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Public Spending without Payoff: Provincial Evidence from Nepal

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Abstract

This study examines the relationship between provincial government expenditure and economic growth in Nepal using panel data from seven provinces covering the fiscal years 2017/18 to 2024/25. The Pooled Ordinary Least Squares (POLS) method was employed to assess the effects of capital and current expenditures on provincial economic growth. The findings reveal that neither expenditure category has a statistically significant impact on economic growth, suggesting that increased fiscal allocations have not yet yielded measurable economic returns at the provincial level. The results indicate that fiscal decentralization alone is insufficient to achieve regional development objectives without effective institutional and governance mechanisms. Weak implementation capacity, dependence on intergovernmental transfers, and inefficient utilization of public resources appear to constrain the developmental role of provincial governments. The study highlights the need to improve expenditure quality, strengthen institutional capacity, and prioritize productive investments to enhance the contribution of provincial governments to Nepal's economic development.

Keywords: provincial government, public expenditure, capital expenditure, current expenditure, economic growth

Public Spending without Payoff: Provincial Evidence from Nepal

The Constitution of Nepal (2015) established a federal governance system with seven provincial governments and constitutionally assigned fiscal autonomy. This decentralized structure aimed to improve resource allocation, strengthen local accountability, and align public expenditure with regional development priorities (World Bank, 2021). Since 2018, intergovernmental fiscal transfers have become a key component of fiscal federalism, increasing public expenditure by approximately 8-9 percent of GDP and raising overall government spending by about 4.5 percent of GDP (Ministry of Finance, 2018). However, whether increased provincial spending has translated into measurable economic growth remains an unresolved question.

One of the most contentious topics in development economics is the relationship between public expenditure and economic growth (Dahal et al., 2025). Classical growth theory tends to treat government expenditure as an exogenous factor, whereas Keynesian perspectives argue that public spending can stimulate private investment through infrastructure development and improved public services. In contrast, neoclassical and endogenous growth theories caution that inefficiently allocated or excessively large public expenditure may crowd out private investment, generate inefficiencies, and ultimately constrain long-term growth. These theoretical divergences highlight the need for empirical investigation, particularly in developing and decentralized contexts such as Nepal.

Empirical studies at the national level have been undertaken on this nexus. According to the results by Gajurel and Dangal (2021) based on time-series data on 1974/75-2018/19, aggregate spending in the public sector had a positive impact on GDP, but the sectoral effects remained different: health and transportation spending were negatively correlated with growth. Dhungel (2022) found that the expenditures of agriculture, education, health, and transport each had a positive relationship with GDP during the period 1990/91 to 2019/20, indicating the effectiveness of conscious investment. ARDL and ECM analysis by Giri (2022) of data from 1975 to 2021, conversely, showed that growth would be significantly increased by agricultural spending, and the spending on education would affect growth negatively, and spending on health and communications would be statistically insignificant. These divided findings imply that spending impacts on growth are severely context-sensitive and composition-sensitive.

Nevertheless, the high heterogeneity among the provinces of Nepal is obscured through the national-level analysis. The economies of the provinces vary widely in terms of endowment of resources, infrastructure capacity, human capital, and the effectiveness of institutions. As an example, both Bagmati Province and Madhesh differ in many ways; human development indicators in Bagmati are usually higher than in Madhesh, whereas Lumbini is now experiencing a high growth after having a large infrastructure project like Gautam Buddha International Airport and major irrigation schemes. Such deviation indicates that the economic payoff of government expenditure at the provincial level can be very different.

There is little evidence on the link between provincial growth and expenditure. Gajurel (2023) is one example in which the author analyzed the impact of economic growth, public expenditure, infrastructure, and financial development on economic growth and public expenditure in the seven provinces of Nepal (2019- 2023). With fixed effects, he learned that, as he expected, infrastructure investment, using the products pipeline and the green construction index, shared significantly positive effects with financial development, but the impact of economic growth was negative, and neither the effect of capital alone nor the effect of current expenditure singly was statistically significant. This work, though insightful, dealt with financial development rather than growth and therefore left the question of expenditure growth as fundamentally unanswered at the provincial level.

The fiscal devolution of authority to the provinces creates a unique chance to evaluate the impacts of capital versus current expenditures in the various kinds of public expenditures on the performance of the regional economies. By funding infrastructural projects, capital expenditure is projected to increase productivity, as well as draw in the investment of privately owned businesses. The wages, subsidies, and operational costs can sustain the delivery of the service, but this current expenditure is likely to have less on long-term growth unless accompanied by capital investment. At the provincial level, empirical testing can provide an answer to whether these theoretical expectations are true or not in post-federalized Nepal.

This study fills this gap by investigating the relationship that exists between provincial public expenditure and economic growth in Nepal through pooled ordinary least squares (POLS) estimation of panel data. The simple form offered by POLS offers a clear lower baseline estimate of average association province-wide prior to regressor with unobserved heterogeneity adjusted. The analysis separates capital and current venture so as to be able to compare their relative effect in terms of growth. In that case, this paper examines the relationship between public expenditure and economic growth at the provincial level with the use of panel data.

Since the empirical evidence is not available at the provincial level in Nepal, the findings will not only be useful to the pool of academic research on fiscal decentralization, but also to the domestic policy argument on optimal allocation of expenditure. When spending seems to have a low or unimportant effect on growth, it can mean matters like the fiscal inefficiency in spending, the wasteful effect of spending (misallocation), or the delayed appreciation of the spending. On the other hand, strong positive impacts would encourage the provincial level of government to augment its investment. Either way, outcomes have a direct influence on the formulation of expenditure policies in line with the federal development of Nepal.

Theoretical Foundations

The relationship between public expenditure and economic growth is explained through three main theoretical perspectives. First, Keynesian and endogenous growth theories posit that government expenditure can stimulate aggregate demand and enhance productivity, particularly through investments in infrastructure, health, and education. Such productive spending may crowd in private investment by reducing costs and uncertainty while generating human capital and network externalities (Okunlola et al., 2024; Sosvilla-Rivero, 2025). Second, neoclassical and public choice theories argue that inefficient or debt-financed public expenditure may crowd out private investment, distort resource allocation, and weaken long-run growth performance (Nguyen & Bui, 2022). Third, a composition-sensitive approach emphasizes that growth effects depend on expenditure structure, where capital spending generally produces stronger and more persistent impacts than recurrent spending, although recurrent expenditure may support growth when it complements productive investment (Onifade et al., 2020; Sosvilla-Rivero, 2025).

These theoretical outcomes are further conditioned by institutional quality. Weak governance, corruption, and limited implementation capacity can significantly reduce or even reverse the expected growth effects of public expenditure (Nguyen & Bui, 2022). Hence, Nepal's provincial context provides a pertinent empirical setting to assess how expenditure composition and governance capacity jointly influence economic growth in a decentralized fiscal framework.

Empirical Evidence: Global Perspective

The relationship between public expenditure and economic growth is widely analyzed through three principal theoretical perspectives. First, Keynesian and endogenous growth theories argue that government expenditure can stimulate aggregate demand and enhance long-run productive capacity, particularly when directed towards infrastructure, health, and education. Such productive public spending may crowd in private investment by reducing production costs and investment risks, while simultaneously generating human capital accumulation and positive network externalities that reinforce sustained economic expansion (Okunlola et al., 2024; Sosvilla-Rivero, 2025). Second, neoclassical and public choice theories contend that inefficient, excessive, or debt-financed public expenditure may crowd out private investment, distort resource allocation, and undermine long-term growth performance by weakening market incentives and fiscal discipline (Nguyen & Bui, 2022). Third, the composition-sensitive approach emphasizes that the growth effects of public expenditure are not uniform but depend critically on its structure, where capital expenditure typically generates stronger, more persistent, and productivity-enhancing impacts compared to recurrent expenditure, although recurrent spending may still support growth when it complements productive public investment and service delivery (Onifade et al., 2020; Sosvilla-Rivero, 2025).

These theoretical predictions are further moderated by institutional quality and governance effectiveness. Weak administrative capacity, corruption, and poor implementation mechanisms can substantially reduce, or in some cases fully negate, the anticipated growth-enhancing effects of public expenditure (Nguyen & Bui, 2022). Against this theoretical backdrop, Nepal's provincial governance structure provides a relevant empirical context to examine how expenditure composition, combined with institutional capacity, shapes economic growth outcomes within a decentralized fiscal framework.

Empirical Evidence: Nepalese Context

The empirical literature on Nepal's public expenditure–growth nexus remains limited and largely national in scope, although recent studies offer useful but mixed evidence. Gajurel and Dangal (2021) report a generally positive association between aggregate public expenditure and real GDP, yet sectoral disaggregation reveals heterogeneous coefficients, suggesting possible misallocation or lagged effects. Similarly, Giri (2022) finds that agricultural expenditure is strongly growth-enhancing, whereas education expenditure is negatively associated, and health and communication expenditures are statistically insignificant. These inconsistent outcomes align with composition-sensitive growth theory, indicating that fiscal effects vary across sectors and transmission channels.

Following federal restructuring, evidence suggests a gradual shift in expenditure composition toward recurrent spending. Upadhyaya (2025) documents an increasing share of recurrent expenditure relative to capital spending, while Khanal (2024) highlights its implications for growth performance. Khatri and Bista (2023) further identify persistent inefficiencies in budget execution, particularly weak capital expenditure performance, which constrains expected fiscal multipliers. At the macro level, Kunwar and Nepal (2024), similarly, show that expenditure-growth relationships are highly sensitive to model specification and expenditure composition.

At the subnational level, econometric evidence remains emerging. Gajurel (2023), using a provincial panel (2019-2023), finds that infrastructure significantly promotes financial development, while capital and current expenditures are individually insignificant in explaining growth–finance dynamics, underscoring strong provincial heterogeneity. Adhikari (2025) also highlights the importance of GDP growth, population, and budget size in shaping fiscal outcomes. Collectively, these studies confirm that Nepal's evidence base is still dominated by aggregated analyses, with limited direct examination of provincial growth effects.

Overall, three stylized facts emerge: (i) aggregate expenditure shows a weak but generally positive association with GDP, while sectoral effects remain inconsistent; (ii) capital budget inefficiencies persist, limiting growth transmission; and (iii) provincial-level evidence on expenditure–growth relationships remain scarce. International literature increasingly distinguishes capital and recurrent expenditure using dynamic panel approaches, emphasizing the role of institutional quality and composition effects. Against this backdrop, a clear empirical gap exists in Nepal regarding whether provincial capital and recurrent expenditures significantly influence provincial economic growth in the post-federal period, motivating a systematic panel-based investigation.

Methods and Materials

Data Sources and Variables

The study uses panel data for seven provinces of Nepal covering 2017/18-2024/25, the federalism implementation period under the 2015 Constitution. Data are drawn from the Nepal Rastra Bank (NRB) Data Bank, ensuring reliable and comparable subnational fiscal statistics. The dependent variable is provincial economic growth, measured by annual percentage change in gross provincial product at constant prices (Onifade et al., 2020; Sosvilla-Rivero, 2025). Explanatory variables include log-transformed current and capital expenditures (Wooldridge, 2013).

Econometric Model Specification

Given the short time dimension (T = 8) and cross-sectional units (N = 7), a Pooled Ordinary Least Squares (POLS) approach was adopted. The POLS estimates a single set of coefficients by pooling all cross-sectional and time-series observations, assuming parameter homogeneity across provinces. This method is widely used in exploratory panel analysis, especially when the primary interest lies in baseline relationships rather than unobserved heterogeneity (Hsiao, 2014). While more complex estimators, such as fixed effects or random effects, can account for individual heterogeneity, POLS provides a useful benchmark, particularly for small-T datasets (Baltagi, 2021). The estimated benchmark model is expressed in equation (i).

$$EGR_{it}=\alpha+\beta_1 CUREX_{it}+\beta_2 CAPEX_{it}+\varepsilon_{it} \quad \text{(i)}$$

To address differences in measurement units, provincial economic growth is measured in percent, while current and capital expenditures are reported in rupees. Accordingly, the expenditure variables are transformed using natural logarithms to reduce scale effects and improve comparability across provinces. This transformation also supports elasticity-based interpretation of the coefficients. The resulting semi-log specification is presented in equation (ii).

$$EGR_{it}=\alpha+\beta_1 \ln CUREX_{it}+\beta_2 \ln CAPEX_{it}+\varepsilon_{it} \quad \text{(i)}$$

EGR denotes the province's economic growth rate; CUREX and CAPEX are the provincial government's current and capital expenditures, respectively. The parameter α is the intercept, β_1 and β_2 are the slope coefficients on ln CUREX and ln CAPEX, ε is the error term, ln is the natural logarithm, i is the entity (provinces), and t is time. The expected signs of β_1 and β_2 are positive and significant. The estimation was performed using E-Views econometric software (version 9).

Findings and Discussion

Trend of Provincial Government Expenditure and Economic Growth

Provincial government expenditure and economic growth are closely connected, highlighting how fiscal policy can influence regional development paths. Understanding this link is crucial for evaluating whether spending enhances productive capacity, promotes equitable growth, and addresses structural inequalities within a post-federalization setting, such as Nepal's evolving provincial structure. Figure 1 illustrates the trend of economic growth across Nepal's seven provinces over the past eight years.

Figure 1

Trend of Economic Growth of the Seven Provinces of Nepal

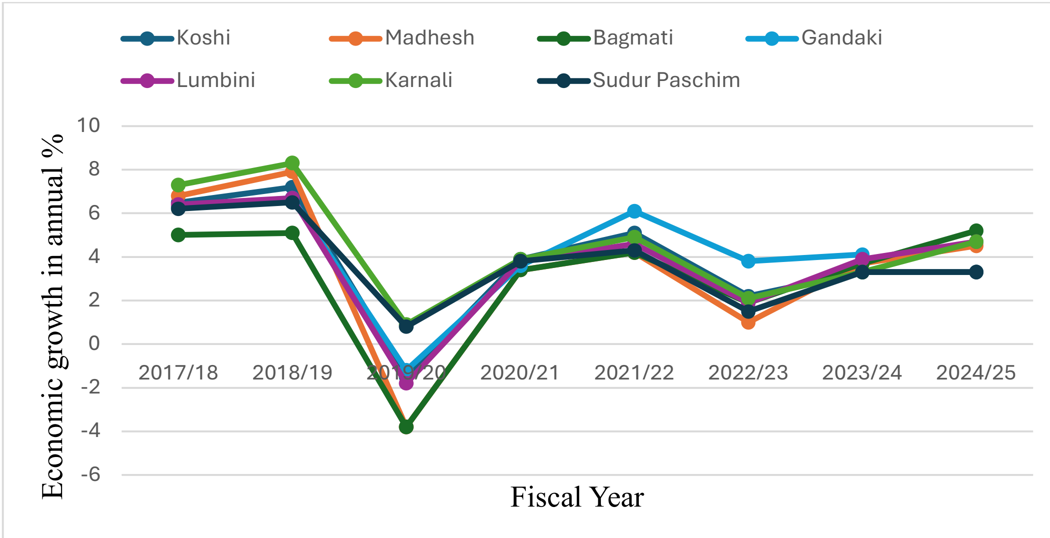
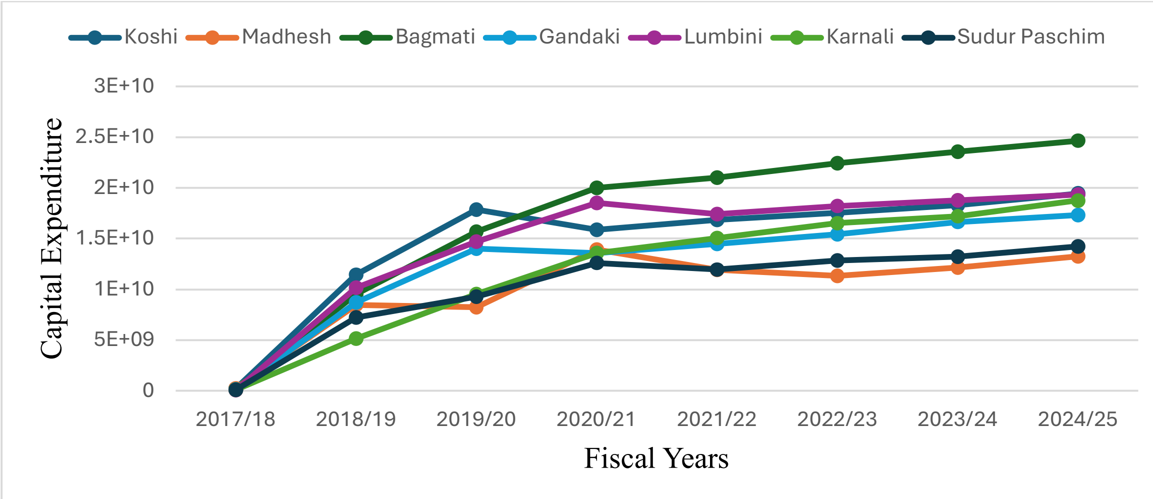


Figure 1 presents annual economic growth rates across Nepal's seven provinces from 2017/18 to 2024/25. Growth is steady in 2017/18–2018/19, with Karnali and Gandaki slightly leading. A sharp contraction occurs in 2019/20, especially in Madhesh and Bagmati, followed by recovery in 2020/21 and a peak in 2021/22, particularly in Gandaki. Growth declines again in 2022/23 before a gradual recovery by 2024/25. The pattern indicates a synchronized shock, likely COVID-19, with uneven provincial recovery. To examine this relationship further, provincial expenditure trends are analyzed through capital and current components, with Figures 2 and 3 illustrating their movement alongside economic performance over time.

Figure 2

Trend of Capital Expenditure of the Seven Provincial Governments of Nepal



The figure illustrates the trend of capital expenditure across Nepal's seven provincial governments, Koshi, Madhesh, Bagmati, Gandaki, Lumbini, Karnali, and Sudur Paschim, from 2017/18 to 2024/25. Capital expenditure, covering infrastructure, equipment, and long-term development projects, rises sharply across all provinces in the early years of federalism. This increase from 2017/18 to 2019/20 reflects institutional establishment, expansion of development programs, and initiation of infrastructure projects at the provincial level. Bagmati consistently records the highest capital expenditure, exceeding NPR 24 billion by 2024/25, while Koshi and Lumbini also show sustained growth. Gandaki and Karnali exhibit gradual increases, narrowing the gap with higher-spending provinces. Madhesh shows relatively modest growth after 2019/20, suggesting either lower project execution capacity or different fiscal priorities. From 2020/21 onward, growth stabilizes across provinces, indicating a transition from rapid expansion to more structured investment planning. This pattern reflects institutional maturation and continued commitment to infrastructure-led development under federalism.

Figure 3

Trend of Current Expenditure of the Seven Provincial Governments of Nepal

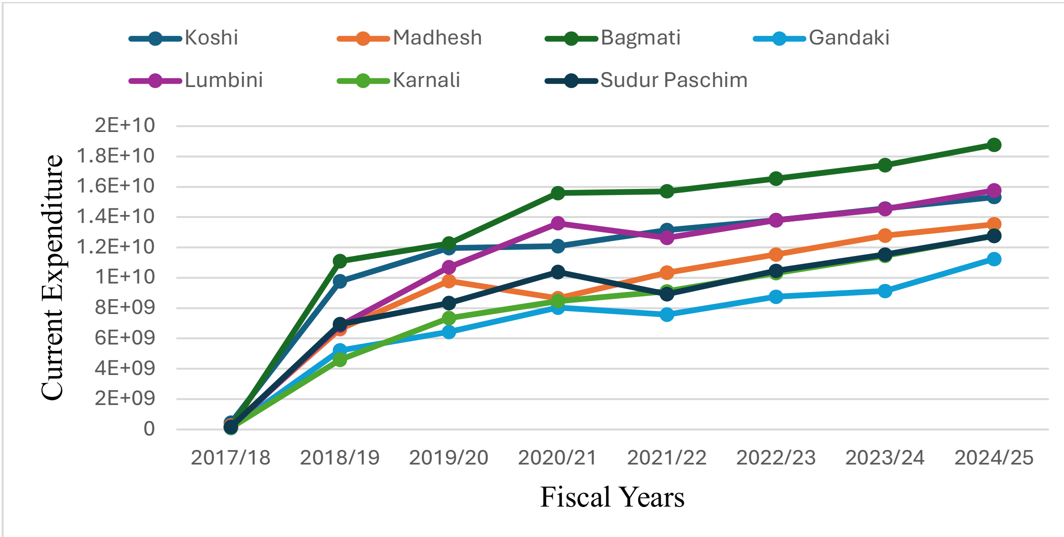


Figure 3 presents trends in current expenditure across Nepal's seven provincial governments from 2017/18 to 2024/25. A sharp rise is observed in 2017/18–2018/19, reflecting the rapid expansion of fiscal operations following federal restructuring. Bagmati consistently records the highest current expenditure, exceeding NPR 18 billion by 2024/25, while Gandaki and Karnali remain comparatively lower. From 2018/19 onward, growth becomes more gradual with minor fluctuations; for example, Gandaki shows a temporary decline in 2021/22 before recovering. Lumbini, Koshi, and Sudur Paschim exhibit steady increases, indicating a gradual expansion of administrative and recurrent spending obligations. Overall, the pattern reflects early acceleration followed by stabilization, driven by institutional maturation and fiscal adjustment, although inter-provincial disparities persist with partial convergence over time.

The eight-year panel analysis indicates that both capital and current expenditures have generally increased alongside provincial economic growth, suggesting a positive association between fiscal expansion and economic performance. Early rapid growth in expenditure reflects post-federal restructuring adjustments, while later stabilization indicates more structured fiscal management. Provinces with higher capital spending, particularly Bagmati, tend to show stronger economic outcomes, implying the growth-enhancing role of infrastructure investment. Increasing current expenditure also corresponds with expanded administrative functions and service delivery, reinforcing economic activity. Overall, the observed patterns suggest that capital expenditure plays a relatively stronger role in supporting provincial economic growth within Nepal's federal system.

Descriptive Statistics

The following analysis presents the descriptive statistics for the key variables, reporting the mean and standard deviation for each across all seven provinces. These measures highlight the central tendency and variability in provincial economic growth, capital expenditure, and current expenditure over the study period. By examining the average levels and dispersion of these variables, the analysis provides insights into inter-provincial differences and the extent of fiscal and economic disparities within Nepal's federal structure.

Table 1

Descriptive Statistics of Economic Growth and Expenditure of the Seven Provincial Governments of Nepal

Province	Mean of EGR	Mean of CAPEX	Mean of CUREX	SD of EGR	SD of CAPEX	SD of CUREX
Koshi	3.75	146911012500	11381150000	2.73	6324496989	4747228102
Madhesh	3.46	9937650000	81860550000	3.61	4411042296	4231611086
Bagmati	3.09	14874915000	1740825000	2.99	9840535006	5942111717
Gandaki	4.36	12534725000	7057675000	2.55	5652032241	3337636333
Lumbini	3.78	14650150000	10999962500	2.71	6621953005	5180788426
Karnali	4.23	11993937500	8025525000	2.48	6544946469	4064686272
Sudurpaschim	3.71	10181912500	8683075000	2.00	4674099126	3901606443

Table 1 presents the mean and standard deviation of economic growth rate (EGR), capital expenditure (CAPEX), and current expenditure (CUREX) across Nepal's seven provinces over the study period. Gandaki records the highest average economic growth rate (4.36%), followed by Karnali (4.23%), while Bagmati shows the lowest (3.09%) despite high expenditure levels. Bagmati leads in capital expenditure (NPR 14.87 billion), followed by Koshi and Lumbini, indicating strong infrastructure investment. It also records the highest current expenditure (NPR 17.40 billion), reflecting greater administrative and recurrent costs, whereas Gandaki and Karnali show lower averages.

Standard deviation values reveal notable variability across provinces. Economic growth variation is highest in Madhesh (SD = 3.61) and lowest in Sudur Paschim (SD = 2.00), indicating relative stability. Capital and current expenditures also fluctuate most in Bagmati, likely due to irregular large-scale projects and administrative expansion, while other provinces show comparatively stable patterns. Overall, the data highlight distinct fiscal profiles across provinces, with differences in spending levels and stability.

The results suggest that higher capital expenditure does not automatically translate into higher economic growth, as evidenced by Bagmati's lower growth compared to Gandaki and Karnali. This indicates that the efficiency and quality of expenditure, rather than its volume, are more important for economic performance. Differences in variability also reflect disparities in fiscal discipline and implementation capacity across provinces, underscoring the need for more efficient and targeted public spending.

Effect of Government Expenditure and Economic Growth at the Provincial Level

The study employs a Pooled Ordinary Least Squares (POLS) estimation using eight years of panel data from Nepal's seven provinces. This method enables the assessment of the combined effect of capital and current expenditure on provincial economic growth while controlling for inter-provincial and temporal variations. The approach provides a comprehensive view of how different categories of expenditure are associated with growth patterns, offering insights into the fiscal dynamics within Nepal's federal governance framework.

Table 2

Nexus of Capital and Current Expenditure of Provincial Government with Economic Growth

Variables	Coefficient	Std. Error	t-Statistic	Prob.
Constant	20.65802	5.588593	3.696462	0.0005
LCAPEX	0.046743	0.849173	0.055046	0.9563
LCUREX	-0.793931	0.962159	-0.825155	0.4130
Goodness of fit test		R-squared = 0.159	Adjusted R-squared = 0.127	
F statistic = 5.011		Prob (F-statistic) = 0.010	Durbin-Watson stat = 1.039	
Breusch-Pagan Test		$\chi2$ (3) = 1.235	Prob. = 0.0778	

In Table 2, the Breusch–Pagan test ($p = 0.0778$) is statistically insignificant at the 5 percent level, indicating no strong evidence of heteroskedasticity and supporting the use of the POLS model without the need to shift to fixed or random effects. The results align with the broader reality of Nepal's political and economic context, where provincial governments have yet to demonstrate a substantial contribution to overall economic growth and development. The insignificant effects of both capital and current expenditure suggest that, despite increased fiscal outlays, provincial spending has not translated into meaningful economic gains. This points to structural and institutional inefficiencies, where issues of governance, implementation capacity, and spending quality overshadow the potential benefits of increased budget allocations. In this context, fiscal quantity alone appears insufficient to drive growth, underscoring the need for systemic reforms to enhance the effectiveness of provincial expenditure in Nepal's federal system.

Public Spending without Payoff

The evidence from this study could hardly be more damning for the provincial tier of Nepal's federal system. Introduced under the 2015 Constitution with the lofty promise of improving efficiency, accountability, and development equity, the provincial governments have yet to demonstrate any measurable contribution to economic growth. The Pooled OLS results confirm what a large segment of Nepali citizens have been saying since 2018, that the provincial structure is, at best, redundant and, at worst, an expensive administrative experiment that diverts resources without delivering results (World Bank, 2021).

At the heart of the problem is a chronic failure of institutional capacity. Provincial administrations have been plagued by unclear mandates, overlapping functions with federal and local bodies, and a high turnover of bureaucrats that disrupts continuity and undermines planning (Paudel et al., 2023; Shrestha & Pyakuryal, 2019). Rather than acting as engines of regional growth, the provinces have become heavily dependent on federal transfers—often exceeding 80% of their budgets, thereby eroding fiscal autonomy and creating a culture of dependency rather than productivity (Sharma & Thapa, 2024).

The composition of spending further compounds the problem. The recurrent budget continues to dominate, financing salaries, allowances, and administrative overheads rather than capital investments with long-term growth potential (Upadhyaya, 2025). Even when capital budgets are allocated, their execution is dismal, frequently falling below 70%, due to procedural delays, political bargaining, and weak procurement capacity (Bahl et al., 2021). This aligns with global research showing that in low-governance environments, decentralization often magnifies inefficiencies, misallocation, and rent-seeking, producing negative or negligible growth effects (Nguyen & Bui, 2022; Okunlola et al., 2024).

Sectoral outcomes under provincial responsibility have been similarly underwhelming. Health financing reforms intended to leverage proximity to citizens have yielded mixed results, with resource distribution skewed toward politically influential districts rather than areas of greatest need (Paudel et al., 2022). Infrastructure spending has lacked coordination with federal strategies, leading to duplication, stalled projects, and politically motivated investments (Thapa & Sapkota, 2023). These patterns reinforce the view that the provincial layer adds complexity to governance without adding commensurate value to service delivery or economic transformation.

In light of these realities, the political case for retaining Nepal's provincial structure appears increasingly weak, as public concerns stem from measurable inefficiencies, fiscal dependency, and the absence of clear growth outcomes. Without a substantial overhaul of governance, clarifying mandates, strengthening accountability, and aligning expenditure with measurable results, provincial governments risk being perceived as a costly political layer rather than a driver of provincial development. In its current form, federalism has created an intermediary tier that absorbs resources, crowds out more effective local investment, and yields limited economic justification. Overall, the evidence suggests that without urgent reforms in governance and fiscal prioritisation, the provincial system will continue to impose administrative costs with minimal developmental impact.

Conclusion

This study concludes that provincial government expenditure has not yet translated into measurable economic growth in Nepal during the period under review. The absence of a significant relationship between both capital and current expenditures and provincial economic growth suggests that increased fiscal allocations alone are insufficient to achieve the developmental objectives envisioned under the federal system. It indicates that the effectiveness of provincial governments is constrained by institutional weaknesses, limited implementation capacity, and the inefficient utilization of public resources. Consequently, the developmental role of the provincial tier remains limited despite the expansion of fiscal responsibilities since the introduction of federalism.

The findings imply that strengthening the economic contribution of provincial governments requires reforms that go beyond increasing public expenditure. Greater emphasis should be placed on improving expenditure quality, enhancing budget execution capacity, and aligning spending priorities with productive and growth-oriented sectors. In addition, clearer functional responsibilities, stronger institutional capacity, and improved accountability mechanisms are essential to ensure that fiscal decentralization generates tangible economic outcomes. Without such reforms, the continued expansion of provincial expenditure may increase administrative costs without producing corresponding developmental benefits, thereby undermining the economic rationale and long-term effectiveness of Nepal's provincial governance structure.

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