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Intergovernmental Fiscal Transfer in Nepal

Does It Lead to Greater Accountability at the Local Level?

Keshav Kumar Acharya,* Thaneshwar Bhusal**

* Governance and Capacity Development Specialist, Visiting Faculty of Kathmandu University, School of Management, Kathmandu, Nepal, e-mail: keshavkacharya@gmail.com

** Honorary Research Fellow, Faculty of Business, Government and Law, University of Canberra, Canberra, Australia, e-mail: thaneshwar.bhusal@canberra.edu.au

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Abstract: The Intergovernmental Fiscal Transfer (IGFT) is a crucial tool for local governments (LGs) to bridge fiscal disparities by providing the necessary funds to fulfil their functional responsibilities. In the context of federal Nepal, IGFT has been classified into four types: fiscal equalisation, conditional, special and matching grants. This research is an attempt to examine the effectiveness of these transfer types in enhancing the local governments' accountability in Nepal. Through a combination of quantitative and qualitative data types, this study collected primary and secondary data from seven purposively selected municipalities. Our analysis finds that IGFT serves as a powerful tool for advancing accountability among local governments in Nepal. However, the current trend of centralisation within federal government agencies, limited bureaucratic capabilities at both federal and local levels and inadequate political commitment to IGFT have hindered accountability at the local level.

Keywords: fiscal federalism, Intergovernmental Fiscal Transfer, local accountability, Nepal

1. Introduction

The concept of Intergovernmental Fiscal Transfer (IGFT) has been incorporated as a crucial component of fiscal federalism, emphasising the transfer of funds from one level of government to another, or even across the same level of government agencies (Dhungana & Acharya, 2021). In the context of Nepal's federal government system established in 2015, IGFT has emerged as an important budgetary tool to bridge the fiscal gap between income and expenditure, maintain vertical and horizontal balance in fiscal capacities and enable the federal government to effectively supervise the performance and accountability of local governments (Pandeya et al., 2016). According to the Constitution of Nepal, the Intergovernmental Fiscal Transfer (IGFT) is an integral part of intergovernmental relations, guided by the principles of cooperation, coexistence and coordination. These principles are aimed at fostering a conducive environment for constructive collaboration between federal, provincial and local governments (Bhusal, 2022a). This intergovernmental cooperation leads to improved coordination and ultimately works towards achieving the overarching goal outlined in the constitution (Bhusal, 2022a; Acharya & Scott, 2022).

Many scholars (Dhungana & Acharya, 2021; Pratchett, 2004) assert that IGFT plays a critical role in safeguarding the fiscal, political and administrative independence of subnational governments. This includes *inter alia* allocation of resources, decision-making processes, and implementation of public policies at the federal, provincial and local levels. Despite this, a significant number of developing countries, whether they have a federal or unitary system, continue to struggle with complex IGFT mechanisms that inadvertently promote corrupt practices and misuse of resources for personal gain (Gordin, 2006; Shah, 2006). Despite those experiences, intergovernmental fiscal transfers in Nepal have endeavoured at balancing budget allocation across levels of government and demoted corruption and fiduciary risk through the application of Public Expenditure and Financial Accountability, such as Sub-National Treasury Regulatory Application (SuTRA) and Public Assets Management System (Dhakal, 2024).

These are further institutionalised by the prevailing Local Government Operation Act (2017), the Intergovernmental Fiscal Management Act (2017) and the National Natural Resources Fiscal Commission Act (2017). These legislative frameworks have provided a consistent legislative framework to strengthen the constitutional spirit of the IGFT system by granting the power of taxation, expenditure rights and regulation to the three tiers of government. Thus, the IGFT is gradually being understood as a robust instrument for bridging resource gaps and addressing issues arising from the performance-based granting system (Acharya & Zafarullah, 2020; Devkota, 2020). Following the background, this paper analyses these transfer types with the aim to understand their efficacy in strengthening the local accountability of local governments in Nepal.

We begin this paper by bringing relevant literature of the IGFT to understand its normative strands. This section summarises key developments in the relevant research field, with references from Nepal's evolving knowledge about IGFT. The third section of the paper illuminates on the methodological aspect of the research. Results are presented in the fourth section. The final section of the paper concludes the research by summarising the core of the research while showing possible future research questions.

2. Literature review: the normative understanding of IGFT

The traditional concept of IGFT is to maintain the financial relationship between the national and sub-national governments by allocating resources efficiently in the public sector. IGFT as a part of fiscal federalism supplements the fiscal imbalances of provinces and local governments. The purpose of these transfers is generally to address fiscal imbalances, distribute resources in an equitable manner and provide public services. According to Boadway and Shah (2007), intergovernmental fiscal transfers are based on the following principles: equity, benefit-cost spill over, allocation efficiency within government, autonomy, planning certainty, ease of administration, transparency and neutrality in grant management. There are many ways in which these principles lead to positive results at the subnational level. First, fiscal transfers are used to reduce regional disparities, promote equal access to services, strengthen local government capacity and formulate specific policies. Second, it facilitates the funding system and sources. Depending on the source, the funds may come from general revenues, specific taxes, natural resources, or borrowing. Third, the resources are distributed according to allocation criteria. A number of criteria, including population size, fiscal capacity, poverty rate and human development index, have been defined to allocate resources. Finally, there is a well-functioning institutional framework for the management and administration of intergovernmental fiscal transfers.

Over the past few decades, IGFT has evolved in developing countries in a systematic way to support LG fiscal autonomy (Boex & Kelly, 2013; Arachi & Zanardi, 2004). Among these relationships, the most notable outcome was improved economic efficiency and stable fiscal accountability, which brought the decentralised government closer to the people. Although these systems are inadequate in federal countries, they are effective at prioritising public needs, providing citizens with adequate levels of public services and ensuring a substantial degree of autonomy for expenditure and tax assignments in unitary countries (Acharya & Zafarullah, 2020; Smoke, 2016). In federal states, IGFT seeks to improve citizens' preferences and public policies while preserving functional relationships between levels of government (Choudhry & Perrin, 2007). In unitary systems, the proposition of intergovernmental fiscal transfer is to ensure central control over local public policies and service delivery mechanisms while balancing territorial development, among other things (Altunbaş & Thornton, 2012).

In the Nepalese context, intergovernmental transfers involve the flow of financial resources from national to subnational levels, either through grants or revenue sharing, or both, to fill fiscal gaps and carry out development activities (Devkota, 2020). According to Devkota (2020), there are four main legal architectures of intergovernmental fiscal transfers. First, expenditure assignment allows the distribution of expenditure responsibilities among the three tiers of government. Second, the revenue assignment, which is practiced in most low- and middle-income countries. Value-added tax and customs duties and income taxes are reserved by the constitution for the federal government. Provincial governments can impose land and building registration fees, vehicles, advertisement, tourism and entertainment. Third, the IGFT provides various types of financial grants from one level to another (equalisation, conditional, special and supplementary grants) and fourth, subnational borrowing, which is provided to the provinces and LGs but only from within the country.

Studies on fiscal transfer – both in federal settings (Shanmugam & Shanmugam, 2022) and unitary systems (Hou, 2011) consider vertical and horizontal coordination their primary areas of analysis. A common analytical element in both scenarios is the notion of vertical and horizontal collaboration across jurisdictions. Shah (2006) notes that collaboration across the government and the method of fund transfers between governments is determined by the structure of the political system, geography, population, social consciousness, political culture and social competence. Evidence from federal countries suggests that the Constitutions devise the structure of intergovernmental financing mechanisms including financing autonomy, fiscal accountability and effectiveness of the social safety net to carry over the development works and scale up for more expenditure at the subnational level (Boadway & Shah, 2007). Thus, the IGFT ponders lubrication for political machinery, which ensures fiscal autonomy, uniformity, harmony and efficiency at the subnational level. Despite these, some authors such as Boex and Kelly (2013) argue that IGFT needs a legal basis, structure, modus operandi and behavioural framework for formal and informal interrelationships between governments at different levels.

2.1. Local accountability in the context of fiscal transfer

Studies on local accountability are rooted in diverse disciplines within the broad field of political science. The principal–agent theories in management science outline accountability as an obligation of local officials, or agents – both elected and appointed – to answer for their actions and inactions to their principals (constituencies). It emphasises the idea that those who have authority or power at the local level should be answerable to the community they serve and should be held responsible for their actions and the outcomes they produce. It refers to local governments and their officials as being accountable for their decisions, resources and overall performance in governance and public administration. To hold local officials accountable for their actions, elections, transparency and information dissemination, public participation, oversight and checks and balances, and legal and regulatory frameworks are the major instruments. Balla and Gormley (2017) impute the new dimensions of local accountability, which is found as fiscal accountability in financial management studies, bureaucratic accountability in administrative studies and civic accountability in governance studies. A common feature of these studies is to see local accountability either as a vertical institution or a horizontal process to hold officials accountable for their deeds (Halligan, 2020).

In Nepal, the federal government allocates resources to the subnational government through intergovernmental fiscal transfers to fill budgetary gaps at the subnational level. It is apparent that the federal government collects direct taxes, royalties and fees from citizens which must be mobilised by the power holders in an accountable manner. Therefore, accountability aims to make public officials, employees and even citizens responsible for their actions. This study focuses on conceptualising local accountability from a government and governance perspective, i.e. to examine analytical elements of how polity, politics and local accountability processes are viewed on both a vertical and horizontal scale (Waheduzzaman et al., 2017).

In unitary systems, local governments are obliged to be answerable to the central government. Although defined in the local government legislations, evidence from the unitary systems continues to attest that local accountability is designed in a way that elected or appointed local officials are always facing upward to the central government whilst making local public policies (Lawton & Macaulay, 2014). Federal settings are inherently considered more conducive for exercising local autonomy, but the question of local accountability seems more complex in such circumstances (Pratchett, 2004). Although recent constitutional developments in countries like South Africa and Nepal show promises for independent local governments, their institutional designs clearly suggest local accountability as upward facing, neglecting the notion of democratic accountability toward principals.

Empirical evidence from federal settings suggests that IGFT has been evolving as a way of arranging and measuring local accountability. Governments in the upper tier provide financial grants, in different names, to lower-level governments with conditions. A stereotypical understanding is that local governments fulfilling such conditions are considered highly accountable as opposed to those remaining less compliant with such conditions being labelled unaccountable. We, therefore, consider fiscal transfer as a medium to ensure consistency across local governments while understanding that too much reliance on grants or aid from the upper governments may hamper the possibility of local governments introducing innovative reforms.

2.2. The Nepali case of intergovernmental fiscal transfer

In Nepal, the grant transfer system from the centre to the lower bodies was started in 1951 to carry out the development works at the local level (Shah, 2016). During the *Panchayat* period, the amount of the grant was not significant and was pushed under the delegation and deconcentration model. In the 1990s, the foundations of sectoral devolution and local governance were provisioned through the Local Self Governance Act 1999, which ensured to collect local taxes as the source of internal revenue of local bodies. Few local bodies were successful in generating local revenue whereas the local bodies in remote areas were not able to make considerable progress in this regard. Therefore, the central government provided local grants to fill this budget gap (Dhungana & Acharya, 2021; Shah, 2006). In 2007, the Government of Nepal initiated Minimum Conditions and Performance Measures to evaluate the performance of the local bodies based on certain set standards and tie up the block grants and revenue sharing with their performance result (Devkota, 2009).

In 2015, a new constitution was promulgated that allows significant spaces for fiscal federalism in Nepal by devolving spending authority to subnational governments. In 2017, some major legislative frameworks were prepared such as the Local Government Operation Act, Intergovernmental Fiscal Transfer Act and National Natural Resources and Fiscal Commission Act. These Acts have opened the avenue for the IGFT system that helps to promote budgetary sustainability on the one hand; on the other hand, the LGs receive four types of grants (fiscal equalisation grants, conditional grants, special grants and matching grants) (Government of Nepal, 2017) under the provision of intergovernmental fiscal transfers (Dhungana & Acharya, 2021). According to the Nepalese constitution, the National Natural Resources and Fiscal Commission (NNRFC) has a new structure for institutionalising fiscal federalism, correcting both types of fiscal imbalances and distributing state revenues and other resources fairly. According to the Constitution, the function of the Commission is mainly to determine the detailed structure for revenue sharing between three tiers of the government; recommend equalisation grants to be transferred to provincial and local governments; to conduct research and studies to prepare the basis for conditional grants given to provincial and local governments; to recommend methods to improve revenue collection and spending responsibilities of three levels of governments; recommend limits for internal loans that three levels of governments may undertake; and conduct research and studies to provide suggestions to resolve conflicts through coordinated cooperation arising during the redistribution of natural resources among the three levels of governments.

However, the transferred mechanism is not efficiently exercised, especially in LG units. Despite efficient budget allocation and weak expenditure management, public services could not be adequately financed due to financial incapacity. Consequently, this leads to horizontal and vertical fiscal imbalances, which result in structural imbalances in the economy and revenue shortfalls for subnational governments (Bhatta, 2011). IGFTs are thus a major dimension of fiscal federalism because they ensure the transfer of fiscal resources from the upper levels of government to the lower levels, grant availability, revenue distribution and the right to collect internal revenues.

3. Methodology

A combination of primary and secondary sources of information was used to collect the data. The primary data were collected from the following 7 LGs purposively during the period of September to December 2021. The selected municipalities were *Nepalganj Sub-Metropolitan City, Bansgadhi, Bheriganga, Dullu, Ghodaghodi, Badimalika* and *Kabilashi* Municipalities. These municipalities were selected primarily because they were pilot areas for a joint program between the German Development Cooperation and the Ministry of Federal Affairs and General Administration (MoFAGA), the leading ministry for federal affairs and local governance in Nepal. Through the Capacity Development Support to Governance (CD-SG) project, the German Development Cooperation provided assistance to these municipalities in several key areas. This included the institutionalisation of federalism and improved service delivery, the development and implementation of Revenue Improvement Action Plans, support for the Own Source Revenue Program, e-taxation and digital financing systems. Additionally, the German Development Cooperation helped in the preparation of annual budgeting and programming, taking into account both IGFT allocations and internal revenues. The cooperation also supported the implementation of recommendations from the Fiduciary Risk Assessments to ensure financial discipline. A total of 42 in-depth interviews were conducted purposively with federal and local government representatives, including the mayor, deputy mayor, head of administration, head of the technical unit and head of the revenue unit in each LG unit.

Additionally, two representatives from local government associations, a joint secretary of the National Natural Resources and Fiscal Commission, an undersecretary of the Ministry of Federal Affairs and General Administration and three independent local governance experts were selected. These interviews aimed to gather the participants' thoughts and insights on Nepal's current fiscal transfer practices, effectiveness and accountability. Further questions were asked regarding how LGs were receiving equalisation, conditional, special and matching grants from the federal government as a constitutional requirement. An open-ended and an open-structured questionnaire were used for the interviews. The qualitative data were transcribed and classified using four themes as detailed below.

4. Results

4.1. Mobilisation of intergovernmental fiscal transfer

According to Dhungana and Acharya (2021), the Government of Nepal has implemented a formula for intergovernmental financial transfers since 2017. This formula considers the size of the administrative area (15%), population size (70%), human development index (5%) and underdevelopment indicator (10%) in determining the allocation of funds. These criteria were chosen with the needs, priorities and expenditure capabilities of local governments in mind. The aim of this formula is to promote fair and balanced development across the country. As a result, there has been a significant improvement in socio-economic development and the delivery of public services at the local level.

At present, most resources for local governments are derived from intergovernmental fiscal transfers. This trend has been emphasised in recent years due to the inequitable distribution of services and economic disparities between different regions and local governments (LGs). In Nepal, the implementation of federalism in 2017/2018 marked the initiation of IGFT, resulting in a substantial amount being distributed directly to the local level (Table 1).

The concept of fiscal federalism aims to empower local governments to exercise their delegated fiscal rights, explore new revenue scopes and deliver efficient services to their citizens. However, despite these intentions, local governments have persistently relied on the federal government to handle delegated functions, indicating a weak accountability to their constituents. As a result, the autonomy of these local levels is gradually being eroded. In parallel, the IGFT strives to promote value for money and drive economic growth, yet multiple examples suggest that corruption has become a significant obstacle hindering the progress of local governments.

For example, allocation of large volume of IGFT resources to current grants and random appointment of political leaders as advisers and consultants; arbitrary purchase of goods and taking undue facilities; preparing final payment for low quality projects/goods; accepting bribes for projects and services; preparation of counterfeit bills and

Table 1.
Allocation of total intergovernmental fiscal transfers in Nepal (FY 2017/2018–2022/2023) (NPR 0000)

		Allocate for FY 2018/2019		Allocate for FY 2019/2020		Allocate for FY 2020/2021		Allocate for FY 2021/2022		Allocate for FY 2022/2023		From 2017/2018 to 2022/2023	
Name of Municipalities	**Allocate FY 2017/2018**	**Budget**	**% of increased/ decreased**	**Budget**	**% of increased/ decreased**	**Budget**	**% of increased/ decreased**	**Budget**	**% of increased/ decreased**	**Budget**	**% of increased/ decreased**	**Increased amount of budget**	**% of increased/ decreased**
Tulshipur	79,574	71,710	−9.88	78,640	9.66	89,780	14.17	91,580	2.00	99,430	8.57	19,856	24.95
Bansgadhi	43,759	33,600	−23.22	37,510	11.64	43,840	16.88	46,960	7.12	50,860	8.30	7,101	16.23
Bheriganga	38,223	29,200	−23.61	30,530	4.55	38,010	24.50	44,260	16.44	47,290	6.85	9,067	23.72
Dullu	41,641	35,490	−14.77	37,310	5.13	45,960	23.18	48,790	6.16	55,410	13.57	13,769	33.07
Dhangadhi	72,392	63,090	−12.85	73,000	15.71	85,670	17.36	88,350	3.13	96,480	9.20	24,088	33.27
Patan	37,113	30,900	−16.74	35,500	14.89	43,330	22.06	48,610	12.19	49,360	1.54	12,247	33.00
Belbari	41,318	36,290	−12.17	37,860	4.33	45,310	19.68	53,480	18.03	52,390	−2.04	11,072	26.80

Source: Ministry of Finance, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023

counterpoints; no settlement of advance budget for long time; non-adherence to procurement rules at budgeted expense; taking double facilities in the name of meeting or daily allowance; allocating funds under the *Abanda* (reserve) title and spending them through decision of the mayor or political leader; not following the provisions of law and not even conducting an audit is creating adverse impact of IGFT at the local level.

It seems that distortions are spreading in local government, despite being expected to be the model unit of good governance. There were few anomalies which brought glitches in IGFT utilisation. Firstly, local governments did not have enough essential laws and policies and the availability of reliable and authentic data. Secondly, there was a lack of knowledge and experience related to financial management and mobilisation in local governments, which created fiduciary risk and financial chaos.

The details of the budgets received and the increase and decrease in the equalisation grant in different municipalities are presented in Table 2 below. In the case of intergovernmental transfer, fiscal equalisation is a key source of finance for subnational governments to reduce regional imbalances in fiscal capability and expenditure needs. In Nepal, the local governments have received the fiscal equalisation grant through both federal and provincial governments based on a few criteria of a formula-based system, which need to be spent on sectoral projects such as education, health, infrastructure development programs, waste management, water supply and sanitation programs, local transportation, small irrigation and many more based on local priorities.

LGs also receive conditional grants to implement projects designated by thematic ministries or departments, in addition to the equalisation grant. These grants are contingent upon achieving specific outcomes and aim to provide local communities with the necessary resources to support national development goals. They are allocated to fulfil the constitutional rights granted at the federal level, as well as to carry out concurrent rights and fulfil domestic and international commitments. Conditional grants shall be executed under the requirements of the level providing the grant, and the allocated amount will be returned to the appropriate level if no expenditure is made for whatever reason. Recent federalisation has led to a significant boost in subsidy funds allocated by the central government to local authorities, amounting to 13 trillion 71 billion 72 million over the past five years. Notably, more than half of this amount, specifically 54.55% is in the form of conditional grants (Government of Nepal, 2022). The conditional grants disbursed to the various municipalities over the last five years, together with the changes in the predetermined amounts, are shown in Table 2.

In addition to both grants above, the federal government also offers special grants to local governments to supplement funding for specific projects and development programs. These grants are subject to similar conditions as conditional grants and are administered by the National Planning Commission (NPC). The goal of this grant is to address the imbalance between the LGs' levels of social and economic development. There could be gaps in health, education and infrastructure development for some groups and regions, while discrimination may affect others. To overcome the problem, the federal government offers local governments a special grant. In the fiscal year 2020/2021, special grants were disbursed locally through intergovernmental transfers. Although special grant protocols were established and enacted in 2018, they were still effectively utilised. See Table 2 for a breakdown of the changes in the budget and special grant amounts within the various municipalities.

A matching fund, also known as a complementary grant or counterpart fund, is provided by the federal government to LGs to implement specific projects or development programs. Under this initiative, municipalities are eligible to propose up to five projects, while metropolitans can suggest up to seven. In the framework of the budget for fiscal year 2022/2023, the government has allocated NPR 20 billion for the complementary grant, empowering municipalities to execute noteworthy initiatives at the grassroots level. As outlined in the 2019 Matching Fund Guideline, the Finance Secretary will coordinate a panel of five members to select the projects. It should be noted, however, that under this guideline, grant funds cannot be used towards salaries, allowances, general expenses or loans. Accordingly, the federal government can offer a complementary grant of up to 40% of the project's total cost at the local level. This fiscal year, a special grant was also distributed locally as a part of intergovernmental transfers. For a more comprehensive breakdown, see Table 2 for details on the budget allocation and changes in complementary/matching grants across different municipalities.

Table 2.
Intergovernmental fiscal grant transfer allocation from federal government and mobilisation at the local level (amount in NPR 00000)

Fiscal Year	Types of IGFT	Status of IGFT Mobilisation	Tulshipur	Bansgadhi	Bheriganga	Dullu	Dhangadhi	Patan	Belbari
Allocate for FY 2017/2018	Equalisation	NPR*	5,654.00	2,668.00	2,719.00	2,734.00	5,295.00	2,227.00	2,851.00
		Expenditure Amount (NPR)**	4,894.00	2,515.00	2541.00	2,446.00	5,111.00	2,036.00	2,787.00
		% of expenditure	86.56	94.27	93.44	89.46	96.53	91.44	97.76
	Conditional	NPR*	2,303.00	1,510.00	1,102.00	1,429.00	1,943.00	1,484.00	1,280.00
		Expenditure Amount (NPR)**	1,998.00	1,208.00	857.00	1,204.00	1,586.00	1,155.00	1,058.00
		% of expenditure	86.77	79.97	77.77	84.28	81.63	77.85	82.62
Allocate for FY 2018/2019	Equalisation	NPR*	2,982.00	1,535.00	1,325.00	1,313.00	2,707.00	1,027.00	1,700.00
		increased/Decreased Amount	–2,672.00	–1,133.00	–1,394.00	–1,421.00	–2,588.00	–1,200.00	–1,151.00
		% of increased/Decreased Amount	–47.26	–42.47	–51.27	–51.98	–48.88	–53.88	–40.37
		Expenditure Amount (NPR)**	2,664.00	1,452.00	1,209.00	1,240.00	2,563.00	961.00	1,561.00
		% of expenditure	89.33	94.61	91.25	94.45	94.68	93.55	91.82
	Conditional	NPR*	4,189.00	1,825.00	1,595.00	2,236.00	3,602.00	2,063.00	1,929.00
		increased/Decreased Amount	1,886.00	315.00	493.00	807.00	1,659.00	579.00	649.00
		% of increased/ Decreased Amount	81.89	20.86	44.74	56.47	85.38	39.02	50.70
		Expenditure Amount (NPR)**	3,259.00	1,510.00	1,237.00	1,813.00	2,915.00	1,518.00	1,555.00
		% of expenditure	77.81	82.76	77.58	81.08	80.92	73.57	80.62
Allocate for FY 2019/2020	Equalisation	NPR*	3,162.00	1,591.00	1,369.00	1,327.00	2,967.00	1,103.00	1,789.00
		increased/Decreased Amount	180.00	56.00	44.00	14.00	260.00	76.00	89.00
		% of increased/ Decreased Amount	6.04	3.65	3.32	1.07	9.60	7.40	5.24
		Expenditure Amount (NPR)**	3,417.00	1,676.00	1,490.00	1,481.00	3,067.00	1,288.00	1,992.00
		% of expenditure	92.54	94.91	91.86	89.62	96.73	85.61	89.79
	Conditional	NPR*	4,702.00	2,160.00	1,684.00	2,404.00	4,333.00	2,447.00	1,997.00
		increased/Decreased Amount	513.00	335.00	89.00	168.00	731.00	384.00	68.00
		% of increased/ Decreased	12.25	18.36	5.58	7.51	20.29	18.61	3.53
		Expenditure Amount (NPR)**	3,661.00	1,762.00	1,336.00	1,985.00	3,024.00	1,867.00	1,599.00
		% of expenditure	77.86	81.56	79.34	82.55	69.78	76.28	80.06

Fiscal Year	Types of IGFT	Status of IGFT Mobilisation	Tulshipur	Bansgadhi	Bheriganga	Dullu	Dhangadhi	Patan	Belbari
Allocate for FY 2020/2021	*Equalisation*	NPR*	3,045.00	1,551.00	1,339.00	1,312.00	1,853	1,094.00	1,647.00
		increased/Decreased Amount	–117.00	–40.00	–30.00	–15.00	–1114	–9.00	–142.00
		% of increased/ Decreased	–3.70	–2.51	–2.19	–1.13	–37.55	–0.82	–7.94
		Expenditure Amount (NPR)**	2,821.00	1,463.00	1,228.00	1,213.00	1711	970.00	1,466.00
		% of expenditure	92.64	94.32	91.73	92.47	92.33	88.64	89.04
	Conditional	NPR*	5,534.00	2,733.00	2,412.00	3,170.00	3,195	3,121.00	2,784.00
		increased/Decreased Amount	832.00	573.00	728.00	766.00	–1138	674.00	787.00
		% of increased/Decreased	17.69	26.53	43.23	31.86	–26.26	27.54	39.41
		Expenditure Amount (NPR)**	4,295.00	2,161.00	1,659.00	2,273.00	2,477	2,215.00	2,280.00
		% of expenditure	77.62	79.08	68.77	71.69	77.54	70.97	81.88
	Special Grant Transfer	NPR*	250.00	100.00	50.00	50.00	150	70.00	0.00
		% of increased /Decreased	0.00	0.00	0.00	0.00	0	0.00	0.00
		Expenditure Amount (NPR)**	0.00	100.00	48.88	50.00	150	70.00	0.00
		% of expenditure	0.00	100.00	97.76	100.00	100	100.00	100.00
	Matching Grant Transfer	NPR*	149.00	0.00	0.00	64.00	136	48.00	0.00
		% of increased/Decreased	0.00	100.00	100.00	28.00	9.33	100.00	0.00
		Expenditure Amount (NPR)**	0.00	0.00	0.00	64.00	136	0.00	0.00
		% of expenditure	0.00	0.00	0.00	100.00	100	0.00	0.00
Allocate for FY 2021/2022	*Equalisation*	NPR*	3,223.00	1,632.00	1,371.00	1,342.00	1963	1,142.00	1,877.00
		increased/Decreased Amount	178.00	81.00	32.00	30.00	110	48.00	230.00
		% of increased/Decreased	5.85	5.22	2.39	2.29	5.94	4.39	13.96
		Expenditure Amount (NPR)**	2,980.00	1,577.00	1,287.00	1,228.00	1,856	1,114.00	1,723.00
		% of expenditure	92.46	96.65	93.88	91.54	94.53	97.52	91.82
	Conditional	NPR*	5,935.00	2,759.00	2,762.00	3,344.00	3,467	3,351.00	3,072.00
		increased/Decreased Amount	401.00	26.00	350.00	174.00	272	230.00	288.00
		% of increased/ Decreased	7.25	0.95	14.51	5.49	8.51	7.37	10.34
		Expenditure Amount (NPR)**	4,919.00	2,343.00	2194.00	3,051.00	3,005	3,018.00	2,730.00
		% of expenditure	82.88	84.91	79.45	91.23	86.66	90.05	88.87
	Special Grant Transfer	NPR*	0.00	166.00	42.00	125.00	233	204.00	203.00
		increased/Decreased Amount	–250.00	66.00	–8.00	75.00	83	134.00	203.00
		% of increased/Decreased	–100.00	66.00	–16.00	150.00	55.33	191.42	–100.00
		Expenditure Amount (NPR)**	0.00	164.00	42.00	125.00	233	177.00	203.00
		% of expenditure	92.08	98.87	100.00	100.00	100	86.75	100.00
	Matching Grant Transfer	NPR*	0.00	139.00	251.00	68.00	139	164.00	196.00
		increased/Decreased Amount	–149.00	139.00	251.00	4.00	3	116.00	196.00
		% of increased/Decreased	–100.00	100.00	100.00	6.25	2.21	241.67	100.00
		Expenditure Amount (NPR)**	0.00	128.00	168.00	50.00	113	150.00	174.00
		% of expenditure	89.05	92.05	66.95	74.07	81.58	91.34	88.74

Fiscal Year	Types of IGFT	Status of IGFT Mobilisation	Tulshipur	Bansgadhi	Bheriganga	Dullu	Dhangadhi	Patan	Belbari
Allocate for FY 2022/2023	*Equalisation*	NPR*	3,280.00	1,719.00	1,445.00	1,426.00	2,070	1,232.00	1,959.00
		increased/Decreased Amount	57.00	87.00	74.00	84.00	107	90.00	82.00
		% of increased/Decreased	1.77	5.33	5.40	6.26	5.45	7.88	4.37
		Expenditure Amount (NPR)**	3174.00	1,633.00	1345.00	1,310.00	2,026	1,137.00	1,872.00
		% of expenditure	96.76	94.99	93.08	91.88	97.87	92.32	95.58
	Conditional	NPR*	5,818.00	3,037.00	3,134.00	3,675.00	3,576	3,444.00	2,960.00
		increased/Decreased Amount	−117.00	278.00	372.00	331.00	109	93.00	−112.00
		% of increased/Decreased	−1.97	10.08	13.47	9.90	3.14	2.78	−3.65
		Expenditure Amount (NPR)**	5,132.06	2,855.39	2,640.40	3,648.17	3,498.76	2,727.99	2,592.07
		% of expenditure	88.21	94.02	84.25	99.27	97.84	79.21	87.57
	Special Grant Transfer	NPR*	220.00	100.00	70.00	350.00	585	100.00	50.00
		increased/Decreased Amount	220.00	−66.00	28.00	225.00	352	−104.00	−153.00
		% of increased/Decreased	100.00	−39.76	66.67	180.00	151.07	−50.98	−75.37
		Expenditure Amount (NPR)**	210.00	88.00	58.00	285.00	448	75.00	45.00
		% of expenditure	95.27	88.21	82.38	81.33	76.64	74.81	89.67
	Matching Grant Transfer	NPR*	330.00	230.00	80.00	90.00	390	160.00	270.00
		increased/Decreased Amount	330.00	91.00	−171.00	22.00	251	−4.00	74.00
		% of increased/ Decreased	100.00	65.47	−68.13	32.35	180.58	−2.44	37.76
		Expenditure Amount (NPR)**	248.00	203.00	80.00	90.00	369	160.00	270.00
		% of expenditure	75.22	88.38	100.00	100.00	94.65	100.00	100.00

Source: * Ministry of Finance, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023; ** Nepalganj Sub-Metropolitan City, Bansgadhi Municipality, Bheriganga Municipality, Dullu Municipality, Dhangadhi Sub-Metropolitan City, Patan Municipality, and Belbari Municipality, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023

4.2. Fiscal equalisation grant

The research demonstrates the significant impact of the fiscal equalisation grant on the local level. First, it helped LGs to build their capabilities considering their limited resource availability. Second, it offered subsidy grants to LGs and facilitated efficient service delivery and the implementation of development projects. Third, the LGs were able to allocate and distribute the equalisation grants according to their own priorities and plans, as outlined in their annual programs.

Finally, this grant was used to reduce vertical and horizontal fiscal imbalances across all tiers of government. As evidenced by the allocation of funds in the fiscal year 2018/2019 for the chosen seven municipalities, there has been a decrease in budget compared to the previous year 2017/2018. In fact, all seven municipalities saw a reduction

Table 3.
Expenditure of fiscal equalisation grants in local governments

% of Expenditure	Tulshipur	Bansgadhi	Bheriganga	Dullu	Dhangadhi	Patan	Belbari
FY 2017/2018	86.56	94.27	93.44	89.46	96.53	91.44	97.76
FY 2018/2019	89.33	94.61	91.25	94.45	94.68	93.55	91.82
FY 2019/2020	92.54	94.91	91.86	89.62	96.73	85.61	89.79
FY 2020/2021	92.64	94.32	91.73	92.47	92.33	88.64	89.04
FY 2021/2022	92.46	96.65	93.88	91.54	94.53	97.52	91.82
FY 2022/2023	96.76	94.99	93.08	91.88	97.87	92.32	95.58

Source: Nepalganj Sub-Metropolitan City, Bansgadhi Municipality, Bheriganga Municipality, Dullu Municipality, Dhangadhi Sub-Metropolitan City, Patan Municipality, and Belbari Municipality, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023

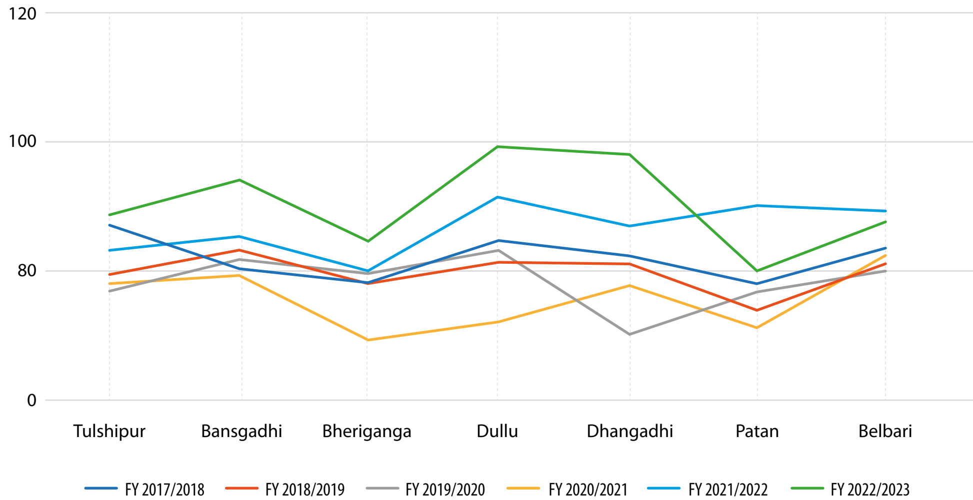

Figure 1.
Expenditure of fiscal equalisation grants in local governments
Source: Nepalganj Sub-Metropolitan City, Bansgadhi Municipality, Bheriganga Municipality, Dullu Municipality, Dhangadhi Sub-Metropolitan City, Patan Municipality, and Belbari Municipality, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023

of 40.37% to 53.88%. This can be attributed to a shift in priorities by the federal government and underperformance in development work and capital expenditures by the local governments.

However, the elected representatives of such municipalities did not endorse the pointed cause of poor work performance. In their opinion, the major factors were the centralised mind set of federalism, which was a new practice in terms of power, functions and systems. Similarly, ineffective and languid staff management, inadequate laws, as well as the lack of work experience of elected representatives and bureaucrats led to weak performance. See below the observation of a mayor who was interviewed during the study.

> "Despite being invited to participate in discussions about intergovernmental fiscal transfers, local government representatives often find that their voices are not given top priority when it comes to addressing issues, meeting demands, and providing necessary resources at the local level. As a result, fiscal equalisation grants may not always deliver the expected benefits to local communities."

During the fiscal year of 2019/2020, there was a consistent rise in the budget across all municipalities, ranging from 1.07% to 9.60%. However, this increase indicates several inconsistencies in the budget allocation process. Elected officials and staff members raised concerns during a field visit about a lack of proper performance and expenditure responsibilities, chaotic employee adjustment process of federal governments, failure to identify areas for investment with maximum production and benefits, and inability to support local level policies, programs and budgets. These were further compounded by political influences that resulted in both unexpected budget increases and decreases.

Nevertheless, some unforeseen events such as the Covid pandemic forced the authorities to increase the expenses of the budgets in FY 2020/2021 compared to the previous year. This was a result of the state having to allocate significant funds towards treatment, while the federal government faced a decrease in revenue collection in this period. Despite these challenges, the following two fiscal years, 2021/2022 and 2022/2023, saw a return to natural growth as all municipalities recorded budget increments of 2.29% to 13.96% and 1.77% to 7.88%, respectively. This data indicates that the budget increments observed in all municipalities were a result of natural growth.

The field visit revealed that 92.91% of the fiscal equalisation grant was being spent. Of this, over 80% was spent on capital expenditures, while 100% was spent on current expenditures. Approximately one third of the budget was kept as an ideal amount, known as the *Awanda* (Reserve) fund. Normally, this amount of the budget is distributed by the mayor or a group of executives of municipalities to politically influential citizens. At the end of the fiscal year, municipalities often return unspent equalisation grants to their consolidated fund and allocate them to new development projects based on the mayor's discretion. Unfortunately, this practice often results in a budget shortfall for on-going projects, making their completion challenging. Furthermore, the repeated allocation of inadequate funds poses a fiduciary risk for local governments every year.

Nevertheless, the value of equalisation grants is important in meeting the needs and development aspirations of citizens at the local level. However, looking at the three-year federal government allocation, the increase in the equalisation grant is almost insignificant, which is extremely low in terms of fulfilling local needs. Criticisms remain that this approach has led to dependency syndrome at the local level, as the federal government continues to push for greater centralisation. Additionally, there has been a growing expectation of increased budget allocations from the federal government. This has resulted in LGs relying heavily on federal funds rather than generating and increasing their own sources of revenue at the local level.

Conditional grants

The LGs are given conditional grants to carry out the projects primarily defined by the thematic ministries or departments. With conditions based on outcomes, this fund is intended to equip local communities with the resources they need to fulfil national development objectives. Conditional grants shall be executed under the requirements of the level providing the grant, and the allocated amount will be returned to the appropriate level if no expenditure is made for whatever reason. Post-federalisation, the federal government has provided the lower governments a total of 13 trillion 71 billion 72 million in subsidies in the past five years. Out of the total volume, 54.55% of the total share is a conditional grant (Government of Nepal, 2022).

The selected municipalities experienced a significant increase of 20.86% to 81.89% in the conditional grant during fiscal year 2018/2019. This upward trend continued in the following fiscal year (2019/2020), with a boost of 3.53% to 20.29%. However, there was a slight drop in the conditional grant of Dhangadhi Sub-Metropolitan City, as their expenditure decreased last year, resulting in a decrease from 26.26% to 69.78%. In FY 2020/2021, the grant rose again to a range of 17.69% to 43.23%. Looking ahead, there was a modest increase of 0.95% to 10.34% in the conditional grant for FY 2021/2022, followed by an increase of 2.78% to 10.08% in the budget for FY 2022/2023.

Unfortunately, both Tulshipur Sub-Metropolitan City and Belbari Municipality experienced a decrease in their conditional grants, with reductions of 1.97% and 3.65%, respectively. The statistics also revealed inconsistencies in the allocation of conditional grants. These inconsistencies can be attributed to three main factors. Firstly, local governments face insufficient capacity in areas such as budgeting, planning, implementation and ensuring sustainability. Secondly, collusion with the federal government, officials, and political figures in prioritising projects with political agendas. Third, there was a propensity to select projects by keeping all the resources in the centre without considering expenditure capacity and distributing the budget without a guarantee of funding. In this way, the conditional grant was increased with the intention of federal interest, which is against the constitution that destroyed the jurisdiction of LGs.

Table 4.
Expenditure of conditional grants in local governments

% of Expenditure	Tulshipur	Bansgadhi	Bheriganga	Dullu	Dhangadhi	Patan	Belbari
FY 2017/2018	86.77	79.97	77.77	84.28	81.63	77.85	82.62
FY 2018/2019	77.81	82.76	77.58	81.08	80.92	73.57	80.62
FY 2019/2020	77.86	81.56	79.34	82.55	69.78	76.28	80.06
FY 2020/2021	77.62	79.08	68.77	71.69	77.54	70.97	81.88
FY 2021/2022	82.88	84.91	79.45	91.23	86.66	90.05	88.87
FY 2022/2023	88.21	94.02	84.25	99.27	97.84	79.21	87.57

Source: Nepalganj Sub-Metropolitan City, Bansgadhi Municipality, Bheriganga Municipality, Dullu Municipality, Dhangadhi Sub-Metropolitan City, Patan Municipality, and Belbari Municipality, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023.

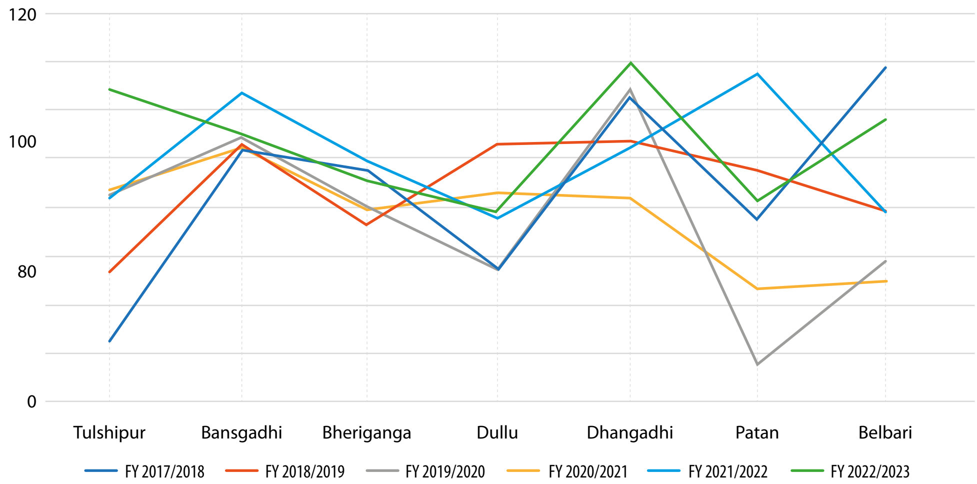

Figure 2.
Expenditure of conditional grants in local governments
Source: Nepalganj Sub-Metropolitan City, Bansgadhi Municipality, Bheriganga Municipality, Dullu Municipality, Dhangadhi Sub-Metropolitan City, Patan Municipality, and Belbari Municipality, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023.

The field visit revealed that only 81.78% of the conditional grant was being utilised in the last 5 years. The findings indicate that the conditional grant was allocated without adequate research, and the work of the local government was always directed by the federal government, which led to dependency and undermined local government effectiveness.

Based on the data, it appears that the allocation of funds from the conditional grant primarily favoured administrative expenses over program-related funding. This imbalanced distribution of funds may have undermined the trust of citizens in the local governance and hindered their ability to participate and fulfil their roles in the community. A municipality staff member's perspective was also considered as part of the research.

> "The conditional grant of NPR 15,000 has been designated for goat breeding; however, the current market price of a hybrid goat ranges from NPR 40,000 to 350,000. This raises the question of how local governments can effectively meet the needs of citizens in this aspect."

According to legal provisions, LGs are not allowed to modify the conditional grants. It must be strictly utilized for its intended purpose. The fact that so many small projects were developed and distributed the fund as part of the conditional grant made elected representatives dissatisfied. Looking at the overall situation, the federal government was frequently sending projects ranging from NRs 1,000 to 200,000. Such projects known as *Khudre Pariyojana* (tailor-made projects) were less attained by the LGs due to not having decision-making authority. Such type of enforcement of the budget and programme every year means the undermining of the LGs and creating vulnerability in the role of elected representatives. First, the enforcement through conditional grants continuously attacked the scope of work, the financial autonomy, and the allocation efficiency of the local governments. Second, allocating tailor-made projects with an indication of the name and implementation of the projects under the supervision of political leaders or elites was very common.

Furthermore, local governments heavily criticized this practice, emphasizing that it failed to address their specific needs and possibilities. Additionally, there is a longstanding tradition of not granting funds with conditions for projects related to exclusive functions, which further diminished the effectiveness of project management and eroded public trust in the government.

Special grant

The LGs have received a special grant from the federal governments as supplemental funding to implement the specific projects or development programs. This has characteristics with conditional grants, which are made available under certain conditions. The National Planning Commission is a responsible institution to deliver the special grant at the local level. The major objective of this grant is to address the imbalanced situation in which LGs' levels of social and economic development varies.

The concept of special grant was initiated from the FY 2020/2021, aimed to alleviate short term budget deficiencies at local governments. For the 2021/2022 fiscal year, the amount provided to the selected municipalities has increased from NPR 50–250 million to between 12% and 150%. In Patan municipality, the budget was increased by 191.42% and in Dullu by 150% in which 66% in Banshgadhi municipality and 55% in Dhangadhi SMC. However, the municipalities of Tulshipur SMC, Bheriganga and Belbari witnessed a significant decrease in the amount of special grants due to various reasons such as inability to draft a high-quality proposal, frequent changes in the Chief Administrative Officer position and inadequate capacity of other staff to prepare the necessary documents in time.

During the fiscal year of 2022/2023, Dullu saw a 180% increase in its special grant, while Dhangadhi and Tulshipur experienced a 151% and 100% increase, respectively. The local government authority accredited this growth to the adeptness of the staff in crafting high-quality project proposals, timely submission of approved projects by the executive board and the unwavering support of elected representatives towards the technical staff in

Table 5.
Expenditure of special grants in local governments

% of Expenditure	Tulshipur	Bansgadhi	Bheriganga	Dullu	Dhangadhi	Patan	Belbari
FY 2020/2021	0.00	100.00	97.76	100.00	100.00	100.00	100.00
FY 2021/2022	92.08	98.87	100.00	100.00	100.00	86.75	100.00
FY 2022/2023	95.27	88.21	82.38	81.33	76.64	74.81	89.67

Source: Nepalganj Sub-Metropolitan City, Bansgadhi Municipality, Bheriganga Municipality, Dullu Municipality, Dhangadhi Sub-Metropolitan City, Patan Municipality, and Belbari Municipality, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023

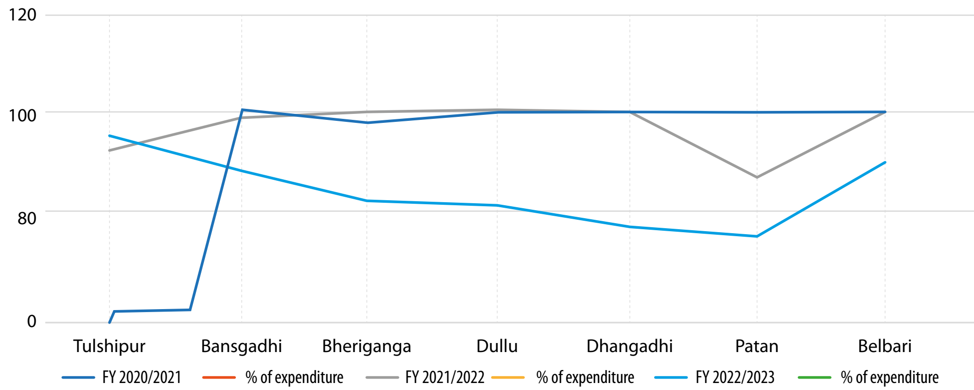

Figure 3.

Expenditure of special grants in local governments

Source: Nepalganj Sub-Metropolitan City, Bansgadhi Municipality, Bheriganga Municipality, Dullu Municipality, Dhangadhi Sub-Metropolitan City, Patan Municipality, and Belbari Municipality, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023

the proposal preparation and project implementation processes. In addition, the incorporation of advanced technology in the submission of project proposals was also cited as a contributing factor.

Nevertheless, Banshgadhi, Patan and Belbari municipalities experienced a reduction in their grant allocations; the reasons for this were not conducive to an increase in the amount of special grants. Such factors included failure to adhere to proper guidelines, submitting proposals without the approval of the executive board, unnecessary transfer of the CAO, political conflicts with the federal government and inadequate technical expertise in submitting project proposals through online process. It is worth noting that the special grant primarily aimed to fund initiatives related to infrastructure development, local pride projects and economic and social development.

During the field visit, it was found that most local governments were not interested in getting the special grant which was provided by the federal government. The main reason for this was that the local governments must contribute to the resources based on the conditions and standards of the projects determined by the federal government. Many procedural steps had to be completed to apply for the projects, and unnecessary follow-up with the NPC led to the local governments' indifference. Similarly, LG representatives claimed that there is discrimination in the distribution of grants and political bias about the submitted projects of local governments. It looks at the hollowing state of intergovernmental relationships that created an adverse impact on the social accountability of all tiers of government.

Complementary/matching grant

Matching fund is also called complementary grant or counterpart fund, which is given by the federal government to LGs to implement the specific projects or development

Table 6.
Expenditure of complementary/matching grants in local governments

% of Expenditure	Tulshipur	Bansgadhi	Bheriganga	Dullu	Dhangadhi	Patan	Belbari
% of expenditure	0.00	0.00	0.00	100.00	100.00	0.00	0.00
% of expenditure	89.05	92.05	66.95	74.07	81.58	91.34	88.74
% of expenditure	75.22	88.38	100.00	100.00	94.65	100.00	100.00

Source: Nepalganj Sub-Metropolitan City, Bansgadhi Municipality, Bheriganga Municipality, Dullu Municipality, Dhangadhi Sub-Metropolitan City, Patan Municipality, and Belbari Municipality, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023

programs. For this, each municipality can request up to 5 projects and the metropolitan can request up to 7 projects.

In most of the selected municipalities, the special grant was received by more than 100% in FY 2021/2022. However, Dhangadhi and Dullu saw a smaller increase of 2.21% and 6.25%, respectively, compared to other municipalities. As for the following fiscal year, a noticeable trend of budget reduction was observed in Dhangadhi (180%), Tulshipur (100%) and Bheriganga (65.47%) municipalities. In contrast, Bheriganga (68.13%) and Patan (2.44%) experienced a significant increase due to the submission of high-quality proposals and demand-driven projects.

This concept of complementary grants was envisioned to equalise the demand for the projects and the imbalance of resources at the local levels, particularly for low-income LGs. According to conversations with local government officials, this grant is requested when there is a financial gap to implement the multiannual LG pride projects. To ensure the

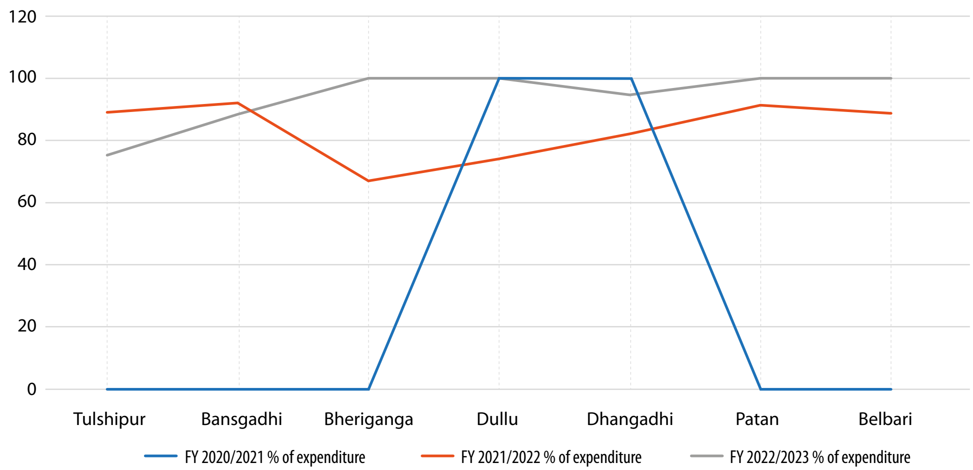

Figure 4.
Expenditure of complementary/matching grants in local governments
Source: Nepalganj Sub-Metropolitan City, Bansgadhi Municipality, Bheriganga Municipality, Dullu Municipality, Dhangadhi Sub-Metropolitan City, Patan Municipality, and Belbari Municipality, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023

effectiveness of the grants, a three year period has been set aside for project operation and completion.

As a result, there was a notable improvement in the contract system and the practice of holding accountable for project implementation became institutionalised. However, due to the political biases of the federal government, the LGs faced many difficulties in obtaining this grant in a justifiable manner. The reluctance of lower income LGs to submit project proposals due to financial insufficiency for the projects, less capacity to prepare detailed project reports (DPRs) and environmental impact assessments (EIAs) resulted in project proposals being rejected. Similarly, it was seen that the selection process of the project and allocation of this grant is less transparent, and priority differences were also reasons to reject the proposal of poor resource-based municipalities.

4.3. Mobilisation of internal revenue mobilisation at the local level

Under the constitution and the Intergovernmental Fiscal Transfer Act of 2017, local governments have the right and authority to collect and utilise local revenues. These rights include the ability to collect taxes (such as land registration, property tax, house rent tax and vehicle tax), service fees, tourism fees, advertisement taxes, business taxes, fines, entertainment taxes and property collections. However, local governments must take into account several key factors when exercising their taxation powers including the rationale for levying taxes, ensuring a balance between tax revenues and local needs and considering citizens' perceptions of paying taxes. A well-designed local tax system should consider these elements. One of the major challenges for local governments is the narrow scope of taxation and inadequate tax education. As a result, they were struggling to generate sufficient revenue from taxes to sustain their operations. The task of revenue collection and mobilisation demands not only resources and capability, but also strong leadership and integrity, as well as support from citizens.

Moreover, the success of revenue mobilisation hinges upon the quality of the financial decisions. If local governments can improve the accessibility and effectiveness of public services and goods funded by local taxes, they can boost revenue collection efficiency and promote tax compliance. Cutting down on administrative costs are also crucial in this process, as it demonstrates a positive commitment towards the tax system. Table 7 below shows the status of internal revenue in different municipalities, while Table 8 depicts the comparison between intergovernmental fiscal transfer and internal revenue at the local level.

The government collects taxes and fees from citizens in accordance with the laws to provide services to citizens. However, in Nepal, the revenue collection system is not homogeneous from one LG to another. Similarly, it did not consider the harmonisation with the citizens and the ability to pay the tax. The findings indicate that local governments usually charge a high amount of fees for services and taxes. Thus, it is crucial for local levels to formulate a revenue improvement action plan with wider citizen engagement. Based on the recommendations, the rate and scope of the tax need to be prioritised for revenue

Table 7.
Internal revenue of different municipalities (NPR 0000)

Municipalities	Internal Revenue for FY 2017/2018 2074/075	Internal Revenue for FY 2018/2019		Internal Revenue for FY 2019/2020		Internal Revenue for FY 2020/2021		Internal Revenue for FY 2021/2022		Internal Revenue for FY 2022/2023	
		Budget	% of increased/ decreased	Budget	% of increased/ decreased	Budget	% of increased/ decreased	Budget	% of increased/ decreased	Budget	% of increased/ decreased
Tulshipur	6,500	14,000	115.38	25,000	78.57	30,000	20.00	60,000	100.00	30,120	−49.80
Bansgadhi	1,520	1,760	15.79	1,120	−36.36	1,186	5.89	2,875	142.41	1,905	−33.74
Bheriganga	1,231	1,865	51.50	2,305	23.59	2,459	6.68	2,539	3.25	2,995	17.96
Dullu	367	300	−18.26	184	−38.67	413	124.46	650	57.38	600	−7.69
Dhangadhi	8,337	13,850	66.13	17,800	28.52	20,007	12.40	18,393	−8.07	26,884	46.16
Patan	150	250	66.67	417	66.80	938	124.94	988	5.33	530	−46.36
Belbari	6,436	6,921	7.54	9,368	35.36	8,050	−14.07	8,705	8.14	13,910	59.79

Source: Nepalganj Sub-Metropolitan City, Bansgadhi Municipality, Bheriganga Municipality, Dullu Municipality, Dhangadhi Sub-Metropolitan City, Patan Municipality, and Belbari Municipality, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023

mobilisation. Furthermore, local governments must be diligent in managing their finances and ensuring transparency in their collection and use of funds.

The municipalities chosen for the study have shown varying levels of progress in terms of internal revenue, as depicted in Table 7; for example, from a modest 7.54% increase in Belbari municipality to an incredible 115.38% rise in Tulsipur in 2018/2019. However, this positive trend does not apply universally, as evidenced by the 18.26% decrease in revenue in Dullu municipality over the same period. Moving on to the following fiscal year 2019/2020, it is evident that progress has been limited in most municipalities. While Dhangadhi has seen a decent 28.52% increase and Tulshipur has recorded an impressive 78.57% rise, other areas such as Bansgadhi have witnessed a decline of 36.36% in their revenue. In a similar vein, Dullu municipality has seen a significant drop. During the fiscal years 2020/2021 and 2021/2022, Belbari municipality experienced a considerable decline of 14.07% in revenue, while Dhangadhi saw a decrease of 8.07%. In contrast, other municipalities have shown positive growth, with a range of 5.89% to 124.94%. Looking ahead to FY 2022/2023, Bheriganga is projected to experience an increase of 17.96%, while Belbari is expected to see a significant growth of 59.79%. The remaining municipalities, unfortunately, are predicted to experience a decrease in internal revenue. Overall, it appears that local governments are struggling to significantly increase their internal revenue amidst challenges such as the Covid pandemic, the implementation of new federal models, inadequate institutional practices and inadequate management of human resources. In terms of increment, Tulshipur (52.83%) and Patan (43.48%) are leading the pack, with other municipalities seeing modest increases ranging from 18.80% to 29.03%.

Table 8.
Comparison between intergovernmental fiscal transfer and internal revenue at local level (NPR 0000)

	Name of Municipalities	Tulshipur	Bansgadhi	Bheriganga	Dullu	Dhangadhi	Patan	Belbari
2017/2018	Received IGF	79,574.00	43,759.00	38,223.00	41,641.00	72,392.00	37,113.00	41,318.00
	Collected OSR	6,500.00	1,520.00	1,231.00	367.00	8,337.00	150.00	6,436.00
	Total IGFT+OSR	86,074.00	42,239.00	36,992.00	41,274.00	64,055.00	36,963.00	34,882.00
	% of OSR	7.55	3.60	3.33	0.89	13.02	0.41	18.45
	% of IGFT	92.45	96.40	96.67	99.11	86.98	99.59	81.55
2018/2019	Received IGF	71,710.00	33,600.00	29,200.00	35,490.00	63,090.00	30,900.00	36,290.00
	Collected OSR	14,000.00	1,760.00	1,865.00	300.00	13,850.00	250.00	6,921.00
	Total IGFT+OSR	85,710.00	35,360.00	31,065.00	35,790.00	76,940.00	31,150.00	43,211.00
	% of OSR	16.33	4.98	6.00	0.84	18.00	0.80	16.02
	% of IGFT	83.67	95.02	94.00	99.16	82.00	99.20	83.98
2019/2020	Received IGF	78,640.00	37,510.00	30,530.00	37,310.00	73,000.00	35,500.00	37,860.00
	Collected OSR	25,000.00	1,120.00	2,305.00	184.00	17,800.00	417.00	9,368.00
	Total IGFT+OSR	103,640.00	38,630.00	32,835.00	37,494.00	90,800.00	35,917.00	47,228.00
	% of OSR	24.12	2.90	7.02	0.49	19.60	1.16	19.84
	% of IGFT	75.88	97.10	92.98	99.51	80.40	98.84	80.16
2020/2021	Received IGF	89,780.00	43,840.00	38,010.00	45,960.00	85,670.00	43,330.00	45,310.00
	Collected OSR	30,000.00	1,186.00	2,459.00	413	20,007.00	938	8,050.00
	Total IGFT+OSR	119,780.00	45,026.00	40,469.00	46,373.00	105,677.00	44,268.00	53,360.00
	% of OSR	25.05	2.63	6.08	0.89	18.93	2.12	15.09
	% of IGFT	74.95	97.37	93.92	99.11	81.07	97.88	84.91
2021/2022	Received IGF	91,580.00	46,960.00	44,260.00	48,790.00	88,350.00	48,610.00	53,480.00
	Collected OSR	60,000.00	2,875.00	2,539.00	650	18,393.00	988	8,705.00
	Total IGFT+OSR	151,580.00	49,835.00	46,799.00	49,440.00	106,743.00	49,598.00	62,185.00
	% of OSR	39.58	5.77	5.43	1.31	17.23	1.99	14.00
	% of IGFT	60.42	94.23	94.57	98.69	82.77	98.01	86.00
2022/2023	Allocated IGF	99,430.00	50,860.00	47,290.00	55,410.00	96,480.00	49,360.00	52,390.00
	Projected OSR	30,120.00	1905	2,995.00	600	26,884.00	530	13,910.00
	Total IGFT+OSR	129,550.00	52,765.00	50,285.00	56,010.00	123,364.00	49,890.00	66,300.00
	% of OSR	23.25	3.61	5.96	1.07	21.79	1.06	20.98
	% of IGFT	76.75	96.39	94.04	98.93	78.21	98.94	79.02

Source: Nepalganj Sub-Metropolitan City, Bansgadhi Municipality, Bheriganga Municipality, Dullu Municipality, Dhangadhi Sub-Metropolitan City, Patan Municipality, and Belbari Municipality, 2017/2018, 2018/2019, 2019/2020, 2020/2021, 2021/2022, 2022/2023

Similarly, the results displayed in Table 8 indicate a clear pattern – the average dependence on IGFT for the municipalities chosen for this study ranges from a low of 77.35% in Tulsipur to the highest of 99.09% in Dullu Municipality. Interestingly, other municipalities such as Dhangadhi (81.91%), Belbari (82.60%), Bheriganga (94.36%), Bansgadhi (96.09%) and Patan (98.74%) display relatively higher levels of dependence on IGFT, respectively. These findings, along with the annual IGFT and internal revenue of municipalities presented in Table 8, offer valuable insights into the role of IGFT in the financial health of these local communities.

5. Discussions: Sustaining public accountability and controlling fiduciary risk

Nepal has taken numerous initiatives to maintain fiscal accountability in local government, firstly an establishment of a legal framework through the Constitution, laws and regulations to govern public financial management. Secondly, the Office of the Auditor General (OAG) audits local government accounts and ensures financial transparency (Shrestha, 2019). Thirdly, fiscal accountability is ensured through budgetary processes, such as the annual budget and program that outline revenue and expenditure plans. Fourth, local governments are obliged to publicise the prepared financial statements, including income and expenditure accounts and balance sheets (Devkota, 2020). Fifth, public procurement processes are applied to procure the services which ensure transparency and fairness. The Public Procurement Act and related regulations govern procurement activities, promoting accountability and preventing corruption in the use of public funds. Finally, various oversight bodies monitor the implementation of budgetary plans and evaluate the effectiveness of public programs. These have helped identify inefficiencies, evaluate outcomes and ensure that funds are being used as intended, enhancing fiscal accountability (Shrestha, 2019). These indicate that the financial accountability of local governments is being transformed from government to governmentality. These initiatives have played a key role in maintaining financial discipline, ensuring public accountability and mitigating fiduciary risk. In Nepal, efforts have been made to institutionalise fiscal discipline for the efficient and effective management of public income and expenditures through laws, regulations, procedures and systems. For instance, the constitution defines the fiscal framework for federal, provincial and local levels in Part 10, 16 and 19. Additionally, the Financial Procedures and Fiscal Responsibility Act of 2019, along with the Intergovernmental Financial Transfer Act of 2017, provide essential regulatory support for maintaining fiscal discipline. With constitutional autonomy, the Supreme Audit Institution is responsible for ensuring financial accountability and discipline. In response to these legal frameworks, Nepal's financial management has been strengthened and modernised. Similar efforts in various countries around the world have also yielded exemplary results.

In Uganda, the transparency and accountability of public resources have been improved by introducing a few reforms in financial management through laws. For example, the adoption of the open and transparent budget consultative process, this was further enacted by the Public Finance Management Act 2015 (Overseas Development Institute, 2018). By contrast, a significant portion of corruption and financial chaos occurred at the local level in the past in Indonesia, where local bureaucrats collect bribes to supplement their salaries. These irregularities were addressed through the implementation of a Financial Management Information System (FMIS), known by its Indonesian acronym SPAN (Sistem Perbendaharaan dan Anggaran Negara). SPAN provides a centralised database for all financial government transactions, enhancing transparency, efficiency and accountability in the management of public finances (Henderson & Kuncoro, 2011). Funk and Owen (2020) conducted random audits of over 5,000 municipalities in Brazil between 2001 and 2012. Their findings revealed that audited municipalities performed better than those that were not audited. The study concluded that oversight mechanisms and their monitoring programs have been effective in enhancing transparency, accountability and the quality of public services.

According to Acharya (2021), Nepal has a strong legislative and institutional framework for public financial management aimed at enhancing fiscal transparency and accountability by enforcing fiscal rules and promoting greater accountability. This framework promotes effective accountability mechanisms, reduces financial mismanagement, prevents corruption and abuse of political power and strengthens public institutions, all of which contribute to a more effective governance system. However, despite these efforts, challenges remain in achieving full fiscal accountability at the local government level in Nepal. Political influence, favouritism and the presence of middlemen within the political economy have led to the significant misuse of public resources and property. A key factor contributing to fiduciary risks is the severity of the common pool problem, where influential politicians redirect significant portions of the budget to their own constituencies in order to satisfy their voters. This leads to a situation where the average benefit received by these voters is far greater than that received by ordinary citizens across the country. While the entire nation bears the financial burden, only specific groups of people reap the benefits. Similarly, downward accountability is deteriorating due to the increasing fiscal dependence of local governments on the federal government. For example, intergovernmental fiscal transfers typically allocated 8–10% of the central government's total budget to local bodies in Nepal under the unitary governance structure. However, with the establishment of federalism, this allocation increased by 17% of the federal budget. For the fiscal year 2022/2023, the budget distribution was as follows: 77% allocated to the federal government, 6% to the provinces and 17% to local governments (Government of Nepal, 2022). While the federal structure has resulted in an increase in both the volume and percentage of the budget allocated to local governments, the fiscal capacity at the local level remains weak and outdated. Local governments lack concrete plans or strategies for boosting their own revenue sources and maintaining fiscal discipline (Dhungana & Acharya, 2021). As a result, local governments are heavily reliant on funds from the federal government, which has gradually shifted accountability and autonomy toward the central level. For example, in the fiscal years 2020/2021 and 2021/2022, local revenue contributed only 8.15% and 8.01%, respectively, to the total resources of local governments with the remainder – 91.85% in 2020/2021 and 91.99% in 2021/2022 – coming from intergovernmental fiscal transfers (IGFT) (Government of Nepal, 2022).

This growing dependency on federal resources raises concerns not only about the autonomy of local governments but also about the erosion of accountability along the vertical axis of governance. It undermines the constitutional principles of the 3Cs – cooperation, coordination and coexistence – by reinforcing hierarchical relationships in public administration (Government of Nepal, 2019a).

Scholars (Gyawali, 2022; Devkota, 2020; Boex & Kelly, 2013) have warned that the growing "fiscal anarchism" at the local level, which is shifting from the federal level, is disastrous and driven by the increasing trend in internal revenue generation. This fiscal chaos stems from the practice of allocating budgets without identifying sources of funds and launching projects without meeting the necessary prerequisites. The lack of proper preparation leads to cost and time overruns, ultimately making the administration inefficient. Bahl and Linn (1994) add that subnational governments in developed countries spend 32.2% of the intergovernmental grant while 67.8% spend was concerned with local revenue. Similarly, 14.9% of expenditure belongs to IGFT compared to 85.1% spend concerned with local revenue in developing countries. Despite rising and falling figures, this evidence points to the "crowding out" of intergovernmental grants in both developed and developing countries. In Nepal, the frequent growth of IGFT has created an adverse impact in local autonomy and political accountability at the federal level.

As compared to previous years, the fiscal equalisation grants for local governments were reduced by the National Natural Resource Fiscal Commission in FY 2023/2024, while conditional grants increased. There is also a broader concern among local governments, including the reduction of conditional, complementary, and special grants to the maximum extent possible, and compensating them by providing fiscal equalisation grants in their place. According to LGs, this process would increase the capacity of the local governments and allow them to use the constitution's rights. Despite that the current trend of wrong prioritisation in the grant distribution system, resource mobilisation has become volatile, fiduciary risks are increasing in budget expenditures, and governing structures are becoming more corrupt. In addition to these factors, several other issues contribute to the deterioration of public accountability and the increase in fiduciary risks at the local level. For instance, local governments have been found allocating budgets for areas where the law does not permit such spending. Furthermore, a number of local governments exhibit a tendency to manipulate project cost estimates, allowing contracts to be awarded at lower amounts in exchange for kickbacks from contractors.

In 2019, the Government of Nepal enacted the Financial Procedures and Fiscal Accountability Act to make the financial management system responsible, transparent, and accountable as well as maintain macroeconomic stability, and financial discipline and regularize the financial procedures at the local level (Government of Nepal, 2019b). Through this Act, high efficiency and effectiveness in public expenditure, and financial discipline have been expected. However, examples indicate that LGs have been facing serious fiduciary risks. For example, elected officials in Africa, Asia, and Latin America are using public resources for personal benefit without ensuring transparency in revenue collection and expenditure (World Bank, 1997). Some LGs of Bangladesh have not approved the budget from the assembly and have gone beyond the approved budget headings and written expenses in an irregular manner transferring funds from capital headings to current ones and transferring funds more than the specified limit (Rahman et al., 2007). The reports of the Auditor General of Nepal for the past two years show low financial accountability, allocation of the budget without approved guidelines, unnecessary administrative expenses from the capital grants, and low amount of internal revenue at the local level (Gyawali, 2022).

Such information indicates that there are inconsistencies in accountability remaining in the fund, functions and functionaries related to local governments from the federal to the local level in Nepal. Despite the ongoing flaws in fiscal accountability in Nepal, the Government of Nepal actively encourages and enforces local governments (LGs) to maintain public accountability and control fiduciary risks by complying with the legal system. To this end, it is crucial to strengthen internal controls and internal audits in accordance with the relevant legal provisions. The digitisation of the public financial management system, including information and asset management systems, is also crucial to reduce the risks of irregularities and wasteful expenditures. Furthermore, robust plans and strategies are needed to institutionalise capacity development initiatives that address local needs. Finally, local citizens should be provided with meaningful opportunities to engage with local governments, set development agendas and hold local authorities accountable.

6. Conclusions

This research focused on analysing Nepal's intergovernmental fiscal transfer (IGFT) mechanisms and their processes. Although it is too early to reach any definite conclusion about the effectiveness of these mechanisms, evidence evolved in the last seven years or so provides plausible insights on their potentially positive contribution to institutionalising fiscal federalism in Nepal. This research finds that Nepal's IGFT regime offers a set of formulae that allocates funds for various development projects relating to economics, social issues, the environment and infrastructure. However, during their first five year electoral tenure, we found that governments at all levels wrestled in expanding and deepening the essence of transfer of diverse types of funds (see also Bhusal & Acharya, 2024; Bhusal & Breen, 2024). For example, the conditional grants, which follow certain conditions from the top, saw a significant increase of 20–67% in the fiscal year 2018/2019, followed by a 15% increase in the next fiscal year. Along with this, LGs also received a special grant to support various projects in areas such as health, education, infrastructure development and social inclusion. However, not all municipalities were able to receive this grant evenly, due to not being at a high level of competency and disputes between LGs and the federal government. In the chosen municipalities, the equalisation grant has seen a decline of 7.98% from 2017/2018 to 2022/2023. At the same time, conditional grants have experienced a significant rise of 20.38%. However, it is worth noting that other grants, including matching and special grants, are not distributed based on rational decision-making but rather on political alliances between the federal and local government. This troubling trend suggests a diminishing sense of social responsibility as the allocation of resources becomes tainted by political manoeuvring. Thus, the decrease in equalisation grants and the increase in conditional grants pose a challenge to effective federal governance.

When analysing data from the selected municipalities, it is evident that there has been a significant rise in internal revenue from 2017/2018 to 2022/2023, increasing from 18.81% to 52.83%. However, this increase is not evenly distributed among the municipalities. Tulshipur, Bansgadhi, Patan and Dhangadhi have experienced a substantial growth. In contrast, other municipalities have only managed to raise their internal income by less than 25%. Figures show that IGFT still played a crucial role in the budgets of these municipalities, accounting for 90.02% of the total budget, while internal revenue shared 9.98%. This shows a significant gap between the two sources. The Nepalese local government is facing a critical issue where their administrative expenditures are growing compared to their revenue capacity. This has led to a decrease in the quality of services available to the citizens and has created financial chaos that poses a fiduciary risk.

For the future, we would encourage research focusing on the analysis of specific policy areas such as health and the environment, to see how the constitutional provision of the IGFT has actually contributed to the decentralisation of these policy areas. Similarly, it is recommended that we look at the IGFT perspective of individual governance mechanisms, such as the provincial government or any municipality.

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