Report No. 53892-AF

# Afghanistan
# Public Expenditure Review 2010
## Second Generation of Public Expenditure Reforms

April 2010

Poverty Reduction and Economic Management
Finance and Private Sector Development Unit
South Asia Region







DFID Department for International Development

Document of the World Bank

Co-produced with the UK Department for International Development

## CURRENCY AND EQUIVALENT UNITS

(As of April 4, 2010)

Currency Unit = Afghani

US$ = AFN 48.3

## Government Fiscal Year (Solar Year)

March 21 – March 20

## ACRONYMS AND ABBREVIATIONS

| | | | |
|---|---|---|---|
| AFMIS | Afghanistan Financial Management and Information System | MoEc | Ministry of Economy |
| AMD | Aid Management Department | MoF | Ministry of Finance |
| ANA | Afghan National Army | MoI | Ministry of Interior |
| ANDS | Afghanistan National Development Strategy | MoPW | Ministry of Public Works |
| ANP | Afghan National Police | MRRD | Ministry of Rural Rehabilitation and Development |
| ARTF | Afghanistan Reconstruction Trust Fund | MTEF | Medium Term Expenditure Framework |
| BD | Budget Department | MTFF | Medium Term Fiscal Framework |
| CAO | Control Audit Office | M&E | Monitoring and Evaluation |
| CSTC-A | Combined Security Transition Command-Afghanistan | Mustofiats | Provincial Office of MoF |
| DFID | UK Department for International Development | O&M | Operation and Maintenance |
| DFR | Donor Financial Review | OECD DAC | OECD Development Assistance Committee |
| EC | European Commission | P&G | Pay and Grading |
| FPU | Fiscal Policy Unit | PEFA | Public Expenditure and Financial Accountability |
| GDP | Gross Domestic Product | PER | Public Expenditure Review |
| HLCAE | High Level Committee on Aid Effectiveness | PFEM | Public Finance and Expenditure Management |
| I-ANDS | Interim Afghanistan National Development Strategy | PFM | Public Financial Management |
| IARCSC | Independent Administrative Reform and Civil Service Commission | PPU | Procurement Policy Unit |
| IMF | International Monetary Fund | PRGF | Poverty Reduction and Growth Facility |
| LOTFA | Law and Order Trust Fund Afghanistan | PRSP | Poverty Reduction Strategy Paper |
| LTO | Large Taxpayers Office | SWAp | Sector-Wide Approach |
| MoD | Ministry of Defense | USAID | United States Agency for International Development |
| MoE | Ministry of Education | VPP | Verified Payroll Program |

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# ACKNOWLEDGEMENTS

This Public Expenditure Review (PER) is a joint venture between the UK Department for International Development (DFID) and the World Bank, and is based on information available as of March 31, 2010.

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Responsibility for individual background working paper for the PER is as follows:

- Working Paper 1: Country Overview and Role of Public Expenditure: Yoichiro Ishihara;
- Working Paper 2: Public Expenditure Trends and Fiscal Sustainability: Yoichiro Ishihara;
- Working Paper 3: Expenditure Framework and Public Financial Management: Peter Jensen and Sebastian Eckardt;
- Working Paper 4: Security Sector: Nicole Ball and Yoichiro Ishihara;
- Working Paper 5: Education Sector: Mary Venner.

Peer reviewers were Freddy Bob-Jones and Andrew Keith (DFID); Borja Gracia (IMF), and Kai Kaiser (PRMPS). The team would like to acknowledge the indispensable support provided by the management team including Ernesto May (Sector Director, SASPF); Nicholas J. Krafft (Country Director, SAC 01), and Mariam Sherman (Country Director, MNC04) during the PER process.

The PER involved extensive interactions with the Ministry of Finance (MoF), other government agencies, and donors, whose valuable cooperation and support were indispensable. The participation of senior government officials and donors in three workshops held in Kabul in March and April 2009 to discuss initial key findings and policy recommendations was greatly appreciated.

From the government of Afghanistan, valuable comments and inputs were provided by Mustafa Mastoor (Deputy Minister, MoF); Ahmad Jalali (DG Budget, MoF); Mohammad Aqa (DG Treasury, MoF); Waleed Payenda (MoF); Ahmad Shaf Zamanzai (DG Revenue, MoF); Wahid Waissi (Director in the Budget Department, MoF); Hamid Jalil (Director in the Aid Management Department, MoF); Graham Burnett (Revenue Department, MoF); David Watt (Revenue Department, MoF); Naresh Duggal (Revenue department of MoF); Vishal Ghandi (Treasury Department, MoF); Lejla Catic Hurtic (Program Budgeting Advisor, MoF); Walid Qazizada (Treasury Department, MoF); Zia-Ur-Rahman Haleemi (Head of FPU, MoF); John Grinyer (FPU, MoF); Megan Grey (Treasury Department, MoF); Amin Ullah Amini (Budget department, MoF), Megan Gray (Treasury department, MoF), Suleman Kakar (Deputy Minister, MoE); Zia-ul-haq Safi (DG Finance and Accounting, MoE); Nargis Nehan (Consultant, planning, MoHE); Karbalayee (Head of Planning Department, MoE); Abdul Wakil Hanifi (Head of procurement, MoE); Assad Zamir (Head of Internal Audit Unit, MoE); Mia Jan Mia (Senior HRM Advisor/ Coordinator (RIMU), MoE); and Rahimi Ismail (Director, MoEc);.

From donors and World Bank colleagues, valuable comments and inputs were provided by Mark Sedra (senior fellow, Centre for International Governance Innovation); Sandeep Kumar (LOTFA manager, UNDP); Erwan Marteil (Counselor, EC); Theodora Dell (USAID); Sari Nurmikolu (UNAMA); Sophie Brown (DFID consultant); Janis Platais (Treasury Advisor, MoF); Michael G. Schaefer (Program Budgeting Advisor, MoF/DFID-project); Roger Calhoun (Team Leader, MoF/DFID-project); Birgit Hansl (SASEP, World Bank); Hamish Nixon (SASDU, World Bank), and Richard Hogg (SASGP, World Bank).

The team also appreciated the logistical and administrative support of Hossai Mahak Aliffi (SACAF); Muhammad Shafiq (SASEP), Marinella G. Yadao (SASEP), Mildred Gonsalvez (SACBD) and Shahnaz Ahmed.

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# Executive Summary

## INTRODUCTION

1. Afghanistan and its donor community face a dilemma that is critical to the country's sustained development: how to channel more foreign assistance through the government's budgetary system (i.e., core budget) in the face of a huge capacity gap to ensure effective administration of such expenditures. Without more money on budget, national objectives such as poverty reduction and the building of a stable state cannot be fully realized.

2. Currently, 90 percent of the national budget[1] is externally financed. Overall aid in 2008/09 amounted to US$5.5 billion or 47 percent of GDP. The critical issue, however, is not so much the amount of aid, but weaknesses in its mode of delivery and impact. Three quarters of the aid bypasses the government's own budget system, moving through what is known as the "external budget". This dual budgetary system means that most economic activity in Afghanistan takes place outside the government's fiscal control, thus undermining the government's legitimacy and relevance to the Afghan people and weakening the budget's primacy as the tool of national policy. The aid needs to be on-budget and aligned with Afghan priorities.

3. If the success of aid can be gauged by the extent to which it enables a recipient country to free itself of the need for that aid, then the Afghanistan foreign assistance program, as currently structured, is failing its mission. Afghanistan's fiscal sustainability, after having risen to a plateau in recent years, regressed in 2008/09 due to rising operating expenditures, mainly for security, and the country remains one of the world's most aid-dependent.

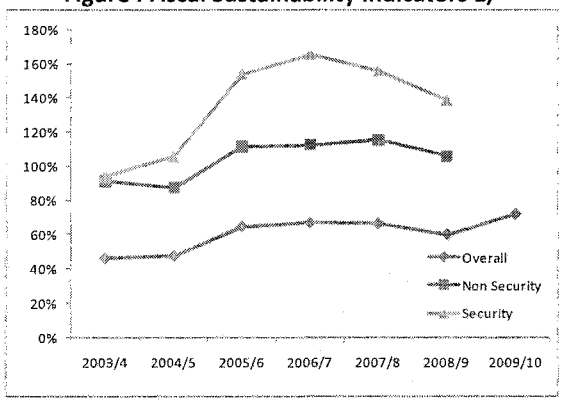
## THE SEARCH FOR SOLUTIONS

4. The government has made some notable fiscal advances in recent years. The Public Financial Management (PFM) system, especially at the Ministry of Finance (MoF), has undergone a structural transformation, confirmed by a significant improvement in the Public Expenditure and Financial Accountability (PEFA) indicators between 2005 and 2007. Core budget expenditures more than doubled nominally in the last four years to reach US$2.6 billion in 2009/10[2], demonstrating rising absorption capacity for funding channeled through the core budget. But more far-reaching reforms are urgently needed for public expenditures to better serve the government's goals. Prioritization and sequencing are prerequisites for successful implementation of reforms for the government and donors in a country where capacities and resources are limited.

5. Four major challenges must be addressed to enable more "external" budget expenditures to be shifted to the core budget:

   (a) **Precarious fiscal sustainability** (Figure I): The fiscal sustainability indicator improved to 72 percent in 2009/10 from 38 percent in 2002/03, due mainly to the sharp increase in domestic revenues (to 9.4 percent of GDP from 3.3 percent). Nevertheless, the faster increase in core operating expenditures relative

**Figure I Fiscal Sustainability Indicators 1/**



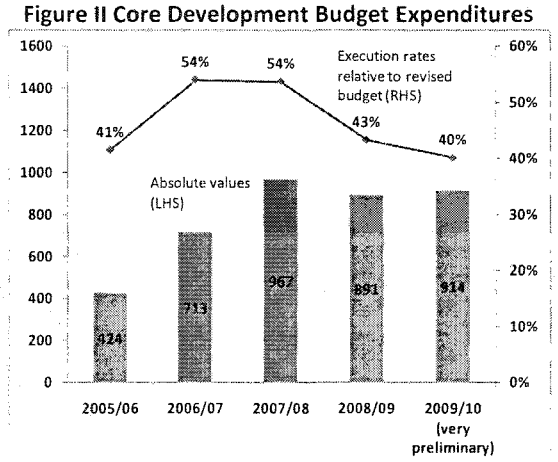

1/ Domestic revenues / operating expenditures
*Source: MoF, World Bank*

[1] The national budget includes the core budget (i.e. on-budget) and the external budget (i.e. off-budget).
[2] Throughout the document, 2009/10 data is very preliminary and subject to revisions later.

to domestic revenues would risk fiscal sustainability and hence macroeconomic stability. The goal is fiscally sustainable core operating expenditures without jeopardizing core government functions. Pressure on operating expenditures, in particular those related to security, amplifies the challenge of achieving fiscal sustainability. The security sector is the largest sector in the national budget, accounting for more than 40 percent of operating expenditures, a reflection of the inescapable security challenges facing the country.

(b) **Low execution rates of core development budget expenditures** (Figure II): Core development budget expenditures are essential for infrastructure investment as well as service delivery. These core development expenditures increased by almost 500 percent between 2003/04 to 2009/10. However, core development budget expenditures equivalent to 9 percent of GDP remain undisbursed each year. Execution rates deteriorated in 2009/10 from the year before falling to 40 percent from 43 percent. Absolute values remained same at US$0.9 billion.

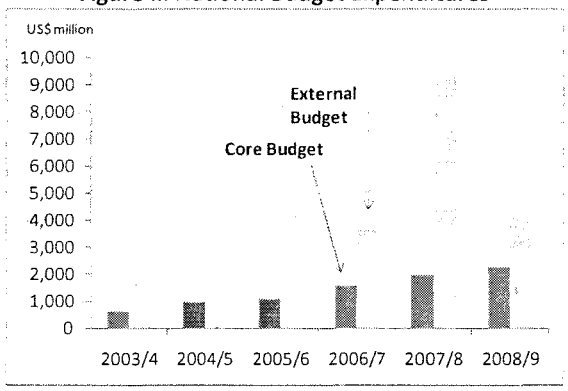
**Figure II Core Development Budget Expenditures**




*Source: MoF, World Bank*

(c) **Large size and poorly aligned external budget** (Figure III): Challenges relate to the large external budget expenditures outside the core budget, which have arisen in response to slow implementation and poor quality of core development expenditures as well as issues of corruption and governance. Between 2002/03 and 2008/09, about three quarters of public expenditures were channeled through the external budget.

**Figure III National Budget Expenditures**




*Source: MoF. World Bank*

(d) **Weak governance of public expenditures:** Public expenditure governance is critical to improving the efficiency and effectiveness of public resources. Concerns about poor governance and accountability relating to public expenditures are one of the main reasons for the large share of donor assistance channeled through the external budget, as donors seek to bypass weak government systems and deliver resources to projects and programs directly and outside the core budget.

6. The response to meeting these challenges, based on the findings of the PER and building on previous analysis, recent encouraging reforms, and ongoing programs and policy directions, is to implement a set of selected prioritized and sequenced actions. The overarching goal of the proposed action program, embodied in a roadmap, is to ensure that public expenditures better serve the national objectives of poverty reduction and state building. Further reforms to attract more aid flows to the core budget from the external budget are critical while ensuring fiscal

sustainability, increasing absorption capacity and project quality, and improving public expenditure governance.

**STRATEGIC OBJECTIVES**

**Strategic Objective 1: Improved (Non-Security) Fiscal Sustainability**
Together with further increases in domestic revenues, better management of the operating budget by both the government and donors will be needed to achieve fiscal sustainability. Currently, MoF is not fully involved in the security sector operating budget (mainly salaries). Given this context, in addition to the full fiscal sustainability indicator, the non-security sector fiscal sustainability indicator should also be used to measure the performance of the MoF. Key reform outcomes are: (i) Unanticipated increase in non-security wages and salaries contained; (ii) Predictability of security sector operating budget improved; (iii) Medium-Term Fiscal Framework (MTFF) evolved into Medium-Term Expenditure Framework (MTEF), and (iv) Predictability of grant financing for the core operating budget ensured.

**Strategic Objective 2: Higher Execution Rates and Better Quality Core Development Expenditures**
The low execution rates are among the causes preventing donors from shifting their aid delivery from the external budget to the core budget as donors question the absorption capacity of the government. However, the core development budget is almost entirely financed by donors. Actions should be taken by both the government and donors. Key reform outcomes are: (i) Budget formulation improved; (ii) Execution levels increased; (iii) Alignment between budget and the Afghanistan National Development Strategy (ANDS) improved, and (iv) Performance monitoring and evaluation of projects initiated.

**Strategic Objective 3: Better Aligned External Budget with Core Budget**
In the short-term, information sharing by donors should be accelerated. In the medium-term, the alignment between the core and external budgets should be improved based on revised sector strategies. In the long-term, along with the further improvements in public financial management (e.g., procurement), donors should shift from the external budget to the core budget. The weak links between the core operating, core development and external budgets undermine public expenditures and risk sustainability. The goal is to consolidate the three budgets, but immature implementation carries risks. Depending on reform progress and capacity building, partial consolidation between the core and external budgets can be implemented or at least full conceptual consolidation reflected in MTFF. Progress towards Sector-Wide Approach (SWAp) can be the foundation of the links between the three budgets. A word of caution is necessary here: While the core development budget could absorb additional funds from the external budget without affecting macro-economic stability, the many contingent liabilities for the operating budget in the development budget (both external and core) such as operation and maintenance expenditures would inevitably delay fiscal sustainability.

**Strategic Objective 4: Improved Governance of Public Expenditures and Sustainability of Reforms**
Afghanistan is perceived to be one of the most corrupt countries in the world. The sustainability of reforms and the ability to implement policies are effectively entwined with the need to improve governance and capacity-building in both the civil service and private sector in order to ensure transparency and accountability, strengthen public procurement and undertake meaningful decentralization. Key reform outcomes are: (i) Progress made on Verified Payroll Program (VPP); (ii) Improved oversight by external and internal audits; (iii) Procurement process strengthened; (iv) Government-led capacity review formulated, and (v) Provincial rollout of the Afghanistan Financial Management System (AFMIS).■

# Key Public Expenditure Challenge and Policy Roadmap

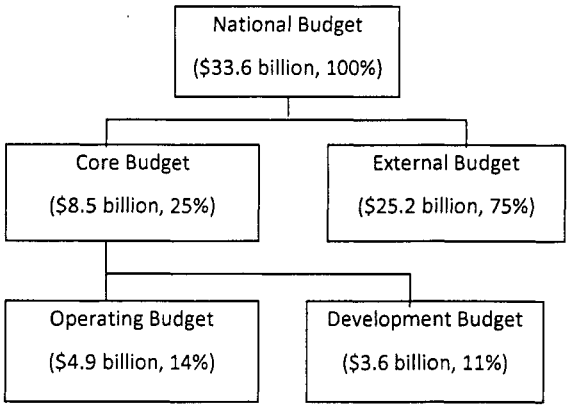
## A. OBJECTIVES AND CONTEXT

The objective of the Public Expenditure Review (PER) is to provide prioritized, sequenced policy measures and actions so that public expenditures are more effective and better serve national goals. The intended audience of the paper and the roadmap of time-bound actionable steps include the government, mainly the Ministry of Finance (MoF), and donors. This PER builds on a 2005 Public Financial Management (PFM) review, and is the result of collaboration between the UK Department for International Development (DFID) and the World Bank with significant inputs from the Government of Afghanistan. Detailed analyses on public expenditure trends and fiscal sustainability, the expenditure framework and PFM, and the security and education sectors are provided in separate annexes. The PER also benefited from a broad consultation process with key stakeholders including several workshops in 2009.

This review goes well beyond the 2005 PFM Review that focused mainly on broader aspects of PFM and included some discussion of public expenditure structure and priorities. Since it was completed before the preparation of the Interim Afghanistan National Development Strategy (I-ANDS) in 2006, it could not adequately address key issues that are central to the Afghanistan National Development Strategy (ANDS) implementation. This PER addresses those needs, particularly how budget/financial management and processes can be made into effective tools for the implementing of the ANDS in order to achieve its development and poverty reduction goals. The PER working papers also includes a detailed assessment of two of the most important sectors, security and education. Each sector working paper seeks to cover the composition, quality and relevance of these programs, among others, as well as the sector's development priorities, and allocative and operational efficiency. These sectoral analyses will also be useful to government officials as a model for evaluating other sectors for planning, budgeting and monitoring purposes.

A key challenge addressed by the PER is to shift more expenditures from the External Budget to the Core Budget[3]. Afghanistan is one of the poorest and most aid dependent countries in the world, with overall aid in 2008/09 amounting to US$5.5 billion or 47 percent of GDP. The critical issue is not so much the amount of aid to Afghanistan, but weaknesses in its mode of delivery which limit impact: some two-thirds of foreign assistance bypasses the core budget. The problems of having large parts of public expenditures flowing through the external budget (i.e., off the core budget) include the lack of alignment with government development priorities, weakening of the budget as a policy tool and undermining its primacy as the principal instrument of national policy, and longer-term issues of fiscal sustainability.

**Figure A. National Budget Structure**
(2003-2008 Actual, % of the national budget)




*Source: World Bank*

[3] The national budget (consisting of the Core and External Budgets, with the Core Budget comprising the Core Operating Budget and Core Development Budget) is approved by the Cabinet and National Assembly and consists of funds that flow through the government's treasury apparatus, and is subject to the government's PFM systems. By contrast, the external budget includes expenditures disbursed directly by donors outside the government PFM system.

Currently, the external budget accounts for 75 percent of public expenditures in the country (Figure A). In addition, nearly 70 percent of the core budget is externally financed, and together with funds channeled through the external budget, external resources represent 90 percent of total (core and external) national expenditures. Some progress has been made in shifting resources from the external budget to the core budget and there is some momentum; the challenge is to move this process forward.

Public expenditures have been central to the government's efforts for the development of the country in the past eight years, after it emerged from three decades of armed conflicts. The country faces far-reaching development challenges even in comparison to other fragile states. Afghanistan's Human Development Index and per capita Gross Domestic Product (GDP) remain among the lowest in the world, and it is perceived as one of the most corrupt countries. The security situation has been deteriorating rapidly since 2006, and the drug economy is the largest sector of the economy.

The Government of Afghanistan formulated the ANDS for 2008-13 serving as the country's Poverty Reduction Strategy Paper (PRSP) in April 2008. The ANDS articulates a broad vision for poverty reduction in the medium term and it establishes public expenditure as the central vehicle for the delivery of development results. Nevertheless, due to lack of prioritization, the ANDS cannot provide clear policy guidance for public expenditures. The presence of the large external budget, especially, makes the alignment of national objectives with the national budget particularly challenging. Public expenditures will have to play a critical role by ensuring that limited resources are optimally allocated to achieve national objectives. Better public resource management is essential and existing institutional arrangements and procedures need to be properly harnessed, rationalized, and strengthened by building on the achievements of the past several years including a solid PFM foundation and legal framework.

**B. ACHIEVEMENTS IN THE FISCAL ARENA**

Fiscal policy and enhanced PFM have contributed to macroeconomic stability by avoiding domestic bank financing as the operating budget balance (including grants) was positive in most years. In addition to grants to the operating budget, the sharp increase in domestic revenues had a positive impact. Greater domestic revenues and grants have increased the role played by core budget expenditures in the economy. Concurrently, the PFM system, especially at the MoF, has undergone a structural transformation. More specifically, key fiscal achievements to 2009/10 are:

- A simple fiscal sustainability indicator, measured by the ratio of domestic revenues to operating expenditures, improved from 40 percent to 70 percent;
- Cumulative operating budget balance (including grants) was 0.8 percent of GDP (until 2008/09);
- Domestic revenues increased by 40 percent nominally per annum on average in the past seven years, while domestic revenues as a share of GDP increased from 3 percent to 9 percent;
- Core budget expenditures increased by 35 percent nominally per annum during the same period, with the share in GDP increasing from 9 percent to 20 percent;
- Core development expenditures increased from 0 percent to 7 percent of GDP, while operating expenditures increased from 9 percent to 13 percent, reflecting the country's capital expenditure needs, and
- A Public Expenditures and Financial Accountability (PEFA) assessment shows improvements in 18 of 28 PFM system indicators between 2005 and 2007. By most indicators, Afghanistan's PFM system is better than that of many low and middle income countries.

## C. KEY CHALLENGES

Despite significant achievements, public expenditures, especially on critical service delivery sectors such as education, have been underfunded and are largely ineffective in achieving national objectives. In addition, past achievements are losing momentum (Table A).

**Table A. Development of Key Fiscal Indicators**

| Subject | Indicator | Bottom (year) | Peak (year) | Latest In 2009/10 1/ | Recent Trend |
|---|---|---|---|---|---|
| Domestic revenues | Percentage of GDP | 3.3 (2002/03) | 9.4 (2009/10) | 9.4 | ↗ |
| Operating expenditures | Percentage of GDP | 8.6 (2002/03) | 13.1 (2009/10) | 13.1 | ↗ |
| Operating budget balance (including grants) | Percentage of GDP | -0.8 (2008/9) | 1.3 (2005-07) | 0.2 (2008/09) | ↘ |
| Fiscal sustainability | Dom. revenues / operating. exp. | 38 (2002/03) | 72 (2009/10) | 72 | ↗ |
| Core development expenditures | Execution rates 2/ | 40 (2009/10) | 54 (2006/07) | 40 | ↘ |
| External budget | Percentage of GDP | 29.1 (2002/03) | 96.1 (2007/08) | 35.0 (2008/09) | ↘ |

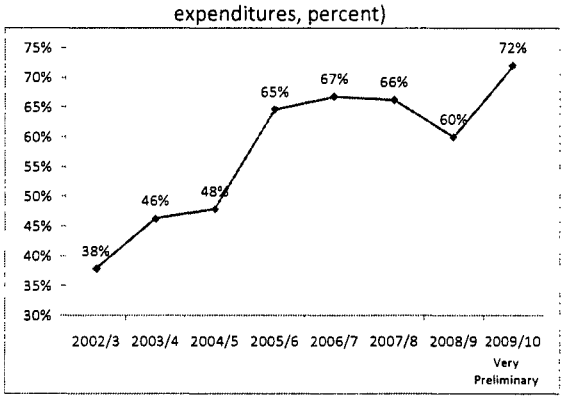
*1/ Very preliminary figures*
*2/ Relative to mid-year budget*
*Source: MoF, World Bank*

Four major challenges need to be addressed squarely for public expenditures to serve their intended purpose, and indeed, to strengthen the role of the budget and expenditures as the prime vehicles to deliver on national objectives. Addressing these issues is also central to any potential increases in external assistance that major donors might be contemplating. The challenges include:

### 1. Precarious fiscal sustainability

The faster increase in core operating expenditures in relation to domestic revenues risks fiscal sustainability and hence macroeconomic stability. The goal is fiscally sustainable core operating expenditures without jeopardizing core government functions. Unlike in other countries, full coverage of operating expenditures by domestic revenues is a reasonable indicator of fiscal sustainability in Afghanistan because there is not yet a steady state in terms of fiscal aggregates, and financing costs are negligible since the bulk of the fiscal deficit is grant-financed.

**Figure B. Fiscal Sustainability Indicator**
(the ratio between domestic revenues and operating expenditures, percent)




*Source: Ministry of Finance, World Bank*

The fiscal sustainability indicator (measured by the ratio of domestic revenues to operating expenditures) improved from 38 percent in 2002/03 to 72 percent in 2009/10 after having declined to 60 percent in 2008/09 (Figure B). Further improvement of the fiscal sustainability indicator requires not only sustained increase in domestic revenues but also managing operating budget expenditures.

However, operating budget expenditures doubled between 2006/07 and 2009/10. The main reasons for the increase are the growth in security sector operating expenditures, Afghan National Army

(ANA) and Afghan National Police (ANP) salaries, and the planned implementation of Pay and Grading (P&G) reforms. Pressure on operating expenditures amplifies the challenge of achieving fiscal sustainability.

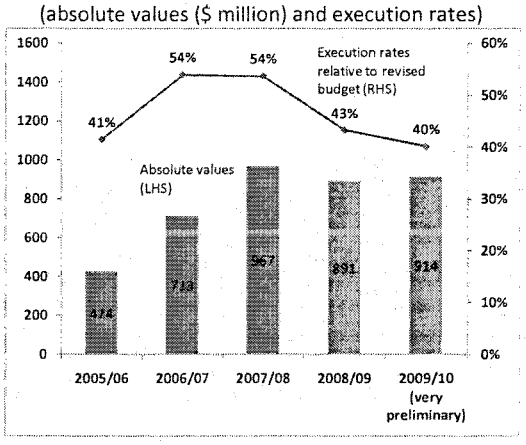
The large share of the security sector is a particular feature of Afghan public expenditures. Accounting for more than 40 percent of operating expenditures, the security sector is the largest sector in the national budget and a reflection of the security situation in Afghanistan. Nevertheless, PFM in the security sector has not been fully integrated into the government-wide system. Analysis suggests that ANA and ANP are not fiscally sustainable from domestic revenues alone. The large commitment to security also limits the availability of financial resources for public service delivery in areas such as health and education.

The achievement of fiscal sustainability is also subject to performance of domestic revenues. Domestic revenue as a share of GDP fell to 6.9 percent in 2008/09 from 7.5 percent in 2006/07[4], before increasing to 9.4 percent in 2009/10. Sustainability of the increase is key to creating fiscal space for public expenditure and consequently to achieving fiscal sustainability.

Furthermore, the recurrent cost implications of increases in the development budget are a major concern, especially the 'contingent liabilities' for the operating budget that exist in both the external budget and in the core development budget. These future liabilities relate, in particular, to the operations and maintenance costs of capital investments in equipment and infrastructure (which for the security sector are large but, to lesser extent, relate to all sectors) as well as pension liabilities and the various enhanced packages paid to civil servants and consultants by donors to implement ongoing programs.

## 2. Low execution rates of core development budget expenditures

**Figure C. Low Core Development Budget Execution**
(absolute values ($ million) and execution rates)




Core Development Budget expenditures are essential for infrastructure investment as well as service delivery. However, core development budget expenditures equivalent to 9 percent of GDP remain undisbursed each year. Both the absolute value of disbursements and rates improved steadily until 2007/08 (Figure C). Between 2004/05 and 2007/08, actual core development expenditures more than doubled from US$0.4 billion to nearly US$1 billion. In 2008/09 and 2009/10 they fell back to US$0.9 billion largely because of poor execution rates in the main spending ministries. The execution rates fell from 54 percent in 2007/08 to 40 percent in 2009/10. Ten line ministries accounted for more than 90 percent of total core development expenditures in 2008/09. The Ministry of Rural Rehabilitation and Development (MRRD) accounted for 27 percent of the overall low execution rates followed by the Ministry of Public Works (MoPW).

There are sets of particular and more generic reasons for this decline. In 2008/09 the drop in execution rates was a result of the premature introduction of program budgeting across seven line ministries without adequate planning and training of staff. Consequently, budget execution in the seven pilot ministries came to a virtual standstill at the beginning of the year. More recently, the

[4] In comparison, domestic revenues are about 11-12 percent of GDP in other low income countries.

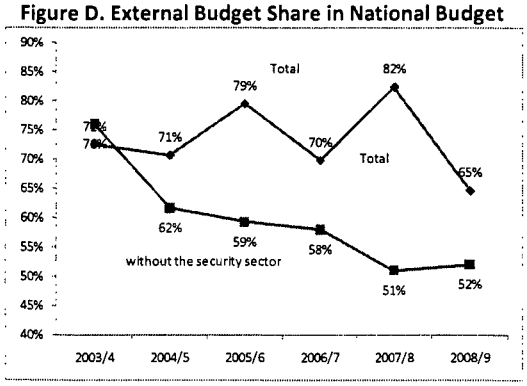
drop at the start of this year was the result of the decision at the time (later rescinded) to require all line ministries to submit their allotment documents to the Ministry of Economy (MoEc) before handing them over to the MoF. This caused widespread confusion in the submission and processing of allotment documents.

More generally, however, poor execution rates are a result of several factors, ranging from: (i) low absorption capacity of implementing agencies, especially when it comes to knowledge about procurement procedures (e.g. the lack of knowledge about the change in Procurement Law in 2008 and rectification in 2009); (ii) weak budget formulation by the MoF and line ministries/implementing agencies which leads to unrealistic budgets and work plans; (iii) poor predictability and late disbursement of donor funds; (iv) low project formulation capacities of donors, and (v) growing insecurity in parts of the country which makes implementation increasingly difficult. Weak absorption and implementation capacities limit the additional amounts of donor funds which can be shifted from the external budget to the core budget. Additionally, the low execution rates negatively affect not only the level of public expenditure on infrastructure and service delivery, but also state-building and GDP growth.

### 3. Large size and poorly aligned external budget

Challenges stem from the large external budget expenditures outside the core budget, which are in turn a response to slow implementation and poor quality of core development expenditures as well as corruption and governance. Between 2002/03 and 2008/09, about three quarters of public expenditures were channeled through the external budget (Figure D). The external budget is not fully coordinated with the government's expenditure policies and priorities in terms of its planning, budgeting, implementation, and monitoring and evaluation (M&E). The presence of the large external budget makes the alignment of public expenditures with the ANDS particularly challenging. Even though most donors consult with the government on external budget projects, the government has difficulty aligning the external budget to achieve national objectives because: (i) information is not properly shared with the government (i.e., external budget data are not reported in a timely manner, creating serious problems for data comparability); (ii) projects are formulated based on donors' interests rather than national objectives, and (iii) operation and maintenance costs are not well reflected in the core budget (especially in the case of investment projects). Major issues include undertaking reforms and policies to incrementally channel more of the external budget through the core budgets, and improve the alignment of public expenditures with national objectives and priorities, and indeed, give national authorities more control over larger shares of public resources.

**Figure D. External Budget Share in National Budget**




*Source: Ministry of Finance, World Bank*

### 4. Weak governance of public expenditures

Public expenditure governance is critical to improve the efficiency and effectiveness of public resources. Concerns about poor governance and accountability relating to public expenditures is one of the main reasons for the large share of donor assistance channeled through the external budget; donors seek to bypass weak government systems and deliver resources to projects and programs directly and outside the core budget. Apart from addressing the heavy financial costs of corruption and leakage of public funds, and thus, poor results and lowered effectiveness, improving public expenditure governance is also a key prerequisite for donors to shift from the external budget

to the core budget[5]. Weak governance is also linked to capacity constraints at every level of government. As with poor implementation rates and quality and efficiency issues, governance concerns also relate to whether the implementation framework is robust enough to handle additional resources effectively and with which the donors are comfortable shifting more of the aid funds.

## D. PER ROADMAP UNTIL 2012/13

Drawing on the findings of the PER and its working papers, previous analysis (such as the 2005 PFM Review), and recent encouraging reforms, programs and policy directions, the best way to deal with these challenges is to select and implement a set of prioritized and sequenced actions. Although prioritization and sequencing are prerequisites for successful implementation of policy measures in general, they are especially important in Afghanistan where government capacity and resources are limited, and the characteristics of public expenditures are different from other countries (e.g., large security sector and external budget). Experience with past reform measures, such as the pilot budgeting program, suggests that hasty implementation of policy could fail. The roadmap requires:

- ***Prioritization***. Policy should prioritize: (i) measures with high impact and ease of implementation; (ii) overcoming capacity and resource constraints; (iii) achieving long-term sustainability, in both financial and human resources; (iv) linking with past achievements and viable ongoing policy measures, and (v) constant review of progress and concrete analyses.
- ***Sequencing.*** The guiding principles of prioritization reemphasize the importance of sequencing of policy measures. The new government was formed in late 2009 for a five-year term and the current ANDS will be completed in March 2013. Public expenditure policy measures can be divided into short-term (3-6 months, or June-September, 2010), medium-term (next two years, to March, 2012) and long-term (next five years, to end-2014). In the **short-term**, the government should focus on the ongoing reform process, such as the pilot result-based budgeting. At the same time, it is important not to introduce new policy measures until resources and capacities catch up. For the **medium-term**, the government will have to be ready to implement new policy measures so that public expenditure will achieve national objectives in the next ANDS cycle. The government should start implementation of new policy measures based on review of ongoing policy measures and the results of systematic analyses. In the **long-term**, to the end of the next government cycle, it should focus on consolidating the results of accelerated policy measures.

The major elements of the roadmap are organized in a results framework with four strategic objectives responding to the four challenges, which are then each further elaborated into a few selected key outcomes. Proposed actions to achieve these outcomes are spelt out with their timing and main responsibilities of the relevant government ministry or agency for implementation and execution (including donors' roles, if appropriate). Indicators for each strategic objective and outcome are specified to allow monitoring and evaluation and quantifiable baseline and target values are provided where possible. The details of the roadmap and indicative quantitative targets of Strategic Objectives are contained in a matrix in tables C and D.

***Overarching Goal***: The overarching goal of the proposed action program embodied in the roadmap is to ensure that public expenditures better serve the national objectives of poverty reduction and state-building. Further reforms to attract more aid flows to the core budget from the external budget are critical while ensuring fiscal sustainability, increasing absorption capacity, and improving public expenditure governance.

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[5] Fighting Corruption in Afghanistan: Summaries of Vulnerabilities to Corruption Assessments (World Bank, May 2009) includes analyses of: (i) Public Financial Management and Procurement; (ii) Revenue Department, and (iii) Budget Department.

**Table B. PER Results Framework: Strategic Objectives and Outcomes**

| **Overarching Goal: Improved public expenditures to achieve national objectives** |
|---|
| **Strategic Objective 1: Improved (Non-Security) Fiscal Sustainability**<br>1.1 Unanticipated increase in non-security wages and salaries contained<br>1.2 Predictability of security sector operating budget improved<br>1.3 Medium-Term Fiscal Framework evolved into Medium-Term Expenditure Framework<br>1.4 Predictability of grant financing for the core operating budget ensured |
| **Strategic Objective 2: Higher Execution Rates and Better Quality Core Development Expenditures**<br>2.1 Budget formulation improved<br>2.2 Execution levels increased<br>2.3 Alignment between budget and ANDS improved<br>2.4 Performance monitoring and evaluation of projects initiated |
| **Strategic Objective 3: Better Aligned External Budget with the Core Budget**<br>3.1 Information sharing within government and by donors improved<br>3.2 Efficiency/ effectiveness of the external budget strengthened<br>3.3 Long-term strategy to integrate the core and external budgets formulated |
| **Strategic Objective 4: Improved Governance of Public Expenditures**<br>4.1 Progress made on Verified Payroll Program (VPP)<br>4.2 Oversight by external and internal audits improved<br>4.3 Procurement process strengthened<br>4.4 Government-led capacity review formulated<br>4.5 Provincial AFMIS rollout operationalized |

**Strategic Objective 1: Improved (Non-Security) Fiscal Sustainability**

The improvement in fiscal sustainability contributes not only to macroeconomic stability but also confidence in fiscal policy. However, both actual and prospective fiscal sustainability indicators deteriorated in 2007 and 2008, mainly due to the increase in the operating budget, before significantly improving in 2009/10. To achieve fiscal sustainability, not only will domestic revenues have to increase, but both the government and donors will have to improve their management of the operating budget. Currently, the MoF is not fully involved in the policy discussion about the security-sector operating budget. For this reason, the non-security sector fiscal sustainability indicator should be used along with the full fiscal sustainability indicator to measure the performance of the MoF.

***Indicator***: Domestic revenues as a share of the operating budget, with and without the security sector, will be the indicators to be monitored. The security sector is defined as the ministries of Defense and Interior, the Presidential Protective Force, and General Directorate of National Security.

***Outcome 1.1: Containment of unanticipated increase in non-security sector wages and salaries***

***Context***: Wages and salaries amounted to 70 percent of the operating budget (56 percent of the non-security operating budget) in 2008/09. The government has a fixed ceiling on the number of non-security civil servants. A Civil Servants Law passed in July 2008 includes provisions for a new P&G structure that has eight grades and monthly salaries ranging from US$100 to US$650. The government started to implement P&G reform in 2009/10, aimed at improving the quality of non-security civil servants by matching capacities and responsibilities with salary scales and abolishing non-transparent payments. The P&G reforms have medium-term fiscal implications for the non-security operating budget, with the budgeted costs of implementation in 2009/10 at 6 percent of the non-security operating budget.

***Actions and responsibilities***: The fiscal policy unit (FPU) of the MoF and the Independent Administrative Reform and Civil Service Commission (IARCSC) produced the first P&G report in November 2009. This report has proved effective and should be continued during the five-year P&G reform implementation period on a semi-annual basis and the findings reflected in the annual budget and Medium-Term Fiscal Framework (MTFF).

***Indicator***: The achievement of this outcome will be monitored by ensuring that semi-annual P&G implementation reports are shared with stakeholders and reflected in the annual budget and MTFF.

***Outcome 1.2: Improved predictability of the security-sector operating budget***

***Context***: The security sector accounts for 43 percent of the core operating budget in 2008/09. Among recurrent items, wages and salaries (including food allowance), and a small portion of operation and maintenance (O&M) expenditures are paid from the core operating budget. The Law and Order Trust Fund Afghanistan (LOTFA) fully finances the ANP, and the Combined Security Transition Command-Afghanistan (CSTC-A) finances top-up salary payments of both the ANA and ANP.

***Actions and responsibilities***: On a technical level, the Budget Department and FPU of the MoF should take the lead by regularly (at least semi-annually) organizing the technical working group in 2010. Key donors such as CSTC-A, LOTFA, EU, IMF and the World Bank should provide information for technical analysis and/or assist the group. A ministry-level committee, including the ministers of Finance, Interior, and Defense, should be established in 2010/11 for decision making on the sizes and salaries of the ANA and ANP as well as medium-term financing. Major donors should be a part of the committee. Decisions should be reflected in the annual budget and the MTFF.

***Indicator:*** Timely and accurate reflections of the security sector operating expenditures/financing in the annual budget, Mid-Year Review and MTFF will serve as the measure of success for this outcome.

***Outcome 1.3: MTFF improved and MTEF initiated***

***Context***: MoF produced the first MTFF in October 2005 and, has contributed to fiscal policy as a basis for medium-term projections. However, the MTFF is still far from being a policy formulation tool. Medium-term expenditure estimates are primarily based on parameter adjustments, although major policy initiatives (e.g., P&G reforms) are costed in the forward estimates. The estimates of future O&M recurrent costs associated with the core/external development budgets are not fully included. The MTFF should provide the complete picture of the operating budget so that the MoF will be able to formulate financing strategy (Outcome 1.4). Furthermore, there are few links between the MTFF and costing of sector/ministry strategies, which is the major bottleneck for the MTFF to become the MTEF.

***Actions and responsibilities:*** As requested in the 2011/12 budget calendar, line ministries should initiate an analysis of future recurrent-cost estimates associated with the core and external development budgets starting in 2010/11. FPU should guide line ministries so that the analyses are based on the same methodology and assumptions. Also, the FPU should agree with line ministries who should provide the analysis associated with the external budget. Donors should provide timely information requested by line ministries and the FPU. After reaching agreement among major stakeholders (i.e., the IMF, World Bank and other key donors, and within the MoF), the results of the analysis should be included in the MTFF in 2011/12. The government will start preparation of the ANDS mid-term review in 2010, which will clarify any changes in prioritization as a result of developments in early 2010 (e.g., London Conference and planned Kabul Conference). The government will also identify improvements to ANDS implementation in the ANDS mid-term review. The MTFF should provide expenditure ceilings to guide these strategies so that sectors/ministries will

be able to formulate realistic costing. The results of the costing exercise should be reflected in the Medium-Term Expenditure Framework (MTEF) (partial) in 2011/12 (relate to Outcome 2.3). During the ANDS mid-term review process, the Budget Department (mainly policy department and sector managers) should provide technical assistance to line ministries.

***Indicators***: (i) PEFA indicator 12(iv), related to linkages between investment budgets and forward expenditure estimates, had a baseline value of 2 in December 2007; a target value of 3 in December 2012 is envisaged[6]; (ii) at least three (from none at present) sector/ministry strategies with realistic costing in line with the MTFF are expected in 2010, and (iii) the MTEF is expected to be formulated by 2011/12 with selected sector/ministry strategies.

***Outcome 1.4: Predictability of grant financing for the core operating budget ensured***

***Context***: Achieving full fiscal sustainability is likely to take several more years and the operating budget will continue to require external financing. Major external financing sources for the operating budget are: (i) Afghanistan Reconstruction Trust Fund (ARTF) recurrent-cost window (including the incentive program); (ii) contributions to the security sector by LOTFA and CSTC-A, and (iii) budget supports.

***Actions and responsibilities***: Based on the evolved MTFF/MTEF (Outcome 1.3), the Budget Department and FPU should take the lead on formulating the financing strategy in 2010/11 (and continuously thereafter). The financing strategy should be approved by top management of MoF for the discussion with donors (relate to Outcome 1.2). Given that the MoF has limited capacity and resources, donors should consider how to harmonize policy benchmarks associated with financing through the operating budget. Also, in order to align financing decisions with the budget calendar, donors should provide multi-year financing projections (if possible, commitments) to the MoF in 2010/11 (and continuously thereafter).

***Indicator:*** The ratio between the actual and budgeted financing amounts should be monitored to measure improvements in predictability. Baseline and target values will be determined after 2008/09 actual financing data become available.

**Strategic Objective 2: Higher Execution Rates and Better Quality Core Development Expenditures**

With a very nascent and still non-vibrant private sector, core development expenditures are essential for infrastructure investments and, therefore, state-building. However, significant portions of the core development budget remain undisbursed each year. The low execution rates are one of the causes preventing donors from shifting their aid delivery mode from the external budget to the core budget, as donors question the absorption capacity of the government. However, the core development budget is almost all financed by donors. Actions should be taken by both the government and donors.

***Indicator:*** The core development budget execution rate (at 43 percent in 2008/09) is targeted to reach 55 percent in 2012/13, only slightly higher than the rate attained in 2007/08 (54 percent).

***Outcome 2.1: Budget formulation improved***

***Context***: While MoF has successfully improved the budget calendar in the past few years, line ministries did not have sufficient time to consult with stakeholders (including their provincial offices)

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[6] In order to reach Score 3, "the majority of important investments are selected on the basis of relevant sector strategies and recurrent-cost implications in accordance with sector allocations and included in forward budget estimates for the sector".

resulting in the dearth of good quality, implementable projects. This raises concerns not only about low execution rates, but also about the development impacts of projects. Currently, line ministries submit project proposals to the Ministry of Economy (MoEc) for clearance before submitting to the MoF. This process duplicates the roles between sector managers in the Budget Department of the MoF and MoEc. The role of parliament in the budget should be strengthened; the World Bank assisted the finance/budget committee through financing, (i) the training of committee members in a course at the World Bank Institute on Public Finance Oversight, and (ii) the salaries of the secretariat staff.

***Actions and responsibilities***: As the Budget Department has successfully improved the budget calendar, the practice should be continued for the 2011/12 budget and beyond. In order to adhere to the budget calendar, donors should provide timely and quality information through the semi-annual donor financial reviews (DFR). The Aid Management Department (AMD) of the MoF initiated DFR in mid-2008 to improve the quality/quantity of donor assistance data with particular attention paid to the external budget. Operationalization of the ARTF financing strategy (discussed during the ARTF quarterly meeting in November 2009), starting with the 2010/11 budget, is expected to further align the ARTF investment cost window to finance the core development budget and the Afghan budget calendar. The submissions of core development budget projects to the MoEc should be streamlined so that the MoEc focuses more on monitoring and evaluation related to the ANDS (relate to Outcome 2.4)[7]. Instead, sector managers of the Budget Department should take bigger roles in quality assurance of core development budget projects by, for example, participating in discussions in line ministries in project formulation. Furthermore, in order to take advantage of pilot provincial budgeting, the Budget Department should continue discussion and preparation of 'norm-based' provincial resource allocations which will link certain indicators with sub-national resource allocations on a pilot basis in 2010/11. Also, the budget formulation process should include more provincial inputs based on experiences with provincial budgeting.

***Indicator***: Outcomes will be monitored by tracking the time given to line ministries for budget formulation and to issue the first Budget Circular, both measured as part of PEFA PI-11 (orderliness and participation in the budget formulation process). The baseline value was 3 in December 2007, and targeted to reach 4 in December 2012[8].

***Outcome 2.2: Execution levels increased***

***Context:*** The core development budget execution level increased from US$0.2 billion in 2003/04 to US$1 billion in 2007/08. However, the level fell to US$0.9 billion in 2008/09 and 2009/10. There are three areas where structural constraints currently impede improvements in the execution levels:

- *Allotment and disbursement procedures between line ministries and the MoF, and within the MoF:* After the budget is approved (i.e., appropriation), line ministries have to submit allotment requests to the MoF. Within the MoF, the Budget Department and Treasury Department[9] deal with the allotment and disbursement processes. The MoEc's involvement in the allotment process (i.e., line ministries had to submit the request to the MoEc before the MoF) was revoked in mid-2009.
- *Procurement processes in line ministries*: According to the Procurement Law, line ministries have to submit a procurement plan within one month after the approval of the budget. Procurement

[7] The MoEc is responsible for M&E of the ANDS, and is one of the Budget Committee members.

[8] In order to reach 4, all three dimensions of PI-11 should be improved. The three dimensions include: (i) existence of and adherence to a fixed budget calendar; (ii) guidance on the preparation of budget submission; and (iii) timely budget approval by the legislature.

[9] An allotment process is critical to cash management and support of the line ministries' authority over its appropriations.

plans have to be shared with the Procurement Policy Unit (PPU) in order to get allotments of the core development budget.

- *Carry-forward projects from previous years*: Line ministries need to request carry-forward projects at least 30 days before the end of the fiscal year to ensure appropriation (i.e., budget approval) at the beginning of the fiscal year. Due to the delays in submitting requests by some line ministries, appropriations were delayed and negatively affected the core development budget execution, especially in 2009/10 (SY1388).

***Actions and responsibilities***: Addressing these constraints will require actions to:

- *Identify bottlenecks in order to streamline the allotment and disbursement procedures*: The Budget and Treasury Departments initiated a study for this purpose, and the study needs to balance between efficiency and control of risks. The results of the study are expected to be reflected in the 2010/11 allotment and disbursement procedures;
- *Ensure compliance with the submission of procurement plans*: The Procurement Policy Unit (PPU) and the Budget Department of the MoF should supervise a procurement-plan formulation process by line ministries in order to ensure timely submission of procurement plans. The World Bank will conduct a procurement assessment in mid-2010 based on the 2009/10 results using the OECD/DAC framework;
- *Ensure timely appropriation of carry forward projects:* Sector coordinators of the Budget Department of the MoF should take the lead to ensure timely requests by line ministries. For 2010/11, all carry-forwards should be projected to the MoF one month before the end of 2009/10 so that all carry-forward projects will be appropriated at the beginning of the year. Sector coordinators also have to ensure the quality of carry-forward projects (i.e., by not including poor-quality projects in carry-forward projects).

***Indicators***: Increases in execution levels can be measured by comparing actual implementation in absolute terms, from a baseline amount of US$891 million in 2008/09 to a target volume of US$2 billion in 2012/13. In addition the following indicators can be used to measure the progress of the outcome:

- Average number of days for the allotment process within the MoF;
- Number of line ministries/agencies compliant with timely submission of procurement plans, and
- Actual implementation of carry-forward projects in absolute values (US$).

***Outcome 2.3: Improved alignment between the budget and the ANDS***

***Context***: The Budget Department of the MoF initiated program budgeting in 2007/08 with three pilot ministries. Although program budgeting aimed to integrate the operating and development budgets (relate to Outcome 1.3) and link public expenditures to national priorities and results, as envisaged in the ANDS, complicated structures and high demands relative to the capacities of the line ministries made the process burdensome. Since 2009/10, the Budget Department has simplified program budgeting, and 19 ministries are now piloting the streamlined procedures. The MoF has prepared a program budgeting implementation plan to roll-out program budgeting to all line ministries and agencies, and to move toward single program/policy-based budget formulation. Furthermore, ongoing results-based management focuses on improving the alignment between the budget and the ANDS by concentrating more on monitoring and evaluation.

***Actions and responsibilities***: The Budget Department of the MoF should further promote simplified program budgeting and focus on developing the M&E systems in the MoF and 10 key line ministries in 2010/11. They will be required to submit quarterly performance reports before extending this requirement to all ministries. For the results-based management pilots, the MoEc should first establish M&E mechanisms (including data collection processes) in the selected ministries and

provinces in 2010/11. Afterwards, the MoEc, together with the MoF Budget Department, should initiate the pilot results-based management.

***Indicator***: Progress will be measured by the number of ministries undertaking program budgeting, with reviews of progress starting from a baseline of 19 ministries (2009/10) and targeted to cover all budgetary units by 2011/12.

***Outcome 2.4: Performance monitoring and evaluation (M&E) of projects and programs initiated***

***Context***: Financial monitoring of the core development budget is conducted through internal and external audits, though these need to be further strengthened. Both internal and external functions have the mandate but neither have the capacity to carry-out performance audits, which could extent to evaluation of results. In any case, both internal and external audit for the mid-term focus on regulatory audits, given that the high risk in the Afghanistan public sector is in compliance with the control framework. The Control and Audit Office (CAO) has done one or two performance audits and wants to expand in this area. However, little performance M&E has been conducted by the government itself. Performance M&E is critical, as the government endeavors to make results-based management meaningful.

***Actions and responsibilities***: Instead of being directly involved in the core development budget formulation process (relate to Outcome 2.1), the MoEc should take a leading role in conducting performance M&E of selected projects and programs. In 2010/11, the MoEc should first formulate an action plan for performance assessment, in line with available financial and human resources and with cooperation from donors. Alternatively, the MoEc can first focus on core development budget projects financed by government discretionary funding. Donors should cooperate with the MoEc initiatives by providing available information and technical assistance. Performance M&E should include efficiency and equity analyses. Once initial performance M&Es are conducted for selected projects and programs, the results and process should be reviewed to identify the pros and cons of performance M&Es. Once performance M&E come on-track, the results should be used for budget formulation. For example, the MoF and MoEc should initiate discussions on how to integrate efficiency and equity indicators into resource allocations (relate to Outcome 2.3).

***Indicator:*** The indicator of progress will be the increases in the number of projects and programs reviewed.

**Strategic Objective 3: Better-Aligned External and Core Budgets**

As the external budget expenditures are disbursed directly outside the government PFM system, alignment with the core budget, and hence national objective, is difficult. The end goal is to shift the external budget to the core budget. In the short term, information sharing by donors should be accelerated. In the medium term, the alignment between the core and external budgets should be improved based on the revised sector strategies. In the long term, along with the further improvements of PFM (e.g., procurement), donors should shift from the external budget to the core budget. The weak links among the three budgets undermine public expenditures and threaten sustainability. The goal is to consolidate the three budgets, but immature implementation carries risks. Depending on reform progress and capacity building, partial consolidation between the core and external budgets can be implemented, or at least full conceptual consolidation reflected, in the MTFF. Progress towards Sector-Wide Approaches (SWAp) can be the foundation of the links among the three budgets.

***Indicator:*** Progress will be indicated by increases in the share of the core budget in the national budget (i.e., including the external budget), from a baseline of 35 percent (2008/09), reaching a target of 40 percent by 2012/13.

***Outcome 3.1: Improved information-sharing by donors with the government, between donors, and within the government***

***Context***: Donor Financial Review (DFR) and the donor assistance database (DAD) have improved information-sharing between the MoF and donors. Timely and quality information-sharing by donors through the DFR is critical to improving the annual budget formulation process (relate to Outcome 2.1). However, not all donors are compliant with the DFR. Also, information-sharing between the MoF and line ministries on the external budget projects has not been systematically conducted.

***Actions and responsibilities***: Donors should make further efforts to provide multi-year projections (on a non-commitment basis) in line with the Afghanistan budget-formulation calendar, albeit under their own constraints (e.g., timing of fiscal years and single-year budgeting), starting with the next DFR in 2010. As donors sometimes share more information on the external budget projects with line ministries rather than with the MoF, efforts should be made to enhance the links between the MoF and the line ministries' knowledge of external budget projects by reconciling the respective databases, starting with a few key spending ministries in 2010/11.

***Indicators***: Improved information-sharing can be monitored by: (i) the number of line ministries with databases reconciled with the MoF database (from none in 2009 to a target of seven by 2011), and (ii) the number of donors fully compliant with DFR reporting (from a baseline of 15 out of 34 in 2009 to a target of 30 in 2012.)

***Outcome 3.2: Efficiency/effectiveness of the external budget strengthened***

***Context:*** The government and donors often differ on whether a core development budget or external budget project is more efficient and effective. Nevertheless, few systematic analyses on efficiency and effectiveness have been conducted. Terms of reference for a peer reviewing mechanism have been discussed under the government-led High-Level Committee on Aid Effectiveness (HLCAE), but it has not yet been operationalized.

***Actions and responsibilities***: In order to ensure the best use of donor assistance, a systematic analysis (e.g., unit-cost comparison between core development and external budget projects) should be conducted. In line with Outcome 2.3, the MoEc should take a lead on the analysis. As the MoEc has limited capacity, the analysis can be started with a few projects, or the MoEc can wait until the performance M&E mechanism for the core development projects comes on-track. As the external budget projects are all donor-driven, donors should share information upon request from the MoEc.

***Indicator***: A simple indicator would be the number of projects conducting the analysis (from a baseline of 0, targeted to increase by five each year.)

***Outcome 3.3: Long-term strategy to integrate the core and external budgets formulated***

***Context***: Despite efforts such as the ANDS financing mechanism under the High Level Committee on Aid Effectiveness (HLCAE), a long-term strategy to integrate the core and external budgets that satisfies both the government and donors has not yet been formulated. As a part of the ANDS financing strategy, Phase I and Phase II assessments of SWAp were conducted in 2009.

***Actions and responsibilities***: Key ARTF donors (with the World Bank as a facilitator) together with the MoF and potential line ministries should constitute a technical working group on SWAps in early 2010. If agreed by the technical working group and ARTF donors, the technical working group should formulate steps and action plan(s) for pilot sector(s) in the first half of 2010. Subject to a successful initiation of the pilot SWAp process, other sectors should follow the process in 2012/13. A SWAp action plan can be integrated into the ANDS mid-term review in late 2010.

***Indicator:*** Indicators would be the formulation of the strategy and the number of SWAp action plans formulated (target 1-2 in 2010 and 5 by 2013).

**Strategic Objective 4: Improved Governance of Public Expenditures and Sustainability of Reforms**

Afghanistan is perceived to be one of the most corrupt countries with very poor governance; Transparency International's Corruption Perception Index for 2009 ranked Afghanistan the second-worst in the world. Indeed, the sustainability of reforms and the ability to implement policies effectively are intertwined with the need to improve governance and further build capacities, including those of the civil service, ensuring transparency and accountability, strengthening public procurement, and undertaking meaningful decentralization.

***Outcome 4.1: Progress made on the Verified Payroll Program***

***Context***: The MoF in June 2006 initiated the Verified Payroll Program (VPP) which aims to reduce the length of the salary distribution process and provide defined windows of management of government payrolls. The number of government employees (including the ANA and ANP) who receive their salaries through bank accounts reached 208,000 by October 2009. Out of a total headcount of 450,000 civil servants, 422,000 are registered and 347,000 have bank accounts. The Treasury Department has been expanding VPP units in Mustofiats (MoF provincial offices). Despite the progress, the issue of 'ghost 'employees remains unresolved[10]. Currently, three databases exist: in the Treasury Department; Kabul Bank for the MoE, and LOTFA for the MoI.

***Actions and responsibilities***: The VPP has turned out to be an effective measure to better manage wages and salaries of government employees. The Treasury Department of the MoF should make further progress on the VPP, although the security situation and the lack of availability of banking networks in rural areas would inevitably affect further rollout. Along with expanding the coverage of the VPP, the Treasury Department should continue the regular assessments of the VPP. It should also initiate the assessment of payroll systems of key line ministries to identify weaknesses, followed by remedial action plans, in 2010/11. Ideally, the government should have one HR payroll database, by integrating different databases[11]. As a first step, the Treasury Department should take the lead on the reconciliation of existing databases.

***Indicator***: The further rollout of the VPP can be tracked by the number of civil servants covered by the system, from a baseline of 208,000 (October 2009) to a target of 25,000 additional civil servants in 2010/11, another 20,000 in 2011/12, and another 15,000 in 2012/13.

***Outcome 4.2: Oversight by external and internal audits improved***

***Context***: The internal audit functions in the ministries are still underdeveloped, except for those of the MoF. Recently, Article 61 of the Public Finance and Expenditure Management (PFEM) law on the MoF's government-wide purview over internal audits was reinstated, which paves the way for the MoF to carry-out audits to a high standard across government. In addition to capacity constraints in CAO, the current legal framework for the external audit function does not meet modern standards for an independent review function. Risks related to business processes (e.g., public service delivery and salary payments) are not well identified.

***Actions and responsibilities***: The audit committee of the MoF should be expanded in line with its restored mandate and support the government-wide plan on internal audits. The internal audit department should initiate the risk-based annual audit plan based on resource availability.

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[10] The issue is explained further in the annexures on security and education.

[11] IACSC is piloting some HR system which if successful would render the database under VPP obsolete

Concurrently, the internal audit department should develop more capacities and skills, with support from a World Bank project. As there are few clarifications about the division of labor between the MoF internal audit department and existing internal audit functions in line ministries, the MoF internal audit department should clarify the issues before conducting internal audits of line ministries.

***Indicator***: The target number of line ministries to be audited by the MoF Internal Audit Department should be specified after the formulation of the action plan.

***Outcome 4.3: Procurement process strengthened***

***Context:*** Decentralizing the procurement function to line ministries with capacity development is expected to improve efficiency and sustainability of the government procurement process. According to the Procurement Law (Article 93), line ministries should take over procurement responsibilities from the MoEc's Procurement Facilitation Unit (ARDS-PU) within three years. In order to take the responsibility, line ministries have to be accredited by the Procurement Policy Unit (PPU) of the MoF. However, capacities in line ministries are far from being ready for accreditation. To begin to address the weaknesses, PPU plans to initiate procurement capacity assessments of seven key spending ministries.

***Actions and responsibilities***: The PPU should conduct procurement institutional assessments of other key line ministries. The World Bank has been providing training to civil servants in line ministries to build capacity so that line ministries can acquire accreditation. This training should be continued. After accreditation, line ministries will have discretionary powers to decentralize procurement to provinces, but should carefully consider their provincial capacities before decentralizing.

***Indicator:*** Progress will be indicated by the number of line ministries eligible to conduct stand-alone procurement (i.e., accredited by the PPU).

***Outcome 4.4: Government-led capacity review on public expenditures formulated***

***Context***: Budget formulation, execution, and M&E capacities (including skill levels of civil servants, roles of national and international technical assistance) differ across line ministries. Except for procurement (related to Outcome 4.3), no government-led-systematic analysis of capacities has been conducted. Currently, the division of labor on capacity development is unclear.

***Actions and responsibilities***: The MoF (responsible department to be identified) and other key ministries (e.g., the IARCSC and MoEc) should formulate an action plan for capacity review of selected ministries/function in 2010/11. Capacity reviews should be started in 2011/12.

***Indicator***: A target of 10 ministries and/or functions which conduct capacity reviews is envisaged by 2011.

***Outcome 4.5: Provincial AFMIS rollout operationalized***

***Context:*** The Afghanistan Financial Management Information System (AFMIS) is connected with all line ministries and Mustofiats in 32 of 34 provinces. The next challenge is how to operationalize the AFMIS in the provinces (i.e., full usage of the AFMIS and avoiding manual inputs of transactions). Operationalization is expected to improve governance and tax compliance.

***Actions and responsibilities***: The Treasury Department of the MoF should take the lead in operationalizing AFMIS rollout in provinces by identifying capacity gaps in provinces. The World Bank can provide support by continuing the training of civil servants as well as expanding the scope of training to other areas (e.g., information technology).

***Indicator:*** The success indicator will be the increase in the number of provinces processing and recording all transactions in AFMIS.

**E. RISKS**

While the proposed roadmap of actions addresses selected issues and key constraints in improving the effectiveness of public expenditures in Afghanistan, there are inevitably matters not included in this prioritized strategy which nonetheless pose significant challenges and risks. There are ongoing efforts to identify other public expenditure risks such as contingent liabilities. Some of the contingent liabilities emanate from: (i) pensions of uniformed (the ANA and ANP) and non-uniformed government employees, and (ii) state-owned enterprises (including, for example, the state fuel company, state electricity company, and state-owned banks). Measures to address selected risks continue. The design of the pension reforms for public employees (including the military) was finalized and implementation of a government-endorsed pension strategy has been initiated. The finalization of reviews of the financial situations of state-owned enterprises is ongoing as one of the structural benchmarks of the IMF Poverty Reduction and Growth Facility (PRGF) program. Moreover, the size of the security sector and its implications to the core budget in the future needs to be regularly assessed. This PER does not provide detailed analysis of contingent liabilities, other than those of the security sector. Depending on the developments of this topic, these risks need to be further addressed in future PERs.

**F. NEXT STEPS**

M&E will be essential to the successful implementation of the roadmap of policy recommendations of the PER. Indicators under the objective and internationally standardized and recognized PEFA assessment can be used as the main M&E tool for policy recommendations. In the past five years, the PEFA was conducted every two-and-a-half years (June 2005 and December 2007). In order to maintain the same cycle, it is suggested that the next PEFA be conducted in June 2010 followed by another in December 2012. The next PEFA is expected to have greater involvement of the MoF and related government agencies. Also, in order to follow-up developments in the area of public expenditures, it is suggested that a smaller version of the PER be produced on an annual basis, with updates/changes in policy recommendations which incorporate the assessments and findings of the M&E exercises. Depending on needs and discussions with the government, the proposed PERs may also include selected sectoral expenditure reviews. ■

**Table C. Public Expenditure Roadmap**

| Outcomes | Actions (Proposed Timing) | Outcome Indicators | Responsibility | |
|---|---|---|---|---|
| | | | Government | Donors |
| **Overarching Goal: Improved Public Expenditures to Achieve National Objectives**<br>Although the government has attained several key achievements in its fiscal developments in recent years, further reforms are needed so that public expenditures better serve to achieve national poverty reduction and state building. | | | | |
| **Strategic Objective 1: Improved Fiscal Sustainability**<br>Indicator: domestic revenues as a percentage of total/non-security core operating expenditures<br>*Total: Baseline: 60% (2008/09); Target: 55% (2012/13), Non-Security 106% (2008/09); Target:120% (2012/13)* | | | | |
| 1.1 Containment of increase in non-security wages and salaries | • Prepare semi-annual P&G report/ action plan and implement (Continuous)<br>• Reflect results of the reports in budget & MTFF (Continuous) | • (Semi) Annual P&G implementation report shared with stakeholders, and reflected in the annual budget and MTFF | Fiscal Policy Unit (FPU), Budget Department (BD), IARCSC | |
| 1.2 Improved predictability of the security sector operating budget | • Involve MoF in decision making process of ANA and ANP with establishing ministry level committee with donors (2010/11)<br>• Agree upon and assess future financing plan based on the sizes of ANA and ANP, on a semi-annual basis (2010/11)<br>• Reflect the results in the budget and MTFF (2011/12) | • Timely and accurate reflections of security sector operating expenditures and financing in the annual budget, MYR and MTFF | BD, FPU, MoI, MoD | CSTC-A, LOTFA, EC, IMF, WBG and other donors |
| 1.3 Medium-Term Fiscal Framework (MTFF) improved, and Medium-Term Expenditure Framework (MTEF) initiated | • Analyze and estimate future recurrent costs associated with core and external development budget (start mid-2010), and incorporate results in MTFF (2011/12)<br>• Prepare realistic costing under revised sector strategies (start 2010/11) under ANDS mid-term review | • PEFA PI-12 (iv) Linkages between investment budgets and forward expenditure estimates;<br>Baseline: 2 (Dec/2007); Target: 3 (Dec/2012)<br>• Number of sector strategies with realistic costing in line with the MTFF<br>Baseline: 0 (2009); Target: 3 (2010)<br>• MTEF initiated with a few sectors (2011/12) | BD, FPU, Donors, Line Ministries | IMF, WBG |
| 1.4 Predictability of grant financing for the core operating budget ensured | • Formulate realistic multi-year financing strategy for the core operating budget (2010/11 and continuous)<br>• Align financing decision and sharing financing information with Afghan budget calendar (2010/11 and continuous) | • The ratio between the actual and budgeted financing Baseline: TBD (2008/09); Target: TBD(2012/13) (after 2008/09 data becomes available) | BD, FPU, MoD, MoI | ARTF, LOTFA, CSTC-A and other donors |

| **Strategic Objective 2: Higher Execution Rates and Better Quality Core Development Expenditures**<br>Indicator: Core Development Budget execution rates<br>*Baseline*: 43% (2008/09); *Target*: 55% (2012/13) | | | | |
|---|---|---|---|---|
| 2.1 Budget formulation improved | • Continue to adhere to budget calendar (2011/12; continuous)<br>• Donors to provide timely information (2010/11; continuous)<br>• Link ARTF financing strategy with the budget and MTFF<br>• Reduce role of MoEc in budget formulation process<br>• Incorporate more provincial inputs in budget formulation process (start 2010/11)<br>• Initiate pilot norms-based provincial resource allocation (start 2010/11) | • PEFA PI-11 (Orderliness and participation in the budget formulation process): Baseline 3 (2007); Target 4 (2012) | BD, Aid Management Department (AMD), MoEc, Parliament | WBG, Donors |
| 2.2 Execution levels increased | • Identify bottlenecks to streamline allotment and disbursement procedures (start 2010/11)<br>• Ensure compliance on the submission of procurement plan (start 2010/11)<br>• Ensure timely appropriation of carry-forward projects (start 2010/11) | • Actual implementation in absolute values<br>Baseline: US$891m (2008/09); Target: US$2.3billion (2012/13) | BD, Treasury Department (TD), Procurement Policy Unit (PPU), MoEc, Line Ministries | WBG, UNDP |
| 2.3 Improved alignment between budget and the ANDS | • Promote simplified program budgeting with capacity constraints in mind<br>• Initiate result-based management with M&E of pilots (start 2010/11) | • The number of pilot program budgeting ministries with reviews of progress<br>Baseline: 19 (2009/10); Target: All budgetary units (2011/12) | BD, MoEc, Line Ministries, CSO, EC, DFID | EC, DFID, WBG |
| 2.4 Performance monitoring and evaluation (M&E) of projects and programs projects initiated | • Formulate action plan on performance assessment (mid-2010)<br>• Conduct pilot performance assessment (start 2010/11)<br>• Provide assessment results to line ministries (2012/13) | • Number of projects and programs reviewed<br>Baseline: 0 (2009); Target: increases by x each year (TBD with MoEc) | MoEc, BDF, line ministries | Donors |

| | | | | |
|---|---|---|---|---|
| **Strategic Objective 3: Better Aligned External and the Core Budget**<br>Indicator: Share of the Core Budget in the National Budget (i.e. including the External Budget)<br>*Baseline: 35% (2008/09) Target 42% (2012/13)* | | | | |
| 3.1 Improved information sharing by donors with the government, between donors and within government | • Enhance link between AMD database and Line Ministry databases (early 2010/11)<br>• Increase the number of compliant donors in DFR (continuous) | • Number of line ministries reconciled with MoF Baseline: 0 (2009); Target: 5 (2012)<br>• Number of donors fully compliant in DFR Baseline: 15/34 (2009); Target: 30/34 (2012) | AMD, BD, Line Ministries | Donors |
| 3.2 Efficiency/ effectiveness of the external budget strengthened | • Conduct systematic analysis of unit costs of the core development and external budgets projects (relate to 2.4) | • Number of projects conducting the analysis Baseline: 0 (2009); Target: increase by 5 each year | MoEc, AMD, line ministries, | Donors |
| 3.3 Long-term strategy to integrate the core and external budgets formulated | • Form technical working group on SWAps to formulate action plan (selected sectors), if agreed by ARTF donors and the government (first half of 2010)<br>• Incorporate SWAp action plan into ANDS mid-term review (late 2010) | • Formulation of strategy Baseline: none (2009); Target 1-2 in 2010, 5 by 2013 | BD, line ministries | ARTF donors, WBG |
| **Strategic Objective 4: Improved Governance of Public Expenditures and Sustainability of Reforms** | | | | |
| 4.1 Progress made on Verified Payroll Program (VPP) | • Evaluate VPP (continuous)<br>• Expand VPP units in Mustofiats (continuous)<br>• Evaluate payroll system of key ministries (start 2010/11)<br>• Reconcile HR Payroll database (2012/13) | • Number of civil servants covered by VPP ( i.e. salary paid through bank accounts) Baseline: 208k (Oct 2009); Target: +25k (2010/11); +20k (2011/12); +15 (2012/13) | TD, MoI, MoE, IARCSC | ARTF MA, WBG |
| 4.2 Oversight by external and internal audits improved | • The audit committee to support the government-wide plan (2010/11)<br>• Initiate risk-based annual audit plan (2010/11)<br>• Improve capacity and skills (continuous)<br>• External Audit Law submitted to parliament (2010) | • The number of line ministries audited by MoF Internal Audit (IA) department (baseline and indicator TBD after formulation of plan) | CAO; Internal Audit Dep. (IA), Line Ministries | WBG |
| 4.3 Procurement process strengthened | • Conduct procurement capacity assessments of remaining key ministries (start 2010/11)<br>• Formulate tailor-made action plans for line ministries based on the assessments (continuous)<br>• Provide TA and training (continuous) | • The number of line ministries eligible to conduct stand-alone procurement (i.e., accredited by PPU) Baseline: 0 (2009); Target: 3 (2010); 5 (2011); 8 (2012) | PPU, line ministries | WBG |
| 4.4 Government-led capacity review on public expenditure formulated | • Formulate action plan on capacity building assessment (focus key sectors/key functions) (2010/11) | • Number of ministries and/or functions which conducted capacity review Baseline: 0 (2009); Target: 10 (2012) | MoF, MoEc, the IARCSC, line ministries | WBG, Donors |

| | | | | |
|---|---|---|---|---|
| | • Conduct capacity reviews (2011/12) | | | |
| 4.5 Provincial AFMIS rollout operationalized | • Identify the gap in provinces to operationalize provincial AFMIS<br>• WBG to support capacity development based on the identification exercise<br>• Undertake more provincial AFMIS rollouts | • Number of provinces processing and recording all transactions by AFMIS<br>Baseline: 28 (2009); Target: all (2011) | TD | WBG |

## Table D. Indicative Quantitative Targets of Strategic Objectives

| US$ millions otherwise mentioned | SY1382 2003/4 Actual | SY1383 2004/5 Actual | SY1384 2005/6 Actual | SY1385 2006/7 Actual | SY1386 2007/8 Actual | SY1387 2008/9 Actual | SY1388 2009/10 Pre Est. | SY1389 2010/11 Proj. | SY1390 2011/12 Proj. | SY1391 2012/13 Proj. | SY1392 2013/14 Proj. | SY1393 2014/15 Proj. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Base | | | | Target | | |
| **Strategic Objective 1** | | | | | | | | | | | | |
| Fiscal Sustainability (total operating budget) | 46% | 48% | 65% | 67% | 66% | 60% | 72% | 61% | 60% | 62% | 65% | 73% |
| Fiscal Sustainability (total operating budget minus security sector 1/) | 91% | 87% | 111% | 112% | 115% | 106% | 136% | 112% | 124% | 136% | 157% | 180% |
| **Strategic Objective 2** | | | | | | | | | | | | |
| Core Development Budget Execution Rates | n/a | n/a | 44% | 53% | 54% | 43% | 40% | 45% | 50% | 55% | 60% | 65% |
| **Strategic Objective 3** | | | | | | | | | | | | |
| Core Budget Share in National Budget | 28% | 29% | 21% | 30% | 18% | 35% | 33% | 40% | 41% | 42% | 43% | 46% |
| Core Budget Share in National Budget (without sec sector 1/) | 17% | 22% | 25% | 24% | 27% | 31% | 34% | 51% | 57% | 64% | 70% | 77% |
| Domestic Revenues | 208 | 268 | 416 | 578 | 674 | 814 | 1,216 | 1,530 | 1,816 | 2,154 | 2,559 | 2,972 |
| % GDP | 4.7% | 5.0% | 6.4% | 7.5% | 7.0% | 6.9% | 9.4% | 9.9% | 10.4% | 10.9% | 11.4% | 11.9% |
| Operating Expenditures | 448 | 561 | 643 | 865 | 1,019 | 1,358 | 1,689 | 2,511 | 3,038 | 3,475 | 3,949 | 4,061 |
| Operating Expenditures excluding the Security Sector 1/ | 228 | 307 | 373 | 515 | 585 | 769 | 892 | 1,361 | 1,464 | 1,582 | 1,633 | 1,652 |
| Core Development Expenditures (Actual) | 165 | 404 | 448 | 705 | 967 | 891 | 914 | 1,407 | 1,800 | 2,251 | 2,683 | 3,175 |
| Core Development Expenditures (Budget) | n/a | n/a | 1,024 | 1,324 | 1,804 | 2,063 | 2,358 | 3,127 | 3,600 | 4,093 | 4,472 | 4,884 |
| Core Budget | 613 | 965 | 1,091 | 1,570 | 1,986 | 2,248 | 2,604 | 3,918 | 4,838 | 5,726 | 6,633 | 7,236 |
| External Budget | 1,612 | 2,322 | 4,219 | 3,618 | 9,282 | 4,101 | 5,291 | 5,851 | 7,059 | 7,792 | 8,808 | 8,608 |
| External Budget (without the Security Sector 1/) | 1,117 | 1,080 | 1,116 | 1,604 | 1,550 | 1,744 | 1,744 | 1,300 | 1,100 | 900 | 700 | 500 |
| Size of ANA and ANP | | | | - | 121,714 | 148,000 | 174,980 | 224,500 | 294,000 | 340,000 | 400,000 | 400,000 |

1/ Security sector includes the Ministry of Defense, Ministry of Interior, President's Protection Forces and General Directorate of National Security