



earmarked  
**grant**  
allocation in Nepal



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- Yatindra K.C



# Earmarked Grant Allocation in Nepal



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# List of Acronyms

ADB-Asian Development Bank

DDC-District Development Committee

DFID-Department for International Development

FCGO-Financial Comptroller General's Office

FRA-Fiduciary Risk Assessment

ICEPP- International Center for Public Policy

IGFA- Intergovernmental Fiscal Arrangement Act

LBFC- Local Bodies Fiscal Commission

LED- Local Economic Development Assessment

LISA-Local Government Institutional Self Capacity Assessment

MoFAGA- Ministry of Federal Affairs and General Administration

MoF-Ministry of Finance

NNRFC- National Natural Resources and Fiscal Commission

NPC- National Planning Commission

OECD- Organization of Economic Cooperation and Development

OLS- Ordinary Least Square Regression

SDC- Swiss Agency for Development and Cooperation

UNCDF-United Nations Capita Development Fund

UNDP-United Nations Development Program

v.s.-Vikram Samvat

VDC-Village Development Committee



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# Executive Summary

Nepal's fiscal architecture is evolving. Having had ample experience with intergovernmental fiscal transfers in the erstwhile unitary system, the current federal intergovernmental fiscal transfer system borrows heavily from the previous system. Changes are also being made to the current fiscal architecture, but this evolution has only been limited to non-earmarked grant allocation. While earmarking has received a fair share criticism from sub-federal governments, it remains an understudied area, to the extent that its purpose remains unclear, and its procedures remain unexamined. A more pressing issue today is also the use of performance earmarking and its scope in the overall intergovernmental transfer system framework.

Equally important is the institutional mechanism. Currently, there are three central agencies—MoF, NNRFC, and NPC that are involved in allocating grants to sub-federal units. Each agency exercises power to a varying degree. When the analysis of the intergovernmental transfer system is framed through the lens of institutions involved and the powers exercised by them, there are some mismatches that come to light. The NNRFC, although deemed to be independent through its status as a constitutional commission, is nonetheless limited by prescriptive legislations that affect the exercise of its constitutional powers. The NPC has the power to allocate grants, yet its power to monitor and evaluate remains minimal. The MoF remains the most powerful agency in so far as it is responsible for the national treasury, and it even exercises monitoring and evaluation function when it comes to earmarked grants.

Special grants, Complimentary grants, and Conditional Grants allocated by the federal government have some form of input-based conditionality. Yet conditional grants are the only text-book earmarked grants in Nepal in so far as the other two grants allow some form of local government autonomy by requiring sub-federal units to submit a project proposal to be eligible for grants.

Grant allocation working procedures for both special and complimentary grants currently envision a framework for performance earmarking. There are at least four indicators currently in place to capture the performance of sub federal governments. But, performance earmarking, although envisioned by the grant allocation procedure, is not implemented currently. Instead, the current system of earmarking, as far as the analysis suggests, functions as a commitment by the federal government that some level of minimum investment in sectors of importance will be guaranteed. Earmarked grants in Nepal to that extent are

more akin to block transfers based on certain conditionality.

Earmarked grant allocations in Nepal requires some fine-tuning. But this matter should be approached from the lens of balancing autonomy considerations and the need for some form of performance earmarking. At the same time, it is also important to consider how the current power sharing arrangements between institutions involved in grant allocation shape the fiscal architecture. Wherever possible powers to recommend grants and monitor the use of grants must lie with the same agency instead of the current multiple agencies with differing powers for the same grant model. There are also some legal reforms that are required in so far as they shape the autonomy of certain agencies.

## Introduction

The practice of decentralisation in Nepal is not entirely new. Since the 1980s, Nepal has gone through varying degrees of decentralisation and complimented it with an intergovernmental transfer system. The architecture of the intergovernmental transfer system to that end was influenced by the governance system in place<sup>1</sup>. Although Nepal adopted a full-fledged system of decentralisation only with the recent promulgation of the Constitution of Nepal in 2015, it nonetheless has had ample time to experiment with varying systems of intergovernmental transfers.

Nepal's experiment with inter-government transfer systems can be best categorized into three phases. The first was a lump-sum transfer system<sup>2</sup>. The second was the adoption of a more rule-based system after the formation of the Local Bodies Fiscal Commission (LBFC) in 2008. The LBFC adopted a formula-based approach specifically designed to capture horizontal fiscal imbalances and take corrective measures. Finally, after 2010/11, the LBFC focused on incentivising the performance of local governments through performance-based allocation. This final shift, although driven by the support of development partners<sup>3</sup>, is nonetheless designed under the pretext of needing some form of incentive mechanism. The predominant thinking concerning fiscal federalism supports the need for incentives and the Nepali practice aligns with the need to put in place a system that works for achieving social welfare maximisation by exploiting a bureaucrat's underlying incentive scheme<sup>4</sup>.

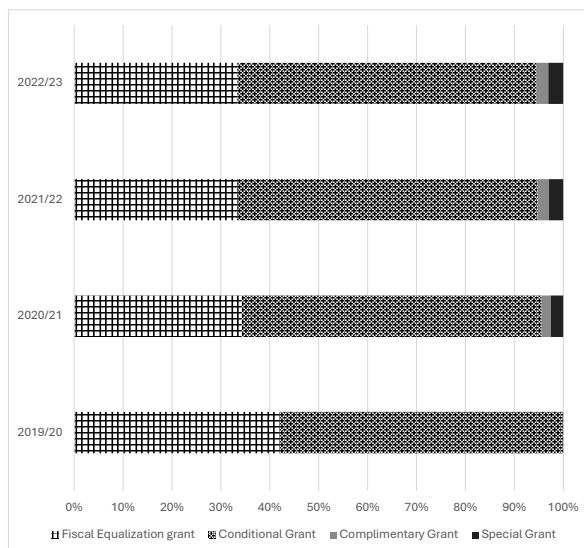
1 For instance, the primary goal of transfers in the unitary system before 2015 was to address horizontal fiscal equity, under the new federal setup the goals are equity both horizontal and vertical, and incentivizing performance. For a detailed discussion on Nepal's decentralization phases and the intergovernmental transfer system see, Roy Kelly, Bimal Koirala and Bansidhar Ghimire, *Stock Taking of Fiscal Decentralization Policies: Consolidated Report* (Kathmandu: Local Bodies Fiscal Commission, 2011), 18-20.; Jamie Boex, "Review of the Criteria and Grant Allocation Formulas for Block Grants to DDCs and VDCs in Nepal", *Population* 40, (2012), 7-14

2 In the absence of data, all local bodies were allocated a lump-sum figure until 1999. Until 1997, each VDC received NPR 300000, this figure was increase by 200000 in 1998. For details see Jameson Boex, "The determinants of the incidence of intergovernmental grants: A survey of the international experience." *Public finance and management* 4, no. 4 (2004), 457

3 Performance based grants to local bodies was administered through the Ministry of Local Development through the Local Governance and Community Development Programme. The programme was supported by the ADB, UNDP, UNCDF, DFID, SDC and others. For details see Kelly, Koirala and Ghimire, "Stock Taking", 31.

4 Wallace E. Oates, "Toward a second-generation theory of fiscal federalism." *International tax and public finance* 12 (2005): 349-373; Barry R. Weingast, "Second generation fiscal federalism: The implications of fiscal incentives." *Journal of urban economics* 65, no. 3 (2009): 279-293. and Prakash Chandra Jha, "Theory of fiscal federalism: an analysis." *Journal of Social and Economic Development* 17 (2015): 241-259. These discussions are not provided here, but briefly they describe the recent shift from benevolent servant approach of the public official to a more incentive driven approach and the need to form a non-linear intergovernmental transfer system that simultaneously seeks to ensure vertical and horizontal equity and incentivize performance.

Despite the existence of transfer systems, Nepal's fiscal architecture in the current setup remains incomplete. Two challenges exist in terms of the transfer system<sup>5</sup>. First, the federal government in Nepal is reluctant to devolve power<sup>6</sup>. As a result, in recent years, earmarked grant allocation, especially allocation of grants for current expenditure, has increased (refer to figure 1 for details). Second, the current mechanism of allocation of funds to sub-federal units has not been able to address both horizontal and fiscal inequities<sup>7</sup>. The latter has been the subject of much discussion<sup>8</sup>, the former however remains understudied.



**Figure 1: Local Government Transfers FY 2019/20-2022/23**

Source: *Intergovernmental Fiscal Transfers Book, Ministry of Finance*

A related concern in recent days is the question of the performance of sub-federal units. Like in the unitary system, the current federal governance system adopts a performance-based transfer system. Currently, the National Natural Resources and Fiscal Commission (NNRFC) allocates 4 per cent of the total fiscal equalisation grant based on its index of performance. The federal government has also put in place mechanisms to capture the performance of sub-federal units. These include the Local Government Institutional Capacity Self-Assessment (LISA), Fiduciary Risk Assessment (FRA) and the Local Economic Development Assessment (LED).

This note, to that extent, elaborates on the mechanism of earmarked allocations in Nepal. In particular, it discusses the rules governing the allocation of special grants, complementary grants and conditional grants. It also analyses the relationship between the performance of sub-federal governments and the allocation of earmarked grants in Nepal to the extent that it is relevant to assess if efforts of the government to capture the performance of sub-federal units have any effect on local government finances or more appropriately if there is a reward and punishment mechanism that has been put in place.

5 For a detailed discussion on Intergovernmental transfer design in the federal context see Khimlal Devkota, *The Fiscal Architecture of Subnational Governments in Federal Nepal* 16-27 (ICEPP Working Paper No. 104, 2021); Khimlal Devkota, *Intergovernmental Fiscal Transfers in a Federal Nepal* 16-36 (ICEPP Working Paper No. 20-17, 2020).

6 Kathmandu Declaration, National Association of Rural Municipalities in Nepal, 3<sup>rd</sup> convention, (2022), 2; Subhas Chandra Shivakoti, Jayadev Shrestha, Sthaniya Sarkarma Sarvajani Vit Vyavasthapanka Sawaal, *Samasya ra Antar-Sarkar Samanvaya Samvandhi Adhyayan* (Kathmandu: National Association of Rural Municipalities, 2022), 46.

7 Devkota, 2020 at 18; Yoshihiro Saito, Nayan Krishna Joshi and Marcela Rincon Roza, *Nepal Fiscal Federalism Update 2024* (Washington DC: World Bank Group, 2024), 22-24

8 See for instance the two previous iterations of the Nepal Fiscal Federalism update.

## A taxonomy of sub-federal grants in Nepal

Intergovernmental transfers can be broadly classified into two groups—General Purpose Transfers and Specific Purpose Transfers.<sup>9</sup> General purpose transfers are transfers that do not have any strings attached to them and are typically mandated by the law. These transfers are provided as budget support to sub-federal units, and they do not remove the basic freedom of sub-federal governments to employ their policy-making power<sup>10</sup>. It is not uncommon for countries to adopt a formula-based general transfer system and Nepal too practices it through the allocation of fiscal equalisation grants.

Specific purpose transfers on the other hand are conditional transfers. The conditions attached to them vary. Depending on the final goal of the transfer system, specific transfers may either have input-based conditionality—conditions on the type of expenditure that can be financed or output-based conditionality—conditions that seek to achieve a certain result. There is, apart from the two broad categories of transfers, a third one that falls into the grey area—bloc transfers. Bloc transfers are provided to support expenditure in a specific area, they fall in the grey area because they allow some form of sub-federal discretion while also maintaining elements of conditionality i.e. input-based conditionality.

Countries, whether federal or decentralised within a unitary framework, adopt varying degrees of the two broad transfers and define them per their own laws<sup>11</sup>. Consequently, the taxonomy of these grants varies by country. Nonetheless, they can still be categorised into the two broad categories based on their features. Table I below provides the taxonomy of grants to sub-federal units and classifies them into two broad categories based on their features:

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9 Anwar Shah, "Introduction: Principles of Fiscal Federalism" in *The Practice of Fiscal Federalism: Comparative Perspectives*, ed. Anwar Shah and John Kincaid (Montreal: Forum of Federations, 2007), 25

10 Jorgen Loetz, "On grant policy and the OECD-taxonomy of grants", in *Measuring Fiscal Decentralisation: Concepts and Policies*, ed. Junghun Kim, Jorgen Lotz and Hansjörg Blöchliger (Paris: OECD Publishing), 38

11 See for instance Hansen, Kjetil; Martinez-Vazquez, Jorge; Tufani, Claudia Mayara, Brazil - Diagnostic and Reform Options for the System of Intergovernmental Fiscal Transfers to Brazilian States (English) (Washington, D.C. : World Bank Group, 2022) for a taxonomy of grants in Brazil.

S.N	Name of the Grant	Local Discretion	Rule based	Conditions	Broad Classification	Taxonomy used in this note
1.	Minimum Fiscal Equalisation Grant	Yes	Yes	No	General Purpose Transfers	Non-Earmarked Grants
2.	Formula Based Fiscal Equalisation grant	Yes	Yes	No	General Purpose Transfers	Non-Earmarked Grants
3.	Performance-based Fiscal Equalisation Grant	Yes	Yes	Yes Output-based Conditionality (The allocation of grant depends on the performance scores received by the sub-federal governments)	Grey Area— More akin to General Purpose Transfers.	Non-Earmarked Grants
4.	Special Grants	Yes Local Governments are allowed to pitch projects to be financed through the grants	Yes	Yes Input-based Conditionality	Grey Area— More akin to Special Purpose Transfers	Earmarked Grants
5.	Complimentary/ Matching Grants	Yes Local Governments are allowed to pitch projects to be financed through the grants	Yes	Yes Input-based Conditionality	Grey Area— More akin to Special Purpose Transfers	Earmarked Grants
6.	Conditional Grants	No	No	Yes-Input-based Conditionality	Special Purpose Transfers	Earmarked Grants

**Table 1: Classification of Grants in Nepal**

Source: Compiled by the Author

Throughout this note, the terminology earmarked grants refers to Special Grants, Complimentary Grants and Conditional Grants. The reasoning that follows is that the terminology General or Special purpose does not adequately capture the nature of the grants. Because there is some form of discretion that is allowed to the sub-federal governments to the extent that sub-federal governments are required to request the amount of grant based on the broad input-based conditionality set, Special and Complimentary Grants fall on the grey area and the terminology “Earmarked” at least in the Nepali context is better suited.



## The legal and policy basis for earmarked transfers

Article 60(6) of the Constitution of Nepal establishes the legal basis for the distribution of special, conditional and complementary grants<sup>12</sup>. It leaves the allocation, provisioning and the decision to dictate the terms of the grants to the federal government through both primary and secondary legislation. The purpose of earmarked grants, at least the original intent of the second constituent assembly remains unclear. On the other hand, non-earmarked grants have a clear purpose since the Constitution of Nepal in Article 60(4) states<sup>13</sup>,

*“The Government of Nepal shall, on the basis of the need of expenditure and revenue capacity, distribute fiscal equalisation grants to the state and the local level”.*

Despite, never expressly stating the words “Vertical and Horizontal Fiscal Equity”, the criteria—need of expenditure and revenue capacity—make it clear that the intention is to address both horizontal and vertical fiscal equity. In fact, the NNRFC when recommending the amount of fiscal equalisation grant made it clear that the grant was a mechanism to address both the vertical and horizontal fiscal gap in line with the provisions of the Constitution of Nepal<sup>14</sup>. The clarification of the intent behind non-earmarked grants or general-purpose transfers in the constitution itself is a common practice in federal countries<sup>15</sup>, some countries even specify the formula for such allocation in the constitution<sup>16</sup>.

In the Nepali context, the power to determine the formula of allocation of non-earmarked grants to address inequities has been given to the NNRFC<sup>17</sup>. On the other hand, the purpose of earmarked grants, their guiding principles are to some extent elaborated by the primary and secondary legislation. The Intergovernmental Fiscal Arrangement Act, 2017 (IGFA), clarifies the purpose of earmarked transfers through sections 9 to 11. The IGFA provisions for the allocation of conditional grants by the federal government to the sub-federal

12 Constitution of Nepal, 2072 v.s., art 60 § 6

13 Constitution of Nepal, 2072 v.s., art 60 § 4

14 National Natural Resources and Fiscal Commission, Nepal Sarkar Bata Pradesh tatha Sthaniya Taha lai pradhan garine Vittiya Samanikaran Anudan, April 14, 2020, 1-2, [https://nnrfc.gov.np/uploads/resources/2020-07-08/vittiya\\_samanikaran\\_anudan\\_099-981.pdf](https://nnrfc.gov.np/uploads/resources/2020-07-08/vittiya_samanikaran_anudan_099-981.pdf)

15 For a brief survey of practices of similar nature in federal countries see John Kincaid and G. Alan Tarr, ed. “Constitutional Origins, Structure and Change in Federal Countries” (Montreal: Forum of Federations, 2005)

16 Celina Souza, “Federal Republic of Brazil” in Constitutional Origins, Structure and Change in Federal Countries, ed. John Kincaid and G. Alan Tarr (Montreal: Forum of Federations, 2005), 76-102

17 Constitution of Nepal, 2072 v.s., art 60 § 3

units<sup>18</sup>. Its purpose is not explicitly clear, the act does however clarify that the provisioning of conditional grants is to be done in accordance with the criteria set by the NNRFC. The rationale of conditional grants in a federal set-up stemmed from the need to give continuity to projects that were previously initiated by the central government in the unitary set-up and were handed over to the sub-federal units during Nepal's transition to a federal setup<sup>19</sup>.

### **Box Case 1: Variations in Conditional Grant Allocation Across Provinces**

Since the IGFA provides discretion to the provincial government in the allocation of conditional grants to local governments there are some notable variations. Madhesh and Sudurpaschim Province have allocated conditional grants inconsistently—depending on their budget and provincial priorities they have allocated conditional grants in some fiscal years. Between fiscal years 2019/20-2024/25 conditional allocation by Madhesh province has gone from 39.53 per cent to 2.78 per cent of the total budget, with no amount allocated in fiscal year 2023/24. In Sudur Paschim allocations in the same period have gone from 0.23 per cent to 3.23 per cent of the total budget with no amount allocated in fiscal years 2021/22 and 2022/23. Except for Gandaki, Madhesh and Sudurpaschim, all other provinces have steadily increased the amount of conditional allocation to local governments. In fact, Gandaki, Madhesh and Sudurpaschim are the only provinces that allocated a higher share of fiscal equalisation grant as a percentage of total budget in comparison to conditional allocations as a percentage of the total budget. An enquiry into the causes of these variations is a relevant agenda in so far as it helps us understand what drives provincial outlook towards local government autonomy.

*Source: Compiled by the author based on Budget details of seven provinces.*

Provincial governments are not mandatorily required to allocate conditional grants to Local Governments. The IGFA provides discretion to the province government in so far as the provision reads “*The State may provide conditional grants to Local level according to the basis prescribed by the Commission in accordance with the State laws.*”<sup>20</sup> There are variations in allocation of conditional grants by provincial governments. Not all provincial governments have allocated conditional grants to local governments, some have allocated a higher share of conditional grants in comparison to fiscal equalisation grants while others have done the exact opposite (See Box Case-I for details).

The motivation for varying degrees of allocation remains unclear, what is clear however is that neither the provincial government nor the federal government

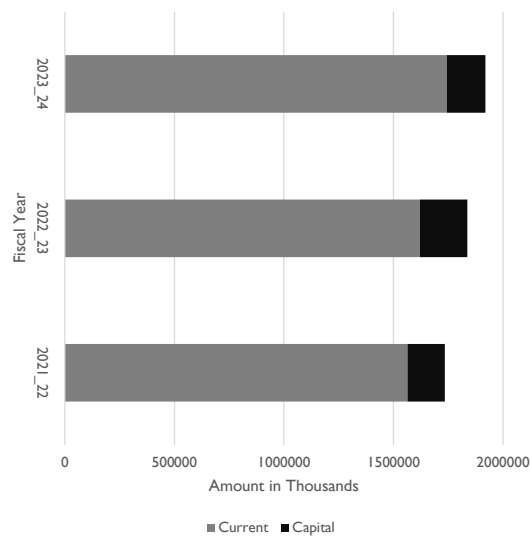
18 Intergovernmental Fiscal Arrangement Act, 2074 v.s., § 9

19 Yatindra K C. Forthcoming. “Intergovernmental Fiscal Relations in a Federal Nepal: Institutions and Performance” in *Federalism, Devolution of Power, and Inclusive Democracy: Nepal's Constitutional Context* (Volume 2), ed. Bipin Adhikari (Dulikhel: Kathmandu University School of Law), September 24, 2024

20 Intergovernmental Fiscal Arrangement Act, 2074 v.s., § 9(3)

has adhered to the criteria set by the NNRFC<sup>21</sup>. This together with the discretion enjoyed by the line ministries in allocating conditional grants and an increasing share of conditional allocation to sub-federal governments suggests that the grant has been used to limit the autonomy of sub-federal governments<sup>22</sup>. To date, conditional grants have been used to finance operating expenditures (see figure-2) of the federal government and it remains the only “textbook” specific-purpose transfer currently in use in Nepal.

Complimentary grant allocation seeks to increase the level of infrastructure in any given sub-federal. The IGFA provisions such allocations to be made for infrastructure development by ascertaining the need and rationale for the project, the feasibility of the project, and the benefits of the project<sup>23</sup>. Similarly, special grants seek to achieve three purposes: delivery of basic services, balanced development and upliftment of economically disadvantaged classes or communities<sup>24</sup>. Although goals one and three are clear and specific, goal three—balanced development—allows some discretion to the agency in allocating the grant. In fact, the allocation of special and complementary grants to a few sectors highlights that the grant has been designed to ensure that all sub-federal governments invest in areas that are crucial and areas where investment is expected from the citizens. Seen from this lens, Special and Complimentary grants in Nepal, like in other countries, is a commitment by the federal government that social needs will be fulfilled regardless of what investment the sub-federal units undertake independently.



**Figure 2: Current and Capital allocations to Local government under Conditional Grants**

Source: *Intergovernmental Fiscal Transfer Book, Multiple Years*

- 21 National Natural Resources and Fiscal Commission, Arthik Barsha 2081/82 ka lagi Nepal Sarkar bata Pradesh Sarkar ra Sthaniya Sarkar lai Pradhan garine Shasharta Anudanka aadhar samvandhama Nepal Sarkarlaai garieko sifarish, March 28, 2024, 10, [https://nnrfc.gov.np/uploads/fivesectors/2024-0520/conditional\\_grant\\_province\\_recommendation1.pdf](https://nnrfc.gov.np/uploads/fivesectors/2024-0520/conditional_grant_province_recommendation1.pdf); National Natural Resources and Fiscal Commission, Arthik Barsha 2081/82 ka lagi Pradesh Sarkar bata Sthaniya Sarkar lai Pradhan garine Shasharta Anudanka aadhar samvandhama Pradesh Sarkarlaai garieko sifarish, May 17, 2024, 10, [https://nnrfc.gov.np/uploads/fivesectors/2024-05-20/conditional\\_grant\\_province\\_recommendation1.pdf](https://nnrfc.gov.np/uploads/fivesectors/2024-05-20/conditional_grant_province_recommendation1.pdf)
- 22 K C, Intergovernmental Fiscal Relations in a Federal Nepal: Institutions and Performance; Khimlal Devkota, “A budget that overlooks federalism,” *The Kathmandu Post*, May 29, 2024, <https://kathmandupost.com/columns/2024/05/29/a-budget-that-overlooks-federalism>; Prithivi Man Shreshta, “Local units flooded with schemes directed by centre,” *The Kathmandu Post*, July 4, 2023, <https://kathmandupost.com/national/2023/07/04/local-units-flooded-with-funds-for-schemes-directed-by-centre>
- 23 Intergovernmental Fiscal Arrangement Act, 2074 v.s., § 10(1)
- 24 Intergovernmental Fiscal Arrangement Act, 2074 v.s., § 11(1)

Whereas conditional grants are allocated by line ministries, special and complementary grants are allocated by the National Planning Commission (NPC). Unlike fiscal equalisation grants, the allocation rules for earmarked transfer are dictated by secondary legislation and to that extent, the choice of legislation has some implications for the autonomous character of the entity responsible for the allocation of grants<sup>25</sup>.

The NNRFC, although deemed an independent commission through its establishment via the constitutional provision, is nonetheless an entity with limited autonomy<sup>26</sup>. There are three reasons for this<sup>27</sup>. First, the laws that guide the commission's work—the IGFA Act, and the NNRFC Act—dictate the factors that the commission needs to consider when making allocations<sup>28</sup>. In practice, the NNRFC has so far only assigned the relative weights of the factors elaborated on by the IFGFA Act and the NNRFC Act. The NNRFC is thus subject to the rules of the allocations determined already through primary legislation, its power is limited only to minor arithmetic changes to the formula based on the rules. While this arrangement to a certain degree provides consistency in the determination of grants<sup>29</sup> it nonetheless invades the constitutionally established power of the NNRFC. As a result, the NNRFC is seen as a weak commission, one that has so far not fulfilled its constitutional mandate<sup>30</sup>.

Secondly, although the commission is an autonomous entity, it is bound by the rules that govern Nepal's civil service. Except for the members of the commission, selection and recruitment of the employees of the NNRFC secretariat is done by the public service commission<sup>31</sup>. This arrangement leads to an inherent conflict of interest on the part of the bureaucrats. The NNRFC is established as an independent agency and thus requires staff that are independent of the general civil service i.e. the staff must be accountable to the NNRFC and not the executive body. In recent years, the general problem of the Nepali Civil Service has also crept its way into the NNRFC—the problem of frequent employee transfers. Together, it has affected the NNRFC's autonomy because it requires, first, to be independent, staff that is accountable to its members and second, consistent staffing.

25 K C, Intergovernmental Fiscal Relations in a Federal Nepal: Institutions and Performance

26 For a brief discussion on the autonomy of NNRFC see Niti Foundation, The National Natural Resources and Fiscal Commission: A Custodian of Federalism in Nepal, Strengthening Constitutionalism in Nepal (Kathmandu: Niti Foundation, 2022), 7-9; USAID, Assessing and Analyzing the Effectiveness of Fiscal Federalism in Nepal: A Political Economic Analysis (Kathmandu, USAID, 2023), 15-17; Yatindra K C. Forthcoming. "Intergovernmental Fiscal Relations in a Federal Nepal: Institutions and Performance" in Federalism, Devolution of Power, and Inclusive Democracy: Nepal's Constitutional Context (Volume 2), ed. Bipin Adhikari (Dulikhel: Kathmandu University School of Law), September 24, 2024.

27 Reasons previously identified, which includes the inconsistencies in laws and lack of technical expertise are not dealt with here.

28 Intergovernmental Fiscal Arrangement Act, 2074 v.s., §§ 7 & 2; National Natural Resources and Fiscal Commission Act, 2074 v.s., §§ 14, 15 & 16

29 Anwar Shah, A Framework for Evaluating alternate Institutional Arrangements for Fiscal Equalisation Transfers (Policy Research Working Paper Series 2039, 2005)

30 Tara Chapagain, "Natural Resources and Fiscal Commission Has Nothing Substantial to Show as It Turns Six | the Annapurna Express," The Annapurna Express, August 2, 2024, <https://theannapurnaexpress.com/story/49959/>.

31 National Natural Resources and Fiscal Commission Regulations, § 17(2)

Finally, the commission's provision to a large degree is guided by primary legislation. Primary legislation in Nepal requires a considerable amount of time to be enacted, most notably because of the involvement of two branches of the government: the executive and the parliament. Unlike secondary legislation, an amendment to primary legislation is also harder for the same reason. The current legislation does not further the autonomous character of the commission and requires some amendment, yet these amendments are not easy to achieve. At the very least, it requires support from the incumbent political parties that will vote on the amendment bill and the bureaucracy that will initially design the bill.

On the other hand, the provisions for earmarked grants are guided by secondary legislation. Except for conditional grants, special and complementary grants have working directives that elaborate the selection, allocation, and monitoring of the grants. As stated earlier, special and complementary grants are project-specific grants that sub-national units must apply for rather than being allocated by the central line ministries. Its responsibility, thus, has been given to the NPC of Nepal which is responsible for planning Nepal's overall budget and mid-term expenditure framework and maintaining the project bank. The NPC's functions are determined by the Complimentary Grant Procedure and the Special Grant Procedure. Both are secondary legislations—legislations that only require the approval of the Council of Ministers. Both procedures have been amended thrice, whereas in the case of the NNRFC, its guiding legislation has not been amended so far. The power to amend the rules governing the transfer further expands on the autonomous character of an agency to the extent that the agency can successfully navigate challenges it faces during implementation through amendments.

Among other things, the amendments have increased the number of projects to be financed, placed stricter conditions on monitoring the grant expenditure, added members to the decision-making committee, and made provisions for details to be shared among various government entities. Table 2 presents the salient features of the Special Grant Procedure and Complimentary Grant Procedure.

	SPECIAL GRANT PROCEDURE	COMPLIMENTARY GRANT PROCEDURE
TYPES OF PROJECTS TO BE FINANCED.	Eight areas, including educational programs, child mortality prevention programs, irrigation programs aimed at remote and economically backward regions, programs that aim to uplift the marginalized and	17 types of projects are financed through complementary grants. These include among other things agriculture warehouses, irrigation projects, waste management projects, housing infrastructure, tourism infrastructure, bridge construction,

	vulnerable communities, and programs that address food security etc <sup>32</sup> .	alternative energy generation projects, health post construction etc <sup>33</sup> .
MAXIMUM LIMIT OF FINANCING	None	<p>Financing is provided based on the type of subnational government.</p> <p>For rural municipality and municipality: projects that have a total cost of NPR 10 million to 100 million</p> <p>For sub-metropolitan and metropolitan: projects that have a total cost of 250 million to 500 million.</p> <p>For provincial governments' projects that have an estimated cost of 200 million to 1 billion</p>
TIMELINE FOR APPLYING FOR GRANTS	Within the end of the Nepali month of Poush (Middle of January)	Within the end of the Nepali month of Poush (Middle of January)
DECISION MAKING COMMITTEE	Six-member committee including representatives from the Ministry of Finance, Office of the Prime Minister and Council of Ministers, Ministry of Federal Affairs and General Administration and National Planning Commission	Six-member committee including representatives from the Ministry of Finance, Office of the Prime Minister and Council of Ministers, Ministry of Federal Affairs and General Administration and National Planning Commission

<sup>32</sup> See Rule number 3 of Procedure Relating to Allocation of Special Grants, 2077 v.s. for detailed list.

<sup>33</sup> See Rule number 3 of Procedure Relating to Allocation of Complimentary Grants, 2077 v.s. for detailed list.

DECISION MAKING CRITERIA	Six criterions including but not limited to the social and economic condition of the subnational unit, the reason for the program and the expected outcome, non-duplication with other government programs etc <sup>34</sup> .	Ten criterions including but not limited to the feasibility of the project, the expected return from the project, consistency with national priorities and goals, the creation of employment opportunities and the capacity to implement sub-national local government <sup>35</sup> .
RELEASE OF TRANSFER	Quarterly basis subject to submission of progress reports.	Quarterly basis subject to submission of progress reports.

**Table 2: Salient features of special and complementary grants**

*Prepared by the author based on special grant and complementary grant procedures.*

Despite having more autonomy than the NNRFC, the NPC nonetheless, suffers from some autonomy deficits arising from the working procedures. Except for the initial allocation and selection of projects by the committee housed by the NPC, it has no role during the implementation phase. The legal and policy basis for special and complementary grants established the need for subnational units to submit the quarterly progress report to the Ministry of Finance, the NPC and the Financial Comptroller General's Office (FCGO). The reporting mechanism is premised on the need for a monitoring and evaluation mechanism and the power to make necessary changes to the program implementation of allocation if need be. The power to issue directives to make changes to the program based on the arrangement stated earlier is however given to the MoF. There is at least some reluctance to engage the NPC after allocations have been made. The initial transfer is decided by the NPC, transfers are made by the FCGO, and changes are made by the MoF.

Although, both earmarked and non-earmarked transfers in Nepal are largely rule-based transfers, the rules do not sufficiently empower the agencies involved in the allocation. Today, both the NNRFC and the NPC are not entirely autonomous. While the latter is autonomous to the extent that it can formulate its policies regarding allocations, its involvement post-allocation is minimal and thus any shortcomings so far seen in the use of both earmarked and non-earmarked grants in Nepal stem from the way in which the powers of the agencies are structured.

An additional thing to note is that special and complementary grants are grants provided for the development of infrastructure. Its effectiveness therefore relies on the absorptive capacity of sub-federal governments, and the sub-

<sup>34</sup> Procedure Relating to Allocation of Special Grants, 2077 v.s. § 3(2).

<sup>35</sup> Procedure Relating to Allocation of Complimentary Grants, 2077 v.s. § 5.

federal unit's capacity to undertake capital spending. The quasi-special purpose nature of the two grants also demands some form of conditionality preferably conditions attached to the capacity of sub-federal governments to undertake capital expenditure and maintain fiscal discipline.

## Performance earmarking

There is now a sizeable body of work on the use of performance measures and earmarking based on the performance of sub-federal units<sup>36</sup>. There is however no consensus on the effectiveness of it<sup>37</sup>. Put simply, performance-based earmarked grants are designed to correct for the distortions of untied grants—a sizeable amount of untied grants provides no incentive to sub-federal units to invest in internal revenue mobilization. Nearly all federal countries have some form of performance-based grant system, but they are implemented only after the distortionary effects of the untied grants are visible.

Nepal too implements a system of performance-based transfer system. This adoption, however, is not premised on the distortionary effects of untied grants. It is rather a part of the fiscal equalisation grant allocation scheme and borrows from a performance-based system put in place in the erstwhile unitary structure<sup>38</sup>. Interestingly, the adoption of a performance-based system in the unitary structure was implemented after the realisation of the distortionary effects of untied grants to local governments. Available evidence so far suggests that untied grants in Nepal are positively correlated with internal revenue collection<sup>39</sup>, to that extent the need for such grants is not clear yet. The NNRF's use of performance-based allocations is not premised on the distortionary effects, it is rather the use of a specific legal provision that empowers the NNRF to allocate grants based on performance<sup>40</sup>.

When Performance-based grant systems are put in place, they are supplementary i.e., they are not part of the equalisation scheme, they rather complement it<sup>41</sup>. Some countries do attach performance-based criteria to the equalisation scheme, but it is done because the fiscal architecture requires the equalisation of capacity<sup>42</sup>, and whenever conditions have been attached to equalisation, they have proved to be tricky in so far as attaching grants to performance can result

36 Anwar Shah, *Autonomy With Accountability: The Case for Performance-Oriented Grants*, in *General Grants versus Earmarked Grants: Theory and Practice*, ed Junghun Kim, Jørgen Lotz and Niels Jørgen Mau (The Korea Institute of Public Finance and The Danish Ministry of Interior and Health, 2010), 74-102; Hansjörg Blöchliger and Camila Vammalle, *Intergovernmental grants in OECD countries: Trends and some policy issues*, in *General Grants versus Earmarked Grants: Theory and Practice*, ed Junghun Kim, Jørgen Lotz and Niels Jørgen Mau (The Korea Institute of Public Finance and The Danish Ministry of Interior and Health, 2010), 167-190; Blane D. Lewis and Paul Smoke, "Intergovernmental Fiscal Transfers and Local Incentives and Responses: The Case of Indonesia," *Fiscal Studies* 38, no. 1 (December 9, 2015)

37 Junghun Kim, *Introduction*, in *General Grants versus Earmarked Grants: Theory and Practice*, ed Junghun Kim, Jørgen Lotz and Niels Jørgen Mau (The Korea Institute of Public Finance and The Danish Ministry of Interior and Health, 2010), 14

38 K C, *Intergovernmental Fiscal Relations in a Federal Nepal: Institutions and Performance*

39 K C, *Intergovernmental Fiscal Relations in a Federal Nepal: Institutions and Performance*

40 National Natural Resources and Fiscal Commission Act, 2074 v.s., § 3(2)

41 Anwar Shah, *Autonomy With Accountability: The Case for Performance-Oriented Grants*, in *General Grants versus Earmarked Grants: Theory and Practice*, ed Junghun Kim, Jørgen Lotz and Niels Jørgen Mau (The Korea Institute of Public Finance and The Danish Ministry of Interior and Health, 2010), 89-100

42 Alan Morris, "Commonwealth of Australia" in *The Practice of Fiscal Federalism: Comparative Perspectives*, ed. Anwar Shah and John Kincaid (Montreal: Forum of Federations, 2007), 58

in poor local governments being penalised for factors beyond their control<sup>43</sup>. Nonetheless, NNRFC allocates a certain percentage of the Fiscal equalisation grant based on performance, table-3 below summarizes the features of this system.

Particulars	Province	Local
Total number of Indicators	11 Indicators	17 Indicators
Measurement Mechanism	Point system—Indicators total to a value of 100.	Point system—Indicators total to a value of 100.
Relative Measurement Criteria	Yes—Provincial governments are assigned value based on their relative performance against other provinces.	Yes—Local governments are assigned value based on their relative performance against other local governments.
Information Collection	By the NNRFC	By the NNRFC
Mechanism for redressal	Province governments are given adequate time to furnish evidence to correct errors made by the NNRFC in calculating the scores.	Local governments are given adequate time to furnish evidence to correct errors made by the NNRFC in calculating the scores.
Total share	4 per cent of the total pool of fiscal equalisation grant.	4 per cent of the total pool of fiscal equalisation grant.

**Table 3: Features of Performance based Fiscal Equalisation Grants**

*Source: Prepared by the author based working procedures for allocation currently in effect.*

So far, the performance-based fiscal equalisation grant has not been able to incentivise performance because it is a minor share of total local government finances (including revenue sharing)<sup>44</sup>. In addition, the current allocation mechanism also benefits those local governments that were already better off when the country adopted a full-fledged federal system. Because the erstwhile unitary system was marked by differential treatment of local governments, some local governments were better off given the existence of adequate structures

43 Roy Bahl, Conditional v Unconditional Grants: The Case of Developing Countries, in General Grants versus Earmarked Grants: Theory and Practice, ed Junghun Kim, Jørgen Lotz and Niels Jørgen Mau (The Korea Institute of Public Finance and The Danish Ministry of Interior and Health, 2010), 131

44 Yatindra K C, Arpita Nepal, and Akash Shrestha, Intergovernmental Transfer systems in Nepal: Performance and Institutions, (Lalitpur: Deutsche Gesellschaft für Internationale Zusammenarbeit, 2023), 29-35

of public service delivery. The current system, therefore, given its emphasis on the relative ranking of each local government regardless of their standing when the country transitioned, is designed not to reward the efforts of the local government made within a constrained environment but to punish the failure of local government to compete with their peers<sup>45</sup>.

The policy basis of performance-based earmarking of special and complementary grants is unclear. The working procedure, both the special and complementary grant, does not provide for an ex-ante performance capacity condition it does however empower the committee tasked with the selection of projects to assess whether a particular sub-federal unit has the capacity—both in terms of financial resources and human resources—to successfully implement the project for which it seeks funding<sup>46</sup>. The Government of Nepal has in place certain mechanisms that capture the capacity of local governments that the committee can rely on. Table 4 below summarizes the key features of these arrangements.

Particulars	NNRFC Indicators	LISA	FRA	LED
Relevant Government Agency	NNRFC	MoFAGA	MoFAGA	MoFAGA
Total Number of Indicators	17	10	5	4
Assessment Mechanism	Weighted point system—indicator values add to 100	Weighted point system—indicator values add to 100	Weighted point system—indicator values add to 100	Weighted point system—indicator values add to 100
Data Collection	NNRFC	Self-Assessment	Self-Assessment	Self-Assessment
Variability in scores	Yes	No	No	No
Duplication with other arrangements	No	Yes	Yes	Yes

45 Yatindra K C, “Performance based allocation: Missing the differences of local governments”, *Nepal Live Today*, August 15, 2023, <https://www.nepallivetoday.com/2023/08/15/performance-based-allocation-missing-the-differences-of-local-governments/>

46 Procedure Relating to Allocation of Special Grants, 2077 v.s., §3(2)(c) and Procedure Relating to Allocation of Complimentary Grants, 2077 v.s., §5(2)(b)

Rule-based scoring	Yes-Working Procedures spell out scoring mechanism	Yes-Working Procedures spell out scoring mechanism	Yes-Working Procedures spell out scoring mechanism	Yes-Working Procedures spell out scoring mechanism
Availability in the public domain	Yes	Yes	Yes	Yes
Mechanism to capture spending capacity of local governments	Yes	Yes	Yes	Yes
Mechanism to capture fiscal discipline of local governments	Yes	Yes	Yes	Yes

**Table 4- Summary of government indicators currently in place**

*Source: Prepared by the author*

But because the proceedings of the committee are not publicly available it is unclear if the committee assesses the capacity of sub-federal governments. The next section attempts to test whether the capacity of sub-federal governments as stipulated in the working proceedings is considered when allocating grants.

## The relationship between earmarked grants and the capacity of local governments

Because special and complementary grants are given for projects that require capital spending, the capacity of local governments can be best assessed by looking at the per capita development spending of the concerned local government. In addition, fiscal discipline is also equally important. The per capita fiscal irregularities in any given local government is a good enough measure of it. Both the MoFAGA and NNRFC indicators contain variables to capture them, but since MoFAGA data is based on self-assessment it is questionable to the extent that the data does not have any variation of significance. This note therefore uses the NNRFC data, which given its emphasis on the collection of data by the secretariat of NNRFC is more reliable. To complement the analysis that follows, per-capita development expenditure and per-capita fiscal irregularities are also calculated by relying on figures made available by the Office of the Auditor General. The hypothesis here is as follows—if the committee does indeed take into consideration the capacity of local governments, then the amount of allocation should be positively associated with the NNRFC scores received and per-capita development expenditures in the year prior and negatively associated with the per-capita fiscal irregularities in the year prior. This note does not attempt to establish causality because of the infancy of the system and the lack of data availability, it rather only attempts to provide, to the best of the author’s knowledge, the first preliminary estimates that can be built on in the future.

Table 5 below presents the OLS results estimating the relationship between special grant allocation and NNRFC scores, per-capita development expenditure and percapita fiscal irregularities in the year prior. Controlling for other factors such as population, the number of wards in any given local government, and the category of local government, there is no relationship between the capacity of local governments and special grant allocation in the fiscal year 2021/22. At the same time, there is a significant but negative relationship between NNRFC scores received and the allocation of special grants in the fiscal year 2022/23. While this can be interpreted as better-performing governments being penalized, it must also be noted that there is no relationship between the grant allocation and per-capita development expenditure or the per-capita fiscal irregularities. If local governments were being penalized, then the relationship between them should have also moved in the opposite direction. The likely reason for this

result is perhaps the objective of the grant and how NNRFC measures the performance of local governments.

Special grants in Nepal have been designed to invest in sectors that remain underinvested i.e. sanitation, health and education among others. The NNRFC indicators do capture data regarding these sectors. It currently ranks local governments based on their performance against the national average on matters of a) student enrollment rate b) student retention rate, c) secondary school student graduation rate, and d) efforts made by local government to provide maternal health services. Consequently, local governments that spend less on these areas are likely to get lower scores. Since special grants are designed to invest in these sectors the results indicate that whether by design or through sheer coincidence money is flowing to local governments where investment is needed. At the same time, however, the results also indicate that there is a positive relationship between a local government's per-capita fiscal irregularities and special grant allocation. While the prior result indicates that money is flowing to local governments where investment is needed, the latter relationship also shows that money is flowing to local governments that do not perform well in terms of fiscal discipline.

	Special grant allocations Fiscal year 2021/22	Special grant allocations Fiscal year 2022/23
NNRFC Performance scores a year prior	0.185 (0.200)	-1.156* (0.585)
Percapita Development Expenditure a year prior	0.000507 (0.000654)	0.000493 (0.000440)
Percapita Fiscal Irregularities a year prior	0.00500 (0.00451)	0.0119* (0.00586)
Constant	94.10 (24.28)	151.8*** (36.49)
Observations	469	503
R <sup>2</sup>	0.127	0.075

Standard errors robust against heteroskedasticity reported in parentheses.

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$

**Table 5: OLS estimates reporting the effect of capacity of local governments on special grant allocations.**

Table 6 below presents the OLS results estimating the relationship between complementary grant allocation and NNRFC scores, per-capita development expenditure and percapita fiscal irregularities in the year prior. As was the case with the allocation of special grants in the fiscal year 2021/22, there is no significant relationship between allocations and the capacity of local governments. Unlike special grants in the fiscal year 2022/23, complementary grant allocation in the fiscal year 2022/23 has no relationship with capacity. The likely reason for this is that instead of capacity, the ability of local governments to match the amount of grants allocated is more important for allocation. Nonetheless, since complementary grants are for infrastructure projects the ability of local government to undertake capital spending and maintain fiscal discipline should not be overlooked.

	Complimentary grant allocations Fiscal year 2021/22	Complimentary grant allocations Fiscal year 2022/23
NNRFC Performance scores a year prior	0.139 (0.183)	0.205 (0.432)
Percapita Development Expenditure a year prior	0.000123 (0.000643)	0.000148 (0.000630)
Percapita Fiscal Irregularities a year prior	-0.00137 (0.00643)	-0.0170 (0.0117)
Constant	91.97 (33.19)	45.49 (36.30)
Observations	722	547
R <sup>2</sup>	0.071	0.157

Standard errors robust against heteroskedasticity reported in parentheses.

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$

**Table 6: OLS estimates reporting the effect of capacity of local governments on complementary grant allocations.**

Table 7 below presents the OLS results estimating the relationship between complementary grant allocation and NNRFC scores, per-capita development expenditure and percapita fiscal irregularities in the year prior. As was the case with Special and Complimentary Grants in the fiscal year 2021/22, there is no relationship of significance between the capacity of local governments and conditional grant allocations. There is however a positive relationship between the scores received by a local government in NNRFC indicators and the

amount of conditional grant allocated in fiscal year 2022/23. While this might be interpreted as line ministries being cautious of the capacity of local governments there is another element of relationship that is worth noting here. Conditional grants are largely allocated for funding operating expenditures that the central government assumed in the erstwhile unitary structure, these include payment of public-school teacher remuneration, remuneration of health post workers, social security programs etcetera. Since the NNRC indicators, in addition to other variables, measure and rank local government based on student retention rate, enrollment rate, secondary school graduation rate and the performance of health posts, it would follow that local governments with adequate number of schools and health posts would score higher. It would also then be plausible to assume that conditional allocations are higher not because of the capacity of local governments but because operating expenditures in local governments with higher numbers of public schools and health posts would be higher. Had capacity been intentionally considered there would have been a positive and significant relationship between per-capita development expenditure and conditional allocations and a negative and significant relationship between per-capita fiscal irregularities and conditional grant allocations.

	Conditional grant allocations Fiscal year 2021/22	Conditional grant allocations Fiscal year 2022/23
NNRFC Performance scores a year prior	0.814 (0.966)	17.60*** (3.279)
Per capita Development Expenditure a year prior	0.00233 (0.00886)	-0.00140 (0.00436)
Per capita Fiscal Irregularities a year prior	-0.0216 (0.101)	0.0163 (0.0619)
Constant	644.1 (408.8)	623.3 (376.1)
Observations	722	723
R <sup>2</sup>	0.733	0.731

Standard errors robust against heteroskedasticity reported in parentheses.

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$

**Table 7: OLS estimates reporting the effect of capacity of local governments on conditional grant allocations.**

## The implications of the current framework

This note was an attempt to provide insights on the current framework of earmarked grants. Except for conditional grants, special and complementary grants in Nepal are rule-based earmarked transfers. The nature of the grant, the extent and scope of the grants, and mechanisms for monitoring and evaluation are provided by the working procedures. Despite its infancy, both special and complementary grants, and conditional grants, to a certain degree, as far as the analysis suggests, function as a commitment by the federal government that some level of minimum investment in sectors of importance will be guaranteed. Unfortunately, it does come at the cost of the autonomy of sub-federal units, especially local governments. In recent years, the allocation of earmarked grants has increased, and many have rightly argued that it is against the Nepali model of federalism. The concern for autonomy is a valid one, but the need for some form of earmarking to ensure adequate investment in certain sectors is also important.

In arguing for the latter, it is important to consider the autonomy of institutions involved in allocating such grants. As it stands today, the MoF is more autonomous than the NPC on matters of special and complementary grants, not because it allocates them but because it exercises more power after the decision for allocation has been made. An equally important consideration is also the autonomy of the institution that allocates untied grants, as was discussed in detail elsewhere, the NNRFC is not as autonomous as we imagined it to be. The current mechanism of allocation of earmarked grants despite being provisioned to account for the capacity of sub-federal governments, in practice does not do so. Since both special and complementary grant demand some level of capital spending, the allocation rules would be more effective if it was designed to balance the need for investment in certain sectors and the need for fiscal discipline. Against this backdrop table 8 below recommends certain steps that can be initiated to accommodate the need to balance both the need for investment and the need for fiscal discipline.

Recommendations	Reasons for the Recommendation	Relevant Government Agency
Formulate rules for conditional grant allocation	The current mechanism of conditional grant allocation is no rule based. Although, the constitution of Nepal specifies that the NNRFC will recommend the basis of conditional grant allocation, the basis prescribed so far has not been followed. To that end, legislation on conditional grant allocation that specifies the power of the NNRFC to dictate the terms and mechanisms that spell out the power of NNRFC to direct line ministries is required.	NNRFC, MoF, Council of Ministers
Amend Rule 11 of the Complimentary grant procedure to read “The Ministry of Finance on the recommendation of the National Planning Commission shall give appropriate directives to provinces and local governments if the NPC finds that the progress made is not satisfactory. The NPC shall also have the power to recommend the FCGO to either release or freeze the amount of complementary grants if the NPC finds that progress is not satisfactory. Provided that the NPC shall give adequate time to province and local governments to furnish evidence contrary to its findings.”	Under the current set-up, the NPC is not given the power of monitoring and evaluation. It is often a good practice to give such powers to the entity that is responsible for grant allocation.	NPC, MoF and Council of Ministers.

<p>Amend Rule 10 of the Special grant procedure to read “The Ministry of Finance on the recommendation of the National Planning Commission shall give appropriate directives to provinces and local governments if the NPC finds that the progress made is not satisfactory. The NPC shall also have the power to recommend the FCGO to either release or freeze the amount of complementary grants if the NPC finds that progress is not satisfactory. Provided that the NPC shall give adequate time to province and local governments to furnish evidence contrary to its findings.”</p>	<p>Same as above</p>	<p>NPC, MoF and Council of Ministers.</p>
<p>Insert provision to Rule 5(2) of the Complimentary grant procedure to read, “Per-capita fiscal irregularities of the province and local government in the year prior or of the year for which the latest report from the Office of the Auditor General has been made available.”</p>	<p>Given the nature of the grants some form of ex-ante condition is required. The conditions, however, should not be very strict but should rather be designed to holistically take into account the need for investment as well as the need for fiscal discipline.</p>	<p>NPC, MoF and Council of Ministers.</p>
<p>Insert provision to Rule 5(2) of the Complimentary grant procedure to read, “Per-capita capital expenditure of the province and local government in the year prior.”</p>	<p>Same as above</p>	<p>NPC, MoF and Council of Ministers.</p>

<p>Insert provision to Rule 3(2) of the Special grant procedure to read, “Per-capita fiscal irregularities of the province and local government in the year prior or of the year for which the latest report from the Office of the Auditor General has been made available.”</p>	<p>Same as above</p>	<p>NPC, MoF and Council of Ministers.</p>
<p>Insert provision to Rule 3(2) of the Special grant procedure to read, “Per-capita capital expenditure of the province and local government in the year prior.”</p>	<p>Same as above</p>	<p>NPC, MoF and Council of Ministers.</p>
<p>Amend rules regarding local government performance measures currently implemented by the NNRFC to allow comparisons between same groups of local government.</p>	<p>Current earmarking based on performance in effect privileges those local governments that already had structures to rely on when the country transitioned.</p>	<p>NNRFC</p>

**Table 8: List of recommended actions**

Source: Compiled by the Author

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## Annex- I: Methodological Note

This note approaches the subject matter from an exploratory lens and does not claim to establish a cause-and-effect relationship. Non earmarked allocations have received a fair bit of attention, earmarked allocations on the other hand remain understudied, to that end it focuses primarily on earmarked allocations, the rules governing the allocations and the institutions involved. In exploring the subject matter, it borrows heavily from the literature on political economy analysis, although it never uses a strict framework of political economy analysis. The use of the political economy analysis here is limited in so far as the note only uses the framework to understand how formal rules lead to certain results, particularly how they influence the autonomy of institutions involved. In doing so, the note relies on an analysis of the legislation, both primary and secondary, and the analysis is framed within the broader context of whether or not they supplement the imaginations of institutions undertaken when the Constitution was enacted and the effect of such legislation or the choice of legislation on the current state of fiscal federalism as can be explored from the available data. Wherever possible, the analysis is complimented with a review of existing literature.

The recommendations presented herein are based the exploratory analysis and, inferences drawn from an ordinary least square regression and, the specification of which is as follows:

$$Y_{it} = \beta_0 + \beta_1 X_{it-1} + \beta_2 zit-1 \dots \dots \dots (1)$$

Where  $Y_{it}$  is the  $i$ th local government's earmarked allocation in the year  $t$ ,  $X_{it-1}$  is the  $i$ th local government's performance score in year  $t-1$  and  $zit-1$  is our control variable.

All data used in drawing inferences are publicly available. The source of the data includes the National Natural Resources and Fiscal Commission's publication, the yearly report of the Office of the Auditor General, and the yearly publication of the Ministry of Finance titled "Intergovernmental Fiscal Transfer Book". Since the main audience of this note are policymakers, it distances itself from the formulaic structuring of an academic research endeavor to that end the methodology is presented as an annex rather than as part of the main text, existing literatures on the subject matter are amalgamated into the main body rather than being given a separate section, and the recommendation section provides actionable recommendations by identifying changes to the law that can be made.

Given that this is merely an exploratory study, it is meant to facilitate future research agenda. One research agenda would be a study of why certain provincial governments have framed their rules in a certain way and why some provincial governments have allocated a lesser percentage of conditional grants. The dynamics of interaction between provinces and local governments because of earmarked allocations is also a possible area of future research.