

Supporting the Financial Integration of the Merged Areas with Khyber Pakhtunkhwa Province

What is Public Financial Management?

In simple terms, Public Financial Management is the way by which a government's department of Finance mobilises and spends money within the public sector. PFM underscores all government activity and exists on a six-phase continuum representing the entire budget cycle. As seen in Figure 1, the cycle encapsulates the laws, rules, systems and processes used by a government to:

- define policy objectives;
- identify, plan and budget for projects;
- gain approval from the legislature;
- execute the budget;
- account for funds; and
- audit the process.

An effective PFM system functions as the nucleus of the government's operations. It has the power to improve service delivery (i.e. healthcare, education, social protection and infrastructure),



strengthen transparency and due process (i.e. build trust and consensus between the government and its constituents), and facilitate economic growth (i.e. promote ease of business, provide access to financing and enable trade). In all countries, the needs of the population are inevitably greater than the resources (people, infrastructure, funds) available to governments. Therefore, all public resources must be used as prudently as possible. In low and middle-income countries that are simultaneously bound by high resource constraints and high demand for public services, effective and efficient Public Financial Management is essential.

Situation Analysis

On 28 May 2018, the 25th Amendment to the Constitution of Pakistan was passed, resulting in the merger of the Federally

Administered Tribal Areas into neighbouring Khyber Pakhtunkhwa (KP) province. The merger, one of the most consequential reforms in Pakistan's 70-year history, is an unprecedented extension of constitutional rights and governance structures to 5 million of the poorest people in Pakistan.

Within the Merged Areas, the former Political Agent system was characterised by rent-seeking and the misappropriation of public funds. The Government now faces two urgent tasks: addressing the Merged Areas' development lag through rapid improvements in KP's legal, regulatory and economic frameworks alongside demonstrating tangible evidence of the merger process through effective service delivery. Recognising that sound Public Financial Management (PFM) is the foundation of basic economic governance, has a significant peace dividend and lies at the heart of the reforms process altogether, UNDP Pakistan works closely with the Government of KP to strengthen the province's PFM systems through dedicated technical assistance.

Problem Driven Iterative Adaptation

UNDP's technical assistance programme was designed using the Problem-Driven Iterative Adaptation (PDIA) methodology out of the Centre for International Development at Harvard University. PDIA techniques are applied to difficult contexts which prioritize iteration and learning as programming management tools. The methodology is based on the conclusion that the most difficult development challenges, including PFM in the context of the 25th Amendment, require a more robust management approach which is iterative, inclusive and adapted to the political context to address deeper fundamental problems. Implementing these methodologies enables UNDP to improve aid efficiency by implementing existing reforms. PDIA is focused on four main principles:

- 1) **Local Solutions for Local Problems.** Exploring local government and justice sector problems as defined locally rather than by international templates.
- 2) **Pushing problem-driven positive deviance.** Encourages local-level innovation to solve delivery problems based on what is already working on the ground.
- 3) **Try, learn, iterate, adapt.** The adaptive policy cycle includes analysis and problem identification, followed by cycles of iteration, which build both authorization and learning.

- 4) **Scale through diffusion.** Practices are developed and proven through iterations and then spread across projects and sectors.

Public Financial Management in Khyber Pakhtunkhwa and the Merged Areas

PFM in the Former Federally Administered Tribal Areas

Before the 25th Amendment, PFM in the Merged Areas was officially a federal remit. The region's resource envelope consisted of transfers from the federal government's consolidated fund alongside the Agency Development Fund (revenue generation through local levies imposed by the Political Agent called Rahdari). Significantly, the Rahdari was a system of transit taxes imposed even on essential commodities for daily use (i.e. food) through executive authority bestowed upon individuals operating checkpoints along specified routes. These taxes were largely vulnerable to misappropriation. Managed by local administrators known as Political Agents, revenue collection and expenditure were excessively centralised, lacked transparency and were subject to the patronage politics of elites. Overall, the population's confidence in the state for fair allocation of resources was low.

A Provincial Update

For nearly two decades, the resources available to the Government of Khyber Pakhtunkhwa (GoKP) have been affected by conflict, natural disaster and the decline in Pakistan's overall economic situation. Challenged by competing priorities and enhanced service delivery responsibilities following the 18th Amendment, the GoKP undertook several Public Financial Management reforms to improve transparency and accountability. As a result, some of the province's notable reforms over the last decade include:

- **IFMIS** – The Integrated Financial Management System enabled the government to commit to transparency and open government through improved reporting, automated functions and publishing all financial information online.
- **Inclusive budgeting** – through pre-budget polling and consultations at the district level, the government has been able to incorporate citizens' desires in the formal system for planning, budgeting and execution. Consultations have been conducted at to the District level and were scaled up to reach 8.5 million people post-Merger.
- **Output-based Budgeting** – working with DFID, the GoKP began the process of moving towards results-oriented programming with performance indicators to improve service delivery. OBB was extended to all government departments; however, practical implementation at the District level is ongoing. To institutionalise OBB, greater

executive flexibility is now provisioned to the spending units under the revamped KP Delegation of Financial Powers Rules, 2018 and an objective review process of the performance benchmarks has been initiated.

- **Revenue Mobilization** – KP established a provincial Revenue Authority to implement a sales tax regime in the Province and reduce dependency upon the Federal system.
- **Pension Reforms** – To a secure and self-sustaining pension regime, the Government of KP achieved a 100% conversion of pensioners' payments through a direct credit system, extended the retirement age and initiated the digitisation of pensioners' records to mitigate the risks of misappropriation and fraud.

New and Ongoing Challenges

Many of KP's old challenges persist today and need to be addressed amidst a new set of challenges arising following the merger. Some of these challenges include:

- **The Political Economy:** KP's PFM system is vulnerable to a wide array of non-associated risks including policy orientation and structural transformation. Progress on the implementation of reforms can be stalled depending on the interests of policymakers and work is required that resources are fairly and realistically distributed.
- **Receipts, Revenue Generation and Releases:** The majority of KP's budget is dependent upon its National Finance Commission award at the Federal Level. Any shocks to the national economy (i.e. inflation, debt, reduced tax potential) impact the NFC to the provincial economy. Currently, KP's NFC has not been adjusted to reflect the merger, and the ad-hoc arrangements are deficient. Further, support for forecasting, releases and project implementation is required.
- **Human Resources and Spending:** KP's civil service wage bill presents a huge payroll burden. Post-merger, another 17,000 government positions need to be created and filled to support the Merged Areas alone. This has implications for service delivery as money is taken from the development budget to cover salaries.

Capacity and Budget Implementation

Though the 2019-20 budget for the Merged Areas has been passed, experts remain concerned that weaknesses in the province's technical planning processes will continue to challenge the timely and predictable release of funds and execution of projects. Given the urgent need for improved service delivery and economic development in the Merged Areas, UNDP's technical assistance is specifically supporting the Government to augment the technical capacity of individuals planning and designing projects as well as that of the legislators who assess them.

How is UNDP supporting PFM in KP after the Merger?

The FATA Governance Project (FGP), Democratic Policy Unit (DPU) and Climate Change Financing Framework (CCFF) have all worked with the Government of Khyber Pakhtunkhwa to strengthen Governance and Public Financial Management.

FATA Governance Project

FGP provides ongoing operational and policy level support to the Government of KP to support the financial integration of the Merged Areas with KP. Through dialogue, technical assistance, working papers and policy analysis, FGP has supported the Government on the political, administrative and financial integration of the Merged Areas with KP.

Operational Support: FGP's technical assistance for the Merged Areas aims to support the government ensuring that its PFM system is transparent, integrated and able to prioritize competing demands on limited resources. PFM interventions will introduce formula-based resource distribution in the Merged Areas by 2020-21, extend IFMIS and set up an audit trail, and design/implement a financial integration plan for the region and KP. In practice, this looks like enhancing the government's capacity to enact reforms, inclusive and gender-responsive planning and budgeting, support for the release process, technical capacity building, accounting and reporting support, facilitating inter-governmental fiscal transfers and integrating PFM within the Merged Areas' Local Government system. To date, FGP's most significant operational support has supported passage of the historic 2019-20 Budget for Khyber Pakhtunkhwa alongside distinct budgets for each Merged District and Subdivision. For the first time, the province's budgeting process was consultative. It engaged more than 8 million people from both the population and government through workshops, polling and robocalls to assess their genuine needs and to monetise them for budgetary purposes.

Policy Support: With support from FGP, the Government of KP approved the Tribal Decade Strategy (TDS) in May 2019. Representing the single largest development intervention in the history of the Merged Areas, the TDS is a landmark document which defines the region's development agenda for the next ten years. Of note, the TDS has specifically earmarked funds for and stimulates discourse around programmes for women, youth and minorities. Further, the Accelerated Implementation Programme (AIP) has emerged from the TDS. Both initiatives have been

designed with Pakistan's economic downturn in mind and mitigate austerity measures by advocating for priority projects in infrastructure, health and education within the scope of limited resources. Further, policy-level support ensures sustainable project implementation by adding technical rigour to all phases of the planning process.

DPU and CCFF

UNDP's Democratic Policy Unit (DPU) is currently working with the Government to generate more revenue for service delivery. Specifically, DPU is exploring PFM reforms through its National Initiative on Sustainable Development Goals (SDGs). Under this initiative, the project is working on localising the SDGs at the grassroots level, on aligning public resources at the PC-1 planning stage with Pakistan's commitments to the SDG process and to effectively tracking public expenditures related to the SDGs over time. This system will enable the government to communicate its outstanding resource needs and solicit support from external partners for SDG-compliant projects. As was elaborated above, KP often lacks the capacity to implement adopted reforms. Here, there is an opportunity for FGP to liaise with the DPU to structurally embed SDG sensitive language and planning in the projects developed with FGP's support through the AIP, thus expanding KP's potential to gain financial support from international donors. Further, FGP can support DPU's efforts to localise the SDGs by including them in its Local Government System Education curriculum, which will sensitise people from the Merged Areas as to how sustainable development can support their community. Together, DPU and FGP could further support the GoKP in leading on yet another PFM reform.

UNDP has also worked closely with the GoKP to develop a Climate Change Financing Framework (CCFF). Despite being one of the lowest contributors to greenhouse gas emissions worldwide, Pakistan is one of the top countries that is negatively impacted by climate change. Through the CCFF, UNDP's support has enabled the government to identify the resource burden of climate change transparently, thus facilitating its access to international climate funds. Under this initiative, two key training manuals were developed. The first manual was designed for legislators in the Provincial Assembly to educate and enhance their ability to scrutinise projects through a climate lens. The second manual was designed for journalists to encourage climate-smart reporting. KP's CCFF will automatically extend to the Merged Areas, and collaboration between UNDP programmes ensures that its Technical Assistance is sensitive to ongoing reforms.

Opportunities for a Coordinated Response

External Actors

UNDP is not the only actor working with the Government to undertake PFM reforms in the province. In 2019, the Government nominated UNDP as the focal point for all Public Finance Management technical assistance provided to the GoKP by donor partners due to its holistic approach to the integration process. As such, ongoing communication with such donors as the World Bank, DFID and GIZ (among others) prevents the duplication of activities and enables each to deliver the most effective development support possible to the Government.

A Note on Participatory Planning

In 2019, the World Bank released two studies assessing the impact of citizen engagement on tax collection. In the first study, authors gathered data from Brazil and found that municipalities that adopted participatory budgeting were able to collect up to 39% more tax revenues than those that didn't. In the second study, 65,000 individuals from 50 countries on all continents showed that regardless of Government system, level of development and culture, citizens are more tax compliant when they can vocalize their preferences about Government spending and when the system is transparent by providing oversight of public resources.

Despite reforms in this sector, revenue generation through taxation remains one of the greatest challenges for the Government of KP. Gaining momentum following its participatory budgeting process, there is an opportunity for UNDP to innovate within the sphere of PFM to sensitize the public as to the significance of taxes and to support the Government in earning the population's trust to increase revenue generation.



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