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INTERGOVERNMENTAL FISCAL TRANSFERS IN NEPAL: AN OVERVIEW

Prakash Regmi
Senior Programme Officer
Embassy of Switzerland in Nepal

CONTEXT

History of decentralization in Nepal can be traced back to the decades of 50s, however, after the restoration of democracy in 1990, the enactment of Local Self Governance Act (LSGA) 1999 can be considered as a landmark in this process. The LSGA institutionalized the local self-governance and provided Local bodies[1] (LBs) greater authority to provide services to the people in their respective constituencies. It also includes key responsibilities such as social and economic planning, physical infrastructure development, environment management, institutional and financial management etc and sectors of service delivery ranges from agriculture, drinking water, primary health, primary education etc. Despite many limitations, there was a good momentum and progress to institutionalize the decentralization process in the beginning years of LSGA i.e from 1992-2002 AD. Consecutively, two rounds of local elections were also held. However, after 2002, when the country was suffered from insurgency, the local bodies in Nepal are running without elected representatives. Currently also they have been running by the civil servants, the central governments employees. That means, all the legislative and executive power of the local bodies, as per the LSGA, remains with one person resulting in the lack of accountability. Despite serious philosophical question and issues, the LGSA, which has not been amended since 1999 , still continues to be in force, has lent a measure of stability and continuity to Nepal's decentralized architecture even in the absence of elected representatives. Efforts at fiscal decentralization are governed by the overarching provisions of the LGSA. Here, we would focus our discussion mainly on the fiscal decentralization aspects being practiced in Nepal based on the Local Self Governance Act 1999.

1. Institutional arrangements of intergovernmental fiscal transfers (IGFT)

The LSGA mandates that "the Government of Nepal shall have to provide the LBs each year with minimum grant prescribed and also with additional grants on such basis as population, level of development, possibility and capability of mobilizing resources, necessity of financial resources, regular record keeping of incomes and expenditures, situation of auditing and financial discipline of the concerned LBs.". The grants from central bodies comprise of:

[1] Local Bodies (LBs) comprises Village development Committees (VDCs), District development Commitees(DDCs) and Municipalities

a) Capital grant (both minimum capital grant and formulae based grant) grant as per the LSGA mandate,
(b) Recurrent grants to pay for the salary and allowances of employees and meet minimal operational expenditures at the LG level
(c) Other unconditional, conditional and program budget grants which also include the grant from development partners. ,

2. Performance based fiscal transfers and design elements

For the purpose of determining the grants to be transferred each local body (VDCs, Municipalities and District Development Committees), there is Local Bodies Fiscal Commission (LBFC) which measures the performance of each local bodies on annual basis and accordingly, the magnitude of the grant is determined. The performance of the LBs is measured through a tool called Minimum Conditions and Performance Measures (MCPMs). There are two parts of this tool, MC and PM. MC Indicators are basically targeting to monitor the compliance with the LSGA provisions, which serves as threshold criteria; this means if a local body fails to meet any of the MC criteria, it will not be eligible for the grants. PMs try to measure the quality and efficiency of the service delivery of the local bodies and this is a main basis to determine how much more or less a local body will receive the grants next year if it meets all the MCs.

If a LB fails to meet any one of the MC indicators, it loses its additional formulae based grant entirely. And based on the score obtained in performance measures out of 100, the grant will be changed accordingly. For example, 20 percent of the additional grant is deducted if a LB fails to receive at least 40 points out of 100 in the performance measures. Here, it is also noteworthy to mention that in the case of VDCs , there is only practice of MC until now, however fiscal commission has already piloted VDCs for the performance measures. So in a nutshell, the unconditional capital grant to the local bodies is linked to the MCPM system and is distributed on a formula with a view to improve service delivery provision of LBs among others. The design element of this grant is explained in below table .

Table 1 : Block grant allocation formula for LBs (in %)

Indicators	VDCs	Municipalities	DDCs
Population	60	50	40
Weighted poverty	-	25	25
Area	10	10	10
Weighted cost	30	-	25
Weighted tax effort	-	15	-
Total	100	100	100

Source : LBFC and Local bodies management and resource mobilization guidelines (LBRMMG)

From the table it is very clear that all the major design elements of determining the IGFT or grant to the local bodies from the center, e.g population, geography and weighted cost index are considered in this formula based system of IGFT in Nepal.

3. Key features of Intergovernmental fiscal transfer in Nepal

3.1 High dependency of LBs on fiscal transfers

There is a high dependence on IGFTs from the Central Government to LBs. Nearly 80 percent of the expenditure basket of Nepal's LBs (combining all VDCs, municipalities and DDCs) is financed by IGFTs from the Centre (LBFC 2072). Thus the financial and overall autonomy of the LBS is severely questioned with this excessive dependency on central level funds.

3.2 Increase of LBs Ggants over time

Initially, IGFTs to LBs were directed only towards DDCs and municipalities. It was only after the restoration of democracy in the country in 1990, the system for direct transfer of grant to VDCs was initiated. The government began to providing each VDC a grant of Rs. 50,000 in 1993-94, which was increased to Rs. 300,000 in 1995-96. Grants to VDCs have shown a continuously upward trend since then and currently stands at Rs. 5 million. Table 2 shows the trends in increase of block grants to LBs from 1995-96 onwards. The years are those where significant increases were made.

Table 2: Block grant transfers to LBs (**NPRsin billion**)

FY	VDCs	Muns	DDCs	Total	% of LBs grant to GDP	Step initiated
1995-96	1.17	0.06	0.57	1.80	0.77	Rs. 30000 given to each VDC
1997-98	1.96	0.14	0.65	2.75	0.91	VDC grants reach Rs. 500000 each
2006-07	3.92	1.35	1.05	6.32	0.97	VDC grants reach Rs. 1 million each
2008-09	7.83	2.32	1.93	12.08	1.48	VDC grants doubled from Rs. 1.5 million to Rs.3.0 million and linked to formula (population 60 %, area 10 % and weighted cost index 30 %).
2013-14	9.21	4.05	3.58	16.84	0.96	Upper limit increases to Rs. 4.6 million.

FY	VDCs	Muns	DDCs	Total	% of LBs grant to GDP	Step initiated
2015-16	8.05	9.73	3.67	21.46	0.99	Performance criteria introduced for VDC grants in 2014-15, Upper limit increased to Rs. 5 million.
2016-17						Government of Nepal has decided to double the funds to the local bodies

Source: LBFC and Budget speech of GoN for the Fiscal Year 2016-17

3.3 Revenue Shares as Part of Fiscal Transfers

Currently, five types of revenue sources, namely, land registration fee, mining, forest, hydropower and tourist/mountaineering are shared by the central level government to the District Development Committees. Over the years, an increasing trend has been observed in sharing the revenue by the center with the local bodies . In 2012-13 it was 5.89 % of the total revenue of LBs which has reached to 8.69% in 2013- 14 it had increased to 8.69 % (LBFC, 2014 & 2015). Table 3 represents the provision of revenue sharing to DDCs by the central level government.

Table 3: Central Revenue Sharing

S. N.	Type of Revenue	Amount Collected	Shared amount (%)
1	Land Registration Fee	Depending on the volume of the collection: Upto 5 million- 90%, between 5 and 10 million- 60%, between 10 and 20 million- 30%, between 20 and 30 million- 20%, between 30 and 50 million- 15%, between 50 and 100 million- 10% and more than 100 million- 5%	5 - 90
2	Mining	Mines and other natural resource excavation	50

3	Forest	From sales of forest product	10
4	Hydro power	12% to power house site districts and remaining 38% to all the remaining districts of the same development region	50
5	Tourist entrance; Mountaineering	Tourist entrance fee, trekking and mountaineering	30

3.4 Inter-LB revenue sharing arrangements:

Apart from transfers that flow from the top, there are horizontal revenue sharing mechanisms between the LBs as well. The VDCs collect land revenue and shares 25 % to the DDCs. Similarly, the DDCs collect source utilization and sales tax and shares 35-50 % to the VDCs and municipalities[2].

4. Implementation Challenges:

a) Lack of elected representatives

One of the major implementation challenges of current MCPM system in Nepal is not having the elected representatives in the respective local bodies. Currently, the local bodies are run by the central level employee and they are never motivated to perform better for the places where they have been assigned. So in practical terms, it does not make that difference for them whether they get more money or less money for the development of the respective local bodies.

b) Lack of Accountability and performance of Local Bodies

Linking above, one of the serious challenges of MCPM system is MCPM is never tied with the individual performance of the central level employee. So, this is not strange to see, if one DDC fails in MCPM but the local development officer[3] of that DDCs get promotions. More importantly, within the current system, any LBs can be failed because of the under or nonperformance of the central level employee but ultimately the people of that area will be suffered because the grant is reduced and development projects will be curtailed because of the reduction in grant.

[2] Source utilization tax comprises tax on wool, turpine, herbs, worn and torn goods, stones, slates, sand and bone, horn, wing, leather etc. Further, sales tax includes the sand in the rivers and canals, roda, stones, soil, wood swept by river, etc. lying in its area.

[3] Central government employee and incharge of DDC at present

c) Lack of authentic data

Though the design element includes the major aspects of IGFTs like population and geography but there is some problem in regard to the authencity of some data like cost index.

d) Lack of result based indicators

One of the serious limitations of the current system of MCPM is, more than 80% indicators are process based indicators. So, even in the case of best performer local bodies, one cannot guarantee the results of out if. Thus, what is needed is to try to get some result based indicators so that real performance of the local bodies could be measured.

e) Issue of time lag

As per the current practice, the MCPM of local bodies is conducted in current fiscal year (T) for the past fiscal year (T-1) and its implication will be for the next fiscal year (T+1). Though, it can easily be justified in terms of processes, however it is also linked with the accountability. By the time the result of MCPM publishes, the then incharge of the local bodies are already been transferred to somewhere in most of the case and the new one does not take the ownership of past performance.

5. Future of IGFTS in Nepal:

With the promulgation of new constitution, Nepal has now in transition to Federalism. As per the new constitution, new layer of government has been introduced in between of local level and central i.e province. Accordingly, local level governments include the municipality and village development committees. The current forms of district development committees have been abolished. In line with these new structures, a separate National Natural Resources and Fiscal Commission has been proposed in new constitution, which has a mandate to design a new IGFT system based on the lessons of current practice. It will be a much more complex system of IGFT since natural resources are also combined with the fiscal transfers and there will be at least two tiers of governments below to the center.

Note:

1. The views expressed in this paper is solely of the author based on the available data and in many cases self-assessment of the author has been reflected unless it is otherwise mentioned.
2. The idea is not to make any conclusion but to share some facts and approach of IGFTs in Nepal- knowledge exchange
3. Almost all the data are taken from the reports of Local Bodies fiscal commission. www.lbfc.gov.np

4. The current form of IGFT, mainly the MCPM system, has been supported by Local Governance and Community Development Programme (LGCDP), a basket fund programme implemented by Ministry of Federal Affairs and Local Development of Government of Nepal , where, SDC is also one of the Joint Financing Arrangement (JFA) signatories.