

# The National Natural Resources and Fiscal Commission (NNRFC): Evolution of Roles and Practices

**Centre for Federalism Studies  
Nepal Administrative Staff College**



# THE NATIONAL NATURAL RESOURCES AND FISCAL COMMISSION (NNRFC): EVOLUTION OF ROLES AND PRACTICES



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## EXECUTIVE SUMMARY

The Constitution of Nepal 2015 paved the way for transformation of nation's unitary system of governance into a federal system of governance. The basic principle of federalism as "co-operation, co-ordination and co-existence" implies that the government has to work in alignment with all three levels of government to successfully implement the federalism. In this regard, fiscal federalism is considered as one of the key aspects for which National Natural Resources and Fiscal Commission has been established as a custodian to ensure just and equitable distribution of resources among all three levels of government through effective, efficient, and scientific method.

This paper records the strategic issues faced by the Commission in successfully fulfilling its constitutional responsibilities and contribute to sustained federalism in Nepal. Achievements of the Commission is reviewed in the areas of institutional development, priorities and indicator development, studies and research work, awareness, capacity building and budget utilization. Issues and challenges of the Commission are analyzed in four major dimensions: mandate and functions, people and resources, processes and technology and organization design. Under mandate and functions, basis and clarity of functions, provision of cost centers, standards and target have been discussed. Similarly, incompatibility in execution of recommendation made by the Commission, dispersed sources of fund at local level and inadequate focus on natural resource front have also been analyzed.

Frequent deputation and transfer of employees without consultation with the Commission, gap in matching competencies among employees are pertinent issues hampering efficiency and productivity of the Commission. The Commission is largely dependent on government machinery to generate data of fiscal affairs where data aggregation and data disaggregation are some major concerns. Efforts have been made to discuss the alignment of people and operating procedures of the Commission to function smoothly and efficiently. It is important to create an environment where all levels of government can have ownership and trust through structural representation or through creation of platforms for all levels of government as meaningful participation.

Based on the overall assessment, key reflections have been drawn. Adoption of holistic approach in fiscal transfer and borrowings, development of integrated information system, meaningful engagement with experts and research institutions, balanced focus in natural resources domain and development of capacity at all levels have been emphasized and recommended.

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# INTRODUCTION

## 1.1 Overview of Federalism in Nepal

The seven-decade long dream of the Nepali people to draft a constitution through their own representatives was finally realized on 20 September 2015, when the people elected Constituent Assembly successfully drafted the new constitution of Nepal. The Constitution of Nepal was drafted by the Second Constituent Assembly after the First Constituent Assembly had failed to deliver on its promises.<sup>1</sup> The new constitution had incorporated many progressive characteristics aspired by the decade long Maoist insurgency (between 1996 and 2006), the Madhesi uprising (2006), and various other political, ethnic, and social movements. One of the salient features of the new constitution is Federalism. The new constitution paved the way for the transformation of the nation's unitary system of governance – which had been in place for nearly three centuries – into a federal system of governance. This change in the design of governance is considered by many to be a “radical” experiment in the history of Nepal.<sup>2</sup>

As mandated by the constitution, the country has been divided into seven provinces and 753 local units, the latter consisting of 293 urban and 460 rural municipalities. Under this new system of governance, a mechanism of exercising state power through all the tiers of government: the federal, provincial and local level has been established. One of the fundamental principles of inter-governmental federal relations across the three levels of government is based on the cooperation, coexistence, and coordination.<sup>3</sup>

Different countries have had different reasons for forming federal administrative units such as unions, provinces, and states. In Nepal's context, the reasons for dividing and devolving the centralized power of the state to federal, provincial and local levels were to establish a participatory democracy, institutionalize republicanism, and disallowing discrimination based on ethnicity, language, gender, religion, class, and other creeds. Furthermore, it has aimed at reducing the different imbalances in regional and local development and ensuring

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1 Promulgated on 22 January 2015, came into effect in September 2015.

2 <https://asiafoundation.org/wp-content/uploads/2018/07/Diagnostic-Study-of-Local-Governance-in-Federal-Nepal-07112018.pdf>

3 Article 232 (Part 20) Constitution of Nepal, 2015



that benefits are shared equitably.<sup>4</sup> The Constitution of Nepal commits at “ending all forms of discrimination and oppression created by the feudalistic, autocratic, centralized, unitary system of governance.” The goal of the constitution is to “fulfil the aspirations for sustainable peace, good governance, development and prosperity through the federal, democratic, republican system of governance.”

To meet this end, the constitution has made provisions for exclusive jurisdictions (Schedule 5), concurrent jurisdictions (Schedules 7 and 9) and a residual jurisdiction to the federal level. These includes 35 exclusive areas of political, fiscal and administrative powers to the federal government. Similarly, Schedule 6 of the Constitution provides 21 areas of exclusive jurisdiction to the provincial governments, and Schedule 8 provides 22 areas of exclusive jurisdiction to the local governments. It also makes provision for concurrent powers: 25 areas are shared only between federal and provincial governments (Schedule 7), while 15 areas are shared among and between federal, provincial and local governments.

Various institutional frameworks have been prepared to successfully implement federalism, wherein fiscal federalism is one of the key aspects. It is a system where fiscal powers and responsibilities are being divided among and between the federal, provincial and local levels. These include, revenue assignment, expenditure assignment, fiscal transfer, and borrowing. The National Natural Resources and Fiscal Commission (NNRFC) has been established as a constitutional body to facilitate effective implementation of fiscal federalism in Nepal.

## 1.2 NNRFC: Constitutional and Legal Provisions

The National Natural Resources and Fiscal Commission (NNRFC) is a constitutional body of Nepal established to ensure just and equitable distribution of natural and fiscal resources among federal, provincial, and local governments through effective, efficient and scientific method. The Commission makes recommendations to all three tiers of governments regarding revenue distribution, equalization grant, conditional grant, internal borrowing, and sharing of natural resources among them.<sup>5</sup>

The NNRFC consists of a maximum of five members including a Chairperson.<sup>6</sup> The President of Nepal on the recommendation of the Constitutional Council appoints the Chairperson and the Members of the Commission. The term of office of the Chairperson and Members of the Commission is six years.

Article 251 of the Constitution of Nepal has mandated the Commission various functions in areas such as revenue distribution, grant distribution, expenditure assignment, and borrowing. The Commission also determines the basis on which the revenue collected at the Federal Consolidated Fund is distributed among the three levels of government. It

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<sup>4</sup> [https://asiafoundation.org/wp-content/uploads/2018/08/Local-Levels-in-Federalism\\_Constitutional-Provisions-and-the-State-of-Implementation-English-Version.pdf](https://asiafoundation.org/wp-content/uploads/2018/08/Local-Levels-in-Federalism_Constitutional-Provisions-and-the-State-of-Implementation-English-Version.pdf)

<sup>5</sup> [https://www.nnrfc.gov.np/uploads/resources/2018-05\\_09/National\\_Natural\\_Resources\\_and\\_Fiscal\\_Commission\\_Act.pdf](https://www.nnrfc.gov.np/uploads/resources/2018-05_09/National_Natural_Resources_and_Fiscal_Commission_Act.pdf)

<sup>6</sup> <https://www.wipo.int/edocs/lexdocs/laws/en/np/np029en.pdf> ( *The Constitution of Nepal*, 2015)

also recommends equalization grants and identifies parameters of conditional grants to be provided to the provincial and local governments. It recommends measures to run the expenditures of three levels of government, ascertains ceiling of internal borrowing, and determines shares of the federal, provincial, and local level in investment and returns of the natural resources mobilization. The Commission conducts studies and researches on possible disputes that may arise between three levels of government and makes suggestions on ways to resolve them.

In addition to the constitutional provision, NNRF has been assigned additional functions as mentioned in the National Natural Resources and Fiscal Commission Act, 2074. NNRF recommends fiscal equalization grant and the criteria for conditional grant to be provided by provinces to the local levels. The Commission facilitates and assists in resolving disputes that arise during the distribution of natural resources across the different tiers of government, among other such disputes arising between and among the local governments. Furthermore, it provides the federal government suggestions relating to revenue distribution and taxation, as well as suggestions on the conservation and use of the natural resources.

NNRF is constitutionally mandated to recommend for addressing horizontal and vertical fiscal imbalance among different levels of government. Intergovernmental Fiscal Management Act, 2074 has specified four types of grants to address horizontal and vertical imbalances. These are the:

- **Fiscal Equalization Grant:** This grant addresses the existing gap in terms of expenditure needs and revenue capacity among different provinces and local levels.
- **Conditional Grant:** As the name suggests, this grant is provided with conditions for the implementation of national-level plans or projects that have been prioritized for implementation at the grassroots level.
- **Complementary Grant:** This grant is provided for the implementation of different infrastructure development plans and projects on a cost-sharing and competitive basis,
- **Special Grant:** This grant makes provision for a specific scheme aimed at developing and supplying basic services, such as health, education, and drinking water. Furthermore, this grant aims at achieving balanced development at the province and local levels. The grants can also be utilized for the development and upliftment of socially and economically marginalized communities.

Intergovernmental Fiscal Arrangement Act (2074) further reinforces the role of the Commission to recommend and provide standards for distribution of revenues, royalties earned from the natural resources, internal borrowing, and intergovernmental fiscal transfer. NNRF considers equitable distribution, necessity, equal opportunity, neutrality, fairness, capability, predictability, and factual and objective basis as core principles<sup>7</sup> for making recommendations or taking decisions. The jurisdiction and role of the Commission is summarized in the following table.

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<sup>7</sup> Annual Report of NNRF, 2076

**Table 1: Summary of role of NNRFC**

Work Areas	Role of the Commission
Expenditure Assignment	<ul style="list-style-type: none"><li>– To recommend measures to meet the expenditure assignment of the provinces and local levels.</li></ul>
Revenue Assignment	<ul style="list-style-type: none"><li>– To recommend measures to improve revenue collection at the provinces and local levels.</li></ul>
Revenue Distribution	<ul style="list-style-type: none"><li>– To recommend the detailed basis and structure of revenue sharing from different sources among the federal, provincial and local level.</li><li>– To review the basis of revenue distribution and recommend modifications</li><li>– To recommend the distribution of taxes among the provincial and local level (example: vehicle tax)</li></ul>
Intergovernmental Fiscal Transfer	<ul style="list-style-type: none"><li>– To make recommendations regarding fiscal equalization grants</li><li>– To prepare and recommend basis for conditional grant</li></ul>
Internal Borrowings	<ul style="list-style-type: none"><li>– To recommend the ceiling of internal borrowings that can be taken by the federal, provincial, and local level</li></ul>
Natural Resources Mobilization	<ul style="list-style-type: none"><li>– To recommend the basis of determining the share of investment and return at the federal, province and local level</li><li>– To make suggestions to the Government of Nepal regarding the environmental impact assessment while distributing natural resources.</li></ul>
Disputes Resolution	<ul style="list-style-type: none"><li>– To facilitate and assist for resolving the dispute that arises during the distribution of revenues among the Government of Nepal, province and Local Level</li><li>– To make suggestions for resolving disputes related to the natural resources and its utilization</li></ul>

Source: Summary of functions based on constitutional provision and NNRFC Act, 2074

Article 293 of the Constitution states that constitutional bodies are accountable and answerable to the federal legislature. As a constitutional body, NNRFC submits the annual report of their activities and performance of their mandates to the President of Nepal which is discussed later in the federal parliament. Hence, there are avenues for the Commission to present implementation status of their recommendations and highlight any discrepancies they experience while performing their roles. Further, Commission also presents separate reports of its recommendations and distribution of revenues to head of each province. Besides these practices, NNRFC also coordinates with governments for the effective implementation of its recommendations and suggestions and facilitates for resolving any disputes in the course of implementation.

### 1.3 Rationale and Approach to Study

The constitutional provisions promise, among others, the distributions of state power across the federal, provincial, and local levels of government to achieve inclusivity in the social, economic, and political development of the Country. Importantly, this entails effective service delivery to the people through sub-national governments and discharge their constitutional mandates. Realizing these promises to fulfill within a reasonable time will require working effectively on different aspects of governance reform and transformation including financial, administrative, legal, and sectoral developments. Among others, management and mobilization of financial and natural resources remains a pre-condition for ensuring effective service delivery. Promoting inter-governmental fiscal relations based on the governing principles of cooperation, coexistence, and coordination amongst the three levels of government is equally important.

In the course of smooth fiscal federal practices and inter-governmental fiscal relations, NNRFC as a custodian of fiscal federalism, has been entrusted with the crucial role of creating a scientific basis for the sharing of the resources among the three levels of governments. In these initial years of practicing federalism, NNRFC has been creating a pathway for sound fiscal federalism through its constitutional framework and institutional arrangements. However, these initiatives are yet to be completed toward maturity. In this context, a need has been felt for a thorough study on the role of the Commission, by identifying issues and challenges facing by the Commission and its improvement prospects in terms of strengthening fiscal health of evolving federation.

This study aims at assessing the role of the Commission in fulfilling its constitutional responsibilities and identifying areas of improvements in the functioning of the Commission. The study largely utilizes secondary data and information along with review of the constitutional and legal mandates around roles and responsibilities of the Commission. Reviews and references from practices of countries having a federal system of governance have also been taken into perspective. In addition, interviews with the Chairperson and other office-bearers of the Commission have shed light on the prospects and imperatives for the Commission and its stakeholders in the days ahead. Based on secondary and primary information, the study has identified strategic issues for the Commission in creating a roadmap to successfully fulfil its mandate and contribute to sustained federalism in Nepal.

## NNRFC ON THE MOVE: ACHIEVEMENTS AND ISSUES

### 2.1 Initiatives and Achievements

The successful implementation of the federal system largely depends on the effective fiscal federalization and its management within the broader constitutional and legislative framework and aspires effective functioning of relevant institutions including NNRFC. This is especially challenging as the country had embarked on federalism while the experience and working knowledge was based on a unitary system. In such a situation, the Commission faced various challenges such as forging appropriate institutional arrangements, build common understanding among the stakeholders, standardizing the new practice, and norming the governments and institutions in this frame. Since its inception, the Commission focused on preparing itself with institutional set-up, studies and stakeholder consultations, and designing indicator framework and bases for recommendations. Major initiatives and achievements of NNRFC in these three years have been highlighted below:

#### *Institutional development*

The Commission primarily focused on its institutional development by creating legislative frameworks, organizational and system architecture, and physical infrastructure. In this course, the Commission formulated basic operating policies, laws and procedures that includes; National Natural Resources and Fiscal Commission Bylaws, 2076, National Natural Resources and Fiscal Commission's Members and employees' code of Conduct, 2076, The Commission published an information booklet containing information on the constitutional and legal provisions related to the work of the Commission, recommendations and suggestions made by the Commission and information related to fiscal federalism and fiscal transfers. The Commission has been involved in setting strategic direction for the long term and preparing strategic plan to fulfill the constitutional mandate.

#### *Setting priority and developing indicators*

The Commission was involved in making new inroads in the first year, immediately after the promulgation of the Constitution, where there were no appointed commissioners in the office. To that end, it sought the opinion of key stakeholders and experts in order to prioritize

its activities. The Commission was able to determine and recommend fiscal transfer to the provincial and local governments, uninterruptedly. Indicators were developed and updated for the purpose of fiscal transfer and revenue sharing from the federal level to the provinces and local level, and from the provinces to the local level.

### ***Studies and research works***

The Commission conducted various studies on fiscal transfer, revenue sharing, and use and distribution of natural resources in the subsequent years of its operation. They include Economic, social, and other inequalities at the provinces and local levels, Performance of the provincial governments, Local levels' performance and Provincial and local level expenditure requirements and revenue potential. The Commission also prepared separate reports on each of the provinces highlighting the works done by the Commission and presented it to Chief Ministers of respective provinces in recent year.

### ***Developing information technology base***

At present, the Commission is performing information generation, processing and interpretation by best utilizing basic computer applications. NNRF is moving toward establishing research and resource center for adding value to its overall performance through modern IT infrastructure. In this course, a digital inventory of natural resources has already been started. In addition to that, all recommendations, tasks, information of the Commission has been uploaded and updated in NNRF's website.

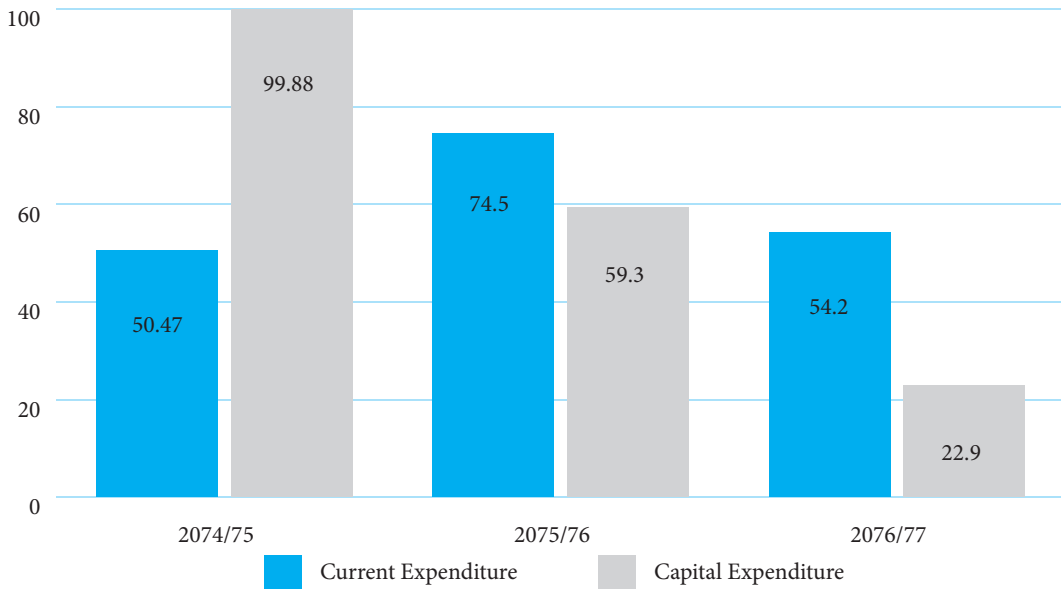
### ***Awareness and capacity building***

The Commission has role of building capacity in managing fiscal affairs of the governments. In these years, it organized orientation training programs in 223 local governments on fiscal federalism and natural resource mobilization and the possible disputes. Series of interactions and consultations have been continued through face to face and virtual platforms with Chief Ministers of provinces and elected representatives of local governments in relation to information collection and solicit suggestions that contribute in the working procedures and decisions of the Commission.

## **2.2 Budget Utilization**

The Government of Nepal provides budget to the Commission on an annual basis to fulfill its recurrent and capital expenditure needs. The financial performance of the Commission in the last three fiscal years is presented below.

**Figure 1: Budget utilization trend of NNRFC (in %)**



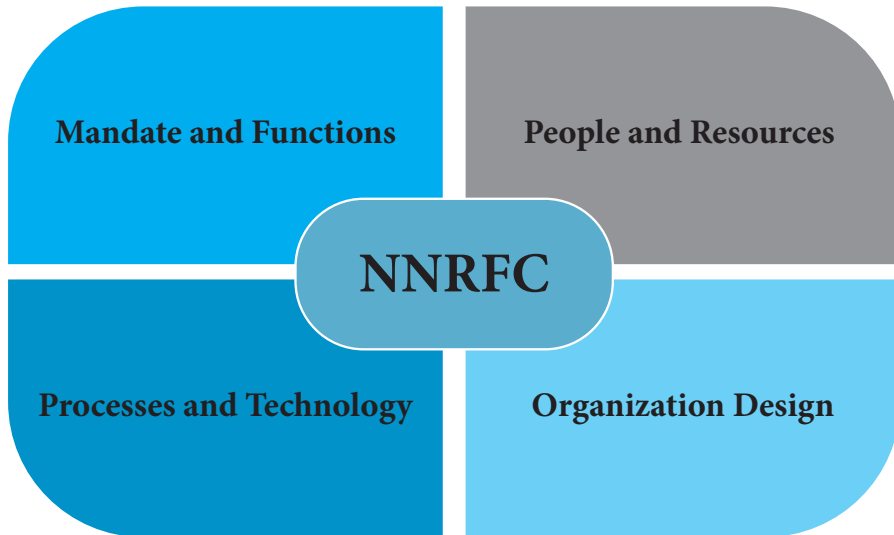
Source: Annual Reports of NNRFC for the Fiscal Year 2076 and 2077

Figure 1 shows that, in 2074/75 B.S., Commission's budget towards capital expenditure was fully utilized. Being an entirely new entity, it is because of the NNRFC had to invest heavily to establish and procure basic infrastructures for its operation, such as office furnishing, computer equipments and vehicles. On the other hand, current expenditure appears to be lacking in both the years, despite a noticeable improvement in 2075/76 B.S. This shows that there has been a lack of budget utilization and program implementation, which can also be attributed because of non-appointment of commissioners and less number of technical and managerial staffs in place. Reason behind low progress in current expenditure and capital expenditure in 2076 B.S. can be attributed to the COVID-19 pandemic that has affected the overall operation of the Commission.

### 2.3 Issues and Challenges

Right from the beginning, NNRFC has been effortful to fulfil its constitutional mandate through the optimum utilization of the available resources. Initiatives and accomplishments mentioned in earlier section shows that NNRFC has created an institutional base and legislative frameworks to perform effectively. However, there are many aspects and issues, which if properly managed can ensure a smooth implementation of fiscal federalism in the country. The issues are classified under four headings as discussed below:

Figure 2: Dimension of assessing issues and challenges of NNRFC



### 2.3.1 Mandate and Functions

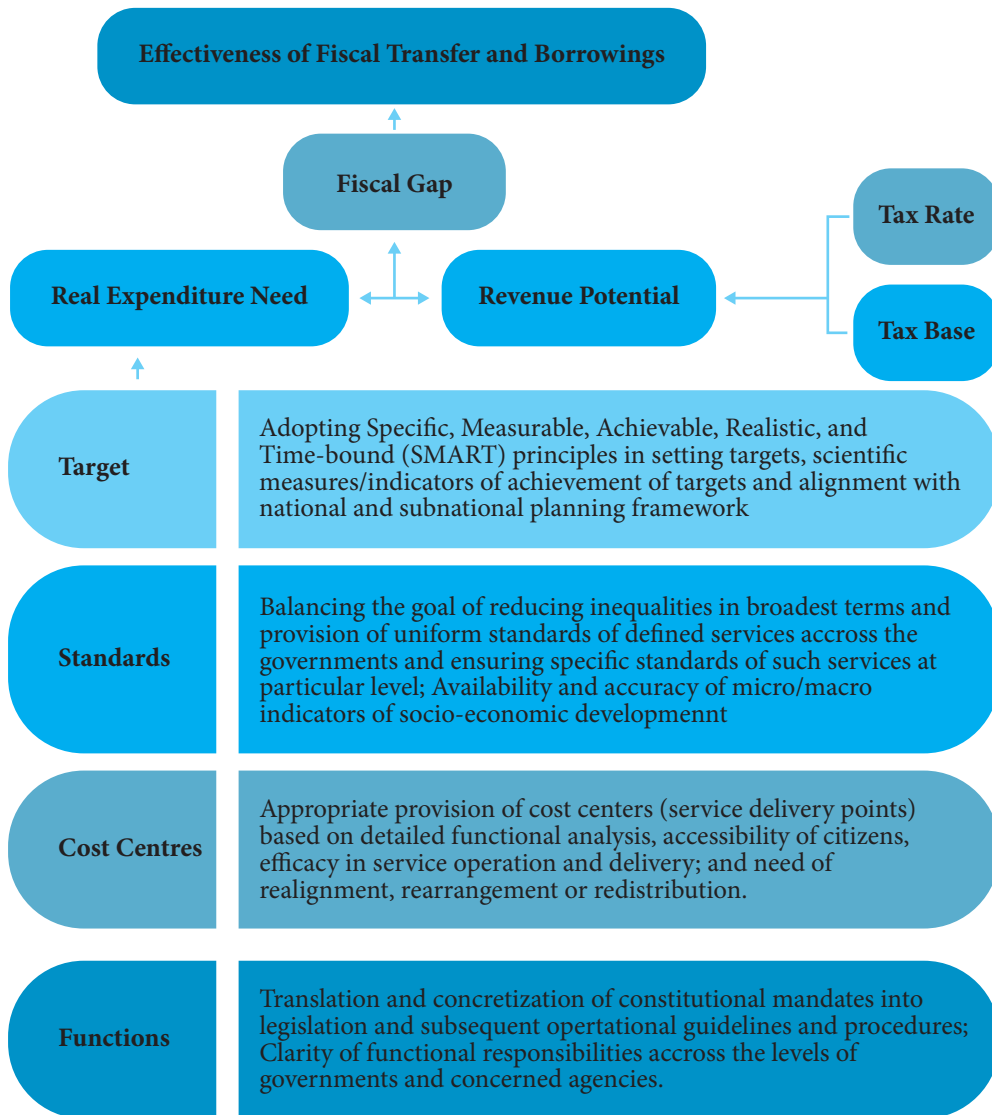
Issues that relate to the NNRFC's mandates and functions are identified below.

#### *Basis for fiscal transfer and utilization*

Sound basis of fiscal transfer and borrowings is largely determined based on the fiscal gaps that is drawn from the difference between real expenditure need and revenue potential of any government. Expenditure need of any government can be assessed or determined precisely on the basis of clarity on functions, appropriate provision of cost centers, predetermined standards and SMART targets in public service provision, and other relevant functions as described in the framework below:



**Figure 3: Framework for effectiveness of fiscal transfer and borrowings**



*Source: Analytical presentation based on authors' review and consultation*

The Commission has faced issues such as overlapping functions and responsibilities of the different governments and ambiguities in regards to their roles. It has made difficult for the Commission to administer fiscal transfer based on the expenditure needs of the sub-national governments. Many constitutional provisions are still evolving and is yet to translate and concretize into legislations and subsequent operational guidelines, procedures, and practices. This has resulted in duplications of resources and efforts, the questioning of the accountability of the concerned governments, and the creation of unfunded mandates.

Another issue is mapping of cost centers to carry out those functional responsibilities of the governments. Cost centers have various dimensions- geographical, political, economic, and social among others that have affected accessibility of citizens, operational efficiency and overall costs of service provisions. This has an impact on developing indicators in assessing expenditures need. In this connection, there are also debates on adequacy of criteria (e.g. of population and geography) currently being used for the distribution of financial resources. Even the local levels that share similar geographical area or topography might have varying needs. Therefore, their specific needs- in relation to their socio-economic context, stages of development, past performance, efficiency, and capacity needs to be carefully assessed.

Clarity of function also has direct impact on defining and enforcing service standards. In many instances, governments have not practiced defining service standards explicitly in relation to time, costs and service quality parameters. There are also confusions over uniformity and local parameters in defining service standards (e.g. local levels have power of managing education up to Secondary Level, but the minimum standards need to be same throughout the country) for ensuring minimum standards of services across the governments and satisfying specific needs of particular government. Defining service standards largely depends on availability and accuracy of macro and micro data, information and indicators about socio-economic development. This is the most challenging issue for NNRFC, which has limited the Commission's efficiency and ability to estimate expenditure needs and revenue potentials based on the facts and figures. In addition, adopting SMART principles in setting target and proper alignment of the targets with national and subnational planning framework are pertinent issues.

There is also deviation in nature of grants and their utilization. Each of the grants i.e. equalization, conditional, complementary and special is based on a specific set of objectives. However, there are instances where the Special Grant has been used by municipalities for the preparation of footpaths or other physical infrastructure, which represents a deviation from this grant's intended objective. The role of the Commission in this regard is to identify the reason behind such deviation in regard to legal complications (if any) in utilization, awareness etc. of local government.

### ***Execution of recommendation made by the Commission***

As per the Constitutional provision, the Commission recommends fiscal equalization grant to be obtained by each province and local level. Federal government is obliged to implement the recommendation made by the Commission. Here, we have tried to assess the status of recommendation made by the Commission and its execution.

**Table 2: NNRFC recommendation and actual fiscal transfer to subnational governments**

Year ( B.S)	Recommendation of Fiscal equalization grant by NNRFC	Actual transfer as reported by Office of the Auditor General	Observation
2075/76	Provinces: NRS 50.2986 Billion Local Level: NRS 85.2075 Billion	Provinces: NRS 50.2986 Billion Local Level: NRS 85.2819 Billion	NRS 74.4 Million amount to local levels has been allocated more than recommended by NNRFC
2076/77	Provinces: NRS 55.2986 Billion Local Level: NRS 89.9470 Billion	Provinces: NRS 50.2986 Billion Local Level: NRS 89.9935 Billion	NRS 46.5 Million amount to local levels has been allocated more than recommended by NNRFC
2077/78	Provinces: NRS 57.5700 Billion Local Levels: NRS 93.74 Billion	Provinces: NRS 55.1950 Billion Local Levels: NRS 90.0550 Billion	NRS 2.375 Billion amount to provinces and NRS 3.6805 Billion to local levels has been allocated less than recommended by NNRFC

*Source: Author's compilation based on annual reports of NNRFC*

The above table shows the recommendation of fiscal equalization grant by NNRFC and actual transfer reported by the office of the Auditor General. The deviation in recommended amount and allocated amount as presented in the above table raises the question in effective implementation of the NNRFC recommendation by concerned governments. Since the Commission also recommends the priority areas for provincial government and local government to use the fiscal equalization grant, the Commission expects these recommendations to be complied by all three levels of government for effectiveness in grant utilization and achieve development goals. The deviation might also raise question on functional autonomy of the Commission. In case of discrepancies, NNRFC should also assess reasons behind those discrepancies, consult with concerned government authorities and with due emphasis report to legislature so that issues come under broader purview of elected representatives and might generate appropriate resolution measures.

### ***Dispersed sources of fund for local governments***

One of the pertinent issues in intergovernmental fiscal relations depends in managing and balancing coordinated functioning around multiple sources of funds across the governments. Multiple sources of funding for local government include fund by federal government and provincial government, revenue distribution, own source of revenue, royalties, provincial lawmakers' constituency development fund, federal lawmakers' constituency development

fund<sup>8</sup>, single tax administration distribution amount, borrowings, and miscellaneous (donations etc.). Such dispersed sources of fund and its effective management may create complexities on the part of sub-national governments in managing funds and affect adversely in reporting and operational efficiency of concerned sub-national governments.

Conditional grants constitute one of the various type of grants. It includes monetary transfers from one level of government to another, either through competitive project grants or through general block grants, which place conditions on the use of the transferred funds by the recipient government. These grants are transferred by federal government to provincial government and local government in order to help implement development plans and achieve national goals. Higher conditional grant in total sphere of transfers reduces the space for independent planning and prioritization of Provincial and local governments. If we look at the current scenario, budget speech of 2020/21 shows that provinces received 60% of transfer from equalization grant and 40% from conditional grant whereas local government received 64.2% of transfers from conditional grant and 35.8% from equalization grant. This implies the local governments have less scope for planning and prioritizing on their own. The higher degree of conditional grant may also limit the functional autonomy of sub-national governments to plan and substantiate constituency specific priorities which is the main spirit of fiscal federalism. In this context, NNRFC need to suggest measures to gradually reduce the proportion of conditional grants and its effective utilization.

### ***Inadequate focus on natural resources front***

The Constitution of Nepal authorizes the Commission to make recommendations for the equitable distribution of natural and financial resources available in the country between the federal, provincial and local governments. The Commission is also responsible for providing recommendations on how the royalties from natural resources should be distributed between the three levels of government. In such cases, the Commission needs to conduct research in order to determine the level of investment required for the use and development of natural resources, as well as how returns on such investment should be apportioned at the intergovernmental level.

Currently there are various legislations in dispersed form. Lack of comprehensive legislation governing royalties from natural resources and its management has created confusion for which comprehensive legislation/act related to natural resource investment and return needs to be formulated. In addition to that, fees and royalties collected from various mountaineering, protected areas are still operating under different funds not aligned to federal divisible fund. These sources needs to be properly mapped in coming days. Further, overlapping jurisdiction among three levels of government needs to be clarified. For example, constitution has provided local government the power of protection and conservation of natural resources. Similarly, province level government has power of

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<sup>8</sup> The Government has revoked the constituency development fund effective from fiscal year 2021/22

management and exploration of province level natural resources and federal government with power of excavation, and formulation of national policies on natural resources. Local Government Operation Act 2074 further provides power to local government with power of permission, renew, management and termination for survey, excavation related to sand, stone and collection of royalty form excavation. All these provide incompatible and duplication of rights among three levels of government. In this context, NNRF need to take initiatives to ensure clarity through legislative framework and develop practical frameworks and standards for revenue sharing mechanism in natural resources domain.

### 2.3.2 Processes and Technology

In case of the NNRF, process and technology refers to how it functions; how workflow is designed and managed; which systems are being used, and overall, how processes undertaken by the Commission are analyzed. Since NNRF has the basic function of developing indicators, conducting research and providing recommendations, it is largely dependent on government machinery to generate data of fiscal affairs (such as information on tax revenues and expenditures). Scientific base of these processes carries importance for effective functioning of the commission.

In order to manage the intergovernmental fiscal transfer and natural resources, the Commission has to create a database of natural resources, so that it can receive needed data and information from regular economic surveys and use to develop a formula and a standardized operating system to allocate revenues. This will also assist in creating a mechanism to promote cooperation among the level of governments at vertical and horizontal level. Similarly, the distribution of revenues from natural resources is a challenging job for the Commission. Natural resources that are under the purview of two or more local government administrations – and where patterns of investment should be carefully handled as per the provision of the Constitution – needs to be coordinated and their joint capacity should be strengthened. Based on the Commission's mandated functions, it seems pertinent to make use of data integration tools, information retrieval processes and the reporting system. In this regard, there needs to be clear-cut guidelines and standard operating procedures. In addition, sub-national governments, who are important stakeholders of the Commission, need to be consulted and receive training on the provisions and elements of fiscal matters in order to enhance effective implementation of recommendations.

#### *Data aggregation and disaggregation*

Data and information are very crucial for implementing mandates of NNRF and ensure objectivity in its decisions. However, there seems to be inadequate data, information and evidences. Availability, quality, aggregation and disaggregation of data are major concerns for the Commission. Proxy indicators have been used due to lack of relevant data. For example, there is inadequate data on how royalties from the use of forest resources should be distributed across government levels. The distribution for local governments has been

done on the basis of the forest ratio, population and geography which existed during unitary system of government. In order to ensure that intergovernmental fiscal transfers are fair, equitable, objective and realistic, all data up to local levels need to be disaggregated, standardized and updated. The Commission has been working in close collaboration with the Central Bureau of Statistics, concerned departments of federal government and research institutions in generation and analysis of data and evidences.

### 2.3.3 People and Resources

The functions of the Commission are highly technical and demand sectoral experts. For example, the majority of tasks as stated on Article 251(h) of the constitution of Nepal, which stipulates about determining the basis for computing the share of investment and returns for federal, provincial and local government are technical in nature and demand sectoral expertise. However, the Commission has higher ratio of employees from administrative service group. Availability of expert with matching competencies is also difficult in the areas like mining and geology. Generic knowledge in administrative responsibilities of civil servants is not sufficient to excel in these mandated areas. Human resource status of the Commission is presented in Table 4.

**Table 3: Staffing positions in the Commission**

Class	Approved Positions	Existing Status
Gazetted Special Class	1	1
Gazetted First Class	3	2
Gazetted Second Class	12	9
Gazetted Third Class	20	13
Non Gazetted	13	8
Total	49	33

Source: NNRFC Annual Report, 2077

Approved number and actual size of human resources as presented in above table shows understaffing in the Commission. The Commission doesn't have its own specific cadre which have resulted difficulty in acquiring technical expertise. Provision of technical position, special experts hiring and development of own cadre is not capitalized. All employees are deputed from civil service.

Similarly, frequent deputation and transfer of employees without consultation with the Commission, gap in matching competencies among employees in the Commission are regarded as pertinent issues hampering the efficiency and productivity of the NNRFC. In order to design and develop programs that build capacity within the Commission, a need-based assessment of employees and their respective skills is pertinent.

### 2.3.4 Organization Design

Performance of NNRFC largely depends on its organizational design and the alignment of people and operating procedures accordingly, as this enables the Commission to function smoothly with operational efficiency and clear policies. The Commission is mandated by the constitution with extended functional mechanism which is based on government machinery and bureaucratic organization design.

If we compare Nepal's fiscal Commission with that of other countries, we find that the NNRFC is a permanent body (expert-type Commission) which makes decisions based on facts and whose recommendations are mandatory to be followed by the government. In other federal countries, we can find various arrangements for fiscal transfers. In India, the members of the Finance Commission are temporary as the Commission is set up every five years by the President comprising specialized personnel of related field and their recommendations cover a period of five years. Likewise, in Pakistan the President sets up National Finance Commission Awards as a temporary arrangement for every five years. Whereas in South Africa, Financial and Fiscal Commission is formed as a permanent body. The selection of Commission members is based on sectoral expertise. Canada, however, has a stand-alone equalization scheme based on formula as an equalization arrangement.

NNRFC being an independent institution, should create an environment where all levels of government can have ownership and trust towards the decision and recommendations of the Commission. This can be achieved either through structural representation or through creating a platform where all levels of government can participate and voice their opinions. If we look at the NNRFC and its composition, there is no direct representation of provincial and local governments. Chairperson of the National Assembly represents provincial government and local governments through constitutional council and the National Assembly. Further, discussion of the report of the Commission in parliament may be a distant process for provinces to participate and express their concerns. In this context, the Commission need to create platforms and proactively engage sub-national governments to generate common understanding in specific needs and issues of sub-national governments and possible ways of resolution in consultation with federal government.

Regarding selection criteria of NNRFC members, the Constitution has specified some criteria but the NNRFC Act doesn't further specify details of expertise and experiences for appointment. The spirit of constitution to appoint technical personnel relevant to the Commission has not been completely reflected in the NNRFC specific legislation, this leaves room for high degree of discretions and political incentives to the members of Constitutional Commission and political leadership. Public Hearing Committee within parliament also adopt ad hoc procedures to date to assess the process and yet could not provide any specific directions to the authorities involved. NNRFC has also not developed its competency framework for its human resources that would guide sourcing and utilization accordingly.

In practice, successful functioning of a research-based institution like NNRFRC relies heavily on autonomy, good institutional memory and expert skills and capabilities. However, such highly specialized services are not easily obtained from local markets in the short run. Since, research conducted by the Commission is time-bound, the efficacy of the Commission will be negatively impacted when specialized services are not procured in a timely fashion. The Commission has been suffering to match the interest and orientation, area expertise and contribution potential of government deputed officials as per the nature and specialized functions of the Commission.



## KEY REFLECTIONS

Successful implementation of federalism will be realized once the intergovernmental fiscal transfer system of the country assures all three levels of government not only with sufficient resources, but also with the capacity and flexibility to carry out their respective mandates and the means by which they are held accountable. The role of the Commission in this regard is very important in terms of reviewing the fiscal situation across the government and determine on balanced fiscal transfer among and between all levels of government based on evidence informed objective criteria for maintaining vertical and horizontal balances.

Article 251 of the constitution has mandated the Commission with various roles regarding revenue distribution, grant distribution, expenditure assignment, and borrowings, for which the basic minimum legal framework exists. NNRFC is itself an institution with a new orientation that emerged with the beginning of the federal system of governance in Nepal, and it took around two years to start functioning in its current state.

In respect to the four key dimensions relating to the role of the Commission, some pertinent issues have been identified. First, in respect of the mandate and functions of the Commission, it is concerning that there is a lack of clarity on functional jurisdiction at an intergovernmental level and it has been aspired that the Commission guide and help the levels of government to overcome it. The functions need to be clear with efficiently arranged cost centers (service providing agency), along with the targets for assessing expenditure need by sub-national government. In addition to this, the dispersed ways of funding in terms of different forms of grants to the sub-national level of government needs to be carefully examined, as this phenomenon deters fiscal accountability and limits their functional autonomy and independent planning and prioritization scope.

Second, regarding the processes and technology, an integrated information and interactive database systems having automated data processing facility is yet to be in place. Such system would provide platform for generating and processing of qualitative and quantitative data related to multiple dimensions of national economy. The system need to be designed ensuring direct access for subnational government as well. Data aggregation, disaggregation, and standardization and update are issues that need to be addressed in order for the Commission to prove its impartiality in decisions.

Third, in terms of people and resources, the Commission is constrained in its capacity. The functions of the Commission demand sectoral expertise on the areas of multilevel governance, economics, financial management, natural resources, data and statistics, among others. However, the Commission does not have autonomy to select the employee based on their competency. It has created a gross mismatch between required and existing competencies of employees that remains as a challenge for the Commission.

Fourth, the organizational design of the Commission is influenced by a typical bureaucratic design. However, the functions of the Commission call for a research-based think-tank nature institution.

Following are the suggested imperatives that would be instrumental to improve the functioning of the Commission:

### ***Adopt holistic approach in fiscal transfer and borrowing***

Effectiveness of fiscal transfer and borrowings demands holistic approach that facilitates decision-making, establishes processes to enable disciplined execution, and develops a common technology platform that drives stakeholder collaboration to achieve intended benefits. Clarity in the bases of identifying expenditure needs is the first step in this regard. The reliable estimates of expenditure needs requires alignment between clearly defined functions and appropriately designed service delivery points, defined service standards and SMART target of service provisions. For the purpose, coordination among three levels of government and expert role of the Commission is crucial.

Identifying expenditure needs doesn't simply rely on static functions of governments. National Planning framework and development plans add dynamism in the functions, service standards, and the target set forth in the national goals. Proper alignment and harmonization of plans and development goals at subnational level with broader national goals is equally important. NNRFC in this regard needs to assess priorities of all levels of governments and identify the real expenditure requirements to fulfill the national goals collectively and make recommendations accordingly. The Commission needs to expedite to generate adequate evidence through conducting relevant studies in this regard. The Commission has to promote collaboration with government agencies, academics and research institutions for conducting studies that would contribute in generating and sharing inference of macro and micro level indicators of socio-economic development.

Governments generate revenues from tax and non-tax sources to finance for performing functions mandated by the constitution. Size of revenues and its potential largely depend on bases and rate of tax and non-tax instruments, volume of economic activities in concerned governments, quality investment opportunities, and effective utilization of natural resources. Governments generally face situations where revenue is not sufficient to finance the expenditures required to fulfill their obligations. In such situation, Borrowing may be one of the important tools of deficit financing. In federal system, discretionary borrowing on

the part of sub-national governments may adversely affect the macroeconomic stability of the country; hence subnational borrowing is taken with high caution. Federal government is authorized to regulate borrowing decisions of the subnational government and mitigate associated risks. The Constitution provisions that only federal government can raise loan on international market and all three levels of government can raise loans on internal market. Provinces and federal government can only raise loans by issuing bonds. All these borrowings must take place within the framework recommended by the Commission. Now the role of the Commission lies in setting parameters or indicators and developing appropriate framework for borrowing considering cost of financing, repayment capacity, and utilization prospects.

### ***Develop integrated information system***

NNRFC as of now is relying with the concerned units of governments to generate information on demand, process information based on basic computer applications and administered access to financial information system of government. An integrated information system needs to be developed that help NNRFC to regularly receive required data and information from relevant agencies at different levels and consolidates data from all three levels of government. This will in turn help to reduce redundancy and ease the insourcing of objective and evidence based decision making. Such system enables the combination of different databases from various sources with data integration tools, visualization, and models and also contribute towards retaining institutional memory for future.

### ***Engage experts and research institutions***

NNRFC, primarily, is a research-based institution that works mainly on objective data and facts. Hence, the workforce need to be equipped with domain expertise and competencies to serve as per its nature, mandate, and roles. Currently, the Commission is relying on officials supplied by federal government having administrative competencies in general. Further, it may not be feasible for the Commission to develop cadre on its own with divergent sectoral expertise in the short run. In this situation, the Commission has to adopt engagement strategy with concrete plan to best utilize the sectoral experts at local and international level. At institutional level, NNRFC needs to strengthen collaboration with other research institutions and think tanks as integral component of engagement strategy.

### ***Increase emphasis on the natural resources front***

Effective mobilization of natural resources enhances revenue potential of government and create sound basis for sustainable financing needs of government in the long run. In this perspective, the constitution has mandated NNRFC to design appropriate framework in mobilization of natural resources including investment, sharing of benefits, and managing potential conflicts among concerned governments.

Enriched database of natural resources, scientific studies for utilization potential, and appropriate legislative framework for regulation of natural resources are necessary conditions for NNRF to perform its role effectively in this domain. The Commission need to engage sectoral experts, elected representatives, and stakeholders in this process.

Mobilization of natural resources inherits potential conflicts among concerned government. In this relation, the Commission has crucial role in dispute resolution through various forms. They can act as a mediator and facilitator to negotiate, advise win-win alternatives, and recommend settlement framework appropriate to the particular nature of the natural resources. Integrated legislation is considered essential that govern affairs of natural resources with adequate provision of economic, technical, and managerial aspects along with appropriate dispute settlement mechanisms.

### ***Build capacity at all levels***

The changing paradigm of governance demands both structural as well as cultural transformation. Cultural transformation demands role re-orientation of the elected representatives, civil servants, and concerned stakeholders who are the real change-makers. Capacity building is pivotal for a successful cultural transformation. In this regard, the Commission need to capacitate them in the dimensions of fiscal federalism by designing training and development programs on its own and in collaboration with various capacity building institutions.

At the same time, the Commission needs to transform itself into a learning organization with continually enhancing institutional capacity to effectively fulfill its constitutional mandates. In this process, the Commission need to develop its competency framework that will guide overall management of its human resources and also create a sound basis for engagement of experts as per need.

## Annex-I: Practice of Finance Commissions in other countries

### Australia

**Name:** Commonwealth Grants Commission

**Nature:** Independent agency (permanent body with secretariat)

**Objectives:**

- Make decisions about how to measure the relative fiscal capacities of the States
- Collecting & assessing data, and undertaking research to provide considered advice to the Commission.
- Recommend to the Commonwealth the allocation of Financial Assistance Grants so that each State could provide government services at standards not appreciably different from the standards of government services provided by the other States.

### India

**Name:** Finance Commission

**Nature:** Temporary Commission comprising of expert for five years

**Approach:** The approach of the finance commissions to determining transfers consists of

1. Assessing the overall budgetary requirements of the centre and states to determine the volume of resources that can be transferred during the period of their recommendation;
2. Forecasting the states' own current revenues and non-plan current expenditures;
3. Determining the states' shares in central tax revenues and distributing them among the states based on a formula; and
4. Filling the post-devolution projected gaps between non-plan current expenditures and revenues with the grants in aid. This is known as the "gap-filling" approach.
5. The Commission also lays down rules by which the centre should provide grants-in-aid to states out of the Consolidated Fund of India. It is also required to suggest measures to augment the resources of states and ways to supplement the resources of panchayats and municipalities.
6. There has been growing dominance of economists (this reflect the growing importance of economic development in Union-state relationship)

## Additional matters referred to India's Finance Commissions

Finance Commissions	Additional matters referred
First	Sum to be prescribed as grants-in-aid of revenues of the state of Assam, Bihar, Orissa, and West Bengal in lieu of the assignment of any share of the net proceeds in each year of the export duty on jute and jute products to these states.
Second	To make recommendations on the principles to govern the distribution of net proceeds of estate duty and those of tax on railway fares, and the proceeds of additional duty of excise (ADE) on mill-made textiles, sugar and tobacco .
Fifth	Issues of border concern, scope for raising revenue by states from taxes and duties, and the problem of unauthorized overdrafts of certain states with RBI.
Sixth	Review policy and arrangements for financing relief expenditure by states affected by natural calamities and feasibility of establishing a National Fund; Assess non-plan capital gap of states on a uniform basis ( also included in ToR of seventh Commission)
Ninth	Examine the feasibility of merger of additional duties of excise in lieu of sales tax with basic duties and evolving a suitable formula for allocating a part of duties of excise for distribution among states.
Eleventh	To draw up a monitorable fiscal reforms programme to reduce revenue deficit of states and to recommend the manner in which the grants to states to cover the assessed deficit in their non-plan revenue account might be linked to their progress in implementing the programme.
Twelfth	<p>-Review the state of finances of union and of states and suggest a plan of action by which the governments might collectively and severally restructure public finances, restore budgetary balance and achieve macroeconomic stability an debt reduction along with equitable growth.</p> <p>The issue of non-tax revenues was brought into the remit of the Twelfth Finance Commission's ToR. It was asked to look into non-tax revenue generated by production of crude oil and natural gas from the fields awarded by central government should be shared with the states and if so, to what extent.</p> <p>Though non-tax revenues of the union are not shareable with states as per constitutional provisions, inclusion of such ToR was perhaps a reflection of growing share of non-tax revenues and state's increasing demand for a share in such revenue.</p>
Thirteenth	Review of state of finances of the Union and the states, particularly keeping in view the operation of the states' debt consolidation and relief facility 2005-10 introduced based on the Twelfth Finance Commission, and suggestion for a stable and sustainable fiscal environment consistent with equitable growth.

Finance Commissions	Additional matters referred
Fourteenth	To review the state of the finances, deficit, and debt levels of the Union and the states in an integrated manner, keeping in view the fiscal consolidation roadmap and to suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth, including suggestions to amend the Fiscal responsibility and Budget Management Acts, then in force. Following reorganization of state of Andhra Pradesh into states of Andhra Pradesh and Telangana in 2014, an additional ToR to take into account the resources available to successor states and to make recommendations for them on all matters referred to in the ToR.
Fifteenth	To examine whether revenue deficit grants should be provided at all ( this additional matter is totally new and unprecedented) Propose measurable performance-based incentives states at appropriate levels of government in as many as nine areas. (Analytical note: There has been a remarkable recognition of changing circumstances in the economy, warranting attention to areas that were not anticipated as integral to Union-state fiscal relations. The expanding list, for most part, helped fiscal federalism and the idea of sound finance that the constitution envisaged.)

Source: *"Indian Fiscal Federalism"* by Y.V Reddy and G.R Reddy: Oxford University Press (2019)

## Pakistan

**Name:** National Finance Commission Awards

**Nature:** Within six months of the commencing day and thereafter at intervals not exceeding five (consecutive) years, the President shall constitute a National Finance Commission consisting of the Minister of Finance of the Federal Government, the Ministers of Finance of the Provincial Governments, and such other persons as may be appointed by the President after consultation with the Governors of the Provinces.

**Objective:** The prime charter of the NFC is to deliberate on the following:

1. Allocation of taxes and duties between the federation and the federating units
2. Extending grants to the provincial governments
3. Exercise of borrowing powers by two level of governments
4. Any other financial agenda referred to the Commission.

The share of the Provinces in each Award of National Finance Commission shall not be less than the share given to the Provinces in the previous Award. The Federal Finance Minister and Provincial Finance Ministers shall monitor the implementation of the Award biannually and lay their reports before both the State Parliament and Provincial Assemblies.

## South Africa

**Name:** Financial and Fiscal Commission

**Nature:** Permanent expert Commission

**Vision:** To provide influential advice for an equitable, efficient, and sustainable Intergovernmental Fiscal Relations (IGFR) system.

**Key Approach:**

The key approach to distribution of resources is the Financial and Fiscal Commission's research and advice, which informs the division of revenue and formulas for horizontal division between provinces and between local governments. (They are taken very seriously by Parliament and the National Treasury), and the intergovernmental mechanisms and structures (Budget Council where national government consults with provinces; Budget Forum where local government is consulted by Ministry of Finance). There has been limited litigation on transfers because the Constitution urges the different governments to avoid litigation and rather seek negotiated settlements.



## Annex-II: Equalization arrangement in various countries

Countries	Provisions
Australia	Federal transfers: based between 1933 and 1981-82 on recommendations derived from determination of needs of claimant states by a standing independent Commonwealth Grants Commission; after 1981-82 took the form of adjustments to the general Adjustment Grant transfers based on calculation of relativities of expenditure needs among states, since 2000 based on application of relativities to distribution of central GST tax. Allocation by CGC based on calculation of revenue capacity and expenditure needs from comparisons of 18 revenue categories and 41 expenditure categories.
Brazil	Distribution of state participation fund (state share of three main federal taxes) with participation coefficient for each state based mainly on redistributive criteria (85 percent of fund goes to poorer regions in the North, Northeast, and West-West). A similar fund for municipalities is less redistributive and more population based.
Canada	Federal transfers: stand-alone equalization scheme based on formula (adjusted from time to time) assessing provincial revenue capacity in terms of 33 provincial tax and non-tax revenue sources against a middle range five-province standard and providing unconditional grants representing 42% of all transfers.
Germany	Primarily inter-state transfers (62%): equalization through an inter-state revenue pool to which rich Länder pay and from which poor Länder draw according to a formula; plus federal transfers (38%): Federal Supplementary Payments of 1.5% of value-added tax (VAT). The primary per capita distribution of the shares of the Länder of a portion of the VAT also has an equalizing effect.
India	Federal transfers from a pool of all union taxes supplemented by unconditional grants, based on the recommendations of quinquennial Finance Commissions recommending both the share to be allocated to the states as a group, and the allocation among states taking account of population, per capita income, area, economic and rural infrastructure needs, and tax effort.
Japan	Local Allocation Tax (the main central government unconditional revenue-sharing transfer) is distributed to local governments on a uniform formula based on basic financial need and basic financial capacity.
South Africa	General national revenue-sharing transfer, with National Government distribution of “equitable shares” among provinces following recommendations of Financial and Fiscal Commission based on demographic profiles of provinces comprising an education share, a health share, a social security share, and population, backlog, economic activity and institutional components.

Countries	Provisions
Spain	Federal transfers: since 1987 criteria including population, size, personal income, and fiscal effort, number of internal provinces within Autonomous Community, and distance to state capital; applied by federal government to shares of federal tax revenue transferred to Autonomous Communities.
Sweden	Cost equalization transfers based on 15 indices: municipalities and country councils whose per capita income is below national average receive a grant and those above pay a fee (i.e. scheme is self-balancing), plus a supplementary block grant from the central government containing a population related and age-related portion. Implemented by an Equalization Commission.
Switzerland	Federal transfers based on formulae involving a range of criteria ranking cantons by financial capacity as the basis for tax-sharing and conditional grants, but the equalizing transfer system is smaller than in Germany, Canada and Australia.
United States	No generalized equalization scheme: some equalization occurs from cumulative effect of provisions in specific federal grant-in-aid schemes as approved by Congress.

*Source: Ronald Watts, Intergovernmental Financial Relationships in Eleven Countries, Working Paper 2005 (5), Queen's University*



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