

Development of a New Budgeting System in Federal Line Ministries under the MTBF

Introducing Programmes and Output-Based Budgeting

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Abbreviations

| | |
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| AO | Accounting Officer |
| BCC | Budget Call Circular |
| BPS | Basic Pay Scale |
| FA/DFA | Financial Adviser/Deputy Financial Adviser |
| FMA | Financial Management Application |
| GFS | Government Financial Statistics |
| GoP | Government of Pakistan |
| IT | Information Technology |
| LM | Line Ministry |
| MTBF | Medium Term Budget Framework |
| NAM | New Accounting Model |
| NBS | New Budgeting System |
| OBB | Output-Based Budgeting |
| P&D | Planning and Development |
| PIFRA | Project to Improve Financial Reporting and Auditing |
| SU | Spending Unit |

Executive Summary

This report is concerned with the development of the budgetary system under the MTBF as the MTBF is rolled out across the federal government. The report was prepared by the MTBF team in Finance Division.

The principal findings and recommendations of the report are as follows

1. Under Phase I of the MTBF process significant changes have been introduced into the budgeting process in the pilot MTBF ministries which have begun to take the budgeting system beyond the traditional “incremental” budgeting.
2. However, there is a need for a continuing process of reform to develop a more robust system of budgeting in the line ministries which will support the modernization of government. This report sets out specific proposals for the form these continuing reforms should take.
3. The report recommends that a **New Budgeting System** should be implemented in the line ministries as the MTBF is rolled out. The New Budgeting System should build on and further strengthen the innovations which have already been introduced under MTBF Phase I. The New Budgetary System aims to put in place the building blocks for realizing a vision of how the budgetary process will be managed in the future. The key elements of this vision are: (i) **empowerment of line ministries** to manage their budgets and service delivery within a resource constraint provided by the central agencies; (ii) the progressive **establishment of a programmatic structure** within line ministries for the delivery and management of outputs (i.e. services) and (iii) the **development of Output-Based Budgeting**, in which the costs of delivery of each service are identified and used for planning efficient and cost-effective delivery of public services.
4. The main elements of the proposed New Budgeting System are:
 - (i) The adoption of a **clear conceptual framework for budgetary development**, based on established concepts of Objectives, Programmes, Outcomes and Outputs.
 - (ii) The development of a **top-down process within the line ministries** whereby the Principal Accounting Officer exercises a greater control over the formulation of the budget and takes responsibility for the allocation of resources within the ministry
 - (iii) **Strengthening the Planning and Budgeting Cycle within the line ministries**, in particular through strengthening of strategy formulation and Monitoring and Evaluation.
5. Specifically, the New Budgeting System proposes to introduce the following innovations to line ministry budgeting:

- **Definition of programmes within line ministries.** In the future, programmes will play important and multiple roles: they will: (a) form the basis for more strategic resource allocation within ministry budgets, (b) constitute units of management for the delivery of outputs (services) which contribute to common broad objectives (outcomes); (c) form the basis for appropriation of resources from both the recurrent and the development budgets for the delivery of groups of services, (e) form appropriate units for the reporting of the actual application of public sector resources and the achievement of service delivery targets.
- **The definition of programmes should be undertaken on a basis which gives weight to both the practicalities of existing organizational structures¹ and form natural units in terms of the Functional classification.** However, it must be recognized that it is not possible to ensure in all cases that programmes reflect both natural units of the Entity classification and the Functional Classification, where there is a conflict the existing organizational structure (i.e. Entity classification) should be given priority as the basis for programme definition since this is the existing basis for assignment of responsibility for the management of funds.
- **Implementation of a system of Output-Based Budgeting (OBB) which will permit the identification of the cost of each major service delivered.** This should be achieved by defining outputs through a top-down process, and subsequently breaking down Spending Unit budgets according to the outputs to which they contribute.
- **Initial estimates of the breakdown of spending unit costs by output** should be prepared on the basis of an existing budget (2007/08, immediately after finalization of the budget). In subsequent years the cost of services should be used in the allocations of available resources across spending units and the planning of service delivery;
- **Development of costing methodologies in respect of both inputs and outputs.** Initially improvement efforts can concentrate on the strengthening of guidelines on the estimation of costs for individual budget lines. At a later stage, once outputs have been defined and the initial costs of outputs calculated, attention can move to analysis and refinement of the cost of outputs as a tool for inducing efficiency improvements in the delivery of public services.

6. The proposals contained in the report constitute initial and modest steps towards modernization of the GoP system of budgeting. They are, nonetheless, framed within the context of a vision for the medium to longer term evolution of the budgetary system in line with international best practice. Application of the New Budgeting System will, however, require a substantial effort to be applied in the detailing of the system, the preparation of training materials and the delivery of training to the line ministries.

¹ In other words, programmes should be linked to the Entity Classification in the New Accounting Model

7. Training on New Budget System should follow a top-down approach, starting with the Secretaries and other very senior officers, progressing to the middle level managers, and finally embracing all relevant accounting officers, including at the Spending Unit level. A cascade training approach (training of master trainers) should be adopted to achieve the necessary coverage in an acceptable timeframe. The MTBF team should support the training process.

8. It is noted that **the New Budgeting System does not require any changes to the Rules of Business** as they relate to the preparation of the Budget for Appropriation.

9. The **New Budgeting System will require refinement of the Financial Management Application (FMA)** a software tool developed under the MTBF) to permit the incorporation of the programme level of analysis and the capture of spending unit budgets broken down by output.

10. **It is recommended that the New Budgeting System be approved in principle** and that it progress to the piloting stage and preparation of training materials.

DEVELOPMENT OF A NEW BUDGETING SYSTEM IN FEDERAL LINE MINISTRIES UNDER THE MTBF

1. Introduction

This report has been prepared under Phase II of the Medium Term Budgetary Framework (MTBF) process in Pakistan. It forms part of a set of initial studies carried out early in Phase II of the MTBF aimed at clarification of the processes to be applied as the MTBF is rolled out across the Federal Government in 2008/09. The report has been prepared by the MTBF team.

2. The Evolution of Budgeting and Costing under MTBF Phase I

2.1 The Traditional Budgeting System

Under the traditional process of budgeting and costing in Pakistan, prior to the MTBF process, the system followed was very largely one of incremental budgeting (particularly so for the recurrent budget). Following the issue of the annual Budget Call Circular (BCC) in September or October, the line ministries instructed their Spending Units (SU) to prepare their proposed budgets for the forthcoming budget year. The methodology whereby the SUs prepared their budgets was:

- Based on expenditures and any supplementary appropriations granted during the first half of the year, to prepare Revised Estimates for their Spending Unit. The Revised Estimates are derived from the original budget allocation as set out in the Appropriation Accounts, with an allowance for the expected impact of anticipated Supplementary Budget appropriations which are expected to be made during the current year;
- The budget for the coming year is then calculated on the basis of a projection forward of the Revised Estimate using a growth factor; SUs were not provided with an indicative budget limit within which they should prepare their estimates.
- The budget proposals thus prepared by the SUs are submitted to the Budget Section for the recurrent budget and P&D Section for development budget for scrutiny and internal approval;
- Once approved the ministry's budget proposal is submitted to the Financial Adviser/Deputy Financial Adviser in the ministry. Typically the FA/DFA recommends a series of cuts in the budget proposal.
- Adjustments are made to accommodate the instructions of the FA/DFA and a revised budget is then submitted to Finance Division (Expenditure Wing) for approval.

The shortcomings of the traditional budgeting system have been elaborated in several documents prepared under MTBF Phase I, and include:

- The lack of linkage between the strategies and priorities of the ministry and the actual budget preparation process;
- The tendency to use simple incremental budgeting based on the previous year's budget without any careful attention to the costing of individual line items²;
- The extensive use of cuts in the proposed recurrent budgets by the FAs/DFAs late in the budget preparation process, which means that the final approved budget may bear little relation to the budget proposal prepared by the line ministry.
- The generally passive role of the senior management of the ministry faced with the arbitrary initial budget preparation process and the arbitrary cuts applied to the budget proposals as it passes to final approval and appropriation;
- Inadequate predictability in the budgetary process, which means that ministries are unable to undertake proper medium term planning of their delivery of services.

2.2 The MTBF Process under Phase I

The MTBF under Phase I introduced a set of innovations into the procedures followed in the pilot line ministries. These included:

- The instructions that MTBF budgets were to be prepared on a three year basis, that is to say, for the year immediately ahead to be appropriated, and for two outer years. This initiative was aimed at increasing the predictability of the budgeting process in MTBF ministries;
- Modifications to the formats for budget preparation at the Spending Unit level which required a shift towards a more planned approach. These were supported by the issuing of a separate MTBF BCC with elaborated instructions (e.g. the MTBF BCC made provision for the LM to define its overall objectives). At the Spending Unit level the MTBF BCC prescribed formats for the preparation of both the Recurrent Estimates and for the Development Budget.
- The MTBF BCC provided for each Spending Unit to prepare 3 year budget forecasts, essentially employing the standard classification of budget lines taken from the New Accounting Model Chart of Accounts. (This relates to both the recurrent and development budgets).
- The MTBF BCC also provides for outputs to be defined during the preparation of the 3-year budget estimates by the Spending Unit.

² Estimates of employee-related expenditures are based on the GoP BPS and an estimate of the number of posts expected to be filled during the year.

- The MTBF Phase I process also saw the development of a dedicated software application, the Financial Management Application (FMA) designed to capture the information prepared by SUs during the preparation of the MTBF budget estimates, including the information on outputs.

The MTBF Phase I approach to budget preparation involved several important innovations in the budget preparation process. Notably:

- The shift to preparation of the budget on a 3-year rolling basis, laid the foundation for increased predictability and a framework within which ministries could start to put their activities on a better planned and programmed basis (yet to be realized in practice, see below);
- The requirement that the SU's define the outputs which they expect to produce or contribute to starting a process of change in thinking in the direction of output and service-oriented budgeting in what had previously been an almost entirely input-driven budgetary process;
- The preparation of the overall MTBF Budget Estimates provided a opportunity for each ministry's forward budget to be cast in a document which set out the higher level objectives of the ministry and the purposes for which funding was required.
- The development of the FMA provided a mechanism for the capture of the detailed SU level budget proposals at an early stage of the development of the budget. This opened up the potential for increased analysis of the budget by the Budget Sections of the ministries.

2.3 The weaknesses in budget preparation under MTBF Phase I

However, the procedures for budget preparation under MTBF Phase I also continued to have a number of fundamental weaknesses:

- **Lack of strategic direction.** The preparation continues to be a process driven almost entirely by a bottom-up aggregation of SU budgets, with little strategic direction coming downwards into the budget formulation process. This imparts an unwarranted conservatism to the budgetary process, which is essentially merely costing the continuation of existing activities, and provides little or no structured opportunities for line ministry senior management to reallocate resources from lower to higher priorities and from less effective to more effective services and activities.
- **No resource constraint.** MTBF line ministry budgets continued to be prepared without any form of prior indication of the resources likely to be available (such as indicative ceilings); given the absence of any aggregate ceiling for the ministry's budget, the Spending Units also continue to prepare budget proposals in the absence of clear guidance on likely resource availability.
- **Still largely incremental in approach.** The detailed costing of inputs (budget lines) by the staff of the SUs remains essentially unchanged and is still largely

incremental in approach. Phase I introduced a requirement to justify inputs but lack of involvement from senior levels within the ministry have limited the impact of this modification to the budgeting process;

- **Lack of a clear link between outputs and objectives.** The outputs, being specified at the Spending Units level, have no necessary linkage and relationship to the higher level objectives and orientation of the ministry and cannot be used as a device for planning the development of service delivery;
- **No impact on preparation of the Development Budget.** With respect to the development budget the MTBF process involves little or no value added, since the MTBF process simply extracted a subset of the information which was already included in the PC1 forms for each project. In addition no linkage was made between the recurrent and development budgets within a line ministry. This was primarily because the specification of outputs was undertaken separately for the recurrent and development budgets.
- **Failure to exploit fully the benefits of IT.** The potential of the FMA to provide a tool which could be used for analysis of budgetary information has not been fully exploited or developed - for example, to compare original budgets to actual expenditures or to analyse unit costs and variance in unit costs across SUs;
- **No requirement to link outputs with budgets.** Although the Spending Units are required under the MTBF procedures to list the outputs (services) to which they contribute they are not required to indicate which parts of their budget contribute to which outputs. Under present procedures outputs cannot, therefore, be costed.
- **No significant empowerment of line ministry management.** The Budget Sections continue to play a largely passive role in the budget preparation process, passing the forms down to the SUs and then watching as their budgets are cut (often very substantially) at the FA/DFA stage of scrutiny. As a result the MTBF budget process has not led to a significant empowerment or increased ownership of the line ministries in their budgetary process.
- **Failure to improve budget predictability.** The intended improvement in predictability in budgets has not been fully realized. In particular ministries included in the MTBF in 2005/06 and 2006/07 prepared outer year budgets for 2007/08 and 2008/09 and were given the expectation by Finance Division that, to the extent possible, the outer year budget forecasts would be respected by Finance Division when it came to the preparation of the annual budgets for these years. However, in the event there had been inadequate coordination within Finance Division over the roll-out of the MTBF, with the result that in some cases the forward year MTBF estimates have been subjected to the normal process of budget cutting by the FAs/DFAs (in some cases, significantly so). This is inconsistent with the promotion of budgetary predictability.

3. Development of the Budgetary Process under MTBF Phase II

3.1 Introduction

In moving towards roll-out of the MTBF across all the ministries of the federal government (indicatively targeted for the 2008/09 budget year) the MTBF project intends to make further innovations in the budgetary process in the line ministries. The underlying objective is to strengthen the budget preparation process by moving rapidly towards adoption of output based budgeting, that is to say, a budgeting system in which the proposed budget allocations are based on the requirements of the ministry driven by its commitments at the strategic level. This implies further fundamental changes in the budgetary system in the MTBF line ministries aimed at making the budgetary process responsive to the requirements of the ministry. This is a complex set of reforms involving major changes in the internal process within each ministry for budget preparation.

This report concentrates on the development of the budgeting process within line ministries. It is noted that this is expected to be supplemented by the introduction of the Top-down component of the MTBF, leading to the setting of indicative budget ceilings set prior to the start of budget preparation. However, the proposals set out in this report are not dependent on the introduction of top-down ceilings. In addition this report does not address the requirement for improved coordination within Finance Division to ensure that budget predictability is increased. The report also has important implications for the way in which Finance Division and the Planning Commission coordinate preparation of the recurrent and development budget respectively.

This section of the report sets out the elements of the proposed new system for budget preparation which, building on the innovations introduced under MTBF Phase I, will bring further important changes to the budgeting system.

3.2 Weaknesses to be addressed by the introduction of the New Budgeting System

The reforms outlined in this report - which taken together constitute the New Budgeting System - are aimed to address a set of recognized weaknesses in the existing system of budgetary management as outlined in section 2.3 above. In particular, it aims to address the following:

- An overall lack of ownership of senior line ministry management for their budgets, associated with a lack of accountability for the delivery of identified services;
- The passive role of the senior management of the line ministries in the face of a highly controlled budgetary environment, characterized by intense interference in the ministry's budget at all stages of the budgetary cycle.

- The lack of a strategic planning and planning budgetary cycle and mechanisms for the strategic objectives of the ministry to be reflected in the allocation of resources through the annual budgetary process;
- A lack of predictability in the future flow of resources and an associated inability to make sensible forward service delivery and budget plans;
- An inability of the ministries to identify the unit costs of the delivery of services and (therefore) analyse issues of cost effectiveness. More generally a lack of linkage between service delivery (outputs) and budget requirements, leading to the prevalence of incremental budgeting.

4. Learning from International Experience in Budgetary Reform

With the accumulation of experience in the implementation of MTBF-type reforms in a wide range of developing and developed country contexts, it is now increasingly possible to learn from the lessons of international experience. Several recent publications³ seek to facilitate this international lesson-learning process. Following a review of this literature, the following lessons have been identified as particularly relevant for Pakistan at the present stage of implementation of the MTBF:

Lesson 1: **The strategic or “top-down” component of the MTBF should be put in place at the start of the process.** This is necessary to provide the underpinnings for providing the line ministries with an indication of the resources which they can expect to access during the annual and 3-year budgeting process. Without such strategic guidance it is difficult for line ministries to develop effective systems of budget preparation and management.

Lesson II: **Attention should be paid at an early stage to the definition of a programmatic structure for the budget within ministries.** The adoption of a programmatic structure can facilitate the development of more strategic approaches to resource allocation both inter- and intra-sectorally. In the longer term programmes can provide an appropriate level for the unification of several stages of the budgetary management cycle, including the appropriation of funds, strategic budget preparation within ministries, the management of service delivery, the development of results-based reporting systems and ex post review and evaluation.

Lesson III: **Significant improvements in planning and budgeting for service delivery require that the costs of delivery of each distinct line of service delivery should be identifiable and transparent.** This is usually achieved through some form of Output-Based Budgeting, in which

³ See, for example, John H. Kim (Ed.), *From Line-Item to Program Budgeting: Global Lessons and the Korean Case*. (Undated, but approximately 2006). www.worldbank.org

the costs associated with each distinct service delivered are clearly defined, and are used by managers in line ministries to plan future eservice delivery and the identification of efficiency improvements.

Under Phase II of the MTBF the lessons of international experience will be systematically incorporated into MTBF design. Specifically, Lesson I, which relates to the strategic component of the MTBF is to be introduced through the development of the Top-down component and its application in 2008/09 budget preparation cycle. This involves the development of the Medium Term Fiscal Framework, the Budget Strategy Paper and the setting of Indicative Budget Ceilings in advance of the start of the budget preparation process. These reforms falls outside the scope of the present paper, but have an important bearing on the “bottom-up” process which forms the core of this paper.

With respect to Lessons II and III, relating to the adoption of a Programmatic Structure and the introduction of Output-Based Budgeting, the following sections set out specific proposals for how these elements should be incorporated into the bottom-up procedures.

5. Introducing a Programmatic Structure for Service Delivery by Line Ministries

5.1 The Concept of a Programme

The term “Programme” is used to define a unit of management of service delivery within a line ministry. The central idea is that a programme should form a set of activities which contribute towards a common objective. Programmes should, accordingly, occupy an intermediate position within line ministries, falling within a single Division but gathering together all those spending units contributing towards a particular set of activities or service. Because the activities of a single programme are oriented towards a common objective, there will often be a close relationship between the definition a programme and the functional classification of the budget, which provides a grouping and coding of expenditures around common functional objectives.

5.2 Why Programmes ?

The programme concept has been used by many countries and to address a number of issues. These include:

- **Programmes as an aid to Strategic Planning:** The desire to promote the strategic planning and allocation of resources in the budget (both by central agencies and by line ministries) through organization of the delivery of services by government into a manageable number of groupings around principal objectives. In the traditional system of line-based budget preparation, there is a

manifest problem that it is easy to lose touch of the strategic purpose of the budget, and it is difficult to give effect to desired strategic shifts in the allocation of budgetary resources. The definition of programmes at an intermediate level within each ministry facilitates strategic planning and budgeting.

- **Programmes as a unit of Management:** An important feature of a programme is that it should be managed by a single manager who is responsible for the application of the funds budgeted for the programme for the achievement of the delivery of the services for which the programme exists. In this way the programme forms a management unit at which managerial responsibility and accountability can be assigned. Of course, the programme manager is also responsible to the Principal Accounting Officer, who remains fully accountable for all expenditures of his/her division or ministry.
- **Programmes as the appropriate level for appropriation and reporting:** the definition of programmes at an intermediate level of service delivery can also provide an appropriate level, in the future, for the appropriation of the budget and for the reporting on results of public expenditure. The use of the programmatic level for budget appropriation and reporting on use of funds can play an important role in concentrating the attention of stakeholders (government officers, parliamentarians, civil society etc) on the purpose for which funds are applied, rather than the minutiae of the budget as presently presented in the Pink Book. This facilitates informed public debate.
- **Programmes as a basis for development of Monitoring and Evaluation systems:** if programmes are defined around a common objective, they can also be used as the natural unit for the development of Monitoring and Evaluation systems. The programme is the natural level at which the monitoring for result-based management can be developed, building on the monitoring of both financial and other inputs and the results achieved from the application of public funds.

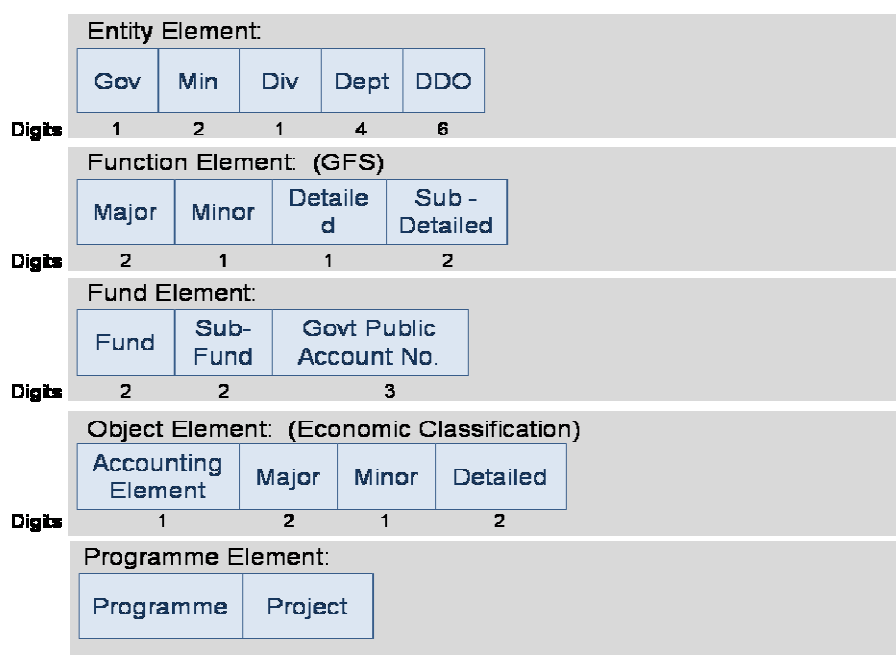
It should be recognized that there can be some tension between the achievement of the different purposes of programmes listed above. For example, for purely reporting purposes it can be argued that programmes should be defined wholly on the basis of the functional classification of the NAM. However, to achieve the management objectives of programmes it is important that programmes correspond to existing organizational units which have responsibility for management of budgets. The implications are (i) it is important to be very clear about the objectives underlying the development of a programmatic structure; and (ii) achievement of multiple objectives usually implies some degree of trade-off between different objectives.

5.3 Definition of Programmes: combining organizational realities with the Functional Classification of expenditure

In an ideal world programmes could therefore be defined within each ministry which serve two purposes:

- (i) mapping directly onto existing organizational structures at an appropriate level of the ministerial organization (often the departmental level), which corresponds to the present assignment of responsibilities for the management of service delivery;
- (ii) corresponding closely to the functional classification of the budget classification system in the NAM, which provides a classification and coding of all public expenditure around an internationally standardized set of “functions” (defined by the GFS).⁴ Figure 1 below illustrates the position of the functional classification within the overall New Accounting Model (NAM) Chart of Accounts.

Figure 1: The PIFRA Budget Classification System



⁴ The CoA provides a framework for organizing accounting transactions and provides the opportunity to view these transactions from different perspectives. The CoA contains five classifications: **Entity** (i.e. organization), **Object** (i.e. expenditure or revenue, by major, minor and detailed classification), **Fund** (i.e. source of funding – voted, charged, grant, etc.), **Function** (describes the economic function to which a transaction should belong – e.g. education or transport – by major, minor and detailed classification, and **Programme/project** (generally relevant to the sub-grant level of the development budget).

In an ideal world there is already a close relationship between the organizational structure of ministries/divisions and the functional classification, since, in general the organizational structure is defined precisely to bring together organizational units which are serving a common function in terms of service delivery.

In practice, however, there is not a simple one-to-one mapping of the organizational structure and the Functional Classification of the NAM. In many cases, several or many organizational units (divisions or departments) contribute to a common functional classification, and these different contributions are picked up by the Functional Classification of the NAM, which permits aggregation and reporting of the budget and expenditure according to the international functional classification. Where there is a divergence between the organisational structure and the functional classification, it is necessary, in defining a programmatic structure, to make a choice as to which mode of classification to follow.

International experience strongly suggests that, where it is intended that the purpose of the definition of the programmatic structure is not simply to facilitate reporting (on the functional classification) but also, and perhaps more importantly, to create an appropriate intermediate level of service delivery aggregation for appropriation and management purposes, it is appropriate to give greater weight to the existing organizational structure as the prime consideration in the definition of programmes. This recognizes the reality of the practical importance of the organizational structure in the management of public sector resources.

5.4 Initial Research on an appropriate Programme Structure for the MTBF Ministries

In order to take the process of definition of a programmatic structure for line ministries forward, the MTBF team has reviewed 14 existing MTBF ministries,⁵ to assess the extent to which it is possible to arrive at a useable and practical concept of programmes, which brings together aspects of both the existing organizational structure and the functional classification of expenditure.⁶ This review was undertaken by making a comparison between the organizational structure of the selected ministries, the potential clustering of services delivered into programmes, and the existing mapping between the Entity (i.e. organizational) and Functional Classification of expenditures, using data from PIFRA. (See Box 1 below on the organizational structure of federal ministries)

The results of this initial review suggest the following conclusions:

- In general it is not possible to define programmes appropriately onto the highest levels of the ministerial/divisional structures (i.e. at the level immediately below

⁵ The Ministry of Narcotics is undergoing organizational restructuring and was excluded from this exercise.

⁶ See *Programme-Based Budgeting: An approach to Development of a Programmatic Structure for Services Performed by Federal Ministries in Pakistan*, MTBF, May, 2007. The examples presented in this document prepared by the MTBF team are purely for the purpose of identifying generic issues and approaches.

the secretary level). This is because the defined functions at the Joint Secretary level are typically a combination of line management responsibilities and technical oversight responsibilities which often cut across a purely functional classification of services delivered.

- However, by going down to the departmental level within each line ministry, it typically is possible to identify the departments which have the prime responsibility for the delivery of common clusters of services which would form appropriate programme units.
- It is frequently the case that a single functional classifier (at the minor or even the major level) is delivered by several organizational units, sometimes in more than one ministry. This implies that it would not be appropriate to define programmes purely on the basis of the functional classification of the NAM, as this would cut across the managerial responsibilities of multiple organizational units within or even across ministries/divisions.

The overall conclusion of this review of the definition of programmes is that it is indeed possible to arrive at an acceptable definition of programmes which combines aspects of the organizational and functional classification. Specific guidelines on how this should be achieved are provided below:

1. In seeking an appropriate definition of programmes within a ministry/division, **prime attention should be paid to identifying the organizational unit(s) responsible for the deliver of major clusters of services** (which in fact contribute to a common functional classification). In other words the primary basis for the identification of programmes should be the Entity Classification, but on the basis of the identification of units of the organization which are already suppliers of homogenous services (and will, therefore, fall primarily under a single functional classification). This approach takes as its starting point the current organizational structures of line ministries. It requires no organizational restructuring (to apply the programme concept) although in some circumstances a programme may be defined which combines contributions from several organization units (within a given ministry/division);
2. **Programmes should always fall exclusively within a single ministry/division**
3. **Programmes will often combine financial appropriations falling under more than one appropriation demand.** [Specifically, the appropriations required for recurrent and development demands of the division which relate to the delivery and development of a common set of services should fall under a single programme; This points to an important role of programmes in providing a force for coherence and unification across the recurrent/development budget divide;
4. **Administration and Services Programmes:** In every ministry there exist a set of organizational units which are primarily providing services to the

- ministry/division itself, and are not directly involved in service delivery. All these units should be gathered together as a single additional programme - "Administration and Services" in each ministry/division. This approach is considered to be preferable to the alternative approach, whereby administration and other overhead costs are apportioned across the service delivery programmes. The latter approach both involves an element of arbitrariness in the allocation of costs across programmes, and ignores the reality of budgetary control by powerful central administration and finance departments.
5. **In general the number of programmes defined within a single Division should be restricted to be less than 10**, and many smaller ministries may require only one or two programmes. It is important not to allow the excessive division of services into a large number of programmes if the strategic purpose of the programme classification is not to be undermined, In some very small or recently created ministries it does not make sense to divide the ministry/division into separate programmes (other than the separation of the Administration and Services programmes mentioned above). Such ministries effectively form single-programmes already. Examples appear to include the Ministry of Ports and Shipping and the Ministry of Textile Industry.
 6. **The definition of programmes should be undertaken primarily by the line ministries themselves**, with generic guidance from the MTBF team. This is important to build ownership in the definition and use of the programme concept.

Text Box 1: The Organisational Structure of Ministries in the Federal Government

The typical organizational structure of ministries in the Federal Government comprises one or more Divisions, each headed by a Secretary. Immediately below the Secretary are several Joint Secretaries (JS), and below the JS are Departments and Sections. Not all ministries conform to this structure. In particular the Ministry of Finance has Wings immediately below the Secretary, each headed by an Additional Finance Secretary, and Sections within each Wing. Ministries (other than Ministry of Finance) have a Budget Section (BS) and a Planning and Development Section (P&D), usually falling under the Joint Secretary (Finance and Administration/Development).

6. Outline of the New Budgeting System for Line Ministries

In order to address the weaknesses set out in Section 3, it is proposed to introduce a further set of reforms in the budget preparation process in the line ministries as the roll-out of the MTBF proceeds. Taken together the reforms are referred to as the **New Budgeting System (NBS)**

6.1 Building Blocks of the New Budgeting System in Line Ministries

The reformed process for budgetary management in the line ministries is based on a number of building blocks. These are:

- a) A **conceptual framework** linking objectives, outcomes, outputs and activities, which forms a logically complete conceptual hierarchy;
- b) The development of a **complete planning cycle** within each line ministry
- c) The definition of a **programme structure** for each line ministry, following the principles set out in section 5 above.
- d) The development of the **outputs as the key operational level** at which around which the planning and budgeting system is constructed;
- e) A budget formulation process using a methodology which links budget allocation to outputs (services delivery) – **Output-Based Budgeting**;

The following paragraphs discuss each of these building blocks in turn.

a) The Conceptual Framework

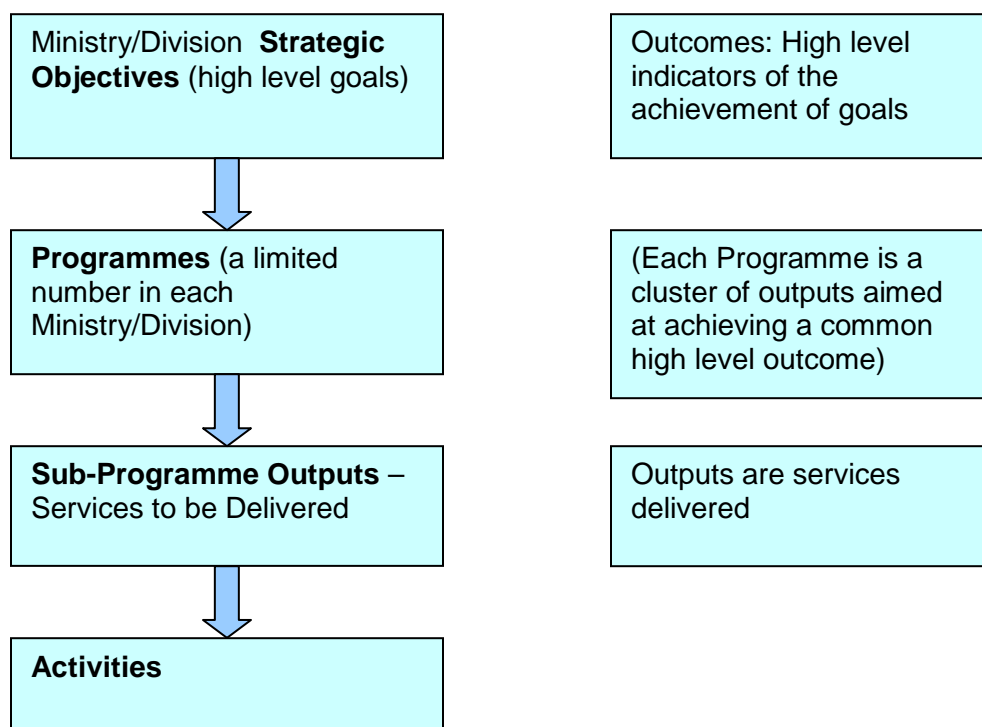
The reform process for the budgetary cycle builds on a fundamental conceptual framework. This links a ministry's strategies, objectives, outcomes, outputs and activities in a logical way. Essentially each activity of the ministry is undertaken because it contributes to one or more of the defined outputs; the outputs are the services delivered. The outputs contribute the realization of broad objectives, and the achievement at the level of objective achievement is measured using outcome measures.

The coherence of the ministry's strategy is based on the **logic of intervention**. The logic of intervention sets out the assumed relationships between outputs, outcomes and the achievement of objectives. Articulating the logic of intervention is important because any programme is based on imperfect knowledge and a set of assumptions. It is assumed that delivery of certain services will have a measurable effect on the achievement of the defined objectives. For example, it is assumed that the universal implementation of vaccination against measles will result in a predictable reduction in the incidence of the disease. It is essential to articulate the logic of intervention so

that it can be checked against the actual results achieved from programmes of service delivery.

The implementation of the New Budgeting System will be based on a standard conceptualization of the processes undertaken by a ministry. This uses concepts which are internationally standard, adjusted in some specific respects to fit the Pakistani situation. Figure 1 below summarises the standard conceptual framework.

Figure 1: A Conceptual Planning Framework in the Line Ministries



The main elements of the Conceptual Framework, as set out in Figure 1 are:

Objectives: These are the aims of the ministry/division. They should typically be few in number and should relate to the impact which the activities of the ministry/division will have on the population of the country or some more specific target group.

Outcomes are the results of the delivery of programmes and are used to provide a measure of the effect of programmes on the target population as a contribution to the objectives of the ministry/division/department. Note that outcomes provide a mechanism for the measurement of success in achieving objectives. They do not constitute a separate level in the hierarchy Objectives-Programmes-Outputs-Activities.

Programmes represent a group of outputs which share a common broader aim. In many cases the activities falling under a Programme will be administered and implemented through a single department or other unit of administration of the ministry/division. However, in some cases responsibility for the delivery of a programme may be divided across several departments. Responsibility for delivery of a programme should always be confined to a single ministry.

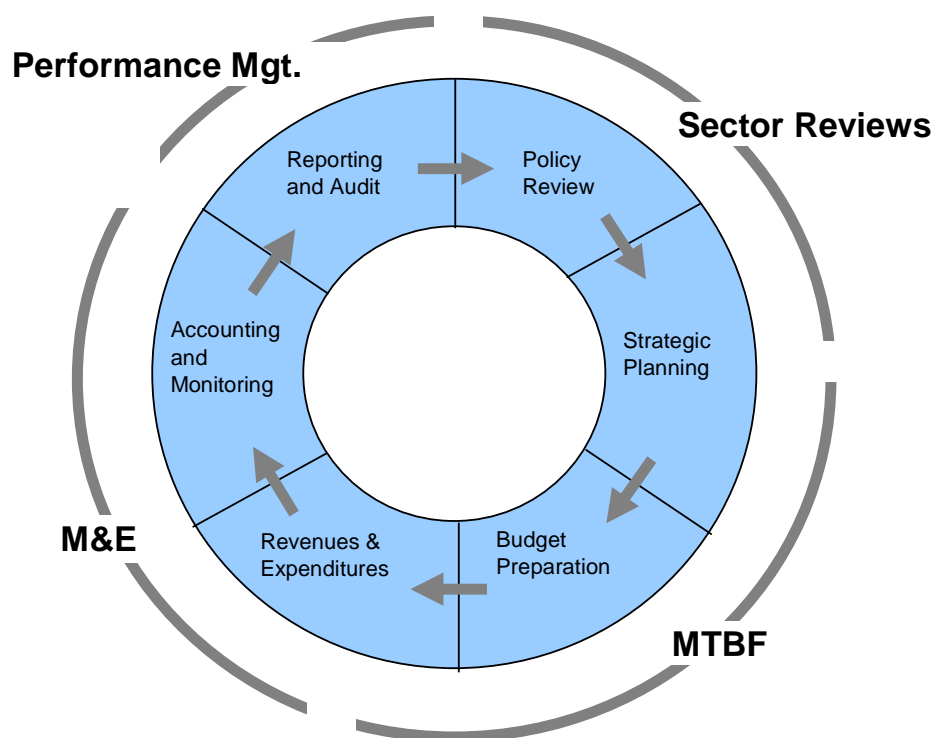
Sub-Programme Outputs (often referred to simply as ‘outputs’) are the actual services which are delivered by a ministry/division/department. Usually these will be the services delivered to the public (e.g. health or education services), but in some cases the outputs may be of an intermediate nature - which means that they are used to contribute to other outputs. Teacher Training is an example of an intermediate output.

Activities: sometimes it is useful to distinguish the services delivered or the activities undertaken in order to contribute to an output at a lower level. This is done using the concept of activities.

b) The Planning/Budgeting Cycle

An effective planning and budgeting process is built as a cycle of activities linking the setting of strategic objectives, the definition of services to be delivered, the preparation of a detailed budget showing the resources required to pay for the services, the execution of service delivery, and monitoring and activity of both use of the budget and actual delivery of services. This is illustrated in Figure 1 below. It should be noted that the budget cycle in each line ministry mirrors the stages of the overall planning/budget cycle of the government as a whole, but concentrates only on the activities of the ministry.

At present some of the stages of the planning/budgetary cycle in the GoP line ministries are either missing or only exist in very rudimentary form. An important aspect of the reform process for the line ministries is to address the weak stages in the budgetary/planning cycle so that the cycle operates as a whole cycle, not as a set of discrete and disjointed activities. In particular, attention needs to be paid to the strategy formulation and monitoring and evaluation stages of the cycle, which are typically weak in the GoP Line Ministries.

Figure 1: The Planning and Budgeting Cycle

c) Definition of a Programmatic Structure for Service Delivery

Following the principles set out in section 5 above, the initial steps should be taken to establish a programmatic structure for the services delivered by the Federal Government. Programmes should be defined at an intermediate level within line ministries, usually following existing divisions of budgetary responsibility for service delivery. The establishment of programmes is intended to put in place a key building block which will be used progressively to meet several objectives as the budgetary reforms deepen in the coming years. These objectives include: the facilitation of strategic planning for service delivery within each line ministry, the linking, at a single level of service delivery, of the process of budgetary appropriation and the management of budgetary execution and the reporting on the budget out-turn both in terms of funds applied and in terms of the results achieved in terms of service delivery.⁷

⁷ It is noted that this proposal is in line with the findings of the 2007 IMF Mission to Pakistan on ROSC (Report on Fiscal Transparency and Codes), which recommended that it would be appropriate at this stage of the MTBF development process to start the process of defining a programmatic structure for the federal government. The IMF Mission report concentrates primarily on the use of a programmatic structure to increase transparency in budget reporting, and hence concentrates mainly on the use of the NAM Functional Classifier (at the Sub-Function level) as the basis for the definition of programmes. The proposals set out in Section 5 of this report give greater weight to the need to ensure that any new programmatic structure conforms closely to existing organizational structures to ensure that the management-related objectives of introduction of a programmatic structure can be fully realized.

d) Use of Outputs (Services Delivered) as the Key Operational Tool

Under the New Budgeting System, particular importance is being afforded to the development of the output level as the lynch-pin of the system. Under the proposed system it is at the output level that the required linking of service delivery (in terms of quantified targets) with the budget will take place. To make this certain definitions and guidelines are set and observed in the definition and use of the terms programmes and 'outputs'.

The New Budgeting System is based on the following definition and gloss on the term "outputs" and "programmes".:

- For operationalizing the reformed planning and budgeting system the term "**programme**" will be used as a relatively high level concept, typically referring to the service or groups of services which would be delivered by a department within a division.
- "**Outputs**" are the major categories of service delivery of a ministry. Programmes are clusters of outputs which contribute to the achievement of a common goal.

The point to be emphasized is that "programmes" refer to a rather high level of service delivery. A ministry should normally be able to identify a relatively small number of programmes, often 3 to 5, and every effort should be made to ensure that the number of programmes does not exceed 10. Where they appear to be a larger number of programmes, these should be reviewed with a view to consolidating and achieving a reduced number of strategically defined programmes

There are several important practical reasons for concentrating on outputs in the reformed budget management system. In particular the number of outputs needs to be kept to a manageably limited number since this will make it easier and more practical to assign budgetary inputs to outputs, and more generally the system will be more manageable. In certain circumstances it may be necessary and useful to define a set of activities at a level immediately below the output level. However, this should be done without eliminating the lynch-pin role of the concept of programmes, as explained in the following point below.

e) Output-Based Budgeting

The core of the **New Budgeting System** is the introduction of Output-Based Budgeting (OBB). The central element of OBB is that budgets should be formulated in a way which defines the budgetary allocations required to support the delivery of defined outputs. Initially (i.e. the first year in which the system is applied) this will involve a process of assigning the existing costs incurred by spending units across the outputs to which they contribute. In future (i.e. all subsequent years) the actual preparation of the budget should be increasingly based on the calculation of the budgets required to achieve defined output/service delivery targets.

The mechanics for the implementation of Output-Based Budgeting are based on the following elements:

- Programmes and planned **outputs must be defined by the senior management of the ministry** as a part of the strategic planning process. This is different from the present practice introduced under MTBF Phase I, whereby the outputs are defined by the individual spending units on the basis of their activities.⁸ This is a critical difference. In future each ministry will define its programmes and outputs as a key stage of a top-down strategic process within the ministry.
- Having defined the programmes and outputs of the ministry, **the Budget Section/P&D Section⁹ will be responsible for identifying the Spending Units which are contributing to each output.** This may involve any of several possibilities: there may be only one spending unit responsible for delivering given outputs or there may be several SU contributing; in addition the situation may exist where a single SU contributes to more than one of the pre-defined outputs. An important stage of the budgetary planning process is, accordingly, the mapping of Spending Units onto the defined outputs by the Budget Section.
- The third element of Output-Based Budgeting is that the **Spending Units which are contributing to more than one output should break-down their budget proposals by outputs.** The MTBF project will be providing guidance on how this breakdown should be achieved. Initially the breakdown of the budget will be achieved by taking a conventionally-prepared budget for the spending unit and breaking down each line item according to the output(s) to which it contributes. The result is that a typical Spending Unit which is contributing to several outputs, will appear as in Table 1 below which illustrates the breakdown of a Spending Unit budget by outputs. It is recognized that a number of technical issues will arise in the breaking-down of budgets by output at the spending unit level.)

It should be noted that the concept of programmes and outputs cuts across the division between the recurrent and the development budgets. This is because the delivery of services in the short term and in future typically depends on a combination of current expenditure (for the delivery of the service and falling under the recurrent budget) and capital expenditure (required to create the capacity for expanded coverage or quality of service in future (which should properly fall under the development budget). The definition of programmes cutting across the recurrent/development budget divide does not of itself require any organizational changes within the line ministries, but is essentially related to budget classification.

⁸ The concept of a 'programme' does not yet feature in the budgeting system of GoP, although it is provided for in the CoA.

⁹ The New Budgeting System does not distinguish between these two organisational parts of the line ministry - in practice most outputs will involve a contribution from both the recurrent and the development parts of the budget.

Table 1: Schematic Illustration of a SU Budget for OBB

| | Output 1 | Output 2 | Output 3 | Total |
|--------------------|-----------------|-----------------|-----------------|---------------------|
| Object Code | - | - | - | - |
| 1 | - | - | - | - |
| 2 | - | - | - | - |
| 3 | - | - | - | - |
| 4 | - | - | - | - |
| 5 | - | - | - | - |
| 6 | - | - | - | - |
| 7 etc | - | - | - | - |
| Total | - | - | - | Total Budget |

6.2 Reconciliation with the Preparation of the Budget for Appropriation

The proposals set out in this paper for the development of the budgetary preparation process are fully compatible with the continuation of the existing procedures for the finalization and compilation of the budget for purposes of appropriation by the National Assembly. In particular, no change is proposed to the existing system whereby appropriation by the National Assembly takes place on an annual basis. It follows that the 3-year budgets prepared by MTBF must be able to produce, as one printed output, the required standard format for the spending unit budgets to be captured by the AS (Coordination) and used for the preparation of the Estimates ('Pink Book'). The breakdown of the Spending Unit budgets into spending on individual outputs will not be utilized for the preparation of the Pink Book, which will continue to be based on the total expenditures of the Spending Units, irrespective of the number of outputs to which a given spending unit contributes to.

6.3 Development of the FMA to Accommodate Output-Based Budgeting

The proposed budget preparation system will require the development of the MTBF FMA software. It must be able to accommodate the breakdown of the Spending Unit budgets broken down by outputs. This is a significant development, which is essential if the aim of aggregation of ministry spending by output is to be achieved.

7. From Budgeting to Costing of Service Delivery

7.1 Introduction

“Costing” is the process whereby the cost is determined for something which is purchased. Costing can be applied at any level of aggregation and can be applied to either outputs or inputs. Applied to **inputs**, for example, costing could be applied at the item level, such as a pencil or to the running of a complete hospital. In this case, the “costing” captures the expected cost of purchasing the set of inputs required.

7.2 Application of Costing under MTBF

Applied to **outputs**, costing refers to the cost of providing something which has been delivered or a service, such as the provision of hospital services. In each case, the costing of an output is simply the aggregated cost of the inputs required to deliver the service in question.

The aim of a costing methodology is to have a mechanism for ensuring that the costing whether of inputs or outputs is undertaken on as economical a basis as possible.

In terms of the MTBF process the aim of developing a costing methodology is to provide tools whereby planners and budget managers have an increased understanding and control over the costs which they are incurring, so that they can move towards more and more efficient and effective forms of service delivery. Improvement in costing should provide one mechanism for lowering the cost of delivery of services through the public sector over time.

At present considerations of costing are applied only at the individual budget line level in the budgetary process: in preparing the budget for next year, the AO in the Spending Unit will work from the unit costs of, for example, the staff on the payroll, based on the pay scales and the allowances applicable to each individual. This form of costing at the individual line item will always be an important feature of the budget preparation process.

However, under Phase II it is intended that costing methodology should also be applied to outputs. That is to say, the MTBF should develop methods for identifying and refining the cost of services which are being delivered by each ministry. This is important for several reasons:

- It is only by looking at the cost of an output or service that it is possible to form a judgment as to whether it constitutes value for money in the government budget;
- The costing of service delivery allows the comparison of the efficiency between different units of government which are applying the same or similar services. In many cases there will be good reasons why the costs of service delivery of services vary between different units (for example in different parts of the

country). In some cases the differences in cost may reflect differences in the quality of the service provided. In other cases the differences in service delivery cost arise from differences in the efficiency with which funds are used. This could points to weaknesses in procurement, problems of small scale (and associated high overheads) or several other reasons.

7.3 The Level at which Costing is Applied

It is important to recognize that the costing of services (whether on an input or output basis) only makes sense at an appropriate level of defined service, and that this level will vary from service to service across the public sector. Costing is typically stated in unit cost terms – that is to say in terms of the cost of the delivery of one unit of service. The choice of a unit will be dependent on the particularities of each service. In order to be meaningful a unit cost for delivery of a service must be calculated across a broadly similar set of services. Some examples will clarify this point:

Consider the cost of the delivery of health services: It is possible to calculate the overall cost of the delivery of all the public sector health services per member of the public, simply by dividing the total public expenditure on health by the population. However, while this resulting figure is interesting in that it provides information on the level of resourcing the health sector is given, it is not useful as a measure of efficiency. At a more detailed level different measures of cost of service delivery can be calculated such as:

- The average cost of treatment of patients admitted to hospital with malaria; or, even more specifically:
- The cost of vaccinating one child against measles.

It will be clear that the usefulness of the concept of costing as applied to services increases the more specific and well-defined the service is which is being costed.

The conclusion drawn from this discussion is that costing is a useful tool for management, that it can be applied at varying levels or degrees of aggregation of service delivery, and the accuracy with which it can be applied and its usefulness as a management tool will be greater at the lower levels of service delivery - where the service delivered (including qualitative aspects) can be defined more precisely.

7.4 The Relationship between Costing and Budgeting

The first part of this report addressed the budgeting methodology to be introduced under MTBF Phase II. The main direction of the reforms proposed is to strengthen the budgeting system to make it more responsive to the demand of service-delivery. In this context it is possible to clarify the relationship between budgeting and the costing of services.

The costing of services should normally take place at a level below the programme level, within a system of budgeting which is based on a top-down process within each line ministry based on high level objectives, a defined programmatic structure and a set of defined outputs within each programme, Costing should relate to specific services which are reasonably homogeneous and of a well-defined quality: This is best achieved at the output level.

7.5 Moving Towards the Costing of Outputs (Services)

The present system of budgeting practiced by GoP relies entirely on the costing of inputs. Costing of inputs is an important part of the overall budgetary process, but needs to be supplemented over time by the progressive introduction of the costing of outputs (services delivered). This will be a process taking several years.

The key steps in moving towards a system of costing of outputs (services delivered) fall into two groups, starting with basic measures necessary to set up a system in the first place, and a second group which undertake later refinement.

a) Basic First Steps in Setting up a Service Delivery Costing System

- **The clear definition of the outputs** (high level services) and lower level more detailed service which a ministry of department delivers. Obviously services cannot be costed until they have been identified and clearly defined. Usually this needs to be done in terms of a set of standards for the delivery of a particular service
- **The establishment of the current (or baseline) cost of delivery of each service.** This requires that at least one year's budget should be prepared which identifies the actual present cost associated with the delivery of each service;
- **The definition of appropriate units** for the presentation of the costs of each service. These will be different for each and every service delivered.

(b) Refinement of the Service Costing System

Once a system of service delivery costing has been set up and incorporated in the budget for at least one year, there will be a set of unit costs available for each service. It must be recognized that initially these service delivery unit costs will initially only be rough and ready, because of the many problems which will arise in the definition of services and in the allocation of budgetary costs across services by departments.

However once a set of 'baseline' (i.e. current actual) unit costs has been established, it becomes possible to undertake a process of refinement, which will take several years, and which will turn into an on-going part of the continuing budget management system.

The refinement of service delivery costs can be approached through several mechanisms, including:

- The **analysis of the variance in the level of unit costs of service delivery across service delivery units** which are delivering identical or similar services. For example, in the primary education sub-sector, the cost of provision of a certain standard of primary education per pupil can be calculated at the level of the individual school or at the provincial level. Experience in other countries suggest that this method of reviewing and comparing unit costs across service delivery units is a very important mechanism for identifying inefficiencies in the system and for identifying specific management improvements which will lead to reduced unit costs for a given level of service delivery.
- **International benchmarking:** the overall Pakistani unit cost of delivering a particular service can be compared to the cost of delivery in other countries. Such comparisons should always also analyse differences in the quality of the service delivered, as information on cost alone is of little value.
- **Analysis of cost variation in relation to scale:** In many areas of service delivery there are potential economies of scale. This is because the necessary overheads get spread over an increased scope of services as scale expands. As a result the overall unit cost per unit of service delivery is reduced as scale expands.

8. Steps in the Introduction of the New Budgeting System and Improved Costing Methodology

The main steps required to implement the recommendations set out above can be summarized as follows:

- **Pilot testing of the proposed methodology** using real data from a single small ministry. This piloting will involve preparation of the full set of tables for the budget (using data from a previous year) broken down by programme and output/service.
- Following the piloting, **establish the agreed conceptual framework** (Objectives, Programmes, Outcomes, Outputs etc). The MTBF Team to work with the line ministries to establish their Logic of Intervention and to define Objectives, Outcomes, Programmes and Outputs
- **Reach agreement on the modifications to the budget preparation process** within the line ministries to implement the top-down process within line ministries;
- **Prepare a set of training materials** to inform line ministry staff about the New Budgeting System, the training to be implemented on a tiered basis, starting with Secretaries and other high level staff, progressing to intensive training of the middle level staff and leading (preferably through a cascade training process) to the training of all relevant staff at spending unit level;
- **Deliver the training courses.**
- **Assist the Line Ministries (Budget Sections and P&D Departments) to establish the mapping of Spending Units onto Outputs.**
- **Revise the MTBF BCC and guidelines** to reflect the new procedures incorporating output costing;
- **Modify the FMA** to be able to handle Spending Unit budgets broken down by output (service delivery);
- **Prepare the 2008/09 budget using the revised methodology;**
- Prepare presentation of the MTBF Forward Budget Estimates (Green Books) based on **presentation of budgets by programmes and outputs.**
- Further development and refinement of the approach **Costing**, once a baseline set of output costs have been established through preparation of the 2008/09 budget following the process outlined above.

9. Conclusions and Recommendations

The main conclusions of this review can be summarized as follows:

1. It is necessary to **build on the progress made under MTBF Phase I** to strengthen the system of budget preparation in the line ministries to address the continuing weaknesses;
2. Strengthening of the line ministry budgetary system should **concentrate on the development of a coherent planning cycle in each line ministry**, which incorporates all the major stages of the planning process, including, strategy development, definition of objectives and outputs for each ministry and department as the driving elements in the formulation of the MTBF budgets;
3. **A clear conceptual framework should be adopted** which uses terminology which is very clearly defined in advance. This conceptual framework should be built around the internationally accepted elements of Objectives, Outcome, Outputs and Services.
4. **Work should proceed as soon as possible on the definition of a programmatic structure, initially for the ministries already included in the MTBF process.** The definition of programmes should be based on consideration of both the Entity classification (organisational structure) and the Functional Classification, but selecting organizational units which correspond most closely to the main units responsible for the delivery of clusters of services (functional classification). Where there is no close mapping of Entity classification onto Functional classification a suitably selected level for the Entity (organisational structure) should be used to define programmes.¹⁰
5. **Particular importance should be paid to the clear definition of outputs as a key level of the conceptual framework** in each ministry. Outputs should be defined at the major programme level and should be limited in number to not more than 10 per ministry. Where possible and appropriate the existing departmental divisions of line ministries should be used as the basis for the definition of outputs
6. **Outputs must be defined as part of a top-down process in each line ministry.** The upper management of each ministry should undertake the mapping of Spending Units onto the pre-defined outputs. SUs which are contributing to no defined output should be closed down.
7. **Services delivered under each output should be identified. They will be used in future for building a system of costing of service delivery.**

¹⁰ See *Programme-Based Budgeting: An approach to Development of a Programmatic Structure for Services Performed by Federal Ministries in Pakistan*, MTBF, May, 2007.

8. **Spending Units should be instructed to prepare their budgets on a basis which provides a breakdown of their total expenditure by output** (in the case of SUs which contribute to more than one output). In the first year this should be done by first preparing the SU budget using established procedures, and then allocating the total expenditure across outputs. The MTBF should provide assistance and guidelines on how the total budget of an SU should be allocated across outputs.
9. **The improvement to Costing Methodology in each line ministry should be addressed only after the New Budget System has been put in place**
10. The **development of Costing should be addressed on two main fronts:** (a) improvement to the **costing of inputs**) which should concentrate on the provision of advice to the SUs as to the methods to be followed in costing each line item in their budgets; and (b) the **development of government-wide system of costing of service-delivery (Outputs)**. The first step in towards the development of the costing of service is the preparation of a budget which allows the identification of the costs incurred on delivery of each output. Subsequently the system will be refined based on definitions of unit costs which are appropriate to each of the outputs and services delivered by each of the departments and ministries.
11. **The Financial Management Application (FMA) should be modified** to (i) incorporate the programme level of budget aggregation and service delivery; (ii) to facilitate the move to Output-Based Budgeting. This latter objective requires the disaggregation of spending unit budgets by output.