NEPAL FISCAL FEDERALISM UPDATE

May 2024

WORLD BANK GROUP

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Acronyms

CAO	Chief Administrative Officer
CG	Conditional Grant
FCGO	Financial Comptroller General Office
FEG	Fiscal Equalization Grant
FFCD	Fiscal Federalism Coordination Division
FY	Fiscal Year
GDP	Gross Domestic Product
IGFA Act	Intergovernmental Fiscal Arrangement Act
IGFT	Inter-Governmental Fiscal Transfer
LISA	Local Government Institutional Capacity Self-Assessment
MAPS	Methodology for Assessing Procurement Systems
MoF	Ministry of Finance
MoFAGA	Ministry of Federal Affairs and General Administration
MoFE	Ministry of Forests and Environment
MTEF	Medium-Term Expenditure Framework
NARMIN	National Association of Rural Municipalities in Nepal
NASC	Nepal Administrative Staff College
NFFU	Nepal Fiscal Federalism Update
NNRFC	National Natural Resources and Fiscal Commission
NPC	National Planning Commission
NPR	Nepali Rupee
NRB	Nepal Rastra Bank
OAG	Office of the Auditor General
OPMCM	Office of the Prime Minister and Council of Ministers
PAC	Public Accounts Committee
PCGG	Provincial Center for Good Governance
PDMO	Public Debt Management Office
PFM	Public Financial Management
PLG	Provincial and Local Government
PMoFEA	Provincial Ministries of Finance and Economic Affairs
PPC	Provincial Planning Commission
PPMO	Public Procurement Management Office
PSC	Public Service Commission
PTCO	Provincial Treasury Controller Office
SuTRA	Sub-National Treasury Regulatory Application
TDF	Town Development Fund
VFG	Vertical Fiscal Gap

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Executive **Summary**

The World Bank's Nepal Fiscal Federalism Update (NFFU) aims to report annually on the progress of fiscal federalism in Nepal and identify implementation gaps. This second update reviews the progress on fiscal federalism since the publication of the first report and provides an update on economic conditions across provinces and local governments. Considering their important role in fiscal federalism and the recent growth of public debate on the role of provincial governments, this edition places special emphasis on the provincial level of government.

Growth has been slow and deficits have manifested across provinces and most local governments.

In fiscal year (FY) 23, Nepal's provinces saw their slowest growth since FY20, ranging from 1.4 percent in Bagmati to 3.3 percent in Gandaki, driven by a decline in wholesale and retail trade and manufacturing. Import restrictions implemented by the federal government in the first half of FY23 to manage external pressures resulted in a significant decline in the wholesale and trade sub-sector across all provinces, while manufacturing and construction sub-sectors also contracted, in part due to the elevated prices of manufactured goods and construction materials. Bagmati, which has the largest services sector, contributed to the slowdown in national growth.

The slowdown in growth along with import restrictions led to a decline in federal revenue from 23.1 percent of gross domestic product (GDP) in FY22 to 19.2 percent of GDP in FY23. This, in turn, caused a decrease of 1.3 percentage points of GDP in fiscal transfers (including revenue sharing) to sub-national governments. Consequently, in FY23, provincial revenue and grants plunged by 0.9 percentage points of GDP to a record low of 3.5 percent, and local government revenue and grants fell by 1 percentage point to 8 percent of GDP. While all provinces and municipality types experienced this decline, Sudurpashchim and urban municipalities saw the largest decrease.

With spending remaining relatively unchanged at around 12 percent of GDP, lower revenue and grants in FY23 led to a deficit for both provincial and local governments, the first time since FY19. Provincial deficits reached 0.3 percent of GDP in FY23, while local government deficits stood at 0.4 percent of GDP. These deficits were financed using the opening cash and bank balances, reflecting unspent unconditional fiscal equalization grants (FEGs) and revenue sharing from previous fiscal years. The severity of the deficit varies significantly across provinces and municipality types, with Sudurpashchim and urban municipalities experiencing the largest deficits.

Provincial and local governments in Nepal underspent their budgets in FY23. Provincial governments underspent at a rate of 34 percent, while local governments underspent at a rate of 24.4 percent. Program expenses (recurrent expenditure), public construction (capital expenditure) and contingencies (recurrent and capital components) were the common drivers of underspending for sub-national governments. Underspending at the provincial level continues to be explained by a lack of alignment between periodic development plans, the medium-term expenditure framework (MTEF), and the budget, as well as the allocation of a significant portion of the budget to the category of 'Economic Miscellaneous.'

Progress on the regulatory framework for fiscal federalism and institutional development has been slow, and urgent action is needed on reinforcing expenditure and revenue assignments, as well as upgrading the Inter-Governmental Fiscal Transfers System.

Nepal's legal and institutional reform under fiscal federalism has been progressing moderately. At the institutional and strategic levels, the Fiscal Federalism Coordination Division (FFCD) at the Ministry of Finance

(MoF) has the mandate to coordinate the implementation of fiscal federalism, including for the development of fiscal federalism strategies. In addition, since November 2023, FFCD has been designated as the unit responsible for coordinating public financial management (PFM) strategies. Proactive reviews on regulatory frameworks, such as the Local Government Operations Act (2017) and Inter-Governmental Fiscal Arrangement Act (2017), together with the review of the Unbundling Report[1] led by the Office of the Prime Minister and Council of Ministers (OPMCM), are underway to further clarify the division of responsibilities among the three tiers of government.

The enabling environment for fiscal federalism and PFM at the provincial level is slowly advancing. Following federal-level institutional developments, provincial-level institutions responsible for fiscal federalism and PFM are in the process of developing their core building blocks. By December 2023, all seven provinces had enacted their Provincial Civil Service Acts (PSCA), paving the way for the recruitment of sub-national civil servants. The dependence of provincial governments on conditional grants (CG) as a share of their total revenue decreased from 19.6 percent in FY22 to 17.3 percent in FY23, which indicates a marginal increase in the fiscal autonomy of provincial governments. Enhancing the capacity for revenue administration at the provincial level ought to be encouraged to further empower provincial fiscal autonomy.

More progress needs to be made on revenue and expenditure assignments across the three levels of government. For instance, some of the sectoral legal and regulatory frameworks, such as the Water Supply and Sanitation Regulations and the Education Bill (currently under review by Parliament), should provide further clarity on expenditure assignment in the sectors, determining which tier of government holds what spending power. On revenue assignment, the Construction Materials Management and Regulation Bill was submitted to Parliament in November 2023 and is expected to provide clarity on the division of revenue rights and responsibilities between provincial and local governments (PLGs) regarding natural resources. It is important to enact these regulatory frameworks without delay to give clarity on concurrent responsibilities among the three tiers of government.

The Inter-Governmental Fiscal Transfers (IGFTs) System requires upgraded institutional arrangements for effective management. The reliance of local governments on the four types of IGFTs is still high – 74.3 percent of total local government revenue in FY23, which is slightly less than the 76.2 percent in FY20[2] – while CGs to local governments have increased slightly over the same period, from 43.5 percent to 46.5 percent of total revenue.[3] The overall trend of IGFTs has remained unchanged, with the largest proportion of resources for local governments being transferred through CGs.

CGs could be decreased and FEGs increased to enable planning and decision-making by PLGs according to bottom-up needs. Furthermore, the design of CGs can be improved by establishing a transparent, consultative process and a technical methodology to increase the predictability of financial resources, as well as by adopting mechanisms to increase the flexibility of PLGs in the programming and use of these grants.

Progress has been made on public financial management at the provincial and local government level, although challenges persist.

Local governments are making strides in planning and budgeting practices. For example, (a) more local governments are preparing periodic development plans, MTEFs, and annual programs; (b) almost all local governments have established the required committees for budget preparation; (c) thematic budget ceilings are increasingly being determined based on legal guidelines; and (d) most local governments delegate spending authority as required by law. However, challenges remain in terms of preparing MTEFs and annual programs based on spatial periodic plans.

Local governments largely complied with accounting standards, but budget transparency remains low. While some types of budget information like revenue and spending estimates are becoming more publicly available for the budget year, problems with comparability and transparency persist in budget speeches, despite the adoption of the Sub-National Treasury Regulatory

1 An Unbundling Report was prepared by the Office of the Prime Minister and Council of Ministers in 2017 to clarify Schedules 5–9 of the Constitution of Nepal 2015. The second review of the Unbundling Report is ongoing.

2 Data from the National Natural Resources and Fiscal Commission (NNRFC) website (https://www.nnrfc.gov.np/).

3 Data from the Ministry of Finance.

Application (SuTRA) by almost all local governments. For example, unlike federal and provincial governments, more than 90 percent of sampled local governments did not present three sets of figures[4] (estimates for the upcoming year, revised estimates for the current year, and actual figures from the previous year) or consistent documentation on budgets based on administrative, economic, and functional classifications. This prevents comparisons between budgets and execution.

There has been progress in terms of procurement capacity and internal control systems at the local level, although there is ample room for improvement. The number of local governments preparing and fully implementing master and annual procurement plans increased from FY22 to FY23. According to LISA data, 44.1 percent of 444 local governments prepared and fully implemented these plans in FY23, marking a considerable increase from 29.1 percent of local governments in FY22. There was also a considerable increase in the number of local governments that prepared, fully implemented, and regularly monitored internal control systems. Despite this progress, close to half of the local governments sampled in FY23 did not prepare any procurement-related plan, and more than half did not have an internal control system.

Despite a decrease in audit irregularities and an increase in public hearings, fewer local governments are complying with legal deadlines for financial reporting. Local governments are increasingly failing to prepare and publish their annual budget execution reports within the mandated timeframe of three months after the fiscal year ends. This decline in adherence to the legal requirement is widespread across all municipality types. The compliance rates in FY23 ranged from a low of 17 percent in metropolitan cities to a high of 22 percent in rural municipalities.

Progress in the uptake of recommendations contained in the NFFU 2023 has been moderate.

Moderate progress has been made against the six key recommendations highlighted by NFFU 2023. Since the first edition of the NFFU in 2023 (with a data cut-off date of March 2023), some progress has been made in the actions recommended by the report in terms of the enabling legal, policy, and institutional frameworks and the PFM implementation status of PLGs. Among these are the decision by the government to prepare a Fiscal Federalism Roadmap for Nepal, led by the FFCD under the MoF, and the ongoing process to review the Unbundling Report through an exercise led by the OPMCM to give further clarity on expenditure and revenue assignments among the three tiers of governments. However, there has been limited progress on some other key recommendations, such as the important reforms needed on the assignment and management of conditional grants (for details, see the recommendation matrix below).

The key recommendations of this report build on the progress achieved since the last NFFU and the remaining gaps. They refer to reforms or amendments in the legal framework, reinforcement of the IGFT system, facilitating economic and PFM-related data production and access, reform of the procurement system, strengthening PFM and procurement capacity, and reinforcement of PLGs' budget credibility. The recommendations are summarized in the following table[5], along with a proposed level of priority (short and medium term) based on their feasibility, impact, and sequencing.

4 Recommended by the Government Finance Statistics (GFS) and Classification of the Functions of Government (COFOG) standards.

5 The table below is reproduced in Chapter 4 as Table 4.1.

Progress on implementation of recommendations in NFFU 2023, and summary of key recommendations in NFFU 2024

Recommendations in NFFU 2023	Recent Developments Since March 2023	Recommendations in NFFU 2024	Responsible Institutions
Short term			
Fiscal federalism and PFM reform national strategies			
Develop a fiscal federalism roadmap based on relevant government strategies, such as the Public Financial Management strategy (2017) and Capacity Development Action Plan on Fiscal Federalism (2022).	The MoF FFCD was designated to coordinate the preparation of the update of the PFM reform strategy. The FFCD has the mandate to prepare the Fiscal Federalism Roadmap. The FFCD is advancing these commitments.	**Develop, validate, and implement the fiscal federalism roadmap.** While the FFCD is committed to developing the roadmap, this NFFU reiterates the importance of preparing it through a consultative process that involves provincial and local governments and swiftly advancing its implementation.	MoF (lead agency) in coordination with the National Natural Resources and Fiscal Commission (NNRFC), National Planning Commission (NPC) and PLGs
Legal framework amendments			
		Pass updated Fiscal Procedures and Financial Accountability Acts, aligned with the corresponding federal-level framework, in the five remaining provinces.	Provincial Ministries of Finance and Economic Affairs (PMoFEA)
IGFT System			
Reinforce the IGFT System to make transfers more flexible, clear, and timely, as well as increasingly performance-based. More specifically, do the following: a. Update the methodology for calculating FEGs. b. Limit earmarking in conditional grants as part of the transition towards the principle of sectoral block grants. c. Strengthen the inter-governmental coordination mechanism among the key fiscal institutions of the MoF, NNRFC, and NPC.	a. The NNRFC has been reviewing the FEG formula, aiming to have a more transparent and user-friendly methodology that better reflects the evolution of the situation of PLGs. b. No significant progress has been made on the flexibilization of conditional grants. c. While the NPC and NNRFC have emphasized the need to enhance coordination regarding these four types of grants, no significant measures have been taken to address this point.	**Upgrade institutional arrangements for IGFTs** to make the transfers more needs-based, clear, and timely, and increase the fiscal autonomy of PLGs. In addition to the recommendations in NFFU 2023, this report recommends the following: a. Establish a transparent, consultative process and technical methodology for determining the divisible pool for IGFTs to help increase the predictability of the financial resources. b. Conclude and implement the review of the FEG formula. c. Improve the design and implementation of conditional grants by: ➢ Reducing CGs and increasing FEGs to enable PLG planning and decision-making according to bottom-up needs ➢ Maintaining CGs only for federal responsibilities implemented through PLGs and for areas of PLG responsibilities where international commitments exist	MoF (lead agency) in coordination with NNRFC, NPC, line ministries and PLGs NNRFC (lead agency) MoF (lead agency) in coordination with NNRFC, NPC, line ministries and PLGs

Recommendations in NFFU 2023	Recent Developments Since March 2023	Recommendations in NFFU 2024	Responsible Institutions
		➢ Allocating CGs based on clear criteria and transparent procedures, including aligning allocations with PLGs' needs by improving vertical coordination ➢ Determining and publishing the amount of CGs earlier in the fiscal year to facilitate planning and more efficient execution	
Access to PFM-related data			
Establish a consolidated PFM performance database to enhance monitoring and evaluation of the overall performance of PLGs in relation to public financial management.	The NNRFC's performance indicators and the Ministry of Federal Affairs and General Administration's (MoFAGA's) Local Government Institutional Capacity Self-Assessment (LISA) data are publicly available. The LISA data also includes some PFM performance information at the local level. However, more needs to be done to create a consolidated PFM database.	**In addition to establishing a consolidated PFM performance database (NFFU 2023 recommendation), enable the PFM data of PLGs to be published by the federal government** by amending the federal Fiscal Procedures and Financial Accountability Act to authorize the federal government to disclose disaggregated PFM data collected by PLGs through their centrally managed information management systems.	MoF (lead agency) in coordination with FCGO, NNRFC, and National Statistics Office (NSO)
Procurement related reforms			
		Conduct a comprehensive MAPS[6] assessment of public procurement. This will help in making informed decisions and introducing necessary procurement reforms involving eGovernment procurement and institutional and regulatory frameworks in the context of federalism.	Public Procurement Monitoring Office
Medium term			
Clarification of concurrent responsibilities			
Amend the legal framework to clarify the concurrent and shared responsibilities among three tiers of government.	The OPMCM has been reviewing the Unbundling Report. Several sectoral acts and policies are under review, such as the Education Bill and the Water Supply, and Sanitation Regulation.	**Approve and implement the reviewed Unbundling Report and pass the sectoral acts to clarify the concurrent responsibilities** among the three tiers of government related to expenditure assignments and revenue from natural resources.	Office of Prime Minister and Council of Ministers (lead agency) in coordination with line ministries and Federal Parliament

6 Methodology for Assessing Procurement Systems

Recommendations in NFFU 2023	Recent Developments Since March 2023	Recommendations in NFFU 2024	Responsible Institutions
PFM and procurement capacity			
Strengthen the capacity of PLGs' PFM human resources to carry out the required functions.	Various capacity-building efforts are being undertaken by the government and development partners. While concerned federal agencies and training institutes are actively providing training to PLG staff to bolster PFM-related technical expertise, there is a need to harmonize capacity-building efforts among the key institutions such as PCGGs, Nepal Administrative Staff College (NASC), and PFM training academy.	**Strengthen internal audit and oversight mechanisms of provincial and local governments** by providing training on these areas, increasing human resources, and establishing institutional oversight mechanisms such as the Account Committees of PLGs. In addition, strengthen the procurement capacity of PLGs.	MoFAGA (coordinating agency) in coordination with PCGGs and the Office of the Auditor General (OAG)
		Strengthen the revenue divisions of Provincial Ministries of Finance and Economic Affairs (PMoFEAs) to effectively perform revenue management roles and increase provincial level own-source revenue.	PMoFEAs
Budget credibility			
Reinforce systems to improve budget credibility and service delivery of PLGs by strengthening: a. The alignment of periodic development plans, MTEFs, and annual budgets b. Cash management systems c. Provincial Appropriations Acts by setting limits on the amount for budget sub-heading 'Economic Miscellaneous'	No significant progress has been made on this recommendation.	**In addition to the NFFU 2023 recommendations on this topic, improve budget credibility by:** a. Reviewing the Provincial Appropriations Acts and amending virement rules to restrict extensive administrative reallocations b. Enhancing the capacity of local governments to adhere to the Intergovernmental Fiscal Arrangement Act 2017 and Local Government Operations Act 2017, particularly concerning the formulation of periodic development plans, MTEFs, and annual development programs c. Standardizing budget speeches by developing guidelines or templates for consistent content and format to allow comparability across all local governments	Provincial line ministries, PCGGs, and Provincial Planning Commissions
Developing local-level GDP data			
		Develop and implement a system for generating local-level GDP data.	NSO

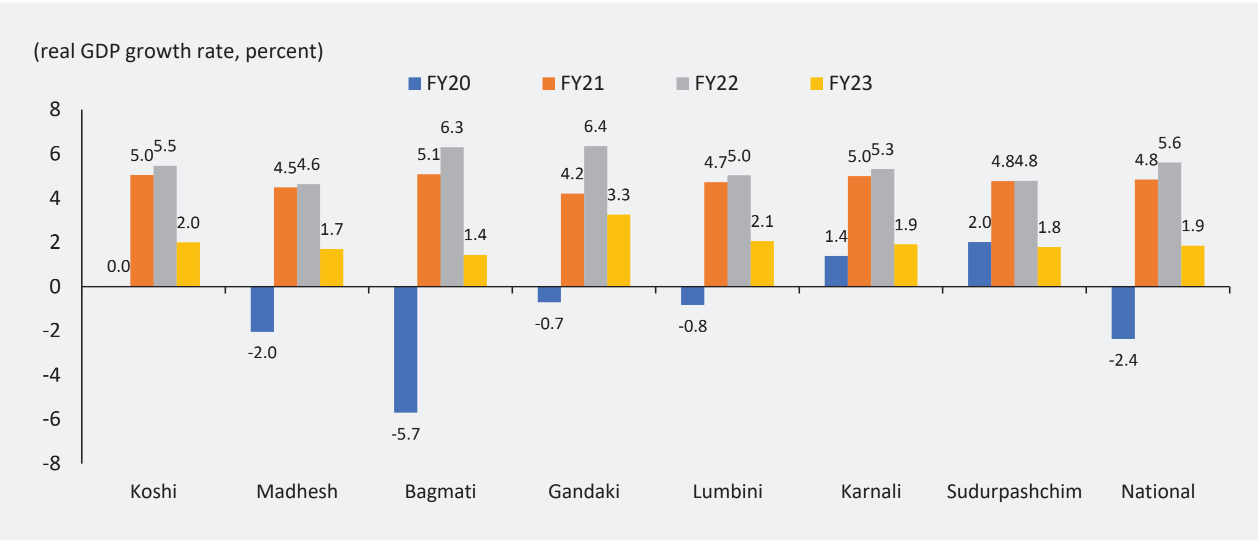
CHAPTER 1

Macro-fiscal Update on Provincial and Local Governments

1.1 Economic growth slowed in all provinces, with the largest provincial economy, Bagmati, experiencing the lowest growth rate, mainly due to the contraction of wholesale and retail trade

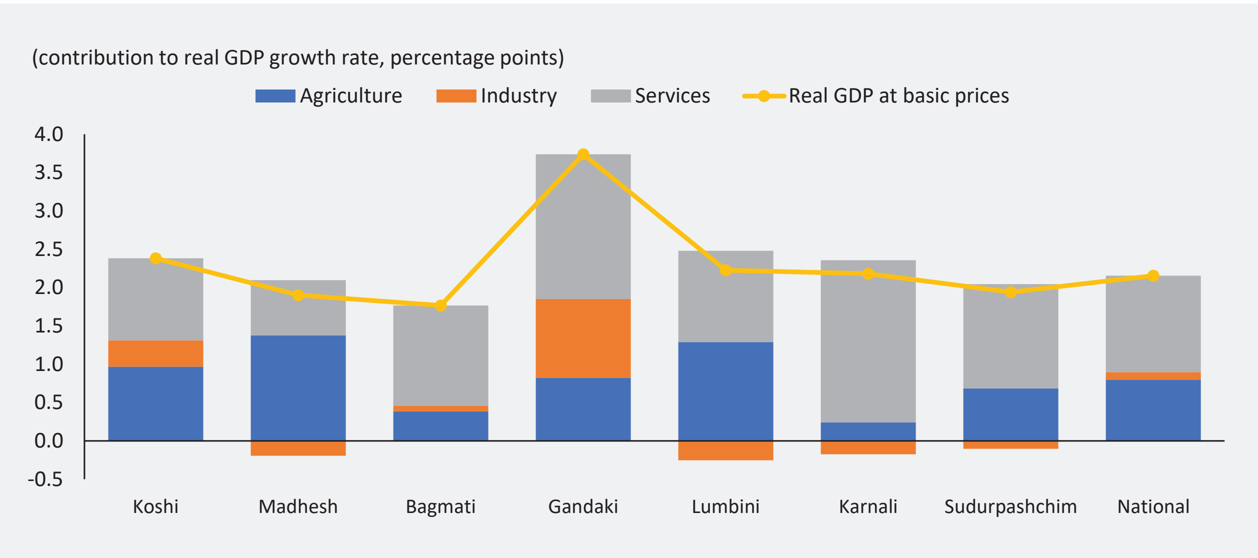
In FY23, Nepal's provinces experienced their slowest economic growth since FY20 (Figure 1.1). This slowdown was in both the services and industrial sectors (Figure 1.2). The services sector's performance was particularly weak due to a contraction in the wholesale and trade sub-sector (Figure 1.3). This decline can be attributed to import restrictions imposed by the federal government in the first half of FY23[7] to manage external pressures. These restrictions resulted in a significant decline of over 2 percent in the wholesale and trade sub-sector across all provinces. The manufacturing and construction sub-sectors within the industrial sector also contracted[8] (Figure 1.4). The provinces of Madhesh and Karnali were most affected by the decline in manufacturing.

Figure 1.1. All Nepal's provincial economies grew at a slower pace in FY23 …



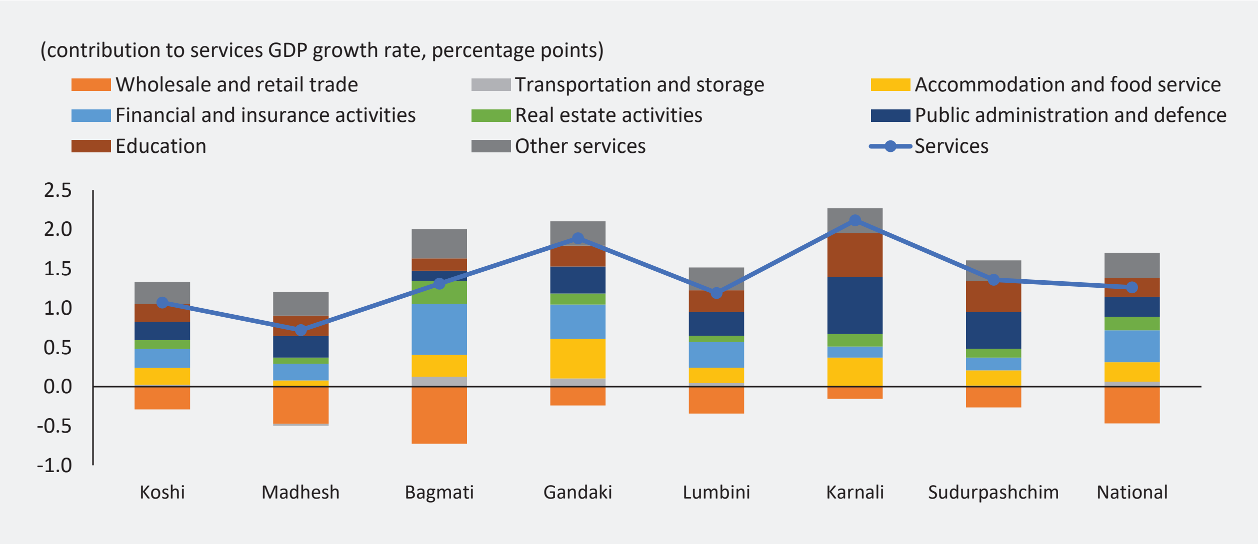
Sources: National Statistics Office and World Bank staff calculations

Figure 1.2. … driven primarily by the services sector …



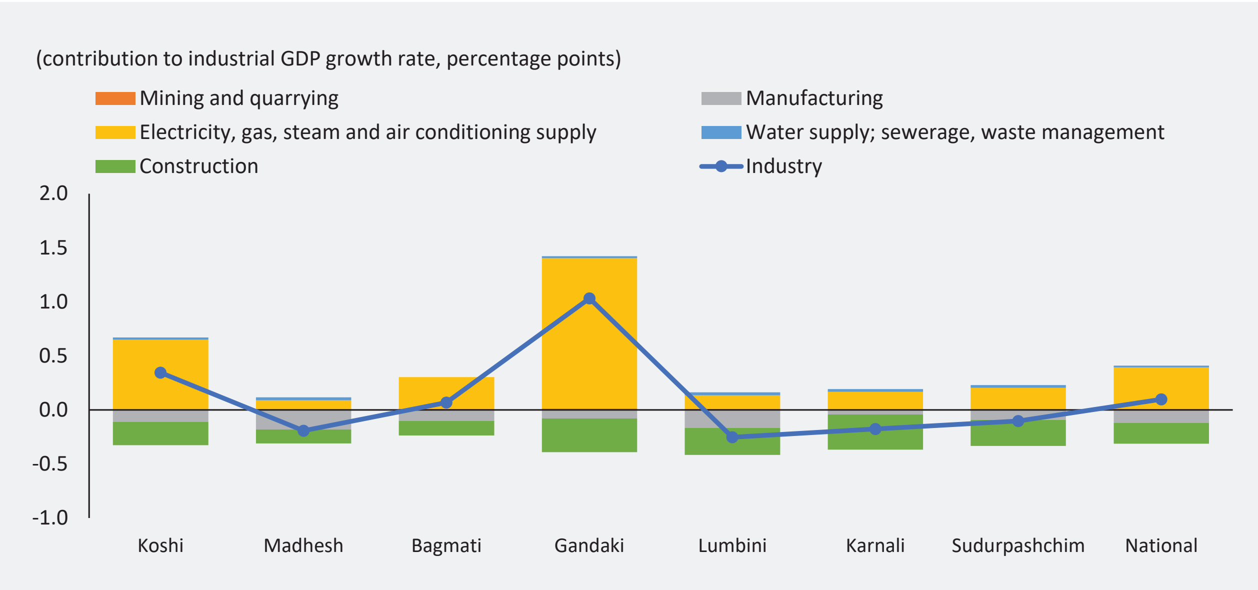
Sources: National Statistics Office and World Bank staff calculations

Figure 1.3. … particularly wholesale and retail trade



Sources: National Statistics Office and World Bank staff calculations

Figure 1.4. Manufacturing sub-sector in all seven provinces contracted in FY23



Sources: National Statistics Office and World Bank staff calculations

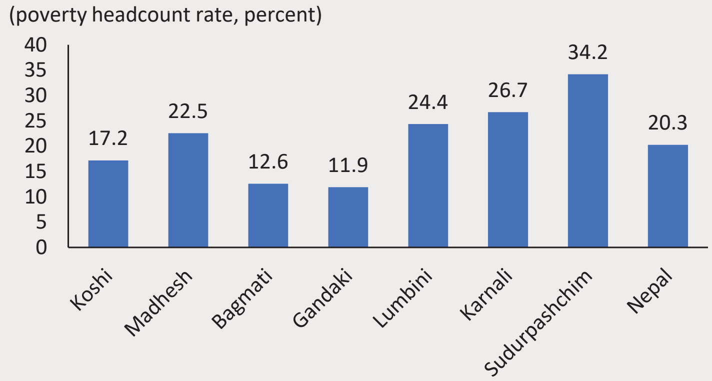
The agriculture sector remained resilient in FY23, with heterogenous performance across provinces. Karnali registered the lowest contribution of agriculture to economic growth at 0.2 percentage points, while Madhesh led with a contribution of 1.4 percentage points in FY23. This variation reflects, in part, the distribution of agricultural land across the provinces. According to the 2021 agricultural census, Koshi, Madhesh, and Lumbini hold more than 19 percent of national agricultural land each, and unsurprisingly, the sector contributes at least 1 percentage point to real gross domestic product (GDP) growth in these provinces.

7 Import restrictions were first imposed on December 29, 2021, and were continued until January 19, 2023. Import restriction measures include bans on specific goods imports, requirements to open a Letter of Credit for importation, and the further requirement of cash deposits (cash margins) backing such Letters of Credit.

8 The decline was partly due to lower production of key construction materials (cement, basic iron, and steel) and vegetable oils in the first half of FY23. Higher frequency indicators suggest that the decline continued in the second half of FY23. Lower demand resulting from the elevated price of manufactured goods and construction materials further weighed on industrial output, which increased by a meager 0.6 percent (see World Bank 2023b).

Box 1.1. Poverty rates across provinces

The Nepal Living Standard Survey 2022/23 shows significant differences in poverty rates across the country's seven provinces. Sudurpashchim has the highest poverty rate at 34.2 percent, followed by Karnali at 26.7 percent. Conversely, Bagmati and Gandaki boast the lowest rates, sitting at 12.6 percent and 11.9 percent, respectively. While Madhesh and Lumbini have poverty rates (22.5 percent and 24.4 percent) above the national average (20.3 percent), they also hold larger portions of the total population. This translates to these two provinces having the highest number of people living in poverty (25.1 percent and 22.8 percent, respectively).

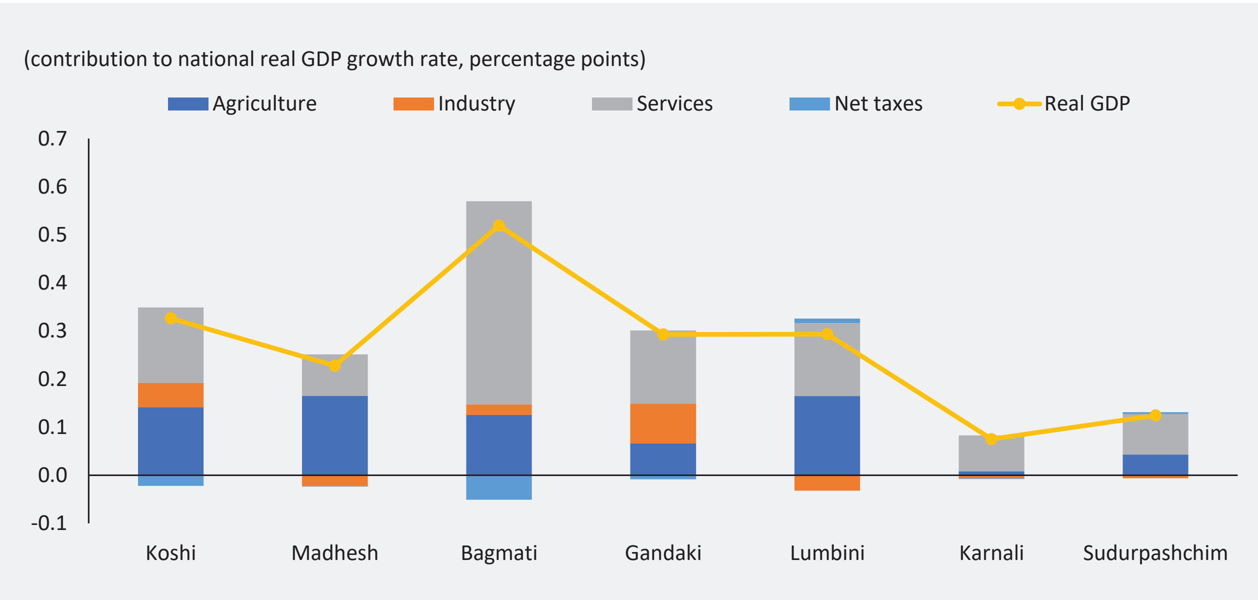


Note: Poverty rate computed using 2023 National Poverty Line
Source: National Statistics Office

Bagmati, the largest provincial economy, saw a significant decrease in growth rate, falling from 6.3 percent in FY22 to just 1.4 percent in FY23 (Figure 1.1). This slowdown was mirrored in all other provinces, although the growth rate in other provinces was higher than in Bagmati. Gandaki led with a growth rate of 3.3 percent in FY23.

The slowdown in Bagmati contributed to a slowing in national growth in FY23, as this province is the major driver of Nepal's national growth (Figure 1.5). National economic growth shrank to 1.9 percent in FY23 from 5.6 percent in FY22, driven by a decline in the services and industrial sector growth. Bagmati accounts for 24.9 percent of the services sector in Nepal, and the services sector in Bagmati alone contributed 0.42 percentage points to the overall national growth of 1.9 percent in FY23. Following Bagmati were Koshi, Madhesh, and Lumbini, each contributing a 6–7 percent share of the national services sector.

Figure 1.5. Bagmati contributed more than one-third of national economic growth in FY23



Sources: National Statistics Office and World Bank staff calculations

1.2 Most local governments also experienced a decline in economic activity in FY23

Local governments experienced a decline in economic activity in FY23, as indicated by nighttime lights data. Growth analysis at the local level relies on nighttime lights data, as local government GDP data are not available. According to the nighttime lights data, all but 10 percent of Nepal's 753 local governments experienced a decline in economic activity in FY23. However, it is important to note that nighttime lights data might underestimate activity in agriculture-dependent regions or services sectors with lower light emissions. As such, local governments, in collaboration with the National Statistical Office, could explore strategies to develop and implement a system for generating reliable local-level GDP data.

Box 1.2. Background on nighttime lights data

Nighttime lights data, as detected by satellites, are increasingly used as a proxy to indicate economic activity (Martinez 2022; Gibson and Boe-Gibson 2021; Gibson and Boe-Gibson 2020). There are four potential advantages of using this data compared to the traditional GDP measure:

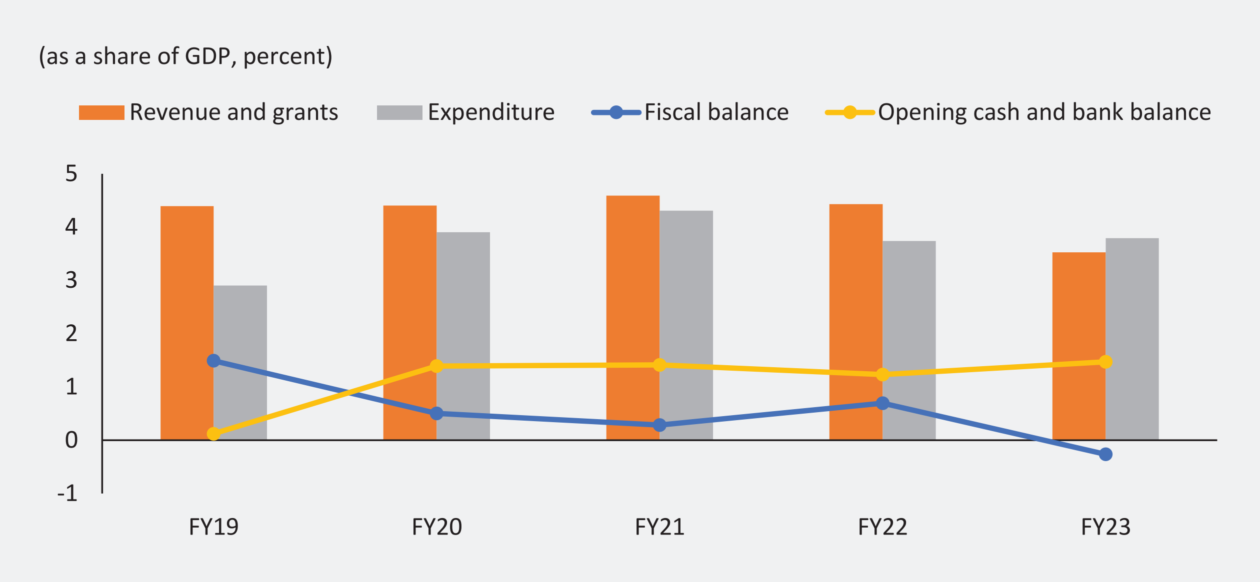
- They are available in real time and at a higher frequency (daily).
- They are less prone to manipulation.
- They are freely available and comparable between countries irrespective of the quality of statistical systems.
- They are available at the local level and are useful for developing countries like Nepal where local level GDP data is not available.

The nighttime lights data used in this study is Visible Infrared Imaging Radiometer Suite Day/Night Band (VIIRS DNB) (Román *et al* 2020).

1.3 Fiscal balances of provincial and local governments fell into deficit in FY23 for the first time since the implementation of fiscal federalism

Provincial governments recorded a consolidated fiscal balance deficit of 0.3 percent of GDP in FY23, the first time since the implementation of fiscal federalism began in FY19 (Figure 1.6). This was driven by lower revenue and grants, which decreased from 4.4 percent of GDP in FY22 to a record low of 3.5 percent of GDP in FY23. On the other hand, expenditure increased only marginally by 0.1 percentage points to 3.8 percent of GDP in FY23. However, there is considerable variation in fiscal balances among provinces, ranging from a deficit of 0.8 percent of GDP in Sudurpashchim to a surplus of 0.2 percent of GDP in Madhesh (Annex 3, Figures A2–A8). Madhesh is the only province that has consistently had a fiscal surplus over the last five years.

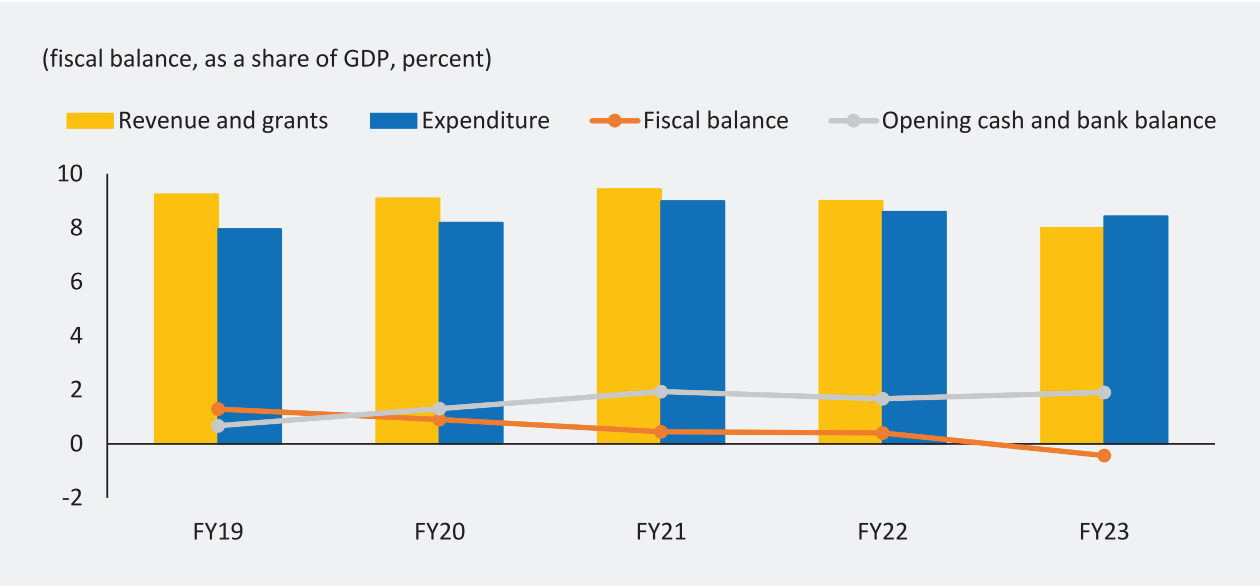
Figure 1.6. Fiscal balance of all provinces moved into deficit in FY23, the first time since FY19



Sources: Provincial Budget Speeches,[9] National Statistics Office, and World Bank staff calculations

Local governments also registered a deficit of 0.4 percent of GDP in FY23, the first time since FY19 (Figure 1.7). This shift stemmed from a significant decrease in revenue and grants, which fell by 1 percentage point of GDP compared to FY22. In contrast, expenditure decreased slightly by only 0.2 percentage points of GDP over the same period. Among the different municipality types, rural and urban municipalities experienced relatively larger fiscal deficit (Annex 3, Figures A8–A11).

Figure 1.7. Fiscal balance of all local governments also fell into deficit in FY23, the first time since FY19



Sources: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

9 In Nepal, as indicated in the Constitution (2015), Article 119, a 'budget speech' is where the Minister for Finance of the Government of Nepal presents to both houses of the Federal Parliament an estimate of revenue, money required to meet the charges on the Federal Consolidated Fund, money required to meet the expenditure to be provided for in the Federal Appropriation Act, a statement of expenses allocated to every ministry in the previous fiscal year, and particulars of whether or not the objectives of the expense have been achieved. It is required they present this at the end May of each fiscal year. Provincial governments present their budget speeches in the provincial parliament, while local governments present their budget speeches in the local assembly.

Despite provisions allowing for domestic borrowing to finance fiscal deficits within prescribed limits, none of the provinces exercised this option in FY23. The Intergovernmental Fiscal Arrangement Act allows sub-national governments to present deficit budgets and take loans domestically, within the specified limits set by the National Natural Resource and Fiscal Commission. For provincial governments, the FY23 borrowing limit was capped at 12 percent of revenue shared by the federal government and their own-source revenue. Similarly, local governments have the same ceiling, calculated as a share of revenue shared by the federal and provincial governments along with their own-source revenue. In accordance with legal provisions, Madhesh, Gandaki, and Lumbini had budgeted domestic borrowing to meet their fiscal deficits in FY23. But no province actually raised domestic loans to finance their fiscal deficit in FY23.

Instead, provincial and local governments relied on opening cash and bank balances, reflecting past underspending, to finance the fiscal deficit in FY23 (Figures 1.6 and 1.7). These balances mainly consisted of unspent unconditional fiscal equalization grants (FEGs) and revenue sharing from previous fiscal years. Between FY22 and FY23, the aggregate opening cash and bank balances of provincial and local governments increased by 0.2 percentage points to 1.5 and 1.9 percent of GDP, respectively.

1.4 Consolidated revenue and grants of provincial and local governments declined to a record low in FY23 due to a decrease in intergovernmental grants and revenue sharing

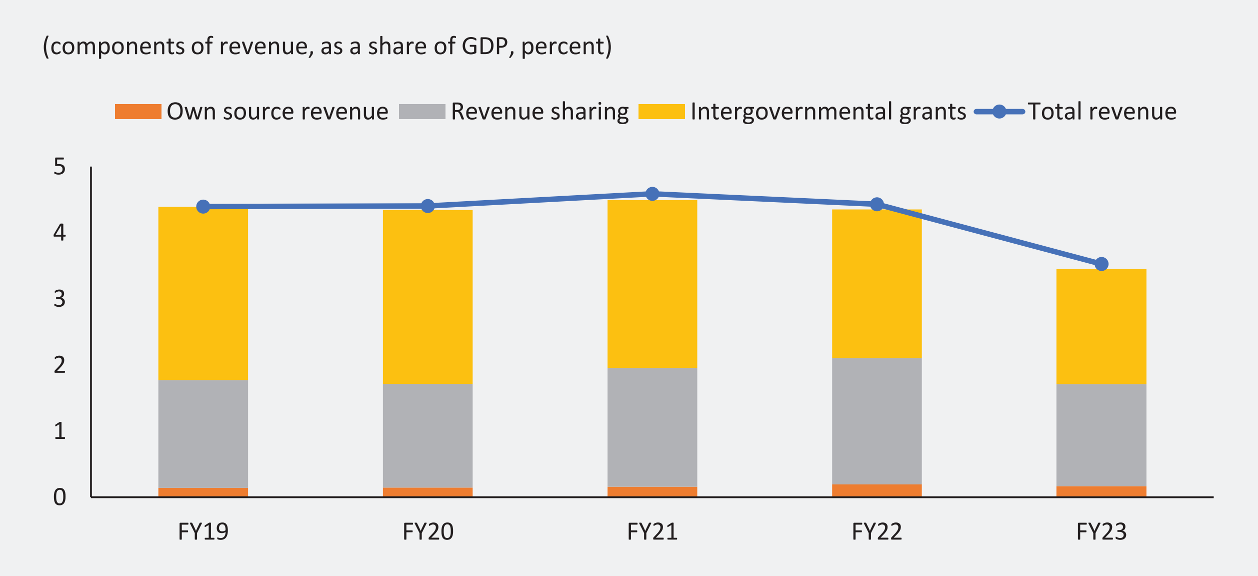
Provincial governments' revenue and grants plummeted to 3.5 percent of GDP in FY23, a decline of 0.9 percentage points compared to FY22 (Figure 1.8). This drop was primarily driven by a decrease in intergovernmental revenue, which makes up over 90 percent of provincial revenue. The decline in intergovernmental revenue reflected a shortfall in federal tax collection due to slowing in growth and import restrictions.[10] This revenue includes grants from the federal government and revenue sharing arrangements between various levels of government.[11] Within the category of intergovernmental revenue, federal government grants fell by 0.5 percentage points, while revenue sharing accounted for the remaining decrease. The decline in intergovernmental grants was widespread, with equalization grants (-0.18 percentage points) and conditional grants (-0.26 percentage points) experiencing the most significant drops. Conversely, provincial governments' own sources of revenue – consisting mainly of non-tax sources like driving license fees (54 percent), business registration fees (8 percent), transport sector income[12] (13 percent), and service charges (22 percent) – remained relatively stable.

10 The import restrictions imposed in FY22, which were eventually lifted in January 2023, along with slower economic growth, led to a decline in revenue due to Nepal's high reliance on trade-related tax revenue (see World Bank 2023a for details). As a result of decline, the federal government cut 50 percent of the third installment of the fiscal equalization grants to be provided to the provincial and local governments in FY23.

11 In FY23, intergovernmental grants constituted 49.3 percent of overall intergovernmental revenue, while revenue sharing from the federal government comprised 31.8 percent, with the remainder including revenue sharing between provinces and local governments. See World Bank (2023b) for information on fiscal transfers and revenue distribution mechanisms across the three levels of government.

12 For example, parking fee.

Figure 1.8. Provincial government revenue and grants plummeted in FY23

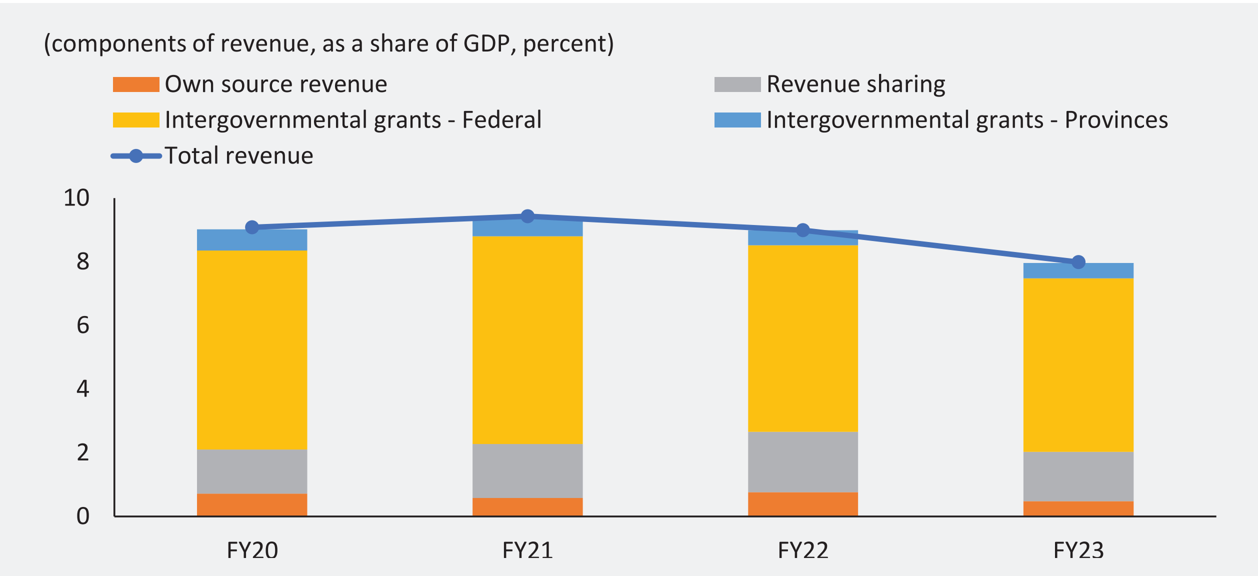


Sources: Provincial Budget Speeches, National Statistics Office, and World Bank staff calculations

The decline in revenue and grants impacted all provinces, but the severity varied (Annex 3, Figures A1–7A). Karnali witnessed the sharpest drop, while Madhesh and Bagmati experienced the smallest decreases in revenue and grants. This largely reflects the differences in economic size (GDP) between the provinces. For example, in FY23, Bagmati's nominal GDP was over five times larger than that of Karnali, yet its intergovernmental revenue in nominal terms was only 16 percent higher than Karnali's.

Local government revenue and grants fell by 1 percentage point of GDP, reaching 8 percent of GDP in FY23 (Figure 1.9). This decline was driven by lower intergovernmental revenue, the largest source of revenue for local governments. Intergovernmental revenue contributed 0.8 percentage points to the overall decline in FY23, while local government own-source revenue accounted for the remaining. However, within intergovernmental revenue, grants from provincial governments to local governments remained unchanged. Property taxes and local government service fees remained the main sources of own-source revenue for local governments in FY23, constituting over 70 percent of this category.

Figure 1.9. Local government revenue and grants also plummeted in FY23

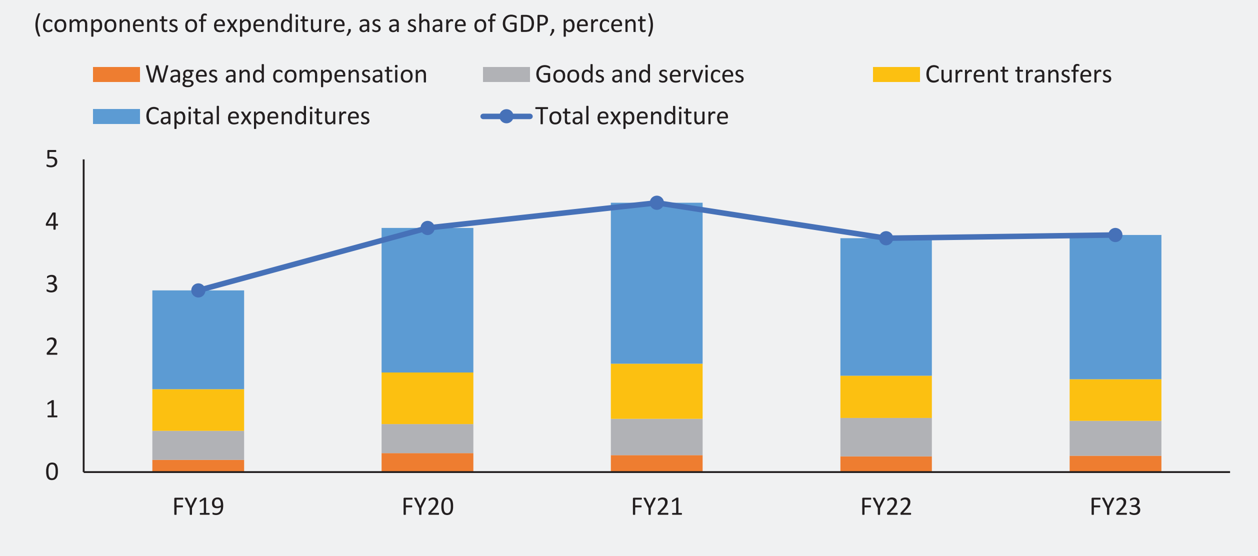


Sources: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

The decline in revenue and grant transfers was broad-based, across all local government types, but the severity of impact was uneven (Annex 3b, Figures A8–A11). Urban and rural municipalities experienced the sharpest drop in revenue and grant transfers, leading to a decline in total of local government revenue and grants. For example, revenue and grants for urban municipalities fell by 0.5 percentage points of GDP in FY23, compared to FY22, which is significantly higher than the 0.05 percentage point decline for metropolitan cities. This is partly due to metropolitan cities relying less on fiscal transfers and revenue sharing, as they generate a relatively large share of their own revenue. In FY23, their own-source revenue accounted for 40.6 percent of overall revenue. Metropolitan cities experienced a decline in revenue and grants, primarily due to reduced revenue sharing, while other municipality types saw a decline due to lower own-source revenue, intergovernmental grants, and revenue sharing.

1.5 Provincial and local government spending edged up marginally in FY23

Figure 1.10. Provincial government spending increased marginally in FY23



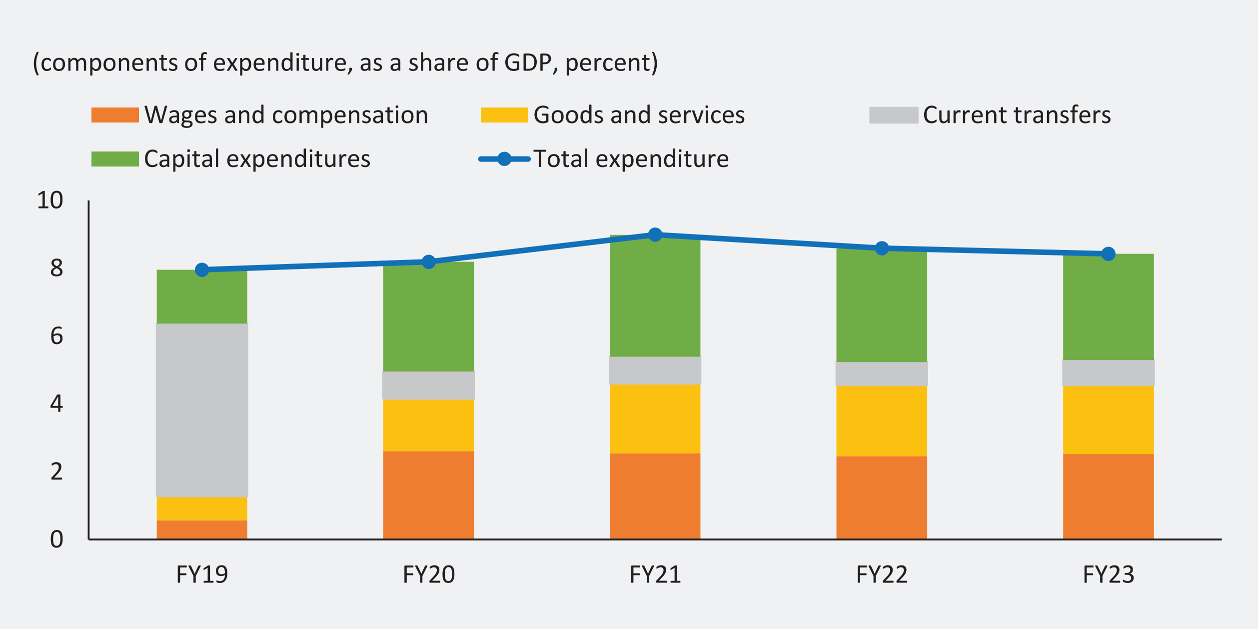
Note: Current transfers include government grants, subsidies, social benefits (like pensions or unemployment benefits), and transfers between different levels of government.

Source: Provincial Budget Speeches, National Statistics Office, and World Bank staff calculations

Provincial government spending went up slightly by 0.1 percentage point to 3.8 percent of GDP in FY23 (Figure 1.10). This increase was driven by a rise in capital spending, particularly for roads, bridges, and other public construction projects. However, a decrease in recurrent spending (spending on salaries, goods and services, and fiscal transfers to local governments, typically around 40 percent of aggregate spending) partially offset the rise in capital expenditure.

Nevertheless, there were significant differences in spending variations across provinces (Annex 3, Figures A1–A7). For instance, Koshi, Karnali, and Lumbini witnessed a decline in overall spending, with recurrent spending driving the decrease in Koshi, capital spending in Karnali, and both in Lumbini. Conversely, other provinces experienced an increase in overall spending, primarily led by capital spending, except for Gandaki, where recurrent spending fueled the increase.

Figure 1.11. Local government spending decreased marginally in FY23



Note: Current transfers include government grants, subsidies, social benefits (like pensions or unemployment benefits), and transfers between different levels of government.

Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

In FY23, local government spending experienced a marginal decrease, reaching 8.4 percent of GDP, representing a 0.2 percentage point decline compared to FY22 (Figure 1.11). This decline was due to a decrease in capital spending, notably in public construction activities, which accounted for over 25 percent of total expenditure. However, the decline was tempered by an uptick in recurrent spending, which accounted for an average of 63 percent of total local government's expenditure.

Across municipality types, rural and urban municipalities experienced a significant decrease in total spending, reflecting a shortfall in their revenue and grants (Annex 3b, Figures A8–A11). Together, rural and urban municipalities accounted for a 0.2 percentage point decline in overall spending as a share of GDP, primarily attributed to reduced capital spending, which tends to be rationalized in the short term due to revenue shortfalls. In contrast, metropolitan cities experienced an increase in spending, driven by both recurrent and capital expenditure, partially offsetting the decrease in spending observed in other municipality types.

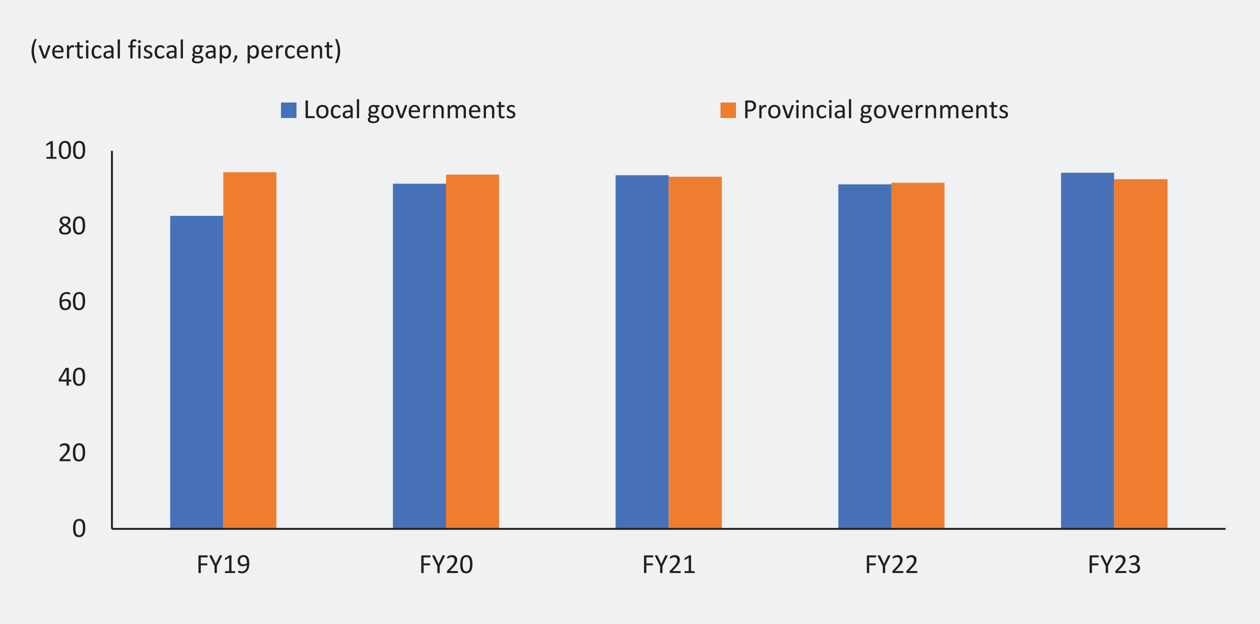
Mirroring the federal government, sub-national governments continued the practice of bunching spending, particularly in relation to capital spending. In FY23, a significant portion (34.4 percent) of the total capital spending by five provinces[13] was concentrated in the last month of the fiscal year. This trend is also evident at the local government level. In FY22, 531 out of 753 local governments spent 35.6 percent of their capital expenditure in the final month, reflecting a slight improvement from FY21, when 547 out of 753 local governments spent 44.9 percent of their capital expenditure in the last month.

13 Koshi, Gandaki, Lumbini, Karnali, and Sudurpashchim

1.6 A large gap remains between sub-national governments' own expenditure and own revenue

Only 8 percent of own spending by provinces was financed by own revenue, and this vertical fiscal gap (VFG) increased marginally in FY23. Defined as the gap between own spending (total spending minus transfers paid) and own revenue (total revenue minus transfers received), VFG stayed at 92.5 percent, close to the historic average of 93 percent (Figure 1.12). However, VFG varies across provinces, ranging from 85 percent in Bagmati to 99 percent in Sudurpashchim, reflecting differences in own-source revenue (Annex 3, Figures A1–A7).

Figure 1.12. Vertical fiscal gap remained higher for local governments than for provincial governments in FY23



Source: Provincial Budget Speeches, Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

The VFG for local governments widened by 3 percentage points to 94 percent in FY23, surpassing that of provincial governments. The higher VFG suggests increased dependence on transfers from higher levels of government, rather than generating own-source revenue. However, there is considerable dispersion among municipality types, ranging from 60 percent for metropolitan cities to 99 percent for rural municipalities, reflecting primarily differences in own-source revenue (Annex 3b, Figures A8–A11). Additionally, apart from sub-metropolitan cities, all types of municipalities experienced an increase in the VFG in FY23.

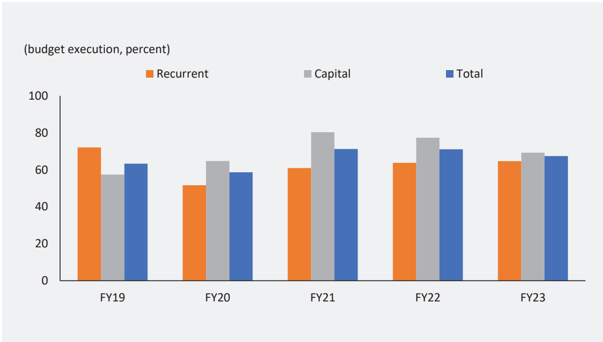
1.7 Budget credibility is undermined by lack of alignment between periodic development plans, medium-term expenditure frameworks (MTEF), and budgets, as well as significant allocation to the category of 'Economic Miscellaneous' spending

Provincial governments underspent their budgets by 34 percent in FY23, up from 28.9 percent in FY22. (Figure 1.13). This was driven primarily by underspending on program expenses (recurrent component), public construction (capital component), and contingencies (recurrent and capital components). Provinces such as Madhesh witnessed relatively higher underspending of 43 percent in FY23 compared to other provinces, where underspending was between 23–33 percent, driven by recurrent underspending. Capital underspending primarily led to the overall underspending in five of the seven provinces (Bagmati, Gandaki, Lumbini, Karnali, and Sudurpashchim, Annex 3a, Figures A1–A7).

Local governments also underspent their budgets significantly by 24.4 percent in FY23, but this represented a marginal improvement from 25 percent in FY22 (Figure 1.14). This was attributed to underspending on program expenses (recurrent), employee salaries (recurrent), and public construction (capital). Across municipality types, the underspending was the lowest for metropolitan cities, averaging 47.4 percent over FY20 to FY23, compared to 23.1 percent for rural municipalities (Annex 3b, Figures A8–A11).

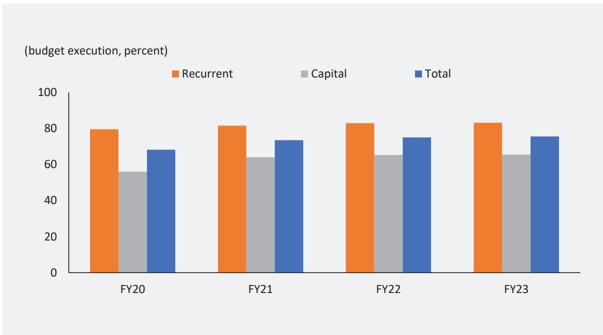
Lack of alignment between periodic development plans, MTEFs, and annual budgets are key drivers of underspending relative to the budget (Figures 1.15a and 1.15b). Data from two provinces (Koshi and Lumbini) for which MTEFs, annual budgets, and five-year development plans were available for FY22 to FY23 suggest that: (a) spending allocations are generally lower in MTEFs prepared for the current fiscal year compared to those covering the same year, but prepared in earlier years (e.g., MTEF prepared in FY23 and MTEF prepared in FY22 and FY21 for FY23); (b) comparing MTEFs and periodic plans, allocations are typically larger in periodic plans; (c) allocations are typically smaller for annual budgets compared to periodic plan; and (d) the differences across MTEFs and between MTEFs and periodic plans are more pronounced for capital spending relative to recurrent spending. As such, alignment between periodic development plans, MTEFs, and annual budgets needs to be strengthened to improve budget credibility.

Figure 1.13. Provincial government underspending increased in FY23



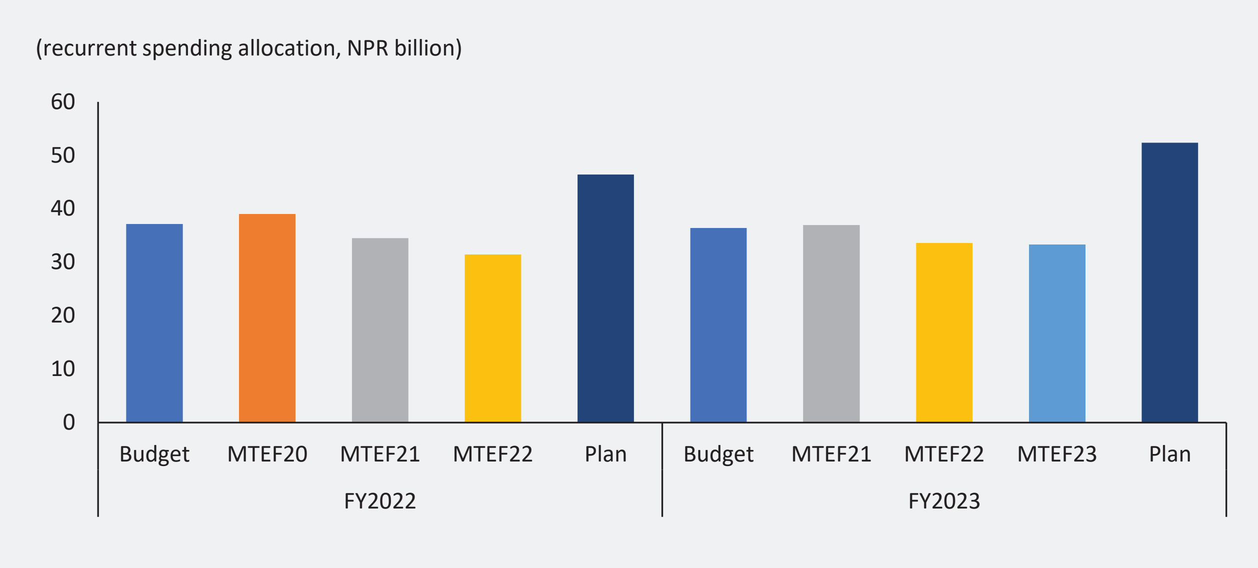
Source: Provincial Budget Speeches, National Statistics Office, and World Bank staff calculations

Figure 1.14. Local government underspending decreased marginally in FY23



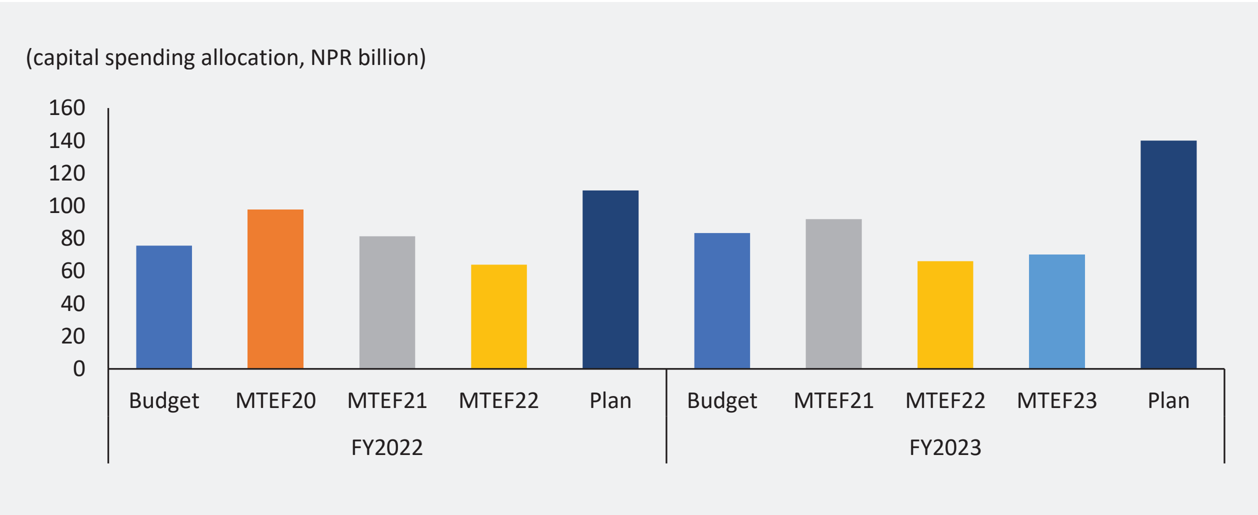
Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure 1.15a. Recurrent spending allocation under budgets, MTEFs, and periodic plans



Source: Provincial Budget Speeches, METF, Periodic Plans, National Statistics Office, and World Bank staff calculations

Figure 1.15b. Capital spending allocation under budgets, MTEFs, and periodic plans



Source: Provincial Budget Speeches, METF, Periodic Plans, National Statistics Office, and World Bank staff calculations

Despite some progress, the allocation of a significant portion of the budget to the category of 'Economic Miscellaneous,' along with the subsequent transfer of funds to other budget items, continues to undermine budget credibility. For example, in FY23, provincial governments earmarked a significant portion, 7.9 percent, of total budgeted expenditure for 'Economic Miscellaneous,' down from 8.8 percent in FY22.[14] However, this allocation varies among provinces, ranging from 3.3 percent in Bagmati to 11.8 percent in Madhesh. Funds allocated to this category are often reallocated to other sub-headings, either midway through the fiscal year or towards its end, including new budget items, thereby bypassing established budgetary controls. The Provincial Appropriation Act set limits on transfers from other budget items, but not for this specific heading. Consequently, underspending on this budget sub-heading accounted for more than one-third of all provincial underspending. Therefore, the Provincial Appropriations Act could be reviewed and the virement rules amended to restrict extensive administrative reallocations and improve budget credibility.

14 This practice is also prevalent at the local level. In FY22, 273 local governments earmarked NPR 6.8 billion as unallocated budget. Additionally, 156 local governments conducted a virement of NPR 8.4 billion in excess of the limit specified in the Local Government Operations Act.


अध्यक्ष
उपाध्यक्ष
राजन प्रसाद घिमिरे
वडा नं. ४ नल्लु
वडा नं. ५ भारदेउ
कोन्ज्योसोम गाउँपालिका
गाउँ कार्यपालिकाको कार्यालय
चौघरे, ललितपुर
बागमती प्रदेश, नेपाल
वि.सं. २०७४ साल देखि निर्वाचित उपाध्यक्ष ज्यूहरुको नामावली
उपाध्यक्ष ज्यूहरुको नाम, थर
कार्यकाल
देखि
सम्म
१. श्री मिङ्मा लामा २०७४/२/७ २०७९/२/६
२. श्री राजन प्रसाद घिमिरे २०७९/२/९

CHAPTER 2

Enabling Legal, Policy, and Institutional Frameworks, with Emphasis on Provincial Governments

This chapter presents recent updates on the progress of the enabling environment for fiscal federalism and assesses both its functionality and implementation status. Considering their important role in fiscal federalism and the recent growth of public debate on the role of the provincial governments, this edition places special emphasis on the provincial level of government.

Since the publication of the first edition of the Nepal Fiscal Federalism Update (NFFU) in 2023,[15] the enabling environment for fiscal federalism has moderately evolved. For example, at the institutional and strategic levels, in November 2023, the Fiscal Federalism Coordination Division (FFCD) at the Ministry of Finance (MoF) was designated as the unit responsible for coordinating public financial management (PFM) as well as fiscal federalism strategies. Also, as an overarching national-level strategy, the National Planning Commission (NPC) has been preparing the 16th National Periodic Plan, which is expected to include provisions on the different pillars of fiscal federalism in Nepal (see Table 2.1). In addition, most of the provinces are working on finalizing their second periodic plan. Furthermore, a review of the Unbundling Report[16] is currently being undertaken to further clarify the division of revenue and expenditure assignments among the three tiers of government.

The regulatory framework for fiscal federalism has also seen progress during the last year. As noted in Table 2.1, the Local Government Operations Act (2017) and the Inter-governmental Fiscal Arrangement Act (2017) are being reviewed under the leadership of the Ministry of Federal Affairs and General Administration (MoFAGA) and MoF, respectively. Following the adoption of the Public Debt Management Act (PDMA) in 2022, the Act's implementing regulation, the Public Debt Management Regulation, was published in the Nepal Gazette on March 14, 2024. Also, as an additional point of progress on the pillar of borrowing, an Act geared to reforming the Town Development Fund (TDF) is under preparation. Finally, the preparation of a regulatory framework on natural resource management is underway, including the submission of the Construction Material Management and Regulation Bill 2023 to the Parliament.

Table 2.1. Snapshot of the five key pillars[17] of fiscal federalism in Nepal

Pillars	Key Regulatory Framework	Relevant Government Agencies and Bodies	Outcomes
Pillar 1. Revenue Assignment and Administration	Constitution of Nepal, Article 60 and Schedules 5–9 Local Government Operations Act 2017 (review underway at MoFAGA)	MoF, Inland Revenue Department, Department of Customs, MoFAGA, and provincial and local governments (PLGs)	These five pillars determine the sources (which and what amount) available to PLGs to effectively fulfill their assigned expenditure functions.
Pillar 2. Expenditure Assignment and Administration	Constitution of Nepal, Schedules 5–9 Federal Procurement Act 2007	OPMCM, PLGs, MoF, Public Procurement Monitoring Office (PPMO), MoFAGA, and line ministries	
Pillar 3. Inter-Governmental Fiscal Transfers	Constitution of Nepal, Article 60 NNRFC Act 2017 Inter-governmental Fiscal Arrangement Act 2017 (review underway at MoF)	National Natural Resources and Fiscal Commission (NNRFC), MoF, NPC, concerned line ministries, and PLGs	
Pillar 4. Borrowing and Capital Finance	Constitution of Nepal, Article 59 Public Debt Management Act (PDMA) 2022, Regulation passed in 2024 Town Development Fund (TDF) Reform Act under preparation	Public Debt Management Office, NNRFC, MoF, Nepal Rastra Bank, TDF and PLGs	
Pillar 5. Fiscal Revenue from Natural Resources	Constitution of Nepal, Articles 51, 59, 60, 250, 251 and Schedules 5–9 Construction Material Management and Regulation Bill 2023 (registered at the Parliament in November 2023)	NNRFC, MoF and concerned line ministries such as MoFE	

Source: World Bank analysis, based on Government of Nepal websites and relevant regulatory framework

15 Data collection was done by March 2023.

16 An Unbundling Report was prepared by the Office of the Prime Minister and Council of Ministers in 2017 to clarify Schedules 5–9 of the Constitution of Nepal 2015. The second review of the Unbundling Report is ongoing.

17 While international literature refers to fiscal federalism consisting of four key pillars (as articulated by Pillars 1–4 in Table 2.1), in Nepal the NNRFC conceptualizes fiscal federalism as five pillars (see Pillar 5 in Table 2.1).

2.1 Legal and institutional setup for fiscal federalism in the provinces has evolved

As the middle tier of government, the provinces are a critical part of fiscal federalism management in Nepal. This is not only for reasons of coordination with federal and local governments, but also because of the mandate bestowed upon them by the Constitution. Even though there is still a long way to go in strengthening this intermediate level of government – especially considering that it is brand new in the governance structure of the country – there has been progress in the setting up of some of the key provincial institutions for fiscal federalism and PFM for last few years.[18] Table 2.2 shows a snapshot of the key institutions responsible for fiscal federalism and PFM at the provincial level and their status.

Table 2.2. Key provincial-level institutions for the implementation of fiscal federalism and PFM

Institution	Brief Description of Responsibilities	Regulatory Framework
Institutions responsible for fiscal federalism and PFM at the provincial level		
Provincial Planning Commission (PPC)	Responsible for the provincial periodic development plan and MTEF of provincial governments	PPC (Formation & Operation Order – passed by all provinces)
Provincial Ministry of Finance and Economic Affairs (PMoFEA)	Provincial equivalent of the MoF; provides vertical and horizontal coordination on finance and economic affairs	Provincial Government (Allocation of Business) Regulation (passed by all provinces)
Provincial Treasury Controller Office (PTCO)	Oversees PFM functions, including budget implementation, treasury administration, internal audit, cash and budget management, expenditure and revenue accounting, and the preparation of consolidated financial statements	Federal Financial Procedures and Fiscal Accountability Act
Institutions related to human resource capacity-building at the provincial level		
Provincial Center for Good Governance (PCGG)	Provides capacity-building support for provincial and local government staff within each province by organizing training programs and technical support	PCGGs established in all provinces (four provinces[19] have passed provincial acts regulating PCGGs functions)
Provincial Public Service Commission (PPSC)	Mainly responsible for provincial and local-level human resources management and recruitment, takes care of civil servant position postings as well as exams, in coordination with the Office of the Chief Minister and Council of the Ministers (OCMCM), local governments and line ministries	Provincial Civil Service Acts (passed by all provinces)

Source: World Bank analysis based on the relevant provincial acts and regulations

There has been no progress made in preparing Provincial Fiscal Procedures and Financial Accountability Acts, in line with the federal overarching act, since the last NFFU report. Two[20] out of seven provinces have updated their Provincial Fiscal Procedures and Financial Accountability Act to align with the corresponding federal level framework passed in 2019. The other five provinces should also update and prepare their Provincial Fiscal Procedures and Financial Accountability Acts in line with the corresponding federal Act.

18 While the main intention of this report is to update the progress of the subject area from the March 2023, since the last NFFU did not adequately cover the provincial development of the fiscal federalism, it is presented here.

19 Gandaki (2019), Lumbini (2020), Koshi (2022), Karnali (2022)

20 Koshi and Gandaki both prepared them in 2022.

The revenue divisions of the Provincial Ministries of Finance and Economic Affairs (PMoFEAs) need to be strengthened to effectively perform revenue management roles. According to interviews with staff at PMoFEAs in Lumbini and Gandaki provinces),[21] there is a need to enhance the capacity of the division responsible for revenue policy and administration. Currently, these divisions are not properly staffed and empowered to coordinate with the agencies managing tax collection. For example, vehicle taxes,[22] which constitute 6.2 percent of total provincial revenue in FY23, are collected by the Vehicle Tax Office under the Provincial Ministry of Physical Infrastructure and Transport. The same situation applies to the house and land registration fees[23] (5.6 percent of total provincial revenue in FY23) and driving license and registration fees[24] (2.4 percent of total provincial revenue in FY23). The provincial governments could benefit from enhancing the capacity of their revenue divisions in the PMoFEAs to effectively coordinate, monitor, and lead policy development to increase sources of provincial-level revenue.

Provincial-level recruitment of staff for Provincial Planning Commissions would enhance policy development. The PPCs provide provincial-level guidance on development planning, including provincial-level MTEF and annual planning guidelines. Most PPC staff are seconded by the federal government and rotate every two years, sometimes more frequently. These rotations, which may take place both vertically and horizontally in Nepal, impede the formation of a solid group with cumulative capacity, institutional memory, and stability to produce and follow up on policies that are critical for the provinces. While this is the feedback from informants that the team met during field visits, it is a general problem for all provincial agencies that rely on staff deputed by the federal government.

As of FY23, all seven provinces have enacted their Provincial Civil Service Act (PSCA), paving the way for recruiting sub-national civil servants, but recruitment still lags behind approved positions. All seven provinces have advanced on their enabling environment for recruiting their own and local government civil servants. The latest human resource gaps are shown in Table 2.3 below and, in most provinces, the percent of positions filled has improved from FY21 to FY22.[25] Staff recruitment for the approved positions ranges from the lowest rate of 47.48 percent (in Lumbini) to the highest of 72.22 percent (in Gandaki) in FY22. While waiting for the enactment of the Federal Civil Service Bill, provincial recruitment has been taking place on the basis of the existing federal regulatory framework and the recently adopted PCSAs.[26]

Table 2.3. Status of enactment of Provincial Civil Service Acts and civil service recruitment

Province	Enactment of Provincial Civil Service Acts (Registration Date on Gazette)	Number of Positions to be Filled (FY21)	Percent of Positions Filled (FY21)	Number of Positions to be Filled (FY22)	Percent of Positions Filled (FY22)
Koshi	December 22, 2022	3,882	57.8	4,441	53.2
Madhesh	February 10, 2021	3,133	65.0	3,121	65.7
Bagmati	March 2, 2023	3,901	59.8	3,764	66.8
Gandaki	March 2, 2023	3,178	72.2	3,178	72.2
Lumbini	December 7, 2023	4,436	58.2	4,944	47.5
Karnali	October 16, 2023	2,848	61.8	2,848	68.7
Sudurpashchim	September 16, 2022	2,699	59.6	2,685	59.6

Source: Provincial government websites and Office of the Auditor General (OAG) reports 2022 and 2023

21 Interviews were conducted with civil servants in Lumbini and Gandaki Provinces in January 2024.

22 As per the NNRFC, none of the provincial governments deposited the mandated 40 percent of vehicle taxes collected into the local consolidated fund on monthly basis in FY22. This issue also persisted in FY23.

23 The Local Government Operations Act (2017) stipulates that provincial governments determine the tax rates for house and land registration fees annually through their Provincial Financial Acts, and local governments collect house and land registration fees.

24 The Provincial Ministry of Physical Infrastructure and Transport is responsible for collecting driving license and registration fees.

25 Even though Koshi and Lumbini provinces appear to have a lower percentage of positions filled in FY21/22 compared to the previous year, this is driven by the creation of new positions.

26 According to informants from PSCs in Lumbini and Gandaki, even before the Provincial Civil Service Acts were enacted, provincial and local civil service recruitment had advanced based on the old Federal Civil Service Act (1993) and Federal Employ Adjustment Act (2017). After passing their Provincial Civil Service Acts, provincial governments have been guided by these acts in their recruitment of provincial and local civil servants.

Box 2.1. Does the federal Civil Service bill reinforce fiscal federalism?

The federal Civil Service Bill was registered in Parliament on March 4, 2024. It acknowledges the right of provinces and local governments to manage their civil service through provincial civil service laws, recognizing the diverse needs of different tiers of government. The bill ensures transition for staff deputed from the federal government to the provinces under the Employee Adjustment Act of 2017 and manages the administrative inter-relationship between the federal, province, and local governments by establishing an Administration Reform Committee.

The new bill introduces significant changes in the deputation of Chief Administrative Officers (CAOs) by granting provinces authority to depute CAOs, if the federal government has not deployed them, empowering the provinces to depute officers from the Provincial Civil Service as CAOs if needed. The bill includes accountability mechanisms for CAOs, such as evaluation responsibility entrusted to the Province Secretary and Principal Secretary of the respective Office of the Chief Minister of Council of Ministers, steps towards effective governance. However, the bill proposes that the appointment of the CAOs and Provincial Secretaries remains at the federal level for a period of 10 years. Given that the Constitution bestows provincial governments with exclusive responsibility for provincial civil service management (Schedule 6), this role should be devolved to the provinces.

2.2 Own-source revenue collection has stagnated, reflecting moderate improvement in policy on revenue assignment and weakness in revenue administration

There is significant scope for improvement to enhance revenue generation by PLGs. Own-source revenue of local governments declined as a share of total local government revenue from 8.5 percent in FY22 to 6.5 percent in FY23. According to the Financial Comptroller General Office (FCGO), metropolitan cities and sub-metropolitan cities generated 40.6 percent and 15.2 percent of their revenue from own-source revenue, respectively, in FY23. On the other hand, urban municipalities and rural municipalities generated only 6.5 percent and 0.6 percent, respectively, from own-source revenue in FY23. This confirms the need to support both urban and rural municipalities in increasing their own-source revenue, as current revenue for these municipalities remains mainly dependent on Inter-Governmental Fiscal Transfers (IGFTs) (Annex 3, Figures A10 and A11).

Nepal is undertaking a proactive review of the regulatory framework for shared revenue responsibilities, mostly between PLGs. This review includes the Unbundling Report 2.0, which is currently being discussed by the National Coordination Council, the Local Government Operations Act (2017), which is being reviewed by the MoFAGA, and the Inter-governmental Fiscal Arrangement Act (2017), which is under review by the MoF. It is critical that the shared revenue items be clarified as soon as possible to give PLGs more predictability.

The review of the regulatory framework is critical to address inconsistencies, such as between federal-level and provincial-level frameworks for house and land registration fees. Schedules 6 and 8 of the Constitution define house and land registration fees as exclusive revenue rights of both provincial and local governments.[27] The Local Government Operations Act (2017) further clarifies that provincial governments determine the tax rates for house and land registration fees annually through their Provincial Financial Acts, and the local governments collect house and land registration fees. However, in the case of Gandaki, the Provincial Finance Act of 2022/23 indicates that the Land Revenue Office, under the Federal Department of Land Management[28], is responsible for collecting and distributing the fees from house and land registration fees in a 40:60 ratio between the provincial and local government. It is important to address this inconsistency between the Local Government Operations Act and the Provincial Finance Acts (as documented in the Gandaki case) to ensure consistency between the federal and provincial regulatory frameworks.

Revenue Improvement Action Plans need to be prepared and implemented at the PLG level in order to improve the own-source revenue of provincial and local governments. With support from the MoFAGA, the Provincial Centers for Good Governance (PCGGs), and several development partners, 3 provinces and 375 local governments had developed their Revenue Improvement Action Plans by March 2024,[29] supporting their strategic efforts to increase their own-source revenue at the sub-national level. There have also been concerns expressed by multiple actors on the quality of these plans and the fact that they might have become an exercise done more for compliance with requirements than an actual technical process that becomes operational to improve revenue levels. PLGs ought to be encouraged to prepare Revenue Improvement Action Plans, but, more importantly, the MoFAGA/PCGGs and development partners should support the improvement of the quality of the Plans, so that they properly consider institutional arrangements (appropriate agency/division), use of technology, mapping of revenue potential, updating tax bases, etc., as well as their effective implementation.

Raising the awareness of local government staff and leaders about tax and non-tax regulations and revenue-sharing arrangements is also important. Recent field visits in Gandaki and Lumbini provinces (in January 2024) confirmed the need to raise the awareness of local leaders and government staff on the current regulatory framework for own source and revenue sharing. Some informants expressed that local political leaders do not have a solid understanding of the revenue sharing formula, such as advertisement and entertainment tax, especially those who have recently been elected as first-term representatives. While PCGGs have already been providing some training modules on PFM rules, further training is required to increase local government staff and political leaders' knowledge of revenue administration and other PFM rules.

2.3 Expenditure assignment is advancing, but is not supported by effective procurement management

Progress has been made in passing or preparing the updated sectoral acts in consideration of the expenditure assignment for the three tiers of government. Since the last NFFU, which was published in 2023, some progress has been made on expenditure assignments, that is, establishing the spending responsibilities for each level of government. This includes the Water Supply and Sanitation Act (2022) and Rules (2024) and the Education Bill (submitted to the Federal Parliament in September 2023), which provide further clarification on expenditure assignments (Box 2.2). These sectoral bills need to be passed and any inconsistencies with other regulations reconciled as soon as possible, while paying special attention to aligning their provisions with the federalism framework established by the Constitution.

27 While house and land registration fees are an exclusive right of provincial governments (Schedule 6 of the Constitution), house rent tax and land registration fees are defined as exclusive rights of local governments (Schedule 8 of the Constitution).

28 The Department of Land Management is part of the Federal Ministry of Land Management, Cooperatives, and Poverty Alleviation.

29 This is according to the Provincial and Local Government Support Programme annual report, which is available at https://plgsp.gov.np/sites/default/files/2024-02/PLGSP%20APR%2022-23.pdf.

Box 2.2. Expenditure assignment implications of the WaterSupply and Sanitation Act (2022) and draft Regulations (as of March 2024)

The Water Supply and Sanitation Act (2022) and draft Regulations (2024) intend to clarify shared responsibilities for expenditure assignments in the water supply sector among the three tiers of government. For example, the draft Water Supply and Sanitation Regulations (2024) includes the following (Clause 3):

> ***Federal government*** *manages projects with a cost of more than twenty million rupees or benefiting a population of more than 15,000 in the Terai or 5,000 in Hill or 1,000 in the Mountain Regions in the design year. Similarly,* ***Provincial governments*** *are given responsibilities for projects with a cost of ten million to twenty million rupees or benefiting a population of 5,000 to 15,000 in the Terai or 3,000 to 5,000 in the Hill or 500 to 1,000 in the Mountain Regions in the design year.* ***Local governments*** *manage up to ten million rupees or benefiting a population of up to 5,000 in the Terai or 3,000 in the Hill or 500 in the Mountain Regions in the design year.*

This clarifies expenditure responsibilities in the water sector, as 'water supply' (among other things) is one of the concurrent responsibilities of the three tiers of government. However, some stakeholders, such as local government associations (Municipal Association of Nepal [MuAN] and National Association of Rural Municipalities in Nepal [NARMIN]) have expressed concern about potential contradictions between the provisions contained in the Local Government Operations Act and the Water Supply and Sanitation Act/draft regulations. For instance, the functions assigned to the local government by the Act are significantly less than those under the Local Government Operations Act. The Water Supply and Sanitation Act provides many functions to the federal government and less to the local government, whereas the Local Government Operations Act has allocated many functions to the local level. The functional assignment of water supply to the three tiers of government by these two laws and draft regulations needs to be reconciled.

Despite the need for comprehensive reform, there has been no significant progress made in relation to the regulatory framework and systems for procurement since Nepal shifted to federalism. No national-level procurement assessment has been conducted since 2002. The current regulatory framework on procurement was enacted in 2007, and it still underpins the country's procurement rules. This implies that, even though Nepal adopted federalism in 2015, the procurement regulatory framework has been unchanged for more than a decade and a half. Nepal could consider applying the Methodology for Assessing Procurement Systems (MAPS)[30] to obtain a complete picture of the current conditions (legal and operational) of the Nepali procurement system at the three levels of government, as compared with recommended international standards. The results of the MAPS assessment can then inform the need for reforms in the procurement system, including to the regulatory framework and institutional setup, as well as the required human resource capacity, all of which are challenges undermining procurement performance in Nepal. At the same time, in reviewing institutional arrangements, the MAPS can also recommend needed legal and institutional strengthening of the Public Procurement Management Office (PPMO).

The e-Government Procurement (e-GP) system needs to be enhanced to monitor and evaluate all procurements in Nepal. While the e-GP system was developed to perform as an integrated system for all public procurement in 2011, the procuring agencies are currently using the portal only to prepare the procurement plan, advertise procurement opportunities, and receive electronic bids. However, the procurement database maintained by the PPMO through the e-GP system is incomplete,[31] indicating that there is ample room for improvement when comparing international good practices. Upgrading the e-GP system to enable the PPMO to access comprehensive procurement related data is recommended.

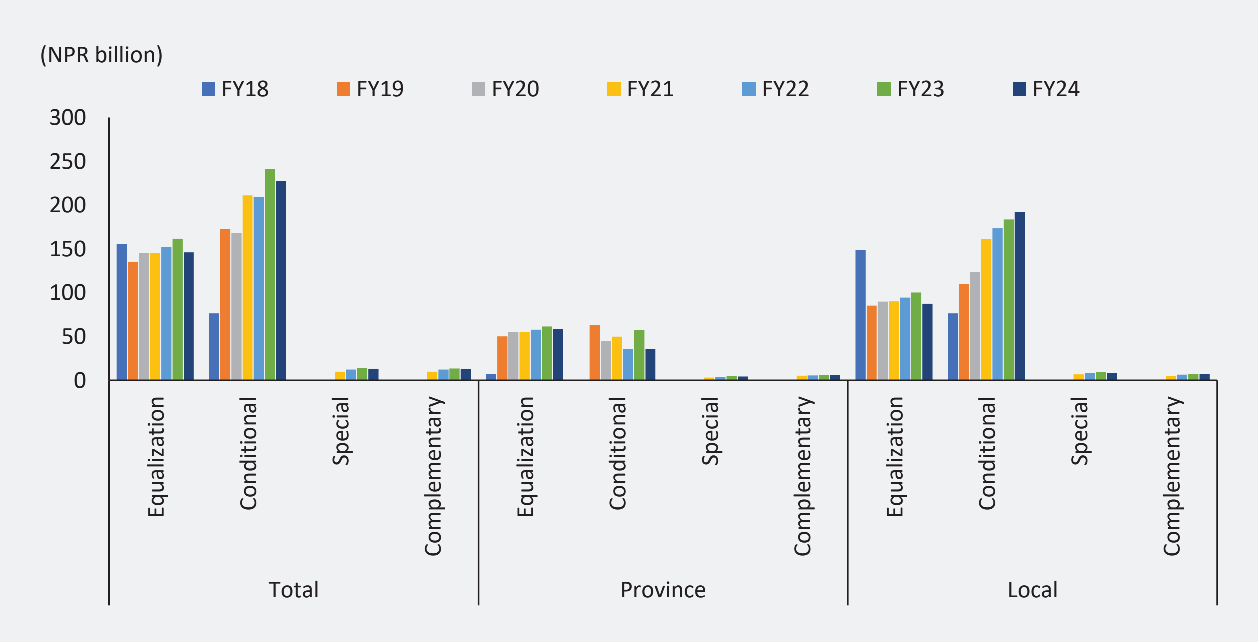
30 MAPS is an international standard and universal tool for evaluating public procurement systems anywhere in the world. This harmonized tool is developed by the Organisation for Economic Cooperation and Development (OECD).

31 Information about contract awards and implementation is either not available or partially available on the portal. Procuring agencies maintain contract records in the form of manual files, which include information on what was procured, the value of the procurement, and who was awarded the contract, so when information is required for procurement monitoring, data has to be compiled manually due to the lack of a comprehensive database.

2.4 The Inter-Governmental Fiscal Transfers System requires upgraded institutional arrangements for effective management

Since FY19, the overall trend of IGFTs has remained unchanged, with the largest proportion of the resources for local governments being transferred through conditional grants (CGs). (Figure 2.1) The dependence of provincial governments on CGs as a share of total revenue decreased marginally from 19.6 percent in FY22 to 17.3 percent in FY23. The reliance of local governments on CGs also decreased slightly, from 46.8 percent to 43.5 percent over the same period.

Figure 2.1. Budget allocations for the four types of grants from the federal government to PLGs



Source: World Bank staff calculation based on MoF data

Establishing a transparent, consultative process and technical methodology for determining the divisible pool for IGFTs will help increase the predictability of the financial resources. At present, there is no legal provision/procedure for how the NPC-led Resource Committee determines the pool of funds to be transferred through IGFTs.[32] Moving forward, Nepal could consider establishing a transparent and consultative process and a technical methodology for how the Resource Committee determines the divisible pool of IGFTs. This could also include a legal requirement that the recommendations provided by the Committee on the size of the divisible pool be adhered to in the MTEF and annual budgeting process. This could help ensure better fiscal planning at the federal level, as a designated share of the budget would be allocated to PLGs, and would also allow for better planning at the PLG level, as the sub-national governments would be able to better predict resource availability.

The fiscal equalization grant formula is under review, so that it can better fill the fiscal gaps remaining after all other resources available to PLGs are accounted for. The FEG is defined based on the need for expenditure and revenue capacity of PLGs. Around 70 percent of

32 In India and Pakistan, the Finance Commission provides recommendations every five years on the share of the tax revenue to be allocated to the center and the state/provinces.

the FEG is determined by a formula[33] developed by the National Natural Resources and Fiscal Commission (NNRFC). Created in 2019, the current formula has been used for the last five years with the same methodology and indicators. The NNRFC is currently undertaking a review of the formula to make it simpler, clearly understandable by all stakeholders, and better able to reduce the fiscal gaps across PLGs. For example, the formula review is looking at including all available sources of funding for PLGs (including conditional grants and revenue sharing) and to update the indices and data used to measure expenditure needs and revenue capacity.

The NNRFC is attempting to expand the performance elements to not only FEGs, but also other mechanisms, such as revenue sharing. Performance incentives can bring positive changes if potential risks are managed well. Some key issues and associated recommendations informed by international good practices are articulated in Box 2.3.

There is ample room for improvement in designing and implementing conditional grants. While the NNRFC determines the parameters of CGs, the allocation across PLGs is determined by federal sector ministries and the MoF. Key issues and recommendations to be considered are:

- **The weight of FEGs within the pool of resources for IGFTs should increase in relation to CGs, to strengthen PLG planning and decision-making according to bottom-up needs.** The Intergovernmental Fiscal Arrangement (IGFA) Act (2017), Article 9, establishes that CGs are allocated for the implementation of PLG projects. As the PLGs, which are closer to citizens, are more familiar with the needs of citizens than the federal government, it would be advisable to fund service delivery functions at the PLGs increasingly through FEGs rather than CGs. The focus of CGs could be mainly for (a) federal responsibilities that the federal government requires support from PLGs in fulfilling, and (b) incentives to encourage PLGs to act on areas that have been devolved to them, but where Nepal as a nation has acquired international commitments (e.g., Sustainable Development Goal [SDG] indicators or the eradication of certain diseases).
- **CGs transferred as 'block grants' can be considered to drive national priorities.** CGs can be transformed into sectoral CGs transferred as block grants with

Box 2.3. Guidance criteria to incorporate performance elements in IGFTs in Nepal

Firstly, it is advisable to use a limited number of accessible and verifiable indicators when assessing performance-related aspects. Per international practice, performance indicators are more effective if they are limited in number, such that achievement has an impact on the allocation of money, which incentivises performance, and available through verified sources to avoid the risk of misrepresentation.

At present, the NNRFC is using 11 performance indicators for provinces and 17 for local governments, which implies that the impact of each indicator on allocation is low. Moreover, data for 7 out of 11 indicators for the provinces and for 8 out of 17 indicators for local governments are not accessible or verifiable.

Secondly, performance indicators could be considered in association with conditional grants. As mentioned before, Nepal's conditional grants are instrumentally allocated and controlled through earmarking. Performance-determined conditional grants transferred as block grants would be more effective in fostering progress in the achievement of sectoral targets.

Third, when designing performance elements, it is important to consider capacity building for weak PLGs. Whenever performance elements are included in revenue-sharing, equalization or conditional grants, and they are associated with fiscal efforts, care should be taken to implement them hand-in-hand with capacity-building, so that the unintended result does not broaden the gap between strong and weak PLGs.

33 According to the NNRFC Act, Article 16.1, the current formula includes the following indicators: (a) Human Development Index indicators like education, health, drinking water within province and at local level, (b) situation of balanced development within province and at local level, (c) situation of economic, social or any other discrimination prevalent within other province and at local level, (d) situation and necessity of infrastructure development within province and at local level, (e) services to be provided by the province and at local level to citizens, (f) situation of revenue of the province and local level and their capacity to collect it, and (g) necessity of expenditure by the province and local level.

no detailed earmarking as a way to retain certainty of expenditure on the functions that each sector needs to perform. Some of the resources of sector CGs transferred as block grants could be allocated to national priorities, as mentioned above, and the rest to the general functions that correspond with the sector. CGs transferred as block grants could be linked with indicators associated with targets and objectives.

- **Clear and transparent criteria are needed in the allocation of CGs.** A recent federal PEFA report (April, 2024) highlights that there is no clear and transparent procedure for the federal line ministries to determine and distribute conditional funding. Clear and transparent procedures are recommended to increase sectoral budget planning and expenditure capacity. Compounding this concern, NNRFC's annual report (2023)[34] reveals that there is no established monitoring mechanism to assess whether the four criteria[35] determined by the NNRFC were adhered to or not when distributing conditional grants to local governments. Consequently, NNRFC has urged the MoF to develop an automated system to monitor compliance with their recommendations regarding the allocation of conditional grants.

- **Decrease earmarking of CGs.** The number of earmarked items in CGs has increased since the last NFFU – from 80,916 in FY22 to 96,619 in FY23. There was some progress in the health sector in FY24, with the number of the earmarked items decreasing from 22,483 in FY23 to 15,898 in FY24 for local governments, and from 7,396 in FY23 to 6,299 in FY24 for provincial governments over the same period.[36] Despite this progress in the health sector – at the level of expenditure headings of PLGs recorded in the Line Ministry Budget Information System (LMBIS) – the problem of earmarking persists, since the specific instructions[37] provided to PLGs for the implementation of CGs are defined at a level of granularity that takes away the increased autonomy provided by the reduced number of expenditure headings. Hence, efforts to provide greater flexibility over CGs to PLGs are needed in these two mechanisms.

- **Vertical coordination can be enhanced to better reflect PLG needs in CGs.** Regarding capital expenditure, there are recurrent complaints that the funds received through CGs do not match the priority investments of PLGs, often resulting in these grants not being disbursed. Improved vertical coordination would ensure that PLG capital expenditure needs are being met when determining the allocation of CGs. The Inter-Governmental Fiscal Council (IGFC)[38] could play a leading role in enhancing vertical coordination on CGs among the three tiers of government.

- **The amount of CGs could be determined/published earlier to facilitate planning and more efficient execution.** As can be seen in Table 2.4, the program and project allocation of the CGs is determined in the fiscal year, and communications that are dependent on these grants are also informed late (by the end of May every year). Earlier publication would empower PLGs to plan ahead of time and be prepared for execution at the beginning of the fiscal year. It would also give more clarity on the actual amount of the IGFT divisible pool for the fiscal year (including the amounts of CGs), giving the NNRFC better information with which to estimate and recommend the distribution of FEGs.

34 Available at: https://nnrfc.gov.np/uploads/resources/2023-04-10/annual_report_2078_79_for_website_.pdf

35 The four criteria recommended by the NNRFC are: (a) when a thematic area or program/project falling under the list of (exclusive) rights of province governments needs to be implemented by the local level, (b) when a provincial policy or program needs to be implemented through the local level, (c) when provincial standards need to be established or implemented at the local level, and (d) when strategically important projects necessary for balanced development within the province need to be adhered to.

36 See: https://projects.worldbank.org/en/projects-operations/project-detail/P176498

37 Provided through the Program Implementation Manual: Related to Conditional Grants implemented programs by the Local and Provincial Levels.

38 The Inter-Governmental Fiscal Council is created by the Intergovernmental Fiscal Arrangement Act, 2017 to conduct necessary consultations and coordinate between the three tiers of government on fiscal management. It is a federal statutory body that deals with revenue powers, revenue sharing, IGFTs, loans, budgetary arrangements, public expenditure, and fiscal discipline for all three tiers of government. The Council is, thus, entitled to hold and maintain necessary consultation and coordination among different tiers of government on intergovernmental fiscal arrangements.

Table 2.4. Schedule for allocation grants

Date	Responsible Agency	Activity
Federal level		
Mid-December	NPC	Project call notice for matching and special grants among provincial and local governments
End of January	Resource Committee	Budget estimation – based on the past FY macro-economic status and current 6 months FY– MTEF next two FY estimation
Mid-February	Resource Committee	Total federal resources FEG pool is communicated to NNRFC
Mid-February	Resource Committee	Total ceiling for conditional grants from federal government to provinces and federal government to local governments is determined
Mid-February	NPC	Project call submission deadlines for matching and special grants among provincial and local governments
December to March	NNRFC	Start calculating the recommendations FEG for the next fiscal year Rounds of discussion at the joint secretary and secretary level Discussion and approval at Commission level
2nd week of March	NNRFC	Recommendations of the FEG amount and communicate with MoF
2nd week of March	MoF	Federal government informs province and local levels about FEG allocation
Mid-April	NPC	Project selection for matching and special grants among provincial and local government
End of May	Line ministries	Programs and projects under CG determined during budget negotiations
Every Month	MoF	Share of revenue from value added tax (VAT) and excise duty received by province and local governments is provided monthly by depositing it in the concerned provincial government divisible fund and local government divisible fund
Provincial level		
Third week of March	Province Resource Committee	Total provincial resources FEG pool is communicated to NNRFC
Mid-April	NNRFC	FEG recommendations provided to the province
3rd week of April	Province	Province informs the local level of FEG allocation

Source: World Bank staff calculations based on Government of Nepal websites and guidelines

There is a need to enhance the capacity of the NPC to manage special and matching grants. Informants at the NPC highlighted the weak management capacity[39] of the NPC in relation to special and matching grants. This weak capacity results in a lack of a monitoring and evaluation system for the results and impact associated with projects funded through grants. Of the total allocation of IGFTs for FY23, matching and special grants consisted of only 6.4 percent. Currently, the project selection has been led mainly by the Project Selection Committee, which is comprised of six members from the MoFAGA, Office of the Prime Minister and Council of Ministers (OPMCM), and the concerned line ministries. This Committee selects from a large volume of applications (around 4,000 plus applications received last fiscal year). It is necessary to increase the capacity of the core team at the NPC (in terms of number and skills) to evaluate grant proposals and to establish a sub-technical team to conduct monitoring, which will expedite and improve the quality of selection and implementation.

39 As at March 2024, the core team responsible for verifying the applications by PLGs for special and matching grants and recommending their approval to the MoF consisted of only six staff.

2.5 The regulatory framework on borrowing and capital finance is evolving

Nepal has made progress in establishing an enabling environment for internal borrowing and capital financing. Based on the Public Debt Management Act (2022), four institutions – the Public Debt Management Office (PDMO), Ministry of Finance, Nepal Rasta Bank (NRB), and NNRFC – advanced the dialogue regarding a concrete regulatory framework and institutional arrangements for internal borrowing by PLGs, which resulted in the enactment of the Public Debt Management Regulation on March 14, 2024. The regulation stipulates the key roles of the four institutions (Table 2.5).

Reform of the Town Development Fund is in progress. At the local level of capital finance, no PLGs have embarked on any borrowing activity. In order to lay the ground for local government capital financing, the Town Development Fund Act[40] is being restructured to mobilize financial sources for infrastructure development growth at the sub-national level. The Cabinet approved the TDF Strategy Paper in FY23, and the relevant bill is expected to be presented by the Ministry of Urban Development to Parliament soon. While the TDF was limited to urban municipalities before, the ongoing reform aims to enable all PLGs to access the borrowing mechanism from the TDF.

Table 2.5. Key roles of the four institutions on borrowing and capital financing

Institution	Role
PDMO	To formulate debt policies and strategies
MoF	To provide oversight roles on internal debt for three tiers of government in coordination with PDMO (including monitoring debt information)
NRB	To manage monetary policy and coordinate with PDMO to ensure consistency between internal debt and monetary policy
NNRFC	To recommend the ceilings for domestic borrowing of PLGs (current ceiling is 12 percent)

Source: Public Debt Management Act (2022) and Regulation (2024)

2.6 There has been limited progress made in the sustainable and equitable mobilization and distribution of natural resources revenue

Increasing fiscal fund flows from natural resources through sustainable mobilization can have an impact on fostering development in PLGs. Natural resource-related revenue is estimated to have the potential to produce 4.56 billion NPR (1.2 % of FY 20 GDP). While natural resources are diverse, Nepal has categorized them into five categories for royalty generation and distribution purposes: mountaineering, electricity, forests, mines and minerals, and water and other natural resources (IGFA Act 2017, Schedule 4).[41]

40 TDF was established to provide essential financial, technical, and institutional support to the institutions relating to the town development for the construction, development, and expansion of the town in 1989.

41 The NNRFC has not produced recommendations for the distribution of water and other natural resources, as per legal and constitutional provisions, except recently in relation to the distribution of royalties from the use of radio frequencies. A study commissioned by the NNRFC on royalty potential from water and other sources has identified inter basin drinking water, inter basin irrigation, water for bottling, industrial uses of water, underground water resources, water transportation, water-related entertainment, and water for hydrogen energy, etc. as potential water-related sources. Solar energy, wind energy, geothermal energy, thermal energy, fossil based energy (including coal and petrol), nuclear energy, waste to energy, telecommunications and so forth were identified as 'other' potential sources of energy for royalty generation (see: https://nnrfc.gov.np/uploads/resources/2024-01-19/Study_of_Royalty_Potential_from_Water_Related_and_Other_Natural_Resources_Sector_in_Nepal1.pdf).

However, the sectoral acts for collecting and managing natural resources revenue have not been updated significantly since the introduction of federalism. Nepal moved to a federal structure in 2015, and the Constitution defines royalties from natural resources as an area of concurrent power at the federal, provincial, and local levels (Schedule 9). However, royalty and revenue generation and collection mechanisms for various natural resources are still governed by sector-specific laws, many of which were enacted before federalism, such as the Tourism Act (1979), Electricity Act (1993), Forest Act (2020), and Mines and Mineral Act (1986). This has created some issues related to the concurrency of rights of the three levels of government in governing natural resources revenue and royalty collection and administration.[42] There are also issues with the centralized collection of the revenue originating from different sources into a federal divisible fund and distribution among the three tiers (IGFA Act 2017, Clause 7), with some sectors not depositing royalties collected in the said fund, impacting the fiscal resources available to PLGs.[43] These sectoral acts ought to be updated to align with the current federal structure of Nepal and clarify who does what in terms of revenue generation from natural resources.

Equity concerns in the distribution of royalties from natural resources between PLGs also need to be addressed. The current formula for the distribution of royalties from natural resources is stipulated in the IGFA Act (2017), which applies a derivation-based approach by which core, affected, and adjoining areas of the natural resource base receive a share of the royalties based on indicators of population and geography. This approach respects the priority and preferential rights of local communities as related to the benefits of the distribution of natural resources, as accorded by the Constitution. However, this approach also has the potential to increase inequalities between areas with and without natural resource bases. For example, only 120 local levels received a share of royalties from electricity, which constitutes the largest share of royalties from all natural resources, and furthermore there are great variations in the distribution of the royalties between local levels. While one local government received only NPR 7,759, another municipality received NPR 89 million as the largest recipient in FY21 (see Table 2.6). The equity concerns can be partly addressed through other transfers, for example, by ensuring that those municipalities receiving less natural resource royalties receive slightly higher fiscal equalization grants.

Table 2.6. Natural resource royalty distribution to PLGs by source FY21

Royalty Source	Province		Local Level		PLG
	Number Receiving Royalties*	Minimum and Maximum Amount (NPR)	Number Receiving Royalties	Minimum and Maximum Amount (NPR)	Total Amount Received by Each Level (NPR)**
Mountaineering	5	9,000–121 million	86	31–90 million	140 million
Electricity	6	781,000–350 million	120	7,759–89 million	706 million
Forest	7	8.8–34.5 million	728	17–3.8 million	173 million
Mines & Minerals	6	224,000–148 million	63	625–45 million	211 million

Source: Adapted from Table 4.8 and 4.9 in NNRFC Third Annual Report (NNRFC 2022, p. 373)

*Madhesh and Lumbini provinces did not receive any royalties from mountaineering. Madhesh also did not receive any royalties from electricity or mining. Karnali and Sudurpashchim provinces received the lowest shares of royalties from all except forests, although Karnali was the lowest receiving province even in the latter.

**While the federal government receives 50 percent of the royalties, both provinces and local governments affected by the mobilization of natural resources receive an equal share of 25 percent each.

42 An example of this includes a case brought before the Constitutional Bench regarding the levying of royalties and taxes on community forest user groups by all three tiers of governments in 2023. Issues related to royalty and revenue from extraction for sand and stone, etc. for construction has also been an area of contestation between the three levels, although a bill related to Construction Material (Management and Regulation) was presented to Parliament on March 22, 2024, to address this.

43 For example, the Forest Development Fund, which was formed under the Forest Act, which collects revenue from the sale of forest products, environmental services, and other things, and the National Nature Conservation Fund, which was formed under the National Nature Conservation Act (1983) to collect revenue from protected areas, do not transfer their collected revenue into the federal divisible fund for distribution among the three tiers (see Third Annual Report of NNRFC, 2022, p. 381).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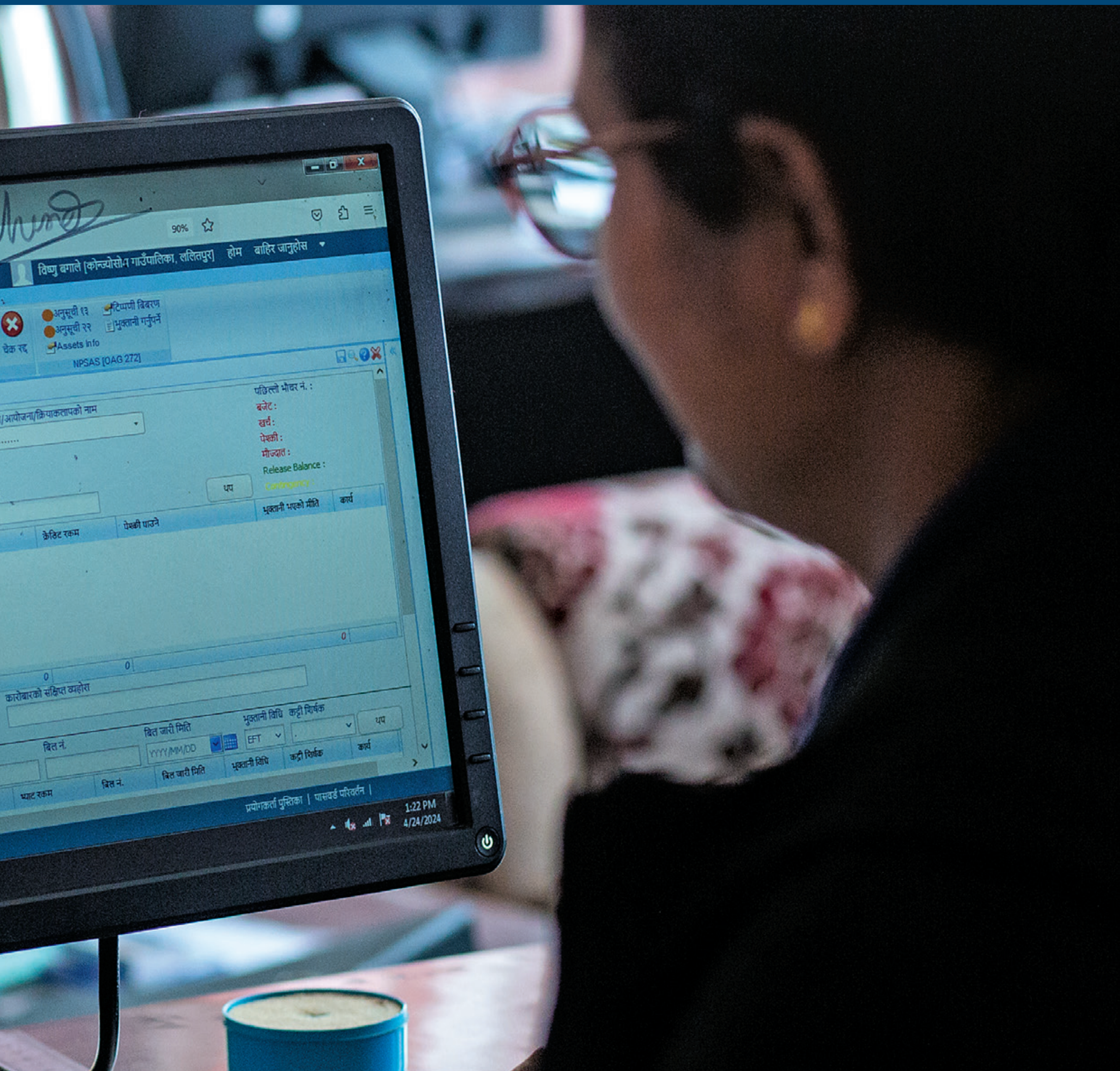
CHAPTER 3

Progress on Public Financial Management by Provincial and Local Governments

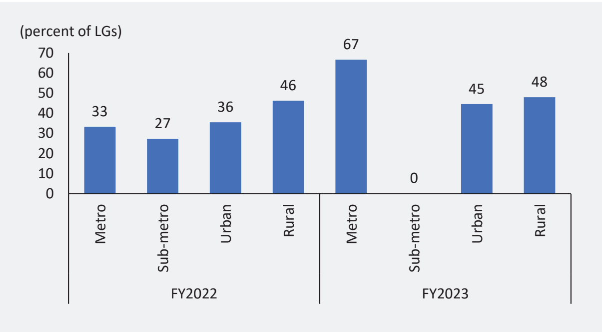


This chapter examines the latest trends and the status of PFM implementation at the sub-national level. The analysis was developed based on: the annual report of the Office of the Auditor General (OAG) for FY22; the Local Government Institutional Self-Assessment (LISA)[44] of 444 local governments for which data is available for the period FY20–FY23; Budget Speeches of a sample of 115 local governments for FY23 and FY24; NNRFC performance indicators for 753 local governments for FY22 and FY23; and consultations with key stakeholders.[45]

3.1 While most local governments adhered to legal requirements for annual budgets and budget spending delegation, progress in preparing periodic development plans and MTEFs remains limited

In FY23, there was an increase in the number of local governments preparing periodic development plans, MTEFs, and annual development programs. Specifically, the percentage of local governments preparing periodic development plans increased from 42 percent in FY22 to 46.2 percent in FY23 (NNRFC data on 753 local governments). This increase was observed across various municipality types, with metropolitan cities, urban municipalities, and rural municipalities experiencing increases of 33.3, 9.1, and 1.7 percentage points, respectively (Figure 3.1). However, sub-metropolitan cities saw a decrease of 27.3 percentage points. LISA data from the MoFAGA reveals further insights. Among the 444 local governments[46] with data available from FY20 to FY23, those preparing spatial-based development plans decreased from 26.1 percent in FY22 to 24.3 percent in FY23 (Figure 3.2). However, the percentage of local governments preparing and implementing MTEFs and annual development programs based on the spatial-based development plan rose significantly, from 25.7 in FY22 to 43.9 in FY23 (Figure 3.3). This increase was particularly pronounced in metropolitan cities (by 33.3 percentage points), urban municipalities (by 18.3 percentage points), and rural municipalities (by 19 percentage points). Although there are concerns about the variable quality of these plans and programs, the fact that they are increasingly being prepared is a step in the right direction.

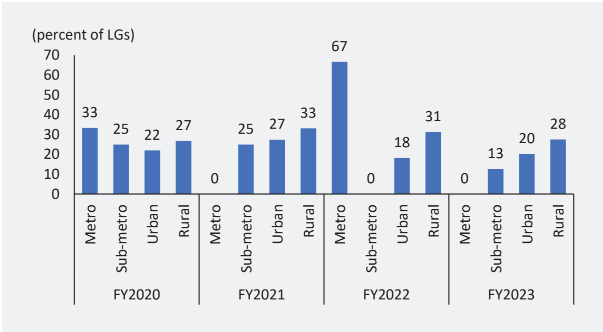
Figure 3.1. Percentage of local governments preparing periodic development plans



Note: Percentage based on the total of local governments under each type

Source: NNRFC and World Bank staff calculations

Figure 3.2. Percentage of local governments preparing only spatial-based development plans



Note: Percentage based on the total of local governments under each type

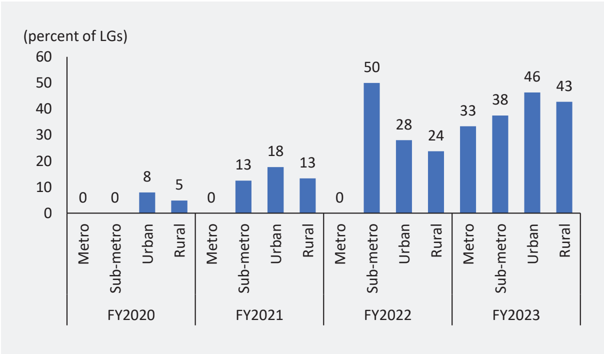
Source: MoFAGA and World Bank staff calculations

44 LISA is a tool managed by MoFAGA and used to assess PLG capacity using 120 indicators. In this chapter, we assessed some of the PFM related indicators to analyze the latest trends. The list of 444 local governments is provided in Annex 2b.

45 The list of stakeholders consulted can be found in Annex 1.

46 This sample includes 3 metropolitan cities, 8 sub-metropolitan cities, 164 urban municipalities, and 269 rural municipalities.

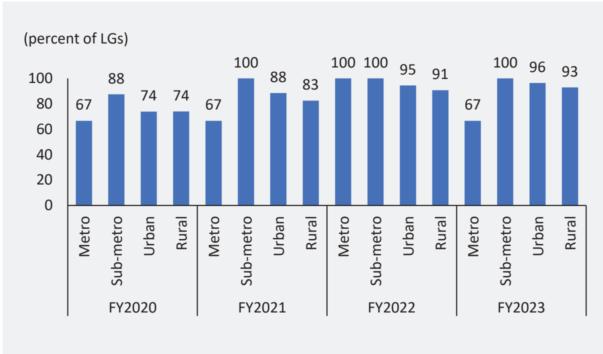
Figure 3.3. Percentage of local governments preparing and implementing MTEFs and annual development programs based on spatial-based development plans



Note: Percentage based on the total of local governments under each type

Source: NNRFC and World Bank staff calculations

Figure 3.4. Percentage of local governments preparing annual budget and program based on recommendations of the three committees



Note: Percentage based on the total of local governments under each type

Source: MoFAGA and World Bank staff calculations

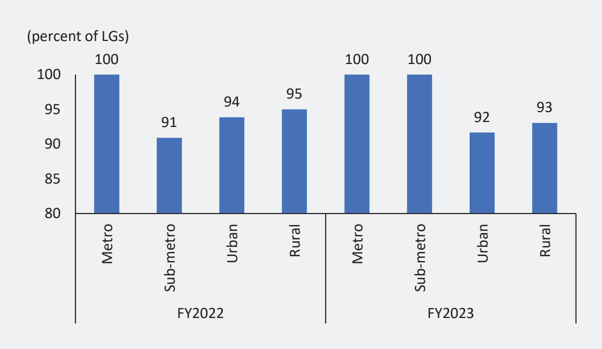
Capacity building and technical assistance are required to prepare MTEFs and other planning documents. The aforementioned analysis showed that almost two-thirds of the 444 local governments still need to prepare and implement MTEFs and annual development programs based on the spatial-based development plan. This indicates a need to provide targeted capacity-building and technical assistance to local governments to strengthen their capacity to prepare all these strategic and operational documents with an adequate level of quality. While various capacity building efforts are made by the PCGGs, the NASC, PFM training academy, and development partners, there is a need to harmonize these efforts in order to avoid the duplication of efforts.

The Local Government Operations Act mandates the establishment of three committees in local governments for preparing and approving annual budgets and programs, which has been done by most local governments. These are the Local Revenue Advisory Committee, Resources Estimation and Budget Ceiling Determination Committee, and Budget and Program Formulation Committee. Among the 444 local governments analyzed, the vast majority (98.6 percent) had established these committees by FY23, reflecting an increase of 1 percentage points from FY22 (Figure 3.4). Out of the 438 local governments where these three committees have been established, 95.4 percent had prepared their annual budget and program based on the recommendations of these committees. Additionally, 91.4 percent of the 444 local government Resource Estimation and Budget Ceiling Determination Committees also determined the thematic budget ceiling for FY24 budget in line with the Local Government Operations Act, up from 89.2 percent for the same for FY23 budget.

There was a slight decrease in the submission of budgets within the stipulated timeline by local governments in the last year. In FY24, over 90 percent of local governments (698 out of 753) submitted their annual budgets to the local assembly by the deadline of June 25, 2023.[47] This reflects a slight decrease from the 94.5 percent of submissions in FY23 (Figure 3.5). Local governments in Madhesh continued to have the highest number of late submissions, with 3.2 percent of local governments missing the deadline. Across municipality types, sub-metropolitan cities were the only ones that saw an increase. Additionally, the law requires local assemblies to endorse the annual program and budget by mid-July of the calendar year. For the FY24 budget, 93.1 percent of 753 local governments fulfilled this requirement, down from 94.6 percent for FY23 (Figure 3.6).

47 Data from NNRFC website

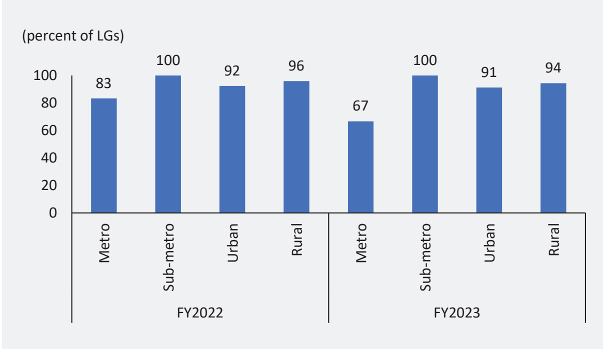
Figure 3.5. Percentage of local governments submitting annual budget to their local assembly



Note: Percentage based on the total of local governments under each type

Source: MoFAGA and World Bank staff calculations

Figure 3.6. Percentage of local governments with their local assembly endorsing submitted budget within legally stipulated timeline

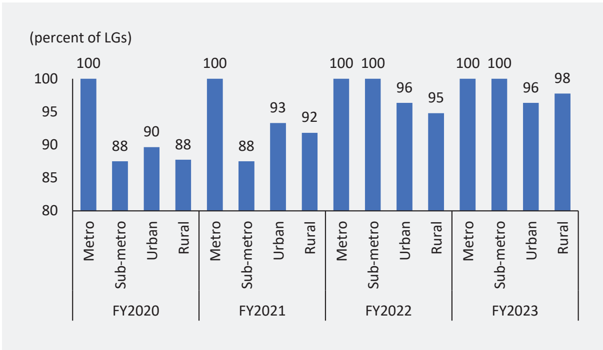


Note: Percentage based on the total of local governments under each type

Source: NNRFC and World Bank staff calculations

Most local governments followed the legal requirement for budget spending delegation. LISA data reveals that 97.3 precent out of 444 local governments adhered to this provision of the Local Government Operation Act in FY23, up from 95.4 percent in FY22 (Figure 3.7). This law mandates that the mayor or municipal chair delegate spending authority to the chief administrative officer within seven days of budget approval by the local assembly.

Figure 3.7. Percentage of local governments complying with legal provisions on budget spending delegation



Note: Percentage based on the total of local governments under each type

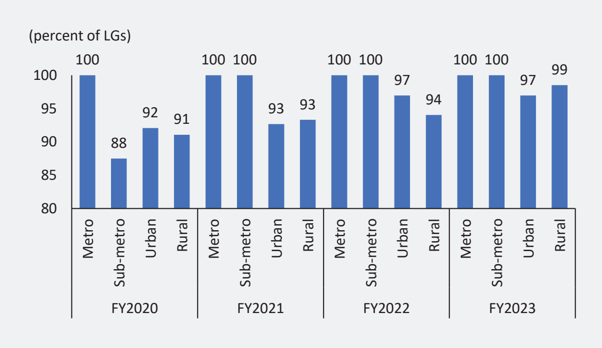
Source: MoFAGA and World Bank staff calculations

3.2 Although local governments seem to be compliant with legal provisions on maintaining accounts according to national accounting standards, the budget transparency of local governments remains low

Most local governments complied with legal provisions on maintaining accounts in line with national accounting standards. The Intergovernmental Fiscal Arrangement Act (2017) requires local governments to prepare periodic statements of income and expenditure in line with Nepal Public Sector Accounting Standards. The LISA data for 444 local governments shows that 98 percent of local governments compiled this with provision in FY23, up from 95.3 percent in FY22 (Figure 3.8).

However, the budget transparency of local governments remained low, with only 33.9 percent out of 115 local governments in the sample having a budget speech publicly available in both FY23 and FY24 (Figure 3.9a). Across municipality types, budget transparency improved for rural municipalities and metropolitan cities, but decreased for others (Figure 3.9a). In particular, the percentage of metropolitan

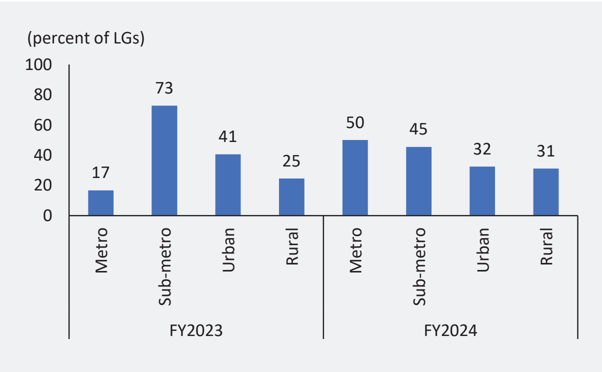
Figure 3.8. Percentage of local governments complying with legal provisions on maintaining accounts in line with national accounting standards



Note: Percentage based on the total of local governments under each type

Source: MoFAGA and World Bank staff calculations

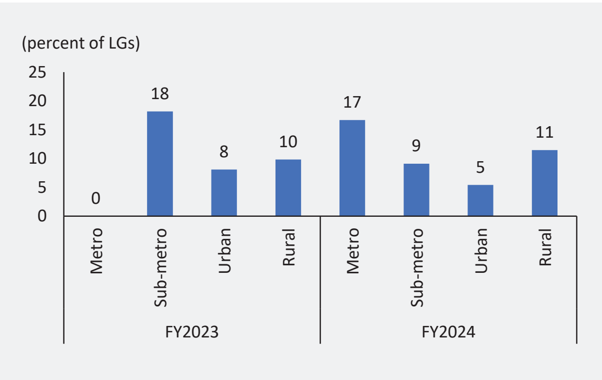
Figure 3.9a. Percentage of local governments making budget speech publicly available



Note: Percentage based on the total of local governments under each type

Source: MoFAGA and World Bank staff calculations

Figure 3.9b. Percentage of local governments with three sets of figures available in budget speech



Note: Percentage based on the total of local governments under each type

Source: MoFAGA and World Bank staff calculations

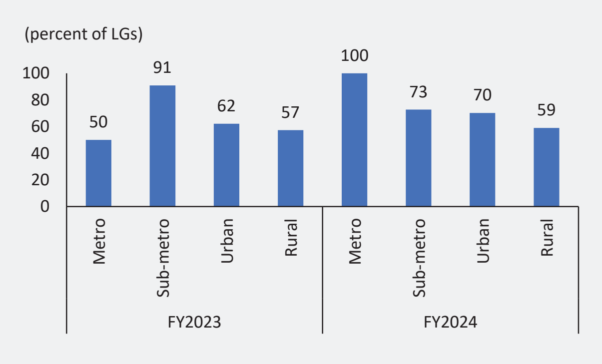
cities and rural municipalities making the budget speeches publicly available increased from 17 percent and 25 percent in FY23 to 50 percent and 31 percent, respectively, in FY24. However, that of sub-metropolitan cities and urban municipalities decreased considerably from 73 percent and 41 percent in FY23 to 45 percent and 32 percent, respectively, in FY24.

Despite widespread use of the Sub-National Treasury Regulatory Application (SuTRA) system, problems with comparability and transparency remain in budget documents, particularly budget speeches, across local governments. Sub-national Government Public Expenditure and Financial Accountability (SNG PEFA) assessment guidelines emphasize the importance of consistent documentation based on administrative, economic, and functional classifications aligned with Government Finance Statistics (GFS) and Classification of the Functions of Government (COFOG)[48] standards. According to the standards, budget documents should present three sets of figures for each classification: estimates for the upcoming year, revised estimates for the current year, and actual figures from the previous year. This approach, adopted by federal and provincial governments in their annual budget statements, enhances comparability. However, at the local level, only 9.6 percent of a sample of 115 local governments included all three figures in both their FY24 and FY23 budget speeches, with economic codes provided for an even lower percentage (7.8 percent) (Figure 3.9b).

The availability of revenue and spending estimates for the budget year, however, showed improvement. For instance, the availability of revenue estimates increased from 49.3 percent in FY23 to 52.8 percent in FY24 (Figure 3.9c). Similarly, spending estimates categorized by function rose from 26.4 percent to 33.4 percent (Figure 3.9e). However, there was a marginal decline in the percentage of local governments providing spending estimates by economic classification (Figure 3.9d). Additionally, the proportion of local governments providing both the amount and the corresponding economic codes is lower for both revenue estimates and spending estimates by economic classification.

48 The Classification of the Functions of Government classifies government expenditure data from the System of National Accounts by the purpose for which the funds are used (see https://www.imf.org/external/pubs/ft/gfs/manual/aboutgfs.htm).

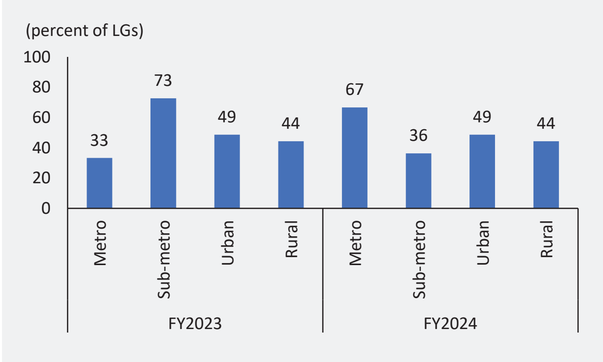
Figure 3.9c. Percentage of local governments with revenue estimate available for budget year



Note: Percentage based on the total of local governments under each type

Source: MoFAGA and World Bank staff calculations

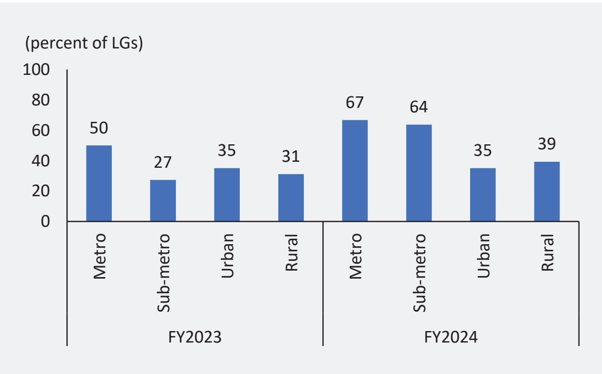
Figure 3.9d. Percentage of local governments with spending estimate based on economic classification available for budget year



Note: Percentage based on the total of local governments under each type

Source: MoFAGA and World Bank staff calculations

Figure 3.9e. Percentage of local governments with spending estimate based on functional classification available for budget year



Note: Percentage based on the total of local governments under each type

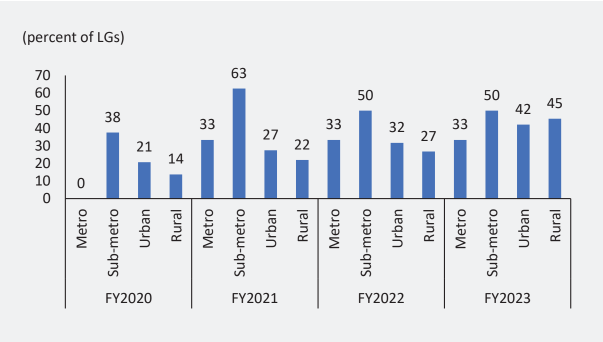
Source: MoFAGA and World Bank staff calculations

Budget speeches of local governments still need to be standardized. This involves developing guidelines or templates for consistent content and format across all local governments. These guidelines should specify required information, such as budget estimates, revised estimates, and actual, aligned with national accounting standards and SuTRA data availability. Providing training and capacity-building programs for local government officials responsible for preparing budget speeches can support this effort. Standardizing budget speeches will enhance transparency, comparability of local government finances, and public understanding of local government budgets.

3.3 Although there has been an improvement in the number of local governments preparing procurement plans, close to half of local governments have still not prepared them

There was a significant increase in the number of local governments preparing and fully implementing master and annual procurement plans in FY23. According to LISA data, 44.1 percent of 444 local governments prepared and fully implemented these plans in FY23, marking a considerable increase from 29.1 percent of local governments in FY22 (Figure 3.10). Additionally, the data shows that 7.7 percent of local governments prepared

Figure 3.10. Percentage of local governments preparing and fully implementing master and annual procurement plans



Note: Percentage based on the total of local governments under each type

Source: MoFAGA and World Bank staff calculations

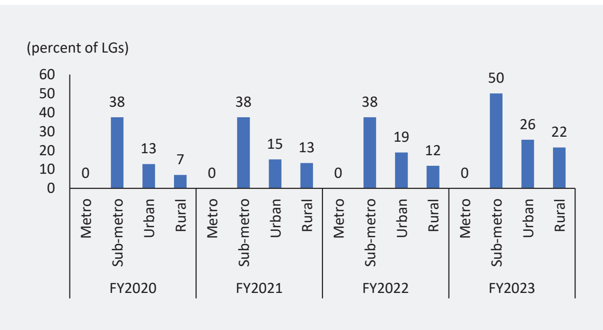
and implemented them partially, while the remaining 48.2 percent of local governments did not prepare any plan. Across municipality types, there was an increase of 10 percentage points of total urban municipalities and 12 percentage points of total rural municipalities in FY23 in terms of fully implementing plans.

Supporting the procurement capacity of PLGs remains a priority. Although LISA data showed an improvement in procurement capacity at the local government level, close to half of these local governments did not prepare any procurement-related plan. Therefore, it would be beneficial for and relevant capacity-building agencies, such as Provincial Centers for Good Governance and development partner-supported PFM programs, to provide hands-on technical support to local governments to help increase their procurement, project management, and capital spending capacity.

3.4 Internal control systems are improving in PLGs, but the coverage of this key oversight mechanism remains limited

In FY23, there was a significant increase in the number of local governments that prepared, fully implemented, and regularly monitored internal control systems. According to LISA data, 23.4 percent of 444 local governments prepared and fully implemented these systems in FY23, up from 14.9 percent in FY22 (Figure 3.11). Across municipality types, there was an increase of 12.5 percentage points for sub-metropolitan cities, 6.7 percentage points for urban municipalities, and 9.7 percentage points for rural municipalities. In addition, the percentage of local governments that prepared the internal control system in FY23, but without fully implementing it, stood close to 30 percent, similar to the percentage in FY22.

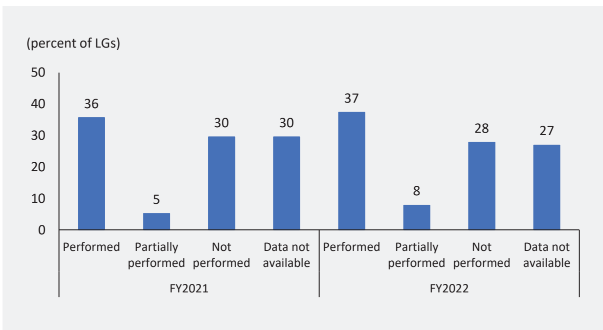
Figure 3.11. Percentage of local governments preparing and fully implementing internal control systems



Note: Percentage based on the total of local governments under each type

Source: MoFAGA and World Bank staff calculations

Figure 3.12. Percentage of local governments performing and not-performing internal audit



Note: Percentage based on the total of local governments under each type

Source: MoFAGA and World Bank staff calculations

There were slight improvements in the internal audit status among the 115 sampled local governments, but there is still ample room for improvement in this area. According to Clause 77(2) of the Local Government Operation Act, an internal audit is required after the completion of every quarter. Similarly, Clause 33(4) of the federal Fiscal Procedures and Financial Accountability Act states that an internal audit is to be undertaken quarterly. Of the 115 local governments sampled, 37 percent performed an internal audit in FY22, a marginal increase from 36 percent in FY21 (Figure 3.12). Similarly, the percentage of local governments that partially performed internal audits increased from 5 percent in FY21 to 8 percent in FY22, while the percentage of local governments that did not perform an internal audit decreased marginally by 1 percentage point to 28 percent in FY22. Data was not available for 27 percent of local governments in FY22.

The performance of Provincial Public Accounts Committees (PACs) remains uneven across different provinces. The audit reports issued by the Office of the Auditor General are submitted to provincial chiefs, PLG legislatures (Assemblies), and their respective Accounts Committees. While all provinces have established PACs, there are variations in the functionality of these committees across the seven provinces. For instance, the fifth OAG report (2023) highlighted that the PAC in Sudurpashchim was formulated to discuss the key issues highlighted in the OAG report. Similarly, the PAC in Karnali met and discussed the second and third OAG reports (2021 and 2022). The irregularities mentioned in the first OAG report (2018) were addressed by the PAC of Madhesh. However, according to the OAG reports from 2018 to 2023, no active implementation of Provincial PACs was reported for Bagmati, Gandaki, Koshi, and Lumbini provinces.

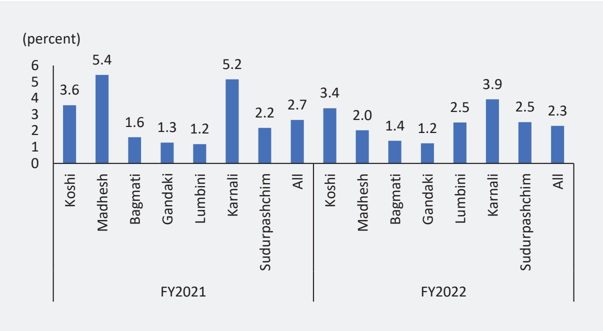
While some progress has been made, internal audit and oversight mechanisms at the PLG level need significant improvement. While there was a slight improvement reported in the internal audit at the local level in the sampled 115 municipalities, more than 50 percent of local governments still have not conducted an internal audit or the status was not available. Furthermore, the status of oversight mechanisms, such as the Accounts Committees, was unknown; the status update obtained from the OAG reports of the provincial PACs in 2022 and 2023 indicated the need for further support to enhance their functionality. It is recommended that concerned federal government agencies, such as the MoFAGA, MoF, and PCGG at the provincial level, as well as development partners, provide further support to enhance this mechanism.

3.5 Audit irregularities at both provincial and local levels decreased

Audit irregularities of all provincial governments decreased in FY22. The Office of the Auditor General reports a decrease in provincial government audit irregularities to 2.3 percent of the audited amount in FY22, a 0.4 percentage point improvement from 2.7 percent in FY21 (Figure 3.13). Notably, all provinces, except Lumbini and Sudurpashchim, saw a decline in irregularities. Among the provinces, Karnali had the highest audit irregularities of 3.9 percent in FY22.

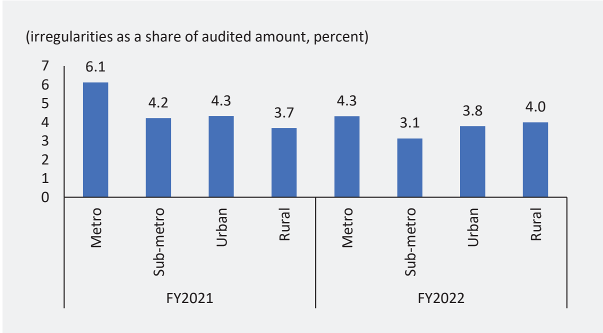
Audit irregularities of local governments as a share of the audit amount also decreased marginally in FY22. Audit irregularities of local governments dropped from 4.1 percent of the audit amount in FY21 to 3.9 in FY22 (Figure 3.14). Audit irregularities decreased for all municipality types, except rural municipalities, in FY22. Metropolitan cities experienced the largest decrease of 1.8 percentage points in FY22.

Figure 3.13. Audit irregularities as share of audited amount for provinces



Source: NNRFC, OAG, and World Bank staff calculations

Figure 3.14. Audit irregularities as share of audited amount for all local governments by municipality type

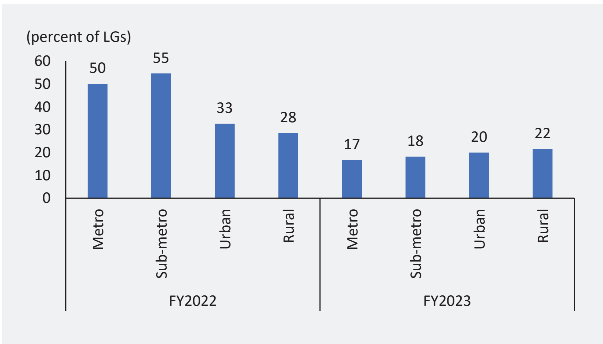


Source: NNRFC, OAG, and World Bank staff calculations

3.6 Compliance with preparing and publishing the annual budget execution report deteriorated for local governments, while public hearings improved

At the provincial level, there was improvement in terms of preparing and making the annual budget execution report public within the legally stipulated timeline. Provinces are required to make the report public within three months of the end of the fiscal year. According to NNRFC data, the number of provinces that complied with this provision increased from five in FY22 to six in FY23. In addition, of the seven provinces, four (Koshi, Madhesh, Bagmati, and Lumbini) were unable to submit the consolidated Annual Financial Statement by the stipulated date. Data were not available for other three provinces. Madhesh continued to be the only province that did not comply with this requirement in both FY22 and FY23.

Figure 3.15. Percentage of local governments preparing and making the annual budget execution report public within the legally stipulated timeline



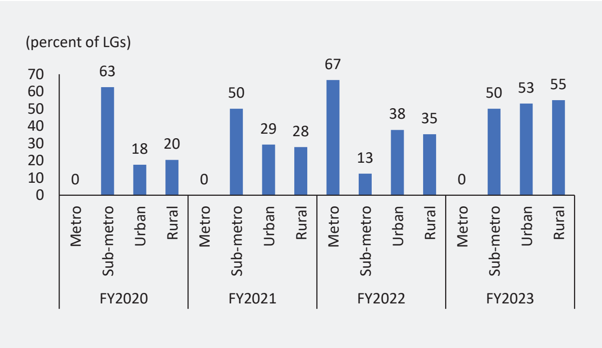
Source: NNRFC, OAG, and World Bank staff calculations

However, there was a deterioration in compliance by local governments with the same provision. NNRFC data shows that only 20.8 percent out of 753 local governments complied with this requirement, which is down significantly from 30.5 percent in FY22 (Figure 3.15). The decline is broad-based across municipality types, with decreases of 33.3, 36.4, 12.7, and 7 percentage points for metropolitan cities, sub-metropolitan cities, urban municipalities, and rural municipalities, respectively.

Public hearings have improved at the local level, as mandated by the Inter-Governmental Fiscal Arrangement Act (2017). According to this Act, project income and expenditure details, implementation progress, targets, achievements, performance status, and the contributions of beneficiaries must be presented during public hearings, at which relevant stakeholders are present. The LISA indicator related to public hearings at the local level shows that 53.8 percent of 444 local governments conducted at least one public hearing every four months in FY23, a significant increase from 36 percent in FY22 (Figure 3.16a). Furthermore, 13.5 percent of local governments conducted two public hearings during the evaluation period (Figure 3.16b), while the remaining 32.7 percent of local governments conducted only one public hearing during the same period. In terms of the variation across the municipality types, while Figure 3.16a shows that rural municipalities that performed public hearings had improved trends from FY20 to FY23, Figure 3.16b highlights that metropolitan municipalities saw the greatest increase.

To improve transparency on the PFM performance of PLGs, the relevant regulatory framework needs to be amended to authorize the federal government to make the disaggregated PFM related data of PLGs publicly available. PFM-related data, currently collected through systems like SuTRA and the Provincial Financial Management Information System, allows for the analysis of the country's overall PFM situation. However, concerns about PLG autonomy have prevented its disaggregated public disclosure. Amending the Fiscal Procedure and Financial Accountability Act is recommended to enable the federal government to make the disaggregated PLG PFM data publicly available. This is crucial for increased transparency, oversight, management and monitoring of the IGFT system, and to enhance informed decision-making regarding the fiscal situation of PLGs.

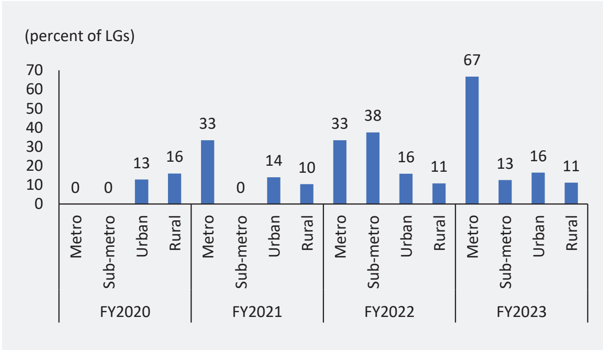
Figure 3.16a. Percentage of local governments conducting at least one public hearing every four months



Note: Percentage based on the total of local governments under each type

Source: MoFAGA and World Bank staff calculations

Figure 3.16b. Percentage of local governments with two public hearings during the evaluation period



Note: Percentage based on the total of local governments under each type

Source: MoFAGA and World Bank staff calculations

CHAPTER 4

Key Recommendations from the NFFU 2024

The key recommendations of this report build on the progress achieved since the last NFFU and the remaining gaps. They refer to reforms or amendments in the legal framework, reinforcement of the IGFT system, facilitating economic and PFM-related data production and access, reform of the procurement system, strengthening PFM and procurement capacity, and reinforcement of PLGs' budget credibility. The recommendations are summarized in Table 4.1, along with a proposed level of priority (short and medium term) based on their feasibility, impact, and sequencing.

Table 4.1. Progress on implementation of recommendations in NFFU 2023, and summary of key recommendations in NFFU 2024

Recommendations in NFFU 2023	Recent Developments Since March 2023	Recommendations in NFFU 2024	Responsible Institutions
Short term			
Fiscal federalism and PFM reform national strategies			
Develop a fiscal federalism roadmap based on relevant government strategies, such as the Public Financial Management strategy (2017) and Capacity Development Action Plan on Fiscal Federalism (2022).	The MoF FFCD was designated to coordinate preparation of the update of the PFM reform strategy. The FFCD has the mandate to prepare the Fiscal Federalism Roadmap. The FFCD is advancing these commitments.	**Develop, validate, and implement the fiscal federalism roadmap.** While the FFCD is committed to developing the roadmap, this NFFU reiterates the importance of preparing it through a consultative process that involves provincial and local governments and swiftly advancing its implementation.	MoF (lead agency) in coordination with the National Natural Resources and Fiscal Commission (NNRFC), National Planning Commission (NPC) and PLGs
Legal framework amendments			
		Pass updated Fiscal Procedures and Financial Accountability Acts, aligned with the corresponding federal-level framework, in the five remaining provinces.	Provincial Ministries of Finance and Economic Affairs (PMoFEA)
IGFT System			
Reinforce the IGFT System to make transfers more flexible, clear, and timely, as well as increasingly performance-based. More specifically, do the following: a. Update the methodology for calculating FEGs. b. Limit earmarking in conditional grants as part of the transition towards the principle of sectoral block grants.	a. The NNRFC has been reviewing the FEG formula, aiming to have a more transparent and user-friendly methodology that better reflects the evolution of the situation of PLGs. b. No significant progress has been made on the flexibilization of conditional grants.	**Upgrade institutional arrangements for IGFTs** **to make the transfers more needs-based, clear, and timely, and increase the fiscal autonomy of PLGs. In addition to the recommendations in NFFU 2023, this report recommends the following:** a. Establish a transparent, consultative process and technical methodology for determining the divisible pool for IGFTs to help increase the predictability of the financial resources. b. Conclude and implement the review of the FEG formula.	a. MoF (lead agency) in coordination with NNRFC, NPC, line ministries and PLGs b. NNRFC (lead agency) c. MoF (lead agency) in coordination with NNRFC, NPC, line ministries and PLGs

Recommendations in NFFU 2023	Recent Developments Since March 2023	Recommendations in NFFU 2024	Responsible Institutions
c. Strengthen the inter-governmental coordination mechanism among the key fiscal institutions of the MoF, NNRFC, and NPC.	c. While the NPC and NNRFC have emphasized the need to enhance coordination regarding these four types of grants, no significant measures have been taken to address this point	c. Improve the design and implementation of conditional grants by: ➢ Reducing CGs and increasing FEGs to enable PLG planning and decision-making according to bottom-up needs ➢ Maintaining CGs only for federal responsibilities implemented through PLGs and for areas of PLG responsibilities where international commitments exist ➢ Allocating CGs based on clear criteria and transparent procedures, including aligning allocations with PLGs' needs by improving vertical coordination ➢ Determining and publishing the amount of CGs earlier in the fiscal year to facilitate planning and more efficient execution	
Access to PFM-related data			
Establish a consolidated PFM performance database to enhance monitoring and evaluation of the overall performance of PLGs in relation to public financial management.	The NNRFC's performance indicators and the Ministry of Federal Affairs and General Administration's (MoFAGA's) Local Government Institutional Capacity Self-Assessment (LISA) data are publicly available. The LISA data also includes some PFM performance information at the local level. However, more needs to be done in terms of creating a consolidated PFM database.	**In addition to establishing a consolidated PFM performance database (NFFU 2023 recommendation), enable the PFM data of PLGs to be published by the federal government** by amending the federal Fiscal Procedures and Financial Accountability Act to authorize the federal government to disclose disaggregated PFM data collected by PLGs through their centrally managed information management systems.	MoF (lead agency) in coordination with FCGO, NNRFC, and National Statistics Office (NSO)

Recommendations in NFFU 2023	Recent Developments Since March 2023	Recommendations in NFFU 2024	Responsible Institutions
Procurement related reforms			
		Conduct a comprehensive MAPS[49] assessment of public procurement. This will help in making informed decisions and introducing necessary procurement reforms involving eGovernment procurement and institutional and regulatory frameworks in the context of federalism.	Public Procurement Monitoring Office
Medium term			
Clarification of concurrent responsibilities			
Amend the legal framework to clarify the concurrent and shared responsibilities among three tiers of government.	The OPMCM has been reviewing the Unbundling Report. Several sectoral acts and policies are under review, such as the Education Bill and the Water Supply, and Sanitation Regulation.	**Approve and implement the reviewed Unbundling Report and pass the sectoral acts to clarify the concurrent responsibilities** among the three tiers of government related to expenditure assignments and revenue from natural resources.	Office of Prime Minister and Council of Ministers (lead agency) in coordination with line ministries and Federal Parliament
PFM and procurement capacity			
Strengthen the capacity of PLGs' PFM human resources to carry out the required functions.	Various capacity-building efforts are being undertaken by the government and development partners. While concerned federal agencies and training institutes, are actively providing training to PLG staff to bolster PFM-related technical expertise, there is a need to harmonize capacity building efforts among the key institutions such as PCGGs, Nepal Administrative Staff College (NASC), and PFM training academy.	**Strengthen internal audit and oversight mechanisms of provincial and local governments** by providing training on these areas, increasing human resources, and establishing institutional oversight mechanisms such as the Account Committees of PLGs. In addition, strengthen the procurement capacity of PLGs.	MoFAGA (coordinating agency) in coordination with PCGGs and the Office of the Auditor General (OAG)

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Recommendations in NFFU 2023	Recent Developments Since March 2023	Recommendations in NFFU 2024	Responsible Institutions
		Strengthen the revenue divisions of Provincial Ministries of Finance and Economic Affairs (PMoFEAs) to effectively perform revenue management roles and increase provincial level own-source revenue.	PMoFEAs
Budget credibility			
Reinforce systems to improve budget credibility and service delivery of PLGs by strengthening: a) The alignment of periodic development plans, MTEFs, and annual budgets b) Cash management systems c) Provincial Appropriations Acts by setting limits on the amount for budget sub-heading 'Economic Miscellaneous'	No significant progress has been made on this recommendation.	**In addition to the NFFU 2023 recommendations on this topic, improve budget credibility by:** a) Reviewing the Provincial Appropriations Acts and amending virement rules to restrict extensive administrative reallocations b) Enhancing the capacity of local governments to adhere to the Intergovernmental Fiscal Arrangement Act 2017 and Local Government Operations Act 2017, particularly concerning the formulation of periodic development plans, MTEFs, and annual development programs c) Standardizing budget speeches by developing guidelines or templates for consistent content and format to allow comparability across all local governments	Provincial line ministries, PCGGs, and Provincial Planning Commissions
Developing local-level GDP data			
		Develop and implement a system for generating local-level GDP data.	NSO

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Annexes

Annex 1. List of Key Stakeholders Consulted

Government Agencies	Civil Society Organizations, Academia, and Think Tanks	Development Partners
Bhaktapur Municipality	Accountability Lab Nepal	Asian Development Bank
Suddhodhan Rural Municipality, Lumbini Province	Centre for Social Change (CSC)	European Union
Pariwartan Municipality, Lumbini Province	Centre for Innovative Governance Practices (CIGP)	Embassy of Switzerland
Modi Municipality, Gandaki Province	Freedom Forum	Norwegian Embassy
Mahashila Municipality, Gandaki Province	International Institute for Democracy and Electoral Assistance (IDEA)	United Nations Development Program
Financial Comptroller General Office	Kathmandu University	Deloitte Touche Tohmatsu Nepal (Delegated by United States Agency for International Development)
Lalitpur Metropolitan City, Bagmati Province	Nepal Institute for Urban and Regional Studies	
Lumbini Provincial Government: Ministry of Finance and Economic Affairs, PTCO, Provincial Service Commission, Provincial Planning Commission	Society of Economic Journalists-Nepal (SEJON)	
Gandaki Provincial Government: Ministry of Finance and Economic Affairs, PTCO, Provincial Service Commission, Gandaki Province Training Academy	South Asia Watch on Trade, Economics and Environment (SAWTEE)	
Ministry of Finance	The Asia Foundation	
Ministry of Federal Affairs and General Administration	Tribhuvan University	
Nepal Rastra Bank		
National Planning Commission		
Office of the Auditor General		
Office of the Prime Minister and Council of Ministers		
Public Accounts Committee		
Public Procurement Monitoring Office		
PEFA Secretariat		
Public Debt Management Office		
State and Good Governance Committee		
National Natural Resources and Fiscal Commission		
Bhaktapur Municipality, Bagmati Province		
Suddhodhan Rural Municipality, Lumbini Province		
Pariwartan Municipality, Lumbini Province		

Annex 2a. List of 115 Municipalities Sampled in OAG Analysis

S.N.	Province	Local Governments
1.	**Koshi**	Bhojpur UM; Chhathar Jorpati RM; Shahidbhumi RM; Chathar RM; Mangsebung RM; Jhapa UM; Buddhashanti UM; Kapilasgadhi RM; Pathari Shanischare; UM;, Rangeli UM; Biratnagar Metro; Molung RM; Kummayak RM; Phidim UM; Chichila RM; Inaruwa UM; Itahari SM; Dharan SM; Mikwakhola RM; Sidingba RM; Triyuga UM (21)
2.	**Madhesh**	Pachrauta UM; Kalaiya SM; Jeetpur Simara SM; Laxminiya RM; Janakpur SM; Matihani UM; Sakhuwa Parsauni RM; Paterwa Sugauli RM; Pokhariya UM; Birgunj Metro; Durga Bhagawati RM; Maulapur UM; Gujara UM; Gaur UM; Agnisair Krishna Savaran RM; Rajgadha RM; Kaudena RM; Brahmapuri RM; Kabilasi UM; Nawarajpur RM; Sukhipur UM; Karjanha UM (22)
3.	**Bagmati**	Kalika UM; Bharatpur Metro; Benighat Rorang RM; Siddhalek RM; Nilakantha UM; Kalinchok RM; Jiri UM; Temal RM; Dhulikhel UM; Budhanilkantha UM; Kathmandu Metro; Lalitpur Metro; Bhimphedi UM; Hetauda UM; Shivapuri RM; Likhu RM; Sunapati RM; Tripurasundari RM; Helambu RM; Barhabise UM (20)
4.	**Gandaki**	Kanthe Khola RM; Tara Khola RM; Jaimini UM; Pokhara Lekhnath Metro; Bulingtar RM; Gaidakot UM; Kawasoti UM; Magashila RM; Modi RM; Anbukhairani RM; Rishing RM; Bandipur RM (12)
5.	**Lumbini**	Chhatradev RM; Narainapur RM; Nepalgunj SM; Badhaiyatal RM; Bansgadhi UM; Thakurbaba UM; Ghorahi SM; Tulsipur SM; Ruru RM; Dhurkot RM; Suddhodan RM; Butwal SM; Krishnanagar UM; Mathagadhi RM; Tansen UM; Madavi RM; Pariwartan RM; & Bhume RM (18)
6.	**Karnali**	Chharka Tangsong RM; Dolpo Buddha RM; Tripurasundari UM; Tajakot RM; Patarasi RM; Pachalijharana RM; Tilagufa UM; Khatyad RM; Chaurjahari UM; Chaukune RM (10)
7.	**Sudurpashchim**	Dhakari RM; Bannigadhi Jayagadh RM; Sunarya RM; Patan UM; Bungal UM; Himali RM; Jagannath RM; Bogtan RM; Chure RM; Lamkichuha UM; Dhanagadhi SM; Krishnapur UM (12)

Note: RM = Rural Municipality; UM = Urban Municipality; SM = Sub-Metropolitan; Metro = Metropolitan City

Annex 2b. List of 444 Municipalities Sampled in LISA Analysis

S.N.	Province	Local Governments
1.	**Koshi**	Mauwakhola RM; Pathibhara Yangwarak RM; Silichong RM; Chainpur UM; Soludhudkunda UM; Chinssugadi RM; Siddhi Charan UM; Manebhangyang RM; Aaiselukharka RM; Rawa Besi RM; Halasituwangchung UM; Diktel Rupakot Majhuwagadhi UM; Tyamkemaiyum RM; Arun RM; Pauwadungma RM; Ramprasadrai RM; Hatuwagadi RM; Aamchok RM; Mahalaxmi UM; Pakriwas UM; Dhankuta UM; Khalcha Chintang Sahidbhumi RM; Sagurigadi RM; Yangwarak RM; Hilihang RM; Phidim UM; Phalgunanad RM; Kummayak RM; Tumwewa RM; Maigokmai RM; Sandakpur RM; Illam UM; Deumai UM; Phakphokthum RM; Mangsebung RM; Chulachuli RM; Mai UM; Shuryodaya UM; Rong RM; Buddhashanti RM; Aarjundahara UM; Kankai UM; Kamal RM; Damak UM; Gaurigunj UM; Gauradaha RM; Jhapa RM; Baradarshi RM; Biratamod UM; Haldibaari RM; Bhadrapur UM; Kachankawal RM; Letang UM; Kerabari RM; Kanepokhari RM; Shanischhare UM; Urlabari UM; Ratuwamai UM; Gramthan RM; Budiganga RM; Biratnagar Metro; Dharan SM; Baraha UM; Koshi RM; Harinagar RM; Ramdhuni UM; Itahari SM; Duhawi UM; Gadhi RM; Inarwa UM; Bhokraha RM; Dewangunj RM; Barju RM; Belka UM; Chaudandigadhi UM; Triyuga UM; Rautaami RM; Sunkoshi RM; Udayourgadi RM (79)
2.	**Madhesh**	Saptakoshi UM; Kanchanrup UM; Agnisair Krishnasabaran RM; Rupeni RM; Surunga UM; Bodebarsign UM; Dakneshwori UM; Hanumaannagar Kaankalini UM; Dhangadhimaai UM; Mechaiya UM; Karnjhaa UM; Naraha RM; Bishnupur RM; Arnama RM; Sukhipur UM; Ganeshman Charnath UM; Dhanusadham UM; Mithila Bihari UM; Bateshwor RM; Laxminiya RM; Mithila UM; Sahidnagar UM; Janaknandini RM; Hariban UM; Bagmati UM; Barhathawa UM; Haripur UM; Brahmapuri RM; Kabilashi UM; Basbariya RM; Dhankaul RM; Godaita UM; Madhavnarayan UM; Karaiyamai RM; Thori RM; Jirabhawani RM; Birjung Metro; Bahudarmai UM (38)
3.	**Bagmati**	Baiteshwor RM; Tamakoshi RM; Melung RM; Shailung RM; Bhimeshwor UM; Bhotekoshi RM; Jugal RM; Panchpokhari RM; Melumchi UM; Barabise UM; Lishankhu RM; Sunkoshi RM; Uttargaya RM; Jagannath RM; Naukunda RM; Khaniyabas RM; Netrawati Dabajong RM; Nilakantha UM; Jawalamukhi RM; Shidlekh RM; Benighat Rorang RM; Galchhi RM; Thakre RM; Dhunibesi UM; Dupcheshwor RM; Tadi RM; Surya Gadhi RM; Bidur UM; Kispang RM; Belkot Gadhi UM; Likhu RM; Panchakanya RM; Shibhapuri RM; Kakani RM; Shankarapur UM; Budhanilkantha UM; Tokha UM; Kirtipur UM; Chandragiri UM; Dakshinkali UM; Changunarayan UM; Bhaktapur UM; Suryabinayak UM; Mahalaxmi UM; Konjyosom RM; Mahankal RM; Bagmati RM; Chauridaurali RM; Bhumlu RM; Madandeupur UM; Bnepa UM; Dhulikhel UM; Panchakhal UM; Temal RM; Nomabuddha UM; Panauti UM; Bethanchwok RM; Rosi RM; Mahabharat RM; Gokulganga RM; Manthali UM; Dudhauli UM; Phikal RM; Tinpatan RM; Golanjor RM; Kamalmai UM; Sunkoshi RM; Ghyanglekh RM;Marin RM; Hariharpurgadi RM; Indrasarowar RM; Hetauda SM; Bhimphedi RM; Bagmati RM; Kalika UM; Ichhaykamana RM; Bharatpur Metro; Ratannagar UM; Khaireni UM; Maadi UM (80)

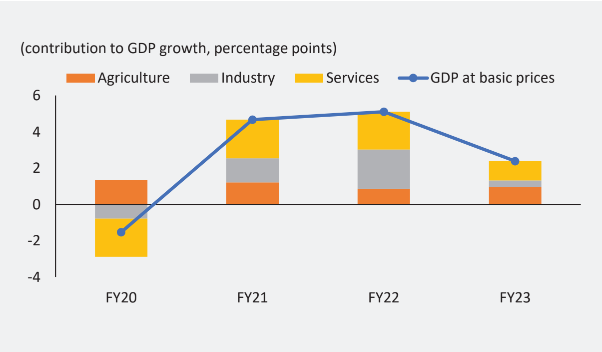
4.	**Gandaki**	Chumanubri RM; Ajirkot RM; Barpak Suliko RM; Darche RM; Aarughat RM; Bhimsenthapa RM; Shiranichwok RM; Palungtar UM; Gorkha UM; Shahid Lakhan RM; Gandaki RM; Manang Ngisyang RM; Chame RM; Nashong RM; Lo-Ghekar Damodarkund RM; Gharpjhon RM; Baragung Muktichhetra RM; Lomthang RM; Thasang RM; Annapurna RM; Mangala RM; Beni UM; Machhapuchre RM; Annapurna RM; Rupa RM; Sundar Bazar UM; Bhanu UM; Shuklagandaki UM; Bhimad UM; Rishing RM; Devghat RM; Aabukhaireni RM; Gaidakot UM; Bulingtar RM; Hupasekot RM; Devchuli UM; Kawasoti UM; Madhyabindu UM; Binayi Tribeni RM; Putalibazar UM; Fedikhola RM; Aadhikhola RM; Arjunchaupari RM; Bhirkot UM; Biruwa RM; Harinas RM; Waling UM; Galyang UM; Kaligandaki RM; Modi RM; Jaljala RM; Falebas UM; Mahasilaa RM; Paiyeu RM; Baglung UM; Kathekhola RM; Tarakhola RM; Tamankhola RM; Dhorpatan UM; Nishikhola RM; Badigaad RM; Galkot UM; Bareng RM; Jaimani UM (64)
5.	**Lumbini**	Sisne RM; Bhume RM; Sunchhahari RM; Paribartan RM; Maadi RM; Triveni RM; Rolpa UM; Runtigadhi RM; Sunilsmiriti RM; Lungri RM; Gaumukhi RM; Naubahini RM; Sworgadwari UM; Mandawi RM; Mallarani RM; Airawati RM; Sarumarani RM; Kaligandaki RM; Satyawati RM; Chandrakot RM; Musikot UM; Ishma RM; Malika RM; Madane RM; Dhurkot RM; Resunga UM; Gulmidurbar RM; Chatrakot RM; Ruru RM; Chatradev RM; Malarani RM; Bhumikasthan UM; Sandhikharka UM; Panini RM; Shitganga UM; Rampur UM; Purbakhola RM; Rambha RM; Bagnaskali RM; Tansen UM; Ribdikot RM; Rainadevi Chhahara RM; Tinau RM; Mathagadi RM; Nimdi RM; Bardaghat UM; Sunwal UM; Ramgram UM; Palinandan RM; Sarawol RM; Pratapur RM; Susta RM; Bevdaha UM; Butwal SM; Sainnamainna UM; Kanchan RM; Gaidahawa RM; Suddhodhan RM; Siyari RM; Tilotama UM; Omsatiya RM; Rohini RM; Siddharthanagar UM; Mayadevi RM; Lumbini Sanskritik UM; Bannganga UM; Buddhabhumi UM; Shivaraj UM; Bijayanagar RM; Krishnanagar UM; Maharajganj UM; Yashodhara RM; Shuddhodhan RM; Bangalachuli RM; Ghorahi SM; Tulsipur SM; Shantinagar RM; Babai RM; Dangisharan RM; Lamahi UM; Rapti RM; Kohalpur UM; Baijnath RM; Khajura RM; Janaki RM; Nepaljung SM; Duduwa RM; Thakurbaba UM; Geruwa RM; Badhaiyatal RM (90)
6.	**Karnali**	Soru RM; Patarasi RM; Kankasundari RM; Sinja RM; Guthichaur RM; Hima RM; Narharinath RM; Khadachakra UM; Tilagufa UM; Mahabai RM; Shubh Kalika RM; Narayan UM; Dungeswor RM; Sanibheri RM; Baafikot RM; Musikot UM; Triveni RM; Chaurjahari UM; Chingad RM; Lekbesi UM; Gurbhakot UM; Bheriganga UM (22)
7.	**Sudurpashchim**	Himali RM; Gaumul RM; Budhinanda UM; Swamikartik Kaapar RM; Jagannath RM; Badimalika UM; Kjapada Chededaha RM; Budiganga UM; Tribeni UM; Kanda RM; Shurma RM; Talakot RM; Masta RM; Jataprithvi UM; Chhabispathibheri RM; Durgathali RM; Kedarsiu RM; Bithdachir RM; Thalara RM; Kaptadchhatra RM; Mahakali UM; Naugaad RM; Apihimal RM; Marma RM; Shailyashikhar UM; Dogadakedar RM; Purchaudi UM; Sunarya RM; Dasarathchand UM; Shivanath RM; Melauli UM; Patan UM; Sigaas RM; Navadurga RM; Amargadi UM; Ajaymeru RM; Bhageshwor RM; Parshuram UM; Aalitaal RM; Ganyapadhura RM; Purbachauki RM; Sayal RM; Shikhar UM; Dipayal Silgadi UM; KIC RM; Bogatan Phudsil RM; Badikedar RM; Jorayal RM; Panchadewal Binayak UM; Melakh RM; Safebagar UM; Chaurpati RM; Mangalsen UM; Bannigadi Jayagud RM; Kamalbazzar UM; Dhurmakhand RM; Gauriganga UM; Ghodaghodi UM; Bardgoria RM; Lamikchuha UM; Janaki RM; Joshipur RM; Tikapur UM; Kailari RM; Dhangadi SM; Shuklaphat UM; Bedhkot UM; Bhimdatta UM; Punarbas UM; Belauri UM; Beldadai RM (71)

Note: RM = Rural Municipality; UM = Urban Municipality; SM = Sub-Metropolitan; Metro = Metropolitan City

Annex 3a. Macro-Fiscal Statistics for Provinces (Figures A1–A7)

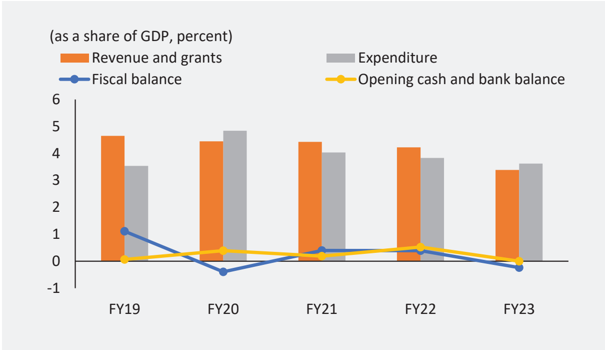
Figure A1. Macro-fiscal statistics for Koshi

Figure A1.a. Contribution of components to overall real GDP growth



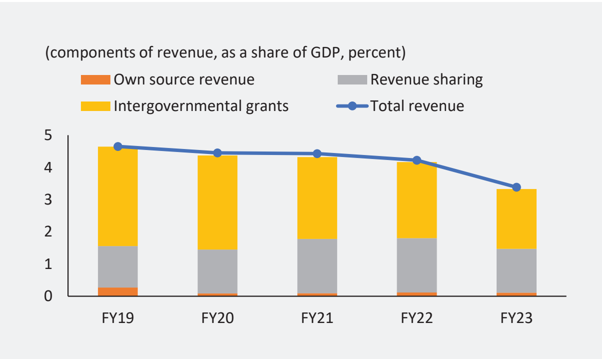
Source: National Statistics Office and World Bank staff calculations

Figure A1.b. Fiscal balance and opening and cash bank balance



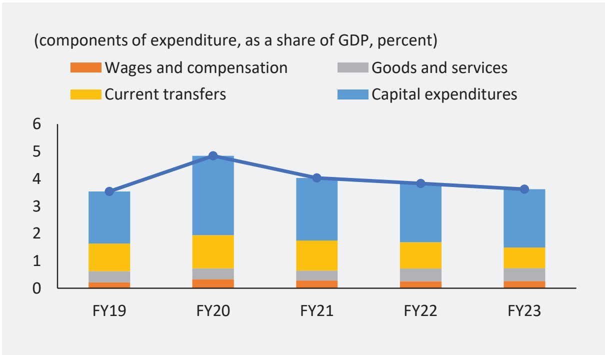
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A1.c. Components of revenue and grants



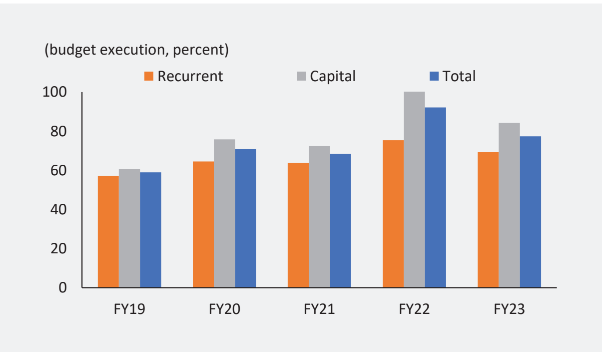
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A1.d. Components of expenditure



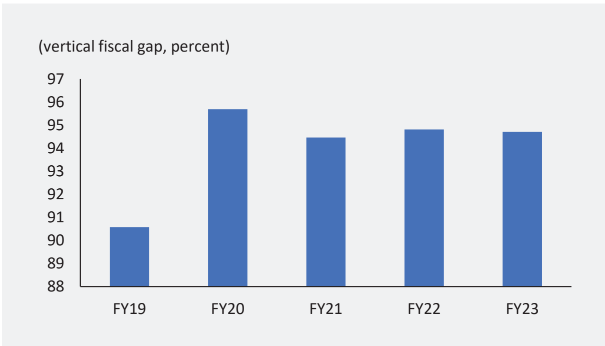
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A1.e. Budget execution



Source: Provincial Budget Speeches and World Bank staff calculations

Figure A1.f. Vertical fiscal gap



Source: Provincial Budget Speeches and World Bank staff calculations

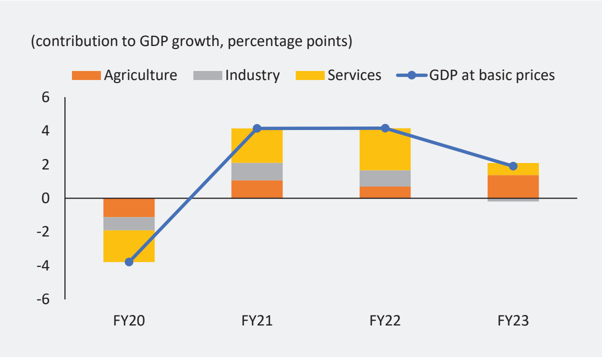
Koshi experienced its lowest GDP growth since FY20 in FY23. The GDP growth (at basic prices) in Koshi slowed from 5.1 percent in FY22 to 2.4 percent in FY23 (Figure A1a). This slowdown reflects a decline in wholesale and trade, manufacturing, and construction activities. In FY23, the service and agriculture sectors each contributed 43.6 and 28.9 percent, respectively, to the province's GDP. The province's share of GDP in the overall national GDP was 15.8 percent in FY23, making it the second-largest share among all seven provinces.

In FY23, Koshi also experienced its first fiscal deficit since FY20. The fiscal deficit stood at 0.2 percent of the province's GDP, a decrease from the surplus of 0.4 percent of GDP in FY22 (Figure A1b). This deficit was primarily driven by a record low in revenue and grants (Figure A1c), amounting to 3.4 percent of GDP, due to a decline in intergovernmental revenue, which includes intergovernmental grants and revenue sharing. Although expenditure also declined, primarily due to lower capital and recurrent expenditure (Figure A1d), it was less than the decrease in revenue. The deficit was financed by opening cash and bank balances from the previous fiscal year (Figure A1b), primarily reflecting unspent revenue sharing and fiscal equalization grants.

The vertical fiscal gap continued to remain large at 95 percent. In FY23, close to 5 percent of own spending (excluding fiscal transfers to local governments) was financed solely by own-source revenue (Figure A1f), as intergovernmental revenue constituted close to 95 percent of overall revenue and grants. Capital spending represented close to two-thirds of Koshi's own spending and 59 percent of its overall spending.

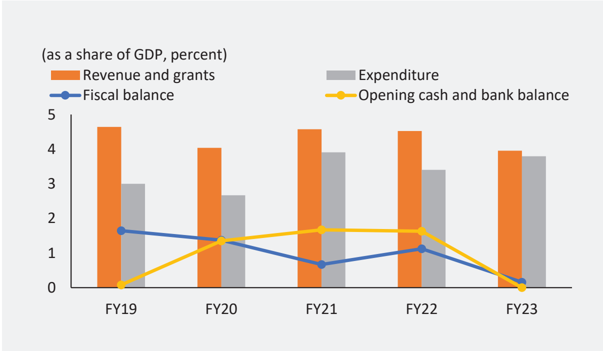
Figure A2. Macro-fiscal statistics for Madhesh

Figure A2.a. Contribution of components to overall real GDP growth



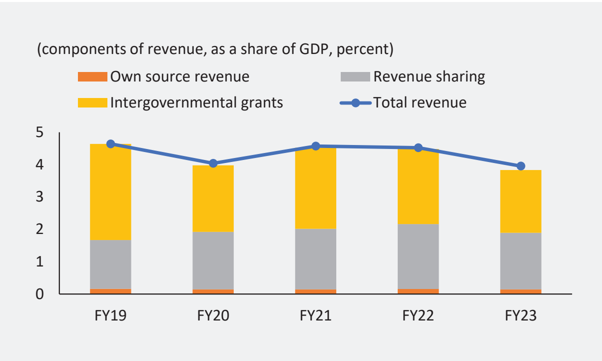
Source: National Statistics Office and World Bank staff calculations

Figure A2.b. Fiscal balance and opening and cash bank balance



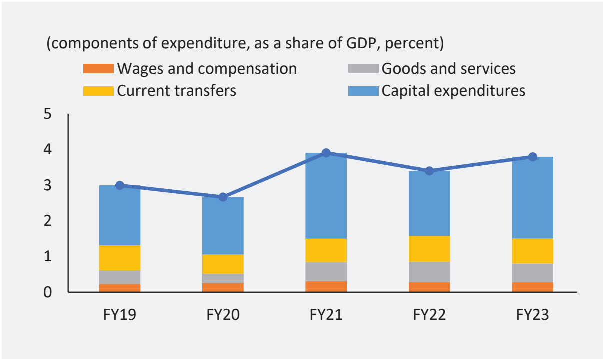
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A2.c. Components of revenue and grants



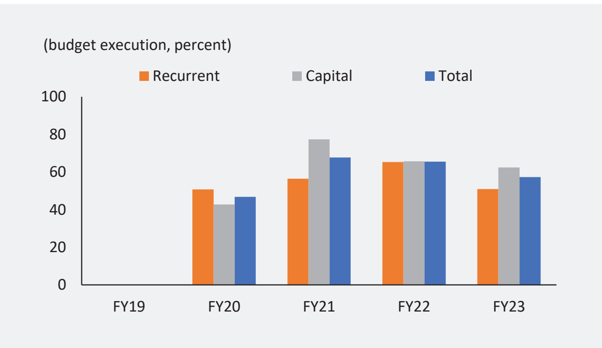
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A2.d. Components of expenditure



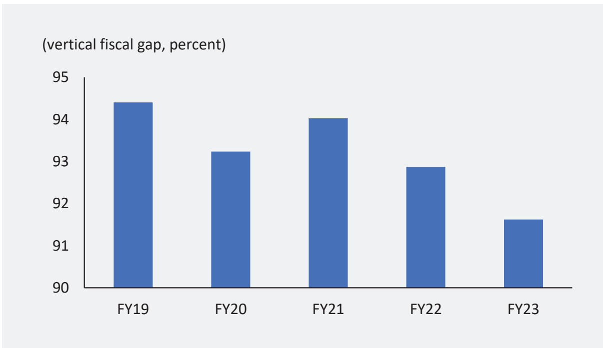
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A2.e. Budget execution



Source: Provincial Budget Speeches and World Bank staff calculations

Figure A2.f. Vertical fiscal gap



Source: Provincial Budget Speeches and World Bank staff calculations

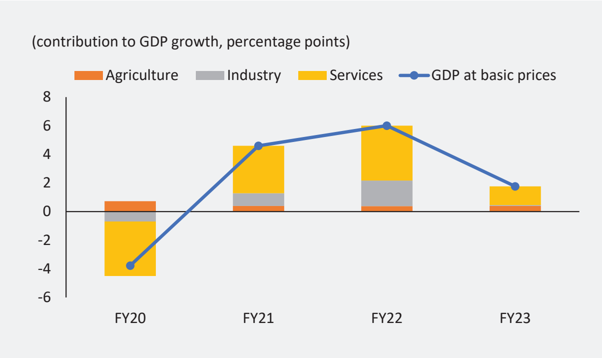
In FY23, Madhesh witnessed its weakest GDP growth since FY20, with its GDP growth rate declining from 4.2 percent in FY22 to 1.9 percent (Figure A2a). This deceleration is attributed to a downturn in wholesale and trade, manufacturing, and construction activities. The service and agriculture sectors contributed 46.4 and 30.6 percent, respectively, to the province's GDP in FY23. Moreover, Madhesh accounted for 13.1 percent of the national GDP, securing the fourth-largest share among the seven provinces.

In contrast to the other six provinces, Madhesh saw a fiscal surplus in FY23. However, the surplus was the lowest since FY19, at 0.2 percent of GDP (Figure A2b). Lower revenue and grants and higher expenditure equally contributed to the narrowing of fiscal surplus. Revenue and grants declined owing to the lower intergovernmental grants and revenue sharing (Figure A2c). In contrast, expenditure increased, driven by higher capital expenditure (Figure A2d).

The vertical fiscal gap persisted at a significant 92 percent. In FY23, nearly 8 percent of Madhesh's own spending (excluding fiscal transfers to local governments) relied solely on own-source revenue (Figure A2f), with intergovernmental revenue making up over 90 percent of total revenue and grants. Capital spending accounted for over 70 percent of Madhesh's own spending and 60 percent of its total expenditure.

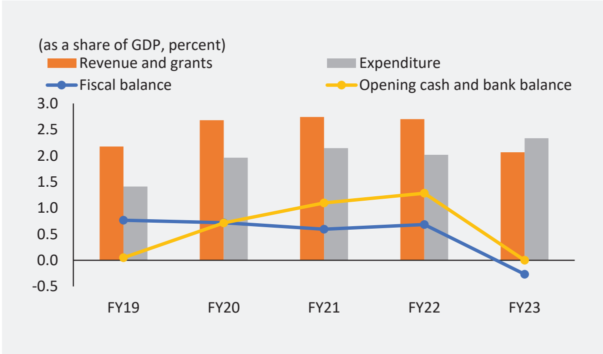
Figure A3. Macro-fiscal statistics for Bagmati

Figure A3.a. Contribution of components to overall real GDP growth



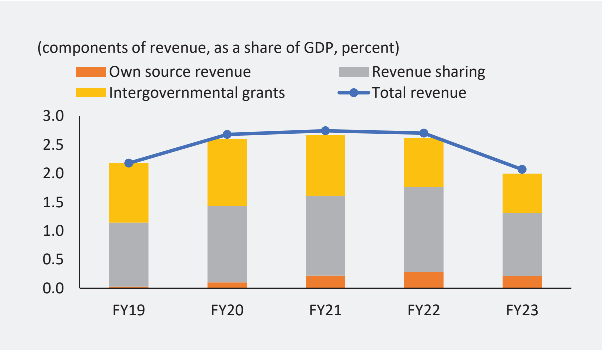
Source: National Statistics Office and World Bank staff calculations

Figure A3.b. Fiscal balance and opening and cash bank balance



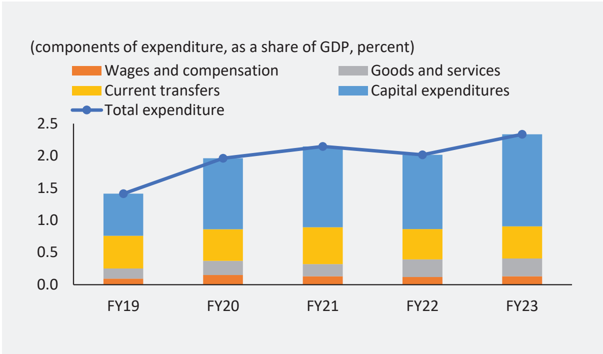
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A3.c. Components of revenue and grants



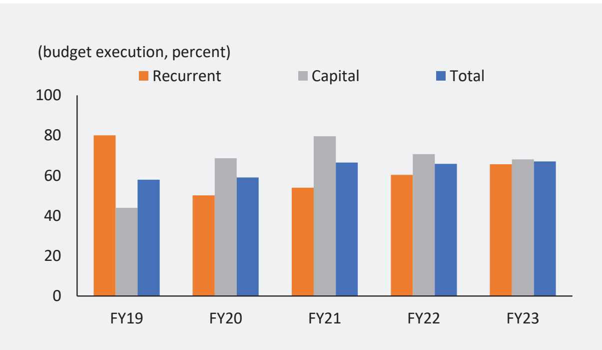
Source: Provincial Budget Speeches and World Bank staff calculations

Fgiure A3.d. Components of expenditure



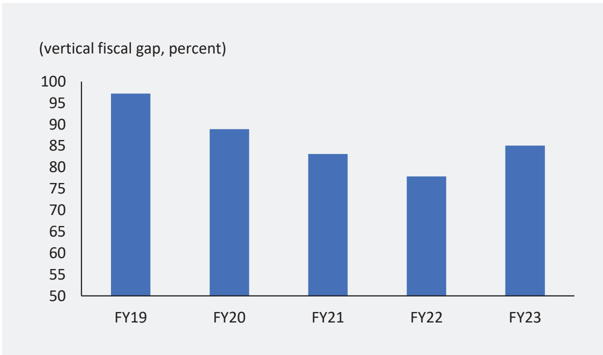
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A3.e. Budget execution



Source: Provincial Budget Speeches and World Bank staff calculations

Figure A3.f. Vertical fiscal gap



Source: Provincial Budget Speeches and World Bank staff calculations

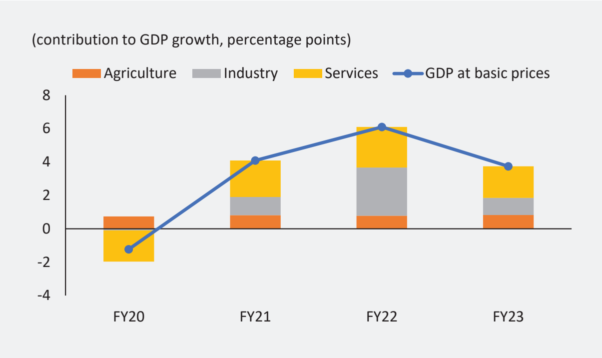
Similar to other provinces, in FY23, Bagmati also experienced its lowest growth since FY20 (Figure A3a). Real GDP growth declined by 4.2 percentage points to 1.8 percent in FY23, marking the largest decline among all provinces. The slowdown in wholesale and trade, manufacturing, and construction activities primarily contributed to this lower pace of growth. Services constituted more than two-thirds of the province's GDP in FY23, with close to one-fourth of the nation's services GDP. Consequently, Bagmati's GDP accounted for close to 37 percent of the national GDP, establishing it as the province with the largest share of national GDP.

Bagmati's fiscal balance shifted into deficit for the first time since FY19. The deficit amounted to 0.3 percent of GDP in FY23 (Figure A3b), primarily driven by a decline in revenue and grants resulting from lower intergovernmental revenue (Figure A3c). However, expenditure increased, mainly due to a rise in capital expenditure (Figure A3d). The deficit was financed by opening cash and bank balances from the previous fiscal year.

The vertical fiscal gap of Bagmati remained the lowest among all of the provinces. In FY23, nearly 15 percent of Bagmati's own spending (excluding fiscal transfers to local governments) relied solely on own-source revenue (Figure A3f), with intergovernmental revenue constituting over 86 percent of total revenue and grants, the lowest proportion among all provinces. Capital spending accounted for over 70 percent of Bagmati's own spending and 61 percent of its total expenditure.

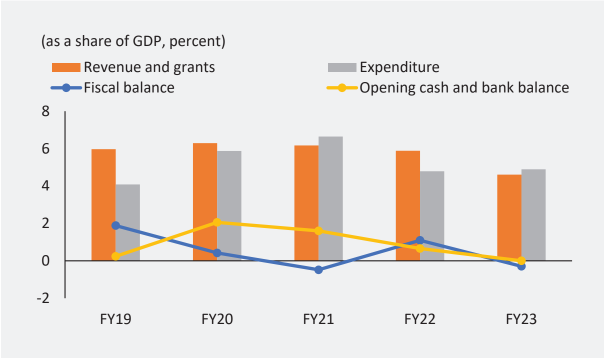
Figure A4. Macro-fiscal statistics for Gandaki

Figure A4.a. Contribution of components to overall real GDP growth



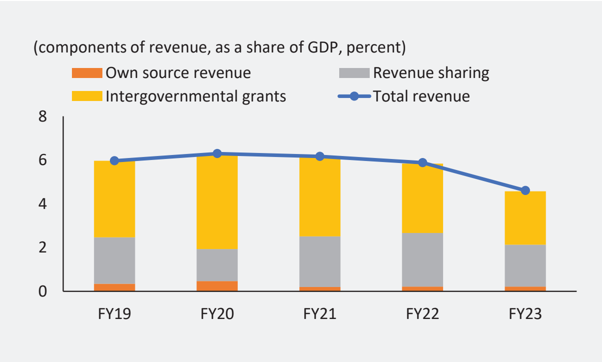
Source: National Statistics Office and World Bank staff calculations

Figure A4.b. Fiscal balance and opening and cash bank balance



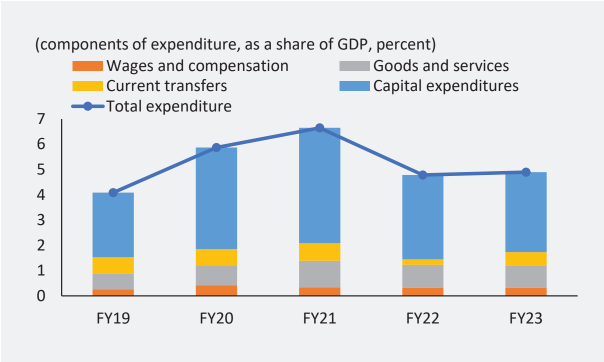
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A4.c. Components of revenue and grants



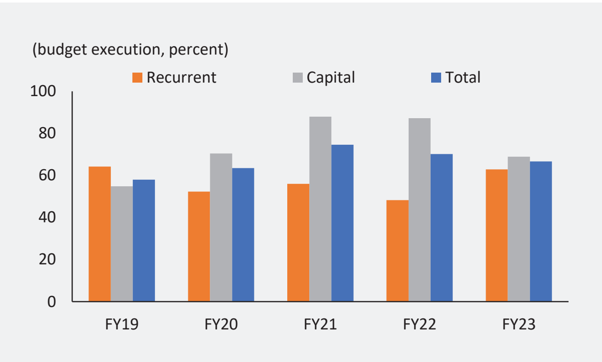
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A4.d. Components of expenditure



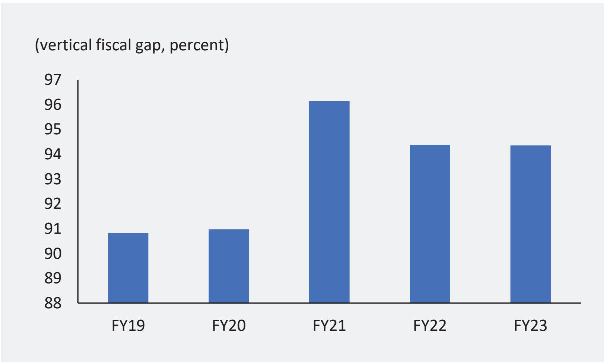
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A4.e. Budget execution



Source: Provincial Budget Speeches and World Bank staff calculations

Figure A4.f. Vertical fiscal gap



Source: Provincial Budget Speeches and World Bank staff calculations

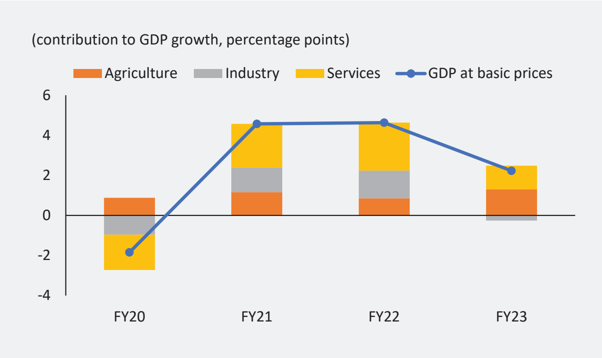
Gandaki's real GDP growth decreased to 3.7 percent in FY23, from 6.1 percent in FY22. The wholesale and trade, manufacturing, and construction sub-sectors were the leading contributors to this pace of growth, the lowest since FY20 (Figure A4a). The services sector contributed close to 50 percent of the province's GDP, and its GDP accounted for less than 10 percent of the national GDP in FY23.

Gandaki registered its second fiscal deficit in less than 3 years in FY23. The deficit stood at 0.3 percent of GDP, a shift from the surplus of 1.1 percent of its GDP in FY22 (Figure A4b), and is due to the decline in revenue and grants by more than 1.3 percentage points of its GDP. Intergovernmental revenue led to a decline in overall revenue and grants (Figure A4c). However, expenditure remained relatively unchanged at 4.9 percent of GDP in FY23 (Figure A4d). The deficit was financed by opening cash and bank balances from the previous fiscal year.

Lower own source revenue led to a continuous elevated vertical fiscal gap. In FY23, nearly 5 percent of Gandaki's own spending (excluding fiscal transfers to local governments) was covered by solely by own-source revenue (Figure A4f), with intergovernmental revenue making up close to 94 percent of total revenue and grants. Capital spending comprised over 70 percent of Gandaki's own spending and 65 percent of its total expenditure.

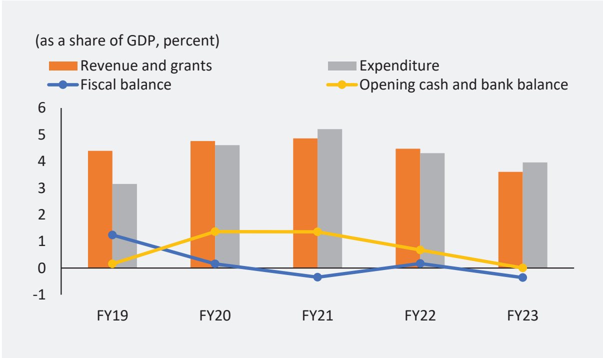
Figure A5. Macro-fiscal statistics for Lumbini

Figure A5.a. Contribution of components to overall real GDP growth



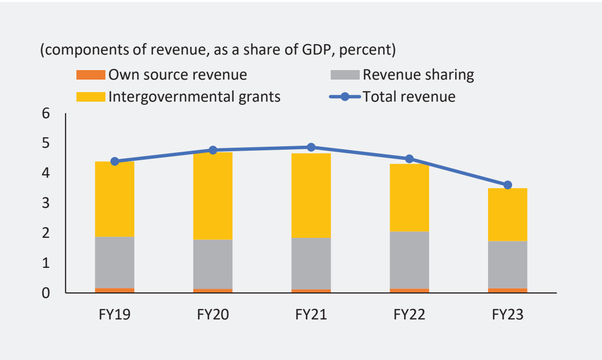
Source: National Statistics Office and World Bank staff calculations

Figure A5.b. Fiscal balance and opening and cash bank balance



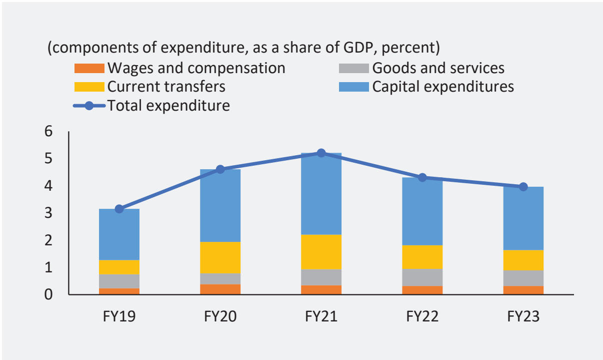
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A5.c. Components of revenue and grants



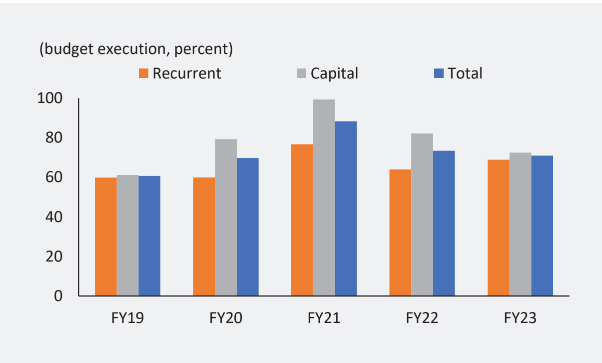
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A5.d. Components of expenditure



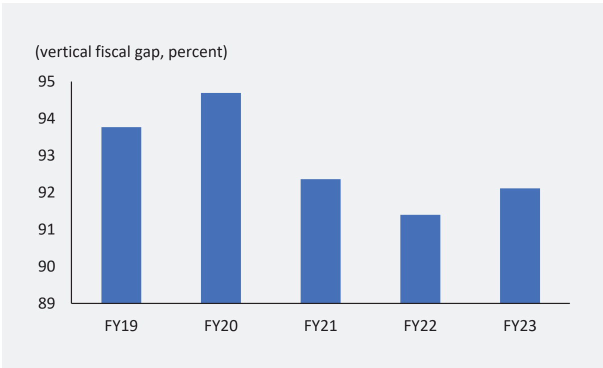
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A5.e. Budget execution



Source: Provincial Budget Speeches and World Bank staff calculations

Figure A5.f. Vertical fiscal gap



Source: Provincial Budget Speeches and World Bank staff calculations

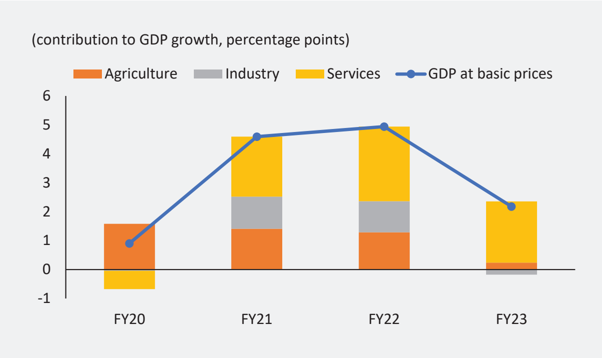
Lumbini's economy slowed down in FY23, experiencing its weakest growth since FY20. Real GDP growth dropped from 4.6 percent in FY22 to 2.2 percent in FY23, reflecting a slowdown in wholesale and retail trade, manufacturing, and construction (Figure A5a). The service and agriculture sectors contributed close to 42 and 32 percent of its GDP, and its share of national GDP was 14.2 percent in FY23 – the third largest among all the provinces.

Following a surplus in FY22, Lumbini experienced a fiscal deficit of 0.4 percent of GDP in FY23 (Figure A5b). This shift was attributed to a decrease in revenue and grants by more than 0.9 percentage points (Figure A5c), with intergovernmental revenue leading the decline. Government spending also decreased, albeit less than revenue, owing to reductions in both recurrent and capital expenditure (Figure A5d). The deficit was financed by opening cash and bank balances from the previous fiscal year.

Similar to other provinces, Lumbini's vertical fiscal gap remained high at more than 90 percent. In FY23, only about 5 percent of its own spending (excluding transfers to local governments) came from its own revenue sources (Figure A5f). Over 93 percent of its overall revenue came from federal transfers and grants. Capital expenditure make up a significant portion of Lumbini's spending – nearly two-thirds of its own spending and 59 percent of its total spending.

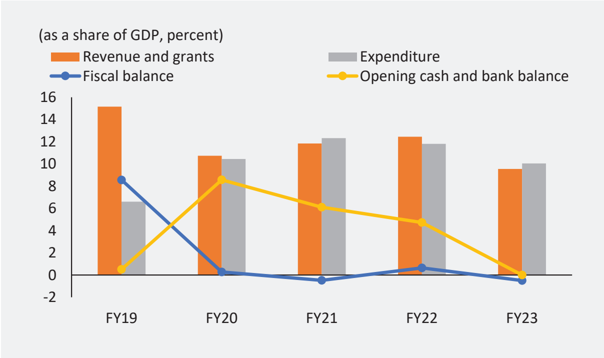
Figure A6. Macro-fiscal statistics for Karnali

Figure A6.a. Contribution of components to overall real GDP growth



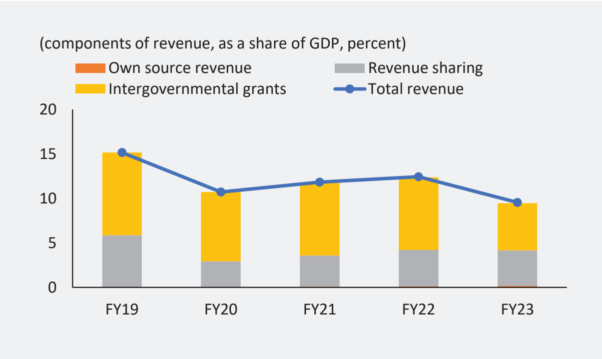
Source: National Statistics Office and World Bank staff calculations

Figure A6.b. Fiscal balance and opening and cash bank balance



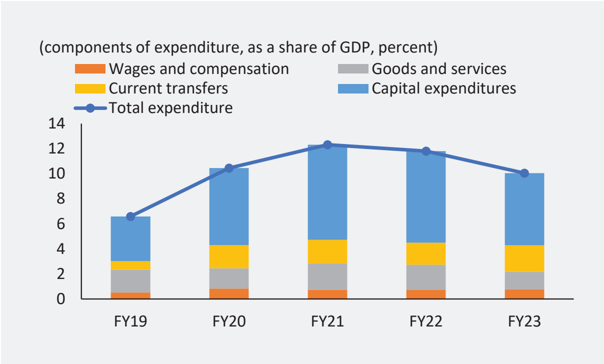
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A6.c. Components of revenue and grants



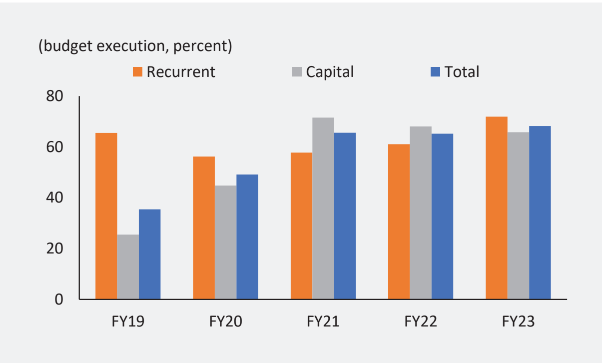
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A6.d. Components of expenditure



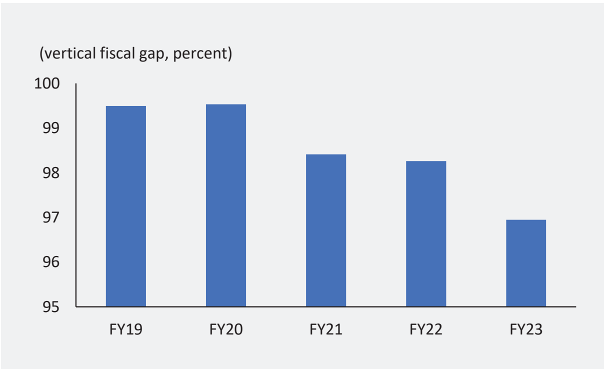
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A6.e. Budget execution



Source: Provincial Budget Speeches and World Bank staff calculations

Figure A6.f. Vertical fiscal gap



Source: Provincial Budget Speeches and World Bank staff calculations

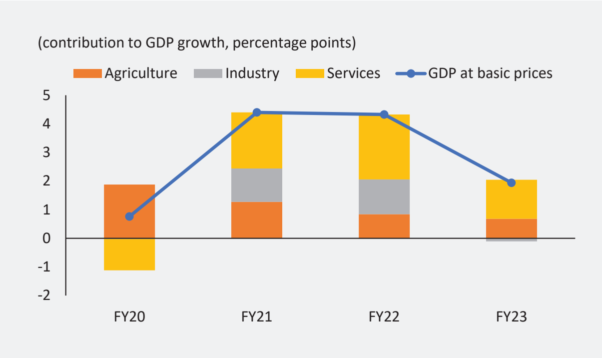
Karnali, which avoided contraction during the COVID-19 pandemic in FY20, also experienced a growth slowdown in FY23 (Figure A6a). Real GDP growth decreased to 2.2 percent in FY23 from 4.9 percent in FY22, primarily due to a slowdown in wholesale and retail trade, construction, and agriculture. The service and agriculture sectors contributed close to 48 and 28 percent, respectively, to its GDP. However, its share of national GDP was at 4.1 percent in FY23, the lowest among all of the provinces.

Karnali experienced a fiscal deficit of 0.5 percent of GDP in FY23, a shift from the surplus of 0.6 percent of GDP in FY22 (Figure A6b). The deficit was driven by a decline in revenue and grants, amounting to 2.9 percentage points of GDP, which more than offset the decrease in expenditure of 1.8 percentage points of GDP (Figures A6c and A6d). The decrease in revenue and grants was attributed to lower fiscal transfers from the federal government, while the reduction in expenditure was primarily due to lower capital spending. The deficit was financed by opening cash and bank balances from the previous fiscal year.

The lower own-source revenue resulted in the second-highest vertical fiscal gap among all provinces in FY23 (Figure A6f). Own-source revenue financed just 3 percent of Karnali's own spending. Over 97 percent of its overall revenue came from federal transfers and grants. Capital expenditure make up a significant portion of Karnali's spending – more than two-thirds of its own spending and 57 percent of its total spending.

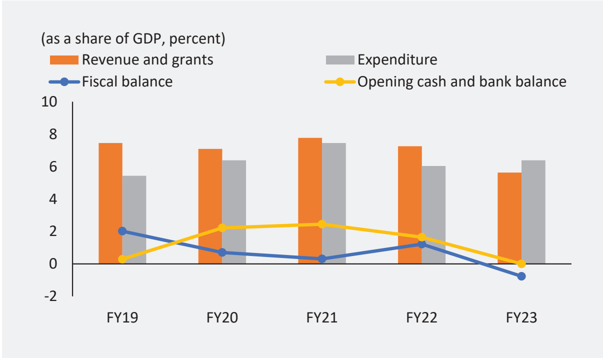
Figure A7. Macro-fiscal statistics for Sudurpashchim

Figure A7.a. Contribution of components to overall real GDP growth



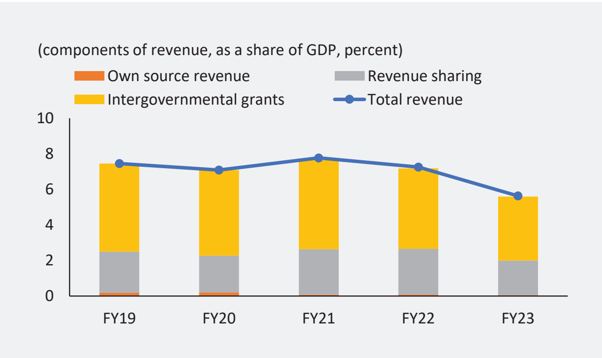
Source: National Statistics Office and World Bank staff calculations

Figure A7.b. Fiscal balance and opening and cash bank balance



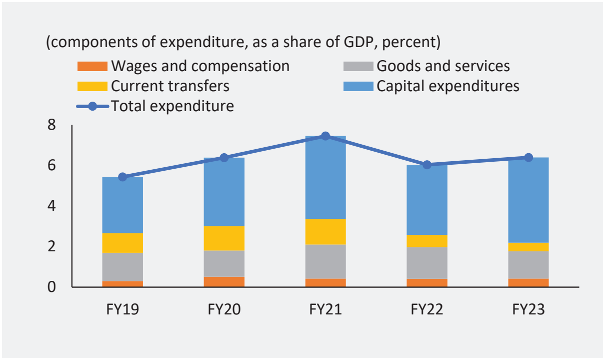
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A7.c. Components of revenue and grants



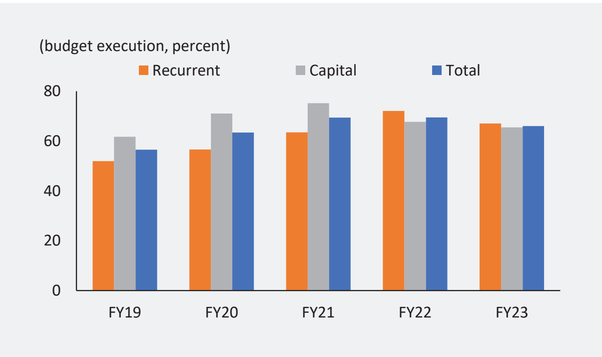
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A7.d. Components of expenditure



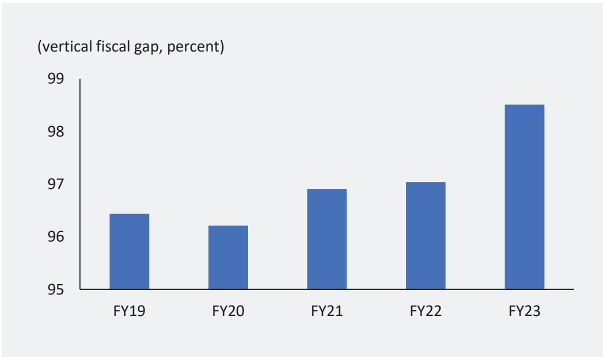
Source: Provincial Budget Speeches and World Bank staff calculations

Figure A7.e. Budget execution



Source: Provincial Budget Speeches and World Bank staff calculations

Figure A7.f. Vertical fiscal gap



Source: Provincial Budget Speeches and World Bank staff calculations

Sudurpashchim witnessed a slowdown in real GDP growth from 4.3 percent in FY22 to a record low of 1.9 percent in FY23 (Figure A7a). Wholesale and retail trade, construction, and manufacturing were the main drivers behind this deceleration in growth. The service and agriculture sectors contributed approximately 46.2 and 29.1 percent, respectively, to its GDP in FY23. Nevertheless, its share of national GDP stood at 7 percent in FY23, the second lowest among all of the provinces.

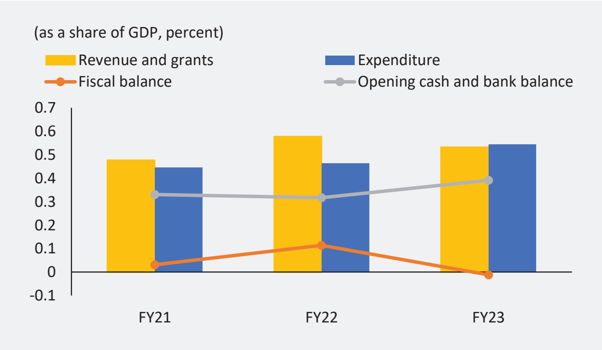
The fiscal balance turned negative, reaching 0.8 percent of GDP in FY23 primarily due to lower revenue (Figure A7b). This deficit marked the largest among all of the provinces in FY23 and was influenced by two factors. Firstly, there was a decline in revenue and grants from 7.3 percent of GDP in FY22 to 5.6 percent of GDP in FY23, attributed to reduced fiscal transfers (Figure A7c). Secondly, there was an increase in expenditure of 0.4 percentage points of GDP, driven by higher capital expenditure (Figure A7d). The province's deficit was financed by opening cash and bank balances from the previous fiscal year.

Sudurpashchim relies more on federal government funding than any other province in Nepal (Figure A7f). In FY23, nearly all of its own spending came from federal transfers and grants, with almost no money coming from its own sources (only 1 percent). Capital expenditure make up a significant portion of Sudurpashchim's spending – more than two-thirds of its own spending and 66 percent of its total spending.

Annex 3b. Fiscal Statistics for Four Types of Municipalities (Figures A8–A11)

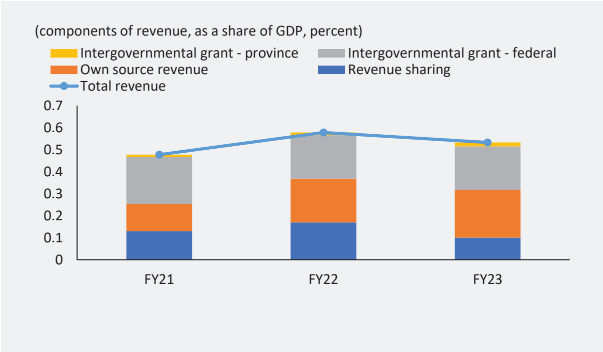
Figure A8. Fiscal statistics for metropolitan cities

Figure A8.a. Fiscal balance and opening and cash bank balance



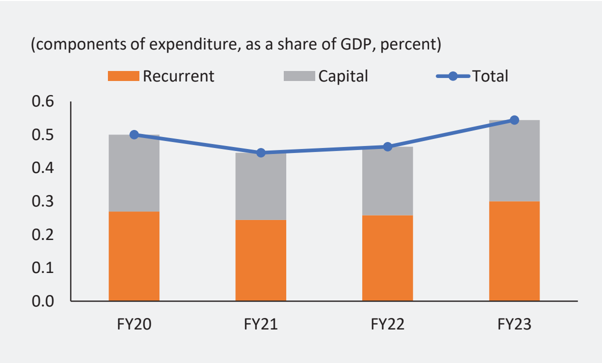
Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure A8.b. Components of revenue and grants



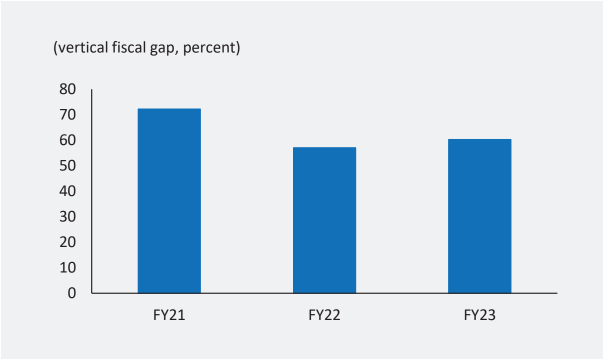
Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure A8.c. Components of expenditure



Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure A8.d. Vertical fiscal gap

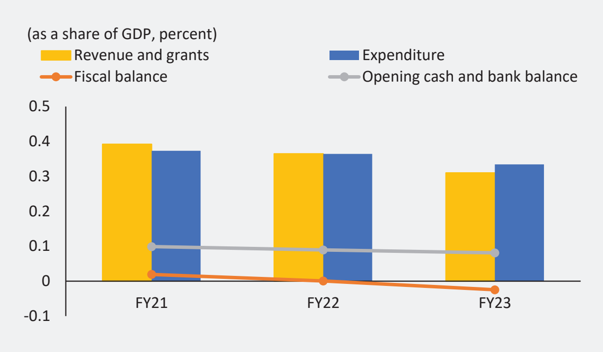


Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Metropolitan municipalities' fiscal surplus narrowed and remained close to zero percent of GDP in FY23 (Figure A8). This was driven by an increase in expenditure of 0.08 percentage points of GDP and a decrease in revenue and grants of 0.05 percentage points of GDP. Revenue declined due to lower revenue sharing, while expenditure expanded due to increases in both recurrent and capital expenditure. Intergovernmental revenue constituted 59.4 percent of overall revenue and grants in FY23, leading to the lowest vertical fiscal gap of 60.3 percent among all municipality types. Capital spending contributed to 44.4 percent of overall spending.

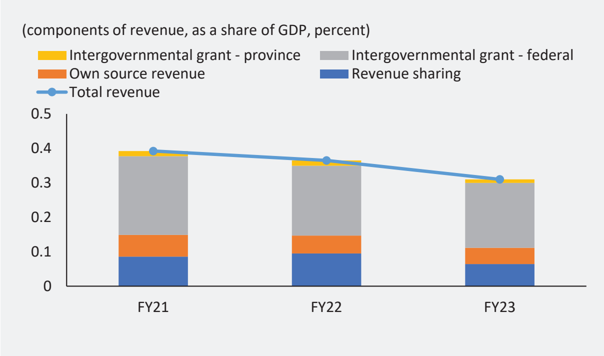
Figure A9. Fiscal statistics for sub-metropolitan cities

Figure A9.a. Fiscal balance and opening and cash bank balance



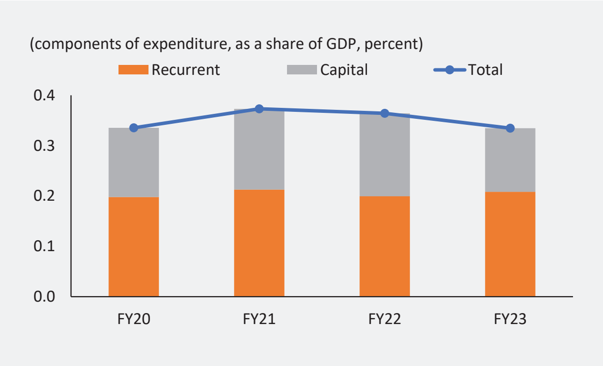
Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure A9.b. Components of revenue and grants



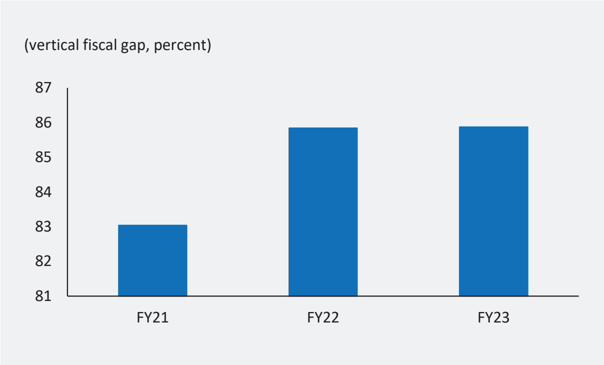
Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure A9.c. Components of expenditure



Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure A9.d. Vertical fiscal gap

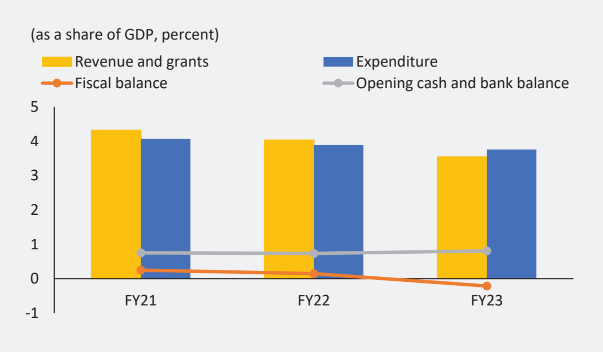


Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Sub-metropolitan municipalities' fiscal balance remained unchanged, at close to zero percent of GDP in FY23 (Figure A9). This stability was attributed to the decrease in revenue and grants being offset by the decrease in expenditure. Revenue fell due to lower revenue sharing, while expenditure contracted due to a decline in capital spending. Sub-metropolitan cities relied heavily on transfers and grants from federal and provincial governments, with intergovernmental revenue constituting 84.8 percent of overall revenue and grants in FY23. This dependence on fiscal transfers contributed to a significant vertical fiscal gap of 85.9 percent. Capital spending contributed to 45.3 percent of overall spending.

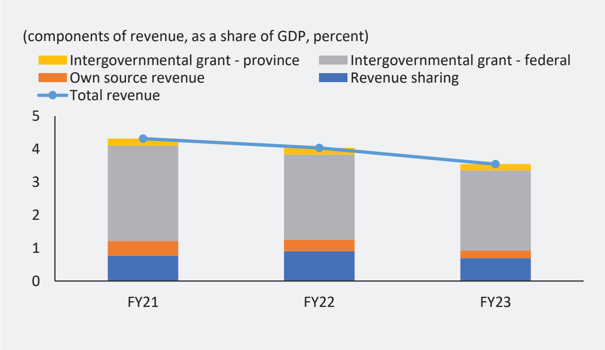
Figure A10. Fiscal statistics for urban municipalities

Figure A10.a. Fiscal balance and opening and cash bank balance



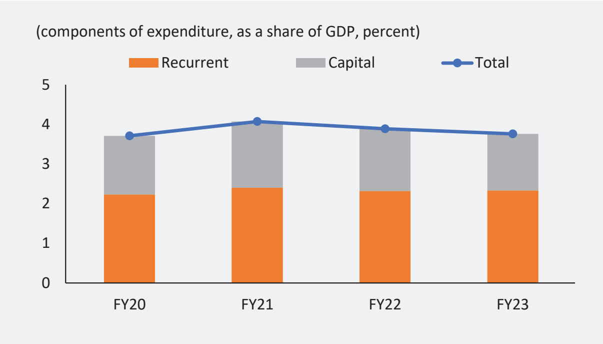
Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure A10.b. Components of revenue and grants



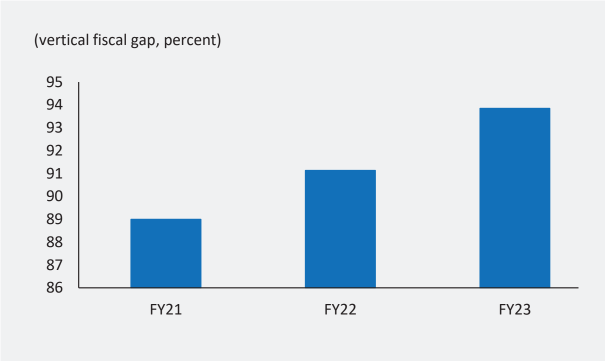
Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure A10.c. Components of expenditure



Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure A10.d. Vertical fiscal gap

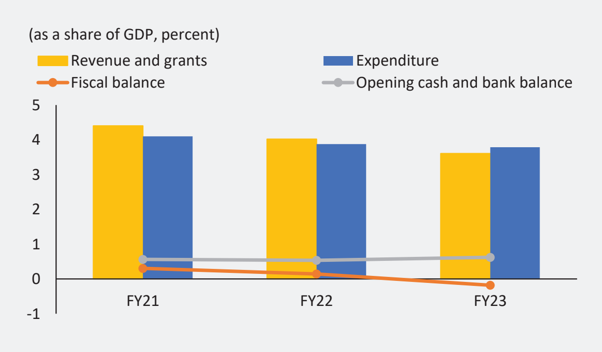


Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Urban municipalities experienced a fiscal deficit in FY23, primarily due to lower revenue and grants (Figure A10). Revenue and grants decreased by 0.49 percentage points of GDP to 3.54 percent of GDP in FY23. This decline was widespread, with revenue sharing, intergovernmental grants, and own-source revenue all decreasing by 0.2, 0.2, and 0.1 percentage points of GDP, respectively. Although expenditure also decreased, it was less than revenue, resulting in a deficit of 0.2 percent of GDP in FY23, compared to a surplus of 0.15 percent of GDP in FY22. Intergovernmental revenue contributed to 93.5 percent of overall revenue and grants in FY23, leading to a vertical fiscal gap of more than 90 percent. Capital spending accounted for 37.9 percent of overall spending in FY23.

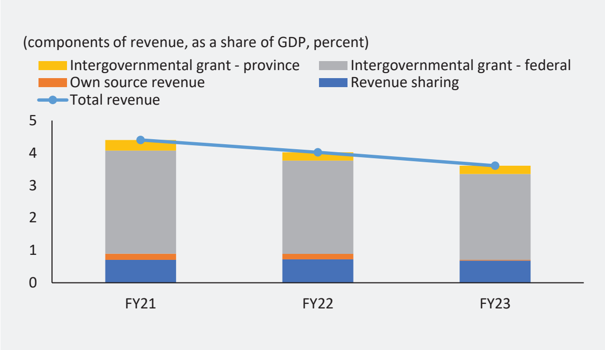
Figure A11. Fiscal statistics for rural municipalities

Figure A11.a. Fiscal balance and opening and cash bank balance



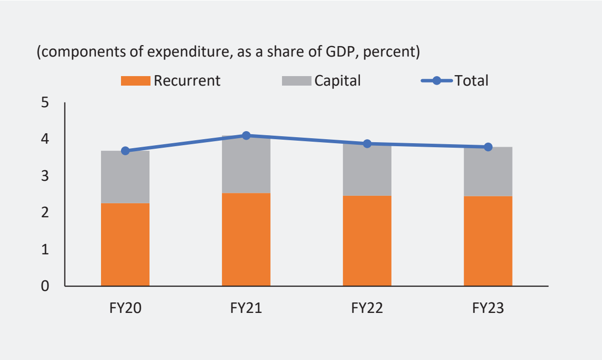
Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure A11.b. Components of revenue and grants



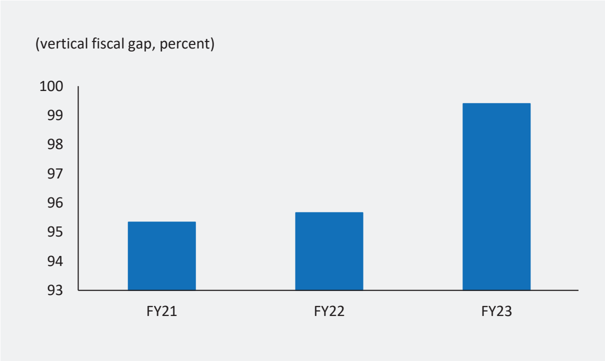
Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure A11.c. Components of expenditure



Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Figure A11.d. Vertical fiscal gap



Source: Financial Comptroller General Office, National Statistics Office, and World Bank staff calculations

Rural municipalities also encountered a fiscal deficit of 0.18 percent of GDP in FY23, marking a shift from a surplus in FY22 (Figure A11). This change is primarily attributed to a decrease in revenue and grants, which declined by 0.41 percentage points to 3.61 percent of GDP. All sources of income for these municipalities experienced a decline, with fiscal transfers from the federal government and own-source revenue exhibiting the most significant decreases. While spending also decreased, it was insufficient to offset the drop in revenue. Similar to sub-metropolitan cities and urban municipalities, rural municipalities rely heavily on funding from provincial and federal governments, with over 99.4 percent of their total revenue and grants originating from intergovernmental revenue in FY23. This dependence contributed to a significant vertical fiscal gap of close to 100 percent. Capital spending accounted for 35.3 percent of overall spending in FY23.

Annex 4. Complementary Studies on Fiscal Federalism in Nepal

Complementary Studies	Brief Description
World Bank. 2023. *Nepal Fiscal Federalism Update*. Washington, D.C.: World Bank.	The first edition of the Nepal Fiscal Federalism Update aims to provide an update on the progress of fiscal federalism since publication of the Federalism Capacity Needs Assessment (FCNA) in 2019.
World Bank. 2017. *Nepal Development Update: Fiscal Architecture for Federal Nepal.* Washington, D.C.: World Bank.	The Nepal Development Update is a semi-annual assessment of economic performance in Nepal. This edition of the update takes a close look at the emerging issues and potential risks in the design of the fiscal architecture for the new federal Nepal.
Georgia State University. 2019. *Nepal: Capacity Needs Assessment for the Transition to Federalism.* Report commissioned by the World Bank and the United Nations Development Program (UNDP).	This report, which is known as the Nepal Federalism Capacity Need Assessment (FCNA), explores the capacity needs for the adoption of federalism covering the federal government, the 7 provinces, and 115 local governments. The assessment focuses on organizational, institutional and regulatory capacity, as well as physical infrastructure.
World Bank. 2019. *Policy Note for the Federalism Transition in Nepal.* Kathmandu: World Bank.	This policy note was prepared based on the findings, analyses, and recommendations of the FCNA study. It provides a synthesis of the FCNA findings, as well as its forward-looking recommendations in terms of the immediate, medium, and long-term actions that the government could take to fully realize the benefits of implementing federalism in Nepal.
World Bank. 2021. *Federalism and Public Expenditure for Human Development in Nepal.* Washington, D.C.: World Bank.	This report provides a comprehensive review of the challenges facing Nepal's human development sectors in the federal context.
World Bank. 2021. *Nepal Public Expenditure Review – Fiscal Policy for Sustainable Development.* Washington, D.C.: World Bank.	This review provides an analytical basis to inform reform efforts to strengthen federalism and create fiscal space to support the new focus on a green, resilient, and inclusive development (GRID) model for Nepal's development.
Ministry of Finance. 2022. *Nepal Knowledge Exchange Program on Fiscal Federalism: Lessons and Reforms.* Kathmandu: Ministry of Finance.	This report was prepared based on the learnings from six country studies under the World Bank Knowledge Exchange Programme from 2019 to 2022, which identified lessons from international experience and the early experiences of implementing fiscal federalism in Nepal. The report covers the four topics of intergovernmental fiscal transfers, provincial and local government performance management and appraisal, public finance management, and taxation.

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