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Fiscal Federalism and Provincial Performance in Nepal: Rethinking Allocation, Efficiency, and Accountability in the Post-Gen Z Protest Era

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Abstract

Nepal's post-2015 transition to federalism tests whether decentralised public finance can deliver inclusive subnational growth. Drawing on the Nepal Competitiveness Index (NCI 2026), this paper argues that while federalism has institutionalised a rules-based system of fiscal transfers, it has shifted the binding constraint on subnational performance away from fiscal availability and toward execution capacity. As a result, despite equitable vertical fiscal transfers, provincial performance has diverged sharply.

The analysis highlights three structural pathologies undermining the federal experiment. First, an efficiency gap: persistent under-absorption of capital budgets, especially in infrastructure-poor provinces such as Karnali and Sudurpashchim, leaves development fund idle. Second, an accountability deficit: weak own-source revenue mobilisation and rising audit irregularities, particularly in Madhesh and Koshi, signal growing fiduciary risk and erosion of the state-citizen compact. Third, a volatility trap: over-reliance on conditional and special grants undermines multi-year planning and produces a flypaper effect, with spending driven by federal mandates rather than local priorities.

In the post–Gen Z protest environment, where public expectations of transparency and results have intensified, we contend that the status quo is no longer sustainable. This paper argues for a shift from a transfer-centric approach to a performance-oriented fiscal architecture. Without clearer links between fiscal transfers, institutional quality, and audit compliance, fiscal federalism in Nepal risks existing in form rather than in function, with limited developmental impact.

Keywords: Fiscal Federalism, Provincial Competitiveness, Own-Source Revenue Mobilisation, Vertical and Horizontal Fiscal Imbalances, Audit Compliance and Accountability, Nepal Competitiveness Index

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1. Introduction

Nepal's transition to fiscal federalism, constitutionally institutionalised in 2015, emerged from prolonged political contestation over state restructuring and demands to move away from a unitary system of governance. Envisioned as both a political and economic reconfiguration of the state, federalism has remained central to Nepal's post-monarch development discourse. Although the 2015 Constitution provided a framework for fiscal federalism, implementation began only in FY2018/19 with the operationalisation of a three-tier system of government - federal, provincial, and local - each vested with constitutionally defined expenditure responsibilities and revenue powers. This transition marked a significant shift toward decentralising authority, improving intergovernmental coordination, and enhancing the efficiency and accountability of public service delivery. In Nepal's young democracy, core fiscal and administrative institutions are still consolidating, underscoring that federalism is a long-term process requiring sustained efforts for justice, equity, and effective governance.

Nepal's federalism has made substantial progress in achieving one of its core constitutional objectives by ensuring the equitable distribution of public resources across provinces through a rules-based system of intergovernmental transfers. Since the operationalisation of the federal structure, vertical and horizontal transfer mechanisms have helped reduce inherited regional disparities and ensure a minimum level of fiscal capacity across subnational governments. However, we observe that this success in allocation has not yet translated sufficiently into consistent improvements in service delivery outcomes, infrastructure quality, or provincial economic competitiveness. Evidence from Nepal's early federal experience suggests that while fiscal decentralisation has expanded subnational spending authority, the development returns from public expenditure remain uneven and, in many cases, limited (Wagle, 2018; Bhattarai, 2024).

This paper suggests that the binding constraint in Nepal's fiscal federalism framework has shifted away from the adequacy and formal equity of intergovernmental transfers toward structural weaknesses in subnational execution capacity, fragmented public investment management arrangements, and insufficient accountability mechanisms at the provincial and local tiers of government. Ambiguities in expenditure responsibilities, weak coordination across tiers of government, and limited incentives for efficient revenue mobilisation have constrained the effectiveness of decentralised spending (Prasad, 2015). At the same time, low own-source revenue mobilisation has reinforced dependence on federal transfers, weakening the accountability link between citizens and subnational governments and reducing incentives for fiscal discipline (Acharya & Zafrarullah, 2025). These institutional constraints are reflected in low capital-spending efficiency and delays in project implementation, which continue to undermine the growth- and service-delivery impacts of public investment.

Importantly, our assessment indicates variations in service delivery performance, infrastructure execution, and development spending efficiency across provinces demonstrate that institutional capacity, administrative discipline, and governance quality exert a greater influence on outcomes than fiscal allocation levels alone. While decentralisation has increased decision-making autonomy, expenditure patterns show that allocations to priority service sectors such as health, education, and local infrastructure remain suboptimal in several provinces, limiting gains and outcomes at the community level (Bhattarai, 2024). The divergences observed across provinces highlight that the effectiveness of federalism is shaped less by the formal distribution of fiscal authority than by how such authority is exercised in practice.

This paper, therefore, argues that the next phase of Nepal's federal reform agenda must shift from a transfer-centric approach toward a performance-oriented model of fiscal federalism. Our reform priorities include stabilising intergovernmental transfer frameworks to enhance predictability, strengthening provincial execution capacity and audit responsiveness, and aligning fiscal incentives with measurable service delivery and outcomes. Strengthening public financial management systems, reinforcing accountability mechanisms, and more closely linking transfers to performance will be essential to ensure that decentralisation delivers visible economic and social returns. In a young democracy with rising public expectations for accountability and state performance, consolidating the institutional foundations of fiscal federalism is critical to sustaining public confidence and realising the long-term promise of Nepal's decentralised governance system.

The recent Gen-Z-led protests serve as a critical reminder of public dissatisfaction with governance outcomes, institutional performance, and accountability, underscoring the need to realign fiscal federalism with its foundational objectives. The protests raised critical questions, including why provincial governments were unable to strengthen institutions despite constitutional authority, and concerns about the lack of administrative autonomy in the provinces. The protests have also articulated a set of governance demands that, in many ways, call for effective implementation of fiscal federalism. Central to these are rising expectations for equitable service delivery, particularly in key development sectors such as employment, education, health, and digital infrastructure, where youth experience and interact with the state most directly. There is renewed demand for fiscal transparency and to re-evaluate current spending patterns to shift towards youth-aligned public spending, one that emphasises investments that support skills development, job creation, innovation, and future-proof economic growth.

In light of these contexts, this study is guided by four primary objectives to critically assess the performance of Nepal's fiscal federalism. It aims to (i) analyse fiscal allocation patterns across provinces, focusing on horizontal and vertical fiscal gaps, (ii) examine fiscal efficiency and resource utilisation across the seven provinces, (iii) assess accountability mechanisms through audit performance and transparency indicators, and (iv) explore the linkages between fiscal performance and provincial competitiveness, including implications for socio-economic performance.

2. Conceptual Framework

Fiscal federalism provides a normative and explanatory lens for analysing the distribution of fiscal authority across levels of government and the resultant performance outcomes (Oates, 1999). Traditionally rooted in public economics, early fiscal federalism literature argued that decentralisation, when appropriately designed, can enhance efficiency, equity, and responsiveness in public service delivery by aligning the provision of subnational public goods with local preferences (Musgrave, 1959; Oates, 1999). However, recent scholarship emphasises the political economy of decentralisation, acknowledging that fiscal outcomes are contingent on institutional incentives, budget constraints, and accountability mechanisms (Weingast, 2008; Rodden, 2006).

2.1 Fiscal Federalism Theory: From First- to Second-Generation

The classical fiscal federalism framework posits that governments should be assigned functions according to the principle of comparative advantage: central authorities should manage stabilisation and redistribution, while local authorities should supply public goods tailored to local tastes (Musgrave, 1959; Oates, 1999). Oates' decentralisation theorem formalises the idea that the decentralised provision of local public goods enhances welfare by better matching heterogeneous preferences (Oates, 1999). Intergovernmental grants are introduced to mitigate vertical and horizontal fiscal imbalances that arise when expenditure responsibilities outpace revenue capacity at the subnational level (Bird, 2015; Musgrave, 1959).

However, first-generation theory assumes benevolent policymakers with uniform welfare-maximising objectives, an assumption often violated in practice. Second-generation fiscal federalism addresses this gap by integrating political incentives and agency considerations into theoretical models. It highlights how fiscal institutions and intergovernmental transfer designs influence subnational decision-making, economic performance, and governance outcomes (Weingast, 2008). Transfers that fail to align incentives can generate soft budget constraints, eroding fiscal discipline and accountability (Rodden, 2006). Thus, beyond normative prescriptions, fiscal federalism must explain why certain federations succeed while others exhibit persistent inefficiencies and imbalances.

2.2 Performance, Accountability, and Intergovernmental Transfers

Provincial performance in fiscal federalism is a multidimensional concept encompassing allocative efficiency, fiscal autonomy, revenue mobilisation, spending execution, and transparency. Intergovernmental transfers—a core mechanism for addressing vertical imbalances—may paradoxically reduce incentives for own-source revenue (OSR) mobilisation and weaken accountability if not tied to performance metrics. Empirical evidence suggests that transfers with broader discretion and performance incentives correlate with stronger public service outcomes, whereas unconditional transfers risk flypaper effects and expenditure inefficiency (Inman, 2008; Courant et al., 1990).

Accountability is central to linking fiscal resources to outcomes. Strong audit institutions, transparency norms, and legislative oversight enhance fiscal discipline and public trust. Conversely, weak oversight can foster opportunistic behaviour and corruption, particularly where subnational governments depend on federal transfers without robust checks (Khanal, 2024). In rapidly decentralising federations, evaluating the interaction between fiscal allocation, efficiency, and accountability is crucial for understanding the differential performance of provinces.

2.3 Nepal's Federal Experience: Institutions, Grants, and Imbalances

Nepal's 2015 Constitution established a three-tier federal system designed to translate political decentralisation into fiscal autonomy. Provinces and local governments were assigned clear expenditure functions; however, revenue authority remains heavily centralised, leading to persistent vertical fiscal imbalance (Devkota, 2024; Shah, 2016). Intergovernmental fiscal arrangements provide multiple grant types—fiscal equalisation, conditional, special, and matching grants—administered primarily through the National Natural Resources and Fiscal Commission (NNRFC) (Devkota, 2024; Devkota, 2017). While formula-based transfers improve predictability compared to ad hoc allocations, they have not significantly enhanced subnational capacity to raise OSR or tailor revenue instruments to local economic conditions.

Provincial budgets remain heavily dependent on central transfers, with OSR often accounting for less than 10 percent of total revenue in many provinces. This structural reliance limits fiscal autonomy and incentivises subnational governments to focus on compliance with transfer conditions rather than on revenue diversification or spending innovation. Moreover, conditional grants exacerbate central control over provincial priorities and can crowd out local accountability mechanisms.

2.4 The Post–Gen Z Protest Context and Accountability Imperatives

The socio-political landscape in Nepal has shifted significantly in the post–Gen Z protest era, with youth mobilisations foregrounding demands for transparency, accountability, and efficient public spending. Public dissatisfaction with visible inefficiencies and under-execution of capital budgets at the provincial level has intensified scrutiny of fiscal federalism performance. This context underscores the need to integrate political economy perspectives into the conceptual framework. As protests spotlight fiscal mismanagement and governance failures, provincial legitimacy becomes increasingly tied to accountable use of public funds, reinforcing the centrality of downward accountability in decentralised systems.

2.5 Integrated Conceptual Model

Synthesising these theoretical strands, this study adopts a three-pillar performance model for provincial fiscal federalism:

a. Fiscal Allocation: Examines the structure, predictability, and equity of intergovernmental transfers, including the design of formulas and adherence to constitutional mandates.
b. Fiscal Utilisation (Efficiency): Captures the capacity of provinces to absorb and execute budgets effectively, particularly in capital and social sector expenditures.
c. Fiscal Accountability: Evaluates transparency, audit compliance, and institutional oversight mechanisms that align resource use with public expectations and outcomes.

This model emphasises that robust performance emerges not from standalone fiscal volume but from the interaction of allocation equity, execution capacity, and stringent accountability. Provinces with lower transfers but strong accountability and efficient execution may outperform better-funded counterparts with weaker governance structures. Such an integrated perspective is particularly relevant given Nepal's evolving intergovernmental fiscal landscape.

3. Methodology

3.1 Research Design and Rationale

This study employs a comparative, descriptive, and mixed-methods design to systematically assess how fiscal allocation, expenditure efficiency, and accountability influence provincial performance in Nepal's federal system. Recognising the institutional complexity and nascent data environment in Nepal, the methodology blends quantitative trend analysis with qualitative contextual interpretation to illuminate patterns rather than asserting strict causal inference.

Fiscal federalism scholarship emphasises that performance evaluation requires capturing both institutional structures and behavioural outcomes of fiscal decentralisation frameworks (Bird, 2015; Oates, 1999). Accordingly, this study frames analysis around observable fiscal indicators at the provincial level over seven years (FY 2018/19–FY 2024/25), supplemented by audit reports, transfer regimes, and PFM assessments.

3.2 Units of Analysis and Temporal Scope

The unit of analysis comprises the seven provincial governments of Nepal. The temporal scope extends from FY 2018/19—the first full budget cycle after federalism implementation—to FY

2024/25. This period captures initial adjustment and maturation dynamics, enabling assessment of fiscal trends and institutional evolution.

3.3 Data Sources

Data are drawn from authoritative secondary sources:

a. Provincial budget documents and audited financial statements obtained from provincial finance ministries;
b. Intergovernmental fiscal transfer data published by the Ministry of Finance;
c. NNRFC allocation reports and transfer formula details;
d. Office of the Auditor General (OAG) audit reports, including irregularity classifications;
e. World Bank Nepal Fiscal Federalism Update data on subnational finances;
f. Nepal Competitiveness Index (NCI) subnational indicators for exploratory linkage to fiscal outcomes.

The use of secondary data is a normative choice in comparative fiscal federalism research to ensure consistency and comparability across units and over time (Bird, 2015).

3.4 Operational Definitions and Variables

The study operationalises the three core pillars—allocation, utilisation, and accountability—into measurable indicators.

Pillar 1: Fiscal Allocation

a. Per capita transfer amounts (equalisation, conditional, special, and matching grants);
b. Transfer composition ratios, indicating the relative share of grant types;
c. Transfer volatility index, defined as the year-to-year percentage change in fiscal transfers.

These indicators reflect both vertical equity (across tiers of government) and horizontal equity (across provinces).

Pillar 2: Fiscal Utilisation (Efficiency)

a. Budget absorption rates, calculated as actual expenditure divided by the approved budget for each province;
b. Capital expenditure execution ratios, focusing on infrastructure and social development spending;
c. Recurrent vs capital expenditure shares to gauge investment orientation.

High absorption and balanced capital allocation are associated with stronger fiscal execution capacity.

Pillar 3: Fiscal Accountability

a. Audit irregularity incidence, capturing frequency and severity of findings in OAG reports;
b. Audit compliance rate, indicating the proportion of previous audit recommendations addressed within the next fiscal year;
c. Transparency indicators, based on the availability and timeliness of budget documents and procurement disclosures.

These indicators assess both procedural and outcome dimensions of fiscal governance.

3.5 Analytical Techniques

The methodology employs a combination of descriptive statistics, trend analysis, and comparative case diagnostics:

a. Descriptive statistics summarise the central tendencies and ranges of fiscal variables across provinces;
b. Time-series graphs illustrate evolving trends in allocations and utilisations.
c. Cross-provincial comparisons identify relative strengths and weaknesses in performance profiles.

Additionally, exploratory correlation analysis examines relationships between fiscal indicators and selected NCI subnational performance scores (e.g., business environment, infrastructure quality). While not intended to establish causality, this analysis illuminates patterns warranting further investigation.

3.6 Qualitative Contextualisation

Quantitative findings are interpreted alongside key institutional developments, such as changes in the NNRFC's allocation formula, new legislative frameworks (e.g., Intergovernmental Fiscal Arrangements Act), and political events (e.g., frequent changes in provincial leadership). This qualitative dimension enables the study to embed fiscal performance within Nepal's broader governance and political economy context.

3.7 Comparative Logic

Comparative logic is central to the study. By contrasting fiscal outcomes across provinces with varying resource endowments, governance traditions, and OSR capacities, the analysis reveals how institutional design interacts with local conditions. For instance, a province with relatively low transfers but high audit compliance and capital execution may be inferred to have stronger fiscal governance than a better-funded but poorly executing province.

3.8 Validity, Reliability, and Data Limitations

The study addresses validity by aligning indicators with widely recognised fiscal federalism performance metrics (e.g., transfer equity, budget absorption) and employing official audited data wherever possible. Reliability is enhanced through consistent data collection protocols across provinces and years.

However, limitations include uneven reporting standards across provinces, occasional gaps in high-frequency data, and the absence of granular subnational revenue breakdowns in some years. Audit narratives, while rich, are inherently qualitative and require careful coding to ensure consistency in the classification of irregularities.

3.9 Ethical Considerations

As this study relies exclusively on publicly available secondary data, no human subjects are involved. The analysis prioritises the accurate representation of provincial fiscal information and refrains from normative judgements in the absence of empirical support.

4. Fiscal Allocation Patterns Across Provinces

Understanding how fiscal resources move from the federal government to Nepal's provinces is essential for evaluating the performance of the country's intergovernmental fiscal system and its implications for balanced development. Provincial governments rely heavily on federal transfers to finance basic services, expand infrastructure, and address regional disparities that vary widely across different regions. This section examines how the current framework influences these flows and assesses whether transfer patterns, both in aggregate and across provinces, support equity, effective service delivery, and long-term competitiveness. The analysis draws on federal data from FY 2078/79 to FY 2082/83 and focuses on four major grant categories: equalisation, conditional, special, and complementary grants. Together, these instruments form the fiscal space within which provinces plan, budget, and implement their development priorities.

4.1 Policy and Institutional Background

Nepal's intergovernmental fiscal system has evolved through a combination of foundational legislation and a series of operational directives that continue to refine how provinces and local governments manage and report the use of fiscal transfers. The Intergovernmental Fiscal Transfer Guidelines of 2075/76 established the core procedures for allocating and administering grants, while subsequent directives issued in FY 2076/77, FY 2077/78, and FY 2079/80 expanded compliance requirements, clarified reporting responsibilities, and strengthened the role of provincial treasuries in budget execution (MoF, 2019; GoN, 2020; GoN, 2021).

More recent province-specific directives introduced in FY2079 and FY2080 attempted to tailor implementation arrangements for provinces such as Lumbini, Sudurpashchim, Gandaki, Karnali, Bagmati, Madhesh, and Koshi, acknowledging the uneven administrative capacities across subnational governments (GoN, 2023a; GoN, 2023b). Complementary guidelines, such as the Provincial Treasury Operation Guidelines 2074, the Tax and Non-Tax Model Bye-Law 2074, and updated expenditure reporting instructions, reflect ongoing efforts to harmonise financial management practices nationwide (MoF, 2017; MoF, 2018).

Despite these improvements, the need for recurring updates to operational directives indicates persistent challenges: inconsistent adherence to procedures, limited provincial capacity for absorption, and ambiguity in roles and responsibilities. Nepal's intergovernmental fiscal framework is becoming increasingly rule-based. Still, it remains in a transitional phase where clearer operational guidance and stronger administrative capacity are critical for ensuring that transfers, whether equalisation, conditional, special, complementary, revenue sharing, or royalty sharing (Annex 1), support provincial competitiveness, fiscal stability, and effective service delivery.

4.2 Trends in Vertical Transfers

Vertical transfers from the federal government to the provinces exhibited moderate fluctuations over the five-year period, shaped by macroeconomic conditions, federal revenue performance, and shifting national priorities. Total transfers rose from NPR 97.7 billion in FY 2078/79 to NPR 102.1 billion in FY 2079/80, driven largely by increased conditional allocations tied to federal development commitments. This expansion proved temporary: in FY 2080/81, transfers dropped to NPR 95.2 billion as federal revenues slowed and fiscal pressures intensified. Transfers recovered slightly to NPR 100.6 billion in FY2081/82 but eased again to NPR 98.5 billion in FY 2082/83, remaining below the FY 2079/80 peak.

The contraction in federal transfers was driven mainly by reductions in conditional and special grants, which are most sensitive to fiscal tightening. These reductions narrowed provincial fiscal space, particularly for those with weaker internal revenue bases, directly affecting financing for infrastructure and social programs. Equalisation grants, by contrast, remained relatively stable and continued to provide a predictable base for recurrent expenditures. However, the broader volatility in conditional and special grants underscores the exposure of Nepal's intergovernmental fiscal system to macro-fiscal shifts. For provinces, this unpredictability complicates annual budgeting and undermines multi-year planning, an issue long recognised as a structural weakness in Nepal's public financial management system (World Bank, 2025).

Table 1: Total Transfers by Grant Type (All Provinces Combined) *(NPR in lakh)*

Fiscal Year	Equalization	Conditional	Special	Complementary	Total Transfers
2078/79	56,55,45	36,38,27	3,83,82	4,07,54	1,00,84,08
2079/80	61,92,27	39,12,53	4,55,73	4,64,09	1,10,24,62
2080/81	60,67,60	39,35,18	4,86,73	4,84,19	1,09,73,70
2081/82	60,10,00	38,64,85	4,65,97	6,20,00	1,09,60,82
2082/83	60,60,67	39,42,36	4,55,92	6,78,06	1,11,36,01

Source: *Intergovernmental fiscal transfer data tables (FY 2078/79–2082/83)*. Ministry of Finance, Government of Nepal.

4.3 Horizontal Distribution Patterns

The distribution of transfers across provinces reveals both consistent structural patterns and notable differences. Bagmati Province remained the largest recipient of federal transfers throughout the period, reaching nearly NPR 194 billion in FY2082/83. This reflects its large population, concentration of administrative institutions, and diverse service delivery responsibilities. Koshi and Lumbini consistently formed the next tier, each receiving over NPR 145 billion annually, reflecting their geographically diverse populations and service needs. Madhesh and Gandaki received comparatively lower transfers despite Madhesh's large population. Madhesh's FY 2082/83 allocation of NPR 127 billion highlights the constraints imposed by formula-based equalisation and limited access to conditional and complementary grants. Gandaki's allocations remained steady but modest, consistent with its moderate population size and revenue-raising capacity. Karnali stands out as a structural exception. Despite its small population and limited economic base, it received among the highest per-capita transfers, reaching NPR 161 billion in FY 2082/83. This reflects Nepal's equity-oriented design, which allocates greater resources to regions with pronounced service-delivery challenges. Sudurpashchim, which shares similar geographic and structural characteristics, also received relatively high per-capita transfers, though its total allocation trended slightly downward in the latter years.

Table 2: Province-Wise Total Transfers by Year (2078/79–2082/83) ***(NPR in lakh)***

Province	FY 2078/79	FY 2079/80	FY 2080/81	FY 2081/82	FY 2082/83
Koshi	1,45,29,364	1,45,08,091	1,66,11,180	1,45,42,766	1,45,40,383
Madhesh	1,28,30,324	1,31,17,089	1,33,45,354	1,19,35,490	1,27,37,484
Bagmati	1,49,29,658	2,02,32,466	1,95,57,323	1,89,59,585	1,93,69,923
Gandaki	1,29,02,850	1,46,45,372	1,35,40,480	1,27,57,454	1,27,23,366
Lumbini	1,45,87,924	1,68,50,464	1,78,36,452	1,61,01,193	1,60,09,191
Karnali	1,50,32,226	1,63,30,671	1,69,27,369	1,65,03,728	1,61,03,238
Sudurpashchim	1,45,28,957	1,47,46,053	1,43,20,718	1,42,52,291	1,41,62,079

Source: *Intergovernmental fiscal transfer data tables (FY 2078/79–2082/83)*. Ministry of Finance, Government of Nepal.

4.4 Composition of Fiscal Transfers

4.4.1 Equalisation Grants

The equalisation grants form the foundation of Nepal's intergovernmental transfer system and are designed to reduce fiscal disparities by ensuring that all provinces have the resources required to deliver basic services. These grants displayed remarkable stability over the five-year period, supporting consistent provincial budgeting for core functions such as education, health, and administration. Karnali consistently received the highest equalisation transfers, reaching NPR 9,16,45 lakh in FY 2082/83. This reflects its structural disadvantages, remoteness, low population density, limited economic activity, and high service delivery costs, all of which are explicitly captured in the formula. Bagmati and Lumbini also received high equalisation amounts due to their population size and administrative responsibilities. Gandaki received the lowest allocations, consistent with its moderate population size and higher relative revenue potential. Madhesh and Sudurpashchim received mid-range allocations, though Sudurpashchim's transfers raise ongoing questions about the adequacy of formula weights assigned to peripheral provinces. Overall, the stability of equalisation grants provides a critical anchor in provincial fiscal planning, particularly given the volatility of conditional and special grants.

Table 3: Province-Wise Equalisation Grants (2078/79–2082/83) ***(NPR in Lakh)***

Province	FY 2078/79	FY 2079/80	FY 2080/81	FY 2081/82	FY 2082/83
Koshi	8,25,48	8,00,28	8,68,35	8,50,62	8,48,58
Madhesh	7,67,99	7,87,85	8,40,01	7,88,65	8,07,41
Bagmati	7,65,63	9,10,20	9,37,46	9,28,46	8,93,68
Gandaki	6,37,86	7,05,26	7,49,15	7,10,91	7,07,26
Lumbini	6,96,79	8,78,46	9,02,97	8,92,59	8,84,94
Karnali	8,10,27	8,66,32	9,14,65	9,12,47	9,16,45
Sudurpashchim	8,30,30	7,61,97	7,91,70	7,83,65	7,82,08

Source: *Intergovernmental fiscal transfer data tables (FY 2078/79–2082/83)*. Ministry of Finance, Government of Nepal.

4.4.2 Conditional Grants

Conditional grants were the most volatile among Nepal's major fiscal transfers. Their levels reflect shifts in federal priorities, budget constraints, and provincial capacity to design and implement programs that meet federal criteria. Bagmati Province consistently received the largest share of conditional grants, peaking at NPR 10,03,40 lakh in FY 2079/80, supported by strong administrative capacity and alignment with federal development objectives. Gandaki, Karnali, and Sudurpashchim received the lowest conditional allocations across the period, reflecting persistent constraints in project preparation, procurement, and implementation readiness. Madhesh and Lumbini received moderate but fluctuating allocations. Because conditional grants often fund development programs and capital projects, their volatility disrupts multi-year planning, delays procurement, and contributes to under-execution, issues frequently observed in Nepal's public investment system. More predictable frameworks and strengthened provincial capacity are therefore essential for improving the effectiveness of these grants.

Table 4: Province-Wise Conditional Grants (2078/79–2082/83) ***(NPR in lakh)***

Province	FY 2078/79	FY 2079/80	FY 2080/81	FY 2081/82	FY 2082/83
Koshi	5,86,37	5,57,24	5,78,56	5,77,83	5,58,10
Madhesh	5,67,71	6,09,66	6,40,07	6,30,59	6,07,12
Bagmati	6,43,66	10,03,40	9,86,27	9,70,80	9,82,18
Gandaki	5,23,34	5,61,11	5,91,42	5,62,36	5,59,47
Lumbini	6,20,56	6,98,38	7,35,66	7,16,78	7,03,82
Karnali	5,42,07	5,49,76	5,91,70	5,61,89	5,63,78
Sudurpashchim	5,27,87	5,24,11	5,11,38	5,02,98	4,98,90

Source: *Intergovernmental fiscal transfer data tables (FY 2078/79–2082/83)*. Ministry of Finance, Government of Nepal.

4.4.3 Special Grants

Special grants account for a relatively small share of total transfers but play a meaningful role in addressing province-specific needs and unforeseen challenges. Their allocations varied considerably across provinces and years, consistent with their discretionary and demand-driven nature. Karnali received the highest special grant allocations throughout the period. Gandaki, Bagmati, and Lumbini received moderate but fluctuating amounts. Madhesh experienced substantial volatility, including no allocation in FY 2081/82 before receiving a renewed grant in the following year. Koshi and Sudurpashchim received modest but stable amounts. Although special grants provide flexibility, their scale is too limited to influence broader development outcomes, and their variability complicates planning. Clearer allocation criteria and greater predictability would enhance their usefulness.

Table 5: Province-Wise Special Grants (2078/79–2082/83) ***(NPR in lakh)***

Province	FY 2078/79	FY 2079/80	FY 2080/81	FY 2081/82	FY 2082/83
Koshi	59,32	48,40	76,00	78,71	55,37
Madhesh	36,57	49,00	44,00	0	39,44
Bagmati	54,84	69,00	73,00	19,14	50,45
Gandaki	58,56	67,00	60,00	69,55	60,05
Lumbini	55,43	68,50	59,70	60,97	49,05
Karnali	69,80	64,25	63,47	67,26	62,97
Sudurpashchim	65,74	52,50	52,12	57,80	51,07

Source: *Intergovernmental fiscal transfer data tables (FY 2078/79–2082/83)*. Ministry of Finance, Government of Nepal.

4.4.4 Complementary Grants

Complementary grants showed the largest interprovincial disparities and the greatest year-to-year volatility. Designed to fill financing gaps in provincial capital projects, they respond closely to the strength of provincial proposals, federal capital priorities, and readiness to execute infrastructure investments. Across the five-year period, Sudurpashchim and Gandaki received the highest complementary allocations, with consistently strong inflows relative to other provinces. Koshi and Bagmati received moderate levels but exhibited substantial fluctuations. Lumbini and Karnali showed variable allocations, suggesting uneven success in securing federal support for capital projects. Madhesh consistently received the lowest complementary amounts, including no allocation in FY 2081/82, indicating challenges in preparing technically sound proposals or meeting federal requirements. Complementary grants help fill capital gaps but are inherently unpredictable. Their volatility reinforces the importance of building provincial capacity to prepare, negotiate, and execute capital projects effectively.

Table 6: Province-Wise Complementary Grants (2078/79–2082/83) ***(NPR in lakh)***

Province	2078/79	2079/80	2080/81	2081/82	2082/83
Koshi	11,96,48	12,01,44	10,46,48	12,04,21	11,86,48
Madhesh	3,24,69	3,48,91	2,97,75	0	3,25,72
Bagmati	5,57,56	5,78,55	5,69,05	5,20,07	5,23,37
Gandaki	7,53,66	6,48,33	6,87,12	6,71,96	6,37,76
Lumbini	3,72,96	4,64,48	4,25,96	4,85,16	4,73,77
Karnali	5,79,34	5,43,51	5,72,86	5,41,71	5,29,76
Sudurpashchim	9,22,49	9,25,85	9,12,27	9,01,56	8,92,85

Source: *Intergovernmental fiscal transfer data tables (FY 2078/79–2082/83)*. Ministry of Finance, Government of Nepal.

4.5 Per Capita Equity and Stability of Transfers

Provincial differences in economic structure and income levels shape uneven fiscal needs across Nepal's federal landscape. Bagmati continues to record the highest per-capita GDP, rising to NPR 320,558 in FY 2022/23, reflecting a diversified and expanding economy. Madhesh, Karnali, and Sudurpashchim remain well below the national average due to limited economic diversification and narrow revenue bases. Despite these disparities, fiscal transfers do not consistently reflect economic need. While equalisation grants direct relatively higher per-capita resources to structurally disadvantaged provinces such as Karnali, provinces like Madhesh and Sudurpashchim, despite similar or lower income levels, receive significantly less per-capita support. In some years, their per-capita transfers fall below those of Bagmati, the province with the highest GDP. Allocation patterns in conditional, special, and complementary grants tend to favour provinces with stronger administrative and technical capacity. Provinces with weaker capacity thus face persistent challenges in securing capital-linked transfers, widening disparities in fiscal space and constraining their ability to invest in infrastructure and public services.

Table 7: Annual Province Per Capita GDP (in NPR)

Province / Year	2018/19	2019/20	2020/21	2021/22	2022/23
Koshi	123,799	126,256	140,789	157,284	169,664
Madhesh	85,248	85,571	95,398	106,299	114,258
Bagamati	245,944	237,286	262,687	297,288	320,558
Gandaki	139,072	141,476	156,523	177,069	194,800
Lumbini	109,300	110,227	121,808	136,141	147,017
Karnali	91,768	96,919	106,977	119,488	130,197
SudurPaschim	98,093	103,207	114,793	128,140	138,829
Total (National Average)	135,889	135,692	150,495	169,038	182,683

Source: *National Statistics Office, Government of Nepal*

5. Fiscal Utilisation and Efficiency

5.1 Fiscal Utilisation and Efficiency

Fiscal utilisation and efficiency at the subnational level are central to understanding how decentralised public finance translates into tangible economic outcomes. In Nepal's federal structure, provincial governments have been entrusted with expanding responsibilities in infrastructure provision, human capital development, and local economic development. However, the effectiveness of this decentralisation depends not only on the size of budgetary allocations, but also on the capacity of provinces to absorb funds and convert them into productive expenditure. Weak absorption, particularly in capital spending, can dilute the developmental impact of public resources and generate persistent gaps between planned and realised investment.

The distinction between recurrent and capital expenditure provides a vital lens for evaluating fiscal efficiency. Recurrent spending finances government operations and services, such as wages and daily expenses, whereas capital spending aims to boost long-term productivity by funding infrastructure and durable public assets. Crucially, both types of expenditure play a role in fostering economic growth.

Within this framework, the analysis of budget absorption trends, capital–recurrent expenditure composition, and inter-provincial variation offers insight into the efficiency with which provincial governments utilise fiscal space. These dimensions are directly linked to broader outcomes, including competitiveness, the quality of human capital delivery, and provinces' capacity to support a conducive business environment.

5.2 Capital vs. Recurrent Expenditure Composition

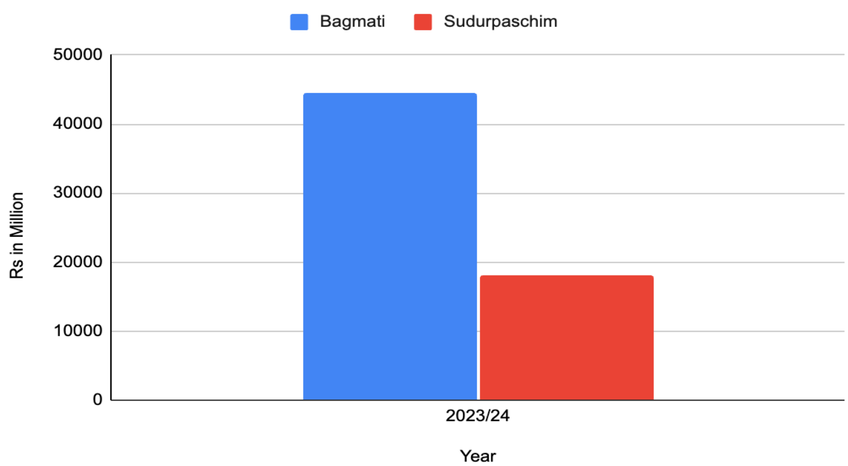
The composition of provincial expenditure indicates a strong emphasis on capital spending across most provinces, although there is notable volatility and interprovincial variation (see Annex 2). In Koshi, capital expenditure consistently exceeded recurrent expenditure after FY 2018/19, increasing from NPR 1,143.87 in FY 2018/19 to NPR 1181.25 in FY 2022/23. In contrast, recurrent expenditure increased more steadily from 976.43 to 1,264.50 over the same period. Bagmati exhibits an even stronger capital-oriented structure, with capital expenditure rising from NPR 955.44 in FY 2018/19 to NPR 2,827.96 in FY 2022/23, consistently exceeding recurrent expenditure, which reached NPR 1,798.24 in FY 2022/23. Lumbini follows a similar pattern, with capital expenditure increasing from NPR 1,017.20 to NPR 1,773.66, outpacing recurrent expenditure in all observed years (MOF, 2023)

However, capital spending exhibits greater year-to-year fluctuations than recurrent expenditure, suggesting implementation challenges rather than strategic reallocation. For example, Koshi's capital expenditure declined between FY 2019/20 and FY 2020/21, while recurrent commitments continued to rise. Provinces such as Karnali and Sudurpaschim exhibit a narrower gap between recurrent and capital spending, with Karnali's capital expenditure reaching NPR 1,277.65 in FY 2022/23, compared with recurrent expenditure of NPR 949.03, indicating a more limited capacity to scale up investment projects. Delays in procurement, land acquisition issues, and weak project preparedness continue to constrain effective execution of capital expenditures at the provincial level, leading to underspending or concentration toward the end of the fiscal year. These patterns align with public investment management literature, which highlights that volatile and delayed capital execution reduces the efficiency and growth impact of public spending (Dabla-Norris et al., 2012; Pritchett, 2000).

5.3 Diagnosis of Low-spending Provinces vs. High-performing Provinces

The bar graph (Figure 1) presents a clear comparison of total provincial expenditure in FY 2023/24, highlighting a significant disparity between the highest- and lowest-spending provinces. Bagmati emerges as the highest spender, with a total expenditure of NPR 44,513.20 million, whereas Sudurpaschim records the lowest expenditure at NPR 18,153 million. The visual contrast between the two bars highlights the asymmetric fiscal capacity and utilisation outcomes that have persisted across provinces for several years into the implementation of federalism. The focus on FY 2023/24 reflects the most recent year for which finalised expenditure data are available and provides a snapshot of current provincial fiscal performance following the initial transition to federalism.

Figure 1: Total Expenditure of Highest- and Lowest-Spending Provinces in FY 2023/24



Source: Financial Comptroller General Office (FCGO), 2023/24

The magnitude of the gap is substantial: Bagmati's expenditure is more than two times that of Sudurpaschim. This divergence reflects the differences in fiscal transfers and revenue bases. It also highlights the variations in administrative capacity, project readiness, and the ability to execute approved budgets within the fiscal year. Bagmati, which hosts the national capital and a relatively dense concentration of economic activity, benefits from stronger institutional infrastructure, greater potential for own-source revenue, and better access to skilled labour. These factors collectively enhance its capacity to absorb funds and translate budgetary allocations into realised expenditure.

In contrast, Sudurpaschim's comparatively low level of spending points to structural and administrative constraints that continue to limit effective fiscal utilisation. Geographic remoteness, weaker market connectivity, and limited technical capacity within provincial line agencies can delay procurement processes and capital project execution. As a result, even when budgetary allocations are available, the province may struggle to convert planned expenditures into actual spending, particularly in capital-intensive sectors such as infrastructure development. The relatively low expenditure level, therefore, signals not merely fiscal restraint but also potential inefficiencies in public investment management and service-delivery mechanisms.

5.4 Implications of Fiscal Efficiency for Development Outcomes

The observed patterns of provincial fiscal utilisation carry significant implications for key dimensions of economic development, particularly infrastructure competitiveness, human capital delivery, and the business environment. Efficient absorption of budgetary allocations, particularly for capital expenditure, directly influences provinces' capacity to develop critical infrastructure.

Provinces demonstrating higher and more stable capital spending, such as Bagmati, Koshi and Lumbini, are better positioned to enhance transport networks, energy provision, and public facilities, thereby improving connectivity and reducing bottlenecks that constrain economic activity. Conversely, provinces with persistent underspending or delayed capital execution risk lagging in infrastructure competitiveness, thereby hindering investment attraction and limiting broader regional development.

Fiscal efficiency also affects the quality and reach of human capital delivery. Recurrent expenditure, when effectively deployed, underpins the functioning of health, education, and social service systems. Provinces with consistent recurrent spending are more likely to maintain reliable service delivery, recruit and retain skilled personnel, and ensure the timely implementation of programs that support human development outcomes. Weak absorption or volatility in either recurrent or capital expenditure can disrupt these services, leading to gaps in learning, health provision, and overall human capital accumulation.

Finally, the ability of provincial governments to efficiently utilise fiscal resources shapes the broader business environment. Predictable and well-executed public investment signals institutional capacity, reduces uncertainty, and creates the foundational infrastructure and services necessary for private sector growth. High-performing provinces, by efficiently translating budget allocations into tangible outputs, provide a more conducive environment for business operations, entrepreneurship, and local economic development. In contrast, inefficiencies in fiscal execution, particularly delays in capital projects and service delivery, may raise transaction costs, weaken investor confidence, and limit the potential for private-sector-led growth.

Overall, the patterns of fiscal utilisation highlighted in this analysis underscore that efficient expenditure management extends beyond budgetary metrics. It is a critical determinant of provincial development outcomes, influencing infrastructure quality, human capital formation, and the investment climate. Strengthening fiscal efficiency across all provinces is therefore essential not only for equitable resource distribution but also for fostering sustained and inclusive economic growth in Nepal's federal system.

6. Fiscal Accountability and Transparency

Nepal's shift to federalism has brought provinces to the centre of public spending and development delivery, making provincial public financial management (PFM) a crucial factor in economic competitiveness. Provinces can now plan and execute large capital budgets, procure contracts for hospitals, administrative buildings, and roads, and channel resources to local levels. Yet, the credibility of these essential developmental aspects depends entirely on the transparency of the budget, the traceability of spending, and honest audit responses. When provincial financial systems are weak, costs are evident through various channels: delays in projects, higher contract prices, uneven service quality, and ultimately, growing public skepticism.

This section assesses fiscal accountability and transparency across Nepal's seven provinces by examining the fiscal accountability using multiple factors: irregularities in audit observations, PFM indicator performance, transparency, and public disclosure of budgets, procurements, contracts, and government expenditure.

6.1 Audit observations: recurring irregularities by province

Nepal's 62nd Auditor General's report indicates that in fiscal year 2023/24, provincial governments collectively recorded approximately NRs 4.3 billion in irregularities, representing about 1.36 percent of the total amount audited across 1,165 provincial offices. The table below breaks down the audit irregularities by province.

Table 8: Provincial Audit Irregularities, FY 2023/24 (NRs billion)

Province	Audited amount 2023/24	This year's total irregularity	Irregularity (% of audited)	Cumulative Irregularity	Advances as % of cumulative irregularity
Koshi	51.4	0.87	1.69	5.4	69.7
Madhesh	46	1.16	2.53	9.2	30.7
Bagmati	82.8	0.85	1.03	4.87	21.2
Gandaki	41.2	0.52	1.26	2.99	26.2
Lumbini	54.2	0.66	1.22	4.58	9.6
Karnali	37.6	0.46	1.22	4.12	17.9
Sudurpashchim	35.6	0.5	1.41	2.98	12.6

Source: 62nd Auditor General's report

Table 8 reveals that Madhesh has the highest irregularity ratio for FY 2023/24 (2.53 percent of audited spending; 2.10 percent while excluding advances). Bagmati, as the economic hub, has the largest audited volume and the lowest irregularity ratio (1.03 percent; 0.89 percent excluding advances) (Office of the Auditor General [OAG], 2024). It has the lowest irregularity ratio in the country. The remaining provinces exhibit irregularity ranging from 1.2 to 17 percent. (OAG, 2025) The interesting story these numbers tell is that the high irregularity percent in Madhesh questions the level of transparency on its spending, and on the other side, the sheer budget size of Bagmati means even a low percent of irregularity translates into hundreds of millions of rupees at risk.

The report highlights the cumulative outstanding irregularities amounting to NRs 34.14 billion across provinces, of which nearly NRs 9.95 billion remain unsettled advances. As expected, this cumulative burden is not evenly distributed. Madhesh carries the largest outstanding amount of 9.2 billion, whereas Koshi has a smaller stock but a strikingly high share of unsettled advances, which is approximately 70 percent of its outstanding irregularity. (OAG, 2024) This suggests

Koshi’s recurring weakness in advance settlement and documentation rather than one-off misstatements.

In contrast, Lumbini and Sudurpaschim have a modest share of their cumulative irregularity coming from advances. This indicates relatively better follow-up on advances, although they still exhibit over one percent irregularity in current-year audits. (OAG, 2024)

Alongside the varied numerical patterns above, the 62nd Auditor General’s report identifies qualitative issues across provinces. One highlight is the division of vehicle tax revenues, in which provinces do not appear to allocate revenue between provincial and local divisible funds. NRs 120.6 million and NRs 175.5 million in Madhesh remain undistributed. Additionally, the grant flows recorded by federal and provincial treasuries do not reconcile, resulting in a mismatch of NRs 4.81 billion. On the revenue side, actual revenue collection is approaching 80 percent of provincial projections, which is reasonable, but the expenditure side appears fragile in some provinces. Madhesh spent approximately half of the budget, and other provinces spent slightly more but appeared to make large end-of-year expenditures to reallocate funds.

Overall, Madhesh is at a higher risk of being an outlier in both annual and cumulative irregularities. Bagmati appears relatively disciplined but carries a higher absolute risk. Other provinces mainly struggle with unsettled advances and compliance with fiscal rules. All provinces look weak in reconciliation and perform poorly in revenue collection. (Nepal Fiscal Federalism Update[NFFU], 2024)

6.2 PEFA indicators for subnational PFM

All seven provinces have planning commissions and periodic plans, and most have drafted or updated PFM laws to align with the federal Financial Procedures and Fiscal Responsibility Act, as reported in the Nepal Fiscal Federalism Update 2024 (NFFU, 2024). (World Bank, 2024) PEFA provides a diagnostic tool for countries to check their public finance systems: budgets, spending, and transparency for better governance. (PEFA Secretariat, 2016; World Bank, 2016) The World Bank, through the NFFU, reports high under-execution of provincial budgets (almost 20 percent underspending in 2021), primarily driven by lump-sum economic-miscellaneous allocations and weak linkages between annual budgets, MTEFs, and development plans. (NFFU, 2024) (World Bank, 2024). On PEFA, these factors score low on budget credibility and policy-based budgeting. (PEFA, 2024)

The first full subnational PEFA in Gandaki in 2025 confirms this pattern: it finds a reasonably aligned regulatory framework and a good-practice level score for budget transparency, predictability of execution, and financial reporting. (World Bank, 2025)

On the other hand, public investment management scores the lowest possible rating. (World Bank, 2025) Asset management is fragmented, with an excellent score for financial asset monitoring but poor scores for Nonfinancial asset monitoring and transparency of asset disposal. (PEFA, 2025; World Bank, 2025). Procurement and internal audit mirror federal weaknesses, receiving poor scores in monitoring, audit response, and most deliverables, but performing well in methods, compliance, and audit implementation. (World Bank, 2025)

Legislative scrutiny is delayed, and unresolved audit observations accumulate. (World Bank, 2025; PEFA, 2024) It also underscores systemic fiscal risk and revenue issues that would appear in PEFA indicators on intergovernmental fiscal relations and fiscal risks: expenditures and extra-budgetary revenues are growing, federal transfers to the provincial government are frequently delayed, and the vehicle tax remains the only meaningful provincial own-source tax. (World Bank, 2025)

These findings imply that Nepal’s provinces, when mapped against the PEFA results, would likely show good to mid-range scores on legal framework, budget preparation, and basic transparency, whereas significantly weaker performance on budget reliability, investment and asset management, internal control and audit, and public participation. (PEFA Secretariat, 2016; PEFA, 2024; World Bank, 2025)

6.3 Budget transparency and publication practices

Budget transparency at the provincial level in Nepal is quite strong on paper, but patchy in practice. All seven provinces are required to prepare annual budgets, review implementation, and make those reports public, usually by mid-November each year. The Ministry of Economic Affairs and Planning, under each province, is also required to publish semi-annual evaluations of budget execution, and internal and final audit reports are to be publicly disclosed. (The Asia Foundation, 2021; Devkota, 2024) The Asia Foundation's report indicates that most provinces are adhering to provincial budgeting calendars, although a few are missing key deadlines. (The Asia Foundation, 2021)

In reality, the publication is uneven and often not user-friendly. The Asia Foundation’s comparative study on provincial planning and budgeting states that, while provinces produce budget speeches, appropriation acts, and financial statements, these documents are primarily intended for insiders and are not consistently accompanied by accessible, public-oriented summaries. (The Asia Foundation, 2021) The World Bank’s Nepal Fiscal Federalism Update 2024 finds a similar pattern at a subnational level: core budget documents are generally and increasingly available, but lack transparency as provincial governments do not present future estimates, revised current estimates, and previous year’s actual numbers in a comparable format, making it difficult to track plans and execution. (World Bank, 2024) Bagmati and Gandaki provinces have stronger administrative capacity and more developed legal frameworks, and tend to publish relatively complete budget information. Poorer provinces such as Karnali and Suduspaschim continue to struggle with the timely reporting of systematic disclosure. (Devkota, 2024; The Asia Foundation, 2021)

Most literature and reports suggest a minimum-compliance model of transparency across Nepal’s seven provinces. Budgets and some reports are public per se, but proactive, comparable, and citizen-friendly disclosure remains limited and highly uneven across provinces. (World Bank, 2024)

6.4 Public disclosure of contracts, expenditures, and audit responses

Public disclosure of contracts, expenditures, and audit responses in Nepal's provinces is highly uneven, with greater progress in systems than in the accessibility and comparability of reports. (World Bank, 2024) Nepal has a national government procurement platform, e-GP, managed by the Public Procurement Monitoring Office (PPMO), which is designed to publish bid notices, awards, and contract details online and to cover the entire procurement life cycle. (Gyawali et al., 2018; Public Procurement Monitoring Office, n.d.)

In practice, coverage remains incomplete; Gyawali et al. (2018) note that, although the legal framework emphasises transparency and competition, implementation is undermined by weak enforcement, off-system procurement, and limited publication of evaluation reports and contract management information, particularly outside large central ministries. A case study of a municipal user committee reports similar findings: many small- and medium-sized works contracts are handled through a local committee, with poor documentation and almost no proactive public disclosure, even when provincial or local websites are available (Koirala, 2023) (Mishra, 2022).

On expenditure disclosures, World Bank's Nepal Fiscal Federalism Update reports that most provinces now use the SuTRA treasury system and prepare annual financial statements. But very few provide timely and comparable spending data, or project-level expenditure reports on public portals. (World Bank, 2024) This limits the public's ability to track whether budgeted amounts were actually spent and, if so, where they were spent. The Asia Foundation's comparative study on provincial PFM goes further, characterising provincial financial structures as opaque to the public. The study states that while budget speeches and red books are usually published, detailed expenditure breakdowns are rarely provided (The Asia Foundation, 2021).

Audit responses sit at the weakest end of the disclosure chain: the Office of the Auditor General audits across all three tiers of government and reports persistent, high levels of irregularity. Yet there is no standard practice for provinces to publish their management responses, and as a result, provincial irregularities remain unresolved across multiple cycles (Nepal News, 2025; Office of the Auditor General, 2024).

Formal systems without robust, transparent disclosure, along with weak audit responses, mean that contracts, expenditures, and audit reports remain largely visible to those with power and access, but not legible to the public. This has direct implications for trust and competitiveness.

6.5 Impact of weak audit compliance on competitiveness and trust

Weak audit compliance in Nepal's provinces seriously undermines economic competitiveness and public trust. This has big consequences for the accountability and rule enforcement aspects of governance. The report published by the Office of the Auditor General indicates that large and irregular expenditures and unsettled advances persist over multiple years. (Office of the Auditor General, 2024) Furthermore, provincial governments have failed to clearly explain them, which suggests politicised procurement decisions, delayed payments, and poorly controlled contract variations. Cross-country evidence on public financial management and investment shows that high corruption and low transparency are directly associated with higher perceived risk, higher bid prices, and lower foreign direct investment. (Smarzynska & Wei, 2000) This directly affects all levels of infrastructure projects, particularly where provincial governments play a gatekeeping role.

The public, on the other hand, is led to believe that taxes and funds are not translated into services as they encounter repeated audit irregularities with little follow-up. Multiple studies on fiscal transparency and trust in government suggest that tax morale declines and the willingness to comply erodes over time when oversight institutions are perceived as ineffective, eventually forcing governments to rely on grants or borrowing. (Capasso et al., 2021, pp. 1031–1050) In Nepal's context, provinces that systematically address audit findings and irregularities and publish their responses in a timely manner, with sufficient clarity and transparency, are more likely to attract investment and sustain public trust than those that do not.

7. Policy Implications and Recommendations

Nepal's experience with fiscal federalism suggests that the binding constraint is no longer constitutional design but the interaction between fiscal incentives, institutional capacity, and accountability mechanisms across tiers of government. Evidence from provincial allocation patterns, utilisation efficiency, and audit outcomes indicates that current intergovernmental fiscal arrangements have not yet translated decentralisation into sustained improvements in subnational competitiveness, as measured by service delivery quality, investment readiness, and institutional credibility. In this context, the following policy implications and recommendations emphasise recalibration rather than structural overhaul, explicitly linking fiscal federalism to competitiveness outcomes consistent with the Nepal Competitiveness Index (NCI) framework.

7.1 Rebalancing Vertical Fiscal Imbalance to Restore Subnational Incentives

Nepal's persistent vertical fiscal imbalance—where provinces and local governments remain heavily dependent on federal transfers—has weakened fiscal autonomy and accountability, reinforcing soft budget constraints and compliance-driven behaviour rather than performance-oriented governance.

Federal government: Gradually recalibrate intergovernmental fiscal relations by expanding constitutionally permitted provincial and local revenue handles (e.g., surcharge authority, rate-setting discretion), while reducing excessive reliance on conditional grants.

Provincial governments: Actively diversify own-source revenues beyond vehicle tax by strengthening fee-based services, land-related instruments, and sector-linked levies aligned with provincial economic structure.

Local governments: Improve tax base administration and valuation systems, particularly for property and business-related taxes, to strengthen the local accountability–service delivery nexus.

These recommended actions will have major implications for strengthening fiscal autonomy, improving institutional credibility and predictability, and enhancing investment confidence, thereby directly affecting provincial business environments.

7.2 Stabilising Intergovernmental Transfers through a Medium-Term Fiscal Framework

Volatility in conditional, special, and complementary grants has undermined multi-year planning, capital project sequencing, and investment efficiency, particularly in lower-capacity provinces.

Federal government: Introduce rolling three-year indicative ceilings for major grant categories through the National Natural Resources and Fiscal Commission (NNRFC), anchored in macro-fiscal realism.

Provincial governments: Align Medium-Term Expenditure Frameworks (MTEFs) with predictable transfer envelopes and prioritise fewer, implementation-ready projects.

Local governments: Integrate municipal planning cycles with provincial medium-term plans to avoid fragmentation and duplication.

These actions ensure that predictability enhances infrastructure quality, capital absorption, and policy credibility, central to NCI's infrastructure and governance findings.

7.3 Linking Transfers to Performance without Undermining Equity

While equalisation grants remain essential for horizontal equity, unconditional transfers alone have not incentivised improvements in fiscal discipline or service outcomes.

Federal government: Introduce a modest, transparent performance-linked grant window, tied to capital execution rates, audit compliance, and transparency benchmarks—without penalising structurally disadvantaged provinces.

Provincial governments: Strengthen internal monitoring systems to track project execution and respond to audit observations within fiscal cycles.

Local governments: Institutionalise minimum service standards and reporting requirements linked to discretionary grants.

These actions will further enhance performance incentives, reinforcing efficient public spending, a core determinant of provincial competitiveness.

7.4 Strengthening Provincial Public Investment Management (PIM)

Low capital expenditure efficiency across provinces reflects weak project preparation, procurement delays, and fragmented asset management systems.

Federal government: Establish a Provincial PIM Support Facility to provide technical assistance for project appraisal, procurement, and contract management.

Provincial governments: Create dedicated PIM units within Ministries of Economic Affairs and Planning, integrating budgeting with asset lifecycle management.

Local governments: Coordinate land acquisition, user committees, and local implementation mechanisms to reduce execution bottlenecks.

These recommended actions are aimed at improving PIM, which directly enhances infrastructure competitiveness, logistics efficiency, and regional connectivity.

7.5 Closing Accountability Gaps through Audit Responsiveness and Transparency

Persistent audit irregularities, unsettled advances, and weak public disclosure undermine trust and raise the cost of public and private investment.

Federal government: Mandate time-bound audit response frameworks and publish comparative provincial audit performance dashboards.

Provincial governments: Institutionalise audit committees within provincial assemblies and publish management responses to Auditor General reports.

Local governments: Improve disclosure of project-level expenditures and procurement outcomes through municipal portals.

These suggestions are based on the fact that transparency and rule enforcement strengthen governance quality, risk perception, and investor confidence.

7.6 Aligning Fiscal Federalism with Youth-Centric and Future-Oriented Spending

The post–Gen Z protest context highlights growing public demand for visible returns from public spending in employment, skills, digital infrastructure, and innovation.

Federal government: Reorient conditional grants toward skills, innovation, and digital public infrastructure aligned with long-term productivity.

Provincial governments: Prioritise labour-market-relevant education, SME support, and regional innovation ecosystems.

Local governments: Serve as delivery platforms for skills, entrepreneurship, and access to services.

To address the ongoing and emerging demands of Nepal's young population, these actions are essential to generating human capital and investment in innovation that anchors long-term productivity and inclusive growth, a central focus of NCI's human capital pillar.

8. Conclusion

This paper examines whether Nepal's transition to fiscal federalism has translated constitutional intent into meaningful provincial performance, with particular attention to allocation patterns, expenditure efficiency, accountability, and their linkages to provincial competitiveness. The analysis reveals a clear and consistent finding: Nepal's fiscal federalism has largely succeeded in allocating resources across provinces, but it has fallen short in translating those allocations into efficient, accountable, and competitiveness-enhancing outcomes.

From an allocation perspective, the intergovernmental fiscal framework, anchored by equalisation grants, has played an important redistributive role. Structurally disadvantaged provinces such as Karnali and Sudurpashchim have benefited from equity-oriented transfers, demonstrating that the system is responsive to horizontal disparities. However, this success remains largely mechanical. The evidence shows that predictability, utilisation efficiency, and accountability have not evolved at the same pace as allocation, resulting in weak developmental returns on public spending. Volatility in conditional and complementary grants, coupled with limited provincial capacity for project preparation and execution, has undermined multi-year planning and capital investment outcomes.

A central conclusion of this study is that provincial competitiveness in Nepal is constrained less by the volume of fiscal resources and more by fiscal misalignment. Provinces with stronger administrative capacity and governance systems—most notably Bagmati—consistently outperform others in budget absorption, audit compliance, and infrastructure delivery, despite operating within the same national fiscal framework. Conversely, provinces with weaker institutions struggle to translate transfers into productive assets, reinforcing regional disparities and dampening competitiveness. This divergence underscores that fiscal federalism, in practice, is as much an institutional and political-economy challenge as a technical design issue.

The post–Gen Z protest context sharpens the urgency of these findings. Public dissatisfaction has shifted the national discourse from demands for redistribution toward expectations of performance, transparency, and visible results. In this environment, continued tolerance for low capital execution, unresolved audit irregularities, and opaque fiscal practices risks eroding trust in subnational governments and in federalism itself. Post-protest Nepal thus demands a new era of fiscal responsibility, in which public finance is judged not merely by compliance with rules but by outcomes that improve employment prospects, service delivery, and economic opportunity.

Ultimately, the paper argues that strengthening fiscal governance is central to improving provincial performance in the long run. Enhancing public investment management, tightening accountability mechanisms, and better aligning fiscal incentives with performance are essential for federalism to contribute meaningfully to competitiveness. Without these reforms, fiscal federalism risks entrenching dependence and inefficiency rather than enabling dynamic, responsive, and competitive provinces. In this sense, the future of Nepal's federal project is inseparable from the quality of its fiscal governance.

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Annex 1 - Types of Intergovernmental Fiscal Grants Under IGFA, 2074

Grant Type	**Meaning**	**Purpose**	**Allocation Basis**	**Nature**
Equalization Grant	Constitutionally mandated transfer to ensure provinces/local governments can deliver basic services.	Reduce fiscal disparities and ensure minimum service standards across regions.	Formula-based: population, area, human development indicators, revenue capacity, expenditure needs.	Mostly recurrent, with some capital components.
Conditional Grant	Funds are provided for programs that must follow specific federal conditions, standards, or guidelines.	Ensure national priority programs (health, education, infrastructure, etc.) are implemented uniformly.	Based on federal policy priorities and provincial/local proposals that meet the set criteria.	Both recurrent and capital.
Special Grant	Grants are provided to address the unique, special, or unexpected needs of provinces/local governments.	Support innovations, address unforeseen challenges, promote balanced development, or respond to disasters.	Need-based; allocated upon request or federal identification of special circumstances.	Can be recurrent or capital, depending on the nature of the need.
Complementary Grant	Additional capital funding is provided when a province lacks sufficient resources to complete a large or strategic infrastructure project.	Supplement funding gaps in capital projects of provincial or national importance.	Project-based; requires a detailed proposal demonstrating the financing gap and strategic value.	Capital only
Revenue Sharing	Constitutionally mandated share of federal revenue distributed to provinces/local governments.	Ensure predictable revenue streams and strengthen fiscal autonomy.	The formula set by the National Natural Resources and Fiscal Commission (NNRFC).	Revenue transfer (not classified as recurrent/capital).
Royalty Sharing	Sharing of natural-resource royalties (hydropower, mining, forestry) with subnational governments.	Promote local benefits from natural resources and incentivise conservation.	Percentage shares defined by IGFA + sector laws.	Revenue transfer.

Source: *Intergovernmental Fiscal Grants Under IGFA, 2074, Government of Nepal*

Annex 2: Provincial Expenditure Details (NPR in 10 Million)

FY/ Province	Koshi		Madhesh		Bagmati		Gandaki		Lumbini		Karnali		Sudurpashchim	
	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital
2017/18	43.51	21.78	26.6	25.73	14.51	12.44	10.34	12.77	12.53	6.55	12.27	11.6	16.58	9.4
2018/19	976.43	1143.87	662.75	846.49	1109.83	955.44	521.1	871.7	686.13	1017.2	460.11	541.5	693.08	23.26
2019/20	1196.66	1786.66	978.2	823.52	1226.88	1568.2	642.69	1398.67	1068.58	1472.1	734.49	953.53	832.36	928.83
2020/21	1208.53	1586.6	864.07	1390.51	1558.66	2000.82	802.78	1759.56	1359.88	1850.42	847.15	1357.05	1036.63	1260.2
2021/22	1312.7	1683.92	1033.6	1192.44	1569.99	2099.51	758.01	1446.38	1264.69	1740.78	909.37	1507.11	892.53	1195.21
2022/23	1264.5	1811.25	1067.03	1619.9	1798.24	2827.96	835.35	1526.14	1250.76	1773.66	949.03	1277.65	824.86	1581.45

Source: Economic Survey of Nepal, 2023/24

Annex 3 - Alignment of Policy Recommendations with Nepal Competitiveness Index (NCI) Scoring Logic and Empirical Fiscal Indicators

Suggested Policy Reform Area	NCI Environment	NCI Indicator (Scoring Logic)	Empirical Variable Used	Direction of Expected Impact on NCI Score	Cross-Reference to Empirical Analysis
Rebalancing vertical fiscal imbalance	GIS, MS	Fiscal decentralisation effectiveness (input–process indicator)	• Per-capita intergovernmental transfers • Provincial own-source revenue share (%)	Higher OSR share strengthens accountability and institutional score	Table 2 (Province-wise Transfers); Table 7 (Per-capita GDP & fiscal capacity)
Stabilising intergovernmental transfers via MTEF	MS, GIS, QLID	Budget credibility and planning reliability (process indicator)	• Year-to-year volatility of conditional and complementary grants • Capital budget execution rate (%)	Lower volatility and higher execution improve infrastructure and governance scores	Table 1 (Transfer trends); Tables 4–6 (Grant volatility); Section 5.2
Introducing performance-linked transfers	GIS, MS	Efficiency of public expenditure (process–output indicator)	• Capital expenditure execution rate (%) • Audit compliance rate (%)	Higher execution and compliance raise the institutional efficiency score	Section 5.3 (High vs low performing provinces); Figure xxx (FY 2023/24 expenditure)
Strengthening provincial PIM systems	QLID	Infrastructure delivery effectiveness (output indicator)	• Capital vs recurrent expenditure ratio • Capital absorption rate (%)	Higher capital absorption improves the infrastructure quality score	Section 5.2 (Capital–recurrent composition); Annex 2
Closing accountability gaps (audit & transparency)	GIS, MS	Transparency and rule enforcement (process indicator)	• Audit irregularity ratio (%) • Share of unsettled advances (%)	Lower irregularities and advances improve governance credibility score	Section 6.1 (Audit irregularities); OAG FY 2023/24 analysis
Aligning spending with youth-centric priorities	QLID, FBMC, MS	Skills availability and workforce readiness (output indicator)	• Sectoral spending share (education, skills, digital, productive sectors)	Increased productive social spending strengthens the human capital score	Section 5.4 (Development outcomes); Conclusion

Notes: MS = Macroeconomic Stability, GIS = Government and Institutional Setting, FBMC = Financial, Business and Manpower Conditions, QLID = Quality of Life and Infrastructure Development