

Economic Freedom Audit: Government Size in Nepal

Subhekshya Ghimire

1. Introduction

Developing nations, including Nepal, tend to have a small fiscal size. This isn't necessarily because governments aim to limit their role in the economy, but due to challenges like resource crunch and systemic inefficiencies. As the Economic Freedom of the World report states, a small fiscal size of government is insufficient to ensure prosperity.¹ In 2022, Nepal scored 7.55 in the Government Size index, making it the 33rd economically free country in terms of government size. Seven years prior, Nepal had ranked 10th globally; admittedly, in the past seven years, government consumption in Nepal has increased significantly.

Studies show that government consumption and GDP are inversely correlated. For instance, Landau and Barro note that an increase in government consumption as a share of GDP is associated with a decline in per capita GDP.² This inverse relationship highlights potential adverse effects of excessive public spending. Their findings, coupled with Brimelow's Rahan curve, suggest that there is an optimum level of government spending given the economic growth rate of the country and the type of government spending or investment that is prioritized.³

Nepal had already reached its optimum level of government spending. The 2015 country audit highlighted that Nepal was at an optimum level of government spending; it further cautioned that additional increases could negatively impact economic growth.⁴ However, since the 2015 earthquake, Nepal has had to invest significantly in reconstruction efforts. Consequently, government consumption has increased; the decline in scores should thus not be surprising. Given the context of reconstruction, this audit frames the analysis of Nepal's government spending through the lens its effectiveness. It examines the changes since 2015 that have resulted in a lower score and argues for some actionable steps that can be taken in the years to follow.

On paper, Nepal has a freer economy with low government involvement compared to regional peers (Table 1). Because most regional peers fall under the developing or least developed category, the inefficiencies in governments can be assumed. Another relevance is the time series comparison that

¹ James Gwartney, Robert Lawson, and Ryan Murphy, *Economic Freedom of the World: 2024 Annual Report* (Fraser Institute, Canada: 2024), 10, <https://www.fraserinstitute.org/studies/economic-freedom-of-the-world-2024-annual-report>.

² Daniel Landau, *Government Expenditure and Economic Growth: A Cross-Country Study*, Southern Economic Journal (1983), 783–792; Robert J. Barro, *Economic growth in a cross section of countries*, The Quarterly Journal of Economics, 106(2), 407–443.

³ Peter Brimelow, "Why the Deficit Is the Wrong Number," *Forbes* 151 (1993): 79.

⁴ Samriddhi Foundation, *Economic Freedom Country Audit Report Nepal 2015* (Samriddhi Foundation, Kathmandu:2015), <https://samriddhi.org/publications/economic-freedom-country-audit-report-nepal-2015/>

shows a decreasing score over the years.⁵ The relatively worse overall ranking than the ranking for government size shows that other components might drag the economic freedom. It is important to understand that even though the government size score in isolation shows a good picture, the reality is far from so. The score fails to capture the nuances that are a hindrance to an effective and efficient government size. Nepal's government size and government investment score look comparable to even some free and developed economies in the index. If the efficiency of the amount spent is high, even low spending can yield high results. However, in economies with high corruption and systematic inefficiencies rooted in the public system, it is seldom the case.⁶

Countries (Rank)	Overall ranking	Government consumption	Transfers and subsidies	Government investment	Top marginal tax rate	State ownership of Assets	Size of Government	Government Size Rank
Bangladesh	127	9.52	9.23	7.57	9	6.33	8.33	14
Bhutan	98	3.78	9.46	6.04	7.5	5.25	6.41	96
Lao PDR	125	5.28	9.73	7.38	9	3.29	6.94	67
Sri Lanka	123	8.72	9.21	8.49	10	7.35	8.75	7
Vietnam	99	7.63		6.87	6	4.61	6.28	106
India	84	7.47	8.23	7.4	7	8.56	7.73	25
Iran, Islamic Rep.	158	5.31	7.99	9.37	8	4.26	6.99	64
Pakistan	134	8.56	9.22	8.78	7	6.67	8.04	18
Thailand	65	4.55	8.94	6.97	7	6.88	6.87	70
Nepal	86	9.11	8.19	8.26	5	7.18	7.55	33
Lower Middle Income Country's Average		5.45	7.53	7.12	6.49	6.66	6.63	
South Asian Countries		5.4	7.51	7.27	6.55	6.81	6.69	

Table 1: Cross-Country Comparison

⁵ The score of Size of Government for Nepal, as reported in the Economic Freedom Index over the years: 7.55 (2022), 7.69 (2021), 7.77 (2020), 8.11 (2019), 7.8 (2018), 7.81 (2017), 8.46 (2016), and 8.55 (2015).

⁶ In 2024, Nepal ranked 107 out of 180 countries with a score of 34/100.

Source: *Economic Freedom of the World, 2024*

Nepal went through significant political and economic transformations, shaped by both internal policy shifts and external shocks. The 2015 earthquake and the COVID-19 pandemic disrupted economic stability and altered the trajectory of government expansion and fiscal policy. The year 2016/17 saw a 39% increase in government expenditure compared to the year 2015/16. In the aftermath of the earthquake, the government had to redirect its funding to reconstruction. Nepal's already high social security expenses continued to increase despite visible shortfalls in revenue collection post-COVID-19.⁷

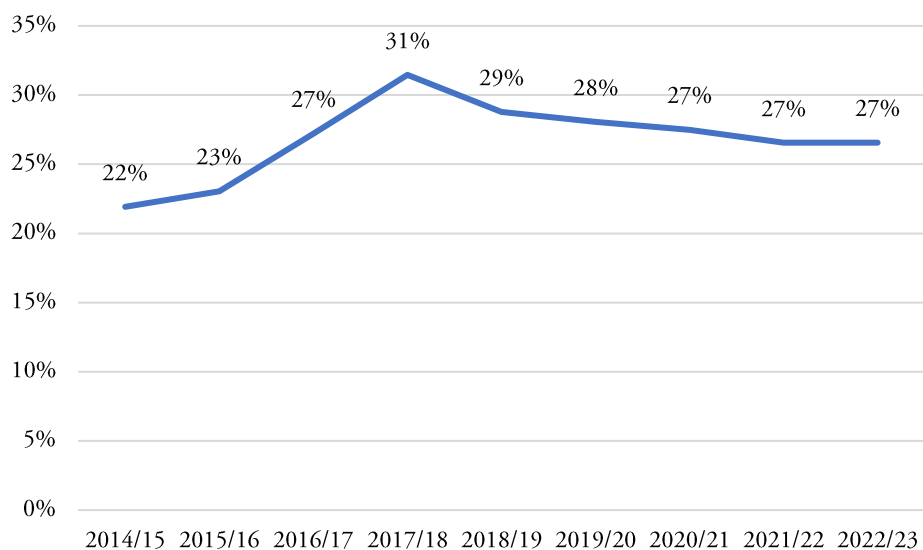


Figure 1: Government spending as a percentage of GDP

Source: *NRB, Current Macroeconomic and Financial Situation*

Between 2015 and 2021, Nepal's spending on transfers and subsidies increased gradually, from around 62% to more than 77% of total government expenditures. Nepal's emphasis on redistribution is comparable to high-income nations such as Sweden, Switzerland, and Japan, where transfers have consistently absorbed about 70-75% of spending. However, unlike these nations, Nepal's fiscal condition remains fragile, and the longevity of a transfer-dependent pattern of expenditure is concerning. The high increase in transfer and subsidies since 2018 (Figure 2) correlates with Nepal's transition to a federal structure, which includes increased grant-based payments to subnational governments and the implementation of new social security systems.

⁷ SPGE and UNICEF, *Public Finance Budget Brief: Review of Expenditure Trends Since 2017/18* (SPGE and UNICEF, Kathmandu: 2023), <https://www.unicef.org/nepal/media/19306/file/Expenditure%20trend.pdf>.

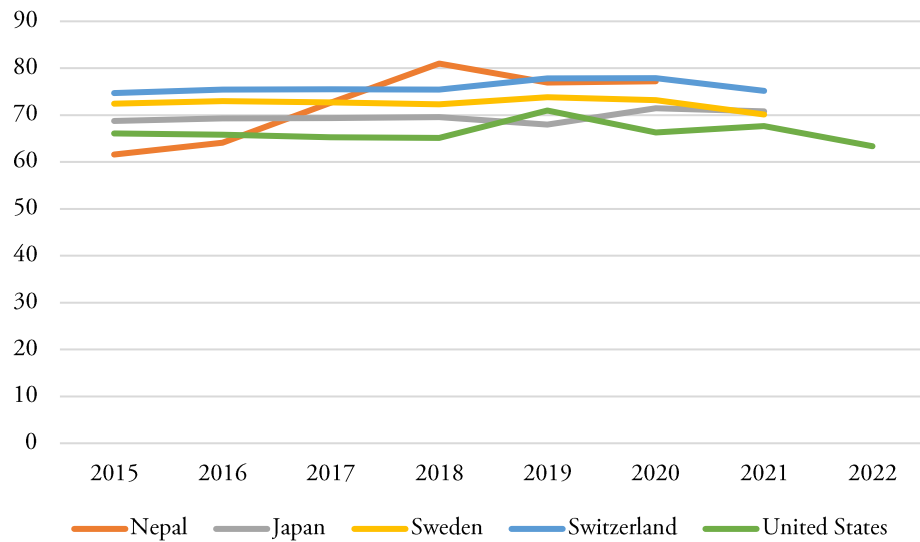


Figure 2: Transfer and Subsidies as a percentage of expenses

Source: World Bank

2. Nepal's Federal Transition

Nepal's federal model was designed to decentralize governance, transferring substantial responsibilities to provincial and local governments, but the federal government's size and influence remain substantial. Nepal's federal transition was a political bargain. This is especially evident after the 2007 Madhesh uprising when federalism was written into the Interim Constitution to guarantee territorial autonomy.⁸ Consequently, the Nepali federal structure represents an Hour-Glass. Like an hourglass, power, resources, and policy attention often bypass the provinces, flowing directly from the federal government in Kathmandu to local governments, leaving the provincial tier weakened and sidelined (Figure 3). To that extent, the federal government's size is significant.

⁸ André Lecours, The Question of Federalism in Nepal. (Publius 44, no. 4 (2014)): 609–32. <http://www.jstor.org/stable/24734639>.

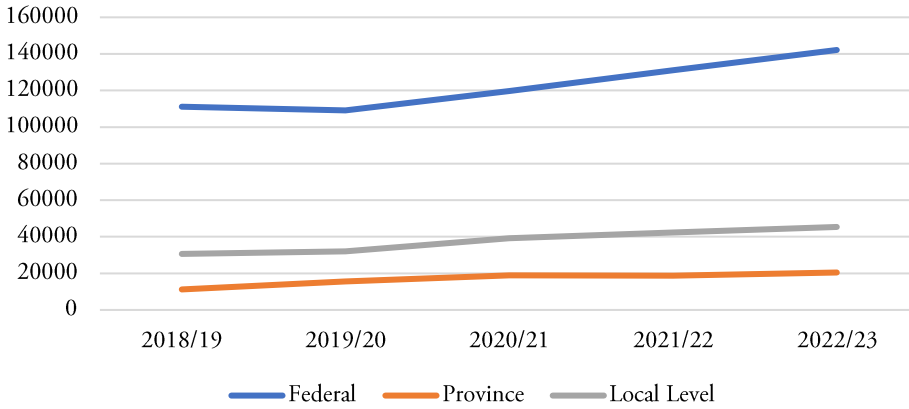


Figure 3: Expenditure of the three levels, including transfer of grants

Source: Database of Nepalese Economy, NRB

Ideally, the recurrent expenditure of the Federal government should have decreased but it has **only increased since**. Despite the theoretical transfer of approximately 60% of the federal workload to subnational governments, overlapping responsibilities persist, limiting the autonomy of lower tiers of government.⁹ The proliferation of federal ministries and personnel exemplifies the challenges in operationalizing federalism. Nepal now has 21 federal ministries, although recommendations suggest that the number could be reduced to 12 or 16 for efficiency.¹⁰ This expansion has contributed to increased recurrent expenditures, including salaries and pensions, further limiting resources available for capital investment. It is worth noting that a significant proportion of recurrent expenditure also consists of conditional grants and some non-conditional grants transferred to provincial and local governments. Such grants remain part of federal recurrent expenditure, even though the expenditures are at the subnational levels and are capital in nature.

Ministry	Total recurrent expenditure	Total expenditure	Recurrent expenditure as a percentage of total expenditure
Ministry of Finance	262,818,431.45	20,963,248,965.33	1.25%
Ministry of Industry, Commerce and Supply	85,444,375.29	6,022,678,842.90	1.42%

⁹ Khim Lal Devkota, Provincial Budgets Suffer amid Federal Neglect, (Kathmandu Post, June 11, 2024) <https://kathmandupost.com/columns/2024/06/11/provincial-budgets-suffer-amid-federal-neglect>

¹⁰ As recommended by the Public Expenditure Review Commission, report retracted from the website

Ministry of Energy, Water Resources and Irrigation	3,479,264,616.92	34,227,965,331.52	10.16%
Ministry of Agriculture and Livestock Development	28,550,744,220.48	30,398,700,032.10	93.92%
Ministry of Home Affairs	173,559,486,366.56	182,484,452,476.95	95.11%
Ministry of Physical Infrastructure and Transport	9,027,716,503.62	94,275,872,254.12	9.58%
Ministry of Urban Development	1,287,686,404.71	21,596,555,914.11	5.96%
Ministry of Education, Science and Technology	42,457,682,645.70	42,616,589,878.99	99.63%
Ministry of Labor, Employment and Social Security	1,051,412,958.82	1,120,748,043.14	93.81%

Table 2: Some ministry wise expenditure at the federal level

Source: Consolidated Financial Statement 2021/22

While each province now has its own Ministry of Physical Infrastructure, the ministry at federal level still continues to dominate the expenditure (see Figure-4). The provincial expenditures range from NPR 6 to 15 billion and the federal ministry alone spends more than NPR 94 billion. Also, more than NPR 9 billion, about 10%, of that sum is recurrent in the federal level. 76.34% of the ministries recurrent expenditures are under the headings non conditional capital and current grants and conditional current grants. When higher levels of fiscal decentralization is substantially related with improved efficiency in public service delivery, this concentration of fiscal resources and administrative overhead reflects the partial fiscal and functional decentralization inherent in federalism.¹¹

¹¹ Arodoye, Niyi L., and Akhere E. Abusomwan. Fiscal Decentralization and Public Service Delivery Efficiency: Evidence from Cross-Country Analysis. *(AIJER: Asian International Journal of Economics and Regional Development* 4, no. 4 (2022): 1–13. <https://www.ij-scholar.in/index.php/aijear/article/view/212466>

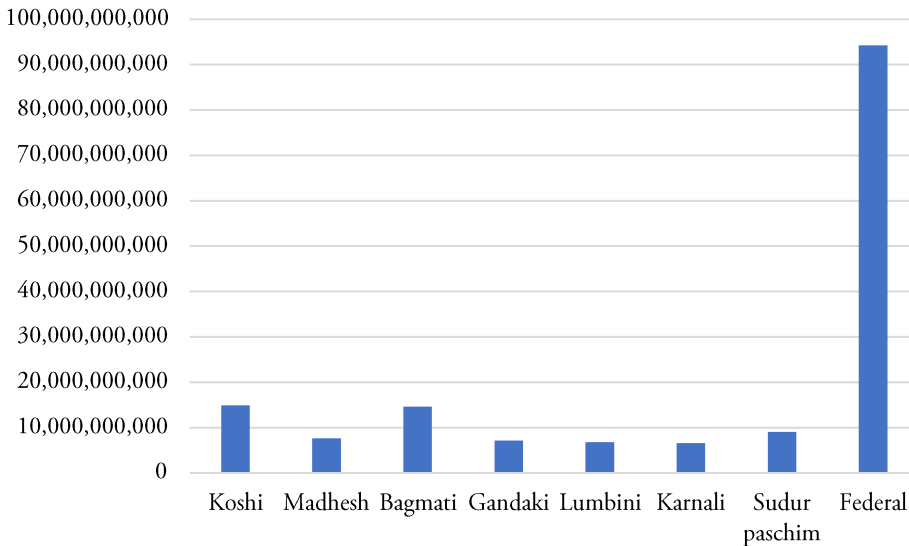


Figure 4: Provincial and federal budget of Ministry of Physical Infrastructure
Source: Consolidated financial statements 2021/22

Federalism was intended as a means to bring governance closer to the people, yet persistent inefficiencies and mismanagement continue to undermine its true benefits. The constitutional arrangement is such that the three levels of the government have exclusive and concurrent functions. However, there still exist huge ambiguities filled with overlapping mandates, resources and efforts, causing confusion and inefficiency in service delivery to the constituencies (Asia Foundation, 2020).

The role of sub-national governments is unclear. Fiscal responsibilities in Nepal are allocated to all three levels of government. The success of the division of responsibilities is contingent on the level of cooperation and mutual reinforcement these bodies have with each other. In practice, however, this cooperation is lacking. One of the participants in our consultation meeting noted that provincial governments frequently try to negotiate with local governments while at the same time trying to lord over the federal government. This failure to clearly define the provincial government’s scope and boundaries has underutilized its potential. While provincial governments should function as intermediaries between the federal government and local government, they seem to be stuck in the middle of competing interests which is detrimental to effective governance and decision making. A survey of Nepali people indicates that the trust in municipal wards, local governments, provincial government, and federal government are 79.7%, 75.1%, 51.6% and 56.2% respectively; the provincial institution is least trusted.¹²

¹² The Asia Foundation, A Survey of the Nepali People in 2022, 2022, <https://asiafoundation.org/wp-content/uploads/2024/08/A-Survey-of-the-Nepali-People-2022.pdf>

There is a significant mismatch between the allocated tasks and available human resources across the tiers. The transfer of 60% workload and responsibilities to the sub-national government and the concentration of civil servants at the federal level is contradictory in themselves. The sub-national governments are not sufficiently staffed to fulfill their responsibilities and are not well-trained. Ex-bureaucrats note that in terms of service delivery, its efficiency does not only depend on the local government's willingness, as in fact, local governments are tremendously constrained in their effort to serve people owing to incomplete decentralization with a lack of a shift in human resources. Even if local governments take the initiative with regard to federalism and its execution, the federal and provincial administrations as self-governing units have not yet fully accepted and owned their roles within the federal system. Crucial bills required for the full implementation of federalism like the civil service bill are yet to be passed.¹³ This uneven commitment has resulted in a governance gap, where both central and local governments seem to be unwilling to divide the decision-making and financial control. Because of this, the multi-tiered system of governance is not yet fully functional and the constant battles between the governments at different levels are not allowing any development to take place.

There is also a recurrent concern of overlapping institutions and duplication of roles across the various levels of government. Politically motivated parallel institutions like the social security scheme and farmers subsidy are being set up at all sub-national levels, among other things, which is bound to add jurisdictional overlap and ambiguity in service delivery. Rather than improving the governance of the state, these setups are creating inefficiencies and wastage of resources as similar institutions are catering to the same functions. One of the most critical aspects of Nepal's effort towards federalism is of defining this phenomenon through the lens of politics and an administrative construct—instead of purely focusing on development. The debate over federalism mostly resorts to issues of authority division and management but fails to capture how federalism can contribute to sustained economic growth, infrastructure investment, or even social development.

3. Fiscal priorities

Nepal's governance system continues to struggle with the persisting issue of fiscal priority misalignment. A key underlying issue is that the expenditure needs of the sub-national governments remain unknown. Even though they are responsible for the delivery of most important public services, the provincial and local governments lack proper identification of their expenditure needs. Their largest source of funds is the federal equalization grant, which theoretically should be apportioned in line with their functional obligations and revenue capacities. In practice, however, this device remains flawed.

¹³ The Kathmandu Post. "Parliament's Winter Session Ends without Passing Crucial Bills." *The Kathmandu Post*, April 2, 2025. <https://kathmandupost.com/politics/2025/04/02/parliament-s-winter-session-ends-without-passing-crucial-bills>

Grant formula design is defective, failing to consider special fiscal capacities and expenditures needs of different regions. The conditional grants limit the autonomy so grants like equalization grant need to be based on resource availability and income capacity and yet this dominates the total grants by the federal level (Figure 5). The system of resource distribution is inefficient leading to disarticulated allocations that fail to meet regional priorities in an effective way. Inability to use explicit and transparent allocation criteria contributes to making budget imbalance more acute, leading to sub-national government disparities and contributing to government expenditure inefficiencies.

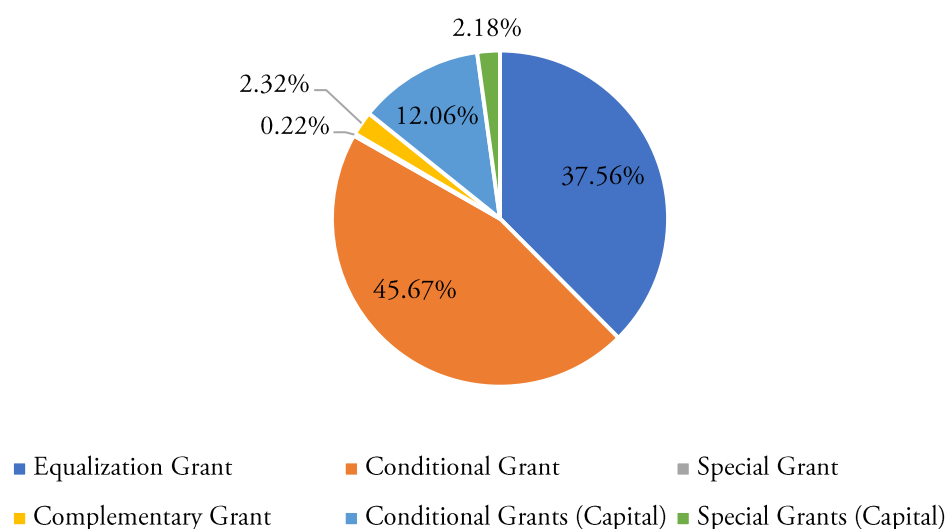


Figure 5: Proportion of grants by the federal level
Source: Consolidated financial statements 2021/22

Periodical relational budgeting and planning are absent or uncoordinated at the federal-provincial-local tier. For instance, policies are developed, or programs are planned and budgeted without considering how similar ones are being executed at other government levels. Sometimes all three or at least two levels allocate budget for the same programs.¹⁴ The Inter-Provincial Council and the National Coordination Council are not operational even though they exist on paper to facilitate this coordination. Despite the cabinet endorsing a policy limiting federal implementation to strategic or large-scale projects above Rs30 million, the federal government continues to execute smaller projects, bypassing subnational governments.¹⁵ The duplication in planning and those partisan budgeting imposed from higher government tiers created weak links among government institutions,

¹⁴ The Asia Foundation. Assignment of Functions Across Levels of Government in Nepal. (The Asia Foundation, 2020) 82 https://asiafoundation.org/publication/assignment-of-functions-across-levels-of-government-in-nepal/?utm_source=chatgpt.com.

¹⁵ Khim Lal Devkota, Budget-making through a Federal Lens. (Kathmandu Post, April 30, 2025). https://kathmandupost.com/columns/2025/04/30/budget-making-through-a-federal-lens?utm_source=chatgpt.com.

inefficient resource allocation, and fragmentation of policies. Rather than respond to changes through active and integrated approaches, various levels of government often undertake separate initiatives, resulting in unproductive expenditure and greater strain on public finances.

Bureaucratic delay, weak accountability systems, and inefficiency in the use of funds are to blame for the pressure on economic productivity and delivery of services. These are structural issues that have concrete consequences—72 local governments did not turn in their budgets, reflecting the structural weakness of the planning and budgeting process. It is not a lack of funds but a governance, planning, and prioritization failure. There is a visible lack of administrative data system to rely on, as a consequence, revenue capacity of sub-national governments remains unknown. Sound Fiscal management requires aligning revenue capacity with expenditure needs.

Nepal has also been suffering from inefficient utilization of resources, with a tendency to scatter resources without an appropriately planned strategy. Inefficiently planned strategy in mobilization of revenues and planning of expenditure has led to irregular delivery of services and fiscal imbalances at the regional level. Perhaps the root of the problem lies in revenue structuring itself, which is underdeveloped and not aligned with the realities of sub-national governance.

Political decision-making fails to prioritize one of the central responsibilities of government, i.e. service delivery. Political players are more concerned with short-term political returns than long-term institutionalization and economic growth. Moreover, private-sector involvement is not prioritized, even though it has the potential to improve service delivery, enhance efficiency, and supplement government income. The lack of an appropriate framework to involve private stakeholders in infrastructure development and public service delivery further limits Nepal to address its economic and developmental issues in an effective manner.

Government spending in Nepal is still largely geared towards recurrent spending, with barely any focus on capital spending that drives long-term growth. While increased spending per se is not always a wrong notion, the lack of visible output from such spending is a cause for serious concern. Capital spending, which is essential for infrastructure development and economic growth, is on the backburner, with actual annual spending always remaining below 70% of budgeted figures. One of the most glaring inefficiencies in expenditure trends is the last-trimester spending, where the bulk of the capital budget is spent in a hurry in the last quarter of the fiscal year. This hasty expenditure typically translates to poor quality of projects, delays, and inefficiencies in public investment. In the 2022/23 financial year, only 17% of the overall budget was spent in capital expenditure, and of that, a staggering 22% was in the last month alone. The predominance of recurrent spending, which accounts for over 65% of total spending, also contributes to the issue by distorting fiscal priorities towards short-term needs away from long-term development goals. Administrative and operational expenditures are

unavoidable, but over-reliance on recurrent expenditure limits the government from making investments in vital infrastructure, public services, and economic productivity. As alarming as the stats are, the consultants also reveal that the stats alone do not do justice to the actual capital and recurrent expenditure in the nation. The data is scattered and does not reflect the reality as the not all of the development expenses are booked as capital expenditure. Even the grant amounts are accounted as current expenditure even if the expenses incurred are of capital in nature. One of the consultants reveal that the discrepancy however is nominal. However, this does question the reliability of such important data points that are used to make fiscal decisions.

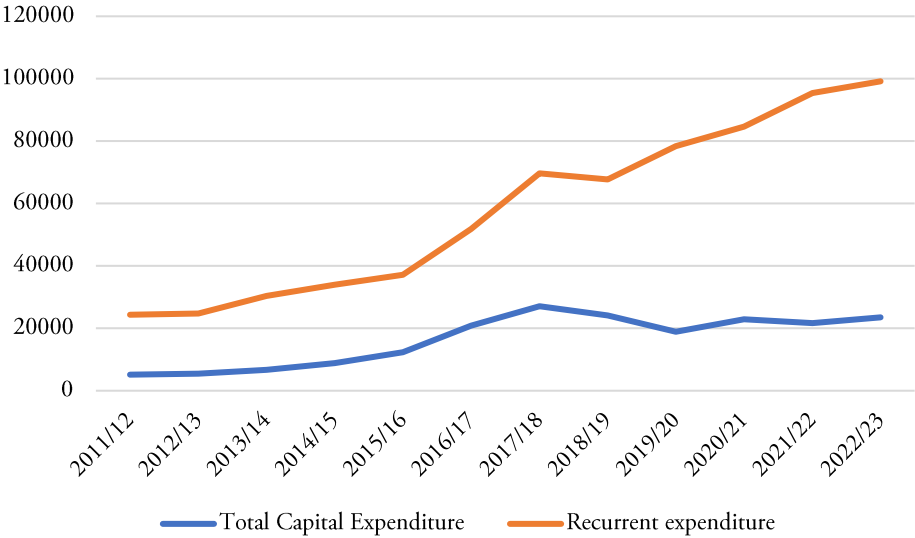


Figure 6: Total capital and recurrent expenditure

Source: NRB

4. Budgetary Process

Nepal's budgeting procedure is linear in nature, meaning that they have same budgeting design for each of the stages. The expenditure for the preparatory stage is different, while it could be different for other stages. This is not reflected in our budgeting system. The rationale behind the budget cycle is to ensure that the execution starts in Mangsir after the necessary preparations are finished. Theoretically, this should enable seamless implementation all year long. The issue, though, is that the preliminary stage is not being used to its full potential. Much of this phase is wasted or poorly managed, which results in inefficiencies later in the fiscal year, rather than setting the foundation for efficient expenditure.

Delays in payments and delays in the process explain last-trimester spending. Payments for finished work are handled at the very end of the fiscal year, which accounts for a large portion of spending in

the last few months of the year rather than projects being completed late. Running bills mount, and because distributions are sometimes made in large quantities at the end of the fiscal year, ministries and agencies scramble to spend what money is left over—not necessarily because the projects call for it, but rather because unused funds run the danger of being reduced in subsequent allocations. To rectify such structural deficiencies and facilitate effective and methodical budget implementation, the LMBIS came into practice. Although the budget is segmented into four quarters, the implementation process shouldn't be seen as perfectly linear. In reality, the inflexibility of this system produces bottlenecks—such as delays in contractor appointment and fund disbursement—which gives rise to eleventh-hour expenditure spikes that reduce productivity and lower project quality.¹⁶

The direct allocation of budgetary funds to specific projects at the local level by ministries distorts municipal priorities. Aside from being contrary to the federal setup, the practice also distorts municipal planning and weakens the autonomy of subnational governments. Local governments are usually left with the responsibility of executing schemes foisted by the federal government and not provided with an opportunity to prioritize their own needs. Instead of allowing local governments to decide their own priorities, they are usually tied down to execute centrally dictated projects. Relational planning and budgeting on a periodic basis are still non-existent or uncoordinated at the federal-provincial-local level. For instance, policies are made or programs are planned and budgeted without considering how similar ones are being executed in other levels of government. The duplication in planning and those partisan budgeting prescribed by the higher levels of government created loose connections between government institutions, wasteful resource allocation, and policy fragmentation. Rather than reacting to shifting circumstances through efficient and timely actions, varying levels of the government can take separate action, resulting in ineffective expenditure and extra strain on the public purse.

5. Nepal's Social Security Programs

Nepal's social security programs have inherent design flaws, generating inefficiencies, misallocation of resources, and fiscal stress. Social security transfers lack targeting accuracy, with numerous eligible recipients left out and ineligible recipients receiving benefits. Increasing administrative expenses have contributed to the burden, making the current social security strategy fiscally unsustainable. World Bank notes that real expenditure on social security programs have increased by over three times over the subsequent 10 years.¹⁷ The increase in national social protection expenditure since 2017 is mainly due to an increase in the size of social security allowance benefits and

¹⁶ Kathmandu Post, "Govt Needs Rs820b to Build Offices and Human Capacity at Local Bodies," *The Kathmandu Post*, October 19, 2017, <https://kathmandupost.com/money/2017/10/19/govt-needs-rs820b-to-build-offices-and-human-capacity-at-local-bodies>.

¹⁷ World Bank, Social Protection: Review of Public Expenditure and Assessment of Social Assistance Programs—Nepal Main Report FY11–FY20, 2021, Retrieved from <https://openknowledge.worldbank.org/server/api/core/bitstreams/5d875453-8579-5636-9fb1-2e32e7a0a10c/content>.

an increase in the benefits provided as public pensions. According to the 61st OAG report (2024), over the last ten years, social security revenue has increased by 19.2%, beneficiaries have increased by 10.42%, and social security spending has increased by 30.53%.¹⁸

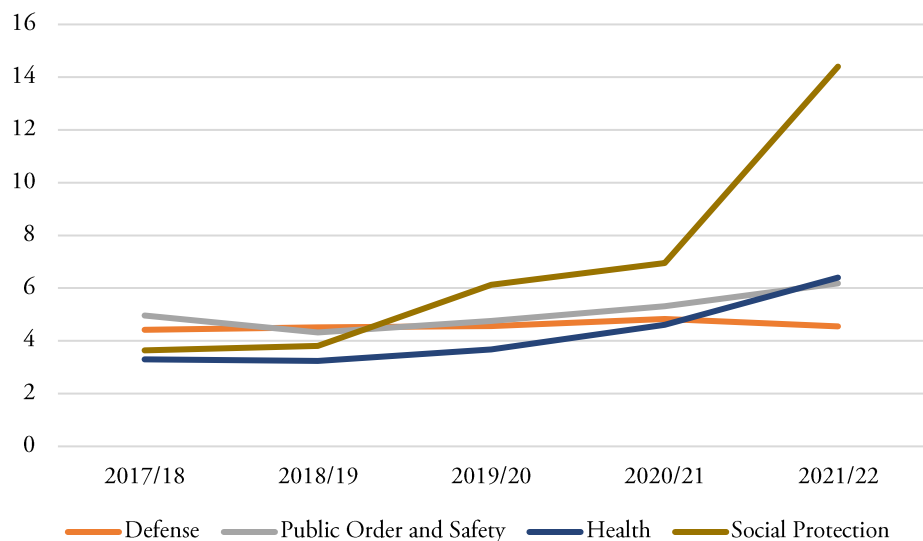


Figure 7: Percentage of government expenditure in different sectors
Source: Office of Auditors General

There is also a case of duplication and triplication error. The social security Act (2075) states that in case a citizen is entitled to more than one kind of social security, he/she shall choose and receive only one kind. The local government operation Act (2017) allows the local government to implement and operate social security programs. In 2021 170 local governments provided social security benefits to beneficiaries with the same citizenship number and birth date by issuing 2 or more identification numbers, or to beneficiaries who had passed away, without properly updating the records. As a result, they have unnecessarily spent more than NPR 22 crore 56 lakh 95 thousand. Likewise, 38 local governments distributed allowances amounting to NPR 78 crore 89 lakh 3 thousand to individuals whose names are not included in the central information system.¹⁹

This is merely an example how there is duplication between tiers of the government. Duplication also exists in the horizontal space as different ministries are implementing programs with same objectives. Currently there are 80 social security schemes in Nepal. If the government is promoting subsidized health care and the average life expectancy is increasing, its only logical to assume that the age criteria for old age allowance should be increased. However, in 2021 the age criteria was decreased from 70 to 68. According to the 2021 census, this expanded the beneficiary pool by 274,667 individuals, adding

¹⁸ Office of the Auditor General, 61st Annual Report of the Auditor General, 2081, 2024.

¹⁹ Office of the Auditor General, Office of the Auditor General's Annual Report, 2078, 2021.

an estimated Rs 13 Arba annually to the fiscal burden. These kind of discrepancies in the understanding of rational behind a program is creating parallel mechanisms that actually have lesser impact compared to the amount being spent.

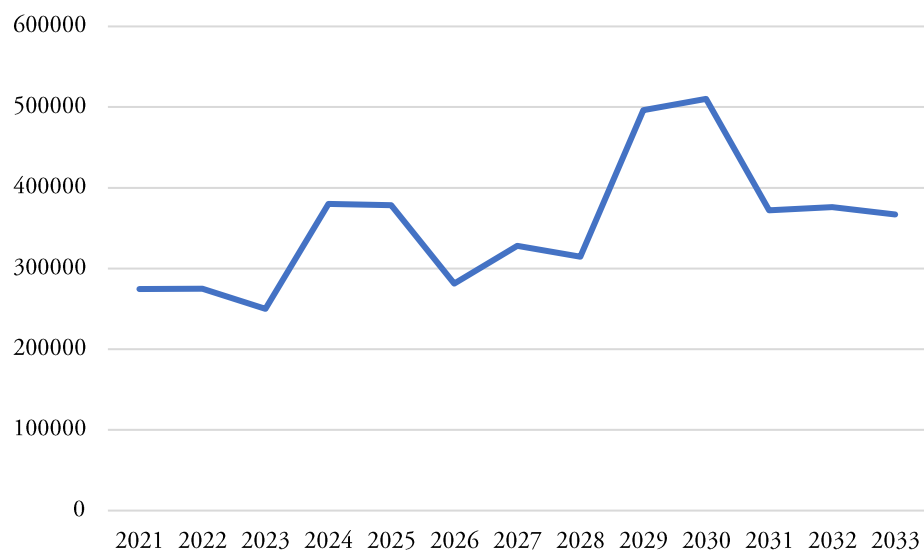


Figure 8: Projected additional expenditure required to fund old age allowance if age limit decreased to 68
Source: Census, Authors Calculation

The absence of a robust data infrastructure has hindered efficient planning, monitoring, and evaluation, leading to inequality in benefit payments. The absence of transparency in such schemes has also eroded people's faith, raising issues of governance and accountability. Rather than promoting economic mobility and independence, Nepal's social security mechanism is largely welfare-oriented, with limited mechanisms of income generation and long-term economic security. Biswo Poudel argues that “we need to reform them (social security programs) to include those that require it and exclude those that do not but to dismiss them in their entirety based on arguments surrounding their viability would also be to dismiss the value they offer in providing some respite to several communities across Nepal.”²⁰

6. Debt Mismanagement and Inefficient Utilization

Increasing debt to GDP ratio of Nepal reflects increasing fiscal risks. There is a clear negative relationship between high public debt and economic growth.²¹ While debt is a means of economic growth, Nepal's excessive dependence on domestic borrowing rather than international borrowing has resulted in fiscal tightening and a liquidity shortage. More alarming, however, is the wasteful

²⁰ Samriddhi Foundation. 2024. Is Nepal Prosperous, Dispatches on Nepal's Economy (December 2024 Issue). Samriddhi Foundation <https://samriddhi.org/wp-content/uploads/2024/12/dispatches-december-024-biswo-poudel.pdf>

²¹ Jung Woo and Manmohan S. Kumar, Public Debt and Growth, (Económica 82, no. 328, 2015), 705–739.

expenditure of borrowed funds—most of which have been spent on non-productive expenditure lacking long-term economic benefits rather than being invested in development-promoting infrastructure.

Political interference in monetary and fiscal policy has also undermined Nepal's debt management framework. Politically more responsive to short-term interests than to long-term economic planning, loans result in misallocation of resources and unsustainable borrowing terms. Nepal can get trapped into debt trap, where low returns on investment and high borrowing cost limit economic freedom, government investment, and overall fiscal sustainability without enhancing fiscal discipline.

Nepal's debt-to-GDP ratio of 42% is a reflection of rising fiscal vulnerability. Debt is an instrument of economic growth, but Nepal's excessive dependence on domestic borrowing compared to foreign borrowing has resulted in liquidity squeeze and fiscal compression. More concerning, however, is the profligate consumption of borrowed funds—instead of being invested in growth-promoting infrastructure, most of the debt was being used for non-productive expenditure that does not bring long-term economic returns.

The service cost paid by Nepal as debt has climbed more than two-fold in mere eight years. This sharp increase suggests mounting fiscal stress, as the government is expending more of its budget in repaying earlier loans rather than funding new development initiatives. The trend shows the combined challenge of debt increase and inefficiency of utilization—while most of the borrowed capital has been sunk into non-productive expenditures, returns have been minimal to help ease repayment obligations. Instead of borrowing to free the economy's growth, Nepal has been resorting more to incurring expenses for its repayment of liabilities to service.

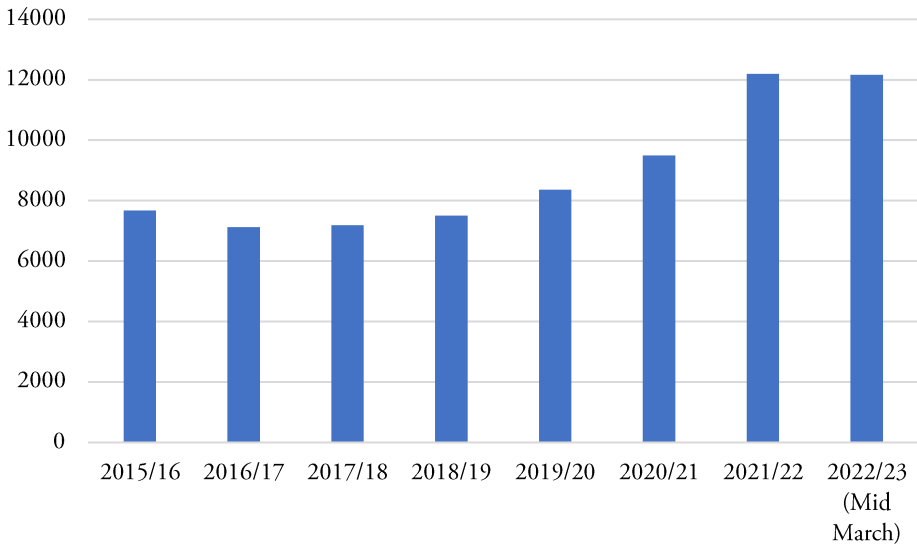


Figure 9: Debt Servicing Cost
Source: Public Debt Monitoring Office

7. State Owned Enterprise

Government ownership of assets is one of the weakest-performing subcomponents for Nepal under the Government Size category in the index. Much of this can be attributed to the ongoing presence of state-owned companies (SOEs), many of which are still politically controlled, ineffective, and financially taxing. Often protected from market competition, SOEs in Nepal are tools for government patronage and interest groups. Many are kept for rent-seeking or populist goals rather than running effectively, which causes a hostile interaction with the private sector. This leads to general economic inefficiencies, misallocation of governmental resources, and crowding out of private investment.

Nepal scores very low compared to other component in government ownership of assets. The nation's last set of tangible efforts to reform the SOEs were decades ago in the 90s. Even though tried nothing has really changed since then. A particularly troubling issue is that 24 of 44 SOEs have not been up to date with their audits, lacking accountability and inhibiting an assessment of their financial health or susceptibility to fiscal risk.

Over the last five years, share investment has increased by 59.2%, and loan investment has increased by 19.9%. As of FY 2079/80, total government investment in SOEs stood at NRS 661 million—approximately 65% in share investment and 35% in loans.

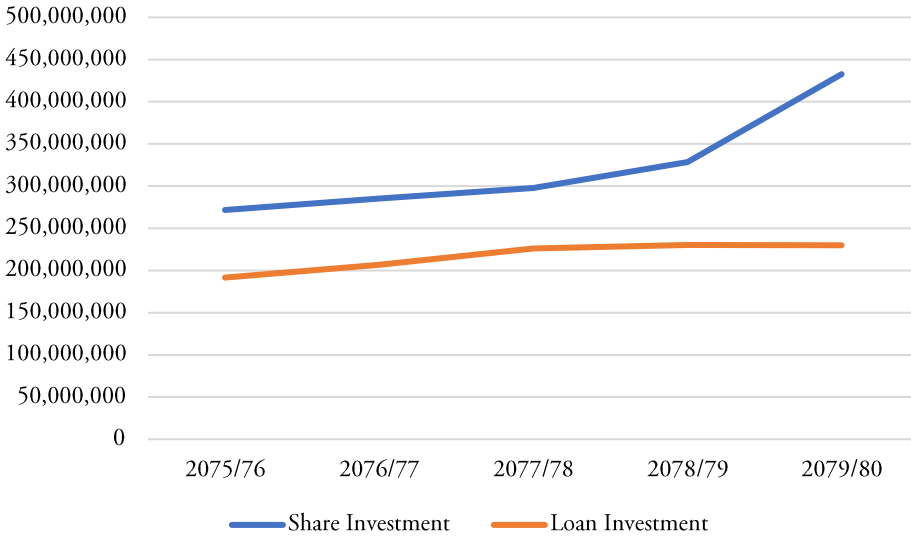


Figure 10: Share and Loan investment in SOEs over the years

Source: Yellow Book, Ministry of Finance

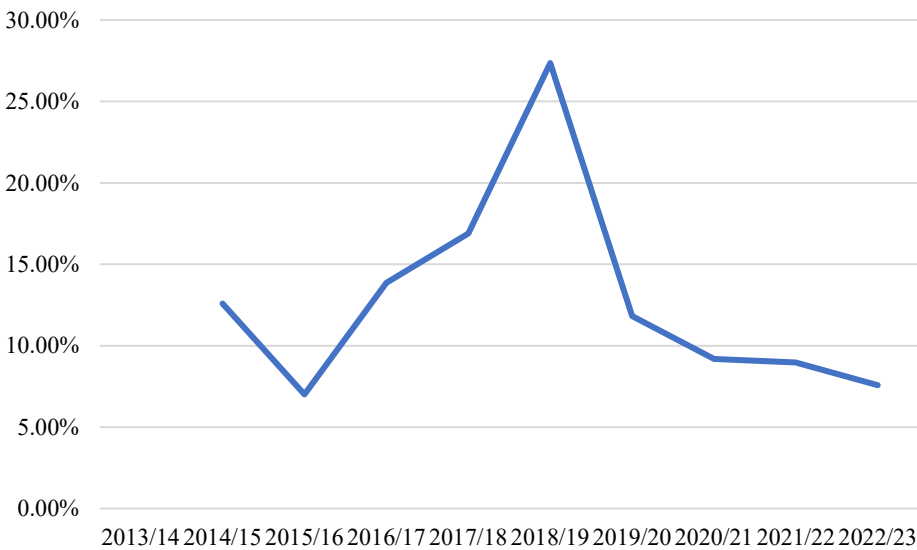


Figure 11: Growth of Investment in SOEs over the years

Source: Yellow Book, Ministry of Finance

The total government investment in state-owned firms has shown a steady increase over the last 10 years. The yearly growth rates are really remarkable, especially with increases like 27.36% in FY 2018/19 showing either capital infusions into existing companies or new projects. Growing investment does not always indicate SOE profitability or efficiency rise. Rather, it shows the government's ongoing and increasing involvement as an economic player. There may once have been plausible ground for

the establishment by the state of a desirable service that had spread too slowly among the populace.²² But that need fades with time as the market evolves. Even within the industrial sector—arguably the area most expected to generate profits—state-owned enterprises have repeatedly failed to deliver positive returns. As the data shows, the industrial SOEs have recorded losses in 9 out of 11 years.

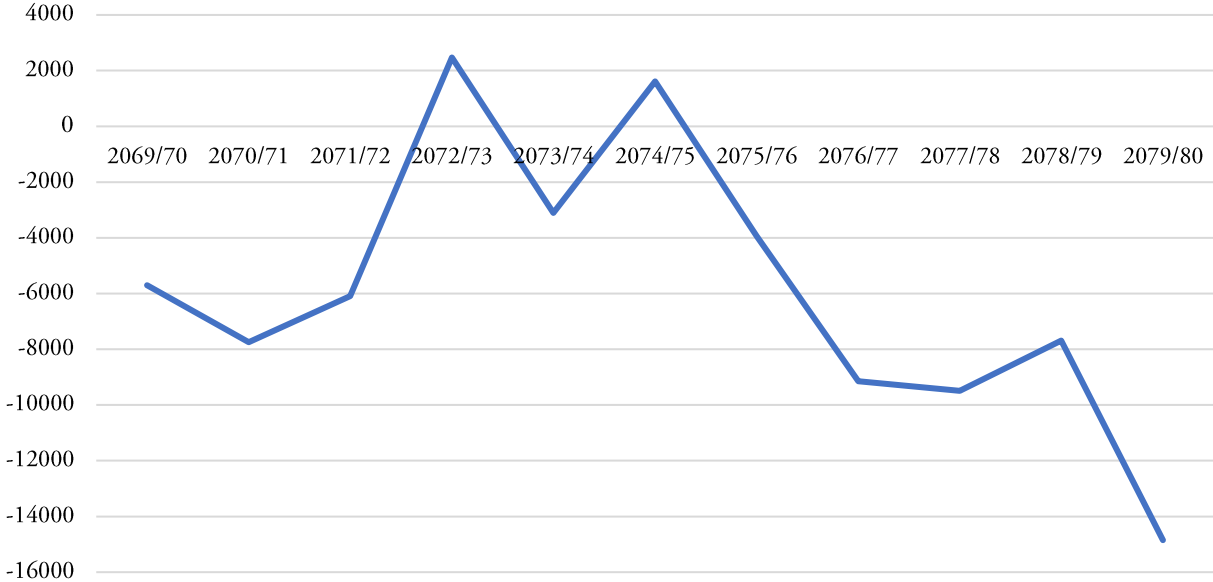


Figure 12: Profit and loss of industrial enterprises (SOEs)

Source: Yellow Book, Ministry of Finance

The Case of NTC: A Partial Reform?

Often mentioned as an effectively reorganized state company, Nepal Telecom (NTC). In 2008, it offered 8.5% of its shares to the public.²³ However, the government remains the promoter and largest stakeholder, and the firm is still listed in the Ministry of Finance’s Yellow Book under both “privatized” and “state-owned” classifications. This generates misunderstanding regarding the genuine nature of its position and administration.

Although NTC is more efficient than many other SOEs, its reform has not served as a guide for more general deregulation. Instead, it remains an outlier, and partial privatization has not appreciably diminished state control.

Airports as White Elephants

²² Arthur Seldon, Government Failure and Over-Government,(Vol. 5 of The Collected Works of Arthur Seldon, 2005), 108

²³ Ministry of Finance, Nepal, Annual Status Review of Public Enterprises 2081, 2024.

While airports may not be "enterprises" in the classic sense, they are state-owned infrastructure projects that operate under complete government ownership, finance, and management – generally through civil aviation authority or government departments. In Nepal's instance, these are administered by the Civil Aviation Authority of Nepal (CAAN), which operates both as operator and regulator – a blatant conflict of interest.

Nepal has 53 airports, of which 19 are operational.²⁴ An example in our case is the Pokhara International Airport constructed in 2079/80 at a total cost of NRS 25.34 billion. It was financed with a loan from the Exim Bank of China at a rate of interest of 2% to be repaid within 13 years from 2026 and an annual repayment term of around \$19.8 million (interest + principal).

However, the airport generates only around NRS 550 million in revenues every year and costs NRS 400–600 million to operate—too small even to pay for running costs, not to speak of debt servicing. Above all, the airport is not approved to operate foreign flights in Indian skies, casting deep doubts on its economic viability. This means the project was politically motivated and not grounded in prudent feasibility study.

The issue with this is that the airport has not received international sanction from Indian airspace to conduct operations. The diplomacy that has gone into it, the economic and environmental sustainability of the venture is very questionable. The experiences are the same with other airports erected all over Nepal. The haste seems to be laying the groundwork for airports and employing it as an election gimmick rather than striving for efficiency.

Recommendations

1. Fixing Resource Mismatches Across Federal Levels

Nepal must establish transparent, evidence-based rules for sub-national governments for better fiscal discipline and resource utilization. The mechanism of fiscal equalization must be reconfigured to create a fairer division of revenue-generating and spending functions.

Distribution of resources has to take into account population, geography, and potential economic basis at the local level to achieve fairness and efficiency in the distribution. Since a local government requires forest, land, and water resources that are in the concurrent list, it's vital to determine how to

²⁴ Office of the Auditor General, 61st Annual Report of the Auditor General, 2081, 2024.

go about this matter.²⁵ Local governments particularly need an expenditure priority framework harmonized through mechanisms of revenue-sharing, complimentary grants, and special grants. Moreover, the level of conditional grants assigned should be gradually reduced to enhance greater adaptability.

Further differentiation of the local governments—focusing on resource endowment, administrative ability, as well as geographical constraint—can help align fiscal policy with the precise requirements of every province. It is important to recognize that each province and local government has varying conditions when developing programs for an effective and responsive fiscal system.

2. Tackling Governance Inefficiencies and Building Institutional Capacity

Inefficiencies in governance still afflict Nepal's federal system. Encouraging intergovernmental coordination is instrumental in preventing duplicative administration and policy inconsistency. Establishing effective functional guidelines among the federal, provincial, and local governments will improve service delivery and governance effectiveness.

There must be a supporting macroeconomic climate to spur provincial competition and investment. There also must be properly defined workload differentiation between government levels to prevent redundant duties.

Autonomy should not be in isolation; past experiences in Nepal have shown misuse of decentralised powers. There needs to be a robust regulatory framework that ensures autonomy is exercised responsibly. Moreover, while capacity development programmes are essential, the mindset of elected members has tended to make it challenging to implement them. Instead, they should be focused on building government staff capacity and human resource management to facilitate long-term institutional development.

3. Reforming Fiscal Priorities

Government spending should shift towards capital investment rather than excessive recurrent expenditures. OAG report still highlights that SUTRA has not been used properly and the case is similar with LIMBS, appropriate and maximum use of programs like this help ensure that budget implementation is tightly monitored to minimize wastage and strengthen accountability at every government level. The non-linearity in the budgeting system should be addressed so that the budget cycle operates as to its intention.

²⁵ Samriddhi Foundation, Local Governments in Nepal: A Brief History and Some Thoughts on Recent Developments (October 2024), <https://samriddhi.org/wp-content/uploads/2024/12/04-dispatches-october-024.pdf>.

Strengthening the fiscal autonomy of local governments by improving revenue-sharing agreements is essential to balance spending with local economic agendas. Local governments must institutionalize prioritization policy of spending, with an arrangement to coordinate revenue-sharing, complementary grants, and special grants for most impactful effects.

4. Bridging the Gap Between Policy and Execution

Nepal's governance issues are not due to the absence of policies but due to their ineffective implementation. A robust institutional foundation for policy implementation is needed in order to improve the government's effectiveness.

This requires:

- Intensive capacity-building efforts to make the bureaucracy more efficient.
- Better systems of transparency and accountability to prevent misappropriation and corruption.
- Systems of real-time monitoring and evaluation to track policy progress, identify bottlenecks, and allow timely course correction.

5. Strengthening Social Security

To improve Nepal's social security as efficient, fair, and budget-friendly, implementation of programs should be coordinated through a centralized umbrella organization to reduce administrative costs and duplication. Evidence-based policies are necessary—a dynamic real-time data system can increase targeting accuracy, making sure that benefits reach the right people who actually need them while reducing exclusion and inclusion errors. Instead of relying on blanket subsidies, Nepal's social security programs must be linked to economic empowerment programs such as skill development, employment schemes, and entrepreneurship support. Improved monitoring and evaluation frameworks are also essential to prevent leakages and inefficiencies. Although the rollout of National ID systems has prevented double-dipping under social security programs, stronger verification and oversight measures are still needed to ensure program integrity.²⁶

²⁶ Shrestha 2024, notes that in 2024 the number of beneficiaries receiving social security benefits were down by 200,000 as NID was introduced; Prithvi Man Shrestha, "Social Security Beneficiaries Down by Almost 200,000," Kathmandu Post, March 2, 2024, <https://kathmandupost.com/national/2024/03/02/social-security-beneficiaries-down-by-almost-200-000>.