

Fiscal Sustainability of Local Governments in Nepal: Challenges, Prospects, and Policy Implications

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ABSTRACT

The Constitution of Nepal, enacted in 2015, abolished the long-standing centralized monarchical system and adopted a federal democratic republic with three tiers of government: federal, provincial, and local government. Given the constitutional recognition, autonomy, and major responsibilities of local governments in service delivery and local development, their fiscal capacity, accountability, and overall success will determine the future of federalism in the country. However, the early experience reveals several challenges, including vertical and horizontal fiscal imbalances, growing audit irregularities, and the dependence of most local governments on grants and transfers. These obstacles threaten fiscal sustainability and decentralized governance in Nepal. This study aims to reflect the current state of fiscal decentralization, following a decade of federal practice in Nepal. It includes both urban and rural local governments to examine how fiscal design and its implementation affect overall local fiscal sustainability in Nepal. Applying a mixed-methods approach, it analyzes local fiscal trends to understand how fiscal federalism operates at the grassroots-level. The preliminary findings suggest that the current local fiscal health appears balanced owing to external transfers and budget surpluses resulting from poor execution. However, the persistent deficit of the federal treasury waves a red flag for local fiscal health and Nepal's overall federal system.

Introduction

Nepal, situated between the two economic giants, of China and India, has a glorious history of independence and sovereignty, but this has been interrupted by frequent ongoing political instability, civil unrest, and internal struggles for democracy. Nepal promulgated a new constitution in 2015 after a decade-long civil war and 19-day *Jana Andolan-II* (People's Movement), which not only restructured the state but also overthrew the legacy of a centuries-old monarchy and replaced it with a federal democratic republic (FDR). This unprecedented constitution envisaged cooperative federalism with three levels of government: federal, provincial, and local. State power is distributed among them through exclusive and concurrent jurisdictions (Schedule-5,6,7,8 and 9 of the Constitution). “*The most attractive aspect of Nepal's federal design is the constitutionally devolved rights to make decisions at provincial and local levels regarding their economic governance.*” (Wagle, 2023).

Local governments, as the government at the doorstep of the people, are constitutionally mandated to discharge significant responsibilities for service delivery and regional development. They serve as a sturdy foundation for federalism in Nepal. Federalism can, in a true sense, be realized through the effectiveness of local governments in fulfilling their constitutional duties, as earmarked by public aspirations. The fiscal autonomy of local governments can only be justified by sustainable fiscal management and the public

welfare they guarantee. Nepal's diverse realities in terms of language, culture, religion, topography, and unevenly distributed natural resources pose both risks and rewards for its federal design. As a developing country, Nepal consistently falls short of financial resources, with approximately one-fourth of the national budget financed through internal borrowing, foreign aid, and loans (Ministry of Finance). As Acharya (2021) cautions, federalism is likely to be an expensive system of governance; frugal, sustainable, and rational use of financial resources by all levels of government is not only desirable but inevitable. This study aims to analyze the fiscal behavior of local governments by examining their revenue and expenditure patterns and evaluating fiscal sustainability within the framework of constitutional fiscal design.

Decentralized countries face both the promises and perils of fiscal federalism. Despite proponents' belief that decentralization enhances the efficiency, accountability, and responsiveness of government, it also carries potential risks when fiscal systems and institutions are weak. Different scholars have noted the darker sides of decentralization, as depicted by Prud'homme (1995), "Decentralization as Dangers, Pitfalls of Fiscal Decentralization" by Tanzi (2002), "Moral Hazards and Bailout Problems" by Rodden (2006), and "Revenue-Expenditure Mismatch" by Morgan and Trinh (2016). According to Broadway and Shah (1994), fiscal federalism primarily involves an assignment problem that concerns the allocation of taxation, expenditure, and regulatory responsibilities among various levels of government. These insights from the global literature show how poor fiscal design or weak institutions can undermine sustainability. Thus, decentralization does not guarantee inherent efficiency. As a young federation, Nepal is experiencing both globally shared challenges and its own country-specific issues.

Nepal's early federal practices, focusing on the local level, highlight both structural (design-related) and behavioral (practice-related) problems with fiscal decentralization. Several studies, including Devkota (2021), Bahl (2022), and Khanal (2024), have exposed the revenue and expenditure mismatches of local governments. Additionally, Ghimire (2018) and the Annual Report of the Office of the Auditor General of Nepal 2025 reflect fiscal indiscipline and growing audit irregularities in local governments. Similarly, Shah (2019), Acharya and Scott (2020), and Sharma et al. (2025) found local governments' capacity constraints to fulfill their constitutional mandates, including planning and budgeting for service delivery. The core concern is whether Nepal's historical shift from a highly centralized unitary system to a federal system, granting significant autonomy to local governments, can be sustained in the long run. Thus, there is a need for a comprehensive empirical study to examine how these issues impact local governments' fiscal conditions and sustainability in Nepal.

This study is guided by three main research questions: What are the impacts of fiscal design and practice on fiscal sustainability? What are the challenges of fiscal decentralization? What is the fiscal autonomy of local governments in Nepal? Thus, it aims to analyze revenue sources and expenditure patterns, explore fiscal challenges, and suggest strategies and policy implications for achieving fiscal sustainability by local governments.

Literature Review

The research lays its foundation on the theory of fiscal federalism, first proposed by Richard A. Musgrave in 1959 and subsequently elaborated by Wallace Oates in 1972. (Ahmad and Brosio 2015). Different scholars (Oates, 1999; Qian and Weingast, 1997) Weingast, (2009); Broaday and Shah (1994, 2009) have shed light on various aspects of fiscal federalism, including both first- and second-generation approaches. The underlying assumption is that the vertical division of fiscal power in a multi-government structure enhances efficiency, equity, and public welfare due to inter-jurisdictional competition and the fulfillment of the needs and preferences of the people at the respective government level.

Components and Principles of Fiscal Federalism

“The principles of fiscal federalism are concerned with the design of fiscal constitutions – that is, how taxing, spending, and regulatory functions are allocated among governments and how intergovernmental transfers are structured.” -Shah, 2007

Different scholars of fiscal decentralization have presented various geneses or principles of fiscal federalism. They guide how the four components of fiscal decentralization—expenditure, revenue, intergovernmental transfer, and subnational borrowing—should be distributed in multi-level governments.

Components and Principles of Fiscal Federalism:

Litvack and Seddon (1999) and Shah (2007) summarize the four key components of fiscal decentralization and the guiding principles for multi-governmental fiscal design.

Components	Principles
Expenditure Assignment	Fiscal efficiency, regional equity, economies of scale, spatial externalities, stabilization, and redistribution are major considerations for expenditure assignment.
Revenue Assignment	Economic efficiency, national equity, administrative feasibility, and fiscal need shape revenue assignment.
Intergovernmental transfer	Intergovernmental transfer should align with the principles of clarity, simplicity, autonomy, predictability, revenue adequacy, transparency, reach, incentive, responsiveness, and safeguarding the grantee's objectives.
Subnational borrowing	Long-lived assets should primarily be financed by raising debt to ensure equitable burden-sharing across generations. Subnational borrowing should meet the principles of repayment capacity, penalty system, hard budget constraints, and fiscal discipline.

Principles for an Optimal Design of Subnational Fiscal Governance

Martinez-Vazquez et al. (2024) discussed the desirable principles for optimum subnational fiscal governance. Considering these principles, fiscal design at the subnational level should be structured to ensure efficiency, equity, and accountability.

Components	Principles
Expenditure Assignment	An optimum subnational expenditure assignment should adhere to the principles of correspondence, subsidiarity, fiscal co-responsibility, affordability, and administrative capacity.
Revenue Assignment	Subnational revenue assignment should be based on the principles of economic efficiency, equity consideration, economic stabilization, fiscal correspondence, and administrative effectiveness.
Intergovernmental Transfer Design	Intergovernmental fiscal transfer should ensure a proper tax base or revenue-sharing mechanism, and the use of equalization grants, conditional grants, and capital grants to minimize the subnational fiscal gaps.
Subnational Borrowing and Fiscal Rules	The subnational governments should have access to different means of internal borrowing, such as bonds, local financial institutions, and commercial debt, constrained by market discipline and different approaches to fiscal rules, including either an administrative or a fiscal rules approach.

Fiscal Sustainability: Result of effective fiscal design and implementation

Theoretical and empirical evidence indicates that fiscal sustainability is fundamentally shaped by the soundness of institutional structures and the effectiveness of their implementation. According to Oates (2006), poorly designed bailout policies can erode fiscal discipline and destabilize the entire system, as in Brazil, Argentina, and Mexico during the 1980s/90s due to their pervasive fiscal practices. Afonso and Alves (2023) argue that more efficient government spending contributes to increased fiscal sustainability. Sow and Razafimahefa (2017), Bahl and Bird (2018), Vazquez (2024), and Shrestha and Hankla (2025) agree that the outcomes of fiscal decentralization rely on the design, implementation, and context. Likewise, Vazquez (2015) and Afonso et al. (2024) believe that the impact of fiscal decentralization on fiscal sustainability depends on factors such as the design of decentralization reforms, the institutional framework, and the fiscal capacity and performance of subnational governments. Nakatani (2025) shows that strong institutions, clear fiscal rules, and well-designed transfers reduce fiscal risks by limiting moral hazards and improving inter-regional risk sharing.

Brief Overview of Local Governance and Decentralization in Nepal

For ease of reference, the history of local governance and decentralization practices in Nepal can be split into the pre-federal and post-federal eras.

Pre-federal Era: Nepal has a rich and extensive history of local governance. The evolution of local governance, characterized by the formulation and execution of collective action at the community level in Nepal, can be traced back to the early Vedic period (approximately 1500 BC; Devkota and Khanal, 2023). However, the restoration of multiparty democracy in 1990 and the enactment of the Local Self Governance Act (LSGA) in 1999 laid a solid foundation for devolved local governance and decentralization in Nepal (Nepal, 2016; Asia Foundation, 2017; Devkota and Khanal, 2023). Pre-federal decentralization was used for controlling and extracting resources. (Subedi, 2014). Local bodies serve as obedient subordinates to the central authority. (Adhikari, 2020)

As noted by Kelly (2016), the LSGA1999 was a major decentralization reform in Nepal. More than three thousand local bodies were established to deliver the dividends of democracy, provide prompt service delivery to people, and ensure meaningful public participation in both the local development process and the equitable distribution of benefits. Unfortunately, a decade-long Civil War (1996-2006) severely disrupted the proper implementation of the LSGA (Bahl et al., 2022). Consequently, local bodies have been without elected representatives for two decades. “Nepal’s immature decentralization process was recentralized in the absence of elected local officials” (Adhikari, 2020). Thus, Nepal’s decentralization efforts can be perceived as the outcome of a continual struggle between power-centric rulers and people’s demand for democracy, organized, motivated, and mobilized by political parties.

Post-Federal Era: The Comprehensive Peace Accord between the Government of Nepal and the Communist Party of Nepal (Maoist Center), signed in 2006, marked the formal end of the Nepali Civil War (Wikipedia) and paved the way for federalism (Acharya, 2016). The 2015 Constitution of Nepal, promulgated after seven years of deliberate efforts by the Constituent Assembly, formally transformed the country into a federal democratic republic. There are 753 local levels (local governments), comprising 293 urban and 460 rural municipalities. The Local Government Operation Act, 2017, a guiding law for local governments, categorizes them as urban (Municipality, Sub-metropolitan, and Metropolitan city) or rural based on population, annual income, and facilities. All local governments (LGs), despite their different sizes or demographic conditions, have equal rights and recognition vested in them by the Constitution. Notably, local governments possess political, administrative, and fiscal autonomy within their authority. According

to Article 59(1) of the Constitution, local governments can make laws, prepare an annual budget, make decisions, and formulate and implement policies and plans on any matters related to their financial powers within their respective areas. Similarly, Article 60(1) allows local governments to impose taxes on matters falling within their respective dominions and collect revenue from these sources. Fiscal power is allocated between levels of government, as presented in Figure 1.

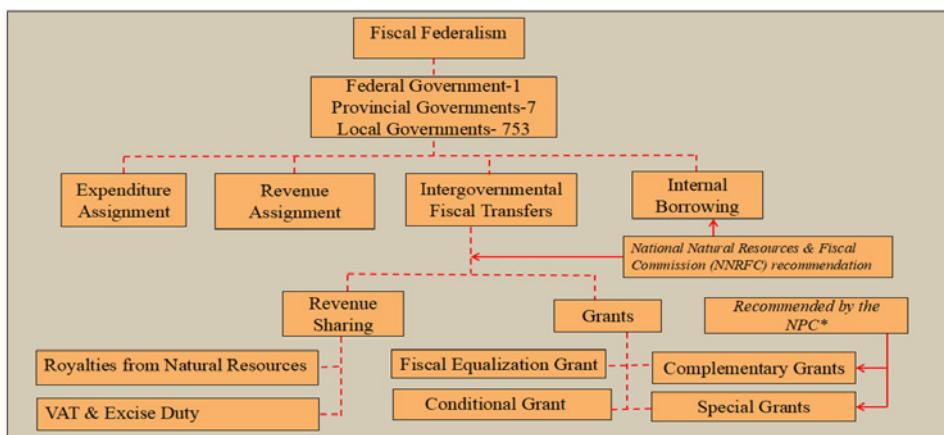


Figure 1: Fiscal Federalism in Nepal
Source: Author's Derivation from the Constitution of Nepal and NNRFC
NPC*- National Planning Commission

A prominent feature of Nepal's federalism is constitutionally divided fiscal authorities across levels of government. The NNRFC is the most pivotal constitutional body for properly implementing fiscal federalism in Nepal (Wagle, 2018), while the NPC implements complementary and special grants designed for local governments.

Revenue Sources of Local Governments

Nepal, a country of great diversity, has local governments that vary in terms of geography, natural resources and socioeconomic conditions. As a result, local governments differ in terms of their revenue potential. This poses a risk of vertical and horizontal fiscal imbalances among local governments. Considering these factors, the architects of Nepal's Constitution deliberately tried to allocate revenue rights and resources among the tiers of government.

Article 60 of the Constitution provides provisions for the distribution of revenue sources among the three levels of government. The Constitution and the Intergovernmental Fiscal Arrangement Act, 2017, distribute revenue powers and resources between levels of government, as presented in Table 1.

The Intergovernmental Fiscal Arrangement Act of 2017 encompasses provisions for grants and revenue sharing. Local governments can receive four types of grants from both provincial and federal governments: fiscal equalization, conditional, matching, and special grants, as recommended and determined by the National Natural Resource and Fiscal Commission, which serves as the custodian of fiscal federalism in Nepal. On the other hand, to reduce the horizontal imbalance among local governments, there is also the provision of revenue sharing from the federal government to the local governments. Specifically, 15 percent of the total amount accumulated from the value-added tax and excise duty by the federal government is allocated to the local governments. Schedule four of this Act depicts the allocation of royalties generated by Natural Resources, stipulating a distribution of 50 percent to the federal government, with twenty-five percent each for the provincial and local governments.

Table 1: Distribution of revenue sources among tiers of governments

Revenues	Federal	Provincial	Local
Tax Revenue	(1) Custom Duty (2) Excise Duty (3) Value Added Tax (4) Corporate Income Tax (5) Personal Income Tax (6) Remuneration Tax	(1) <i>House and Land Registration Fee</i> (2) <i>Vehicle Tax</i> (3) <i>Entertainment Tax</i> (4) <i>Advertisement-Tax</i> (5) Tax on Agricultural Income	(1) Property Tax (2) House Rent Tax (3) <i>House and Land Registration Fee</i> (4) <i>Vehicle Tax</i> (5) Land Tax (Land Revenue) (6) <i>Entertainment Tax</i> (7) <i>Advertisement Tax</i> (8) Business Tax
Non-Tax Revenue	(1) Passport Fee (2) Visa Fee (3) Tourism Fee (4) <i>Service Fee</i> (5) Gambling/Lottery (6) <i>Fines and Penalties</i>	(1) <i>Service Fee</i> (2) Tourism Fee (3) <i>Fines and Penalties</i>	(1) <i>Service Fee</i> (2) Tourism Fee (3) <i>Fines and Penalties</i>
Other Revenue	(1) Other taxes and non-tax revenues raised/levied according to federal and other prevailing laws.	(1) Other tax and non-tax revenues raised/levied according to provincial law and other prevailing laws within the provincial jurisdiction.	(1) Other taxes and non-taxes raised/levied according to the local law and other prevailing laws on the local government level jurisdiction.

Source: *The Constitution of Nepal* and Devkota, 2021

Expenditure Responsibilities of Local Governments

The Constitution has provisioned the expenditure responsibilities of local governments in Schedule 8 as absolute powers and in Schedule 9 as a shared list of powers. Similarly, the Local Governance Operation Act, 2017, and the Intergovernmental Arrangement Act, 2017, guided the duties and expenditure responsibilities of local governments. Based on these constitutional and legal obligations (Table 2), local governments manage their expenditures.

(1) The Government of Nepal, the State, and the Local Level shall prepare an estimated statement of public expenditures to be made about their domain each Fiscal Year.

(2) While preparing the Statement pursuant to Sub-Section (1), the amount required for recurrent expenditures, capital expenditures, and fiscal arrangements shall also be allocated therein.

Source: *Intergovernmental Fiscal Arrangement Act, 2017, Article 16*

Table 2: Distribution of expenditure powers/ responsibilities

Governments	Exclusive Powers	Concurrent Powers	
Federal	Defense, central planning, currency, foreign affairs, citizenship, passport, etc. (Schedule 5) Total- 35 Exclusive Powers and Residual Powers	<u>Federal and Provincial:</u> Civil and criminal procedure, supply and distribution of essential goods, population management, social security, casinos, etc. (Schedule 6) Total- 25 Powers	<u>All three tiers:</u> Cooperatives, education, health, agriculture, irrigation, mines, minerals, disaster management, environment, forest, personal events, archaeology, motor vehicle permits, etc. (Schedule 9) Total- 15 Powers
Provincial	Provincial police administration, provincial civil service, higher education, provincial-level development activities such as electricity, irrigation, roads, land management, etc. (Schedule 6) Total- 21 Powers		

Source: *The Constitution of Nepal*

Research on Local Governance and Fiscal Federalism in Nepal

Nepal, being new to federalism, exhibits a scarcity of research on the subject, particularly at the local level. To date, most studies have largely described the constitutional design and structural issues of fiscal federalism.

The Nepal Administrative Staff College published a Nepali-language handbook on federalism in 2020, providing an informative and accessible overview of Nepal's federal system. Likewise, the Ministry of Federal Affairs and General Administration of Nepal, in the same spirit, released an instructive publication about the concept and practice of Fiscal Federalism in Nepal in 2021, serving as a useful reference for policymakers and practitioners.

Devkota (2020) discusses the intergovernmental fiscal transfer system in federal Nepal. His study describes the present constitutional provisions for fiscal transfers among different tiers of government. Subnational governments in Nepal receive approximately 12% of GDP in fiscal transfers, which is higher than in most federal countries. This study also reflects the gaps in the existing fiscal transfer systems.

Devkota (2021) reviewed the fiscal architecture of subnational governments in Nepal and noted institutional ambiguity, legislative delays, and inadequate cooperation from the federal government as barriers to implementing fiscal federalism. In addition, the study observed limited fiscal space at the subnational level, a lack of laws and market mechanisms for subnational public borrowing, and disappointing subnational performances (no efficient and quality delivery service to people, inability to meet public aspirations).

Bahl et al. (2022), in their study, *Implementing Federalism: The Case of Nepal*, explored the objectives of federalism in Nepal, the cost and benefit of decentralization, and the major barriers to federalism in Nepal.

Bhattarai (2024) investigated the expenditure practices of provincial and local governments and concluded that local governments have more recurrent expenditures (60%) than provinces (43%). Rural local governments have less capital spending than urban ones (Metro-45%, Sub-Metro-44%, Municipalities-41%), and Rural Municipalities (37%).

KC (2024) studied the earmarked grant allocation system in Nepal. He discussed the current practice of conditional grant allocation, institutional arrangements for it, and the relationship between conditional grants and the capacity of local governments.

GC et al. (2025) examined the factors affecting the financial condition of urban municipalities and discovered that they have favorable financial conditions characterized by satisfactory revenue, resources, and long-term solvency. The study found different factors influencing urban municipal financial conditions.

- Structural factors include immigration, citizens' quality of life, and literacy rates.
- Economic factors: capacity to meet commitments, resource availability, and cost management,
- Governance factors include strong leadership, good governance practices, and transparency.
- External factors: central government policies and municipal independence had no influence.

Poudel et al. (2025) observed the financial conditions of urban municipalities in Nepal. They assessed six key financial dimensions: short-term solvency, budgetary solvency, long-term solvency, service-level solvency, and financial flexibility, and concluded that sub-metropolitan cities have strong short-term

solvency, whereas metropolitan cities are strong in terms of long-term solvency, operational efficiency, and financial flexibility.

A range of national and international institutions have also assessed the progression of federalism in Nepal, including the World Bank Group, the Asia Foundation, Nepal, the Samriddhi Foundation, and the Niti Foundation.

Literature Gaps:

Studies on federal practices at the local level remain limited because of Nepal's relatively short duration of federal governance. Existing studies lack key aspects, including long-term analyses of local government revenue and expenditure trends, attention to opportunities for fiscal federalism at the local level, and comprehensive coverage of both rural and urban local governments with their financial data.

Thus, a comprehensive analysis of fiscal trends and fiscal sustainability covering both urban and rural municipalities, accompanied by quantitative evidence of fiscal health, remains lacking. This study aims to address this gap.

Research Method:

This study adopted a mixed-method approach using quantitative and qualitative data. Fiscal data from the five most recent fiscal years were applied to analyze the revenue and expenditure trends of local governments, while qualitative data were utilized to explore the fiscal challenges and prospects. Additionally, an in-depth analysis was conducted to determine how the current fiscal design and its implementation by local governments influence their fiscal sustainability status. Local government officials, high-level officials from different government agencies associated with the local government, and fiscal federalism at the local level were the primary data sources. Secondary data were collected from various government and agency reports, websites, books, journals, and scholarly articles. The sample population was selected based on the Non-Probability Sampling Method (Judgmental Sampling).

Results and Discussion:

As ongoing research, the results of the study are yet to be finalized; however, the preliminary findings are presented from different perspectives, such as revenue and expenditure trends of local governments, intrinsic challenges, and possibilities of fiscal sustainability related to the fiscal design and practice of local governments. Overall, the local budgetary balance supported by external grants and revenue sharing places their fiscal health in good condition, while the federal position is in a growing deficit. Ultimately, such a trend can harm local fiscal sustainability and the long-run stability of the federal system in Nepal.

Revenue trends of local governments

Federalism in Nepal was fully implemented after the election of all three tiers of government in 2017. The first tenure (2017-2022) was dedicated to establishing the institutional and operational frameworks of federalism at the local level. After a decade of experience, local governments' revenue trends reveal an absolute dependence on federal grants and transfers as their primary source of revenue, which may challenge their autonomy and long-term fiscal sustainability.

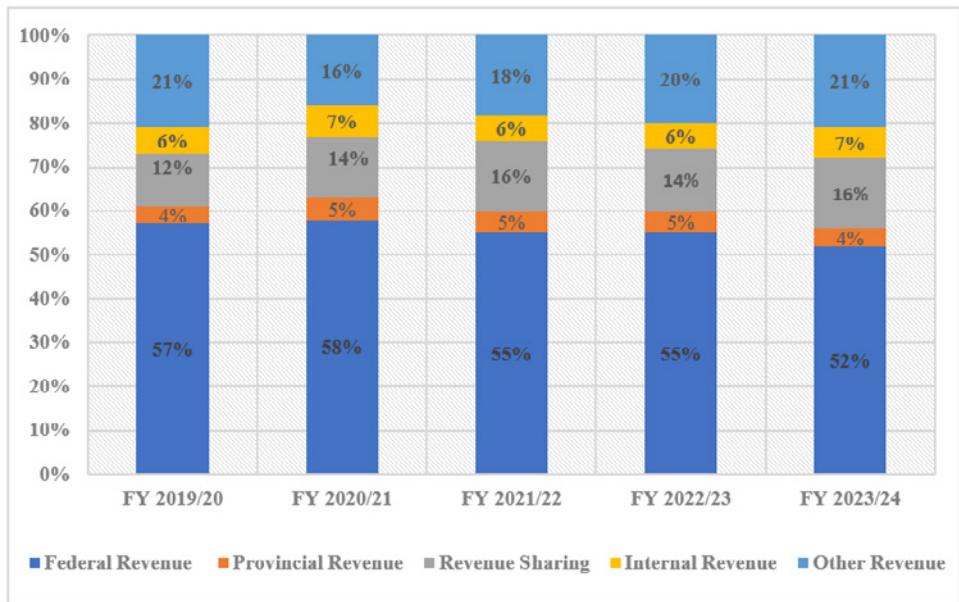


Figure 2: Source-wise Revenue of Local Governments in the last five fiscal years

Source: *The author's calculation based on Annual Audit Reports of the Office of the Auditor General*

Similar to many developing countries, the local government's own revenue in Nepal makes a nominal contribution to its total income. Heavy reliance on external sources may compromise their independence and harm the long-term financial health of local governments. Despite having equal constitutional status, local governments in Nepal demonstrate markedly diverse fiscal capacities and revenue potentials. Some urban municipalities benefit from strong economic bases and consequently operate with surplus revenues. In contrast, most local governments heavily rely on external fiscal sources, generating less than one percent of their total revenue from own-source revenues. This disparity highlights a notable vertical fiscal imbalance between urban and rural regions, despite the current constitutional arrangements for intergovernmental transfers and revenue-sharing provisions.

Table 3: A Comparative Analysis of Rural Vs Urban Revenue Sources

Fiscal Years	Local Governments	Federal Grant	Provincial Grant	Revenue Sharing	Internal Revenue	Other Revenues
2019/20	Rural Municipalities (419)	68%	56%	12%	2%	18%
	Urban Municipalities (275)			12%	8%	24%
2020/21	Rural Municipalities (443)	64%	6%	13%	2%	15%
	Urban Municipalities (279)	53%	4%	14%	11%	18%
2021/22	Rural Municipalities (458)	60%	6%	14%	2%	18%
	Urban Municipalities (291)	50%	4%	17%	10%	19%
2022/23	Rural Municipalities (456)	59%	6%	15%	2%	18%
	Urban Municipalities (290)	53%	4%	14%	9%	20%
2023/24	Rural Municipalities (460)	58%	5%	15%	2%	20%
	Urban Municipalities (293)	48%	3%	16%	10%	23%

Source: *Author's calculation based on Annual Audit Reports of the Office of the Auditor General*

The revenue performance of local governments over the past five fiscal years exclusively illustrates the deficient fiscal condition of rural municipalities in comparison to their urban counterparts, particularly with respect to their internal revenue. Over 90 percent of rural municipalities possess one percent or less of their total revenue from their internal sources. A preliminary study identified two primary factors contributing to this difference. First, most rural local governments have very narrow tax bases. Second, they exhibit poor tax efforts because of the ease of grants and fiscal transfers from higher tiers of government. Likewise, expanding local tax rates may result in political costs for elected officials, serving as a disincentive for local revenue maximization efforts.

Expenditure Trends of Local Governments

The expenditure responsibilities of local governments are shaped by constitutional mandates, the needs of their constituencies, and legal provisions and guidelines for local governments' budget formulation. Efficient allocation and effective execution of local budgets are imperative to justify the significance of fiscal federalism and strengthen local governance. However, the current expenditure practices at the local level reflect the prevalence of exceeding non-capital spending, which can jeopardize long-run fiscal health.

Table 4: Expenditure Trends of Rural and Urban Municipalities (As % of total expenditure)

Fiscal Years	Types of Local Governments	Recurrent Expenditure %	Capital Expenditure %	Other Expenditure %
2019/20	Rural Municipalities(419)	49	30	21
	Urban Municipalities (275)	44	31	25
2020/21	Rural Municipalities (443)	53	32	15
	Urban Municipalities (279)	50	34	16
2021/22	Rural Municipalities (458)	56	28	16
	Urban Municipalities (291)	52	32	16
2022/23	Rural Municipalities (456)	55	29	16
	Urban Municipalities (290)	53	28	19
2023/24	Rural Municipalities (460)	54	24	22
	Urban Municipalities (293)	49	28	23

Source: Author's calculation based on Annual Audit Reports of the Office of the Auditor General

(The figures in parentheses indicate the total number of rural and urban municipalities, which differ due to the unavailability of data.)

The expenditure trends of local governments over the past five fiscal years illustrate that both urban and rural municipalities are characterized by the dominance of non-capital spending. Collectively, less than one-third of their expenditure is allocated to capital investment, which serves as an early warning regarding the long-term fiscal sustainability of these local governments. A prominent factor contributing to this is the escalating administrative costs associated with the federal framework. The remaining factors are subjects of ongoing research.

Revenue and Expenditure Trends of Selected Local Governments

The subsequent analysis focuses on three local governments showing revenue trends. Kathmandu Metropolitan City, at the local level, has the highest population among all municipalities, in contrast to

Narpabhum Rural Municipality, which has the lowest population. Putalibazar Municipality occupies an intermediate position in terms of both demography and revenue generation.

Revenue Trends in Kathmandu Metropolitan City:

Kathmandu Metropolitan is the first metropolitan city of Nepal, with a total area of 57.67 square kilometers and 862,400 population within thirty-two wards. (Census of 2021) Situated in the federal capital city, it hosts most of the economic hubs of the country. Additionally, as an epitome of several cultural heritages and historical monuments, tourism contributes more to its own revenue. Consequently, it is the most independent local government in Nepal, which earns more internal revenue than the grants and intergovernmental transfers from the upper tiers.

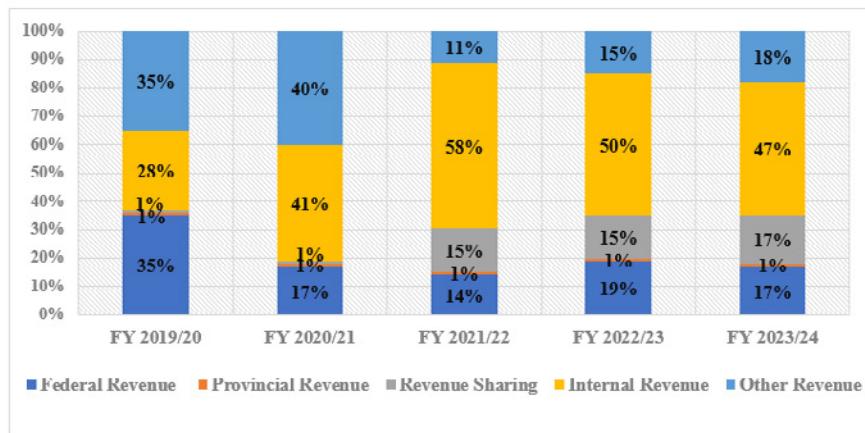


Figure 3: Revenue Trends of Kathmandu Metropolitan City

Source: Compiled by the author based on the OAG Report

Revenue Trends of Putalibazar Municipality:

Putalibazar Municipality was first established in 1997 as a local body during the unitary governance system and was restructured in 2017 after federalism was adopted. Divided into 14 wards, it has an area of 147.19 square kilometers and a population size of 41,743. (Census of 2021) As a hilly municipality, it also has low internal revenue, like other hilly urban local governments.

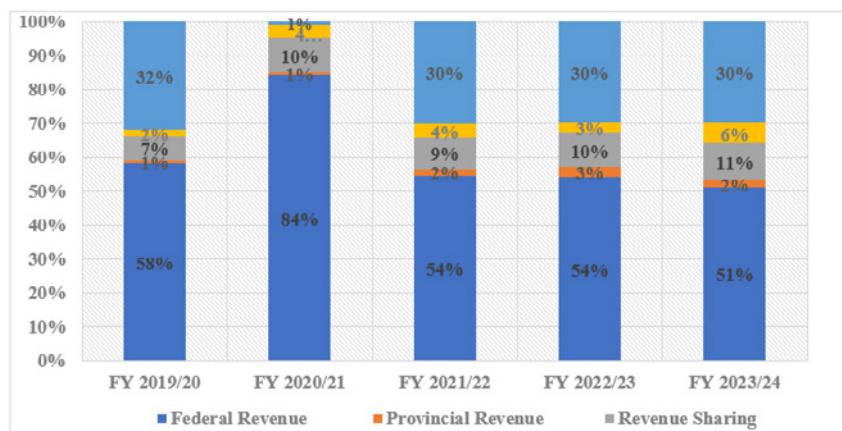


Figure 4: Revenue Trends of Putalibazar Municipality

Source: Compiled by the author based on the OAG Report

The Narpabhum Rural Municipality was established in 2017. Despite an area of 837.54 square kilometers, it has a population of only 396 and is the least densely populated local government unit in Nepal. (Census of 2021) As a remote mountainous local government, it has extremely poor internal revenue and is heavily dependent on external revenue.

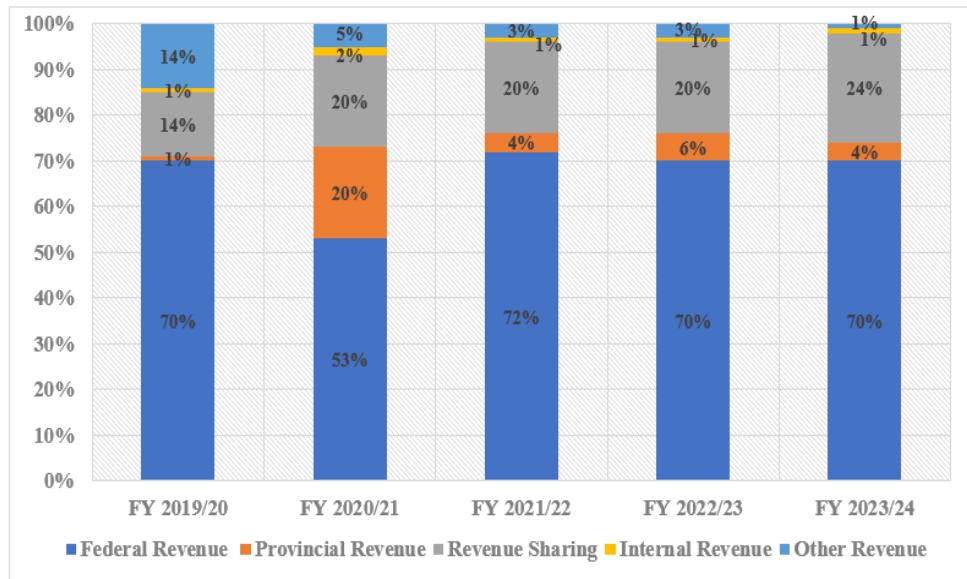


Figure 5: Revenue Trends of Narpabhum Rural Municipality

Source: Compiled by the author based on the OAG Report

Revenue trends across all three local governments exhibit a common feature of a slightly upward trajectory; however, they rely on external sources, except for Kathmandu. In contrast, Kathmandu Metropolitan City has a robust position in terms of internal revenue generation. These samples explicitly represent the horizontal fiscal imbalance prevalent among Nepal's local governments.

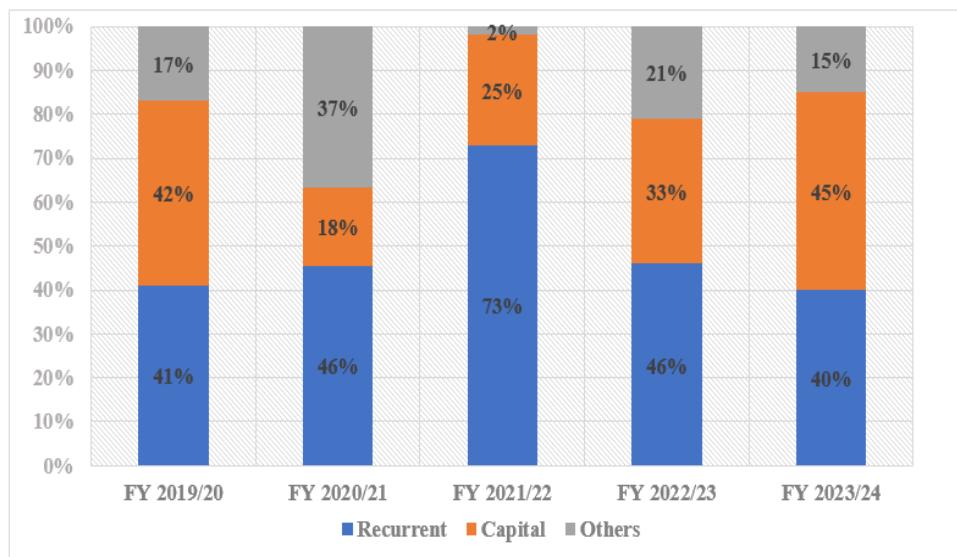


Figure 6: Expenditure Trends of Kathmandu Metropolitan City

Source: Compiled by the author based on the OAG Report

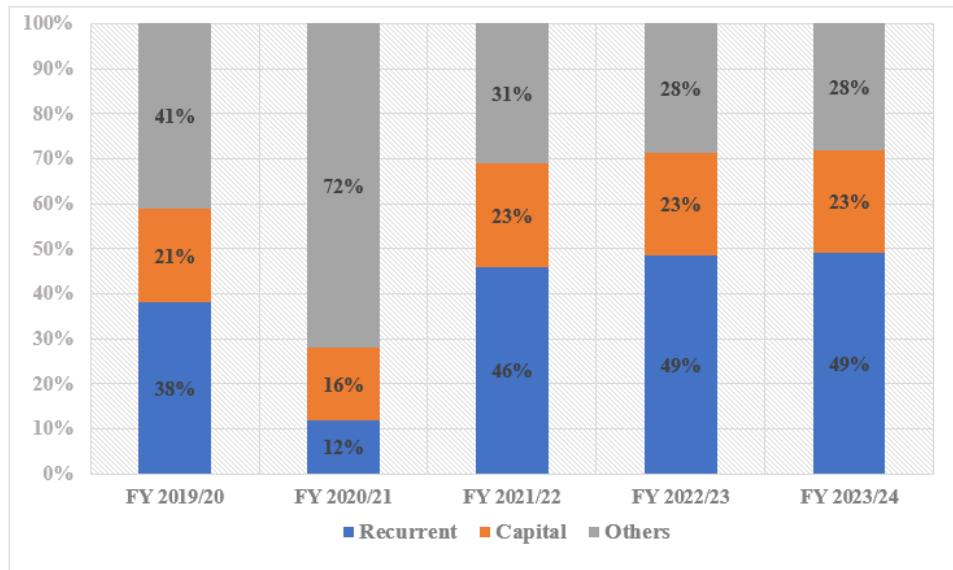


Figure 7: Expenditure Trends of Putalibazar Municipality

Source: Compiled by the author based on the OAG Report

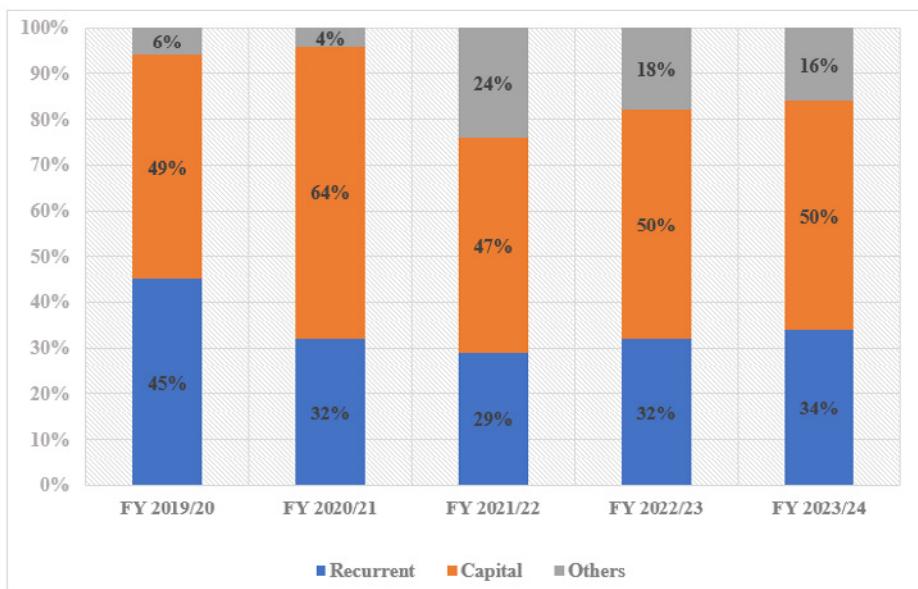


Figure 8: Expenditure Trends of Narpabhumi Rural Municipality

Source: Compiled by the author based on the OAG Report

The expenditure patterns of all three local governments comprise excessive non-capital expenditures. Superficially, rural municipalities have better budget allocation efficiency than urban ones. However, merely a larger capital spending size may not guarantee effective utilization of the public purse; rather, expenditures should align with genuine local needs and generate beneficial outcomes. For instance, increased spending may reflect political myopia rather than efforts to maximize public welfare.

The rising recurrent expenditure not only poses a significant threat to the fiscal sustainability of local governments but also may raise a red flag of dissatisfaction from local people, as it depletes the budget available for capital formation, developmental projects, and the overall betterment of the taxpayers. Therefore, it is mandatory to excavate the underlying causes of the constantly expanding recurrent budget.

Fiscal Sustainability of Local Governments in Nepal: Challenges, Prospects, and Policy Implications

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Table 4: Per-Capita Revenue and Expenditure of selected Local Governments

Fiscal Years	Local Governments	Total Revenue (NRs. Million)	Per-capita Revenue (NRs. Thousand)	Total Expenditure (NRs. Million)	Per-capita Expenditure (NRs. Thousand)
2019/20	Kathmandu Metropolitan City	9913	11	6450	7
	Putalibazar Municipality	1157	28	1193	29
	Narpabhami Rural Municipality	157	397	120	303
2020/21	Kathmandu Metropolitan City	12209	14	7567	9
	Putalibazar Municipality	1035	25	1005	24
	Narpabhami Rural Municipality	151	382	136	243
2021/22	Kathmandu Metropolitan City	14234	17	11185	13
	Putalibazar Municipality	1195	29	1186	28
	Narpabhami Rural Municipality	174	440	155	391
2022/23	Kathmandu Metropolitan City	11863	14	11299	13
	Putalibazar Municipality	1191	29	1165	28
	Narpabhami Rural Municipality	183	461	164	414
2023/24	Kathmandu Metropolitan City	12883	15	14641	17
	Putalibazar Municipality	1184	28	1211	29
	Narpabhami Rural Municipality	159	402	142	359

Source: Compiled by the author based on the OAG Report Population based on the census, 2021(National Statistics Office)

It is interesting that rural municipalities in Nepal have comparatively higher per-capita revenue and expenditure than their urban counterparts. One of the primary reasons for this is the current intergovernmental fiscal transfer system, which favors rural municipalities with smaller populations and larger territories (Bahl et al. 2022). Additionally, the uneven demographic distribution between urban and rural areas contributes to this difference. Other factors include the higher per-unit expenditure costs faced by remotely situated local governments due to greater transportation costs and the absence of economies of scale.

Table 5: Trend of Fiscal Transfer from Federal to Local Government

Transfer Types	Amount in NRs. Ten million									
	FY 2019/20		FY 2020/21		FY 2021/22		FY 2022/23		FY 2023/24	
Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	
A. Grants										
a. Fiscal Equalization	8996	30	9623	26	9457	26	9270	26	8724	26
b. Conditional	15101	51	19106	53	19111	53	19288	54	17130	52
c. Matching	484	2	1208	3	498	1	683	2	602	2
d. Special	477	1	866	2	636	2	529	1	458	1
B. Revenue sharing	4455	15	5576	15	6403	18	5860	16	6194	19
Total	29513	100	36379	100	36105	100	35630	100	33108	100

Source: Compiled and calculated by the author based on the Economic Surveys published by the Ministry of Finance

The flow of fiscal transfers from federal to local governments appears to be on a slightly declining trend. Of the four types, the **conditional grant** remains dominant, accounting for more than half of the total transfers, contrary to the NNRFC's recommendations to reduce its share and increase untied grants. While transfers such as fiscal equalization and revenue-sharing allow some allocation flexibility to the local government, such excessively tied transfers restrict the fiscal discretion of the recipients.

Prospects and Challenges of Fiscal Sustainability

Nepal's historical shift from an absolute, unitary, and highly centralized governance to a federal framework embodies the lofty ambitions and aspirations of its people. This ongoing research has some initial findings that illustrate both the opportunities and constraints of fiscal decentralization at the local level within Nepal's federal structure.

Prospects for fiscal sustainability:

- a) Constitutional recognition and autonomy of local governments: Local governments in Nepal originated in the Constitution. They have autonomy within their respective jurisdictions, especially in financial matters, such as creating and executing fiscal policy, setting tax rates, and preparing and implementing their budgets, with minimal interference from other levels of government. This constitutional and fiscal independence offers opportunities for sustainable local fiscal management.
- b) Stability of local governments and elected officials: The term of elected officials in local government can only be terminated in three situations: voluntary resignation, a proven case of corruption filed against the official, or death. Likewise, elected officials can be re-elected for a second term if they win the subsequent election. This political incentive can motivate local leaders to use fiscal resources efficiently and sustainably to benefit their constituencies. Similarly, the stability and consistency of local governments can support the continuity of plans and policies related to fiscal matters, allowing elected representatives to concentrate on long-term goals rather than short-term gains and populism.
- c) Advantages of local information: Government representatives at the local level are experts in their locality and possess in-depth knowledge of their region. They are acquainted with revenue resources and overall fiscal opportunities.
- d) Redistribution benefits: At first glance, the present revenue trend of Nepal seems to be largely centralized; however, it is essential for the federal government and can be justified on the grounds of redistributing resources and ensuring fiscal justice for the distant, underdeveloped, and fiscally weak local governments through fiscal transfers. By effectively utilizing transferred resources, such governments can develop their capabilities and gradually achieve fiscal self-reliance.
- e) Techno-friendly administrative officials: Most newly recruited administrative officials at the local level are techno-friendly. If their talents are utilized properly, the automation of local tax administration and the use of ICT in service delivery can contribute to fiscal sustainability.

Challenges to Fiscal Sustainability:

The initial findings regarding the challenges of the long-term fiscal sustainability of local governments are as follows:

Design-related challenges

Fiscal design includes the assignment of spending functions to each level of government and the determination of requirements for own-source revenues. (Ahmad and Brosio, 2006~ Vazquez et al, 2024)

The Constitution of Nepal, crafted through a deliberative seven-year effort by the constituent assembly, incorporates several remarkable features and unprecedented strengths. Despite this, the fiscal decentralization model has different drawbacks, posing risks to the long-term sustainability of the subnational governments. *The present institutional framework for fiscal federalism faces intrinsic challenges inherited from the weaknesses in state restructuring, which is creating the expected implementation of multilevel financial relations in Nepal.* (Wagle, 2023)

- Overlapping revenue and expenditure assignments: The Constitution of Nepal serves as the foundation for fiscal decentralization in the country. However, there are some inconsistencies and duplication in the constitutionally scheduled fiscal powers across government levels. (Acharya et al., 2020). Overlapping fiscal powers can lead to conflict during implementation or, at the very least, delay or distract the smooth operationalization of federalism. For instance, while the management of secondary-level education falls under the absolute authority of local governments, several parallel federal and provincial offices operate in district headquarters to provide services that are constitutionally intended to be provided by local governments. Likewise, cases were filed in different courts challenging the *Local Education Acts* formulated by various local governments.
- Highly centralized revenue design: More than 90 percent of the total national revenue is retained by the federal government (FCGO, 2024), leading to vertical fiscal imbalances. To some extent, this can be justified given the fiscal disparities of local governments, but it should be supported by equitable redistribution and intergovernmental transfers from the federal to the subnational levels.
- Overlapping legal provisions: Several sectoral federal laws concerning education, health, forest, and financial affairs contradict the provisions of the Local Governance Operation Act, 2017, and other local laws, impeding the smooth execution of fiscal federalism. Acharya et al. (2020) have minutely reviewed the overlapping assignment of functions across levels of government in Nepal.
- Symmetric system of local governance: All local governments, regardless of their varying demographic size, topographical features, or municipal types, receive equal status and possess a uniform set of powers. For example, Kathmandu Metropolitan City, hosting about three percent of the country's total population, holds the same constitutional power as the least populated rural municipality, Narpabhami, with a population of only 396 residents. Additionally, the allocation of revenue and expenditure responsibilities for the three tiers exhibits a one-size-fits-all approach. For instance, the local revenue streams for municipalities that are more developed and endowed with abundant natural resources are the same as those of remote, socioeconomically disadvantaged rural governments, despite their vastly diverse contexts. Thus, the revenue generation of local governments in the Bagmati Province surpasses that of most of its counterparts. Conversely, some rural municipalities demonstrate a better revenue position than several so-called urban municipalities situated in remote and geographically disadvantaged areas.

Practice-related Challenges

No fiscal design can be perfect and entirely flawless; however, when supported by sound intentions and efficient implementation by its actors, it can achieve better outcomes. Nepal, being in the early phase of federal practices, faces notable implementation challenges arising from a lack of federal experience or other unexplored factors. Some performance-related challenges have been identified in ongoing research.

- **Institutional Challenges:** Local governments are hindered by significant institutional challenges that affect their fiscal sustainability, including poor administrative and political capacity of local officials to manage the assigned responsibilities in the federal structure, a shortage of skilled local administrative staff, and the absence or frequent transfer of the chief administrative officer (CAO), who is the administrative head of local government and is assigned by the federal government.
- **Internal Conflict within Local Governments:** Hostility between political leaders and bureaucrats or the conflicts among elected officials due to different political ideologies or conflicts of interest are currently growing. Consequently, local governments are unable to formulate and implement their annual budgets and manage their offices smoothly, which risks fiscal sustainability, local development, and the overall functioning of local governance.
- **Dominance of the federal government:** The federal government, with constitutionally granted revenue-generating sources, residual power, and legal supremacy (any subnational laws confronting federal laws are void), can play a decisive role in shaping local fiscal health. The annual reports of the National Natural Resources and Fiscal Commission (NNRFC) disclose how the federal government has altered or delayed the amounts of fiscal transfers to subnational governments recommended by the NNRFC. Such practices cannot be accepted from the perspective of sound and good fiscal health. In contrast, the volume of conditional grants is steadily expanding every year, which does not guarantee meeting local needs or priorities.
- **Poor tax efforts by local governments:** “Subnational governments have not been serious in utilizing the revenue-raising powers assigned to them.” (Devkota, 2021) and are reluctant to maximize local revenue despite their potential because of the easy grants and shared revenues received from federal and provincial governments. Such diminished tax effort is not only beyond the assumption of fiscal decentralization theory but can also be self-induced and detrimental to local fiscal health.
- **Growing corruption, fiscal irregularities, and fiscal indiscipline:** According to the 62nd Annual Audit Report, 2025, of the Office of the Auditor General (*the supreme audit agency of Nepal*), the highest level of audit irregularities of the local governments (2.26% of the audited amount) compared to the federal (1.54%) and provincial governments (1.36%). Such fraudulent behavior erodes the underlying belief of fiscal decentralization that local governments are more efficient and responsible for their constituencies.
- **Untimely budget:** A growing challenge of fiscal federalism in Nepal is that local governments, due to internal conflicts and unidentified reasons, are unable to formulate and submit their budget to municipal assemblies within the legally mandated deadline (around the last week of June). The Ministry of Federal Affairs and General Administration, the liaison agency for local governments, updates the records of local municipal assemblies. According to the Ministry’s website, by mid-September 2025, a total of fifty-two local governments had not submitted their annual budget to the municipal assembly for the Fiscal Year 2025/26, reflecting the recurrence of previous trends.
- **Poor capital budget absorption rate of local governments:** Poor capital budget allocation and execution rate of local governments worsens the progress of federalism in Nepal. (Capital budget absorption rate: 33% in FY 2023/24, FCGO)
- **Historical legacy:** Political and administrative officials in Nepal have been accustomed to the unitary system. Consequently, the past tendency of a centralized mindset and concentration of power may persist even in the federal design.

Conclusion

Nepalese federalism has not matured fully yet. Although local governments currently have budget surpluses and appear to be in good fiscal condition, this does not guarantee their long-term sustainability. The present budget surpluses result from transferred grants and revenue sharing from higher tiers, as well as their weak budget implementation rate. Conversely, according to the FCGO's consolidated reports, the federal treasury has been facing a steady deficit. Overall, such federal deficits can negatively affect not only the central government but also all subnational governments. Therefore, sound fiscal management is crucial for the effectiveness and success of fiscal federalism in Nepal. In particular, discerning fiscal administration by local governments is essential, as the impact of their actions, whether commendable or detrimental, can immediately be perceived by locals. The constitution envisions Nepal's cooperative federalism, founded on the principles of cooperation, coordination, and coexistence. Consequently, the three tiers of government must engage in joint efforts to ensure fiscal sustainability and consolidate fiscal decentralization in Nepal. Local governments should justify their fiscal power and autonomy through sustainable management of financial resources to maximize public welfare, equity, and balanced local development. Otherwise, there could be widespread dissatisfaction with the entire federal system, as evidenced by Gen Z protests across the country in September 2025.

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