

(Unofficial Translation)



National Natural Resources and Fiscal Commission

Recommendations on the Revenue Distribution from Federal Government to the Provincial and Local Governments for the Fiscal Year 2018/19

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Singh Durbar, Kathmandu

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1. Background:

The constitution of Nepal has made several provisions for equitable distribution of resources among the federal, provincial and local level entities considering inter-governmental fiscal transfer as one of the significant component of fiscal federalism. The expenditure and revenue assignments, the important element of fiscal federalism, of the federal, provincial and local level have been clearly mentioned in the schedules of the Constitution. As per the constitutional provisions, the subjects such as defence, foreign affairs, international relation, national standards, and central infrastructures are under the jurisdiction of federation; the matters related provincial administration, province level infrastructure, agriculture, land management fall under provincial jurisdiction and the subjects like local service management, primary education, primary health, agriculture and livestock and infrastructure for local services are the responsibilities of the local level. Some of the subjects are under the common jurisdiction of the federal, provincial and local level. Similarly, the federal, provincial and local levels also follow the state policies and guiding principles mentioned in the constitution while performing their functions. While provinces have significant role in development activities, the local levels act as important mechanism of service delivery.

The Constitution has made provisions regarding the distribution of revenue assignments among the federal, provincial and local level entities. Though some revenue assignments have been constitutionally devolved to the local level and the province level, most of the revenue assignments remain in the central government. The taxes such as custom duty, excise duty, Value Added Tax (VAT) and income tax are in the jurisdiction of the federal government while the house and land registration fee, Motor vehicle tax, Agro- income tax and local tax are transferred to the provincial and local governments.

There remains clear fiscal gap at province and local level as they have to deliver services which require greater cost in comparison to their revenue mobilization. Hence, the government of Nepal has to provide the fiscal transfer and revenue sharing to the province and local level to fulfil such gaps. The three tiers of government have to play a significant role for providing broader public services such as education, health and infrastructure development. It is also the responsibility of the central government to maintain the quality of the services delivered by the province and local level entities. In the same way, the Government of Nepal may need to mobilize the province and local levels for implementing the comprehensive national policies and programs. Therefore, there is the provision of revenue distribution, fiscal equalization grant and conditional grant to address the responsibilities of province and local level such as service delivery and development; and to implement the central policies and programs from these levels.

2. Constitutional and legal provisions

(a) Constitutional provisions:

The Constitution of Nepal has made following provisions related to the inter-governmental fiscal management:

- Article 60 Clauses (3): The amount of fiscal transfers the province and local level entities are to receive shall be as recommended by the National Natural Resources and Fiscal Commission(NNRFC)
- Article 60 Clause (8): while distributing the revenue, the matters such as national policy; national needs; the autonomy of provinces an local level entities; the service delivery of the provinces and local entities and the fiscal rights given to them; their capacity to generate revenue; feasibility and use of revenues; their contribution to development works; regional imbalance; poverty and inequality; exclusion, emergency works and support to meet temporary needs to be considered.
- Article 251 Clause (1): It shall be the function of NNRFC to determine the extensive grounds and measures, regarding the distribution of revenue from the federal consolidated fund to the federal, provincial and local level entities.

(b) National Natural Resources and Fiscal Commission Act 2017:

The National Natural Resources and Fiscal Commission Act 2017 has been formulated to provide necessary arrangements regarding the functions, duties and powers of the Commission as per the provisions of Article 250 and 251 of the Constitution. This Act has provided the following criteria and framework for recommending the revenue distribution.

- Population and demographic factors
- Area
- Human Development Index
- Expenditure needs
- Revenue collections efforts
- Infrastructure development
- Special situation

(c) Inter- governmental Fiscal Management Act 2017:

Intergovernmental Fiscal Management Act 2017 has been enacted and implemented with the objective of managing the matters related to revenue rights, revenue sharing, budget management, public expenditure and fiscal discipline among the federal, provincial and local level entities. This Act has basically included the issues such as revenue and expenditure responsibilities, inter-governmental fiscal transfers, internal loan that can be taken by province and local entities as the important elements of fiscal federalism.

Further, to establish the ownership of taxpayers over the tax paid, the Act has provisioned to distribute the amount collected from Value Added Tax (VAT) and Excise duty in the ratio of 70 percent, 15 percent and 15 percent respectively to the federal, province and local level entities.

3. Methodology adopted by the NNRFC to recommend for revenue sharing and fiscal equalization grant for the F.Y. 2018/19

An independent constitutional body has been established to ensure transparent, just and balanced fiscal transfer among the different levels of governments. The NNRFC has adopted the following methodology to recommend the bases and framework of revenue sharing and fiscal equalization grants.

- Met the criteria enshrined in the National Natural Resources and Fiscal Commission Act 2017 and Inter-Governmental Fiscal Management Act 2017
- Developed different indices using proxy values where disaggregated data were not available
- Studied and analysed the data received from the local level entities
- Sample data, representing the different geographical regions; categories of province and local entities; intensity of settlement; collected to validate the used data
- Conducted studies to estimate service delivery cost, to evaluate socio-economic discrimination and to assess the capacity of local governments.
- Interaction with Ministers, Chief Secretary as well as Secretaries of the provinces
- Estimated expenditure needs based on minimum expenditure and infrastructure development needs of different levels of government
- Revenue projection based on revenue rights, information received from local level as well as the secretariat of Local Body Fiscal Commission
- Developed the following indices
 - **Human Development Index**- Human Development Index (HDI) of the province and local level has been prepared on the basis HDI of geographical regions, rural –urban area and district level since National Census 2011 and Nepal Human Development Report 2014 have provided HDI at district level only.
 - **Human Poverty Index** - Human Poverty Index (HPI) of province and local level has been prepared on the basis HDI of geographical regions, rural –urban area and district level since National Census 2011 and Nepal Human Development Report 2014 have provided HDI at district level only.
 - **Infrastructure Index** – Infrastructure index has been prepared based on connectivity related aspects such as road, electricity and access to information technology. For

this purpose, the density of road network, population benefited from the electricity services and access to information and communication technology in province and local level are considered. These three sectors are given different weightage while developing the infrastructure index of province and local level. In case of province, 80 percent weightage is given to the road network as it has greater influence in infrastructure development. Similarly, availability of electricity and access to information and communication technology are given 10 percent weightage each.

As the area of local level is smaller than that of province, all the three aspects highly influence the development as well as service delivery cost. Therefore, the infrastructure index of the local level is developed by giving 50 percent weightage to the road density, 30 percent to availability of electricity and 20 percent to access to information and communication technology.

- **Socio-economic Discrimination (Disparity) index-** Disparity Index was developed based on available economic, social and climate change vulnerability data. For this purpose, economic discrimination factors, social discrimination factors and climate change vulnerability of the province and local level were given the weightage of 50 percent, 45 percent and 5 percent respectively. Poverty, dependent population, status of infrastructure development has been considered as representative indicators of economic discrimination in the province and local level. In the same way, the caste and ethnic factors, population ratio of persons with disability, adult and female literacy, and access to safe drinking water supply have been considered as the indicators of social discrimination. The data received from CBS and other governmental agencies as well as findings of the studies conducted by this Commission have been used as an important basis for this purpose.
 - **Underdevelopment Index-** The development index of province and local level plays important role to measure status of balanced development. The underdevelopment index of all provinces and local levels has been developed to measure the status of balanced development of the province and local level as provisioned in NNRFC Act 2017. While preparing this index, the weightage was given as 70 percent for infrastructure development, 20 percent for service delivery cost and 10 percent for socio-economic discrimination. For this purpose, the data received from CBS and other government agencies as well as the studies conducted by NNRFC have been considered.
- While preparing the indices, data were made more realistic by using arithmetic mean for province level and geometric mean for local level, as the number of provinces were less while that of local level were more.
 - Developed required composite indices based on different indices developed by the Commission

4. Bases considered to recommend the framework (formula) of revenue sharing for the F.Y. 2018/19

In line with the above mentioned Constitutional and legal provisions, recommendations are made regarding the revenue distribution from the Government of Nepal to the province and local level governments. The section 21 subsection 4 of the Inter-Governmental Fiscal Management Act 2017 provisioned that the province and local governments have to limit their administrative expenditure within amount received from revenue distribution and their internal income; section 23 subsection 4 of the same Act mentioned that deficit budget cannot be prepared for administrative expenditures. Hence, minimum amount of revenue distribution has also been recommended for the province and local governments.

The extensive grounds and measures regarding the distribution of revenue for the fiscal year 2018/19 was determined based on the following measures/bases:

(a) Population and demographic factors (70 percent)

The features such as population and ratio of dependent population affect the size of legislative and government of province and local level which in turn influences the administrative expenses of these levels. The increase in population increases the scope of service delivery, the operational cost and this ultimately affects the service delivery cost. Therefore, 70 percent weightage has been given for the population and demographic factors. Out of the weightage given to population, 80 percent weightage is given to total population and 20 percent weightage to ratio of dependant population. The population data was sourced from National Census 2011.

(b) Area (15 percent)

The expenditure needs of province and local levels are influenced by their area. Geographical factor not only increases the service delivery cost but also raises the operational cost significantly. Due to this reason, 15 percent weightage is given to the area of the province and local level.

(c) Human Development Index (5 percent)

The amount received from distribution of revenue is basically used for the administrative expenses. However, the province and local level entities have to accomplish the constitutional obligation related to human development as well. Therefore, 5 percent weightage has been given to the HDI of the province and local level.

(d) Under Development Index (10 percent)

The Underdevelopment Index has been given 10 percent weightage in order to address the expenditure needs and development status of province and local level entities

(e) Minimum amount received in Revenue distribution

A minimum threshold of NRs. 30 million is ensured for each local level through revenue distribution, as the internal revenue source and the amount provided on the above basis may not be adequate

enough to address the administrative expenses of some local level entities. The province and local governments receive equal percent from the revenue collected in the form of VAT and Excise duty levied on internal production. In the case of province level, as the number of province being less than that of the local level, the minimum amount is not recommended assuming that the amount received through the revenue distribution will be adequate to address their administrative expenses.

5. Limitations while providing recommendations on revenue sharing and fiscal equalization grants

- Since the members of the Commission are not appointed yet, the basis for the revenue distribution and fiscal equalization grants has been prepared by the bureaucratic level.
- Almost all the legal criteria were addressed while formulating the basis of resource estimation; some proxy values were also used due to unavailability of basic data (such as Underdevelopment Index used for estimating the expenditure needs)
- Information about the programs, project and activities formerly implemented by different ministries which are to be transferred to the province and local level were not sufficiently available in spite of series of discussion, interaction and correspondence
- The measures of revenue distribution and fiscal equalization grant have to be prepared in short time after the establishment of the Commission.
