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Fiscal Decentralization and Economic Growth of Sudurpashchim Province

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Abstract

Article Info

Purpose: The study aims to analyze how Nepal's fiscal decentralization has affected the economic growth and implementation status of elected government agencies of Sudurpashchim Province after introducing a new federal government structure.

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Methods: The study employed a descriptive and analytical research design that considered a quantitative approach using primary and time series data. Among 88 local-level governments, 46 were selected as samples. The primary data were collected through a semi-structured questionnaire and secondary data were collected from the annual report of the Ministry of Financial Affairs of Sudurpashchim Province.

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Results: The results show that around 50 percent of local-level governments only utilized the exclusive right and regarding the concurrent rights majority of the local-level governments are ambiguous. The expenditure of local level governments has been found significant and positive impact on economic growth. Whereas, the expenditure of provincial and federal governments has been found insignificant.

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Conclusion: The provincial government has a very small part of revenue-generating rights, for strengthening the federal system, more economic rights should be provided. The findings of the study are useful to policymakers and employees of local-level governments, provincial governments, and federal governments.

Keywords: Exclusive and concurrent rights, Federalism, Revenue generation, Expenditures

I. Introduction

Federalism is a governance system in which the federal government shares power with state or local authorities (Elazar, 1987). Recognizing it as an effective approach to decentralization,

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many nations have recently adopted this structure. Federalism distributes powers among different levels of government, including financial, administrative, and political responsibilities. According to the United Nations (UN), there are 195 countries globally, 34 of which practice federalism in various forms. Among these, 14 consistently apply the federal system, 5 use it predominantly, 8 implement it occasionally, 1 applies it rarely, and 6 follow a quasi-federal approach.

Table 1

Federal States 2024

Always	Usually	Sometimes	Rarely	Quasi-federal
India, United States, Pakistan, Brazil, Russia, Ethiopia, Germany, Argentina, Canada, Malaysia, Australia, Belgium, UAE	Mexico, Nepal, Venezuela, Austria, Bosnia and Herzegovina	Sudan, Iraq, Somalia, South Sudan, Switzerland, Comoros, Micronesia, and Saint Kitts and Nevis	Cyprus	Philippines, France, South Africa, Italy, Spain, Chile

Sources: Retrieved from <https://worldpopulationreview.com/country-rankings/federal-states> on 9th May 2024

Nepal adopted a federal system of governance in 2015, introducing a democratic and republican structure aimed at fostering long-term peace, good governance, and economic prosperity (Constitution of Nepal, 2015). The country, situated in South Asia and bordered by China to the north and India to the south, east, and west, is globally known for its stunning natural beauty, including the Himalayas and Mount Everest. Despite these assets, Nepal remains among the world's poorest nations, with a GDP of approximately \$46.097 billion and a per capita income of about \$1,336.5 (World Bank, 2022). Agriculture drives the economy, contributing around 25% of GDP and employing the majority of the population (Field survey, 2024).

Nepal's transition to federalism was marked by significant political and administrative reforms, including the division of the country into seven provinces and 753 local levels, as outlined in Article 56 of the constitution. This restructuring replaced older administrative units and aimed to enhance decentralization. The constitution's schedules allocate exclusive and shared powers across federal, provincial, and local governments, providing a framework for fiscal decentralization. Several laws, such as the National Natural Resources and Fiscal Commission (NNRFC) Act and the Intergovernmental Fiscal Arrangements (IFA) Act, have been enacted to operationalize fiscal federalism. These laws regulate revenue sharing, intergovernmental transfers, and expenditure allocation.

Reports like the World Bank's Fiscal Federalism Update 2023 and the Sustainable Development Goals (SDGs) progress evaluation have analyzed various aspects of Nepal's fiscal framework. However, gaps remain in understanding the structural patterns of revenue and expenditure, particularly at the provincial level. Sudurpaschim Province, located in far-western Nepal, exemplifies these challenges. Spanning 19,539 square kilometers and housing 2,552,517 people, the province lags in development, with a per capita income of \$1,111 and a Human Development Index (HDI) of 0.41. Poverty affects 45% of its population, and literacy rates show significant gender disparity.

The study explores three key questions: how well Sudurpaschim Province has implemented its exclusive and concurrent rights, the revenue and expenditure structure at the provincial level, and the impact of fiscal decentralization on economic growth. Fiscal federalism, as noted by scholars like Laleye and Oloru (1989) and Yang (2019), aims to integrate local aspirations, enhance public participation, and improve service delivery by decentralizing fiscal responsibilities. While it offers opportunities for economic growth and governance, challenges include high administrative costs, limited capacity at local levels, and unclear tax jurisdictions.

The findings aim to provide insights for policymakers and researchers, addressing the implementation gaps and proposing strategies for better revenue generation and resource

allocation in the context of Nepal's federal system. By fostering economic growth and reducing inequality, fiscal federalism could significantly contribute to achieving Nepal's developmental aspirations.

II. Reviews

Painter and Bae (2001) analyzed the factors influencing state-level government spending in the United States. Using panel data from 1965–1966 to 1992–1993, they employed variables such as institutional, political, and demographic characteristics as independent factors, while state spending per capita served as the dependent variable. Their findings revealed that demographic factors significantly affect state government spending. Additionally, variables such as the unemployment rate, total long-term debt, and per capita income were found to have a positive impact on state spending.

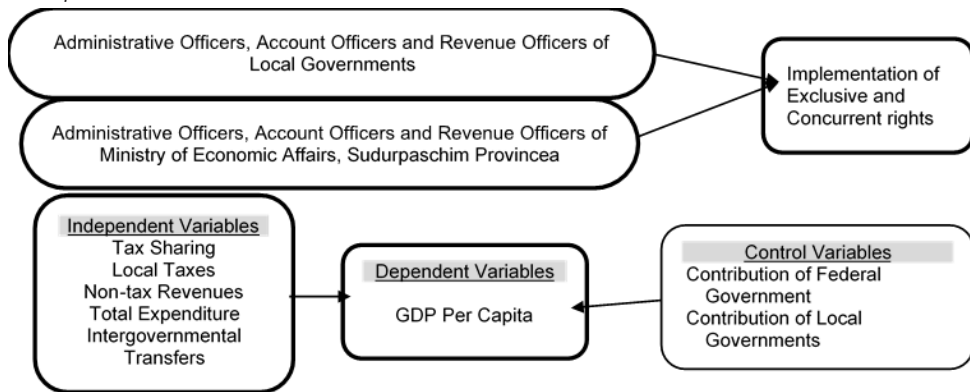
Ding (2007) examined the effects of fiscal decentralization on economic growth in China, focusing on the period following its implementation in 1994. Using panel data from 30 provinces (1994–2002) and an endogenous growth model accounting for government expenditures at various levels, the study demonstrated that fiscal decentralization significantly enhances economic development. The findings supported the theoretical notion that decentralization improves economic efficiency. Furthermore, the study explored variations in the relationship between fiscal decentralization and economic growth across three traditional economic zones in China: the eastern, central, and western regions. Results showed that the impact of fiscal decentralization on economic growth varied significantly among these regions.

Amagoh and Amin (2012) highlighted the advantages of fiscal decentralization for public sector governance, such as promoting growth, accountability, and responsiveness to local needs. However, they noted mixed opinions on its broader effects on macroeconomic development. Their study suggested that while fiscal decentralization offers benefits, its impact on economic growth depends on specific societal and economic contexts, which may limit its effectiveness in certain situations.

Adil and Anwar (2015) investigated fiscal decentralization's impact on economic growth in Pakistan. Pakistan's fiscal system operates across three levels: federal, provincial, and municipal. Resources are distributed through mechanisms such as the National Finance Commission (NFC) and Provincial Finance Commission (PFC) awards, along with development grants and discretionary funds. Their study, spanning 1972 to 2010, utilized Johansen's cointegration technique within an endogenous growth model. The analysis included revenues and expenditures as indicators of fiscal decentralization. While the findings suggested that decentralization positively impacts long-term economic growth, its short-term effects in Pakistan were statistically insignificant without enhanced political accountability and local government capacity.

Bojanic (2018) explored the relationship between fiscal decentralization and political freedoms, civil liberties, economic freedom, and accountability in twelve American countries. The study employed panel data analysis, with measures of fiscal decentralization (based on revenue and expenditure) regressed against indicators of political and economic freedoms. Results indicated that while decentralization initially hindered political freedoms and accountability, it ultimately contributed to their improvement. However, the effects of decentralization on economic freedom were less consistent, suggesting that its role in promoting accountability and civil rights is more complex than expected.

Kuntari et al. (2019) analyzed factors influencing local governments' capital expenditures in Central Java, Indonesia. Using regression analysis on data from 2014/15 to 2016/17, the study examined the effects of locally generated revenue, revenue-sharing funds, and allocation funds on capital expenditure. The results showed a positive impact of all independent variables on capital expenditure, which included investments in infrastructure, roads, irrigation, and other fixed assets. The framework for the study is depicted in the figure below.

Figure 1*Conceptual Framework*

In the context of Nepal, the adoption of a federal governance system following the 2015 constitution introduced three levels of government: federal, provincial, and local. These levels share exclusive and concurrent powers, enabling subnational governments to legislate on financial rights, create budgets, levy taxes, and implement plans and policies. However, issues have emerged during the six years since this system's implementation, including concerns about insufficient cooperation from the central government in drafting laws, allocating funds, and transferring institutional frameworks (Devkota, 2021). Despite fostering healthy competition among local and provincial governments, disagreements persist over the fiscal framework governing newly devolved powers. Limited research has been conducted on the effectiveness of fiscal decentralization in Nepal, particularly regarding its impact on economic growth. This study aims to fill that gap by providing empirical evidence on the financial autonomy of provincial and local governments and its influence on economic performance. Secondary data will be used to analyze revenue sources, expenditures, and their relationship with GDP per capita, with control variables included to account for external influences.

Exclusive Rights: Exclusive rights grant local and provincial governments the authority to collect and allocate revenues for their own plans and projects. The variables selected under this category include Integrated Property Tax, Land Tax and Housing Tax, Malot Tax, House and Land Rent Tax, Business Tax, Rental Tax, Parking Tax, Herbal, Scrap, and Livestock Tax, Service Fees, and Loans and Grants.

Concurrent Rights: Concurrent rights involve the joint collection and distribution of revenues between local and provincial governments. The selected variables in this category are Vehicle Tax, House and Land Registration Fee, Advertisement Tax, Entertainment Tax, Tourism Fees, Natural Resource Taxes, and Revenue from Other Sources.

Dependent Variable: The dependent variable in this study is GDP per capita, specifically focusing on the GDP per capita of Sudurpaschim Province.

Independent Variables: The independent variables include tax sharing, local taxes, non-tax revenues, total expenditure, and intergovernmental transfers.

Control Variables: The contributions of the central government and local governments are treated as control variables in this study.

III. Methodology

The study's methodology included the research design, population and sample, methods of analysis, and variables utilized. A combination of descriptive and analytical research designs

were employed, incorporating both primary and time series data. Descriptive statistics were applied to analyze the primary data, while both descriptive statistical tools (e.g., mean, median, and standard deviation) and inferential tools (e.g., correlation and regression analysis) were used for secondary data analysis. Consequently, the study adopted a descriptive and analytical research design. Purposive sampling was used to gather the required data. The research focused on Sudurpashchim Province, one of Nepal's seven provinces. A sample of 46 local governments, comprising 1 sub-metropolitan city, 17 municipalities, and 28 rural municipalities across 9 districts was selected out of the 88 local government units in the province.

Table 1

Sample Local Level Governments

Local level governments	Total	Samples
Sub Metropolitan city	1	1
Municipality	33	17
Rural Municipality	54	28
Total	88	46

The secondary data utilized in this study spans seven years (2017–2023). Data was collected from various sources, including the Ministry of Economic Affairs of Sudurpaschim Province, Nepalese government agencies, international financial institutions (IFIs), and the Central Bureau of Statistics (CBS), to calculate the nominal per capita GDP growth rate for each province.

The selected regression model facilitates an in-depth analysis of the relationship between fiscal federalism and economic growth in the context of Sudurpaschim Province, Nepal. The model incorporates the fiscal decentralization index as the key explanatory variable, along with relevant control variables. The dependent variable in the analysis is the annual per capita GDP of the provincial government. Below is the regression model specification used in this study:

$$\ln \text{GDPPC}_t = \beta_0 + \beta_1 \ln \text{TS}_t + \beta_2 \ln \text{LT}_t + \beta_3 \ln \text{NTR}_t + \beta_4 \ln \text{TE}_t + \beta_5 \ln \text{IGT}_t + \varepsilon$$

Where,

$\ln \text{GDPPC}$ = Log of GDP per capita of Sudurpaschim Province.

$\ln \text{TS}_t$ = Log of tax sharing for the period of Sudurpaschim Province.

$\ln \text{LT}_t$ = Log of local tax for the period of Sudurpaschim Province.

$\ln \text{NTR}_t$ = Log of non-tax revenue for the period of Sudurpaschim Province.

$\ln \text{TE}_t$ = Log of total Expenditure for the period of Sudurpaschim Province.

$\ln \text{IGT}_t$ = Log of inter-governmental transfer for the period of Sudurpaschim Province.

ε = Error term

β = Beta coefficients

This study examines the exclusive and concurrent rights of local and provincial governments in Nepal. The exclusive rights include integrated property tax, land and housing tax, Malpot (land revenue tax), house and land rent tax, business tax, rental tax, parking fees, herbal, scrap, and livestock tax, service fees, loans, grants, and revenues from other sources. Concurrent rights, on the other hand, encompass vehicle tax, house and land registration fees, advertisement tax, entertainment tax, tourism fees, natural resources tax, and additional

revenue sources.

Nepal transitioned to a federal system with the adoption of its new constitution in September 2015, restructuring the unitary state into three levels of government: federal, provincial, and local. The country is now divided into seven provinces and 753 local governments. The Constitution outlines the responsibilities and rights of these three tiers of government in its schedules, which include functional rights, revenue rights, borrowing rights, and provisions for fiscal transfers. Following federalization, provincial and local governments have been allocated grants across four categories, with the National Natural Resources and Fiscal Commission (NNRFC) managing fiscal transfers.

To establish a legal framework for fiscal transfers, Nepal enacted the National Natural Resources and Fiscal Commission Act, 2017, and the Intergovernmental Fiscal Arrangement Act, 2017. Additionally, the Local Government Operation Act, 2017, delineates the exclusive tax revenue rights of local governments. These rights enable local bodies, including Rural Municipalities and Municipalities, to independently impose and collect taxes within their jurisdictions, supporting local development initiatives, service delivery, and administrative functions. Table 3 presents the allocation of significant government powers among the three levels of government.

Table 2

Exclusive and Concurrent Powers by Assignment

	Exclusive Powers	Concurrent Powers	
		Federal and Provincial	Federal, Provincial, and Local
Federal	Defense, central planning, currency, foreign affairs, citizenship, passport, etc. (Schedule 5)		
Provincial	Provincial police administration, provincial civil service, higher education, provincial-level development activities such as electricity, irrigation, roads, land management, etc. (Schedule 6)	Civil and criminal procedure, supply and distribution of essential goods, population management, social security, casino, etc. (Schedule 7)	Cooperatives, education, health, agriculture, irrigation, mines, minerals, disaster management, environment, forest, personal events, archaeology, motor vehicle permits, etc. (Schedule 9)
Local	Town Police, management of local services, basic and secondary education, basic health, local roads, drinking water, etc. (Schedule 8)		

Note. Constitution of Nepal 2015

IV. Results and Discussion

Many of the functional responsibilities assigned to federal, provincial, and local governments in Nepal overlap and are repeated across the three tiers. To minimize confusion and align more effectively with the “finance follows the function” principle, the constitution clearly defines the responsibilities of each level of government. This clarification addresses the fundamental question of functional assignment: “Who will do what?” (Devkota, 2020).

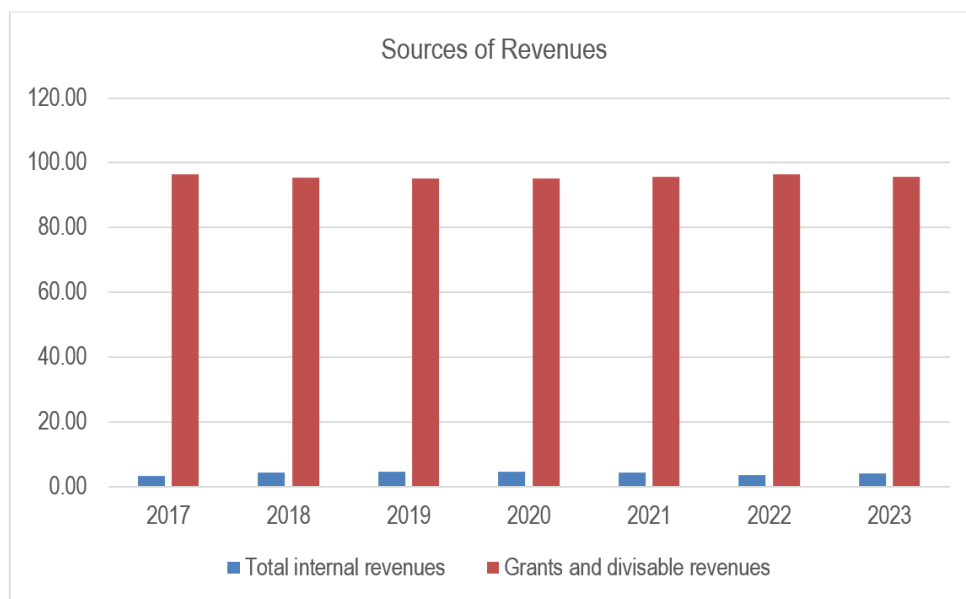
An analysis of revenue distribution reveals that the federal government holds the majority of authority to generate revenue as per the constitution. However, this does not mean all federal revenue is retained at the federal level. Article 60 (2) of the constitution stipulates that “the Government of Nepal shall make necessary arrangements for the equitable distribution of the revenue generated by it from its sources, between the federal, province, and local level entities.” Consequently, a portion of federal revenue is allocated to sub-federal units. Additionally, the National Natural Resources and Fiscal Commission (NNRFC), established

under constitutional provisions, is tasked with overseeing fiscal transfers.

This study focuses on assessing the implementation of exclusive and concurrent fiscal rights at the municipal and provincial levels in Sudurpashchim Province. To achieve this, structured and open-ended questions were administered to key informants (KI) through a survey. Key informants included account officers and chief administrative officers from local governments in Sudurpashchim Province. Out of 88 local governments across nine districts, responses were received from 46. Respondents were asked about the status of exclusive and concurrent revenue rights, challenges in their implementation, and potential solutions.

Figure 2

Sources of Revenues



The findings indicate that 65.22% of local governments collect Integrated Property Tax, Land Tax, and Housing Tax, while 34.78% do not. Malpot Tax collection is common, with 86.96% of local governments reporting its collection, whereas 13.04% do not. Similarly, 63.04% of local governments collect the House & Land Rent Tax, while 36.96% do not. Business Tax exhibits the highest collection rate, with 95.65% of local governments successfully collecting it, while only 4.35% do not. However, other taxes and fees show lower collection rates. For example, only 28.26% of local governments collect Rental Tax, and just 10.87% collect Parking Tax, with 71.74% and 89.13%, respectively, not collecting these revenues. Herbal, Scrap & Livestock Tax collection is split evenly at 50%, while 76.09% of local governments impose Service Fees, compared to 23.91% that do not. Loans and grants are utilized by only 4.35% of local governments, with 95.65% not leveraging these sources. Likewise, only 2.17% of local governments report revenue from other sources, while 97.83% do not.

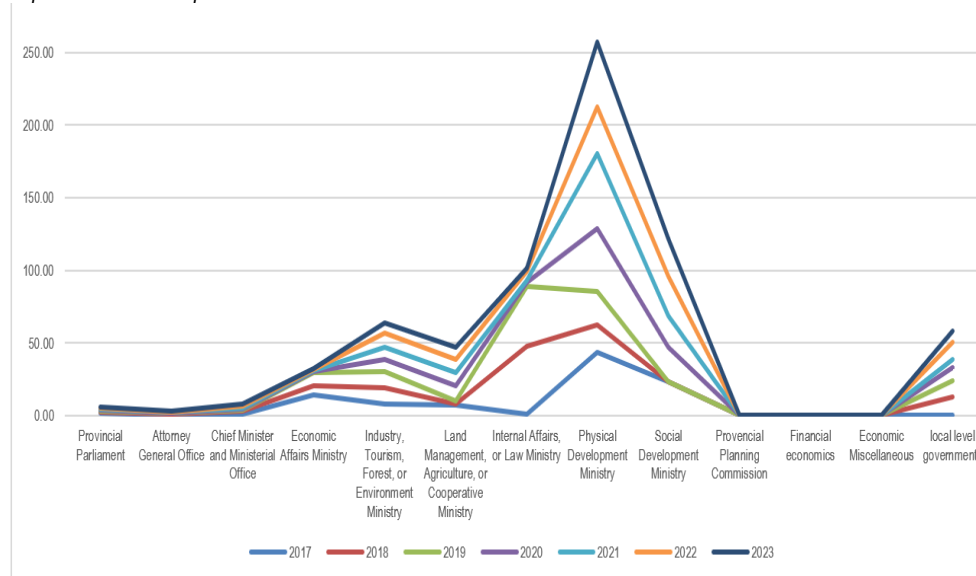
The findings highlight that internal revenue sources contribute less than 5% of the total revenue over the seven-year study period (2017–2023). The highest share of internal revenue was recorded in 2020 at 4.76%, while the lowest was in 2017 at 3.48%. This indicates that internal revenue sources represent a very small proportion of total revenue. Without a significant increase in internal revenue generation, the impact of federalism will remain limited. The structural pattern of revenue sources has remained largely unchanged,

with only minor adjustments observed. This suggests that efforts by the federal government to enhance internal revenue generation have been insufficient.

Figure 2 shows internal revenues and grants and divisible revenue. The internal sources of revenue are found small part in comparison to grants and divisible revenue. This indicates that the economic condition of the federal government is more dependable and weaker. If we want to make a sound federal system, more revenue-generating power should be handed over to the federal government.

Figure 3

Expenditure of Sudurpaschim Province



The expenditure of Sudurpaschim Province has been increasing for the study period. Among all the expenditures Physical Development and Internal Affairs Ministries expenditure holds majority part of the expenditure.

Table 3

Correlation Between Variables

	GDPPC	TPE	TS	LT	IGT	NTR	CLG	CGC
GDPPC	1.0000	-0.3912	-0.6928	0.8883	-0.9827	-0.7301	0.8944	-0.8811
TPE		1.0000	0.5784	-0.2681	0.3448	0.7553	-0.3156	0.4714
TS			1.0000	-0.3602	0.7272	0.8450	-0.3710	0.9326
LT				1.0000	-0.8652	-0.5398	0.9977	-0.6323
IGT					1.0000	0.7284	-0.8669	0.8917
NTR						1.0000	-0.5519	0.8578
CLG							1.0000	-0.6328
CGC								1.0000

Correlation coefficients, using the observations 2017 - 2023

Where,

GDPPC = Gross domestic production per capita

TPE = Total provincial expenditure

TS = Tax sharing

LT = Local governments tax

CLG = Contribution of local governments

IGT = Inter governmental transfer

NTR = Non-tax revenue

It is assumed that the expenditure of local level, provincial level and federal level have positive impact on the economic growth. However, the results shown that local level government contribution has positive impact on economic growth, but the contribution of provincial and federal level have negative impact. This implies that the expenditure of provincial and federal level governments better to reform.

Table 4

Regression Analysis:

Panel-1

GDP per capita is dependent variable and tax sharing, local tax, non-tax revenue, total provincial expenditure, and inter-governmental transfer are independent variables

Model	Constant	lnTS	lnLT	lnNTR	lnTPE	lnIGT	Adj. R ²
OLS	1313.49 (0.2936)	-0.0000 (0.9828)	0.0000 (0.8421)	0.0000 (0.9566)	-0.0000 (0.8378)	0.0000 (0.5222)	0.8510

Panel-2

GDP per capita is dependent variable and contribution of local level government and federal governments are independent variables

Model	Constant	lnCLG	lnCFG	Adj. R ²
OLS	1000.84 (0.0023)	0.00001 (0.0094)	-0.00001 (0.0118)	0.948333

The results show that the insignificant relationship between expenditure of provincial government and federal government. Whereas, the expenditure of local level governments shows significant and positive relationship. This implies that the provincial government should be strength and the modality of provincial government and federal government should be reformed.

The expenditure of provincial government has found very small, which is less than 5 percent of total expenditure. Furthermore, the expenditure of provincial and federal government has been found less effective. Whereas, the expenditure of local level governments has been found significant and positive relationship with economic growth. For the success of federal system, the government should increase revenue collecting and expenditure right of provincial government. The findings are supportive for the policy reform and implication.

Discussion

The research on fiscal decentralization of Nepal, with a focus on Sudurpashchim Province, offers valuable insights into the effectiveness of the federal system adopted in 2015. The findings indicate that while local governments have made strides in exercising their exclusive rights, approximately half still face challenges in fully utilizing these powers. Concurrent rights, which require collaboration between local and provincial governments, remain unclear for many local entities, resulting in operational inefficiencies. The study underscores that expenditures by local governments significantly and positively influence economic growth, in contrast to provincial and federal expenditures, which show no meaningful impact. This suggests that empowering local governments with greater fiscal autonomy could be pivotal for driving economic progress. However, the limited revenue-generating capabilities of provincial governments pose a significant hurdle, emphasizing the need to allocate more economic rights and resources to this tier of governance. These insights are vital for policymakers, as they highlight the necessity of clarifying fiscal roles and improving the resource management capabilities of local and provincial authorities.

The study also addresses the broader challenges within federal framework of Nepal, particularly in Sudurpashchim Province, which trails in key development metrics such as per capita income and human development indices. The analysis reveals that internal revenue streams account for less than 5% of total revenue, underscoring the province's heavy dependence on federal grants and shared revenues. This reliance weakens the potential of fiscal decentralization to spur economic growth and reduce disparities. The research concludes that for the federal system to achieve its goals, provincial governments must be equipped with enhanced revenue-generating authority and greater fiscal independence. Furthermore, the findings advocate for reforming the spending practices of provincial and federal governments, which currently lack a significant impact on economic growth. Addressing these issues can help Nepal fully realize the benefits of fiscal federalism, ensuring that decentralization fosters sustainable economic development and strengthens governance at all levels.

V. Conclusion and Implication

Around 50 percent of the local level governments have been utilized the exclusive rights and around 50 percent of the local government have unable to utilize the exclusive right. Regarding the concurrent right majority of the local governments are confused and provisions are not clear. The expenditure of local level governments has significant and positive relationship with economic growth. Whereas, the expenditure of provincial and federal government has insignificant relationship with economic growth. The findings of the study are helpful to the policy makers, and employees of local level government, provincial government and federal governments offices. This study has focused Sudurpaschim Province only, if the study can be extended covering all the provinces of Nepal would have more impressive and valuable results.

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