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Theoretical Review on Intergovernmental Fiscal Transfer in Nepal

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Abstract
The history of intergovernmental fiscal transfer begins with the conception of transfer, fiscal redistribution, and equal welfare system according to Constitution 2072. Nepal is Federal state. According to this structure, Intergovernmental fiscal transfer system promotes the co-ordination and cooperation between central and local level government and ensure the revenue for expenditure in development. In various kinds of political period, anyway, there was fiscal transfer system in state as vertical or symmetrical between state to state, central to local, local to central government. The fundamental objective of this article is to analyze the different perspectives and theoretical arguments of intergovernmental fiscal transfer relating to government policies. Intergovernmental fiscal transfer is meant to bridge the horizontal and vertical fiscal imbalances that are inevitable to exist between the federal and regional governments and among the regional governments. Intergovernmental fiscal transfer is guided by principle and theory of fiscal federalism (1st generation and 2nd generation). Accordingly, this article examines current theories and concept, methodologies, including debate and issues of fiscal transfer system.

Keywords: Intergovernmental, fiscal, transfer, theoretical, expenditure, development

1. Introduction

Intergovernmental fiscal transfer is needed to fulfill the resources for each level of government. It promotes the co-ordination and co-operation between central and local level government and ensure the revenue for expenditure in development. For the good public service delivery, fiscal transfer system plays the important role and makes responsive /accountable government. As fiscal function, there may necessarily be relation between expenditure assignment and tax assignment. Revenue sharing, grants transforming otherwise called intergovernmental transfers from higher to lower-level governments have, therefore, formed a part of fiscal arrangements in multilevel governments. The structure of these transfers is equally important for efficiency and equity in local public service arrangement. The circumstance and objective is differing from country to country not uniform pattern of transfer universally. In various kinds of political period, anyway, there was fiscal transfer system in state as vertical or symmetrical between state to state, central to local, local to centralgovernment. Without fiscal transfer, there is difficult to achieve fiscal balance at sub national level. It is an important component of fiscal federalism. It was coined with starting of sub-national level of government. In all of country, any kinds of fiscal transfer system is needed. Federal or unitary system, there is any kinds of fiscal transfer. It is linked with the origin and use of ruling power. There are various kinds of theories as like good governance equity, effective public service are the theoretical base of IFT.

This article is about the theoretical aspect of intergovernmental fiscal transfer (IGFT) in Nepal. This article helps understand: (i) The factors determining the optimal degree of fiscal decentralization; (ii) principles underlining the assignment of functions and sources of finance of governments of different vertical levels; and (iii) to design suitable inter-governmental transfer schemes to fulfill the objectives of 'equity' and 'efficiency'.

2. Objectives and Methodology

Primarily, this article assesses the theoretical and conceptual issues of Intergovernmental fiscal transfer (IGFT). The fundamental objective of this article is to analyze the different perspectives and theoretical arguments of IGFT relating to government policies.

The broader understanding of the existing global, regional, and national scenario of Intergovernmental fiscal transfer and its implications shapes the discourse of all levels of development plans and policies as well. Different theories relating to federalism

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as well **as** first-generation theories are assessed critically to know the essence of IGFT and Fiscal federalism in the global context as well.

This article is fully based on the systematic review of secondary literature published in journals, books, reports, and other academic publications. It has applied the qualitative method to assess the IGFT. The arguments developed in this article are based on the critical approach mainly dealing with the IGFT. The article is analytical and descriptive.

3. Research Gap

Intergovernmental fiscal transfer (IGFT) is an important element of federalism.IGFT system promotes to federalism. Although theories, constitutions, laws, and so many criteria have guided to intergovernmental fiscal transfer. It is difficult to implement because the following issues are in intergovernmental fiscal transfer system. All level of government has made budget without medium-term budget planning. A sizeable increase in the consolidated government's budget envelope and the lack of realistic medium-term fiscal framework.

In this situation it will not be fiscal sustainability, will be increasing budget deficit and rising public debt

The heavy reliance of the sub-national governments on shared revenues and transfers from the center has put pressures on the fiscal balance. Budget is not exceptionally high, but the share of the sub-national governments' own source revenue in their total revenue is very low. Cross-country experience suggests that large Vertical fiscal imbalance(VFIs) are associated with worse fiscal performance, in terms of general government balance, as it could relax the fiscal discipline of subnational governments (Eyraud and Lusinyan, 2011).

More specifically, sub-national governments' dependency on shared revenues and transfers from the center may create incentive problems. The provincial and local governments face little incentive to raise revenue to finance their spending.

Local authorities may fail to fully internalize the cost of local spending when they can finance their marginal expenditure with central transfers that are funded by taxpayers in other jurisdictions; therefore, this behaviour can lead to overspending, relaxation of tax collection, low revenue, and weakening of fiscal balance (Sow and Razafimahefa, 2017).

Cross-Country Subnational Government Operations Fiscal decentralization may impede the conduct and effectiveness of fiscal policy. If a large share of taxes and spending is shifted to subnational governments, the central government's fiscal policy levers become less powerful. This could be an important issue given also that policy priorities often differ across government levels.

Ter-Minassian (1997) noted that revenue-sharing arrangements on a tax-by-tax basis with fixed distribution coefficients like in Nepal tends to make fiscal policy more pro-cyclical: increases in shared revenues during a boom period increase the availability of resources for sub-national governments, and vice versa. This will tend to limit the ability of the central government to conduct counter-cyclical stabilization policies.

Razafimahefa(2017) found fiscal decentralization to be associated with increased fiscal policy pro-cyclicality or reduced counter-cyclicality, thus suggesting that fiscal decentralization has a destabilizing effect on fiscal policy. This issue deserves attention in Nepal where fiscal policy in recent years tended to be pro-cyclical, and decentralization could further reduce the effectiveness of fiscal policies going forward.

Rapid devolvement of spending responsibilities and augmentation of resources to subnational governments could stretch the capacity at subnational levels, therefore limiting allocate efficiency gains.

Decentralization of expenditure responsibilities could lead to allocative efficiency gains, for example by allowing for better alignment of expenditure priorities with preferences of citizens. However, these gains may be negated in practice by administrative weaknesses and the lack of capacity at the subnational level (Ter-Minassian, 1997).

In the case of Nepal, rapid federalization carries the risk of disruption of public services. This could be exacerbated in case roles and responsibilities across the three levels of governments are not clearly defined.

Subnational governments appear to have limited implementation capacity to fully utilize their resources. A substantial share of the resources transferred to provincial and local governments is often kept in government deposit accounts, as evidenced by a surge of government deposits during the fiscal year.

The absence of well-developed public financial management systems at the subnational levels, including expenditure reporting and control systems could raise the risk of misallocation and waste (Ahmad et al, 2006).

Framework and Institutional Design Issue (FIDI)is as yet unclear to what extent the current fiscal transfers and revenue-sharing will align with subnational governments' actual cost of public service delivery.

In principle, the design of revenue sharing and grants to subnational governments in Nepal appears to be broadly in line with practices in other countries. Nevertheless, the expected cost of service delivery remains unknown, as a comprehensive costing of subnational governments' expenditure assignments has not yet been completed.

There is a need to review and refine subnational governments' budget envelopes to bring them in line with the expected cost of service delivery. Gaps in the existing framework remain to be filled.

The framework for internal borrowing will need to be developed, with the criteria and borrowing limits to be set effectively. Cross-country experiences suggest such conditions will be crucial to

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enforce fiscal discipline and mitigate macrofiscal risks arising from subnational levels.

Political will and orientation, Provincial arrangement and designing all the system including administrative set-up, Jurisdictional clarity and concurrent list implementation, Transitional Management (Political, administrative, and planning), Economics of scale and service delivery, and sectoral coordination and ownership are the issues of intergovernmental fiscal transfer in Nepal.

4. Conceptual and Theoretical Review

Different theories argue about the essence of IGFT in governance in different political, social, and economic contexts. However, there is no solid specific theory that completely deals with the multiple dimensions and implications of IGFT in governance. [1]Meanwhile, classical theory, decentralization theory, economic theory, federalism theory, and participation theory provide fundamental theoretical grounds to study and investigate the issues of intergovernmental fiscal transfer and federalism from different perspectives. Intergovernmental fiscal transfer has been made research subject now.

As per UNDP (1999), there are four models (direct, privatization, decentralization, and public-private partnership as an alternative) applying by local government throughout the world from public service delivery perspective. For better system it depends on a number of variables such as appropriate constitutional and legal framework, sufficient and competence human resources, adequate financial resources, accountability, and transparency, ensuring the easy access to community for information and services, mutual understanding between central and lower level of governments.

Whether in unitary countries or federal countries, revenue-raising powers are often centralized. In fact, fiscal transfers are the means to address the vertical fiscal imbalance stemming from centralized revenue-raising rights. In some countries, fiscal transfers are provided for in the constitution, while in others, they are provisioned for through other legal acts. The issue of determining the proper criteria for fiscal transfers, be it constitutional or legal, is very complex. In fact, the necessary condition of the fiscal transfer system is that it should address fiscal needs and be technically sound. Similarly, it must be politically acceptable.

a. Evolution of IGFT

The history of intergovernmental fiscal transfer begins with the conception of transfer, fiscal redistribution, and equal welfare system. In 1928, the economist Pigou first revealed this concept (a study in Public Finance,1928). It was developed as an important component of fiscal federalism with the "mainline" theory of fiscal federalism which that was solidly embedded in the view of public finance that prevailed in the 1950's and 1960's. Three major figures played a key role in defining this perspective on the public sector: Kenneth Arrow, Richard Musgrave (1959), and Paul Samuelson (1954, 1955). In particular, Samuelson's famous two articles on the nature of public goods, Arrow's conceptualization (e.g., 1970) of the roles of the private and public sectors, and Musgrave's monumental volume (1959) on public finance set forth an active and positive role for the government sector in terms of correcting various forms of market failure, establishing an equitable distribution of income, and stabilizing the macro-economy at high levels of employment with stable prices in a basically Keynesian framework (Rao and Singh, 2005).

American economist Richard Musgrave defined fiscal federalism and mentioned intergovernmental fiscal transfer as main element of federalism. India, China, England, and other countries of world took seriously to IGFT in their governance for effectiveness of public service delivery.

b. Meaning and Definitions of IGFT

The term "transfer" is often used interchangeably with the term "grant". In some countries, transfer may also be known under different names, such as "subventions" or "subside". IGFT means transfer of grant and revenue from one level of government to another level of government(often higher to lower) (Oates, 1972). In addition, IGFT is a kind of transition of fiscal revenues between the central and sub-national government (Musgrave 1959). International experiment indicates that the IGFT system impacts the equity and the efficiency of the whole fiscal system in many areas(Oates, 1972).IGFT is meant to bridge the horizontal and vertical fiscal imbalances that are inevitable to exist between the federal and regional governments and among the regional governments (Oates, 2005).

Once we have ascertained that the possibility of horizontal and vertical fiscal imbalance is inevitable, there has to be a mechanism devised to bridge the fiscal gaps that occur between the federal and state governments or among the latter. Such gaps can be mitigated through a transfer of a predetermined share of, in most cases, the revenues collected by the federal government. It is at this juncture that the issue of IGFT is raised. Different scholars of fiscal federalism propagated that these fiscal imbalances have to be rectified by devising different means.

Broadway and Shah (2007) contended that there are two broad ways through which fiscal gaps are rectified. The first is revenue sharing while the second falls under the general rubric of federal-state transfers. Revenue sharing and grants (transfers) are therefore the two main means through which fiscal imbalances are handled. Intergovernmental fiscal transfer is, therefore, an allocation by the federal government as a means of bridging the fiscal imbalances (vertical or horizontal). IGFTs involve two main decisions: the federal government needs to decide on the aggregate pool of federal grants and the pool has to be distributed among the respective lower sub-national governments. The federal government may use different parameters both to decide on the aggregate pool and the amount that is going to be distributed to sub-national governments.

In Nepal, IGFTs are used as a means of bridging the vertical and horizontal fiscal imbalances and the Nepal fiscal equalization system provides for four steps. But IGFTs are used to ensure that revenues roughly match the expenditure needs of various levels of sub-national governments. The structure of these transfers creates

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incentives for federal, provincial and local governments that affect fiscal management, macroeconomic stability, distributional equity, allocation efficiency, and public service delivery.

On the other hand, IGFTs are the dominant source of revenues for sub-national governments in most developing and transition economies. These transfers come in a variety of forms unconditional or conditional. Unconditional transfers come simply as a budget support with no strings attached. Conditional transfers typically specify the type of Expenditures that can be financed. IGFTs as the system through which most countries achieve vertical fiscal balance, that is, ensure that the revenues and expenditures of each level of government are approximately equal. Fiscal transfers to local governments are direct financial allocations from the federal government or state government to the local government.

Financial federalism is the decentralization of economic rights. Intergovernmental financial transfers are one of the four pillars of fiscal federalism. The role that IGFTs play in strengthening fiscal federalism can be summarized as follows:

- To provide the necessary financial resources to the government close to the people to implement the rights,
- To create an environment of cooperation, coexistence, and coordination between the federal, state, and local levels,
- To make the federal government free to exercise its powers within its jurisdiction as a concept of financial federalism.
- To enable local governments to identify and mobilize the resources needed to identify and mobilize internal resources,
- To bridge the gap between local needs and the resources to meet them,
- To manage the necessary funds for the projects of pride under the responsibility of the federal government,
- To eliminate regional inequality and guarantee human rights through equalization grants,
- To reduce fiscal imbalance and develop proportionately, etc.

Overall, IGFTs have an effective role to play in making fiscal federalism sustainable, sustainable, and coordinated.

c. Dimensions of IGFT

As the objectives of fiscal transfer is to address the fiscal imbalances, the transfer system should be based on revenue capacity and expenditure need of the sub-national governments. It is because the vertical and horizontal fiscal imbalances among the sub-national governments are generated because of unequal revenue sources and demand for the services. The revenue capacity of the sub-national governments should be determined by these variables: tax base, tax rate, tax efforts, fiscal discipline, and tax rebate. Likewise, expenditure need of the sub-national governments should be determined by these variables: population, area, per capita GDP, poverty, remoteness, level of development, and cost index(Chhetry, 2019). The role of IGFT in federations and other multi-government countries are viewed as fulfilling three main purposes. One is simply to finance the difference between state expenditure and revenue-raising responsibilities (the fiscal gap). Although transfers themselves are passive, the federal government's role in determining the fiscal gap is by no means passive. A second purpose is to use equalizing transfers to compensate for differences in state fiscal capacities that arise from the decentralization of fiscal responsibilities. The capacity to raise revenues from own sources may differ across states, as may the expenditures required to provide given levels of services. A third purpose of transfers is to allow the federal government to exercise influence or oversight over the design of state programs

IGFT has been adopted as an important component of fulfill of the fiscal gap the worldwide often in developing countries. It deals with different aspects and dimensions for fiscal federalism. In fact, every intergovernmental fiscal transfer has two dimensions: the first is the vertical dimension, the distribution of revenue between the central and local government. The second is the horizontal dimension, the allocation of transfers among the recipient units(WBI,2003)

Vertical fiscal imbalance means difference between expenditure and revenue from own sources in various layers of government. However, the horizontal fiscal imbalance appears among the sub-national governments which have different capacities, different need, and priorities. It is also called regional inequalities. Usually, vertical fiscal transfer is determined on the basis of expenditure requirement and need for making provision of minimum services of the sub-national governments. But horizontal fiscal imbalances are addressed by providing the vertically determined fund among the sub-national governments by adopting the equity and efficiency principle (Hajra, Rakhe, &Gajbhiye, 2008). Nevertheless, Shrivastava (2011) argues that the initial transitional phase of fiscal federalism has had two different interlinked stages. First stage includes structural changes like reorganization of the country, division of resource and responsibilities among the different levels of government, and establishment of institutional bodies for the settlement of upcoming vertical and horizontal imbalances. Secondly, redesigning the administrative structure and designing of intergovernmental fiscal transfer model would have to be on place. Apart from these dimensions, other dimensions also could be described in IFGT which that are in below.

d. The Social Dimension

The social dimension belongs to quality of life and human development which depends on education and health. It measures the level of basic education, health facilities, and sanitation access which are major components of human quality of life (Gurung & Tamang, 2014). Hence, social development aspect is mentioned in IGFT. Resources are allocated for education health and other social development. IGFT should have to address the problems related to social development. Besides, social a process that ensures resources for poverty allegation and social inclusion. It ensures

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that all kinds of people participate more in the decision-making process that affects them and gain equal access to the resources, opportunities, and services they need to enjoy their fundamental rights (UNDP, 2017). The role of government in **maximizing social welfare** through public goods provision came to be assigned to the lower tiers of government. It also distributes the fiscal decision-making powers between the federal government and regional States. Government transfers the resource for social development.

e. The Economic Dimension

The economic dimension of IGFT is determined by the involvement in the economic activities of people in society. It possesses equal access to resources and employment opportunities as well as measures by following major domains like economic opportunity, absence of poverty, and standard of living. Since the economic dimension is related to the revenue level of governments and transfer level. The distribution of revenue is a primary concern rather than regular income level of sub-national government while discussing IGFT. Intergovernmental transfers between central governments and federal subunits focuses almost exclusively on the economic justifications for such transfers, their design, and the challenges they pose to democratic accountability, transparency, and the autonomy of federal subunits. One aspect of fiscal transfer is assigning responsibilities between the national and sub national governments is economic. The common understanding in this regard is that among the allocation, redistribution, and stabilization roles of the government, it is wise to give the sub-national governments the allocation role (save for those allocations such as defence that provides services for the entire population of the country).

f. The Political Dimension

The political dimension of IGFT is widely accepted globally for federalism and governance which leads to reduce the social disparity and promoting equitable distribution of revenue and grant. Since developing countries like Nepal has a more challenging situation of intergovernmental fiscal transfer, it has become a serious concern of federal discourse in terms of balance development and expenditure. A decade-long armed conflict of Nepal has also raised the issues of federalism focusing on the political rights and privileges of local- level people. It is essential to address the issues of development politically as it strengthens the capacity of local government, creates opportunity, and accesses for their involvement in decision-making and development. Local consumers confronted with the costs of alternative levels of service can express their preferences by voting for rival political candidates (voting with their hands) or moving to other jurisdictions (voting with their feet). In this respect, local politics can approximate the efficiencies of a market in the allocation of local public services by pricing municipal services and relying on the local political process and household mobility to clear the market. Grant can be used to gain political goals that means when the fiscal decentralization is made correctly or served politically decentralization but in practice or reality due to lack of resource sometimes local governments alive for political reasons.

g. The Legal Dimension

The legal dimension of intergovernmental fiscal transfers has received comparatively little scholarly attention. Systems of intergovernmental transfers are constituted and governed by domestic constitutional law, intergovernmental agreements, and legislation. One cannot fully appreciate how these systems operate without studying the legal instruments through which intergovernmental transfers are provided as well as their interpretation and enforcement by the courts. Each legal framework involves crucial design choices that determine which level of government makes the rules governing intergovernmental transfers, who may modify those rules and under what conditions, and who resolves intergovernmental conflicts when they arise. Every design choice reflects policy preferences in favour of centralization versus decentralization, political decision-making versus adjudication, fiscal autonomy versus fiscal restraint, and acceptance of economic disparity versus insistence on fiscal solidarity. Policy preferences are thus embedded in the legal structure of every intergovernmental transfer system. There is impact of legal design on the legitimacy, effectiveness, and stability of systems of intergovernmental transfers. In Nepal, constitution and intergovernmental fiscal arrangement act has included the intergovernmental fiscal transfer system

5. Theoretical Contexts of Intergovernmental Fiscal Transfer

The theoretical literature on intergovernmental transfers largely deals with the conceptual elements and design of intergovernmental fiscal transfers in a context of competitive federalism (Bird and Smart, 2002; Boadway and Shah, 2007; Musgrave,1959; Oates, 2005; Qian and Weingast, 1997; Rodden,2000; Smart,1996; Tiebout, 1956; Weingast, 1995; Wibbels, 2000). IGFT has been described by various authors in literature. They have written about principle but not described the special theory of fiscal transfer. In federalism, all level of government has strong fiscal relation for the purpose of fiscal equity. Main concept of fiscal transfer is fiscal arrangement in three level of government. The main purpose of fiscal transfer is that resources should be transferred for fiscal equity and equitable development. The Theoretical base of intergovernmental fiscal transfer is the fiscal federalism. It is an important part of fiscal federalism. So, theories of fiscal federalism guide to intergovernmental fiscal transfer, Is guided by principle and theory of fiscal federalism. Now we brief that IFGT is guided by principle and theories of fiscal federalism. The theory of fiscal federalism was originally developed by German-born American economist Richard Musgrave in 1959.

Musgrave (1959) argued that federal government systems have the ability to solve many of the issues local governments face by providing the balance and stability needed to overcome disruptive issues like uneven distribution of wealth and lack of widely available resources. Musgrave further theorized that federal governments should manage a nation's money from the top and give it to states, who can distribute it locally as needed. He considers government as benevolent (see Musgrave and Musgrave,

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1984).

It was Tiebout (1956: 416) who first developed the decentralization theorem, which is also known as 'Tiebout Hypothesis'. According to Tiebout, "his model yields a solution for local goods which reflects the preferences of the population more adequately than they can be reflected at national level." Later on, 'Tiebout Hypothesis' was further developed by Oates (1972).

According to Bird and Smart (2002: 899) note: "When evaluating the structure of transfer programmes, however, it is essential to pay close attention to the incentives they create for central and local governments and, indirectly, for residents of the different regions of the country. Whether the results of transfers are good or ill depends upon the incentives— whether intended or not that are built into transfer systems". Godspeed (2002: 409) maintains: "The recent move towards decentralization in countries such as Spain, Hungary, and South Africa and the difficulties that central governments have had in dealing with fiscal irresponsibility on the part of regional governments in countries such as Argentina, Brazil, and India has made the study of transfer systems one of the most important areas of research in federalism today".

Among the political scientists, who have contributed a great deal to the recent literature in fiscal federalism or what is known as second-generation literature, are Barry Weingast (1995), Jonathan Rodden(2000), and Erik Wibbels (2000), among others. Works by Weingast have emphasized the incentive effects of federalism: how inter-governmental fiscal relations affect the behaviour of different levels of government. Rodden and others have examined how large vertical imbalances create fiscal problems. They focus on the problems of 'soft budget constraints', sub-national borrowing, and 'bail-outs'. Wibbels(2003) has studied the relation between political federalism and fiscal federalism.

A number of studies (Oates, 2005; Musgrave, 1959; Musgrave and Musgrave, 1984; among others) have mentioned some theories of fiscal federalism. Theory of fiscal federalism have recently been divided into the first-generation theory and the second-generation theory which

a. The First-GenerationTheory (FGT)

The first-generation theory (FGT) was prevailed in the 1950's to1960's and explains the basic vision of the early normative theory of fiscal federalism (Oates, 2005). The FGT emphasizes the principle that state is a welfare institution so state should optimum use of means and resource and mobilizes the financial source for the maximum welfare of the people. This theory defines the responsibilities of state that state should keep economic stabilization with the correcting market failures, equitable distribution and maximum utilization of fiscal and monetary policy.

This theory has divided the state responsibility in three parts: economic stabilization, distribution, and allocation for public service delivery in view of public finance. This theory includes principle of subsidiary and the most appropriate agency. This theory emphasizes to decentralize the responsibilities to local government for effective service delivery. The principle of this theory is that government should perform these works, which these are effective in own level. But central government not to be involve in local level's works without adequate reason. This theory believes that sub national or local level government, which are near the people knows local demand, needs, and priority that local government has allocate efficiency.FGT emphasizes the maximum decentralization of fiscal power.

The FGT of fiscal federalism is associated with decentralization of expenditure responsibilities and centralization of revenue responsibilities for the purpose of achieving 'efficiency' and 'equity' in the federation. It emphasizes the importance of transfers for addressing the problems of vertical and horizontal imbalances. It is largely normative and assumes that federal and sub-national decision-makers are 'benevolent' and maximizes the social welfare.

The FGT of fiscal federalism is also known as classical normative theory. The FGT "was solidly embedded in the view of public finance that prevailed in the 1950's and 1960's" (Oates, 2005). It offers some general prescriptions on the allocation of functions among vertical levels of government and the assignment of fiscal instruments. Generally understood, the function of public sector is to ensure an efficient use of resources to establish an equitable distribution of income and to maintain the economy at high level of employment with reasonable price stability. In other words, the functions of public sector can be divided into three branches: allocation of resources i.e., provision of public goods and services; redistribution of income; and macro-economic stabilization of economy (Musgrave, 1959; Musgrave and Musgrave, 1984).

In brief, normative theoretical considerations strongly support decentralization on the ground of efficiency, accountability, manageability, and autonomy principles. However, this does not mean that FGT favours a decentralized model for assignment of tax. It is important to emphasize here that while the case of decentralization of expenditure responsibilities is widely accepted, the FGT is very cautious about the decentralization of revenue responsibilities. One of the main elements in the FGT is the implicit view of the working of the public sector which implies that if market failure occurs, the government would interact and correct the failures by introducing appropriate policy measures. Public economists try to diagnose the source of the failure, work out a solution for the problem and leave it to public officials to establish the remedy. The assumption is that government agencies act in public interest to maximize social welfare because of electoral pressure.

In this context the Arrow-Musgrave-Samuelson (AMS) perspective states that the aim of each level of the government is to maximize social welfare in the respective electorate. In particular, decentralized finance opens up the possibility to provide so-called "local public goods", which meet the demand of the residents in the respective area more accurately, compared to a central government which provides only a uniform level of public output. Oates (1972)

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formalized this proposition as "decentralization theorem": Two key assumptions are made:- Each level of government is benevolent;- With centralization, the per person levels of public good provision are uniform across jurisdictions.

The decentralization theorem states that the level of government which should interact in the cases mentioned above depends on the size of regional or public good spillovers as well as on differences in preferences for public goods between the areas. More precisely, decentralized provision is always more or at least as efficient as a centralized provision if: the preferences of the residents differ between the administrative units but not inside a single administrative unit; - no externalities are existing. By a simple application of the traditional Pigouvian theory of subsidies the FGT dealt with the issue of allowing decentralized provision an approach to a centralized and uniform level of public outputs and still having welfare gains: The central government should provide subsidies (e.g., grants) to decentralized governments to internalize the benefits. The amount of local public goods would then be extended by recipient governments to the point on which marginal social benefits for the whole society equal marginal costs.

Another key element of the FGT is taxation in a federal system, known as the "tax assignment problem". It tries to answer the question of what form of taxation are best at different government levels. In this theory decentralized, especially local, levels of governments, should place a primary focus on benefit taxes which are for example property taxes. The central, or higher levels of government have a bigger scope for the use of other forms of taxes as for example progressive income taxes just as a part of a much broader program - the redistribution of income. Or in other words: Local governments should focus on benefit taxes like property taxes rather on non-benefit taxes on mobile factors, such as labour, as these could lead to distortions in the location and levels of economic activity. In order to provide assistance to poorer jurisdictions and to correct distorted migration patterns, the FGT addresses the issue of equalizing lump-sum grants from the central to the local governments.

b. The Second-GenerationTheory (SGT)

The more recent literature on public choice and political economy, problems of information, and other new literature on fiscal federalism emerges the decentralization in a different approach which that is the SGT (Second Generation Model). The basis of SGT is "Principal Agent Model (PAM)". This model has included a special form of a game with principals and agents, who have asymmetric information of which they can make use SGT literature has used PAM between center and sub national government in intergovernmental fiscal relation. Central government acts as principal and tries to structure intergovernmental fiscal relations in such a way that the agents, which are the regional or local governments, behave in ways that assist the aims of central officials. Asymmetric information takes place as the Centre only has imperfect information over the fiscal activities of decentralized public agents.

SGT views critically to automatic virtues in the decentralization of fiscal power. Mainly, this theory indicates the fiducially risk in fiscal federalism with the reason of selfless, need for personal welfare, and rent-seeking of political member and employers. Fiscal federalism may bring fiscal risk in governance, so SGT advocates the fiscal accountability and responsibility in the allocation of fiscal power. SGT emphasizes to maximum balance, control and central monitoring of optimum use of fiscal resource in fiscal federalism. The SGT is in favour of decentralization of both expenditure and revenue responsibilities, and it gives minimal role to revenue-sharing and inter-governmental transfers. Moreover, it also posits that ‘inter-jurisdictional competitions’, a ‘common market’, and ‘hard budget constraints’, may provide protections against infringements to market operations.

The SGT is a emerging theory which approaches the fiscal federalism from different perspective and does the design of systems of intergovernmental fiscal transfer systems is generally recognized as being one of the most challenging tasks within the field of public finance. The specific manner through which a transfer system is developed is often based on a complex mixture of political choices, economic principles, historical reasons, and national contextual factors including the size and structure of the system of governments (Steffensen, 2010). The SGT, especially the theory of market-preserving federalism assumes that public officials have goals induced by political institutions that often systematically diverge from maximizing citizen’s welfare. Unlike the FGT which emphasizes the importance of transfers for mitigating vertical and horizontal imbalances, the SGT gives more importance to incentives generated by sub-national tax collection for fostering economic prosperity. The SGT has had significant implications for the design of transfer systems so that equalization goals can be achieved without diminishing the incentives of public officials to foster thriving sub-national economies. In brief, the SGT is in favour of decentralization of both expenditure and revenue responsibilities; and it gives minimal role to revenue-sharing and inter-governmental transfers. Moreover, it also posits that ‘inter-jurisdictional competitions’, a ‘common market’, and ‘hard budget constraints’, may provide protections against infringements to market operations. The SGT is an emerging theory.

The SGT has underlined several economic rationales for inter-governmental transfers (Ahmad and Craig, 1997): as like as vertical and horizontal fiscal imbalance, little incentive for lower levels of government to raise own revenues or restrict or manage expenditures efficiently, differences in fiscal capacities, extraordinary expenditure needs, to address inter- jurisdictional spill-over effects(or externalities) measures such as pollution control, inter- regional high-ways, higher education. The SGT comes from its focus on the political economy of intergovernmental structure–on the incentives embodied in various political and fiscal institutions.

It regards politicians as ‘rent-seeking individuals’ using their positions to pursue private goals, and government as institutions that encroach upon individual freedom and seek to increase their hold on the private economy as much as possible. Public choice

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theorists view government as 'leviathan' and emphasize the importance of institutional rules and arrangements forcing politicians to serve the public interest in the pursuit of their own goals and limiting their discretionary power (Buchanan, 1995: 19-27).

Inman and Rubinfeld (1997) have articulated a complex positive theory about how the politics of public expenditure programmes and budgeting introduces a range of inefficiencies. These economists and several others approach the problems of fiscal federalism with the assumption of a 'malevolent government'. Scholars of the 'market-preserving federalism', public choice theorists such as Geoffrey Brennan and James Buchanan, and others, the 'theory of the firm' have played roll to build SGT.

Fiscal discipline at sub-national levels can be strengthened by better aligning sub-national governments' taxation powers with their spending obligations, thus narrowing the vertical fiscal imbalances (Eyraud and Lusinyan, 2011). State and local taxes should be carefully selected, based on feasibility and efficiency considerations.

According to Yilmaz and Zahir (2020), the design of intergovernmental transfers has a huge bearing on the efficiency and equity of public service provision as they play a prominent role in financing sub-national governments across the world. In the first-generation theory (FGT) of fiscal federalism, they are viewed as economic policy tools to correct imperfections. The FGT assumed that decision-makers are benevolent actors who would intervene to provide public goods efficiently. On the other hand, the recently emerged second-generation theory (SGT) of fiscal federalism focuses on the political economy implications of transfers and pays attention to the institutional and political incentives that induce or constrain the behaviour of politicians. The SGT sees intergovernmental transfers as a potential tempting target for rent-seeking politics. This chapter summarizes the main arguments of both theories and provides examples from federations.

c. International Policy Review

This section explore how is the position of intergovernmental fiscal transfer in international policies that have played a solid role in national policy-making as well as a guide to formulate the national multi-year Intergovernmental fiscal transfer plan along with achieving of vision and goal in the economic development roadmap because of Nepal 's policy is affected by international direction and policies. World Bank, IMF, and ADB are main institutions for recommending policies to many countries.

Over the past few decades, a clear trend has emerged worldwide toward the devolution of spending and, to a lesser extent, revenue-raising responsibilities to state and local levels of government. One view is that the decentralization of spending responsibilities can entail substantial gains in terms of distributed equity and macroeconomic management. The articles in this volume, edited by Teresa Ter-Minassian (1997), examine the validity of these views in light of theoretical considerations, as well as the experience of a number of countries.

Shah (2006) has explained the Intergovernmental fiscal transfer's feature, the expenditure needs of various levels of sub-national governments. This article also included advance national, regional, and local area objectives, such as fairness and equity, and referred. The structure of these transfers which that creates incentives for national, regional, and local governments that have a bearing on fiscal management, macroeconomic stability, distributional equity, allocate efficiency, and public services delivery. This article suggests making policy to design the fiscal transfer's structure which that create the right incentives for prudent fiscal management and competitive and innovative service delivery. It provides practical guidance on the design of performance-oriented that emphasize bottom-up, client-focused, and results-based government accountability. It cites examples of simple but innovative grant designs that can satisfy grantors' objectives while preserving local autonomy and creating an enabling environment for responsive, responsible, equitable, and accountable public governance. The article further provides guidance on the design and practice of equalization transfers for regional fiscal equity as well as the institutional arrangements for implementation of such transfer mechanisms. It concludes with negative (practices to avoid) and positive (practices to emulate) lessons from international practices. It is directive guide for federal country to make fiscal transfer policy.

The work of OECD/KIPF (2016) offers a succinct overview of fiscal decentralisation in OECD countries and identifies common trends. To that end, it seeks to answer a few crucial questions. How does decentralisation evolve overall? Which countries have undertaken intergovernmental fiscal reforms, and which were the most common and important? What was the impact of the 2008 crisis on sub-central deficits and debt? How did sub-central power and responsibilities evolve in the aftermath of the crisis? Is there a "new normal" in intergovernmental fiscal relations and sub-national public finance, and what does it look like? To answer these questions, OECD reviews the evolution of the main fiscal indicators, such as spending and revenue decentralisation, tax autonomy, the tax and spending composition of sub-central governments, the size and structure of the intergovernmental grant system, and deficit and debt developments at the sub-national level. Finally, the review looks beyond purely financial decentralisation indicators.

Kim(2021) brings into discussion on the design of intergovernmental fiscal relations often revolve around the premise that intergovernmental grants–especially earmarked grants – should be minimised. It is also often argued that intergovernmental grants imply a vertical fiscal imbalance between central and sub-national governments. These arguments are based on the "benefit principle", and emphasise the importance of establishing a clear linkage between expenditure and revenue decisions of sub-national governments. But in reality, almost all local governments worldwide provide, at least to some extent, essential (redistributive) public services such as health, education, and social services, which require substantial revenues. The four country cases examined in this article show the importance of

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intergovernmental relations in the role of co-ordinating across levels of government for the efficient and equitable provision of essential public services. They also show that, in many countries, earmarked grants play an important role in the provision of these services.

The work of Smoke, Kim, Y., & Bank(2002)has explained that in recent years, the issue of IGFTs has received increasing attention among policymakers for various reasons. These include (i) disparity in delivery of social services between regions, (ii) economic gap between growth centers and lagging areas, and (iii) progress in economic and political decentralization. While strengthening institutions, functions, and finances of state/local governments is becoming increasingly important, developing a more productive and equitable intergovernmental transfer scheme has likewise become a priority issue. The issue of allocating national resources to local communities has been a major policy agenda as sub-national governments play a stronger role in carrying out socioeconomic policies. For a long time, the governments in the Asia-Pacific region have made enormous efforts to minimize distortions and defects in the countries' fiscal transfer schemes. However, existing disparities in production growth, fiscal bases, and the extent of public services call for greater governmental interventions including a reform in central-state fiscal relations. An expeditious reform aimed at addressing the underlying fiscal and economic imbalances and ensuring equitable delivery of public services across states would place powerful impetus to the long-term socioeconomic progress. The new focus on the greater fiscal role by local governments has been supported by international development agencies including ADB.

UNDP (2013) considers the extent to which internationally accepted practices of intergovernmental fiscal relations (IGFR) principles may provide important lessons for Sudan. However, it is important to note that the diverse nature of IGFR and fiscal decentralization has given rise to an equally diverse and extensive body of international literature. For this reason, the article can only present a brief and selective general review of the issues. In particular, the article reviews and discusses lessons for Sudan with specific reference to fiscal decentralization principles and practices to address pro-poor and poverty reduction policy objectives for Sudan. Thus, the article reviews the international IGFR literature on principles and best practices from which policymakers may draw lessons for application in Sudan. Using concrete examples the article discusses the essential background features and challenges in IGFR systems and the tensions that exist, and compromises that must be made in order to resolve these tensions. UNDP recommends to other country like ties Sudan and effects to policy making.

Boadway& Shah (2007) bring together trainings modules on intergovernmental fiscal transfer. Different articles wearer collected as learning program by Canadian International Development Agency. This is World Bank institute learning events. Various authors had collected theoretical and behavioural information and explained the practice.

The work of Bird & Smart (2002) was studied as a report of world development, which collected information from different countries and analyzed. They suggested some way to make effective fiscal transfer using both qualitative and descriptive method to show and analysis the situation of fiscal transfer and future way.

6. Conclusions

A sound and rational intergovernmental fiscal transfer system is precondition for the well fiscal federalism. The main objective of intergovernmental fiscal transfer is to balance the resources and development. It is also means for vertical and horizontal fiscal balance among three tiers of government. It was started since the starting of legal state. Mainly, it was structured by Pigou, Musgrave, and other scholars in the period from 1950 to 1960.In Nepal,it is institutionalized in with promulgation of local self-government constitutionally; it is also included in Nepal Constitution (GoN, 2015) which has been guided by the theories of fiscal federalism. Some principle and criteria are included in constitution and laws.

IGFT modality presented in the present constitution has centralized most of the revenue generation power at federal government whereas most of the expenditure responsibilities are assigned to the provincial and local level government. As per the constitutional provision, the central government collects around 80 percent of tax revenue and 90 percent of the total revenue. This situation creates the significant vertical fiscal imbalances among the levels of governments. Newly promulgated the 2017 Intergovernmental Fiscal Management Act (IGFMA) provisioned the modality of the sharing of VAT and excise duty on domestic production among federal, provincial, and local government.

Two types of fiscal transfers including fiscal equalization and conditional grants are provided to the provincial and local governments as a transitional arrangement. Thus, to address the problem the article suggests that in the initial phase of the new governance system, fiscal transfer formula should be research-based, very simple, and clear. The variables used in formula should be relevant, non-disputable, and selected on the basis of national context and availability of the data. The common major variables used in the fiscal transfer formula in selected federations are Population, Area, per capita, Tax effort/capacity, expenditure need, Education, Health, Poverty, Fiscal discipline, Index of infrastructure, etc. On the basis of experiences from the international practices and study carried out at the national level, this study suggests that the intergovernmental fiscal system in Nepal also should be based on the revenue capacity and expenditure need of the transfer-receiving governments. Regarding the revenue capacity the variables can be used are tax base, tax Rate, tax efforts, fiscal discipline, and tax rebate. Likewise, the variables for estimated expenditure need could be population, area, per capita GDP, poverty, remoteness, level of development, and cost index. Use of these variables for the fiscal transfer depends up on the availability of the data for the required field. Provincial and local governments should be developed accordingly, and the fiscal transfer formula should be amended periodically which will serve

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more the constitutional spirit of fiscal equalization. Moreover, specific and clear guidelines should be formulated to implement the matching and special grants. In theoretical part, some issues such as midterm expenditure budget, use of revenue rights, formulation of long-term projects, and capacity development should be solved through policies and laws.

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