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ABBREVIATIONS AND ACRONYMS

ACD	Afghanistan Customs Department
ADB	Asian Development Bank
AEP	Afghan Expatriate Program
AFMIS	Afghanistan Financial Information System
ANA	Afghan National Army
ANDS	Afghanistan National Development Agency
ARTF	Afghanistan Reconstruction Trust Fund
ASYCUDA	Automated System for Customs Data
BPHS	Basic Package of Health Services
BOT	Build Operate Transfer
CAO	Control and Audit Office
CDCs	Community Development Councils
DABM	Da Afghanistan Breshna Moasessa
DFID	Department for International Development
DDR	Disarmament, Demobilization and Reintegration
EU	European Union
GDP	Gross Domestic Product
GPR	General Presidency of Revenue
IARCSC	Independent Administration Reform & Civil Service Commission
IDA	International Development Association
IMF	International Monetary Fund
IT	Information Technology
LEP	Lateral Entry Program
LTO	Large Taxpayer Office
M&E	Monitoring and Evaluation
MoE	Ministry of Education
MoEW	Ministry of Energy and Water
MoF	Ministry of Finance
MTBF	Medium-Term Budget Framework
MTEF	Medium-Term Expenditure Framework
MTFF	Medium-Term Fiscal Framework
NDF	National Development Framework
NGOs	Non-government Organizations
NSC	National Security Council
NSP	National Solidarity Program
OECD	Organization for Economic Cooperation and Development
OED	Operations Evaluation Department
O&M	Operation and Maintenance
PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Review
PETS	Public Expenditure Tracking Survey
PFEM	Public Finance and Expenditure Management Law
PFM	Public Financial Management
PIU	Program Implementation Unit
PMUs	Program Management Units
PPAs	Performance-based Partnership Agreements
PRR	Priority Restructuring and Reform
PRSP	Poverty Reduction Strategy Papers
SAF	Securing Afghanistan's Future
SOE	State Owned Enterprises
TA	Technical Assistance
TIN	Taxpayer Identification Number
TSA	Treasury Single Account
UK	United Kingdom
VAT	Value Added Tax

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ACKNOWLEDGEMENTS

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EXECUTIVE SUMMARY

i. Afghanistan's reconstruction has made considerable progress during the past four years. Led by the Government with international support but relying most on the energy and initiative of the Afghan people, reconstruction has resulted in solid achievements – rapid economic growth, unprecedented primary school enrollments including for girls, great expansion of immunization, rehabilitation of major highways, a new and stable currency, promulgation of a new Constitution, Presidential and Parliamentary elections, return of refugees, and demobilization of militias. Public Finance Management (PFM) has made a major contribution to these successes. Yet the challenges remain enormous.

ii. The main objective of the Afghanistan PFM Review, conducted by the World Bank and partner agencies in close cooperation with the Government of Afghanistan, is to consolidate, deepen, and present in an accessible, action-oriented form the knowledge base on Afghanistan's public finance system, review recent progress, analyze key challenges, and put forward options and recommendations for moving forward. This main report is supplemented by four additional volumes, covering PFM performance and procurement (Volume II); key cross-cutting issues (Volume III); selected sector studies (Volume IV); and security sector expenditures (Volume V).

PUBLIC FINANCE MANAGEMENT AND AFGHANISTAN'S DEVELOPMENT

iii. ***Fiscal structure and trends.*** Afghanistan has an unusual fiscal structure reflecting its historical legacy (e.g. traditionally low revenue mobilization), the long period of conflict (e.g. civil service wages greatly eroded and compressed by hyperinflation), and current reconstruction activities (very high spending) and priorities (e.g. massive expenditures on security). More specifically:

- Public expenditures are extraordinarily high; total budgetary expenditures in 2004/05 were equivalent to 57% of GDP (excluding the drug economy).
- This is accounted for by extremely high development spending; unlike in most countries, the development budget ($2.8 billion in 2004/05) dwarfs the operating budget ($0.6 billion).
- Operating expenditures (9% of GDP in 2004/05) are well within international patterns.
- There are however large recurrent expenditures in the development budget, including health services, technical assistance, salary payments, and grants, among others.
- There is substantial underspending on non-wage operation and maintenance (O&M).
- Most spending (three quarters in 2004/05) occurs outside Government channels and oversight through the External Budget (as opposed to the Government-controlled Core Budget).
- The security sector (39% of total expenditures in 2004/05) is a major driver of spending.
- A disproportionate share of public spending occurs in Kabul (e.g. 70% of non-wage O&M).
- Domestic revenues (5% of GDP) are very low (likely the lowest ratio in the world for a sizable country) and pay for only about 8% of total expenditures.
- The fiscal deficit is extremely high and entirely financed by aid, mostly grants.

iv. Turning to fiscal trends since 2001/02, (i) budgetary expenditures have increased sharply during 2002/03 to 2004/05, with operating expenditures almost doubling and development spending growing even faster; (ii) revenues also have risen rapidly, more than doubling during the same period; (iii) since revenues started out from a much lower base, the absolute gap between recurrent spending and revenues more than tripled; (iv) this means that external financing of recurrent expenditures has been a fast-growing component of the budget; (v) the budget deficit (before grants) has increased sharply, reflecting large inflows of external assistance predominantly on a grant basis; and finally, (vi) actual development expenditures (in both core and external budgets) have fallen far short of budget targets (reflecting past inclusion of unfunded projects in the development budget, confusion in some cases between commitments and disbursements, overly optimistic projections of disbursements, insufficient project screening, large contingencies in the original budget, and implementation constraints).

v. ***Contribution of PFM to Afghanistan's development.*** Public finance has played and will continue to play a critical role contributing to economic stability, state-building, growth, and poverty reduction, including in particular enabling Government to perform effectively and deliver public services to the Afghan people (Chapter 1). To support these objectives, public finances must be: (i) affordable; (ii) well-prioritized in accordance with the national strategy; (iii) efficient in terms of value for money and service delivery; and (iv) fair, accountable, and transparently reported to the Afghan public, private business, and other stakeholders. On the negative side, weaknesses in public finance can enormously harm development. Poor fiscal management can result in hyperinflation (as occurred in Afghanistan in the 1990s). Failure to prioritize spending among programs or problems in budget execution (payments, procurement, accounting, etc.) can result in waste of resources and poor value for money. And lack of accountability and transparency can result in corruption and loss of public support. This is an area of serious concern for many Afghans; there are widespread allegations of various kinds of corruption, including massive corruption associated with the drug industry as well as petty corruption.

vi. Facing a difficult post-conflict situation, Afghanistan has achieved remarkable progress on the fiscal front. Despite pressures, ***fiscal discipline*** has been strictly enforced and maintained, notably through control over the Government wage bill. This has been the essential ingredient of macroeconomic stability. ***Domestic revenues*** have increased substantially, growing at an average annual rate of 60% per year during 2002/03-2004/05 and rising from 3.2% of GDP to 4.5% in this period. Major efforts have been made to improve the ***budget process,*** and it has come a long way since the first post-Taliban budget of 2002/03. ***Budget execution*** also has greatly improved in many respects – not least, most civil servants are now being paid, on time. Finally, the Government has made a strong commitment to ***financial transparency and accountability***, resulting in improving fiduciary performance. There have also been ***institutional improvements and capacity development***, especially in the Ministry of Finance (MoF). These achievements have provided confidence to donors resulting in mobilization of high levels of external support for the national budget, mainly through the Afghanistan Reconstruction Trust Fund (ARTF) which finances most of the civilian recurrent budget. These achievements are commendable compared to experience in other post-conflict countries. However, improvements have been to a large extent dependent on external capacity brought in on an "emergency" basis to get things going. The shift from this situation to sustainable core Government capacity for key public finance functions has barely begun for the most part, and there are also daunting weaknesses in PFM capacity in the line ministries.

vii. ***PFM performance measurement framework and assessment.*** As discussed in Chapter 2, a PFM performance rating system has been recently developed by the Public Expenditure and Financial Accountability (PEFA) multi-agency partnership program (including the World Bank, IMF, EC, and a number of other agencies). It is intended to provide an objective, internationally comparable framework for assessing the performance of a country's PFM system. This does not attempt to measure fiscal outcomes, the substantive appropriateness of public expenditure policies and decisions, or the actual impacts and value for money achieved through public expenditures. The PFM performance measurement framework instead should be seen as assessing the PFM system, which is a crucial enabling factor for achieving broader development goals and substantive outcomes. Structured around six core dimensions of PFM performance (budget credibility; comprehensiveness and transparency; policy-based budgeting; predictability and control in budget execution; accounting, recording, and reporting; and external scrutiny and audit), the framework includes 28 high-level PFM performance indicators and three indicators of donors' performance. The performance of Afghanistan's PFM system against this framework as of June 2005 has been assessed as part of the PFM Review (see Table 2.1).

viii. This assessment generally portrays a public sector where financial resources are, by and large, being used for their intended purposes as authorized by a budget which is processed with transparency and has contributed to aggregate fiscal discipline. The expenditures and financial position of the Government are reported regularly in an understandable format. Performance regarding the allocation of spending across programs and agencies and the efficiency of operations is not as good, however. Given that the starting point in 2001 was extremely weak, this is overall a remarkable achievement – yet

pointing to the need for further progress. Using these ratings as a baseline, future progress in improving the performance of the PFM system can be monitored. However, measurable progress in terms of changes in ratings is more likely to occur over periods of a year or longer than on a short-term basis. Moreover, since the ratings assess the system's current performance with external support (both advisory and operational), questions arise about sustainability. Further improvements in many cases may be manifested not in higher ratings but rather in maintenance of current ratings based on sustainable national capacity and with declining levels of external support. The ratings also provide an assessment for the donor community of the potential capacity of Government systems (currently supported by external assistance) to implement the operations which are now occurring outside Government systems.

EIGHT CHALLENGES FOR PUBLIC FINANCE MANAGEMENT

ix. Despite recent progress, Afghanistan's PFM system faces daunting challenges, which can be summarized as follows.

x. ***Progressing toward fiscal sustainability.*** Afghanistan's annual budgets have been prudent, and the Government has a strong policy to avoid domestic borrowing (relying instead primarily on external assistance and to a much lesser extent on growing domestic revenues to pay for its expenditures). From a medium-term perspective, however, progressing toward fiscal sustainability (defined very simply in this report as reaching a fiscal position where domestic revenues are large enough to cover total recurrent expenditures) will be a daunting challenge (discussed in Chapter 3). Right now, domestic revenues cover less than half of total recurrent budgetary expenditures and only a quarter of all recurrent expenditures (if the large amounts of recurrent expenditures in the entirely donor-financed Core Development Budget and External Budget are included). Failing to keep public expenditures within affordable limits would have dire consequences. A large influx of aid, combined with lack of domestic capacity and low domestic revenues, can result in an unaffordable pattern of expenditures if not well-managed. While international support gives Afghanistan an opportunity to temporarily soften its national budget constraint, a visionary medium-term framework (i.e. a Medium-Term Fiscal Framework, MTFF) is needed to ensure that the country moves toward a sustainable fiscal position. Afghanistan has taken the first step in this regard by approving its first MTFF in October 2005. Progressing toward fiscal sustainability will require, *inter alia*, (i) sustained rapid growth of domestic revenues (discussed below); (ii) containment of overall expenditures – notably for non-discretionary expenditures such as wage bill and pensions – in line with medium-term resource constraints; (iii) ensuring that downstream expenditure liabilities created by public investments and other spending decisions are affordable; and (iv) incorporating recurrent expenditures funded directly by donors through the External Budget (notably those in the security sector) in the fiscal sustainability equation and bringing these expenditures progressively into national budget channels.

xi. ***Mobilizing domestic revenues.*** Sustained rapid growth of domestic revenues will be the lynchpin of progress toward fiscal sustainability (Chapter 4). Afghanistan's revenue-to-GDP ratio at around 5% is well below half the level even in other very poor countries. In order for revenues to catch up with recurrent expenditures over a period of a decade or so in line with the Government's objectives, revenues will have to grow much more rapidly than expenditures on a sustained basis – most likely at least twice as fast. At the same time, a sound revenue system should be conducive to development of the private sector. Key challenges in raising revenues include: (i) lack of capacity in the tax administration system as well as among taxpayers to calculate and pay taxes; (ii) the existence of numerous, low-yielding "nuisance taxes", illicit revenue collection by many local authorities, instances of double-taxation (mainly between municipal and national taxation), and ambiguities in the tax laws; (iii) the dominance of agriculture and the informal sector in the economy, which are difficult to tax in any country; and (iv) widely perceived corruption in the tax administration. The Government has already made progress in reforming the Customs tariff structure and improving the income tax system. Further progress will depend on focusing efforts on larger taxpayers and high-yielding revenue sources; eliminating "nuisance taxes" and cracking down on illicit levies as well as clarifying ambiguities in the tax code; and building capacity in the form of a well-managed professional tax cadre with integrity and associated physical, IT (information

technology), and business process assets. Increasing domestic revenue mobilization needs to be given very high priority: it will reduce aid dependence over time, create fiscal space for development, and send a very strong signal of the Government's commitment to progressing toward fiscal sustainability. Full implementation of the current policy and administrative reform plans would raise the revenue to GDP ratio from 5% to 8% by 2010. More forceful implementation of administrative reforms, reaching quickly to provinces, and additional revenue measures could bring this ratio to 10-11% in 2010.

xii. ***Prioritizing expenditures.*** Strategically prioritizing expenditures so they effectively support national development objectives is both one of the most important and one of the most difficult aspects of public finance management (Chapter 5). Prioritization is critical because: (i) like any country, Afghanistan faces major resource constraints over the medium term; (ii) with the bulk of public spending externally financed and most of it donor-executed, if the Government does not prioritize the allocation of expenditures, priorities will be determined in an ad hoc manner by the fragmented priorities of others; and (iii) capacity is limited. Prioritization is a political process; an orderly budget process (see below) is the means by which decision makers (Cabinet, Parliament) make trade-offs under the constraint of limited resources. This process must be anchored in national and sectoral strategies and based on solid evidence coming out of the monitoring and evaluation system.

xiii. There are no easy answers on how to prioritize expenditures *across sectors*. Simple rules of thumb (identifying and mitigating gross anomalies, looking at international patterns of spending and outcomes, identifying bottlenecks and directing expenditures to alleviate them) are likely to work better than sophisticated technical approaches. For example, the allocation to the justice sector appears to have been grossly inadequate in recent years. It is very important that inter-sectoral prioritization be comprehensive – no sector (e.g. defense) should be considered sacrosanct or immune from scrutiny. Prioritization of expenditures *within sectors* and major programs needs to be firmly anchored in sector strategies. Within sectors, prioritization can rely on analysis of the costs and benefits of various interventions (e.g. highways, dams). Of particular importance is the review of the costs of operating and maintaining (O&M) public investments (e.g. hospitals, roads). For instance, new investments are being made in the power sector, even while existing power supply in Kabul depends on off-budget provision of fuel by an external donor. A simple rule of thumb suggests that investments made in 2004/05 could generate an additional $100 million in annual O&M costs (i.e. 40% of all domestic revenues collected in that year). Taking into account complementarities (where the effectiveness of spending on one activity is dependent on another activity) and sequencing issues also can help guide intra-sectoral prioritization.

xiv. ***Making the national budget the central instrument of policy and reform.*** While much progress has been made in strengthening the budget formulation process, there is a long way to go toward a policy-based, well-prioritized budget with strong political buy-in. As discussed in Chapter 6, key constraints include: (i) limited capacity in MoF and especially in line ministries; (ii) the dominant share of expenditures directly by donors outside Government systems; (iii) serious timing dilemmas and a compressed budget schedule which weakens the quality of the budget; and (iv) lack of a medium-term strategic and fiscal perspective to guide annual budget formulation. An MTFF (Medium-Term Fiscal Framework), integrally linked to annual budgeting, is critical to improve the budget process. Key cross-cutting issues such as gender and counter-narcotics need to be mainstreamed in budgetary decision-making. Meaningful processes of political engagement and approval (including by Parliament) and public communications are required. There is also an urgent need for greater inputs and participation in budget formulation by lower levels of the Government administration (provinces and districts).

xv. ***Enhancing the effectiveness of budget execution.*** While considerable progress has been made in some areas of budget execution, a great deal remains to be done in four respects – which would improve the quality of spending and the trust that the Afghan people, the private sector, and donors place in the Government's systems (Chapter 7). First, financial management processes need to ensure that funds reach service delivery units; this is a serious weakness in most sectors (e.g. education). Second, further strengthening of the control framework for public spending in particular requires implementing the new Public Expenditure and Financial Management Law and creating a strong internal audit function. Third,

while the existing procurement framework includes basic financial controls and stresses competitive bidding, it places an excessive emphasis on price (at the expense of quality of goods and services), and there is too limited participation from the private sector. Progressive implementation of the new Procurement Law, combined with substantial training of civil servants as well as private firms, will create the foundations for a fair, transparent, and effective procurement system. Finally, external scrutiny and audit are necessary to hold Government accountable for the use of public funds. Much remains to be done to build the external auditor's capacity. The election of the Parliament also creates an opportunity – with its own challenges – to further strengthen accountability and participation. Progress in these four areas will help greatly in the fight against corruption, and should be a key part of a holistic anti-corruption strategy. Corruption is considered to be a symptom of poor governance, and international experience demonstrates that anti-corruption strategies work better through addressing the underlying governance problems (e.g. in the PFM system), rather than through investigation and prosecution of corruption cases.

xvi. ***Delivering services to the Afghan people.*** As discussed in Chapter 8, the ultimate outcome of the PFM system is service delivery, essential for public spending to achieve results and extremely important for the credibility and legitimacy of the State. However, as recognized by the Government's strategy documents, it is not required for the Government to deliver all public services itself. Other possible Government roles include financing, setting policy, contracting/regulating, and monitoring. Various stakeholders – non-Government providers, private sector, users, and citizens – also have important roles to play. With a few exceptions, public service delivery in most sectors is poor, as demonstrated by available data on outcome indicators, giving rise to frustrations and weakening the credibility of the Government.

xvii. The experience in Afghanistan provides some important lessons. Performance-based contracts in the health sector appear to be a promising way to deliver services effectively, while keeping full regulatory control and sufficient visibility for the Government. Private sector participation, supported by direct payments from users, has stimulated rapid growth of telecommunication services, while state-owned enterprises have been much less successful. As part of the National Solidarity Program, half of the villages of Afghanistan now have elected development councils empowered to make local investment decisions using block grants. Afghanistan can also learn from less positive experiences, such as the failure to provide non-salary budgets to most schools and the unsustainability of financing for electricity. Some key lessons include: (i) the critical need to focus on service delivery, put people at the center, and get accountability and incentives right; (ii) choices and expenditures should depend on sector strategies and circumstances and be guided by adequate monitoring and evaluation; and (iii) sustainable financing and, where appropriate, cost recovery are essential.

xviii. ***Institutional reforms and capacity development.*** Meeting the challenge of sustainable national capacity development is critical for success in improving Afghanistan's PFM system (Chapter 9). At present, national capacity in the PFM system is limited, virtually non-existent in many areas. External capacity has been brought in to support core functions on an "emergency" basis, and large amounts of technical assistance ($400 million per year according to OECD data) injected (for all areas of activity, not just PFM). But this is not sustainable, and there are serious risks that slower but more sustainable national capacity development will be undermined, making Afghanistan highly vulnerable to a reduction in aid flows. Developing capacity requires public administration reforms (recruitment, pay, human resources), organizational restructuring and improvements, and training. Better management of external technical assistance is needed to ensure that it supports longer-term national capacity development

xix. Finally, underlying all these challenges is the ***need for coordination and donor alignment***, within an overall national strategic and budgetary framework. Coordination within Government needs to be improved (this can be accomplished around a widely-owned national development strategy and a sound budget process), and public communications and transparency will be extremely important in fostering Government accountability vis-à-vis citizens and their elected representatives. Coordination is a major challenge for donors as well, which also needs to occur around the national development strategy and budget process; the low share of external assistance going through national budget and treasury channels

is a serious constraint in this regard. Improving aid effectiveness requires a continuing and deepening partnership between the Government and the donors.

A FIVE POINT AGENDA FOR ACTION

xx. The Government has fully recognized these challenges and the centrality of the budget process and PFM performance for Afghanistan's future. As the Government is preparing its national development strategy, a five-point agenda to improve PFM is put forward in this report for consideration (Chapter 10).

xxi. ***First, the path toward fiscal sustainability needs to be mapped out and steady progress in this direction achieved.*** Based on a sound MTFF (rudimentary at the outset but improved over time), this will require particular attention to (i) increasing domestic revenue mobilization (through administrative improvements leading to better compliance as well as sound tax policies); (ii) maintaining control over aggregate expenditures within the overall resource envelope; (iii) setting and implementing clear policies for key expenditure components notably the Government wage bill (including the non-civilian component, much of which is currently outside the Core Budget); (iv) monitoring and controlling fiscal risks (including pension liabilities, external debt, and liabilities of SOEs); and (v) ensuring that strategic and public expenditure decisions are affordable over the medium-term, including downstream O&M implications. Progress toward fiscal sustainability will be measured by achievements against fiscal targets under the MTFF.

xxii. ***Second, a number of policy decisions and actions are needed to improve service delivery.*** This will require clarifying the roles of the State (operational, financing, policy, and regulation) in service delivery in different sectors; strengthening accountability; ensuring sustainable financing arrangements including cost recovery where appropriate; and determining the responsibilities of various levels of Government administration (central ministries, provinces, districts). A variety of different models of service delivery are possible within Afghanistan's Constitutionally-mandated unitary state structure, and the choice among them should depend on sector-specific conditions. Although "one size does not fit all," the effectiveness of service delivery depends largely on the degree of ownership and the coherence of the models in terms of accountability, incentives, and financing. Donors also need to ensure that their interventions strengthen rather than undermine national service delivery mechanisms. Progress in improving service delivery will be measured by the articulation of the Government's strategy – with a clear set of indicators, baseline data, and targets – and achievements against these indicators.

xxiii. ***Third, the capacity of the key PFM institutions should be developed.*** Priority areas include training, recruitment practices, pay structures, organizational reforms, detailed business processes, specific IT systems, etc. While these issues cut across all levels of Government, MoF's capacity is of particular importance. As chief custodian of the PFM system, its capacity to develop and implement policies is at the core of PFM performance. Progress toward an MoF Strategic Plan – initiated in May 2005 – will be very important in developing MoF's capacity and performance. PFM capacity development in line ministries also is very important but will take more time. Progress in this area will be measured by the finalization of an MoF Strategic Plan with monitoring indicators and achievements against these indicators.

xxiv. ***Fourth, and related to the previous recommendations, the Government should adopt a clear action plan to improve PFM performance, with time-bound milestones, quantified objectives, and clearly identified responsible agencies.*** This proposed PFM action plan would consist of a set of mutually supportive measures that are feasible, realistic, and sustainable, and that can generate a step-change in PFM performance each year. The action plan should in addition include (i) a reform communication plan (with staff in MoF, with the Cabinet and other Government agencies, with the Afghan people, and with the international community); (ii) a solid organizational and institutional plan; and (iii) a process to monitor actions and performance, review progress, and adjust the program. A detailed roadmap for improving PFM performance, which is linked to the PFM performance indicators and could form the basis for annual action plans, is presented in the form of a matrix at the end of this

report (see Table 10.1). Progress in implementing the action plan could be measured by the key fiscal outcomes as well as progressive improvement of the MTFF, and by the PFM performance indicators presented in this report. Monitoring of progress, along with a meaningful feedback loop into subsequent decision-making, will be as important as the action plan itself.

xxv. ***Finally, continuing and further deepening collaboration between the Government and the international community will be critical for the success of the reform program.*** The Government's development strategy – which may include plans toward fiscal sustainability, more effective service delivery, capacity development, and strengthened PFM performance – should serve as the basis for a framework of mutual accountability. Donors would align their support to national strategic objectives and the national budget and increasingly use the Government's systems, while the Government would implement the decisions it has announced and further improve the performance of the PFM system. In addition, the content, mode, and capacity-building contribution of technical assistance will be very important and needs to be well-managed and well-coordinated in line with Government leadership and national budgetary and other capacity-building processes.

xxvi. ***Way forward.*** Not surprisingly in view of the major challenges that Afghanistan faces, this is a multi-faceted, demanding, and ambitious medium-term agenda. Each of the five elements includes difficult sub-agendas and important actions required for success. This points to the need to prioritize and focus on a set of realistic yet meaningful short-term measures that will achieve significant improvements and step-changes, thereby setting the stage for further progress. A package of prioritized short-run actions could thus comprise a "platform" from which the next set of actions would take off, with monitoring and feedback to guide the process at each stage. Moreover the package, rather than any single measure or mechanical target, would be what the Government takes responsibility for and could form the basis for dialogue and agreements with the international community.

xxvii. In each of the five points of the agenda outlined above, a small number of key elements stand out as critical for a first platform (see table below). For instance, the MTFF provides a foundation on which the Government can subsequently anchor fully costed sector strategies. With implementation of the PFEM Law and Procurement Law, the Government will be able to establish its credibility in terms of managing public funds, better analyze patterns of public expenditures, and introduce more sophisticated PFM practices over time. Following the establishment of a track record of mutual accountability with donors, a higher share of external assistance could be channeled through the Government's systems.

xxviii. In this process, the Government first needs to develop and reach agreement on its strategy. The Afghanistan National Development Strategy (ANDS) needs to include or to be complemented by an MTFF and PFM action plan adopted by the Government, as well as an MoF reform strategy. Clear sector strategies also are needed to guide prioritization and sector expenditure programs. The ANDS and sector strategies need to specify the roles of the State and put forward sound approaches to ensure effective service delivery, differentiated by sector as appropriate (see Chapter 8). The sector strategies will take varying amounts of time to develop and, like the interim ANDS, MTFF, and PFM action plan, will need to be improved over time and adjusted in the light of experience. It is critically important that these strategies have wide national ownership, both within and outside Government.

xxix. The strategy as it applies to Public Finance Management would then be translated each year into annual plans that would consist of three building blocks: (i) an updated medium-term view of the fiscal path (MTFF); (ii) an annual budget consistent with the MTFF and ANDS; and (iii) an "annual action plan" (a list of a small number – certainly less than 20 – of key actions to be accomplished during the year). Successful implementation of this package (not necessarily all of the measures but at least a critical mass of most of them) would build the "platform" on which the following year's action plan could be based, leading to further progress subsequently. This type of process would help in coordinating the expectations of partners as to what the Government realistically will be able to achieve each year and, with adequate monitoring, would help the Government establish a strong track record of implementation. Adequate monitoring and evaluation should also feed back into the next year's annual plan and revisions to the overall strategy – this requires significant development of statistical and analytical capacity.

xxx. In conclusion, the five-point reform agenda outlined above is ambitious, requiring sustained efforts over a considerable period of time based on meaningful steps each year. But, as seen earlier, the challenges in building an effective, accountable, financially self-sufficient state that facilitates sustained economic growth, ensures adequate delivery of services to the Afghan people, and reduces poverty are enormous and pressing – requiring a commensurate response. The Government, with strong support from the international community, has demonstrated its willingness and commitment to embrace an agenda along these lines and move forward with implementation in a determined yet realistic manner. Building on the achievements of the past several years, the table below suggests key short-term priorities, progress indicators, and responsible entities to move toward the next level of strengthened PFM performance.

Key Priorities and Progress Indicators for Improving Public Finance Management

1. Moving Toward Fiscal Sustainability		
Progress will be measured by: • Increase in revenue to GDP ratio • Decline in ratio of operating expenditures to revenues • Progress according to fiscal targets in MTFF	*Suggested short-term priorities include:* • Further improve MTFF over time and use it for setting budget envelopes (Chapter 3) • Implement tax measures already gazetted, focus administrative reform on Customs and Large Taxpayer Office (Chapter 4)	*Implemented by:* • Cabinet • MoF
2. Improving Service Delivery		
Progress will be measured by: • Adoption of I-ANDS with monitoring framework • Progress according to indicators in ANDS monitoring framework • Improved alignment between budget and ANDS • Progress against monitoring indicators in sector strategies	*Suggested short-term priorities include:* • Improve alignment of budget and ANDS by correcting significant mismatches (Chapter 5) • Develop selected sector strategies with a service delivery focus (Chapter 8) • Enhance statistical capacity for monitoring and evaluation (Chapter 8)	*Implemented by:* • Cabinet • Line ministries • CSO
3. Developing Capacity of PFM Institutions		
Progress will be measured by: • Adoption of MoF reform strategy with monitoring framework • Progress according to indicators in MoF reform strategy	*Suggested short-term priorities include:* • Further develop and adopt MoF Reform Strategy (Chapter 9) • Pilot reform of administrative (finance / HR) department (including budget process) in MoF	*Implemented by:* • MoF • MoF
4. Improving PFM Performance		
Progress will be measured by: • PFM Performance indicators (Chapter 2) • Progress according to fiscal targets in MTFF	*Suggested short-term priorities include:* • Adopt PFM action plan (to be developed by MoF, Chapters 6, 7, 10); this would include *inter alia* implementation of PFEM Law (notably development of internal and external audit) and Procurement Law • Develop means for public engagement on budget matters (formulation and implementation)	*Implemented by:* • Cabinet • Parliament and civil society, supported by Government and donors
5. Deepening the Collaboration between the Government and the International Community		
Progress will be measured by: • Proportion of external assistance through budget channels	*Suggested short-term priorities include:* • Agree on a framework of mutual accountability • Agree on good principles for TA management, use of Government systems (Chapters 6, 7, 9)	*Implemented by:* • Cabinet and donors • Donors

CHAPTER 1. PUBLIC FINANCE IN AFGHANISTAN'S DEVELOPMENT

1.1 This report is the product of the Afghanistan Public Finance Management (PFM) Review. The main goal is to consolidate, deepen, and present in an accessible, action-oriented form the knowledge base on Afghanistan's public finance system, review recent progress, analyze key challenges, and put forward options and recommendations for moving forward. The report consists of this main volume plus four other volumes, covering PFM performance and procurement (Volume II); key cross-cutting issues (Volume III); selected sector case studies (Volume IV); and security sector expenditures (Volume V).

1.2 This work has been carried out by the World Bank in collaboration with other agencies working on specific areas: IMF (revenue), DFID (state-owned enterprises, security), the European Commission (highways), and ADB (procurement). The team has worked closely with the Government of Afghanistan, especially the Ministry of Finance (MoF).

1.3 The objectives of the PFM Review as a whole have been to (i) respond to specific Government requests, in particular by MoF; (ii) provide inputs for and support to Afghanistan's annual budget cycle; and (iii) consolidate and deepen knowledge of Afghanistan's public finances, including assessment of fiduciary aspects (financial management and procurement). The process involved extensive interactions with MoF and other Government agencies, and produced numerous intermediate products providing technical inputs on specific topics of interest to the Government (see list of additional documents prepared, p. 99). Specific stages and activities during the PFM Review process are outlined in Box 1.1.

Box 1. 1: Highlights of the PFM Review Process

The Afghanistan PFM Review has been very much oriented toward real-time learning and interactions in partnership with the Government, particularly MoF. In this regard, responding in a timely manner with technical inputs and discussions on topics of immediate relevance to Afghanistan from a PFM perspective was given highest priority. Selected activities which occurred as part of the PFM Review are listed below, along with some key milestones.

Initial discussions with MoF and other Government agencies on PFM Review (July-September 2004): The concept, content, and rationale for a PFM Review by the World Bank were discussed with Government officials, and feedback was obtained. Specifically, MoF requested that the PFM Review include analysis of the security and mining sectors.

Initiation of PFM Review task (September 27, 2004): Internal World Bank meeting reviewed the concept paper for the PFM Review, endorsed moving ahead, and provided guidance from Peer Reviewers. Terms of reference for each component of the Review were subsequently prepared and agreed with MoF.

PFM Review mission (November 28-December 19, 2004): A sizable team of World Bank staff, joined by team members provided by DFID, the EC, and other agencies, visited Afghanistan during this period for information gathering and discussions on the whole range of topics covered in the PFM Review, including institutional, cross-cutting, sectoral, and financial management/procurement aspects. In particular, in response to a request from MoF, a World Bank member of the PFM Review team worked intensively with MoF officials on the restructuring of MoF Treasury and Accounting Departments and prepared a technical paper outlining issues and options.

Discussions on security sector expenditures (December 2004 – May 2005): Analysis of security sector expenditures was initiated during the December 2004 mission and continued thereafter. Major findings, in particular related to fiscal sustainability issues, were shared with the Government, and a short paper was prepared.

Inputs for 1384 (2005/06) Budget (January-March 2005): During this period, the team produced and shared with the Government several technical papers on relevant topics for the 1384 Budget then under preparation. Examples include papers on budget formulation, the Government wage bill, medium-term fiscal issues, and state-owned enterprises.

Internal reviews (mid-term: February 6, 2005 and final: October 24, 2005) to assess progress and outcomes.

Meetings and workshops on MoF strategic planning and reform (May 22-30, 2005): At the request of the Ministry, World Bank staff helped facilitate a series of meetings on the development of a strategic planning/reform process in MoF. Earlier a draft "vision paper" for MoF had been prepared, and in May-June a more detailed paper outlining a possible approach to MoF strategic planning/reform was drafted and shared with MoF.

Ongoing discussions on the PFM Performance Assessment (January-August 2005): a draft of the assessment (see Chapter 2 and Volume II, Part 1) was shared and discussed with the Government, which decided to release it on the website of the *Afghanistan Development Forum* (April 2005). Further discussions were held in May and August around this assessment, and it was subsequently presented by MoF to donors at a local Consultative Group meeting.

1.4 The scope of the PFM Review is intended to be comprehensive, including revenue, procurement, financial management, and fiduciary issues as well as more traditional Public Expenditure Review (PER) topics. There is also a focus on institutional and capacity aspects. The coverage of different sectors, however, is not complete but is intended to provide selected examples. Given the comprehensive scope of the PFM Review, this volume inevitably is highly condensed; more details are available in the other volumes and additional background papers.

1.5 This overview report has ten chapters. This first chapter discusses the contribution of public finance to Afghanistan's reconstruction and development and key challenges. Chapter 2 provides a framework for assessing the performance of a country's PFM system and an evaluation of Afghanistan's current PFM performance. Chapter 3 focuses on the key imperative of progressing toward fiscal sustainability in the medium-term, highlighting possible fiscal scenarios and fiscal risks. Given the critical importance of mobilizing domestic revenue, Chapter 4 is devoted to this issue. Moving from the aggregate level to the sectoral and subsectoral level, Chapter 5 looks at prioritization and allocation of expenditures across and within sectors. Turning to process issues, Chapter 6 discusses budget formulation and making the national budget the central instrument of policy and reform. Chapter 7 is about the budget execution process, including getting funds to service delivery units, controlling use of public funds, improving public sector procurement, and enhancing accountability. Chapter 8 looks at service delivery, presenting some models and examples and also discussing subnational strategy from a service delivery perspective. Chapter 9 analyzes the critical issues of institutional reforms and capacity development in relation to public finance management. Chapter 10 provides a closing summary of key challenges along with a roadmap for improving the performance of Afghanistan's PFM system. The Statistical Appendix presents key macroeconomic, social, and fiscal data.

1.6 Afghanistan's reconstruction has made considerable progress during the past three years. Led by the Government with international support but relying most on the energy and initiative of the Afghan people, reconstruction has already resulted in solid achievements – for example rapid economic growth, unprecedented primary school enrollments including for girls, great expansion of immunization, rehabilitation of major highways, a new and stable currency, promulgation of a new Constitution, Presidential and Parliamentary elections, return of refugees, and demobilization of militias. Yet the challenges remain enormous. The role of public finance in contributing to national achievements and in meeting challenges in the future is the main subject of this chapter. The chapter starts by reviewing recent economic performance and the development strategy pursued by Afghanistan. It then discusses the contribution of public finance management to these achievements and the role that it will need to play in the future. The chapter ends by briefly outlining some key public finance issues faced by the country in its efforts to achieve national objectives of growth, state-building, and poverty reduction.

A. Economic Performance and Challenges and Development Strategy

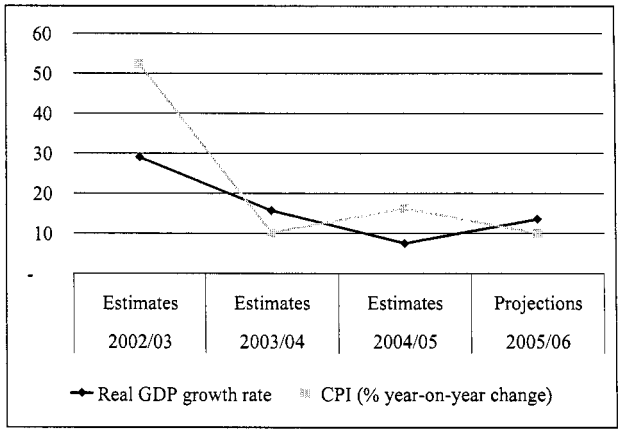
PROGRESS AND PROBLEMS

1.7 ***Economic growth***. Afghanistan's economy has rebounded since 2001, stimulated by the end of major conflict, good precipitation for agriculture, the initiation of reconstruction activities, and strong demand and financing from opium, remittances, and reconstruction aid inflows. Economic growth has generally been at double-digit rates (averaging 20% p.a. during 2001-2004), and is expected to continue in the 10% per year range (Figure 1.1). However, recent growth has been based largely on one-time, unsustainable, or undesirable (opium) factors and appears to have been concentrated in urban areas, notably Kabul. Moreover, the predominantly informal Afghan economy (outside the formal legal framework and largely outside the tax base) is also a constraint on future development, despite its benefits in many respects. As argued by the Government's *Securing Afghanistan's Future* report, Afghanistan will need to achieve sustained economic growth on the order of 9% per year over the next decade or so in order to phase out opium production while maintaining per-capita income growth at reasonable levels. The key challenge therefore is to transform recent rapid growth into robust, sustainable growth over the

medium term, based on private investment and increasingly competitive production, with strong growth of exports.

1.8 ***Macroeconomic stability.*** In contrast with the hyperinflation Afghanistan suffered from in the 1990s and unlike experience in many post-conflict situations, inflation has been kept well under control (Figure 1.1), and the exchange rate has been stable. Particularly noteworthy has been the successful introduction of a new currency to replace the multiple, severely devalued currencies inherited from the 1990s. Prudent, conservative fiscal policy (embodied in the "no-overdraft rule") and sound monetary policy have contributed to price stability, and external financing has covered Afghanistan's large trade deficit and contributed to exchange rate stability. One concern is that the significant albeit controlled level of inflation (on the order of 10% per year) combined with exchange rate stability are symptomatic of a "Dutch-disease" type of problem, whereby resource inflows due to opium, remittances, and aid drive up domestic prices and costs, making it difficult for the Afghan economy to produce for export or compete against imports, exacerbating the other obstacles to private investment and activity. Overall, however, the macroeconomic achievements compare favorably with other post-conflict countries (World Bank, 2005a).

Figure 1. 1: Economic Growth and Inflation



Source: IMF.

1.9 ***Private sector development.*** Afghanistan's private sector, predominantly informal as noted earlier, has been flexible and responsive and has contributed to the economic recovery. However, there are serious weaknesses in the business environment (e.g. lack of access to electricity, land, and finance, problems with corruption as well as numerous illicit levies and "nuisance taxes" in the fiscal sphere, see Chapter 4 and World Bank, 2006) and in private sector capacity, which need to be rectified if the private sector is to become the "engine of growth" for Afghanistan's economy.

1.10 ***State building.*** In addition to implementation of the Bonn process of political normalization including promulgation of a new Constitution, significant progress also has been in other aspects of state building. This includes restoring at least a minimal degree of Government functioning, paying civil servants on time, and initially bringing capacity in from outside followed by efforts to build capacity within Government on a selective basis. However, capacity in most of the Government is still grossly deficient, services are not being delivered, and disproportionate staffing and resources are concentrated in Kabul. Subnational administration for the most part is plagued by lack of capacity; extremely limited financial resources (particularly non-salary allocations); and the emergence of multiple parallel mechanisms at subnational level, outside of Government leadership. Thus there are numerous challenges in the area of state building, and public finance will have to play a critical role in meeting them.

1.11 ***Security.*** Security is widely considered as the number one short-run issue for Afghanistan's reconstruction. There have been undoubted improvements, including formation of the Afghan National Army (ANA), disarmament and demobilization of armed militias, initial progress in interdiction against drug trafficking, etc. However, different types of insecurity remain endemic in many parts of the country,

ranging in severity up to outright conflict in some areas. Reforms in the police and especially in the judicial system have lagged far behind the development of the ANA. Another challenge is that the development of security forces is proving to be costly, with serious questions about the fiscal sustainability of security sector expenditures (see Chapter 3 and Volume V).

1.12 ***Infrastructure.*** Road investments, both rehabilitation of Afghanistan's main highways and building smaller and rural roads, have moved ahead, although implementation has been in some cases slower than desired for various reasons including security, and costs of highway rehabilitation have tended to be high (see Volume IV, Chapter 5). Progress has been much slower in other sectors such as power and irrigation; financing of infrastructure is not on a sustainable basis; many state-owned enterprises are defunct; and there are major regional differences and gaps.

1.13 ***Human development.*** Primary school enrollments have reached unprecedented high levels (54% in 2003) including for girls (40%), and basic health services are expanding while immunization campaigns have sharply increased coverage since 2001. Progress has also been made in reviving tertiary education. Nevertheless, primary enrollments remain far below international norms especially for girls, with wide regional gaps especially by gender. Access to health is still problematic in many rural areas, especially for females. There are serious quality problems at all levels of education, and differences in levels of service provision are dramatic (see Chapter 6).

1.14 ***Narcotics.*** The opium economy – linked with insecurity, anti-state interests, poverty, weak governance, and economic distortions – is an enormous problem and challenge for Afghanistan's development. Modest progress has been made in interdiction against drug trafficking, and opium cultivation has been greatly reduced in some areas, but it has grown rapidly elsewhere and is now found in all of the country's 34 provinces. Large numbers of people – farmers, wage laborers, traders, militia forces, commanders, government officials – are involved in the drug business. The nexus between drugs, insecurity, warlords, and weak government is a profound threat to state-building and reconstruction.

DEVELOPMENT STRATEGY

1.15 ***Progress achieved.*** The Government articulated a compelling vision of the country's future in the *National Development Framework* promulgated in 2002, and then with a more specific program in *Securing Afghanistan's Future,* presented at the Berlin Conference in 2004. More recently, the Government's documentation for the 2005 Afghanistan Development Forum presented a comprehensive overview of development issues and challenges, as well as Government plans. Progress has been slower in building ownership for this vision across the Government, consulting with civil society, and ensuring that Government policies and decisions are in line with national strategic objectives and priorities.

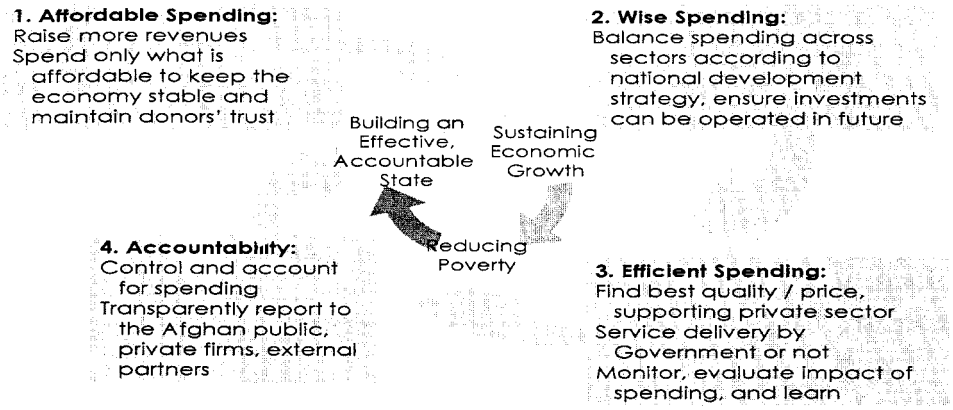
1.16 ***Preparation of the National Development Strategy.*** The Government is currently reviewing, updating, modifying, and refining its development vision and strategy, including through widespread consultations within the Government. The interim Afghanistan National Development Strategy (ANDS) is expected to be approved by the Cabinet, presented to Parliament (for which elections were held on September 18, 2005), and discussed at a high-level donor meeting planned for January 2006.

1.17 ***Strategic foundation for public finance management.*** As will be discussed later in this report, it is essential that there be a close linkage between development strategy and medium-term fiscal planning as well as annual budgeting. In this regard, the Government intends that the ANDS will form the strategic anchor for the 2006/07 National Budget. It is also very important that the ANDS embody a medium-term fiscal framework (MTFF) to guide fiscal policy and reforms as well as public sector resource allocation.

B. The Contribution of Public Finance

1.18 Public finance has played and will continue to play a critical role in contributing to economic stability, growth, and poverty reduction, and in enabling the government to perform effectively and deliver public services to the Afghan people. Key linkages between public finances and the strategic objectives of growth, state building, and poverty reduction are shown in Figure 1.2.

Figure 1. 2: Linkages between Public Finance and Strategic Objectives



1.19 In order to promote sustained economic growth, building an effective, accountable state, and reducing poverty, public finances must be: (i) affordable (dynamically growing revenues and expenditures under control); (ii) prioritized in terms of allocation across sectors in accordance with national strategy, and over time so that investments made today can be effectively operated and maintained in the future; (iii) efficient in the sense of value for money and service delivery; and (iv) accountable and transparently reported to the Afghan public and other stakeholders.

1.20 On the negative side, weaknesses in public finance can be very harmful for development. As discussed in Box 1.2, poor fiscal management can lead to hyperinflation. It can also result in failure to prioritize spending among sectors and programs and reduced development effectiveness. Problems in budget execution (payments, procurement, accounting) can lead to waste of resources and poor value for money. And lack of accountability and transparency can generate corruption and loss of public support.

Box 1. 2: Bad Public Finance Management is Bad for Development

Afghanistan's history in the 1990s, as well as examples from many other countries, highlights that poor public finance management adversely affects national development in a number of ways:

At the aggregate level, lack of a credible, realistic, policy-based (including a medium-term dimension), and reasonably comprehensive budget can result in high inflation and macroeconomic instability, and a crisis for the currency and for external relations. As inflation tends to hurt the poor most severely, poverty can be exacerbated. Reducing expenditures in such a crisis situation usually means cutting discretionary spending (including investments, non-wage operating costs), and being excessively aggressive in striving to raise domestic revenues penalizes economic activities. Lack of affordability over the medium-term often is manifested in inability to operate and maintain public facilities and service delivery networks – deteriorating roads, inability to pay for fuel for power stations, hospitals unable to pay for running costs, health facilities without medicines, schools suffering from lack of maintenance and educational materials, etc. Such adverse outcomes disproportionately harm the poor, as they typically have few alternatives whereas better-off people are often able to arrange private alternatives to essential public services.

At the sector level, a weak budget process can result in misallocations of resources and mismatches with national priorities, less value for money, and, in the end, inadequate service delivery.

At the level of individual programs and activities, lack of a sound budget process can result in resources being wasted, roads built to inappropriate standards; power capacity constructed without finances for fuel and operations; hospitals opened without funding, medical staff, equipment, and medicines to run them; etc.

Weaknesses in procurement, insufficient financial data given to line managers, and initial delays in making payments outside Kabul have also been a constraint on the efficiency of public expenditures. If the procurement system is too complex, there is limited participation in particular from Afghan contractors, and contracts end up being more expensive. On the other hand, if the procurement system does not ensure adequate competition and sound technical review, there is a risk that opportunities for higher quality standards and lower prices stemming from competition are missed. Lack of fiduciary safeguards in procurement can result in outright corruption and poor value for money.

Failure to generate information on development results, on contract awards, on financial accounts, or on audits contributes to suspicion and lack of trust between the Government and the people. A mismatch between the Government's capacity and its policy decisions can also weaken the legitimacy of the Government, and is likely to reduce the willingness of the international community to come forward with longer-term financial contributions.

Source: PEFA (2005), especially Appendix 1.

1.21 ***PFM achievements***. In a difficult post-conflict situation, Afghanistan has made remarkable progress on the fiscal front (see Table 1.1). Despite pressures, ***fiscal discipline*** has been strictly enforced and maintained, including control over the Government wage bill. Although the fiscal deficit (before grants) understandably has been very large in the context of post-conflict reconstruction, expenditures have been contained within the level of resources available from domestic revenues and external assistance, and there has been no resort to domestic borrowing to finance the budget. This has been the essential ingredient of macroeconomic stability (see above). ***Domestic revenues*** have increased substantially, growing at an average annual rate of 60% per year from 2002/03 to 2004/05, rising from 3.2% of GDP to 4.5% in this period. Revenue mobilization has been supported by wholesale reform and rationalization of customs duties as well as the income tax regime, and initiatives are underway to strengthen the customs administration. Major efforts have been made to improve the ***budget process,*** and it has come a long way since the first post-Taliban budget of 2002/03 (see Chapter 6). An initial Medium-Term Fiscal Framework (MTFF) has been approved by the Cabinet. ***Budget execution*** also has greatly improved in many respects – not least, most civil servants are now being paid, on time. Finally, the Government has made a strong commitment to ***financial transparency and accountability,*** which has been manifested in a number of ways and has resulted in adequate fiduciary performance albeit based on an injection of external capacity. These achievements have provided confidence to donors resulting in mobilization of high levels of external support for the national budget, mainly through the Afghanistan Reconstruction Trust Fund (ARTF) which finances most of the civilian recurrent budget (Box 6.2).

Table 1. 1: Fiscal Outcomes ($ million)

	2002/03 Budget	2002/03 Est.	2003/04 Budget	2003/04 Est.	2004/05 Budget	2004/05 Est. a/	2005/06 Budget
				(In millions of US dollars)			
Domestic Revenue	**62**	**129**	**184**	**208**	**322**	**269**	**333**
Donor Assistance Grants (to operating budget) b/	**283**	**208**	**322**	**206**	**313**	**314**	**345**
Donor Assistance Grants (to core development budget)	**-**	**-**	**-**	**93**	**772**	**173**	**714**
Total Expenditure (Core Budget)	**345**	**342**	**505**	**614**	**1,706**	**874**	**1,887**
Operating Expenditure	**345**	**342**	**505**	**449**	**635**	**558**	**678**
Wages and Salaries c/	...	...	264	282	377	374	460
Purchase of goods and services	...	...	133	87	101	110	83
Debt service and Interest payments	...	...	-	1	6	2	8
Other recurrent	...	...	20	18	43	30	22
Capital expenditure	..	...	34	61	37	41	47
Reserves and Contingencies	...	...	53	-	70	-	57
Core budget development spending d/	**-**	**-**	**-**	**165**	**1,072**	**317**	**1,209**
By Program	**345**	**342**	**505**	**614**	**1,706**	**874**	**1,887**
Human Capital Development	...	...	187	130	470	349	575
Physical Infrastructure	...	...	24	142	380	152	584
General Administration	...	..	48	106	129	81	258
Security	...	...	193	235	354	292	384
Reserves and Contingencies	...	...	53	-	374	-	86
Operating budget balance (excluding grants)	**(283)**	**(213)**	**(322)**	**(241)**	**(313)**	**(289)**	**(345)**
Operating budget balance (including grants)	**-**	**(5)**	**0**	**(35)**	**0**	**25**	**0**
Core budget balance (including grants)	**-**	**(5)**	**(0)**	**(107)**	**(300)**	**n/a**	**(494)**
Float and Adjustment	**-**	**(14)**	**0**	**3**	**300**	**53**	**2**
Financing	**-**	**19**	**-**	**104**	**-**	**66**	**492**
External Loans (net)	-	-	-	100	-	309	492
Domestic (net)	-	19	-	4	-	(243)	1
				(In share of GDP)			
Revenues	1 5	3.2	4.0	4.5	5.4	4.5	4.7
Donor Grants	6.9	5.1	7.0	6.5	18.1	n/a	14.9
Total Expenditure (Core Budget)	8.5	8.4	11.0	13.4	28.6	14.6	26.5
Operating Expenditure	8.5	8.4	11.0	9.8	10.6	9.3	9.5
of which wages	...	...	5.8	6.2	6.3	6.3	6.5
Development Expenditure	-	-	-	3.6	17.9	5.3	17.0
Operating budget balance (including grants)	-	(0.1)	-	(0.8)	-	0.4	-
Core Budget Balance (including grants)	-	(0 1)	(0.0)	(2.3)	(5.0)	n/a	(6.9)
Memorandum item:							
External Budget (US$ million)	-	503	1,955	2,182	3,448	2,503	3,180
Exchange Rate (AFA per USD)	45.3	45.3	49.0	49.0	47.8	47.7	48.5
GDP (US$ million)	4,084	4,084	4,585	4,585	5,975	5,975	7,130

a/ Preliminary annual statements.

b/ Financing data based on IMF reports (ARTF for 2004/05 estimate and 2005/06 budget)

c/ For 2002/03 to 2004/05, includes an estimate of in-kind food given to employees of the Ministry of Interior, Defense, and National Security (this amount is shown under "purchase of goods and services" in the Government's budget).

d/ The 2004/05 budget includes US$304 million shown as "unallocated" in the original budget.

Source: MoF documents, IMF.

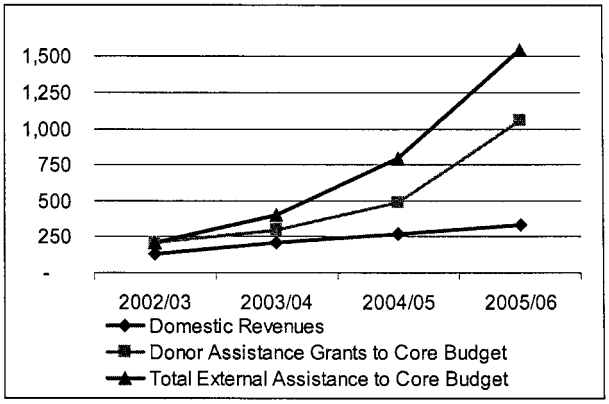
1.22 These achievements have been supported by ***institutional improvements and capacity development***, notably in MoF. So far, improvements have been to a large extent dependent on external capacity brought in on an "emergency" basis to get things going. Examples include budget formulation, payments and reporting, procurement, audit, and support to central banking functions. However, some progress has also been made in building national capacity in the fiscal realm on a more sustainable basis, for example in the Treasury and certain other departments of MoF. The shift from reliance on external capacity to sustainable core Government capacity for key public finance functions has only just started for the most part, and there are also very serious weaknesses in public financial management capacity in the line ministries (Chapter 9).

C. Key Public Finance Issues

1.23 Despite the real progress made in many areas, fiscal challenges remain daunting. Among the key of public finance issues for the coming years are the following.

1.24 ***Extremely low domestic revenue.*** Afghanistan's revenue to GDP ratio (below 5%) is one of the lowest in the world (it would be even lower if the opium economy were included in GDP), well below half the level achieved by most poor countries. Only around 8% of total budgetary spending is covered by domestic revenue. This constitutes a major constraint and liability for the country, necessitating substantial reliance on external assistance for the operating budget, which donors generally are reluctant to provide in most country contexts. Figure 1.3 highlights that domestic revenues are much smaller than external assistance, and that the gap between the two has increased sharply in recent years due to the rapid growth of aid. Thus sustained rapid growth of revenue and a rising revenue-to-GDP ratio are imperative.

Figure 1. 3: Domestic Revenues and External Assistance, $ million



Note: Original budget for 2005/06. Source: MoF, IMF.

1.25 ***A challenging expenditure structure.*** Strikingly, public expenditure in Afghanistan not only is very large (57% of GDP in 2004/05) but is dominated by external financing. Only a quarter is channeled through national Treasury and budgetary procedures (the "Core Budget"): three quarters is executed by donors through implementing agencies contracted directly by them (the "External Budget", see Figure 1.4). This constitutes a major challenge – for both Government and donors – in budget management. In this regard, Box 1.3 highlights key issues related to aid effectiveness.

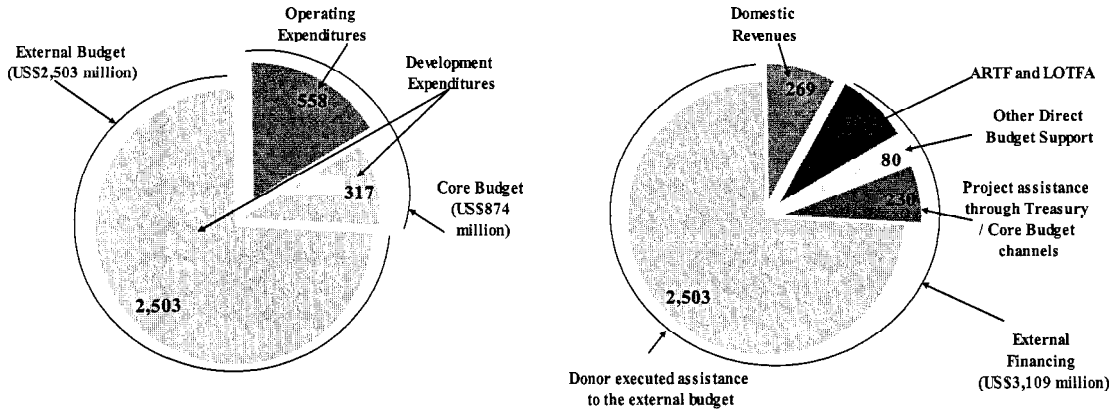
1.26 ***The need to further improve the budget process.*** In order to make the national budget the central instrument of policy and reform it must become more strategic (with expenditures linked to the Afghanistan National Development Strategy), multi-year in its orientation (anchored in a Medium-Term Fiscal Framework), integrated (as between the recurrent and development budgets), and with strong political buy-in and ownership (Cabinet, Parliament, public).

1.27 ***Sustainability of expenditures.*** Massive expenditures are occurring in areas like security, counter-narcotics, and highway rehabilitation and road construction, mostly through the External Budget.

In addition, social services like education and health are being sharply expanded. These investments and programs are creating substantial expenditure liabilities for the future – roads will need to be maintained, teachers paid, and the sustaining costs of the Afghan National Army (ANA) and other security services covered. The same will be true of investment programs in sectors like electric power and irrigation. The challenge in this regard is two-fold: (i) public spending – both aggregate and at the sector level – needs to be increasingly based on a medium-term vision of what the public sector can and will deliver, within a sustainable fiscal resource envelope, and (ii) a variety of funding sources for operation and maintenance (O&M) will need to be developed as appropriate in the sector and program context, getting away from relying primarily on budgetary funds.

Figure 1. 4: Expenditure Structure and Financing, 2004/05 Estimates

1.3a. Expenditure **1.3b. Financing**



Source: MoF preliminary financial report; Staff estimates.

1.28 ***Problematic salary structure and weak public administration.*** A key driver of spending is Government staffing and salaries. Afghanistan's civil service is not large by international standards, but it is not very effective, and many staff lack required skills and qualifications. Severely eroded by a decade of hyperinflation and sharply compressed by across-the-board cash allowances, the salary structure is dysfunctional and inadequate to attract and retain qualified people for managerial and technical positions. The Priority Restructuring and Reform (PRR) program is intended to provide a short-run remedy by allowing some qualified staff to be paid more on a temporary basis. Key challenges include: (i) implementing an appropriate (and affordable) pay and grading structure across the public sector; (ii) fully implementing merit-based recruitment and promotion practices; (iii) handling appropriately the many civil servants whose skills and qualifications are inadequate for a reformed public administration; and (iv) restructuring organizations for greater effectiveness.

1.29 ***Need to further strengthen fiduciary systems on a sustainable basis.*** While considerable progress has been made in developing the legal framework and in installing adequate fiduciary systems, these have relied largely on external capacity provided by firms contracted by the Government. Although understandable, even essential as short-term measures, these mechanisms are not sustainable and will have to progressively give way to national fiduciary systems based on core Government capacity. Getting procurement right is of particular importance in view of the downside risks associated with weak procurement practices (Chapter 5). Financial management in line ministries is another area of weakness where major improvements will be needed.

1.30 ***Poor service delivery.*** While much has been done to improve public finances in Afghanistan, it will not mean anything if it does not translate into delivery of essential public services to the Afghan people, with widespread access and adequate quality (Chapter 8). There has been progress in some areas (e.g. telecommunications, health, and education – based on very different models), but many public services remain grossly inadequate, giving rise to widespread public complaints. The challenge of

improving service delivery is multi-fold and will require capacity building (see below), good financing arrangements, sound institutions, and appropriate incentives and accountability frameworks. Service delivery mechanisms need to vary in accordance with the characteristics of the service concerned; the market structure, ability to introduce competition, etc.; and the appropriate role of the state.

1.31 ***Lack of sustainable Government core capacity.*** The progress achieved in most aspects of public finance management so far is fragile and excessively dependent on unsustainable external capacity. Thus building core Government capacity that will outstay the current large aid inflows and associated injection of external capacity will be essential (Chapter 9). Capacity development is at the heart of public administration reforms but also involves related aspects like making the best possible use of external technical assistance and ensuring that it helps build sustainable Government capacity as opposed to substituting for or detracting from it.

1.32 Addressing these issues will be discussed in more concrete detail in subsequent chapters, following an overview of the performance of Afghanistan's PFM system in Chapter 2.

Box 1. 3: The Challenges of Increasing Aid Effectiveness

Given its low revenue base (Chapter 4) and the enormous needs for reconstruction (Chapter 5), Afghanistan very much needs external assistance (Chapter 3). With external assistance above 40-50% of GDP (Figure 6.1) and above 90% of public expenditures, the importance of increasing aid effectiveness cannot be overstated. In 2003, Afghanistan was among only seven countries in the world with an aid to GDP ratio above 30% (with Burundi, Congo, Eritrea, Guinea-Bissau, Sierra-Leone, and Timor-Leste). However, in other post-conflict countries aid has often declined after a few years even though such declines correspond with the period of time when absorptive capacity and aid effectiveness increase (World Bank, 2003a). This box reviews some of the critical challenges of aid effectiveness.

First, at the macroeconomic level, these massive **inflows of foreign exchange** – compounded by very large flows resulting from opium exports – challenge the management of monetary and exchange rate policies. These inflows increase demand for goods and services. Whereas demand for tradables can be met by an increase in imports, increased demand for nontradables may encounter production bottlenecks, resulting in price increases, pushing up the real exchange rate. There is considerable uncertainly about this effect, known as "Dutch Disease", but the magnitude of foreign exchange inflows and capacity constraints in Afghanistan require that this risk be monitored and managed. Certainly, the impact on the skilled labor market in Afghanistan is marked (Chapter 9).

Second, also at the macroeconomic level, is the issue of **aid predictability**. International experience indicates that aid can be more volatile than domestic revenues. This is challenging in terms of maintaining a stable macroeconomic environment. Uncertainty about available resources also makes budget preparation more complex. This requires donors to provide as much predictability as possible to the Government, as well as reducing the constraints attached to their support (notably in the form of project earmarking). On the Government's side, an adequate budget formulation process is required, as well as a cautionary approach to programming pledges from donors (to make the budget realistic, some countries systematically discount pledges by as much as 30%). Chapter 6 explores these issues.

The third, related issue is **fiscal sustainability**, including the risk of "aid dependency." Afghanistan's severe fiscal constraint is of course eased by significant aid inflows – but these inflows are difficult to manage. First, for a number of decisions it has to make (e.g. pay and grading reform; investment decisions with downstream maintenance costs), the Government needs clarity from donors on their medium-term support. Second, there is a risk that incentives to raise more domestic revenues could be reduced by massive external assistance, also jeopardizing medium-term fiscal sustainability. This requires the Government to be upfront in preparing a Medium-Term Fiscal Framework (MTFF) and donors to establish a good dialogue around such a framework (Chapter 3).

Fourth, massive aid inflows have implications for **strategic sector allocations**. Chapter 5 reviews these issues, stressing the role of a Government-led strategic plan to guide budget allocations. This is especially important for building the State, where the Government can demonstrate its stewardship of the reconstruction process. This issue is related to the previous one: aid not only could be ineffective if not well spent, it could make Government's budget ineffective if aid forces the Government to use its resources to operate and maintain low-priority or low-quality investments.

Fifth, making aid effective requires **adequate delivery and management mechanisms**. At the very minimum, donors should follow the Government's strategic leadership and report to the Government on expenditures. More systematic use of Government systems can increase aid effectiveness, reducing the burden on the Government's limited capacity (e.g. to prepare dedicated reports, see Chapters 6 and 7) and clarifying accountability. However, the Government does not need to create the capacity to itself deliver a large development program. The modalities of aid delivery (including parallel mechanisms, Chapter 8, and technical assistance, Chapter 9) require attention. Finally, the implications of large amounts of external assistance for vulnerability to corruption need to be monitored (Chapter 7).

CHAPTER 2. ASSESSING PERFORMANCE IN PUBLIC FINANCIAL MANAGEMENT

2.1 The challenges outlined at the end of Chapter 1 need to be addressed in a systematic way that transforms Afghanistan's public finance management (PFM) system into a highly effective enabler of national development through its beneficial impact on fiscal and budgetary outcomes. Assessing the current and future performance of the PFM system provides a basis for evaluating progress and identifying areas of weakness for priority actions. A PFM performance rating system has been recently developed by the Public Expenditure and Financial Accountability (PEFA) multi-agency partnership program, which is intended to provide an objective, internationally comparable framework for assessing the performance of a country's PFM system (see PEFA, 2005). This framework is outlined below, followed by a summary of the performance of Afghanistan's PFM system against the PEFA indicators.

A. A Framework for Analysis and Action

2.2 The PFM system and the PEFA indicators do not attempt to measure fiscal outcomes, the substantive appropriateness of public expenditure policies and decisions, or the actual impacts and value for money achieved through public expenditures. The PFM system instead should be seen as a crucial enabler for achieving broader development goals and substantive outcomes (including in the public finance sphere), which depend on sound Government strategies, policies, and institutions. The discussion below starts from outcomes and moves to processes and the linkages between them.

2.3 ***Three levels of budgetary outcomes.*** The outcomes of a country's PFM system can be assessed in terms of three levels, all of which have wider implications for national development (Figure 1.2):

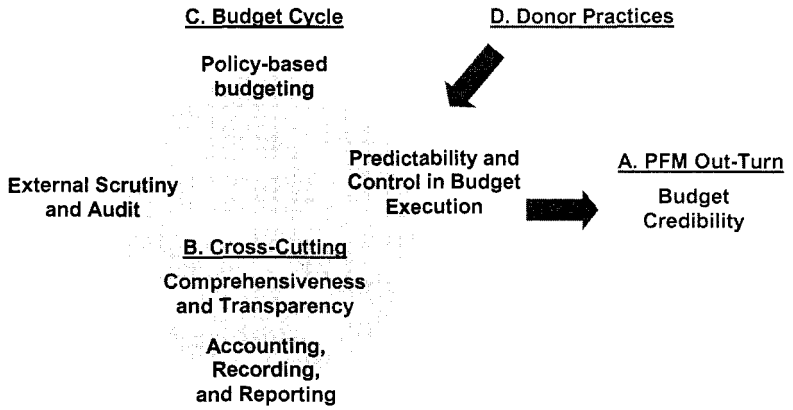
- *Budgetary aggregates and overall fiscal discipline* (including fiscal sustainability from a medium-term perspective). Desirable outcomes include macro-fiscal balance and low inflation in the short run, and fiscal sustainability or (in the case of Afghanistan) sustained progress toward fiscal sustainability over the medium term.
- *Strategic allocation of resources across sectors and programs* in accordance with Government priorities to implement national objectives. Desirable outcomes include allocation of public sector resources across programs based on an agreed development strategy, allocation of resources within programs based on sound sector strategies, and allocation of expenditures over time in line with appropriate prioritization (e.g. taking into account recurrent cost implications of public investments and staffing decisions).
- *Managing the use of budgetary resources* in the interest of efficient service delivery and value for money. Desirable outcomes include cost-effective service delivery, avoidance of waste or corruption, proper accountability for use of resources, etc.

2.4 ***Critical dimensions of PFM performance.*** Turning from broad budgetary outcomes to the performance of the PFM system itself (as "enabler"), PEFA has identified six critical dimensions of a well-functioning PFM system. Four of these comprise important parts of the budget cycle (policy-based budgeting; predictability and control in budget execution; accounting, recording, and reporting; and external scrutiny and audit – see Figure 2.1). Another relates to key cross-cutting features of the budget process, i.e. comprehensiveness and transparency, and the last covers out-turns of the PFM system, namely the credibility of the budget. Figure 2.1 also signals that, given donors' importance in providing financial support to many developing countries, donor practices have a significant impact on the performance of the PFM system.

2.5 ***PFM indicator set.*** In order to operationalize the PFM performance assessment framework, 28 high-level PFM performance indicators have been developed, each of them measuring performance in one

of the six critical dimensions. Three additional indicators of donor performance have also been developed. As indicated earlier, the PFM performance indicators measure how key parts of the budget process are working, cross-cutting features of the budget, and whether the budget is credible (as demonstrated by its out-turn). These are of critical importance as enabling factors for achieving national development and fiscal objectives.

Figure 2. 1: Linkages Among the Six Core Dimensions of PFM Performance



Source: PEFA (2005, p. 4).

2.6 ***Overall structure of the PFM performance measurement framework.*** Assessment of the high-level PFM performance indicators provides an evaluation of performance in terms of the six core dimensions of the PFM system, which in turn leads to an assessment of the performance of the PFM system in achieving key desired outcomes (aggregate fiscal discipline, strategic allocation of resources, and efficient service delivery). A model for a PFM performance assessment is presented in PEFA (2005) and applied to Afghanistan in Volume II, Part 1.

B. The Performance of Afghanistan's PFM System

2.7 The full list of indicators along with the ratings for Afghanistan, which reflect an assessment of the PFM system's performance as of June 2005, is shown in Table 2.1. The assessment is discussed in detail, rating by rating, in Volume II, Part I; it is summarized below under the six critical dimensions of a PFM system. The situation in Afghanistan has some special features which need to be kept in mind when interpreting the ratings. First, some ratings reflect temporary factors (for instance the absence – at the time of the assessment – of a Parliament). Second, some ratings are based on changes made recently, and it is still uncertain whether these changes will be sustained. Third, the ratings assess the current situation in which significant external support (both advisory and operational) is being provided to the Government; in several areas, this raises sustainability issues as the external support will decline over time, especially in relation to financial management operations.

2.8 ***Credibility of the budget (Performance Indicators 1-4).*** Progress has been made toward a credible budget, based on fiscal discipline and improvements in the budget process in recent years. However, the credibility of the budget is hampered by optimistic budget projections, attributable to a combination of lack of realism at the budget formulation stage and limited capacity to implement the budget, and large deviations between budgeted amounts and actual out-turns. This is in particular the case for the External Budget (accounting for as much as three-quarters of total public spending), which remains effectively outside the Government's control, further reducing the credibility of the budget.

Table 2. 1: Public Finance Management Performance Indicators

	Indicators		1 2 3 4
	A. PFM OUT-TURNS: *Credibility of the budget*		
PI-1	Aggregate expenditure out-turn compared to original approved budget	2	
PI-2	Composition of expenditure out-turn compared to original approved budget	2	
PI-3	Aggregate revenue out-turn compared to original approved budget	4	
PI-4	Stock and monitoring of expenditure payment arrears	2	
	B. KEY CROSS-CUTTING ISSUES: *Comprehensiveness and Transparency*		
PI-5	Classification of the budget	2+	
PI-6	Comprehensiveness of information included in budget documentation	2	
PI-7	Extent of unreported government operations	3	
PI-8	Transparency of inter-governmental fiscal relations	1	
PI-9	Oversight of aggregate fiscal risk from other public sector entities.	1	
PI-10	Public access to key fiscal information	2	
	C. BUDGET CYCLE		
	C(i) Policy-Based Budgeting		
PI-11	Orderliness and participation in the annual budget process	2	
PI-12	Multi-year perspective in fiscal planning, expenditure policy and budgeting	1+	
	C(ii) Predictability and Control in Budget Execution		
PI-13	Transparency of taxpayer obligations and liabilities	1+	
PI-14	Effectiveness of measures for taxpayer registration and tax assessment	1+	
PI-15	Effectiveness in collection of tax payments	1+	
PI-16	Predictability in the availability of funds for commitment of expenditures	1+	
PI-17	Recording and management of cash balances, debt and guarantees	2+	
PI-18	Effectiveness of payroll controls	2	
PI-19	Competition, value for money and controls in procurement	2/3	
PI-20	Effectiveness of internal controls for non-salary expenditure	2	
PI-21	Effectiveness of internal audit	2	
	C(iii) Accounting, Recording and Reporting		
PI-22	Timeliness and regularity of accounts reconciliation	3	
PI-23	Availability of information on resources received by service delivery units	1	
PI-24	Quality and timeliness of in-year budget reports	2	
PI-25	Quality and timeliness of annual financial statements	2	
	C(iv) External Scrutiny and Audit		
PI-26	Scope, nature and follow-up of external audit	2	
PI-27	Legislative scrutiny of the annual budget law	1	
PI-28	Legislative scrutiny of external audit reports	1	
	D. DONOR PRACTICES		
D-1	Predictability of Direct Budget Support	4	
D-2	Financial information provided by donors for budgeting and reporting on project and program aid	1+	
D-3	Proportion of aid that is managed by use of national procedures	1	

Note: In the rating system 4 is the top performance rating, 1 the lowest. The ratings measured performance as of June 2005. Broadly speaking, most indicators would have been rated "1" in 2002.
Source: Staff estimates based on PEFA framework (PEFA, 2005, Annex 1, and table on p. 9).

2.9 ***Comprehensiveness and transparency of information (Performance Indicators 5-10).*** The Government is committed to share budgetary information transparently. The annual budget for the national Government is impressive, with coverage of most public spending of the general Government sector, whether implemented by the Government or directly by donors. It is a useful public document

relating the expenditures on specific projects to National Programs. Fiscal, revenue, and expenditure records for the Core Budget are maintained through the budget implementation system based in AFMIS (the Afghanistan Financial Management Information System). Comprehensive reports on budgetary aggregates are produced monthly and are now available on MoF's website. This information is generally reliable but is affected by lags in recording provincial operations in AFMIS. Improvements are needed with respect to external audit reports. There are also uncertainties about the quality of information on the External Budget. In addition, fiscal risks which could arise from activities in state-owned enterprises and municipalities are not effectively monitored because the financial information is unverified and too limited for fiscal risk management in these areas.

2.10 ***Policy-based budgeting (Performance Indicators 11-12).*** Some progress has been made toward the Government's key objective of making the national budget the central instrument of policy and reform, but there are still important constraints. The full implications of policy decisions, including for fiscal sustainability, are not taken into account due to lack of capacity in Government to develop policy, agree on trade-offs between investments and recurrent costs, and match resources with policies. Multi-year planning is also constrained by the complexity of aid coordination. Budgeting for recurrent and investment expenditures is carried out separately in parallel, exacerbating fiscal sustainability risks from recurrent expenditure implications of investment operations. The budget process is orderly and well understood within the Government, but it needs to be linked more closely with the Government's strategy; more widely owned politically including by the Cabinet and the Parliament; and more reflective of sector issues and with more engagement by sector agencies, provinces, and civil society.

2.11 ***Predictability and control in budget execution (Performance Indicators 13-21).*** Much progress has been made in improving the implementation of the budget (in particular with respect to the allotment process and cash management), but there is a need to enhance the predictability of funding for service delivery units. Line departments at the provincial level often cannot predict with accuracy the funds that will be available to them because of delays in communicating with the Mustoufiats (provincial offices of MoF) and the complexity of the allotment process; this has led to cash rationing at the discretion of the Treasury and the Mustoufiats. Many adjustments are made during the year, in particular through allotment transfers and the use of contingencies. No information is available at the local level (e.g. primary schools) on actual resources available.

2.12 A particular weakness in the budget execution cycle is related to revenue collection. The system is not very effective, as demonstrated by the large gap between revenues that could be collected and actual collections. In addition, despite some progress with taxpayer registration, the control framework on the revenue side remains weak. Nevertheless, clarification of the legislation and strengthening of financial management (including banking arrangements to ensure a steady flow of collected revenues to the Treasury Single Account, TSA) have generated some improvements in revenue performance.

2.13 Much progress has been made in implementing the control framework, as reflected by a significant increase in the eligibility rate measured by ARTF. There is a division of duties between the line ministries, which approve expenditure, and MoF, which makes payments. The controls also include effective cash management, allotment control on budget uses, and reconciliations of records of the Treasury and the line ministries. Significant weaknesses remain, however, compounded by the lack of internal audit to provide feedback on performance. Further improvements in the internal control framework therefore are needed both for payroll and non-payroll expenditures and for revenues. These arrangements are also fragile since they rely on external operational support in Treasury and the review by the ARTF Monitoring Agent (Box 6.2). The recent approval of a new Public Finance and Expenditure Management (PFEM) Law will help in further strengthening the control framework.

2.14 Most procurement at present is carried out under standards agreed with donors. The procurement carried out under national rules has been subject to an outdated regulatory framework which lacked adequate institutional support for effective enforcement. There has been insufficient competition as the basis for contract awards and no guarantee of value for money. The Procurement Law recently approved provides the basis for modernization of the procurement framework.

2.15 ***Accounting, recording, and reporting (Performance Indicators 22-25).*** Considerable improvements have been made in this area. The recording of expenditures and revenues has been strengthened by implementation of a computerized system (AFMIS) in MoF. Accountability of line ministries and MoF to the Cabinet is supported by frequent reporting on budget implementation, but more reporting and accounting capacity in line ministries is required. Significant progress has been made toward consolidation of bank accounts under the TSA system. However, much remains to be done to improve standards of accounting, frequency of bank reconciliation, and usefulness of reporting for line ministries' management.

2.16 ***External scrutiny and audit (Performance Indicators 26-28).*** Government accountability generally is sought through the publication of audited financial statements on the state budget and specific donor funds. The Auditor General is working to international auditing standards with operational support from an audit advisor. However, the final audit of the 2003/04 annual statements has not yet been released. In addition, the absence of a Parliament (until recently) has limited the extent of external scrutiny of the budget and its performance.

2.17 ***Donor practices (Donor Performance Indicators 1-3).*** Donors have mobilized a considerable amount of support for Afghanistan's budget, mainly through the ARTF. In particular, support to the Government's recurrent budget through ARTF has been large and predictable. However, direct budget support still accounts for only a very small percentage of total external assistance to Afghanistan, and the proportion of aid that is managed by use of national procedures remains low, with most aid executed by donors through their contractors. Financial information provided by donors on donor-executed assistance activities, while reasonably comprehensive, is subject to delays, usually relates to disbursements rather than actual expenditures, and may suffer from inaccuracies and inconsistencies

2.18 ***Concluding summary.*** Afghanistan's ratings against the PFM performance indicators generally portray a public sector where financial resources are, by and large, being used for their intended purposes as authorized by a budget which is processed with transparency and has contributed to aggregate fiscal discipline. The expenditure and financial position of the resources under the authority of the Government are reported reliably in an understandable format, although there is some uncertainty with respect to revenue reporting. Performance regarding the allocative efficiency of spending across programs and the efficiency of operations is not as good, however. Given that performance most likely would have been rated "1" on all dimensions in 2001 or 2002, this assessment highlights the significant achievements of the last four years. In most dimensions, the ratings are now comparable to other low-income developing countries (for instance African countries). Areas of relative weakness include tax collections (indicators 13-15), as well as legislative oversight (27-28) due to the absence of a Parliament hitherto. Payroll control (18) and predictability of budget-support (D1) are areas of relative strength.

2.19 Using the ratings of this report as a baseline, future progress in improving the performance of the PFM system can be monitored. However, the nature of the indicators and ratings means that measurable progress in terms of changes in ratings is more likely to occur over periods of a year or longer than on a short-term basis. Moreover, since the ratings assess the system's performance with significant external support (both advisory and operational), questions arise about the sustainability of current levels of PFM performance. This may mean that further improvements will be manifested in maintenance of current ratings based on sustainable national capacity and with declining levels of external support.

2.20 The ratings against the PFM performance indicators also provide an assessment for the donor community of the potential capacity of Government systems (currently supported by external assistance) to implement the operations which are now occurring outside Government systems.

2.21 Chapters 3-7 of this report discuss in more detail key development and budgetary outcomes and aspects of the PFM system, frequently referring back to the PFM performance indicators. After Chapter 8 (on the organization of public service delivery) and Chapter 9 (on institutional reforms and capacity development), Chapter 10 returns to the PFM performance measurement framework and puts forward a roadmap for making improvements (see Table 10.1).

CHAPTER 3. PROGRESSING TOWARD OVERALL FISCAL SUSTAINABILITY

3.1 A key outcome of a well-performing PFM system is fiscal discipline: the Government spends only what it can afford. Affordability in the short run relates to the budget balance, i.e. keeping the fiscal deficit within available normal financing. In the medium-term, fiscal sustainability is critical – spending decisions and the time-path of expenditures need to be affordable from a multi-year perspective. Failing to keep public expenditures within affordable limits has dire consequences (Box 1.1). Risks are especially great in post-conflict situations like that faced by Afghanistan. A large influx of aid, combined with lack of domestic capacity and low domestic revenues, can result in an unaffordable pattern of expenditures if not well-managed. While international support gives Afghanistan an opportunity to temporarily soften its national budget constraint, a visionary medium-term framework is needed to ensure that the country moves toward a sustainable fiscal position. This chapter first reviews the structure of Afghanistan's budget and recent fiscal trends. It defines fiscal sustainability and puts forward the concept of a Medium-Term Fiscal Framework (MTFF). The main expenditure drivers related to fiscal sustainability are then analyzed – mobilizing domestic revenues is discussed in Chapter 4. The final sections look at financing options and management of fiscal risks, and present several illustrative medium-term fiscal scenarios.

A. Fiscal Structure and Trends

BUDGET STRUCTURE AND RECENT TRENDS

3.2 ***Fiscal Structure.*** Afghanistan has an unusual fiscal structure reflecting its historical legacy (e.g. traditionally low revenue mobilization), the long period of conflict (e.g. civil service wages greatly eroded by hyperinflation and severely compressed by fixed allowances), and current reconstruction activities (very high spending) and priorities (e.g. massive expenditures on security). More specifically, as shown in Table 1.1 and in the Statistical Appendix:

- *Public expenditures are extraordinarily high.* Total budgetary expenditures in 2004/05 were equivalent to 57% of GDP (excluding the drug economy from the denominator).
- *This is accounted for by extremely high development spending.* Unlike in most countries, the development budget ($2.8 billion in 2004/05) dwarfs the operating budget ($0.6 billion).
- *Operating expenditures are in line with international patterns.* At 9% of GDP in 2004/05, the operating budget was split roughly 70-30 between wage and non-wage spending.
- *There are however large recurrent expenditures in the development budget.* These include health services, technical assistance, salary payments, and grants, among others (Figure 6.2).
- *There is underspending on non-wage operation and maintenance requirements.* In education, for instance, there is almost no spending at the school level other than teacher salaries (textbooks, chairs, etc. are provided in-kind, for the most part directly by donors).
- *Most spending occurs outside Government channels.* Around three-quarters of expenditure in 2004/05 was donor-executed, in the external budget, with very limited Government oversight.
- *The security sector is a major driver of overall spending.* Security spending has been growing rapidly and accounts for 39% of total expenditure
- *A disproportionate share of public spending occurs in Kabul.* Most notably, only 30% of non-wage O&M expenditures are made outside Kabul (see Figure 7.1).
- *Domestic revenues are very low.* They comprise only about 4.5% of GDP (likely the lowest ratio in the world for a sizable country) and pay for only about 8% of total expenditures.

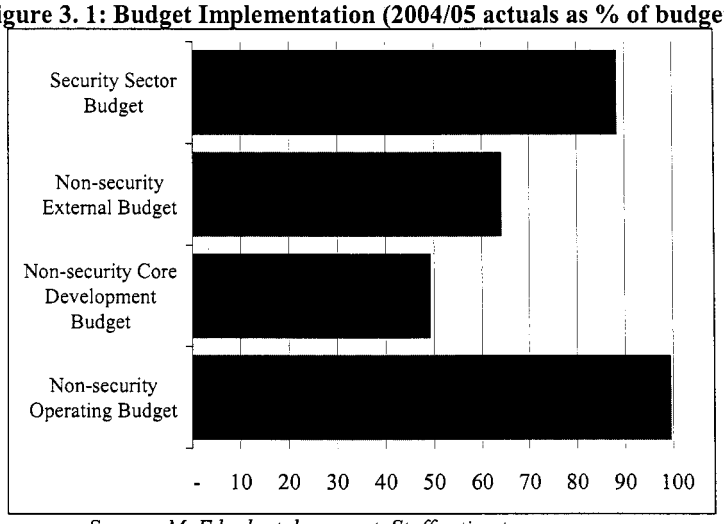
- *The fiscal deficit (before grants) is extremely high and entirely aid-financed,* mostly through grants. The non-resort to domestic financing of the deficit is salutary and shows strong fiscal discipline, but this level of budget deficit and foreign financing clearly are unsustainable.

3.3 ***Fiscal trends.*** Assessing fiscal trends based on only three years of data since major conflict ended in late 2001 is not easy, and there have been both significant volatility and step-changes in public expenditures. Nevertheless some important developments have occurred:

- *Budgetary expenditures have increased sharply* during 2002/03 to 2004/05, with operating expenditures almost doubling and development spending growing even faster
- *Revenues also have risen rapidly,* more than doubling during the same period.
- Since revenues started out from a much lower base, although their growth was more rapid than that of recurrent expenditures in percentage terms, *the absolute gap between recurrent spending and revenues more than tripled.*
- This means that *external financing of recurrent expenditures has been one of the fastest growing components of the budget* (Figure 1.3).
- *The fiscal deficit (before grants) has increased sharply,* reflecting large inflows of external assistance. Although aid predominantly has consisted of grants and thus does not have implications for debt sustainability, it will eventually decline and shift more toward a mix of grants and loans, with implications for the fiscal deficit and external debt.

3.4 Actual development expenditures (in both Core and External Budgets) have fallen far short of budget targets, by margins of around half in recent years (see Figure 3.1 for 2004/05). These shortfalls are attributable to several factors, including the existence of unfunded projects in the development budget (a practice now changed for the Core Budget), confusion sometimes between commitments and disbursements, optimistic projections of disbursements, insufficient project screening during budget preparation, large contingencies in the budget, and implementation constraints (security issues, lack of capacity to prepare sound budget proposals, excessive optimism about implementation delays, etc.).

Figure 3. 1: Budget Implementation (2004/05 actuals as % of budget)



Source: MoF budget document, Staff estimates.

IMPLICATIONS

3.5 The first implication of the fiscal structure and trends outlined above is that ***there is a great and urgent need to mobilize more domestic revenue.*** Only an intensive effort to improve tax collection – with sound policy measures and administrative improvements leading to higher compliance – will result in sustained rapid revenue growth and a sustainable fiscal balance over the medium term (Chapter 4). Robust revenue growth will also give donors greater confidence to continue providing external assistance

to finance the operating budget. However, taxation efforts need to be non-distortionary and should not impose an excessive burden on the private sector which would adversely affect economic growth.

3.6 A second implication is that ***all spending decisions have to be considered in the light of their multi-year implications.*** Even if substantial operating costs can be paid for by external assistance in the short run, they will become a claim on the Government's own resources later.

3.7 A third implication is that ***significant external assistance will be required for Afghanistan's operating budget for some time,*** and for the development budget over the longer term. Projecting budgetary aggregates forward, taking into account likely growth of expenditures and even with aggressive measures to promote rapid growth of domestic revenues, there will continue to be a gap between the Government wage bill and total domestic revenues for a few years to come, and for some years longer a gap between total recurrent expenditures and revenues.

3.8 A fourth implication is that ***the budget needs to be realistic.*** Overspending leads to budget cuts during the year and can harm fiscal and program management, undermining development effectiveness. Underspending, particularly what has been seen in relation to the civilian development budget in recent years, can undermine public confidence and discourage donors from providing funding. The Government can aggressively hold donors to their pledges/commitments of external financing, and "stretch" targets can be set for accelerated domestic revenue mobilization (as has been the case in the IMF Staff Monitored Program for the current year), but the Government should plan its budget on a conservative basis.

3.9 Fifth, ***key drivers of public expenditures must be carefully planned and monitored.*** As discussed in Section C, these include notably the Government wage bill, security spending, public investments, expansion of social services, and recurrent costs in the development budget.

3.10 Finally, there is a need to ***increase expenditures outside Kabul***. The Kabul-centric pattern of spending and small non-salary budgets in the provinces and districts, as well as difficulties in accessing and spending non-salary allotments, negatively impact on service delivery (Chapter 8).

B. A Framework for Achieving Fiscal Sustainability

FISCAL SUSTAINABILITY IN THE CONTEXT OF AFGHANISTAN

3.11 ***What is meant by fiscal sustainability?*** The standard definition of fiscal sustainability is that a country's fiscal balance and underlying trends are such that, in a steady state, the ratio of total public debt and debt servicing to macroeconomic aggregates like GDP is not increasing over time.[1] Key parameters determining fiscal sustainability under this definition include the projected economic growth rate, the revenue growth rate and its elasticity with respect to GDP growth, expenditure growth, and the interest rate at which the Government can borrow to finance its fiscal deficit (because the cost of financing the deficit forms a component of budgetary expenditures). Of particular interest is the level of primary deficit (i.e. the fiscal deficit excluding interest payments) that is sustainable over the medium term. A number of countries have adopted laws with specific rules related to fiscal sustainability (based for example on a targeted debt level, overall deficit, or primary deficit).

3.12 Afghanistan does not fit neatly in this conceptual framework. The country is nowhere near a "steady state" in terms of fiscal aggregates. Financing costs are negligible since the bulk of the fiscal deficit is grant-financed, and the Government has adopted a conservative stance that forbids overdrafts or borrowing from the Central Bank. On the other hand, as seen earlier the fiscal deficit (before grants) is enormous as a ratio to GDP, and the levels of external grant assistance seen in recent years will eventually decline over time. Domestic revenue and its growth are far too low to support fiscal sustainability as defined above in the absence of massive grant financing. Under these circumstances the size of the fiscal deficit in relation to GDP would be a better (negative) indicator of fiscal sustainability, but it also is highly imperfect for this purpose and would vary greatly with the level of external grant financing.

[1] See for instance Heller (2005).

3.13 ***A practical definition of fiscal sustainability for Afghanistan.*** This report analyzes a simpler and more practical fiscal sustainability objective for Afghanistan: ***whether and at what point in time the country will be able to cover its recurrent expenditures from domestic revenues,*** with an intermediate target of when domestic revenues will be able to cover the government wage bill, a primary component of recurrent spending. The logic is that the recurrent budget to a large extent represents the core costs of maintaining government functionality and hence needs to be covered by reliable domestic revenues. Issues related to the sustainable level of borrowing and primary deficit will become more relevant over the longer term, after this critically important objective is achieved. This definition of fiscal sustainability does not imply dual budgeting as between operating and development budgets.[2] On the contrary, there is a strong argument for moving toward fully integrated budgeting of recurrent and development expenditures, recognizing that, if the existing grant financing of the development program dries up, funding needs for this purpose would still remain, putting heavy pressure on the budget.

3.14 By this definition, Afghanistan falls far short of being in a sustainable fiscal position. In 2004/05 domestic revenues were equivalent to only 48% of recurrent expenditures, and the budget for 2005/06 has a similar target (49%). The simple mathematics of growth from different bases means that domestic revenue will need to grow much more rapidly than total recurrent expenditures for a number of years in order to "catch up".

MEDIUM-TERM FISCAL FRAMEWORK: WHAT IT MEANS, HOW IT WORKS

3.15 The concept of an MTFF is straightforward. An MTFF sets forth a multi-year fiscal path that reaches, or at least makes progress toward, a sustainable fiscal position for the country. In addition to projections (typically over 3-5 years) of fiscal aggregates including revenue, expenditure, deficit, and key expenditure components (e.g. the wage bill), the MTFF lays out the assumptions behind the projections, including the fiscal strategy and set of policy actions envisaged to achieve the fiscal objectives embodied in the MTFF targets. Projections in the absence of policies and actions to achieve the forecasts would be an empty exercise. Both quantitative projections and the policy package would be reviewed and updated annually. Possible elements of an MTFF for Afghanistan are outlined in Box 3.1.

3.16 It should be noted that the MTFF is more rudimentary than other medium-term frameworks that are commonly talked about and sometimes applied. A Medium-Term Budget Framework (MTBF) introduces a sectoral perspective to the multi-year framework. At a more advanced stage, a Medium-Term Expenditure Framework (MTEF) would contain the same aggregate and sectoral projections but would also seek to fully cost sectoral strategies and reconcile projected costs with sectoral resource envelopes. While this provides more detailed guidance for the allocation of present and future spending across sectors (see also Chapter 5), the technical demands of an MTEF are much greater than those for an MTFF. Thus an MTEF is a more distant prospect than an MTFF which can be prepared fairly quickly.

3.17 While the technical analysis that underpins the MTFF is important, political buy-in and a meaningful linkage to the annual Budget are essential for an MTFF to be effective. The former is facilitated by Cabinet review and approval of the MTFF, along with presentation of the MTFF to Parliament, either in conjunction with the annual budget or as part of a national strategy document (e.g. the ANDS). Chapter 6 reviews in more detail the budget formulation process.

3.18 MoF has prepared an initial MTFF for Afghanistan which, together with the 2005/06 mid-year budget review, was discussed and approved by the Cabinet in October 2005. This initial step represents a good start in developing a medium-term fiscal vision. The key to success will be steadily improving the MTFF over time and ensuring that it is closely linked with both the national development strategy and the annual budget process, which is clearly the Government's intention. This will in particular require a gradual improvement in the capacity to cost policies (Box 3.1).

[2] For example, the UK has a policy rule of limiting capital expenditures to the level of borrowing, but this is a fiscal discipline tool and does not detract from unified budgeting which the UK practices (Sarraf, 2005, p. 4).

Box 3. 1: Possible Elements of a Medium-Term Fiscal Framework for Afghanistan

An MTFF could have two main components:
(i) *a fiscal table with three- or five-year projections* of domestic revenues, expenditures (both aggregate and key items like the wage bill), the fiscal deficit, and sources of financing, and
(ii) *a concise description of the policy actions which support the projections* (i.e. which will contribute to achieving the fiscal targets).
Within this broad structure, the MTFF for Afghanistan could seek to address questions like the following.
Domestic revenues: What are the sources of expected increases in domestic revenues? These could include:
(i) *Expansion of the base* on which domestic revenues are collected. Expansion of the tax base is mostly driven by (non-agricultural) economic growth, so the MTFF would need to specify assumptions regarding economic growth.
(ii) *An increase in revenue collection efficiency.* Important measures that have been introduced to increase tax collection efficiency include the creation of the Large Taxpayer Office (LTO) and implementation of the Customs reform. What are the medium-term collection objectives from these measures? Does the Government intend to implement additional measures to increase revenue collection efficiency? If so, what measures?
(iii) *New measures to increase domestic revenues.* Does the Government plan to introduce new measures to increase domestic revenues? Which ones? What are the expected impacts in terms of incremental revenue?
Civilian wage bill: What policy actions explain the projected civilian wage bill. The civilian wage bill depends on:
(i) *The number of civil servants.* What is the Government's strategy regarding the size of the civil service. What public services does the Government plan to deliver itself? For example, has the Government endorsed the purchaser-provider model in health? Has the Government decided that the overall size of the civil service should not be increased except for teachers?
(ii) *Wage structure.* What salary structure does the Government plan to implement in the coming 3-5 years? Is it the salary scale which is going to be derived from the on-going Pay and Grading Review? What are the Government's intentions with respect to other salary increases (annual, ad-hoc, other)?
(iii) *Short-term programs.* How many people are expected to be hired under short-term programs created to attract skilled Afghans at higher rates on short-term contracts and the PRR and PRR superscale program? At what cost?
Absorption of non-civilian expenditures into the Budget: Does the Government plan to absorb non-civilian expenditures (including on the new Afghan National Army) into the Budget? How will these expenditures be financed? What trends are expected in the security sector wage bill in particular, and its key components?
Development expenditures: The Government is preparing its interim Afghanistan National Development Strategy (ANDS). How does the Government plan to ensure that the ANDS is translated into annual national budgets?
Fiscal Deficit: Domestic revenues are expected to fall short of total (ordinary and development) expenditures, leading to a fiscal deficit. How is the Government planning to finance fiscal deficits? How much financing does the Government expect from the recurrent and investment windows of the ARTF? How much from other sources?

C. Managing Expenditures from a Medium-term Perspective

3.19 In addition to domestic revenue (discussed in Chapter 4), total expenditure and key expenditure components comprise the core of an MTFF. The main expenditure drivers for Afghanistan include the Government civilian wage bill, non-wage operating costs, development expenditures, and security spending (Figure 3.2). Medium-term issues around each of these expenditure categories are summarized below. Underlying these issues are key questions about the role of the state – which services it should deliver and finance itself, which it should deliver but finance only partly (relying in part on cost recovery), which it should finance but deliver through the private sector, and for which services both financing and delivery should be left to the private sector, with Government regulation as appropriate. These strategic issues are also discussed in Chapters 5 and 8.

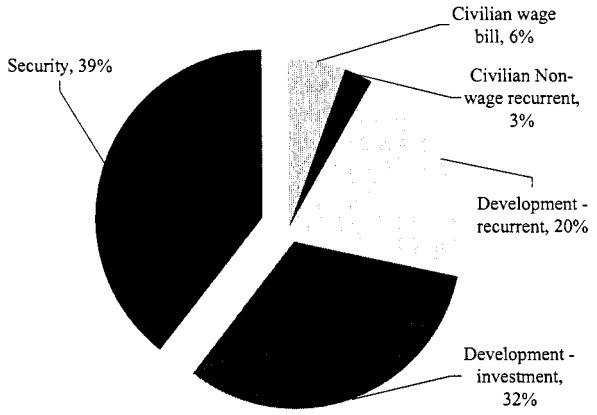
THE GOVERNMENT NON-SECURITY PAYROLL ($187 MILLION IN 2004/05)[3]

3.20 Managing and containing the growth of the Government payroll, while ensuring that the salary structure is adequate to attract and retain qualified staff (Chapter 9), is a major challenge for Afghanistan. In many countries, the Government's wage bill tends to be a source of upward pressure on expenditures in both the short run and over the medium-term, since there are often political pressures to increase recruitment into the civil service as well as to raise pay (at least to keep up with inflation). Afghanistan has maintained a remarkable record of fiscal discipline during the past several years, with limited

[3] Excludes police, army, and justice. The total wage bill including security was $377 million in 2004/05 (Table 1.1). See Volume III, Chapter 2.

recruitment into the Government except for teachers and security forces. However, there have already been pressures for ad-hoc pay increases, and pressures for higher pay and recruitment can only be expected to increase with the transition toward more "normal" politics and the formation of Parliament. Another fiscal risk factor is pensions, whose cost to the budget is still relatively low despite a recent increase, but which can be expected to rise over time particularly with increasing retirements.

Figure 3. 2: Key Drivers of Afghanistan's Public Expenditures, 2004/05 (% of total budget)



Source: MoF reports; staff estimates for development budget classification into "recurrent" and "investment".

3.21 With average salaries equivalent to 3-3.5 times average per-capita GDP (Table 3.1), current pay levels in Afghanistan's civil service are not particularly high compared to other countries. The challenge is to decompress the salary structure to ensure that pay at higher levels is adequate to attract and retain qualified staff, while keeping the overall wage bill affordable.[4] Hyperinflation in Afghanistan during the 1990s almost completely eroded the real value of base pay, which was offset (but only in part) by giving a cash allowance that was the same for everyone and comprised the bulk of overall compensation. As a result, in 2001 Afghanistan inherited what was probably the most compressed civil service compensation structure in the world, with total pay varying by less than 20% between the top and bottom grades. A pay increase in 2003 somewhat decompressed the salary structure, increasing the variation to 55%, still much lower than in other countries. In addition, various interim reform schemes provide higher pay for selected positions (Figure 3.3), but these affect only a small part of the civil service.

Table 3. 1: Wage Bill in Afghanistan

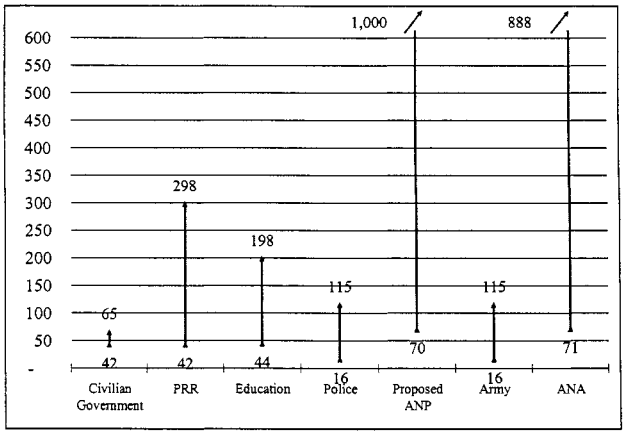
Region	Size of the Civil Service (% population)	Average salary (as multiple of per capita GDP)	Wage Bill (% GDP)
Afghanistan	**1.2**	**3.1-3.5 a/**	**5.3**
Africa	2.0	5.7	6.7
Asia Pacific	2.6	3.0	4.7
Central and Eastern Europe and the FSU	6.9	1.3	3.7
Latin America and the Caribbean	3.0	2.7	4.9
Middle East and North Africa	3.9	3.4	9.8
OECD	7.7	1.6	4.5

Note: for comparison purposes, this table refers to the civil service, including justice and police (but excluding the army). Source: Afghanistan: staff estimates for 2004 (a/ unweighted average pay scale for general civil service (3.1) or 2004/05 budgeted wage bill (3.5) divided by the non-drug GDP); other countries: Schiavo-Campo et al (1997) for various years in the 1990s.

[4] There is a risk, seen in many countries, that political pressures (including from civil servants) result in a compressed pay structure in the interest of "equity" across employees, while fiscal constraints keep average and top salary levels relatively low, leaving the Government unable to recruit and retain qualified staff in management and senior technical positions.

3.22 Afghanistan's ***civil service size*** is not large by international standards, as can be seen from Table 3.1, even taking into account that basic health services have been almost entirely contracted out (Chapter 8). But its composition raises a number of challenges (Chapter 9). First, Afghanistan's civil service has not been very effective, in running itself or in delivering services to the Afghan people. Thus the developmental returns on the Government wage bill may be relatively low. This means that some retrenchment – possibly limited to early retirement or natural attrition – may be unavoidable in the medium-term. In parallel, recruitment needs to be managed to focus on genuine needs for qualified staff, e.g. teachers. Finally, there is excessive concentration of staff in Kabul, where a third of civil servants are located, and correspondingly relatively low staffing levels in the provinces and especially in rural areas. This pattern is problematic for service delivery, although it is gradually changing in particular as more teachers are being recruited.

Figure 3. 3: Pay Scales ($/month)



Lower and upper bounds of the scales. This includes base salary and an estimate of cash allowances See Volume III, Chapter 2.

3.23 Thus a modest increase in the size of the civil service may be expected in the future, as well as pay increases at least in line with growth of per-capita GDP. As a result the ratio of the wage bill to GDP is likely to moderately increase in coming years. This trend will be accentuated by the need for the operating budget to absorb substantial salary costs currently in the development budget (paras 3.30-3.32).[5]

3.24 These considerations underline the need for careful management of the Government payroll. First, there needs to be a strategy for managing the payroll from a medium-term perspective, as opposed to merely responding on an ad-hoc basis to pressures as they arise. Second, the Government will need to implement its strategy carefully. Even if the wage bill grows in a programmed manner as envisaged in the *Securing Afghanistan's Future* (SAF) projections, this must not be perceived to soften the hard fiscal constraints within which the Government operates. All sources of financing for the payroll – domestic revenues, ARTF contributions, other budget support – are scarce, precious resources for Afghanistan's reconstruction which have a high opportunity cost in terms of alternative uses. Third, maintaining strict control over staffing levels will be critical, even as disciplined recruitment of needed skills proceeds. Fourth, transfer to the operating budget of salary costs currently covered by donors in the external budget needs to be handled carefully, with transitional mechanisms to avoid unmanageable fiscal outcomes. And finally, the Government needs to provide full information to donors to secure their continued support. The SAF projections were well-received when presented to the international community in April 2004, but there needs to be a clear statement of Government policy on the wage bill and updated projections.

[5] In addition to these recurrent costs, reforming public administration will have additional costs. The Government, in its *Securing Afghanistan's Future* report (2004), estimated these costs at about $200 million over 2004-2010, including a large amount for public buildings, systems, and equipment; a small component for retrenchment and retraining; and a component for technical assistance (to restructure ministries, develop policies, etc.).

NON-WAGE OPERATING EXPENDITURES ($96 MILLION IN 2004/05, EXCLUDING SECURITY)

3.25 In contrast to the Government payroll, non-salary expenditures tend to be unduly low in many countries, reflecting a variety of factors including a political preference for investments and salaries and the Government's response to short-run fiscal constraints – non-wage O&M is much easier to cut in the short run than salaries. More fundamentally, underspending on non-wage O&M may reflect previous decisions with respect to public investment, public sector service delivery institutions, and staffing that turn out to be unaffordable. This results in chronic shortfalls in O&M spending, which means that public assets are deteriorating due to lack of maintenance (e.g. roads); they cannot fully function due to shortages of fuel or parts (e.g. power stations); service delivery networks' ability to deliver services is impaired due to lack of needed inputs (e.g. teaching materials for schools, medicines for basic health facilities); and Government employees lack the resources to do their jobs (e.g. fuel for vehicles).

3.26 Also constraining non-salary recurrent spending at the local level in Afghanistan is the low allocations for such expenditures provided to provinces and districts, and the difficulties lower levels of administration face in accessing and utilizing their non-salary allocations (Figure 7.1). This appears to reflect Ministries protecting non-salary expenditures at the central level, as well as various constraints affecting allotments and payments (Chapter 8). As the amounts involved are relatively small, such imbalances between Kabul and the provinces/districts can and should be rectified relatively easily, with monitoring through the budget execution process.

3.27 Turning to the future, fiscal challenges in meeting non-wage O&M requirements will be daunting. A simple rule of thumb would suggest that every dollar of public investment leads to at least ten cents of additional recurrent costs on an annual basis. This suggests that the public investment of 2004/05 would generate more than $100 million of additional O&M costs each year. The highway sector, with a current rehabilitation investment program of more than $1 billion, is an important example. Annual maintenance costs, not including those of future highway investments envisaged by the Government, are expected to be in the range of $40 million per year (as a first step, the 2005/06 budget includes $10 million for road maintenance). Another important example is electric power, where access to the grid is extremely low (estimated at only 10%) and large increases in capacity will be required to support private sector development and home consumption, yet even now the main thermal power plant in Kabul requires $40 million worth of fuel per year, currently being provided by a donor in-kind outside the budget.

3.28 Although the examples cited above point to cost recovery as an essential way forward (Chapter 8, Section B), non-wage O&M will nevertheless be a rapidly growing claim on budgetary resources that will need to be well-managed. Clearly, inadequately funding O&M requirements is damaging to service delivery outcomes and development objectives, but the root of the problem usually lies in public investment decisions made years earlier. This highlights the need for such decisions to take into account their future consequences for the budget (Chapter 5).

THE DEVELOPMENT PROGRAM ($300 MILLION CORE, $1,467 MILLION EXTERNAL IN 2004/05)

3.29 ***Public investment.*** At some 30% of GDP, Afghanistan's non-security investment program is very large, reflecting massive requirements for reconstruction and availability of large amounts of external financing. These requirements had been reviewed by the Government in its SAF report, presented to donors in Berlin in 2004. This report projected a capital investment of some $26 billion between 2004 and 2010. As the development budget is fully funded by external assistance and most of it is donor executed (only about one-sixth of civilian public investment spending flows through the Treasury), it is easy to make the mistake of thinking that it does not have fiscal consequences for Afghanistan. However, the very large O&M requirements for future years generated by current public investments (in both core and external budgets) cannot be ignored (Chapter 5).

3.30 ***Recurrent costs in the development program.*** As noted earlier, Afghanistan's development program does not consist entirely or even predominantly of public investment – there is a large

component of recurrent costs estimated very roughly at 38% (and more than 75% in the Core Development Budget, see Figure 6.2). These include:

- *Basic health services,* which are contracted out to NGOs and funded by both Core and External development budgets. The estimated cost in 2004/05 exceeded $100 million, which includes salaries and other recurrent costs (e.g. vaccines) as a large component.
- *Technical assistance,* which predominantly consists of recurrent costs (payments to consultants etc.). This is truly large: OECD data estimate TA flows at $400 million in 2003, but only a fraction is on budget (the 2004/05 budget identifies around $200 million as stand-alone capacity-building, technical assistance, or feasibility studies projects).
- *Salary payments and top-ups* paid by donors through the External Budget in several sectors.
- *Transfer schemes,* such as the National Solidarity Program (NSP, $130 million in 2004/05) which provides block grants to communities; most of these are used for small investments but likely include some recurrent costs as well.
- *Teacher training*, textbook printing, and other smaller items of recurrent costs.

3.31 Since the funding of these recurrent costs by donors cannot be expected to be permanent, and in many cases is committed by donors only on a yearly basis, such expenditures will sooner or later become a charge on the Government's core fiscal resources. The magnitudes of some of these recurrent costs are sufficient that they pose a large, even unmanageable fiscal risk over the medium term. Moreover, as they are usually funded and executed by donors on a fragmented basis with a focus on implementing the activities themselves and often without competitive procurement, there is a tendency for costs to be higher than underlying conditions in Afghanistan, let alone fiscal affordability considerations, would dictate. This aggravates further the fiscal risks involved and could inflate costs more generally.

3.32 There are no easy answers to the dilemmas posed by recurrent costs in the development budget, as for the most part they are responding to urgent and high-priority reconstruction needs. At a minimum such recurrent costs need to be fully understood and their fiscal implications taken into account by the Government and donors. This requires accurate reporting by donors and a dialogue with the Government on the levels of activities and costs involved, as well as the time horizon of the donors concerned in providing assistance. It is also quite legitimate for the Government to raise concerns about the unit costs and procurement methods used, as keeping unit costs within reasonable limits will help ensure fiscal sustainability of the activities concerned (see for instance Chapter 8 on the cost of health services).

SECURITY SECTOR SPENDING ($1,328 MILLION IN 2004/05, OF WHICH $292 MILLION CORE)

3.33 The security sector is a major driver of expenditures with a large impact on Afghanistan's fiscal position over the medium term. Therefore it needs to be fully incorporated in the MTFF and analysis of the national budget. In view of the critically important and complex security problems that Afghanistan faces, it is not surprising that massive resources (including Afghanistan's own domestic revenues as well as donor funds) are being spent on security. However, with the bulk of security sector expenditures occurring through the External Budget, decisions on funding and spending have occurred in a fragmented way, often somewhat in isolation from the requirements and strategy for the security sector as a whole as well as from medium-term fiscal affordability issues. The lack in the past of an agreed national security strategy has made it more difficult for the Government to provide oversight and coherence across the various security subsectors and activities. There is also a risk that pay levels established in the security services will exert upward pressure on general pay levels in the civil service (Figure 3.3).

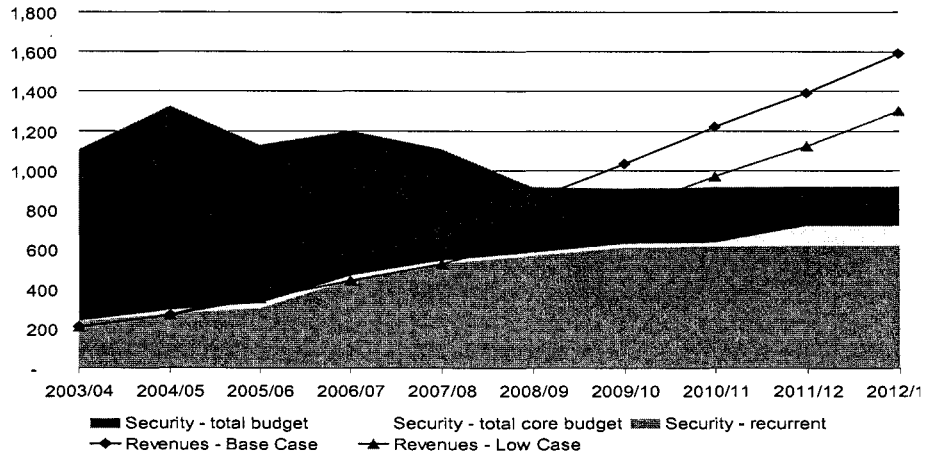
3.34 Some salient characteristics of Afghanistan's security sector are summarized in Box 3.2. The analysis of security sector expenditures conducted as part of the PFM Review (discussed in detail in Volume V) has identified the following key issues from a PFM and development perspective:

- *The need for an integrated security strategy and policy framework,* without which sound decisions on programs – e.g. force sizes, equipment – and expenditures cannot be made. The

national security strategy, preparation of which is at an advanced stage, will facilitate the necessary strategic coordination and decisionmaking including on public expenditures.

- *Very high donor-executed spending through the External Budget* (Figure 3.4), which renders achieving coherence of spending across and within subsectors much more difficult, and also raises questions about the fiscal sustainability of the security sector in the medium term when donor funding may decline.
- *Difficulties in coordinating and prioritizing security sector expenditures and actions,* reflecting the above problems and fragmentation of decision-making across donors. These factors make it more difficult for the National Security Council (NSC) to fully carry out its mandated strategic, leadership, and coordination functions, although the situation in this regard has improved in 2004 and 2005.
- *Concerns about the growing security sector wage bill and pressures for fiscally unaffordable salary increases, as well as the fiscal sustainability of security sector staffing levels.* The ANA salary structure, determined apparently without reference to fiscal constraints or pay elsewhere in the civil service, has set a precedent which the police and other sectors aspire to and which will be fiscally costly (Figure 3.3). There are also doubts about whether recruitment practices are being regulated by staffing establishment size limits.
- *Slow implementation of priority public administration reforms and capacity building in security sector management and oversight institutions,* which have lagged behind the development of security forces like the ANA. This imbalance, and also the lack of progress in some security subsectors (e.g. justice), carry a variety of risks for the future.
- *The need to develop good governance and sound and sustainable financial management practices* in the security sector, fully in line with and integrated with national budget processes and fiduciary provisions.

Figure 3. 4: Forecast Security Sector Spending Against Projected Revenues



Source: Volume V, Chapter 4.

3.35 The most important message emerging from this analysis of security sector expenditures is that ***the security sector needs to be appropriately integrated into all aspects of Afghanistan's PFM system:*** medium-term fiscal programming (MTFF), annual budget formulation, staffing and payroll management, procurement, financial management and controls, and external scrutiny, among others. There is no justification for treating the security sector as separate or sacrosanct, and not subjecting it to budgetary and fiduciary processes. Specific recommendations include the following.

3.36 ***Review the Fiscal Implications of Ongoing Security Sector Reforms:*** Quickly enhance the information base on security sector expenditures, and conduct an integrated security sector-wide fiscal

review to forecast fiscal implications of security sector development and reforms over the medium- and longer-term. This would serve as a basis for revisiting security sector force levels and for discussions with donors on longer-term financing. It would also facilitate policy- and program-based budgeting of security sector expenditures with a medium-term perspective.

Box 3. 2: Salient Features of Afghanistan's Security Sector

As discussed in detail in Volume V, Afghanistan's security sector has some important characteristics with fiscal and development implications.

First, *the historical legacy of conflict was fragmentation into regional and local militias, capture of policing and military functions by non-legitimate actors, and erosion of both formal and traditional justice systems,* also with capture by non-legitimate authorities. Building the state since 2001 therefore has entailed reconstituting and reforming the security forces under legitimate oversight by the civil authorities.

Second, *the immediate security threats faced by Afghanistan are variegated and disputed* by different stakeholders. Some observers see the continuing insurgency in the south and east and conflict with Taliban/Al Qaeda forces as the most important security problem. Others are most concerned about criminality and lack of rule of law at the local level, with associated capture of policing and justice functions by warlords and commanders. Still others are concerned about the limited management capacity of civil authorities and inadequate oversight/accountability of security forces. The drug industry is widely seen as a major cause and consequence of insecurity. An agreed national security strategy, currently at an advanced stage of preparation, will facilitate reaching consensus on different security threats and their relative priority.

Third, *the overall size of the security sector does not seem unreasonably high by international standards.* This includes a planned size of the ANA of 70,000 (not all of them combat troops) and a planned size of the Afghan National Police (ANP) of 62,000. However, the appropriateness of the size and balance between different security forces can be questioned in the context of Afghanistan's particular situation and security needs. For example, the role of the ANA in meeting different external and internal threats would need to be clarified in order to assess the appropriateness of its size.

Fourth, *Afghanistan's security sector nevertheless is costly and may be unaffordable.* The lack of short-run budget discipline (and lack of policies and programs to form the basis for sound budgeting), and the involvement of different "lead donors" and line ministries in decision-making on force levels and expenditures, have resulted in limited efforts to control costs. Over the medium term, it is extremely doubtful whether the sustaining costs of Afghanistan's security sector at planned force levels can be absorbed by Afghanistan's national budget (Figure 3.4). This implies that difficult trade-offs will need to be made in prioritizing expenditures, means of achieving efficiencies in security-related expenditures will need to be identified, and the possibility of multi-year donor financing commitments for the security sector should be explored.

Fifth, *the progress in developing different parts of the security sector has been uneven.* After a slow start initially, the formation and expansion of the ANA have moved forward rapidly. Progress in forming the new ANP has been much slower, and reform and capacity building in the justice sector have lagged far behind, with adverse implications for legal reforms and for a pro-private sector business climate. Moreover, within sectors there has been a disproportionate focus on building up security forces and less attention to strengthening the key management and oversight institutions, including the Ministry of Defense and especially the Ministry of Interior.

Sixth, *security and fiscal issues are closely interlinked.* For example, low domestic revenue (discussed in Chapter 4) is both a consequence and a cause of insecurity. Reconstruction costs tend to be higher due to insecurity, while on the other hand security sector expenditures are a source of considerable fiscal pressure.

3.37 ***Further Develop Policy Making Capacity in the NSC and Finalize the National Security Strategy:*** The NSC and National Security Advisor are tasked with coordinating policy development and overseeing integrated strategic planning across all security institutions. Adequate capacity is required for these purposes. An integrated security sector strategy and policy is needed to determine acceptable longer-term costs of security institutions and to appropriately prioritize and sequence spending across and within subsectors (e.g. justice and police versus ANA). As in the case of the ANDS as a whole (discussed below), the National Security Strategy is being developed by Afghan stakeholders, with full Government ownership (across the ministries and agencies involved), and will need to gain wide buy-in within and outside Government. This will require a meaningful and substantive consultation process.

3.38 ***Treat Security as an Integral Part of the National Development Strategy currently under Preparation:*** The ANDS can be used as an opportunity to ensure that the security sector both is accorded its due importance as a development issue for Afghanistan and that the broader developmental and fiscal perspective is injected into the security sector strategy.

3.39 ***Implement Priority Administrative Reforms and Develop Security Sector Management and Oversight Capacity:*** Support reforms enhancing human resource capabilities in the Ministries of

Defense, Interior, Justice, Counter Narcotics, and National Security Directorate. A particular priority is developing solid financial management capacity and practices in these line ministries. Strengthening the control framework, notably with the development of an internal audit function, is a priority.[6]

3.40 ***Rigorously Enforce Staffing Size, and Set Salary Increases Based on Fiscal Absorption Capacity:*** It is vital that the agreed formal staffing establishment sizes be enforced. Moreover salaries, like non salary costs, must be subject to the normal rigors of public expenditure management and fiscal discipline – the security sector wage bill must remain affordable.

3.41 ***Role of donors.*** Donors play an even greater role in Afghanistan's security sector than they do in other sectors. Specifically, donors can contribute to improving public finance management in the security sector by: (i) supporting development of an agreed national security strategy and corresponding strategies and policies for the individual sectors (defense, police, justice, etc.); (ii) reassessing their views about force sizes and cost requirements in the light of fiscal constraints; (iii) helping enhance the capacity of oversight actors (such as the Auditor General, legislature) and economic managers (Ministry of Finance Budget Office) to address issues relating to financial management in the security sector; (iv) channeling more of their assistance to the security sector through the Core Budget; (v) for resources not channeled through the Core Budget, ensuring that timely and accurate information is made available to the budget authorities, and maximizing use of internationally acceptable procedures e.g. for procurement; (v) helping key security ministries strengthen their budget formulation and budget execution processes; and (vi) discussing medium- and longer-term availability of external resources for the security sector.

3.42 Implementing these recommendations and other initiatives to improve security in Afghanistan, which is a necessary condition for the country's development, undoubtedly will take time. However, the need to get a handle on the fiscal sustainability issues in the security sector is urgent, as there is a risk that decisions on force levels, pay, non-salary spending, equipment, construction, etc. that are being made or implemented today will be unaffordable for Afghanistan in the future. Dialogue with donors, including on possible medium-term financial support to Afghanistan's security sector, also is urgently needed.

D. Financing Reconstruction and Managing Fiscal Risks

MANAGING BUDGET FINANCING OVER THE MEDIUM TERM

3.43 Afghanistan has been relying entirely on external assistance to finance its fiscal deficit, including a large operating deficit as well as the entire development budget. This approach has made a great deal of sense in a context where reconstruction needs are enormous, revenues are extremely low, and large amounts of external assistance have been available (mostly grants), including substantial amounts for financing recurrent expenditures. The "no overdraft rule" has been an effective tool for inflation control and macroeconomic stability. While substantial external assistance can be expected to continue over the medium-term, it may decline in magnitude, and in particular external financing for the recurrent budget is expected to be phased out over time. Thus financing of the fiscal deficit will need to become more diversified, probably including prudent levels of domestic borrowing in the medium term.

3.44 ***Looking forward, risks to budget financing, external financing in particular, may be exacerbated by poor performance in revenue mobilization or expenditure management.*** Future external assistance, particularly the part going through the Core Budget, is likely to be positively correlated with domestic revenue effort and improved expenditure management. This suggests that mutually-reinforcing trends may lead to a high scenario whereby good revenue performance and expenditure management (money gets well spent) encourage high inflows of external assistance, further enlarging the resource envelope, or a lower scenario whereby poor revenue performance and weak expenditure management

[6] One option would be to focus the newly developing Internal Audit Department of MoF initially on the security sector. The vocation of this department, as per the new Public Finance and Expenditure Management Law, is to cover the whole of Government. Given that a mechanism (the ARTF Monitoring Agent) is temporarily in place for most of the civilian recurrent budget, this department could initially prioritize its work program toward the security sector.

(including inability to fully spend resources) result in flagging external assistance, severely constraining the resource envelope. Thus progress toward fiscal sustainability could occur under a highly constrained situation or under a developmentally very positive scenario, enabled by rapid revenue growth and more generous external assistance. Achieving the positive scenario requires careful management and further underscores the need for strong revenue mobilization and effective utilization of resources.

3.45 ***Within the supply of external assistance, Afghanistan needs to carefully assess what level of external debt it can prudently incur***, to serve as the basis for a sound debt management strategy. The International Monetary Fund (IMF, 2005) has undertaken a debt sustainability analysis for Afghanistan, although handicapped by lack of data and uncertainties about initial conditions (most notably about the disposition of Soviet-era Russian claims on the order of $10.8 billion – equivalent to about 190% of 2004/05 GDP excluding the opium economy). The main findings of the analysis are as follows:

- Assuming forgiveness of all pre-existing bilateral claims (including Soviet-era debt), strong economic and revenue performance, and a very high degree of concessionality in new debt (i.e. along the lines of IDA concessionality), Afghanistan can engage in modest new borrowing while keeping its debt sustainability indicators within safe limits.
- However, it is clear that the bulk of external assistance for some time to come will need to be in the form of grants.
- Any combination of weaker economic or revenue performance, failure to secure full forgiveness of all bilateral claims, a substantial share of loans in total external assistance, or a lower degree of concessionality of new borrowing could lead to a situation where Afghanistan's debt and debt service burden become unsustainable.
- Given the uncertainties, a very prudent external borrowing strategy is called for, relying only on modest amounts of highly concessional loans and ruling out commercial or export credits for the foreseeable future.

STRENGTHENING MUNICIPAL FINANCES

3.46 Afghanistan's municipalities constitute the only semi-autonomous level of government and should play a very important role in urban service delivery (Chapter 8). They have their own budgets, but levels of municipal taxes and fees are determined by the central Government, which also approves municipal budgets. Since municipalities are supposed to live within their means (i.e. expenditures are constrained by resources), they do not directly contribute to fiscal deficits. However, there are important issues related to future municipal expenditure liabilities associated with public investments (which often are decided on and executed by central ministries rather than by municipalities themselves). Similar potential issues arise with respect to staffing, although there is no indication that municipalities have gone on hiring sprees, probably due to their relatively hard budget constraints. There are serious weaknesses in the basics of public financial management at the municipal level – budget formulation, budget execution, accounting, and auditing. And there are widespread perceptions of corruption in municipalities.

3.47 Managing the fiscal risks associated with municipalities will require: (i) much better information on municipal revenues and expenditures; (ii) clear delineation of their roles and responsibilities (in particular avoiding confusion and overlaps vis-à-vis central ministries); (iii) an assessment of the future municipal expenditure liabilities that are being created by public investments, including those by the Ministry of Urban Development and other line ministries; (iv) pro-active revenue mobilization efforts by municipalities (focused on a small number of tax sources that have been widely demonstrated by international experience to be appropriate municipal revenue sources); (v) strengthening municipalities' core PFM capacity; (vi) integrating their operating and development budgets; and (vii) improving governance. Progress in these areas will require significant capacity development (see Chapter 9).

3.48 Kabul Municipality is much larger than all other cities in Afghanistan (accounting for something like 15% of the total national population) and currently has a special status (more-or-less akin to that of a ministry) in the overall structure of the Government. Thus it is particularly important that budget data for

Kabul Municipality be made available on a timely and transparent basis, and that the Municipality's PFM system – including the budget process – is improved (Volume III, Chapter 5).

MANAGING NATIONAL ASSETS INCLUDING STATE-OWNED ENTERPRISES[7]

3.49 Public investments create state assets, whose sound management is very important for the effectiveness of the PFM system. Often (though not always) public assets are managed by State-Owned Enterprises (SOEs) involved in delivery of public services or other commercially-oriented activities. Government departments also are custodians of various types of public assets. While many SOEs in Afghanistan are defunct and were involved in activities that would be more appropriately handled by the private sector, there are some activities (e.g. public utilities like electricity and water supply) that are likely to remain primarily in the public sector for the foreseeable future. SOEs and other commercially-oriented activities carried out by the state also entail fiscal risks which need to be managed. In many countries the financial losses, wage costs, and other liabilities of SOEs constitute a serious risk to fiscal and macroeconomic stability.

3.50 The SOE sector in Afghanistan does not appear to be very large, and many SOEs are defunct, with their main asset being land. Information compiled by the SOE Department of MoF indicates that there are about 70 SOEs, with total employment of 20,000. Although financial reporting by SOEs and their supervisory line ministries is poor and incomplete, it appears that, particularly in 2004/05 when controls on SOE spending were tightened up, budgetary transfers to SOEs (subsidies and payments of salaries to SOE workers) have been small. Transfers from SOEs to the budget also appear to have been very small. However, a very rough estimate of public investments in SOEs through the (core and external) development budget since late 2001 is in the range of $150 million, of which 70-80% has gone to the electricity and water utilities. Analysis by the SOE Department suggests that 10 SOEs would appropriately stay under Government ownership, 20 could be liquidated, and 40-plus privatized.

3.51 The figures on SOEs are far from complete, however, leaving out some very important enterprises and their assets. Certain joint venture enterprises are excluded from the list even though their total Government ownership is well above 50% (e.g. Ariana Airlines, and some public sector banks). In other cases, activities and associated assets are under Government departments without formal creation of an SOE. Moreover, both SOEs and their supervising line ministries generally lack financial management capacity, and as in the case of the budget in general, their sources of financing tend to be fragmented, including investments sponsored by line ministries and also those channeled through the External Budget.

3.52 It is very important to ensure that SOEs do not become a significant fiscal risk factor for Afghanistan and that those which are defunct or which are engaged in activities which should be in the private sector are appropriately disposed of in a manner that encourages private sector development, with reasonable provisions for the affected SOE employees. Key priorities for monitoring and managing the fiscal risks associated with SOEs include:

- *Improving the legal framework and information base* on SOEs and other state assets. It is strongly recommended that the existing legislative framework within which SOEs operate be reviewed. It may be better to repeal the SOE Law and corporatize all SOEs so that they can be governed under the same legislative provisions as other companies. An inventory of state assets should be compiled, including SOEs and other public sector activities.
- *Regular reporting of key financial variables by SOEs* (including those with less than 100% Government ownership), and their compilation for use in monitoring and policy decisions. This will require capacity development in SOEs, supervising line ministries, and MoF.
- *Careful policies on and monitoring of SOE investments (including avoiding creation of new SOEs),* which should include SOE investments occurring outside the Core Budget (Box 3.3 suggests practical guidelines for responding to funding proposals related to SOEs).

[7] This discussion on SOEs is based on Volume III, Chapter 4, and also on Volume IV, Chapter 4 on the mining sector, which looks at SOEs in this sector.

- *Ensuring transparent financial transfers between SOEs and the Government budget* (tax payments and subsidies).
- *A sound legal and policy framework for privatization/restructuring of SOEs.* The Cabinet has recently adopted a privatization policy and has amended the SOE Law to facilitate divestment of SOEs. The privatization process will need to be clear and transparent; investments in SOEs to be divested as well as creation of new SOEs should be avoided.

Box 3. 3: Recommended Guidelines for Responding to Budget Proposals for SOEs

First, *use of public funds (whether domestic resources or external assistance) should be limited to existing SOEs that will remain under public ownership for some time.* MoF should first confirm whether the Government has full ownership of the firm concerned, to avoid potential claims by private parties. MoF should then make use of the SOE Department's prioritized list, in which the SOEs that will remain under public ownership are identified. Specifically:

- Fresh investments in utilities could be considered, as utilities are likely to remain under public ownership for some time, so long as these investments are accompanied by necessary reforms and improvements in financial management in the public utilities concerned, including a sound business plan.
- No investment should be made in SOEs on the privatization list. Labor or financial restructuring could be considered, but other investments (e.g. in new equipment or technology) are not appropriate as international experience demonstrates that Governments usually do not recover such investments through a higher sale price.
- No investment should be made in SOEs that are to be liquidated.
- No investment should be made to create new SOEs because this would send an adverse signal to the private sector, and creation of new SOEs would generate fiscal risks and potential liabilities for the Government.
- Finally, some rehabilitation investments may be considered for SOEs that will stay in the public sector.

Second, *SOEs should have an acceptable minimum level of financial oversight.* A certain level of administrative reform in the parent ministry of the SOE is required, so it has the capacity to supervise the SOE's operations. There also needs to be a minimum level of financial management capacity (accounting and reporting in particular) in the SOE itself. Being able to regularly assess the cash flow of the SOE is important, and ideally, audited accounts should be available. If these conditions are not met, major investments should be held back until improvements are made.

Third, *MoF in general should not respond positively to proposals for budget funding of SOEs' operating costs.* In exceptional cases the budget may have to cover operating costs of certain SOEs in the short run, but such funding when required should be tied to improvements in cash flow, e.g. through increased cost recovery.

Finally, in reviewing SOE funding proposals, *MoF should consider the value for money within a limited resource envelope, and also the multi-year fiscal implications.* The benefits and value of SOE proposals can be compared with other budget proposals, and the estimated economic rates of return should be adequate. Proposals with substantial downstream fiscal implications need to be turned down until there are sustainable financial arrangements.

E. Medium-term Fiscal Scenarios

3.53 In October 2005, the Government adopted its initial MTFF. As indicated in Chapter 6, an MTFF should be an evolving document, updated at the beginning of each budget cycle. Most important, the MTFF needs political buy-in, widespread ownership within the Government, and strong linkages to the development strategy and the annual budget process. Three illustrative medium-term fiscal scenarios are presented in this section, based on a simple spreadsheet model, to show some of the trade-offs involved in medium-term fiscal decision-making and the implications of some of the key issues discussed earlier in this chapter. For simplicity, the macroeconomic framework is the same in all three scenarios.[8]

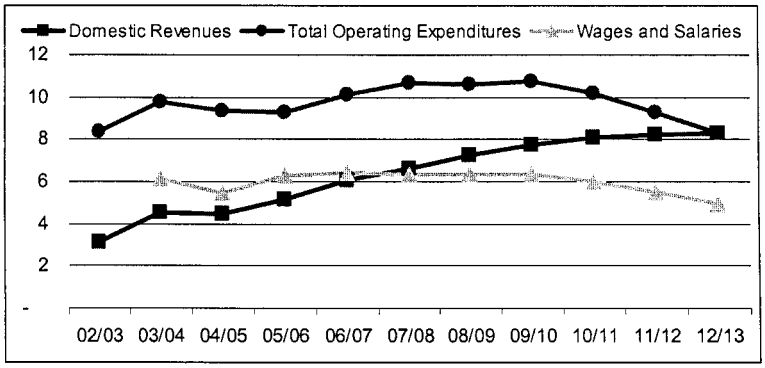
3.54 In the base case, it is assumed that a combination of prudent expenditure management, effective efforts to raise revenues, and sustained donor assistance allows Afghanistan to achieve a number of its policy objectives in the next decade: implement a pay reform, finance the wage bill by 2007, bring the ANA on budget (by 2010 in this scenario), increase O&M expenditures to operate and maintain new investments, and close the operating fiscal deficit before grants by 2012 (Figure 3.5a and Table 3.2). Revenue collection is expected to increase by one-half percentage point of GDP per year as a result of

[8] The key assumptions are: (i) dynamic growth and stable inflation (based on IMF projections, with the exchange rate assumed constant); (ii) an increase in the wage bill driven by recruitment of teachers, pay reform, and progressive inclusion of ANA salary costs on budget; (iii) an increase in O&M expenditures to operate new investments (based on data from the SAF report); (iv) an increase in investment expenditures, notably in the short run (based on data from the SAF report); and (v) a gradual move of development expenditures from the External to the Core Budget. More details are given in the Statistical Appendix (Table A.6).

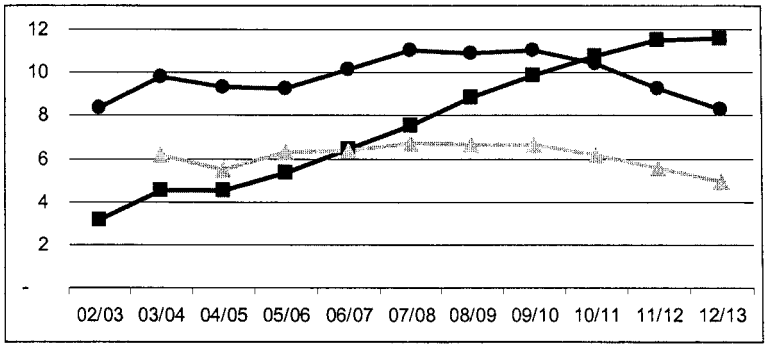
forceful implementation of the customs and tax administrative reform program and some expansion of the tax base through the implementation of tax policy measures already decided. Even though revenue would only rise to 8.3% of GDP by 2012/13 (still very low by international standards), in absolute terms it would quintuple from less than $300 million in 2004/05 to more than $1,500 million in 2012/13 (Chapter 4). The wage bill is projected to remain largely stable as a proportion of GDP. It is assumed that external assistance, primarily grants, could finance the gap between revenues and operating expenditures (more than $2 billion over seven years – compared to $0.7 billion during the first three years of reconstruction).

Figure 3. 5: Three Illustrative Fiscal Scenarios (% of GDP)

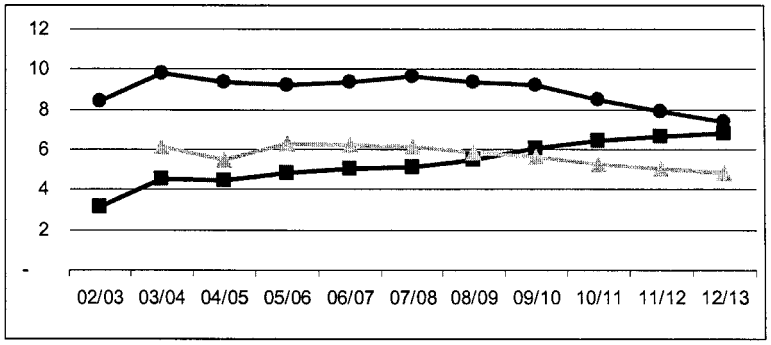
a. Base Case



b. High Case



c. Low Case



Source: MoF estimates; Staff projections.

3.55 However, some recurrent expenditures currently included in the Core Development Budget – e.g. health services – and in the External Budget – e.g. costs of running elections – would still not be financed by domestic revenues. Based on simple assumptions, it is estimated that in 2004/05 revenues covered 48% of the Government's Core Recurrent Budget but only 28% of all recurrent costs. With similar assumptions, in the base case revenues would cover only three quarters of all recurrent costs by 2012/13.

3.56 Turning to the high-case scenario, with additional effort collection of domestic revenue could reach 11% of GDP toward the end of the projection horizon (2011/12), i.e. at the lower end of the range observed in other low-income countries (Figure 3.5b and Chapter 4). This could enable the Government to speed up implementation of its civil service reform program, with a positive impact on budget implementation in the outer years. In this scenario, the Government could almost pay for its wage bill in 2006/07 and would be in a position to cover all operating expenditures by 2010/11. The external financing required for operating expenditures would be reduced to $1.4 billion over six years, freeing additional external assistance to finance development programs.

3.57 On the other hand, under a low-case scenario, if domestic revenues grow more slowly than in the base case the Government is likely to delay the implementation of pay reform and limit the increase in O&M spending (Figure 3.5c). This would have a negative impact on the Government's capacity and on the effectiveness of the investment program. Moreover, the Government would not be able to finance its wage bill before 2009/10 and would still run an operating deficit in 2012/13. This scenario probably would prove unsustainable, as external assistance is unlikely to finance the considerably larger fiscal gap ($2.7 billion over the next eight years). Consequently, the Government might seek to finance part of its budget deficit through domestic borrowing, with significant potential adverse implications for macroeconomic stability. The Government might also for example delay the necessary recruitment of teachers, slowing progress on education. There would also be a risk of long-term dependency on external funding for the ANA, and/or pressures to reduce its size.

3.58 In sum, these projections highlight the importance of domestic revenue mobilization for Afghanistan to achieve steady progress toward a sustainable fiscal position. They also indicate how more rapid revenue growth can create fiscal space for critical expenditures in support of reforms and capacity building. Conversely, lower revenue growth can be expected to have adverse development and macroeconomic impacts, which may be exacerbated if lower revenues lead to loss of donor confidence and financing. This exercise also highlights the benefits of a simple MTFF – to outline the fiscal path that the Government has embarked upon, manage the reform process, review affordability issues, and engage the international community on issues of fiscal sustainability.

Table 3. 2: Three Illustrative Fiscal Scenarios ($ million)

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	actuals			projections							
BASE CASE											
Domestic Revenues	129	208	269	379	532	677	853	1,033	1,220	1,393	1,593
Core Expenditures	342	558	874	1,226	2,116	2,360	2,434	2,614	2,376	2,588	2,597
of which Operating Expenditures	342	449	558	678	892	1,094	1,251	1,431	1,535	1,576	1,585
of which wages	n/a	282	374	460	562	649	749	845	900	940	948
Fiscal Deficit Before Grants	**213**	**350**	**606**	**847**	**1,584**	**1,684**	**1,581**	**1,581**	**1,156**	**1,195**	**1,005**
of which operating	213	241	289	299	361	417	398	398	315	183	(8)
HIGH CASE											
Domestic Revenues	129	208	269	393	569	770	1,046	1,315	1,618	1,954	2,225
Core Expenditures	342	558	874	1,226	2,116	2,398	2,471	2,651	2,407	2,588	2,597
of which Operating Expenditures	342	449	558	678	892	1,131	1,288	1,468	1,566	1,576	1,585
of which wages	n/a	282	374	460	562	685	785	882	930	940	948
Fiscal Deficit Before Grants	**213**	**350**	**606**	**833**	**1,546**	**1,628**	**1,425**	**1,336**	**789**	**634**	**373**
of which operating	213	241	289	285	323	361	242	154	(52)	(378)	(640)
LOW CASE											
Domestic Revenues	129	208	269	353	443	527	651	804	970	1,125	1,303
of which Core Expenditures	342	558	874	1,226	2,046	2,254	2,285	2,406	2,117	2,350	2,431
of which Operating Expenditures	342	449	558	678	823	988	1,102	1,224	1,276	1,338	1,418
of which wages	n/a	282	374	460	545	631	694	754	794	854	931
Fiscal Deficit Before Grants	**213**	**350**	**606**	**874**	**1,603**	**1,727**	**1,634**	**1,602**	**1,146**	**1,225**	**1,128**
of which operating	213	241	289	325	380	460	451	420	306	213	116
Memo											
GDP growth (real terms)	28.6	15.7	8.0	13.6	11.2	10.8	9.7	7.5	7.5	7.5	7.5
GDP deflator (%)	(22.2)	6.4	17.0	10.0	8.0	5.0	5.0	5.0	5.0	5.0	5.0
Exchange rate (AFA / USD)	45.3	49.0	47.7	48.5	48.5	48.5	48.5	48.5	48.5	48.5	48.5

Source: MoF estimates; staff projections.

CHAPTER 4. MOBILIZING DOMESTIC REVENUES

4.1 As seen in Chapter 3, sustained rapid growth of domestic revenue is a central element of Afghanistan's state-building and reconstruction agenda. International experience suggests that the larger the tax gap (the difference between the taxes actually paid and what should be paid according to existing laws and statutes), the more radical are the changes needed. With a tax gap on the order of 60%, Afghanistan needs to adopt a comprehensive strategy including revamping of the tax administration in order to obtain significant improvements in compliance. Based on the more detailed analysis in Volume III, Chapter 1, this chapter first briefly outlines the key features of Afghanistan's existing revenue base. It then reviews progress and summarizes key issues in improving revenue policy and strengthening tax administration. The last section presents some illustrative medium-term revenue projections.

A. Revenue Structure

4.2 While in industrialized countries the revenue to GDP ratio is typically around 45-55%, for the least developed countries it is closer to 20%. With revenue at 4.5% of GDP in 2004/05, Afghanistan is an outlier even in this group (Table 4.1). Tax revenues (3.4% of GDP) are only one-fourth the average for low-income countries.

Table 4. 1: Central Government Revenues (% of GDP)

Country/region	GDP per capita (USD) 1/	Total revenue	Total tax revenue
Afghanistan (FY2004/05 est.)	253	4.5	3.4
Sub-Saharan Africa	765	19.7	15.9
Asia and Pacific	1,447	16.6	13.2
Low-income countries	n/a	18.0	14.9
Low- middle income countries	n/a	21.8	15.8
Non-OECD average	n/a	n/a	15.2
Selected countries average	n/a	17.4	14.8
Pakistan	420	16.4	12.4
Iran	1,700	20.5	8.6
India	470	18.5	14.3
Kazakhstan	1,520	22.3	18.4
Kyrgyz Republic	290	19.1	15.0
Azerbaijan	710	20.5	19.4
Uganda	240	11.5	10.7
Rwanda	n/a	10.4	n/a

Sources: Government Finance Statistics (IMF); Keen (2004).
Notes: Figures refer to country averages between 1997-2001, where available.
For each revenue classification, only countries for which data are available are included.
1/ Country data refers to GNI per capita (World Bank)

4.3 Afghanistan's economy has many features commonly associated with a low tax base, including: (i) extremely low level of development; (ii) a large informal sector implying a narrow tax base; (iii) the dominance of agriculture which is hard to tax; and (iv) capacity constraints hindering the ability of the Government to collect taxes and of taxpayers to comply with tax regulations. Revenue mobilization is further complicated by the large opium economy that cannot be taxed directly, the need to consolidate Government control throughout the country, and heavy reliance on aid funds that are exempt from taxation. In addition, Afghanistan historically had very low domestic revenue mobilization — in the 1970s the tax to GDP ratio was around 7%, one of the lowest in the world. Afghanistan's medium-term revenue potential therefore is likely to be toward the lower end of the 11-14% of GDP range.

4.4 Domestic revenues have grown significantly over the last two years, starting from an extremely low base. In 2002/03, they reached $129 million, equivalent to 3.2% of GDP. In 2003/04, revenues reached $208 million (4.5% of GDP), and in 2004/05 they rose to an estimated $269 million, also 4.5% of

GDP (Table 4.2). The 2005/06 budget projected a modest increase in revenues to $333 million (4.7% of projected GDP).

Table 4. 2: Domestic Revenue Collection

	2002/03 Est.	2003/04 Est.	2004/05 Est.	2005/06 Budget
Domestic Revenue (percentage GDP)	3.2	4.5	4.5	4.7
Domestic Revenue (Afs)	5,864	10,168	12,812	16,150
Domestic Revenue ($)	129	208	269	333
Domestic Revenue (percentage shares)	..	**100**	**100**	..
Tax Revenues		62	75	
Taxes on income, profits and capital gains		4	8	
Domestic taxes on goods and services		3	9	
Taxes on international trade and transactions		53	57	
of which: Import duties		52	54	
Non Tax Revenues		38	25	
Admin. fees & charges, non-industrial sales		35	20	
Central Ministries (percentage shares)	..	**29**	**21**	..
Provinces	..	**71**	**79**	..
of which (in percent of total revenue),				
Herat		41	34	
Kandahar		7	11	
Nangarhar		7	12	
Kabul		5	5	
Balkh		3	9	

Source: MOF, Fund staff estimates.

4.5 ***Revenue is concentrated in a small number of taxes*** (Table 4.2). As in many less developed economies, import duties are the main source of revenue because they are relatively easy to monitor and collect, comprising over 50% of the total (Table A.5 in the Statistical Annex). Box 4.1 summarizes the major tax instruments currently being utilized in Afghanistan.

Box 4. 1: Summary of Major Tax Instruments in Afghanistan

Customs duties constitute the largest source of revenue in Afghanistan, as in many developing countries, largely because they are relatively simple to administer. While domestic taxes tend to grow in importance as countries develop, these are more difficult to administer and will be a long-term objective for Afghanistan. In the interim, the average import tariff should be kept relatively low, with a limited dispersion of rates to reduce arbitrary and excessive effective rates of protection as well as to minimize opportunities and incentives for corruption.

Export taxes should be avoided since they tend to cause an outflow of resources from the export sector to less efficient uses, compromising growth objectives. Recent tax reforms have lowered tax rates for exporters.

Income Taxes. Income taxes ideally should be levied on a global basis and include all forms of income. The corporate and top personal tax rates have been aligned at 20%, relatively low by international standards. Accompanying this move, new administrative provisions were added to the law, including introduction of self-assessment principles; provision for tax rulings so that investors have greater certainty about tax rules; and strict secrecy rules to heighten the accountability of the tax administration in dealing with sensitive business information. The planned restoration of the wage withholding tax and the simplification of personal tax rates, with only two nonzero personal rates, should help improve compliance. The level of exemption has been set to effectively remove most civil servants from taxation (which should ensure a progressive system).

Sales taxes. These taxes should be consolidated as a simple and broadly based tax on final consumption. However, Afghanistan currently has a complex and cascading system of Business Receipts Tax (BRT) based on turnover and numerous presumptive (fixed) taxes for smaller traders, which is far from ideal. While a single rate Value-added-tax (VAT), with crediting provisions and zero-rating of exports, is one of the most efficient taxes, it would be administratively too complex to implement at this time. However, over the medium term Afghanistan should expand the BRT toward a more broad-based consumption tax that broadens the tax base and avoids cascading.

Excise taxes. There are currently no excise taxes in Afghanistan.

4.6 ***Over 93% of total revenue is collected either by Central Ministries (mainly in Kabul) or in just five of Afghanistan's 34 provinces:*** Herat, Nangarhar, Kandahar, Balkh, and Kabul. Four ministries account for 88% of total revenue reported by central ministries: MoF, Ministry of Communications which derives revenue from the sale of telephone services, Ministry of Commerce from commissions on imported goods, and Ministry of Interior from motor vehicle registrations.

4.7 ***In addition, municipalities collect some revenues.*** These include, for example in the case of Kabul, taxes on real estate (a rental tax and a levy on property notionally intended to cover the cost of sanitation services); various duties for business licenses, contracts, property deeds, markets, etc.; fees for services (e.g. cleaning of septic tanks of residential properties); rents; and proceeds from sale of land etc. The revenue yields of these taxes and levies are low, however: in the case of Kabul, total municipal revenues in 2004/05 are roughly estimated at around $6 million – in a center of economic activity with a population of around three million.

4.8 ***There are many small "nuisance" taxes.*** With around 90 active taxes – half of them generating less than Afs 1 million ($21,000) during 2004/05 – the administrative costs of some taxes most likely outweigh the revenue gain. The income tax law provides for a variety of presumptive taxes on small businesses, usually referred to as fixed taxes, as well as the cascading turnover tax (BRT). The law also identifies 170 tax categories of business establishments. Removing many of these small "nuisance" taxes and simplifying the tax collection system will be cost-effective and helpful to the private sector.

4.9 ***There are also illicit taxes and instances of double taxation or ambiguities in tax laws.*** The business community has noted numerous cases where illicit taxes add to the cost of business. For example, additional "transport taxes" may be levied on the owner of the goods, and provincial or municipal authorities may charge other ill-defined taxes. Municipal taxes also need to be streamlined as noted above, and there are cases of double taxation, for example on rental property income as the central government introduced a new services tax on rental income in 2004 (in most countries, property income is taxed at the local level). Businesses have also complained that the legal code is often unclear; for example with respect to tax-deductible expenses, with varying interpretations. This can lead to disputes and corruption.

B. Improving Revenue Policy and Tax Administration

4.10 MoF is responsible for revenue policy and revenue collection, with functions divided between the Afghanistan Customs Department (ACD) and the General Presidency of Revenue (GPR). The ACD historically has been a much more distinct entity, with functions including collection of customs duties and management of a customs service. The GPR has traditionally been in charge of domestic taxation policy, with actual collection being handled by the Mustoufiats.

GENERAL APPROACH

4.11 ***The ideal tax system raises in a fair manner the required revenues while minimizing distortions.*** It should (i) minimize interference with individual consumption, saving, and investment decisions; (ii) be relatively simple, transparent, and rules-based to encourage compliance and discourage corruption; and (iii) be stable and predictable to reduce uncertainty.

4.12 ***The Government's strategy should focus on improving compliance for taxes and locations with the highest revenue yields.*** This also implies getting rid of numerous low-yield "nuisance taxes" and curbing illicit levies as well as avoiding double-taxation and confusion. Some taxes may have good potential over the longer run, but large revenue yields in the short- to medium-term should not be expected. Mineral exploitation has good potential and is likely to generate tax and other revenues once the recently approved Minerals Law is implemented (see Volume IV, Chapter 4). Similar potentials may also exist in hydrocarbons, for which a Hydrocarbons Law is being prepared. However, these potential revenue sources will take time to develop.

4.13 Agricultural taxes have a long history as a religious tax (*zakat*). Subsequently taken over by the State and collected at the local level, agricultural tax was once a significant source of revenue. However, it has fallen into disuse over a long period of time, and any attempt to reinstate it is likely to be severely hampered by the security situation and prevalence of opium, as well as widespread poverty in rural areas. Nonetheless, given the importance of agriculture to the economy – and to avoid distortions that might

result from exempting an entire sector permanently from taxation – it may be advisable to revitalize agricultural and land taxes over time.

4.14 ***Tax policy and tax administration reform will be closely linked.*** Afghanistan's strategy for revenue mobilization needs to take into account the very weak state of institutions and limited implementation capacity. Tax policy needs to provide a modern framework within which the tax administration can be built. International experience suggests the following guiding principles for tax administration reform: (i) ***reducing the complexity of the tax system*** by reducing the number of taxes, harmonizing rates, reducing exemptions, and eliminating illicit charges and double taxation; (ii) ***encouraging taxpayers' voluntary compliance*** with simplified self-assessment procedures and better taxpayer education; (iii) ***differentiating the treatment of taxpayers by their revenue potential,*** commonly through the creation of a Large taxpayer Office and risk management strategies; and (iv) ***ensuring effective management of tax reforms.***

4.15 ***A major improvement was the establishment in 2004 of the Treasury Single Account (TSA),*** which integrates Government accounts into an account or set of linked accounts through which the Government collects revenues and transacts payments. The apex of the system is a single account held by the Ministry of Finance (Treasury) at the Central Bank. The TSA is designed to ensure that all Government revenues, wherever collected, are transferred to the central Government.

4.16 ***Civil service reforms are required to develop a motivated and skilled cadre of revenue staff*** (Chapter 9). The customs and tax administrations face unique challenges in having to collect funds for the Government, which increases the risk of corruption. Therefore a key component of the customs and tax reform programs is the development of professional (dedicated) tax and customs services. This entails specialized training programs and institutions, a career development structure within the service, and as and when appropriate, a performance-based remuneration system. These reforms are currently being undertaken as part of MoF's PRR program

CUSTOMS ADMINISTRATION REFORM

4.17 Customs administration reform will continue to be critical for success. During 2004, the ACD implemented important measures to: (i) simplify the tariff system (Box 4.2); (ii) introduce simplified customs clearance documentation and procedures; and (iii) establish an effective system of customs brokers to facilitate a speedier transit process. Ongoing reforms are extending ACD's operations in the provinces and include: (i) a modern customs code; (ii) major improvements in the customs infrastructure throughout the country; (iii) gradual introduction of a computerized recording and management system (ASYCUDA, a standard international program for customs, Box 7.2); (iv) re-organizing and re-building of human capacity in the central and regional customs offices; and (v) legislation to establish effective enforcement mechanisms, combined with an effort to reduce illegal charges and consolidate and rationalize the number of charges.

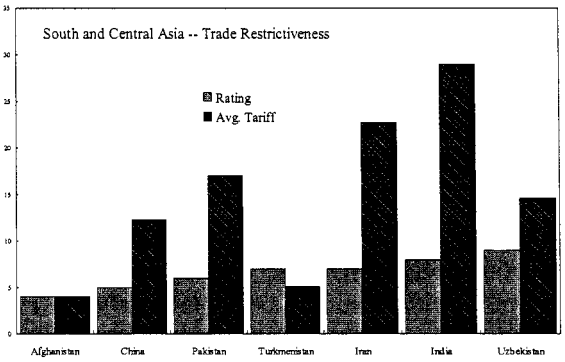
4.18 The Customs administration faces many challenges, including the poor security environment, lack of experienced managers, poorly trained staff, inadequate facilities and equipment, and outdated and cumbersome operating policies and procedures. Customs regulations reportedly are not applied consistently throughout the country, and the lack of an automated system undoubtedly impacts negatively on revenue performance.

DOMESTIC TAX ADMINISTRATION REFORM

4.19 The domestic tax base is likely to remain relatively narrow for some time, and reforms being implemented will focus on large taxpayers. The current set of reforms includes: (i) the adoption of a tax reform package in June 2004; (ii) the creation of a Large Taxpayer Office (LTO) and restructuring of the headquarters and provincial revenue organizations; (iii) the nationwide roll-out of a new Taxpayer Identification Number (TIN); and (iv) the consolidation of tax legislation amendments to address the excessive use of tax holidays, exemptions, and "special agreements".

Box 4. 2: Afghanistan's Trade Regime

Establishment of an open and transparent trade regime has been a consistent priority of the Government, which has made sweeping tariff and customs administration reforms, resulting in a significant improvement in transparency and simplicity, leaving Afghanistan as one of the most open economies in the region.



Under the previous trade regime there were 25 tariff bands, with rates ranging from 7-150%, and with a simple average of about 43%. However, a highly-appreciated artificial exchange rate was used in calculating payments of customs duties (made in domestic currency), which meant that actual payments were on the order of only 5-10% of nominal tariff levels. An overhaul of the tariff system brought the number of rates down to six (2.5, 4, 5, 8, 10, and 16%), with relatively low dispersion of rates, and shifted to use of the market exchange rate in calculating duties payable. By virtue of this rationalization, the average tariff declined to 4% (weighted by the number of items in each rate category). Even with the addition of a range of "fees", the estimated average applied tariff is only 5.3% – the lowest in the region. Afghanistan maintains import bans on only a few products (largely for religious purposes), and imposes no seasonal restrictions, quotas, or other non-tariff barriers. Furthermore, licensing requirements – reformed effective April 2004 – have been drastically simplified. The import license application process, which previously involved 42 steps, 58 signatures, and several weeks of processing, now involves only three steps, six signatures, and two days to process. As a result, Afghanistan's trade regime currently rates as a "4" in terms of the IMF's Trade Restrictiveness Index, same as the EU and United States.

4.20 ***A focus on large taxpayers can enhance revenues.*** In many countries a small number of taxpayers (perhaps 5%) account for 75% or more of total tax collections. In Afghanistan, the need to focus on large taxpayers is heightened by the low level of compliance and very limited administrative capacity. Afghanistan established an LTO in 2004 within the Revenue Directorate of MoF. In order to become fully effective, this newly-created organization needs to focus on selecting and then developing an appropriate relationship with the largest taxpayers, and should not get diverted to collect revenue from smaller clients. Appropriate criteria for large taxpayers have been developed by the Government. Within about two years, the LTO can be expected to be collecting at least 60% of total (non-customs) domestic tax revenue.

4.21 ***Reform of provincial tax offices will require long-term capacity building efforts.*** Although the LTO in due course should collect a considerable proportion of tax receipts, the provincial revenue offices, currently based in the Mustoufiats, will continue to collect substantial amounts, which will be important to ensure a relatively broad base of taxation. However, the GPR has never been the headquarters of the tax administration as the provincial Mustoufiats report to the Treasury. To develop a more professional service, the current PRR plan aims to build a new tax administration headquarters and operational tax offices in provinces reporting to it.

MOVING TOWARD A BROAD-BASED CONSUMPTION TAX

4.22 The current indirect tax system has serious deficiencies, including: (i) a narrow tax base leading to low revenue yield; (ii) serious potential cascading (albeit generally at a low rate); and (iii) disincentives to export. These problems could be addressed by moving toward a broad-based manufacturers sales tax in 3-5 years, which can generate a significant amount of revenue and will be necessary to ensure fiscal sustainability over the longer term. Value Added Tax (VAT) is the most common form of consumption tax imposed by central governments, used in more than 100 countries.[9] However, introduction of a VAT

[9] In a VAT system, all persons or businesses engaged in supply of taxable goods and services are required to register for VAT and charge VAT on all taxable sales. Their actual liability, however, is only the net of the VAT charged on their sales (output tax), reduced by the VAT paid or payable by them (input tax) for goods and services purchased for use in their taxable activities.

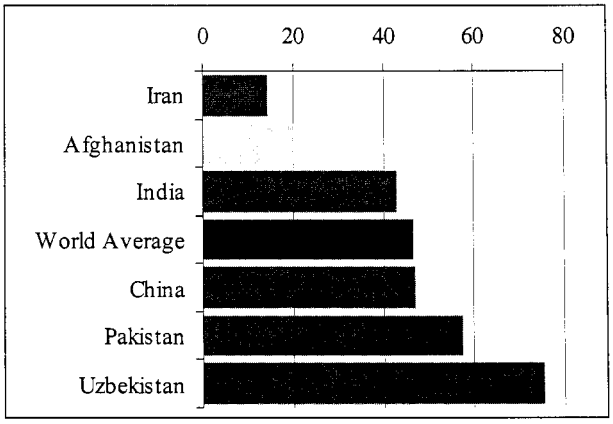
through to the retail level may represent a more radical reform of the tax system than the Government is prepared to introduce, or is needed.

4.23 ***A single-stage sales tax at manufacturing level may be the best option.*** Phased extension of the recently introduced taxes on selected services could pave the way for a broader-based consumption tax as development of administrative capacity permits. A manufacturing sales tax imposes the tax at the point where goods are first sold in the case of domestically produced goods, and at the point of customs clearance for imported goods. A single tax rate for all goods would be simpler to administer and would not distort relative prices. This kind of sales tax has been employed in many countries in the earlier stages of their tax development, and it can be expanded further to wholesale and eventually retail commerce with a minimum of disruption.

TAXATION AND INVESTMENT INCENTIVES

4.24 Overall, the tax regime in Afghanistan is rather competitive, with one of the lowest corporate income tax rates in the region. In 2004, the corporate income tax was reduced to a flat rate of 20% of net taxable income. Cross-country comparisons of tax rates are difficult, but in Pakistan corporate tax rates range from 35% to 50%, Iran charges a flat rate of 25%, in China the rate is 30%, in India the rate is 36.75% for domestic companies with a more complex schedule for foreign companies, and in Uzbekistan the corporate tax rate ranges from 20-35%. Figure 4.1 highlights Afghanistan's relative position by comparing the total tax burden (excluding tax on labor) that would face a typical firm in several countries.

Figure 4. 1: Total tax payable (% of gross profits)



Note: World Average covers 155 countries. Source: Doing Business Indicators, World Bank.

4.25 The first-best strategy for sustained investment promotion consists of providing a ***secure, stable, and transparent legal and regulatory framework,*** as well as adequate supporting institutions, including a tax system in line with international norms. On the other hand, available evidence suggests that providing ***tax incentives for investment promotion*** is not cost-effective and that the revenue cost is potentially significant. As a general rule, indirect tax incentives should be avoided (as inefficient), and discretion in granting incentives should be minimized as this can encourage corruption.

4.26 More specifically, tax holidays, which are widespread in developing countries, have well-known shortcomings. They basically consist of applying a rate of corporate income tax lower than the regular rate – often zero – to companies in a certain sector or region for a pre-specified period. The main objective of tax holidays is to increase investment. They raise several issues:

- By exempting profits irrespective of their amount, tax holidays benefit an investor who expects a high rate of return and probably would have invested even without the incentive.
- Tax holidays provide strong incentives for tax avoidance, as taxed enterprises could enter into economic relationships with exempt ones to shift their profits to the latter through transfer pricing. The duration of tax holidays also is prone to abuse.

- Time-bound tax holidays, if they have any impact at all, tend to attract short-run projects, which typically are less beneficial for the economy. In Afghanistan, over 40% of tax holidays granted before mid-2004 were reportedly awarded to construction companies.
- The revenue cost is seldom transparent, unless enterprises are required to file proper tax returns and the aggregate fiscal "loss" is calculated. Conservative estimates by MoF put the revenue loss due to exemptions and concessions granted prior to July 2004 at $30 million.
- Tax incentives could be of questionable value to a foreign investor because the benefits may be offset when profits are repatriated through an increased tax charge in the home country.

4.27 In 2004, tax holidays and exemptions were replaced by two tax incentives: accelerated depreciation and unlimited loss carry-forward. These have the least of the shortcomings associated with tax incentives. Since merely accelerating depreciation of an asset does not increase the total allowable depreciation beyond its original cost, little distortion in favor of short-lived assets is generated. Neither is there much incentive for an enterprise to engage in tax abuse. Accelerated depreciation also does not have the other negative elements associated with tax credits.

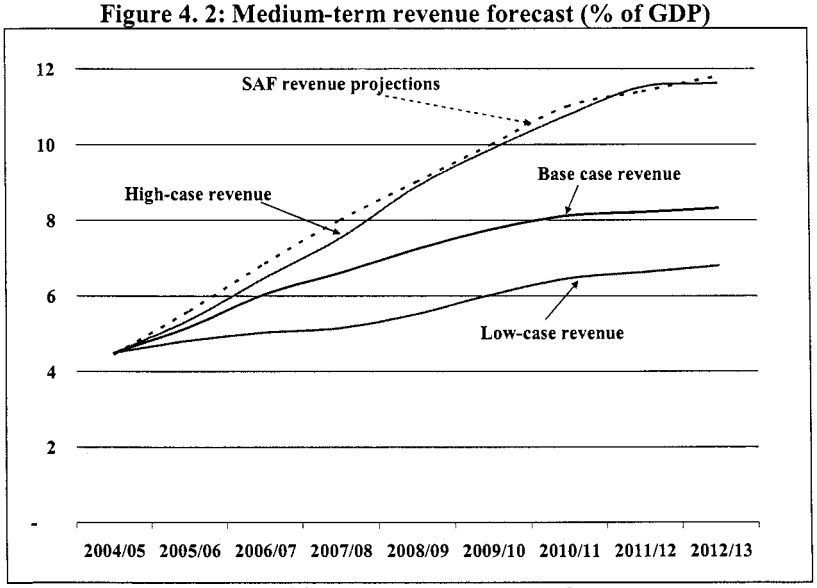
C. Medium-term Revenue Projections

4.28 Underlying the fiscal scenarios outlined in Chapter 3 are illustrative revenue projections driven by: (1) economic growth and inflation: (2) customs and tax policy reforms; (3) customs administration reforms; and (4) tax administration reforms. The macroeconomic assumptions are similar for each scenario, with real GDP growing at around 10% over the first four years and falling to around 7.5% thereafter. Inflation also falls from an initial rate of 10% per annum to 5%, while the nominal exchange rate remains stable. Several alternative scenarios illustrate the implications of different reform paths over a ten-year period:

- *Scenario 1 (baseline case) assumes gradual implementation of the five-year customs and tax administration reforms.* These include the wage withholding tax (raising a total of $120 million in the first three years); selected service taxes including roll-out to other urban centers ($36 million in the first five years); and the airport tax ($2.7 million over three years). Improvements in compliance are 10-15% per annum during the first six years before falling to 5% per annum subsequently.
- *Scenario 2 (high-case) assumes accelerated implementation of the five-year customs and tax administration reforms combined with additional revenue measures.* Improvements in compliance rates are higher than in scenario 1, 20% p.a. in the first four years, then gradually falling to 5% annually, assuming stronger performance from Customs administration and the LTO. There is also a gradual move toward a consumption tax which broadens the tax base, and eventually royalties from the mineral sector gradually come on stream.
- *Scenario 3 (low case) assumes no further tax policy reforms.* Based on reforms so far, compliance rates improve by around 10% p.a. during the first six years before falling to 5% p.a. thereafter. No additional major policy reforms are implemented.

4.29 The revenue ratios for each scenario are shown as a percentage of GDP in Figure 4.2 (see also Statistical Appendix Table A.6). These ratios may provide useful benchmarks for assessing Afghanistan's revenue path. As discussed in Chapter 3, in the low case scenario Afghanistan would fail to meet a number of its policy objectives. ***While the high-case scenario would require considerable efforts and thorough reform implementation, experience in other post-conflict countries suggests that it could be achieved.*** Although the revenue to GDP ratio rises by in excess of one percentage point per year in the first four years, some other post-conflict countries have achieved this level of revenue performance. For example, the creation of the revenue authority in Uganda helped to double the tax revenue/GDP ratio from 6% to around 12% in the 1990s (Figure 4.3b). In Rwanda the tax revenue/GDP ratio increased sharply from a low of 4% in 1994 to around 12% in late 2002 (Figure 4.3a).

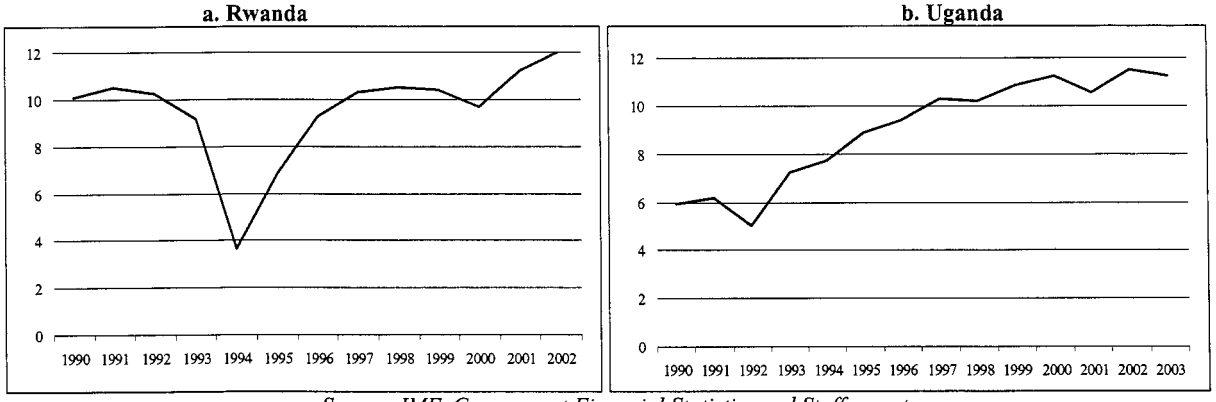
Figure 4. 2: Medium-term revenue forecast (% of GDP)



Source: Securing Afghanistan's Future (SAF) and IMF estimates.

Figure 4. 3: Comparative Growth in Revenue Collection (% of GDP)

a. Rwanda **b. Uganda**



Source: IMF, Government Financial Statistics and Staff reports.

4.30 ***However, Afghanistan's particular context and the inherent risks it faces should be kept in mind.*** The country's GDP, for example, depends to a large degree on agriculture, which is volatile. The exchange rate, relatively stable since the introduction of the new Afghani (and assumed to remain so under all scenarios), may also be subject to bouts of instability in the face of shifts in demand, uneven aid inflows, or actions against the opium economy. Furthermore, institutional capacity is still weak, and the quality of policy-making (while strong thus far) is uncertain over the medium term. These factors suggest that there is a risk that revenues would turn out to be considerably lower than projected here.

4.31 ***Nevertheless, fiscal sustainability considerations (Chapter 3) imply that increasing domestic revenue mobilization needs to be given very high priority.*** This will reduce aid dependence over time, create fiscal space for development, and send a very strong signal of the Government's commitment to progressing toward fiscal sustainability – both to Afghanistan's own people and to the international community – thereby enhancing the latter's confidence to continue to provide financing for the country's operating budget until the gap between recurrent expenditures and revenues is bridged.

CHAPTER 5. PRIORITIZING EXPENDITURES

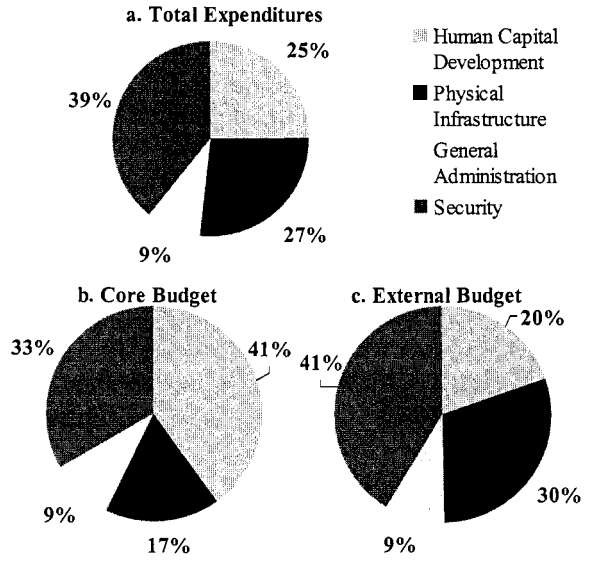
5.1 A second key desired outcome of the PFM system is effective allocation of public sector resources to different sectors, programs, and activities. This should be within an affordable budget envelope (as discussed in Chapter 3); in accordance with Afghanistan's development strategy, sector strategies, and national policies; and in a manner that achieves good development outcomes. With Afghanistan facing immense needs in most sectors, the issue clearly boils down to prioritization: What is the right balance across and within sectors? What is the right sequencing between competing priorities? What are the most effective interventions? This chapter first reviews the broad pattern of expenditures across sectors and recent trends, and discusses why it is so important to prioritize. The second section looks at prioritization of expenditures across sectors, the third section at prioritization within sectors.

A. Sectoral Expenditure Patterns: Why It is Important to Prioritize

THE ALLOCATION OF SPENDING ACROSS SECTORS AND RECENT TRENDS

5.2 Afghanistan's budgetary expenditures can be classified along programmatic lines, and divided into four broad pillars established by the Government in its strategy documents (Figure 5.1): human capital development (25% of total spending in 2004/05), physical infrastructure (27%), general administration (9%, including trade and investment and public administration and economic management), and security (39%). Aside from the fact that security is the dominant sector, with a rough balance between the human capital and infrastructure pillars and much less going into the fourth pillar, it is not possible to say much at this very aggregated level. However, the pattern of expenditures differs significantly as between the Core Budget and the External Budget. Human capital development is the largest pillar in the Core Budget, reflecting substantial spending in the recurrent budget on teachers' salaries and in the development budget on the National Solidarity Program (NSP) and on basic health services (contracted out to non-government providers – see Chapter 8). On the other hand, security is considerably smaller than human development in the Core Budget but twice as large in the External Budget (reflecting in particular massive spending on the Afghan National Army). Infrastructure comprises a much larger share of the External Budget than of the Core Budget.

Figure 5. 1: 2004/05 Expenditure Composition (% of total of each category)



Source: MoF (preliminary annual statements for Core Budget and preliminary annual report for External Budget).

5.3 Within the broad pillars, spending can be divided among 16 national programs, of which the major ones include Education; Health; Livelihoods and Social Protection; Transport; Energy, Mining, and Telecommunications; Public Administration and Economic Management; National Police; and Afghan National Army (Table 5.1 and Table A.7 in the Statistical Annex). The ANA was the largest single sector in terms of expenditures in 2004/05; the transport sector, mainly consisting of roads, was second.

Table 5. 1: 2004/05 National Budget Expenditures by Program ($ million)

	Core Budget			External Budget	Total Budget		
	Operating Exp.	Development Exp.	Total	Development Exp.	Total	*% of total*	of which developt.
Human Capital Development	**192**	**157**	**349**	**494**	**843**	*25*	**651**
1.1 Refugees and IDP return	2	-	2	73	75	*2*	73
1.2 Education	115	7	122	102	224	*7*	108
1.3 Health	25	39	63	91	154	*5*	130
1.4 Livelihood and Social Protection	37	111	148	192	340	*10*	303
1.5 Culture, Media, Sport	13	0	13	36	50	*1*	36
Physical Infrastructure	**33**	**119**	**152**	**749**	**901**	*27*	**869**
2.1 Transport	6	78	83	497	581	*17*	575
2.2 Energy, Mines, and Telecom	12	33	45	177	222	*7*	210
2.3 Natural Resources Management	14	2	15	30	45	*1*	31
2.4 Urban Management	1	7	8	45	53	*2*	52
General Administration	**58**	**23**	**81**	**217**	**298**	*9*	**240**
3.1 Trade and Investment	3	6	9	31	40	*1*	37
3.2 Public Administration and Economic Management	55	17	72	186	258	*8*	203
Security	**275**	**17**	**292**	**1,036**	**1,328**	*39*	**1,053**
3.3 Justice	21	0	21	24	45	*1*	24
3.4 National Police and Law Enforcement	146	17	163	177	340	*10*	194
3.5 Afghan National Army	108	-	108	681	788	*23*	681
3.6 Mine Action	-	-	-	96	96	*3*	96
3.7 DDR	-	-	-	59	59	*2*	59
Unallocated	**-**	**-**	**-**	**8**	**8**	***0***	**8**
Total	**558**	**317**	**874**	**2,503**	**3,378**	***100***	**2,820**

Source: See Figure 5.1.

WHY PRIORITIZE? KEY TRADE-OFFS

5.4 First, like any country ***Afghanistan faces major resource constraints over the medium term*** (Chapter 3), and prioritization is essential to ensure that the available resources are well used. Substantial external assistance is available now but inevitably will decline over time, so making good use of these extra resources during the current window of opportunity is critical for success.

5.5 Second, with the bulk of public spending externally financed and most of it donor-executed, ***if the Government does not prioritize, the allocation of expenditures will be determined in an ad hoc manner by the fragmented priorities of others.*** The External Budget has a very large influence in determining the *ex post* prioritization of expenditures. In 2004/05, for example, the relative ordering of total expenditure by pillars (security, infrastructure, human development, general administration) was determined by the External Budget, whereas expenditure was allocated quite differently in the Core Budget (Figure 5.1). Moreover, the two top national programs in terms of funding (ANA and Transport) were determined by the External Budget, as these were only fourth and fifth in terms of spending in the Core Budget.

5.6 Third, ***prioritization is a political process*** (Box 6.1), which needs to be informed by and to interact with the national development strategy at the broader level (and strategies for different pillars like security as well as sector strategies at the narrower level), and sound technical inputs and guidance are required for budget decision-making (by Cabinet, later by Parliament). While at one extreme there is no technical "magic formula" and it is unrealistic to expect a purely technical prioritization of expenditures to be feasible (or even desirable), at the other extreme political decision-making in the absence of any sound technical inputs can lead to disastrous outcomes.

5.7 Fourth, ***Afghanistan faces especially severe issues in terms of prioritizing expenditures over time,*** in particular related to the downstream O&M consequences of public investment decisions made today (in both Core and External Budgets). The large amounts of recurrent expenditure in the External (Development) Budget will generate enormous pressures later (Chapter 3, Section C).

B. How to Prioritize: Allocating Expenditures Across Sectors

5.8 There are no easy answers on how to prioritize in allocating public expenditures across broad pillars and sectors. Sophisticated technical approaches can require a great deal of resources and even so are highly imperfect and can result in misleading conclusions. Simpler rules of thumb may work better. Judgment is called for. And inevitably political factors will be prominent.

5.9 A first critical point is that ***inter-sectoral allocation decisions need to be anchored in an encompassing national strategy for development.*** The national strategy document should provide general guidance and a framework for prioritization, as well as broad strategic priorities. The Government's *National Development Framework* (NDF – 2002) and subsequently *Securing Afghanistan's Future* (SAF – 2004), as well as documents prepared for Afghanistan Development Forum meetings, have provided a strategic vision and framework. In the SAF, a detailed medium-term investment program also was put forward. However, prioritization and sequencing were not concretely spelled out, and the discipline of a resource constraint was not applied. The Government is currently preparing its interim Afghanistan National Development Strategy (ANDS). It is hoped that the ANDS, and the consultative process around it, will provide guidance on broad prioritization of spending.[10] Prioritization will also be facilitated by setting a medium-term fiscal resource envelope (Chapter 3), and progressively strengthening its sector content.

5.10 Without overall strategic guidance, intersectoral allocation decisions can be arbitrary and counter-productive. A good example is security where, most strikingly, the justice sector has received only 3% of total security funding over the past three years (Figure 5.2). Police reforms have progressed slowly compared with the rapid development of the ANA. Based on the PFM Review's analysis (see Volume V), contributing factors to these anomalies include (i) the earlier lack of an agreed national security strategy (not surprising in the initial period following the end of major conflict in late 2001); (ii) the overwhelming dominance of the External Budget in overall security spending; (iii) the above problems, and fragmentation of decisionmaking across donors, making it more difficult for the National Security Council to fully carry out its mandated strategic, leadership, and coordination functions, although the situation has improved in 2004 and 22005; and (iv) fragmentation across sectors possibly exacerbated by the "lead donor" approach (whereby a lead donor was assigned for each sector within the Security Pillar).

5.11 More generally, ***identifying and mitigating gross anomalies in inter-sectoral allocations of expenditures can be a powerful tool for prioritization,*** if informed by strategy and mediated by the resource envelope. Outliers can be identified in terms of their relatively low (or very high) shares of total expenditures, or through comparing expenditure growth rates for different sectors. Agriculture may be a good example of a critically important sector (in the natural resources management national program) that has been underfunded.[11] On the other hand, the size and growth of expenditures on roads, while reflecting massive rehabilitation needs and the high priority assigned to this sector by the Government and partners, do seem to have far outrun investments in other major infrastructure sectors.

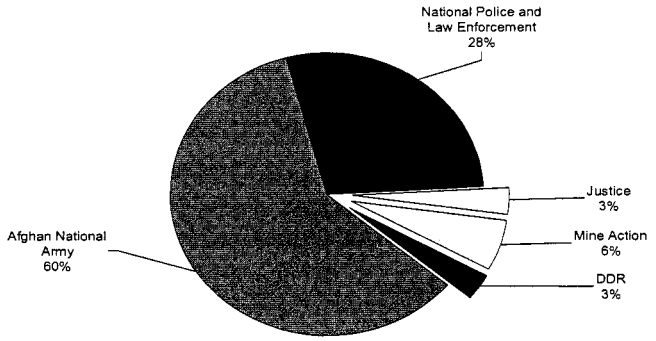
5.12 It is very important to ascertain the reasons behind gross anomalies in inter-sectoral expenditure patterns. Where major underspending in a sector is related to limited capacity or poor performance of the

[10] Such prioritization at a strategic level is challenging but possible, with success dependent on having a meaningful linkage to the budget process (medium-term framework and annual budgeting). For example, Armenia's draft Poverty Reduction Strategy Paper (PRSP) proposed interventions in over 100 areas, but intensive consultations supported by a software tool facilitated reaching consensus to concentrate on 12 priority areas linked closely to the MTEF and well-specified policy actions.

[11] In 2003/04, less than $40 million was spent in the Development Budget on projects under the Ministry of Agriculture's oversight, of which only $1 million was in the Core Budget.

concerned ministry, then additional funding alone will not solve the problem and on the contrary could waste resources. Sometimes gross anomalies may be in large part attributable to donors' preferences, as they may gravitate toward visible, popular, or well-performing sectors and away from others. Thus rectifying underspending needs to be accompanied by measures to address the underlying problem that resulted in low spending in the first place.

Figure 5. 2: Composition of Security Expenditures, 2002/03-2004/05



Source: Volume V.

5.13 At the opposite extreme in terms of technical sophistication is ***use of cost-benefit analysis as a guide to inter-sectoral prioritization.*** While superficially attractive, this approach carries heavy technical and informational requirements, and even in the industrialized countries it is not used systematically except in the evaluation of new project proposals. Moreover, there appear to be biases across sectors. For example, power projects and roads tend to have high estimated economic rates of return, whereas those for large irrigation projects tend to be more marginal. Since such differences are common across projects and country situations, they most probably reflect differences in the methods applied, data, etc. rather than mainly underlying differences in the development impact across sectors. Thus using cost-benefit analysis to prioritize across sectors can be misleading and counterproductive.

5.14 Information on ***international patterns of spending and outcomes across sectors*** may provide some guidance, although it must be applied judiciously in line with the country context. An international comparison highlights the very large share of Afghanistan's public expenditures allocated to the security sector (Statistical Appendix Table A4). It also suggests that, if the External Budget is taken into account, the share of education and health in total spending is lower than in other countries (11% against 18%).

5.15 An approach based on ***identifying bottlenecks and directing expenditures to alleviate them*** also may be useful in the short run. One example is building an electricity transmission line from northern Afghanistan to Kabul to deal with the power supply bottleneck facing the city. Strengthening the judiciary and creating a solid statistical system appear to be important enabling factors for many other sectors. Similarly, identifying successes can lead to scaling up or replicating them, for example in the case of the National Solidarity Program.

5.16 Another important lesson is ***the need for inter-sectoral prioritization to be comprehensive*** – no sector (e.g. defense) should be considered sacrosanct or immune from scrutiny.

5.17 In certain countries, the Government may ***allocate domestic resources so as to counterbalance donors' allocations of donor-executed assistance,*** thereby ensuring that the overall pattern of spending is in line with national strategic priorities. In Afghanistan, however, the External Budget is so large that it would be impossible to use the limited resources in the Core Budget to offset donors' priorities manifested in the External Budget. Hence there is no alternative to close cooperation with donors to ensure that the overall allocation of resources in the External Budget corresponds with national priorities. But this is difficult, and the problems faced by the Government in managing the External Budget provide strong grounds for more external assistance to go through Core Budget channels (Chapter 6).

5.18 From an incentive standpoint, it may make sense to have some ***linkage between sectoral allocations and performance.*** For example, ministries/sectors that do better in terms of spending the money they are allocated would get continuing or higher allocations in the future, whereas those that are not able to spend their allocations would get reduced allocations. However, a strong linkage to performance can result over time in underperforming sectors systematically getting less resources than the importance of the sectors concerned in the national strategy would call for. Since donors in their own allocation decisions respond to perceived good performance, they can exacerbate such imbalances. Thus while some short-term performance linkage may be desirable, from a medium-term perspective it is essential to correct the reasons for underperformance and ensure that well-performing sectors do not become grossly overfunded in relation to their strategic importance, within overall resource constraints.

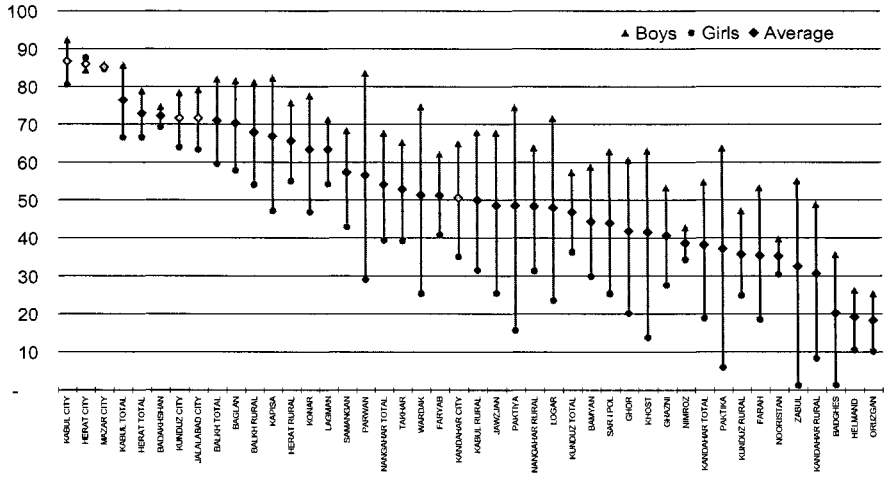
C. How To Prioritize: Allocating Expenditures Within Sectors

5.19 As in the case of inter-sectoral allocation, prioritization of spending within sectors (e.g. health, power, highways, irrigation) needs to be anchored in sound sector strategies, which should provide general guidance on priorities. Technically, prioritization within sectors is more manageable than inter-sectoral prioritization because the alternatives tend to be more comparable. Cost-benefit analysis, which cannot be used uncritically for broad intersectoral allocation decisions, is much more useful for prioritizing projects or programs/activities within a sector. Moreover, in sectors where benefits cannot be easily expressed in value terms or doing so is controversial (e.g. health), cost-effectiveness analysis can be applied, whereas this could not be used for the most part across sectors.

5.20 ***A very important consideration is the appropriate role of Government for the activity.*** The two key reasons for public interventions are because of public goods or externalities (i.e. goods and services that would not be adequately provided by the private sector alone) and for redistribution. Even when there is a clear case for Government intervention, the type of intervention can vary: regulation, financing, or direct provision. Public expenditures should therefore be reviewed against these criteria (Box 5.1).

5.21 ***Geographical and gender disparities comprise an important dimension for prioritization within sectors.*** For instance, in education disparities in enrollments between boys and girls, rural and urban areas, and provinces suggest that adjustments in expenditure allocations are necessary (Figure 5.3). A review of the education sector suggests that these issues can be addressed by an appropriate strategy, including recruitment of teachers (notably female teachers), targeted programs to increase enrollment, and use of local participatory mechanisms such as School Management Committees (Volume IV, Chapter 2).

Figure 5. 3: Net Enrollment Ratios, Grades 1-6 (2003)



Source: Volume IV, Chapter 2.

5.22 ***Technical analysis can be used to evaluate individual project proposals*** and as general guidance for prioritization of expenditures within a sector. Health is a good example of the latter approach, where the cost per life saved (cost per DALY[12] saved) of different types of interventions can be compared. In general, basic health interventions are much more cost-effective than more expensive curative care including hospitals (Table 5.2). A general rule of thumb is that when the cost per DALY saved of a health intervention exceeds average GDP per capita (around $250 in Afghanistan today), allocating public resources to that activity constitutes a relatively inefficient use of resources (particularly if activities with lower cost per DALY saved are underfunded). Based on these considerations, the Government has prioritized provision of an agreed Basic Package of Health Services, and has tried to resist pressures to make major new investments in hospitals, particularly in Kabul.

Table 5. 2: Cost-Effectiveness of Different Health Interventions

Intervention	Cost per DALY Saved
Vitamin A Supplementation	$1-3
Treatment of Tuberculosis	$1-3
Measles Immunization	$20
Oral Rehydration Therapy	$116
Point of use treatment of drinking water	$124
Management of childhood pneumonia	$133
Treatment of depression	$827
Hospital treatment of Leukemia	$1,156

Note: DALY is a disability adjusted life year. Source: Volume IV, Chapter 1.

5.23 In major infrastructure sectors where large projects are involved, decisions on individual projects form a primary element of intra-sectoral resource allocation, and ***cost-benefit analysis can be very useful.*** The highway sector is a good example. Afghanistan already has a large highway rehabilitation program underway, with a total cost exceeding $1 billion. Particularly in view of the future O&M requirements, any major new highway project proposals must therefore be treated with great caution and carefully prioritized. Benefits depend greatly on traffic forecasts (both freight and passengers), and on available alternative routes. Costs per kilometer may be fairly standard (depending on the type of road construction involved and the condition of the existing road), although there has been a great deal of cost variation in Afghanistan – depending in part on mountains, the number of bridges, tunnels, etc. (Box 7.3). High altitude and steep grades also affect the costs of users and reduce the net benefits to them. Another factor is extra security costs, estimated at 3-15% for highway rehabilitation projects.

5.24 Some other considerations are very important for the intra-sectoral allocation of spending. One is ***complementarities*** between different projects. A good example is the power sector, where gross imbalances between investments in generation, transmission, and distribution would sharply reduce returns. This highlights the need for a robust sector strategy, in this case an Energy Master Plan, which provides the rationale for prioritization, based on sequencing investments, taking into account lags in building large-scale infrastructure equipments, and adequately financing O&M.

5.25 Prioritization of public investments within sectors also must include the ***time dimension***. Medium-term targets for service delivery (whether for physical infrastructure or social services) need to inform investment decisions and O&M implications – not investments driving O&M. In addition there are critical sequencing issues in terms of what comes first, what comes later. As public investment accumulates over several years the O&M requirements become truly daunting, leading to questions about what size of investment program is affordable over the longer run, and to the critical need and potential for cost recovery to partially or fully fund O&M requirements (Chapter 8).

5.26 The hydrocarbon and mining sectors provide good examples of how important, and intricate, sequencing issues can be. Managing these underground resources is important for the Government, because of their potential impact on both domestic revenues and private sector development (including in

[12] DALY is a disability adjusted life year, which provides a common measure for comparing the burden of disease taking into account both death and disability arising from illness.

downstream sectors). Capacity development is an urgent priority, as lack of capacity to shift to an effective regulatory approach, limited political leadership to shift toward private development of underground resources, lack of policy consistency, and limited external assistance can combine to prevent progress, whereas a breakthrough is required.

5.27 Finally, technical criteria including cost-benefit analysis can be used to ***clean out excessive "wish lists" of proposed projects*** in the portfolios of different ministries. A damaging practice that is sometimes found in other countries is to maintain much too large a portfolio of approved/ongoing projects, for which the likely funding available will be far from sufficient to complete all of the projects. This must be avoided through ruthless culling of new project proposals as well as dropping approved projects and even those under implementation that have little hope of being completed. In Afghanistan some progress has been made in this regard: the 2004/05 development budget included 540 projects out of the 1,110 proposed by line ministries, of which only 210 were in the Core Budget. But this most likely is still too many, and the slow pace of project implementation suggests that better project screening and budget realism is required (Figure 3.1). The preparation of the ANDS creates an opportunity to strengthen this process and create a lean, high-quality portfolio of public investment projects (Box 5.1).

Box 5. 1: Prioritizing When Everything is Critical

Prioritization is technically and politically a daunting task in the Afghan context, with limited data and analytical capacity and enormous needs. However, prioritizing is important technically (not all projects will have the same economic and social impact and some projects require other projects to be completed first), fiscally (unrealistic budgets either produce large fiscal imbalances, or, not being implemented, make the budget an irrelevant tool), and politically (poorly prioritized budgets raise expectations, leading to disenchantment).

The first filter for prioritization is that each project should contribute to the ANDS's objectives and be part of the sector's master plan. The contribution to objectives of the ANDS should be clearly specified.

Beyond this filter, projects could be ranked based on four simple criteria:

- *Rationale* (Weight 15%): Should this be done by the public sector or can the private sector adequately undertake the activity? Does the project target the poor?
- *Cost-effectiveness* (Weight 15%): For the output of the project, has the least-cost alternative been identified? Are multi-year implications laid out, and is the project likely to be self-financing after completion?
- *Benefit-cost* (including identification of beneficiaries) (Weight 50%): Have benefits (e.g. social, financial) been quantified? Do benefits exceed costs?
- *Risk and mitigation* (Weight 20%): Is the project likely to be completed on time? Have allowances been made to address potential physical and financial contingencies? Are there institutional/managerial/technical constraints in carrying out the project? Are there any environmental risks?

Based on this ranking, the top-priority projects can be included in the budget up to the sector resource envelope.

It should be noted that a framework along the lines put forward above would need to be flexible in accordance with sector-specific circumstances. For example, some sectors like security are not expected to be self-financing, so the point in the second criterion about a project being self-financing after completion would not apply.

Based on Swaroop (2004).

CHAPTER 6. MAKING THE NATIONAL BUDGET THE CENTRAL INSTRUMENT OF POLICY AND REFORM

6.1 Previous chapters have looked at important outcomes of the PFM system; the next two focus on the PFM system itself, starting with the central process of national budget formulation. The first section of this chapter reviews the legal and institutional framework of the budget. The second analyzes progress and challenges in making the budget an effective policy tool. The third outlines issues of ownership and political buy-in for the budget. The last section looks at the implications of the large amounts of external aid for Afghanistan and discusses how donors can support the Government's efforts to make the budget the central instrument of policy and reform.

6.2 The issue of Afghanistan's weak institutional capacity (Chapter 9) has to be taken into account. It would be futile to reform budgeting without improving the Government's overall management framework. Ultimately, performance is a management issue, and there would be no demand for a performance-oriented budget without performance-driven management. Moreover, effective budgeting is demanding in terms of information and analysis. Thus appropriate sequencing is essential to bring about improvements that achieve their objectives.

A. Budget Preparation Process

6.3 The 2004 Constitution provides the legal authority for preparing, approving, and executing the national budget. The Public Finance and Expenditure Management (PFEM) Law, approved in June 2005, further specifies the processes and responsibilities. The Government is responsible for preparing the budget (and executing it, see Chapter 7), with MoF leading the process. The budget is then to be presented for approval to the bicameral legislature no later than 45 days before the start of the fiscal year, and approval is required no later than a month after the start of the fiscal year. In previous years, as the Parliament had not yet been established, the Cabinet approved the national budget through a Presidential Decree (see also Box 6.1 on the political economy of the budget).

6.4 As reflected in PFM indicator 11, progress has been made toward an orderly annual budget process. In particular, it has moved from a pure bargaining process to a more policy-oriented discussion. Modernization of Soviet-inherited practices has started. The mid-year review, established since 2004, has significantly improved the quality of budget management by allowing transparent adjustments during the year and creating a feedback loop from one year's budget implementation to the next year's budget preparation. Finally, significant information is publicly available on the Government's website, notably the budget guidelines, budget decrees, and fiscal reports (PFM indicator 10 and Box 7.2)

6.5 But much more remains to be done. A review of the seven steps of the budget formulation process (Table 6.1) reveals two key issues (in addition, some features of the process weaken the policy content of the budget, see next section). First, as in many countries the schedule is very compressed, starting after the mid-year review (late December 2004 for the 2005/06 budget). Either the process ends on time (for the operating budget) but with limited opportunity for substantive analysis and discussions, or it ends after the start of the fiscal year (for the development budget), constraining budget implementation. Timing is now even more critical since the Parliament will need sufficient time to review the budget. Second, the early stages of the process are weak, with no pre-determined budget envelope or sector ceilings. In many countries, the Cabinet reviews and agrees on the fiscal envelope (updating the MTFF, see Chapter 3) and on budget ceilings by sector, which sets a clear direction for aggregate fiscal discipline and broad allocations across sectors, reinforcing the budget's strategic content. The absence of such ceilings weakens the budget's policy content (Section B) and increases political bargaining (Section C). Section D looks at the role of external assistance in the process.

Table 6. 1: Key Steps and Issues in Budget Preparation

Steps	Description	Issues
1. Issue Budget Guidelines	Prepared by Budget Department and issued to line ministries	- Schedule gives little time for analysis - Development and operating budgets remain disconnected
2. Decide Budget Envelope	Prepared by MoF – requires Cabinet discussion and buy-in, and consultation with donors on external assistance	- No review process (in particular by Cabinet) - Difficult to operationalize with large aid inflows
3. Prepare Expenditure Proposals	Cabinet establishes "provisional operating budget" (envelope) for each ministry; line ministries and Budget Working Groups (in collaboration with donors) prepare their proposals for both operating and development budgets	- Absence of sector ceilings - Limited capacity to prepare fully justified expenditure proposals and to learn from previous years (weak monitoring and evaluation systems)
4. Appraise Proposals	Budget Committee (Cabinet subcommittee) appraises proposals and holds hearings	- Limited capacity to appraise proposals and prioritize them
5. Budget consolidation	Ministries revise their proposals and MoF prepares a consolidated budget	
6. Cabinet approval	Cabinet discusses consolidated budget, revises it, and approves it	
7. Enactment	Currently through a Presidential Decree, released transparently to public	- To be approved by Parliament once established

Source: "Budget Formulation in Post Conflict Afghanistan (2005/06)", background paper for the PFM review.

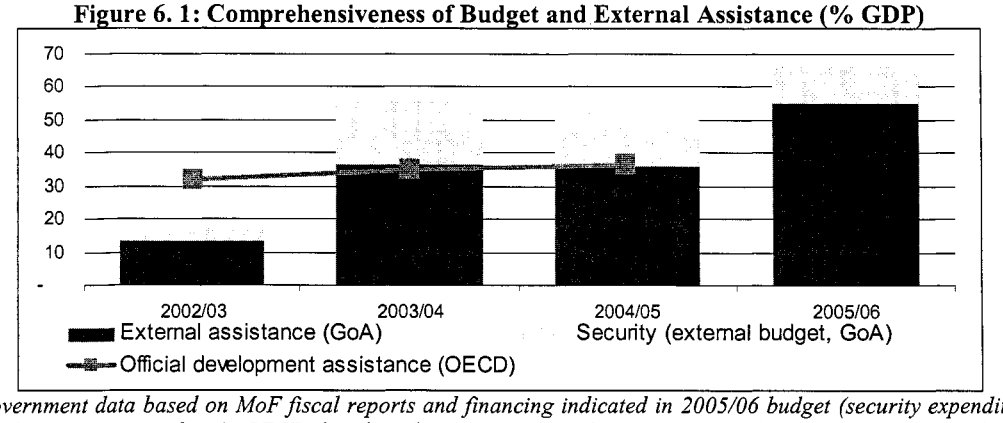
B. Policy Orientation of the Budget

COMPREHENSIVENESS AND CLASSIFICATION

6.6 There are two technical requirements for the budget to be a useful policy tool (see PFM indicators 5 to 9). First, the budget needs to give an overall picture of public finances; if parts (e.g. humanitarian or defense spending) are excluded, the Government cannot assess the impact of the budget on the macro-economy or make meaningful sector allocations. Second, the budget must follow a classification system that allows meaningful analysis.

6.7 Progress has been made toward a comprehensive budget. Thanks to strong aid coordination efforts, the broader budget concept captures most external assistance (Figure 6.1). However, for the External Budget the Government relies on voluntary reporting by donors. The quality of data is poor (data are incomplete, based on somewhat different definitions, classifications, and reporting periods) and actuals are often not available (see in Figure 6.1 the discrepancy between the Government's 2002/03 data and OECD data). Another issue is that the fiscal risks from public entities other than the Central Government are not monitored: there is very limited information on SOEs and on municipalities.

Figure 6. 1: Comprehensiveness of Budget and External Assistance (% GDP)

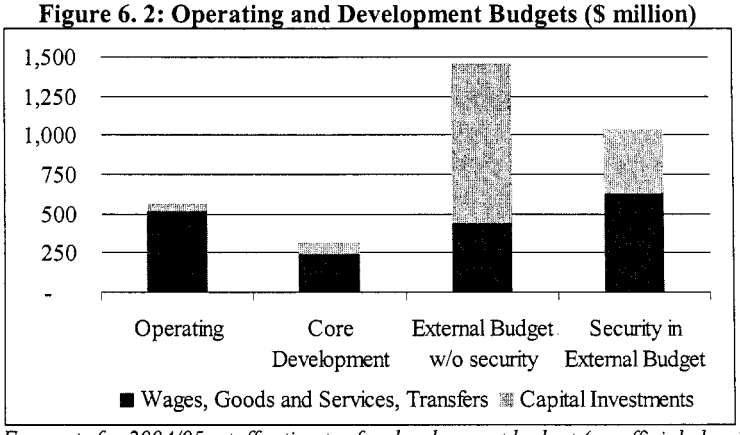


Source: Government data based on MoF fiscal reports and financing indicated in 2005/06 budget (security expenditures in the External Budget are separated out); OECD data based on reports from donors to OECD / DAC (in principle excludes military support) – data available up to 2004.

6.8 Progress toward a meaningful classification system also has been commendable. Since March 2005 a chart of accounts, covering all Government transactions, has been in place and should provide information in line with internationally accepted standards.

6.9 The main classification problem is the lack of integration between operating and development budgets. The dual budget structure has no policy basis, as the operating budget includes 7% of capital expenditures and the development budget includes almost 40% of recurrent expenditures (based on simple estimates, Figure 6.2). Lack of integration is very detrimental to the effectiveness of public spending, as investments are made without planning (and financing) for maintaining them. There is also a bias toward investments, crowding out operation and maintenance of completed investments to actually deliver services, which can also lead to political difficulties (investments raise hopes that are disappointed afterward). Dual budgets also potentially open up the opportunity for double-allocations for the same purpose (e.g. maintenance costs in a ministry's operating budget and in a donor-financed project).

Figure 6. 2: Operating and Development Budgets ($ million)



Source: Based on MoF reports for 2004/05; staff estimates for development budget (no official classification is available).

6.10 Achieving progress toward integrated budgeting requires three reforms. The first is to structure MoF's Budget Department along sectoral lines, with no organizational separation between the operating budget and the development budget, and build up its capacity, complemented by similar reforms in line ministries. This is already being initiated. The second is alignment of classifications and the presentation in budget documentation, accounting, and reporting systems, which has already started with the Chart of Accounts implemented in March 2005. Finally, donor practices need to support budget integration (see Section D).

6.11 A number of other accounting issues also need to be addressed in order to improve the quality of budget presentation, notably full adoption of a cash-based presentation instead of mixing cash flows with commitments. The current presentation of the financing framework is weak and does not show properly the amount of cash that is carried over from one year to the next on the Government's accounts. These shortcomings contribute to weakening the realism of the budget and its usefulness as a policy instrument.

FROM POLICY TO BUDGET

6.12 Building on these two important technical aspects, the budget can actually become a policy instrument if the country's development strategy is translated into annual budgets. First, the budget should reflect the Government's multi-year strategy. At the aggregate level, annual budgets represent the year-wise articulation of the path toward fiscal sustainability (see Chapter 3). To facilitate this linkage, the MTFF should be updated every year with Cabinet approval. Within sectors, budgets should anticipate the flow of resources necessary to operate and maintain new investments, thus requiring integration of operating and development budgets as discussed above.

6.13 Second, across and within sectors, the budget should operationalize the Afghanistan National Development Strategy (ANDS), whose interim version is currently at an advanced stage of preparation.

This means aligning with the main strategic trade-offs across sectors (see Chapter 5); hence it is advisable for the Cabinet to agree on broad sector envelopes early in the annual budget formulation process. For example, while improvements in the justice sector are high on the development agenda, spending has not been in line with this priority (see Figure 5.2). The strategic linkage also implies careful prioritization of projects within each sector, as discussed in Chapter 5, and adequate input from a monitoring and evaluation system, as discussed in Chapter 8.

6.14 Finally, the budget should reflect cross-cutting issues such as gender, environment, counter-narcotics, and provincial allocations. The first entry points are the sector strategies themselves (e.g. recruiting female teachers to reduce disparities in school enrollment between boys and girls). This strategy of "mainstreaming" is consistent with the view that these issues cut across many sectors. In particular, the issue of gender needs to be reflected in budgeting, not only in sectors like Health and Education but also in Agriculture, Public Administration and Economic Management, etc. where women's contribution to the economy is significant and growing (see World Bank, 2005b). This approach can be complemented by expenditure analysis. For instance, some countries have created virtual "poverty funds": expenditures that seek to reduce poverty (e.g. in health, education) are tagged in the Government's accounting system to allow analysis. Such an approach may also be useful in the counter-narcotics strategy. In some cases, targeted expenditure programs can be created for these cross-cutting issues, but their size should remain under control to avoid wasteful overlaps with sector programs.

C. Enhancing Ownership and Political Buy-In

6.15 Political buy-in is of utmost importance for making the budget a credible policy tool – which reflects the Government's strategy and is effectively implemented – and an instrument of nation building. This requires the involvement of many stakeholders at various stages of the strategic and budget cycle, which is extremely challenging in Afghanistan, with a political transition, a fragmented Cabinet, the absence hitherto of a Parliament, a fragmented civil society, and extensive foreign involvement. As outlined in Box 6.1, this means that it is difficult to assess who decides on the budget and therefore the extent of buy-in for the budget.

6.16 This section outlines two key directions to enhance political buy-in: participation and transparency in budget preparation. Implementation of the PFEM Law is a priority in this regard.

Box 6. 1: Who Decides on the Budget?

The budget is one of the most important political tools, the one that provides financial means to implement policies. In Afghanistan the rules are straightforward; the Cabinet collectively prepares the budget, the Parliament approves it, the Government implements it, and the Parliament has final oversight with respect to the audited financial statements.

The management of this political tool has been complex, however. First, in the absence of an elected Parliament, the budget has been approved by the Cabinet with the President signing Budget Decrees. There was limited external demand to release financial statements and audit findings. Second, during the transitional administration, budgets were based on imperfect information and thus reflected the outcome of a game among key political actors rather than a consistent strategic framework. Much progress has been made on this front, but political constraints have remained significant. Third, the President, both by his authority to sign decrees with financial implications (including decrees to increase establishment lists) and by his authority over large contingencies, retained significant power to reallocate budgets during the year. While contingencies have been significantly reduced in 2005, a more cohesive approach to budget management will require strengthening of the Cabinet Secretariat.

Fourth, MoF is the counterpart for a number of donors, including the ARTF, in terms of resource allocation. In the absence of a strong Cabinet Secretariat and a comprehensive budget, projects have been proposed for financing without going through the due process of budget formulation.

Fifth, both line ministries (by allotting funds to provincial departments) and MoF (by allocating cash to provinces) can influence the distribution of spending between Kabul and the provinces, with little external oversight.

Finally, the international community retains considerable influence over the budget, mainly by directly financing ring-fenced projects but also through involvement in policy dialogue.

6.17 Participation starts within the Government. At the technical level, ownership – as well as the quality of the budget, as argued in Chapter 8 – will be greatly enhanced when provincial departments have a substantive input into the national budget. This should in particular correct the gross imbalances in resource allocation between Kabul and the provinces in sectors like education. At the political level, buy-in – as well as strategic content, see the previous section – will be stronger if the Cabinet is engaged early in the budget formulation process through the establishment of a clear fiscal strategy and sector envelopes (preparation and approval of the ANDS also contributes to this objective).[13] In many countries the budget process starts with a "strategy period", which gives the opportunity for collective political buy-in on high-level decisions such as the multi-year fiscal framework and sector ceilings for the budget. Progress in these areas will also require modernization of the processes and rules of the Cabinet (including strengthening of the Cabinet Secretariat).

6.18 Participation of the Afghan people also should be increased (directly and indirectly through media or civil society organizations). This is mainly relevant at the policy-making stage (preparation of the ANDS), while budget preparation itself can be viewed as a more technical exercise requiring decisions under a tight deadline. Even without formal public participation, greater transparency in the Government's budget preparation process (e.g. through improvements in publicly available budget documentation, with translation into Dari and Pashtu) can help strengthen ownership. Chapter 8 explores various mechanisms to give citizens a voice in service delivery.

6.19 The election of Parliament in September 2005 also provides a basis for more participation and transparency in decision-making. Although there are risks of the Parliament becoming fragmented and paralyzed, the Parliament can also emerge as a major element of peace-building, notably through its role in representation and reconciliation (WBI 2005). From the PFM perspective, the two major roles of Parliament are to provide democratic participation in the budget process (through its budget approval function) and oversight of budget execution (by reviewing the Government's annual financial statements and external audit reports). In both cases, Parliament can generate demand for the Government's accountability – provided that its internal rules allow for constructive politics and its capacity (notably that of the dedicated Committees for Fiscal Affairs and Public Accounts) is built up. The role of donors, including their role in ownership and political buy-in, is the subject of the next section.

D. Role of Donors in Improving the Budget Process

6.20 As emphasized in several chapters, the international community plays a significant role in PFM. This is a major opportunity for Afghanistan, as donors bring significant financial resources as well as technical advice based on worldwide experience. But history suggests that this opportunity could be short-lived, as many post-conflict countries experience at best only a few years before levels of assistance go down to more normal levels (World Bank, 2003a).

6.21 With respect to PFM performance, the involvement of donors does give rise to challenges (Box 1.3). First, at the policy level, donors influence the agenda and the directions in a way that, when uncoordinated, reduces Government ownership and policy consistency (e.g. in education, see Box 7.1). Even high-level prioritization across broad pillars can be altered by donor funding (Figure 5.1), and the same is true of prioritization across sectors and programs. Second, when the strategy is translated into budgets, donors can undermine budget choices by funding projects that are not high priorities for the Government or that the Government cannot afford to operate and maintain. Third, the sheer magnitude of external assistance creates fiscal risks, since aid flows tend to be unpredictable over the medium term. As discussed in Chapter 3, this is especially problematic in the security sector. By negotiating projects directly with line ministries, donors may also undermine the hard budget constraints that MoF seeks to enforce (including with respect to decisions on affordability of O&M). Finally, reflecting their own

[13] The disconnect between development programs and ministerial portfolios – partially addressed by the December 2004 Cabinet reshuffling – also contributes to fragmentation, lowers programs' coherence, and lessens political buy-in.

fiduciary interests, donors often promote fragmented, ring-fenced projects that bypass Government systems and use donors' own fiduciary processes, with lack of harmonization across donors (see PFM indicator D2). All of these issues arise not by design but because donors' presence itself alters the incentives of various actors – to fragment projects, attract funding that bypasses fiscal discipline, etc.

6.22 Should the Government go so far as refusing aid? In extreme cases, this might well be appropriate. For instance, donor-driven investments in public hospitals are sometimes referred to as "Trojan horses" because of their large operating costs which crowd resources out of priority areas such as the basic package of health services. In most cases, however, the recommendation is not to refuse aid but to progressively integrate donor assistance in the budget.

6.23 As suggested by Table 6.2, ***there are various degrees of integration with national systems***. First, in 2002 the Government established the concept of an "External Budget": even if resources are not flowing through the Government's accounts, donors should coordinate their interventions through the Consultative Group process and report financial data to the Government. Second, the introduction of the Core Budget concept in 2004 has formalized a Consolidated Fund under Government control. In most cases, the Government can decide on the allocation of resources in the Core Budget (e.g. for IDA allocations, the Government develops the work program in consultation with the World Bank), funds flow through the Government's accounts, and accounting and reporting follow national procedures. Often external audit is done independently, but this could be reformed since Afghanistan's Auditor General already audits the whole of Government accounts, which include these funds. Similarly, donors often require the use of their own procurement guidelines, but this could change once the new, modern Procurement Law is implemented (Chapter 7).

Table 6. 2: Using National Budget Systems

Areas		Budget Formulation		Budget Execution			
	Amount a/	Multi-Year	Allocation	Procure ment	Banking	Accounting / Reporting	Auditing
Own Revenues	333	✓	✓	✓	✓	✓	✓
ARTF recurrent window	280	✓b/	✓c/	✓	✓	✓	d/
ARTF investment window	360	e/	✓c/	f/	✓	✓	d/
Programmatic budget support	256	✓g/	✓	✓	✓	✓	✓
IDA grants	129	g/	✓c/	f/	✓	✓	d/
Other grants and loans to core budget	446		h/	f/	✓	✓	d/
External budget	1,629		h/			i/	
Off-budget	unknown						

Each ✓ indicates when the Government's system is used: for multi-year (predictability in the Government's MTFF), allocation (full discretion on allocation of resources), procurement (national rules), banking (Government's bank accounts and payment processes), accounting and reporting (national accounting standards and reporting processes), and auditing (for external audit).

Notes: a/ $ million (2005/06 Budget); b/ can be multi-year (e.g. DFID three-year commitment); c/ Government can only decide the allocation within the operating budget (ARTF recurrent window) or the development budget (ARTF investment window and IDA grants); d/Government's systems could be used since the Auditor General audits all Government accounts, which include ARTF and IDA; e/ once funds are committed,, they are available for disbursements over the project's life; f/ donor procurement rules are used, but a Government agency (ARDS) process contracts; g/ multi-year predictability is subject to meeting policy benchmarks; h/ depends on donors; i/ most donors provide some reporting to the Government, but with quality issues (see main text).

6.24 The ultimate step is direct budget support, for example through IDA and ADB programmatic budget support operations. In this case, procurement and external audit also follow national processes. These operations provide some multi-year predictability – even though contingent on progress against a reform program. ARTF provides a framework for such support and represents very good practice in providing predictable funding for the Government (especially for recurrent costs) and fiduciary standards providing confidence to donors (see Box 6.2).

6.25 These various positive factors, together with donors' commitment to move toward aid harmonization as exemplified in the Paris agenda (see www.aidharmonization.org), suggest a way forward. It is hoped that the ANDS will open up the possibility for multi-donor support, as in many other countries that have prepared Poverty Reduction Strategy Papers (PRSPs). The annual budget will be the vehicle to implement the ANDS and could be complemented by an annual plan of policy actions. Such a package of prioritized short-run actions could thus comprise a "platform" from which the next set of actions would take off, with monitoring and feedback to guide the process at each stage.[14] Moreover the package, rather than any single measure or mechanical target, would be what the Government takes responsibility for and could form the basis for dialogue and agreements with the international community.

6.26 ***Donors*** could also commit to: (i) increase the predictability of their financing (i.e. provide clear indications of their commitments early in the budget process and, to the extent possible, multi-year commitments); (ii) condition their project assistance on the inclusion of the projects concerned in the national budget; and (iii) provide timely and harmonized reports to the Government (including an agreement on simple, harmonized definitions for concepts such as expenditures, disbursements, and commitments). The ***Government*** for its part cannot decree donor harmonization, but progress in PFM performance will certainly contribute to substantial progress on this aspect. In particular, the Government's continuing commitment to maintaining adequate fiduciary standards and taking actions to further improve fiduciary performance, and demonstrated performance in this regard, will be critical, as will be strong performance in domestic revenue mobilization (Chapter 4). Progress in budgeting, notably the recent adoption of an MTFF and strengthening of the MTFF over time, will also help deepen the partnership with the international community.

Box 6. 2: The Critical Role of the Afghanistan Reconstruction Trust Fund

The Afghanistan Reconstruction Trust Fund (ARTF) was set up in the spring of 2002 to provide coordinated external financial support to the Government budget. Up to the end of 2004/05, it has received contributions worth $847 million from 24 donors, disbursed $610 million, and committed an additional $98 million. The World Bank is the administrator of the ARTF, while the World Bank and three other multilateral institutions (ADB, IsDB, and UNDP) are members of the ARTF Management Committee. The main outcome achieved is that the ARTF has financed Afghanistan's civilian recurrent budget ($508 million, mainly focused on education and a few other civilian sectors, as police and military expenditures are not eligible), while a dozen investment projects are under implementation.

In 2005, an external evaluation stressed the importance of the ARTF, in particular its recurrent cost window, in strengthening the Government's financial management systems. ARTF provides stability and predictability to Afghanistan's public finances and strengthens MoF and the budget process. Through the use of a Monitoring Agent – an external firm which reviews recurrent expenditures prior to reimbursement by the ARTF – it is also strengthening fiduciary standards and provides what is in effect an internal audit function to MoF.

The evaluation also made recommendations to further strengthen the ARTF, notably the need to place ARTF support in a medium-term framework and to address the issue of capacity in public finance management. DFID's recent three-year commitment is a major step in the direction of multi-year predictability.

Based on external evaluation of ARTF, March 2005.

[14] See DFID (2005) for a discussion of the background, rationale, and modalities of how such a "platform" approach could work in the context of country situations involving external budget support. This type of approach is currently being used in countries like Cambodia, East Timor, and Russia.

CHAPTER 7. ENHANCING THE EFFECTIVENESS OF BUDGET EXECUTION

7.1 If institutions and processes lead to a well-conceived budget (Chapter 6), the quality of expenditures depends on four conditions. Are service delivery units receiving budgeted funds on time? Are there adequate processes and controls with respect to the use of these resources? Are procurement methods generating value for money? And is the Government accountable for its management of public finance? This chapter discusses these four conditions (PFM indicators 13-28), and also looks at the very important issue of corruption in this context.

A. Getting Funds to Service Delivery Units

7.2 To deliver services, units must receive the necessary funding in a predictable and timely way. Despite much progress, there is evidence that this is not yet the case. Substantial achievements have been made in reforming the payments system. However, further improvements are needed at two main levels, MoF and line ministries. Indeed, timely flow of funds to ministries is mainly MoF's responsibility in terms of managing cash assets and reviewing budget implementation. But line ministries need to allocate these funds to their departments, including in the provinces and districts.

7.3 The development of mid-year reviews and basic fiscal reporting (to line ministries and the Cabinet) has been an early success (in part due to investments in a computerized system, see Box 7.2). In addition, some cash flow projections have been developed, and cash management has been greatly facilitated by the ARTF (Box 6.2). Finally, despite remaining challenges the Central Bank, which acts as the Government's banker, has made great progress since 2002 in ensuring timely payments throughout the country (see Box 8.3 and, for the example of teachers' salaries, Box 7.1).

Box 7. 1: Tracking Public Expenditures in Education

A small Public Expenditure Tracking Survey (PETS) was conducted in the education sector as part of the PFM Review. The study involved interviews with 217 teachers and 109 head teachers across 109 schools randomly chosen from 36 districts in nine provinces. The findings were as follows.

First, schools as well as district and provincial education departments have little record of expenditures, which made analysis difficult. There are inconsistencies of records on financial allotments, notably for non-salary expenditures, because of miscommunication between Kabul and provinces and between the Ministries of Finance and Education. When available, records on expenditures were found to be largely consistent, however.

Second, staffing controls through financial allotments were found to be effective. Three quarters of the teachers receive their salary every month, even though a third of them complain about delays. One third of them indicated that they had to pay a modest commission, usually to a bonded trustee, for the receipt of their salary every month (on average equivalent to about $1), a practice that was considered "normal" as a fee for travel expenditures.

Third, it was confirmed that schools spent hardly anything on non-salary expenditures (books, maintenance, etc.). Kabul allots only 15% to non-salary expenditures; only 65% of this goes to provinces; provinces allot little if anything to lower levels; and Mustoufiats regularly reject requests from schools because of cash constraints. In fact, hardly half of schools made a request for non-salary allotments in the last quarter of 2004/05, and half of the requests were rejected. In sum, schools incur almost zero non-salary expenditures, and they mainly get books, desks, chairs, etc. in kind, usually from non-governmental organizations (although sometimes from the Ministry of Education itself). Given the uneven presence of these organizations around the country, significant disparities were found across schools.

Fourth, schools and even district and provincial departments do not provide much input into budget formulation. in particular for the non-salary budget. However, they are often visited by the district or provincial department, sometimes even by the Ministry, to review performance or financial records.

Finally, most schools report having a Parent-Teacher Association and a School Management Committee, usually to organize activities, sometimes to supervise teachers. Almost no school or teacher reported any payment from parents.

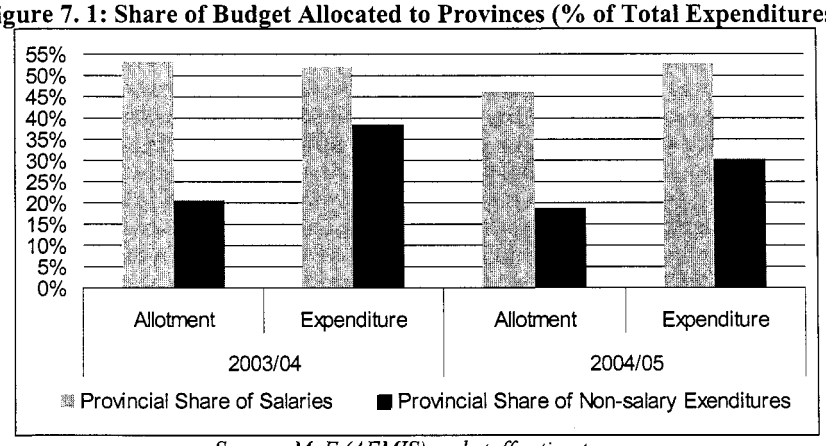
Source: World Bank Education Expenditure Tracking Survey.

7.4 Much work remains to be done by MoF to ensure that service delivery units receive the cash and information necessary to perform their operations. A first issue is that of ***quarterly allotments***. Because their management is unclear and not tied to cash availability, service delivery units sometimes receive conflicting information, and MoF may turn down their requests because of misunderstanding or lack of cash. A second issue is ***cash management***, which needs to be further strengthened to optimize the use of resources and avoid unnecessarily constraining expenditures by service delivery units. In the medium term, these two instruments (allotments and cash planning) will have to be complemented by recording and controlling expenditures at the commitment stage, before it is too late in terms of incurring a liability.

7.5 An effective mechanism to make progress on this front would be to develop ***financial reporting***. Such information is useful for all managers in the Government. The Cabinet and the President should get information to hold ministers accountable. The Afghan public, and soon the Parliament, should also get such data. Routinely, basic data on spending should be prepared from the Government accounting system. In addition, the use of public expenditure tracking surveys should be explored to focus on specific issues. The small-scale tracking survey on education conducted as part of the PFM Review highlights the wealth of analysis available from this instrument (Box 7.1). Another need is for gender disaggregated data to facilitate proper monitoring of social inclusiveness.

7.6 The ***role of the central line ministries*** also is problematic. Less than 20% of the non-salary allocation is given to provinces, whereas more than 50% of the salary allocation (and staff) are in provinces (Figure 7.1; see also Box 8.2). This situation is all the more problematic in that provinces tend to have better capacity to absorb these resources, as their share of estimated actual non-salary expenditures is higher than their share of allotments. In addition, local units have little influence over allotments, receive conflicting information on them, and are subject to unexpected changes in allotments. Local departments, since they have more local information and are themselves accountable to deliver services, should be given a role in the budget formulation process (Chapter 6) and receive clearer information on budget allocations. In turn, central ministries should be held accountable for the constraints they impose on service delivery units, for instance through frequent monitoring by MoF and the Cabinet on allocations made to provinces and the frequency of changes in these allocations.

Figure 7. 1: Share of Budget Allocated to Provinces (% of Total Expenditures)



Source: MoF (AFMIS) and staff estimates.

B. Controlling the Use of Public Funds

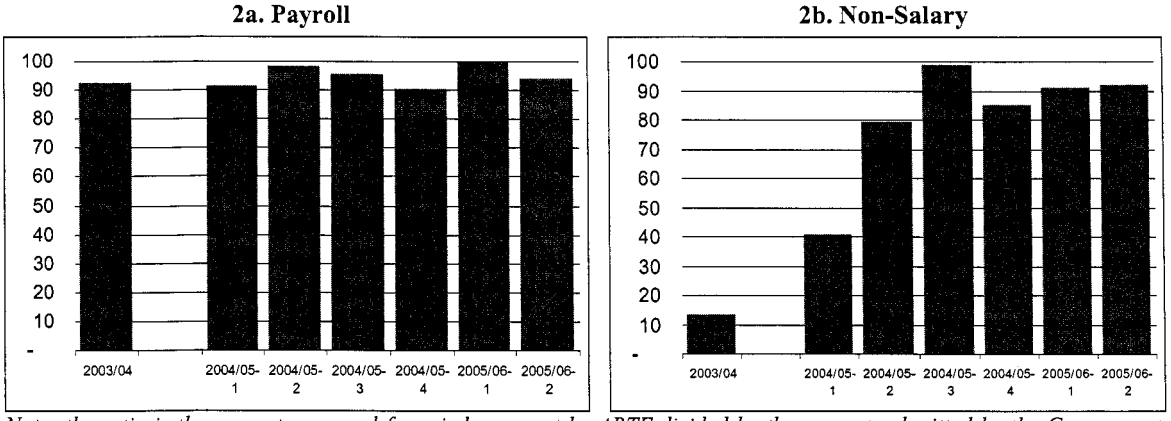
7.7 A solid control framework should ensure that Government organizations are working within their legal and policy responsibilities and are achieving the results set for them. This implies that basic fiduciary standards must be observed, i.e. funds are spent only when there is an approved budget, a secure process is followed to authorize expenditures, and the process is documented. At a more advanced level, this process will be simplified to shift its focus toward performance, while the systems themselves will be

controlled continuously through audit. Treasury functions range from the commitment of expenditures to recording, payment, and accounting. Internal audit provides a feedback loop that can foster improvements in expenditure management. The overall system needs to be complemented by effective enforcement mechanisms (Section D).

TREASURY FUNCTIONS

7.8 Basic fiduciary standards for civilian recurrent expenditures have reached decent levels (Figure 7.2). Simple budget controls, accounting, recording, and reporting have much improved, notably with the implementation of a computerized system in MoF (Box 7.2). Progress has also been made on payroll control; a review by ARTF's Monitoring Agent suggests that there is almost no problem of "ghost workers" in several central ministries. Another significant improvement is the introduction of a Treasury Single Account system (Chapter 4). Although still to be completed, this has already made cash management easier, bank account reconciliation simpler, and control of revenue collection more robust.

Figure 7. 2: Share of Expenditures Reimbursed by ARTF



Note: the ratio is the amount approved for reimbursement by ARTF divided by the amount submitted by the Government, measured on a quarterly basis. The ratio of eligible expenditures over monitored (instead of submitted) expenditures is lower, notably because the Monitoring Agent uses a risk-based approach to monitoring. However, for accounting reasons, this ratio is difficult to track on a quarterly basis. Source: Monitoring Agent and ARTF Quarterly Reports.

7.9 However, as demonstrated by the PFM performance indicators, much remains to be done to improve payroll controls, record-keeping, accounting standards, frequency of reconciliation, and the usefulness of reporting for line ministries' management. Overall, the way forward requires improving business processes to reduce discretion, limiting the number of opportunities for corruption, and developing the practice of reconciling accounts. Computerization is a possible tool to further pursue these objectives (Box 7.2). In addition, individual and institutional capacity needs to be developed to devolve responsibilities to the appropriate level (Chapter 9).

7.10 The ***Public Finance and Expenditure Management (PFEM) Law***, gazetted in June 2005, provides the legal basis for further progress. The new law empowers the Government, through MoF, to regulate and control the financing and expenditures of the State. All state revenue and expenditure, other than Special Funds, flow through a general budget fund, under the Treasury, while uses are authorized by agencies from the funds appropriated under the annual budget. MoF has responsibility for comprehensive reporting on budget execution, ex-post oversight through its internal auditors (see below), and application of financial management laws and regulations. MoF intends to implement a fairly centralized system (although without the financial controllers that MoF traditionally posts in line ministries in francophone systems). This is appropriate in the short to medium term, given generally low capacity and the need to ensure adequate controls, and does not preclude gradually decentralizing some responsibilities closer to line management in the future, when capacity and systems will have been developed.

7.11 MoF is implementing a "***Verified Payroll Plan***" to ensure timely and accurate salary payments to Government employees. More than 24,000 staff in 17 agencies in Kabul are paid directly (as opposed to the bonded trustee system) and 400 of them receive their salaries directly in their bank account; 6,000-plus employees in Kabul have received an individual identification card; and 10 central ministries are using a payroll database to prepare the payroll. The roll-out of these three components – automated payroll, individual identification system, and transfer to bank accounts – will move payroll management a long way toward an effective, secure process.

Box 7. 2: Can E-Government Play a Role in Afghanistan?

In 2001, Afghanistan had very limited telephone land lines and computer skills. However, the Government had a great need to communicate effectively with district and provincial offices and to promptly deliver services. Although e-Government seemed promising – to deliver services quickly, reach remote districts, and transparently publish information – it seemed impossible due to lack of skills and infrastructure. Four examples demonstrate that this pessimism was unwarranted.

The success of cell phones demonstrates the ability of modern technology to be quickly implemented and that demand for it is large; the mobile footprint now covers 50-60% of Afghanistan's population, and mobile prices have declined by 70% during the last year and a half. In addition, a Government Communication Network has been set up in nine provinces and is expected to be expanded.

A simple computerized general ledger was installed in record time in 2002. Initially set up to print checks, the system now records all expenditures and revenues as well as budgets. It has allowed breakthroughs in reporting and transparency. Basic financial controls (e.g. checking the availability of a budget) are now much easier. Annual financial statements were produced in the second year of the transitional administration whereas none had been produced in previous decades. Requests for reimbursements to ARTF were streamlined with this system, facilitating cash management. The system is now operational in the central MoF, two central ministries, and a pilot Mustoufiat.

The Government has created a website (www.af) where a number of important documents are posted. In particular, all budget decrees and fiscal reports are available publicly. This website can also be used for communication campaigns, notably a tax information page (http://www.mof.gov.af/tax/index.htm).

The ongoing implementation of the Automated System for Customs Data (ASYCUDA) will increase transparency (easy reporting, international classification, performance monitoring) and control (including through a reduction in interface between customs officers and traders), while facilitating trade (more standardized, predictable, transparent procedures). Transit is considered a priority: all goods entering into Afghanistan will be reported to the system and automatically discharged when they reach their destination. The first application is expected to be operational shortly; it will cover the transit corridor between the Torkham border point with Pakistan and Kabul and will be extended to the border with Uzbekistan.

Some lessons emerge from experience in Afghanistan, as well as that of other countries. First, e-Government is not a panacea and needs to be well conceived. The "Systems Study" that has been initiated by MoF is welcome since it will define a master plan for financial management systems. Second, e-Government works when it is combined with improvements in business processes that seek to put the client (citizens, businesses, other parts of the Government) at the center. Third, e-Government requires strong leadership at the higher levels, as implementation is a long-term effort which disrupts habits, and widespread training at lower levels is needed. Fourth, some implementation issues – such as translation of English-based software or insufficient bandwidth for communication – have already emerged from early experience in Afghanistan and should be factored into any future proposal.

7.12 For non-salary expenditures, the most critical improvements are related to procurement (see next section). Other controls are well established in the central MoF with the computerized system but need to be rolled-out to provinces and line ministries, complemented by systematic commitment controls in the medium-term.

7.13 A final control issue is related to asset management, including the assets generated through donor-funded projects. The development of a simple asset registry is a priority for the Government if it wants to retain these assets and be able to account for them. Other asset management issues, related to SOEs and underground resources, are discussed in Chapter 5 (see also Volume III, Chapter 4 and Volume IV, Chapter 4).

INTERNAL AUDIT FUNCTIONS

7.14 Reports from central ministries and from provinces suggest significant audit activities, by internal audit departments, the Control and Audit Office, the Attorney General's Office, and sometimes the

Governor or the National Security Office. Unfortunately, all of these activities review transactions only to assess compliance with rules and detect errors, irrespective of their cause or impact on performance. The only effective feedback loop has been an extraordinary arrangement whereby the ARTF Monitoring Agent, after reviewing expenditures to assess eligibility for reimbursement, transmits performance reports to MoF, which has tabled them at Cabinet meetings and has included a provision in the Budget Decrees to reduce budgets of agencies not performing against these eligibility criteria (Box 6.2). Improvements shown in Figure 7.2 are a testimony to the impact of this innovative practice.

7.15 Sustainable arrangements for internal audit need to be developed, however. The PFEM Law calls for a centralized system, in which MoF's internal audit department has authority to audit all Government operations. MoF has developed a plan to implement this rule and expects to focus on compliance audit. This seems appropriate in the short run given lack of capacity. MoF's internal audit department will, however, need to strike a balance by promoting improvements in financial management practices without paralyzing the system through excessive intrusion in line ministries' management. Over the longer term, line ministries themselves would be expected to play a more active role in internal audit, with MoF shifting to systems and performance reviews.

C. Procuring goods and services

7.16 In 2004/05, the Government spent more than $500 million on goods and services as part of the Core Budget (of which $100 million was for capital investments). Given the size of these expenditures, a 10% increase in efficiency and value for money generated by procurement reforms would be equivalent to a 20% increase in domestic revenues. In addition to promoting efficiency gains, a good public procurement system should also adhere to key principles of non-discrimination, equal treatment, and transparency. Although the rules in Afghanistan until recently fell short of these objectives, actual performance has been more encouraging thanks to temporary external support and ongoing legal reforms. Nevertheless, there are numerous issues and difficulties, as illustrated by the experience with highways (Box 7.3).

Box 7. 3: Procurement for Highways

A review of major road projects implemented in Afghanistan over the last three years reveals some key issues and constraints to obtaining value for money with adequate accountability and transparency. Major variances of unit costs, from $123,000 to $589,000 per km of road, were found.

First, all projects incurred higher than expected security costs (3-15% of total project costs). While there were also other exogenous factors such as weather conditions, security remains a major constraint on project implementation and value for money (with further implications for delays, safety of personnel, etc.).

Second, the price, availability, and quality of supply, often imported, raised unit costs. For example, unit costs for asphalt pavements were estimated to be 30-45% higher than in neighboring countries.

Third, lack of participation by the Afghan private sector in bidding processes has somewhat reduced competition and increased costs. Constraints include lack of experience in managing large-scale projects and in following donors' financial management and procurement processes; lack of up-front capital (or financing) to mobilize equipment; and difficulties in mobilizing construction labor.

Fourth, many of the projects were contracted with limited competition.

Other factors also contribute to higher unit costs. For example, it was noted that implementation delays occurred because of red-tape on the Government's side, for instance to clear the importation of equipment.

Source: Volume IV, Chapter 5.

7.17 The existing regulatory framework has some essential positive features, for instance basic financial controls and an emphasis on competitive bidding, but it is outdated. There has been excessive focus on prices – at the expense of quality – and an absence of complaints and review mechanisms. Similarly, the practice of public procurement has positive features – such as some familiarity with modern basic processes, but also significant shortcomings – such as absence of implementation regulations and monitoring mechanisms. The line ministries lack capacity to define and communicate effectively their

desired technical specifications. In addition, the approval process seems unnecessarily cumbersome. These elements are of critical importance in contributing to delays in budget implementation (Figure 3.1).

7.18 An additional deficiency relates to the ***Afghan private sector***. Even though the review found a large number of contractors and suppliers, sometimes offering up to 50 bids for small contracts, their participation is limited for several reasons that should be addressed (Table 7.1). Afghan women entrepreneurs face particular constraints that need to be alleviated (see World Bank, 2005b).

Table 7. 1: Constraints on Local Private Sector Participation to Public Procurement

Constraint	Possible Way Forward
Mistrust in the way the public sector operates	Simplify and disseminate rules (awareness campaign), increase transparency
Cost of doing business with Government (e.g. procurement and payment delays)	Simplify procurement rules and develop standard contracts; promote e-procurement; develop direct payments to vendor (ongoing in the Treasury); focus on simplification of procedures for small enterprises
No quality standards	Develop standards
Poor capacity to prepare bids	Prepare model contracts and detailed handbooks; train private sector
Lack of financial capacity	Creating leasing businesses (e.g. through reforming tax rules); develop financial sector (require legal reforms)
Lack of skilled labor	Develop crash courses in selected topics; build-up capacity of tertiary / vocational education system
Preference given to SOEs	Discontinue these preferences

7.19 Turning to ***external support***, an international firm, the Procurement Agent reporting to the Ministry of Economy, has processed more than 200 contracts with a total value of almost $400 million, mainly for projects financed by ARTF and IDA, but increasingly for projects financed by the Government itself. Performance under this arrangement has been reasonably good, using competitive methods, with adequate timing (to prepare and evaluate bids) and transparency (advertisement of bids and publication of awards). However, the overall performance of this mechanism is constrained by the limited capacity of line ministries to prepare all the necessary documents (see above), as well as sometimes delays in obtaining required approvals. Private sector participation has been limited – with typically less than five bids per offer. Similar extraordinary external support is also available in a number of line ministries that have set up Program Management Units (PMUs). The short-term benefits and potential longer-term shortcomings of these practices are discussed in Chapter 9.

7.20 In addition to building capacity, further progress requires improvements in the ***regulatory framework***. The new Procurement Law that was recently approved by the Cabinet will establish a solid legal framework. The accompanying regulations, including handbooks, operational procedures, standard contracts, etc., will be critical for operationalizing this framework. Progress is contingent on expanding Government ownership. The lack of a clear champion in the Government, probably reflecting low capacity and misunderstanding of the scope of the procurement function (e.g. a belief that only major works or purchases are "procurement"), has been detrimental to reforms. Creation of a Procurement Policy Unit in MoF would represent an important step forward. This unit will be able to take the lead in preparing detailed regulations, overseeing training, and monitoring procurement performance.

D. Holding Government Accountable for the Use of Public Funds

EXTERNAL SCRUTINY OF THE BUDGET

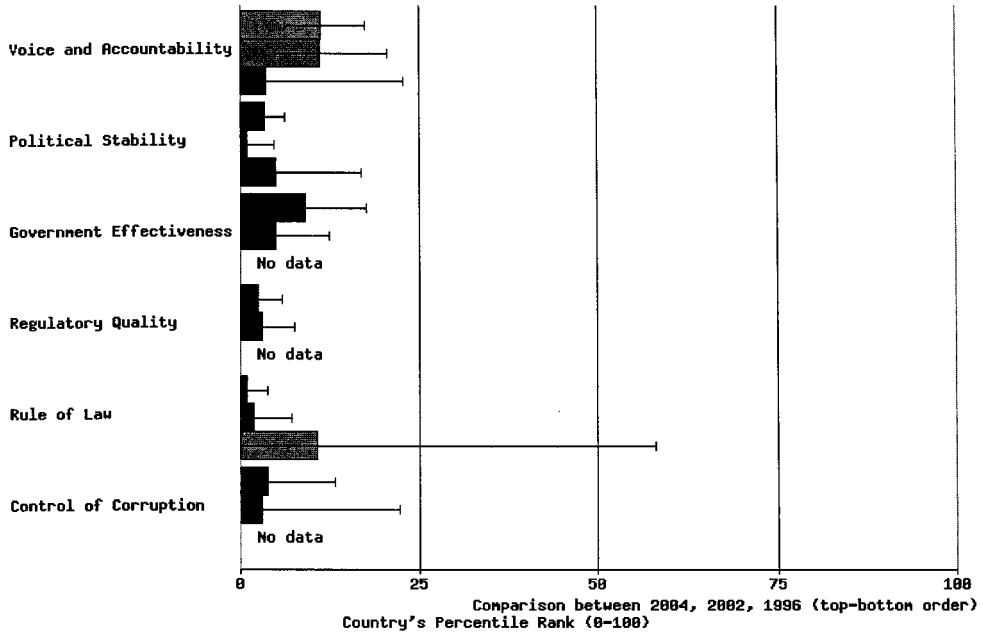
7.21 Development of the external audit function has been a key component of the Government's efforts to enhance transparency. The PFEM Law mandates audit of annual financial statements by an independent auditor. The Control and Audit Office (CAO), which reports directly to the President, is performing this function. With the support of an international firm, it has made progress in preparing audits, first for ARTF and then for the Government's accounts. It has also audited a number of departments and has reported its findings to the Cabinet twice a year.

7.22 Much remains to be done, however, to create demand for control and accountability. The CAO's capacity is weak and its focus is limited to basic financial audits of annual accounts. Moreover, while MoF has been preparing follow-up matrixes, there is little evidence of actual follow-up on audit findings, and reviews of departments are never followed up. Part of the explanation probably is that audit reports are not publicly disseminated. This also relates to the absence, until recently, of a Parliament to hold the Executive accountable for addressing audit findings. While the PFEM Law (and Constitution) mandate approval of the Budget and review of audited annual financial statements by Parliament, this has not been possible so far without a Parliament. The President and Cabinet have had legislative powers, but with obvious limitations in terms of separation of duties. Civil society – weak media, challenged NGOs, frequently unorganized communities – has been unable to perform its role either, in part due to lack of capacity to analyze PFM issues. Donors have been active in promoting external scrutiny, but their unwillingness to use Government systems for most aid has undermined the Government's efforts to improve PFM performance. On the other hand, the ARTF has played an important role in enhancing external scrutiny of budgetary spending financed by ARTF (Box 6.2).

FIGHTING AGAINST CORRUPTION

7.23 There are widespread allegations of corruption, sometimes referring to unintended misuse of funds (for example by error or lack of capacity to follow the rules) or to traditional practices (for instance payment of a commission to a bonded trustee who arranges salary payments, Box 7.1), sometimes referring to outright corruption. Box 7.4 reviews vulnerabilities to corruption. This issue is part of the broader challenge of governance. As highlighted by an international comparison largely based on polls and surveys (and hence subject to significant margins of uncertainty), Afghanistan ranks among the countries for which governance problems are the most severe (Figure 7.3). While significant progress has been made in some areas (voice, accountability, and Government effectiveness), Afghanistan remains among the bottom one-eighth of all countries in terms of all six dimensions of governance measured, and is among the worst-off in terms of rule of law, regulatory quality, and control of corruption.

Figure 7. 3: Six Dimensions of Governance



Note: The three bars represent, for each dimension of governance, Afghanistan's percentile rank for 2004, 2002, and 1996 (top-bottom order). The line represents the standard deviation of this measure (in other words the margin of uncertainty).
Source: Kaufmann, Daniel, Kraay, and Mastruzzi (2005).

Box 7. 4: Vulnerabilities to Corruption

While specific evidence of corruption is difficult to find, concerns in a number of areas point to important vulnerabilities to corruption in Afghanistan. For example, significant "unofficial payments" reportedly are paid by Afghan firms (World Bank, 2005e). Corruption is also one of the main concerns of many Afghans (HRRAC, 2004).

First, there are widespread allegations of abuse of power, bribing, and other forms of corruption in the justice and police system (HRRAC, 2004). Land management is an important vulnerability for corruption (Volume III, Chapter 5). The recent Parliamentary elections also have generated rumors of corruption.

Second, by all indications there is massive corruption associated with the drug industry, with many Government officials directly or indirectly benefiting from narcotics revenues. Other criminal activities also are likely to be associated with (lower levels of) corruption.

Third, the State has traditionally been built on a patronage system. While recent civil service reforms are trying to reduce this factor (Chapter 9), the vulnerability to this form of abuse of power (power of hiring) remains.

Fourth, vulnerability in the area of revenue collection has been reduced by a number of administrative reforms (Chapter 4). Nevertheless, the existence of numerous small "nuisance" taxes with obscure rules and the continuing collection of revenues by actors other than the MoF create a climate of uncertainty that is conducive to corruption. The lack of a clear privatization process could generate additional vulnerability to corruption if privatization occurs without this lacuna being corrected (Chapter 3).

Fifth, concerns with regard to the misuse of public funds have been much less widespread. However, anecdotal evidence – such as striking differences in procurement delays in the power sector (unusually speedy process for one contract; unnecessarily protracted process for another, Volume IV) – suggest that vulnerabilities are real. Vulnerabilities seem more pronounced at the local level (notably in municipalities – see Volume III – but also in provinces and districts). In addition, even with strong PFM processes, PFM institutions could still be captured by private interests.

Finally, these vulnerabilities are not yet well offset by opportunities for civil society to hold public officials accountable. While in the PFM area the Government has been transparent in reporting on budgets and expenditures, the capacity of the media and the people to hold Government accountable remains to be developed.

7.24 Corruption is widely considered to be a symptom of poor governance. This suggests that treating the symptom (corruption) directly most likely will be less effective than addressing the underlying problems that create or exacerbate vulnerabilities to corruption, including problems in the PFM system. International experience bears this out, although experience also demonstrates the importance of setting a strong example at the top in terms of taking action against high-level corruption on the part of government leaders.

7.25 Tackling these issues requires a holistic approach, based on further analytical work and possibly leading to adoption of an ***anti-corruption strategy*** by the Government. International experience offers a number of lessons for the design of such a strategy. First, anti-corruption strategies work better through prevention than through investigation and prosecution.

7.26 Second, sound anti-corruption strategies need to cover five pillars:[15] (i) institutional restraints on power (independent and effective judicial system and prosecution and enforcement, legislative oversight); (ii) political accountability (political competition, credible political parties, transparency in party financing, asset declaration, conflict of interest rules); (iii) civil society participation (freedom of information, public hearings on draft laws, active role of media and NGOs); (iv) competitive private sector (economic policy reform, competitive restructuring of monopolies, regulatory simplification for entry, transparency in corporate governance, collective business associations); and (v) public sector management (meritocratic civil service with monetized, adequate pay; budget management – coverage, treasury, procurement, audit; tax and customs; sectoral service delivery – e.g. health, education, energy; decentralization with accountability). While this report focuses on the last pillar, the other four pillars include a number of areas where progress is needed. Examples related to PFM include a strengthened judicial system, rigorous processes of legislative oversight, transparency to enhance civil society participation, simplification of regulations, and a merit-based civil service.

[15] See the World Bank's website on anti-corruption strategy, http://www1.worldbank.org/publicsector/anticorrupt/strategies.htm.

7.27 Third, improvements in PFM practices will help very much in reducing vulnerabilities to corruption, by limiting transactions that provide opportunities for graft, reducing likely benefits from corruption, and enhancing information, transparency, and oversight. This report includes recommendations to simplify taxation rules and strengthen revenue administration (Chapter 4); improve the coverage of the budget (Chapter 6); develop internal controls, procurement, reporting, audit, and external scrutiny (this chapter); explore innovative accountability mechanisms (Chapter 8); and strengthen the management of SOEs and municipalities (Chapters 3 and 8, see also Volume III).

7.28 Finally, while these recommendations should constitute the core of the anti-corruption strategy, an additional question is whether an Anti-Corruption Commission would play a useful role, such as the Commission created in Afghanistan by the 2004 Anti-Corruption Law, which reports to the President. While there are some examples in other countries of such approaches having a positive impact, many experiences have been less positive, with sometimes the commission losing all credibility in its fight against corruption. A first issue in Afghanistan is that the 2004 Law does not distinguish between corrupt practices and mistakes or negligence. A second issue is the lack of capacity to prosecute and try corruption cases. Additional issues include risks of politicization, predation, diversion of attention and resources from other necessary areas, and bureaucratic duplication.

7.29 ***In summary, enhancing the effectiveness of budget execution should be at the center of the governance and anti-corruption strategy***. Among the key priorities – both to increase the effectiveness of public spending and to reduce vulnerabilities to corruption – are a further increase in transparency (transparent allotments to service delivery units; release of annual financial statements and external audit opinions; publication of bid requests and contract awards), strengthening of the audit function (both internal and external), and drafting of procurement regulations. The recent approval of the PFEM Law and the Procurement Law provides the legal foundation for pursuing these priorities. On this basis, capacity of line ministries (and of the private sector to participate in public procurement) will need to be enhanced (Chapter 9) and PFM responsibilities gradually devolved to line ministries; the role of the Parliament as a promoter of accountability can be developed; and, over time, more ambitious PFM reforms can be introduced.

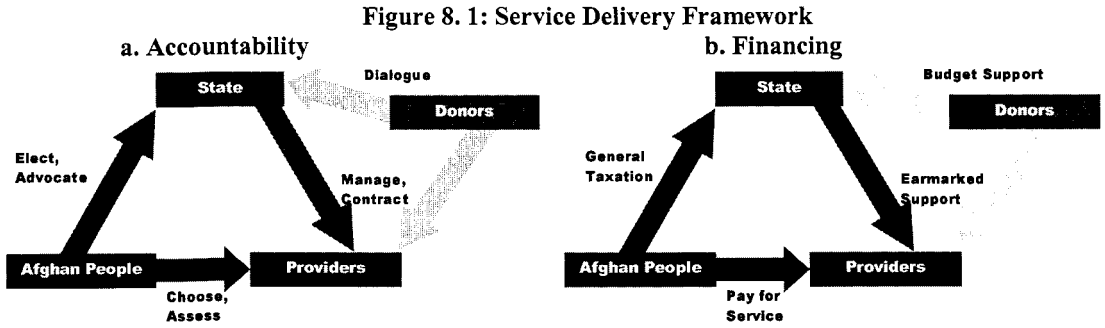
CHAPTER 8. DELIVERING SERVICES TO THE AFGHAN PEOPLE

8.1 The ultimate objective of the PFM system is to deliver services to the Afghan people. Service delivery can take various forms, ranging from direct delivery by Government-paid civil servants, to delivery by non-governmental organizations financed from private or foreign contributions, to private provision funded by user fees. While the main message of this chapter is unequivocal – people should be put at the center of the service delivery framework – the institutional implications are more diverse. The chapter reviews the institutional framework for public service delivery, building on examples of particular sectors and drawing lessons from experience. It also looks at PFM issues related to subnational administration from a service delivery perspective.

A. Six Models of Public Service Delivery

8.2 A simple conceptual framework illustrates different models of service delivery and their implications (see World Bank, 2003b). There are three main actors: ***the people*** (as citizens and consumers/clients of services), ***the state*** (as political body and policymaker), and ***the service providers.*** The interactions by which these three actors influence and are accountable to each other form an "accountability triangle" (Figure 8.1a), and there are correspondingly financial flows among them (Figure 8.1b). The people can affect service delivery by influencing policy makers (e.g. by voting or through the advocacy role of civil society), who in turn exert influence on the service provider (this is the so-called "long route" of accountability). The people can also directly influence service providers (the "short route" of accountability) by selecting the provider (when there is competition), using their voice (e.g. complaints), or making financial contributions (when there is cost recovery). Another important set of actors is ***the donor community,*** which exerts influence through its dialogue with policymakers, its financing, and its direct contracts with service providers.

Figure 8. 1: Service Delivery Framework

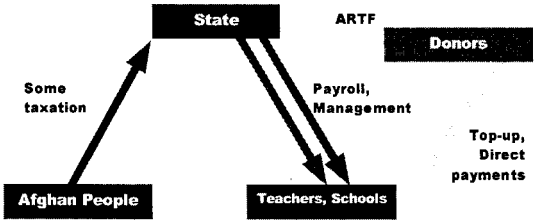


Source: Adapted from World Bank (2003b).

CENTRALIZED GOVERNMENT SERVICE DELIVERY

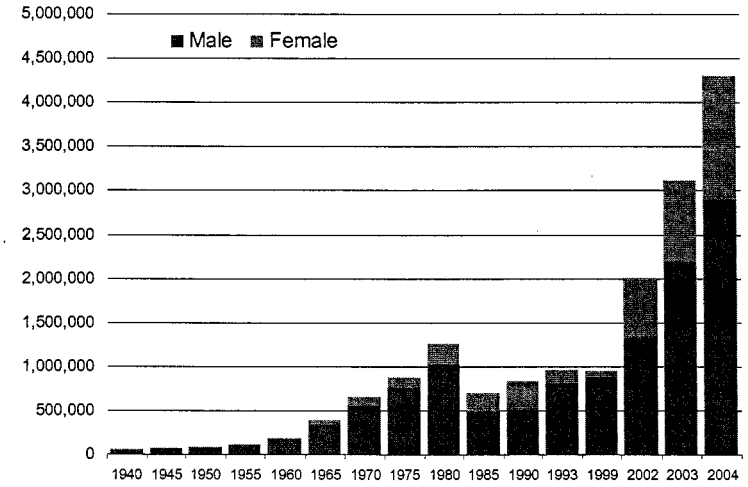
8.3 The "traditional" service delivery model in Afghanistan is that the State itself provides services through its centralized bureaucracy (Figure 8.2). Ninety-seven percent of Afghan students are enrolled in public schools operated by civil servants under the management of the Ministry of Education (MoE). This model directly links the Government with the population and thereby may enhance the former's perceived legitimacy; it facilitates propagation of nationwide service content (e.g. curriculum); and it may be able to exploit economies of scale. Certainly Afghanistan has seen an unprecedented expansion of elementary education since 2001, based on the application of this centralized model (Figure 8.3 – also see Volume IV, Chapter 2). Both girls' and boys' enrollments have reached levels far higher than at any time in Afghanistan's history, including prior to the conflict.

Figure 8. 2: Service Delivery by Central Government (Education)



8.4 The centralized service delivery model has major weaknesses, however. Management of the ***primary education*** system, for example, is highly centralized. All important decisions, and even relatively less important decisions like appointments of teachers, are made by MoE in Kabul, often a very long distance and at least three management layers away from the schools and the students they serve. Schools have very little access to non-salary budget allocations, and many inputs are provided in-kind by donors and NGOs (Box 7.1) – leading to disadvantages associated with the "outside government" mode of service delivery discussed later. The distribution of expenditures, especially non-salary expenditures, between Kabul and the provinces is skewed against the providers, and there are major gaps in service delivery between urban and rural areas (which when combined with gender and regional disparities become enormous).[16] The needs of each school are not effectively responded to by distant decision-makers. The efficiency of the centralized system is reduced by management difficulties, in particular how to hold teachers and principals accountable for their work from a distance. Another issue is the role of donors, who may provide financing to the State for education (through ARTF or project financing), but also may provide salary top-ups, direct payments, and in-kind contributions directly to schools. The result of all of these shortcomings is poor quality of education and serious geographical as well as gender disparities (see Figure 5.3), reducing the returns to the large investments being made in education.

Figure 8. 3: Enrollment Growth (Grades 1-12)



Source: MoE, UNESCO, and UNICEF for various years

8.5 This centralized model, or variants of it, also exists in other sectors, a legacy of Afghanistan's history. Whereas in education (and in the pre-war health system), as well as in the ***military*** and national ***police***, the service provider is an arm of the central ministry, in other cases the provider may be a ***State-***

[16] In the health sector, similarly large disparities can be seen in Government-provided services like doctors and hospitals. For example, there is one doctor per thousand population in Kabul, one per 100,000 in Bamiyan Province. Operating expenditures of the Ministry of Public Health (MoPH) per capita of population are more than four times as high in Kabul as the national average, and there is great variation across provinces as well (see Volume II, Chapter 1, Figure 1.11).

Owned Enterprise (SOE) closely supervised by a parent ministry (e.g. power, water supply, major irrigation schemes). In the case of ***electricity***, the national power utility, Da Afghanistan Breshna Moasessa (DABM), is supervised by the Ministry of Energy and Water (MoEW) and has neither an appropriate governance structure nor financial resources to improve the country's electricity services (Volume IV, Chapter 3). The result is very limited access to power (only an estimated 10% of the population has access to grid power supply) and poor quality of supply (unreliable service, frequent interruptions, and high technical losses).

8.6 There are several ways to improve service delivery while staying within this basic model. First and foremost, mechanisms need to be created whereby the people can use their voice directly with the service providers and monitor them. Good examples in the education sector include Parent-Teacher Associations / School Management Committees. Community monitoring, for example through the elected Community Development Councils (CDCs), is a promising approach for certain sectors. Second, within the State, options include de-concentration and delegation to improve budget allocation decisions and bring management closer to the provider. In this context, ensuring that non-salary budget allocations reach and can be utilized by the service providers (e.g. schools) is a priority. Greater management autonomy for service facilities can yield good dividends based on international experience, including through flexibility in managing and utilizing the budgetary resources made available to them. Third, information sharing and greater transparency (both from the state and from the service providers) can enhance the voice of the Afghan people, and a free and capable press and other watchdogs can enhance oversight and accountability. Donors providing financing need to respect the Government's systems and work through them rather than providing resources directly to providers outside the Government's ambit (which undermines the accountability relationship between service provider and State).

8.7 Short of privatization (the fourth model, see below), better financial management of SOEs, along with higher cost recovery as appropriate, can improve service delivery. In the power sector, required reforms include corporatization of DABM; computerization of billing and accounts; enhanced cost recovery; capacity building in MoEW; and prioritization of investment projects. Private sector participation in power generation also can be pursued on a limited basis.

OUTSIDE GOVERNMENT

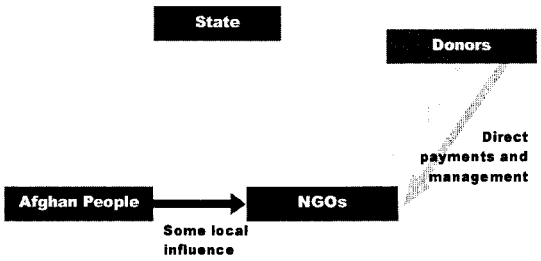
8.8 This second model is common in conflict and post-conflict countries, with a failed State. Donors directly finance and contract or manage non-government providers (NGOs, private providers, sometimes international agencies e.g. UN agencies) to deliver services, often of a humanitarian nature, with little or no direct involvement on the part of the Government (Figure 8.4). This model is still being used for a number of activities in Afghanistan, but much less than in the 1990s when it was the primary mode of international assistance. A variant consists of setting up a narrow Project Implementation Unit (PIU), with weak or no linkages to the Government, specifically to oversee a donor-financed project. And even in sectors where the basic model is different (e.g. centralized government service delivery in education, see above), there may be elements of direct donor involvement through direct provision of various inputs, financial top-ups, etc. The appeal of this model is its simplicity and that it is straightforward and visible for donors as well as service recipients. Moreover, by bypassing Government procedures (and often normal international competitive procurement procedures), this model enables a rapid response to humanitarian crises and other urgent problems.

8.9 However, this approach does not support longer-term national capacity building and does not exploit the opportunity for aid to help build up the State's legitimacy but on the contrary undermines it. From a policy point of view, it also defeats the purpose of policy coordination discussed in Chapter 6. Finally, it can lead to higher unit costs (for example in the case of building schools) and weaker cost controls. Thus this model is not desirable beyond short-term emergency and humanitarian interventions.

8.10 The overall thrust of Afghanistan's development strategy during the past several years has been to move away from humanitarian interventions isolated from the Government and toward longer-term development activities under Government leadership. The way forward need not be through direct

Government provision, however, but rather through the Government taking policy leadership and control of the contracting and funding process vis-à-vis non-government service providers, thereby making the latter accountable to the State and supportive of the Government's efforts to build up its credibility and legitimacy. This is the third model of service delivery, discussed below. There is in any case a great need for strengthening monitoring of service providers by the people and their communities. For PIUs, the best approach – strongly advocated by the Government – is that they be fully integrated in the concerned line Ministry and provide services (e.g. procurement, financial management) to its entire development program rather than only to a specific donor-funded project or program (Chapter 9).

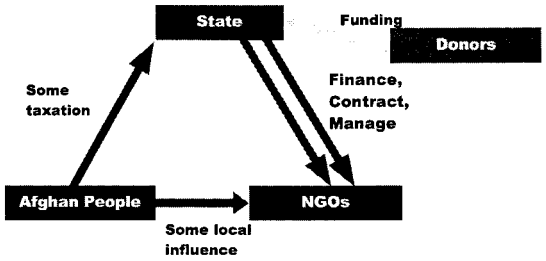
Figure 8. 4: Service Delivery Outside Government (Humanitarian)



GOVERNMENT OUTSOURCING TO NGOS/PRIVATE SECTOR

8.11 In the third model, the Government is in charge of (and accountable for) policy, financing, and monitoring, but non-government service providers (NGOs, non-profit entities, or private firms) are put in charge of delivery on a competitive contractual basis by the Government (Figure 8.5). This model is being applied in the ***health*** sector, for delivery of the Basic Package of Health Services (BPHS) through Performance-based Partnership Agreements (PPAs) in eight provinces.

Figure 8. 5: Service Delivery by Outsourcing to NGOs (part of Health services)



8.12 There can be significant efficiency gains from this model as compared with centralized Government provision of services (the first model). A review of global experience found that, in selected examples, unit costs for contractual provision of health services were 11-50% lower than for government provision (Loevinsohn and Harding, 2004). In Afghanistan, the per-capita cost of the BPHS covered by PPAs averages around $3.80, which is fully in line with patterns of health expenditure in other low-income countries. A competitive process overseen by the Government thus contains unit costs within reasonable limits. By contrast, the same BPHS package provided under donor-executed projects in the External Budget have more widely varying and often substantially higher unit costs (Table 8.1). Thus while it is too early to come to very strong conclusions, it appears that open competition for contracts to provide basic health services holds down unit costs and reduces the variance in costs.

8.13 Moreover, as compared with the second model, this approach provides for Government leadership on policy, contracting, and financing, and thereby potentially also can enhance the legitimacy of the Government. In addition, this model can exploit existing capacity in the non-government sector and harnesses it to meeting national development priorities, as has occurred in the health sector.

Table 8. 1: Contracted Costs for Delivering BPHS ($ per capita of population served)[17]

Donor/Program	Unweighted Average	Lowest	Highest
Ministry of Public Health Strengthening Mechanism (World Bank-supported)	4.1	n/a	n/a
Performance-based Partnership Agreements (World Bank-supported)	3.8	3.3	5.2
Rural Expansion of Afghanistan's Community-based Healthcare (USAID)	6.7	0.3	46.5
Support to Health Service Delivery in Afghanistan (European Commission)	4.2	2.2	5.3
Asian Development Bank	4.8	n/a	n/a

Source: MOPH; Strong et al (2005); Staff estimates.

8.14 This model requires adequate Government capacity to carry out policy/contracting/financing roles. In the case of health, this capacity to a large extent was brought in from the NGO sector, which had experienced managerial and technical personnel from its work in the 1990s. It also requires that non-government capacity for service provision be available – whereas some non-government providers from outside the country may bid on and win contracts, it is important that there be a critical mass of experienced provider capacity in-country. This was the case in Afghanistan's health sector for historical reasons, but not necessarily in other sectors. Capacity limitations at the provider level may well limit the scale and in some sectors the applicability of this approach. There are challenges in terms of contract design depending on the nature of the service. And finally, while this model is fully consistent with state-building, the Government is less visible than in model 1 where it is providing the service directly. Thus public communications and other efforts may be needed to ensure that the people are fully aware that the service is being provided under Government auspices.

8.15 The requirements for maximizing the benefits of this model (which has preconditions as seen above and may not be applicable, especially on a large-scale basis, in some sectors) include the following:

- Opening up scope for feedback and monitoring by beneficiaries and their communities.[18]
- Strong monitoring and evaluation by the State, which is critical for assessing results.
- Ensuring managerial autonomy to providers
- Ensuring adequate competition in contracting, and monitoring costs.
- Consider diversifying financing to include partial cost recovery, as appropriate.

REGULATION AND/OR CONTRACTING OF THE PRIVATE SECTOR

8.16 In the fourth model, the State focuses on its regulatory role (which may or may not involve explicit contracting), and services are delivered by the private sector with users paying for them (Figure 8.6). The ***mobile telecommunication*** sector is a highly successful example of this model (Box 7.2). The benefits of this approach include efficiency, bringing in private investment, competition holding down prices, and (often) enhanced revenue for the Government.

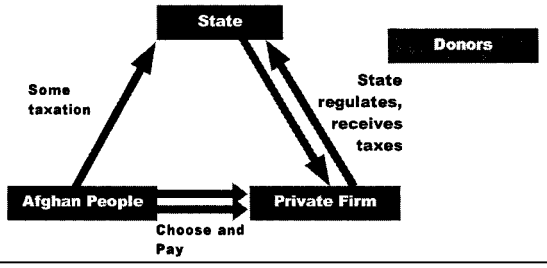
8.17 While attractive in many respects, this model requires adequate regulatory capacity, which cannot be taken for granted. Since the private providers are (quite rightly) profit-oriented, issues of equity and of access (e.g. in remote parts of the country in the case of telecommunications) also arise. Designing

[17] It should be noted that these figures represent contracted levels; actual unit costs may differ and in the case of PPAs appear to be lower than contractual levels. Also, cost figures are not strictly comparable across donors/programs; for example the costs for the USAID-REACH program do not include the cost of drugs and most training (which are included in the PPAs), whereas the EC program includes some training and construction costs. Overhead costs of running different programs vary widely, ranging from $1.5 million during three years for the first two programs (run by MOPH) to $23 million for the USAID-REACH program, although the latter includes extra TA to MOPH (Strong et al, 2005).

[18] This includes the possibility of trying out various models for increasing gender targeting and inclusion, both in terms of staffing and beneficiaries, drawing on experiences from the NGO sector. This will lead to greater potential for inclusive strategies (vulnerable groups, minorities etc.)

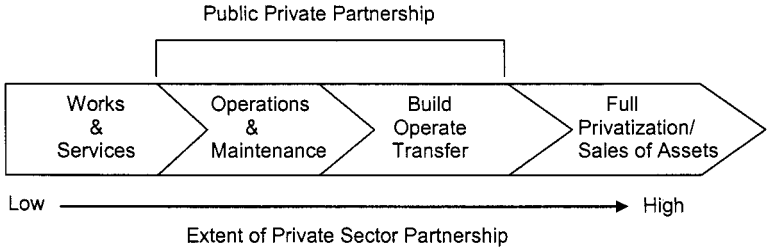
appropriate regulatory frameworks can be a technical and political challenge. Effective competition, as has been achieved in the case of telecommunications, is critically important. Where competition is impossible (in some network industries), the pressure on the regulatory framework to ensure efficiency and reasonable pricing is all the greater.[19] Regular monitoring and evaluation by the Government, including reliance on feedback from customers, can play an important role in this regard.

Figure 8. 6: Service Delivery by Private Sector (Telecommunications)



Box 8. 1: Forms of Private Sector Participation in Infrastructure/Utility Sectors

There are numerous forms of public-private partnerships. The simplified figure below shows the main categories, where the extent of participation of the private sector grows from left to right:



Works and services contract: A works or services contract is an arrangement in which the public utility contracts out specific works (e.g. rehabilitating and expanding a distribution system, construction of a new power plant, etc.) or services (e.g. technical assessments or project management for large works contracts) to the private sector.

Operation and maintenance contract: An operation and maintenance contract is an arrangement by which a private company is entrusted with various types of tasks usually performed by the public authority, such as day-to-day operation and maintenance of existing electricity operations (e.g. a power plant).

Concessions: A concession is an arrangement under which a public entity, owner of the asset concerned (e.g. power generation plant, transmission line, etc.), delegates to a private entity (concessionaire) the responsibility for providing and maintaining a specified level of service to users in exchange for the right to collect revenue from the users. Unlike the previous forms of public-private partnerships, a concession shifts some of the financial risk to the private sector. Concessions may take various forms:

- Under a Build Operate Transfer (BOT) concession, the responsibility of the concessionaire is not limited to operation and maintenance of the infrastructure but also includes initial construction, upgrading, or major rehabilitation component. Large investment and consequent mobilization of private funding sources is therefore required from this company and is to be repaid from the revenue collected from users. BOT stresses the responsibility of the private entity during construction and operation of the asset and the handing over (transfer) of the assets to the public entity at the end of the concession period. The high initial investment required from the private sector and the consequent long concession period make the distribution of risk between the parties a key element of success in such schemes. Many variations of this type of contract have been implemented:
- BOO: Build, Own, and Operate type project financing
- BOOT: Build, Own, Operate, and Transfer type project financing
- BOT: Build, Own, and Transfer type project financing

Source: Volume IV, Chapter 3.

[19] It may be possible to unpackage services so that competition can be introduced at least for some components (e.g. power generation as opposed to transmission and local distribution). Moreover, in some cases introducing contestability (periodically re-opening service contracts or other arrangements for bidding on a competitive basis, so that a monopoly is not permanent) can reap benefits associated with competition. This approach does, however, raise important technical design issues.

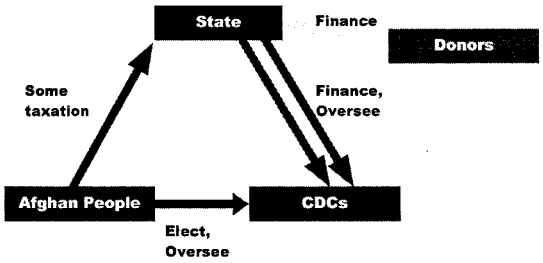
8.18 For ***public utilities***, there is actually a range of options between service delivery by a Government enterprise or department and purely private service delivery. In particular, various types of contractual arrangements involving different degrees of private sector participation are possible (Box 8.1).

COMMUNITY-BASED

8.19 The fifth model involves community decision-making and leadership (Figure 8.7). In the ***National Solidarity Program*** (NSP), the most notable example in Afghanistan, communities elect by secret ballot Community Development Councils (CDCs) which prioritize community development needs with support from a facilitating partner. The communities are then provided block grants from the Government which are used for the identified priority activities. Implementation is overseen by the CDC itself.

8.20 This approach has turned out to be a powerful instrument for building community social and governance capital, empowering rural people, and enhancing the legitimacy and credibility of the State. Moreover, there are built-in incentives for the communities to contain costs. In addition to small-scale rural roads at the village level, NSP has funded other small-scale infrastructure (for example irrigation, drinking water, sanitation, rural energy). This approach also holds the biggest promise for involving women on a widespread basis across the country in local level decision-making and as active participants in economic activities (Boesen, 2004).

Figure 8. 7: Service Delivery by Communities (National Solidarity Program)



8.21 Although the NSP has achieved good initial results, there are significant issues:

- *Continuity* – What will be the roles and responsibilities of CDCs beyond their work with respect to block grants? How will the community assets created under NSP be maintained?
- *Capacity* – How much and how quickly can the CDCs, a very new and possibly fragile institution, take on additional activities?
- *Coordination* – How can it be ensured that community development activities mesh with development activities of other local actors, for example with respect to local road networks?
- *Scale* – Are there possibilities for communities/CDCs to be involved in larger activities that encompass more than one community? How can this be managed?
- *Linkages with local administration* – What are and what should be the linkages between CDCs and district administration? There are both benefits and risks from such linkages.[20]

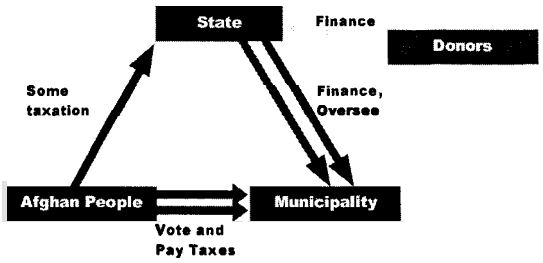
8.22 The way forward with respect to NSP would therefore involve, first, a review of the implementation of NSP so far, its accomplishments and shortcomings, including an honest assessment of the capacity and potential of CDCs. An enhanced, structured role for CDCs in monitoring local service delivery by other (State and non-government) organizations in the village would appear to be a promising option. On the other hand, expanding the role of CDCs very widely into, for example, credit provision or revenue collection would appear to be excessively burdensome and risky.

[20] Potential benefits include infusing a more participatory, accountable approach into local administration; potential risks include "bureaucratization" of CDCs if they come to be seen as *de facto* the lowest level of government administration, and increased possibility of "capture" by local powerbrokers.

MUNICIPAL SERVICES

8.23 The sixth model (Figure 8.8) pertains to municipal authorities, which are the only level of government in Afghanistan with a measure of *de jure* autonomy (Chapter 3). They have their own revenues to fund municipal government costs and delivery of certain municipal services (e.g. trash collection, recreation, park services). However, their tax and fee rates are set by MoF, and they are under the supervision of the Ministry of Interior which approves their budgets (except for Kabul Municipality which has the status of a ministry itself). This model has some promising aspects, since the management of the service provider, and in principle the political accountability, are located close to where the service is delivered, potentially strengthening both the "long" and "short" routes of accountability. Moreover, municipalities' autonomous budgets and their fees and levies could provide some linkage between funding and service delivery.

Figure 8. 8: Service Delivery by Municipalities



8.24 However, the municipalities of Afghanistan, exemplified by Kabul, face a host of problems and constraints, including most notably the following:

- *Confused roles vis-à-vis central ministries,* especially the Ministry of Urban Development, that are involved in planning and investments and sometimes supervising service delivery (e.g. water supply). Some of this confusion stems from lack of clarity in the legal framework.
- *Dysfunctional management arrangements with municipal service providers.* For example, in Kabul Municipality the current institutional arrangements and existing departments do not adequately address the full range of service delivery challenges. Several key functions are not being performed, such as environmental sanitation and property management. Although solid waste collection, maintenance of urban roads, cleaning of ditches and drains, and apparently some responsibilities with respect to water supply and sewerage are handled by a couple of departments in the Municipality, these departments are hamstrung by poor capacity, lack of funding for capital investment projects, excessive bureaucracy (i.e. being subject to the full gamut of administrative procedures), and lack of incentives to effectively provide services.[21] Service providers seem to have very little in the way of management autonomy, incentives, or accountability for service delivery, either to the Municipality or to beneficiaries.
- *Lack of political accountability to the urban population.* Although elections are the ultimate form of political accountability and elected Mayors and city councils are called for in Afghanistan's Constitution, Mayors of Municipalities currently are appointed by the administration instead of being elected.
- *Weak governance, budgeting, and financial management.* In Kabul, budgets are prepared mechanically and never revised within the financial year; expenditures are constrained by cash availability; and the Mayor can approve expenditures outside the budget. Capacity is sorely lacking in the vast bulk of municipalities. As a result, municipalities are vulnerable to corruption (Box 7.4).

[21] In fact, one of the municipal departments responsible for service delivery in Kabul was previously an SOE but was transformed into a department of the municipal government in 2004.

8.25 The reform agenda for the municipalities is formidable, but an emphasis on service delivery will help provide focus. Key priorities include (i) clarifying responsibilities (in particular between larger municipalities like Kabul and the Ministry of Urban Development); (ii) improving the budget process and execution controls; (iii) building human and organizational capacity in core municipal functions (including PFM functions); (iv) reforming the relationship between municipal governments and municipal service providers, including consideration of contracting for private or community provision where appropriate; and (v) ensuring effective outreach and response to community needs, especially those of vulnerable and marginal groups and women.

B. Lessons and Implications

8.26 As demonstrated in the previous section, there are a variety of different modes of service delivery, and rich experience both in Afghanistan and internationally. The first lesson is precisely that ***"one size does not fit all"*** – different approaches can and should be used depending on the characteristics of the service concerned and the specific context. However, it is essential that the underlying accountability relationships support and encourage adequate service provision.

8.27 A second lesson is that, in general, ***service providers need to be made more accountable directly to consumers/beneficiaries,*** through enhanced channels for voice, choice of providers, or in some cases by paying for the service and thereby having a greater incentive to be concerned about quality. The need to strengthen the "short route" of accountability applies to most of the different models outlined above, and to virtually all types of services – a striking example in the security sector is the police.

8.28 Third, ***different models of service delivery have different implications for state-building.*** Several dimensions seem to be important in this regard: (i) the actual role played by the Government (e.g. policy, financing, management, provision); (ii) the visibility of the Government in relation to consumers/beneficiaries; and (iii) the effectiveness of the services (access, quality, inclusiveness with respect to women and other vulnerable groups, etc.). Except for the second model (delivery completely outside government), the Government does play an important role of one kind or another in all of the models, but in some of them (e.g. outsourcing to NGOs or private sector provision) there may be a need for measures to enhance the Government's visibility.

8.29 Fourth, where possible ***competition (or at least contestability) among providers can play a useful role.*** Mobile telecommunications is a notable example of competition resulting in major improvements in access, quality, and efficiency. In health, competitive contracting (even though there ends up being only a single service provider in each province) can help control unit costs.

8.30 Fifth, although it seriously constrains service delivery in the short run, ***the lack of capacity in traditional centralized service delivery systems provides an opportunity to rethink, modify, or move away from this model.*** In most sectors (whether social services or public infrastructure), Afghanistan has much more of flexibility in choosing options than other countries with well-established service delivery institutions and networks. Depending on the sector, this may involve de-concentration within the Government hierarchy, moving toward more commercialized modes of provision by a utility, private sector participation, etc.

8.31 ***There are important lessons for donors as well***, including the need to work through Government budget channels and not build up parallel structures, avoid undermining service providers' relationship with the State by providing resources (including salary top-ups) directly to providers, resist "flagging" of projects/activities that they finance to the detriment of the Government's visibility, and encourage rather than undermine cost containment, for example by supporting competition in their own and Government procurement procedures. While the need for quick impacts and concerns about weak Government capacity are valid, the various models outlined above highlight the importance of placing donor interventions under Government leadership and, when possible, using Government institutions (Chapter 6 discusses the use of the Government's budget and budgetary systems).

FINANCING OF SERVICE DELIVERY AND THE ROLE OF COST RECOVERY

8.32 Financing and cost recovery deserve attention from both fiscal and service delivery perspectives. The fiscal impact of downstream O&M requirements associated with public investments and (re)building of social service networks can be truly daunting (Chapter 3), and cost recovery where appropriate can be an instrument for managing these downstream costs and reducing associated fiscal risks. Cost recovery can also be an instrument for demand containment (for example adequate power and water tariffs, and nominal charges for health facility use or higher education to discourage unnecessary or excessive use).

8.33 Whether and to what extent it is appropriate to charge for any given service depends on the characteristics of the service (whether people can be excluded from benefiting from the service or not – e.g. defense versus domestic piped water supply, whether charges can vary with usage), demand (whether not charging will result in overuse, e.g. in the case of electricity), and consumers (whether poor and non-poor consumers can be distinguished, whether the poor are disproportionate – or at least equal – users e.g. primary education, etc.).[22] In many cases significant cost recovery may be neither feasible nor desirable – Government-provided primary education is one of the best examples. Nevertheless, there are good technical grounds for additional cost recovery for many public services.

8.34 In addition to its fiscal implications, cost recovery can be a tool of accountability for improving service delivery. People who pay for a service are more likely to be concerned about whether and at what quality level they are benefiting from the service, and to be more vigilant and selective, positively influencing the behavior of providers. These beneficial effects depend on whether there is competition among providers (and therefore the possibility of exercise of choice by the consumer), on other factors that enable payment for services and exercise of voice to reinforce each other, and on receipts transparently accruing to the service provider.

8.35 Turning to some examples, although willingness to pay for ***power*** is demonstrated throughout Afghanistan (widespread use of expensive small generators with full cost recovery), in Kabul (and other largely hydel-based cities like Kandahar) the effective grid tariff is only $0.021/kwh, far below the actual cost of supply. Nationally, the effective tariff is roughly estimated at $0.051/kwh, compared to a cost of supply of $0.123/kwh, implying an average cost recovery rate of 40% (Table 8.2). Although donors are funding various power investments as well as recurrent costs such as fuel (diesel fuel provided by USAID for the Kabul Northwest Power Plant cost about $40 million in 2004/05), this pattern of financing is fragmented and unsustainable.

Table 8. 2: DABM: Effective Tariffs and Costs by Region, 2004/05

Region	Effective Tariff	Costs	Share of Power Billed as % of System Total
	(US¢/kWh)		
Kabul*	2.1	15.4	49%
Kunduz	4.6	3.2	4%
Balkh	7.4	6.5	17%
Herat**	2.5	5.2	7%
Nangarhar	7.3	1.3	6%
Kandahar	3.3	1.1	14%
NATIONAL AVERAGE	5.1	12.3	

Note: Data apply to DABM. Source: Volume IV, Chapter 3.

8.36 Thus there is an urgent need to raise power tariffs where they are very low. Moreover, it is important not to exacerbate the problem of low cost recovery. For example, MoEW recently purchased several diesel generating sets for use in Kabul. Without higher user charges, it will be impossible to cover

[22] See World Bank (2003b, Box 4.4, p. 71) for a schematic summary of these considerations (reproduced and discussed in the context of Afghanistan in World Bank, 2005a, p. 85).

the estimated $10 million annual cost of diesel fuel for these generators. In June 2005, MoEW sharply reduced power tariffs (by on the order of 40%) in Herat, reflecting the lower cost of imported power from Iran. This will damage the ability of the power system in Herat to finance expansion of its distribution network to improve coverage. These examples highlight the importance of fully incorporating financing and cost recovery issues in decisions.

8.37 The ***natural gas*** sector also faces very serious financing and cost recovery issues. As noted in Box 8.2, private investment based on commercial pricing will be essential if this sector is to be revived and developed. Currently natural gas tariffs are far too low to fund rehabilitation, O&M, and necessary expansion of gas production and infrastructure. Moreover, non-payment by end-users is common even at present low prices, raising serious doubts about whether they will be able to pay full cost-recovery prices. It seems clear that development of this sector will require a set of complementary investments including in downstream end-user industries, based on effective Government regulation and economic pricing.

Box 8. 2: Natural Gas Pricing

After years of neglect and underinvestment, many steps are needed to revive and develop Afghanistan's natural gas sector. Given the characteristics and investment requirements of the sector, large amounts of private investment will be essential. Two critical first steps for attracting private investment in natural gas are (i) pricing natural gas on commercial terms, and (ii) establishing a track record of full and timely payment for gas by end-users.

Gas tariffs today are too low to cover costs of rehabilitation, O&M, and expansion of gas production and infrastructure. For incremental gas production, tariffs may be less than half of what they ought to be. Moreover, the Government collects no taxes or royalties from the natural gas sector, missing out on a potentially substantial source of revenue.

Gas transmission and distribution tariffs tend to be regulated by the Government in all countries. Gas prices at the wellhead are generally determined by market forces, although some Governments such as Pakistan have established pricing formulas to attract investors. Determination of economic natural gas prices requires, among other technical work, separation of reasonable and prudent costs from unnecessary expenditures for cost recovery purposes. For the benefits of regulation to exceed its costs, regulation should be simple, workable, and cost-effective. The Government needs to strike a balance between abuse of market power (in the absence of competition and effective regulation) and over-regulation, in light of the available resources and its own capacity to regulate.

A closely related question is the ability and willingness of consumers to pay prices that allow cost recovery. International experience demonstrates that creditworthy large-volume consumers form an important market base for the natural gas industry. In Afghanistan, non-payment by consumers has been a serious problem despite the current very low gas price. It is not clear whether current consumers, in particular the Kud Bergh fertilizer/power plant (the only large-volume consumer at present), can pay for gas at economic pricing levels. There is a need to identify potential creditworthy large-volume gas consumers to help develop the gas sector. A new power plant based on natural gas may be such a candidate. At the same time, what to do about current gas users who may not be in a position to pay for gas at cost-recovery levels needs to be carefully considered.

Finally, the discussion above strongly suggests that development of the natural gas sector in Afghanistan will have to involve a set of complementary private investments in gas production, infrastructure, and major gas end-use activities, with effective Government policies and regulation.

8.38 ***Higher education*** provides a good illustration from the social sectors of the need for cost recovery and sustainable financing arrangements. Given its enormous needs and the high socio-economic returns to investments in elementary education, this is being prioritized in terms of budgetary allocations (see Chapter 5). But delivering quality higher education services leading to significant numbers of well-qualified graduates will be essential for state-building and capacity development in both public and private sectors. While charging fees for higher education is not popular in any country, the private returns to higher education are substantial enough that partial cost-recovery is well-justified, with scholarship or loan programs for those unable to afford fees. Moreover, an astonishing 40% of the recurrent budget of the Ministry of Higher Education is spent on running costs and food at university dormitories. Since another 50% of the operating budget of the Ministry goes for salaries, very little is left for indispensable pedagogical inputs such as internet access, textbooks, journals, lab materials, etc. Even if charging fees for higher education is not possible in the short run, expecting students to cover part of living costs – at least food – would be reasonable and would free budgetary resources to improve the quality of higher education.

MONITORING AND EVALUATION

8.39 Information flows and monitoring and evaluation (M&E) are critically important for effective service delivery, as shown in the various models and examples discussed. Some progress has been made in improving statistics and information flows, but there is a long way to go in further improving these and exploiting them for effective M&E leading to better service delivery. In particular, there have been substantial improvements in flows of financial information on expenditures (Chapter 7). Good examples of progress in developing timely information flows include the Health Management Information System and Education Management Information System. But little information is available on outputs and outcomes. Moreover, gender-disaggregated data is largely lacking. These deficiencies will need to be corrected over time.

8.40 Transparency and dissemination of information are extremely important as well. In addition to, and often more important than, vertical flows of information to and within the administrative hierarchy, information needs to flow to the public and civil society in a horizontal manner.

8.41 Better information flows are only part of the story, however. Appropriate performance benchmarks need to be set and regularly monitored. For example, performance benchmarks will help in identifying where bottlenecks occur, e.g. in terms of girls' retention rates in schools, women's access to maternal health services, causes of high maternal mortality, etc. Setting the right benchmarks requires a clear strategy and objectives. Indeed, setting benchmarks and monitoring performance can be a good device to clarify objectives and make them truly operational.

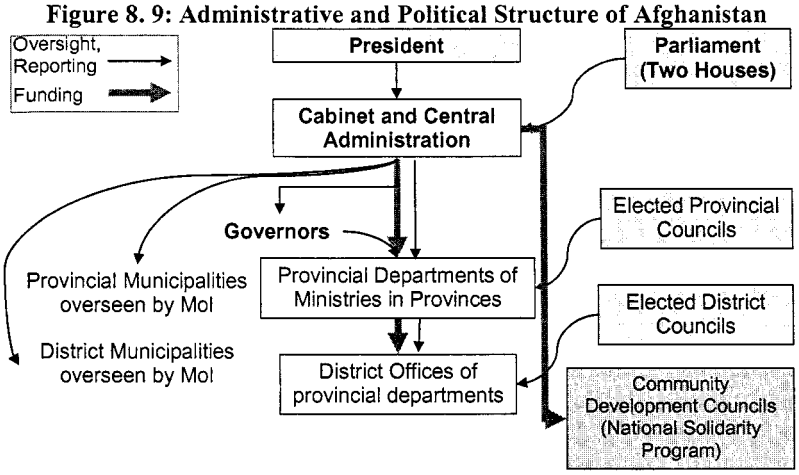
8.42 Finally, institutions need to take on the role of monitoring and evaluation and treat it as a serious part of their work. This is clearly one of the important roles of Parliament at the national level. The elected Provincial Councils can and should play a role in monitoring at the provincial level, and similarly the elected District Councils (mandated under the Constitution but to be formed later) at the district level. At the community level, as discussed above the CDCs could play a very important monitoring role vis-à-vis local delivery of services.

C. Sub-National Strategy

8.43 Afghanistan is *de jure* a highly centralized state, with lower levels of administration serving as arms of central ministries. Provincial Governors are supposed to play a coordinating role and are responsible for security, but they report to the Ministry of Interior, and they have no supervisory authority over line departments in provinces. Only municipalities have some degree of fiscal autonomy (Section A.6). The *de facto* situation, however, is that central control has been weak and non-state power bases at regional and local levels strong. The structures of a unitary state, provided for in Afghanistan's Constitution, are in place in rudimentary form, but there are glaring capacity weaknesses. With formation of the elected Parliament and Provincial Councils (and later District Councils), Afghanistan's administrative and political structure will be as shown in Figure 8.9.

8.44 The need to improve service delivery and the challenge of building an effective, accountable state are closely linked; both are at the core of Afghanistan's reconstruction agenda. An effective state delivers services to the people, and by ensuring that services are delivered with widespread access by citizens (including women and other vulnerable or marginal groups), the state can build its legitimacy. Subnational levels of administration (provinces and districts) are very important from both perspectives. A service delivery perspective provides some discipline in considering subnational strategy and focuses it on relevant outcomes. For example, there have been improvements in financial management and other aspects of subnational administration (Box 8.3), but these may be only beginning to translate into improved service delivery.

Figure 8. 9: Administrative and Political Structure of Afghanistan



Box 8. 3: Improvements and Challenges in Subnational Administration

A recent update report on subnational administration, based on field visits to six provinces and interviews in Kabul, found that financial management at the provincial level has improved significantly over the past two years or so:

- In most cases civil servants at subnational level receive pay monthly, and on time.
- Access to cash balances for non-salary expenditures is much improved, particularly in very poor provinces.
- Financial reports are being submitted on time for the most part.
- The single expenditure and revenue accounts are working well.
- Audits are being conducted, although their impacts are not yet clear.

However, there are still significant issues to be addressed:

- Low pay continues to be a major complaint.
- The *takhsis* (budget authorization) and *tashkeel* (administrative authorization for staff positions) arrive late in many cases, which can result in delays in pay and other expenditures; there can also be disconnects between the line ministries' *takhsis* and that reaching the Mustoufiats (provincial finance departments).
- The system of transferring positive balances into the provinces' single expenditure account, while effective in getting cash out to provinces, is still placing unnecessary constraints or delays on spending.
- Non-salary allotments are still low, and there continue to be inequities between provinces.
- There is still a lack of written manuals, and more training is needed.
- Management of the education budget is still a major issue.

Moreover, little has changed in terms of recruitment and staff appointments. Although senior appointments are being channeled through the Independent Administrative Reform and Civil Service Commission (IARCSC), political and ethnic considerations appear to feature prominently in recruitment.

Many (though not all) of these issues can be addressed relatively easily. However, there is confusion among a number of parallel and separate provincial coordination mechanisms supported by different external agencies (including for counter-narcotics), which detracts from the functionality and effectiveness of subnational administration (Lister, 2005).

Source: Adapted from Evans and Osmani (2005, pp. 3-4); also see Volume III, Chapter 3.

8.45 Decentralization is an important political choice made by a country, which may have a variety of motivations. Although better service delivery is often one of the avowed objectives of decentralization, international experience has been mixed. Moreover, there are examples where rushed and not carefully thought through decentralization initiatives turned out to be counterproductive. Among the risks of decentralization which may be particularly salient in Afghanistan are the following:

- *Possible "capture" of the decentralization process and structures* by local elites – this risk is particularly great in Afghanistan given the importance of non-state forces (often retaining some armed capabilities despite the DDR process). Capture of national revenues by Governors and other local power-holders has sometimes occurred and is problematic for fiscal stability.

- Associated risk of inadvertently undermining *the effort to build up a credible unitary state.*
- *Weakening of financial controls and fiscal discipline.* Afghanistan's existing mechanisms and continuation of the Government's strong "no-overdraft" policy will likely enable strong fiscal discipline to be maintained. However, decentralization mechanisms such as block grants to lower levels of Government administration, without proper financial controls and monitoring, could increase fiduciary risks. The experience in 2002/03 (until the creation of the Treasury Single Account) shows the risk that revenues will be spent by provinces and poorly accounted for and that, even in resource-rich provinces, liabilities will be created.
- *Issues related to ensuring reasonable equity* in funding (and ultimately service delivery) across the country.
- *Design risks* that could result in counterproductive outcomes, for example inadequate accountability at lower levels of Government administration.

8.46 Nevertheless, Afghanistan's geographical characteristics and regional and ethnic diversity would suggest that over the longer run, decentralized modes of governance may well be appropriate and could be considered. From a service delivery perspective, as seen earlier, there is very often a case (depending to some extent on sector-specific circumstances) for management and oversight of service delivery to be close to the providers and consumers. However, the current situation and the legacy from conflict provide ample grounds for exercising caution in this difficult area in the short run, and in particular not undermining the state-building agenda.

8.47 Keeping within the present unitary state structure and taking a practical, results-oriented service delivery focus, there are some promising options which include:

- *Enhancing the functioning of the present subnational administration,* including through measures to address the problems noted in Box 8.3. One concrete example would be increasing the share of non-wage recurrent budgets going to lower levels of administration.
- *Making available information* on budgetary spending by provinces (and to the extent possible districts).
- *Providing greater management flexibility to provincial and district line departments* in oversight of service delivery facilities (e.g. for provincial and district education departments in overseeing schools). This can include an extended role for local user groups (e.g. the Parent-Teacher Association for primary schools).
- Giving provincial line departments (and through them districts) *an explicit role in the national budget formulation process,* which could include proposals, consultations, etc.

8.48 Finally, "top-down" measures to strengthen subnational administration and enhance its capacity to oversee service delivery can complement "bottom-up" community-based efforts such as the NSP. There is a risk of the two approaches clashing, particularly in a highly politicized atmosphere, but this can be mitigated by maintaining a service delivery focus. As demonstrated by the initial successes achieved by NSP, community-based organizations can play important developmental and governance-improving roles, building on the traditional role of communities in decision-making and on participatory mechanisms (including elections), and promote social inclusion (securing representation not only of local minorities but most remarkably also of women).

CHAPTER 9. INSTITUTIONAL REFORMS AND CAPACITY DEVELOPMENT

9.1 While the previous chapter reviewed options for organizing effective delivery of services, this chapter focuses on building individual and organizational capacity to improve PFM performance. At the outset, the "sequencing" or "time horizon" dilemma must be emphasized – there is a dichotomy between the need to deliver services quickly to the people (Chapter 8) and the need to develop effective, sustainable national public institutions. The trade-off is complex, as both are necessary to build a legitimate, well-functioning State. How to quickly deliver services while progressively developing capacity over time? The chapter opens with a discussion of the broader long-term agenda of capacity development. It then reviews the reform process of MoF, the core of the PFM system. The third section analyzes the challenges of building PFM capacity beyond MoF – in line ministries, provinces, and municipalities.

A. Developing the Government's Capacity

9.2 A quarter-century of wars and civil strife left Afghanistan with a collapsed administration. While there was some institutional memory of rules and processes (notably with regard to financial management, see Evans et al., 2004b, and Box 8.3), service delivery by the Government had largely ceased. Skills have been depleted, due to both the weak education system and a major "brain drain" (Box 9.1). The Government is committed to building an effective administration, with the Government not delivering all services but often acting as a financier and/or regulator. This requires significant enhancement of Government capacity.

Box 9. 1: Harnessing Afghan Expertise

Severe capacity constraints in Afghanistan's civil service result from a number of factors. Millions of Afghans, including many with skills, were killed or fled the country during the conflict. Universities and schools were closed or operating at low capacity. This has left the country deprived of expertise, knowledge, and experience in managing the development process. Women in particular suffered from lack of education opportunities. Many Afghans who left gained a better education and entered into skilled and professional employment in the region (especially in Pakistan and Iran) and also farther away (in countries such as the USA, UK, France, and Germany). In the early reconstruction phase, the Afghan civil service suffered further losses from among the (very few) skilled staff who had remained or returned immediately after the end of conflict, as NGOs and donor agencies offered much better salaries and working conditions than were available in the Government. It would be misleading, however, to conclude that Afghanistan has no usable expertise; while external assistance is very much needed, tapping existing Afghan expertise is crucial.

The first option has been to make use of the expertise and experience of Afghans working in NGOs and also some of the international agencies (these groups are generally referred to as the "second civil service"). Given the importance (and, in some cases, size) of NGOs delivering services in the 1990s (Chapter 8), they have accumulated a wealth of management and technical expertise. In the early days of the transitional Government, several ministries tapped these human resources to quickly build very able management teams. The second option is to tap human resources from the Afghan diaspora. A number of talented Afghans returned from abroad, sometimes working as volunteers, and brought important skills and experience to the Government.

In order to better tap both of these reservoirs of skills, the Government has created the Lateral Entry Program (LEP) and the Afghan Expatriate Program (AEP), both of which are being managed by the IARCSC. Under the LEP, the Government will inject up to 1,500 professional and skilled Afghans into senior and middle-level positions of the civil service, with enhanced pay that goes beyond PRR scales. The primary target of this program is the "second civil service" and Afghans in regional labor markets.

Under the AEP, the Government will appoint up to 100 highly skilled Afghan expatriates to work in advisory positions in priority areas, of which around 50 are already in place. This program's success is based on a number of factors: (i) a dedicated Executive Committee; (ii) clear guidelines on recruitment and pay levels; and (iii) a thorough review of both the capacity of the line ministry to use an expatriate Afghan effectively and of the expatriate to bring the required skills.

THREE STRATEGIC COMPONENTS

9.3 The Government has outlined its strategy as part of the Public Administration Reform and Economic Management (PAREM) program, one of the 12 NDF programs. This strategy, currently under revision for the ANDS, focuses on three key aspects.

9.4 First, ***individuals (civil servants)*** must be well qualified and motivated. Recruitment based on merit has been found to be the most effective way to raise skills and motivation, even though it can be politically sensitive in a fragmented society with a history of patronage. A diverse workforce – notably in terms of gender and ethnic group – is necessary to build a legitimate State. Women are especially needed in the civil service for delivery and management of public services for the female part of the population. However, the workforce composition needs first to be adequately understood and monitored before plans can be designed to enhance diversity. A talented workforce also requires an adequate pay and grading structure, providing attractive wages and potential for promotion. Wages and promotion should also be linked to performance. A strong ethos – a sense of service and accountability – is very important. While partly linked to issues of pay levels, this also requires leadership by management teams that model these values. In addition, capacity can be created from inside by training, not only formal training but also on-the-job training or coaching from senior staff or external advisors (Box 9.2). Finally, tapping skilled Afghan expatriates may be a way to quickly bring talented Afghans into the civil service (Box 9.1).

9.5 Second, ***organizations (ministries and agencies)*** need to function well. In addition to recruiting the right people, this requires institutional reforms to (i) specify each organization's mission (in line with the ANDS); (ii) improve (simplify and standardize, with clear reporting lines) the organizational structure, and (iii) review and improve business processes. The solution of creating new organizations to solve each problem should be resisted (for instance, Chapter 7 highlights issues and problems associated with anti-corruption agencies). Adequate management processes (including sharing information, making decisions, implementing decisions, and following up) need to be established, which often requires some disconnect between, and clear accountability of, the political level (working toward and making high-level policy decisions) and the administrative level (providing information and analysis and implementing policy decisions). Some core functions need to be created or modernized, such as HR, finance (see below), and communications units. Implementing these sweeping changes requires preparing a vision for the agency, translated into a medium-term strategy and annual business plans with performance indicators, and implemented with regular monitoring. It also requires physical investments (buildings, IT, equipment).

9.6 Third, ***the institutional environment*** needs to be supportive of effective individuals and organizations. The PFM Review has highlighted a number of policies which are important in this regard. Policies should be matched to capacity, because a commitment to unenforceable policies is economically costly (risk of red-tape and corruption – Chapter 7, poor service delivery – Chapter 8) and politically harmful (failure to keep promises). In addition, decision-making should be supported by adequate coordination mechanisms throughout the Government. As indicated in Chapter 6, the Cabinet Secretariat will need to play an important role in coordinating policies and making sure that Cabinet decisions are informed and implemented. The capacity of the justice system to enforce laws is also critical for the Government's capacity to deliver services. Finally, the role and capacity of the Parliament will be necessary for the Government to operate under adequate oversight (Chapters 6 and 7).

9.7 Progress on these three dimensions has been uneven. At the institutional level, a number of policies have been adopted related to PFM that seek to simplify the regulatory framework, and MoF envisages further simplifying the tax code. Projects are underway to reform the Cabinet Secretariat. At the organizational level, the Priority Reform and Restructuring (PRR) scheme (which allows departments to place staff on an elevated pay scale in exchange for organizational restructuring) is being implemented for 15,000 positions. Finally, at the individual level, more than 100 senior appointments are now processed monthly by the Independent Appointment Board, following merit-based procedures. More than 100 appeals on recruitment, transfer, and termination of employment have been evaluated. A short-term

capacity building framework (including programs for Afghan expatriates and lateral entrants from neighboring countries, Box 9.1, and funding for short-term technical assistance and feasibility studies) is under implementation. However, there remain many issues, at the institutional (weak enforcement capacity in the justice system, for instance), organizational (lack of in-depth organizational reviews and reforms), and individual (uncoordinated training programs and slow recruitment) levels.

TWO KEY CHALLENGES

9.8 This uneven progress should be viewed in the context of two important challenges that capacity development faces. First, international experience has amply demonstrated that capacity development – recruiting and training people as well as reforming and strengthening institutions – is **a long-term endeavor**. It involves technical assessments and preparation of detailed strategies, politically sensitive changes in practices, and learning by doing. Faced with the "time horizon dilemma", an asymmetric approach – in which reforms are implemented in selected agencies first and gradually rolled-out – may be the only solution. But this is a risky strategy, which can be threatened by frustration at lack of more widespread results; social discontent arising from disparities among pay levels; slow progress because unreformed departments weaken the performance of reformed ones; and ineffectiveness due to uncertainties surrounding institutional reforms. These risks can only be mitigated by high-level political leadership, a large and effective injection of technical assistance (Box 9.2), an adequate monitoring mechanism, and communication efforts.

Box 9. 2: Using Technical Assistance Effectively

According to OECD/DAC data, more than $400 million of external assistance to Afghanistan was spent on Technical Assistance (TA) in 2003. Such a high level of TA may well be necessary given the low capacity in the Government and the need for a short-term injection of capacity (including for highly specialized skills). Nevertheless, various problems suggest that TA could be better managed. The following lessons can be learned from experience:

- TA should be based on explicit demand and leadership from a clearly identified counterpart, and should report to that counterpart (with quality control as needed from the donor); this should increase follow-up on TA recommendations.
- TA proposals should include clear and monitorable indicators and should be monitored, with outcomes evaluated; this would enable assessment of the quality of TA and better management of it. More specifically, there needs to be differentiation between (i) operating TA (directly carrying out certain Government functions – this should be on a strictly temporary basis until national capacity is built up); (ii) advisory TA (a small number of advisors on a long-term basis, with provision for short-term advisory support on specific issues and for identified analytical work); and (iii) capacity-building TA (intended to directly support sustainable capacity building).
- Ministries could also create dedicated processes to ensure adequate TA oversight and coordination; while a clear ministry strategic framework with specific milestones should help, more structural coordination may be required.
- To the extent possible, TA provision should be aligned with organizational structures to avoid unnecessary fragmentation, which would avoid in particular conflicting advice (some departments have up to six or more TA providers). This may, in some cases, lead to assigning one TA provider per department or agency, or pooling donor resources together (as is done, for instance, in Tanzania and Cambodia for PFM reforms).
- TA contracts should be subject to international procurement standards to seek maximum value for money.

9.9 The experience with the PRR highlights these difficulties. Technically, implementing this scheme requires significant assistance, as organizing ministries and grading jobs require specialized skills. Implementation is also contingent on having experienced management capacity. Politically as well, the asymmetric approach requires solid high-level leadership and a good communication campaign to maintain support for – or at least acceptance of – this strategy, especially when its impact is difficult to quantify and takes time to materialize. As indicated above, an asymmetric solution may well be the only option, but the risks have to be mitigated.

9.10 Second, **donors**, while bringing financial and technical assistance, can distort incentives and the labor market (impacts on the budget are discussed in Chapter 6). Given the shortage of skills (notably

management, language, and computer skills), competition between local offices of the international community and the rest of the market has led to higher salaries, especially in Kabul, reaching levels that the Government, in need of similar skills, cannot afford. In some cases, donors even directly pay civil servants' salaries or "top-ups", which is not fiscally sustainable for the Government and can disrupt accountability and loyalty relationships. Such relationships are also harmed when separate units dedicated only to supporting donor projects are created (Section C). In some cases donors approve salary/wage levels that are well above prevailing rates for whole categories of employees – such as for the ANA, National Security Directorate, and Counter Narcotics Police – but which are never costed or assessed from a fiscal standpoint. Finally, external technical assistance, while very much needed to "buy capacity" in the short term, needs to be well managed to be effective (Box 9.2): otherwise it can result in a waste of resources that generates resentment among less well-paid staff without having much positive impact.

B. Reforming the Ministry of Finance

9.11 As emphasized throughout this report, MoF has a crucial stewardship role in public finance management. Its capacity to fulfill its role in PFM is therefore critical for overall PFM performance as captured by the PFM indicators (Chapter 2). Progress in mobilizing revenues also requires the development of a professional cadre in the tax and customs administration (Chapter 4). Progress has been substantial – under the leadership of a strong management team and with external assistance supporting, sometimes operating, core systems such as AFMIS. But the challenges remain enormous.

9.12 In the first half of 2005, MoF therefore initiated a strategic planning process. The first step was to put forward a vision for the Ministry, based on five goals: (i) mobilizing revenue and managing Government finances; (ii) supporting economic management and promoting economic growth; (iii) managing public wealth; (iv) promoting good governance; and (v) being a best-practice leader within Afghanistan's public sector.

9.13 A review of the Ministry's capacity, from an individual and organizational point of view (policy issues are discussed in Chapter 6 and 7), suggests the following issues:

- *Organizational adjustments*: The newly-created Fiscal Policy Unit in MoF should help strengthen analytical capacity; the Treasury Department and the Accounting Department are being merged; a Procurement Policy Unit should be created as a clear champion of procurement in the Government (see Chapter 7); the creation of the Large Taxpayer Office is intended to help mobilize more revenues; and the planned creation of Revenue Offices in the provinces, with the Mustoufiats becoming sub-Treasuries, would clarify accountabilities at the provincial level.
- *Departmental reforms*: With these organizational adjustments, the Ministry could submit a Ministry-wide PRR (as a further step to existing PRR programs in several departments); this should cover the strengthening of the Budget Department (along sectoral lines, with no separation of operating and development budgets), the Internal Audit Department (in line with the PFEM Law), and the Finance and Administration Department.
- *Institutional strengthening*: A number of processes should be created or strengthened to improve the Ministry's effectiveness, including the budget process for MoF's own budget; human resource strategy; internal and external communications strategy; information sharing and decision-making processes; and TA management (Box 9.2).

9.14 MoF may want to pursue a rigorous institutional reform process in order to develop its capacity as steward and custodian of Afghanistan's public finances. The next step would consist of translating MoF's vision into detailed and quantified performance targets to measure progress; specific and realistic annual business plans; and consistent strategic plans, performance targets, and annual business plans at the department level. Implementation will require sustained efforts and regular monitoring. A possible

vehicle for this purpose would be an institutional reform working group / monitoring cell within MoF, with support from MoF's top leadership.

C. Building PFM Capacity Throughout Government

9.15 Beyond MoF, strengthening overall PFM performance calls for financial management reforms and capacity development in ***line ministries*** (including those responsible for the security sector as well as other sectors). Most of them have very weak capacity and operate based on outdated practices. Most ministries continue to have two departments, sometimes reporting to two different deputy ministers, separately working on their operating and development budgets. Many processes – including the expenditure process – involve dozens of signatures. This overabundance of ex-ante controls not only adds nothing to the effectiveness of internal controls but also leads to slow processing and creates opportunities for corruption.

9.16 Financial management units or budget units in line ministries should therefore be reformed. MoF intends to pilot a "model office" in one ministry, before rolling out reforms more widely in line ministries. This would need to be coordinated with the procurement reform, according to which procurement authority is to be decentralized in line ministries. Over time, such reforms could allow a number of responsibilities to be devolved to line ministries, notably access to AFMIS for reporting and, later, posting of expenditures (Chapter 7). This process would need to be subject to well-defined criteria, building on the experience of Thailand, where under the so-called "hurdle approach", PFM functions were devolved to line ministries after they met performance standards.

9.17 The creation of Program Management Units or Program Implementation Units (PMUs/PIUs) can support better PFM performance but also gives rise to risks. Donors often favor having such units to manage their funds. These units have proven useful, even indispensable, in cases where the civil service and the existing institutions have no capacity. However, autonomous PIUs can become "super-ministries", which require a long time and high spending to establish, absorb civil servants from ministries and generate resentment from others, expand their purview, and become over-stretched and entrenched. As a result, PMUs/PIUs easily can become an obstacle to national institution building and sustainable capacity development. It is therefore extremely important to ensure that enclave/isolated PMUs/PIUs do not become the norm, and that those already established are reformed. In particular, these units should not cover only donor programs but rather should be integrated in line ministries (OED, 1998). The Grant and Contract Management Unit in the Ministry of Public Health highlights these issues: well integrated in the Ministry, its strong capacity not only facilitated implementation of donor-financed projects but also contributed to the overall achievements of the Ministry. Nevertheless, tensions and resentments (including among donors) were not easy to manage.

9.18 At the ***subnational level***, the PFM system works through the Mustoufiat network. Analysis has shown that administrative and financial regulations are adhered to in provinces (Box 8.3). However, as the Government seeks to implement the budget more effectively outside Kabul, Mustoufiat reform is essential. At the individual level, this requires the implementation of pay reform and training. At the organizational level, it is recommended to separate Treasury functions from revenue functions, with a view both to specialize these units (with different skills and different clients) and ensure adequate separation of duties. At the institutional level, strengthening Mustoufiats requires a commitment from the central ministries (MoF in particular) to deliver funding in full and on time; to take into account local realities and demands in the formulation of the budget; and to provide clear manuals, training, and other forms of support (e.g. implementation of AFMIS) to implement modernized PFM rules throughout the country. Finally, devolving responsibilities to line ministries (see above) would require developing PFM capacity not only in the central ministries but also in their provincial line departments.

9.19 While ***municipalities*** have an institutional set-up that has potential to effectively deliver urban services (Chapter 8), their PFM capacity is currently very weak. A study of Kabul Municipality highlights the constraints: unclear institutional responsibilities between the municipality and line

ministries (notably the Ministry of Urban Development and Housing); outdated functions including some (e.g. price control) inherited from the era of the Soviet occupation; an organizational structure that has been adjusted but is still in need of further improvement (see Volume III, Chapter 5); poor budgeting (e.g. separation of operating and development budget functions), financial management, procurement, and record-keeping processes (for instance, if there is no line item in the budget for a certain type of expenditure, the expense is simply not entered in the ledger); and opaque revenue collection mechanisms applied to numerous low-yield local revenue sources. Therefore, PFM processes and capacity need strengthening as a prerequisite for realizing municipalities' potential to deliver services in urban areas.

9.20 In summary, the capacity development agenda is far-reaching, as it covers the three dimensions outlined in Section A and cuts across the central Government, its provincial and district departments, and municipalities (to which SOEs and the private sector – for participation in public procurement – should be added, see Chapters 3 and 8). Further developing MoF's capacity – both in Kabul and in the Mustoufiats – is the short-term priority as MoF is the core of the PFM system and the custodian of public funds. Building on this, organizational reforms (budget, financial management, procurement departments) and training can be rolled-out to line ministries and municipalities while, in a sequenced way, authorities (e.g. for procurement) are de-concentrated to line ministries based on performance.

CHAPTER 10. KEY CHALLENGES AND A ROADMAP FOR PFM REFORM

10.1 The previous chapters of this report have highlighted both the progress achieved and the problems faced by Afghanistan's PFM system. Building on the analysis presented earlier and looking to the future, this concluding chapter briefly summarizes the major challenges that need to be addressed and puts forward a roadmap for strengthening and reform of the PFM system.

A. Eight Main Challenges

10.2 Good public finance management is a key enabling factor for implementation of Afghanistan's development strategy and for achieving central national objectives of state-building, sustained rapid economic growth, and poverty reduction. The following broad challenges for Afghanistan's PFM system have been identified and discussed in this report.

10.3 First, and from a macroeconomic and growth perspective of critical importance, there is ***the challenge of fiscal sustainability.*** Afghanistan needs to make continuous and sustained progress toward a fiscal position where domestic revenues cover all operating expenditures. This will require, *inter alia*, (i) rapid growth of domestic revenues (see below); (ii) containment of overall expenditures in line with medium-term resource constraints; (iii) ensuring that downstream expenditure liabilities created by public investments and other spending decisions are affordable; and (iv) incorporating recurrent expenditures funded directly by donors through the External Budget in the fiscal sustainability equation (notably in the security sector), and bringing these expenditures progressively into national budget channels.

10.4 Second, there is ***the challenge of sustained rapid growth of domestic revenues,*** which will be the lynchpin of progress toward fiscal sustainability). Afghanistan's revenue-to-GDP ratio at around 5% is well below half the level even in other very poor countries. Revenues have to grow much more rapidly than expenditures on a sustained basis. At the same time, a sound revenue system should be conducive to development of the private sector. Key challenges in raising revenues include: (i) lack of capacity in the tax administration system as well as among taxpayers to calculate and pay taxes; (ii) existence of numerous, low-yielding "nuisance taxes", illicit revenue collection by many local authorities, instances of double-taxation (mainly between municipal and national taxation), and ambiguities in the tax laws; (iii) the dominance of agriculture and the informal sector in the economy, which are difficult to tax in any country; and (iv) widely perceived corruption in the tax administration.

10.5 Third, there is ***the challenge of a policy-based, well-prioritized budget with strong political buy-in.*** This will require a close linkage with national and sector strategies that themselves will need to be oriented toward private sector-led growth and have widespread national ownership. A Medium-Term Fiscal Framework (MTFF), integrally linked to annual budgeting, also will be critical. Effective strategic prioritization of budget allocations will be difficult (including politically) but essential. Key cross-cutting issues such as gender will need to be mainstreamed in budgetary decision-making.

10.6 Achieving this gives rise to a fourth challenge: ***the challenge of making the national budget the central instrument for policy and reform***. Key constraints include: (i) limited capacity; (ii) the dominant share of expenditures directly by donors outside Government systems; (iii) serious timing dilemmas and a compressed schedule which weakens the quality of the budget; and (iv) lack of a medium-term strategic and fiscal perspective to guide annual budget formulation. Meaningful processes of political engagement and approval (including by Parliament) and public communications will also be needed. Finally, there is an urgent need for greater inputs and participation by lower levels of the government administration (provinces and districts) in the budget formulation process.

10.7 Fifth, there is ***the challenge of effective budget execution.*** While considerable progress has been made in some areas, a great deal remains to be done. Relying on sound institutions and adequate

capacity, strengthening financial controls, procurement, recording/reporting, and audit will be key elements of better budget execution. Meaningful implementation of the Public Finance and Expenditure Management (PFEM) Law and the Procurement Law will support effective budget execution. Strengthening accountability and reducing vulnerability to corruption will be critical. International experience demonstrates that the latter is best achieved by addressing the underlying governance problems (in the PFM system and elsewhere), rather than through investigation and prosecution of corruption cases. Thus improvements in the PFM system, particularly in the area of budget execution, will need to be a key element of a holistic anti-corruption strategy.

10.8 Sixth, there is ***the challenge of service delivery***, the ultimate outcome of a PFM system. With a few exceptions, public service delivery in most sectors is poor, as demonstrated by available data on outcome indicators, giving rise to frustrations and weakening the credibility of the Government. Accountability relationships and incentives for service providers need to be gotten right, although institutional arrangements can and will vary by sector. Sustainable financing and, where appropriate, adequate levels of cost recovery, will be essential. Donors will need to ensure that their interventions strengthen rather than undermine national service delivery mechanisms.

10.9 Seventh, closely related, there is ***the challenge of sustainable national capacity development.*** Unless this happens, Afghanistan will remain excessively dependent on foreign expertise indefinitely, and highly vulnerable to reductions in aid flows and external TA. Capacity development will require public administration reforms (recruitment, pay, HR), organizational restructuring and improvements, and training. Better management of the massive amounts of external TA currently being injected into Afghanistan will be needed to ensure that it supports longer-term national capacity development.

10.10 Finally, there is ***the challenge of coordination and communication*** within an overall national strategic and budgetary framework. Coordination within the Government needs to be improved (this can be done around a widely-owned national development strategy and a sound budget process), and public communications and transparency will be extremely important in fostering Government accountability vis-à-vis citizens and their elected representatives. Coordination is a major challenge for donors as well, which also needs to occur around the national development strategy and budget process – the low share of external assistance going through national budget and treasury channels is a serious constraint in this regard.

10.11 While the challenges outlined above are numerous and daunting, Afghanistan can build on earlier progress, and prospects for success are better than it might superficially appear at first sight. In fact, the major progress already achieved – for example in Treasury functions, in currency reform and monetary policy, in expansion of education and delivery of basic health services – gives ground for hope. The Ministry of Finance has developed a vision to guide it in identifying and implementing a wide range of actions required for strengthening its current functions and capacities and moving forward from the emergency needs of the last two years toward a modern and effective public financial management organization.[23] Other supportive factors include positive developments in the financial reporting system, solid institutional reforms in a few line ministries, the establishment of basic processes to manage the budget, and the positive collaboration with the international community, notably through the ARTF.

10.12 However, there are also many downside risks and threats, ranging from insecurity to difficulties in mobilizing domestic revenue, lack of core capacity in Government, and fragmentation of much international assistance in the External Budget. Much will depend also on establishing the functionality and processes of Parliament as an essential element promoting accountability. Finally, it must be recognized that improvements will not be easy and will take time, not least because a stable political culture will take time to develop. Given the "time horizon dilemma" that was mentioned earlier related to achieving quick results versus longer-term national capacity building, interim and asymmetric mechanisms have been used and will continue to be required, but they need to be applied in a way that does not detract from sustainable progress over the medium term.

[23] "Afghanistan Ministry of Finance – The Way Forward", background paper for the World Bank PFM Review.

B. A Five-Point Reform Agenda

10.13 The Government has fully recognized these challenges and the centrality of the budget process and PFM performance for Afghanistan's future. It is preparing the interim Afghanistan National Development Strategy (ANDS), in which the PFM agenda needs to be anchored. This report concludes with a suggested five-point agenda to concretely move forward.

10.14 ***First, the path toward fiscal sustainability needs to be mapped out and steady progress in this direction achieved.*** Based on a sound MTFF (which can be rudimentary at the outset but improved over time), this will require particular attention to increasing domestic revenue mobilization (through administrative improvements leading to better compliance as well as sound tax policies); maintaining control over aggregate expenditures within the overall resource envelope; setting and implementing clear policies with respect to key expenditure components notably the Government wage bill; and ensuring that strategic and public expenditure decisions are affordable over the medium-term, including downstream O&M implications of public investments and service delivery networks.

10.15 ***Second, a number of policy decisions and actions are needed to improve service delivery.*** This will require clarifying the roles of the State (operational, financing, policy, and regulation) in service delivery in different sectors; strengthening accountability; ensuring sustainable financing arrangements including cost recovery where appropriate; and determining the responsibilities of various levels of Government administration (central ministries, provinces, districts). As discussed in Chapter 8, a variety of different models of service delivery are possible within Afghanistan's Constitutionally-mandated unitary state structure, and the choice among them should depend on sector-specific conditions. Although "one size does not fit all," the effectiveness of service delivery is largely dependent on the degree of ownership behind the approaches and the coherence of the models in terms of accountability, incentives, and financing. (including multi-year fiscal implications).

10.16 ***Third, the capacity of the key PFM institutions should be developed.*** Without stronger capacity and institutional reforms, improvements in PFM performance as well as progress toward key national development objectives will be difficult to achieve and impossible to sustain. Priority areas include training, recruitment practices, pay structures, organizational reforms, detailed business processes, specific IT systems, etc. While these issues cut across all levels of Government, MoF's capacity is of particular importance. Since it is chief custodian of the PFM system, its capacity to develop and implement policies is at the core of PFM performance. Progress toward an MoF Strategic Plan – initiated in May 2005 – will be very important in developing MoF's capacity and performance. PFM capacity development in line ministries also is very important but will take more time.

10.17 ***Fourth, and related to the previous recommendations, the Government should adopt a clear action plan to improve PFM performance, with time-bound milestones, quantified objectives, and clearly identified responsible agencies.*** Table 10.1 seeks to provide a comprehensive, high-level roadmap of policy reforms required. It is comprehensive in the sense that all areas of PFM are covered. It is high-level in the sense that some concrete next steps are identified for the next 6-12 months, but many actions are less specific and will need to be converted into detailed action plans later by the responsible Government departments. Also, some key accountabilities, left out of the PFEM Law, will need to be fully specified, especially with regard to the respective roles of MoF and the line ministries (the Procurement Law clearly gives authority to line ministries). Progress along this roadmap could be measured by key fiscal outcomes and implementation and progressive improvement of the MTFF, and by the PFM performance indicators presented in this report. Monitoring of progress, along with a meaningful feedback loop into subsequent decision-making, will be as important as the action plan itself.

10.18 ***Finally, continuing and further deepening collaboration between the Government and the international community will be critical for the success of the reform program.*** The Government's development strategy – which may include plans for progressing toward fiscal sustainability, more effective service delivery, capacity development, and strengthened PFM performance – should serve as the basis for a framework of mutual accountability. Donors would align their support to national strategic

objectives and the national budget and increasingly use the Government's systems, while the Government would implement the decisions it has announced and further improve the performance of the PFM system. In addition, the content, mode, and capacity-building contribution of technical assistance will be very important and needs to be well-managed and well-coordinated in line with Government leadership and national budgetary and other capacity-building processes.

10.19 ***Way forward.*** Not surprisingly in view of the major challenges that Afghanistan faces, this is a multi-faceted, demanding, and ambitious medium-term agenda. Each of the five elements includes difficult sub-agendas and important actions required for success. This points to the need to prioritize and focus on a set of realistic yet meaningful short-term measures that will achieve significant improvements and step-changes, thereby setting the stage for further progress. A package of prioritized short-run actions could thus comprise a "platform" from which the next set of actions would take off, with monitoring and feedback to guide the process at each stage.[24] Moreover the package, rather than any single measure or mechanical target, would be what the Government takes responsibility for and could form the basis for dialogue and agreements with the international community.

10.20 In this process, the Government first needs to develop and reach agreement on its strategy. The Afghanistan National Development Strategy (ANDS) is expected to be completed on an interim basis shortly. It needs to include or to be complemented by the MTFF, as well as a PFM action plan that would be adopted by the Government and an MoF reform strategy. Clear sector strategies also are needed to guide prioritization and sector expenditure programs. The ANDS and sector strategies need to specify the roles of the State and put forward sound approaches to ensure effective service delivery, differentiated by sector as appropriate (see Chapter 8). The sector strategies will take varying amounts of time to develop and, like the interim ANDS, MTFF, and PFM action plan, will need to be improved over time and adjusted in the light of experience. It is critically important that these strategies have wide national ownership, both within and outside Government.

10.21 The strategy as it applies to public finance management would then be translated each year into annual plans that would consist of three building blocks: (i) an updated medium-term view of the fiscal path (MTFF); (ii) an annual budget that is consistent with the MTFF and with the ANDS; and (iii) an "annual action plan" (a list of a small number – certainly less than 20 – key actions to be accomplished during the year). Successful implementation of this package (not necessarily all of the measures but at least a critical mass of most of them) would build the "platform" on which the following year's action plan could be based, leading to further progress subsequently. This type of process would help in coordinating the expectations of all partners as to what the Government realistically will be able to achieve every year and, with adequate monitoring, it would help the Government to establish a strong track record of implementation. Adequate monitoring and evaluation should also feed back into the next year's annual plan and possible revisions to the overall strategy – this requires significant development of statistical and analytical capacity.

10.22 In conclusion, the five-point reform agenda outlined above is ambitious, requiring sustained efforts over a considerable period of time based on meaningful steps each year. But as seen earlier, the challenges in building an effective, accountable, financially self-sufficient state that facilitates sustained economic growth, ensures adequate delivery of services to the Afghan people, and reduces poverty are enormous and pressing – requiring a commensurate response. The Government, with strong support from the international community, has demonstrated its willingness and commitment to embrace an agenda along these lines and move forward with implementation in a determined yet realistic manner.

[24] See Brooke (2003) for a discussion of the background, rationale, and modalities of how such a "platform" approach could work in the context of country situations involving external budget support.

Table 10. 1: Roadmap to Strengthen PFM Performance

Area	Short–term (Next 6 to 12 Months)			Medium-term (Beyond 6 to 12 Months)		
	Actions	Ind	Resp.	Actions	Ind	Resp.
A. Revenue Mobilization						
Sound and Fair Revenue Policies; Revenue projections	A1. Implement agreed policy decisions on income tax A2. Consolidate / simplify tax measures (reducing small 'nuisance' taxes) A3. Develop revenue projections and publish underlying assumptions as part of budget documentation (see B1)	3, 13, 14, 15	MoF/ Revenue & customs MoF/ Revenue and Budget	A4. Develop policy proposals for modern tax policy (e.g. consider excise taxes, convert Business Receipts Tax into a simple broad-based consumption tax) A5. Enact modernized tax laws A6. Review and modernize tax policy for municipalities	3, 13, 14, 15	MoF/ Revenue & Customs MoF/ Municip.
Effective Revenue Administration	A7. Improve focus of Large Taxpayer Office and its performance monitoring A8. Develop enforcement powers of customs and revenue administration A9. Strengthen accounting mechanisms of revenue collection	3, 13, 14, 15	MoF/ Revenue & Customs Ditto with Treasury	A10. Implement 5-year tax plan (and revise as needed) A11. Implement 5-year customs plan (and revise as needed) A12. Prepare and implement plan to modernize revenue collection by municipalities	3, 13, 14, 15	MoF/ Revenue MoF/ Customs MoF/ Municip.
B. Budget Formulation						
Strategic, realistic, predictable multi-year framework	B1. Strengthen medium term fiscal projections (in particular wage bill, revenues, donor contributions) in light of the ANDS B2. Use clear standard budget definitions in new budget (e.g. cash budget vs. commitments) B3. Define clear criteria for investment program prioritization and establish link to the ANDS and Budget B4. Set budget ceilings for all major sectors based on policy orientation and allocative efficiency (as informed by mid-year review)	12	MoF/ Budget, IARCSC MoF/ Budget	B5. Deepen link between National Development Strategy and Budget B6. Develop sector strategies and medium-term expenditure framework in selected sectors B7. Roll-out preparation of sector strategies and medium-term expenditure framework B8. Develop monitoring and evaluation system B9. Move gradually toward an output-based budget system and, over the longer-term, a results-oriented system	12	MoF/ Budget, line Ministries MoF/ Budget, MoE, CSO

Area	Short–term (Next 6 to 12 Months)			Medium-term (Beyond 6 to 12 Months)		
	Actions	Ind	Resp.	Actions	Ind	Resp.
Comprehensive, fully integrated budget	B10. Enforce requirement to estimate recurrent costs implications of proposed investments for largest investments B11. Further integration of off-budget activities	9, 11	MoF/ Budget MoF Budget, line ministries MoF Treasury	B12. Clarify definitions of ordinary and development budget and present core budget under a fund structure and fully unify classifications B13. Further develop linkages between investments and recurrent costs (starting with key sectors such as education, health and road development) B14. Further integrate external assistance in budget (see below) B15. Develop the budget along policy goals and objectives (program budget) supported by the budget classification B16. Identify poverty-reduction related expenditure in the budget based on functional classification B17. Include data on municipalities in budget documentation B18. Include data on State-Owned enterprises in budget documentation (requires program to strengthen SOE PFM capacity, see D11) B19. Include data on pensions in budget documentation	9, 11 5 9	MoF Budget and Treasury MoF/ Budget, donors MoF, MoI, municip. MoF, line ministries MoF/ MoLSA
Orderly, open, participative budget process and revisions	B20. Introduce new budget calendar (starting early in the year with the budget envelop, e.g. with a Budget Policy Statement, and sending budget circular in advance) B21. Introduce notion of sector ceilings (see B4) B22. Review provincial expenditures by Cabinet and publish the report B23. Solicit input from provinces on 2006/07 budget and review their role on budget formulation B24. Reduce frequency of transfers across budgets and reliance on contingencies	11, 12 11 2, 16	MoF/ Budget (and donors) Cabinet Secretariat	B25. Develop capacity in line ministry to articulate budget proposals (see C26) B26. Continue and strengthen practice of mid-year review B27. Formalize role of provinces in budget formulation process (encouraging higher participation, including on investment programs)	11, 12 11	MoF/ Budget

Area	Short–term (Next 6 to 12 Months)			Medium-term (Beyond 6 to 12 Months)		
	Actions	Ind	Resp.	Actions	Ind	Resp.
Adequate legislative scrutiny of the annual budget law	B28. Prepare 2006/07 Budget for parliamentary approval, with a focus on enhancing transparency in provincial allotments for both the operating and development budgets	27	MoF/ Budget	B29. Develop support for the Parliament to carry-out informed review of the budget	27	MoF / Budget Committee
C. Budget Execution						
Effective Cash Management	C1. Develop monthly forecast for TSA flows and provincial flows C2. Create Cash Flow Management Committee (Treasury / Budget/ Revenue/ DAB/ MoE) C3. Further consolidate banking arrangements toward TSA	17 17, 19	MoF/ Treasury	C4. Refine monthly cash flow forecasts C5. Introduce cash management and payment scheduling procedures for line ministries and Mustoufiats C6. Fully consolidate TSA	17, 19	MoF/ Treasury
Effective Debt and Guarantees Management	C7. Conclude review of existing debt C8. Develop external debt strategy	17	MoF/ Treasury	C9. Develop requirements for debt management system consistent with AFMIS architecture C10. Implement debt management system C11. Review internal debt policy ("no overdraft") and link with cash management C12. Develop domestic debt instruments as appropriate C13. Develop and implement policy on guarantees	17	MoF/ Treasury Treasury; DAB Budget; Treasury
Smooth, predictable Budget Implementation	C14. Capture and report expenditure by province under all appropriations (including development budget) C15. Repeat simple survey of arrears at year-end C16. Develop an asset registry to be established under each budgetary unit and develop related procedures for incorporating assets received through operations implemented outside the government systems	16 4 9	MoF/ Treasury (with budget)	C17. Improve allotment system to ensure transparent assignment of scare resources C18. Develop a strategy for enhancing financial management information systems and implement outcome of system study C19. Initiate roll-out of AFMIS to line ministries and Mustoufiats (see D4 and D5) C20. Develop commitment control (processes; regulations; systems) which will form basis for monitoring arrears C21. Develop expenditure tracking surveys C22. Roll-out asset registry to the budgetary units	16 16, 4 23 9	MoF/ Treasury (with budget) MoF

Area	Short–term (Next 6 to 12 Months)			Medium-term (Beyond 6 to 12 Months)		
	Actions	Ind	Resp.	Actions	Ind	Resp.
Internal controls	C23. Align MoF control staff with PFEM Law (Financial Controllers to stop pre-approval of expenditure and to be integrated in budgetary units or MoF Internal Audit) C24. Review and streamline internal controls for contracts to speed up implementation while strengthening accountability	20	MoF MoF/ Treasury MoF, Office of the President	C25. Develop standards of internal control and adopt related PFEM regulations C26. Carry out reforms of line ministries' administrative units and implement the PFEM provisions for Chief Financial Officers C27. Roll-out AFMIS for on-line recording and editing to the budget units and Mustoufiats (see D4 and D5) C28. Develop control framework for municipalities	20	MoF/ Treasury MoF/ Treasury & Admin; CAO MoF/ Treasury
Internal audit.	C29. Use Monitoring Agent to provide feedback to MoF and line ministries on compliance with fiduciary standards C30. Implement PRR in MoF's internal audit department C31. Carry out training and certification of internal audit staff C32. Develop internal regulation, audit manual, and audit programs for key typical reviews	21	MoF/ Treasury MoF IA	C33. Roll-out implementation of MoF's internal audit department reform and annual internal plan C34. Develop internal audit activities in line ministries C35. Coordinate all internal audit activity from the MoF C36. Develop internal audit for municipalities	21	MoF IA
Payroll	C37. Expand coverage of Individualized Salary Payments (including pay from the list and payment by bank transfer)	18	MoF Treasury	C38. Develop a human resources management system for the budgetary units and means to consolidate information centrally for personnel, pension and other needs (see C18) C39. Extend verified payroll program to whole of national government	18	MoF Treasury
Procurement	C40. Adopt regulations to implement the new Procurement Law (and clarify rules regarding projects in development budget) C41. Establish Procurement Policy Unit	19	MoF / MoE	C42. Line ministries progressively take responsibility for procurement transactions C43. Train private sector in tendering procedures C44. Prepare a needs analysis in respect of product standardization, building codes C45. Establish an independent review mechanism and an appeal mechanism C46. Develop and implement standards of transparency	19	MoF / MoE

Area	Short–term (Next 6 to 12 Months)			Medium-term (Beyond 6 to 12 Months)		
	Actions	Ind	Resp.	Actions	Ind	Resp.
D. Accounting and Reporting						
Accounting, in-year reporting	D1. Automate reconciliation of government accounting records with banking data, particularly the Treasury Single Account (TSA)	22, 25 22 5	MoF/ Treasury; DAB MoF/ Budget (with Treas.)	D2. Develop public accounting standards and clarify role of line ministries (regulations to implement PFEM Law) D3. Enforce use of modern budget classification and increase capacity to issue timely monthly reports D4. Complete roll-out of AFMIS to line ministries for complete and timely in-year reporting D5. Undertake roll-out of AFMIS to Mustoufiats D6. Develop accounting capacity of municipalities D7. Develop accounting capacity of SOEs D8. Move towards modernized accounting standards over time	22, 25 6,7,8,9	MoF/ Treasury MoF/ Treasury and Budget MoF/ Treasury / SOE dpt
Transparent and Accessible External Financial Reporting	D9. Develop the means to capture and report accurately expenditures of donor implemented projects D10. MoF to commit to preparing formal accounting period cut-offs at least quarterly	25	MoF/ Budget with Treasury MoF/ Treasury	D11. Disclose state enterprises annual financial results and financial position, company objectives, ownership, governance structure and information on employees. All information should be audited. All SOEs (regardless of form of public ownership) should be covered D12. Establish the procedures and requirements for the line ministries for collection, review and follow-up of the external audits of donor implemented projects	9, 25	IARCSC MoF/ Line Ministries CAO; MoF/ Budget
E. External Accountability, Audit, and Scrutiny						
External Audit	E1. Carry-out accounting and auditing certification process for all professional staff E2. Develop audit work of whole-of-Government annual accounts	26	CAO CAO; MoF/IA	E3. Finalize draft and gazette new Audit Law E4. Develop external audit regulation, implement Audit Law E5. Develop external audit of procurement E6. Create Public Accounts Committee and its processes E7. Develop the system for scrutiny and response to audit reports including responses by involved ministries and scrutiny by a Public Accounts Committee of Parliament E8. Develop role of media and civil society in the scrutiny of the budget (formulation and execution)	26, 28	CAO

Area	Short–term (Next 6 to 12 Months)			Medium-term (Beyond 6 to 12 Months)		
	Actions	Ind	Resp.	Actions	Ind	Resp.
F. Donor Practices						
Donor Funding	F1. Develop medium – term expenditure framework to which donor financial support can respond (see B1) F2. Donors to provide timely information on actual expenditures following Government's definitions (see D9) F3. Donors to provide information on planned disbursements early in fiscal year	1, D1, D2	MoF Donors	F4. Government to regularly publish internal and external assessment of PFM performance F5. Support enhanced alignment of donor funding for priorities established under the ANDS F6. Donors to further move toward support through Treasury and budget support	D3	MoF Donors
G. Reform Management						
	G1. Revise PRR applications for MoF and start implementation; coordinate with Government-wide public administration reform G2. Adopt Government-wide PFM Action Plan G3. Create taskforce(s) to oversee reform process and monitor implementation G4. Develop an approach to communicating on PFM reforms within and outside government G5. Prepare detailed plan by MoF department G6. Plan and initiate training activities			G7. Initiate and roll-out reform of budget and administrative departments in line ministries G8. Implement public administration reforms G9. Monitor progress and adjust plans G10. Continue to implement communications strategy G11. Continue training activities		

STATISTICAL APPENDIX

TABLE A. 1: MACROECONOMIC INDICATORS

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	Estimates				Projections		
A. Output							
GDP (US$ million, excluding opium production)	2,463	4,084	4,585	5,975	7,130	8,562	9,951
GDP (millions of new Afghani)	133,987	182,862	225,108	284,504	355,338	426,708	495,946
Real GDP growth rate	...	28.6	15.7	8.0	14	11	11
GDP per capita (in US dollars)	123	182	199	253	293	342	386
Opium production (metric tons)	185	3,400	3,600	4,200	4,100	...	...
Opium value (millions of US dollars)	56	1,300	2,300	2,200	...	...	...
B. Prices							
CPI (% year-on-year change)	(43.4)	52.1	10.2	16.3	10	8	5
C. Exchange rates							
Afghani/US dollars (average during solar year)	54.4	44.8	49.0	47.7	...	...	...
Afghani/US dollars (end-solar year)	31.0	52.6	50.3	48.7	...	...	...
D. Monetary indicators							
Domestic currency in circulation (percentage change)	...	20.1	40.9	37.5	28	23	...
Gross foreign exchange reserves (US$ million)	...	426	816	1,261	1,691	2,036	...

Source: GoA, UNODC, IMF.

TABLE A. 2: SOCIAL INDICATORS (2003)

Indicator	Rural	Urban	National
Survival			
Infant mortality (# of deaths per 1,000 infants under 1 year)	121	97	115
Under five mortality (# of deaths per 1,000 children under 5 years)	183	142	172
Morbidity (%)			
Diarrhea (children under 5 reporting incidence in past 15 days)	30	30	30
Increased fluid and continued feeding given during diarrhea	54	51	53
Acute Respiratory Infection (children under 5 reporting incidence in past 15 days)	19	19	19
Advice or treatment sought from hospital/HC during ARI	27	32	28
Malnutrition (%)			
Children that have not received timely complimentary feeding (6-9 months)	73	66	71
Households consuming non-iodized salt	90	74	85
Pregnancy (%)			
Births not taking place in health facility	96	68	89
Married women (<49 years) who have not heard of a method to delay pregnancy	78	55	72
Married women (<49 years) not currently using a method to delay pregnancy	94	79	90
Disability and Orphanage (%)			
Children 1-4 years that are disabled	2	3	3
Children 7-17 years that are disabled	3	4	3
Children with both parents dead	6	6	6
Preventive Health (%)			
Children 12-23 months that have received DPT 3 immunization	23	48	30
Children 12-23 months that have received Polio 3+ immunization	43	71	51
Children 9-59 months that have received Measles immunization	73	84	76
Children under 5 that have received BCG immunization	55	73	60
Access to Sanitation and Water (%)			
Households with drinking water from pump/protected spring	31	61	40
Households having a flush or pit toilet	59	87	67
Households with water source and latrine within 15 meters	77	60	67
Education			
Illiteracy rate: Male (% of pop. aged 15 and over)	64	40	57
Illiteracy rate: Female (% of pop. aged 15 and over)	92	72	86
Primary school net enrolment rate (% of 7 to 13 year olds) Male	61	81	67
Primary school net enrolment rate (% of 7 to 13 year olds) Female	30	63	40

Source: NRVA (2003).

TABLE A. 3: FISCAL SUMMARY (AFS MILLION)

	2002/03 Budget	2002/03 Est.	2003/04 Budget	2003/04 Est.	2004/05 Budget	2004/05 Est.	2005/06 Budget
				(In millions of Afghanis)			
Domestic Revenue	**2,822**	**5,864**	**9,000**	**10,168**	**15,380**	**12,812**	**16,150**
Tax Revenues				6,262		9,546	
Taxes on income, profits and capital gains				363		995	
Taxes on international trade and transactions				5,369		7,247	
Other taxes				531		1,304	
Non Tax Revenues				3,906		3,266	
Donor Assistance Grants (to operating budget)	**12,828**	**9,430**	**15,750**	**10,074**	**14,952**	**14,984**	**16,733**
ARTF			11,250	8,182	12,575	12,319	13,580
LOTFA and Army Trust Fund			4,500	1,892	2,377	2,583	3,153
Other grants			-	-	-	82	-
Donor Assistance Grants (to core development budget)	**-**	**-**	**-**	**4,569**	**36,882**	**8,250**	**34,648**
Total Expenditures (Core Budget)	**15,650**	**15,514**	**24,750**	**30,054**	**81,562**	**41,710**	**91,513**
Operating Expenditure	**15,650**	**15,514**	**24,750**	**21,972**	**30,332**	**26,605**	**32,883**
Wages and Salaries			12,954	13,818	18,027	17,842	22,311
Purchase of goods and services			6,493	4,243	4,850	5,247	4,037
Debt service and Interest payments			-	25	278	97	404
Other recurrent			1,002	881	(12,438)	1,440	(345)
Capital expenditure			1,683	3,005	1,752	1,979	2,301
Reserves and Contingencies			2,618	-	17,863	-	4,175
Core budget development spending	**-**	**-**	**-**	**8,082**	**51,230**	**15,105**	**58,630**
By Program			**24,750**	**30,054**	**81,562**	**41,710**	**91,513**
Human Capital Development			**9,181**	**6,388**	**22,458**	**16,657**	**27,881**
1.1 Refugees and IDP return			132	81	127	105	187
1.2 Education			6,002	3,938	7,513	5,824	9,179
1.3 Health			1,256	1,233	2,327	3,007	2,850
1.4 Livelihood and Social Protection			1,192	627	11,870	7,079	14,537
1.5 Culture, Media, Sport			600	509	621	642	1,128
Physical Infrastructure			**1,159**	**6,941**	**18,160**	**7,253**	**28,312**
2.1 Transport			188	1,381	9,100	3,975	12,537
2.2 Energy, Mines, and Telecom			363	3,224	5,840	2,163	9,577
2.3 Natural Resources Management			575	2,017	2,091	725	3,594
2.4 Urban Management			33	319	1,129	390	2,604
General Administration			**2,358**	**5,203**	**6,155**	**3,876**	**12,521**
3.1 Trade and Investment			99	231	1,298	421	1,489
3.2 Public Administration and Economic Management			2,259	4,972	4,857	3,455	11,032
Security			**9,434**	**11,523**	**16,925**	**13,924**	**18,623**
3.3 Justice			424	599	921	1,002	1,122
3.4 National Police and Law Enforcement			3,250	5,515	10,689	7,792	11,288
3.5 Afghan National Army			5,760	5,409	5,315	5,130	6,100
Reserves and Contingencies			**2,618**	**-**	**17,863**	**-**	**4,175**
Operating budget balance (excluding grants)	**(12,828)**	**(9,650)**	**(15,750)**	**(11,804)**	**(14,952)**	**(13,794)**	**(16,733)**
Operating budget balance (including grants)	**-**	**(220)**	**-**	**(1,730)**	**0**	**1,190**	**0**
Core budget balance (including grants)	**-**	**(220)**	**(0)**	**(5,243)**	**(14,348)**	**(5,665)**	**(23,982)**
Float and Adjustment		**(656)**	**0**	**140**	**14,348**	**2,507**	**97**
Financing		**876**	**-**	**5,103**	**-**	**3,158**	**23,885**
External Loans (net)		-	-	4,886	-	14,754	23,853
Domestic (net)		876	-	217	-	(11,596)	32
Memorandum item:							
External Budget		22,777	95,733	106,879	164,794	119,398	154,235

Source: MoF, IMF.

TABLE A. 4: EXPENDITURE COMPARISONS

	Afghanistan (core budget)	Afghanistan (total budget)	Median	Belarus	Bhutan	Bolivia	Bulgaria	India	Jordan	Kazakhstan	Kyrgyz Republic	Moldova	Pakistan	Philippines	Romania	Senegal	Sri Lanka
Total Expenditure (including net lending)	**14.6**	**57**	**19.6**	**18.4**	**42.3**	**17.3**	**19.5**	**18.2**	**31.6**	**14.4**	**17.3**	**21.0**	**23.3**	**19.7**	**16.4**	**21.5**	**26.7**
Current Expenditures	10.8	28 c/	16.8	13.5	18.1	16.0	17.7	15.4	26.8	12.6	15.8	19.5	20.7	17.7	14.8	13.6	20.2
Wages	6.3	n/a c/	3.6	2.7	7.2	3.5	2.6	1.7	15.0	1.1	4.7	2.5	0.8	5.5	3.7	5.8	5.5
Purchase of Goods and Services	2.8	n/a c/	3.6	3.5	8.6	2.2	7.0	2.1	1.7	3.3	6.2	2.9	9.9	4.5	1.8	3.7	4.9
Interest Payments	0.0	n/a d/	3.7	0.8	0.4	1.7	3.9	4.7	3.5	1.3	1.4	6.4	7.4	4.3	4.0	1.5	5.7
Subsidies and current transfers	1.6	n/a c/	4.1	6.5	1.3	8.6	4.1	6.9	2.3	6.8	2.3	7.3	2.5	3.4	4.6	2.6	4.2
Capital Expenditures	3.9	29 c/	2.2	4.8	22.7	2.1	3.0	1.3	4.8	1.1	2.2	1.7	2.1	1.8	1.6	7.2	5.4
Lending minus repayments	-	- a/	0.0	(0.0)	1.4	(0.8)	(1.1)	1.5	(0.0)	0.6	(0.7)	(0.2)	0.5	0.1	(0.0)	0.2	1.1
Total Expenditures (w/o net lending)	**14.6**	**57**	**19.5**	**18.4**	**40.8**	**18.1**	**20.6**	**16.7**	**31.7**	**13.7**	**18.0**	**21.2**	**22.8**	**19.6**	**16.4**	**13.1**	**25.6**
General Public Services	1.4	5 e/	1.3	1.3	8.8	1.3	2.2	1.1	2.0	0.9	2.7	1.1	0.7	1.0	0.8	3.1	1.5
Defense	1.8	13	1.7	1.2		1.7	2.3	2.6	6.0	0.6	1.7	0.4	4.5	1.0	1.3	1.6	4.5
Public Order and Safety	3.1	6 f/	1.4	1.2	2.2	1.8	1.9		2.9	1.3	1.1	1.3	0.3	1.4	1.8		1.1
Education	2.0	4	2.5	1.1	5.5	3.5	1.5	0.4	5.0	0.5	3.5	1.2	0.2	3.7	2.5	2.9	2.5
Health	1.1	3	1.0	1.0	3.8	1.2	1.4	0.3	3.3	0.3	2.0	1.0	0.1	0.4	0.4	0.7	1.6
Social Security, Welfare, Housing, Community amenities	2.5	7 g/	2.2	0.5	1.4	5.3	0.9	0.8	5.7	5.6	2.7	3.5	0.5	0.9	1.7	0.6	3.3
Recreational, Cultural, Religious Affairs	0.2	1	0.3	0.4	0.3	0.1	0.6		0.5	0.2	0.5	0.3	0.0	0.2	0.2		
Economic Services	2.5	15 h/	2.3	4.4	18.5	1.0	2.9	2.3	2.4	1.5	2.1	1.7	0.8	3.3	2.9	-	4.3
Other Expenditures	-	3	3.0	7.1	0.4	2.3	6.9	9.2	3.7	2.8	1.6	10.7	15.6	7.7	4.8	4.2	6.8

Notes: This table includes all countries with GDP per capita below US$2,000 and a complete set of data available. Statistics should be used with caution given the small number of countries with available data and classification issues.
a/ Unknown; b/ to be revised; c/ Includes estimates from development budget; d/ includes debt service; e/ Trade and Investment and Public Administration Reform and Economic Management Programs; f/ Justice and Police Programs;
g/ Refugees and IDP return and Livelihood and Social Protection Programs; h/ Physical Infrastructure Programs.
Source: MoF and staff estimates for Afghanistan (2004), IMF / GFS for other countries (2000)

TABLE A. 5: REVENUE COMPARISONS

	Sample Size	Total Revenue	Tax Revenue	Other Revenue	Taxes on Income, Profits, and Capital Gains			Social Security Taxes	Payroll Taxes	Domestic Taxes on Goods and Services			International Trade Taxes			Property Taxes
						of which:					of which:			of which:		
					Total	Individual	Corporate			Total	General sales, turnover or VAT	Excises	Total	Import duties	Export duties	
Albania	1997-98	17.7	13.7	4.0	1.2	0.2	1.0	2.7	...	6.9	5.4	1.0	2.9	2.8	...	0.1
Argentina	1997-01	23.2	20.9	2.3	4.6	3.0	1.5	3.4	...	5.6	3.7	1.8	0.8	0.7	0.0	1.5
Azerbaijan	1997-99	20.5	19.4	1.2	5.0	1.5	1.9	3.9	0.1	8.2	3.4	1.5	1.5	1.4	0.3	0.5
Belarus	1997-01	45.1	41.7	3.4	7.8	3.2	3.0	10.1	1.1	18.6	5.9	2.4	2.0	2.4	...	1.1
Bolivia	1997-01	22.8	18.1	4.8	1.7	0.3	1.3	1.9	...	10.3	5.5	2.9	1.0	1.0	...	1.7
Brazil	1997-98	37.6	29.4	8.2	4.5	0.3	1.4	8.6	1.1	12.6	2.1	1.9	0.7	0.7	0.0	1.1
Bulgaria	1997-01	37.5	29.2	8.3	8.1	4.1	2.8	7.6	0.7	11.2	7.9	3.2	1.3	1.3	0.0	0.3
Chile	1997-01	23.5	19.3	4.2	4.0	...	...	1.4	...	10.8	7.8	2.2	1.5	...	...	0.7
China	1997-99	13.8	12.6	1.2	1.8	0.3	0.5	...	...	9.0	3.9	1.0	0.5	0.4	...	0.3
Croatia	1997-01	48.4	43.8	4.6	7.2	5.2	1.4	13.9	...	18.8	14.2	4.4	3.0	3.0	...	0.6
Estonia	1997-01	37.9	33.7	4.3	9.7	8.0	1.7	10.6	...	12.9	9.2	3.6	0.0	0.0	...	0.5
India	1997-99	18.5	14.3	4.3	2.8	1.2	1.5	...	...	8.1	0.0	3.2	2.6	2.5	0.0	0.1
Israel	1997-01	44.6	37.5	7.1	15.4	11.1	3.4	5.8	1.0	12.6	10.6	1.5	0.3	0.3	...	2.7
Kazakhstan	1997-00	22.3	18.4	3.9	5.4	2.0	1.7	3.7	0.5	6.2	4.0	0.5	0.6	0.4	0.0	1.2
Kyrgyz Republic	1997-00	19.1	15.0	4.1	3.2	1.5	1.1	...	...	11.1	5.4	2.1	0.7	...	...	0.0
Latvia	1997-01	38.3	32.5	5.8	8.1	5.9	2.2	10.2	...	12.6	8.2	3.9	0.5	0.5	...	1.1
Lithuania	1997-01	31.9	30.0	1.9	8.8	7.8	0.9	7.7	0.0	12.4	8.7	3.5	0.5	0.5	0.0	0.6
Malaysia	1997	27.3	19.4	7.9	8.4	2.4	6.0	0.3	...	6.2	2.0	2.2	2.9	2.5	0.4	0.2
Moldova	1997-01	34.0	28.6	5.4	4.2	2.2	1.1	7.2	...	14.4	8.3	4.0	1.4	1.0	...	1.3
Mongolia	1997-01	32.2	23.8	8.5	5.8	1.4	3.0	4.7	...	11.0	5.7	2.8	1.4	1.1	0.2	0.0
Peru	1997-01	18.1	14.5	3.6	3.5	1.5	2.0	1.3	0.2	8.4	6.4	2.0	1.6	1.6	...	0.0
Romania	1997-01	32.3	28.2	4.1	6.8	3.8	2.9	9.7	...	9.2	5.7	2.8	1.3	1.3	...	0.4
Russia	1998-01	35.9	30.3	5.7	7.6	2.7	2.0	7.0	...	10.7	5.3	2.1	2.5	1.0	1.4	1.4
Slovenia	1997-01	42.3	39.5	2.8	7.6	4.3	1.2	13.6	1.5	14.8	11.6	2.9	1.2	1.2	...	0.7
South Africa	1997-01	30.6	27.3	3.3	14.4	10.2	4.0	0.5	0.2	9.3	6.0	2.7	0.7	0.7	...	1.6
Thailand	1997-01	18.3	15.9	2.4	5.0	2.2	2.6	0.4	...	8.4	3.5	3.6	1.7	1.7	0.0	0.3
Unweighted average 1/		29.8	25.3	4.5	6.2	3.4	2.1	5.9	0.6	10.8	6.2	2.5	1.4	1.3	0.2	0.8

Sources: *Government Finance Statistics* (IMF); and *International Financial Statistics* (IMF).

1/ For each revenue classification, only countries for which data are available are included in the calculation.

TABLE A. 6: FISCAL SCENARIOS

6a. Base Case

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
		actuals					projection				
				Afs millions							
Domestic Revenues	5,864	10,168	12,812	18,392	25,789	32,821	41,363	50,095	59,176	67,570	77,254
Core Expenditures	15,514	30,054	41,710	59,483	102,602	114,482	118,044	126,760	115,222	125,510	125,978
of which Operating Expenditures	15,514	21,972	26,605	32,883	43,284	53,049	60,664	69,392	74,448	76,450	76,882
of which wages	n/a	13,818	17,842	22,311	27,280	31,464	36,313	40,988	43,670	45,590	45,986
of which non wage	n/a	8,154	8,764	10,572	16,004	21,585	24,351	28,404	30,778	30,860	30,896
of which Development Expenditures	-	8,082	15,105	26,600	59,318	61,433	57,380	57,368	40,774	49,060	49,096
Fiscal Deficit Before Grants	9,650	19,886	28,899	41,091	76,813	81,661	76,682	76,665	56,045	57,941	48,724
of which operating	9,650	11,804	13,794	14,491	17,494	20,228	19,301	19,297	15,271	8,880	(372)
External Dvpt Expenditures	22,777	106,879	119,398	79,021	130,050	124,896	110,515	105,956	74,690	44,620	44,620
Total Expenditures	38,291	136,933	161,108	138,504	232,652	239,379	228,560	232,716	189,912	170,130	170,598
				As percentage of GDP							
Domestic Revenues	3.2	4.5	4.5	5.2	6.0	6.6	7.2	7.8	8.1	8.2	8.3
Core Expenditures	8.5	13.4	14.7	16.7	24.0	23.0	20.6	19.6	15.8	15.3	13.6
of which Operating Expenditures	8.5	9.8	9.4	9.2	10.1	10.7	10.6	10.7	10.2	9.3	8.3
of which wages	n/a	6.1	6.3	6.3	6.4	6.3	6.3	6.3	6.0	5.5	5.0
of which Development Expenditures	-	3.6	5.3	7.5	13.9	12.4	10.0	8.9	5.6	6.0	5.3
Fiscal Deficit Before Grants	5.3	8.8	10.2	11.6	18.0	16.4	13.4	11.9	7.7	7.0	5.2
of which operating	5.3	5.2	4.8	4.1	4.1	4.1	3.4	3.0	2.1	1.1	(0.0)
External Dvpt Expenditures	12.5	47.5	42.0	22.2	30.5	25.1	19.3	16.4	10.2	5.4	4.8
Total Expenditures	20.9	60.8	56.6	39.0	54.5	48.2	39.9	36.0	26.1	20.7	18.4

6b. High Case

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
		actuals					projection				
				Afs millions							
Domestic Revenues	5,864	10,168	12,812	19,064	27,616	37,339	50,729	63,766	78,457	94,766	107,905
Core Expenditures	15,514	30,054	41,710	59,483	102,602	116,289	119,860	128,579	116,723	125,510	125,978
of which Operating Expenditures	15,514	21,972	26,605	32,883	43,284	54,855	62,479	71,212	75,949	76,450	76,882
of which wages	n/a	13,818	17,842	22,311	27,280	33,217	38,073	42,753	45,127	45,590	45,986
of which non wage	n/a	8,154	8,764	10,572	16,004	21,639	24,406	28,458	30,823	30,860	30,896
of which Development Expenditures	-	8,082	15,105	26,600	59,318	61,433	57,380	57,368	40,774	49,060	49,096
Fiscal Deficit Before Grants	9,650	19,886	28,899	40,419	74,986	78,950	69,130	64,813	38,266	30,744	18,073
of which operating	9,650	11,804	13,794	13,819	15,667	17,517	11,750	7,445	(2,508)	(18,317)	(31,023)
External Dvpt Expenditures	22,777	106,879	119,398	79,021	130,050	124,896	110,515	105,956	74,690	44,620	44,620
Total Expenditures	38,291	136,933	161,108	138,504	232,652	241,185	230,375	234,535	191,413	170,130	170,598
				As percentage of GDP							
Domestic Revenues	3.2	4.5	4.5	5.4	6.5	7.5	8.9	9.9	10.8	11.5	11.6
Core Expenditures	8.5	13.4	14.7	16.7	24.0	23.4	20.9	19.9	16.0	15.3	13.6
of which Operating Expenditures	8.5	9.8	9.4	9.2	10.1	11.0	10.9	11.0	10.4	9.3	8.3
of which wages	n/a	6.1	6.3	6.3	6.4	6.7	6.7	6.6	6.2	5.5	5.0
of which Development Expenditures	-	3.6	5.3	7.5	13.9	12.4	10.0	8.9	5.6	6.0	5.3
Fiscal Deficit	5.3	8.8	10.2	11.4	17.6	15.9	12.1	10.0	5.2	3.7	1.9
of which operating	5.3	5.2	4.8	3.9	3.7	3.5	2.1	1.2	(0.3)	(2.2)	(3.3)
External Dvpt Expenditures	12.5	47.5	42.0	22.2	30.5	25.1	19.3	16.4	10.2	5.4	4.8
Total Expenditures	20.9	60.8	56.6	39.0	54.5	48.6	40.3	36.3	26.3	20.7	18.4

6c. Low Case

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
		actuals					projection				
				Afs millions							
Domestic Revenues	5,864	10,168	12,812	17,115	21,466	25,577	31,571	38,992	47,069	54,542	63,172
Core Expenditures	15,514	30,054	41,710	59,483	99,211	109,329	110,821	116,711	102,659	113,953	117,890
of which Operating Expenditures	15,514	21,972	26,605	32,883	39,893	47,896	53,441	59,343	61,885	64,893	68,794
of which wages	n/a	13,818	17,842	22,311	26,416	30,588	33,671	36,576	38,517	41,412	45,173
of which non wage	n/a	8,154	8,764	10,572	13,477	17,308	19,770	22,767	23,368	23,481	23,621
of which Development Expenditures	-	8,082	15,105	26,600	59,318	61,433	57,380	57,368	40,774	49,060	49,096
Fiscal Deficit Before Grants	9,650	19,886	28,899	42,368	77,745	83,752	79,251	77,719	55,591	59,411	54,717
of which operating	9,650	11,804	13,794	15,768	18,427	22,318	21,870	20,352	14,817	10,351	5,622
External Dvpt Expenditures	22,777	106,879	119,398	79,021	130,050	124,896	110,515	105,956	74,690	44,620	44,620
Total Expenditures	38,291	136,933	161,108	138,504	229,261	234,225	221,337	222,667	177,349	158,573	162,510
				As percentage of GDP							
Domestic Revenues	3.2	4.5	4.5	4.8	5.0	5.1	5.5	6.0	6.5	6.6	6.8
Core Expenditures	8.5	13.4	14.7	16.7	23.2	22.0	19.4	18.1	14.1	13.8	12.7
of which Operating Expenditures	8.5	9.8	9.4	9.2	9.3	9.6	9.3	9.2	8.5	7.9	7.4
of which wages	n/a	6.1	6.3	6.3	6.2	6.2	5.9	5.7	5.3	5.0	4.9
of which Development Expenditures	-	3.6	5.3	7.5	13.9	12.4	10.0	8.9	5.6	6.0	5.3
Fiscal Deficit	5.3	8.8	10.2	11.9	18.2	16.9	13.9	12.0	7.6	7.2	5.9
of which operating	5.3	5.2	4.8	4.4	4.3	4.5	3.8	3.2	2.0	1.3	0.6
External Dvpt Expenditures	12.5	47.5	42.0	22.2	30.5	25.1	19.3	16.4	10.2	5.4	4.8
Total Expenditures	20.9	60.8	56.6	39.0	53.7	47.2	38.7	34.5	24.3	19.3	17.5

Source: staff projections.

TABLE A. 7: EXPENDITURES BY PROGRAM FROM 2003/04 TO 2005/06

	2003/04 Est.	2004/05 Est.	2005/06 Budget	2003/04 Est.	2004/05 Est.	2005/06 Budget
		US$ million			*% of total budget*	
Human Capital Development	**688**	**843**	**1,549**	**25**	**25**	**31**
1.1 Refugees and IDP return	33	75	66	1	2	1
1.2 Education	185	224	485	7	7	10
1.3 Health	168	154	259	6	5	5
1.4 Livelihood and Social Protection	273	340	668	10	10	13
1.5 Culture, Media, Sport	29	50	71	1	1	1
Physical Infrastructure	**751**	**901**	**1,223**	**27**	**27**	**24**
2.1 Transport	452	581	542	16	17	11
2.2 Energy, Mines, and Telecom	113	222	327	4	7	6
2.3 Natural Resources Management	97	45	207	3	1	4
2.4 Urban Management	88	53	147	3	2	3
General Administration	**251**	**298**	**594**	**9**	**9**	**12**
3.1 Trade and Investment	8	40	78	0	1	2
3.2 Public Administration and Economic Management	243	258	517	9	8	10
Security	**1,105**	**1,328**	**1,615**	**40**	**39**	**32**
3.3 Justice	16	45	63	1	1	1
3.4 National Police and Law Enforcement	209	340	597	7	10	12
3.5 Afghan National Army	797	788	830	28	23	16
3.6 Mine Action	63	96	77	2	3	2
3.7 DDR	21	59	48	1	2	1
Unallocated	**-**	**8**	**86**	**-**	**0**	**2**
Total	**2,796**	**3,378**	**5,067**	**100**	**100**	**100**
Core - Operating	449	558	678	16	17	13
Core - Development	165	317	1,209	6	9	24
Total Core	**614**	**874**	**1,887**	**22**	**26**	**37**
External	2,182	2,503	3,180	78	74	63
Total Budget	**2,796**	**3,378**	**5,067**	**100**	**100**	**100**

Source: MoF (preliminary annual statements for operating budget and 2005/06 Budget Decree estimates for development).

LIST OF ADDITIONAL DOCUMENTS PREPARED AS PART OF THE PFM REVIEW

In addition to the thematic chapters in Volume II to V, a number of background papers were prepared and shared with the Government during the process of the PFM review:

Additional background papers on the budget and fiscal management:

Budget Formulation in Post Conflict Afghanistan (2005/06), December 2004
Public Finance in Afghanistan: Trends and Prospects, February 2005
State-Owned Enterprises and the National Budget, February 2005
Operating Budget Allotment Control, February 2005
Overview of the 1384 Budget, March 2005
Reforming the Fiscal System and Achieving Fiscal Sustainability, March 2005
Policy notes on PRR and pay reform, March - June 2005
Strengthening ARTF and Enabling Budget Support Through Selective Use of Benchmarks, July 2005

Additional background papers on institutional reforms:

Reforming the Treasury in Afghanistan, December 2004
Afghanistan Ministry of Finance – The Way Forward, December 2004 / February 2005
Institutions for Economic Policymaking: Key Considerations and Options, February 2005
Ministry of Finance: Toward a Five-Year Strategic Plan, May/June 2005

Additional background papers on sectors:

Public Expenditure Management in Livelihoods and Social Protection – summary of findings, February 2005
Public Expenditure Review of the Highway Systems in Afghanistan, February 2005
Public Expenditure Management in the Security Sector: Initial Findings and Conclusions, April 2005
Education Expenditure Tracking Survey – report on key findings, June 2005

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