Sustainable Energy Sector Reform Program
Fiduciary Risk Assessment
Federal Government of Pakistan
Executive Summary

1. This Fiduciary Risk Assessment (FRA) of the Federal Government of Pakistan has been carried out as part of the preparation of Sustainable Energy Sector Reform Program financed by Asian Development Bank (ADB). The proposed [1]Sustainable Energy Sector Reform Program aims to support the plan of the government of Pakistan to make the energy sector affordable, reliable, and sustainable and to secure the country's economic growth. The structure of the program is based on National Power Policy and its related action plan. The program takes the sequential approach over five years with sub program for each year. The program will leverage government effort in three policy areas; (i) managing tariffs and subsidies; (ii) improving sector performance; (iii) improving sector accountability and transparency. The proposed loan amount for the entire program is US$1.2 billion from the ADB special fund allocated over five years as per the estimated requirement of each subprogram.

2. The program has been developed in line with the IMF Extended Fund Facility for the government reform agenda to avoid double counting of reform achievements for each program. Thus, EFF requirements are not met; the program impact outcome may not be achieved. As per the proposed implementation arrangement the Ministry of Finance (MoF) will be the executing agency and the Ministry of Petroleum and Natural Resources and the Ministry of Water and Power will be the implementing agency.

3. The fiduciary assessment has been drawn out from the latest Public Expenditure and Financial Accountability Assessment (PEFA) of Pakistan Federal Government completed in June 2012 and the findings are then triangulated with IMF IV consultation 2013 and World Bank's Pakistan Policy Notes-Public Financial Management. The primary objective of this fiduciary assessment is to understand the fiduciary risk environment at the federal level, provide guidance on mitigating any significant risks to the proper use of funds, and suggest risk-mitigating actions.

4. The overall fiduciary risk at the federal level is assessed to be medium to high with some positive progress observed within individual PEFA dimensions. Federal government has a well-structured public financial management system and over the years the reforms undertaken have resulted in improving overall budget management. Country wide automation of financial accounting, budgeting and reporting, introduction of medium term planning tools and use of a risk-based audit methodology by the Office of the Auditor General of Pakistan are some of the key reforms implemented over the past few years. An overview of the key challenges/issues confronting Public Financial Management (PFM) at the federal level follows. To present the most recent analysis, where possible the PEFA assessment has been updated with the latest figures. For each issue, underlying causes and risk analysis has also been provided. This is followed by the brief review of the ongoing PFM reforms and assessment of their credibility. A risk mitigating matrix is presented prioritized based on the impact, relevance and realism of implementation in the medium term.

[1] ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan for Subprogram-1 (Sustainable Energy Sector Reform Program) to Pakistan.* Manila.

5. PFM institutional arrangements are fragmented[2] and there is no single PFM[3] specific law that provides an overarching framework for all institutions involved in the PFM cycle. The Constitution of Pakistan and different statutes provide for budget formulation and execution A PFM specific law could augment the legislative framework, particularly if the law addresses the relationships between the Executive and Legislature, the accountability framework and an unambiguous stipulation of mandatory legislature endorsement for all public expenditure.

6. The PEFA 2012 noted that although the government has introduced a Medium Term Budgeting Framework, which is a step in the right direction, the reform has yet to take root. The alignment of the annual budget with Mid-term Budget Framework (MTBF) is weak, and there are no sector strategies for efficient resource allocation. With the introduction of modern planning tools, the Ministry/Department/Autonomous Institutions (MDAs) have more roles in PFM and therefore require FM capacity to develop and execute medium term plans, and to monitor expenditure against results for impact and efficiency. Sector ceilings are neither presented to standing committees nor discussed in assembly, undermining the value as a medium term policy statement of the government. In the context of political economy, the MTBF must be developed through a consultative process by ensuring involvement of the public representatives during its preparation, and it should similarly be monitored against the physical results.

7. Budget credibility is maintained when deviations from the original budget are kept at a minimum, are well justified, and are applied against expected physical results. The IMF Article IV consultation underscores the importance of low budget deficits for Pakistan, with its low tax-to-GDP ratio and high debt levels that are sensitive to even small changes in interest rates.[4] Therefore, in the medium term fiscal consolidation should focus on careful expenditure management, reducing poorly targeted subsidies, and on increasing tax revenue. According to PEFA 2012, at the aggregate level the actual budget expenditure exceeded the original budget by 15.3% in FY 2010-11. The underlying factor was an additional subsidy of Rs. 254 billion to the power sector due to tariff differential subsidy and public sector power company losses (technical and commercial) over and above the original budgeted amount. On the revenue side, the aggregate revenue out-turn was 15% in FY 2011-12. The major part of the variance has come from non-tax receipts. As per PEFA 2012, the Federal Bureau of Revenue (FBR) needs strengthening to better forecast tax revenue. The decline in non-tax revenue is due to petroleum levy gaps, major shortfalls in dividends from public sector entities, and a sharp decline in receipts from defence services.

8. Another factor that adversely affects budget management is the frequent use of legal provisions allowing the executive branch to re-appropriate budget line items without recourse to the legislature. The budget revisions are presented to the legislature ex-post along with the next year's budget. PEFA observed that cash constraints and changes in

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[2] To name the few: Ministry of Finance(MOF), Executive Committee of the National Economic Council (ECNEC), Economic Affairs Division, National Economic Council, State Bank of Pakistan, National Bank of Pakistan (NBP), Federal Bureau of Revenue (FBR), Planning Commission, National Finance Commission, Controller General of Accounts and Office of Auditor General of Pakistan. Each one of them has a role in PFM with MoF leading the way.

[3] Although the Constitution contains provisions relating to public financial management, they are broad. Various Acts, Ordinance and Notifications have been issued to regulate PFM activities. No single law is available to govern PFM. The annual Finance bill is the only budget law that covers annual appropriations and generation of revenue.

[4] Debt Sustainability Analysis-IMF article IV consultation 2013

development priorities are main causes of in-year budget revisions. The Public Sector Development Program is worst hit by these budget cuts and sudden policy U-turns. Due to developing democratic base, allocation efficiency and fiscal discipline objectives are overturned to accumulate political capital. The development plans generally reflect constituency interests rather than highest ranked development needs, thus resulting in an unrealistic and ambitious budget that cannot be implemented and requires frequent in-year adjustments.

9. As per the IMF Article IV consultation 2013, the declining revenue and increasing power subsidies have worsened the already large fiscal deficit. The IMF suggests that, apart from reducing subsidies, the government needs tax policy reforms for fiscal consolidation. The frequent issuance of Statutory Regulatory Orders (SROs) is one of the key problems in tax compliance and a stable and fair tax regime. The SROs change the shape of the finance bills approved by the parliament at the start of the financial year, thus making it difficult for taxpayers to track changes and ensure compliance. The PEFA 2012 underlines the weak tax registration process as another reason for low revenue generation. The PEFA assessment noted that though the FBR has established an investigation and intelligence wing to broaden tax registration, results have been far from desirable. Recently, the government is proposing legislation that will allow the FBR to access bank account data on individuals. One of the major gaps identified in latest PEFA assessment is the absence of reconciliation at the individual taxpayer level. The withholding tax deducted during the year cannot be reconciled with taxes assessed. The weak control over reconciliation reduces the reliability of financial reports regarding tax collection.

10. The Federal PEFA 2012 has noted the absence of any monitoring mechanism for the over 200 autonomous institutions and state owned enterprises. The Ministry of Finance has the prime responsibility to take regular stock of the financial position of these organizations; however, due to limited capacity, the monitoring is restricted to review individual financial reports of the organizations on an ex post basis. No efforts have been made to consolidate and determine the overall financial exposure of these organizations. Recently, state owned enterprises like Pakistan International Airlines and Pakistan Steel Mill have been reporting heavy losses (according to print media the total may be at the tune of Rs. 500B annually), risking their and the federal budget sustainability and undermining the transparency of fiscal policy and contingent claims against the government. The drain on the budget of these loss-making SOEs will also impact the effectiveness of the poverty alleviation efforts of the already heavily-indebted federal government. After the 18th Constitutional amendment, the tax revenue allocation to the provinces has increased with enhanced role in service delivery for the provinces. Currently, federal government does not have any mechanism or legal framework to monitor and control the consolidated deficit.

11. The PEFA 2012 identifies a lack of systematic cash monitoring mechanism as one of the reasons for weak cash management. The assessment underlines that the Ministry of Finance, in order to develop realistic cash plans, requires information from FBR, SBP, Accountant General Pakistan Revenue, and NBP. The flow of information from these government agencies is varied in terms of accuracy and timing. Another reason for weak cash management is the absence of commitment accounting from Government Financial Management Information System\m (GFMIS). The inability to update quarterly cash forecasts affect the implementation plan of the Ministries/Divisions/ autonomous bodies (MDA). Given that government is committed to fiscal consolidation to reduce the budget deficit and avoid Balance of Payment crises, weak cash management puts these targets at risk.

12. The internal control environment has improved over the years chiefly due to the introduction of SAP R/3[5] for financial transaction processing across all district account offices. However, as per the federal PEFA 2012, the number of audit observations for non-compliance has still not gone down, as reflected by a low PEFA rating. According to the latest Audit Report for FY 2011-12 the financial impact of noncompliance instances, which is a major risk underlying government transactions, is around 11%. The segmentation of roles and responsibilities to execute a transaction has resulted in lack of ownership of an effective internal control environment. The Principal Accounting Officer (PAO) lack motivation to develop and implement systems for internal controls in their respective ministries. Another reason for the weak control environment is that the General Financial Rules (GFR) have not been updated, and most of the rules are either excessive or redundant. MoF needs to update the GFR to decrease the risk of management override, misuse of funds and delays in budget execution.

13. Internal Audit has never been a priority of the federal government, and the overall PEFA rating of D suggests ineffective internal audits. The government has introduced the position of Chief Finance and Account Officer (CFAO) in line ministries as an internal auditor, but due to the absence of proper legislative backing it has not made any significant impact. As PEFA 2012 highlighted, coverage and reporting has not been in line with best international practice. This reflects lack of ownership and commitment from the government to establish a well-functioning internal audit system. Internal audit itself is one of the key internal controls providing timely feedback to management about control breaches to enable mid-course corrections.

14. The PEFA assessment noted that account reconciliation has been improving, especially on the payment side. The reconciliation issues mostly relate to the use of Revolving Funds Account (RFA), previously known as assignment accounts, by the project authorities. As per the procedure issued for RFA by MoF, project authorities are required to reconcile monthly their expenditure with AGPR. However, compliance is very low. This results in large unreconciled balances between AGPR and the project authorities. The government is now bringing in all projects to GFMIS at the transaction level. The absence of commitment accounting, as discussed earlier, diminishes the usefulness of in-year budget reports, which would otherwise have significant financial information on spending units. The PIFRA system has been configured for commitment recording but the MoF has not urged the entities to expedite implementation.

15. Annual financial reporting has shown improvement. In the financial year following the PEFA assessment, the federal Annual Financial Statement (AFS) has been issued as per the International Public Sector Accounting Standards (IPSAS) format. In addition, AFS provides information on Asset and Liabilities per division. However, the financial results of Autonomous Institutions (AI) and State Owned Enterprises (SOE) are not consolidated into the national financial statement. The budgetary grants to these organizations are expensed on release rather than per transaction. The country's financial statement, therefore, does not provide the full scope of the actual size of operations and complete financial results of the government.

16. In the recent years Office of the Auditor General of Pakistan (OAGP) has undergone significant reforms, most notably separation of account and audit functions, development of the financial audit manual and use of risk- based audit methodology. However, the independence of the Auditor General is still an issue when considered against the requirement of international auditing standards. The head of state directly appoints the

[5] Automation is done through computer system, Project to Improve Financial Reporting and Auditing (PIFRA) sponsored by World Bank.

AGP, and its budget is financed under MoF budget line as an attached department. AGP's financial dependence on MoF undermines its work as an independent supreme audit institution.

17. PEFA 2012 observed that there was limited participation by the legislators in the detailed review of budget proposals[6]. The relevant rules for the budget review do not accord adequate time for review by the legislators to vote upon[7], undermining the effectiveness of legislative scrutiny. The constitution provides for annual approval of the budget by the legislature, and inclusion of all revenues and expenditures in the budget. The standing committees are adequately represented by both treasury and opposition members and a debt management policy is in place. However, the supplementary budgets, re-appropriations and revisions in the budget question the comprehensiveness, credibility and predictability of the budget process and the limited time for debate on the budget by legislators. The low PEFA score indicates the need for a deeper involvement of the legislature in budget formulation and execution.

18. PEFA assessment observed that there were delays in processing of audit reports. The delay was mainly due to the 10 year backlog which was eventually cleared by the Public Accounts Committee (PAC) during the period 2008-11. Another reason for delay in processing of audit reports was that the line ministries did not convene regular Departmental Accounts Committee (DAC) meetings[8]. It is important to note that from the election in May to the notification on 2nd December 2013 there was no chairman PAC.

19. In 2002 the government of Pakistan established a Public Procurement Regularity Authority (PPRA) at federal and provincial levels. However, no efforts have been made to augment the capacity of theses authorities with very little budget allocation. PPRA procurement has been decentralized to line ministries. This underlines the importance of implementation of PPRA framework and capacity building of MDA procurement staff. The existence of legal provision in PPRA that allows for procurement without open competition and lack of centralized procurement database that can provide consolidated view are main factors resulting in low PEFA score.

20. **PFM Reforms:** As per PEFA 2012 the Federal Government has a steady agenda of PFM reforms, which are focused on areas of weakness in PFM administration. Major efforts are underway to:

- Establish an effective system for financial management, reporting and audit;
- Implement a medium-term budget framework;
- Reform tax administration and strengthen the FBR;
- Strengthen the capacity of the public sector in key areas (including PFM);
- Consolidate and strengthen the country's public procurement system.

21. Various donors have joined hands with federal government in support of PFM reforms, notably the World Bank, United Kingdom Department for International Development (DFID), European Union (EU), Asian Development Bank (ADB), US Agency International Development (USAID) and Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH (GIZ). To harmonize reform efforts, in June 2010, the donors formed a joint working group, which has been meeting bi-monthly. Core donors

[6] Demands for grants arise out of delay in submission of the budgetary proposals to the legislature. – National Assembly Rules of Business 2007-Rule 182.

[7] National Assembly Rules of Business 2007-Rule 187.

[8] PAC annual report dated March 2013.

represented are: WB (chair), DFID, EU, GIZ, ADB and USAID. Canadian International Development Agency (CIDA) and Department of Foreign Affairs and Trade (formerly AusAID) also participate from time to time.

22. There is no PFM reform plan that can serve as a single point of convergence. Despite on-going PFM reforms, there are a number of key gaps in PFM systems that increase fiduciary risk. It is important to note that for reforms to materialize, donor's efforts need to complement each other. Concerns are noted in the reform progress, notably failures in tax administration and public administration reforms. One of the main problems of PFM-related reforms in Pakistan is the sequencing of PFM reforms that have resulted in over ambitious scope of the key reforms. The benefits of these reforms in some cases are unlikely to be realised for a number of years. The over stretch timelines has aggravated the change management challenges associated with them. A coordinated approach to PFM reform at the federal and provincial levels, based on PEFA analysis and recommendations are key to addressing them in the reforms.

23. **Proposed Mitigating Actions:** The following table summarize the proposed mitigating actions ranked with respect to their likely impact, implementable, and relevance towards realization of PFM budgetary outcomes:

PEFA Dimension	**Mitigating Actions**	**Priority**
Credibility of Budget	• Increase involvement of political leadership in budget planning process. Introduce a system where MTBF is presented and debated in the parliament, thus, creating ownership of the medium term plans.	M
	• Develop robust PFM specific legal framework to build environment around country financial management systems.	H
	• Implement full commitment accounting as provided in New Accounting Model (NAM).	H
Comprehensiveness & Transparency	• MoF to introduce financial reporting system for monitoring and analysis of fiscal risks arising out of the Autonomous. Government Agencies (AGAs) and State Owned Enterprises (SOE).	M
	• Develop MOF capacity for monitoring performance of government subsidies/assistance for SOEs and issue annual consolidated reports thereto.	M
Policy Based Budgeting	• MTBF incorporated in PFM legislative framework (enact PFM law mentioned above)	M
Predictability and Control in Budget Execution	• A comprehensive review of tax policy to be conducted to with the aim of reducing the maximum number of SROs promoting simplicity, closing loop-holes, and reduce opportunities for fraud and evasion.	H
	• Avenues to be explored for creating linkages with other public sector entities[9] to increase taxpayer registration.	M
	• Improve reconciliation process between assessment, collection	H

[9] Like the Securities Exchange Commission of Pakistan

PEFA Dimension	**Mitigating Actions**	**Priority**
	and deposit in treasury at FBR.	
	• Review and update General Finance Rules (GFRs).	L
	• Establish procurement database at PPRA that can provide analytical reports for informed decision-making.	M
	• Establishment of functional internal audit in most important government entities.	H
Accounting, Recording and Reporting	• For fiscal discipline most clearing and advance accounts should be cleared at least annually.	H
	• IPSAS compliant Annual Financial Statements to be prepared.	L
External Scrutiny and Audit	• PAC to clear backlog by continuing the strategy of reviewing current and past years reports concurrently.	H