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Improving Financial Management

This note outlines Pakistan's challenges in public financial management and suggests recommendations for meeting them. The legal and institutional framework for public financial management is well structured. The government has taken steps in the right direction including automating budgeting, accounting, and financial reporting nationwide, modernizing auditing practices, and adopting medium-term budgetary frameworks. The need now is to consolidate these reforms and introduce a second generation, focused on decentralizing budget management by fully delegating budget preparation and implementation functions to the line departments (including accounting and financial reporting responsibilities), strengthening cash management through business process reengineering (to prepare accurate and complete statements of cash positions as well as reliable and timely forecasts of cash requirements), and augmenting the capacity of procurement regulatory authorities (to enable them to fulfill their mandate effectively).

Pakistan has a fairly developed infrastructure for public financial management (PFM). At the policy level, Parliament has a key role in authorizing revenues, expenditures, and debts. The Ministry of Finance plays a pivotal role in budget preparation and expenditure control. Line ministries, departments, and agencies (MDAs) have well-defined roles in implementing budgets and submitting accounts for expenditures incurred. The controller general of accounts (CGA), with an extensive network of offices, makes payments, maintains accounts, and prepares annual financial statements. The auditor general has a well-established organization for reviewing financial compliance and conducting performance audits.

Over the years, the government has undertaken a range of measures for improving PFM, most notably:[1]

- *Decentralization.* The 18th Amendment to the constitution passed in 2010 abolished the Concurrent List (subjects on which both the National Parliament and provincial assemblies can legislate) and transferred 17 service delivery–related functions to the provinces. Further, the share of provinces in federal receipts increased from 46.5 percent in 2010 to 57.5 percent in subsequent years under the seventh award of the National Finance Commission (Mustafa 2011). The Council of Common Interests, comprising the federal government and the provinces, formulates and regulates policies on matters in Part II of the Federal Legislative List and exercises supervision and control over related institutions. The council has been strengthened, and the independence and powers of the auditor general have been enhanced (Burki 2010).
- *Separation of accounting and auditing functions.* The promulgation of the Controller General of Accounts Ordinance and the Auditor General's Ordinance in 2001 separated roles and responsibilities of the CGA (accounting) and the auditor general (auditing).

- *Medium-term budgetary framework.* The federal Ministry of Finance has rolled out medium-term budgetary frameworks to all line ministries. This framework has also been piloted with some line departments in the provinces of Khyber Pakhtunkhwa, Punjab, and Sindh.
- *Output-based budgets.* Khyber Pakhtunkhwa has piloted these budgets using conditional grants in health and education, which are being scaled up in 2012/13.
- *Cash management.* The government has largely abolished personal ledger accounts that allowed parallel cash balances, along with the consolidated cash balance. Special drawing accounts have been introduced with expenditure ceilings that do not transfer cash until it is actually spent.
- *Procurement regulatory authorities.* The federal government and the provincial governments of Sindh and Punjab have established procurement regulatory authorities, which are custodians of the rules for all public procurement. Responsibilities include monitoring application of rules, recommending revisions to rules, making regulations, providing guidance to implementing agencies, and supporting these agencies' capacity building. Audit responsibility rests with the Auditor General's Office, and other laws are in place to address financial misappropriation.
- *Coordination and transparency.* The government has established a sound legal framework for coordinating fiscal and debt management policies and improving fiscal transparency through the Fiscal Responsibility and Debt Limitation Act 2005, even though compliance has been less than stellar.
- *Project for Improving Financial Reporting and Auditing.* This project has helped improve PFM systems (Box 1).

These measures have achieved concrete results. In 2012, the government and its development partners (World Bank, Department for International Development, Asian Development Bank, and European Union) carried out the Public Expenditure and Financial Accountability (PEFA) repeat assessments for the federal and Punjab governments. Limited updates of PEFA assessments were conducted for Khyber Pakhtunkhwa in 2010 and Sindh in 2011. A full update of the Sindh 2009 assessment is

Box 1 Project for Improvement of Financial Reporting and Auditing

In 1997, the Project for Improvement of Financial Reporting and Auditing set up a public financial management reform agenda. The project has supported enhanced internal control and financial accountability systems by:

- Implementing a government-wide financial management information system at all levels using a state-of-the-art SAP application, thus enabling automated budget compilation, accounting, and financial and fiscal reporting nationally, including for district account and finance offices.
- Introducing a new accounting model based on international principles and standards.
- Adopting a uniform chart of accounts for budgeting and accounting by federal, provincial, and district governments since 2007/08, compliant with the International Monetary Fund's Government Finance Statistics.
- Separating accounting and auditing functions. However, the auditor general still has authority for prescribing the form of accounts of the government.
- Supporting informed decision making for public sector management through the availability of timely and reliable in-year budget execution reports. Connectivity is in place for all line departments to monitor budget execution on a real-time basis. Further, within 15 days of the end of each month, civil accounts are prepared and presented to the Ministry of Finance. The reliability of these reports has also improved, with material reductions in irreconcilable differences and the elimination of suspense accounts.
- Preparing annual financial statements using cash-basis International Public Sector Accounting Standards. Submission of annual financial statements for audit has improved to an average of two to four months after the end of the fiscal year, compared with more than 15 months before 2006/07.
- Enhancing the effectiveness, independence, standards, and capacity of government audit and introducing risk-based audit methodology compliant with international standards for certification of annual financial statements.
- Improving the efficiency of external audit through computer-assisted audit techniques and a system-based audit methodology. The financial statements and audit reports are submitted to the president and governors within eight months of the close of the financial year.

under way in 2013. In 2007, an assessment was undertaken for Balochistan. These assessments support findings presented below and confirm certain improvements in recent years, as well as shortcomings.

Substantial progress on transparency through public availability of information stands out for Pakistan. It is evident in the good ratings for indicators in PEFA assessments and the marked improvement in the open budget score, from 38 in 2010 to 58 in 2012 (International Budget Partnership 2012). Annual financial statements and an audit report are laid before Parliament within nine months of the end of the fiscal year. Some of the provincial finance departments are uploading in-year reports to their websites. Pakistan's overall scores on PEFA performance indicators are comparable with those in other South Asian countries (Figure 1).

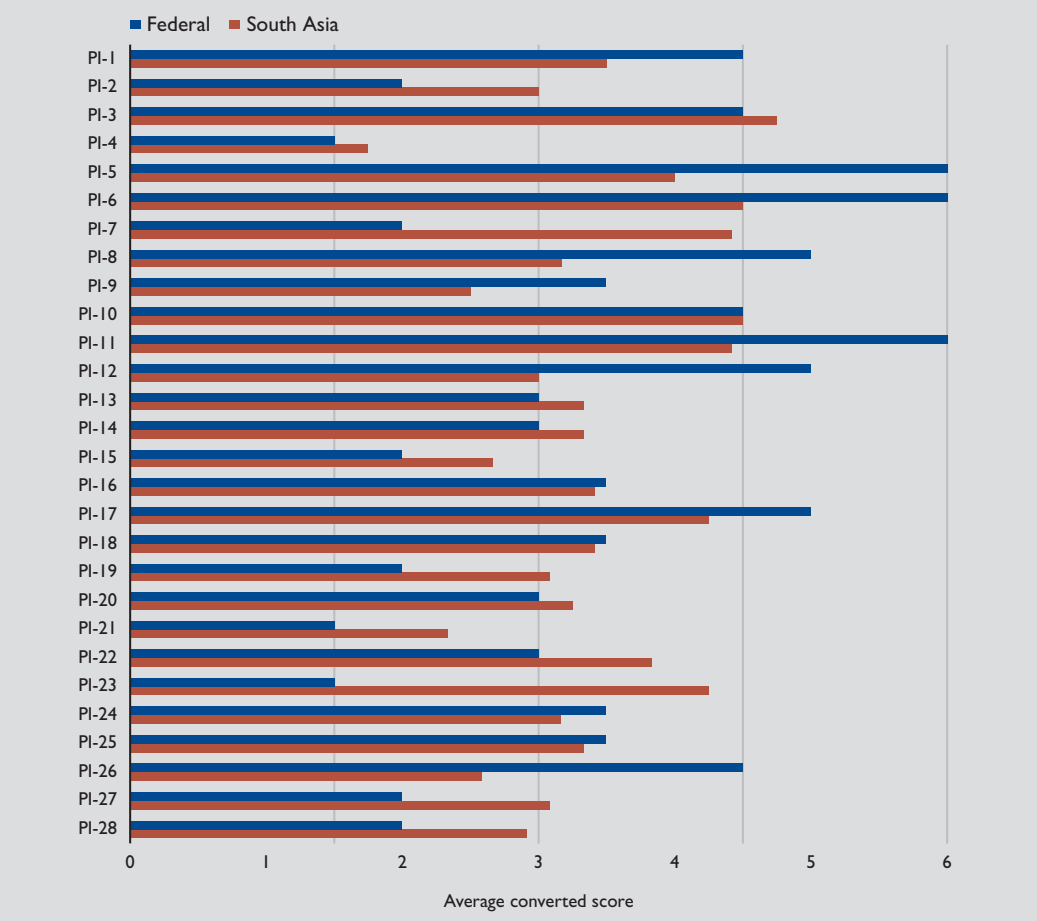
Weaknesses in the PFM framework can be traced to colonial heritage, resistance to change, rent seeking by power groups, and a lack of political will. Yet a popular surge among all segments of society demands change. The next section presents a diagnostic of key issues and selective policy options for more effective performance of the public financial management systems.

Policy Issues

Pakistan faces several challenges in the PFM framework:

- *PFM is fragmented.* The Ministry of Finance plays a dominant role in budgeting and expenditure control. The CGA makes payments and maintains accounts. The MDAs execute the budget within the residual space permitted by the Ministry of Finance and the CGA even though the secretary of each line department is the designated principal

Figure 1 **PEFA assessment scores of federal government in 2012, compared with the average of selected South Asian countries**



Note: South Asia represents the simple average scores of Afghanistan (2008), Bangladesh (2006), Bhutan (2010), India (2010), Maldives (2009), and Nepal (2008).
Source: Government of Pakistan and others 2012a.

accounting officer (PAO) accountable for MDA performance.

- *Internal controls are excessive but weak.* Extensively documented rules are issued by the Ministry of Finance. The CGA applies controls on payments and accounts. The MDAs only exercise operational controls. Partial controls, exercised by three silos of authority, leave loopholes (as highlighted in audit reports).
- *The MDAs have yet to develop the capacity for professional financial management.* This is largely because they have not been given full responsibility and authority to manage their budgets.
- *The MDAs do not link budgets to implementable procurement plans.* Without this link, the MDAs do not have a full picture of a prioritized expenditure plan for development or for major recurrent activities, leading to fragmented budget utilization and poor cash planning. Moreover, the MDAs do not report the planned and actual expenditures regularly and do not adjust budget priorities in light of actual events.

From these problems stem weaknesses in PFM systems, as in the accountability framework. With fragmented controls, no single authority can be held accountable for failing to deliver. Similarly, because the Ministry of Finance controls budgets and cash, the MDAs cannot always deliver services on time and economically, which is why a stronger public procurement function is key for enhanced PFM management.

Centralized budget management

Good budget management enables a government to be effective in the following areas: planning, executing, and monitoring resource management; ensuring targeted outcomes; and strengthening accountability. Pakistan needs to decentralize budget management. The roles of the Ministry of Finance and the CGA need to be redefined for greater delegation. Over the years, the ministry has taken some steps in this direction, for example:

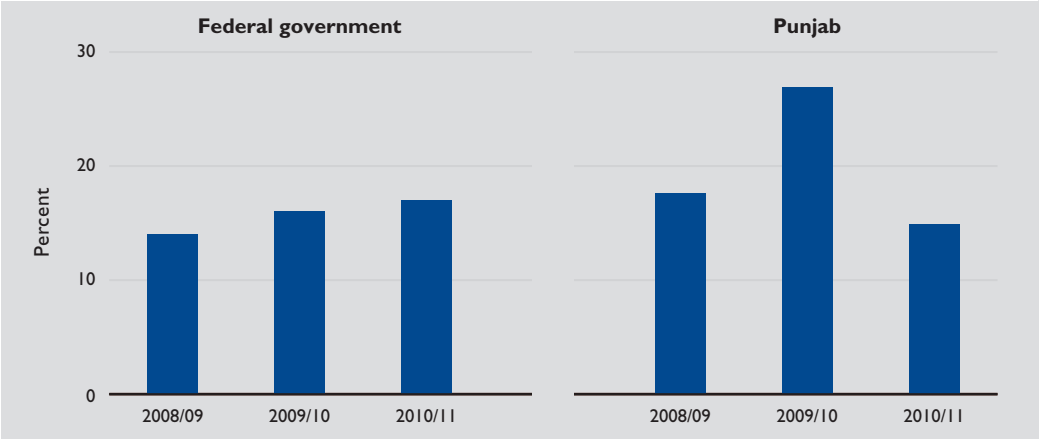
- It oversees more transparent and fair processes for reappropriation of funds and supplementary grants.
- It has delegated more financial powers to PAOs in several steps (the latest in 2006).
- It has decentralized accounting and payment functions for some MDAs like the military, railways, foreign affairs, food, forests, and public works.
- It has improved information on fund releases to the MDAs.

Despite these steps, some shortcomings still hold. The PAOs, for example, still have limited flexibility in executing budgets, and they must revert to the Ministry of Finance at several stages. Independence of the PAOs is further infringed by a centralized system of payments and accounts. Account offices under the CGA process payments, maintain accounts, and prepare annual financial statements. Although the PAOs sign off the final appropriation accounts, they do not assume ownership of them. The performance of the system in terms of budgetary outcomes is poor, as seen in the expenditure outturns for federal and Punjab governments in the June 2012 PEFA assessment (Figure 2).

Similarly, the MDAs need approval from the Ministry of Finance for the following: allocating savings from one grant to another or even from one budget line to another within the same grant; transferring funds from current to development expenditure, or vice versa; and using approved lump-sum grants. And though in 2006 the federal government created 22 posts of chief finance and accounts officers in the MDAs, their role is still secondary to the Ministry of Finance, which maintains the primary role for stewardship of funds. The financial advisors assigned to the MDAs by the ministry exercise considerable influence over frequent in-year reappropriations.

The centralized budget management influences the MDAs' ability to prepare realistic budget estimates. Despite credible and accurate data available on a timely basis from the government financial management information system, decision makers have not started using this information. Equally, although the PAOs are responsible for internal controls, due to shared responsibility with the Ministry of Finance and the CGA they have not developed the systems and processes for implementing the controls, overseeing

Figure 2 **Expenditure outturns for federal and Punjab governments (PI-2), 2008/09–2010/11**



Note: PI-2 is a composite variation (budget and actual expenditures) taking all sectors by functional classification.
Source: Government of Pakistan and others 2012a.

management overrides, or preventing waste and fraud. These weaknesses have led to poor ratings for internal audit and nonsalary internal controls, per the latest PEFA assessments, and increase the risk of over- or underspending. These weaknesses also contribute to Pakistan's low rating in PEFA assessment scores (PI-1 to PI-4) on budget credibility—lower than the average of similar lower middle-income countries (Figure 3).[2] Other scores (PI-13 to PI-21) related to budget execution demonstrate a similar pattern (Figure 4).

Weak cash management

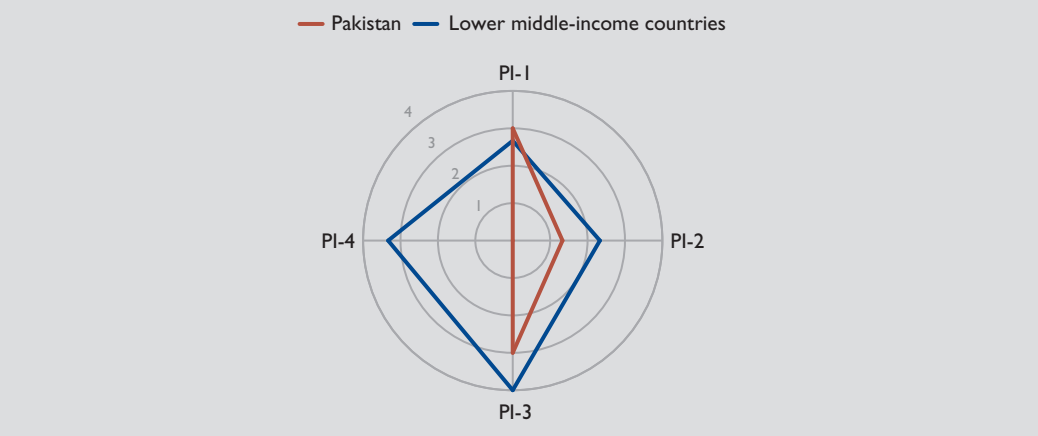
The objectives of modern cash management are to ensure that cash is available to pay for expenditures when due, borrowing occurs only when needed at optimum costs, returns on idle cash are maximized, and risks are managed by productive investment of surpluses. The generally accepted good practice for every government is to have a single treasury account, which Pakistan has yet to achieve according to PEFA assessments. At all levels of government, some accounts still remain outside the consolidated funds, even though they represent a very small share of total outlays (largely related to donor-funded projects).

The Ministry of Finance has taken several steps for improving cash management, although accuracy, completeness, and timeliness of information remain a challenge. The federal, Sindh, and Khyber Pakhtunkhwa governments prepare cash forecasts quarterly while the Punjab government prepares them every month. However, there are significant gaps on cash forecasts and actual cash positions. The accuracy of the cash forecasts is undermined by missing information on the stock of arrears, commitments, and unresolved reconciliation differences. While the State Bank of Pakistan provides daily data on monetary balances, the National Bank of Pakistan submits data with varying lags.

Weak cash management affects the Ministry of Finance's ability to prepare monthly cash-flow forecasts, in turn influencing the MDAs' capacity to implement the budget effectively. Due to delayed information on cash positions and commitments, the Sindh government unknowingly exceeded its overdraft limit in June 2012. Lack of timely reconciliation of balances, unresolved reconciliation differences, and substantially incomplete information on commitments and arrears undermine the Ministry of Finance's other efforts to streamline cash management (Figure 5).

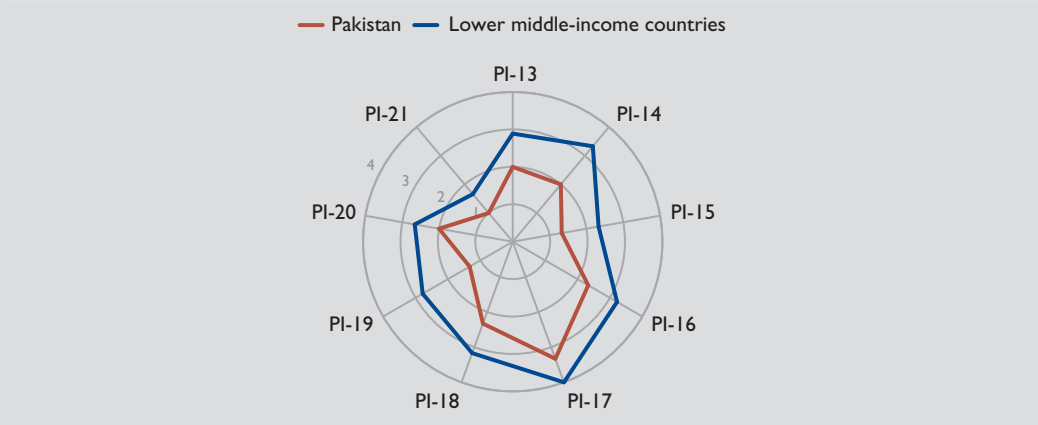
PEFA assessments indicate some improvement in reconciling bank and book balances in the Khyber Pakhtunkhwa, Punjab, and Sindh governments but report an unsatisfactory rating for the federal and Balochistan governments. There remain long-outstanding differences between the Economic Affairs Division and the Accountant General Pakistan Revenue on the status of foreign debt, but the overall net unresolved

Figure 3 Budget credibility (PI-1 to PI-4)



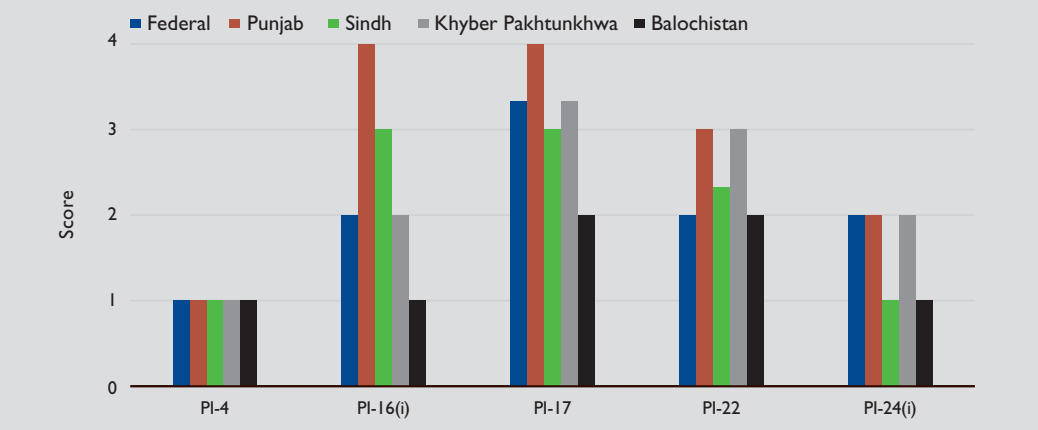
Note: PI-1 is aggregate expenditure outturn compared with original approved budget; PI-2 is composition of expenditure outturn compared with original approved budget; PI-3 is aggregate revenue outturn compared with original approved budget; and PI-4 is stock and monitoring of expenditure payment arrears.
Source: Government of Pakistan and others 2012a.

Figure 4 Predictability and control in budget execution (PI-13 to PI-21)



Note: PI-13 is transparency of taxpayer obligations and liabilities; PI-14 is effectiveness of measures for taxpayer registration and tax assessment; PI-15 is effectiveness in collection of tax payments; PI-16 is predictability in the availability of funds for commitment of expenditures; PI-17 is recording and management of cash balances, debt, and guarantees; PI-18 is effectiveness of payroll controls; PI-19 is competition, value for money, and controls in procurement; PI-20 is effectiveness of internal controls for nonsalary expenditure; and PI-21 is effectiveness of internal audit.
Source: Government of Pakistan and others 2012a.

Figure 5 PEFA assessment scores for indicators related to cash management



Note: PI-4 is stock and monitoring of expenditure payment arrears; PI-16(i) is extent to which cash flows are forecasted and monitored; PI-17 is recording and management of cash balances, debt, and guarantees; PI-22 is timeliness and regularity of accounts reconciliation; and PI-24(i) is scope of reports in terms of coverage and compatibility with budget estimates.
Source: Government of Pakistan and others 2007, 2011a,b, 2012a,b.

differences on this account as of June 30, 2012, were marginal, at PRs 1.86 billion. Progress in implementing commitment accounting has been quite slow. Data on commitments and expenditure arrears are absent from the in-year reports—generating poor scores in the latest PEFA assessments—thus creating a risk of overspending or failure to make timely payments, which can lead to penalties. One contributing factor is the centralized accounting and payments function.

Lack of capacity in procurement regulatory authorities

Procurement is a devolved subject under the constitution. Reform progress has been intermittent at the federal and provincial levels, though all levels of government have clear regulatory frameworks that apply to all public procurement for which open competitive bidding is the default method, for adequate disclosures of all procurement information, and for dispute mechanisms. The federal and provincial governments have enacted public procurement rules, generally aligned with good practice.

The federal government, as well as Punjab and Sindh, have procurement regulatory authorities (PRAs), but Balochistan and Khyber Pakhtunkhwa have yet to establish them. Regulatory frameworks at the federal and provincial levels follow a uniform principle of keeping PRAs in the role of custodian of rules. The PRAs develop adequate documentation and monitoring, assessing and enhancing procurement effectiveness. The audit function lies with the Auditor General's Office, and parallel laws and systems are in place to take action if major issues arise in compliance, including financial misappropriation. Yet although these responsibilities for custodianship, audit, and penal actions seem to ensure sufficient checks and balances, effective implementation has yet to be established.

Implementing agencies conduct the procurement transactional function. Procurement responsibilities are allocated at different operational levels, depending on the cost ceilings of contracts. Various implementing agencies have developed their own operating procedures for devolving financial powers. Transactions with the highest costs require approval of the concerned secretary. Thus, understanding and compliance with procurement rules vary by agency. Some have a good appreciation of them, as well as the resources and capacity for sound procurement, while others do not. The latest PEFA assessments on procurement management show very low scores for Pakistan, largely because of a general lack of credible data among PRAs stemming from the absence of effective monitoring and evaluation (Table 1).

The major challenge is to improve the implementation of the procurement framework. The PRAs are responsible for initiatives to better implement and further develop the framework, but they face many challenges, such as a lack of resources, undermining their capacity. Broader challenges include a general lack of procurement capacity at every level of public administration and an Auditor General's Office historically focused on compliance rather than outcomes.

More urgent issues include the following:

- The PRAs do not have a monitoring and evaluating system to collect and analyze data on procurement actions or evaluate the procurement performance of the MDAs.
- A capacity-building strategy for procurement by the MDAs is lacking.

Table 1 PEFA assessment scores for the procurement-related indicator (PI-19)

Government	Score
Federal	D+
Punjab	D
Sindh	C
Khyber Pakhtunkhwa	C
Balochistan	D+

Note: PI-19 is transparency, competition, and complaints mechanism in procurement.
Source: Government of Pakistan and others 2007, 2011a,b, 2012a,b.

- There is no clear capacity-building program for vendors, especially small and medium-size enterprises. Any healthy procurement system relies on its vendors, who are fundamental for competition and thus in overall procurement, including its transparency.
- The PRAs have no mechanism (formal or otherwise) for knowledge and experience sharing, coordination, or cooperation.
- The regulatory framework considers independent dispute resolution mechanisms for vendors' complaints, but they have yet to be set up.

Policy Recommendations

Decentralize budget management

Experiences of countries like Norway, South Africa, and Sweden suggest that the best option is to move toward decentralizing budget management, through the following measures:

- All MDAs should have dedicated units for financial management with qualified staff. The PAOs should have full responsibility and accountability for the entire budget cycle. Internal controls need to be strengthened through internal audits.
- The Ministry of Finance's role in budget management should be limited to broad policy guidelines, and the current regime of the financial advisor needs to end.
- Payments and accounts functions, including accounting for revenues, should be transferred, with staff, to the MDAs. They would be responsible for ensuring commitment accounting, preparing annual financial statements, and getting these statements passed by the auditor general.

The Ministry of Finance, CGA, auditor general, and Establishment Division will need to work in tandem in bringing to being the proposed decentralized system. It will require dedicated financial management units staffed by professional personnel, who can initially come from the existing accounting staff. The automation of budgeting, accounting, and financial reporting, as well as connectivity to line ministries, is already in place and provide a basic platform for this reform.

Improve cash management

Informed cash management based on monthly cash-flow forecasts, a single treasury account, and regular reconciliation of accounts has become generally accepted best practice. Especially in times of fiscal constraint, a credible statement of the cash position and a robust basis for preparing a comprehensive cash forecast are critical. Given current gaps, business process reengineering will be required to meet these objectives. For institutionalizing top-rate cash management, the Ministry of Finance should set up a high-level committee to oversee monthly cash-flow forecasts, reconcile accounts, and borrow and invest surplus funds in the short term. Countries such as Argentina, Brazil, Chile, Costa Rica, Ecuador, and Peru have such committees in their treasury departments (van Eden and Weiner 2010).

Arrangements to be carried out include the following, benefiting the Ministry of Finance as well as the MDAs, which will get more reliable information on resource availability:

- *Procedures to ensure that all cash balances become part of the consolidated funds.* Policies and procedures already issued for the establishment of a single treasury account need to be made operational. All existing exemptions for keeping some cash balances out of the consolidated funds should be withdrawn.
- *Timely and regular reconciliation of differences in accounts needs to be enforced.* The present pace of reconciling outstanding balances must be accelerated. A cut-off date must be specified for historical items, after which these should be written off as a one-time adjustment.
- *Associated with timely information on commitments are the data on stock of arrears, which are unavailable at any level.*
- *Better and more robust planning through preparation of procurement plans concurrently with the finalization of budget proposals.*

Ensure that PRAs run effectively

Making federal and provincial governments' PRAs operational and effective should be a priority, based partly on the following recommendations:

- Effectively implement a complaint and dispute resolution mechanism and strengthen

information disclosure mechanisms, as well as civil society engagement in them.

- Design a mechanism for monitoring and evaluating the MDAs' procurement performance. This would be cost-effective and would help benchmark the MDAs' performance, develop action plans for better functioning, and improve underlying documents and rules. E-procurement is crucial, as it will provide the raw data on which to build indicators and algorithms that will empower the PRAs in their enforcement task. It will also provide natural integration with the country's financial management systems.
- Have PRAs write consistent and sustainable capacity-building strategies for procurement professionals inside the MDAs and the vendor community, reflecting the vendors' crucial role.
- Set up a forum for sharing knowledge among all PRAs, and streamline the standard documents of the PRAs, to harmonize the national procurement regime.
- Support the auditor general to develop a strategic plan for auditing the procurement performance of all major procurement actions to improve oversight and accountability.

Notes

This note was written with contributions from Uzma Sadaf, Muhammad Akram Khan, and Hammad Yunus.

1. "The government" in this note generally includes the federal government and provincial governments.
2. For more information on performance indicators (PI), see Government of Pakistan and others (2007, 2011a,b, 2012a,b).

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