt Management) for the management of debts. Members of this committee are the Jt. Secretary (Economic Analysis Policy Division), MoF, Chief of Public Debt Management Research Department, NRB, Chief of Bank and Financial Institution Regulation Department, NRB, Chief of Banking Office, NRB and Directory Treasury, Public Debt Management Department, NRB. The purpose of this committee is to decide about the above debt raising mechanism.

d) There is a Liquidity Management Committee chaired by the DY Governor, for the management of liquidity. Members of the committee are the ED of Public Debt Management Department, ED of Research Department, NRB, Jt. Secretary (Economic Analysis and Policy Division), MoF, Director (Senior) of Public Debt Management Department, NRB and Member Secretary. The purpose of this committee is to ensure the day-to-day liquidity position in the money market and do open market operations.

e) NRB is regulating the banks in Nepal and it decides the various prudential ratios such as CRR, SLR, capital adequacy ratio, credit/deposit ratio and the classification of loans extended by them. These are suitably changed based on the economic and financial situation of the country.

f) Of the various bonds raised through NRB as part of government borrowings, development bonds are listed in the NEPSE though they are rarely traded and, instead, kept until maturity by the subscribers, which are mostly banks.

9. TDF is a development oriented intermediary that funds various municipal projects based on funds availability. TDF's requirements of funds are met through a) equity and long term loans from Government and b) grants from donors.

TDF gives loan for two types of projects:

a) Donor funded projects: The various departments / municipalities choose the project and get it appraised through TDF. The funding for the projects is received by TDF either through the Nepal Government / donors or a mix of both. In such projects, the maturity of loans is in the range of 15-25 years and the cost of funds is also low, since these are developmental projects.

b) TDF funded projects: TDF conducts studies and appraises the project based on the request of the municipalities and funds them.

10. Municipal Level:

a) There is no efficient and transparent system for funding the borrowings at the municipal level. Deficits in the municipal budget is met directly by the Government in the form of grants. There are very few projects that are appraised by the TDF and loan is taken against them.

b) Currently, the GoN transfers funds to the municipalities as per the provisions made in LSGA (which is being replaced by the new one in line with the new Constitution), which also includes direct on-lending by MoF to municipalities. For example, under ADB funded urban and tourism projects, the federal Government directly on-lends the funds to the municipalities (E.g. Municipal Infrastructure Improvement Project (MIIP) in Kathmandu Metropolitan City from ADB assistance).

11. Creation of a Strong Credit Rating Infrastructure

ICRA Nepal is the rating agency in the country. However, there are no statutory requirement of maintaining the Issuer rating. Only in case of IPO or Right Issue the rating is mandatory for the transaction. Hence there are very few companies who are rated despite 235 Companies listed on the Nepal Stock Exchange.

2.2 Key gaps identified by the PATA team

The PATA team conducted an as-is assessment, and identified the following key gaps that currently exist in Nepal:

Overall subnational borrowing
▸ **Fiscal responsibility legislation is absent:** This legislation is necessary for maintaining fiscal discipline wherein borrowing by subnational government should be controlled and governed by acts enacted under federal law. The legislation should contain provisions that set targets for fiscal deficit and an upper ceiling over a period of time. ▸ **There is no system of issuer rating for debt:** Rating imbibes a certain level of confidence in investors when assessing the borrowers. The credit worthiness of LGs is still an unknown territory for investors. Moreover, LGs have a demand for borrowing of funds. A rating system by reputed agencies with international experience will enable the lenders to invest without inhibitions. ▸ **Only one credit rating agency is existing in Nepal:** At present, ICRA Nepal is the only credit rating agency. However, assessment of projects by two independent rating agencies give more comfort to the lender at both domestic and international level and will also enable the borrower to borrow at lower costs. ▸ **Banks are not in a position to lend funds to LGs:** The banks are mostly focused on raising funds for short term periods. Therefore, they are not in a position to lend long-term loans for infrastructure projects to LGs. ▸ **Planning of expenditure is required to be strengthened:** Budgets are prepared with a deficit of expenditure over revenue, however, the actual figures denote a surplus since the expenditure incurred was not in line with the planned expenditure. Since the expenditure planning is not effective, borrowings may get severely affected because LGs will borrow as per their expenditure requirements but may not be able to execute the projects which would result in default of loans/borrowings in the long term.
Town Development Fund
▸ **Accrual basis of accounting not being followed:** TDF is not following accrual basis of accounting, which is essential for lenders who would prefer to obtain a true and fair view of the financial statements. ▸ **Non-performing assets (NPA) recognition policy is required to be strengthened:** At present, NPA recognition by TDF is required to be strengthened. Appropriate accounting entries are required to be made and strategy for recovery of debt is to be developed. ▸ **Manpower with relevant technical and financial expertise is required:** In order to fund subnational governments, TDF is required to conduct project appraisal and financial system analysis. Therefore, TDF requires adequate manpower who would possess technical and financial expertise to handle the proposals of the subnational governments.

3. Constitutional Provisions

Under Article 59 (6) of the Constitution of Nepal the GoN shall have power to obtain foreign assistance and borrow loans. Such assistance or loans shall be so obtained or borrowed as to have macroeconomic stability of the country. According to Article 59 (7), provisions relating to the management of budget deficits and other fiscal discipline of the federation, state, and local level shall be as provided for in the federal law.

Article 110(3) (c) states the regulation of matters relating to the borrowing of money or the giving of guarantee by the Government of Nepal, or any matter pertaining to the amendment of the law with respect to any financial obligations undertaken or to be undertaken by the Government of Nepal, Article

115 (2) states no loan shall be raised and guarantee given by the Government of Nepal except as provided for in the Federal law.

Article 198(3)(c) states the regulation of matters relating to the borrowing of money or the giving of guarantee by the State Government, or any matter pertaining to the amendment of the law with respect to any financial obligations undertaken or to be undertaken by the State Government

Article 203 (2) states no loan shall be raised and guarantee given by the State Government except as provided for in the Federal law.

Article 228 (1) states No tax shall be levied and collected and no loan raised in the Local level except in accordance with law.

Article 251 (1)(f) states to analyse macro-economic indicators and recommend ceiling of internal loans that the Federal, State and LGs can borrow.

Further, Schedule 5 sr. no. 5, ‘List of Federal Power’, of the constitution states, “Central planning, central bank, finance policies, monetary and banking, monetary policies, foreign grants, aid and loans”.

Schedule 6 sr. no. 2, ‘List of State Powers’, of the constitution states, “Operation of banks and financial institutions in accordance with the policies of NRB, cooperative institutions, foreign grants and assistance with the consent of the Centre”.

4. International Experiences

In order to develop a subnational borrowing framework best suitable for Nepal, the PATA team has considered three countries in varying stages of development with established and functional federal financial systems. The countries are as follows: Mexico, Brazil and India. The countries have been considered keeping the context of Nepal in mind and the team has tried to extract the best practices. Therefore, all the recommendations suggested by the team may not be visible in the countries listed below.

4.1 Mexico

Supporting a market approach Mexico’s subnational debt framework was substantially reformed in 2000. This reform has fostered the expansion of a domestic credit market for state and municipalities at large.

Mexico has developed a subnational debt framework that is a hybrid of the first and third subnational capital market management options which involves an explicit no bail-out commitment by the federal government and a system aimed at enabling lenders to correctly assess idiosyncratic subnational risks. These objectives were earlier pursued through (a) the creation of subnational governments’ Master Trust Funds (MTF); (b) establishment of a link between the capital risk weighting of bank loans to subnational governments and their credit rating; (c) and a requirement to register subnational loans with the MoF.

The establishment of the MTF was a key factor to reduce risks and borrowing costs as it was having a financial and legal framework. Some subnational governments also introduced reforms in their debt laws and fiscal codes to meet the legal requirements harmonizing budgeting, financial management, fiscal codes and debt regulations for the three levels.

In August 2004, the National Banking and Securities Commission (CNBV) introduced changes to the regulations for commercial and development banks on loans to subnational entities. The current legislation in Mexico encourages private rating agencies to appraise LG budgets by evaluating their financial systems, operational activities, economic profiles and performance using criteria such as liquidity, debt, systems support, etc. The new provisioning rule took into consideration loans that benefit from a credit enhancement mechanism provided by credit or financial assets, such as by the pledging of tax participation revenues. The CNBV risk level was also adjusted depending on the credit, financial, and legal strength of the structure or the guarantee mechanisms for the loan.

Credit ratings reinforced the subnational indebtedness framework based on market discipline. By 2010, all states and a growing number of municipalities had been assigned credit ratings by at least one recognized rating agency. As a result, subnational public finances are subject to growing surveillance and scrutiny by private markets and rating agencies The four major rating entities in Mexico are Standard & Poor's, Moody's, Fitch, and HR Ratings.

4.2 Brazil

The fiscal behaviour and indebtedness of state and municipal governments in Brazil had traditionally been a major source of macroeconomic instability in the 90s. Expansionary fiscal policies and the lack of effective indebtedness controls resulted in frequent subnational debt crises. This resulted in three debt-refinancing operations (bailouts) by the federal government to state government and two bailouts to municipalities between 1989 and 1997.

This stimulated the Federal Government to make a stronger effort to address the issue of subnational government indebtedness via a third comprehensive bailout in 1997 for states and in 2001 for municipalities with the National Treasury simply assuming the bond debt of state governments and state financial institutions. However, this bailout by the Federal Government was conditional and each of the 25 states needed to sign a debt negotiation contract with National Treasury.

These were specified in three-year rolling Fiscal Adjustment Programs which set annual targets or limits on gross indebtedness, primary balances, personnel spending, own tax revenue collection, credit operations, guarantees, and public investment, in order to assure a gradual decline in indebtedness. The programme also include structural reforms such as those relating to privatization and public sector modernization initiatives.

In 2000 the government also brought in Fiscal Responsibility Law (FRL) to further strengthen controls on subnational fiscal performance. The objective of creation of FRL was to: (a) institutionalized fiscal discipline at all levels of government, (b) incorporating hard budget constraints, (c) prohibits debt refinancing operations between different levels of government.

The FRL also prohibit borrowing if:

a) the net consolidated debt exceeds twice net current revenue
b) new credit operations exceed 16% of net current revenue
c) debt service exceeds 11.5% of net current revenue
d) if it violates the earlier debt renegotiated contract

The government also brought in the supply side constrain by limiting the total subnational borrowing at very low so that funds are not available from banks and financial institutions. The Federal Government through the National Monetary Council has limited the amount of loans that each financial institution may offer to the public sector to 45% of its net worth. Further, there is also a limit for loans to the public sector altogether. These limits are controlled by the Central Bank.
These strict observances of debt renegotiation contracts and the FRL have resulted in robust primary surpluses in the state governments. These surpluses have been key to the improvement of the country's macroeconomic conditions and restoring credibility and increasing transparency in subnational governments.

4.3 India

The key reforms in India at subnational borrowing level began in FY 2004 after the federal government adopted the Fiscal Responsibility and Budget Management Act (FRBMA) in 2003 and the recommendations of the 12th Finance Commission (FC) incentivized adoption of similar legislations at the State level in 2004. The period of fiscal consolidation was enforced with legislative changes introduced at the national and subnational level.

The Federal Government and all subnational Governments are bound by their FRBM legislations. Though specific legislations may have different titles, the rationale for all these laws is to ensure fiscal stability and prudence by reducing fiscal deficit, eliminating revenue deficit and establishing transparent processes regarding matters pertaining to public finance.

Fiscal consolidation by subnational governments was incentivized following recommendations of the 12th Finance Commission. Recommendations of the 12th Finance Commission proposed a debt restructuring plan for the subnational governments wherein the proposed debt relief was explicitly linked to rules-based legislative reforms.

All states were eligible to obtain relief from the year they enacted fiscal responsibility legislation. Key features of the 12th FC recommendations include:

A) Subnational should be allowed to consolidate and reschedule their outstanding loans to the Centre if they maintain the fiscal deficit targets
B) Subnational should be allowed to approach the market directly for borrowings. If some fiscally weak subnational are unable to raise funds, then they could borrow through on-lending from the Centre.

External Assistance

On-lending of funds is also practiced in India. In order to facilitate institutions requiring funding for projects or programmes, federal government 'on-lends' funds to other institutions, such as state or LGs or specialized urban development funds. Thereafter, these intermediaries may on-lend the funds to a lower level of government or to the end users.

For the project proposals of central ministries/state governments, all agreements with the multilateral/bilateral agencies are signed by the federal government since this is part of the Union list. The Department of Economic Affairs (DEA), Ministry of Finance is the nodal department for this job.

DEA, MoF is responsible for:

a. Procuring and coordinating foreign assistance from multilateral and bilateral agencies
b. Overlooking policy issues pertaining to external aid received by Government of India (GoI)

The following table elucidates the international best practices prevailing in 3 countries discussed above. Existence of these practices are a sign of sound subnational borrowing systems ensuring fiscal discipline and regulation.

Table 4: A snapshot of the practices being followed by the above mentioned three countries:

International experience				
Sr. No.	**Areas**	**Mexico**	**Brazil**	**India**
1	FRBM at federal level	Yes	Yes	Yes
2	FRBM at state level	Yes	Yes	Yes
3	Incentive to governments for compliance with FRBM	Yes	Yes	Yes
4	Existence of credit rating framework	Yes	Yes	Yes
5	Existence of multiple credit rating agencies	Yes	Yes	Yes
6	Existence of development funding bodies	Yes	Yes	Yes
7	Foreign borrowing by federal government	Yes	Yes	Yes
8	Foreign borrowing by state government directly	- *	No	No
9	Borrowing based on government guarantees	Yes	Yes	Yes
10	Bailout policies in place	Yes	Yes	Yes
11	Accounting structure in place	Yes	Yes	Yes

Note: Information not available

Table 5: An overview of the approached adopted by various countries for controlling subnational borrowings. The countries' list is illustrative only.

Approach	Market Discipline	Rules-based controls	Administrative controls
Advantages	- Emphasis on self-control - Monitoring by credit rating agencies	- Transparent - Avoid bargaining	- Potential federal government control - Better terms and conditions - Useful for foreign borrowing
Preconditions	- Complete information - Developed financial market	- Sound and credible rules (e.g. well defined, transparent and flexible)	- Ability of federal government to effectively monitor and implement
Examples	Canada, Finland, USA	India, Germany, EU	India, Brazil, Mexico

The above sections are further discussed in annexure 3.

5. Policy Recommendations and implementation strategy

5.1 Enactment of a Fiscal Responsibility & Budget Management Legislation (FRBM) for ensuring fiscal discipline

The GoN should enact a Fiscal Responsibility & Budget Management (FRBM) Act for the Federal, State and LG. According to Article 59 (7) of the Constitution of Nepal, provisions relating to the management of budget deficits and arrangements relating to fiscal discipline of the federation, state, and local level shall be in accordance with the federal law. This means that the budget deficits and fiscal discipline can only be decided by the federal government. Therefore, FRBM shall be enacted at the federal government level, which will also suggest parameters for state and LG fiscal discipline. Based on discussion and understanding with MoF officials, there is no FRBM Act at present in Nepal. Therefore, the following framework is suggested that would facilitate the preparation of FRBM Act, a much needed legislation for fiscal discipline.

The above recommendation is also in line with the draft report "Designing a Framework for Sub-National Government Financing through borrowing in the context of Fiscal Federalism in Nepal, February 2016" wherein a fiscal decentralization strategy along with borrowing regulations have been suggested.

The maximum acceptable fiscal deficit and consequently borrowing limit at federal, state and LG are to be prescribed by rules under the act. The laws will ensure fiscal stability and prudence by reducing fiscal deficit, eliminating revenue deficit and establishing transparent processes regarding matters pertaining to public finance at federal, state and LG level.

The following table illustrates the rules that should be inculcated in the legislation so as to exercise control over borrowing activities.

Table 6: Borrowing Rules in other countries

Type of Restriction	Description	Countries following
"Golden Rule" Provision	Borrowing for capital expenditures	Brazil, India
Affordability Formulae	Ceilings on (i) debt service / local revenues; (ii) debt service / local current saving	Brazil, India
Indebtedness Formulae	Limit on total outstanding debt / net revenues	Brazil, India, Mexico
Balanced Budget	Local councils are required to pass balanced budgets	Brazil, India, Mexico
Control over foreign borrowing	Federal governments are the power to directly borrow from foreign funding agencies	India, Nepal

As per the best international practices in Brazil and India, and in accordance to the constitution of Nepal the below recommendations have been made.

The FRBM legislations should contain a provision that sets targets for fiscal deficit reduction over a period and set an upper ceiling after a particular period of time. These targets may be revised from time to time by the federal government in consultation with the MoF as Nepal is in a developing stage.

It is pertinent to note that there are no universally acceptable fiscal rules. There is always a trade-off, flexibility with simplicity and fiscal anchor. One of the major triggers for adopting FRBM has been to address any future economic crisis happening due to debt issues. Hence, the recommendations with respect to the FRBM in the following sections have to be looked from the perspective of current economic situation in Nepal. The debt ceilings and other fiscal parameters need to be fixed by giving due consideration to the need for higher level of public expenditure required in the next few years. As per article 251 of the constitution, NNRFC is required to analyse macro-economic indicators and recommend ceiling of internal loans.

Stringent imposition of debt rules will severely affect the economic growth and sustainability of the country. Therefore, the PATA team suggests the need for flexibility in fiscal targets. This is important because a fixed deficit target can pose problems if there is a cyclical downturn in GDP. Lower growth means lower revenue, which means expenditure has to be reduced to keep the absolute level of the deficit on target. The lower GDP will also reduce the denominator in the fiscal deficit ratio, which means the absolute size of the fiscal deficit will have to be lower than originally projected to keep the deficit as a percentage of GDP at the targeted level. Both factors will force a contraction in expenditure, which would worsen the cyclical downturn.

Table 7: FRBM framework – Recommended key features

Components	Description
Target preparation	Government of Nepal should be required to prepare and present before the Legislature a budget, medium term fiscal policy statement and a fiscal policy strategy every year.
Fiscal policy statement	The Medium Term Fiscal Policy Statement and the Fiscal Policy Strategy Statement shall set forth the fiscal objectives, strategic priorities of the federal government and a three or five year rolling target for fiscal management with enunciation of underlying assumptions. In particular, the medium term fiscal policy statement shall include assessment of sustainability relating to: the balance between revenue receipt and the revenue expenditure; the use of capital receipts including open market borrowings; grants for generating productive assets; and the estimated yearly pension liabilities worked out on actuarial basis, for the next ten years or within such period as the federal government may, by order, specify. FRBM would establish fiscal year targets pertaining to: • Taxation Policy • Expenditure policy • Borrowing policy for federal government, Public Sector Units (PSU), Special Purpose Vehicles (with ceiling) and any other equivalent instruments where the liability for repayment is on federal government • Other liabilities • Lending and investments in productive assets • Pricing of administrative goods and services • Key fiscal measure and strategic priorities of federal government • Guarantees and activities of PSU, which has potential budgetary implications on federal government

Components	Description
Fiscal management principles	• Transparency in setting the fiscal policy objectives, the implementation of public policy and in the publication of public accounts; • Stability in fiscal policy making process; • Responsibility in the management of public finances; • Fairness in policy decisions of the federal having due regard to the financial implications on future generation; • Efficiency in design and implementation of the fiscal policy and managing the public sector; • To manage guarantees and other contingent liabilities prudently • To maintain the integrity of the tax system by minimizing special incentives, concessions and exemptions • To ensure that federal uses resources in such a way that give best value for money and also ensure that public assets are put to the best possible use; • To minimize fiscal risks • To formulate budget to realistic and objective manner
Fiscal management targets	• Reduce the revenue deficit to minimal level within a period (to be decided by federal government), specific goals can be set for each year. • Ceiling within a period of certain number of years - the total public debt of the federal at certain % of the estimated Gross Domestic Product (GDP) for that year • Cap outstanding guarantees within a limit • Provided that the revenue deficit and the fiscal deficit may exceed the limits specified under this section because of unforeseen circumstances or natural calamity
Measures for transparency	The significant changes in the accounting standards, policies and practices affecting or likely to affect the computation of fiscal indicators; - in line with the draft report on “Designing a Framework for Sub-National Government Financing through Borrowing in the Context of Fiscal Federalism in Nepal, February 2016”. The contingent liabilities created by way of guarantees, actual liabilities arising out of borrowings by Public Sector Undertakings (e.g. insurance companies) and Special Purpose Vehicles and other equivalent instruments where liabilities for repayment is on the federal government having regard to the potential budgetary implications, off-budget borrowings, if any, and the committed liability in respect of major works and supply contracts; Revenue demands raised but not realized; and The estimated yearly pension liabilities worked out on actual basis, for the next ten years or within such period as the federal government may, by order, specify.
Compliance	Various measures to enforce compliance of the above rules are to be formulated along with triggers (e.g. missing the fiscal management target), and corrective actions (e.g. plan to increase revenue or reduction of unplanned expenditure).

Scheme of Enforcement of FRBM

The enforcement of provisions of FRBM is sought through a variety of methods. The key categories of enforcement measures are:

I. Creation of Joint Fiscal Responsibility and Budget Management Council
II. Measures to be mandatorily undertaken by the federal, state and LG;
III. Prohibitions on the Federal, state and LG.
IV. Parameter for borrowing at state & LG level

I. Creation of Joint Fiscal Responsibility and Budget Management Council

Table 8: Structure of Joint FRBM Council

Joint Fiscal Responsibility and Budget Management Council	
Composition	The council should be an autonomous body under the aegis of MoF, and should consist of a Chairman and members appointed by the federal government. The principle underlying the composition of the Council should be a combination of effectiveness and participation. Consequently, the Council must not be too large, as that would impede effectiveness; at the same time, it must be participatory with representation from the federal and subnational. It is thus proposed that the Council be a five-member body (suggestive). The power of appointment of the Chairperson and members of the Council shall be taken with the concurrence of the Constitutional Council as defined under clause 284 of the constitution of Nepal. The Chairperson and members should be persons with experience in public finance, economics, public administration or law and must satisfy other eligibility criteria as the federal government may deem fit. They should have a five-year term/or other terms as government deems fit and their independence in functioning must be statutorily secured.
Functions	The following is an illustrative list of functions of the council: • Preparing multi-year fiscal forecasts • Preparing a fiscal sustainability analysis that makes projections on key fiscal indicators • Providing an independent assessment of the federal government's fiscal performance and compliance with targets set under the FRBM • Recommending suitable changes to fiscal strategy to ensure consistency of the annual financial statement with targets set under the FRBM • Taking steps to improve quality of fiscal data • Producing an annual fiscal strategy report which will be released publicly • Providing policy guidance to federal government on any matter relating to fiscal policy where advice is sought • Advising the federal government on whether conditions exist to permit a deviation from the targets established and make recommendations on the plan to return to the established targets • Advising the federal government on corrective steps to be taken if periodic review demonstrates non-compliance with any targets set under the FRBM
Legislature	The council must be set up by a parliamentary legislation. Since the purpose of the council is to ensure overall fiscal co-ordination and strategy including oversight of borrowings, its functions are squarely covered by this legislative entry. The FRBM should detail the actions which the federal, state and LG may take based on advice from the council.
Review reports	Review of the trends in receipts and expenditures in relation to budget estimates is a measure that is required to be followed by all for effective budget monitoring. The frequency of the review may vary among quarterly, half-yearly or yearly. The outcome of this review is a 'Review Report' is to be placed before the House(s) of the concerned federal, state and LG legislature.
Statement explaining deviations	Federal, state and LG cannot deviate from the obligations cast on them under the FRBM Act. However, due to any unforeseen circumstances, if any deviations are made, the Finance Minister shall make a statement in the House(s) of the Legislature explaining (i) the said deviation; (ii) whether such deviation is substantial and relates to the actual or the potential budgetary outcomes; and (iii) the remedial measures that the federal, state and LG proposes to take. There is no requirement for the Finance Minister to submit a Review Report, however for better transparency the Finance Minister's obligation to make a statement explaining deviations is a measure suggested.

II. Measures to be mandatorily undertaken by the federal, state and LG

Certain measures should be undertaken by the federal, state and LG to ensure that fiscal discipline as suggested by FRBM act is maintained. The following measures may help the government to maintain the fiscal discipline.

1. **Measures for increasing revenue and/or reducing expenditure**: In the event of either shortfall in revenue or excess of expenditure over the intra-year targets mentioned in the Fiscal Policy Strategy Statement mandated under the FRBM Acts or the rules made under the Acts, the federal, state and LG is mandated to take appropriate measures for increasing revenue and/or for reducing the expenditure.

2. Statement of remedial measures in case of possible measures which may lead to revenue deficit:
In case any measure is proposed by the federal, state and LG in the course of the financial year, which may lead to an increase in revenue deficit, either through increased expenditure or loss of revenue, it shall be accompanied by a statement of proposed remedial measures. These remedial measures should strive to neutralise such increase or loss and such statement shall be placed before the House(s) of Legislature.

3. Consistency with the objectives of the Long Term Fiscal Plan: Another measure which can be imposed by federal government is that principally, the annual budget and the policies announced at the time of presentation of the budget shall be consistent with the objectives and target set in the long term fiscal plan, the medium-term fiscal policy plan and the fiscal management targets of the federal government.

4. Proposals for Supplementary or Additional Demands and Statements for curtailment of expenditure: In some cases federal government may have measures relating to supplementary or additional statements of expenditure. The provision relating to this measure mandates that not more than one supplementary statement of expenditure shall be presented in a financial year. Whenever such supplementary estimates are presented in Parliament the federal government shall also present an accompanying statement indicating the corresponding curtailment of expenditure to fully offset the fiscal impact of the supplementary estimates in relation to the budget targets of the current year and the medium term fiscal plan objectives.

5. Increase in revenue deficit and fiscal deficit in case of unforeseen demands: In case the revenue deficit and fiscal deficit increase in the case of unforeseen demands on the finances of the federal, state and LG. The federal, state and LG shall identify the net fiscal cost arising due to natural calamity and such cost would provide ceiling for extent of non-compliance to the specified limits.

6. **Triggers and Corrective Actions:** There should be triggers as well as corrective actions that should be initiated upon activation of triggers.

7. **Guidelines to be issued by the Federal Government**: This enforcement measure mandates that federal should issue appropriate guidelines from time to time, for timely spending of budgetary grants. Also, guidelines regarding borrowings not to be used for revenue expenditures should be issued.

III. Prohibitions in the Federal Government

In order to maintain fiscal discipline, the following restrictive conditions are suggested:

1. **No guarantees to be given after a certain limit:** This is a most critical measure that is to be observed by all the subnational. It mandates that whenever outstanding risk weighted guarantees exceed the limits specified in the Act, no fresh guarantee shall be given. However, the fresh guarantee may be given for the purpose of replacing high cost debt with low cost debt in such a way that there is no net increase in outstanding guarantees after such debt swap.

2. **No liability to be given outside the budgetary provision of the officers responsible:** This is the more onerous measure for enforcing compliance which can be put in FRBM Act. It says that no liability shall be created outside the budget provision in a financial year without the approval of the Ministry of Finance.

3. **No unpaid liabilities beyond a certain period of time:**
It says that no department of the federal shall allow any liabilities:
(i) Which have become due, to remain unpaid for a period of more than three months; or
(ii) To incur fresh liabilities, if previously incurred liabilities, have remained unpaid for a period of more than three months.

IV. Parameter for borrowing at state and LG level

Presently, there are no borrowing limits set out for federal, state and LGs. The MoF in consultation with federal government should allow them to borrow upon the security of the Central Consolidated Fund (as defined in clause 117 of the constitution). It is suggested that the following key fiscal measure and strategic priorities to be strictly monitored by state and LG before approaching state TDF for borrowing:

The PATA team suggests that the targets should be a fixed number and not a range since the latter for the fiscal deficit will tend to get operationalized at the upper end of the range. Also, some amount of flexibility is automatically built if targets are fixed to one decimal, which allows for some space for changes within the decimal point. Further, fixed targets rather than a range can make fiscal policy more predictable, and therefore enhance investor confidence.

State Government

- Revenue deficit to be a certain % of state GDP
- Fiscal deficit to be a certain % of state GDP
- Public debt to be a certain % of state GDP

Local Government

- Public debt to be a certain % of revenue

For the purpose of ascertaining the GDP at federal and state level, relevant consolidation relating to revenue and expenditure of federal, state and local should be made. In order to determine the cap/ ceiling of public debt as a percentage of GDP, the GoN may adopt several practices. The following are some of the methods of determining the debt ceiling:

- Debt and growth
- Maximum level of sustainable public debt
- Comparison with other emerging markets
- Debt intolerance
- Credit rating agencies

The following inferences should be included in the enforcement mechanisms suggested under FRBM Act:

1) The act is directed primarily at preventing revenue and fiscal deficit targets from being breached. A range of measures for increasing revenue and reducing expenditure, statement on remedial measures and a few prohibitions to prevent widening of revenue and fiscal deficits are to be provided for.

2) In the event such targets being missed, the act should not prescribe significant punitive action to ensure enforcement but instead opt for a soft accountability measures— a Review Report by the Finance Minister to the central Legislature and a statement explaining deviations and action plan for the rectifications. Since Nepal is in its developing stages, softer measures would ensure effective achievement of targets. However, soft accountability measures are only suggested for the initial stages.

3) A further provision is suggested to make such review independent by setting up an agency for this task. In any event, accountability in case of deviations is sought to be enforced through a reporting obligation, rather than any more stringent consequences.

Further, there should be a consistency in the policy framework. The Federal should not make frequent changes in its policy stance and deviate significantly from the policy it has established so as to give the confidence to the investor on the maturity of the market.

Suggestive roadmap for enactment of FRBM

Table 9: Roadmap for enactment of FRBM

Sr.	Activities	Short Term 0 to 1 Year	Mid-term 1 to 3 Years	Long Term More than 3 Years
	(a) Policy framework	Initiation and enactment of bill under the federal law	Management of budget deficits and fiscal discipline of the federation, state, and local level under the federal law	Enactment of FRBM at state level (amendment of constitution is required)
	(b) Creation of Joint FRBM Council	Creation of council	Monitoring of the fiscal rules and the targets at federal level	-
	(c) Establishment of accounting standards, policies and practices	Establish accounting norms and standards that require accrual accounting and reflect international accounting standards	Continuous updating with international practices and changes	-
	Note: The roadmap illustrates minimum activities (not limited to) that should be undertaken for effective subnational borrowing. Further details are also discussed in the report in relevant sections			

It is suggested that the preparation of bill be initiated and legislation enacted within a time frame of 12 months from the date of adopting the roadmap. Thereafter, state FRBM act may be enacted eventually after a time period of 3 years post which the subnational government will be aware of the means and ways of fiscal discipline.

Along with the FRBM act, a joint FRBM council should be created to monitor the fiscal rules and targets set by the FRBM. The details of the council have been elaborated in the previous sections.

Also, accounting standards, policies and practices are required to be established which will at par with international standards.

5.2 Creation of a borrowing framework for state and local government

It is the responsibility of the federal government to guide the state and LGs in maintaining fiscal deficit within reasonable limits. This is done through providing guidelines on subnational borrowings to state and LG and is one of the fundamental principles followed in assigning functions to state and LG.

5.2.1 Restructuring TDF for development of borrowing by the state and LGs

The proposed activities for evolution and restructuring of TDF are (i) bringing TDF under the umbrella of MoF and (ii) creating special legislation for the operation of TDF as an autonomous institution.

The PATA team suggests the strengthening of the existing TDF Act to make TDF an autonomous independent organization (under the aegis of MoF) drawing on a steady source of funds, having greater capacity to engage in a wide range of economic development activities than acting on the strength of borrowing and grants from the federal government. This is in line with the draft report “Designing a Framework for Sub-National Government Financing through borrowing in the context of Fiscal Federalism in Nepal, February 2016” wherein reform of TDF has been suggested.

The team suggests establishment of 7 branches of TDF (under the central TDF) at the state level for meeting the financing needs of the states and various LGs within the boundary limits of the particular state. All TDF branches should be independent of each other but should work under the guidelines and control of the existing central TDF which has the necessary expertise and knowledge of lending to LG in Nepal.

However, the 7 branches (at each state) may not be established at once. Although the establishment of branches has been suggested as a medium term goal (please see roadmap in subsequent section), the eventual procedure of setting up branches shall be based on the actual demand of loans which may vary from state to state. Therefore, it is suggested that an assessment of actual demand of loan be conducted and branches of TDF be established accordingly in a phased manner. Till the time there are any branches set up in a state, the borrowings can take place through the central TDF.

Rational for considering TDF as an intermediary for subnational borrowing

Subnational governments rarely gain direct market access in developing financial markets. For that reason, market intermediaries are created that reduce risks and facilitate market access. The following table gives an example of a financial intermediary created for urban sector in Tamil Nadu. [31]

Table 10: Tamil Nadu Urban Infrastructure Financial Services Limited

TNUIFS is "a Public-Private Partnership in the urban sector." It started out as a simple MDF and is now a Public Limited Company registered under the provisions of the Companies Act, in 1996. It is promoted by the Government of Tamil Nadu with equity participation from banks and financial institutions. The company lists its main functions as: - Managing trust funds and other funds and acting as managers, consultants, advisors, administrators, attorneys, agents, or representatives of or for any funds; and - Acting as consultants, financial advisors and investments advisors and rendering consultancy, financial and investment advisory services. One of its trust funds, the Water and Sanitation Pooled Fund (WSPF), has raised funds in the financial markets including through bond issues. TNUIFS identifies both public and private financial institutions as strategic partners. The WSFP functions in a similar manner to the Revolving Fund envisioned for TDF. The other trust funds are managed on behalf of particular donors or for projects in specific targeted sectors. This fund structure allows TNUIFS to account separately for and manage the profitability of each line of credit, while support the demand for management of donor programs with lending components

In Nepal, TDF could link subnational governments to the capital market in the medium term. Further, the track record of lending by TDF to municipalities shall be considered as an advantage for facilitating subnational borrowing.[31] The following are the key reasons for suggesting TDF as an intermediary for lending of funds to subnational government:

- **Avoiding radical institutional changes**
  Establishing an entirely separate financial intermediary would be a lengthy procedure including institutional changes that would involve enactment of legislation, deployment of manpower, capacity building from scratch, etc. Therefore, strengthening the existing TDF and replicating it at subnational level will be a simpler process.

- **Challenges faced by TDF**
  TDF, in Nepal, has already encountered various challenges such as donor demands, inexperienced clients, non-bankable projects, delay in repayment of interest and principal, etc. Therefore, the PATA team suggests it to be restructured as a strict lending institution.

- **Requirement of borrower discipline[31]**
  TDF with its various reforms has been able to improve its balance sheet and financial results and has managed to bring in some degree of discipline among the borrowers. By strengthening TDF through establishment of branch offices at states, it will be easier for them to enforce borrower discipline.

- **Single window coordination for MoF in case of foreign borrowing**
  Since there are 753 LGs along with 7 states, MoF will have a single window (TDF) to coordinate for matters relating to project appraisal, repayment, monitoring, etc. It will not have to directly lend to 753 different LGs.

- **Pooling of borrowing demands**
  TDF can pool the borrowing demands (e.g. activity wise) of the 753 LGs and approach lenders directly or through MoF (foreign borrowing) for funds. This system of pooling of demands will enable them/MoF to negotiate a better terms of loan from the lender.

- **Internal credit enhancement**
  TDF may consider entering the market by refinancing a pool of seasoned well-performing subnational loans and use the cash flows from the pool as security instead of using government guarantees as its first line of security for borrowing from banks.[37]

- **Direct access to funds by subnational government**
  Creation of state branch of TDFs will ensure presence of the intermediary throughout the country enabling borrowers to have a direct and easier access to the lender for its various borrowing requirements.

- **Intercepting fiscal transfer[31]**
  As we have proposed TDF under MoF, it has an ability to intercept fiscal transfer in case of delay or default by borrowers (with the support of MoF)

In light of the above, the PATA team has made the recommendation on restructuring of TDF with establishment of branches. The number of branches has been considered as seven as per the number of states as it has been presumed to be an eventuality, which will occur in the long term.

Table 11: Assessment of 16 municipalities on MC/PM data[31]

Summary of analysis	
No. of municipalities considered for analysis:	**16**
No. of municipalities where data was available	**14**
Results	
Grade	
A (Score more than 80)	6 (Bharatpur, Birendranagar, Butwal, Hetauda, Ithaki, Pokhara)
B (Score more than 70 but less than 80)	2 (Byas, Dhangadhi)
C (Score more than 60 but less than 70)	2 (Damak, Bhimdutta)
D (Score more than 55 but less than 60)	1 (Lalitpur)
Fail	3 (Birgunj, Chandrapur, Janakpur)

Table 11 justifies the PATA team's suggestion to establish state TDFs, as only 6 out of 16 municipalities have received a score of more than 80 on various assessment parameters. The above analysis justifies the need for creation of state level branch offices of TDFs which will cater to the various municipalities coming under its jurisdiction for their financial and development needs. Further, the state TDF offices will facilitate technical assistance to the subnational government. The branch offices at states with their project appraisal department, monitoring and supervision department, etc. will solve the issues currently being faced by subnational governments (that has resulted in such poor results, as given above). Further, strengthening of subnational government in areas relating to preparation of budget calendar (states) and guidelines for preparation of budget, enactment of FRBM legislation, implementation and effective internal audit procedures, drafting of financial procedures, strengthening overall financial management, etc. may ensure that fiscal discipline is maintained and result in improved performance of subnational governments in terms of loan repayment.

The following steps have been suggested for restructuring of TDF in order to serve the purpose of being a financial intermediary for subnational borrowing:

I. Restructuring of existing TDF

(i) **Change in nomenclature:** TDF was established to cater to the development of towns which include metropolitan cities, sub-metropolitan cities, municipalities and town oriented villages.

[37] Final report - Designing a Framework for Subnational Government Financing through Borrowing in the Context of Fiscal Federalism in Nepal

Since TDF is mainly focused on urban development, and going by the recommendations rural municipalities will also be dependent on TDF for borrowing needs therefore, it is recommended that the restructure of TDF is initiated with a change in nomenclature.

(ii) **Amendment in legal provisions/enactment of a new law for TDF:** The following are some of the required legal provisions that need to be included/strengthened in the existing legislation for effective functioning of the TDF:

- Lending procedure and practices
- Loan recovery mechanism
- Enforcement of loan recovery conditions
- Confiscation of collateral

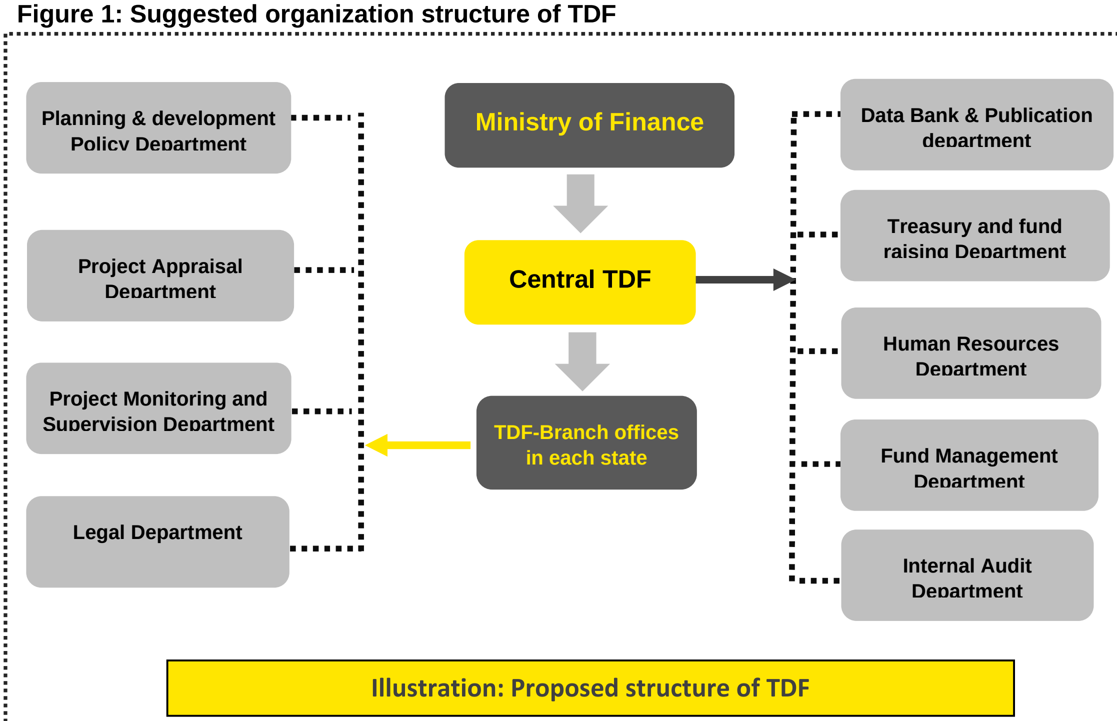
The key features for the proposed amendment/law governing the TDF are illustrated below:

- TDF should have a strong capital base owned by the government institutions.
- TDF should be able to raise its equity capital through public offering of the shares up to 40% and also should be enabled to raise funds from the capital market by issuing bonds and certificates of deposits for institutional savers.
- The intermediary should come under the umbrella of the MoF to better coordinate international funding agencies and mobilize resources from the domestic capital market.
- The organizational structure of the intermediary will be overhauled to make it more like a business organization

(iii) Suggested organization structure:

For the growth of the various states and LGs the PATA team suggests that the TDF at the federal level and its branch offices should have the following departments on a minimum:

Figure 1: Suggested organization structure of TDF



Note: Branch offices of the TDF will cater to the states as well as the local governments of the concerned states

The roles of state TDF will include coordination and assessment of various development needs at state/local government level. The various state TDFs created as above shall have the following key departments:

Central TDF

i) **Data Bank and Publication Department**: It will be responsible for collection and publication of various types of data and other literature regarding institutional credit on various projects by branch offices of TDFs. These data can be shared among the various state TDFs for future development projects.

ii) **Treasury and Fund Raising Department:** The main objective of this department would be to raise long term funds based on assessment of various requirements received from the branch offices of TDF at state level. Further, it will also raise funds domestically and internationally as specified in the next section 'B' – Sources of funds.

iii) **Human Resource Department**: This department is responsible for preparing various schemes for upgrading the human resource at the federal and state level. It will primarily be responsible for training activities and capacity building of TDF staff. The department will also prepare outlines for various seminars and workshops, etc. It will also be responsible for personnel administration and industrial relations.

iv) **Fund Management Department**: The fund management department will be responsible for (a) preparation of budget, (b) planning and mobilization or resources, (c) investments, (d) collection and payment, (e) account management, (f) preparation of reports, returns and other correspondence therewith, (g) planning for utilization of funds, (h) framing of rules relating to provident funds, medical benefits and other allowances payable to the employees of TDF (i) maintenance of proper books of accounts of all receipts and payments, (j) preparation of bills and disbursement of salaries, (k) identification of NPA and its resolution through accounting and recovery, etc.

v) **Internal audit department**: There should be an efficient and effective internal audit department independently reporting to the Board of Directors of the TDF. The key job of the department will be to ensure that all the policies and principles of TDF are strictly followed at central TDF level as well as at the branch offices of TDF at the state level. Any variation with the stated rules and regulations should be immediately brought to the notice of the Board for corrective actions. The department can also prepare the inspection reports, which include suggestions for improvement of the working of the TDF. Further, the department will ensure that the interests of the equity investors, lenders, and other depositors are protected and both central TDF and state TDFs follow healthy and approved financing practices.

Branches of TDF at state level

i) **Planning and development policy department:** It will study the changing needs of the state/local governments and formulate key policies of the independent state TDFs on an annual basis. For example, for development of farm sector the department may design a framework and help state/local government to work in the policy framework for sanction of loan.

ii) **Project appraisal department**: This department should consist of technical and financial experts. The key role of this department will be to study and appraise the various development projects submitted to them by state/local government. Their focus should be on projects with significant economic returns. Additionally, this department will also advise on the financial parameters of the loan such as:

- Repayment procedure
- Repayment structure
- Moratorium of loan
- Repayment before due date
- Penalty clauses in case of default
- Request for modification in terms of loan, etc.

iii) **Project monitoring and supervision department**: Once the project gets appraised and loan gets sanctioned to state/local government, this department would start monitoring the project on various parameters such as cost, time, purpose of the project for which the loan has been sanctioned. The department will also monitor the timely repayment of the loan. The reports will have to be prepared on a monthly basis and any variation with the appraised project would be brought to the knowledge of its Board and as well as the state/local government. The monitoring and evaluation activities will enable TDF to learn useful lessons from the experience of development schemes. This department will also focus on NPA recognition, treatment and strategy of recovery.

iv) **Legal department**: There should be a strong legal department at each state level TDF office. They are needed for (a) ascertaining the legal accuracy and title deed, verification of assets acquired by state TDF, (b) preparation and execution of all legal documents, and (c) taking legal actions where it is necessary to protect the Interest of TDF.

The above departments will be involved in the overall project management activities.

Board of Directors: The existing Board of directors of TDF need to be restructured and strengthened to bring in the autonomy and independence. It should be a broad based mixture of independent experienced and knowledgeable professionals from various background such as technical, accounts and finance, legal, bureaucrat, experts in rural economic development and representatives from NRB, Ministry of Finance (federal), Ministry of Finance (state).

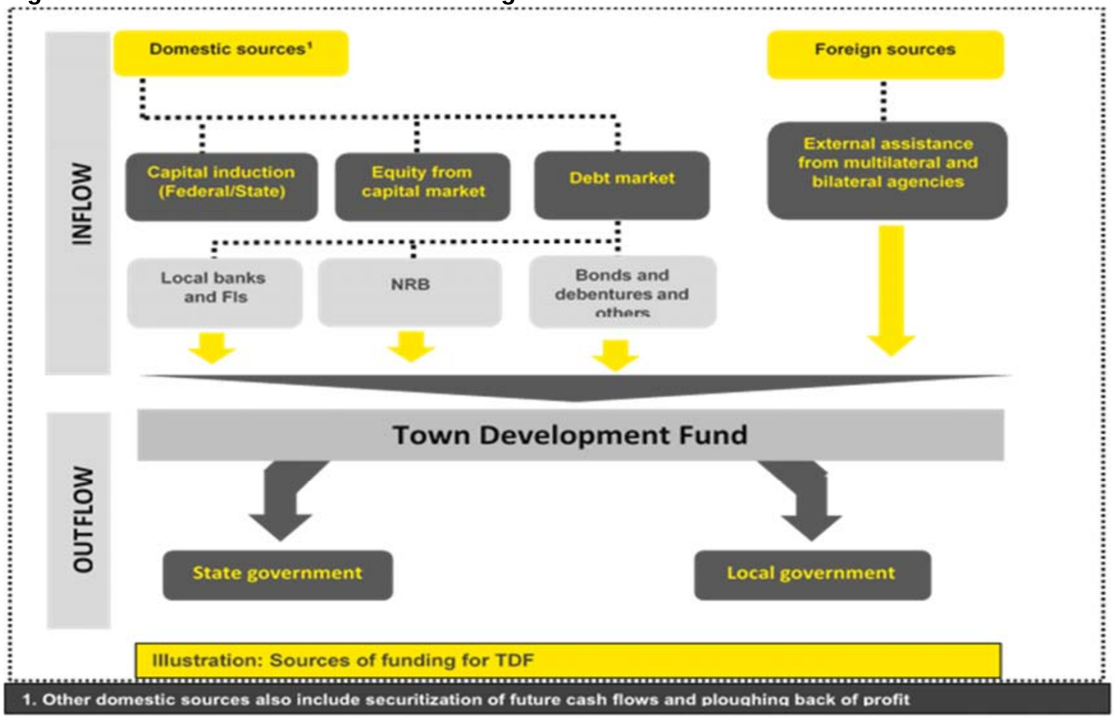
As per the international best practices the general superintendence, direction and management of the affairs and business of the TDF shall vest with the Board of Directors, which shall exercise all powers and do all acts and things, which may be exercised or done by them as an independent development bank and not as a nominee of federal government .

The Board shall constitute an advisory council consisting of such number of directors and such other persons who in the opinion of the Board, have special knowledge in areas (illustrative) such as infrastructure credit, agricultural credit, cooperation and rural economics, small-scale industries, village and cottage industries and handicrafts and other rural crafts or have special knowledge and appreciation of the country's overall development policies and in particular overall monetary and credit policies, which are considered by the Board as useful to TDF.

II. Sources and modes of borrowing by TDF

TDF would require funds for the on lending for various development project. Certain funds can be raised for the specific project matching with its cash flow and requirements whereas some funds can be raised for general purposes and shall be used based on the need of the project. Fund raising capabilities of TDF should be enhanced and they should be allowed to raise the funds from various sources.

Figure 2: Sources and modes of borrowing of TDF



TDF is the only organization in public sector for financing urban infrastructure development through loans and grants. It has financed several urban infrastructure projects ranging from urban roads to city bus terminals for long term financing schemes about 20 years. Despite an incentive mechanism of topping some loans by grants and very concessional terms of lending, the municipal demand for loan from the TDF is very low. As of July 2015, the outstanding borrowing of the municipalities was only Rs 1,136 million. The borrowing capacity of municipalities is still very low as total borrowing capacity of the municipalities for the FY 2015/16 would only be Rs 340 million. Municipal borrowing capacity is assessed against the ability to repay through internal revenue mobilization, the borrowing capacity will be enlarged if the municipalities enhance their existing revenue performance[38].

The modes of borrowing of the TDF have been divided into two parts – domestic and foreign.

Domestic sources

The PATA team suggests the following domestic sources of borrowing:

1) **Capital induction:** Paid up capital and reserves could be a significant financial strength of the TDF. The capital base of the TDF should be large enough to cater to the demand of the state and local government towards the development of the country. The proposed financial intermediary will have to possess at least NPR 20 billion[30] of capital at the beginning on which they can leverage and borrow corresponding that amount from the market.

   The current capital of TDF amounting to around NPR 2.5 billion implies that strong government commitment will be needed to be a majority shareholder of the TDF as a financial intermediary.

   The above capital can be raised by the TDF from a) federal government, b) state government and c) stock exchange (capital market).

[38] Final Report – Municipal Finance Framework for the National Urban Development Strategy (NUDS) of Nepal

2) **Issue of long-term bonds, debentures, local banks and financial institutions in the market:** The TDF may take the debt market route by issue of rated long-term bonds and debentures. These bonds may be subscribed by the provident funds, pension funds, and insurance companies and also by the citizens of Nepal.

   Additionally, TDF may issue rated long-term tax free bonds at a low coupon rate in which the investment may be done by the citizens of Nepal. Further, TDF can also borrow the above instruments from domestic lender based on guarantee issued by GoN. However, such mechanism should only be used for long term infrastructure projects.

3) **Securitization of future cash flows**: Long infrastructure projects where there is the certainty of cash flows can also use the securitization route for raising the funds.

4) **Plough back of profit generated on various lending over a period:** The TDF may generate profits over a period of their operations. This could be a significant source of fund to finance the subnational projects.

Foreign sources

External assistance from multilateral and bilateral agencies such as ADB, World Bank, DFID, etc. has played a significant role in the development of Nepal. The role of external assistance has gained further significance in view of the large gap in funding requirements for social and infrastructure sectors to acquire competitive strength under the globalized economic framework.

An important component of flow of fund from federal to state and local government is through on-lending of funds sourced from multilateral and bilateral agencies. Most of these loans are procured to fund investment in infrastructure. Since subnational government in Nepal does not have direct access to borrowing from foreign sources owing to 'foreign loans' being a matter within the sole legislative competence of the federal government, and consequently, a matter to which executive power of the Union extends, the federal government must take on the loan on behalf of the state and local government and on-lend the funds to subnational government through the proposed structure of TDF.

With regard to the proposed structure of on-lending in Nepal, the PATA team suggests IECCD division of the MoF to be responsible for:

a. Procuring and coordinating external assistance from multilateral and bilateral agencies
b. Overlooking policy issues pertaining to external assistance received by Government of Nepal (GoN)
c. Reviewing and evaluating projects in consultation with TDF
d. Negotiating external assistance terms & conditions

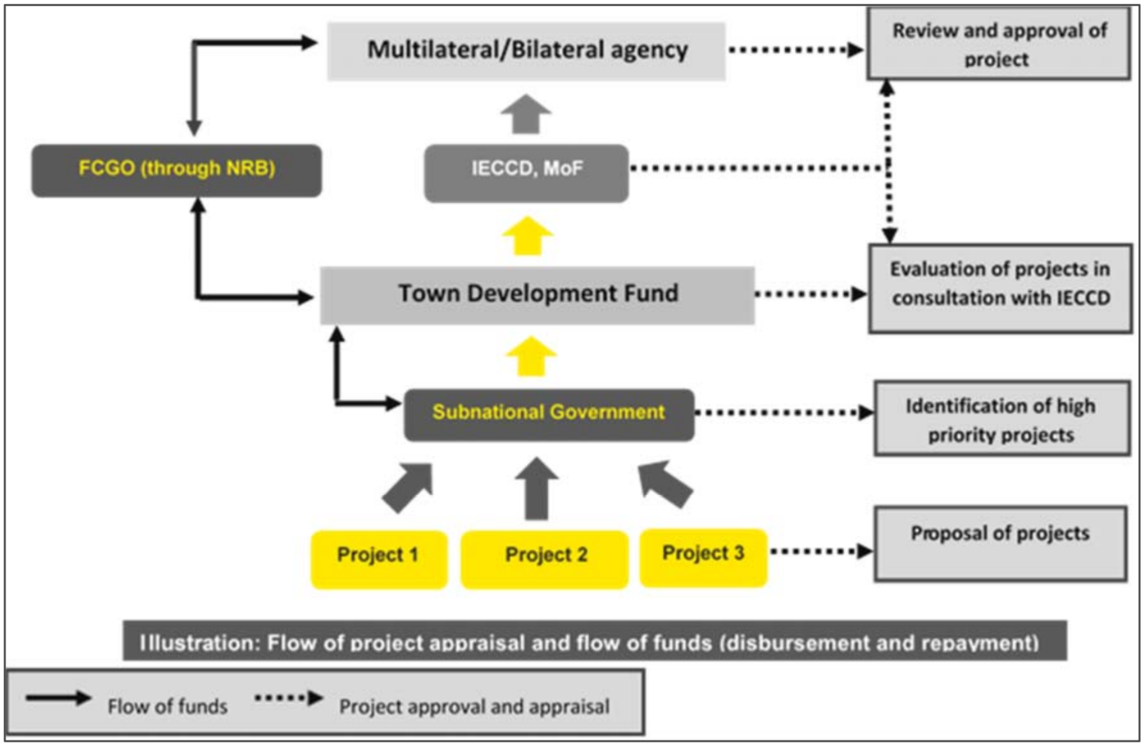
The suggested procedure is similar to the current practice but is relatively streamlined. Presently, the MoF is directly on-lending funds to LGs (some funds are routed through TDF) and is charging a spread on the interest rates to cover overhead costs and currency fluctuation losses. Further, a separate contract with revised terms and conditions is executed between the federal and LGs. However, the PATA team suggests all the on-lending to be routed through the TDF. The TDF will be responsible for identifying projects at the subnational government level and bringing it to the table of federal government. Federal government, on basis of the sectors for which funds are required will coordinate with the multilateral and bilateral agencies to obtain funds.

However, MoF will have to enter into a subsidiary contract with the TDF wherein TDF will bear the foreign currency loss. The terms and conditions will be discussed between TDF and MoF and will be finalized accordingly.

With regard to the subnational government and TDF, the intermediary will be responsible for drafting the agreement with the borrower.

In order to facilitate the smooth and speedy flow of external assistance the GoN has to make a procedure for fund flow.

Figure 3: Suggested procedure for flow of fund from multilateral/bilateral agencies to borrower and back (on-lending)



A. Project Identification

The concerned subnational government (borrower) identifies the project having high priority in the development perspective and prepares the project proposal describing its objectives, implementing agency, implementation schedule, project cost, amount of assistance, etc. The formal responsibility for preparation of project rests with the borrower, although the funding agencies assist the eventual borrower in preparation of sound projects and also provide technical and financial assistance for preparation of project reports.

After the TDF receives the project proposals, they are evaluated in consultation with the IECCD, MoF and project authorities and proposed to the multilateral/bilateral agency.

B. Project Appraisal

The multilateral/bilateral agency in consultation with the IECCD reviews the project comprehensively. Appraisal covers four major aspects of the project: (i) technical; (ii) institutional; (iii) economic; and (iv) financial. The multilateral/bilateral agency ensures that projects are soundly designed, appropriately engineered, and follow accepted standards. At this stage, the various conditions and covenants, project activities, amount of loan, repayment procedures, rate of interest and other procurement issues are discussed and finalized.

C. Loan Negotiation & Signing

The negotiating team consists of representatives of IECCD on one side and multilateral/bilateral agency on the other side. All conditions are thoroughly discussed and agreed to. At the end of negotiations, minutes of the loan negotiations are signed and draft loan agreements are approved by both the negotiating agencies. The key terms negotiated are:

i) Project Activities
ii) Amount of Loan
iii) Period of Loan & its repayment procedure
iv) Moratorium of Loan repayment
v) Terms in case of repayment before due date
vi) Penalty clauses in case of delay in project, default in payment of principal or interest

vii) Request for modification in terms of loan based on changes which are unforeseen at the time of the appraisal of the project
viii) Guarantee if any given by the federal government
ix) Obligation and responsibility of executing agencies and federal government

Based on the draft loan agreement the multilateral/bilateral agency takes approval from its sanctioning authority/board. After the loan is approved it is signed by IECCD and the multilateral/bilateral agency. .

D. Transfer of assistance to state and local governments

After the agreement is signed, the funds shall be drawn from the lending agencies to the FCGO. The process of withdrawal of funds from the funding agencies to the borrower is known as 'Disbursement'. The type of procedure normally adopted for withdrawal of loan /grant/ credit (disbursement) from the funding agency are as under:

- Reimbursement procedure.
- Direct Payment procedure.
- Liquidation/Replenishment
- Report based disbursement.

The PATA team suggests a direct payment[39] of loan amount to central TDF, as per the defined schedule through the FCGO (routed through NRB), who will subsequently disburse the funds to the local governments.

E. Guarantee by the federal government

The provisions relating to guarantee by the federal government should be subject to the FRBM Act of Nepal. Power to grant guarantees by the GoN should vest with the MoF. The GoN should cover only the principal and normal interest amount.
The subnational government shall enter into an agreement with the GoN for the payment of guarantee fee on the principal and interest amount of the loan drawn.

F. Currency fluctuation risk

Many of these loans tend to be of longer maturities, which help state/local government to manage the project more efficiently. However, any currency fluctuation risk should be on the account of the TDF.

G. Project execution/evaluation and monitoring:

The multilateral/bilateral agency and the IECCD may monitor the project execution closely. However, TDF will be primarily responsible for monitoring the projects. Tripartite portfolio review meetings should be held from time to time amongst the TDF, multilateral/bilateral agency and IECCD. Mid-term review should also be carried out by the multilateral/bilateral agency.

The monitoring should include comprehensive evaluation of the project, both of performance and impact, in the project design itself. Evaluation arrangements for the project, whether concurrent, mid-term or post-project should be spelt out in the project proposal.
Further, two years after the completion of the project, an Impact assessment study may also be conducted on selected projects by a neutral organization to ascertain the actual achievement of the project.

H. Repayment[3] procedure

The repayment has to be made as per the amortization/repayment schedule in the financing agreement between the TDF and MoF. FCGO should be responsible for repayment of all the charges i.e. repayment of principal amount of loan/credit and payment of interest, commitment charges, etc., on the due date mentioned in the agreement. For the subsidiary contract between MoF and TDF, the intermediary should be responsible to make the payment to the federal government. With regard to the agreement between TDF and subnational government, payment shall be made by the concerned state/local government to the TDF office as per their agreement.

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[39] State and local governments should ensure the repayment amount of principal and interest is duly reflected in subsequent budgets.

III. Strong Assessment Process

The assessment process at federal/state TDF level is required to be strengthened for various development projects submitted to it by state and local governments.

The decision of the importance of the project lies with the state/federal government and TDF has no role in deciding the same. It should specify, but not limited to, rules in respect of (a) matching of the quality of cash flows with respect to the projects for which funds may be borrowed; (b) the works for which funds may be borrowed; (c) the manner of making applications for permission to borrow funds; (d) the manner of raising loans (long term loans or grants, funding from own sources or external source, domestic debt or international debt with the approval of federal government) ; (e) assets to be provided as the security for the loan; (f) the attachment of such funds and the manner of disposing them; (g) the maximum interest rate at which the funds can be borrowed: (h) system not based on guarantee from the federal government; (i) currency of loan NR or foreign currency (with federal government approval); (j) development of a system for rating the creditworthiness of instruments and the subnational government or municipalities

IV. Rating

For long term sustainability of any financial intermediaries it is essential that it should be rated by any of the internationally acclaimed Rating Agency. The rating will not only assess the financial status and performance of TDF but will also help in raising funds in the domestic and international market at competitive pricing. Regular rating exercise by independent rating agency will also enforce discipline in functioning of the TDF.

V. Capacity building

The GoN is recommended to create a training and development institution under the leadership of MoF for capacity building of TDFs. The trainings will be conducted with close coordination with the human resources department of TDF. The Institution should have a proper budgetary allocation from the GoN for expenditure. This is in line with the draft report on “Designing a Framework for Subnational Government Financing through borrowing in the context of Fiscal Federalism in Nepal, February 2016” which suggests building of technical capacity.

The key objectives of this proposed institution would be:

- To act as a national resource pool which provides information on best practice across the country and the globe.
- The state/local government owned resource centers/institutes (e.g. centers for poverty reduction, waste management, water management, and electricity management) should provide capacity building support to TDF to ensure specialization of sectors. A detailed study and guideline note is required to be prepared for each type of center for effective utilization of funds borrowed for the respective purposes.
- Strengthening of financial management of TDF (e.g. accrual basis of accounting) which would instill confidence in the investors.
- TDF officials should be trained on subjects relating to financial debt market, Nepal accounting standards, computer skill and knowledge, data management, MIS reporting, etc.
- Other important areas of capacity building are treasury and risk management, optimized utilization of available fund, management of foreign currencies and interest rate risk in respect of borrowing under on-lending mechanism at MoF level etc.

The above capacity building shall be done for a period of five years after which the TDFs should take the ownership of the same from the GoN.

5.2.2 Establishment of a strong credit rating environment

1) Creation of a Strong Credit Rating Infrastructure

   a) A credit rating is an independent opinion on the future ability, legal obligation and moral commitment of a borrower to meet its financial obligations of interest and principal in full and in a timely manner. Rating is important to issuers for two key reasons:
   (i) Investors are reluctant to buy bonds if they are not rated; in several countries, the federal government does not permit sub-sovereigns to sell unrated bonds
   (ii) The rating often serves, particularly in countries where interest regimes are allowed to operate freely, to determine the interest rate at which sub-sovereigns can issue debt in the capital market.
   b) The main objective is to provide superior and low-cost info to investors for taking a decision regarding risk return trade off, but it also helps to market participants in the following ways:
      i) improves a healthy discipline on borrowers,
      ii) Lends greater credence to financial and other representations,
      iii) Facilitates formulation of public guidelines on institutional investments,
      iv) Helps merchant bankers, brokers, regulatory authorities, etc., in discharging their functions related to debt issues,
      v) Encourages greater information disclosure, better accounting standards and improved financial information (helps in investors protection),
      vi) May reduce interest costs for highly rated companies,
      vii) Acts as a marketing tool
   c) Credit ratings are not:
      i) Recommendations to buy, sell or hold a security.
      ii) Opinions about the general quality of a government or statements about the quality of life in a community.
      iii) Opinions about the correctness of a government's policy decision.

ICRA Nepal is the rating agency in the country. However, there are no statutory requirement of maintaining the Issuer rating. Only in case of IPO or Right Issue the rating is mandatory for the transaction. Hence there are very few companies who are rated despite 235 Companies listed on the Nepal Stock Exchange.

The PATA team suggests that the credit rating agency in Nepal, drawing upon the experiences of its International partner, should undertake an exploratory exercise to evaluate the credit quality of TDF, states and municipal entities in Nepal, with a view to explore the feasibility of expanding the horizons of its rating operations. This will help the bond market in Nepal to have a noticeable growth in terms of issuers and investors, instruments, and volume of transactions.

Going forward TDF, states & municipal entities have to look at raising resources in the capital market on the strength of their own credit standing and credit enhancements based on escrowing of the cash flow. The acceptance of municipal bonds in Nepal as an instrument for raising resources for financing infrastructure projects will help in broadening and strengthening of the local debt market. Municipal bonds in Nepal can be securitized debt instrument, providing future revenue flows from the project as collateral. The same can be effective based on a strong rating frame work.
The above recommendation is in line with the draft report on "Designing a Framework for Sub-National Government Financing through borrowing in the context of Fiscal Federalism in Nepal, February 2016" which suggests introduction of credit rating agencies to develop a system for rating the creditworthiness of municipalities.

2) Establishment of multiple rating agencies

At present, ICRA is the only rating agency in Nepal which is rating the IPOs and right issues. However, with the growing need of issuer rating for various development projects, bonds, debentures and others, PATA team suggests development of another credit rating agency in Nepal having international partner.

Assessment of projects by two independent rating agencies give more comfort to the lender at both domestic and international level and will also enable the borrower to borrow at lower costs.

Suggested roadmap for creation of a borrowing framework for subnational government

Table 12: Roadmap for creation of a borrowing framework

Sr.	Activities	Short Term 0 to 1 Year	Mid-term 1 to 3 Years	Long Term More than 3 Years
	(a) Restructuring of TDF	1. Financial strengthening of existing TDF 2. Capacity building and employing technical and financial experts in existing TDF 3. Strengthening the project appraisal procedures of existing TDF 4. Accrual basis of accounting should be adopted 5. Development of lines of credit	Creation of state level TDF following the framework of Central TDF as applicable	1. Sustainable capacity building at central and state level TDFs 2. Adopting various financial borrowing structures such as securitization of receipts, etc.
	(b) Who will be lenders - Domestic borrowing	Existing TDF	State branch of TDF	State branch of TDF, subnational government
	(c) Who will be lenders - External borrowing	Existing TDF	State branch of TDF	State branch of TDF, subnational government
	(d) Technical capacities	Existing TDF	State branch of TDF	State branch of TDF, subnational government
	(e) Financial modelling	Existing TDF	State branch of TDF	State branch of TDF, subnational government
	(f) Capacity building	Creation of training and development institution for capacity building in project and municipal finance	Creation of a pool of workforce in project and municipal finance	Establish a training of trainers programs
	(g) Establishment of a strong credit rating infrastructure	Commencement of issuer rating mechanism for the borrower by the existing rating agency (ICRA)	1. Development of multiple credit rating agencies. 2. Deepening of issuer rating market with mandating of rating of instruments for borrowing above a threshold	Issuer rating can be taken for all the projects
	Note: The roadmap illustrates minimum activities (not limited to) that should be undertaken for effective subnational borrowing. Further details are also discussed in the report in relevant sections			

The restructuring of TDF should be in phased manner. In short-term, it is suggested to strengthen the existing TDF. Thereafter, the creation of state branches can be undertaken as and when the demand arises (a detailed demand analysis is suggested) in the next 1 to 3 years. After 3 years, when the market and subnational governments will be matured enough, various other borrowing structures may be adopted. During the course sustainable capacity building is an absolute necessity.

The PATA team has considered the suggestions made in "Designing a Framework for Subnational Government Financing through Borrowing in the Context of Fiscal Federalism in Nepal" by UNCDF and the report on Municipal Finance Framework for NUDS of Nepal.

6. Perceived challenges and risks in implementation

In the present context, even though it is evident that subnational borrowing is necessary for infrastructural development, successful implementation of a borrowing framework in Nepal faces several ground level risks and challenges. Such risks and challenges may exist at every stage of implementation of the framework and may directly or indirectly impact the overall borrowing exercise.

The following are the key risks and challenges that are expected to arise during the implementation of the framework:

Table 13: Key Risk and Challenges for implementation of subnational borrowing

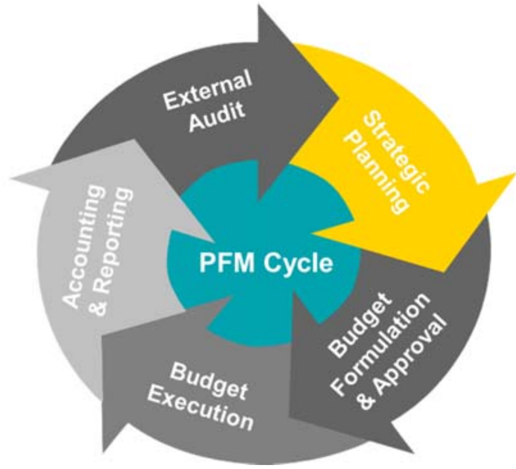
Implementation of subnational borrowing	
Key Risks	**Challenges**
▶ Keeping public debt at acceptable levels is a long-term objective. However, given the uncertainty of emerging fiscal situation in Nepal at subnational level, devising fiscal rules and quantum of prudent debt levels is a very difficult task. ▶ Proper coordination between fiscal and monetary policy is an essential condition for success of fiscal responsibility legislation. Currently, the coordination is at a very nascent stage with fiscal policy domination the monetary policy, which does not augur well for fiscal discipline. ▶ Implementation of sanctions for non-adherence to targets will jeopardize the relations between central units. ▶ Availability of necessary data at state and local level for computation of parameters for fiscal discipline. ▶ Delay/Non-implementation of the projects for which the borrowing has been by states & Municipalities will result in default on the loans ▶ Timely creation of state level TDF with effective control mechanism as suggested in the study. ▶ As the currency of Nepal is linked to INR any adverse movement in the same will increase the loan amount payable in case of loans taken by state & Municipalities under the on-lending mechanism through federal government	▶ Adequate fiscal data needs to be collated for assessing the fiscal health of subnational governments, which should be the basis for setting any debt limits. ▶ Mechanism needs to be put in place between the MoF and NRB for ensuring adequate coordination between fiscal and monetary policy of the government. ▶ As a top down approach is advocated in setting fiscal targets, monitoring the adherence to targets will be a very difficult task. ▶ Timely implementation of the project by the subnational governments without cost overruns ▶ TDF to get the requisite amount of capital and debt for on-lending to subnational governments ▶ TDF to have requisite trained manpower for effective evaluation of the project and its monitoring for implementation and timely repayment of debt by the borrower ▶ Implementation of internationally accepted accounting standards and policies and keeping pace with the changes in the global markets. ▶ Preparation of all the budgets of subnational governments so as to calculate their fiscal status

Chapter IV

Component 4: Improving Expenditure Allocations and Public Sector Budgeting

1. Introduction

Budgeting is a key step in a public financial management (PFM) cycle. It is an estimate of government revenue and expenditure during a given period of time. Budget is that document of government that captures how the government plans to prioritise its expenditure decisions and activities to accomplish its annual and multi-year goals. Budget is the key instrument for implementing fiscal policy, thereby influencing the economy as a whole, in addition to financing existing and new programmes. With the aid of government policies including laws and regulation and coordinated action among other stakeholders in society, a budget aims to convert plans and programs into reality.



The financial aspects of all levels of government, i.e., federal state and local are encompassed in budgeting. This includes the various mandates and powers stipulated by the constitution for the different autonomous bodies of the country. Ideally, to prepare a credible budget, there needs to be integration and coordination among the systems and procedures of budgeting, consistent across the hierarchies of government.

Good practices in budgeting entail the support of the various pillars of good governance including budget honesty and integrity; transparency and participation of decision makers, executive and beneficiaries; ownership; and a strategic multi-year approach to planning and allocation.

The important principles for preparing and executing a credible budget are summarized below:

- Setting direct, credible and predictable limits for fiscal policy
- Synchronizing plans with the medium-term goals and priorities of the government
- Designing budgeting framework to cater to national development goals in a cost-effective and coherent manner
- Ensuring collation, openness, transparency and accessibility of budget data
- Discussing budgetary decisions in an inclusive, participatory and objective manner
- Capturing a comprehensive, realistic and credible account of the public finances
- Effectively planning, managing and regularly monitoring budget execution, followed up with corrective measures
- Incorporating performance linkages, evaluation and value for money perspectives
- Deliberating on feasibility and sustainability of budgetary targets
- Identifying and mitigating probable fiscal risks
- Improving quality of budget planning, forecasting and execution by carrying out independent audit and evaluation

The Government of Nepal (GoN) is undergoing a structural transformation from a unitary form of government to a federal form, owing to the adoption and enforcement of a newly formed constitution in Nepal. This requires major changes in fiscal processes including budgeting to comply with and enhance the powers and functions stipulated in the constitution that accrue to the various levels of government.

In this context, the Asian Development Bank (ADB) funded Policy Advisory and Technical Assistance (PATA) aims to identify and design policy actions to consolidate public financial management (PFM) reforms at the subnational level in the GoN. The PATA primarily revolves around 5 components among which this chapter deals with component 4: improving subnational expenditure allocations and public sector budgeting.

It is pertinent to note here that public financial management reforms typically take more than a decade to be implemented and show tangible results, especially reforms such as MTEF, MTBF and outcome based budgeting. The success is dependent on a number of factors, such as commitment from the top leadership, a prudent level of fiscal deficits, reliable fiscal data, lower levels of deviation between budget and outturns, fiscal discipline, and baseline data on key performance indicators for critical sectors such as health, education, drinking water and roads. Nepal is going through a phase of consolidation post an unstable phase. The recommendations suggested in this report have taken into consideration above factors; however, given that the states are yet to be operationalized and devolution is still in progress, some of the reforms would require time to take off.

This report is a consolidation of the interim and mid-term reports and addresses the issues in budget preparation and medium-term planning and budgeting in the GoN. Subsequently, recommendations have been suggested for successfully implementing budgetary processes including MTEF, MTBF and outcome-based budgeting at the subnational level.

The next deliverable for this component, in the form of a draft final report, shall focus on developing indicative budget guidelines as well as MTEF guidelines for subnational government, followed by an economic feasibility report, once the recommendations in the draft final report are finalized.

2. As-Is Assessment

The drafting of the report began with an as-is assessment of the current scenario of the GoN with respect to the budget preparation process as well as MTEF, MTBF and outcome-based budgeting.

2.1 Objectives

The **objectives of the as-is assessment** were as follows:

- To identify provisions in the constitution with respect to the new federal structure
- To understand the division of financial powers among the federation, the states and the local levels as mandated by the constitution
- To identify the documents based on which the existing budget preparation guidelines have been issued
- To understand the current budget formulation process at the federal and local levels (budgeting process is yet to start for states)
- To gauge the changes being proposed for implementing the new federal structure
- To identify provisions in the constitution with respect to implementation of MTEF, MTBF or other outcome based budgeting frameworks.
- To gauge the status of implementation of such performance budgeting frameworks by GoN.
- To assess readiness/ feasibility of implementation of such performance oriented budgeting practices at states and urban & rural local levels.

2.2 Approach

The following approach was adopted with regard to conducting the as-is assessment:

- **Analysis of budget data** for the years 2013-14 (actual estimates), 2014-15 (actual estimates), 2015-16 (actual estimates), 2016-17 (revised estimates) and 2017-18 (budget estimates)

- **Desk study** of various documents relating to budget preparation, including the following:
  - The Constitution of Nepal
  - Budget Digdarshan (budget preparation guidelines)
  - Budget Speech of Minister of Finance, GoN, for FY 2017-18
  - The PEFA Journal, March 2017, published by the PEFA Secretariat, MoF, GoN

- Annual Municipal Development Plan document of Lalitpur Sub-Metropolitan City
- Local Self-Governance Act and Rules

- **Discussions** with the following key stakeholders involved in formulating the budget preparation process and relevant rules:
  - **National Planning Commission (NPC)** — Points discussed:
    - Formulation of the devolution formula for the ensuing year, including the parameters considered
    - Revision in the planning process at the local level
    - Updating of national accounts as mentioned in the Budget Speech
    - Modalities for helping LGs in conceptualizing projects
  - **Lalitpur Municipality** — Points discussed:
    - Issues in LG budgeting
    - Modality of transaction in the absence of a formal consolidated fund
    - Dependence of the municipality on funding from the Federal Government
    - Lack of technical manpower to deploy the new budgetary process at the local level
  - **Inter-Governmental Finance Management Division (IGFMD)** — Points discussed:
    - Action Plan of IGFMD for implementing the new federal structure
    - Updates on changes that are being proposed in the GoN regarding the implementation of new budgetary processes at the national and subnational levels
    - Expectations of IGFMD with respect to best practice study on the inter-governmental fiscal transfer system
    - Preliminary recommendations as detailed out in this report
  - **Financial Comptroller General Office (FCGO)** — Points discussed:
    - Preparation of a unified chart of accounts (CoA) by FCGO
    - Modality to operationalize a consolidated fund at the local level

The desk study of GoN budgetary process and the discussions were followed by a desk review of international practices in MTEF, MTBF and outcome based budgeting with the aim to identify good practices in these budgeting approaches. Based on the aforementioned reviews, discussions and subsequent analysis, key gaps in implementing MTEF / MTBF and linking them with outcome based budgeting at subnational level were identified. This was followed by suggesting recommendations to address the gaps identified.

2.3 Observations and Findings

The broad observations and findings from the as-is assessment are summarized below. The details of the current budgetary process are provided in the Annexure 5.

2.3.1 Existing budget guidelines

The existing budget preparation guidelines (Budget Digdarshan) are based on relevant sections from a gamut of acts, rules, policies and procedures, and particular provisions in the Constitution itself. Based on discussions with NPC, IGFMD and FCGO, some of these documents may be revised through amendments or replaced by new mandates going forward. This is expected to happen due to efforts to operationalize the new federal structure with respect to budget preparation.

2.3.2 Budget and planning calendars

The current budget guidelines issued by the Ministry of Finance (MoF) lays down budget preparation calendars for the federal level as well as district programs. These are complemented by a 14-step planning calendar for LGs. The budget calendar details out the activities related to budget preparation and approval, alongside mapping of these activities with the executing organization/agency and corresponding timelines. Budget calendar for states is yet to be prepared.

2.3.3 Other budgetary reforms

- The GoN has prohibited transfer of funds from capital to recurrent head in the budget.
- Mid-term budget performance review is conducted by MoF.
- The GoN has provided for a maximum of 10% increment on current year budget to arrive at the budget ceiling for the ensuing year with regard to budget transfer from federal to local government.
- The incremental budgeting practiced by the GoN (normally with a 10% increase over last year's allocations) is also supplemented by program budgeting, entailing program activities and estimation of associated costs (using MTEF).

2.3.4 Financial management systems

- The GoN has introduced/has been using a series of IT-based systems in conducting its financial operations:
    - Revenue Management Information System (RMIS)
    - Financial Management Information System (FMIS)
    - Line Ministry Budget Information System (LMBIS)
    - Budget Management Information System (BMIS)
    - Computerized Government Accounting System (CGAS)
    - TSA-DEC Software (for treasury single account and budgetary control)
    - CDRMS (for debt recording and management)
    - e-Procurement system
    - e-Payment system (in process of being rolled out)

2.3.5 Treatment of foreign aid

- Program aid has been introduced in place of foreign project aid
- Sector Wide Approach (SWAP) has been adopted to address hindrances due to lack of GoN's own sources of funding and reimbursement of funds from donors, through matching multi-donor financing

2.3.6 Possible changes proposed/underway

- As per discussions with GoN officials, an Inter-Government Finance Management Bill, 2074 is currently under discussion. The bill is expected to cover provisions on revenue sharing between federal, state and LGs, taxes to be collected under a sharing mechanism etc. as well as address Articles 234 (Inter-State Council) and 235 (Coordination between Federation, State and Local Level) of the Constitution.
- Also, an NNRFC Bill has been submitted to the Cabinet for approval. The bill is envisaged to encompass matters relating to organizational structure and terms of services of members of NNRFC. The bill may also mention the duties and powers of the commission, basis for revenue distribution and natural resources exploitation, basis for mobilization of natural resources and distribution of sources of revenues, budget and expenditure related matters of the commission etc.
- A third bill, relating to local governance, is also under deliberation and, if passed, would replace the existing Local Self-Governance Act, which, along with the Local Self-Governance Rules, have been suspended for the time being, till the passing of the new bill. The provisions relating to planning and budgeting processes by the LG are expected to be determined through this bill.

- As per discussions with NPC, a makeshift formula for inter-governmental fiscal transfer has been used as the basis for allocating funds to the subnational government (LG) for the ensuing fiscal year. This formula comprises criteria of population (70%), level of development (15%) indicated by level of education and access to electricity, and geography (terrain) and cost adjusted area (15%). However, the GoN is also making efforts to establish a more comprehensive devolution formula based on international best practices in inter-governmental fiscal transfers in federal countries.

2.3.7 Analysis of GoN budget

An analysis of GoN budget (data based on Budget Speeches by the Finance Minister, GoN from 2013-14 to 2017-18) was carried out, to understand the trends in budget of GoN in the last 5 years, as provided below:

2.3.7.1 Budget summary

Table 1: Overall financials of GoN in the past 5 years (figures in NRs. million)

Description	2017-18 BE	2016-17 RE	2015-16 A	2014-15 A	2013-14 A	CAGR (%)
Revenue & Grant	802,223	656,162	524,783	450,023	410,864	18
Revenue	730,056	580,989	485,239	411,848	368,658	19
Taxes	666,205	528,575	421,097	355,955	312,440	21
Non-Tax Revenue	63,851	52,414	60,865	49,911	50,484	6
Cash Balance of Last Year and Irregular	0	0	3,277	5,982	5,734	-100
Grant	72,168	75,173	39,544	38,174	42,206	14
Expenditure	1,138,707	823,654	493,337	428,033	370,226	32
Recurrent	803,531	561,619	370,987	339,278	303,532	28
Compensation of employees	130,529	129,637	89,268	88,543	84,357	12
Use of goods and services	120,054	71,510	44,275	31,824	29,950	41
Interest and Services	30,800	21,242	8,673	9,263	12,038	26
Subsidies	1,016	1,696	942	1,019	1,146	-3
Grant	184,738	247,592	170,848	157,561	134,941	8
Social Security	102,640	88,557	56,747	50,758	40,802	26
Other Expenditure	1,556	1,386	234	310	298	51
Fiscal Transfer	232,198	0	0	0	0	-
Capital Expenditure	335,176	262,035	122,350	88,755	66,695	50
Budget Surplus (-)/ Deficit(+)	336,484	167,493	-31,446	-21,990	-40,637	-
Financing	-233,748	-135,844	-15,905	33,327	26,274	-
Net Internal Loan	19,763	35,622	25,495	26,257	12,928	11
Net Investment	55,356	21,860	12,701	10,510	9,451	56
External - Net Borrowing	-183,914	-122,474	-16,661	-8,503	-1,274	247
Domestic Net Borrowing	-124,952	-70,851	-37,440	5,062	5,170	-
Surplus(-)/Deficit (+)	102,736	31,649	-47,351	11,337	-14,363	-

Source: Budget Speeches by the Finance Minister, GoN from 2013-14 to 2017-18

Table 2: The growth rates (in %) of the various components of the GoN budget in the past 4 years

Description	2017-18 BE	2016-17 RE	2015-16 A	2014-15 A	Avg.
Revenue & Grant	22	25	17	10	18
Revenue	26	20	18	12	19
Taxes	26	26	18	14	21
Non-Tax Revenue	22	-14	22	-1	7
Cash Balance of Last Year and Irregular	-	-100	-45	4	-47
Grant	-4	90	4	-10	20
Grants	-4	90	4	-10	20
Expenditure	38	67	15	16	34
Recurrent	43	51	9	12	29
Compensation of employees	1	45	1	5	13
Use of goods and services	68	62	39	6	44
Interest and Services	45	145	-6	-23	40
Subsidies	-40	80	-8	-11	5
Grant	-25	45	8	17	11
Social Security	16	56	12	24	27
Other Expenditure	12	492	-25	4	121
Fiscal Transfer	-	-	-	-	-
Capital	28	114	38	33	53
Capital Expenditure	28	114	38	33	53
Budget Surplus (-)/ Deficit(+)	101	-633	43	-46	-134
Financing	72	754	-148	27	176
Net Internal Loan	-45	40	-3	103	24
Net Investment	153	72	21	11	64
External - Net Borrowing	50	635	96	567	337
Domestic Net Borrowing	76	89	-840	-2	-169
Surplus(-)/Deficit (+)	225	-167	-518	-179	-160

- **Observations on overall budget in the past 5 years:**
  - Revenue has grown at an average of 19% over the past 4 years, mainly due to growth in tax revenues
  - During the same period, expenditures have grown by an average of 34%, mainly dominated by growth in capital expenditure on land, building and civil works
  - Such significant divergence between growth of receipts (revenue) and expenditure is one of the reasons behind such high levels of budget deficit which may not be sustainable in the long run
  - In the three years from 2013-14 to 2015-16, there has been budget surplus, indicating that receipts (revenues and grants) have exceeded expenditure. Although expenditure has grown at a much higher rate than receipts during this period, the budget surplus indicates that the government has not been able to prioritize and utilize funds to their fullest capacity
  - Similarly, in the years 2013-14 and 2015-16, there has been fiscal surplus, mainly influenced by net borrowings of the GoN
  - A trend is observed wherein the GoN has attempted to finance the deficit by raising loans and through and borrowing from domestic and external markets.

2.3.7.2 Revenue and expenditure composition

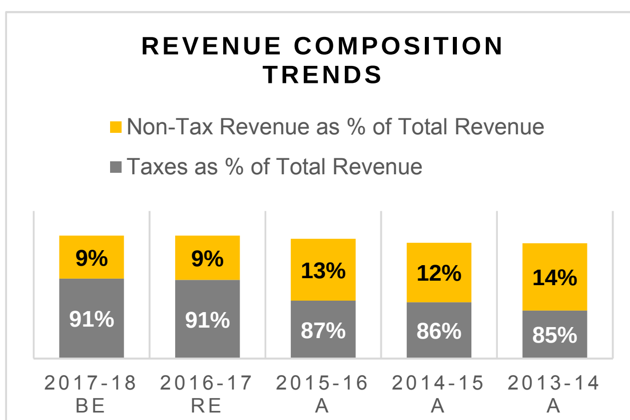
Table 3: The percentage composition of the various components of revenue and expenditure in the past 5 years

Description	2017-18 BE	2016-17 RE	2015-16 A	2014-15 A	2013-14 A	Average
Revenue & Grant						
Revenue as % of Total Revenue & Grant	**91**	**89**	**92**	**92**	**90**	**91**
Taxes as % of Total Revenue	91	91	87	86	85	88
Non-Tax Revenue as % of Total Revenue	9	9	13	12	14	11
Cash Balance of Last Year and Irregular as % of Total Revenue	0	0	1	1	2	1
Grant as % of Total Revenue & Grant	**9**	**11**	**8**	**8**	**10**	**9**
Expenditure						
Recurrent Expenditure as % of Total Expenditure	**71**	**68**	**75**	**79**	**82**	**75**
Compensation of employees as % of Recurrent Expenditure	16	23	24	26	28	23
Use of goods and services as % of Recurrent Expenditure	15	13	12	9	10	12
Interest and Services as % of Recurrent Expenditure	4	4	2	3	4	3
Subsidies	0	0	0	0	0	0
Grant as % of Recurrent Expenditure	23	44	46	46	44	41
Social Security as % of Recurrent Expenditure	13	16	15	15	13	14
Other Expenditure as % of Recurrent Expenditure	0	0	0	0	0	0
Fiscal Transfer as % of Recurrent Expenditure	29	0	0	0	0	6
Capital Expenditure as % of Total Expenditure	**29**	**32**	**25**	**21**	**18**	**25**

- **Observations on revenue and expenditure composition in the past 5 years:**

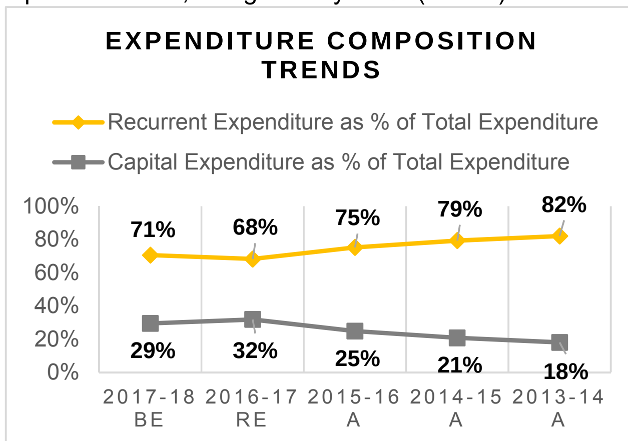
  ***Revenue composition*:**

  - Out of the total revenue and grants, an average of 91% is composed of revenue only
  - Revenue and grants have grown at a CAGR of 18%
  - An increasing trend is observed for tax revenue (as a percentage of total revenue) against a decreasing trend for non-tax revenue (as a percentage of total revenue)



***Expenditure composition*:**

- Expenditure has shown a compounded annual growth of 32%
- Other expenditure which mainly comprises refunds, has grown by 51 % (CAGR)
- Expenditure under 'use of goods and services' has grown at a CAGR of 41%, mainly dominated by growth in 'program expenses' and 'consultancy and other services fee'
- A decreasing trend is observed in case of recurrent expenditure as a percentage of total expenditure
- An increasing trend is observed in case of capital expenditure as a percentage of total expenditure, implying that the GoN is focusing more on development expenditure. This change is welcome since the GoN is aiming towards becoming a developing nation by 2022



2.3.7.3 Budget outturns

Table 4: Comparison of the outturns in the budget estimates to the actuals / revised estimates (for FY2016-17) (figures in %)

Description	FY2015-16	FY2014-15	FY2013-14	Average
Revenue & Grant	**-10**	**-13**	**-3**	**-9**
Revenue	**2**	**-7**	**4**	**0**
Taxes	-1	-5	-1	-2
Non-Tax Revenue	27	4	27	19
Cash Balance of Last Year and Irregular	-	-68	-	-68
Grant	**-64**	**-48**	**-39**	**-51**
Grants	-64	-48	-39	-51
Expenditure	**-29**	**-17**	**-16**	**-20**
Recurrent	**-23**	**-15**	**-14**	**-17**
Compensation of employees	-14	-16	-6	-12
Use of goods and services	-44	-50	-43	-45
Interest and Services	-60	-60	-35	-52
Subsidies	-64	-61	-48	-58
Grant	-17	8	-9	-6
Social Security	-18	-13	-3	-11
Other Expenditure	-75	-16	26	-22
Fiscal Transfer	-	-	-	-
Capital	**-41**	**-24**	**-22**	**-29**
Capital Expenditure	-41	-24	-22	-29
Budget Surplus (-)/ Deficit(+)	**-129**	**-2585**	**-381**	**-1032**
Financing	**-73**	**-3866**	**-281**	**-1407**
Net Internal Loan	-48	-24	-47	**-40**
Net Investment	6	-24	32	**4**

Description	FY2015-16	FY2014-15	FY2013-14	Average
External - Net Borrowing	-77	-71	-95	**-81**
Domestic Net Borrowing	-20	-125	-127	**-91**
Surplus(-)/Deficit (+)	**-198**	**-**	**-**	**-198**

- **Observations on budget outturns:**
  - Underestimation of non-tax revenue receipts is observed
  - Actual grants received are much lower than those estimated, implying performance issues and lack of GoN's conformity with the conditions necessary to be fulfilled for receiving grants
  - Revenue expenditure is highly overestimated with regard to use of goods and services, interest and services on foreign and internal loans, and subsidies to public corporations and private enterprises
  - Use of goods and services consist of rent & services, operation & maintenance of capital assets, offices materials & services, consultancy and other services fee, program expenses, monitoring, evaluation & travelling expenses, miscellaneous, and recurrent contingencies
  - Trends show overestimation of expenditure / shortage of release of funds / underutilization of budgeted allocation
  - (Negative) outturn of recurrent and capital expenditure has been increasing at an increasing rate indicating ambitious expenditure estimates
  - Capital expenditure comprises expenditure on land, building, furniture & fittings, vehicles, plant & machinery, civil works, capital research & consultancy, and capital contingencies.

2.3.8 Review of current status of MTEF and MTBF

2.3.8.1 Medium Term Expenditure Framework

- GoN adopted MTEF from the fiscal year 2002-03, with assistance from a donor agency.
- Currently, MTEF is used by GoN for prioritization of budget allocation for trimester budget releases as per priorities given below:
  - P1: First priority – budget releases under these programs are given first priority
  - P2: Second priority – budget releases remaining after allocation to P1 category, are allocated to these programs
  - P3: Third priority – these are the least priority programs

- The **current approach** envisaged by the GoN towards implementation of MTEF process is summarized below:
  - **Orientation program for technical committee members:** The objective is to familiarize the members on MTEF, its objective and rationale, its comparison with the present budget preparation process, and the various processes followed in preparing MTEF. The orientation program also focuses on preparing macro-fiscal framework and sectoral prioritization as well as synchronizing plan and budget.
  - **Workshop for familiarizing MTEF, its process and dummy preparation:** The participants of the workshop are the technical committee members and the focal unit personnel at the line ministry. The objective is to familiarize the participants with the theoretical and actual practical process of MTEF preparation. Estimation of unit cost and annual updating of the key elements of program and projects, estimation of annual budget requirements by projects and programs, completion timelines, priority as per the sectors and the plans are discussed in the workshop. Similarly, the estimation of total budget required for continuing ongoing projects, prioritization of projects and matching resources with expenditure requirements are also focused on here.
  - **Unit cost Estimation:** Methods of estimating unit cost of main activities and programs are discussed and prepared by the participants in the workshop.

- **Estimation of macro-economic framework:** Based on the available updated data, the technical committee develops macroeconomic framework for the next three years. While doing so, it reviews the estimation made by the Central Bureau of Statistics (CBS) on the Gross Domestic Product (GDP) and its components as well as the NRB estimation on price, monetary situation, trade and balance of payments, foreign exchange reserves, apart from the budgetary situation of the past and on-going fiscal year. The team also reviews the forecasts made by the multilateral institutions before finalizing the macro-economic framework for the MTEF.
- **Estimating fiscal framework:** The technical team is also responsible for estimating the fiscal framework for the MTEF exercise. While doing so, it assesses the performance made by the ministries, departments and agencies in the last fiscal year and that of the current fiscal year as well as tries to identify the potential for extra resource mobilization.
- **Preparing budgetary ceiling and guidelines:** Based on the resource envelope and the expenditure requirements as per the plan, the technical team prepares a detail sectoral budget ceiling and the guidelines for preparing sectoral MTEF. The guidelines highlight MTEF schedule, synchronization of plan and budget, criteria for project and program prioritization and for assessing all on-going projects and programs and allocation of resources, estimation and updating of unit cost of key elements of programs and projects and finally the reporting system and the monitoring mechanism.
- **Finalizing MTEF:** The technical team supports in finalizing sectoral MTEF and integrates all sectoral MTEF in a consolidated MTEF format for final output. While finalizing MTEF, the committee overviews matching resource envelope with the expenditure requirements and also the prioritization of the projects and programs with the sectoral plan priority. After finalizing MTEF, the committee submits it to the steering committee for its approval.
- **Steering committee approval and submission to the MoF:** After approving the MTEF by the steering committee, the chairman submits it to the Minister of Finance for inclusion in the budget and submission to the Parliament.
- **Monitoring MTEF implementation:** The steering committee will monitor the implementation of the MTEF process and budget implementation periodically. A system of monthly reporting of priority projects and programs to the steering committee, in a pre-determined format, will be made mandatory for the purpose. Besides, a bi-monthly monitoring meeting at the line agency will also monitor all projects and programs, both priority and non-priority, and take necessary action for its smooth implementation.

- The **major issues** in MTEF implementation in the GoN are listed below:
  - **Delay in preparation:** The practice of formulation of MTEF at the end of the fiscal year to coincide with the announcement of the next year's budget is by no means a timely exercise. The MTEF objective rather, should be to guide the budget preparation. The GoN’s budget is guiding the MTEF, which should be the other way round.
  - **Need for a MTEF budgetary calendar in practice:** Although there is a budgetary calendar in operation since long, the MTEF preparation lacks any specific calendar for its own operation nor it is synchronized with the budgetary calendar of the GoN.
  - **Prioritization only for ongoing projects:** MTEF prioritizes ongoing projects based on definite criteria and such criteria have been continuously refined but prioritization has not touched upon the new and upcoming projects.
  - **Resource gap not properly reflected by the MTEFs:** Currently in the GoN, MTEFs are limited to ensuring allocative efficiency and only consider the projects at hand that are being implemented or are under the current portfolio. There is little interlink age between upcoming projects and MTEF's existing portfolio.

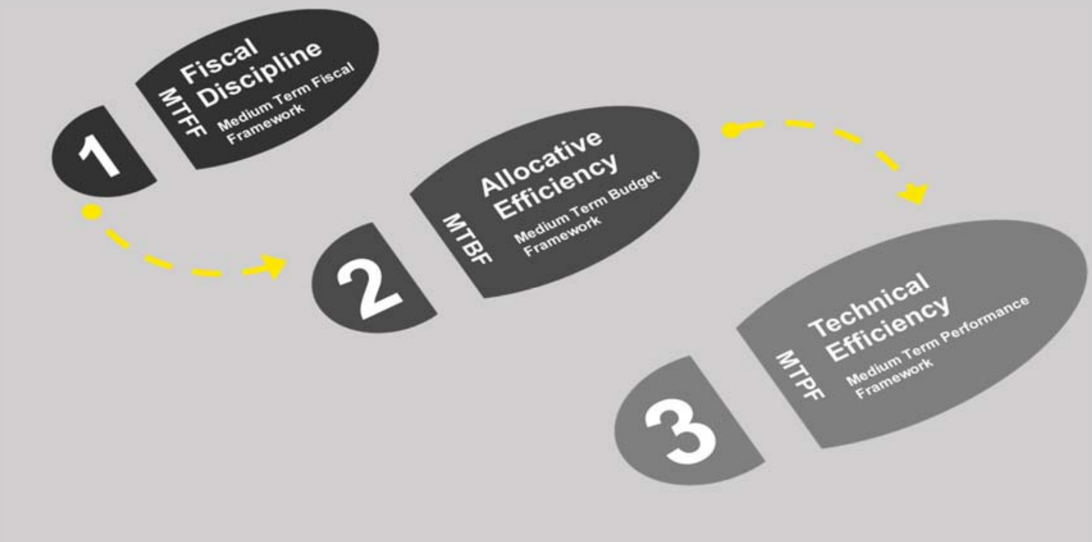
- **Allocation is yet to be linked with performance result:** MTEF has tried to link the budgetary inputs to the physical outputs and performance of the project. However, even after the implementation of this framework, no appreciable improvement has been observed with regard to the implementation and performance of the projects.
- **Lack of proper performance monitoring mechanism:** Monitoring and supervision particularly from MTEF perspective is still missing.

2.3.8.2 Medium Term Budgetary Framework (MTBF)

- GoN has recently attempted to introduce MTBF as part of the budgeting process
- MTBF was initially piloted in Education and Health sectors
- The GoN has entrusted accountability on line ministries for prioritization and achieving results
- MoF has been assigned the role of monitoring and supervision
- The MTBF is being complemented by Line Ministry Budget Information System (LMBIS)

Medium-term expenditure frameworks (MTEFs) *constitute an approach to budgeting and public financial management (PFM) that addresses well-known shortcomings of annual budgeting, including short-sightedness, conservatism, and parochialism* (Wildavsky 1986).

MTEF involves **multi-year forward looking performance-oriented planning and budgeting approach. It takes future costs and benefits into account and links resource allocation to strategic priorities and performance of spending agencies within the overall macro-fiscal targets set forth by the government.** A comprehensive and fully functional MTEF is achievable through a stage-wise implementation of the following three approaches to medium-term budgeting:



- **Stage 1 – Medium Term Fiscal Framework (MTFF)**, ensuring **fiscal discipline**: This involves top-down estimation of the aggregate resource envelope likely to be available in the ensuing 3 years and the stipulation of resource allocation to spending agencies. This also entails preparation of a medium term macro-fiscal framework for budget preparation that aids in improving input-driven annual budgeting
- **Stage 2 – Medium Term Budgetary Framework (MTBF)**, ensuring **allocative efficiency**: MTBF encompasses the bottom-up estimation of resource needs of spending agencies and reconciliation between the top-down resource envelope and the bottom-up estimates. Adopting a medium-term approach to budget planning improves expenditure prioritization
- **Stage 3 – Medium Term Performance Framework (MTPF)**, ensuring **technical efficiency**: An MTPF facilitates the shift in approach from inputs to outputs, with a focus on the measurement and evaluation of performance. Thus it serves a dual purpose – (i) the means of encouraging results and (ii) a way of using budget allocations to improve performance by establishing link between funds and results. However, an MTPF, and in turn, a fully functional and comprehensive MTEF, is achievable only after implementing a full-fledged MTBF

3. Constitutional Provisions

3.1 New federal structure

- The Constitution of Nepal mandates a three-tier structure of the state, namely, the federation, the states and the LGs.
- The new middle tier, the states (7 in number), would comprise the 77 districts as per Schedule 4 of the constitution.
- The local level would consist of village council, municipal council and district assembly.
- Federal law would stipulate the number of wards in village councils and municipal councils.

3.2 Division of financial powers among the three-tiers as per the Constitution

- Under the new federal form, the revenue and expenditure functions are divided among the national (federation) and subnational (states and local government) levels. Schedules 5, 6, 7, 8 and 9 enumerate the federal, state, concurrent (federal and state governments), local level governments and concurrent (federal, state and local governments) powers. The residual powers will rest with the Federal Government. In accordance with those provisions, the respective governments can make laws, make annual budgets, take decisions, formulate and implement policies and plans on any matters related to financial powers within their respective jurisdictions (Article 59).
- Schedule 5 lists out the Federal Government functions, which include central planning, central bank, finance policies, monetary and banking, monetary policies, foreign grants, aid and loans. It also lists out the revenue powers of the Federal Government as customs, excise-duty, value-added tax, corporate income tax, individual income tax, remuneration tax, passport fee, visa fee, tourism fee, service charge, fee and penalty.
- Schedule 6 enumerates the state government functions and revenue powers. The tax powers include house and land registration fee, motor vehicle tax, entertainment tax, advertisement tax, tourism, agro-income tax, service charge, fee and penalty. The financial powers of the states as per Schedule 6 also include matters relating to operation of banks and financial institutions in accordance with the policies of Nepal Rastra Bank, cooperative institutions, foreign grants and assistance with the consent of the Federal Government.
- The local government's revenue-raising powers as listed in Schedule 8 include local taxes (wealth tax, house rent tax, land and building registration fee and motor vehicle tax), service charge, fee, tourism fee, advertisement tax, business tax, land tax (land revenue), penalty, entertainment tax, land revenue collection etc.
- The Constitution (Article 250) mandates the establishment of a National Natural Resources and Fiscal Commission (NNRFC) for making provisions for equitable distribution of the collected revenue of the federation, states and local levels.
- The Constitution also stipulates the establishment of a consolidated fund at each of the three tiers of the Government — central (Article 116), state (Article 204) and local (Article 229). All revenues and grants received, all loans raised and amounts received from other sources would be credited to such a fund.

4. Gap Analysis

The PATA team had conducted a study of the existing budgetary processes in GoN as mentioned earlier. This was complemented by discussions with GoN officials regarding changes in budgeting process that are currently being deliberated upon. Further, an analysis was carried out on the budget data of the past 5 years to identify trends in budget allocation.

4.1 Gaps relating to budget preparation

With respect to implementing a budget preparation process at the subnational level, the following gaps were identified through study and discussions:

- States, the new middle tier of government, as mandated by the new Constitution, are yet to be created
- An Inter-Government Finance Management Division (IGFMD) within the MoF has just been set up, whose responsibilities toward states are still under discussion and may increase manifold once the new federal structure (especially at the subnational level) becomes fully operational
- Sectors are yet to be mapped with ministries in a structured manner
- The Constitution entrusts responsibility of the planning and budgeting to states and local levels, but a planning and budgeting division is yet to be established at the state level
- Financial procedures for states and urban and rural LG are yet to be finalized by FCGO and enacted; also, costing guidelines for states and urban and rural LG, and budget (including MTEF) preparation guidelines (linked to outcome/performance) for states are yet to be drafted
- The basis for revenue and expenditure projections for subnational level budgeting is yet to be formulated by the GoN
- Currently, budget calendar exists only for federal and local levels; also, the Constitution and prospective financial rules provide timelines only at a broad responsibility level and not for individual activities under budget preparation. A budget calendar for states is yet to be designed
- As of now, a consolidated fund exists only at the federal level, and the LGs operate their finances from a local bank account; a formal consolidated fund is yet to be established at state and local levels
- Currently, NNRFC is entrusted with the responsibility of recommending the quantum and basis of grants from the federal to the state and local levels, as well as policies on revenue and borrowing; moreover, the Constitution mandates the establishment of an Inter-State Council for resolving disputes between the federation and the states and among the states. However, provisions are yet to be made for establishing a state fiscal commission for the purpose of determining transfer of funds and fiscal arrangements between states and LG
- The Constitution and prospective financial laws mandate the preparation of an annual budget and a three-year budget without clear stipulation for the integration of the annual plan and budget with the three-year plans and projections (from MTEF), especially directives to derive the annual plan and budget from those of the first year of the three-year plan in MTEF
- ICT systems at states and urban and rural LG are yet to be established in a full-fledged manner
- The GoN is in the process of finalizing bills for the following areas, which, when passed, would replace existing acts, rules and practices:
    - Inter-governmental Fiscal Transfer
    - National Natural Resources & Fiscal Commission
    - Local Level Governance
    - Fiscal Responsibility

4.2 Gaps relating to implementation of MTEF, MTBF and outcome based budget

With respect to implementing MTEF, MTBF and outcome-based budgeting at subnational level, following **key gaps** were identified through study and discussions:

- **Planning and budgeting**
  - High level of budget outturns especially with respect to grants and expenditure
  - Lack of proper prioritization among projects/ programs leading to spending in non-priority areas
  - Limited implementation of MTEF and MTBF
  - Lack of clear linkages between MTEF/ MTBF and annual budget

- **Execution**
  - Disproportionate progress of projects/ programs compared to stipulated targets
  - Non-uniform distribution of capital expenditure, with majority expenditure being made towards end of fiscal year
  - Divergence between plan and actual implementation of programs/ projects
  - Inadequate performance/ non-compliance with modalities and targets laid down leading to limited release of funds from funding agencies

4.3 Addressing the gaps

The **probable reasons** for the aforementioned issues are listed below:

- Approval of budget and programs without conforming to the overall fiscal position
- Absence of a Medium Term Fiscal Framework (MTFF) to guide macro-fiscal targets and budget ceilings compliant with fiscal responsibility law
- Incorrect sequencing of PFM reforms, i.e., introduction of MTBF happened after implementation of MTEF and no initiatives for MTFF and MTPF are yet to be in place
- Lack to experience/ competence of authorities in implementing MTEF/ MTBF and outcome-based budgeting

Hence, as **reform measures** the following approach may be adopted by the GoN:

- Support capacity building of officials involved in budget preparation
- Assign accountability on Line Ministries through enforcement of MTBF and strengthening MTEF
- Entrust MoF and NPC with the responsibility of ensuring compliance with fiscal position, while approving budget and programs
- Sequence PFM reforms in correct order – 1) MTFF, 2) MTBF and 3) MTPF
- Introduce outcome-based budgeting

The following section covers the observations based on a desk review of international practices to identify good practices relating to budget preparation with a focus on MTEF, MTBF and outcome based budgeting.

5. International Experience

5.1 Australia

5.1.1 Outcomes and output framework

Australia uses an outcomes and outputs framework which works as a decision hierarchy:

- The government specifies the results/ outcomes and impact it seeks to achieve in a given sector
- The Parliament appropriates funds to facilitate the process of achieving these outcomes through administered items and outputs of the departments
- Agencies administer items such as grants, transfers and benefit payments on behalf of the government, with the objective of maximising their contribution to the desired outcomes
- By specifying and managing outputs, agencies seek to maximise their contribution to the achievement of the envisaged outcomes
- Performance indicators are developed to allow monitoring of effectiveness (i.e. the impact of the outputs and administered actions and items on the outcomes) and efficiency (through the application of administered items and the price, quality and quantity of outputs) and to enable further augmentation of the system in order to improve performance and accountability for results

All agencies and authorities in the government sector which are the basic unit of organization in the government, come under the purview of this outcomes framework.

Therefore, the outcome statements are basically agency statements. However, these statements must be agreed upon by the portfolio minister and the Minister for Finance and Administration. Each minister sets performance measures and targets for his/ her areas of responsibility, aligned with the conditions under which they operate including budget availability.

The outcomes framework is envisioned to serve the following **objectives:**

- Strategically guide overall resource allocation decisions by the government in the context of budget preparation
- Provide basis on which the Parliament appropriates money in the annual appropriation acts. In practice, however, only administered programmes included in the annual appropriation acts are appropriated by outcome
- Direct departmental outputs and administered programmes for the purpose of achievement of the results or impacts envisaged in the relevant agency's outcome statement
- The framework also renders accountability and transparency to relevant stakeholders through reporting on the performance of the agency in achieving the government's envisaged outcomes through the departmental outputs it delivers and the programmes it administers.

5.1.2 Performance reporting

The budget documentation process involves detailed reporting on the budget plans and the forward estimates of all constituent agencies by each portfolio. These portfolio budget statements encompass the following performance information:

- Details of all sources and uses of funds as per outcome
- Information on inputs and outputs resulting in an outcome
- Comprehensive set of performance indicators, measures and targets for envisaged results and plans of future evaluations
- Financial statements comprising budgeted estimates of each agency for the ensuing years and revised estimates based on performance in current year

In addition to the portfolio budget statements, an annual report for each agency is published within 4 months of the end of each fiscal year. These agency annual reports cover the following:

- Audited financial statements
- Clarification on agency performance during the reporting period
- Actual results against individual performance measures for outcomes and outputs
- Impact of evaluations stipulated during the year

5.1.3 Costing of public policies

Under the Charter of Budget Honesty Act, 1998, the Commonwealth of Australia also issues the Charter of Budget Honesty Policy Costing Guidelines that guides the process of preparing and submitting the costing of publicly announced policies.

Figure 1: A snapshot of the table of contents of the said guidelines is shown below:

CONTENTS

5.2 Canada

5.2.1 Fiscal legislation

The Government of Canada has enacted the Federal Accountability Act, 2006 that provides "*for conflict of interest rules, restrictions on election financing and measures respecting administrative transparency, oversight and accountability*".

Among other things, the Act mandates the following with respect to fiscal management:

- Establishment of a parliamentary budgetary office
- Expanding the power of the Auditor General
- Implementation of a systematic evaluation of the grants and contributions programmes of the Government of Canada

The key principles of the government's federal expenditure management system are based on:

- Focusing the programs on results and value for money
- Ensuring consistency of government programmes with federal responsibilities
- Rationalization and eliminating programmes that no longer serve their envisaged purpose

This Act addresses the following areas of governance:

- Conflicts of Interest, Election Financing, Lobbying and Ministers' Staff
- Supporting Parliament
- Office of the Director of Public Prosecutions, Administrative Transparency and Disclosure of Wrongdoing
- Administrative Oversight and Accountability
- Procurement and Contracting

5.2.2 Evaluation of policies and programs

The Evaluation Policy and Standards for the Government of Canada were approved by the Treasury Board of the country in 2001. The policy distinguished between the evaluation and internal audit functions. It also advocated for extending the scope of evaluation to include programs, policies and initiatives. The evaluation policy emphasized on results-based management and was aimed to embed the discipline of evaluation into business practices for service delivery.

Under the 2009 Policy on Evaluation, the Centre of Excellence for Evaluation (CEE) provides functional leadership for evaluation across the federal government of Canada through advice and guidance in the conduct, use and advancement of evaluation practices. The CEE interacts and works directly with departmental evaluation units and evaluators. It facilitates the using of evaluation findings in central agencies and across government including providing support to ensure accountability and public reporting, manage expenditure and results, and improve policy and program design. The federal department and deputy heads of agencies support the evaluation process.

The key activities of CEE are listed below:

- Development of guidance materials and tools to support policy implementation in departments and agencies and to augment evaluation practices
- Monitoring the evaluation capacity and implementation policy implementation in departments
- Encouraging and facilitating community and capacity development in order to support in the capacity building and improvement of competence of evaluation units across the government

5.3 Brazil

A summary of MTEF case study for Brazil is provided below:

Table 5: A summary of MTEF case study for Brazil

Topic	Description
Introduction	A structure similar to MTFF exists since 2001 although a comprehensive MTEF is yet to be put in place
Broad features	The MTFF is largely based on the Budget Guidelines Law (Lei de Diretrizes Orçamentárias – LDO). The Multiyear Plan (Plano Plurianual de Acao – PPA) is a four-year plan to reflect the strategic priorities of the government and to enforce annual budget laws, although it is in itself, subject to annual revisions. The structure does not qualify as an MTFB and in practice, there are evidences of limited focus on performance measurement and evaluation. Hence it cannot be classified as an MTPF also. The LDOs and PPAs exist at subnational level as well.
Fiscal responsibility legislation	The Brazilian Fiscal Responsibility Law (Lei de Responsabilidade Fiscal – LRF) "establishes public finance rules enforcing responsibility in fiscal management, and other provisions". It stipulates responsibility in fiscal management in terms of "well-planned and transparent actions to prevent risks and correct deviations that may affect the equilibrium of public accounts, by compliance with revenue and expenditure results targets,

Topic	Description
	observing limits and satisfying conditions regarding tax breaks, generation of personnel and social security expenditures, among others, consolidated and security debt, credit operations, including those involving revenue anticipation, guarantees issued and outstanding liabilities".
Macro-fiscal framework	The LDO is a comprehensive, three-year rolling projection of revenue, expenditure, and the fiscal balance. The medium-term forecasting is less accurate compared to short-term forecasting. The LDO also stipulates priority expenditures, which are exempted from reduction in budget.
Link with annual budget	Ideally, the annual budget laws are required to be synchronized with the PPA and the LDO. However, in practice, the PPA and the LDO revenue estimates are subject to revision during drafting of the Budget Guidelines Law.
Responsible bodies	The PPA is overseen by the Ministry of Planning and Budget while the responsibility of developing the LDO is jointly shared by the Ministry of Planning and Budget, Ministry of Finance and the Presidency.
Performance orientation	The annual and medium-term budgeting processes are yet to acquire a full-fledged performance orientated character. This may be achieved by enforcing the PPA in practice with a mandatory focus on linking funds with performance, improving the quality of performance indicators and strengthening the overall monitoring and evaluation framework.

5.4 South Africa

A summary of MTEF case study for South Africa is provided below:

Table 6: A summary of MTEF case study for South Africa

Topic	Description
Introduction	In 1998, Government of South Africa initiated MTBF while MTFP was initiated in 2002.
Broad features	The three-year rolling framework indicates out-year expenditure ceilings. The current MTEF encompasses all categories of spending at both national and state levels. The federal government follows the same expenditure classifications for MTEF and the regular budget. The MTEF process entails identifying funds including those in underperforming programs that can be reprioritized and re-appropriated to programs that are expected to achieve envisaged outcomes.
Strategic objectives	Parliament provides significant strategic guidance on sector strategic plans although the same is more satisfy a formal requirement than to inform prioritization decisions.
Link with annual budget	The MTEF is integrated with the annual budgetary process.
Responsible bodies	The Ministry of Finance, in consultation with national and state medium-term expenditure committees is responsible for implementation of MTEF. Revenue forecasting and macro-fiscal modeling are primarily done by the National Treasury which also reviews the expenditure demands from federal and state spending agencies, synchronized with the sector strategies.
Performance orientation	In terms of performance indicators, the spending agencies generate a mixture of input, output, and outcome indicators although budget decisions are yet to be significantly dependent on these indicators.

5.5 Korea

A summary of MTEF case study for Korea is shown below:

Table 7: A summary of MTEF case study for Korea

Topic	Description
Introduction	MTEF was formally introduced in 2004 whereas MTPF was piloted in 2003, with full-fledged implementation in 2004.
Broad features	The MTPF estimates are rolling in nature, covering a five-year planning horizon. Successive MTEFs and budget are not limited by out-year ceilings. MTPF covers all federal government agencies and categories of spending which are further bifurcated by sector or objective and major program.
Macro fiscal framework	Before MTEF was introduced, the fiscal policy and budget formulation process were guided by a medium-term macro-fiscal framework although there was no formal MTFF.
Strategic objectives	Key policy issues are reviewed by sector task forces. Some of the spending agencies prepare strategic plans. However, there is no systematic costing procedure.
Link with annual budget	Based on five-year cost estimates, the Ministry of Finance stipulates program ceilings although those ceilings are neither published nor approved by the parliament. However, the Budget Office uses expenditures in the previous MTEF as a guiding parameter for determining ceilings of the rolling MTEF.
Responsible bodies	The Ministry of Finance leads the MTEF, in consultation with senior officials from line ministries.
Performance orientation	A performance monitoring and review system is put in place, and funding in based on achievement of results.

The next section comprises the recommendations for addressing the gaps identified earlier. These cover recommendations suggested in both the interim and mid-term reports. The said recommendations, along with indicative budget guidelines and MTEF guidelines for subnational government shall be consolidated into a draft final report. Once these recommendations are finalized post submission of the draft final report, the PATA team shall prepare the economic feasibility report as envisaged in the inception report.

6. Policy Recommendations

6.1 Benefits and value expected

This section covers recommendations on addressing these gaps through corrective/ new actions so as to achieve the following **envisaged benefits**:

- Adherence to fiscal discipline supported by accountability for budget outturns, which is the essential first step toward preparing credible budgets.
- Greater transparency and standardized practices through stipulating standards, guidelines and formats for states on accounting and reporting of financial transactions
- Improvement in management, accounting, reporting and accountability of all public money earned and spent by the collecting and spending agencies through consolidated fund.
- Performance linked fund allocation based on prioritized programs/projects, critical for achieving national and subnational goals and targets

The **expected value** to be delivered through these recommendations include:

- Value for money
- Institutionalization of fiscal federalism
- An efficient budgetary process linked to performance

The gaps identified in the previous section need to be addressed on a priority basis in order to successfully introduce budgetary processes at the subnational level including MTEF, MTBF and outcome-based budgeting at sub-national level. Hence, recommendations in the form of corrective / new actions have been drawn up that would aid in filling these gaps. This, in turn, shall facilitate the successful transition of GoN to the federal structure, in terms of operationalizing commensurate performance oriented budget preparation processes at state and local level.

6.2 Preparatory work

Assumption: The scope of work for this report covered only recommendations for "operationalizing" budgeting process (including MTEF, MTBF and outcome-based budget) at subnational level. Hence, the recommendations suggested in this report cover steps that need to be followed once states start to function at a basic level. Also, for successfully implementing these recommendations, some preparatory work as outlined below need to be carried out.

Preparatory work: Before implementing the below mentioned recommendations, it is of prime importance that the GoN establishes a robust **fiscal data collection mechanism** across the states and local government units. A mechanism for record keeping of financials is essential to be operationalized before any other recommendation can be implemented. This may be implemented using the GoN's financial management information systems including MARS (for local government) or other ICT systems for states and local government. Data reporting timelines may be stipulated on a need basis as daily, weekly, monthly, quarterly, or annually. The formats for collecting the same may be developed by the MoF, in consultation with NPC, CBS and FCGO.

At the **local government** level, each local government unit should be mandated to input financial information (detailed head-wise as well as aggregate level revenue, expenditure, grants received, borrowings, medium term estimates etc.) into the ICT systems to be put in place at subnational level. These should be collected and entered into the system at the earliest possible, from the lower level agencies for collation and submission to the state level.

At the **state level**, the Department of Finance should be delegated the responsibility of collating similar financial information from all the districts under its purview as well as the state level information, through the ICT systems.

At the **federal level**, the Ministry of Finance, with support from the CBS and the FCGO, should be made responsible for collecting financial data from the states through the ICT systems. This data shall be augmented by the federal government data as well as reconciled with the data collected by FCGO systems, and shall constitute an exhaustive and comprehensive universe of data for necessary analysis, budget preparation, strategic decision making etc.

Data may also be sought by the **NNRFC** from the states and local governments for devising formula for devolution of grants from the federal government to the subnational government. Such data requirements may include population, geography and terrain, human development index (health, education, per capita income etc.), specific needs etc. These information should be reported to the NNRFC by the states and local governments into ICT systems/ formats stipulated by the NNRFC.

As an example, the broad level the objective of the financial data collection should be to populate the following format for each state:

Table 8: An indicative format of financial data to be collected at a state level:

Description	Y-2 Actuals	Y-1 Revised	Y Budget	GoN	Grants	Loans
1. Revenue Receipts (i to iv)						
i) State's own Tax Revenue						
ii) State's own Non-Tax Revenue						
iii) State's Share of Central Grants						
iv) Other Grants from Foreign Governments						
2. Capital Receipts (i to iii)						
i) Recovery of Loans						
ii) Borrowings						
iii) Loans from Public Account						
3. Total Receipts (1 + 2)						
4. Revenue Expenditure (i + ii)						
i) On interest payment						
ii) Others						
5. Capital Expenditure (i + ii)						
i) On Repayment of Loans						
ii) Others						
6. Total Expenditure (4 + 5)						
7. Revenue Surplus (+) / Deficit (-)						
8. Fiscal Surplus (+) / Deficit (-)						
9. Primary Deficit (-) / Surplus(+)						

INDICATIVE

6.3 Recommendations

Need for recommendations: Once the states are set up, administration begins and financial data collection mechanism is put in place, provisions need to be made for budget preparation by relevant departments and agencies at the subnational level. These needs can be catered to by implementation of the following recommendations to address the gaps identified.

The following section details out the actions to be undertaken for successfully implementing budgetary process including MTEF and MTBF in the GoN. These are grouped into 3 categories based on their timeline of implementation. This section of the report also entails a section on policy guidance for implementing outcome-based budget into the regular budgetary process of the GoN.

6.3.1 Recommendations for the short term

These actions need to be taken up **immediately within 0–6 months** for initiating basic budgeting activities at state and local levels. The recommendations are:

1. Draft financial procedures for states and urban and rural LG

- *Rationale:*
  - To ensure compliance with fiscal targets and standard modalities of financial operations, it is necessary to guide states and local governments in terms of financial rules and procedures. These are critical for facilitating financial activities of subnational government, including budget preparation, accounting and reporting.
  - Financial procedures encompass detailed executive orders in matters relating to public finances for all states
  - Financial procedures stipulate standards, guidelines and formats for states on accounting and reporting of financial transactions, thereby ensuring transparency and standardized practices
  - The present Constitution mandates that no tax be levied, no loans be raised and no expenditure be made except in accordance with the law. It sets forth only broad-level mandates regarding matters relating to public financial management by states
- *Implementation steps:*
  - Finalize financial procedures for the federal government as per the relevant responsibilities covered in schedules 5, 7 and 9 of the Constitution
  - Determine the organization structure and responsibilities of states and urban and rural LG
  - Formulate policies for PFM at the state level as per the financial powers and responsibilities of states and urban and rural LG
  - Draft financial procedures for states and urban and rural LG, guided by the Constitution and the state and local financial policies

2. Draft a budget calendar for states and align it with the calendars of urban and rural LG

- *Rationale:*
  - A budget calendar is necessary to provide the ministries, departments and agencies with an all-encompassing view of the budget process. This helps in ensuring that all aspects of the budget process have been taken into consideration and that commensurate time has been provided to meet deadlines
  - A budget calendar highlights important statutory deadlines to ensure timely preparation, execution and monitoring of budget

- Information to relevant stakeholders regarding timelines of key budget tasks, events, and decisions so as to facilitate timely planning and ensure participation in the budgeting process
- The budget preparation process starts with issuance of a budget calendar, which currently does not cover the responsibilities of states
- With the establishment of states as the middle tier of government, there is a need for the existing budget calendar for urban and rural LG to be aligned with that of the states
- Given the transition phase in Nepal, there is a shortage of trained staff

- *Implementation steps:*
  - Finalize the central budget calendar to be used as the base for preparing the budget calendar of states
  - Synchronize the budget calendar for states with that of the federal government
  - Revise and align the budget calendar for urban and rural LG with that of the states
  - Ensure the indication of possible resource transfer and ceilings for programs of ministries in the states precedes the budget preparation process at the state level
  - Start the budget preparation process of states a couple of months later than that at the federal level during the coming three fiscal years until the operations of states stabilize

An indicative budget calendar for states is provided in Annexure 6.

3. Draft guidelines for operationalizing a consolidated fund at states and urban and rural LG

- *Rationale:*
  - As per the Constitution, all incomes (revenues, loans, grants etc.) are to be credited to and all expenditure to be made from the consolidated fund at each tier of the central units (federal, state and local). Currently local governments operate through local bank accounts and not a formal consolidated account. Also, states are yet to be established, hence, state consolidated funds have not been operationalized
  - A consolidated fund is a standard global practice in managing government finances; in case of the GoN, the practice of including all transactions in the consolidated fund at each tier of government will assist in monthly/quarterly/annual reconciliation across the three levels
  - Operationalizing a consolidated fund at the subnational level will ensure management, accounting, reporting and accountability of all public money earned and spent by the collecting and spending agencies
- *Implementation steps:*
  - Define the responsibilities for FCGO and/or any other agency for treasury operations at the state and local (urban and rural) levels
  - Finalize treasury rules and prepare a unified CoA to be followed for accounting of transactions processed through the consolidated fund at each of the three tiers of government
  - Seek the buy-in of NRB on the establishment and operations of the consolidated fund
  - Identify and open accounts in banks where the fund will be maintained at the state and local (urban and rural) levels
  - Till the time the consolidated fund becomes operational at the subnational level, FCGO may maintain an escrow account for the state and local (urban and rural) levels for the purpose
  - Apart from operationalizing consolidated fund at the subnational level, the treasury single account (TSA) currently operational at the federal level, needs to be made operational at state and local level as well and linked with the consolidated fund. Establishment of TSA is critical to ensure effective aggregate control over the cash balances of GoN

> For example, like **Government of Nigeria**, the Government of Nepal may **establish a rule** that all unspent balances of cash allocated to implementing agencies after entering commitments into the **TSA** for both recurrent and capital expenditure, shall lapse automatically and the balances transferred back to the **consolidated fund** account for appropriation by the National Assembly.

An indicative structure of consolidated fund and mechanism for operationalizing TSA are provided in Annexure 6

6.3.2 Recommendations for the medium term

These actions may be taken up in sequential order as given below, **within 6–12 months** of establishment of states and implementation of the short-term recommendations. The recommendations are:

4. Draft and enact a Fiscal Responsibility & Budget Management (FRBM) Act

- *Rationale:*
  - Fiscal discipline, which is the essential first step toward preparing credible budgets, can only be ensured through drafting and enactment of fiscal responsibility legislation, that is applicable to both the national and sub-national level
  - Macro-fiscal targets consistent with the national development goals need to comply with the fiscal regulations for ensuring spending as per targets for achieving the objectives of the ministries, departments and agencies
  - As such, there seems to be no provision under existing laws for any fiscal responsibility legislation for enforcing fiscal discipline
- *Implementation steps:*
  - Undertake fiscal and financial studies, analysis and diagnosis to determine fiscal targets
  - Draft fiscal responsibility legislation rules for all levels of government
  - Disseminate international good practices that will lead to greater efficiency in the allocation and management of public expenditure, revenue collection and debt control and ensure transparency in fiscal matters

For framework of suggested Fiscal Responsibility Budget Management Act, please refer to recommendations provided in Chapter III Subnational borrowings - Establishing borrowing arrangement for subnational governments.

5. Suggest principles for projection of revenues and expenditure for states and urban and rural LG

- *Rationale:*
  - Standard principles for projection of revenues and expenditure are necessary to ensure uniformity in methodology and assumptions made during budget estimation.
  - These principles provide guidance to budget preparing authorities so as to facilitate consistent forecasting practices, thereby enabling the GoN to compare estimates across ministries and programs
  - Revenue and expenditure projections are the two main pillars of a budget
  - Standards and bases are necessary to bring about uniformity in projections of expected income (grants and own source of revenue — tax, non-tax, foreign aids etc.) and expenditure (capital, current, commitments etc.) across states and urban and rural LG

- Revenue and expenditure bases provide guidance for forecasting future revenue and expenditure trends that may have an immediate or long-term influence on the policies and strategic goals of the states and urban and rural LG

- *Implementation steps:*
  - Finalize revenue and expenditure projection bases for federal government level
  - Define the time horizon of projection and specify the standards of projection for each sub-category within revenues and expenditure
  - Consult market players at the subnational level and do a trend analysis on past revenue collection and expenditure
  - Synchronize the basis for revenue and expenditure projections for the subnational level governments and at the federal level, and include in costing guidelines for states and urban and rural LG

The principles for projection of revenues and expenditure shall be covered in the next deliverable, i.e., the MTEF guideline to be submitted alongside the final report.

6. Suggest framework for mapping of sectors with ministries at subnational level

- *Rationale:*
  - Mapping of sectors with the correct ministry is essential for ensuring that same sector needs are no duplicacy in service delivery by two or more ministries and also for identifying needs for cross-ministry execution of programs/ projects
  - Correct classification of sectors aids in identifying sector-specific needs and addressing priorities by relevant ministries through development of commensurate program, within the purview of the particular ministry/ department
  - Classification of sectors is essential for mapping sector needs with the overall goals and priorities of the GoN
  - Mapping of sectors with federal and state ministries/departments is necessary for planning and sectoral/ministry-wise budget allocation and implementation of plans
- *Implementation steps:*
  - Finalize government goals, strategies and programs/projects at the federal and state levels
  - Classify functions based on overall common goals, needs, objectives and issues
  - Group functions as per the needs of the sectors they address (e.g., health, education etc.)
  - Map functions with the responsibilities of each line ministry/department at the federal and state level
  - Using a mapping framework, align sectors with the ministries/ departments at federal and state level using the functional classification as the basis

For the purpose of mapping sectors with ministries, the Classification of the Functions of Government (COFOG) developed by OECD should be considered as a guiding document. COFOG classifies government expenditure data from the System of National Accounts[40] by the purpose for which the funds are used. The COFOG structure is provided in the Annexure.

[40] The System of National Accounts (SNA) is the internationally agreed standard set of recommendations on how to compile measures of economic activity.

7. Draft budget guidelines for states and urban and rural LG

- *Rationale:*
  - Budget guidelines are necessary for the states and urban and rural LG for duly carrying out financial functions in a structured manner, while adhering to the laws of the GoN
  - Budget guidelines are expected to provide the states with detailed instructions for executing the broad mandates in budget formulation, execution and monitoring as per the Constitution
  - Budget guidelines ensure accountability, efficiency and standardization of procedures to be followed by states and urban and rural LG
  - Division of financial powers among the three tiers of government has been mandated by the Constitution with only broad level instructions on the budgeting process
  - Given the transition phase in Nepal, there is a shortage of readily available staff experienced in budget preparation and limited guidelines to enable them in budget preparation
- *Implementation steps:*
  - Finalize the budget calendar for the federal, state and local (urban and rural) levels
  - Finalize plans for the three tiers
  - Issue budget guidelines synchronized with the state and local level financial powers, budget calendars, prospective plans
  - Ensure indication of resource transfer and ceilings for programs of ministries in the states and issuance of budget guidelines occur simultaneously so as to maintain parity between the resource availability and the expenditure needs

An indicative structure for budget guideline is furnished in Annexure 6.

8. Draft MTEF and MTBF guidelines, for states and urban and rural government

- *Rationale:*
  - MTEF and MTBF guidelines are necessary for the states and urban and rural local government for duly carrying out financial functions while adhering to the financial laws of the GoN
  - MTEF and MTBF guidelines necessary for preparing medium term targets and budget, consistent with the national development goals
  - Given the transition phase in Nepal, there is a shortage of readily available staff experienced in budget preparation
- *Implementation steps:*
  - Finalize perspective plans for the three tiers
  - Issue budget guidelines as well as MTEF and MTBF guidelines synchronized with the state and local level financial powers, prospective plans and MTEF
  - Ensure indication of resource transfer and ceilings for programs of ministries in the states and issuance of budget guidelines occur simultaneously so as to maintain parity between the resource availability and the expenditure needs

Indicative MTEF and MTBF guidelines are furnished in Annexure 6.

9. Provide guidelines to prepare three-year rolling plans using Medium Term Expenditure Framework (MTEF) and annual plans for states and urban and rural LG

- *Rationale:*
  - Good practices in budgeting entails setting rolling targets and preparing proportionate budget, with the annual budget being based on the first year estimates of the MTEF. Subsequently in the medium-term, these estimates are revised based on progress of programs/ projects against the targets stipulated through MTEF

- Prospective budget preparation rules of the GoN mandate the preparation of MTEF with a three-year planning horizon apart from the annual budget
- The three-year rolling plan guided by MTEF and the annual plan provide states with a basis and direction for budget estimation
- Expenditure demands based on annual plans and three-year rolling plans (MTEF) are essential for justifying state and local (urban and rural) budgetary needs and commitments during budget discussion
- A budget synchronized with the annual plan and three-year rolling plan of MTEF ensures adherence to overall federal priorities, SDGs and fiscal discipline

▶ *Implementation steps:*

- Prepare program/ project plans of ministries in the states based on sectoral needs and overall goals of the GoN**
- Identify special needs of urban and rural LG under the states, if any
- Conduct inter-state discussion to avoid duplicity in plan and for cross-state planning, if necessary
- Ensure compliance with overall federal goals, national interest and consideration of plans of urban and rural LG
- Ideally, start the planning exercise slightly ahead of the budget preparation and integrate the two

The GoN may review programs before finalizing them using the **Six Criteria for Program Review as is used by the **Government of Canada**:

▶ Does the programme serve a public interest?
▶ Is this an appropriate role for the government?
▶ Could this be done better by another level of government – state or local?
▶ Could this be left to the private sector or volunteer sector?
▶ Could the programme be delivered more efficiently?
▶ Is it affordable?

The guidelines to prepare three-year rolling plans shall be part of the next deliverable i.e., the MTEF guideline to be submitted alongside the draft final report.

10. Draft costing guidelines for existing and new programs for states and urban and rural LG

▶ *Rationale:*

- Uniform methodology and assumptions in costing programs/ projects, guided by costing guidelines is necessary for preparing standardized plans and budget, consistent across states and local governments. This will allow the budget approving authorities to compare programs/ projects during prioritization
- Costing guidelines facilitate improved budget management, enhanced resource allocation and accountability, and greater efficiency in service delivery by states and urban and rural LG. They also ensure sustained improvements in fiscal discipline supported by accountability for budget outturns
- Costing of programs/projects at unit level (expenditure heads) is necessary for estimating total cost of programs/projects for subnational-level budgeting
- Detailed costing of inputs for programs/projects provides justification in favor of the expenditure needs of states and urban and rural LG
- Given the transition phase in Nepal, there is a shortage of trained staff and lack of standardized costing guidelines for subnational governments

▶ *Implementation steps:*

- Finalize budget guidelines for states and urban and rural LG
- Provide clarity in terms of the roles and responsibilities of various stakeholders in estimating costs

- Establish a standardized methodology for arriving at cost estimates, including principles of determining unit costs for various cost heads
- Issue costing guidelines synchronized with the budget calendar, budget guidelines and prospective plans of states and urban and rural LG

An indicative costing guideline is presented in Annexure 6.

11. Suggest prioritization framework for fund allocation by the federation, the states and urban and rural LG

- *Rationale:*
  - Historically, the GoN has faced issues in terms of resource constraints over the medium term. Also, the GoN prepares a deficit budget, with the deficit being substantially dependent on funding from foreign aid. Prioritization is crucial to ensure optimal utilization of available resources
  - Prioritization of programs/ projects, informed by the national development goals at the broader level, helps in providing sound technical inputs and guidance for decision-making during budget preparation
  - Prioritization of programs/projects is an essential tool to ensure funds are approved and allocated to priority programs/projects, critical for achieving national and subnational goals and targets
  - Under resource constraints, it is critical that right programs/projects are identified for funding based on the priorities of the sectors and spending is made on development purposes, thereby avoiding the risk of increase in recurrent expenditure as compared to capital expenditure
- *Implementation steps:*
  - Finalize the Prioritization Framework through discussions among NPC, MoF and line ministries
  - Use prioritization matrix and apply prioritization principles to rank programs/ projects during budget allocation

The detailed indicative steps of the prioritization process are appended in Annexure 6.

12. Draft guidelines for the preparation of outcome-based budgeting for states and urban and rural LG

- *Rationale:*
  - Outcome-based budget differs from traditional budget process, by using performance information (financial and physical) throughout the budget preparation process. This is supplemented by a change in the modalities of expenditure controls to promote use of performance indicators, including delegating input control plans to spending agencies while improving ultimate reporting and audit
  - The GoN prepares a deficit budget; therefore, budget constraint and demands from existing urban and rural LG as well as those to emerge from states necessitate an outcome-based approach toward budget preparation and approval
  - Under a constrained budget, outcome/performance information is a critical success factor for effective and efficient fund allocation, linked to the level of service/output delivered
- *Implementation steps:*
  - Get the buy-in of key stakeholders for outcome-based budgeting as an indispensable component of budget preparation and approval processes
  - Draft guidelines to capture:
    - The objectives of the program/project and for establishing linkages with national and sectoral priorities

- The key services or outputs and the ultimate outcome that the program/project is expected to deliver
- The activities through which the program/project is expected to achieve its results
- Key performance indicators and evaluation results by program/project
- Costing of the program/project

Detailed policy guidance on outcome-based budgeting is provided in the next section.

13. Draft guidelines for providing performance measures and targets aligned with national and local goals and priorities

- *Rationale:*
  - Standard performance measures necessary to institutionalize MTEF/ MTBF or other performance-based budgeting processes
  - Performance measures facilitate tracking of the efficiency and service delivery standards of the various programmes of ministries, departments and agencies
  - Stipulation of targets and matching performance measures to gauge the progress which aid in taking decisions on corrective measures / scalability of operations
- *Implementation steps:*
  - Conduct meetings/ focused group discussions (FGDs) among NPC, MoF, line ministries, donor agencies and sector experts on identifying indicators
  - Rationalize indicators to a manageable size for ease of monitoring
  - Set feasible targets based on national and local development goals and physical and financial capacities of the GoN
  - Draft guidelines and revise it based on piloting and feedback from key stakeholders in the ministries, departments and agencies

The broad table of contents of the guidelines for providing performance measures and setting targets is provided in the Annexure 6.

14. Suggest framework for integrating annual budget with MTEF and MTBF

- *Rationale:*
  - MTEF/ MTBF fail to achieve desired results if budget systems of the country are weak and annual budget lacks credibility
  - Shift to a performance-based approach to budgeting (MTEF/ MTBF) require commensurate changes in budgeting process
  - Typically, annual budgets are based on the previous year's budget with modifications in an incremental manner, leading to difficulty in reprioritizing policies and expenditure
  - MTEF has the ability to translate macro-fiscal objectives and constraints into broad budget estimates and detailed expenditure plans, guided by strategic priorities
  - Integration of annual budget with MTEF/ MTBF renders the budgeting process a forward-looking approach linked to establishment of priorities and allocating resources
- *Implementation steps:*
  - Enact fiscal responsibility laws and finalize fiscal rules
  - Conduct capacity building workshops for officials involved in budget preparation process
  - Issue circular to ministries, departments and agencies to include MTEF and MTBF processes as essential steps in the regular budgeting process

A framework for integrating annual budget with MTEF and MTBF is appended in the Annexure 6.

6.3.3 Recommendations for the long term

These actions need to be pursued **after 12 months**, once the short and medium-term actions are implemented and institutions and operations are fairly stable for augmentation of the budgeting process at the subnational levels of government. The recommendations are:

15. Suggest structure and functions of state fiscal commission

- *Rationale:*
    - The Constitution entrusts the NNRFC with the responsibility of determining detailed basis and modality for the distribution of revenues between the states and local governments out of the state consolidated fund. However, a separate body at each state is necessary to address the needs of local governments under that state, based on specific local priorities and to maintain fiscal relations among the state and the local governments, which may be addressed by the state only
    - A state fiscal commission for each of the states is essential to govern the distribution between the state on the one hand and the LG on the other, out of the net proceeds of taxes, penalties, fees etc. to be levied by the state and the inter-se allocation among different village bodies and municipalities
    - State fiscal commission renders greater fiscal autonomy to the state in a federal structure, especially in matters relating to sharing of revenue
    - Recommendations of the state fiscal commission, focused on local needs, impart greater stability and predictability to the subnational level transfer mechanism
- *Implementation steps:*
    - Define the organizational structure, roles and responsibilities of the state fiscal commission
    - Stipulate the term of office and responsibilities of the members constituting the state fiscal commission
    - Ensure that the responsibility calendar of the state fiscal commission is in line with the NNRFC
    - Delegate the responsibilities to the state fiscal commission in a phased manner, considering the transition of the GoN into the new federal structure and the paucity of time and resources; until then, the NNRFC may conduct the functions on behalf of the state fiscal commissions

Options for the structure of the state fiscal commission as well as broad functions of the said organization are provided in Annexure 6.

16. Operationalize ICT systems for states and urban and rural LG

- *Rationale:*
    - Successful implementation of ICT systems for conducting financial functions is expected to help in:
        - Improvement in effectiveness and efficiency of financial management through adoption of modern public expenditure management practices compliant with international standards
        - Facilitation of better fiscal management and optimal resource allocation, and also improvement in management of resources resulting in value for money.
        - Reduction in possibility of fraud and leakages, besides lowering of transaction costs and also ensuring transparency and accountability in government
    - ICT systems would be required to ensure accountability, transparency and efficiency in the allocation and utilization of funds
    - It is imperative for the federal government to ensure that the fund transfers are being utilized for the specified purposes
    - Idle funds at various levels of governance lead to loss of opportunity cost capital

- Strengthening the PFM systems at the state and local (urban and rural) levels will ensure easy access of funds through capital markets

- *Implementation steps:*
  - ICT systems must be preceded by PFM reforms at the subnational level (states and urban and rural LG). The indicative reforms/areas of reform include:
    - Delegation of financial power
    - Budget policy definition and budget classification
    - Formation of consolidated fund at the national and subnational levels
    - Defining CoA to be followed based on the COFOG standards
    - Requisites changes in receipt and payment to ensure acceptability of digital payment and digital signatures
    - Defining internal controls expenditure management
  - Define functional requirement specification for ICT systems at subnational and local levels

As-Is assessment of the Municipal Administration and Revenue System (MARS) and recommendations on its phase-wise approach have been provided in Part B: Information and Communication Technology (ICT) and Management Information System (MIS) under Component 5: Improving Transparency in PFM and Reducing Fiduciary Risks.

17. Sequence MTEF implementation in stages – MTFF, MTBF and MTPF

- *Rationale:*
  - In the context of sound public financial management, the fiscal policy objectives advocate establishment of three pillars – fiscal discipline, allocative efficiency, and technical efficiency
  - International experiences suggest that a comprehensive MTEF can be instituted only through sequential introduction of MTFF, MTBF and MTPF
  - A **Medium Term Fiscal Framework (MTFF)** is the first step necessary towards implementing an MTEF. Typically, an MTFF comprises a statement of fiscal policy objectives and stipulates medium-term macroeconomic and fiscal targets and projections to achieve **fiscal discipline**
  - A **Medium Term Budget Framework (MTBF)** strengthens the previous step (MTFF) by developing medium term budget estimates for individual spending units. MTBF is aimed at allocating resources linked to the strategic goals and priorities of the government, apart from ensuring alignment between allocations and overall fiscal objectives. This renders an **allocative efficiency** characteristic to the budget and also provides a certain degree of budget predictability to spending units within the overall limits of fiscal discipline
  - A **Medium Term Performance Framework (MTPF)** is an even advanced stage of medium term budgeting that involves resource allocation decisions based on programme outputs and performance indicators of the sector strategies. The efficacy of the programs/ projects of the spending units are evaluated on the basis of performance indicators. The objective of an MTPF is to ensure **technical efficiency** in budgeting by linking resources allocation to outputs and outcomes.
- *Implementation steps:*
  - Finalize macro-fiscal framework indicating national development goals and spending priorities in the medium term
  - Issue top down ceilings to ministries based on debt situation and revenue forecasts

- Prepare medium term targets and commensurate budget requirements within budget ceilings received, from an input perspective, based on standard costing guidelines
- Establish performance indicators to measure outputs and outcomes of programs/ projects executed by the spending agencies
- Update targets and necessary inputs based on review of performance

The suggestive steps for sequencing MTFF, MTBF and MTPF is included in the Annexure 6.

18. Suggest structure and functions of a Costing Secretariat at the federal level

- *Rationale:*
  - An overseeing body necessary to ensure accurate costing of programs
  - Review of costing methodology and estimates necessary to ensure effectiveness of costing exercise which aids in preparing a sound case of budget demands during budget discussions
  - Expected benefits include cost savings and value for money
- *Implementation steps:*
  - Define the organizational structure, roles and responsibilities of the costing secretariat
  - Stipulate the term of office and rules for the members constituting the costing secretariat
  - Design the modalities of functioning of the secretariat including timings of meetings, costing review and approval process, reporting mechanisms etc.

An indicative structure and functions of the costing secretariat are suggested in Annexure 6

6.4 Policy guidance for outcome-based budget

6.4.1 Definition

Outcome-based budgeting is a budgeting approach helps in improving the efficiency and effectiveness of public expenditure by using performance information to establish linkages between the funding (inputs) of public sector organizations to the results/ outputs they deliver.

6.4.2 Benefits

The major benefits of outcome-based budgeting are listed below:

- Improvements in expenditure prioritization
- Efficient and effective spending by agencies by linking level of funding with achievement of results
- Compliance with fiscal discipline
- Facilitation of implementing MTEF/ MTBF

6.4.3 Prerequisites

In the area of PFM reforms, successfully implementing such "second generation" initiatives like outcome-based budgeting entail fulfilment of the following important prerequisites:

- Sound management of macro-fiscal policy such that spending agencies can go about preparing and executing budget without any uncertainty regarding the funds that are committed to them from the GoN, through the resource ceilings for the ensuing years
- Enforcement of the execution of budgets as planned through compliance with budgetary rules and procedures and the capacity to apply and control them during execution.
- Good accounting and auditing procedures in line with international standards
- Adequate staff trained in handling requirements of performance information

6.4.4 Recommendations for implementation

Following recommendations are suggested for implementing outcome-based budgeting in the GoN:

- Determine the scope of the outcome-based budgeting exercise, in terms of:
  - Ministries, departments and agencies who shall be mandatorily required to follow outcome-based budgeting as part of their regular budgeting process as also those agencies which might be exempted (discretionary) from it
  - Programs/ projects on which outcome-based budgeting will be applied
- Define outputs and outcomes and identify suitable indicators:
  - Output – It provides a measure of the quantity of the goods or services produced through an activity under a program / project. It is an intermediate stage between financial resources and outcomes.
  - Outcome – It is the ultimate result/ work product of the programs/ projects. It gives information about the quality and effectiveness of the goods or services produced, consequent to a program/ project
  - Identify commensurate indicators that are S.M.A.R.T. (Specific, Measurable, Attainable, Relevant and Time bound)
- Suggest framework to capture conversion of financial resources into outputs/ outcomes:
  - Define intermediate and final outcomes preferably in measurable and monitor able terms
  - Standardize unit cost of delivery
  - Benchmark the standards/quality of outcomes and services
  - Conduct capacity building for ensuring necessary efficiency at all levels, in terms of equipment, technology, knowledge and skills
  - Facilitate timely flow of adequate funds avoiding both delay and 'parking' of funds
  - Include outcome-based budget as an indispensable component of the regular budgetary process of the GoN
  - Set up effective monitoring and evaluation systems, to indicate the directions for improving processes further, in order to deliver the intended outcomes
  - Involve participation of the target groups/ beneficiaries of the service, with easy access and feedback systems
- Draft guidelines to capture:
  - The objectives of the program/project and for establishing linkages with national and sectoral priorities
  - The key services or outputs and the ultimate outcome that the program/project is expected to deliver
  - The activities through which the program/project is expected to achieve its results
  - Key performance indicators and evaluation results by program/project
  - Costing of the program/project
  - Get the buy-in of key stakeholders for outcome-based budgeting as an indispensable component of budget preparation and approval processes

An indicative format for capturing the process of conversion of financial resources to outcomes is provided in Annexure 6.

7. Implementation Strategy

The GoN is going through a transition phase, shifting from a unitary to a federal form of government. Such an all-encompassing political transition is typically a long-drawn process till operations stabilize at each tier of the federal government, as envisaged by the Constitution.

In this backdrop, recommendations have been suggested in the previous section with detailed steps necessary for their implementation. However, the recommended actions need to be carried out in a phased manner, as suggested earlier (short, medium and long term). Keeping such a phased approach in mind, the following steps have been suggested to take forward the recommendations on implementing a budgeting process at the subnational level in the following sequential manner:

- Hold dissemination workshops to share the findings and recommendations with key stakeholders
- Get the buy-in of key stakeholders on the recommendations and their ownership to implement them
- Establish a Program Implementation Committee (PIC) for deliberating on the recommendations and adopting them as deemed necessary
- Finalize financial policies for the subnational government based on which financial procedures have to be drafted, as recommended
- Determine the responsibilities and finalize the overall budget preparation start and end dates for states, synchronized with the central budget calendar
- Ensure that all states and LG have an active account in a bank, which is a necessary condition for operationalizing consolidated fund at subnational level
- Discuss and finalize the structure of the log frame to be used to map sectoral issues and needs with the respective ministries
- Issue a circular to adopt MTEF as a mandatory step during annual and three-year budget preparation
- Conduct meetings of relevant stakeholders to finalize the structure of budget guidelines to ensure comprehensiveness and non-ambiguity regarding such guidelines
- Deliberate on and finalize the items to be covered and costing models to be suggested in the costing guidelines
- Conduct a trend analysis on past data in order to decide on the basis for revenue and expenditure projections
- Deliberate among NPC, MoF and line ministries on selection of a suitable model of outcome-based budgeting in the context of the GoN
- Analyze the completion status of ongoing programs/projects and merits of new programs/projects envisaged to be taken up, for identifying relevant programs/projects for prioritization
- Conduct a best practices study to decide on the organization, functions and operations of the state fiscal commissions
- Issue a circular to federal and subnational budget preparation and planning authorities, mandating the formulation of annual budgets based on the first year estimates of the three-year planning period; this should also mandate revision of the three-year plan based on project/program progress
- Conduct ICT readiness assessment of states and urban and rural LG and prepare an ICT implementation roadmap
- Draft and enact Fiscal Responsibility Budget Management Act and issue financial rules
- Discuss and finalize structure of MTEF and MTBF to be implemented
- Issue list of standard costs for goods and services generally procured by the GoN
- Conduct focused group discussions for identifying standard performance indicators
- Facilitate capacity building workshops to train relevant officials on budget preparation encompassing both annual budget and medium term budgets

- Design macro-fiscal framework for the GoN
- Conduct meetings among relevant stakeholders for establishment of a costing secretariat at the federal level

8. Perceived challenges and risks in implementation

8.1 Risks emanating from the gaps

- Overestimation/ underestimation of costs of programs/ projects and actual expenditure and debt exceeding fiscal targets leading to major budget outturns and unsustainable debt levels
- Lack of consistency in program/ project costing across ministries, departments and agencies leading to over/ underquoting of budgetary requirements and limited scope for comparison and evaluation during budget discussions
- Increased spending for non-development purposes (recurrent expenditure) due to lack of proper prioritization which may not be sustainable for the GoN in the long run
- Non-compliance with conditions stipulated by funding agencies leading to reduction in actual receipt of grants and loans as compared to estimates
- Lack of synchronization of various activities in budgeting process leading to time-lags in individual processes, resulting in delay in the entire budget cycle which also affects timelines of fund release and in turn, those of project execution
- Manual errors in budget preparation, execution and monitoring in the absence of full-fledged ICT based financial systems at LG level, leading to inaccuracy of data
- Over-dependency on the federal level ministries and institutions, thereby limiting the capacity of sub-national governments to exercise their financial autonomy

8.2 Implementation challenges

- Implementation of MTEF, MTBF and outcome based budgeting at the subnational level (state and LG) is a challenge given the capacity constraints and resource gaps of the subnational level bodies. With states yet to be formed and the LGs being at different levels of maturity, some of the subnational bodies will require a longer time frame and focused capacity development support while those with a higher degree of modernization and capacity may require comparatively lesser support. Hence, a "one size fits all" approach may give rise to unprecedented risks and make the implementation of these performance based budgeting approaches ineffective in the context of the GoN.
- Therefore, a phased approach may be adopted for implementation of MTEF, MTBF and outcome based budgeting at the subnational level. Highly advanced subnational governments may be targeted in the first year, moderately advanced ones in the second year and relatively less advanced ones beyond the second year. This approach will ensure that necessary technical and capacity development support are more targeted and effective. The criteria for classification of subnational governments into advanced, moderately advanced and less advanced for implementation may be based on the following:
  - Fiscal capacity including own revenue generation potential
  - Existing or newly formed LG
  - Level of computerization and related ICT infrastructure developed
  - Available manpower and skillset
- Additionally, incentives or punitive measures linked to fiscal devolution (performance based grants, conditional grants, special grants etc.) may be introduced. These may be contingent upon the performance of the subnational governments in applying these performance based budgeting tools (MTEF, MTBF and outcome based budgeting) as envisaged. It is critical to link degree of using of these tools with the budget approvals or grants to ensure proper planning and commensurate utilization of funds.

Chapter V

Component 5: Improving Transparency in PFM and reducing fiduciary risks

Part A: Internal audit and internal control

1. Introduction

The fifth component of the PATA project is aimed at improving transparency in PFM and reducing fiduciary risks. The sub-component on internal and external audit is further divided into three parts

- internal audit,
- internal controls and
- External audit.

The internal controls and internal audit are the primary managerial functions and aim at improving the economy, efficiency, and effectiveness of decision making, simultaneously introducing the desired element of transparency in the process. On the other hand, external audit is about giving assurance to the nation, to its citizens that the resources, that were put at the hands of the executive were spent toward achieving what these were required to achieve. All these put together emphasize the importance of Parliamentary Financial Control, the essential element of which is that “expenditure should be incurred by the executive only after the legislature (at whichever level – Local, State or Centre) has approved the same in the form of budget and it should be incurred efficiently and effectively only on those items for which the legislature had given its approval”.

The COSO framework defines internal control as a process, effected by an entity's board of directors, management and other personnel, designed to provide "reasonable assurance" regarding the achievement of objectives in effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations and safeguarding of assets.

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Internal auditing is a catalyst for improving an organization's governance, risk management and management controls by providing insights and recommendations based on analyses and assessments of data and business processes. With a commitment to integrity and accountability, internal auditing provides value to governing bodies and senior management as an objective source of independent advice. Professionals called “internal auditors,” are employed by organizations to perform the internal auditing activity.

Nepal is currently in a state of transition and the new structures are in the process of being setup. The relationships among these structures, both horizontally as well as vertically are also being redefined and this calls for a relook at the accountability setup. Accountability is about the obligation of the government officials and the civil servants to account for their activities, to accept responsibility for their acts, and to disclose the results in a transparent manner. This requires necessary controls to be put in place as per predefined processes and reporting systems to ensure that the discretion entrusted with decision making bodies is exercised in a judicious manner.

2. As-is Assessment

2.1 Approach and Methodology

Nepal is currently in a state of transition. The elections have concluded recently and after almost 20 years, the LGs will be fully functional with the elected representatives assuming office. Keeping this in mind, the PATA team planned to visit one each of metropolitan cities, sub-metropolitan cities, urban municipalities and wards in which elections were over.

The PATA team visited the following LGs:

- Kathmandu Municipality
- Lalitpur Municipality
- Hetauda Sub-Metropolitan City
- Bharatpur Metropolitan City and One ward of Bharatpur Metropolitan city
- Thakre Rural Municipality and,
- Galchi Rural Municipality.

The team covered different geographies and LGs of varying nature since Nepal is geographically different in the plains (terai), hills (pahad) and mountains (himal) and a mix of all the three would bring out the true picture.

They also had one to one meetings with officials in Financial and Comptroller General Office (FCGO) to understand the scheme of things in the functioning of the IA Department and also of the functioning of internal controls.

The team also interacted with officials in the Ministry of Finance (MoF), Ministry of Federal Affairs and Local Development (MoFALD), OAG and Local Governance and Community Development Plan (LGCDP) to gain an understanding on the controls and systems. Below is a list of people the team interacted with for PATA:

Table 1: List of people interacted with for PATA

SN	Name	Department	Designation
1	Mr. Maheshwaor Kafle	OAG	Assistant Auditor General
2	Mr. Laxman Aryal	MoF	Joint Secretary
3	Mr. Mukunda Raj Panthee	Budget Implementation Division, FCGO	Joint Secretary
4	Mr. Vishma Neupane	Treasury Management Department, FCGO	Under Secretary
5	Mr. Murari Niraula	PEFA	Member Secretary
6	Mr. Chandrakant Bhandari	OAG	Director
7	Mr. Biswa Raj Basyaula	LGCDP	Ex PFM Consultant
8	Mr. Subas Siwakoti	FCGO	Deputy FCGO

In these meetings the team tried to understand both the as-is scenario as well as the officials' expectations and the potential steps correct the gaps. In addition to the above, the PATA team went about reading the risk-based IA manual that was developed under the SPMP for the subnational level. The team's assessment of the manual and recommendations is presented in **annexure 10**. While suggesting the structure of the IA in the country, the team referenced countries with a federal structure and socio-economic-political conditions similar to that of Nepal, such as South Africa, Botswana and India.

The PATA team visited a few municipalities and VDCs to assess the principles and practices of IA at the subnational level and the extent to which these support the execution of efficient and effective operations, compliance with applicable laws, accountability obligations and safeguarding of resources against loss, misuse, and damage. Before that, the PATA team had meetings with officials of the FCGO and OAG to ascertain their views.

The team studied and reviewed the constitution, relevant laws and regulations, including the laws relevant to the pervious governance structure, guidance notes and directives associated with internal audit and internal control for subnational levels issued by various government agencies.

Since the LGs have not yet taken the intended shape and structure and have not commenced their intended functioning and operations, the internal control as was applied in the erstwhile LGs have been referenced with regard to the existing control system and gap assessment. The following table indicates the references that were used for the purpose of the assessing the as-is situation on internal controls in the LGs in Nepal.

Table 2: References

Sr. No.	LG	Reference used
1	Urban municipalities • Metropolitan, • Sub-metropolitan and • Urban municipalities	Erstwhile municipalities
2	Rural municipalities	Erstwhile Village Development Committees (VDC) and District Development Committees (DDC)

The existing structure of the Government was vertical and all LGs were administered centrally. The codes, till now, provided for internal audit of VDCs to be conducted by the District Development Committees (DDCs) and for municipalities an IA section in each of the municipality. A manual for risk-based IA at the subnational levels had been developed under SPMP-I. The PATA team is aware that these codes and acts are undergoing revision so as to cater to the new three-tier governance structure enshrined in the Constitution of Nepal; the PATA team attempts to provide some directions in that regard keeping in view the requirement of accountability and transparency in the functioning of the Government at the subnational level. It is accepted norm that accountability and transparency are hallmarks of good governance in any democratic setup.

FCGO is the main government agency responsible for the treasury operation of the Government of Nepal. This office is under the MoF and is headed by the Financial Comptroller General of Nepal. FCGO is responsible for overseeing all federal government expenditure against the budget, tracking revenue collection and other receipts and preparing consolidated financial statements of the Government. The IA unit in FCGO is responsible for conducting IA of all offices at the federal level.

Limitations

LGs as conceived by the current federal constitution are yet to take shape and operate with the autonomy and decentralized authority as conceived. The as is situation is based on the functioning of the LGs in the previous system of governance. The team was not able to cover the as-is assessment of the States because the States are yet to be formed. However, in the recommendations, the team has covered the basic contours of internal control and provided a recommended structure of IA Department in the country.

2.1.1 Approach and Methodology - Internal Audit

The PATA team identified the following issues for discussions during the field visits:

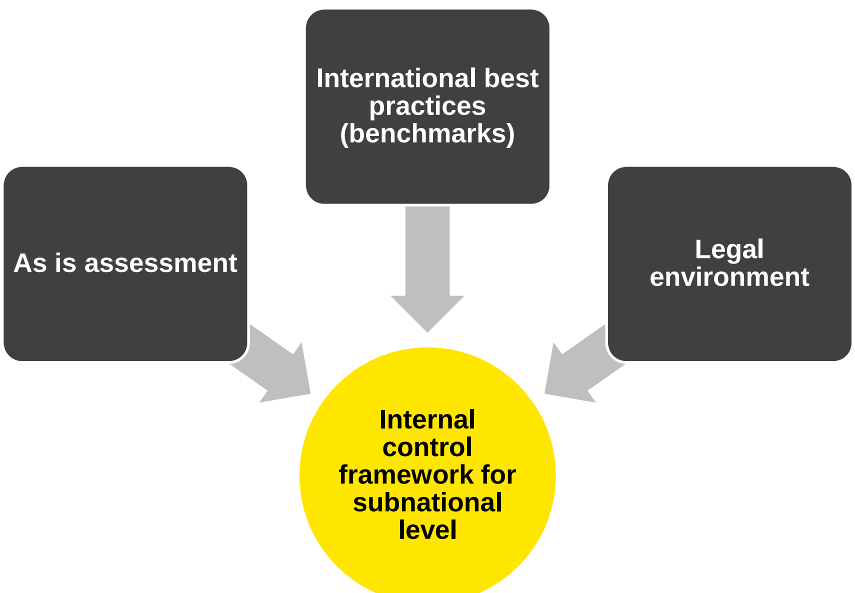
- Does the IA unit have an organizational set-up?
- Do IA procedures encompass financial as well as operational areas?
- Do the auditors function independently and have requisite organizational status and the desired degree of objectivity?
- Is there a proper mandate for conduct of IA?

- Does the mandate define the scope of the audit and also various types of audits to be conducted by the IA wing?
- Are the audits are planned and executed appropriately?
- The periodicity and regularity of evaluation by IA and the quality of the work done
- Do the auditee departments timely respond to the observations of IA?
- Does the IA wing maintain a data base of all audit observations raised by them and further action taken on these observations?
- Also with a view to assess the seriousness with which IA reports are treated by the senior management and followed up,
- Role of the accounts committee, and
- Can LGs Public Accounts Committee make IA more effective?
- Is there a need for introducing Internal Auditing Standards?
- What are the HR issues such as recruitment, deployment and training?

Documents reviewed for internal audit were as follows:

- Internal audit reports of municipalities, erstwhile DDCs, VDCs
- Risk Based Internal Audit Manual prepared by MoFALD under SPMP I
- Internal audit directives issued by FCGO

2.1.2 Approach and Methodology - Internal Control



2.1.2.1 As is assessment

- The team visited municipalities (both urban and rural) and metropolitan cities to discuss with the officials to assess the control environment and internal control activities that were being carried out.
- Internal control assessments which were conducted by the development partners and by agencies such as OAG have been reviewed by the team.
    - Many development partners have conducted control assessments and fiduciary risk assessment of GoN (UN Agencies' assessment of local bodies under micro assessment, reports, implementing partner capacity assessment test reports and PEFA reports among other documents)
    - External Audit by OAG is required under the Audit Act to review and report on the internal controls and their effectiveness.
- Internal controls are to be designed commensurate to the nature and scope of the entity. Therefore scope of the works of the subnational governments (State and local governments) under the constitution (Schedule 6 to 9 of Constitution of Nepal 2015) have been considered.

2.1.2.2 International Benchmarks (Best Practices used)

- Committee of Sponsoring Organisation (COSO) has an ICF which is widely accepted as the benchmark for control practices globally, in both public and private sectors. Therefore COSO Framework has been extensively referred in designing the Internal Controls Framework for the subnational governments in Nepal.
- For public sector INTOSAI Gov 9100 series are considered relevant and have been referred in designing the Internal Control Framework.
    - INTOSAI Gov 9100 – Guidance for Internal Control Standards for Public Sector.
    - INTOSAI Gov 9110 – Guidelines for reporting on effectiveness on Internal Control.
    - INTOSAI Gov 9120 – Internal Control - providing foundation for accountability in government.
    - INTOSAI Gov 9130 - Guidance for Internal Control Standards for Public Sector – Further information on entity risk management.

    Note: INTOSAI Gov 9100 series are also based on the broader COSO framework.

2.1.2.3 Legal environment

Following legal documents have been referred during the course of the assignment:

- Constitution of Nepal 2015
- Audit Act 1992 as amended in 2016.
- Financial Procedure Act 2055 and Financial Procedure Rules 2064

2.1.2.4 Internal Control Framework (ICF)

Considering the existing circumstances, legal environment, scope of activities of the subnational level governments and international best practices, a suggestive ICF has been designed. For each scope / activity of the subnational level government ICF has been suggested applying five pillars of COSO framework. The framework also contains the objectives which will be achieved by the controls.

2.2 As-is assessment of the Internal Audit at Subnational levels in Nepal

Independence is key to any audit, and this message was reverberated by all the IA officials of the LGs that the PATA team interacted with. Currently, the structure is such that the head of the IA Department in any LG reports to the chief executive of the LG. In such a case, that individual will not be able to exercise independence. There was no person in the IA Department in Lalitpur Municipality and the posts in the department had been lying vacant for the past two years.

In Kathmandu Municipality, there was a fully functional IA Department, with the head of the department Mr. Shiva Raj Adhikari having a team size of 11. He makes audit plans, conducts audit and submits reports to the chief executive. As per their mandate, his scope is limited to areas of deposits, incomes and expenditures. The remaining areas are covered by external auditors (OAG). The most common issue that he finds during his audit is that many items which were supposed to be purchased through the tendering process are not purchased through the same process. Staff strength is also a common issue for the IA Department to function effectively. The total strength in the IA Departments of all the LGs is 300.

Hetauda Sub-Metropolitan, as per their officials, is a model LG, which has been recognized as the best LG many times. All the pilots are tested in their LG. However, they have an issue of shortage of staff. They require at least 5 people in the IA Department to carry out their operations effectively and independently. A peculiar thing was noticed in Bharatpur Metropolitan City, where the head of IA was also heading one other executive department in the LG. This is far from the concept of independence. There is one committee called the Anugaman and Lekha Committee to which the IA Department is supposed to report. The committee includes the Deputy Mayor apart from other people. As there have been no elections, this committee is non-operational and hence he believes that the IA Department is not effective and can be said to be non-operational currently. He is supposed to make reports and send them to the chief executive four times a year, but he reports only when asked to by the OAG.

The team's assessment can be grouped in the following broad headings:

2.2.1 IA Structure and function

- The codes provide for an in-house department for IA in DDCs (these will not exist in the new set up). An account office deputed from FCGO heads the accounting functions at DDCs and the other support staffs in account section are locally recruited by the DDC itself.
- Municipalities have the same structure and conditions like DDCs except that the finance function at municipalities are locally recruited. Only the chief executive is deputed from MoFALD in the absence of an elected body, i.e. people for the municipalities locally recruit the entire finance function and internal auditors.
- No IA function exists at the VDC level. In the existing set up DDCs have the responsibility for auditing VDCs
- There is a provision of an Accounts Committee both at the VDC and the municipality level. This committee reports on whether or not the resources have been mobilized and amounts have been collected as per the estimation in the annual budget, whether or not the programs stipulated in the annual budget have been conducted and whether or not necessary actions have been taken in order to regularize, realize and settle the unsettled and irregular amounts as determined from the auditing.
- Internal auditors are mainly required to perform the following function:
  - Checking compliance with laws and regulation, specifically focused on financial procedure acts, regulations and directives
  - Inventory (asset) management
  - Certification of payroll statements
  - Checking arithmetic accuracy and adequacy for documentation

Note: State level: The level does not exist as of today. No system of IA is in existence at the state level.

2.2.2 Risk Based Internal Audit

Accordingly, a RBIA manual was developed under the SPMP. The PATA team has read the RBIA manual that was prepared. The team's assessment of the manual is provided in **annexure 10** and the recommendations on the manual are provided in the recommendations section.

2.2.3 The IA organization

Each of the municipalities visited had an IA wing. Whereas Kathmandu had 11 officials posted in the IA wing, no one was posted in the IA wing in Lalitpur, one person was posted in Bharatpur; he was there for 15 years and two persons were posted in Hetuada. At present co-ordination between all the different municipalities is taken care of by MOFALD; they organize meetings, workshops, etc. The ground realities indicate lack of strong commitment on the part of the management towards IA. Rotation of auditors is a requirement for proper and effective public financial management. In the existing set up, such rotation is not possible. The PATA team learnt that inter-LGs transfer of employees are negligible.

2.2.4 Mandate of IA at the subnational level

At the federal level, FCGO decides the mandate and scope of IA. The LG Acts and Regulations provide for IA at the subnational level but its mandate and scope has nowhere been defined. At Kathmandu, the LG has set a mandate for itself and has decided that deposits, income and expenditure are to be audited. Remaining areas are to be audited by the OAG. However, the LG feels that the authority of the IA head is very limited. To be effective, IA needs to wield adequate authority and report at a sufficiently senior level within the government organization.

2.2.5 Execution and widening the scope of IA

At Kathmandu, an opinion was expressed that only paper-based audit is conducted currently and that more and more field level audit of projects under implementation should be conducted to add value to the process of governance. At Kathmandu, the common issues identified by the IA is purchase without releasing a tender. The PATA team downloaded a few IA reports from the internet and observed that most audit observations are related to non-settlement of advances. There is also the need to introduce other forms of audit such as IT audit and environment audit. There is no proper mechanism for keeping records of audit observations issued and settled over a period of time. This makes it difficult to monitor the Action Taken Report (ATR).

2.2.6 Planning

Though the Act prescribes auditing of accounts as a duty of the secretary, no procedures exist for audit planning. At Kathmandu Municipality, an annual audit plan is made that attempts to cover all wards and an annual audit report is prepared and submitted to the management. At Lalitpur, no audits have been conducted in the past two years; there have been no audit plans either. At Bharatpur, only one audit has been conducted during the past one year and audit assignments are taken up as and when the IA wing is instructed by the management. At Hetauda, the PATA team was told that the staff in the IA wing is inadequate (there are two persons as against their assessed requirement of five), which is why it has not been possible to prepare audit plans. The IA wing at Hetauda used to make audit plans earlier but was not supported by the other wings in the LG.

2.2.7 Independence

The PATA team learned that the executive officer of the LG does performance appraisals of the head of the IA unit as the IA unit reports to him. In all the LG, similar views were expressed that IA should have an independent structure. This lack of independence could have a serious impact on the planning and execution of audits

2.2.8 User Group Projects

No audits of projects have been undertaken by any user group.

2.2.9 HR issues

No well-defined provisions exist for training of staff. At Lalitpur, the PATA team were told that only on-the-job training is provided to new entrants (in any wing). A few job descriptions do exist, but there is no procedure prescribed for having a job description for each post (in any wing). At Kathmandu, the PATA team was given a rough estimate of 30 as the total strength of IA across LGs.

2.2.10 Accounts Committee

During the team's discussion at various field visits, it appeared that the Accounts Committees had not been very effective.

2.2.11 Basis of accounting

The PATA team observed that cash based accounting is done in the municipalities. An opinion was expressed that it is difficult to do accounting according to the accrual based system.

2.2.12 Internal controls

Few procedural internal controls exist in most LGs. A bill is passed only if the budget is sufficient. For releasing project-related payments, the measurement book, project completion report and muster rolls are called for. However, there does not exist any set of rules in writing or a checklist for releasing payment. Most taxes are collected in cash, though all the payments are in check form. There is provision of monthly reporting.

2.3 As-is assessment of the Internal Controls at Subnational levels in Nepal

Internal controls at the local level is implemented not separately as a part of the control framework or risk assessment but by way of implementation of the norms and directives issued under the law and compliances of those procedures and directives are supposed ensure controls. Since laws and regulations are not changed frequently the controls they ensure do not always meet the changes in risk situation or changes in operational circumstances of government organisation.

Table 3: As-is internal control processes

As-is process
Fund Management
▸ Funds are received and paid through banks. ▸ Sources of funds include conditional or unconditional appropriation from central treasury and the local taxes and duties that are levied and collected. ▸ In addition to the above, the VDCs used to receive funds from DDC as conditional and unconditional grants into their bank accounts. ▸ Funds from the federal government are received through the central treasury TSA system through DTCOs.
Staffing
▸ Chief Executive is recruited by MoFALD as per GoN rules and normally transferred on every two years rotation basis. (this will change under the central constitutional provisions) ▸ The LGs itself recruits all other staffs. Most of the staffs are permanent staffs of the LGs. ▸ Most of the LGs do not have approved organizational chart. ▸ Staffs in smaller LGs including some sub-metropolitan municipalities and rural municipalities have not been formally given their job descriptions. ▸ The LGs do not have a training policy. Finance Staff feel that they require specific subject related trainings.
Accounting and Financial Reporting
▸ Chart of account is maintained in accordance with the annual budget of the LGs. Local Governance Regulation directs on the mode of accounts to be maintained.

As-is process
▶ Where program is undertaken though NGOs, all documents in original are obtained from NGOs and maintained at the LGs. ▶ Software is used to record financial transactions and ledgers are generally balanced. A bilateral donor supported project has implemented the common accounting system for LGs across Nepal. ▶ Activities-wise details are maintained by the program function. However activity-wise accounting is not supported. ▶ Roles and responsibilities are defined and segregated. ▶ Cash basis of accounting is followed. There is a commitment by government to implement accrual system of accounting within the government accounting at the local level. ▶ No specific accounting or reporting standard is followed. Financial Regulation under the Local Governance Act is applicable to LGs.
Planning and Budgeting
▶ Budget committee prepares budget after discussion with the stakeholders at the ward levels. The activities identified from stakeholder consultation are then prioritized considering the available resources and budget is finalized. ▶ Budget is approved by Executive Officer (in absence of elected body) ▶ Though description of activity and amount is indicated in budget physical target is not indicated in the annual budget. ▶ Variation reports are generated and presented. Approvals are taken prior to any variation (within the authorized limit), however capital budget cannot be transferred to current account budget.
Procurement
▶ Purchase order issued by store and goods are received by the store. Payment is checked by the accounts department and paid by cheque. Paid stamp is made on voucher but not on the invoices. All collected cash are deposited in the next working day. Some municipalities have bank counters to do cash collection on their behalf. ▶ In VDCs, Public procurement act is to be followed 'in principle'. ▶ Since the procurements are the VDC level do not generally exceed more than couple of hundred thousand rupees, simple quotations are used as the documentary benchmark to ensure procurement propriety.
Cash and Bank
▶ Dual signatories are enforced for bank operation. ▶ All cashbooks are maintained in software system and are generally maintained up to date. ▶ Most municipalities do not do monthly bank reconciliations. Most do as and when financial reports are to be audited. ▶ There is a limit on cash transaction and cashier is responsible for the petty cash. All the programs are paid by way of bank payments or through settlement of employee advances.
Asset Management
▶ Custody is assigned for the asset custodian. ▶ Store and accounts balance are not reconciled as assets are expenses on cash basis ▶ Physical verification of assets is done annually. ▶ All assets are not insured, only vehicles are insured. ▶ A rudimentary asset register is maintained.
IA
▶ Low level (generally Assistant level) staff is overseeing the IA function in most of the LGs. ▶ Internal auditor is not sufficiently independent to make critical assessments as he/she report to the chief executive. ▶ All IA queries are not settled in timely manner. ▶ IA is generally limited to arithmetic accuracy only and to some extent compliance aspects of the LG's funds. ▶ In urban municipalities, there is an in house IA department. ▶ VDC financials are subject to the IA review conducted by DDC IA units ▶ IAs are carried out as a requirement rather than value addition. ▶ Mostly IAs of VDCs are completed in haste as at the year ends and the ward level records are not reviewed.

As-is process
External Audit
▶ Generally chartered accountants are selected by urban municipalities for external audit. ▶ Entire accounts will be brought under the purview of the audit. ▶ Audit issues are repetitive though urban municipalities claim that the audit issues are in the process of settlements. ▶ Registered Auditors of Class 'C' or 'D' levels conduct the audits of the VDCs. The auditors have to be listed in the DDC. These auditors' reports are submitted to DDC.
Reporting and Monitoring
▶ For municipalities, financial reporting is done to DTCO and MoFALD. DTCO reviews and monitors financial reporting, monthly expenditure detail, trimester accounts are financial progress report, and annual financial statement are reported to DTCO and MoFALD. ▶ Financial and physical report needs to be collated separately for reporting purpose. ▶ Roles and responsibilities are defined by financial regulations for Executive Officer, Board and Executive Council. ▶ Financial management reports are prepared as a requirement but not as a management tool. ▶ VDC report to the DDCs and MoFALD. ▶ Dues to lack of resources monitoring is not done effectively. ▶ VDC work in the grassroots level, therefore unofficial social audit act as the monitoring tool. However in many VDCs social audits are not conducted at all or if conducted only to meet the formality requirements.
Information System
▶ Many municipalities (mostly the existing municipalities other than newly classified as municipalities) have computerized accounting and reporting system. The systems are either the common one provided through programs like LGCDP or are tailor made for individual municipalities. Most VDCs that are accessible by highways have computers. ▶ Staff needs to be further trained for transformation to accrual system. ▶ Back up is generally taken at regular intervals but mostly maintained within the same location ▶ In VDCs, The computers are generally used for secretarial works only and not for accounting and reporting.

3. Constitutional Provisions

Constitution of Nepal mandates a new governance structure, which is in three tiers. The first tier, the Federal Government, has well defined processes and administrative structures. The third tier, the local level government, had existed earlier though in a different form and being controlled by the first tier itself. The local level government has been reorganised in a more structured manner by creating municipalities, sub-metropolis, metropolis based on the population and other criteria.

The Constitution also mandates creation of seven States. Not many legislations have been adopted to clarify on the details on how the state governments will operate. Schedule 6 to the Constitution indicates areas, which fall under the jurisdiction of State Governments. These areas relate to clause (2) of Article 57, clause (4) of Article 162, Article 197, clause (3) of Article 231, clause (7) of Article 232, clause (4) of Article 274 and clause (4) of Article 296. Schedule 7 gives a list of concurrent powers of the federation, the States and the local level, and schedule 9 lists concurrent powers of the federation and of the states.

A close study of these schedules provides areas where internal controls will be required as regards the functioning of the State Governments are concerned. The State Government may be required to formulate Schemes/ programmes to address different areas of public interest, within the jurisdiction of the State Government, such as education, health, rural development, etc. Depending on the nature of the programme, multiple agencies may be involved in their planning and execution and these schemes and programmes may involve a significant outlay of the tax-payers' funds, thus requiring a robust control mechanism. A scheme/ programme face a number of challenges/ concerns that can impair its effective performance and realisation of the programme objectives.

Further, based on discussion with the stakeholders, the team was made aware that the following is also applicable to the local levels related to internal audit and internal controls:

- The local level shall carry out the final audit of its income and expenditure from the Auditor General.
- The local level should carry out internal auditing of its income and expenditure as per the law.
- While carrying out the internal audit, the regularity and austerity should be audited and the remarks pointed out by the internal auditor should be addressed by the concerned official before the final auditing takes place.
- A copy of the internal auditing should be provided to the dora deputed for the final auditing or the individual or agency as designated by the Auditor general.
- Every local level should develop and enforce an internal control mechanism as per the nature of their work to execute the works to be carried out by itself and through its office in an austere, efficient and effective manner, to make the financial reporting system reliable and to carry out works as per the prevalent law.
- While developing the internal control mechanism, attention should also be paid to issues like the environment of the control as per the nature of work, identification of risk areas, and exchange of information, monitoring and evaluation.
- To monitor the internal control mechanism, the concerned local level Chair or Mayor or district coordination committee Chief should him/herself do the work or designate a responsible officer to carry out the monitoring.
- The responsibility of improving the shortcomings/weakness observed through the monitoring and consolidate the internal control mechanism lies on the concerned chair or mayor or district coordination committee chief.

4. Gaps identified

4.1 Gaps identified - Internal Audit

The PATA team observed gaps in many areas of planning and executing of IAs. These can be grouped under the following headings:

- Planning
- Execution
- Quality of audit reports
- Follow-up of audit reports
- Independence
- User group projects
- No standard format for IA reports
- Monitoring implementation of projects
- Timely submission of audit reports for smooth release of grants
- Ineffective Audit (Accounts) Committees
- Lack of trained staff
- Work study – job description
- Nepal Standards of Auditing

For internal audit function to be effective, it requires independence, adequate professionally competent manpower, a carefully drawn audit plan and quick and effective follow up mechanism. All the above gaps indicate the absence of these parameters. Thus, it is proposed that major reforms and capacity building programs are required to put an effective IA system in place.

4.2 Gaps identified - Internal Control

Based on the understanding of as is process of LGs, the team has identified the below high impact gaps:

Table 4: Internal control observations and risks which have a high level of impact

Sl. No	Observation	Risk	Area
1	Most of the LBs do not maintain proper records of the data in their LB. For example, Integrated Property Tax is collected on the basis of the record of land and buildings in the area. This record is vital for reconciliation and budgetary perspectives.	Revenue loss	Planning and Budgeting
2	Cash Basis of Accounting is followed	Financial statements may not give a true and fair view of the books of accounts	Accounting and Financial Reporting
3	Internal auditor is not sufficiently independent to make critical assessments as he/she report to the chief executive. Internal auditor sometimes supports other departments.	Ineffective IA, weak internal controls	IA
4	All IA queries are not settled in timely manner.	Ineffective IA, weak internal controls	IA
5	External Audit issues are repeated year on year.	Chances of irregularities	External Audit

6	There are no plans in case of system failure. Moreover, back-up is maintained in the same room where finance department computers are located.	Loss of data/theft of data, security risk	Information and Technology
7	Lack of manpower and local recruitment.	Lack of capacity of workforce, quality of work may get hampered	Human Resources
8	Scope of IA is very weak. IA is generally limited to arithmetic accuracy only and to some extent compliance aspects.	Ineffective IA, weak internal controls	IA

For internal controls to be effective the top management should establish the control environment where by the risks are identified on time and appropriate control activities are instituted. The monitoring of the controls are done periodically so as to ensure that controls are effectively functioning to meet the organisational objectives.

The detailed table of observations related to internal control and their respective recommendations are provided in **annexure 7.**

5. International Experiences

5.1 International Experiences - Internal Audit

South Africa:

It has a three-tier federal structure -The local sphere of the government consists of municipalities, which are established for the entire country and the executive and legislative authority of a municipality is vested in its Municipal Council. A municipality has the right to govern, on its own initiative, the LG affairs of its community, subject to national and state legislation. Section 165 of the LG Municipal Finance Management Act of South Africa provides for an IA unit in each municipality. The Act also provides for an Audit Committee. It also has provision for outsourcing of audit. The Act also prescribes the duties of IA unit as follows:

- **Prepare** a risk-based audit plan and an IA program for each financial year.
- **Advise** the accounting officer and report to the audit committee on the implementation of the IA plan and matters relating to IA, internal controls, accounting procedures and practices, risk and risk management, performance management, loss control and compliance with this Act, the annual Division of Revenue Act and any other applicable legislation.
- **Perform** such other duties as may be assigned to it by the accounting officer.

Notes:

- In South Africa, it is the Audit Committee that heads the accountability structure of LGs.
- The PATA team has recommended that the Act in Nepal should empower the IA Department and also spell out the scope.

Botswana:

It has only one tier of Government, though the LGs are entrusted with many responsibilities. These do not function in an independent manner. There is a department of IA within the Ministry of Finance and Development Planning, Government of Botswana. Though the department exists but the law has not clearly spelled out its duties. There is no periodic IA done but in case any irregularities are noticed, the department is asked to probe the issue. There are two kinds of LGs, Council (similar to urban municipalities) and Land Board (similar to rural municipalities). The Auditor General conducts the external audit of the LGs and there is a Local Authorities Public Accounts Committee (LAPAC) as an accountability establishing mechanism.

India:

In India, there are three lists in the Constitution – Union List, State List and Concurrent List, LGs comes under the State List. Each state has its own set up for IA of LGs. Each state has a 'Panchayat Act' providing for IA, among other issues. In some states, Finance Department conducts the IA, while in a few other it is the Department of LGs, some states have a separate Local Audit Department.

In Kerala, the Panchayat Act requires auditors to specify in their report all cases of irregular, illegal or improper expenditure or of failure to recover moneys or other property due to the Panchayat, or any loss or waste of money or other property thereof caused by neglect or misconduct of the officer and authorities of the Panchayat. The Municipal acts in the respective states provides for the organization of IA, scope and procedure for the conduct of IA at Municipal Bodies. The Act confers on the auditors, all the powers of the civil court under the Code of Civil Procedure, 1908 (Central Act 5 of 1908) while trying a suit in respect of (a) summoning and enforcing attendance of any persona and examining him on oath; (b) requiring the discovery and production of any document; (c) receiving evidence on affidavits; and (d) requisitioning any public record or copy thereof, from any court of office.
The Act also allows that after giving a reasonable opportunity to the person concerned to explain his case, disallow every item of expenditure incurred contrary to law and surcharge it on the person incurring, or authorizing the incurring of, such expenditure and may charge against any person responsible therefore the amount of any deficiency, loss or unprofitable outlay occasioned by the negligence or misconduct of that person or of any sum that ought to have been but is not brought into account by that person and shall, in every such case certify the amount due from such person.

5.2 Best Practices – Internal Control

There are three main international standards on Internal Control Framework.

1. COSO Framework
2. INTOSAI Framework
3. ISO 31000 : 2009

5.2.1 COSO Framework

The Committee of Sponsoring Organisations of Treadway Commission (COSO) Internal Control Framework (ICF) consists of five interrelated components derived from the way the management runs a business. According to COSO, these components provide an effective framework for describing and analysing the internal control system in an organization. The five components are control environment, risk assessment, control activities, information and communication and monitoring activities. In internal control system comprises the whole network of systems established in an organization to provide reasonable assurance that organizational objectives will be achieved. The COSO framework on internal control outlines three categories of objectives – operational, reporting and compliance.

As per COSO Framework, internal control consists of five integrated components:

1. Control Environment
It is the set of standards, processes, and structures that provides the basis for carrying out internal control across the organisation. The control environment comprises the integrity and ethical values of the organisation; the parameters enabling the governing body to carry out its governance oversight responsibilities; the organizational structure and assignment of authority and responsibility. Elements of the control environment are as follows:

- The personal and professional integrity and ethical values of management and staff, including a supportive attitude toward internal control at all times throughout the organisation.
- Commitment to competence.
- The "tone at the top" (i.e. management's philosophy and operating style).
- Organisational structure.
- Human resource policies and practices.

2. Risk Assessment

It involves a dynamic and iterative process for identifying and assessing risks to the achievement of objectives. Risk is defined as the possibility that an event will occur and adversely affect the achievement of objectives. It implies:

- risk identification:
- related to the objectives of the entity;
- comprehensive;
- includes risks due to external and internal factors, at both the entity and the activity levels;
- risk evaluation:
- estimating the significance of a risk;
- assessing the likelihood of the risk occurrence;
- assessment of the risk appetite of the organisation;
- development of responses - four types of responses to risk must be considered:
- transfer,
- tolerance,
- treatment or
- termination;

Of these, risk treatment is the most relevant to these guidelines because effective internal control is the major mechanism to treat risk. The appropriate controls involved can be either detective or preventive. As governmental, economic, industry, regulatory and operating conditions are in constant change, risk assessment should be an on-going iterative process. It implies identifying and analysing altered conditions and opportunities and risks (risk assessment cycle) and modifying internal control to address changing risk.

3. Control Activities: These are the actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of objectives are carried out. Control activities are performed at all levels of the entity and at various stages within business processes. Control activities are the policies and procedures established to address risks and to achieve the entity's objectives. To be effective, control activities must be appropriate, function consistently according to plan throughout the period, and be cost effective, comprehensive, and reasonable and directly relate to the control objectives. Control activities occur throughout the organisation, at all levels and in all functions. They include a range of detective and preventive control activities are diverse. Entities should reach an adequate balance between detective and preventive control activities. Corrective actions are a necessary complement to control activities in order to achieve the objectives.

4. Information and Communication: Management obtains or generates and uses relevant and quality information from both internal and external sources to support the functioning of other components of internal control. Communication is the continual, iterative process of providing, sharing, and obtaining necessary information.

Information: A precondition for reliable and relevant information is the prompt recording and proper classification of transactions and events. Pertinent information should be identified, captured and communicated in a form and timeframe that enables staff to carry out their internal control and other responsibilities (timely communication to the right people). Therefore, the internal control system as such and all transactions and significant events should be fully documented. Information systems produce reports that contain operational, financial and non-financial, and compliance-related information and that make it possible to run and control the operation. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to enable decision-making and reporting. Management's ability to make appropriate decisions is affected by the quality of information, which implies that the information should be appropriate, timely, current, accurate and accessible.

Communication: Effective communication should flow down, across, and up the organisation, throughout all components and the entire structure. All personnel should receive a clear message from top management that control responsibilities should be taken seriously. They should understand their own role in the internal control system, as well as how their individual activities relate to the work of others. There also needs to be effective communication with external parties

5. Monitoring Activities - On-going evaluations, separate evaluations, or some combination of the two are used to ascertain whether each of the five components of internal control, including controls to affect the principles within each component, is present and functioning. Findings are evaluated against criteria established by regulators; recognised standard-setting bodies or management and deficiencies are communicated to management.

- Ongoing monitoring of internal control is built into the normal, recurring operating activities of an entity. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. Ongoing monitoring activities cover each of the internal control components and involve action against irregular, unethical, uneconomical, inefficient and ineffective internal control systems.
- Separate evaluations scope and frequency will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Specific separate evaluations cover the evaluation of the effective- ness of the internal control system and ensure that internal control achieves the desired results based on predefined methods and procedures. Internal control deficiencies should be reported to the appropriate level of management.
- Monitoring should ensure that audit findings and recommendations are adequately and promptly resolved.

5.2.2 INTOSAI Framework

The International Organisation of Supreme Audit Institutions (INTOSAI) operates as an umbrella organisation for the external government audit community. For more than 50 years it has provided an institutionalised framework for supreme audit institutions to promote development and transfer of knowledge, improve government auditing worldwide and enhance professional capacities, standing and influence of member SAIs in their respective countries. INTOSAI Gov are guidelines for good governance in public sector. INTOSAI Gov 9100 is about internal controls and its broad contours which is based on five pillars of COSO – control environment, risk assessment, control activities, information and communication and monitoring. INTOSAI Gov 9110 is about reporting on effectiveness of internal control which is again based on COSO five pillars. INTOSAI Gov 9120 is about establishing accountability in government which is about framework for establishing and maintaining internal control and the role of managers, internal auditors and staff members in the accountability perspective. Finally INTOSAI Gov 9130 is about risk management – definition of risk management, entity's vision and mission, setting organisational objectives in four categories i.e., strategic, operational, reporting and compliance, identifying risks and opportunities, communicating and learning from risks and setting the limitations of this risk management framework.

Table 5: A checklist on the basis of INTOSAI Gov 9120 for subnational governments of Nepal

In establishing the internal control framework, each subnational government body can conduct a self-assessment as under and adopt controls as appropriate commensurate with the nature, size and complexity of the organization.

- Assessed the risks the organization faces?
- Identified control objectives to manage the risks?
- Established control policies and procedures to achieve the control objectives?
- Created a positive control environment?
- Maintained and demonstrated personal and professional integrity and ethical values?
- Maintained and demonstrated a level of skill necessary to help ensure effective and efficient performance?
- Maintained and demonstrated an understanding of internal controls sufficient to effectively discharge responsibilities?

For implementing internal control, each subnational government body needs to ensure whether

- Adopted effective internal control throughout the organization?
- Based the organization's internal control on sound internal control standards?
- Included in the organization's internal control structure appropriate and cost-effective control practices?
- Prescribed control practices through management directives, plans, and policies?
- Established a means of continually monitoring the operation of the organization's internal control practices?

5.2.3 ISO 31000: 2009

ISO 31000:2009 provides principles and generic guidelines on risk management. It can be used by any public, private or community enterprise, association, group or individual. Therefore, it is not specific to any industry or sector. It can be applied throughout the life of an organization, and to a wide range of activities, including strategies and decisions, operations, processes, functions, projects, products, services and assets. It can be applied to any type of risk, whatever its nature, whether having positive or negative consequences. Various Governments across the world have used these standards to develop their ICF. Australia and New Zealand have developed 'AS/NZS ISO 31000:2009 Risk Management – Principles and guidelines' which is a joint Australia/New Zealand adoption of ISO 31000:2009.

The PATA team has considered the COSO framework, INTOSAI Gov and ISO 31000 for development of ICF for the subnational level of governments in Nepal.

6. Policy Recommendations

6.1 Recommendations for internal audit

6.1.1 Institutional Structure

A new organizational structure should be conceived for IA, which is vital from the point of view of accountability and transparency – two essential elements of good governance. The new structure is required because DDCs have ceased to exist, thus responsibility for conducting IA of village level LGs will have to be entrusted somewhere. The team looked at the organization structure of IA in countries with similar socio-economic-political conditions as that of Nepal to suggest an appropriate organization structure of IA Department. Below are the countries and their organizational set-up of IA Department.

Flowing from the IA function at local level in the countries with similar structure as that in Nepal and based on best practices and the discussions with the officials in various departments and ministries in GoN, there could be the following three possible structures for IA at the local level:

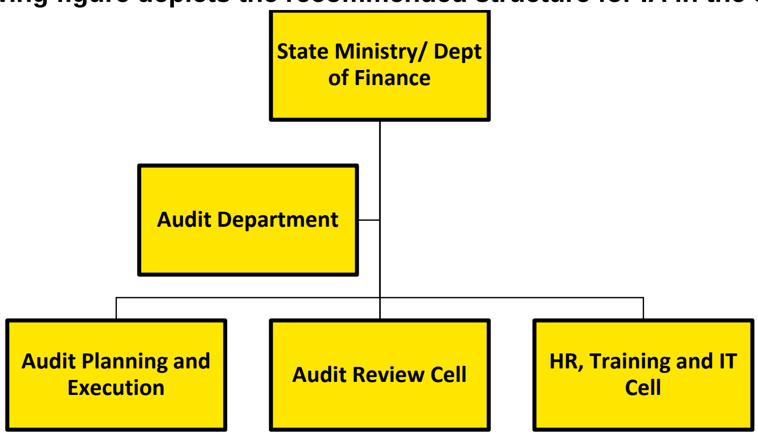
a. A Centralized structure within the Federal Government
b. A Centralized structure within the State Government
c. A department within the LG itself

The Constitution of Nepal grants complete independence to the subnational governments. Therefore, a centralised structure for audit of subnational government will not be in the spirit of the constitution. Moreover, IA, by definition, is an internal process and is an integral part of internal control mechanism of an institution. Hence, PATA team recommends option "c". Each LG should have an IA department, responsible for conducting internal audit of the LG. It is also recommended that the IA wing directly reports to the Council. To make this possible, the LG Financial regulations must provide that IA department will prepare annual audit plans before the beginning of a Financial Year and get the plan approved by the Council. The IA reports should be given to the auditee department, to the Chief Executive and also to the Council. Council should monitor the progress of action on the observations of IA included in their audit report. The external audit will be conducted by the OAG, as mandated by the Constitution of Nepal. OAG audit parties must assess the effectiveness of IA as well.

For States

At the state level, there should be an IA department under ministry/department of finance of state government.

Figure 1: Following figure depicts the recommended structure for IA in the States:



6.1.2 Institutional strengthening

A. At State Level

The states are yet to be formed. Once the states are formed and in order to formalise the internal audit structure at the states, we are proposing that the states can start with only an audit department which will have minimum number of staff who can do the audit planning, audit execution and consequent reporting, gradually the department can be further institutionalised, wherein the following cells should be a part of the IA department:

Audit Planning and Execution Cell

This will primarily study past trends, conduct a risk profile of the population to be audited, prepare a risk based matrix, prepare an annual audit plan, monitor the Annual Audit Plan throughout the year and ensure maximum coverage of the plan. This will also be responsible for carrying out the field audit work in accordance to audit plan. The conduct of audit in the field will be with the help of the AMS and will prepare a report containing audit paras and submit the same to the **Review Cell.** This will be responsible to prepare and maintain documentation and working papers as prescribed in the norms and the manual. The documents and evidence shall also be sent to the review cell to substantiate the report and its findings.

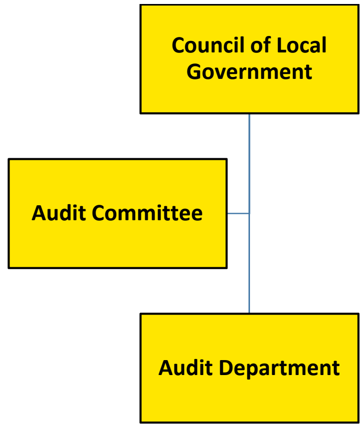
Review Cell will obtain the audit reports and working papers and review them. Thereafter, comments will be drafted and sent back to the planning and execution cell. The members of the planning and execution cell shall prepare replies and ensure that the queries are all met. The cell shall comprise senior auditors who are not involved in execution to ensure independence and objectivity of the review.

The **HR, Training and IT Cell** will be responsible for providing support services to the audit function such as assessing the training needs of the auditors (all cells), prepare training strategies, plans, calendars and conduct trainings to enhance capacity building, assisting the other cells in assisting with IT and technology related issues and provide backup technological support.

B. For Local Governments

Internal Audit should be commensurate with the nature, size and the complexity of activities and operations of the organisations. Local governments in Nepal vary vastly from very large Metropolitan Cities to very small Rural Municipalities. Therefore the size and strength of the local government's internal audit function (department) will be in accordance with the size, nature and complexity of operation of the local governments. Audit Department will directly report to the LG council through audit committee. Audit department will not be responsible for any operational duties to ensure independence. Periodic training and capacity development will have to be ensured to enhance competence and to ensure quality of IA.

Figure 2: The following illustrates the structure of IA at LGs



6.1.3 Public Accounts Committee at States / Audit Committee of LG Council

Public Accounts Committee (at States) and Audit Committee (at Local Governments) needs to be formed at the consisting of elected representatives. These committees will examine the audit reports submitted by the internal auditors.

6.1.4 Introduction of Internal Audit Standard

To ensure standardisation of processes and systems of audit, a Nepal should consider adopting Internal Audit Standards from internationally available internal audit standards.

- CIPFA (Public Sector Internal Audit Standards - PSIAS)
- IIA (International **Standards** for the Professional Practice of **Internal Auditing)**

These standards consist of basic requirements for professional practice of IA and for evaluating the effectiveness of performance and guidelines for planning, sampling, conducting, documentation and reporting.

6.1.5 Strengthening legislation:

Revamp in the legislation is needed to include suitable changes to the act /rules /procedures to facilitate operationalization of IA scope / framework, reporting lines, expanding mandate of internal audit. Additionally, methodology to address the backlog in audits and minimize build-up in future, an effective mechanism to enforce production of records and documents for audit, resolution of audit findings by the auditees and strengthening the consolidated annual audit report to the chief executive needs to be addressed. The above mentioned law should empower the IA department by clearly stating its authority, responsibility and scope and also mandate the conduct of IA as per provisions contained in RBIA manual.

6.1.6 Stakeholders' Consultation

A communication strategy needs to be developed for stakeholders which would include strategies for, but not limited to, the Federal Legislature, the OAG, MoF, LGs, and States (in the process being set up). The strategy will lay down measures to effectively communicate the work plans, audit procedures, findings, reports, frequent defaults to the concerned authorities including discussions with ministry officials to agree on the set of possible recommendations (action plan) and provide appropriate sequencing (short, medium and long term), the resources needed and whether there is need for legislative sanction. The strategy will also illustrate the statement of purpose, current situation, different type of analysis, and department's objectives with stakeholder participation

6.1.7 Audit Management Software (AMS)

The PATA team recommends introduction of a computerised AMS to keep record of all audits conducted along with the audit observations recorded. Law, mandates and regulations should define a timeline for the departments to submit responses to IA queries. A suitably designed AMS will enable auditee at the subnational level to upload their responses to the audit observations and will result in effective monitoring apart from creating a valuable database. The AMS will address the following illustrative list of key issues:

- Lack of proper audit planning
- Audit back-logs
- Lack of follow-ups
- Lack of documentation and working papers maintenance
- Monitoring and evaluation of programs
- Generation of standardized audit reports
- Lack of compliance to mandates
- Lack of communication between auditee and auditor

Linkage of AMS with OAGN NAMS

Such an AMS can be integrated among all states and also with the audit management information software of OAG named Nepal Audit Management System (NAMS). Under Audit Act 1992 Sec 4, OAGN is obligated to review the internal audit findings and recommendations made by the internal auditors. AMS will have following two benefits for compliance of Sec 4 requirement for OAGN, if interfaces with the Internal Audit AMS of the subnational governments:

- OAG Auditors can assess risk of the subnational governments by accessing the online IA reports
- The implementation of the IA recommendation and settlement of audit findings will be available real-time for compliance with Sec 4 scope of the Audit Act 1992

Table 6: Suggested modules of AMS can be

Functions/modules of AMS
▪ Preparation of Annual Audit Plan ▪ Assignment of audit to audit parties ▪ Preparation and monitoring of site / field visit programs ▪ Reviewing progress of audit vs. the plan ▪ Analytical functions for audit findings ▪ Audit compliance management ▪ Audit report generation ▪ Scrutiny and approval of audit reports ▪ Documentation and working paper repository ▪ Other functions including grievance redress ▪ MIS reporting ▪ SMS and e-mail alerts

AMS will be integrated to ensure coverage of the entire audit life cycle.

Figure 3: Audit life cycle

6.1.8 Delivery of audits through Risk Based Internal Audit

Currently, the audits are being conducted in a traditional manner including checking of accounts, balances and transactions. In a government set up, these traditional archaic practices does not ensure proper controls, proper monitoring and evaluation of risks and exposes the government to a variety of risks because checking all transactions requires a lot of manpower which in turn involves a lot of costs leading to a high burden on the exchequer which a country as small as Nepal cannot afford. Risk based approach involves creating a risk profile of the units and transaction type to be audited and critical risk indicators will ensure coverage of all the high risk areas. It also facilitates strategic use of audit resources, aligns audit efforts with its objectives, facilitates institutional development and reduces risk exposure by focusing attention on areas of weakness. Additionally, the RBA provides the benefits of increased and effective controls and reduced risks. Hence, in the context of Nepal, it is highly recommended that the IA department uses risk based audit approach in the conduct of all its audit.

Risk based internal auditing (RBIA) is defined as a methodology that links auditing to an organization's overall risk management framework. RBA allows audit to provide assurance that risk management processes are managing risks effectively in relation to the risk appetite. RBA involves risk profiling of the audit portfolio over time; thus, it In RBA, risk is measured on the basis of the following parameters (illustrative):

- Materiality
- Ethical climate
- Competence of personnel
- Size of the assets
- Size of the operations
- Results of previous audits

To identify risks, direct probability estimates, normative tables, and comparative risk are typically used. Thereafter, risk factors are converted from conceptual and subjective (qualitative) data into quantitative data. Scoring and weighing the risk factors derive an overall risk score. The result is a risk-based engagement plan that guides the deployment of audit resources to high-risk areas. For the selection of samples, the manual needs to be updated with the two-tier risk based approach to be followed. The two-tier risk based approach is:

i. **Selection of units to be audited**: There cannot be a 100% checking of all the units and operations during the year. Therefore there has to be selection of units for IA, e.g. departments to be audited at state level or wards or departments to be audited at local government level. Further the risk based approach will provide required information to the audit team to guide their focus and resources in conducting audit of more risky units and operations by planning the nature and extent of the audit in accordance with the risk profiling.

ii. **Selection of transactions and processes to be audited**: Once the units are selected and extent of audit determined, the next approach is the selection of the transactions and processes to be audited. This can again be done by planning the nature and extent of the audit of transactions and events – such as vendor selection, risky transaction selection, risky account heading selection and risky items selection e.g. high-value / key items etc.

6.2 Recommendations for internal control

6.2.1 Implementation of Internal Control Framework (ICF)

ICF is a generic framework with the main objective to ensure effective realisation of the objectives set-forth for the governance process. This will require identifying the risks (potential concerns or impediments) for the successful implementation of a scheme; and designing and operationalizing adequate measures to address these risks and concerns. Governance is all about delivery and good governance is about good delivery. Did the government deliver what it promised; was it delivered in time, was the right quantity delivered, of the right quality and to the right beneficiary? Thus the ICF should be such designed so as to ensure delivery of the intended objectives. A comprehensive ICF, in COSO model, considering the local governments in Nepal, their activities and scope is given in **Annexure 8**.

ICF also takes in account various reforms being initiated by the Government of Nepal. Under Nepal's Public Financial Management Reform Strategy/Program (PFMRP) Phase II (2016/17-2025/26), following outcomes have been envisaged; all of the areas are being covered under the suggested ICF:
Outcome 1: Improved Budget Credibility
Outcome 2: Improved Comprehensiveness and Transparency of Budgeting
Outcome 3: Improved Policy-based budgeting
Outcome 4: Strengthened Predictability and Control in Budget Execution
Outcome 5: Improved Accounting, Recording and Reporting
Outcome 6: Improved External Scrutiny and Audit
Outcome 7: Improved Human Resource Management and Capacity Development for PFM
Outcome 8: Improved Donor Practices

Expected benefits of implementation of ICF

Controls and accountability have an inverse relationship. More robust the controls, accountability will accordingly be more pronounced. The flip side to that is that with many controls in place, the need to apply discretion by various government officials will be much less.
As good governance is all about making delivery to the target population and to provide better amenities to the citizens, internal controls will play a very important part in ensuring good governance.
Following are some of the expected benefits of the implementation of the aforesaid ICF for the subnational government of Nepal:

- Subnational governments will have a ready-made document that can be used for instituting and implementing internal controls. Further the subnational government can further customize the framework to suit their requirements.

- The aforesaid ICF has been prepared on the basis of international standards such as COSO Framework, INTOSAI Standards, and ISO Standards which will benefit the governments.
- Control environment for each area of activity or area of risk has been suggested for those responsible for governance at subnational level to draft policies and procedures to institute controls.
- The possible risks have been for each key areas of scope of subnational governments have been identified in detail (but not limited to) based on the past practices. The identified risks give the subnational governments something to build upon when new risks become evident in future.
  - The ICF tests suggested in the report gives an assessment model to assess risk in terms of Likelihood (Probability) and Impact (Consequences).
  - The assessment will allow the management to grade the risks in terms of their likely severity based on the risk score.
- The suggested control activities are the recommendations of controls that can be applied to manage the identified risks. The control activities are to be reinforced by the suggested
  - action plan and
  - timeline for implementation as suggested

This ensures institutionalisation of internal controls.

- The risk-based approach gives the forward-looking approach to the subnational governments. Traditionally, in Nepal, the government's structure of internal control implementation was on post-mortem model i.e. when the risk event has already occurred. However this framework provides the forward-looking approach to the subnational levels, focused on prevention and timely detection.
- Information and Communication of internal controls will be formalised after the implementation of this framework.
- The framework provides for the controls to be monitored for ensuring effectiveness. This framework suggests the following:
  - Instituting internal controls (existence) commensurate to the nature and size of the organisation
  - Efficient operation of controls, for the entire period
  - Ensuring the controls have been able to meet their objectives (control effectiveness)
- Control objectives met are assigned with each control areas to ensure that effectiveness has been met.

6.2.2 Internal Control Self-Assessment tool

Local governments can use the self-assessment tool under INTOSAI Gov 9120. The sample of the self-assessment tool is given in **Table 5** under **Section 5.2.2**.

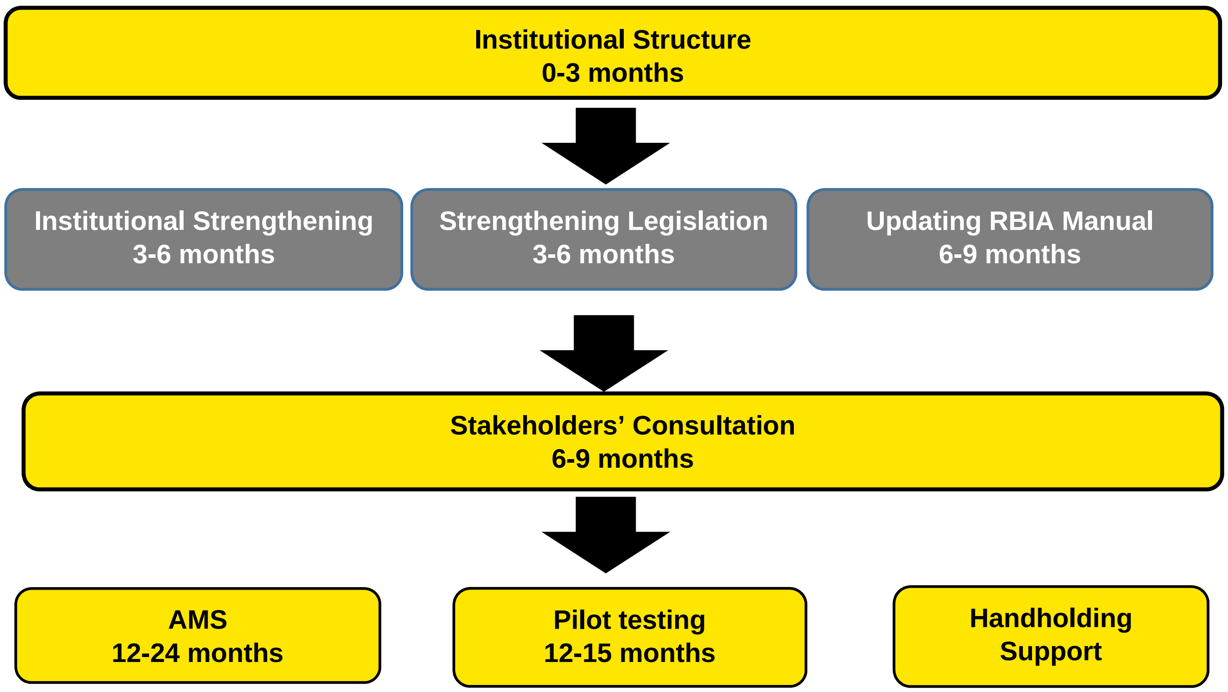
6.2.3 Internal Control assessment checklist for sub-national levels in Nepal

Internal Control assessment checklist for sub-national governments in Nepal, based on the internal control objectives has been given in **Annexure 9**. This checklist provides a tool to review the existence, efficiency and effectiveness of the internal controls.

7. Implementation Strategy

7.1 Implementation Strategy for recommendations on internal audit

Figure4: The following are the recommendations and suggestive timelines for its implementation:



Phase-wise implementation of AMS on the basis of piloted results

There is a need to demonstrate value-addition to the IA function through risk-based audit pilots and "proof of concepts" for contemporary audits and ensuring the go-live of AMS. It should serve as a basis for the auditors to improve the manual, revise the plans, modify the checklists and accordingly make necessary changes in the execution of audits. The pilot project should cover different types of audits such as performance audit, systems audit, technical audit, social audit, financial audit, compliance audit and special audit, different geographies (Terai, Hills and the Mountain) and different types of LGs in different states and state level departments. Piloting the AMS in one state and in one of urban and rural municipality will ensure that the software is working properly. It will also help understand whether the AMS is able to achieve the desired result and the end users are able to use the system effectively and efficiently. On the basis of the pilot, the software can be further improved.

Handholding Support:

Handholding support from a team of experts would ensure effective utilization of the AMS and efficiently executing the IA functions. It will include on-field guidance on the following:

Operational aspects of AMS:

AMS will be an easy to use software. User based access will be provided to all the IA personnel in the subnational (both states and LG) level. As mentioned in the recommendations section, it will also be integrated with NAMS which will facilitate the external auditors to review the internal audit findings and recommendations as mandated by the constitution. GoN is responsible for the policy determination for all the levels of government. Therefore the federal government may finance an AMS to be piloted and replicated in states and LGs. The federal government can take the responsibility to review and upgrade the system on the basis of the requirements and feedbacks from the states and LGs. AMS will be installed in computers or laptops of the internal auditors. The hosting of the database can be done centrally in government database such as Government Integrated Data Centre (GIDC). With this easy implementation no separate networking will be required. The access to the external auditors can be ensured through allowing access to the GIDC data base. The Financial Comptroller General Office (FCGO) department under the Ministry of Finance (MoF) is responsible for Internal Audit at the federal level. Hence, it may take up the responsibility for managing and regulating the AMS. However, it has to be deliberated and discussed within the government whether the power to regulate AMS should vest with the FCGO or a separate department at the federal level should take the responsibility. The rationale behind this is, since the FCGO is also the accounting body, considering independence, a separate department managing the AMS will be useful.

Table 7: Activities to be carried out during the handholding phase

Activities to be carried out during handholding phase
▪ Preparation of audit work plan ▪ Risk analysis and assessment ▪ Conducting audit, reporting and follow-up ▪ Using AMS, framework and manuals ▪ Conduct training ▪ Amendment of manuals and guidance ▪ Prepare Quarterly Handholding Report

The handholding period would ensure successful implementation of the IA system within the subnational level of GoN.

The Handholding Report shall cover the following (illustrative):

- Progress of work plan, i.e., Audit Plan vs. Audit Execution
- Risks noted during the planning phase
- Findings observed
- Observations relating to limitations faced during implementation of Institutional Structure of IA, RBIA manual, AMS.
- Training Reports
- Amendments required in the given frameworks, manuals, etc.
- Overall handholding status

Workshops can be organized including officials of different states and LGs to discuss the audit issues and the challenges faced by them so that steps can be taken to ensure smooth conduct of the audit.

RBIA Updating, Piloting, Handholding and Rollout

Under SPMP I a comprehensive Risk based Internal Audit Manual for local governments have been prepared. The manual covers most of the areas of the internal audits in details. PATA team conducted the detailed review of the RBIA manual and has some recommendation for implementation, details of which is given in **Annexure 10.** The implementation strategy for RBIA should be as follows:

- RBIA manual should be updated with the recommendations made.
- Training of Trainers should be conducted on the RBIA to produce champions of risk based internal auditing.
- The champions in conjunction with external expert should carry out pilot audits on the basis of the RBIA manual
- Then in phase-wise manner RBIA should be rolled out to the rest of the LGs by way of trainings.

Continuous capacity building activities should be carried out to retain the competency of the internal auditors.

7.2 Implementation Strategy for recommendations on internal control

It may be important to adopt a particular ICF or customize a framework suiting the local requirements; the concept of adopting best practices of other countries in identifying and mitigating risks may not be advisable. Therefore it is suggested that each state and local government tailor make their ICF in line with their organisational size, nature and operations. The reference to the suggested ICF would be a useful guiding tool.

8. Perceived challenges and risks in implementation

8.1 Perceived challenges and risks in implementation for recommendations on internal audit

Following challenges and risks are perceived for implementation:

- IA in public sector is being carried out traditionally therefore there will be resistance to change to modern approaches and tools such as RBIA and AMS.
- Availability of competent IA staff at LGs, especially at remote rural municipalities, is a serious matter of concern.
- Resources at LGs to institute modern system like AMS will be a challenge.
- Further control of AMS system, periodic upgrading, hosting and maintaining among 7 state governments and 753 local governments is a challenge.

8.2 Perceived challenges and risks in implementation for recommendations on internal control

PATA team's assessment of the internal control at the LG level had identified the control gaps and for each gaps the team has included risks, the level of impact, area and the action plan to mitigate the risks, constraints and challenges for implementation; details of this has been provided in **Annexure 7**

The challenge was to create a single document (framework) that will be applicable for:

- Full-fledged state governments
- Resourceful Metropolitan / Sub-Metropolitan city governments
- Average sized urban Municipalities
- And resource crunched rural municipalities

However internal control principles are/will-be common for all level and sizes of governments. Each local governments can choose from the framework the applicable risk area and control activities as they would be relevant for them. In addition for each area the kind of the control environment to be created and the monitoring activities to be ensured can be based on the framework. ICF given framework for broad control environments, risk assessment, control activities (recommended control actions), communication of control issues and monitoring activities. The ICF is made comprehensive so that the document can be referred as a reference for Internal Control implementation.

Chapter VI

Component 5: Improving Transparency in PFM and Reducing Fiduciary Risks

Part B: Information and Communication Technology (ICT) and Management Information System (MIS)

1. Introduction

The main objective of PATA is to carry out a comprehensive assessment of reform priorities through detailed and operationally relevant studies, and provide actionable policy recommendations to the Government of Nepal for operationalizing fiscal federalism.

The PATA will primarily revolve around 5 components relating to (i) improving revenue mobilization at the subnational level, (ii) revenue sharing among different tiers of government, (iii) subnational borrowing, (iv) improving subnational expenditure allocations and (v) improving transparency in PFM and reducing fiduciary risks at subnational level.

The fifth component of PATA is about improving transparency in PFM and reducing fiduciary risks. One of the sub-components of this component is about Information and Communication Technology (ICT) and Management Information System (MIS).

This report has been prepared in line with the scope of work —appraise the effectiveness and efficiency of MARS currently implemented in KMC and review and strengthen the rollout strategy by developing an operational plan with the required IT infrastructure and capacity building needs and costs to expand the system to other LGs.

The new constitutional provisions have resulted in an increase in responsibilities of the LGs. Rolling out of MARS in LBs would ensure that the functions are efficiently carried out and services delivery is effective and swift with active engagement of citizens.

In its continuous endeavor toward automation of the functions of the LBs, MARS was developed and piloted in Kathmandu Metropolitan City (KMC). The system helps to provide solutions for financial management, budget monitoring and planning, revenue management, human resource management, office management and fixed asset management along with various reporting tools for management/decision makers and interface for citizens.

2. As is Assessment

2.1 Approach and Methodology

The PATA team gained an initial understanding of the expectations of the stakeholders at the workshop organized in March 2017 wherein the scope of work and related methodologies were discussed. Thereafter, the team initiated a detailed assessment and submitted the Inception Report in May 2017. After the inception phase, the team was mainly involved in the following activities:

The PATA team reviewed the documents, laws, by-laws, manuals etc. in order to obtain an understanding of the current scenario. The key documents consulted were as follows:

- The Local Self-governance Act, 2055 (1999)
- Local Self Governance Regulation 2056 B.S (2000)
- Manual of MARS
- Annual Action Plan 2072-73, Dhulikhel Municipality
- Annual Action Plan 2072-73, Hetauda Municipality
- Annual Action Plan 2073-73, Bharatpur Municipality
- Replication strategy paper by Mr. Anup Baskota

As part of the LGCDP II, MARS has been piloted in KMC. In order to gain an understanding of the system, the team made multiple visits to KMC and the Micro Data Centre and reviewed the various functional aspects of MARS.

The team also met the development team of MARS (Real Solution Pvt. Ltd.) and MoFALD's support team.

Thereafter, the team made the following visits to LGs to understand the ground realities beyond the peripheries of KMC and assess the feasibility of the replication of MARS. The team made the assessment from the perspective of capacity building, technical assistance, software and hardware.

Table 1: Details of field visits

LG	Date of Visit
Dhulikel Municipality	June 2, 2017
Hetauda Sub-Metropolitan City	June 6, 2017
Bharatpur Metropolitan City	June 7, 2017

The PATA team also met Mr. Anup Baskota, former chief of NITC and GIDC, who is currently working on the replication strategy of MARS.

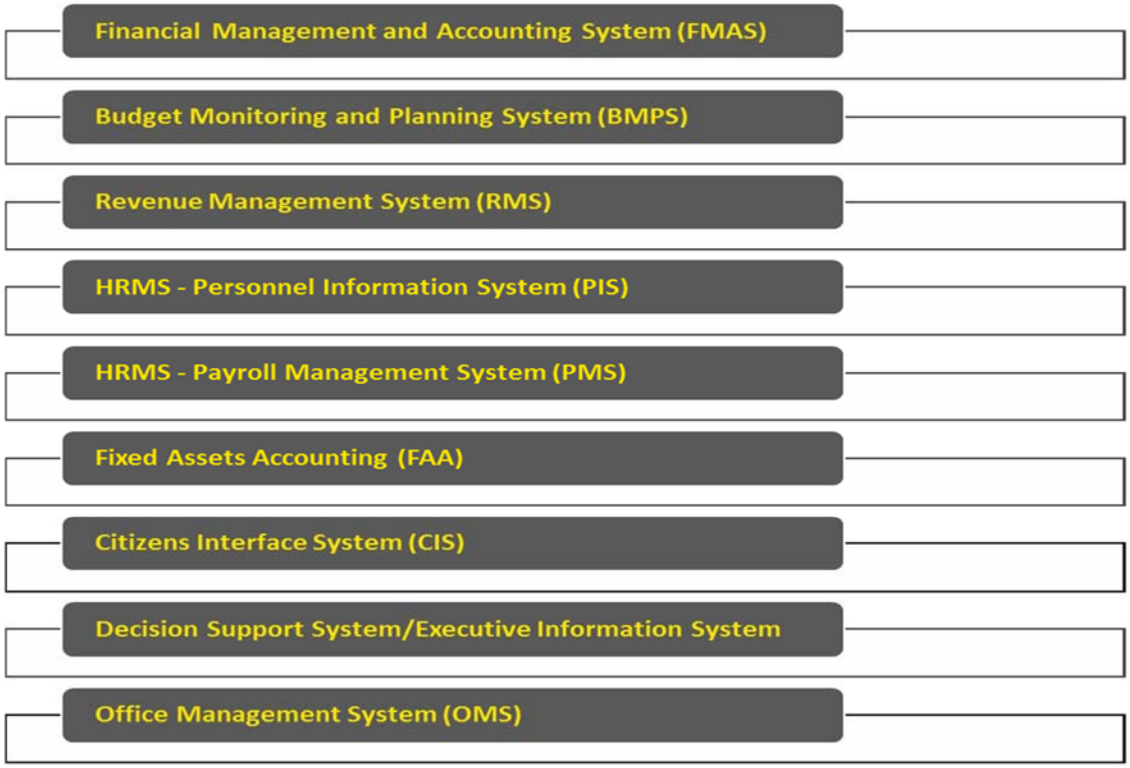
2.2 Assessment of Effectiveness and Efficiency of MARS and Operational Plan

Nepal is one of the fastest urbanizing countries in the world, and to keep pace with the rapid growth and development there is a strong need for automation and digitization of governance at LGs. The base of the entire economy lies at the local level, thus urging the need for well-integrated systems that are user-friendly, easy to maintain and effective and can generate information useful to the federal authorities.

In its endeavor to digitize municipal governance and standardize the information obtained from these systems, the GoN has expressed interest to initiate the replication of MARS across all LGs.

MARS was primarily designed for a pilot in KMC and it contains the following modules:

Figure1: Modules of MARS



Financial Management and Accounting System (FMAS): This module consists of general ledger, accounts receivable, accounts payable, cash management and expense management features. It also provides managerial and operational reporting analysis, reduces operating costs and increase business value.

Budget Monitoring and Planning System (BMPS): This module is used for planning and managing cost and revenue estimates, controlling costs and ensuring that the annual program is completed within the specified budget.

Revenue Management System (RMS): This module is used for enhancing revenue and improving revenue administration. It includes records of taxes such as integrated property tax, business tax, house rent tax and vehicle tax, as well as property rental, vehicle parking fee etc.

HRMS- Personnel Information System (PIS): This component manages all the demographic and service profiles of a municipal employee. The PIS maintains the vital information of an employee such as profile, name, date of birth, gender, father’s and grandfather’s names, nominee, permanent address, PF number and also includes transfer, promotion and training records.

HRMS- Payroll Management System (PMS): This module organizes employees’ monthly payments. It also tracks working hours, calculates wages, prints and delivers checks, and pays employees’ taxes to the Government.

Fixed Assets Accounting (FAA): This module is used to account for transfer of assets from one division to another, compute depreciation charges on fixed/intangible assets and conduct re-valuation of fixed assets.

Citizen Interface System (CIS): This module interfaces with municipal citizens on grievances received. It also enables applicants to trace the status of the grievances. Through this module, the citizens interact and get solutions pertaining to municipal taxation, social benefits and municipal procedures.

Decision Support System (DSS)/Executive Information System (EIS): This module provides information to the management level to facilitate decisions.

Office Management System (OMS): This module helps in tracking workflow management, document management and inter office communication.

Details of features of MARS is given in **Annexure 12.**

In the first phase, MARS was rolled out in 14 out of the 32 wards at KMC. KMC has prepared physical ICT infrastructure to implement the system and trainings have been imparted in the remaining 18 wards. However, as informed by KMC officials, the remaining wards have not started using the system. All the wards are connected to an optical fiber network. The system has been installed in KMC in a Micro Data Center and replicated data is stored in Government Integrated Data Centre (GIDC) which is as a centralized system (repository system).

MARS will support government efforts to foster effective LG budget and expenditure management and fiscal sustainability. MARS has been conceptualized to enhance the revenue of KMC by broadening the scope of the citizen services and by providing efficient service delivery mechanisms for citizen services with the integrated software covering revenue management, budget, expenditure, property tax, etc.

Further, MARS has been developed to facilitate municipal decision making processes, provide better level of services to the citizens with enhanced transparency, accountability and inclusiveness, through the provision of relevant, accurate and up-to-date data and information at all levels of KMC.

The advantages of implementing MARS include increased mobilization of own-source revenue, particularly house and land taxes. A base-case scenario of tax collection gains in one medium-size LG shows an increase of $8 million–$11 million on a cumulative basis in the first 5 years of the introduction of MARS[41]. This is based on an assumption of an annual 5% increase in new houses registered and an increase in compliance rate from the current low level of 30% to around 90% in 5 years.
Other benefits include reduction in financial irregularities and better public service delivery as a result of improved accounting systems and results-based management.

The primary stakeholders for the successful rollout of MARS are:

(i) **MoFALD** - Responsible for overseeing the replication process and needs to understand the strength and limitation of MARS and ensure proper monitoring, evaluation and support mechanism,

(ii) **LGs**- Responsible for identifying gaps by determining their functional requirements vis-à-vis the services provided by MARS,

(iii) **Donor agencies** - They should also be aware of the requirements of the LGs.

2.2.1 Assessment of Effectiveness and Efficiency of MARS

As discussed in the previous sections of the report, MARS was primarily developed for a pilot at KMC, and its modules were designed in accordance to the needs of the metropolitan. The piloting exercise of MARS at KMC has positively impacted the metropolitan in several ways. The following are the key impacts that illustrate the effectiveness of MARS with regard to automation of municipal services.

[41] Source: Financial and Economic Analysis – SPMP (Asian Development Bank)

Table 2: Key impacts/Effectiveness of MARS

Assessment of effectiveness of MARS
All wards of KMC are interlinked and connected to each other, enabling the respective authorities to view the information system and data of all wards from a single web-based window.
Accrual-based Double Entry Accounting System (DEAS) has been introduced at the LG level.
Revenue administration has been strengthened as KMC is moving toward the adoption of an integrated revenue collection system.
The working culture and functions of KMC have been streamlined and there is greater emphasis on citizen-centric services.
Workforce capacity at KMC has been enhanced.
The budget planning and formulation process has become transparent.

As discussed in Chapter VI of this report, operationalizing of ICT systems would be required to ensure accountability, transparency and efficiency in the allocation and utilization of funds. Therefore, the key components cover functions relating to financial management, budget planning, revenue management, human resource management, payroll, citizen interfacing, fixed assets management, etc. However, during the assessment of the ground realities, the PATA team observed that the needs and functions of various LGs are diverse.

Also, considering that the capacity of the workforce is limited in remote locations and MARS will be implemented at the ward level, certain aspects relating to service delivery and tax structure may need customization and improvisation.

Primarily, MARS contains 9 modules:

Table 3: Modules of MARS and their functions

Module	Functions
BMPS	Planning and managing cost and revenue estimates, controlling costs and ensuring that the annual program is completed within the specified budget
FMAS	Consists of general ledger, accounts receivable, accounts payable, cash management and expense management features; also provides managerial and operational reporting analysis, reduces operating costs and increases business value
RMS	Used for enhancing revenue and improving the revenue administration of sources relating to integrated property tax, business tax, house rent tax, vehicle tax, property rental, vehicle parking fee etc.
HRMS/PIS	Manages the demographic and service profile of a municipal employee and information such as name, profile, date of birth, gender, father’s and grandfather’s names, nominee, permanent address, PF number and CIT number as well as transfer, promotion and training records
HRMS/PAS	Facilitates employees’ monthly payments and tracks working hours, calculates wages, prints and deliver checks and pays employees’ taxes to the Government
FAA	Used to perform transfer of assets from one division to another, compute depreciation charges on fixed/intangible assets and conduct re-valuation of fixed assets
OMS	Facilities workflow and document management and intra-office communication and notifications
DSS	Provides the information to the management level to take decisions on the basis of the information obtained from the other modules.
CIS	Interfaces with municipal citizens on grievances received and also enables the applicants to trace the status of the grievances; enables citizens to interact and get solutions pertaining to municipal taxation, social benefits and municipal procedures

MARS has been developed as per robust AAA security standards. It includes protection of data exchanged between clients and the server by means of the SSL protocol, which provides data integrity and strong authentication of users and HTTP servers.

Although MARS is a comprehensive and sophisticated system, the following modules may be introduced in MARS in a phased manner to further enhance the effectiveness of the system. The existing modules may need updating in line with the evolving changes relating to federalization and restructuring of LGs.

We suggest that these additional modules be developed and integrated provided the existing 9 modules are effectively implemented.

- **Inventory Management System (IMS)**

The system will contain information about the opening stock, purchases made, stock utilized, closing stock, etc. The system can also enable the LGs to request for and approve various processes. Further, inventory valuation reports can be generated from the system. Some examples of inventory in a municipality are: street lights, sewerage pipes, spare parts, meters, etc.

- **Waste Management System (WMS)**

The WMS manages information relating to wastes, collection center and re-usable wastes and also provides information to the top level for decision making.

- **Geographic Information System (GIS)**

GIS manages household information, street maps and geospatial data and lets users view a location with related information attached to it.

- **Building Permit System (BPS)**

E-BPS is an application software system that has been developed to assist municipalities to improve their current building permit process. It ensures compliance with the National Building Code (NBC) and Building By-Laws (BBL) in urban regions, thus promoting safe building practices and planned urban development for the entire nation.

- **Fund Flow Management System**

This system provides the infrastructure and workflow for managing and distributing funds. It also facilitates the identification, forecasting and categorization of all source funds.

In order to determine the efficiency of the functionalities of the MARS software, the financial statements of KMC generated from the system were required to be reviewed. However, the team was not given access to the balance sheet and related financial statements. Further, the Functional Requirement Specification (FRS) and System Requirement Specification (SRS) documents were also not made available for review. Therefore, the team could not conduct a thorough analysis of the controls and flow of data/information in the system.

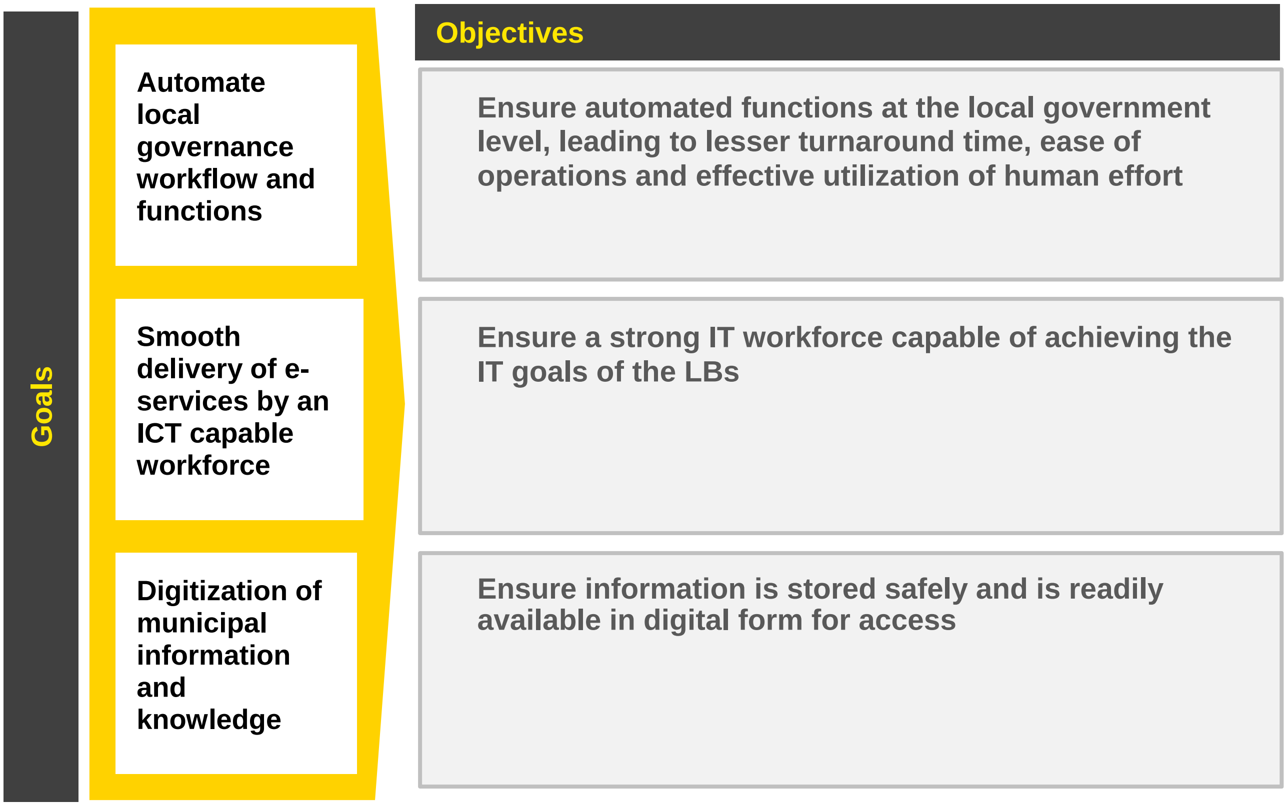
3. Policy recommendations and implementation strategy

3.1 Replication Strategy for MARS

Implementation of MARS in LGs will support the GoN's commitment to strengthen its oversight and accountability functions. The system is comprehensive and will enable automation of both the revenue and the expenditure side of the financial statements of the LGs. The system will facilitate increased revenue generation and effective planning and monitoring of budget at the LG level. Further, PIS and PAS will enable LGs to maintain information about their officials and ensure accurate calculation of salary and tax deductions.

The vision of the MARS replication strategy is to integrate all municipal services onto a single web-based platform and provide efficient and automated services to the citizens of 753 LGs.
Primarily, the strategy has 3 goals:

Figure 2: Goals of the replication strategy



The goals above can be achieved only with robust strategies that complement the GoN's vision of automating local level governance.

The strategies to achieve the above-mentioned goals are given below:

Table 4: Goals and strategies for rollout of MARS

Goal 1: Automate Local Governance Workflow and Functions
Key Strategies
▸ Establish reliable, secure, affordable and suitable ICT infrastructure at LG level
▸ Identify alternative IT solutions for automation where implementation of MARS is not feasible
▸ Provide end-to-end TA with handholding support
▸ Enable a comprehensive IT security framework to help address the challenges relating to information security, network security, disaster recovery and compliance issues
Goal 2: Smooth Delivery of E-services by an ICT-Capable Workforce
Key Strategies
▸ Improve IT literacy and skills among workforce by conducting sustainable capacity building programs
▸ Conduct system administration and operational level training for the staff of LGs
▸ Spread awareness about the automated e-services and their benefits to the citizens
▸ Conduct subject and module specific in-depth training to the users on financial management, budget planning and monitoring, revenue management and payroll management to enable them to utilize the functions of the system effectively and efficiently
Goal 3: Digitization of Municipal Information and Knowledge
Key Strategies

▸ Identify relevant past data to be captured
▸ Migrate all legacy information to the new system
▸ Educate the users about the digitized data and its availability

Post replication of MARS, the implementing agency will have to decide the transition strategy. A transition strategy determines how the LGs would be placed in terms of transiting from one system (existing) to another (MARS). The PATA team suggests a phase wise implementation of MARS in the LGs. In this strategy, the modules of the new system are introduced in a well-planned and phased manner and the legacy systems are not replaced abruptly with the new one. The main advantages of phased implementation are:

- Lesser manpower is required
- Change management is less complicated considered it is a gradual process
- Lesser risk of system failure

3.2 Operational Plan for Rollout of MARS

In order to implement the operational plan, the GoN needs to carry out certain activities that would not only ensure effective replication but also build sustainable capacity of the workforce to enable long-term benefits in terms of local level governance. The capacity building exercise should not be limited to technical trainings (e.g. hardware and software) only, but should also focus on the modules of MARS such as financial management, budget planning and monitoring, revenue management, fixed assets management, payroll, citizen interfacing, DSS, etc..

The PATA team suggests phase-wise implementation of MARS at LGs.

The tentative phase-wise implementation arrangements are given below:

Table 5: Phase-wise implementation arrangement

Phase	LG	Justification
First	58 LGs	These 58 LGs have been in existence for a substantial period of time, have available resources and have been running different types of e-government service.
Second	205 LGs	These urban LGs were established after 2014 and have basic infrastructure, connectivity and electricity.
Third	481 (all) rural municipalities	These are newly restructured and have poor connectivity and inadequate infrastructure.

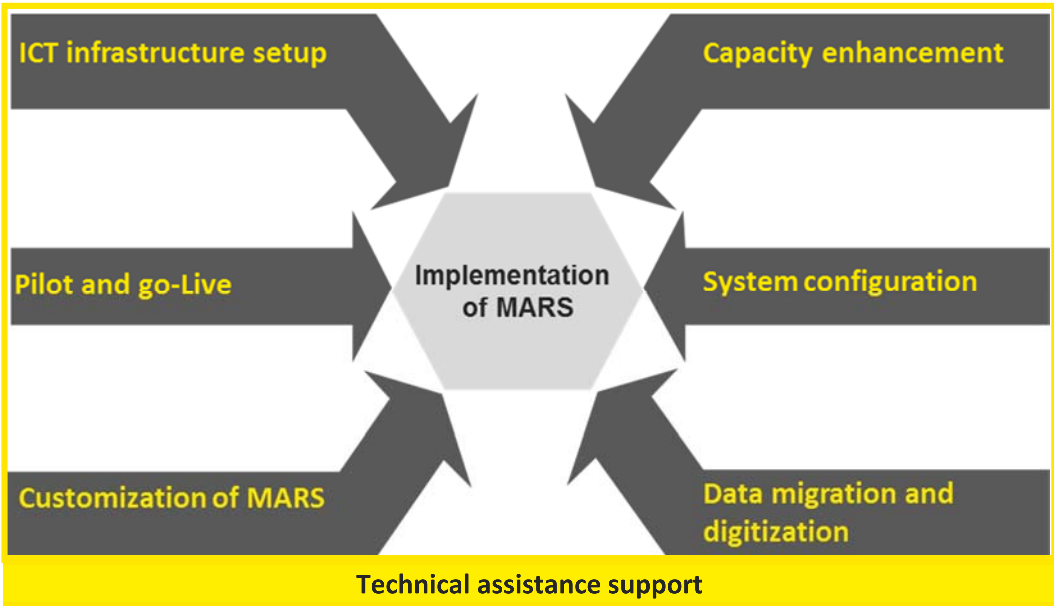
The details of the LGs classified above are given in **Annexure 13.**

The ultimate aim for the GoN should be make the end user and base (location where MARS is to be implemented) ready for effective operation of the software.

The following sub-section of the report elaborate the activities to be **carried out for rollout of MARS** across all LGs.

3.2.1 Activities to be carried out for rollout of MARS

Figure 3: Overview of the activities to be carried out for rollout of MARS:



Activity 1: ICT Infrastructure Setup

One pre-requisite for effectively implementing MARS is a reliable, secure and sustainable ICT infrastructure. The existing scenario at the local level is so diverse that it is almost impossible to suggest a standard methodology for setting up of ICT infrastructure.
Therefore, the PATA team suggests the following alternatives to set up the infrastructure.

Table 6: Alternatives for ICT infrastructure set-up

Alternative 1: G-Cloud	Alternative 2: Data Center Subscription Model	Alternative 3: Colocation System	Alternative 4: Micro Data Center
G-Cloud is run by the Department of IT (DoIT) and is hosted in GIDC at Singha Durbar. G-Cloud service provides public IP for each municipality, unlimited space and structured self-managed services.	In this case, a subscription is to be made based on the requirements of MARS and the service provider will create and manage all the required arrangements such as platform, IP, memory, storage, backup/restore and bandwidth. After the platform is set up, MARS would be installed. The service can be accessed from any device, at any place and at any time by the citizens and by the ward office via the internet.	In this case, each LG would be required to purchase minimum hardware systems. The colocation system will be at GIDC or any other third part data center.	In this case each LG would be required to purchase Modular Data Center that includes all the necessary power, cooling system, security and associated infrastructure

Note: The alternatives mentioned above are for metropolitans, sub-metropolitan and municipalities only. In case of rural municipalities, the PATA team suggests a separate approach given in Section 3.2.2 of this report.

The following table summarizes the proposed alternatives mentioned above:

Table 7: Alternatives in detail

Alternative	Major Tasks	Advantages	Disadvantages	Responsible Body	Resources and Support
Alternative 1: G-Cloud	▸ G-Cloud would provide individual machines with IP, storage and memory. ▸ Operating system, database and application would need to be set up.	▸ Centralized government cloud system will ensure centralized standards for backup, security and control. ▸ Cost is very low. ▸ The Government is responsible for upgrade and maintenance. ▸ It is reliable and scalable.	▸ Local intranet connectivity would be required. ▸ Technical expertise would be required to set up cloud machines in municipalities. ▸ GIDC would not be responsible for any loss of data ▸ G-Cloud is in pilot stage. ▸ Disaster recovery facility is not yet available ▸ Security audits and certifications are not available	Cloud managed by G-DOIT and other configuration and support by the municipality	G-Cloud machine would need to be handled by an IT officers at the LG level. TA would be required.
Alternative 2: Data Center Subscription Model	▸ Platform and operating system would be provided by the private third party data center. ▸ Database and application would need to be set up.	▸ Robust system with large no. of corporate organizations already using the system. ▸ Cost to implement would be low as the system is already in use. ▸ Third party is responsible for upgrade and maintenance. ▸ Security audits and certifications are available	▸ Data security and privacy may be compromised. ▸ Local intranet connectivity would be required.	Third party Data Center or cloud services provider in Nepal, LG	Resources would be provided by the third party data center.
Alternative 3: Colocation System	▸ Hardware and software would need to be purchased by the LG and collocated into GIDC or the third party data center. ▸ System would be control by the LG.	▸ Additional modules can be easily integrated. ▸ It would be an own system, with no dependency on third parties ▸ It would offer enhanced security and privacy of data.	▸ Purchase of hardware and software for the system will increase the costs. ▸ Upgrading of hardware and software is complex. ▸ Technical expertise would be required.	LG	Skillful IT person capable of handling the hardware, software and application would be required. Some of the services can be outsourced.
Alternative 4: Micro Data Center	▸ It requires purchase and setup of own micro data center and installation of hardware, software and applications.	▸ It would be an own system, with no dependency on third parties ▸ Expansion of the system capacity would depend on the requirements.	▸ Purchase of hardware and software for the system will increase the costs. ▸ Upgrading of hardware and software is complex. ▸ Technical expertise would be required.	LG	TA would be required.

Activity 2: Capacity Enhancement at Local Level

Replication of MARS in different LGs requires capacity enhancement at the local level.

First category of training refers to technical training focusing on setup of software and system, troubleshoot the system, training other staffs, etc. This exercise will be supported by a TA team.

Second category is user-level training, including basic knowledge of computer systems, software, and hardware and MARS-specific components. This exercise will be supported by a TA team.

Third category covers awareness about the e-services and other services available to the citizens.

Fourth category emphasizes on module-specific training to users of MARS. The training will cover financial management, budget planning and monitoring, HR management, payroll, revenue management, fixed assets management, citizen interfacing, DSS etc. This exercise will be supported by a TA team.

To note that the TA team stated in this report refers to future TA resources that would be appointed based on the requirements of the activities to be carried out for the rollout of MARS in LGs.

Table 8: Training activities in detail

Activities/ Sub-activities	Major Tasks	Key Contents	Responsibilities
Training for technical operator	▸ Training on system administration and system configuration ▸ Training of trainers ▸ Set up of hardware and software in different platforms	Window server, database server, middle layer support, system, troubleshoot, configuration and ToT)	MoFALD, supported by TA
User-level training	▸ Basic user computer training about system, hardware and software	Office package, Basic contents ICT, hardware, mobile device operation and troubleshooting	LG, supported by TA
End user	▸ Training on importance of e-services ▸ System awareness at the citizen level	Importance of e-services, use of handheld devices for services and security awareness, operation of MARS	LG
Capacity enhancement	▸ Specific training on module/functions of MARS	Using IT in budget monitoring and planning, financial management and accounting, revenue management, HR, personnel information, payroll accounting and assets accounting	LG, supported by TA

Overall, the training is structured in 2 tiers: (a) Training the trainers and (b) training the officials of LGs and users.

In case of ‘train the trainers’ program, the trainings should be conducted district wise. For each phase of implementation, the training of trainers shall take place for the first 6 months with an interval of 2 months. Therefore, by the end of 6 months, each district would be covered thrice.

The trainers would receive training on subjects relating to ICT, software, hardware, financial management, budget planning, revenue management, payroll, assets management, citizen interfacing, DSS etc.

In the initial stages the trainers would be sent to the field to conduct trainings with the TA team and representative of implementing agency.

The trainings would be taken by the representatives of the implementing agency and the TA support team. The composition of the TA support team is given in Activity 7 of this section.

All other trainings, apart from ‘train the trainers’ would be conducted as per the following envisaged plan:

Table 9: Training plan (tentative)

Training subject	LG	Areas of focus	Total no. of days*	Interval
Software	Metropolitan city,	Portal usage, portal administration, maintenance, content management	3	Yearly
	Sub-metropolitan city		3	Yearly
	Municipalities		3	Yearly
	Rural municipalities		10	Half-yearly
Hardware	Metropolitan city,	Troubleshooting, basic repair and maintenance, replacement of parts, etc.	5	Yearly
	Sub-metropolitan city		5	Yearly
	Municipalities		5	Yearly
	Rural municipalities		10	Half-yearly
Functional	Metropolitan city	Financial management, Budget planning, Revenue management, Human resources management, payroll, office management, assets management, DSS, etc.	10	Half-yearly
	Sub-metropolitan city		10	Half-yearly
	Municipalities		20	Quarterly
	Rural municipalities		36	Monthly

Note: The plan can be modified based on further assessment.

Activity 3: Steps for System Configuration

Step 1: Identify and review the hardware and software that are required to be installed for operationalizing MARS in LGs

Step 2: Configure Window server in the server

Step 3: Set up database, email and web server in the server machine

Step 4: Configure MARS in the system and set up AAA security and firewall before go-live

Step 5: Configure the backup and data recovery strategy

Step 6: Establish connection between departments and ward offices of the municipalities

Activity 4: Data Migration and Digitization

During data migration, existing database and manual registers/files are digitized into the system. In cases where auto-conversion of data is not possible, manual procedures are carried out for migrating the data. The local authorities would be involved in the data cleansing and data validation process.

Figure 4: The following illustration gives an overview of the process of data migration:

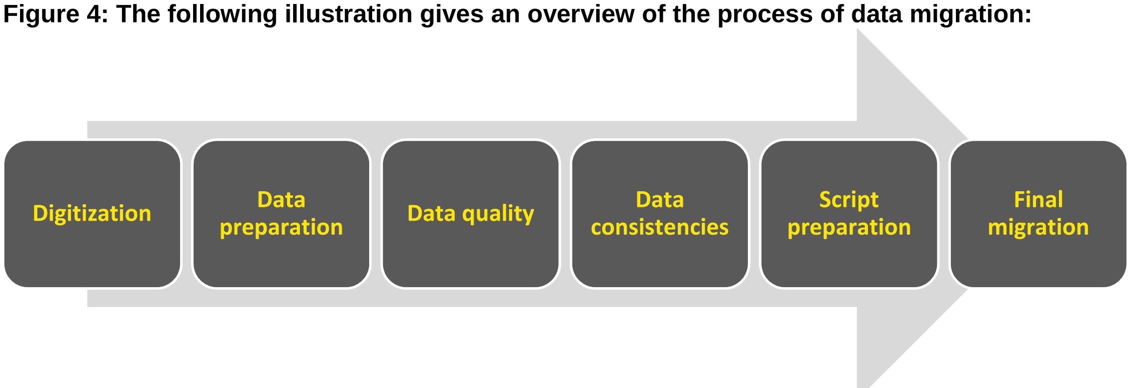


Table 10: Stages of data migration and digitization

Stage		Activities to be carried out
1	Digitization	Digitize data for migration to online system
2	Data preparation	Ensure that the format of the data is rationalized and is a direct fit for MARS
3	Data quality	Ensure data collected does not have test and redundant data
4	Data consistencies	Ensure all required information is present for all records
5	Script preparation	After the data is ready, undertake preparation of script in order to facilitate the migration process.
6	Final migration	Execute the script for final migration

The data migration exercise would be supported by the TA team.

Activity 5: Customization of MARS

For successful and smooth implementation of MARS software at the local level, the end users should have a positive outlook toward the system that was initially developed for KMC. Their acceptability and positivity will depend on the utility they derive from the system. However, the system was initially developed for KMC, which is a large-sized metropolitan city with infrastructure and capacity.

Therefore, in order to implement the system at the rural level where there are many capacity and infrastructure issues, MARS should be customized accordingly so as to derive maximum utility. The customization should focus on rural municipalities and should be rolled out only after assessing all the factors and the resultant modifications. The following is a list of the customization activities required on an overall basis (all LGs):

- Determine the tax structure of the LGs
- Assess the services delivered by the LGs
- Enable a unified chart of accounts in MARS
- Consider GFS guidelines in the system
- Bring the system in line with constitutional provisions
- Configure the system as per the respective ICT infrastructure
- Validation of integrated property tax (IPT) calculation
- Interfacing with local governance services which is already running in Municipalities.

Rural municipalities may not have the required infrastructure or capacity to make effective use of the MARS software. However, the modules of the system should not be reduced for ease of use at the rural municipality level. Rather, customization should factor in technical aspects, tax structures and services delivered and suit the infrastructure and capacity requirements of the rural LGs. Thereafter, the rollout process should be initiated.

The implementation of MARS at rural municipalities is given as a separate section (3.2.2) in the later part of this report.

Customization may also take place after conducting the pilot at all level of the LGs (except metropolitan city). The process of pilot and eventual go-live is given below.

Activity 6: Conducting Pilot of MARS at Select LGs and Go-Live

The PATA team suggests a phase-wise implementation of MARS in the LGs. In the first phase, MARS should be implemented at the well-established LGs (58), which have long-standing practices of local governance.

In the second phase, the newly formed LGs (205) where basic ICT infrastructure has already been established should be selected.

The third phase should focus on rural municipalities. The details of these LGs are provided in **Annexure 13.**

However, before initiating the implementation of MARS software at the LGs, a pilot is required to be conducted at each level of LG (one sub-metro, one municipality and one rural municipality, except metropolitan city) to assess the effectiveness of the functions of MARS at the local level. The pilot will enable the stakeholders to adjudge whether the users will be able to derive optimal utility and whether any customization or modification is required.

After conducting the pilot of MARS at every level of LG and making the requisite customizations to the system, the go-live process should be initiated.

The LGs would require TA during implementation.

Implementation of the MARS software will be at the ward level, where several remote locations are faced with shortage of electricity, lack of computers and even a workforce without basic IT knowledge.

Activity 7: Technical Assistance

For the smooth implementation and sustainable operation of MARS, TA support from the relevant agency is highly necessary. The TA will provide end-to-end support for successful implementation with regard to capacity building, training, handholding support, conducting pilots, customization of MARS, data migration etc. Policy measures go hand in hand with technical support.

The key areas for TA from relevant agencies are given below:

Table 11: Key areas for TA

Support Sector	Tasks to be Performed	Responsibility
Capacity enhancement, including handholding support	• Module-specific training to users of MARS • Training to be provided for payroll, fixed assets management, financial management, accounting, audit, planning and monitoring of budget, revenue management, citizen interfacing etc.	GoN (supported by TA)
System Customization and Localization	• Customization of MARS as per the requirements of the local offices • Configuration of the system • Testing and debugging software • Enabling a unified chart of accounts • GFS guidelines to be considered • Align with constitutional provisions	Developer and GoN (supported by TA)
Training	• Technical training related to hardware and software • TOT • Technical training • User-level training	TA team
Conducting pilots	Pilots by relevant agency in coordination with the local offices and central authority to assess the effectiveness of MARS	GoN (supported by TA)
Data Migration	• Digitization of manual data • Migration of data from old system to the new system	GoN (supported by TA)
Change Management	• A robust framework should be designed for change management for a smooth implementation of MARS. Areas of potential risk should be highlighted and adequate attention should be given to overcome the challenges.	GoN (supported by TA)

The TA team may be stationed in MoFALD with the following structure of manpower (suggestive):

Table 12: Structure of manpower for TA

Domain	Information technology	Financial management
Team composition	1. System architect - (1) 2. Database expert- (1) 3. System engineer- (1) 4. Security expert- (1) 5. Programmers – (2) 6. Tester (1)	1. Financial management expert (1) 2. Budget specialist - (1) 3. Human Resource expert- (1)
	Overall administrator – (1)	

3.2.2 Implementation of MARS at Rural Municipalities

As discussed earlier, rural municipalities may not have the required infrastructure or capacity to make effective use of MARS. Therefore, its technical aspects need to be customized to suit the infrastructure and capacity requirements of the rural municipalities. Thereafter, the rollout process of MARS should be initiated.

The infrastructural base for implementation of MARS is not standardized across LGs. Rural municipalities are plagued with issues such as lack of capacity, infrastructure and electricity. Therefore, rural municipalities should be paid very specific attention with regard to the implementation of MARS software.

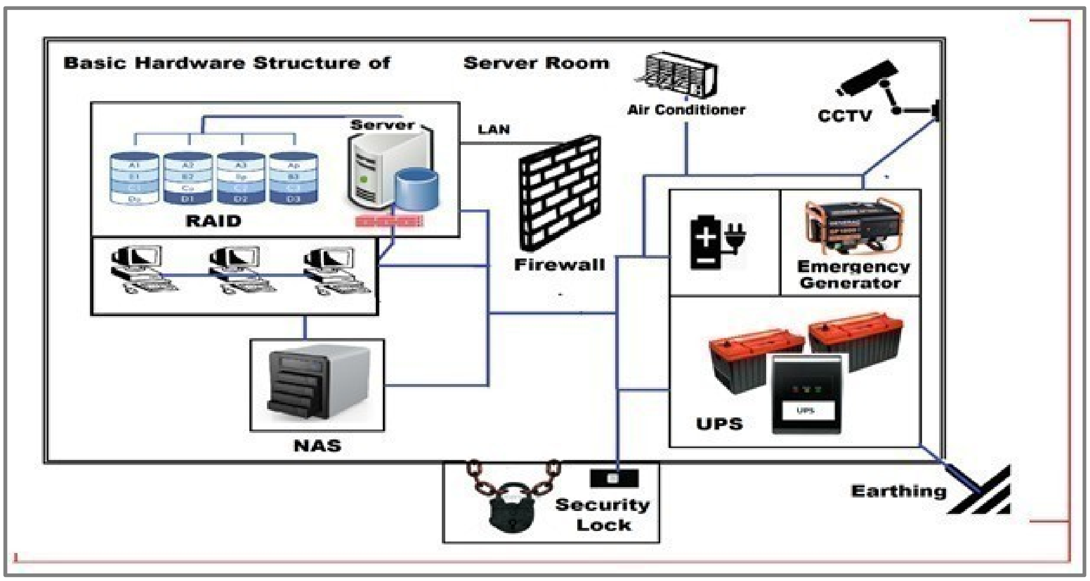
Therefore, the PATA team suggests the following alternative to implement MARS in rural municipalities.

Activities to be undertaken:

- Install a server in rural municipality offices
- Connect the sections of the municipalities through the local area network
- Install software and configure the system
- Use the major modules of MARS and disable online-based features
- Offline functions can be carried out manually

System requirement:

Figure 5: System requirements



Server specifications:

- Minimum Quad/Hex core processor
- 16/32 GB RAM
- 2 x Disks RAID 1 (for mini-servers, including examination database server)
- 4 x Disks RAID 5 (most preferable for main server) in 4 TB RAID mirroring for server

Advantages:

- Internet connectivity not required
- Low cost of implementation
- Remote connection (Team Viewer) based support.

Disadvantages:

- Not all modules of MARS would be functional
- Citizen interfacing would be difficult
- Separate backup, control and security system would be required
- Integration of tasks into a central repository would be difficult

Costs involved:

The costs involved are given as follows.

Table 13: Costs involved for rural municipalities

Sr. No.	Cost Item	Estimated Cost for Each Municipality (NPR, in '000)
1	Computer server	500
2	Operating system and other utilities software	50
3	System configuration	100
4	MARS customization	100
5	Networking for each section of municipalities	200
6	Data migration	100
7	Training	200
8	Technical support for software	300
	Total	**1,550**

The costs mentioned in the table above focus only on the replication of MARS. End user equipment costs such as computers and laptops have not been considered as the costs involved would be similar depending on the number of users.

3.2.3 Functional Team: Workforce

For smooth functioning of MARS, MIS/ICT support units should be established in each LG. The tentative structure is given below:

Table 14: Support units (tentative)

MoFALD	DCC Level	Local Level
Facilitation Unit Coordinated by Joint Secretary, including LGCDP and ICT unit and other related departments	**Coordination Unit** Coordinated by District Coordination Committee (DCC) member to coordinate between district level subnational governance	**Operation Unit** Coordination by ICT unit, including the persons responsible for the 9 components of MARS

3.2.4 Costs Involved in Rolling out MARS to LGs (except rural municipalities)

The costs involved in rolling out MARS to LGs are given below. The costs have been determined for each alternative as suggested in Section 3.2.1 (activity 1).
In the following table, costs pertaining to rural municipalities are not given. The PATA team has suggested a separate approach for rural municipalities because of the lack of infrastructure there, including internet connectivity. Therefore, the costs relating to rural municipalities are given in section 3.2.2.

Table 15: Cost details (other than rural municipality) ***(Estimated in NPR in '000)***

Sr. No.	Cost Items	Alternative 1			Alternative 2			Alternative 3			Alternative 4		
		1	2	3	1	2	3	1	2	3	1	2	3
1	Operating system and other utilities software	50	40	30	-	-	-	50	40	40	50	40	40
2	Cloud server (per year)	-	-	-	50	40	40	-	-	-	-	-	-
3	System configuration	50	50	30	50	50	30	50	50	40	50	50	40
4	MARS customization	100	100	80	100	100	80	100	100	80	100	100	80
5	Hardware	-	-	-	-	-	-	1000	800	800	6,300	5,500	5,000
6	Data migration	300	200	150	300	200	100	300	200	100	300	200	100
7	Training	300	250	200	300	250	200	300	250	200	300	250	200
8	Technical support for software	500	400	400	500	400	400	500	400	400	500	400	400
	Total	**1,300**	**1,040**	**890**	**1,300**	**1,040**	**850**	**2,300**	**1,840**	**1,660**	**7,600**	**6,540**	**5,860**

Note: 1 — Metropolitan city
2 — Sub-metropolitan city
3 — Municipality

The costs mentioned in the table above focus only on the replication of MARS. End user equipment costs such as computers and laptops have not been considered as the costs involved would be similar depending on the number of users. Costs relating to network connection have also not been considered as majority of the locations are covered by reputed third-party network service providers.

The costs relating to rural municipalities is given in section 3.2.2.

3.2.5 Timeframe for Implementation of MARS

Table 16: Tentative timeframe

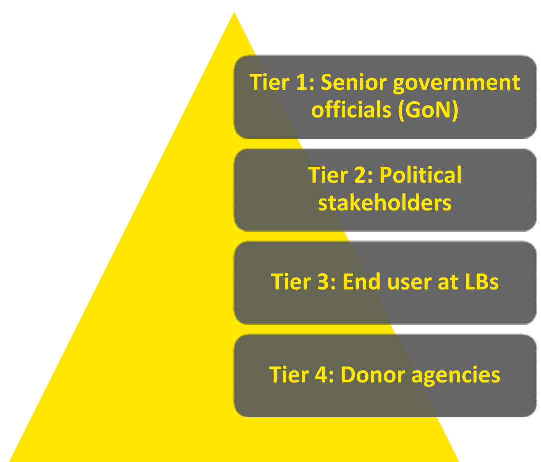
Activity	First Phase	Second Phase	Third Phase (Months)
ICT infrastructure setup	4th month	9th month	12th month
System configuration	5th month	12th month	18th month
Data migration and digitization	6th month	15th month	18th month
Customization of MARS	6th month	15th month	20th month
Conducting pilot of MARS at selected LGs and go-live	8th month	16th month	22nd month
TA	12th month	18th month	24th month

The above timeframe signifies completion of the activities. E.g. ICT infrastructure set up will be completed after 4 months, thereafter, system configuration will take another 1 month to complete (will be completed in the 5th month). Also, capacity building would be a continuous exercise except in case of 'train the trainers' where prospective trainers would be trained for the first 6 months (at an interval of 2 months) from the start date of each phase.

3.2.6 Communication Strategy for change management

A communications strategy, or plan, is a document that expresses the goals and methods of the department's outreach activities, including what a department wishes to share with the stakeholders and whom the department is trying to reach. As discussed in the earlier part of the report change management will be a key challenge during replication of MARS. Therefore, the implementing agency would have to have a robust communication strategy which would enable the stakeholders and end users to understand the benefits of MARS and facilitate smooth change management.

Figure 6: A 4-tier strategy can be prepared as follows:



Tier 1: In this case, senior government officials would be communicated about MARS

Tier 2: Political stakeholders should be made aware about how beneficial MARS would be for the citizens and ensure political commitment

Tier 3: End users are the most important stakeholders and detailed strategy should be prepared for educating them about the benefits of MARS

Tier 4: Donor agencies should be well aware of the ongoing activities relating to ICT/MIS in Nepal.

The above recommendations are based on the assessment done till date. The PATA team is conducting a PFM assessment and the upcoming report on ICT/MIS shall contain the details.

Further, the recommendations in this chapter have not been categorized in accordance to their importance (high, critical, medium, low etc.) since they are interlinked and dependent to one another and are equally significant for the smooth replication of MARS.

The timelines for the activities recommended are given in section 3.2.5 of this chapter.

3.3. Expected benefit and value to be delivered

The above suggestions by the PATA team shall provide outcomes that would result in a smooth and effective rollout of the MAR software in the LGs. The following gives the eventual envisaged outcomes and the value to be delivered.

Expected benefits and value to be delivered:

- Strong and effective implementation of MARS.
- Infrastructure development in rural municipalities.
- Efficient use of MARS with trained users.
- Users aware of the benefits of MARS.
- MARS would be a comprehensive e-governance tool
- Integration of all 753 LGs.
- Transparent budget processes
- Revenue augmentation
- Improved citizen interaction
- Digitization of data
- Improved documentation and record keeping at LBs

4. Perceived Challenges and risks in implementation

4.1 Key challenges:

The following section gives an illustrative list of the key challenges that are envisaged during the rollout processes.

The following table illustrates the key challenges that are envisaged during the implementation of MARS and their respective recommendations:

Table 17: Key challenges and recommendations

Sr. No	Challenges	Recommendations
1	Poor or lack of connectivity of ward office and municipal center	A loop network may be created using optical fiber and arrangements be made for coordination with NPIX and network service provider
2	Lack of technically competent human resources	Workforce requirement should be conducted at the local office level. Further, periodic technical trainings on financial management, budget planning and monitoring, revenue management, fixed assets management, payroll, citizen interfacing etc. should be carried out
3	Lack of basic infrastructure (e.g., electricity and computers)	A thorough assessment should be conducted to identify such LGs and a roadmap for improving the connectivity and infrastructure should be prepared. The roadmap would enable the LGs in the remote locations to stay connected with the rest of Nepal, thus facilitating effective and optimum utilization of MARS.
4	Political commitment	Highlight and make the political stakeholders aware of the benefits of the MARS software and how it would positively impact the citizens. A constant effort should be made to keep the stakeholders informed about the progress of implementation and other activities related to MARS.
5	Customization of MARS for different levels of LG	In order to address all the above customization factors, the existing IT infrastructure, tax structure followed and services offered by the LGs should be assessed and based on that, a plan comprising a set of customization activities that would be classified on the basis of the assessment should be drafted.
6	Data migration	The requirements for data migration need to be assessed to determine if the existing system can provide information in the given specification.

Sr. No	Challenges	Recommendations
7	Change management	Adequate attention should be given and arrangements should be made for change management. For successful implementation of MARS a robust change management system should be adopted. A communication strategy should be developed through which the implementing agency would be able to educate the end users about the benefits of MARS. The users of the system should be convinced that MARS is a replica of the processes currently executed by them and that the system is reducing their effort to carry out the functions. Further, trainings should be conducted to build capacity of the workforce at LGs. Additionally, it is also important to consider the views of the end users and design the processes accordingly. This would keep the users interested and involved, resulting in a wider scope for adapting the revised business processes
8	Other systems already in use	It is advisable to integrate the other systems with MARS. It would be an uphill task to operate multiple applications in a single LG. MARS supports the integration with other systems as it is based on SOA and open data exchange interface. Since MARS contains most of the important modules, it is not a necessity to maintain other systems and run them parallel to MARS. Therefore, the other systems should be integrated to MARS in a phased manner.
9	Disaster recovery	Off/on-line backup of the data should be taken at regular intervals and should be stored at multiple locations to ensure availability of the data and information.
10	Support of MARS	Training should be conducted to educate the end users to carry out basic troubleshooting processes. Also, a maintenance and support expert should be deployed in district offices and equipped with remote connectivity so as to provide support over telephone as well. It will require maintenance and support at regular intervals for smooth and effective operation.

4.2 Prerequisites for Implementation of MARS

Preparedness for implementation of MARS at LGs is a major factor in the smooth and effective rollout of MARS. The following is an illustrative list of prerequisites for implementation of MARS:

- **Understanding the ground reality**
  An analysis of the ground realities such as available workforce, capacity and infrastructure should be made.

- **Facilitating data migration and digitization of processes**
  The data to be migrated should be prepared and inconsistencies therein, if any, should be highlighted. Thereafter, script preparation should be conducted, followed by the final migration.

- **Enhancing and strengthening the existing modules of MARS**
  The existing modules are required to be assessed and additional modules, functions and further strengthening measures can be assessed.

- **Ensuring basic ICT infrastructure and capacity building of workforce**
  Considering that the infrastructure in local municipalities is poor, basic ICT facilities should be set up to initiate the rollout of MARS. Further, the workforce should undergo sustainable, periodic trainings to build capacity so as to handle the system effectively and efficiently.

- **Customizing MARS**
  Factors such as services to be delivered, revenue structure and infrastructure should be assessed and a plan should be prepared to customize the system.

- **Appointment of TA team for support**
  A TA team should be appointed to provide support relating to capacity building, data migration and customization of MARS; and conduct pilots at select local government offices.

- **Educating users on the benefits of MARS**
  The end users of MARS should be educated about the benefits of the system so as to ensure acceptability and enthusiasm to adapt the system. This is very critical considering that several LGs are already using e-government systems, which could result in resistance from them.

4.3 Critical Success Factors for Implementation of MARS

Figure 7: The Critical Success Factors to be considered for the implementation of MARS are given as below:

- **Robust governing model** – To deliver a program of this size and scope, a robust governing model is required with regular reviews and connects across teams and across the management chain.
- **Diverse team** – A strong technical team with experience of enterprise level system as well as local experience is required in order to understand the behavior of the users.
- **Effective planning** (milestone-driven) – Advanced planning with details of milestones and activities on a single spreadsheet should be conducted.
- **Resourcing** – Right skillsets and domain knowledge should be built by conducting periodic capacity building exercises.
- **Process adherence** – Process manuals should be in place and respective processes should be adhered to.
- **Value additions** – Continuous effort and review of MARS would ensure value additions from time to time, ensuring enhanced efficiency and effectiveness of the software.

5. Limitations

The PATA team is not able to comment on the following:

- Efficiency of the MARS software, since the team was not given access to:
  - Financial statements generated from MARS
  - FRS and SRS documents
  - Read-only username and password to analyze the system

- The details of costs relating to replication of MARS are given on the basis of the PATA teams visit to the three locations.

Acknowledgement and Bibliography

Acknowledgement

The PATA team would like to thank the Ministry of Finance (MoF), Ministry of Federal Affairs and Local Development (MoFALD), Ministry of Industry, Office of Auditor General (OAG), National Planning Commission (NPC), Financial Comptroller General Office (FCGO), Local Governance and Community Development Programme (LGCDP), Public Expenditure and Financial Accountability (PEFA) Secretariat, Kathmandu Metropolitan City, Lalitpur Metropolitan City, Bharatpur Metropolitan City, Dhulikhel Metropolitan City, Hetauda Sub-Metropolitan City, Thakre Rural Municipality, Galche Rural Municipality for their continued help and support for preparation of this report.

The team would like to extend their special appreciation to The Asian Development Bank for their continued cooperation, guidance and support for preparation of this report.

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Annexures

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