
Financing Local Governance: Insights From Neelakantha Municipality

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Abstract

This study explores the financing of local governance in Nepal, focusing on Neelakantha Municipality to evaluate fiscal federalism under the country's three-tier governance system. Analyzing revenue and expenditure data from FY 2077/78 to 2079/80, the research reveals a significant dependence on intergovernmental transfers, which comprised over 55% of total revenue, while internal revenue generation declined to as low as 2.8%. Despite consistent budget surpluses, the municipality struggled with capital expenditure execution, achieving as little as 61% in some years. Using indicators such as the Fiscal Autonomy Ratio (FAR), Local Fiscal Dependency Ratio (LFDR), and Financial Autonomy Index (FAI), the study identifies weak fiscal autonomy and increasing external dependence, with FAR values ranging from 4.0% to 38.5%, FAI declining to 18.0% by FY 2079/80, and LFDR trending upward. These trends reflect administrative inefficiencies in revenue collection and budget implementation. Although Nepal's legal provisions for fiscal federalism are robust, the study concludes that implementation gaps—such as vertical and horizontal fiscal imbalances, overlapping tax structures, and limited local capacity—continue to undermine effectiveness. It recommends enhancing local revenue administration, improving expenditure management, and strengthening performance monitoring. The case of Neelakantha Municipality underscores the need for governance reforms to support institutional design and realize the goals of meaningful fiscal decentralization.

Keywords: fiscal federalism, local governance, fiscal autonomy, revenue dependency, decentralization

Introduction

The transition from a centralized to a decentralized governance system marks a significant shift in Nepal's political and fiscal landscape, particularly after the promulgation of the Constitution in 2015. This constitutional reform established Nepal as a Federal Democratic Republic, dividing the state into three tiers of government: federal, provincial, and local. The decentralization of fiscal responsibilities to local governments, such as municipalities and rural municipalities, was envisioned to enhance

governance efficiency, improve public service delivery, and foster economic development at the grassroots level (Prashad, 2015). However, the success of fiscal federalism hinges on the ability of sub-national governments to mobilize their Own-Source Revenue (OSR), a challenge that remains critical for sustainable local governance (IIDS, 2019). Against this backdrop, this study explores the financing mechanisms of local governance, with a focus on Neelakantha Municipality, to understand the dynamics of revenue generation, expenditure patterns, and fiscal autonomy in Nepal's federal structure.

Nepal's journey toward fiscal decentralization is rooted in its historical context. Prior to 2015, the country experimented with various forms of decentralization, beginning with the Panchayat system in the 1960s, which introduced local governance units but retained central control over fiscal and administrative powers (Devkota, 2014). The post-1990 democratic reforms, including the Local Self-Governance Act (LSGA) of 1999, marked a more substantive effort to devolve authority to local bodies. The LSGA empowered local governments to levy taxes, manage resources, and undertake development activities, laying the groundwork for fiscal decentralization (Prasad, 2015). Despite these efforts, the pre-2015 era was characterized by limited fiscal autonomy, with local governments heavily reliant on central transfers and struggling to mobilize OSR effectively (Shrestha & Veniak, 2019). The 2015 Constitution sought to address these limitations by formally recognizing fiscal federalism and assigning specific revenue and expenditure responsibilities to each tier of government.

The theoretical underpinnings of fiscal decentralization emphasize its potential to enhance allocative efficiency, accountability, and responsiveness to local needs (Oates, 1972). According to the first-generation theory of fiscal federalism, local governments are better positioned to provide public goods and services tailored to the preferences of their constituents, thereby maximizing welfare gains (Oates, 1972). This perspective is complemented by the second-generation theory, which incorporates political economy considerations, highlighting the risks of fiscal imbalances and opportunistic behavior by sub-national governments (Oates, 2005). In practice, fiscal decentralization rests on four pillars: expenditure assignments, Revenue Assignments, Intergovernmental Fiscal Transfers (IGFT), and sub-national borrowing (Bird & Vaillancourt, 1998). A well-designed fiscal framework requires clear delineation of responsibilities, equitable revenue-sharing mechanisms, and robust institutional capacity to ensure sustainable local governance (Shah, 2006).

For Nepal, the mobilization of OSR by local governments is not merely a fiscal imperative but also a cornerstone of democratic governance. OSR, which includes taxes, fees, and service charges, enables municipalities to reduce dependence on central transfers, exercise fiscal autonomy, and prioritize local development agendas (IIDS, 2019). The experience of Nepal reveals significant gaps between these theoretical expectations and on-the-ground realities. Yet preliminary evidence suggests this revenue streams remain underdeveloped, with collection rates for key taxes like property assessments hovering below 50% (Awasthi, 2019). This revenue shortfall forces heavy reliance on intergovernmental transfers, which account for 60-70% of local budgets nationwide (IIDS, 2019), undermining the very autonomy that federalism sought to create.

The municipality's struggles reflect systemic challenges across Nepal's local governance landscape. First, unclear assignment of taxation powers has created overlapping jurisdictions between federal, provincial and local authorities (Prasad, 2015). Second, weak administrative capacity manifests in outdated property registers, manual collection systems, and limited taxpayer databases (Subedi, 2013). Third, political economy factors - including resistance from local elites and low citizen trust in government - constrain revenue compliance (Sharma, 2021). These barriers collectively inhibit the emergence of strong, self-reliant local governments envisioned by the constitution.

However, challenges such as overlapping taxation powers, weak administrative capacity, and low taxpayer compliance hinder effective revenue mobilization (Bahl & Bird, 2008). The case of Neelakantha Municipality offers a microcosm of these broader issues. As a local government in Dhading District, Neelakantha Municipality faces the dual challenge of fulfilling its constitutional mandates while navigating constraints in revenue generation and expenditure management. Understanding its fiscal dynamics can provide insights into the gaps and opportunities for strengthening local governance financing across Nepal.

The rationale for this study stems from the limited empirical research on sub-national revenue mobilization and fiscal autonomy in Nepal. While the constitutional and legal frameworks for fiscal decentralization are well-established, their implementation remains uneven across local governments (IIDS, 2019). By examining Neelakantha Municipality, this study aims to contribute to the literature on fiscal decentralization, offering evidence-based recommendations for policymakers and stakeholders. The findings will shed light on the status of taxation powers, revenue-

expenditure patterns, and the degree of fiscal autonomy, thereby informing strategies to improve OSR mobilization and intergovernmental fiscal relations.

Research Methodology

This study has tried to examine the financing mechanisms of local governance in Nepal, with a particular focus on Neelakantha Municipality. The research adopts a descriptive and analytical research design, combining qualitative assessment of legal-institutional frameworks with quantitative analysis of fiscal data to evaluate Nepal's fiscal decentralization process.

The study relies exclusively on secondary data sources, including Nepal's, 2015, the Local Government Operation Act (2074), annual budgets and audit reports of Neelakantha Municipality for fiscal years 2077/78 to 2079/80, and publications from relevant government ministries and commissions. Neelakantha Municipality was selected as the case study through judgmental sampling, considering its representative characteristics as a semi-urban local government established post-federalization with available complete fiscal records. The three-year study period was chosen to capture mature implementation trends of federal structures while including both normal and COVID-19 affected years for robust analysis.

Quantitative analysis employs percentage calculations to examine revenue composition and expenditure allocation patterns, alongside four key fiscal autonomy indicators: Fiscal Autonomy Ratio (FAR), Local Fiscal Dependency Ratio (LFDR), Financial Autonomy Index (FAI), and Tax Autonomy Index. These metrics are complemented by qualitative assessment of constitutional provisions versus actual implementation, evaluation of intergovernmental fiscal relations through policy documents, and identification of systemic constraints from government reports.

The methodology ensures ethical use of publicly available data with proper attribution and provides a robust framework to analyse Neelakantha Municipality's fiscal ecosystem and generate insights applicable to Nepal's broader local governance challenges. The integrated approach of legal analysis and fiscal metrics enables comprehensive assessment of decentralization outcomes across multiple dimensions.

Specifically, the quantitative analysis calculates FAR as total local own revenue divided by total expenditure, with values above 0.5 indicating stronger autonomy. LFDR is computed as intergovernmental transfers relative to total revenue, where World Bank benchmarks classify below 33% as strong autonomy and above 50% as weak dependence. FAI examines the share of own revenue in total revenue, with

benchmarks above 75% representing strong autonomy and below 60% indicating weak independence. Tax autonomy is measured as the tax revenue proportion of total internal revenue, where higher values reflect better local tax administration capacity. These fiscal ratios are applied to Neelakantha Municipality 's three-year budget data to assess trends and patterns in revenue generation and expenditure management. The qualitative component systematically reviews constitutional provisions, legal frameworks, and policy documents to evaluate the implementation gap between formal decentralization mandates and actual fiscal practices at the local level.

The methodology incorporates several validation measures, including triangulation of data sources, consistency checks across different fiscal years, and comparison with World Bank benchmarks for fiscal autonomy indicators. The three-year timeframe allows for identification of both structural patterns and annual variations in fiscal performance, while the exclusive focus on secondary data ensures reliance on verified government records and published reports. The case study approach enables in-depth examination of Neelakantha Municipality 's fiscal ecosystem while maintaining relevance to broader challenges facing Nepal's local governments in the federal system.

By integrating quantitative fiscal metrics with qualitative policy analysis, the methodology provides a comprehensive assessment framework that captures both the numerical dimensions of local government finance and the contextual factors influencing fiscal decentralization outcomes. This dual approach facilitates identification of not just statistical patterns but also the underlying institutional and governance factors that shape local fiscal autonomy in practice.

Results

Revenue Analysis

The revenue analysis of Neelakantha Municipality has been presented in table 1. It reveals significant dependence on fiscal transfers, with internal revenue generation remaining consistently low across the three fiscal years examined. Fiscal transfers constituted 53.9% (2077/78), 55.7% (2078/79), and 55.9% (2079/80) of total revenue, while internal revenue accounted for only 30.2%, 2.8%, and 4.8% respectively. The combination of internal revenue and revenue sharing receipts represented 46.1%, 21.1%, and 18.0% of total revenue in successive years, indicating declining fiscal autonomy.

Table 1*Revenue Composition of Neelakantha Municipality (in NPR)*

Fiscal Year	Fiscal Transfer	% of Fiscal Transfer	Internal Revenue	% of Internal Revenue	Revenue Sharing Receipt	% of Revenue Sharing Receipt	Total Revenue
2077/78	665,014,611	53.9	371,845,905	30.2	196,114,284	15.9	1,232,974,800
2078/79	681,731,717	55.7	34,788,245	2.8	222,867,601	18.2	1,223,856,330
2079/80	748,224,606	55.9	63,697,748	4.8	177,323,286	13.3	1,337,839,308

Source: Based on Various Issues of Consolidated Financial Statement

Expenditure Performance

The budget and expenditure analysis of Neelakantha Municipality over three consecutive fiscal years (Table 2) reveals a consistent gap between allocated budgets and actual expenditures. In the fiscal year 2077/078, the municipality achieved 79.6% of recurrent expenditure and 66.1% of capital expenditure, resulting in an overall budget achievement of 73.7%. This trend continued in 2078/079, with a slight improvement in recurrent expenditure to 80.4%, but a decline in capital expenditure to 61.0%, lowering the total budget execution rate to 73.0%. In the most recent fiscal year, 2079/080, there was a notable improvement in both recurrent (81.0%) and capital expenditures (71.3%), raising the total expenditure achievement to 77.0%. Despite these improvements, the data indicates a persistent underutilization of the allocated.

Table 2*Gap Analysis of Allocated Budget and Actual Expenditure of Neelakantha Municipality*

Fiscal Year	Allocated Budget			Achievement in Expenditure (%)		
	Recurrent Expenditure	Capital Expenditure	Total Budget	Recurrent Expenditure %	Capital Expenditure %	Total Budget %
2077/078	737327235	571461013	1308788248	79.6	66.1	73.7
2078/079	744507664	454198763	1198706427	80.4	61.0	73.0
2079/080	893200991	627303264	1520504255	81.0	71.3	77.0

Source: Based on Various Issues of Consolidated Financial Statement

Fiscal decentralization and autonomy

The municipality demonstrated weak fiscal autonomy across all standard measures (Table 3). The Fiscal Autonomy Ratio (FAR) declined sharply from 38.5% to

just 5.4% when considering only internal revenue, and from 58.9% to 20.6% when including revenue sharing. Similarly, the Financial Autonomy Index (FAI) dropped from 30.2% to 4.8% for internal revenue and from 46.1% to 18.0% with revenue sharing. The Local Fiscal Dependency Ratio (LFDR) remained consistently high (53.9-55.9%), exceeding the World Bank's weak autonomy threshold of 50%.

Table 3

Fiscal Autonomy Measures

Fiscal Year	FAR (Internal)	FAR (With Sharing)	FAI (Internal)	FAI (With Sharing)	LFDR
2077/78	38.5%	58.9%	30.2%	46.1%	53.9%
2078/79	4.0%	29.4%	2.8%	21.1%	55.7%
2079/80	5.4%	20.6%	4.8%	18.0%	55.9%

Source: Based on Various Issues of Consolidated Financial Statement

Financial gap analysis

Despite expenditure gaps, the municipality maintained financial surpluses ranging from 12.5% to 28.5% of total revenue (Table 4). This paradoxical situation of simultaneous underspending and surplus accumulation suggests administrative inefficiencies in budget execution rather than fiscal constraints.

Table 4

Financial Gap Analysis (in NPR)

Fiscal Year	Total Revenue	Total Expenditure	Surplus	% Surplus
2077/78	1,232,974,800	964,895,513	268,079,287	21.7%
2078/79	1,223,856,330	875,262,663	348,593,667	28.5%
2079/80	1,337,839,308	1,171,060,359	166,778,949	12.5%

Source: Based on Various Issues of Consolidated Financial Statement

Discussion

The findings from Neelakantha Municipality present a critical examination of Nepal's fiscal federalism implementation, revealing substantial gaps between constitutional aspirations and operational realities. This analysis demonstrates three key challenges that undermine the decentralization process envisioned by Prashad (2015)

and the constitutional framers. First, the heavy dependence on central transfers (exceeding 55% of revenue) persists despite constitutional provisions for local fiscal autonomy, confirming IIDS's (2019) concerns about weak own-source revenue mobilization. Second, the declining internal revenue generation (to just 4.8%) reflects systemic weaknesses in local taxation systems that Awasthi (2021) identified as a major constraint. Third, the chronic budget underspending (23-27% gaps) reveals implementation challenges that Sharma (2021) attributed to both administrative capacity limitations and political economy factors.

These findings challenge the theoretical assumptions of first-generation fiscal federalism (Oates, 1972) about automatic efficiency gains from decentralization. While the constitutional framework established by Prashad (2015) created the structure for local autonomy, our results show how capacity constraints can negate these theoretical benefits. The municipality's struggles with revenue collection and expenditure execution align with Shah's (2006) emphasis on the importance of complementary institutions beyond legal frameworks. The declining fiscal autonomy ratios (FAR dropping to 4.0-5.4%) fall far below international benchmarks, suggesting Nepal's system operates more as a deconcentrated administration than genuine fiscal federalism.

The study reveals several systemic barriers to effective decentralization. The unclear assignment of taxation powers noted by Prasad (2015) creates implementation confusion, while the outdated administrative systems described by Subedi (2013) hinder revenue collection. Most significantly, the political economy constraints analysed by Sharma (2021) manifest in both low taxpayer compliance and inefficient budget execution. These findings suggest that Nepal's fiscal federalism faces both technical implementation challenges and deeper institutional barriers.

Three critical policy interventions emerge from this analysis. First, comprehensive capacity building must address both technical skills and systemic weaknesses in revenue administration. Second, strategic fiscal rebalancing should clarify revenue assignments while creating incentives for local revenue effort. Third, performance-based governance mechanisms could improve accountability and expenditure efficiency. These reforms would need to be implemented sequentially, beginning with immediate capacity building while working toward longer-term institutional changes.

The study contributes to broader debates about fiscal federalism in Nepal by demonstrating how implementation challenges can undermine well-designed

constitutional reforms. While the legal framework for fiscal federalism exists, the case of Nilkantha shows that meaningful local autonomy requires parallel investments in governance capacity. Future research should examine variations in performance across different types of municipalities and identify factors that contribute to successful decentralization.

Ultimately, these findings suggest that Nepal's federal transition requires moving beyond legal frameworks to address implementation challenges. The experience of Neelakantha Municipality highlights the need for balanced attention to both institutional design and governance capacity to realize the full benefits of fiscal decentralization.

Conclusion

This study reveals significant implementation gaps in Nepal's fiscal federalism, as evidenced by Neelakantha Municipality's financial patterns. The municipality demonstrates heavy dependence on central transfers (exceeding 55% of revenue), declining internal revenue generation (dropping to just 4.8%), and chronic budget underspending (23-27% gaps). These findings suggest that administrative capacity constraints are undermining the intended benefits of decentralization, despite the robust constitutional framework.

The research highlights three critical reform priorities: strengthening local revenue administration and expenditure execution, rebalancing intergovernmental fiscal relations, and implementing robust performance monitoring systems. These measures are essential to address the paradox of growing fiscal dependence coexisting with unspent funds, which currently reflects governance inefficiencies rather than sound financial management.

Ultimately, Nepal's federal system requires complementary capacity building alongside legal provisions to achieve meaningful local autonomy. The case of Neelakantha Municipality underscores that successful decentralization depends on addressing these implementation challenges, ensuring local governments can effectively exercise their constitutional powers for improved service delivery and development outcomes.

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