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Conceptual Framework of Fiduciary Risks

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Abstract

Nepal has adopted a course of federal governance by transferring expenditure and revenue functions to sub-national government in the form of fiscal federalism. Nevertheless, in recent years, fiduciary risks have been frequently discussed topics in fiscal federalism. This article provides some conceptual framework of fiduciary risks with particular focus on local finance. This descripto-analytical article briefly examines the relationship between the level of fiscal decentralization and fiduciary risks at local government as well. Despite some methodological limitations of cross-sectional regression analysis, it is found that the level of fiscal decentralization is associate with fiduciary risks. This provides some hints for precaution. Government of Nepal should help local government to improve their level of fiduciary governance.

Keywords: *fiduciary risks, principal-agent relationship, common pool problem, corruption risks*

1. Introduction

A fiduciary is an agent who is responsible to take care of money or other assets for another person. The politicians and bureaucrats are the fiduciary agents of the people to whom the people have assigned them with utmost trust and confidence to protect public funds. It is a legal and moral obligation of bureaucrats and/or politicians to act in the best interests of their principals, i.e., the citizens. However, the fundamental features of public finance are that the money does not belong to those who are in charge of spending. Politicians and/or bureaucrats spend people's money. "The money always belongs to the principal or the citizens and it is the agent or the bureaucrats and/or politicians to spend it for the maximum benefits of citizens. In practice, the self-interested, if not rent seeking, agents may not always act in the best interests of their masters.

The two most cited problems of public finance are the *principal-agent problem* and *common pool problem*. The principal-agent relationship in democracy between the voters (the principals) and politicians (the agents) may also be a causal effect of fiduciary risks. In a democracy, voters delegate spending and taxing power to their elected representatives and there comes a possibility of rent extraction by spending agents against the will of general people. The weak principal-agent relationship is one of the causes of fiduciary risks. The common pool problem arises when spending agents spend public fund only to the benefits of certain groups and those net benefits accrued to such groups exceed the average benefits received by people of the whole country. The powerful politicians

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and or bureaucrats may divert a large chunk of budget to their constituency so that their constituents get more benefits in comparison to other constituents. The common pool problem therefore becomes an inequitable allocation of public fund to certain groups at the cost of the larger public. The burden is borne by whole country but the benefits are enjoyed by certain groups of people. These problems violate the fiduciary duty of spending agents, which comes because of incomplete contracts in public finance.

The public officials are public agents and it is their legal and moral obligation to spend public fund at the best interests of citizens living in countries. In other words, they are fiduciary agents of the people and their fiduciary duty is to spend public fund efficiently and effectively for the maximum benefit of people. Any sort of misuse, mismanagement, inefficiency, and ineffectiveness in the use of public fund is the violation of their fiduciary obligations. Fiduciary risks, therefore, reflect on such possibilities of violation of fiduciary duty by fiduciary agents in a country.

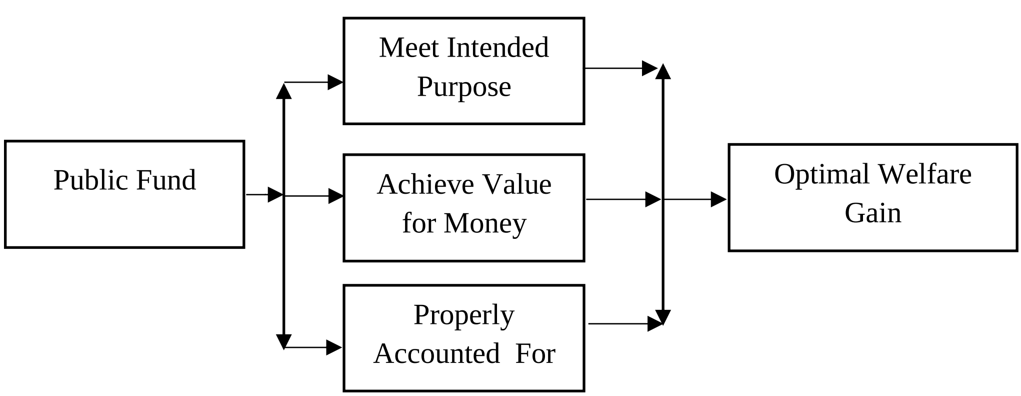
2. Meaning of Risk

The word 'risk' derived from the early Italian word 'risicare', which means 'to dare'. Risk, in this respect, is a choice rather than a fate. Risk is a chance that an event or action will an effect on an organization's ability to achieve its objectives and to successfully execute its strategy. We define the risks as *the possibilities of unintended events that will result in negative and unexpected results*. If we ignore the the risks it may result in negative outcomes that can reverse hard-won achievements and endanger the quality of institutions that produced these gains.

2.1 Understanding Fiduciary Risks

The notion of fiduciary risks in public finance is based on a simple premise of public governance that "no fund can be mobilized from the citizens or spent without explicit approval of their elected representatives". The UK's Department for International Development (DFID) has defined fiduciary risks as the "risks that funds are not used for the intended purpose; do not achieve value for money; and/or not properly accounted for". A range of factors are responsible for fiduciary risks like lack of capacity, practice of corruption, and weak accountability in the system of public finance. Fiduciary risks are the results of corruption, capacity constraints, and other weaknesses in the system of public finance.

Figure 1: Concept of Fiduciary Risks

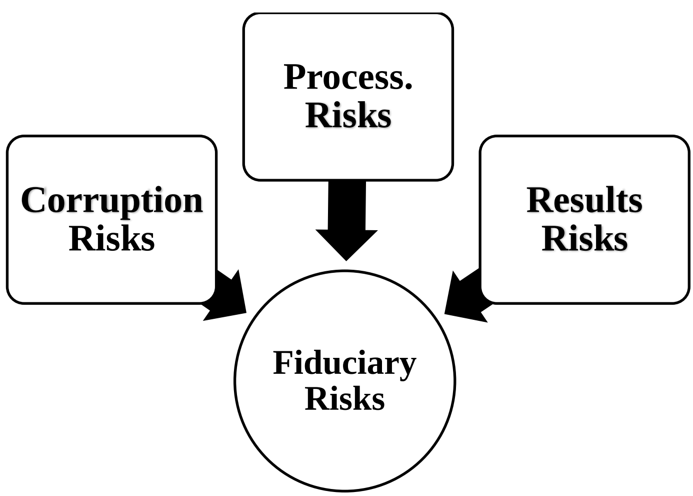


We define fiduciary risks as the possibility of misuse, mismanagement, inefficiency, and ineffectiveness of public fund due to weak capacity to deliver results, poor or non-compliance of due process of law, and corruption in public sectors. Capacity involves the ability to perform and ability to produce beneficial changes. Inefficiency occurs in public finance when spending agents use more resources than necessary to accomplish the assigned tasks primarily due to lack of ability or skills. Ineffectiveness occurs when spending agents cannot produce intended results out of public funds.

2.2 Components Fiduciary Risks

In this article we categorize the fiduciary risks into process risks, corruption risks, and result risks. Process related risks encompass the risks of non-compliance of due process of law in public financial management. Corruption risks are possibilities of misuse of public fund for private gains by the officials. The result risk is the exposure of not producing expected outputs, outcomes, and impact due to corruption and/or weak capacity. Outcomes are immediate benefits generated by outputs from the use of public fund and other institutional resources. The outcome cannot be bought as it is about the beneficial changes for societies and/or organizations. Impacts are the long-term benefits to intended groups produced by the outcomes. Any development initiative financed through public funds lies on input-process-output-outcome-impact continuum. Any deviation of this continuum is the symptom of fiduciary risks.

Figure 2. Components of Fiduciary Risks



2.3 Corruption Risks

Corruption is commonly defined as the misuse of entrusted power for private gains. We can use following formula of corruption: C= M+D-A, where C is corruption, M is monopoly, D is discretion, and A is accountability. Corruption thus equals monopoly plus discretion minus accountability. Ccorruption is the exercise of official powers against public interests or the abuse of public office for private gains.

Corruption is a critical governance issue and has a negative effect on public services, quality of institution, development, and other area of public governance. Corruption is an obstacle to effective management of public fund. Corruption undermines development. Corruption distorts the quality of public expenditures.

We can examine corruption from the structural and interactive perspectives of social science. Structural approach defines corruption as an endemic to some societies. Examining the formal rules and institutions, the structural approach describes how and why certain actors, particularly elites, are able to act for personal gain. Unlike structural approach, interactional approaches focus much on the behaviours of actors in particular public office settings. Corruption in this approach is defined as the behaviour that deviates from the formal duties of a public role in favour of private or personal gain.

2.4 Process Risks

One of the main risks associated with public performance is that there are many instances where public officials circumvented the due process of law. Compliance with due process of law is essential not only for ensuring conformity with legal provision, but also for institutionalizing justice and fairness. Due process of law is also equally important for quality. Corruption occurs when compliance rate is low.

Office of Auditor General in Nepal have noticed the inefficient and ineffective fund flow processes, weak financial management capacity, and poor audit capacity in public sectors. It further highlights that lack of follow up on the audit, including poor internal audit, weak procurement capacity, weak monitoring and non-streamlined monitoring processes, and weak transparency and accountability framework have posed fiscal threats at public sectors.

2.5 Results Risks

Results are the beneficial changes brought by the public interventions. The ultimate goal of public fund is to bring public welfare that will result in sustainable prosperity for citizens. While the overall resources for government have increased, the competition for those resources has also increase. The public officials must furnish the evidence of results about the use of public fund. The results-based public financing also holds the government to account on the use of fund. Results risks occur when the beneficial changes are not produced with the use of public fund. We can illustrate the results chain in following figure. If the expenditures on health do not contribute to expected outcome and impact it will consider as the result risks.

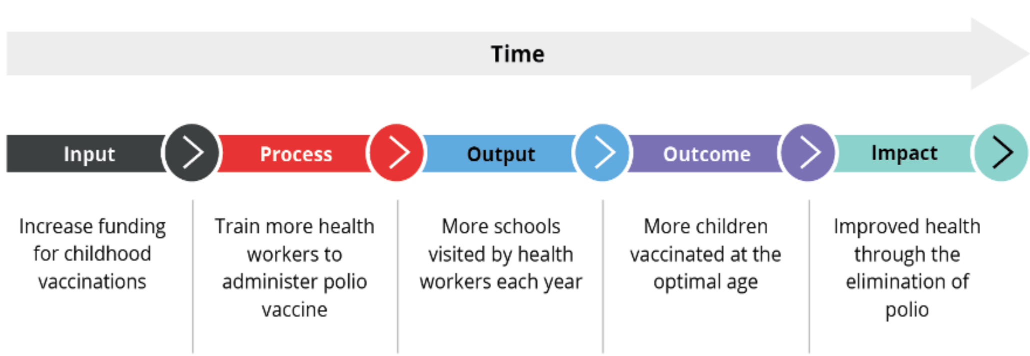


Figure 3: Results Chain

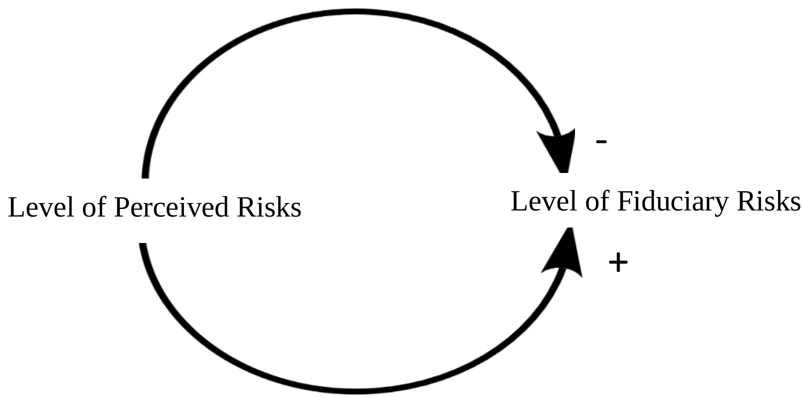
Source: London School of Economics: Public Policy and Analysis Course.

2.6 Fiduciary Risks and Perceived Risks

There is a negative relationship between fiduciary risks and perceived risks. Perceived risks mean fear of being caught in case of corruption or misuse of fund. One of important measures to control corruption is to increase the level of perceived risks. The media and oversight agencies and civic oversight have important role to play to increase the level of perceived risks. If the level perceived risks are low then the level of fiduciary risks may increase.

Perceived risks can be increased through both the formal and informal measures. Promoting free and fair media with impartial reporting, promoting civic awareness of people to fight against the corruption, and enforcement of social accountability measures are some of the well-established approaches to increase the perceived risks. Constitutional bodies such as Commission of Abuse of Authority and Office of Audit General have the most significant roles to increase the perceived risks.

Figure 4: Fiduciary Risks and Perceived Risks



3. Fiduciary Risk Assessment in Nepal

Government of Nepal has approved the fiduciary risks assessment framework for local government in Nepal. District Coordination Committees have been authorised to carry on annual assessment of fiduciary risks of municipalities and rural municipalities. Ministry of Federal Affairs and General Administration is executing agency of this framework The Ministry has developed the online e-portal to track the level of fiduciary risks at local governments. This framework will also serve as the monitoring tools of district coordination committees as these agencies have constitutional responsibilities of monitoring and coordination of local government in Nepal.

There are 100 indicators related to process risks, results risks, and corruption risks in the areas of planning, budgeting and programme management; implementation capacity; accounting and reporting; monitoring, evaluation, and auditing; and revenue management.

Dimensions	Process Risks	Results Risks	Corruption Risks	Total
Planning, budgeting and programme management	15	2	4	21
Implementation capacity	14	4	11	29
Accounting and reporting	10	2	5	17
Monitoring, evaluation, and auditing	5	3	8	16
Revenue management	9	2	6	17
Number of indicators	53	13	34	100

4. Fiduciary Risks and Fiscal Decentralization: Empirical Evidences

The empirical literatures have produced conflicting results on the relationship between fiscal decentralization and fiduciary risks. For instance, consistent with some of the claims found in the literature, Khanal (2017) found empirical evidences that sketched an inverse relationship between level of own-source revenues and its consequential fiduciary risks. He found that the increasing amount of own-source revenues was not associated with swelling fiduciary risks. On the contrary, his analysis found positive, albeit moderate, association of vertical fiscal imbalance with fiduciary risks indicating that increasing level of transfer dependency was associated with increasing level of fiduciary risks. His findings highlighted the importance of revenue decentralization vis-à-vis fiscal transfers.

Smoke and Fedelino (2013) found a positive association between fiscal decentralization and public financial management reforms. They noted that better coordination between these reform initiatives could potentially yield benefits for public sector performance in general and local fiscal discipline in particular. They suggested that strengthening public financial management is instrumental for effective local service delivery and downward accountability of local governments to their constituents. Examining fiscal behavior in China, Guo (2008) found that fiscal decentralization initiatives in China were driven by political motives to buy political stability. He found that institutional structure of local fiscal system was not conducive to sustainable fiscal behaviors.

Bird and Smart (2002) noted the flypaper effect of transfers at local level. They argued that people tend to be more careful about the expenditure of their own money. Local governments may become careless in spending grants. The local citizen may not put pressure on local politicians for effectiveness of grant. Local politicians may perceive the grant as free lunches. Sato (2007) noted, "grant can also distort to local public choice, undermining the disciplinary functions of local autonomy, which in turn gives rise to overexpansion of local spending" (p. 177). The flypaper effect arises when a grant recipient local government increases the level of public spending more than an increase in local own-source revenue due to ignorance of voter about the value of such resources for their well-being (King, 2016).

Bhatta (2010) conducted a study on fiscal decentralization and fiduciary risks in local governance and found a range of fiduciary issues such as poor public financial management systems, weak central oversights, and/or low levels of downward accountability. The aforementioned research argues that the nature and severity of fiduciary risks are such that they need to be understood in the broader context of the general public financial management system as well as the constraints inherent in local governance (Bhatta, 2011). In 2011, MLD carried out public expenditure and tracking survey of topping-up grants to LBs provided by LGCDP and draws on conclusions that perceived risks of being caught when committing a fraud or an act of corruption is very low at LBs (LGCDP, 2011). However, this study surveyed a very limited sample of three districts, six VDCs, and only one municipality.

In this article, taking the amount of arrears as the proxy of level of fiduciary risk and annual budget of local government as the proxy of level of fiscal decentralization, it is observed that the level of fiscal decentralization is associated with the level of fiduciary risks[*]. Without log transformation, the amount of fiscal decentralization explains about the 35 of variation in the amount of arrears. The

[*] Cross-section data for FY 2075/76 available from Ministry of Federal Affairs and General Administration. Log-log relationship was taken to address the problem of heteroscedasticity.

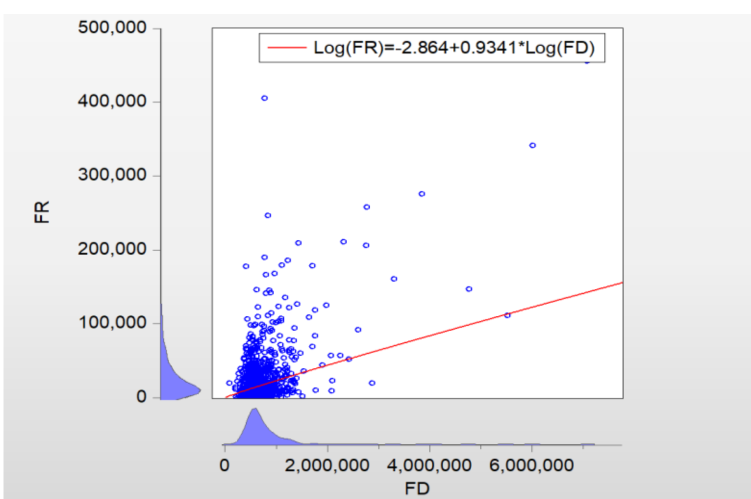
positive statistical association between degree of expenditure decentralization and level of fiduciary risks demonstrates that higher level of transfer dependency could be counterproductive for fiscal outcomes. Though there are some limitations on cross-sectional regression, this analysis provides some hints on the relationship between fiscal decentralization and fiduciary risks. This empirical finding suggests that seeking other important measures to address the vertical fiscal gaps in local government would be recourse at hand. Given the high level of fiscal dependency, this empirical observation shows that relying on fiscal transfers to meet the expenditure needs of local government may invite fiduciary risks.

View | Proc | Object | Print | Name | Freeze | Estimate | Forecast | Stats | Resids

Dependent Variable: LOG(FR)
Method: Least Squares
Date: 02/19/22 Time: 17:18
Sample: 1 742
Included observations: 742

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-2.864051	1.392142	-2.057298	0.0400
LOG(FD)	0.934060	0.103676	9.009419	0.0000

R-squared	0.098846	Mean dependent var	9.671417
Adjusted R-squared	0.097629	S.D. dependent var	1.326078
S.E. of regression	1.259684	Akaike info criterion	3.302290
Sum squared resid	1174.235	Schwarz criterion	3.314715
Log likelihood	-1223.150	Hannan-Quinn criter.	3.307080
F-statistic	81.16962	Durbin-Watson stat	1.866760
Prob(F-statistic)	0.000000		



5. Conclusion

Fiduciary risk is about the possibility of misuse, mismanagement, inefficiency, and ineffectiveness of public fund due to weak capacity to deliver results, poor or non-compliance of due process of law, and corruption in public sectors. Fiduciary risk is one of the critical issues in public finance. The two main causes of fiduciary risks are the common pool problem and principal-agent problem. There is always a negative relationship between perceived risks and fiduciary risks. Building public financial management institution is crucial to achieve the fiscal outcomes. Increasing the perceived risks among political and bureaucratic actors is important to reduce fiduciary risks. Literature on fiscal decentralization has conflicting findings about the relationship between fiscal decentralization and fiduciary governance. In a cross-section study, it is found that fiscal decentralization is associated with increasing level fiduciary risks in Nepal. Improving fiduciary governance through sound public financial management is fundamental to control fiduciary risks.

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