
FISCAL FEDERALISM AND LOCAL GOVERNANCE IN NEPAL: INSTITUTIONAL CAPACITY, FINANCIAL AUTONOMY AND SERVICE DELIVERY

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Abstract

Fiscal federalism represents a fundamental component of Nepal's transition from centralized governance to a three-tier federal system. The Constitution of Nepal, 2015 established financial powers and responsibilities for the federal, provincial and local governments, while subsequent legislation created mechanisms for intergovernmental fiscal transfers, revenue assignment and subnational budgeting. This paper examines the relationship between fiscal federalism, institutional capacity and local governance in Nepal. It is based on a qualitative thematic review of the literature contained in the attached report, supplemented by selected external literature on Nepal's fiscal transition. The analysis focuses on revenue assignment, expenditure responsibilities, intergovernmental transfers, fiscal dependency, administrative capacity, decentralized planning and service delivery. The findings indicate that fiscal decentralization has expanded the financial and planning responsibilities of provincial and local governments, but implementation remains influenced by limited own-source revenue, dependence on intergovernmental transfers, uneven institutional capacity and differences in technical and administrative preparedness. Fiscal autonomy and administrative capacity are mutually reinforcing: financial authority without implementation capacity can produce underutilization or inefficient expenditure, while administrative institutions without predictable financial resources cannot effectively perform assigned functions. The paper also identifies opportunities associated with improved local planning, digital financial management, institutional capacity development, transparent budgeting and evidence-based fiscal governance. The study concludes that sustainable fiscal federalism in Nepal requires closer alignment between expenditure responsibilities, revenue authority, transfers and institutional capacity. Strengthening local fiscal systems should therefore be treated as part of the broader process of institutional consolidation rather than as a purely financial reform.

Keywords: Fiscal Federalism; Nepal; Local Government; Provincial Government; Fiscal Decentralization; Intergovernmental Transfers; Financial Autonomy; Institutional Capacity; Service Delivery.

1. Introduction

Fiscal federalism is one of the most important dimensions of Nepal's federal transition because decentralization of political authority requires corresponding arrangements for financial resources and expenditure responsibilities. The Constitution of Nepal established three levels of government and provided financial powers to the federation, provinces and local governments. Article 59 provides that the Federation, States and Local Level may make laws, prepare annual budgets and formulate and implement policies and plans concerning financial powers within their respective jurisdictions.

The transition therefore required Nepal to develop a new fiscal architecture. This included expenditure assignment, revenue assignment, intergovernmental transfers and financial management systems. The process has been particularly important for provincial and local governments because many responsibilities involving basic public services are implemented at subnational levels.

The original report identifies fiscal federalism and institutional capacity as two of the most extensively interconnected themes in the literature. It notes that fiscal transfers have strengthened subnational financing while also identifying continuing dependence on federal transfers, limited internal revenue generation and differences in fiscal capacity.

External research similarly identifies fiscal federalism as a central component of Nepal's federal transition. The Asian Development Bank's review of Nepal's fiscal decentralization examines public expenditure assignment, revenue mobilization, intergovernmental fiscal transfers and subnational borrowing, while emphasizing the continuing need to refine the fiscal federalism framework.

2. Background of Fiscal Federalism in Nepal

Before federalization, Nepal operated under a predominantly centralized administrative system. The federal transition redistributed responsibilities across three levels of government.

The Constitution established exclusive and concurrent responsibilities for different levels and provided the legal basis for subnational financial powers. The Local Government Operations Act and Intergovernmental Fiscal Transfers Act subsequently contributed to the operational framework of subnational fiscal management. The IMF has described the transition as involving a substantial redesign of revenue and expenditure assignments and intergovernmental financial arrangements.

The transition created a new relationship between fiscal authority and service delivery. Local governments were expected to manage important local functions, while provinces acquired responsibilities that required coordination between local and federal institutions.

Fiscal federalism therefore cannot be separated from administrative federalism. The capacity to prepare budgets, collect revenue, manage expenditure, maintain financial records and implement development projects determines how effectively fiscal decentralization translates into governance outcomes.

3. Statement of the Problem

The central challenge identified in the source report is the imbalance between constitutional responsibilities and institutional capacity. Subnational governments have acquired significant responsibilities, but their ability to generate own-source revenue and manage complex financial responsibilities varies.

Fiscal dependency can arise when expenditure responsibilities are greater than locally generated revenues. Intergovernmental transfers can address such vertical imbalances, but excessive dependence may limit incentives or opportunities for strengthening own-source revenue systems.

The IMF has highlighted the importance of public financial management and implementation capacity for effective fiscal federalism in Nepal.

The issue is therefore not simply whether provincial and local governments receive funds. It is whether the overall fiscal system creates predictable resources, appropriate incentives, adequate capacity and sufficient autonomy for governments to perform their constitutionally assigned responsibilities.

4. Research Questions

1. How has fiscal federalism evolved in Nepal following the Constitution of 2015?
2. What are the major fiscal challenges confronting provincial and local governments?
3. How does institutional capacity affect fiscal decentralization and service delivery?
4. What opportunities exist for strengthening sustainable fiscal federalism in Nepal?

5. Objectives of the Study

The study aims:

1. To examine the evolution of fiscal federalism in Nepal.
2. To analyze revenue, expenditure and intergovernmental transfer arrangements.
3. To examine the relationship between fiscal autonomy and institutional capacity.
4. To identify opportunities for improving fiscal governance and local service delivery.

6. Methodology

The study adopts a qualitative thematic review methodology based primarily on the attached federalism report. The source literature covered approximately 2008–2025 and included scholarly publications, government documents, policy reports and constitutional materials.

The present paper reorganizes the source material around fiscal federalism and local governance. The analytical categories include:

- expenditure responsibilities;
- revenue assignment;
- intergovernmental fiscal transfers;
- fiscal dependency;
- administrative capacity;
- local financial management;
- decentralized planning;
- service delivery; and
- fiscal sustainability.

No new survey, interview or primary quantitative dataset has been introduced. The findings represent an interpretive synthesis of existing literature.

7. Conceptual Framework

7.1 Fiscal Federalism

Oates (1972) conceptualized fiscal federalism around the assignment of expenditure and revenue responsibilities among levels of government. The central issue is determining which functions should be undertaken at which governmental level and how resources should correspond to those functions.

In Nepal, this framework is relevant because constitutional responsibilities have been distributed across federal, provincial and local governments.

7.2 Fiscal Decentralization

Fiscal decentralization involves transferring financial decision-making authority and resources to subnational governments. Bird and Vaillancourt (1998) emphasize the importance of appropriate revenue and expenditure assignments in developing-country decentralization.

Shah (2007) similarly stresses the importance of aligning responsibilities, revenue authority and intergovernmental transfers.

7.3 Institutional Capacity

Fiscal autonomy cannot automatically produce effective governance. Governments must possess the administrative and technical capacity to plan, budget, procure, implement and monitor public programmes.

The source report therefore treats fiscal capacity and administrative capacity as mutually reinforcing foundations of federal performance.

8. Evolution of Fiscal Federalism in Nepal

8.1 Constitutional Foundation

The Constitution of Nepal created the legal framework for fiscal decentralization. Financial powers were distributed among the three levels and mechanisms for intergovernmental financial relations were established.

The constitutional arrangement represented a significant departure from centralized fiscal governance.

8.2 Institutional Establishment

After 2015, Nepal developed institutions and legislation necessary for implementing the new fiscal framework. Provincial and local governments required budgetary systems, financial procedures and administrative personnel.

The period also involved the development of transfer arrangements intended to address disparities between levels and regions.

8.3 Implementation and Consolidation

The implementation phase demonstrated that fiscal decentralization involves more than transferring financial resources. Subnational governments require technical skills, financial-management systems, revenue administration and planning capacity.

Bahl, Timofeev and Yilmaz report that Nepal's new system assigned substantial functional responsibilities to provincial and local governments while financing remained strongly connected with intergovernmental transfers.

8.4 Adaptive Fiscal Governance

The later stage of Nepal's federal transition has increasingly focused on improving fiscal management, strengthening institutions, developing digital systems and refining intergovernmental fiscal arrangements.

ADB's 2022 assessment identifies expenditure assignment, budgeting, revenue mobilization and intergovernmental fiscal transfers as central areas for further development.

9. Revenue Assignment and Own-Source Revenue

Fiscal autonomy depends partly on the ability of subnational governments to generate revenue within their jurisdictions.

Own-source revenue can provide governments with greater flexibility in responding to local priorities. However, revenue-generation capacity differs according to geography, economic activity, population, infrastructure and administrative capability.

The source report identifies limited internal revenue generation and differences in fiscal capacity as recurring concerns. This suggests that fiscal decentralization needs to recognize the unequal revenue-generating potential of different jurisdictions.

The challenge is therefore twofold. First, local governments need appropriate authority and capacity to mobilize revenue. Second, intergovernmental transfers remain necessary to address differences in fiscal capacity and expenditure needs.

10. Intergovernmental Fiscal Transfers

Intergovernmental transfers are an essential component of federal fiscal systems because revenue capacity and expenditure responsibilities are rarely equal across jurisdictions.

Nepal's federal system uses transfer mechanisms to provide resources to subnational governments. The broader literature identifies transfers as necessary for financing responsibilities that cannot be supported entirely through local revenue.

However, transfer design matters. Transfers should be sufficiently predictable for budget planning while also maintaining appropriate accountability.

Prasad's analysis of Nepal's constitutional fiscal framework emphasized the importance of intergovernmental transfers, revenue assignment and institutional arrangements for managing fiscal federalism.

11. Fiscal Dependency

The source report identifies fiscal dependence of provincial and local governments on federal transfers as a persistent concern.

Fiscal dependency does not necessarily mean that federalism is unsuccessful. In multi-level systems, transfers can be necessary to equalize fiscal capacity and support nationally important services. The issue is whether transfer dependence is accompanied by effective expenditure management, accountability and opportunities for strengthening own-source revenue.

A sustainable fiscal system therefore requires an appropriate balance between:

- own-source revenue;
- shared revenue;
- intergovernmental transfers;
- expenditure responsibilities; and
- administrative capacity.

12. Institutional Capacity and Fiscal Management

One of the strongest themes emerging from the source report is the connection between fiscal and administrative capacity.

Local governments require personnel with knowledge of public finance, procurement, budgeting, accounting, taxation and development planning. Where such capacity is limited, the implementation of fiscal decentralization can be affected.

The IMF similarly emphasizes strengthening public financial management and implementation capacity at all levels of government as important for fiscal sustainability and effective resource allocation.

Institutional capacity therefore determines whether fiscal authority can be converted into public outcomes.

13. Fiscal Federalism and Service Delivery

Fiscal decentralization is ultimately connected with the delivery of public services. Local governments are positioned closer to citizens and can potentially adapt programmes to local needs.

The source report identifies improvements in localized planning, local responsiveness and service delivery as opportunities associated with federalism. However, it also notes that implementation varies across provinces and municipalities because of differences in administrative capacity, fiscal resources and institutional maturity.

The relationship can therefore be expressed conceptually as:

**Fiscal Authority → Institutional Capacity → Planning and Expenditure Management
→ Service Delivery → Local Governance Outcomes**

If any part of this chain is weak, the benefits of decentralization may be limited.

14. Decentralized Planning

One of the major opportunities created by fiscal federalism is localized development planning.

Provincial and local governments can identify development priorities according to geographical, economic and social conditions. Decentralized planning can potentially improve the relevance of public expenditure by allowing local governments to respond to community-level needs.

However, effective decentralized planning requires reliable local information, competent planning institutions, participatory mechanisms and financial resources.

15. Fiscal Disparities

Nepal's provinces and local governments differ considerably in economic conditions, geographic characteristics and institutional capacity.

Such differences can produce unequal fiscal capacity. A jurisdiction with a strong economic base may generate more own-source revenue than one with a weaker economic base.

This creates an important role for equalization and other transfer mechanisms. Fiscal federalism therefore has both efficiency and equity dimensions.

The objective is not necessarily to make all governments financially identical but to ensure that differences in fiscal capacity do not prevent citizens from accessing essential public services.

16. Digital Governance and Financial Management

Digital governance offers opportunities for improving fiscal federalism through:

- electronic budgeting;
- digital revenue collection;
- transparent expenditure reporting;
- integrated financial information;
- online procurement;
- digital monitoring;
- public disclosure of budgets; and
- data-based planning.

Digital systems can also strengthen relationships between government levels by facilitating information exchange.

The source report identifies digital governance as one of the emerging opportunities for Nepal's adaptive federal governance.

17. Major Challenges

The analysis identifies the following interconnected challenges:

17.1 Limited Own-Source Revenue

Some subnational governments have limited capacity to generate internal revenue, increasing dependence on transfers.

17.2 Uneven Administrative Capacity

Differences in technical personnel, institutional experience and financial-management capacity affect fiscal performance.

17.3 Transfer Dependence

Transfers remain an important financing source but can create dependence when own-source revenue remains weak.

17.4 Unequal Fiscal Capacity

Differences among jurisdictions can create disparities in development resources and service-delivery capacity.

17.5 Financial Management Challenges

Budget preparation, procurement, expenditure management and financial reporting require specialized administrative skills.

17.6 Coordination Problems

Fiscal responsibilities frequently intersect with administrative and policy responsibilities. Consequently, fiscal governance cannot operate independently from intergovernmental relations.

18. Opportunities for Sustainable Fiscal Federalism

Several opportunities emerge from the literature.

First, subnational governments can improve own-source revenue through better revenue administration and digital systems.

Second, capacity-building can strengthen budget preparation and expenditure management.

Third, predictable transfers can improve medium-term planning.

Fourth, transparent financial reporting can strengthen accountability.

Fifth, decentralized planning can improve the alignment of expenditure with local priorities.

Sixth, institutional cooperation can reduce duplication and improve the use of public resources.

Seventh, evidence-based fiscal policy can improve transfer design and resource allocation.

19. Discussion

The evidence indicates that fiscal federalism in Nepal should be viewed as an institutional system rather than simply a mechanism for transferring money from the federal government to lower levels.

The effectiveness of fiscal decentralization depends on the relationship between resources, responsibilities and institutional capacity. When responsibilities are decentralized without adequate resources, implementation gaps can occur. When resources are transferred without sufficient administrative capacity, expenditure effectiveness may remain limited.

This relationship is consistent with fiscal federalism theory. Oates (1972) emphasizes the relationship between decentralized decision-making and the allocation of public resources, while Bird and Vaillancourt (1998) and Shah (2007) emphasize the need for coherent revenue, expenditure and transfer arrangements.

Nepal's experience therefore demonstrates the importance of synchronizing fiscal and administrative reforms.

20. Policy Implications

The study suggests the following policy directions:

1. Align expenditure responsibilities and revenue authority.
2. Strengthen own-source revenue systems at provincial and local levels.
3. Improve predictability of intergovernmental transfers for effective planning.
4. Strengthen public financial management systems.
5. Develop professional financial-management personnel.
6. Use digital platforms for budgeting and financial reporting.
7. Improve transparency in local expenditure.
8. Strengthen fiscal equalization mechanisms to address differences in fiscal capacity.
9. Link fiscal transfers with clearly defined responsibilities and outcomes.
10. Improve participatory local planning so fiscal resources reflect local priorities.
11. Develop institutional mechanisms for fiscal coordination among all three levels.
12. Promote evidence-based evaluation of fiscal federalism using comparable indicators.

21. Conclusion

Fiscal federalism represents one of the central pillars of Nepal's federal transformation. The Constitution of 2015 established a three-tier system in which federal, provincial and local governments exercise constitutionally defined financial and administrative responsibilities.

The evidence reviewed in the attached report demonstrates that fiscal decentralization has expanded opportunities for local planning, financial decision-making and decentralized service delivery. At the same time, significant challenges remain, including limited own-source revenue, dependence on intergovernmental transfers, uneven fiscal capacity, administrative constraints and financial-management difficulties.

The analysis demonstrates that fiscal autonomy and institutional capacity are closely connected. Financial resources cannot automatically generate effective governance without capable institutions, while administrative institutions cannot effectively perform decentralized responsibilities without adequate and predictable resources.

Sustainable fiscal federalism therefore requires an integrated approach that connects revenue assignment, expenditure responsibilities, intergovernmental transfers, financial management, administrative capacity and local planning.

Nepal's future fiscal federalism is consequently likely to depend on institutional consolidation rather than fiscal decentralization alone. Strengthening subnational capacity, improving transparency, refining transfer mechanisms, expanding digital financial management and encouraging evidence-based planning can contribute to a more coherent and sustainable system of decentralized governance.

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