

Public Finance Management in Federalism

The importance of public financial management in the successful operation of federalism should be realised at all levels and more collaborative approaches to PFM reforms should be pursued involving local authorities, development partners and international organisations, and professional accounting institutions such as the ICAN.



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Introduction

Federalism is perhaps not a new phenomenon in a global context. Different types of federalism are evident across countries. At one extreme, there are countries such as the US and Switzerland where the federalism appears to be more of a conglomerate of international sovereign states. Countries such as Germany and Austria are at the other extreme, where the federalism represents more of a state decentralisation. Federalism is still a nascent concept of state devolution and decentralisation in Nepal. The federalism in Nepal resembles that of India, where the

very notion of state decentralisation is coupled with preserving a specific demographic, cultural and ethnic identity. Being a centralised and unitary state for more than 250 years, federalism has resulted in substantial changes in the management of state administration in Nepal, including public finance. The country now consists of one federal government, seven province governments and 753 local authorities; in total, 761 governments at different levels are functioning in Nepal.

The experience of many federal states, for instance, Germany, Austria and Switzerland, shows

that the appropriation and distribution of public funds have continued to remain key contentious issues in the functioning of federalism (see e.g., Adam & Behm, 2006; Jochimsen, 2018; Ter-Minassian et al., 2017). For instance, the financial section of the German constitution, which is ten pages thick and made up of 16 articles, is still reckoned to be the most complicated part of the constitution and has been the subject of more amendments than other parts of it. Sound public finance management (PFM), which ensures transparency and fairness in resource allocation, is therefore of utmost importance for the effective functioning of federalism. In general, public finance management is a collection of different components: budgeting, accounting, reporting, treasury and revenue management, procurement, and management information systems – all of which are indispensable for the functioning of the government. However, budgeting has drawn more attention as compared with other components of public finance management in many countries, as it accommodates the interests and concerns of multiple and diverse stakeholders. While the budget serves as a tool for a federal government through which to discharge its public sector accountability, it provides a negotiating tool for provinces and local authorities to ensure their share in resource allocation.

Nepal's commitment to implementing public finance management reforms has been commended internationally. Donors have supported Nepal's initiatives of improving the overall PFM system, setting up a provision for the Multi Donor Trust Fund (MDTF) in 2010. The MDTF is a collective basket fund administered by the World Bank and jointly contributed to by multiple donors: the UK Department for International Development (DFID), the governments of Norway, the Australian Embassy, the USAID (United States Agency for International Development), the European Union, and the government of the Swiss Confederation. A key objective of the MDTF has been 'to strengthen the performance, transparency and accountability in public financial management in Nepal'.

PFM reforms, both at the province and local levels, have now become the priority of donors and international organisations. As part of improving the PFM system, all provinces and local governments have established a consolidated treasury single account, as required by the constitution. These governments have started receiving federal grants based on published formulas by National Natural Resources and Fiscal Commission (NNRFC). Almost all local authorities have submitted their accounts to the auditor general. A large number of local authorities have introduced an act to regulate the budget process and voted a budget on time.

The financial frameworks necessary for the effective operation of federalism have been completed. These include, among others, an Intergovernmental Fiscal Arrangement Act, a Local Government Operations Act, a National Natural Resources and Fiscal Commission Act, an Audit Act, and a Financial Procedures and Fiscal Responsibility Bill. Additional regulations and guidelines relating to PFM have been issued in 2019, which include Internal Control Guidelines and Gender Responsive Budgeting Guidelines for Provinces. In this paper, our aim is to demonstrate how PFM is being reformed and developed to support the functioning of federalism in Nepal.

Regulatory Aspects of Federalism

Public sector entities undertake their financial activities adhering to the financial procedures and regulations. While adhering to centrally introduced acts and procedures, provinces and local authorities in Nepal have obtained the constitutional right to enable their own financial procedures and acts. Provinces and local authorities have started issuing rules applicable to their specific jurisdictions, and a need for aligning these rules and regulations with the national protocols and constitutions has already been felt. As part of fiscal federalism, transactions taking place between governments are required to be handled following the Intergovernment

Fiscal Arrangement Act of 2017 (2074 BS). In November 2019, the federal government has issued a new act, i.e. the 'Finance Procedures and Fiscal Responsibility Act 2076', with a view to regulating the PFM system at the federal level. Another objective of this act is to align province and local levels finance procedures. Regulations to support the implementation of this act are being drafted and expected to be put into place by 2020. Provinces are also required to comply with the 'Local Government Operation Act of 2017 (2074)' in the process of executing the PFM system. In addition to this, the federal government is in the process of developing the finance procedures to monitor the implementation of all such public finance regulations imposed on local authorities, and engender the intended results and outcomes in terms of enhanced financial transparency and accountability.

Another important initiative introduced to strengthen fiscal federalism has been the enforcement of 'Unified Charts of Accounts' in 2017; two further amendments have already been made to the Charts of Accounts in 2019 to improve the overall PFM systems at all three tiers of governments. The Charts of Accounts have been developed complying with the principle of uniformity and following the IMF's government finance statistics manual 2014, a guide which is built on the principle of accrual accounting. The essence of the manual is that it can be enforced uniformly across federal, provincial and local governments, and that the guidance is available to those governments wishing to undertake a transition towards accounting in the future. However, the cash basis of accounting is being practised across all local authorities, albeit by adding up some of the components of the accrual system, such as advances and accruals, and some governments have approved the disclosures of some components of accruals. Financial statements prepared by local authorities have been consolidated at the federal level following the requirements laid down in the Nepal Public Sector Accounting Standards (NPSASs), a set of cash basis accounting standards which correspond

to the IPSASB's Cash Basis IPSAS. Efforts have also been undertaken to consolidate financial information engendered by local governments. Legal procedures for banking transactions have also been updated. For instance, the revised Government Transaction Manual 2019 (2076) has come into force from this year (2019); the revised manual has been reckoned to be an important breakthrough in terms of promoting transparency in governmental financial management. This update in the manual has been complimented by the revision of OAG (Office of the Auditor General) accounting formats, which are the primary basis of accounting and reporting in Nepal. The new formats and forms have already been approved for use across all levels of government from this financial year (2019–20). The Financial Comptroller General Office (FCGO) has issued an internal control framework, with a view to strengthening the internal auditing mechanisms at the local level and ensure compliance with the COSO and ISSAI 9100 frameworks. As part of streamlining and clarifying the accounting processes and procedures, the FCGO has also started initiatives to revise the Government Accounting Manual 2073; this is expected to be completed by 2020. In addition to the above-mentioned regulations, the Audit Act of 2019 has also obtained approval. This act has been especially developed to promote auditing federalism, which implies the decentralisation of the authority of the Office of the Auditor General. Taking into account the regulatory developments taking place in the country, it can be assumed that the fundamentals of the PFM system are now in place. However, as was the case previously, the enforcement of these regulations/acts/procedures has continued to remain a major issue.

Setting up Federal Institutions

An important element for the success of federalism is that each government unit should have its own implementation mechanism and institutional structure for public finance. In this regard, the Financial Comptroller General Office's (FCGO) effort is commendable in that the structure for

public financial management is already set up, both at the district and province levels. While the District Treasury and Control Offices (DTCOs) handle the accounts relating to treasury and fund management at the district levels, such accounts are consolidated at the province levels before they are forwarded to the concerned ministries and the FCGO. All seven provinces have now established 'Province Treasury Controller Offices' (PTCOs), with the responsibility of undertaking all public finance-related activities. A separate accounting section is being planned within the PTCOs to handle the transactions of each provincial unit. The Office of the Auditor General (OAG) has also initiated the process of establishing its province auditor general units, which will then decentralise the OAG functions. In the existing structure, internal audit activity is performed by the DTCOs and the PTCOs, and the role of the OAG is to facilitate the statutory audit function for the whole of the country. The Finance Procedure and Responsibility Act (FPRC) has mandated internal auditing, both at the district and province levels, and envisioned the need for having a separate audit department within the FCGO. Such is also asserted in the FPRC. An effort of establishing a separate auditing unit has already gained momentum, and the details regarding the functioning of this unit are expected to be released soon. In addition, the Public Expenditure and Financial Accountability (PEFA) unit, which is responsible for implementing public finance reforms and capacity development of government accountants, and which works under the Ministry of Finance and the FCGO, has also extended its activities at the district and province levels. Another important development taking place in public finance concerns the transformation of the former Revenue Administration Training Center (RATC) into a new unit – the Public Financial Management Training Center (PFMTC). The following government units are now playing key roles in promoting financial federalism in the country:

- Ministry of Finance-MOF
- Financial Comptroller General Office- FCGO
- Public Procurement and Monitoring Office-PPMO
- Office of the Auditor General-OAG
- Provincial Ministry of Economic Affairs and Planning – MOEAP
- All local governments.

However, the establishment of new units and the enactment of regulations are simply inadequate to achieve the spirit of financial federalism. Challenges and obstacles in facilitating the public financial management system across Nepal more effectively and ensuring good governance, financial transparency and accountability have remained intact. A major problem underlies the recruitment of capable manpower and the professionalisation of public administrators and accountants. Professionals are rarely getting any opportunity in the Nepalese bureaucratic system, and the recruitment of public administrators continues to follow a traditional approach based on meritocracy in the Public Service Commission (PSC) examination. Although the PSC has undertaken several initiatives in recent years to revisit its curriculum for civil services, these have turned out to be inadequate. Accounting and other public finance-related positions continue to be filled by candidates with no prior education and background in government accounting. Notwithstanding all of these, several institutions, such as the Nepal Administrative Staff College (NASC), the Local Development Training Academy (LDTA) and the Urban Development Training Center (UDTC), have increased their involvement in promoting the public finance system, both at the central and local levels, launching training and capacity development programmes for public administrators. Such initiatives are generally facilitated in support and collaboration with development partners and donor agencies, such as the ADB, the USAID, the EU and the GIZ, the World Bank being the key funder of public finance reforms in the country.

Ongoing IT Development

Figures, graphs and tables are widely used at a global level to demonstrate how the system of public finance management (PFM) works and its connection with governance and accountability. For instance, the Financial Report of the US Government starts with 'Results in Brief', presenting the pictures of 'net cost' and 'taxes and other revenue' (see e.g. the Department of Treasury, 2018). The whole process of the PFM system is being digitalised across countries, not least in Nepal, engendering massive accounting data through the application of sophisticated IT systems. There is a separate section within the FCGO handling the IT systems for PFM. Over the last two decades, the FCGO, with the financial support of the World Bank and other donors, has developed a number of software systems based on Oracle and MS SQL. While some of these systems have already been outdated, others are being modified and reinvested to address the new requirements imposed in the aftermath of federalism. Software systems such as CGAS, FMIS, RMIS, TSA and SUTRA are currently in practice in the management of revenue accounting, public expenditures and banking. A separate software system for debt management is under construction; this is named as the DOMS. SUTRA is a special web-based integrated system developed for managing public finance of local governments. Efforts are now put into place to facilitate the PFM system using an integrated approach known as an IFMIS. The PEFA unit in the FCGO has been conducting a study on different aspects of the IFMIS and its implementation. In addition, the Ministry of Finance has been using the line ministry budget information system (LMBIS), a well-known IT tool for budget planning and implementation. However, the digitalisation of public procurement has continued to pose challenges due to the multiplicity in the use of the IT systems. At present, public procurement contributes to a material level of expenditure – roughly 60% of the capital spending. Currently, two versions of e-GP systems have been developed and rolled out and the third one is being

planned, all of which have complicated the effective management of public procurement. This has created the opportunity for many contractors and other corrupted stakeholders to fabricate transactions and contracts to fulfil their illicit personal interests and financial gain. The development of a uniform IT system and the digitalisation of transactions have become paramount to ensure transparency in the operation of public procurement.

Implementation Status of Regulations

As is the case in other developing countries (see e.g. Adhikari et al., 2019), a lack of resources, an absence of effective planning and reform strategies, limited opportunities for capacity development and dwindling employees' motivation have been some of the key challenges in implementing the PFM system and instigating reforms in Nepal. In terms of enacting regulations for PFM, Nepal's efforts are perhaps appreciable, but a key issue concerns the implementation of such regulations in practice. In fact, enforcement of regulations has always been an issue in Nepal, and this was clearly outlined as early as the beginning of the new century in the World Bank's Country Financial Accountability Assessment (CFAA). Limited infrastructure and capacity of public administrators, coupled with the ascendancy in corruption and political patronage, have resulted in many PFM-related regulations issued over time remaining ineffective in practice; the intended enforcement of such regulations would have significantly improved governance and accountability in the country. What appears to be important at the moment is to identify the mechanisms to incentivise public administrators at the field level to execute the existing PFM regulations and deliver the intended results. This certainly needs the prioritising of the capacity development of public administrators, offering them the opportunity to attend appropriate training and courses in IT and public finance. Indeed, the number of trainings and observation opportunities offered to the accounting cadre has increased in recent years, but these appear to be too little given the intensity

and pace of changes taking place in the country's public finance system. For instance, the budget data provided by local governments show that at latest 45 local authorities, mostly in province 2, have been unable to publish their annual budgets on time. Limited capacity development opportunities and a lack of competence of accountants have contributed to such budgetary non-compliance at local levels. This ground-level local reality is yet to be realised at the ministerial level. Instead, a policy is agreed on which enables the central government to delay and, if necessary, stop the equalisation and matching grants to local authorities unless they produce their budgets on time. Such is also evident in the implementation of SUTRA – a web-based system for budgeting, accounting and reporting for local governments. Around 450 out of a total of 753 local governments in the fiscal year 2017/18 were unable to execute this system and their grants were halted, if not delayed. Training offered by the central government adhering to a cluster-based approach and drawing certain participants from each province were simply inadequate to disseminate SUTRA at local levels. As the matching and equalisation grants contribute to more than 70% of local governments' overall budgets, many local governments have been forced to claim compliance with the requirements imposed, irrespective of their capacity and competency.

Many other initiatives that have started both at the federal and province levels have remained ineffective in practice. For instance, the intergovernmental fiscal committee at the central (federal) level, set up under the chairmanship of the Prime Minister in 2017/18, has developed an action plan for fiscal federalism; there is no evidence which shows that the plan has been put into action. Similarly, provinces have adopted a cooperation strategy among themselves, which has yet to come into force. A lack of coordination between the federal and provincial governments has become another obstacle in the enforcement of many regulations. The federal government is responsible for deploying officials at the province levels, and many of such officials have no prior experience working in the federal structure. Being forced by the elected government

at the province level, these officials are at times expected to work with high pace and intensity. There are few cases in which the provinces have been further ahead than the federal government in terms of promulgating financial procedures, further complicating the enforcement of such measures.

Reports published by many international organisations, mainly the PEFA assessment and the World Bank's Country Review, provide an overall scenario with regard to Nepal's performance in improving financial transparency and accountability. The PEFA defines 31 specific indicators, which are further disaggregated into 94 dimensions focusing on the key measurable aspects of the PFM system. The most recent PEFA assessment for the country was conducted in 2013/14 and the report was released in May 2015. The results show that the country has made significant improvements in 28 performance indicators (Pi). Improvements have been recorded in other 16 indicators, whereas ten indicators have remained unchanged and two deteriorated. These financial results offer room for optimism, but much is left to be accomplished in terms of improving public service delivery at the province and local levels. This implies that the danger of falling into the danger zone of the PFM system is yet to be avoided.

Conclusion

The introduction of a new federal structure in Nepal has brought forth in discussion a number of issues. Delegation of administrative and functional responsibilities to local authorities, the design of the intergovernmental fiscal system, provisions of resource allocation and service delivery, and the mobilisation of public administrations at the local and provincial levels have continually drawn attention at the policy-making level. In public finance management, there are ongoing concerns over the need for bringing the PEFA framework to the provincial and local levels and articulating day-to-day financial activities and reforms adhering to the guidance laid down in the framework. Nepal has now undertaken Phase II of the Public Finance Reform Strategy/Programme

(PFMRP), which extends from the financial year 2016/17 until 2025/26. A wide range of activities, reforms and guidance are included in the PFMRP, the effective implementation of which have the potential to ease the process of financial federalism and ensure a sound PFM system across the country. Public finance experts are also of the view that adopting a simple strategic decision, such as the aggregation of the DTCOs, would also help provinces deliver effective service delivery to citizens. Local authorities are required to focus their attention on maintaining transparency by engaging more with citizens through public hearing, citizen charters and the disclosure of financial information. Perhaps an easy alternative for local authorities would be to adhere to the guidance embedded in the PEFA framework. The World Bank and many other donors assert that the adherence of the PEFA framework is an indicator which shows the country's desire to improve the overall public finance system.

More importantly, the success of financial federalism in the country depends on how public administrators and accountants are imparted with appropriate financial competences and skills. India perhaps serves as an example; a number of Indian states are attempting to acquire the required human resource competences and skills through the introduction of the competency framework (Adhikari & Thankom, 2019). It is also important to realise that the appropriate IT systems are paramount for the execution and implementation of PFM practices and reforms. The integrated approaches being used in Nepal, for instance the IFMIS, should therefore be executed ensuring a uniform application platform. The government should also enforce a strategic software development programme to make the use of the IT system more sustainable, economic and secure. All such initiatives require altering the existing curriculum at school and university levels with the introduction of courses/programmes in public financial management and accountability. The recruitment strategy of the Public Service Commission should also be altered, focusing more on competencies and public financial skills rather than academic mediocrity. In addition, professional

institutions such as the Institute of Chartered Accountants of Nepal (ICAN) can also play an important role in developing and promoting professionalism in public sector accounting. The importance of public financial management in the successful operation of federalism should be realised at all levels and more collaborative approaches to PFM reforms should be pursued involving local authorities, development partners and international organisations, and professional accounting institutions such as the ICAN. In this regard, valuable insights could be drawn on from ongoing public finance reforms in Sri Lanka (Adhikari & Kuruppu, 2018).

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