FISCAL FEDERALISM MODEL IN NEPAL: AN ANALYTICAL STUDY

R.K. Shah*

ABSTRACT

The Constitution of Nepal as Federal Democratic Republic was promulgated on September 20, 2015 by the second CA. The primary objective of this study is to review the modality presented in the new constitution on the natural resources, economic rights and revenue allocation. The study finds that the fiscal decentralization initiatives have not been successful in minimizing the political, social, economic, regional and ethnic inequalities inherent for nearly 240 years of a unitary system of governance in Nepal. The study recommends that VAT and income taxes will have to be collected concurrently at both the central and sub-national levels. Other taxes including excise duties will have to be collected by the sub-national governments which will support the expenditure responsibilities of the sub-national governments adequately in federal Nepal. Intergovernmental transfer modality has to be included in the constitution. National Natural Resources and Fiscal Commission (NNRFC) have been constituted at the central level to make national level development plans and to make recommendations for additional grants and loans. A State Planning Commission (SPC) and a State Fiscal Commission (SFC) can be established in each state to prepare state development plans and to deal with the transfers to be made to local bodies.

Key Words: Fiscal decentralization, Fiscal federalism, Constituent assembly, Expenditure assignment, Revenue assignment, Local government, Inter-governmental fiscal transfer, fiscal gap.

INTRODUCTION

FISCAL DECENTRALIZATION

Fiscal decentralization is the transfer of expenditure responsibility and assignments in generating revenue to the lower levels of governments. It is the granting of independence or autonomy to the local governments. It is the mechanism of sharing fiscal resources among the different tiers of the government. Fiscal decentralization involves transferring expenditure and revenue responsibilities from the central government to sub-national governments.

Fiscal decentralization enhances the economic growth directly by increasing the efficiency of public expenditures (Samuelson, 1994 and Oates 1972, 1993) and indirectly through enhancing economic efficiency,

* Dr. Shah is Professor in Economics at Central Department of Economics, Tribhuvan University, Kirtipur, Kathmandu, Nepal.

creating horizontal fiscal equality and by maintaining macro-economic stability (Martinez-Vazquet and McNab, 2005).

FISCAL FEDERALISM

Fiscal federalism is financial relations between units of governments in a federal government system.

Fiscal federalism is one of the important areas in the public finance discipline. The term fiscal federalism was first introduced by the German-born American economist Richard Musgrave in 1959. Fiscal federalism deals with the division of governmental functions and financial relations among levels of government (Musgrave, 1959).

Fiscal Federalism is concerned with the division of revenue and expenditure responsibility among different tiers of government. Hence, allocation of tax and expenditure function to the various levels of government is the foremost issue of fiscal federalism (NEA, 2009: 28). Fiscal federalism is concerned with understanding what functions and instruments are best centralized and what are best placed in the sphere of decentralized levels of government (Oates, 1999: 1120).

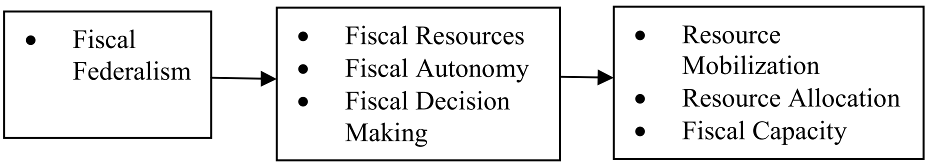
"Fiscal federalism explores the roles of the different levels of government and the ways in which they relate to one another" (Oates, 1999: 1110).

“Fiscal federalism refers to the allocation of tax-raising powers and expenditure responsibilities between different levels of government” (Akindele and Olaopa, 2002).

Fiscal federalism is the financial relations between units of governments in a federal government system. Fiscal federalism deals with the division of governmental functions and financial relations among levels of government.

Fiscal federalism is the system or approach used to apply the principles of federalism in inter-government relations in which government interact with each other by co-operation, coordination and competition to maximize the welfare of the citizens.

CONCEPTUAL FRAMEWORK OF FISCAL FEDERATION



OBJECTIVES

The key objective of this study is to analyze fiscal federalism model in Nepal. But the specific objectives of this study are as follows:

- To clarify fiscal decentralization and fiscal federalism,
- To explore components of fiscal federalism,
- To explain about Inter-governmental fiscal transfers,
- To analyze local borrowing in fiscal federalism.

METHODS AND MATERIALS

This study is an analytical study based on the application of macroeconomic theory of the public sector. It is based on secondary data. Data published from various governmental and non-governmental organizations are used to analyze the situation. Economic surveys, budget speeches and plan documents published by the Ministry of Finance and the National Planning Commission and various reports published by the Local Body Fiscal Commission and Financial Comptroller General Office are the major sources of statistical information. Apart from this, reports published by the World Bank and UNDP are also taken under consideration.

COMPONENTS OF FISCAL FEDERALISM

Fiscal Federalism			
Expenditure assignment	Revenue assignment	Inter-governmental fiscal transfer	Sub-national borrowing

EXPENDITURE ASSIGNMENT

Expenditure assignment is the first step in designing an international fiscal system. Designing revenue and transfer components of a decentralized inter-governmental fiscal system without concert expenditure responsibilities would weaken decentralization process. The key success of a decentralized system is matching expenditure responsibilities with the objectives of service assignment.

A report prepared by the US Advisory Commission on Inter-governmental Relations (ACIRs) on Governmental Functions and Process (1974) lists four criteria is assigning services such as economic efficiency, fiscal equity, political accountability and administrative effectiveness.

The characteristics of expenditure assignments should be made to government units that can

(1) Supply a service at the lowest possible cost,

(2) Finance a function with the greatest possible fiscal equalization,

(3) Provide a service with adequate popular political control,

(4) Administer a function in authoritative technically proficient and co-operative fashions.

REVENUE ASSIGNMENT

Once the assignment of expenditure responsibility has been determined the second key question as: who gets what resources? "The revenue assignment acquisition as tax policy is known in the context of inter-governmental fiscal relation is often considered the second main pillar or building block of fiscal decentralization policy" (Bird, 2011).

No universal model for local government and revenue assignment is applicable for all countries around the world and the best model depends on many other factors on (Steffensen and Holm, 2000):

- The type of local government,
- The size of local government,
- The type of functions they are going to perform,
- The cultural context of the country and historical experiences, and
- The administrative capacity at the local level.

In assigning taxes to the government at state and local level, the following considerations should be kept in mind (Hicks, 1955: 115):

(a) Revenue from taxes should not be subject to inherent fluctuations. The jurisdiction of these governments is small. Their power of manoeuvre is limited. So, they need steady incomes.

(b) From administrative point of view, these taxes should be easy to assess and collect. It is an admitted fact that general level of state administration is lower than that of the national governments.

(c) For the sake of convenience, it is necessary that, at lower levels of government, tax base be localized in order to avoid dispute over jurisdiction.

Financing responsibilities require resources. Hence, revenue assignment is concerned with the question "who should levy what taxes?" Revenue resources for different levels of government are identified.

INTER-GOVERNMENTAL FISCAL TRANSFERS (IGFTS)

Inter-governmental fiscal transfers (IGFTs) are transfers of funds from one level of government to another. This may be to fund general government operations or for specific purposes.

Since revenue assignment often does not provide regional and local governments with sufficient revenues to fund their expenditure functions, inter-governmental transfers are often necessary to assure revenue adequacy. Transfers are often necessary to assure revenue adequacy. Transfers are grants from one level of government to another (often from higher to lower) for the purpose of funding government activities. The term *transfer* is often used interchangeably with the term **grants, subsidies or sub-ventions.**

Inter-governmental fiscal transfers are the dominant sources of revenue for both sub-national governments in most developing countries. Central transfers finance 85 percent of local 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 (Shah, 1994).

Inter-governmental transfer is one of the major components of public sector responsibilities in federations. In most of the cases, inter-governmental transfer takes place from higher level to lower level of government.

The share of social sector expenditures in total spending is very high in modern welfare states and these responsibilities are usually heavily borne by constituent unit governments with some federal assistance all over the world. In this background, virtually every country faces the problem of fundamental imbalance between expenditures and revenues. Therefore, the need for inter - governmental fiscal transfers arises to close the budgetary gap. No simple and uniform pattern of transfers will be suitable for all circumstances.

Fiscal transfers are particularly important in fiscal federalism that do not have extensive tax sharing. Fiscal transfers are, therefore, alternative to tax devolution. Fiscal transfers can be of legal entitlements, discretionary, conditional and unconditional. Large grants are legal entitlements in many federations. Conditional grants encourage sub-national governments to spend more on program which are prioritized by the federal government.

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

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

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

Where,

a = Minimum grant

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

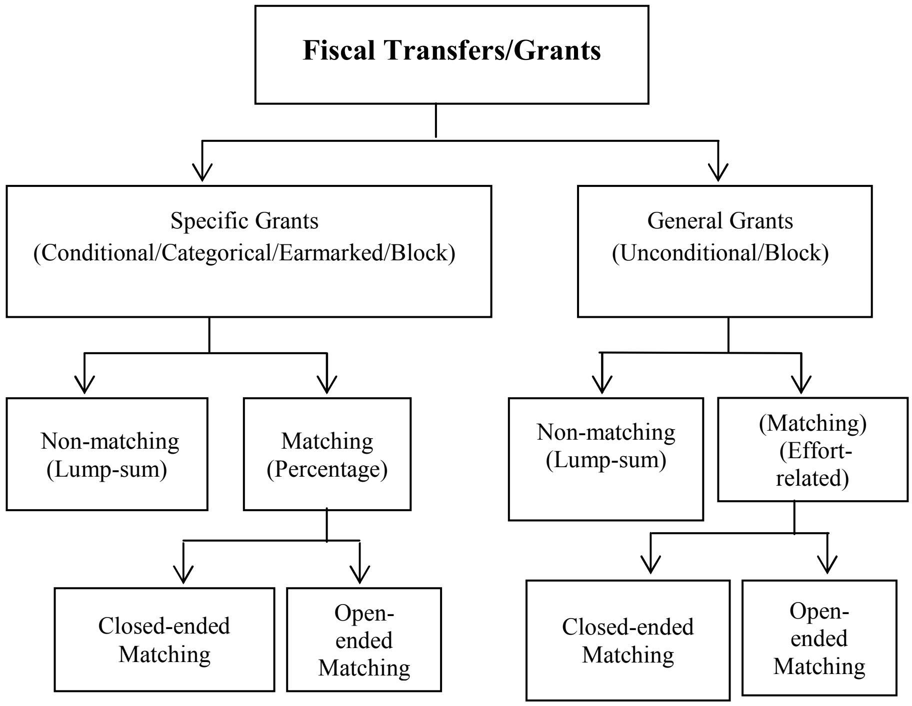
b = Coefficient of expenditure need variables.

Table-1: Expenditure Needs Variables and their Weight (%)

Particulars	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: Local Bodies Fiscal Commission, 2015.

Flowchart-1: Classification of Fiscal Transfers (Grants)



Source: Dafflon, 2012.

CONDITIONAL AND UNCONDITIONAL GRANT

Another method of transferring revenues to the lower layers of government in a federation is the system of grants used very widely in almost all federations. This method is used to accomplish various inter-governmental objectives as well, besides being a balancing factor (Tripathy, 1978: 186).

Three types of grants may be distinguished:

(1) Grants may be general (also called block grant or unconditional grant) or selective (also called restricted, categorical or conditional).

(2) Grants may be matching or non-matching.

(3) Grants may or may not be related to the fiscal needs of the recipients.

The inter-governmental transfers are of two primary types: the conditional and the unconditional transfer in both theory and practice.

Conditional

A conditional transfer (grant) from a federal government to sub-national government or local government involves a certain set of conditions and rules. If the lower strata of the government are to receive this type of transfer, it is compulsory to agree to the spending instructions of the federal government.

A matching grant is one, which matches the lower government's expenditure on some specific good or goods.

When there is ceiling on the total amount of matching grant, it is a **closed-ended matching grant.**

A grant that is earmarked for a particular use is called an earmarked or a specific or non-matching grant. Often a higher-level government gives earmarked grants to lower governments.

Unconditional

The second type of grant (transfer), unconditional, is usually a cash or tax point transfer, with no spending instructions. An example of this would be federal equalization transfer (Bhurtel, 2009).

An unconditional grant is one, which a higher government gives to a lower government without imposing any conditions regarding how it should be used.

It is just like a transfer income received by the community from the higher level of government. The lower government, being representative of the members of the community, spends it in such a manner that the community's social welfare is maximized.

Conditional grants can be of two types: non-matching where the recipient should not deposit counterpart money and matching (earmarked or specific) grant where the counterpart money is needed.

Unconditional grants and conditional grants are the grants provided to local bodies at different levels. Amongst them, the unconditional grants are allotted based on formula. Grants channeled from the center to local bodies can be observed in grants allotted to VDCs, DDCs, and municipalities (NEA, 2009: 60).

SUB-NATIONAL BORROWING

Borrowing in sub-national level would be for capital expenditure only in federal structure. Sub-national level-especially the province and local governments would be given the right of borrowing but only from within the country. International lending, if necessary to sub-national level, would be allowed in condition of permission from the centre in advance.

FISCAL ISSUES

FISCAL IMBALANCE

With the different roles of different tiers of the government on expenditure and revenue, it is possible that there will be monetary imbalance among different levels of the government. For example, federal government may generate more revenue but spend less while state level governments may generate less but spend more and vice-versa. Similarly, among the states, some states may be more needy but generate less while others may require less but generate more revenue. **These types of imbalances are known as fiscal imbalance** (NEA, 2009).The lack of symmetry between the tax powers and the expenditure responsibilities of sub-national governments result in fiscal imbalances (Singh, 2014: 408).

Lack of adequate funds at the local level creates a problem known as fiscal gap. Fiscal imbalance is also called sometimes fiscal gap.

In a federation, provision of revenue assignment has to be decentralized, but most of the tax powers have to be vested in the center. This will obviously lead to considerable fiscal imbalance between the center and the states. The levels of vertical and horizontal fiscal imbalances are key issues in the fiscal federalism.

There are two types of fiscal imbalance:

(a) Vertical Fiscal Imbalance

Tax powers are concentrated in the center. But functions are more or less evenly distributed between the center and the states. This has created substantial vertical fiscal imbalance i.e., imbalance between the center and the states in respect of their incomes relative to needs.

Vertical fiscal imbalance is concerned with the question "How is any imbalance between expenditure and revenue at different levels of government resolved?" This deals with the provision of central grants to local governments.

Vertical fiscal imbalance refers to surplus resources relative to responsibilities with one tier of government, usually the Central Government and corresponding deficiencies of resources relative to responsibilities at the lower tiers government, i.e., provincial and local governments.

Vertical fiscal imbalance refers to a gap between revenue sources and spending responsibilities between the federal governments.

The center has much larger amount of tax collection than what it needs to provide the revenue resources that it has to provide, while the states or the lower bodies have in their command much less resources than what they need for providing the revenue resource that they should provide. This imbalance is referred to as vertical fiscal imbalance. This problem is removed through transfers of incomes from the center to the lower level governments. These transfers are called grants.

Lane (1968) states that "In a multi-level government, vertical fiscal imbalance refers to a situation in which the division of revenue sources and expenditure functions between the federal government is insignificant".

(b) Horizontal Fiscal Imbalance

Horizontal fiscal imbalance means fiscal imbalance among states and also among local bodies within a state.

Horizontal fiscal imbalance refers to the differences in the ability of provinces/territories to raise revenues to meet the needs (expenditures) of their citizens. This type of imbalance is referred to as the existence of economic inequalities between the states. Horizontal fiscal equity in a federation seeks to achieve inter-personal equality in tax payment among the different states.

Horizontal fiscal imbalance refers to imbalances in fiscal capacities at the same tier of government i.e., differences at the provincial level or differences at the level of local bodies.

Horizontal fiscal imbalance is concerned with reducing or removing differences in need and capacity at the same level of government.

Vertical imbalance and horizontal imbalance together are known as the issue of inter-governmental fiscal transfers.

The concepts of fiscal federalism are related to vertical and horizontal fiscal balance in federation. The nations related to horizontal fiscal system are related to regional imbalance and horizontal computational. Similarly, the vertical fiscal systems are related to vertical fiscal imbalance between two senior levels of government that are the central and the states. The concept of horizontal fiscal imbalance is relatively non-controversial. The concept of vertical fiscal imbalance is quite controversial.

While vertical fiscal imbalance refers to imbalance between two tiers of government, horizontal imbalance refers to imbalances at the same level of government, i.e., with respect to provinces or the local governments.

CORRECTIVE MEASURES OF FISCAL IMBALANCE

Some corrective measures of fiscal imbalance are as follows:

(a) Fiscal Commissions (FCs) Transfers

The FCs practice of filling up the gap between projected revenue need and fiscal capacity of a state with tax devolution and grants- in – aid is referred to as **gap filling.**

(b) National Planning Commission (NPC) Transfers

Another source of central funds to the states is the National Planning Commission (NPC) which was set up by the central government to implement Five Year Plans and one year development budget.

(c) Central Ministry (Ministry of Finance) Transfer

The central ministry transfers constitute the third source of central funds to the states. The central ministries make transfers to their counterparts in the states for specific projects, which may be wholly funded by the center or by both the center and the state.

(d) Inter-governmental Loans

Another key source of central funds to the states is the inter-governmental loans. States get loans from the center at subsidized rates.

(e) Rural/Urban Local Bodies

Given the functions and tax powers assigned to the local bodies, there also exists considerable vertical imbalance between the state and its local bodies.

FISCAL INSTITUTIONS

Although there is a guideline given by economic theory for assigning role for expenditure and revenue generation along with guidelines for grant design, there is no uniformity among different nations towards these responsibilities. It may be due to the difference in social, political, cultural, geographical, economical and other characteristics.

Fiscal institutions are those types of institutions which distribute or share the inter-governmental fiscal grant or transfer from central government to state or local level government rationally either by vertical or horizontal way.

Each level of government has its own fiscal institution. Fiscal institutions established or licensed or chartered from Central Government may be classified as central level fiscal institutions and those charted or licensed from state level Government may be classified as state level fiscal institutions.

FISCAL TRANSFERS: ROLE OF FISCAL INSTITUTIONS

The Committee on Division of Natural Resources, Financial Rights and Revenue Sharing has recommended the setting up of a National Natural Resources and Fiscal Commission (NNRFC) to oversee the system of fiscal transfers in federal Nepal. It is important for the NNRFC to consider the constitution, duties, responsibilities, technical support, and coordination with other institutions. Suitable ideas can be derived taking into account the international experience in this regard.

There have not been any major controversies regarding the establishment of a National Natural Resources and Fiscal Commission (NNRFC) that were recommended by the Constituent Assembly Committee on Natural Resources, Financial Rights and Revenue Sharing.

COORDINATION BY NATIONAL NATURAL RESOURCES AND FISCAL COMMISSION (NNRFC)

NNRFC would deal with issues of vertical and horizontal imbalances. The recommendation of the NNRFC regarding access to non-tax revenues may have significant implications for the determination of shares in central taxes and grants by the NNRFC for determining equalization transfers. A useful mechanism for the two Commissions would be to have a common member and to have provisions for joint meetings.

MANAGING NATURAL RESOURCES CONFLICT

The demand for federation and autonomy arises at times from the real or perceived unequal distribution of resources, including natural resources. And there is no guarantee that the federal arrangement howsoever conceived will automatically militate against such conflict arising in the course of provincial and national governance.

In Nepal, where water and, to some extent, forests are the most prominent natural resources with significant economic and social values, the assignment of authority and responsibility for their uses and the distribution of accrued benefit is of critical importance. For this reason also, the criteria defining the boundaries of constituent states should be as broad as possible with the resource endowments of various regions enhancing the possibility of fair distribution of potential benefits from their uses. Both resources are critical economically and from the standpoint of environment. In all probabilities, the latter subject will remain in the central government sphere. Apart from the issues of economy, including the royalties involved, and the trade-offs, social issues, such as the water rights of the local population, can emerge in the course of the development of one project or another.

MODEL OF ECONOMIC RIGHTS AND REVENUE ALLOCATION IN THE NEW CONSTITUTION

The Federal Democratic Republic Constitution of Nepal 2015 has provided the model of fiscal federalism based on the recommendations presented by the Committee on Natural Resources, Economic Rights and Revenue Allocation.

The Constitution of Nepal 2015 has provided the following responsibilities of the allocation of revenue among the different level of government.

Table-2: Situation of 7 Provinces

Province No.	*Population/ (Percent)	Area (sq. km.)/ (Percent)	Human Development Index **	Per Capita Income (in US $)***	Population not to be Reached Drinking Water Facility (%) **	Production of Agriculture Sector (Index) ***	Local Income (in %)ø	Fiscal Distribution (in %)ø	Central Revenue Collection (in %)ø	Key Road (%)ø	Local Road (%)ø
One	4,534,943 (17.12)	25,905 (17.60)	0.500	1,211	17.77	0.216	8.63	32.95	8.63	17.99	15.47
Two	5,404,145 (20.40)	9,661 (6.56)	0.422	967	7.52	0.259	30.12	10.69	30.12	10.84	13.97
Three	5,529,452 (20.87)	20,300 (13.79)	0.506	1,357	21.06	0.297	48.76	19.63	48.76	19.05	25.89
Four	3,112,587 (11.75)	24,951 (16.95)	0.506	1,277	15.19	0.146	1.08	20.84	1.08	16.33	21.29
Five	4,083,985 (15.41)	17,852 (12.13)	0.455	948	16.60	0.247	10.23	9.99	10.23	16.09	14.75
Six	1,276,875 (4.82)	28,973 (19.66)	0.409	808	32.70	0.077	0.12	3.00	0.12	8.45	2.97
Seven	2,552,517 (9.63)	19,539 (13.20)	0.416	663	25.87	0.135	1.05	2.89	1.05	11.25	5.65

Source: *CBS (2011).

** Nepal Human Development Report (2014)

***Economic Survey (2014/15)

ø Economic Survey (2013/14)

Table-3: Federal Structure of Nepal- Key Demographic and Economic Particulars of the Seven States

Particulars	STATE 1	STATE 2	STATE 3	STATE 4	STATE 5	STATE 6	STATE 7
Population	4,534,943	5,404,145	5,529,452	3,112,587	4,083,985	1,276,875	2,552,517
Land Area (in sq. km.)	25,905	9,661	20,300	24,951	17,852	28,973	19,539
Human Development Index (HDI)	0.500	0.422	0.506	0.506	0.455	0.409	0.416
Per Capita Index	0.216	0.258	0.297	0.146	0.247	0.077	0.135
Per Capita Income (US $)	663	808	943	1,277	1,357	967	1,211
Local Taxation (%)	15.39	11.40	29.14	13.52	22.44	1.38	6.73
Revenue Sharing (%)	32.95	10.69	19.73	20.84	9.90	3.00	2.89

Source:

HDI= Nepal Human Development Report 2014

Population = Census Report 2011

Per Capita Income = Nepal Human Development Report 2014

Revenue (Central): Ministry of Finance; (Local) = Local Bodies Fiscal Commission.

This table highlights the key demographic and economic particulars of the seven states. These snapshots taken into account state indices such as population, geographical area, the Human Development Index, per capita income, revenues, etc.

CONCLUSION AND RECOMMENDATIONS

The Federal Democratic Republic of Constitution of 2015 has many positive aspects on the issues of Natural Resources, Economic Rights and Revenue Allocation. However, some provisions seem to be incompatible with the global fiscal federalism practices.

The major sources of revenue custom duty, value added tax (VAT), corporate income tax, excise duty and personal income tax, which comprise around 80 percent of total tax revenue, are assigned to be collected by the central government. The service charges, punishment and fines and tourism charges are assigned to be collected concurrently by all three levels of government. In this modality, around 90 percent of total tax revenue will be under the jurisdiction of the central government. The custom duties by nature have to be collected by the federal government. Therefore, VAT and income taxes will have to be collected concurrently at both the central and sub-national governments which will support the expenditure responsibilities of the sub-national governments adequately.

The Constitution has provisioned the National Natural Resources and Fiscal Commission (NNRFC) at Federal level to manage natural resources conflicts and grants provided to the state and local governments. However, a three-tier institutional set-up may be useful, for which constitutional provisioning is needed. A Federal Fiscal Commission (FFC) and the National Planning Commission will have to be constituted at the central level to make national level development plans and to make recommendations for additional grants and loans. A State Planning Commission (SPC) and a State Fiscal Commission can be established in each state to prepare state development plans and to deal with the transfers to be made to local bodies.

Box-1: Area of Rights of Local Governments

- Municipality police
- Cooperative societies
- Managing FM radio
- Local tax
- Local service management
- Local statistics and records
- Local development agencies and projects

- Basic and secondary education
- Basic health and sanitation
- Market management, environmental conservation and biodiversity
- Local roads and irrigation
- Village, municipality district council/local court/harmony/ mediation
- Local records management
- Distribution of land ownership certificate
- Agriculture, animal husbandry and cooperatives
- Elderly citizens, crippled and disabled
- Data collection of unemployment
- Agriculture publicity
- Watershed, wildlife management, mines and minerals,
- Language, culture conservation and development

Box-2: Bases of Re-structuring of Local Level

- Population
- Maximum number
- Number of ward and size of population
- Geography and area
- Caste, linguistic-cultural denseness
- Market center, and closeness of infrastructures
- Geographical continuity and cluster
- Natural resources
- Income and educational infrastructures
- Urban infrastructures (in contexts of municipality)
- Base of name and center

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