INTERGOVERNMENTAL FISCAL RELATIONS AND SUBNATIONAL EXPENDITURES IN AFGHANISTAN

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ACRONYMS AND ABBREVIATIONS

ACSP  Afghanistan Country Stability Picture
AFMIS  Afghanistan Finance Management Information System
ANA  Afghanistan National Army
ANDS  Afghanistan National Development Strategy
ANP  Afghanistan National Police
ARTF  Afghanistan Reconstruction Trust Fund
ASP  Afghanistan Solidarity Programme
BPHS  Basic Package of Health Services
CDC  Community Development Council
CDP  Community Development Plan
CERF  Commander’s Emergency Response Program
CIMIC  Civilian-Military Cooperation
CV  Coefficient of Variation
DAA  District Development Assembly
DAB  Da Afghanistan Bank
DAD  Development Assistance Database
EC  European Community
EQUIP  Education Quality Improvement Program
FY  Financial Year
GBS  General Budget Support
I-ANDS  Interim Afghanistan National Development Strategy
IDLG  Independent Directorate for Local Governments
IDA  International Development Association (World Bank)
ISAF  International Security Assistance Force
LSDE  Local Service Delivery Entities
MIS  Management Information System
MOI  Ministry of Interior
MOPH  Ministry of Public Health
MRRD  Ministry of Reconstruction and Rural Development
MUDH  Ministry of Urban Development and Housing
NABDP  National Area-Based Development Program
NGO  Non-Governmental Organization
NSP  National Solidarity Programme
OECD  Organization for Economic Cooperation and Development
<table>
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<tr>
<th>Abbreviation</th>
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<tr>
<td>O&amp;M</td>
<td>Operations and Maintenance</td>
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<tr>
<td>PAA</td>
<td>Provincial Administrative Assembly</td>
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<td>PC</td>
<td>Provincial Councils</td>
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<td>PDC</td>
<td>Provincial Development Committee</td>
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<td>PDP</td>
<td>Provincial Development Plan</td>
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<td>PG</td>
<td>Provincial Governors</td>
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<td>PIU</td>
<td>Project Implementation Unit</td>
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<td>PRT</td>
<td>Provincial Reconstruction Team</td>
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<td>SMC</td>
<td>School Management Committee</td>
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<td>SWAP</td>
<td>Sector Wide Approach</td>
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<tr>
<td>SY</td>
<td>Solar Year</td>
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<td>USAID</td>
<td>US Agency for International Development</td>
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Currency Note: US$ 1 is equal to 50 Afghanis (Afs), June 2008.
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1. INTRODUCTION

1.1. Background, purpose and structure of the report

1. In the years following the establishment of the Interim Authority of Afghanistan in December 2001, much attention has focused on building a strong central state. This was a logical initial response to the prior absence of strong state institutions in the areas of security, governance and economic policy. Indeed, the governance vision expressed in the Constitution and the Afghanistan National Development Strategy (ANDS) emphasize the unitary nature of the Afghan state. Recently, however, increasing recognition has been given to the fact that strengthening the intergovernmental fiscal system as well as subnational administration and subnational service-delivery structures in Afghanistan is necessary if the three basic goals of the ANDS - security, governance and development - are to be realized.

2. An expanding body of analysis considers various aspects of subnational governance and service delivery in Afghanistan. Several of these studies describe the country’s subnational administrative and governance structures, identify bottlenecks and areas of confusion, and develop broad proposals for the way forward in this area. However, the existing work on subnational governance and service delivery has paid relatively little attention to the fiscal aspects of intergovernmental relations and the subnational structure.

3. In this context, the current study develops an analysis of intergovernmental finances and subnational expenditures in Afghanistan. The primary audience for this analysis includes Afghan government officials representing ministries with a policy interest in intergovernmental finance in Afghanistan, including the Ministry of Finance, IDLG, as well as other sectoral ministries and relevant organizations. The secondary audience for this study comprises the government’s development partners and other donor agency officials. The study focuses primarily on the vertical and horizontal division of publicly financed expenditures between the central and provincial administrations, but also gives some attention to the finances of local governments (municipalities) and local service delivery entities (such as CDCs and School Management Committees) below the provinces. The study’s main contribution is the development of a new approach to defining and measuring subnational expenditures in the context of the limited data availability in Afghanistan. On the basis of this analysis, the study aims to identify the key policy and reform challenges confronting Afghanistan in the area of intergovernmental finance.

4. As background to the discussion of the fiscal aspects of the intergovernmental system, the remainder of this chapter will present an overview of the intergovernmental or territorial-administrative structure of Afghanistan (Section 1.2) as well as an overview of the structure of the government budget (Section 1.3). These overviews are supported with more detailed discussions in the study’s annexes. Next, Section 1.4 defines the two different metrics which will be used in subsequent chapters to analyze the intergovernmental fiscal system in Afghanistan: the ‘disbursement metric’ (which measures at what government level are public resources disbursed) and the ‘expenditure metric’ (which tries to capture at which government level public resources are actually spent or used). Section 1.5 expands on the policy context for the current study.

5. Based on these two different metrics, Chapter 2 of this report considers the ‘vertical allocation’ of public resources and expenditures, signifying how resources are allocated between the different administrative tiers and government levels in the country. This analysis considers the vertical allocation of the budget in aggregate as well as the vertical allocation of

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1 This document comprises non-lending technical assistance undertaken by the World Bank for the Government of Afghanistan. The authors are Roland White and Jamie Boex.
different budget components and different sectoral expenditures. In turn, Chapter 3 discusses the ‘horizontal’ allocation of resources, addressing how public expenditures are distributed between jurisdictions at each administrative tier or government level. In other words, is public spending more or less equal between provinces, or are there large variations between provincial expenditures?

6. Whereas Chapters 2 and 3 consider central-provincial financial relations, Chapter 4 analyzes and considers central-local finances, including municipal finances and the financing of Local Service Delivery Entities (LSDEs). Finally, Chapter 5 seeks to draw some implications of the foregoing analysis for the upcoming phase of intergovernmental fiscal reforms in Afghanistan.

1.2. An overview of Afghanistan’s intergovernmental structure

7. As a starting point for the current discussion on intergovernmental relations and subnational finance in Afghanistan, a clear distinction should be made between (subnational) government and (subnational) administrative jurisdictions. As opposed to an administrative jurisdiction, a government (i) is an autonomous body corporate, which is (ii) not-for-profit, and has an obligation to serve all members of a subnational (or local) community, and (iii) has authoritatively binding decision-making power, including at least some degree of discretion over its financial resources. Afghanistan has two government levels: the central government level (the national government or state) and the local government level. In the context of Afghanistan’s Constitution, municipalities are the only recognized type of local governments. Each government level in principle has its own functions and (elected) political leadership structure.

8. The central government in Afghanistan is divided into two administrative levels or tiers: the central administration level of various government agencies (primarily line ministries), and the provincial level which includes the provincial departments of these line agencies, the provincial governors’ offices and associated bodies (e.g. the provincial councils). Unlike a number of other countries in South Asia, the provincial level in Afghanistan does not constitute a separate vertical level of government, nor are the provincial line departments in each province horizontally integrated into provincial administrations. Provincial Governors are appointed by the President and report to the central government; Directors of provincial departments are appointed and report to their respective central line ministries (although, on a day-to-day basis this line of accountability is blurred by their relationship to the Provincial Governors). Likewise, provincial treasury offices (mustoufiats) function as deconcentrated arms of the central treasury.

9. Afghanistan’s 34 provinces are administratively further subdivided into 398 districts. Districts are generally very poorly resourced and the administrative capacity at the district level is extremely weak. Many district offices of government ministries have few or no staff and no real operating budget, and there are no elected bodies at the district level. It is reported that an estimated 40 percent of district governors have less than an elementary school education.

10. In accordance with the Constitution, only municipal governments are legally recognized as true local governments. This means that in substantial parts of the country, there are effectively no government entities below the provincial level. In Afghanistan, this gap is substantively filled by Local Service Delivery Entities (LSDEs). In the context of Afghanistan’s intergovernmental structure, a LSDE can be defined as an organ that, in the absence of formal local governments, has local service delivery functions and has many of the

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2 See Appendix A for a more complete description of the structure of Afghanistan’s public sector.
3 See , ‘Service Delivery and Governance at the Subnational Level in Afghanistan’, World Bank, July 2007 for a full discussion of this.
same features as a local government, but that does not have the same legal standing. Examples of LSDEs include entities such as Community Development Councils (CDCs) and School Management Committees (SMCs). Although LSDEs expend significant amounts of public money, these entities derive their budgetary resources and authority from national programmes.

11. While the Constitution defines the general legal context for the relationship between the central and the provincial level and between the central governments and local governments (municipalities), in many ways, the exact institutional and fiscal architecture of the system of intergovernmental relations is still evolving. The establishment in August 2007 of an Independent Directorate on Local Administration (IDLG) signals the Government’s intention to give a clearer definition to the country’s intergovernmental structure. However, it may be noted that intergovernmental finance is not a policy area that falls exclusively under IDLG: intergovernmental fiscal relations falls within the policy nexus that is covered both by IDLG and the Ministry of Finance, while numerous other stakeholders (including various line ministries) have a clear stake in this topic.

1.3. **Afghanistan’s budgetary structure**

12. A unique feature of Afghanistan’s budget cycle is that it follows the Afghan solar year, which starts on March 21 of the Gregorian calendar. A second feature of the Afghan budget process is that the public sector budget is highly dependent on external funding; contributions from international donor community to the Government Budget are largely funnelled through Afghanistan Reconstruction Trust Fund (ARTF), which essentially provides a multilateral modality for general budget support (GBS). With these two main exceptions, the Afghan budget follows a fairly typical annual budget cycle, with a budget formulation process led by the Ministry of Finance, budget approval by Parliament preceding the beginning of the budget year, budget implementation through the central treasury, and an ex-post audit.

13. **Key components of the Afghanistan’s budget.** Broadly speaking, the central government’s budget has four distinct components. The government’s core operating budget (i.e., the ordinary recurrent budget) can be divided into a wage component and a non-wage component (i.e., operation and maintenance expenditures). Likewise, the development budget can be divided into the ordinary (core) development budget and the external development budget. Whereas the core development budget is fully planned and executed through the Government’s budget systems, the external budget is defined as spending by international donor organizations which is not routed through the government’s budget or treasury system. In addition, certain off-budget funds exist which are used to finance public sector activities, but which are not acknowledged in either the core or external components of the budget. These off-budget funds lie beyond the scope of the current study.

14. Like most budgets, Afghanistan’s ordinary recurrent budget (or core operating budget) is structured by primary budget organization (i.e., ministry, department or government agency) and by main economic classification (including wages and salaries; goods and services; acquisition of assets; Code 21, 22, and 25 respectively). The recurrent budget is presented to parliament by ministry at this high level of aggregation. With the exception of the ministries engaged in the programme-budgeting pilot (as discussed in Appendix B), ministerial budgets lack any further departmental or programmatic breakdown. The absence of a detailed sub-organization or sub-vote classification makes it impossible to

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4 See Appendix B for a more complete description of the public sector budget and budgetary systems in Afghanistan.

5 It should be noted that, in contrast to the concept of a capital budget, both the core and external development budgets in Afghanistan contain recurrent elements, such as financing for wages and salaries of project staff. In addition, as discussed in greater detail in Section 2.3, the external development budget contains several large projects that are recurrent in nature.
determine a link between the budgeted resources for a ministry and the ministry’s different departments or the ministry’s different programmatic objectives.

15. The development budget is presented at the project level, sorted by Ministry, separated into Approved Budget (projects for which the budget resources are available) and Approved Projects (projects which are ‘in the pipeline’ and are conditionally approved upon funding being made available from external sources).

16. **Size and composition of the budget.** Figure 1.1 presents both the budget plan (budget estimates) as well as actual expenditures for SY 1385 (2006/07) across all components of the budget and all levels and tiers of government. This year was chosen for the analyses in this study because it is the latest year for which data are available. Total actual expenditures in SY 1385 amounted US$ 2.3 billion (Afs. 116 billion). This is considerably less than the budget plan for the year, which contained spending plans for US$ 3.7 billion (Afs. 186 billion).6

17. Typically, a lack of budget realism and limited absorptive capacity are the main sources of discrepancy between the planned and actual budgets. Accordingly, the analysis of the Afghan budget data shows that budget execution (or budget performance) is not uniformly poor, but that it varies significantly among the different components of the budget. In particular, the recurrent budget is generally executed at a faster pace than the development budget, consistent with the expectation that it is easier to spend funds on payroll than it is to implement large infrastructure projects. However, a surprising finding is that the execution ratio of the external budget (as far as the data compiled by the Ministry of Finance based on the reports provided by donor agencies) is actually below the budget execution ratio for either the recurrent budget or the core development budget.

18. **Intergovernmental aspects of the budget process.** Whereas local governments and LSDEs (municipalities and CDCs, respectively) have their own, separate budgets, there is no such thing as a provincial budget or budgetary account. Instead, there is only one (national) budget to cater for the central and provincial administrative levels. The only sense in which a province may be said to have a budget is as the aggregate of all expenditures which take place in that province i.e. as a descriptive category without any institutional character.

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6 Throughout the analysis, an exchange rate of Afs. 50 per US$ 1 is maintained.
19. As such, all government revenues and expenditures at the central and provincial (including district) levels are contained in the central government budget. All public expenditures within the central government are planned for and budgeted centrally, with little or no provincial input into the budget process. In fact, all budget authority resides with the central ministries, which are designated ‘primary budget units’. Not only do ministerial budgets lack any organizational or programmatic breakdown, but there is no provincial division of ministerial budget plans either. Only after the annual national budget is adopted by parliament does each ministry divide its budget into provincial-level allotments in order to deliver sectoral public services in each province. As a result of the highly centralized budget authority structure, provincial officials have little control over the planning of provincially-delivered services.

20. Although a Provincial Budgeting project is currently underway within the Ministry of Finance that seeks to involve provincial officials more closely in the budget formulation process, this process does not foresee fundamentally altering the structure of budget or the degree of budget authority of central and provincial officials. In addition, a Programme-Budgeting approach is currently being implemented.  

21. Whereas their influence and authority over the budget formulation process is quite limited, in reality provincial officials have significant influence and power over the implementation of the public sector budget. For instance, provincial officials may have a degree of discretion over the allocation of expenditures that are disbursed through the provincial mustoufiats. In addition, the Provincial Governor and other provincial officials are assigned certain signatory powers for expenditure authorization and procurement and other aspects of budget implementation within each province, even if the expenditures are disbursed by the central treasury. As discussed further in Appendix A, this de facto decentralization to the provincial level of responsibilities associated with budget implementation is problematic in that it takes place in the absence of appropriate accountability mechanisms at the provincial level.

1.4. Metrics for assigning subnational expenditures

22. The analysis in this study considers four different levels of public expenditure: (i) central administrative level, (ii) provincial administrative level (iii) municipalities, and (iv) local service delivery entities (e.g. CDCs, SMCs). Attributing finances to these different levels can be more difficult in a centralized country such as Afghanistan than in decentralized countries, where there is a clear delineation of responsibilities between different government levels each of which has its own budget authority. In a decentralized country, resources used for the delivery of primary education would be assigned to the local government level if that were a responsibility assigned to the local level, so that local governments would administer these education expenditures from their local budgets. In contrast, in a fully centralized country, all public finances are held in central government accounts. Alternatively, in a decentralized country, one could attribute public resources to different government levels based on which level controls – or has expenditure discretion over - public resources (for instance, see Ebel and Yilmaz, 2002, and OECD, 1997, 1999, 2001). However, in the context of a centralized public sector, it is impossible to use this as an attribution rule, since all government functions are legally assigned and controlled by the central government level. Thus, rather than attributing public finances to different government levels based on a functional approach or assignment rule (to determine which government level administers or has discretion over public spending), for a centralized fiscal system such as Afghanistan, it makes sense to consider two different approaches to assigning fiscal resources across the four levels.

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7 See Appendix B (Section B.7) for a more detailed discussion of the Programme-Budgeting program and the Provincial Budgeting pilot exercise.
8 For convenience, this level is often referred to in this report as the ‘provincial administration’ although, as described earlier, there really is no such thing. It includes the districts.
different levels identified above. These two different approaches are termed here the ‘disbursement metric’ and the ‘expenditure metric’.

23.  **Disbursement metric.** To date, the common approach to assigning public finances to different administrative and government levels in Afghanistan has relied on the point of disbursement of public expenditures. Under this metric, if a public expenditure was disbursed at the provincial level (through a provincial mustoufiat) then it is considered a provincial expenditure. Similarly, if a payment was processed through the central treasury then it is considered a central expenditure. Likewise, if the final point of disbursement for a public expenditure is a municipality or LSDE, then this disbursement should be assigned to that government level or tier.

24.  The disbursement metric describes a certain reality in Afghanistan, but is highly misleading as a way of understanding how resources are actually used across different levels of government or administration. It implies that any expenditure which is centrally disbursed is expended on an activity which is directly administered by the central offices of any line ministry (or other government agency), or which benefits a central, as opposed to a subnational, institution. Moreover, the disbursement approach fails to account meaningfully for expenditures in which the central administration level procures inputs for activities which are executed at the provincial level (medications which are centrally procured but dispensed through provincially managed clinics, for example). The disbursement metric simply disregards such ‘in-kind’ transfers.

25.  **Expenditure metric.** In order to deal with these weaknesses and get a more realistic sense of the vertical and horizontal expenditure patterns within the public sector in Afghanistan, this study has defined a second approach or ‘metric’ as a device to assign financial resources to different government/administrative levels. This is referred to as the (subnational) ‘expenditure metric’. Under this metric, a subnational expenditure is taken to occur when disbursement takes place at the subnational level or one or more of the following three conditions holds true:

   a. subnational (e.g. provincial) officials have some degree of resource allocation control;

   b. the expenditure directly benefits a subnational institution;

   c. the expenditure is used for the development or operation of a subnationally managed facility.

26.  In the ensuing analysis, the expenditure metric was applied to public expenditures at all government levels and administrative tiers. The application of the expenditure metric is explained in Box 1.1 through examples of what is considered a central expenditure versus a subnational expenditure. The assignment of expenditures to different government levels and administrative tiers under both metrics was based on a careful review of various budget documents, including central government expenditure data extracted from the central treasury system (covering both central and provincial administrative levels). In addition, the analysis relies on available financial data for municipal and LSDE expenditures. The assignment of expenditures in accordance with the expenditure metric is discussed in greater detail in Annex C. It should be stressed that the use of this metric does not indicate anything about the extent to which the intergovernmental system in Afghanistan is (or should be) substantively devolved. As will be seen shortly, one of the most important conclusions of this study is that public expenditures are much more decentralized in Afghanistan than is commonly believed. This should not be taken to suggest that budget authority is substantively devolved to the provincial agencies (on the contrary, in fact) – just that much larger proportions of public resources are used for activities which are managed and executed at the provincial level, or which benefit subnational institutions or facilities, than the disbursement metric implies.
BOX 1.1: EXAMPLES OF SUBNATIONAL EXPENDITURES IN AFGHANISTAN UNDER THE EXPENDITURE METRIC

Ad. 1. The disbursement takes place at provincial level. For instance, when a civil servant’s wage is disbursed through a provincial mustoufiat, this expenditure is considered provincial. Provincial officials are believed to have some degree of control over the establishments (“tashkeel”) in their province, and most civil servants paid at the provincial level contribute to the delivery of public services at the provincial level. As a result, the expenditure metric may overstate provincial expenditures to the extent that recurrent disbursements are made through provincial mustoufiats for “non-provincial” functions (for instance, military salaries). As is shown in the later expenditure analysis by sector, provincial disbursements largely take place in the traditional “subnational” sectors of education, health, agriculture and rural development, and so on.

Ad. 2. Subnational (e.g. provincial) officials have some degree of resource allocation control. For instance, some of Kabul Municipality’s development expenditures are funded and executed through the central government budget. However, since Kabul Municipality prioritizes and prepares the plans for the development projects, these are considered subnational expenditures.

Ad. 3. The expenditure directly benefits a subnational institution. For instance, capacity building support or the development of infrastructure that directly benefits subnational institutions (such as the Provincial Governor’s Office, or District Governors) is deemed to be a subnational expenditure.

Ad 4. The expenditure is used for the development or operation of a subnationally managed facility. For instance, spending on the building and maintenance of schools or classrooms in a province is considered a provincial expenditure, since this function is managed by the provincial education director.

27. Data limitations. The expenditure metric is neither exhaustive nor perfect – it has been developed simply because it allows for a more realistic understanding of intergovernmental expenditure patterns in Afghanistan than the disbursement metric. It should be stressed that data limitations constrain this study’s ability to assign expenditures to different government levels and to measure central versus subnational expenditures with a high degree of accuracy. Data sources, the way in which they have been utilized, and the extent to which data availability limits the accuracy of the expenditure metric is discussed in detail in Appendix C.

1.5. Policy context of this study: Addressing the subnational challenge

28. The main objective of this study is to analyze key features of the intergovernmental fiscal system in Afghanistan and, in so doing, to identify key policy challenges for the government in this area. The study builds on an earlier report, Service Delivery and Governance at the Subnational Level in Afghanistan, (The World Bank, July 2007) which provided an analysis of the institutional structure of the intergovernmental system in Afghanistan, identified key issues and weaknesses, and made recommendations as to how these might be addressed. The current study takes this earlier work as a point of departure which thus provides an important analytic and policy context for interpreting the results and conclusions of the current analysis.

29. The earlier analysis of the intergovernmental institutional structure identified, amongst others, two important features of the system in Afghanistan:

- First, the overall structure is characterized by significant systemic contradiction. Direct formal functional and budget authority for the delivery of most key services in the provinces - such as education, health, water and roads - is held by highly centralized Line Ministries which work in vertically integrated silos with relatively weak, ‘externalized’ linkages between them. However, this system co-exists with –
and is cut across by - the Provincial Governor (PGs) system which allows the PGs to intervene in the affairs of the Line Ministries and other agencies (e.g. the Municipalities) through a number of ‘soft’ institutional channels, some legislated, some not. For example, PGs – who are not ‘downwardly accountable’ – hold extensive powers over the appointments of civil servants to departmental positions in their provinces and they hold approval powers for all expenditures of all the Provincial Departments funded from the core budget. In sum, centralized modalities of service-delivery are combined with – and subject to – a range of interventionist powers on the part of the PGs in a way which blurs and undermines accountability and introduces significant organizational inefficiencies

- Second, existing institutional arrangements are often highly inefficient. In particular, Line Ministries tend to be over-centralized, with their central offices in Kabul retaining functions which could more efficiently be performed at the provincial level. To some extent this problem is not unrelated to the one discussed above. So long as Line Ministries perceive that any significant deconcentration of budget or functional authority to their Provincial Departments is likely only to make these authorities subject to influence and capture by the Provincial Governors, they are unlikely to have much incentive to do so.

30. Given the Afghan constitutional dispensation and the prevailing political climate, both of which preclude any significant political devolution to the provincial level, the report identified a number of general measures to deal with these weaknesses. Two of the most important of these were:

- To establish an overall direction for reform of the SN institutional system which diminishes the existing levels of systemic contradiction and begins to reduce the unproductively ‘mixed’ character of current arrangements. This implies (i) it is important to strengthen and consolidate the role of the office of the Provincial Governor in the areas of co-ordination and planning, while limiting it with respect to the exercise of functional, budget and operational authority in the delivery of main services which fall under the Provincial Line Departments; and (ii) in order to enhance accountability the oversight and ‘supervisory’ role of the PCs to provide checks and balances over the activities of the delivery agencies should be strengthened;

- To strengthen the performance of the main service-delivery agencies through improving their organizational structures. One key, cross-cutting activity in this area is for Line Ministries to ensure that functions are divided between their Central offices and the Provincial Departments in order to improve their organizational efficiency. In a number of cases this is likely to involve the deconcentration of various powers and functions of the Line Ministry from Central to Provincial Department level.

31. As will become clear in later sections, the analysis provided in this report complements, on the fiscal side, the analysis and overall policy thinking that the earlier report contained in respect of the institutional dimensions of the intergovernmental system in Afghanistan.
2. THE VERTICAL ALLOCATION OF PUBLIC EXPENDITURES IN AFGHANISTAN

32. One of the most important dimensions along which to assess an intergovernmental fiscal system is the vertical allocation of resources. The vertical allocation of resources indicates how the public resource pool is divided between different levels of government and administration.

33. As discussed in Chapter 1, the vertical allocation question could be answered based on two different approaches. First, financial resources could be assigned to different government levels based on the traditional disbursement approach. Second, the vertical allocation of resources could be analyzed based on the government level at which the public resources are used, in accordance with the expenditure metric. In this chapter, the vertical allocation of resources will be analyzed in accordance with both the disbursement and expenditure metrics.

34. Given that the Afghan budget is expressed in two currencies (with the recurrent budget reported in Afghanis (Afis.), and the development budget generally denominated in US dollars, the analysis of the overall budget was standardized in US dollars (with conversions in Afghanis indicated as appropriate), unless noted otherwise. Solar year 1385 (2006/07) was chosen as the primary financial year for this analysis, since this is the latest completed financial year for which most data are available at the time of writing, including both budget plans as well as budget execution data. The data used for the analysis and details of the attribution of resources to different government levels in this chapter is discussed in Appendix C.

2.1 The overall vertical allocation of public resources

35. Figures 2.1 and 2.2 show the vertical allocation of public resources according to the two different metrics: Figure 2.1 shows the vertical allocation of resources based on which government level or tier disbursed the funds; Figure 2.2 highlights which level or tier was the ultimate beneficiary of the resources in accordance with the expenditure metric. Both pie charts divide up the actual public expenditures that were made in SY 1385 (which, as noted in Figure 1.1 amounted to US$ 2,322.0 million).

36. Consistent with the commonly-held view that Afghanistan’s public sector is highly centralized, Figure 2.1 reflects that over three quarters (76%) of public resources are expended through the central treasury (or in the case of the external budget: by the central government’s donor partners) at the central administration level. Provincial mustoufiats manage only 17% of public resources, or less than one-fifth of national budget (central plus provincial government) resources.)
Figure 2.1: The Vertical Allocation of Public Resources in Afghanistan
Actual Public Spending (in US$ mn), SY 1385

- Central Provinces: 1,775.7 (76%)
- Municipalities: 388.7 (17%)
- CDCs: 107.9 (5%)
- 49.6 (2%)

Figure 2.2: The Vertical Allocation of Public Resources in Afghanistan
Benefits from Public Spending (in US$ mn), SY 1385

- Central Provinces: 709.6 (31%)
- Municipalities: 1,416.2 (61%)
- CDCs: 143.6 (6%)
- 52.6 (2%)

37. Figure 2.2 reflects the vertical allocation of public resources under the expenditure metric. This figure provides a substantially different picture of the vertical allocation of public resources in Afghanistan. In sharp contrast to Figure 2.1, Figure 2.2 shows that over 69 percent of public sector spending was spent on operations, service delivery and infrastructure at the subnational level. Under the expenditure metric, 61 percent of public expenditures take place at the provincial level.

38. This data suggests two major findings on intergovernmental finance in Afghanistan. First, whereas the budget authority and formulation are highly centralized in Afghanistan and budget execution through provincial mustoufiats is limited, the total amount of resources that is expended on service delivery and infrastructure development activities which are administered at the subnational level or which benefits subnational institutions is very substantial. In fact, such expenditures account for over 60 percent of all public spending. This finding contrasts sharply with the traditional notion that resource usage in the public sector in Afghanistan is highly centralized.
Second, local government (i.e., municipal and LSDE) spending accounts for only a small portion of the public sector expenditures. The fact that only about 7 percent of public spending takes place via subnational governments may reflect the lack of clear and substantial expenditure assignments to the local levels in Afghanistan (especially the absence of social sector responsibilities such as primary education or public health services). As explored further in Chapter 4, the limited local expenditures also reflect the absence of a sound fiscal framework for municipalities. In turn, the lack of adequate own source revenues at the local level may reflect a mistrust that local entities are able to serve as effective public service providers, or the lack of political/institutional interest from either the central or provincial levels in decentralizing public resources to the local level.

2.2. Analysis of vertical fiscal allocations by budget component

The finding expressed in paragraph 39 is not equally true for every budget component. Substantial variations in vertical allocation patterns are revealed when the intergovernmental distribution is considered across the different components of Afghanistan’s budget. This is illustrated in Figure 2.3.

Panel A in Figure 2.3 presents the vertical allocation of resources in terms of disbursements across the four government levels (central, provincial, municipal, and CDCs) for each of the four main budget components (payroll, O&M, core development, and external development) in a series of bar diagrams. Each bar represents the share of public resources for the relevant budget component that is disbursed at each government level. For instance, 43.1% of payroll expenditures are executed though the central treasury, while 26.2% of O&M expenditures flow through provincial mustoufiats, and none of the external budget flows through accounts at any subnational level. Across the four government levels, the bars for each budget component add up to 100 percent. In this visual representation, if the bars are concentrated on the left-hand side of the graph (gravitating towards the central administration) a centralized fiscal system is indicated whereas the further the centre of gravity of the diagram shifts to the right, the more fiscally decentralized the system would be.

Panel A reveals that the share of public spending that takes place at the subnational administration level (provinces) or at the subnational government level (municipalities and LSDEs) varies substantially by budget component. In particular, payroll expenditures are relatively decentralized to the provincial level (with only 43% taking place at the central level), whereas O&M resources are much more centralized in terms of disbursements, with 72.7% of all O&M expenditures taking place centrally. Development expenditures are managed in an even more centralized manner, with 78.4% of the core development budget directly executed through the central treasury (with most of the remainder of the development spending taking place at the municipal level and through CDCs). Although no external funds are disbursed through the treasury system (either at the central or provincial levels), 100% of the disbursement of the external budget takes place centrally through international donor agencies.

In contrast, Panel B (at the bottom of Figure 2.3) presents the vertical allocation of public resources in terms of the expenditure metric. This graph presents a much more decentralized picture, indicating that the provincial level benefits from a substantial share of the public spending across government levels. The contrast with the disbursement pattern is strongest on the development side of the budget.
44. As far as payroll spending is concerned, the division between the central and provincial levels (under both metrics) depends on the location where the public servant is posted, and thus, where the salary is disbursed. It is therefore assumed that the allocation of payroll expenditures under the expenditure metric has the same vertical impact as the actual disbursements for payroll. Since a majority of civil servants are posted in the provinces (where public service have to be delivered), payroll spending is relatively deconcentrated with over 55.9 percent taking place at the provincial level, compared to 43.1 percent at the central level. The balance of public payroll spending (0.9 percent) is contributed by municipal payroll. In international experience, it is typical for payroll to be the most deconcentrated or
decentralized budget component, as many subnational public services (including basic education, local administration and police) are labor-intensive.  

45. In contrast, the disbursement and expenditure of non-payroll recurrent spending (spending on operation and maintenance) tends to be quite concentrated: only 26.2 percent of O&M is done at province level versus 72.7% at the central administrative level. The fact that O&M expenditures tend to be much more centralized than payroll expenditures is true for Afghanistan as well as for most other countries. There are several reasons for this pattern. For instance, it is not unusual for central ministries to cling to O&M expenditures and resist devolving these funds to the local level, either out of self-motivated reasons or for fear of these funds being misused at the local level. However, the budget data might understate the level of O&M resources provided to the provincial level, as the data do not reveal to what extent the benefits from central O&M are passed on in-kind to the provincial level in Afghanistan. It is thus difficult to pass judgment on the vertical allocation of O&M resources. Nonetheless, it is quite likely that the centralization of O&M and the resulting vertical imbalance between payroll and O&M is hampering public service delivery at the provincial level.

46. The core development budget is the only budget component from which resources are allocated to all administrative and government levels. While virtually all core development resources are disbursed through the central treasury, a majority (52 percent) of the development projects included in the core development budget fund provincial level activities. At the municipal level, in addition to self-funded municipal development expenditures, municipalities benefit from spending by the Ministry of Urban Development and Housing. In addition, Kabul Municipality receives a small amount of development support from the core development budget. Although this support is provided as an in-kind transfer rather than as a monetary transfer, the expenditure metric nonetheless counts this as municipal-controlled spending. The amount which is indicated in Panel A of Figure 2.3 as being disbursed by the CDC level in Figure 2.3 reflects actual CDC expenditures (both from NSP grants received by councils, as well as from community contributions) but excludes the other NSP expenditures that take place at the subnational level (including significant facilitation, capacity building, and administrative expenditures). In contrast, the benefits received by CDCs under the expenditure metric (in Panel B of Figure 2.3) include these indirect expenditures as well. The cumulative impact of these considerations is that while Panel A portrays a highly centralized core development budget in terms of disbursements, Panel B indicates that the core development budget is highly decentralized in terms of the utilization of budget resources, with 77 percent of core development spending funding provincial or local government activities.

47. Finally, under the disbursement metric, the external development budget is considered fully centralized, as the disbursement of these resources does not take place through the provincial moustoufiats, but rather takes place directly from international donor agencies as coordinated with central authorities. In contrast, their classification under the expenditure metric (based on how these resources are utilized) reveals that over 90 percent of external development resources are ultimately employed for provincial-level activities.

2.3. An intergovernmental analysis of sectoral finances

48. Until this point, the analysis has considered the vertical allocation of resources across all different sectors in an aggregate fashion. As will be noted below, different sectors in

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9 It should be acknowledged that to the extent that provincial payrolls include salary spending on typically ‘central government functions’ (such as security), both the disbursement metric as well as the expenditure metric might somewhat overstate the degree of decentralization to the provincial level. Although security spending is an important budget category in Afghanistan, it should be noted that on-budget recurrent provincial MOD spending in fact accounts for less than 5 percent of total recurrent spending. Out of Afs. 6.6 billion recurrent spending for the Ministry of Defense (MOD), over two-thirds is disbursed through the central treasury.
Afghanistan show substantially different patterns. A more careful analysis of vertical allocation patterns by sector also allows adjustments to be made for sector-specific anomalies in the spending data, which cannot be taken into account in more aggregate-level analysis. Considering the position of each of these sectors is therefore critical in order to determine how the current intergovernmental fiscal and budgetary arrangements are helping or hindering in the delivery of infrastructure and public services in the respective sectors, and what reforms are needed in the realm of intergovernmental arrangements to facilitate infrastructure development and public service delivery.

49. As such, this section will analyze the vertical allocation of sectoral finances for four key sectors that typically deliver their services at the subnational level: (i) public education, (ii) public health, (iii) agriculture and rural development, and (iv) municipal and urban services. In order to place these sectoral discussions in the proper context, Table 2.1 illustrates the relative budgetary shares of selected sector ministries in Afghanistan’s budget. The four sectors listed above account for approximately one-third of total budget spending (across all budget components). Further analysis (not shown in the table) suggests that the eight ministries listed in Table 2.1 account for approximately three-quarters of all provincial expenditures in Afghanistan.

<table>
<thead>
<tr>
<th>Sector / Ministry</th>
<th>Recurrent</th>
<th>Payroll</th>
<th>OM</th>
<th>Core Dev.</th>
<th>Ext. Dev</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>151.9</td>
<td>143.0</td>
<td>8.9</td>
<td>18.1</td>
<td>42.2</td>
<td>212.2</td>
</tr>
<tr>
<td>Public Health</td>
<td>26.5</td>
<td>14.3</td>
<td>12.2</td>
<td>41.2</td>
<td>36.1</td>
<td>103.8</td>
</tr>
<tr>
<td>Agriculture</td>
<td>12.2</td>
<td>9.1</td>
<td>3.1</td>
<td>13.2</td>
<td>17.4</td>
<td>42.8</td>
</tr>
<tr>
<td>Interior</td>
<td>188.9</td>
<td>135.0</td>
<td>53.9</td>
<td>15.3</td>
<td>1.8</td>
<td>206.1</td>
</tr>
<tr>
<td>Public Works</td>
<td>9.0</td>
<td>3.0</td>
<td>6.0</td>
<td>98.6</td>
<td>197.3</td>
<td>304.9</td>
</tr>
<tr>
<td>Rural Development</td>
<td>7.6</td>
<td>3.3</td>
<td>4.3</td>
<td>228.2</td>
<td>63.6</td>
<td>299.4</td>
</tr>
<tr>
<td>Urban and Housing</td>
<td>6.1</td>
<td>0.9</td>
<td>5.2</td>
<td>13.3</td>
<td>25.7</td>
<td>45.1</td>
</tr>
<tr>
<td>Energy and Water</td>
<td>51.2</td>
<td>2.1</td>
<td>49.1</td>
<td>65.6</td>
<td>95.2</td>
<td>212.0</td>
</tr>
<tr>
<td>Other</td>
<td>415.7</td>
<td>218.5</td>
<td>197.1</td>
<td>213.7</td>
<td>206.4</td>
<td>835.7</td>
</tr>
<tr>
<td>Total</td>
<td>869.0</td>
<td>529.1</td>
<td>339.9</td>
<td>707.3</td>
<td>685.7</td>
<td>2,261.9</td>
</tr>
</tbody>
</table>

Note: Central government spending includes expenditures at both central and provincial administrative tiers.

50. Basic education. Basic education is widely seen as one of the most critical public services in Afghanistan. Not only does education have an important impact on the country’s economic growth and poverty reduction, but widespread access to basic education is also seen to be a major factor in achieving security and good governance in the country. As such, improvement of basic education is one of the main priorities identified in the ANDS.

51. Accordingly, basic education has been an important public spending priority, absorbing significant amount of public resources. As indicated in Table 2.1, actual education payroll spending for SY 1385 (2006/07) comprised US$ 143 million, which represents over one-quarter (27%) of total payroll spending included in the national (operating) budget. In addition to the large amount of payroll expenditures, significant amounts of development spending were budgeted within the education sector for SY 1385 (US$ 161 million; not shown in the table). However, due to weak budget execution in the core and external budgets,

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10 Although security is a public function of overriding importance in Afghanistan, we choose not to analyze this sector, as this function is funded to a large extent through extra-budgetary mechanisms. It is expected that for the near future, the funding provided to the ANA and ANP (as well as other security-related expenses) will continue to be funded in a way that circumvents the regular budget process. Likewise, the public works sector was not analyzed here in-depth, since the sector predominantly implements very large scale infrastructure projects that are mostly funded through the external budget.
only US$ 60.3 million was actually spent on education development. In contrast, relatively few non-wage operating expenditures were budgeted or spent as part of the basic education budget for 1385 (US$ 8.9 million).

52. Figure 2.4 shows the different vertical allocation patterns for education expenditures, comparing the disbursement metric (Panel A) with the expenditure metric (Panel B). Note that Figure 2.4 (as well as subsequent figures in this chapter) present disbursements and spending in millions of dollars rather than showing the relative share of public spending at each government level for each budget component. The advantage of this approach is that the diagram shows not only the relative allocation of resources for each budget component across different government levels, but is also able to convey the relative importance of each budget component within the sector.

53. A consideration of the vertical allocation of resources within the education sector on the disbursement metric (Panel A), indicates that basic education expenditures are relatively decentralized as the preponderance of the sectoral finances (largely payroll) are disbursed at the provincial level. In addition to these payroll resources, approximately US$ 5 million was disbursed through the provincial level for operation and maintenance expenditures. Essentially all other education resources were disbursed at the central government level.  

54. When the vertical allocation of education resources is considered in accordance with the expenditure metric (Panel B), only a slightly different picture emerges. The biggest difference between the two patterns is visible in the development budget; while most education development projects are accounted for centrally, most of these development resources ultimately are used to support and develop the provision of educational services at the provincial level, rather than being retained at the central administrative level.

55. Whereas the education disbursements and expenditures are relatively decentralized, nonetheless, two intergovernmental aspects of the budget process seem to stand in the way of the sound financing and delivery of primary education at the provincial level in Afghanistan: first, the limited amount of non-payroll operational resources that found their way to the provincial level in 1385, and second, the poor implementation of (core and external) development spending that was intended to benefit the provincial level.

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11 In practice, some core development spending for EQUIP is actually transacted through provincial mustoufiats. Unfortunately, no indication was available to us what share of education development spending this constitutes.
Figure 2.4: The Vertical Allocation of Education Resources in Afghanistan

Panel A: Disbursement by government level, SY 1385

Panel B: Expenditure by government level, SY 1385
56. **Public health.** The health sector displays substantially different budgetary and intergovernmental fiscal patterns than the education sector.\(^{12}\) The different budgetary patterns for the health sector are largely a direct result of the financing and service delivery modality chosen by the health sector in Afghanistan. In contrast to the education sector – which relies on a traditional public approach to the delivery of basic education – the Ministry of Public Health has adopted an approach whereby the private sector and NGOs deliver basic health services. Therefore, rather than providing health services by attracting large numbers of medical personnel and delivering health services through the public sector in most provinces, the Ministry tenders contracts for the provision of a prescribed Basic Package of Health Services (BPHS) to the private or non-governmental sector. With the exception of a handful of provinces, the delivery of basic health services under BPHS is funded through the development budget. In fact, a large share of BPHS is funded through the external development budget. Notwithstanding the centralized contracting and disbursement process, the BPHS is delivered mainly through facilities and activities which are subnational (provincial and local) in character. This is also true for those provinces where basic health is delivered via the public sector rather than contracted out.

57. Whereas contracting-out of basic health services has allowed the health sector to rapidly ramp up the expenditures on basic healthcare services, the chosen funding approach (funding BPHS largely through the development budget) has created a number of its own problems. Whereas the bulk of primary health services are funded through the (core and external) development budgets, in truth, BPHS spending is largely recurrent in nature. As such, the budget provides a highly distorted picture regarding the real composition of sectoral finances by substantially understating recurrent health spending while over-stating development spending in the health sector.

58. As a result of this funding structure, the disbursement metric picture of expenditures in the health sector is highly centralized (Figure 2.5; Panel A), with virtually all sectoral resources disbursed at the central level. This is particularly true for the sector’s development budget, which is wholly disbursed either through the central treasury or by the donor agency at the central government level. In contrast, Panel B allocates health care expenditures in accordance with the expenditure metric. This figure shows that the large majority of financial resources ultimately fund recurrent health activities which are undertaken at the provincial level.

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\(^{12}\) First, the planned budget expenditures for the health sector (particularly when only considering the recurrent and core development budget components) is substantially lower than the primary education sector, possibly suggesting that public health provision is, relatively speaking, a lower budget priority of the Government of Afghanistan. Second, the composition of the health sector budget is very different, with the operational budget (payroll and O&M spending) being only a small portion of the sector budget. In contrast, core and external development spending comprise the largest components of the sector’s budget plan. Third, in stark contrast to the education sector, the budget performance ratio of development spending in the health sector is significantly above average. In fact, the budget performance of the external budget (when compared to the budget plan for the beginning of the year) exceeds 100%. As a result of the strong budget implementation, actual health care expenditures come close to matching education expenditures, whereas the budget plan for the health sector is only half the size as planned education sector spending for 1385.
Figure 2.5: The Vertical Allocation of Health Resources in Afghanistan

Panel A: Disbursement by government level, SY 1385

Panel B: Expenditure by government level, SY 1385

59. Agriculture and rural development. Agriculture and rural development sector (defined here as spending of the Ministry of Agriculture and the Ministry of Rural Rehabilitation and Development) expenditures reveal yet another intergovernmental expenditure picture (see Figure 2.6)\textsuperscript{13}, due largely to the more capital-intensive nature of the sector. In contrast to the social sectors, most of the spending in agriculture and rural development is aimed at development activities and infrastructure development. In contrast to the health sector, the rural development sector funds the majority of its development activities through the core budget.

\textsuperscript{13} The MRRD budget accounts for the lion share of the sectors budget, with the Ministry of Agriculture budget contributing only $42.8 million in actual spending, versus MRRD’s $299.4 million for SY 1385.
Part of the sector’s success in managing financial resources (particularly for MRRD) has been by the reliance on Project Implementation Units (PIUs) that operate within – rather than around – the Ministry. Furthermore, by the very nature of rural development, MRRD seems to have been more sensitive about the geographical distribution of resources in comparison to other sectoral ministries. For instance, it has developed its own project MIS system (preceding AFMIS), with which it is able to develop and track programme-based activities and budgets by province.
61. Another significant feature of the agriculture and rural development budget is that a large share of the sector’s budget is not spent by the Ministry itself, but rather transferred under the National Solidarity Programme (NSP) to Community Development Councils in the form of CDC grants. The fact that financial resources are actually transferred to the CDC level and spent from CDC budgets in accordance with Community Development Plans means that, both in terms of the final point of disbursement as well as in terms of expenditure benefits, the sector is relatively decentralized.

62. Consistent with the patterns noted in the other sector discussions, the expenditure of funding in the agriculture and rural development sector is more decentralized than the disbursement of these resources suggest, on account of the fact that many development projects are procured and executed centrally for the benefit of provincial infrastructure, capacity building and service delivery. For instance, whereas spending for the National Area-Based Development Programme (NABDP) exclusively takes place at the central government level, benefits from this programme are felt at the provincial (and district) levels.14

63. Urban and municipal services. The final sector highlighted in this chapter is urban development and municipal services.15 In principle, this sector encompasses the spending of the Ministry of Urban Development and Housing (MUDH), along with self-funded municipal-level spending. Central government allocations to Kabul Municipality in the development budget are also counted towards urban spending. Municipal spending includes spending on typical local public services such as municipal waste collection, urban water supply and sewer services, minor urban infrastructure, street cleaning, and other such local services.

64. Approximately US$ 100 million was spent on urban development and municipal services in 1385, with roughly half contributed by the municipal level itself, and the other half contributed by MUDH.16 Figure 2.7 presents the vertical allocation of all spending on urban development and municipal services, including both ministerial expenditures as well as municipal own-revenue spending. Given that municipal spending is fully self-funded, the vertical allocation of resources based on disbursements (in Panel A) reveals a clear dichotomy in sectoral funding, with roughly half of the sector’s resources raised (and hence, disbursed) at the municipal level itself, whereas almost exactly half of the sector’s resources (those which are spent through MUDH, plus development expenditures for Kabul Municipality) are channelled through the central treasury.

65. Since the delivery of many municipal services (such as refuse collection, street cleaning, and administration) are rather labour-intensive, it is surprising to find that recurrent expenditures play only a small role in the delivery of municipal services in Afghanistan. This may either reflect a local bias towards development spending; the under-payment of municipal staff; and/or the imposition of limitations and controls by the central government on municipalities preventing them from expanding the size of their tashkeels in favor of municipal development spending.

14 As noted in Section 2.3, whereas CDC-level disbursements include the spending of the CDC grant along with community contribution, CDCs also receive the benefit of community organization and capacity building support from Facilitating Partners, which are funded centrally through MRRD. These latter are counted as central government resources under the disbursement metric, but CDC-level expenditures under the expenditure metric.
15 Note that in addition to the discussion here, Section 4 deals in greater detail with municipal and LSDE finances.
16 See the discussion in Section 4 surrounding the estimates (and the caveats placed regarding) the estimate of municipal revenues.
The vertical allocation of sector spending –based on the expenditure metric- portrays a highly decentralized picture, with most of the benefits from public spending in the sector falling squarely on service delivery at the subnational (in this case, municipal) level. Indeed, a review of the spending program of MUDH reveals that many of the Ministry’s development projects are traditional municipal infrastructure projects, including municipal/urban water supply projects and other types of municipal projects, including support for reforms in Kabul Municipality.
2.4. Chief conclusions

67. Although different budget components and different sectors show distinctly different intergovernmental fiscal patterns, the comparison between subnational disbursements and subnational expenditures suggests that public expenditure in Afghanistan is much more decentralized than previously believed. While the disbursement metric indicates that only 24 percent of public resources is channelled to the subnational level, the expenditure metric suggests that over two-thirds (69 percent) of public resources is spent on subnational-level activities.

68. However, as section 1.2 indicates, budget authority and the budget formulation process in Afghanistan are highly centralized. In other words, the analysis reveals a substantial disconnect between the vertical pattern of expenditure allocations and the character of the intergovernmental budget structure. In principle, this disconnect might not be a problem if central government line officials were able to make budgetary and other decisions affecting service delivery at the subnational level informed by clear and detailed information regarding provincial expenditure needs. However, there is clear evidence that significant information asymmetries between the different administrative levels make it difficult for central line ministries to prioritize across provinces and among provincial-level activities.\(^{17}\) As such, the disconnect between the relatively decentralized nature of public expenditure in Afghanistan and the highly centralized system of budget authority stands as a serious constraint to the efficiency of planning and implementation of large proportions of the national budget.

69. Put differently, the vertical fiscal imbalance in Afghanistan is not necessarily a resource imbalance (though there may be elements of this); rather it is an imbalance of discretion or authority over provincial resources. Such over-centralized decision-making contributes to problems such as the selection of low-priority provincial projects; schools without teachers, and bottlenecks in provincial project implementation. To resolve this imbalance it will be necessary to address the budget process, as MoF is currently doing through the provincial budgeting reform pilots. It will also be necessary to address the distribution of budget authority across different levels of administration. The Afghan Constitution, political realities and institutional considerations – particularly the absence of downwards accountability mechanisms at the provincial level – limit the number of feasible and sensible options that are available. Broadly, however, steps to bring greater alignment between public expenditure patterns and the intergovernmental fiscal structure should be undertaken within the context of a sectorally deconcentrated system (i.e. decentralizing budget authority within the line departments) as opposed to a territorially deconcentrated one (i.e. giving greater budgetary resources and authority to the Provincial Governors), and in accordance with the existing centralized (central-provincial) treasury structure.\(^{18}\)

\(^{17}\) For instance, the horizontal fiscal imbalances uncovered in Chapter 3 provide a clear indication that central ministries have difficulty arriving at a rational provincial allocation of resources. In addition, there is ample anecdotal evidence that central allocation processes do not connect with provincial needs. The inability of the centre to effectively recruit teachers to be employed at the provincial level is an example.

\(^{18}\) See Appendix A (Box A.1) for a discussion on sectoral versus territorial deconcentration.
3. THE HORIZONTAL ALLOCATION OF SUBNATIONAL RESOURCES IN AFGHANISTAN

70. Chapter 2 focused on the vertical allocation of financial resources, or the distribution of resources (and the benefits from spending those resources) between different government levels. In contrast, the current chapter considers the horizontal allocation of resources. Horizontal fiscal balance is achieved when the financial resources provided to a government level (or administrative tier) are distributed among the jurisdictions at that level in a manner that balances the resources available to each jurisdiction with each jurisdiction’s expenditure needs. In other words, horizontal fiscal balance is achieved when fiscal resources are distributed ‘fairly’ across the national territory.

71. One of the concerns with the current intergovernmental (fiscal) system in Afghanistan is that the system appears to have led to substantial horizontal fiscal imbalance. As shown later in this chapter, substantial variations exist in the levels of per capita fiscal resources provided to different provinces.

72. The horizontal distribution of fiscal resources across subnational jurisdictions affects the relative level of public service delivery between those jurisdictions and is thus an important issue in itself. Moreover, to the extent that the visible provision of key public services (such as basic education and public health) and public infrastructure (such as roads) is an important element in improving the credibility of the public sector and the long-run security situation in the country, assuring horizontal fiscal balance is an important part of achieving success in all three components of the ANDS (security, governance and economic policy).

73. The discussion on the horizontal allocation of public resources is divided into five sections. Section 3.1 presents an overview of the overall horizontal allocation of resources at the provincial level. The next sections consider the horizontal allocation of recurrent resources, both in aggregate (in Section 3.2) and then by sector (in Section 3.3). Section 3.4 analyzes the horizontal allocation of development spending among provinces. Concluding observations are made in Section 3.5.

3.1 The overall horizontal allocation of provincial resources

74. To the extent possible, the analysis of the overall horizontal incidence of public expenditures is based on the ‘actual’ distribution of resources across provinces for SY 1385 (2006/07) based on the expenditure metric. The contrast between the disbursement metric and the expenditure metric is much less relevant in the case of the analysis of horizontal allocations presented in this chapter. With regard to the horizontal allocation of recurrent resources, the data do not allow us to make a distinction between provincial disbursements and provincial expenditures.

75. Descriptive statistics for the overall horizontal allocation of resources to the provincial level (combining recurrent provincial spending and development spending at the provincial level) are shown in Table 3.1 for a selected group of ministries.19

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19 The selected ministries include sectors that are typically active at the provincial level, including the Ministry of Education; Public Health; Agriculture; Interior; Public Works; MRRD; Urban Housing and Development; and Energy and Water. These eight ministries account for two-third of recurrent provincial spending. Data limitations make it impractical to analyze the overall horizontal allocation of resources across all ministries.
Table 3.1: Descriptive Statistics for Per Capita Provincial Spending for Selected Ministries, 1385 (in Afs, per person)

<table>
<thead>
<tr>
<th></th>
<th>Recurrent Spending</th>
<th>Core Dev Spending</th>
<th>Total Spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average</td>
<td>750.2</td>
<td>296.5</td>
<td>1,063.4</td>
</tr>
<tr>
<td>Std Deviation</td>
<td>306.8</td>
<td>334.2</td>
<td>421.2</td>
</tr>
<tr>
<td>Coef. of Variation</td>
<td>0.409</td>
<td>1.127</td>
<td>0.396</td>
</tr>
<tr>
<td>Minimum</td>
<td>198.4</td>
<td>1.2</td>
<td>275.1</td>
</tr>
<tr>
<td>Maximum</td>
<td>1,590.6</td>
<td>1,144.0</td>
<td>1,722.5</td>
</tr>
<tr>
<td>Total (Afs. million)</td>
<td>14,007.3</td>
<td>5,329.4</td>
<td>19,336.7</td>
</tr>
</tbody>
</table>

76. For the selected group of ministries included in Table 3.1, the average level of provincial spending is Afs. 1,063 per capita (slightly more than US$ 21 per person). However, as shown by the other descriptive statistics in the table, there are substantial variations in spending levels across different provinces, as indicated by the different measures of dispersion and range.20 For instance, the analysis shows that the best-off province benefits from 6 times more in resources than the least-endowed province (1722 / 275). Furthermore, judging both by the coefficient of variation as well as the range, the per capita variations in provincial spending are substantially greater for development spending than for recurrent spending.

77. Another notable statistic (not shown in the table) indicates that the correlation between per capita recurrent spending and per capita development spending across provinces is negative (-0.12), meaning that provinces that receive less in operational resources receive more in development resources. One possible interpretation of this inverse relationship is that previously under-serviced areas with infrastructure deficits are receiving more infrastructure resources to catch up. An alternative explanation might be that substitution is taking place between recurrent and development expenditures: if a province loses out in the recurrent budget process, policy makers try to make up for it on the development side of the budget, and vice versa. This may be politically expedient to the extent that resources are fungible and development expenditures can be used to fund the operational cost of delivering services. However, if recurrent spending and infrastructure spending are complementary in nature, then the current resource allocation pattern (where recurrent and development expenditures are either negatively correlated, or at best, uncorrelated) could have a potentially substantial negative impact on the overall quality of service delivery at the provincial level.

78. However, it is hard to draw any definitive policy conclusions from the descriptive statistics in Table 3.1 due to the high level of aggregation. The subsequent sections (Sections 3.2-3.4) break down the analysis by the recurrent and development expenditures and by sector.

3.2 The horizontal allocation of recurrent spending

79. Table 3.2 presents detailed descriptive statistics for the horizontal allocation of recurrent spending across provinces. The table suggests that a province spends an average of Afs. 988 on recurrent activities using financial allotments from the centre when considering the provincial spending of all primary budget units (ministries). Consistent with the conclusion of Table 3.1, Table 3.2 indicates that there is considerable variation in recurrent spending across provinces, ranging from Afs 220 per person to Afs 1903. As such, the best-off province receives almost 9 times more in recurrent resources than the worst-off province in terms of recurrent funding. Such large differences cannot be explained by variations in

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20 Whereas the standard deviation is a common measure of dispersion, the standard deviation is not neutral with respect to the scale of the variable. The Coefficient of Variation (CV) is defined as the standard deviation divided by the mean.
provincial cost levels or differences in expenditure needs between provinces. This main conclusion remains essentially unchanged if the analysis is limited to the sub-group of eight ministries for which further expenditure details are available.

Table 3.2: An Analysis of Per Capita Recurrent Provincial Spending, 1385

<table>
<thead>
<tr>
<th></th>
<th>Total Average</th>
<th>Total Payroll Average</th>
<th>OM Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average</td>
<td>988.0</td>
<td>750.2</td>
<td>609.8</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>413.0</td>
<td>306.8</td>
<td>231.7</td>
</tr>
<tr>
<td>Coefficient of Variation</td>
<td>0.418</td>
<td>0.409</td>
<td>0.380</td>
</tr>
<tr>
<td>Minimum</td>
<td>219.7</td>
<td>198.4</td>
<td>188.7</td>
</tr>
<tr>
<td>Maximum</td>
<td>1,903.3</td>
<td>1,590.6</td>
<td>1,110.3</td>
</tr>
<tr>
<td>Max/Min Ratio</td>
<td>8.7</td>
<td>8.0</td>
<td>5.9</td>
</tr>
</tbody>
</table>

80. The information contained in Table 3.2 is presented in greater detail in Figure 3.1 in the form of a bar chart. Rather than merely showing the descriptive statistics, the figure shows the different levels of recurrent spending engaged in by different provinces. The figure reveals that, surprisingly, Kabul Province is the worst-off province in terms of recurrent per capita resources, with provincial-level spending of only Afs. 219 per person. (In contrast, Nuristan is the best-off province in terms of per capita recurrent spending, at Afs. 1,903 per capita). The finding that Kabul Province is the worst-off province in terms of recurrent spending stands in stark contrast to the common perception that Kabul Province receives more than its fair share of the country’s financial resources.

Figure 3.1: The Horizontal Allocation of Public Resources in Afghanistan Per capita Recurrent Spending by Province, SY 1385

81. There is not a country in the world where every subnational jurisdiction spends exactly the same per capita amount, and there are good reasons for this. For instance, provinces with higher expenditure needs (for instance, a province with a higher poverty rate or with inaccessible terrain) might receive greater resources from the centre to offset the higher cost of service delivery and to engage in poverty alleviation. Alternatively, political

21 For reference, this degree of variation is not unlike the range of fiscal disparities encountered in other countries, such as China (max-min ratio: 10.4), and Indonesia (max-min ratio: 10.8). However, horizontal fiscal disparities in these countries are driven by large inequities in own revenue sources and shared revenue sources across provinces or regional governments. One would expect smaller horizontal disparities in countries that rely (almost) exclusively on intergovernmental financial flows to fund subnational governments, such as Mozambique (max—min ratio: 2.5) or Tanzania (max-min ratio: 7.0).
and institutional realities may result in the opposite pattern: less urban provinces with higher poverty rates or other unfavourable conditions might actually receive fewer public resources, since rural, illiterate communities often demand fewer public services, while at the same time teachers and other public officials have a tendency to prefer to live in well-off, urban areas. An additional consideration in Afghanistan would be the impact of the security situation in different provinces and districts on the ability of the government (as well as the private sector or NGOs) to deliver public services.

82. With adequate data availability, multivariate incidence analysis could be used to uncover the main determinants of the variations in inter-provincial resource allocations.\textsuperscript{22} International research in this area has shown that horizontal allocations are often influenced by several factors, such as differences in subnational expenditure needs (with needier jurisdictions typically receiving more resources), differences in the economic potential of the region, the population size of jurisdictions, as well as the political power of different subnational jurisdictions. While a comprehensive multivariate analysis of inter-provincial expenditure variations falls beyond the scope of the current study, it is likely that to a large extent the variations in recurrent spending in Afghanistan are unintentional or random, and that the degree to which these variations reflect cost differences or true variations in the policy environment faced by provinces is limited. Certainly, there is no clear policy which determines subnational horizontal distributions on transparent and stipulated policy or other grounds. Instead, different ministries determine the allocation of resources between provinces in a substantially discretionary manner. It appears that different types of notional allocation rules are used by different ministries in order to guide the horizontal allocation of resources during budget formulation. Taken together, however, historical allocation patterns, institutional and political factors, the perceived absorptive capacity of different provinces and the provincial security situation seem to be more important factors in determining provincial allocations than policy-driven allocation factors.

83. One pattern that was revealed by a preliminary analysis of the provincial spending data is that there is a substantial negative correlation between the provincial population and per capita recurrent spending (-0.47).\textsuperscript{23} The negative relationship is clearly shown in Figure 3.2. Whereas one might argue that this correlation is spurious (since population is included in the denominator in the definition of per capita spending, per capita spending has to go down as population increases), this pattern nonetheless suggests that on a per-person basis, more populous provinces in Afghanistan are provided with fewer recurrent resources per resident to deliver public services.

\textsuperscript{22} See Boex and Martinez-Vazquez (2004) for a review of the determinants and international experience with respect to horizontal allocation of government resources.
\textsuperscript{23} This pattern persists even after adjusting for Kabul Province, which is an outlier (r = -0.38).
While there are several potential economic justifications why more populous jurisdictions need fewer resources per capita (see Box 3.1), the strong, inverse relationship that is uncovered appears hard to justify on economic grounds. In addition, the variation in per capita recurrent spending that is not explained by differences in population size appears unsystematic and substantial in scale.

Variations in payroll and O&M spending. Another dimension of concern in the review of the horizontal incidence of recurrent provincial spending is the separation between payroll expenditures and non-wage (O&M) expenditures. In addition to analyzing the horizontal allocation of recurrent resources, Table 3.2 further presents the breakdown of provincial recurrent spending into payroll and non-payroll spending (for the same selected group of ministries identified earlier). For this subset of ministries, over 80 percent of recurrent spending at the provincial level is for payroll and reveals extreme variations among provinces in the allocation of O&M resources.

Although public finance theory and international best-practices suggest that payroll and non-payroll expenditures should be planned together in a unified process, in Afghanistan (as in many developing and transitional countries) different planning and approval processes exist for the approval and funding of public service establishments (taskeels) as opposed to the allocation processes used for non-wage spending. As a result of the different processes involved in planning and implementation of wage expenditures versus non-wage expenditures, a somewhat different pattern emerges. Whereas the best-off province receives eight times more in recurrent resources per resident than the worst-off province for the selected ministries, per capita payroll spending is somewhat less variable than overall recurrent spending (with a maximum-to-minimum ratio of 6). In contrast, O&M expenditures show much greater dispersion, although the dispersion of O&M expenditures is driven in part by a number of outliers (particularly Kabul on the low end and Nuristan on the high end). Yet despite the different allocation processes used for determining wage and non-wage expenditures, there is a relatively high degree of correlation (0.77) between overall per capita provincial payroll expenditures and O&M expenditures.
In contrast to common perceptions, Kabul Province is by far the worst-off province in terms of per capita recurrent spending levels. It is unclear why this is, as typically highly urbanized jurisdictions (particularly those with the national capital) demonstrate higher public spending rather than lower public spending. As such, the current finding is rather counter-intuitive. Several economic arguments could be considered as possible explanations why Kabul has the lowest levels of recurrent expenditures in the country:

- The low level of per capita spending in Kabul might be the result of the nature of public goods. To the extent that each province provides a fixed level of so-called ‘pure public goods’ (which can be enjoyed by many people at once), the same amount of spending can be shared by a larger number of people in more populous provinces. As a simple example, a fixed cost (for instance, the cost of running the Provincial Governor’s Office) can be shared by 3 million people in Kabul, whereas the same cost is divided by only 130,000 residents in Panjsher Province.
- Likewise, the higher population density in Kabul could lead one to argue that Kabul in fact has lower needs per person than other provinces, since it is likely much costlier to provide public services (especially in per capita terms) in other provinces due to their lower population density and smaller population.
- Furthermore, Kabul residents are much wealthier than residents in other provinces, and therefore may be much less dependent on public services, but rather rely more on private services (such as private schools, or private health care).

A number of other explanations should be offered as possibilities as well. First, the finding could be a statistical artefact or caused by incomplete fiscal data. It is possible that recurrent expenditures in Kabul Province are routinely disbursed through the central treasury. Similarly, Kabul might draw recurrent resources from the development budget or rely more heavily on services provided either through the central administration, or even through Kabul Municipality.

Another possible explanation is that the population estimate for Kabul might be excessive, therefore under-stating provincial-level expenditures in per capita terms. A related possible explanation is that, as the population of Kabul grew over time, recurrent expenditures have failed to keep up with population growth.

Finally, the pattern might be the result of the political economy of resource allocations and accurately reflect political realities in Afghanistan, which may require greater allocations to be made to provinces outside of Kabul in order to maintain national cohesion.

### 3.3 The horizontal allocation of recurrent resources by sector

In order to be able to make clear policy inferences, it is prudent to analyze the horizontal allocation of recurrent expenditures in greater detail on a sector by sector basis. This is done in Table 3.3. Rather than presenting all descriptive statistics, Table 3.3 focuses on the variation of recurrent resource allocations in each sector. As such, the first three columns in the table present the Coefficients of Variation for per capita payroll, O&M, and recurrent expenditures, respectively, whereas the fourth column shows the correlation between per capita provincial payroll and O&M expenditures in each sector.
Table 3.3: Variation In Per Capita Provincial Expenditure Levels
Payroll, O&M And Total Recurrent Expenditures
(Coefficient Of Variation And Correlation Coefficients)

<table>
<thead>
<tr>
<th></th>
<th>Payroll</th>
<th>O&amp;M</th>
<th>Total Recurrent</th>
<th>Correlation Payroll, OM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>0.417</td>
<td>0.611</td>
<td>0.400</td>
<td>0.11</td>
</tr>
<tr>
<td>Public Health</td>
<td>1.280</td>
<td>1.231</td>
<td>1.018</td>
<td>0.16</td>
</tr>
<tr>
<td>Agriculture</td>
<td>0.716</td>
<td>0.585</td>
<td>0.647</td>
<td>0.59</td>
</tr>
<tr>
<td>Interior</td>
<td>0.672</td>
<td>0.674</td>
<td>0.638</td>
<td>0.73</td>
</tr>
<tr>
<td>Public Works</td>
<td>0.773</td>
<td>2.245</td>
<td>1.992</td>
<td>0.37</td>
</tr>
<tr>
<td>MRRD</td>
<td>0.800</td>
<td>0.682</td>
<td>0.737</td>
<td>0.92</td>
</tr>
<tr>
<td>Urban</td>
<td>2.048</td>
<td>2.241</td>
<td>2.098</td>
<td>0.91</td>
</tr>
<tr>
<td>Energy and Water</td>
<td>0.925</td>
<td>0.818</td>
<td>0.721</td>
<td>0.36</td>
</tr>
<tr>
<td>Total for Subgroup</td>
<td>0.380</td>
<td>0.644</td>
<td>0.409</td>
<td>0.77</td>
</tr>
</tbody>
</table>

88. Several patterns are revealed by the table. For instance, while payroll generally shows less variation between provinces than O&M expenditures (as noted before), there are significant differences between sectors in the degree of variation that exist in provincial per capita expenditures, both for payroll as well as for O&M expenditures. This should come as no surprise. Based on the nature of service delivery in different sectors, some sectors tend to be provided more equally across the national territory than others. For instance, social sector services tend to be delivered (and therefore, funded) more evenly across provinces than some other government services. In contrast, spending on sectors such as agriculture or urban development tends to vary much more among provinces, based on the greater variations in the need for these types of spending across provinces (based on differences in geographic, demographic or other conditions). In accordance with this expectation, recurrent education spending shows relatively limited variation across provinces in Afghanistan.24

89. Since payroll and non-payroll expenditures are expected to complement each other in the service delivery process, one would hope to find a strong positive correlation between per capita payroll expenditures and O&M expenditures in each sector. While this pattern holds in aggregate (with a correlation coefficient of 0.77), Table 3.3 reveals a relatively weak correlation between payroll and O&M expenditures revealed for several sectors (in particular, education and health expenditures).

3.4 The horizontal allocation of development spending

90. It is not unusual for the horizontal allocation of development resources for a specific year to be much more unequal than the horizontal allocation of recurrent resources, as infrastructure programs tend to be much more discrete in nature and more geographically concentrated. For instance, the horizontal allocation of development resources can easily be biased by one or a few large infrastructure projects. Similarly, it is not unusual for sectoral infrastructure programs to focus on a limited number of subnational governments in any particular year. Another factor that contributes to greater disparities in development spending across subnational governments is the existence of differences in absorption capacity across provinces.

24 In contrast, public health expenditures show an unexpectedly high degree of variation. Further analysis of the data revealed that the variation in the health sector payroll expenditures is largely driven by three outliers (Pashjer, Parwan and Kapisa), each of which spend more than four times the provincial average on health payroll. The high variation in recurrent health spending is the function of the particular service delivery modality chosen by the health sector, which relies on private service delivery for their basic package of health services in 31 of the country’s 34 provinces. As a trial for future sustainability, BPHS is delivered directly by MOPH in Pashjer, Parwan and Kapisa.
91. Figure 3.3 shows the variations in per capita development expenditures across provinces in Afghanistan.\footnote{As noted in Appendix C, Kabul Province is excluded from this analysis.} Not surprisingly, the bar diagram shows a much more unequal distribution of provincial development resources (per person) than was the case for the horizontal allocation of recurrent resources.

![Figure 3.3: The Horizontal Allocation of Public Resources in Afghanistan Per Capita Development Spending by Province, SY 1385](image)

92. Table 3.4 presents the descriptive statistics for the horizontal allocation of development expenditures at the provincial level in Afghanistan, broken down by sector. The Coefficients of Variation indicate that, across the board, per capita development spending shows considerably more variation across provinces than recurrent spending.

<table>
<thead>
<tr>
<th></th>
<th>Education</th>
<th>Health</th>
<th>Ag/Rural Develop.</th>
<th>Urban Develop.</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average</td>
<td>13.62</td>
<td>17.23</td>
<td>51.64</td>
<td>1.17</td>
<td>212.80</td>
<td>296.46</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>29.26</td>
<td>26.84</td>
<td>81.04</td>
<td>3.47</td>
<td>323.83</td>
<td>334.19</td>
</tr>
<tr>
<td>Coeff. of Variation</td>
<td>2.148</td>
<td>1.558</td>
<td>1.569</td>
<td>2.959</td>
<td>1.522</td>
<td>1.127</td>
</tr>
<tr>
<td>Minimum</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>1.18</td>
</tr>
<tr>
<td>Maximum</td>
<td>133.55</td>
<td>90.01</td>
<td>411.94</td>
<td>17.68</td>
<td>1,083.64</td>
<td>1,144.03</td>
</tr>
</tbody>
</table>

Note: ‘Other’ includes provincial development spending by the Ministries of Interior, Public Works, and Energy & Water.

3.5. Chief conclusions

93. Using the expenditure metric defined in Chapter 1, the analysis of horizontal allocations in Afghanistan revealed that there are large variations in per capita expenditure levels between provinces in Afghanistan. In some cases, these patterns followed expectations, while in some other cases, these variations were decidedly counter-intuitive. For instance, the analysis revealed that Kabul Province receives the least recurrent expenditures per person when compared to all other provinces.
Although it is beyond the scope of the current study to identify the exact factors that cause the variations in provincial resources across provinces, differences in provincial expenditure needs are probably only a small part of the story. Instead, historical differences in infrastructure endowment, the impact of the security situation and political economy factors seem to be much more important in explaining the large variations in provincial resource allocations. As such, the expenditure variations indicate pronounced inequities in resource distribution among provinces. While substantial provincial expenditure variations in some sectors (such as agriculture or urban development) are understandable, substantial variations also exist for sectors where provincial expenditures should be more equal, such as education. These provincial inequities have important implications, not only for the delivery of public services, but also for the security situation at the provincial level as well as for the credibility of the national government.

This situation constitutes a significant policy challenge for GoA. In the context of the budget structure reforms suggested in the previous chapter, GoA will also need to consider introducing policies – for example budget/expenditure norms – which, in time, will lead to a more rational, equitable and transparent allocation of public resources across subnational jurisdictions.
4. MUNICIPAL FINANCE AND THE FINANCING OF LOCAL SERVICE DELIVERY ENTITIES

96. In contrast to provinces, which are a deconcentrated tier of state administration, municipalities are recognized in the constitution as the only ‘real’ local government level in Afghanistan. The legislative framework for municipalities (which pre-dates the constitution) assigns them the responsibility to deliver many urban public services, such as refuse collection, recreation and parks, road maintenance and similar urban services and infrastructure. As such, municipalities have their own budgets and are meant to be largely fiscally self-sustaining, as they do not receive any intergovernmental fiscal transfers. Municipal revenue sources include property taxes, local service charges and retail licenses. Despite their high degree of fiscal autonomy, all municipalities are required to seek approval for their annual budgets and staff establishments (municipal ‘tashkeel’ ) through the Provincial Governor’s Office from IDLG. Hitherto this was a responsibility of the Ministry of Interior. Beyond the approval of their annual budgets, municipalities are supposed to be (largely) fiscally autonomous and operate independently.

97. In addition to municipalities, Local Service Delivery Entities and community-based service delivery organizations (such as Community Development Councils and School Management Committees) also exist and operate at the subnational level in Afghanistan. Significant amounts of public expenditures take place through Local Service Delivery Entities. LSDEs derive their existence, budget authority and budget resources not from the constitution or legislation, but rather from national programmes (such as the NSP).

98. The discussion of the vertical allocation of resources in Chapter 2 indicated that local government spending accounts for only a small portion of the public sector’s total resources. As shown in Figures 2.1 and 2.2, approximately 7 percent of public resources is spent at the local level: municipal expenditures account for approximately 2 percent of total public spending, while spending by LSDEs through national programmes accounts for approximately 5 percent.

4.1 Municipal Finance

99. Despite their relatively limited share of overall public finances, municipalities and LSDEs make up an important part of the intergovernmental system in Afghanistan. However, until recently, engagement by the central government and by donor agencies on municipal issues has been extremely limited. With the exception of a limited number of reforms in Kabul Municipality, little attention has been paid to the role of municipalities in the public sector.

100. A number of factors have contributed to the lack of emphasis on municipal reforms and municipal finance. First, unlike the central government and the provincial administrative tier, there are (surprisingly, perhaps) no elected councils yet at the municipal level. Second, it has been possible to largely ignore the municipal level of government with the broader policy framework because they are (almost completely) self-funded, and therefore do not draw resources and attention through the national budget process. Third, due to the scope of functions assigned to municipalities (which exclude key social services) and due to the lack of national coverage of municipal services, municipal reform seems to have been put on the backburner during the initial transition period, while priorities of greater prominence (such as the security situation and pro-poor social services) garnered policy makers’ attention. A possible fourth reason for the limited attention to municipalities might be because municipalities are not necessarily seen by all stakeholders as an autonomous level of

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26 The role of municipalities and LSDEs in the intergovernmental structure of Afghanistan is discussed in greater detail in Appendix A.
government, but rather as entities ‘belonging’ to IDLG (and previously, to the Ministry of Interior).

101. Municipal finance and the vertical allocation of public resources. Whereas the central government budget is highly dependent on external donor funding, municipalities generally do not have access to funding from higher government levels or from international donors. Instead they rely heavily (indeed, almost exclusively) on own source revenues and receive minimal –if any- intergovernmental transfers from the central government. The only municipality that receives direct intergovernmental support is Kabul Municipality, which has part of its municipal development budget funded from the central government budget.27

102. As such, the fact that municipalities in Afghanistan only constitute a small vertical share of public expenditures (2 percent) can be attributed to the fact that municipalities are financially constrained from two sides: on one hand, (as discussed further below) the ability of municipalities to generate own revenue sources is extremely limited, and on the other hand, municipalities receive no intergovernmental transfers. The absence of a fiscal framework that provides municipalities with adequate funding has left municipalities vulnerable to the criticism that they lack the capacity to deliver municipal services and infrastructure. In this context, certain line ministries (in particular, the Ministry of Urban Development and Housing) have stepped in. As discussed in Chapter 3 (Section 2.3 and Figure 2.7), over 50 percent of spending on urban services and infrastructure is currently controlled and disbursed by central government. This practice is causing an imbalance between the vertical allocation as defined by the disbursement metric on one hand, and the vertical allocation as defined by the expenditure metric on the other hand. The lack of a sound municipal fiscal framework is undermining the viability of this sphere of government.

103. Municipal revenues and the horizontal incidence of municipal finances. Since municipalities are essentially self-funded, the ability of municipalities to engage in public spending is highly constrained by their ability to collect municipal revenues. Municipalities have a large number of revenue sources, including a large number of nuisance taxes, providing them with an excessively fragmented municipal revenue structure.28 In combination with low (centrally-determined) local tax rates, the narrow tax base of municipal revenue sources only provides municipalities with a limited revenue potential.

104. Although municipal budgets are subject to review and approval by IDLG, the Directorate does not (yet) systematically tabulate and disseminate formal municipal revenue and expenditure data. The lack of data on municipal finances is a substantial limiting factor in analyzing the ‘fiscal space’ occupied by the municipal level for the current study, and in informing the policy debate surrounding the state of municipal finance. Even compiling the main financial statistics for the country’s major municipalities proved to be a significant challenge (Goga et al., 2007). Given the dearth of official municipal finance data, only unofficial estimates of municipal revenue collections were available for analysis. Based on these unofficial figures, aggregate municipal revenue collections for SY 1385 were estimated to equal AfS. 3,692 million (US$ 73.8 million), or approximately AfS. 776 per capita (US$ 15-16 per capita). These levels of reported municipal revenue collections seem extremely high and most likely reflect inflated self-reporting of revenue collections by municipal officials.

105. A breakdown of municipal revenue collections indicates that collections for individual municipalities range from as little as AfS. 245,000 (less than US$ 5,000) to as much as AfS 846 million (US$ 16.9 million).29 This range in revenue collections reflects the

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27 These transfers are actually made in-kind, as the payments for the development projects for Kabul Municipality are disbursed directly to the contractors by the central treasury.
29 Again, the quality of the available municipal finance data is uncertain. The (apparently self-reported) municipal revenue data is rather suspect, as municipalities consistently report major budget surpluses. Furthermore, the
broad array of urban and rural conglomerations that are covered under the definition of municipalities in Afghanistan. Unfortunately, the overall lack of detail and quality of the municipal revenue data, in addition to the absence of reliable municipal population data, provide obstacles to engaging in any further analysis within the scope of the current study.30

106. One area that – despite the dearth of relevant municipal revenue data – requires some further attention is the likely (in fact, unavoidable) horizontal inequalities in the ability of municipalities to generate revenues. Because the economic base that municipalities are able to tax varies significantly across the national territory, the quality and level of local services that municipalities are able to offer will differ tremendously. This is especially the case in Afghanistan, as in many other countries local differences in revenue-raising capacity are often off-set by some type of equalization grant provided by the central government, so that similar municipalities are able to offer a more equal set of local services at similar levels of local taxation.31 However, as noted above, no such system exists in Afghanistan.

107. Although data on per capita municipal revenue collections (or data on the tax base of different municipalities) are currently unavailable, something can be learned regarding the likely horizontal fiscal imbalance facing municipalities by analyzing the incidence of revenue collections at the provincial level.32 Although municipalities have a defined list of municipal revenue instruments that is distinctly different from the central government’s revenue sources collected in each province, nonetheless municipalities broadly tax the same economic base (within their municipal boundaries) as the central government level, particularly when central government revenues from customs duties are excluded.

108. Within this line of reasoning, Table 4.1 shows the total per capita provincial tax collections (excluding customs revenues) for three groups of provinces, sorted by their population size. In this simple analysis, provincial population size is used as a proxy for the province’s level of urbanization and economic activity, with more populous provinces expected to be more urbanized and prosperous.33 The table shows that fiscal capacity (or revenue potential per person) of medium-sized provinces is nearly twice larger than small provinces, whereas large provinces collect 3-4 times more revenue per person than medium-size provinces. Although the analogy between provinces and municipalities is not perfect, one could speculate that municipal revenue collections could easily display the same range of divergence, with less-fortunate (and potentially smaller) municipalities able to collect only 10-20% of the revenues per person that larger and more prosperous municipalities are able to collect at the same level of effort.

aggregate amount of revenues would suggest municipal revenue collections of around Afs. 775 per urban/municipal resident in Afghanistan, which is extremely high compared to the Afs. 388 collected per person in Kabul Municipality.

30 This is an area where further analysis could substantially enhance the depth of understanding of intergovernmental finances in Afghanistan.

31 International examples of such equalization grants or equalizing grants include the Fund for the Financial Support of the Regions (FFSR) in the Russian Federation; the Equitable Shares transfers received by provincial and local governments in South Africa, and the Dana Alokasi Umum (DAU) in Indonesia. Likewise, many Municipal Funds or municipal development funds around the world also tend to allocate their resources in an equalizing manner.

32 Recall that all revenues collected at the provincial level are in fact central government revenues.

33 An argument could be made that a large share of Afghanistan’s economic activity lies outside the formal economy in poppy cultivation, and that the production of narcotics could have an indirect (multiplier) effect on the economic (and tax) base of (certain) peripheral areas in Afghanistan. The current analysis does not seem to support that contention.
Table 4.1: Provincial Revenue Collections, by Type of Province, 1386

<table>
<thead>
<tr>
<th>Province type (number)</th>
<th>Population</th>
<th>Per Capita Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small province (19)</td>
<td>&lt; 500,000</td>
<td>49.9</td>
</tr>
<tr>
<td>Medium province (10)</td>
<td>&gt; 500,000</td>
<td>91.9</td>
</tr>
<tr>
<td>Large province (5)</td>
<td>&gt; 1 million</td>
<td>343.6</td>
</tr>
<tr>
<td>All provinces</td>
<td></td>
<td>170.3</td>
</tr>
</tbody>
</table>

Note: Revenue collections reflect provincial tax collections for 1386 (excluding customs revenues), up to 10 January 2008 (approx 9 months), as reported by Munez (2008).

109. One area of municipal finance that has not received sufficient attention in Afghanistan is the potential scope for intergovernmental transfers at the municipal level. The potential scale of the municipal horizontal fiscal disparities highlighted in Table 4.1 suggests the need to consider the introduction of some type of municipal grant scheme in order to ensure the sustainable funding of municipalities. While it is laudable that municipalities are able to generate own source funding for municipal services and infrastructure, the current funding structure is resulting in vertical and horizontal fiscal imbalances. This requires central government ministries to provide considerable additional funding in the area of urban development in a manner that largely circumvents the municipal level and holds back the development of capacity at the municipal level to performing the functions assigned to them. This lack of correspondence inevitably will undermine the quality of these services.

4.2 The financing of Local Service Delivery Entities

110. The vertical allocation of LSDE resources. In contrast to municipalities, Local Service Delivery Entities such as Community Development Councils and School Management Committees do not have their own formal local revenue sources. Instead, LSDEs receive their budget authority as well as their financial resources from national programmes, such as the National Solidarity Programme (NSP).

111. In addition to the grant resources provided to the CDC level, CDCs are entitled to collect voluntary contributions from the community. Indeed, in order to receive the NSP’s CDC Development Grant, a minimum community contribution of 10 percent is required. These contributions may either be contributed in monetary terms or in kind. Despite the voluntary nature of these contributions and their possible in-kind nature, these contributions could be considered public revenue collections for the purpose of the current analysis, as they are used to deliver local public services and to construct local public infrastructure.

112. Analysis of financial records for a sample of 537 CDCs (provided by NSP) suggests that the average community contribution for CDC projects is actually 10.7 percent of the grant amount received. Based on the actual amount of CDC grant disbursement under NSP for 1385, it is possible to estimate CDC revenue collections to equal around Afs. 521 million (US$ 10.4 million). It is likely that this estimate reflects the bottom range of the revenue potential for CDCs.

113. CDC spending takes place within numerous sectors, in particular water supply, transport and irrigation, but also power and (albeit to a lesser extent) education. The total impact of these funding flows on the vertical allocation of rural development resources was already shown in Chapter 2 (Figure 2.6). The analysis in Chapter 2 concluded that the fact that financial resources are actually transferred to the CDC level and spent from CDC budgets in accordance with Community Development Plans means that, both in terms of the final point of disbursement as well as in terms of expenditure, the sector is relatively decentralized. Nonetheless, consistent with the patterns noted in the other sector discussions, NSP expenditures (under the expenditure metric) are more decentralized than the disbursement of
NSP resource, since the cost of Facilitating Partners (which provided substantial capacity building assistance to CDCs) are procured and managed centrally by MRRD.

Table 4.2: Sectoral Breakdown of CDC Subprojects
(Since Start of Program, as of 31 March 2007)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Total No. of Subprojects</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>20</td>
<td>0.1</td>
</tr>
<tr>
<td>Education</td>
<td>2,351</td>
<td>10.5</td>
</tr>
<tr>
<td>Emergency Response</td>
<td>10</td>
<td>0.0</td>
</tr>
<tr>
<td>Health</td>
<td>23</td>
<td>0.1</td>
</tr>
<tr>
<td>Irrigation</td>
<td>3,891</td>
<td>17.3</td>
</tr>
<tr>
<td>Livelihood</td>
<td>1,918</td>
<td>8.5</td>
</tr>
<tr>
<td>Power</td>
<td>3,389</td>
<td>15.1</td>
</tr>
<tr>
<td>Public Building</td>
<td>22</td>
<td>0.1</td>
</tr>
<tr>
<td>Rural Development</td>
<td>344</td>
<td>1.5</td>
</tr>
<tr>
<td>Transport</td>
<td>4,763</td>
<td>21.2</td>
</tr>
<tr>
<td>Water Supply &amp; Sanitation</td>
<td>5,727</td>
<td>25.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>22,458</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>


114. The horizontal allocation of LSDE resources. The final dimension to be considered in the discussion of the horizontal allocation of subnational resources in this chapter is the allocation of grant resources to Community Development Councils (CDCs). While CDCs are not local governments per se, they are responsible for the expenditure of significant amounts of public resources.

115. According to project documentation of the National Solidarity Programme, each community with an elected CDC council and a completed Community Development Plan (CDP) is entitled to receive a Block Grant of up to US$ 200 per family under the Program, with a ceiling of US $60,000 per community. Although the structure of the grant provides a strong financial incentive for CDCs to limit themselves to 300 families, CDCs can then engage in larger-scale projects by combining resources through voluntary CDC associations. With an average village comprising 150 families (equivalent to 900 persons), the average block grant provided by NSP to a CDC is around US$ 30,000 (Afs. 1.5 million), which would be equivalent to slightly more than 30 dollars (or about Afs. 1,500) per person. In addition, CDCs match the grant with (monetary or in-kind) community contributions equivalent to 10 percent of the project cost.

116. Since the main source of funding for CDCs is a simple, population-based formula grant allocation, in principle, the horizontal allocation of CDC resources should be straightforward and equitable across CDCs and provinces. However, an analysis of CDC expenditures shows a less clear-cut scenario with substantial variations in per capita CDC spending across the national territory (Table 4.3).
### Table 4.3: Descriptive Statistics of Per Capita CDC Spending By Province

<table>
<thead>
<tr>
<th></th>
<th>Number of Funded CDCs</th>
<th>Average CDC Grant Per Resident (Afs.)</th>
<th>CDC Grant Per Capita (Afs.)</th>
<th>Population Coverage Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average</td>
<td>489</td>
<td>668.6</td>
<td>7,206.1</td>
<td>113.8</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>193</td>
<td>190.3</td>
<td>4,561.3</td>
<td>67.3</td>
</tr>
<tr>
<td>Coefficient of Variation</td>
<td>0.395</td>
<td>0.285</td>
<td>0.633</td>
<td>0.591</td>
</tr>
<tr>
<td>Minimum</td>
<td>44</td>
<td>418.1</td>
<td>714.2</td>
<td>12.5</td>
</tr>
<tr>
<td>Maximum</td>
<td>773</td>
<td>1182.9</td>
<td>26,374.3</td>
<td>327.1</td>
</tr>
</tbody>
</table>

117. Since the CDC grant is one-off funding (rather than an annual grant), the analysis in Table 4.3 takes on board cumulative CDC funding from the program’s inception until the latest date available (September 29, 2007; approximately half-way through SY 1386). Over this period, a total of 16,625 CDCs were constituted and funded, with an average of almost 500 CDCs per province.34

118. The establishment and funding of CDCs has not taken place in an even manner across the country. Whereas universal coverage has been one of the goals of NSP (indeed, NSP reports regularly against this benchmark on the number of provinces and district within the program’s coverage), there are clear variations in the number of CDCs by province, ranging from 44 (Uruzgan) to 773 (Kunduz). Conducive security conditions have been a factor in the successful roll-out of NSP in some provinces and districts, while in others insurgent activity formed an obstacle for implementation. However, it is unclear to what extent the security situation as well as other factors, such as political considerations (or even discretionary factors influencing Facilitating Partners) contributed to the selection and sequencing processes within and between provinces.35

119. The descriptive statistics in Table 4.3 confirm that, whether intended or not, considerable divergence has arisen from the equitable funding targets that are noted in the NSP documents. In particular, the average grant amount per resident of qualifying CDCs appears to be substantially lower than originally intended at Afs. 669 per person.36 Although the grant amount does vary around this mean (with a standard deviation of 190 Afs.), the grant amount per CDC resident does not appear to suffer from excessive variation. At the extremes, in the best-off province, CDC residents received an average of 2.8 more per person than CDC residents the worst-off province. However, much larger variations in per capita resource allocations are revealed if we consider the aggregate amount of CDC grants transferred to councils in each province, divided by each respective province’s total population. Under this scenario, the best-off province received over 30 times more per person in CDC resources than the worst-off province. This suggests that – when compared to horizontal allocation of provincial and municipal resources – even under the relatively more controlled environment of a national programme, it appears difficult under current circumstances to achieve a horizontally balanced allocation of public resources across the national territory in Afghanistan.

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34 One potential problem with the CDC disbursement data is if CDCs do not receive their entire CDC grant in one year. In that case, it would be possible for the total CDC population reported to be receiving grants to be counted more than once (during each year in which CDC grants are received). If this is the case, this might put a downward bias on the CDC grant per CDC resident, while upwardly biasing the population coverage ratio.

35 It cannot be discounted that political or ethnic factors play a part in such decisions. For instance, the NSP Mid-Term Evaluation notes that in Balkh the Provincial Governor acknowledged (but rejected) the criticism from one of the ethnic groups in the province that he had manipulated the selection of NSP villages in response to ethno-political allegiances (NSP MTR 2007: 173).

36 Despite the financial incentive not to form CDCs with more than 300 families, this appears to have happened for two reasons – large villages were prevented from splitting into two or more by the NSP, and villages where original estimates of population made by the NSP subsequently increased through the return of IDPs and refugees.
5. POLICY ISSUES FOR THE GOVERNMENT OF AFGHANISTAN

120. Analysis of the vertical pattern of expenditures across the different levels of administration in Afghanistan indicates a significant disconnect between the de facto decentralized nature of this pattern and a highly centralized budget authority structure and process. This constrains efficient and effective budget planning and execution. Analysis of the horizontal distribution of expenditures across provinces further indicates significant inter-jurisdictional inequities which are problematic in themselves, but which also have serious implications for government’s ability to deliver public services and establish its legitimacy across the national territory, both of which are considered preconditions for achieving security. A more limited analysis of municipal finances indicates that the absence of a municipal financing framework is inhibiting the establishment of these entities as effective local governance and service-delivery agencies.

121. While the purpose of this study is descriptive rather than prescriptive, the analyses presented above carry several important policy implications. In essence, GoA faces three priority policy issues in the area of subnational and intergovernmental finance:

a. Reforming the budget authority structure and process. Both the vertical and horizontal fiscal imbalances revealed in this study suggest that there is a disconnect between provincial expenditure needs and the mechanisms for how public resources are allocated and spent through the national budget process. The absence of any degree of budget authority at the provincial level means that central officials are determining expenditure priorities with inadequate information while provincial line officials are effectively disenfranchised. Addressing this disconnect will require reforming the budget authority structure and process. In general terms, this will need to involve exploring some steps to decentralize a limited amount of budget authority within the context of a sectorally deconcentrated system (i.e. deconcentration or decentralizing budget authority within the line departments). Given the constitutional and accountability structure in Afghanistan, it would not be appropriate to pursue a territorially deconcentrated approach at this stage (i.e. giving greater budgetary resources and authority to the Provincial Governors. See Appendix A, Box A.1). Any such reform should also proceed in accordance with the existing centralized (central-provincial) treasury structure.

b. Ensuring a more equitable and transparent allocation of fiscal resources between the provinces. The current degree of horizontal fiscal imbalances in Afghanistan not only suggests substantial fiscal inequities, but the apparent inability of the centre to allocate resources across the provinces in a more even manner is limiting the ability of the central government to deliver adequate public services across its national territory. As such, there is a need to introduce policies to ensure a more equitable and transparent allocation of fiscal resources between the provinces. In general terms, this will probably need to entail the development of certain types of budget and/or expenditure norms to guide sectoral budget allocations across provinces. Developing such allocation norms will require a collaborative approach involving the Ministry of Finance, IDLG, line ministries, as well as provincial line departments.

c. Developing a fiscal framework for financing municipalities. The final element of a comprehensive intergovernmental fiscal strategy in Afghanistan is the development of a fiscal framework for financing municipalities. Such a municipal fiscal framework will involve identifying modalities to ensure that municipalities are funded through a combination of own-source revenues and intergovernmental fiscal
transfers, while simultaneously strengthening the financial management capabilities of the municipal level.

122. These policy challenges are important and pressing, but they are not unique. Many other countries have confronted similar issues and have developed effective approaches to deal with them. Afghanistan can benefit from the experiences and practices from other countries while it generates approaches which are appropriate to its specific circumstances.
LIST OF REFERENCES AND DOCUMENTS REVIEWED


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APPENDIX A: THE STRUCTURE OF THE PUBLIC SECTOR IN AFGHANISTAN

Before considering the intergovernmental fiscal system and intergovernmental fiscal flows in Afghanistan (as is done in the main body of this study), it is important to first understand the overall administrative structure of the public sector and the governance mechanisms that are in place at the various tiers and levels of the public sector’s organization. As such, the review of the territorial-administrative structure of the country contained in the Appendix will assist in clarifying between which government levels (or administrative tiers and units) resources flow, and in establishing the degree of control that the different government units have over fiscal resources.

A.1 An overview of the public sector in Afghanistan

As is elaborated in Chapter 2 of the study, the structure of Afghanistan’s public sector is de facto highly centralized, with approximately 93% of all (fiscal) decisions made by the central government (‘the State’) with local governments and local service delivery entities accounting for only about 7% of the public sector’s ‘fiscal space’. Yet, while Afghanistan is highly centralized, this does not mean that the central government is a fiscal monolith that is exclusively concentrated at the ministerial level in Kabul. In order to fully understand the country’s intergovernmental system, it is useful to make a clear distinction between the terms ‘subnational administration’ and ‘subnational governments’.

Within Afghanistan’s intergovernmental institutional and fiscal architecture (both in law and in practice), provinces and districts in Afghanistan are administrative subdivisions of the State (i.e., they are part of the national or central government) rather than autonomous government levels. Whereas governments by definition should have their own autonomous political leadership structures and discretion over specific functional responsibilities, provinces and districts in Afghanistan have no autonomous functional (service delivery) responsibilities nor do they have any autonomous political leadership or decision-making powers. Thus, provinces and districts in Afghanistan are merely deconcentrated units of the central government or ‘subnational administration’ units, as opposed to subnational government units. As a consequence, provinces (or districts) do not have autonomous budgets and in principle make no fiscal decisions of their own. The details of the organization and functioning of the central government’s subnational administration at the provincial and district levels are discussed further in Section A.2.

In contrast, separate from the subnational elements or administrative tiers of the central government, there are two types of autonomous subnational entities in Afghanistan, including formal local governments (municipalities) as well as other local service delivery entities (including Community Development Councils and School Management Committees). Local governments and LSDEs have some features in common. For instance, both municipalities as well as CDCs are corporate bodies; and both municipalities as well as LSDEs each have certain service delivery responsibilities. Yet, whereas municipalities are constitutionally and legally considered to be part of the public sector, LSDEs are not accorded that same legal status.

While municipalities should be considered ‘real’ subnational (local) governments or local self-government units, in practice, municipalities are currently led by appointed local leaders rather than elected leaders, as specified in the Constitution. This could cause one to question whether municipalities are indeed an autonomous government level at this time. The details of the organization and functioning of local governments (as well as local service delivery entities) are discussed further in Section A.3.
Table A.1 presents an overview of the overall organizational ‘structure’ of the public sector in Afghanistan covering both the state administration (reflecting tiers at the central, provincial and district levels) as well as the local government level, which is cast broadly here to include both municipalities as well as local service delivery entities.37

<table>
<thead>
<tr>
<th>Government level</th>
<th>Number of jurisdictions</th>
<th>Average jurisdiction size:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Population</td>
</tr>
<tr>
<td>Central administration</td>
<td>1</td>
<td>22,097,900</td>
</tr>
<tr>
<td>Provinces</td>
<td>34</td>
<td>649,938</td>
</tr>
<tr>
<td>Districts</td>
<td>398</td>
<td>55,522</td>
</tr>
<tr>
<td>Municipalities</td>
<td>157</td>
<td>N/A</td>
</tr>
<tr>
<td>Communities / CDCs</td>
<td>Approx. 24,000</td>
<td>921</td>
</tr>
</tbody>
</table>

Note: Various sources. See text for further description.

A.2 Organization of the state administration

Chapter 8 of the 2004 Constitution provides the primary legal foundation for the public sector’s subnational administrative structure. Chapter 8, Article 1 declares that the administration of the Islamic Republic of Afghanistan shall be based on central and local administrative units, where the central administration is defined to comprise the ministerial level, while the ‘local’ administrative unit of the state is defined as the province.38

With respect to the assignment of responsibilities to the different levels, the Constitution states that ‘[t]he government, while preserving the principle of centralism, shall delegate certain authorities to local administration units for the purpose of expediting and promoting economic, social, and cultural affairs, and increasing the participation of people in the development of the nation’ (Chapter 8, Art. 2). Furthermore, ‘[i]n order to organize activities involving people and provide them with the opportunity to actively participate in the local administration, councils are set up in districts and villages in accordance with the provisions of the law’ (Chapter 8, Art. 5).

It should thus be noted that constitutionally, district and village councils are merely intended as a modality to involve people and provide them with the opportunity to actively participate in the local (i.e., provincial) administration. As such, districts and villages do not constitutionally form separate administrative levels. However, in practice, the organization of the state administration in Afghanistan comprises three different administrative tiers: the central government level, the provincial level, and the district level.

The Central Administration Level

Constitutionally, the executive branch of Afghanistan’s central government is divided into a number of central administrative units, each of which is headed by a minister. The country’s central administration level consists of 45 government ministries, departments, agencies, offices, independent directorates, and other budgetary units. These central government ministries and institutions are considered ‘primary budgetary units’, and the respective budgets of these organizations are determined by the annual budget law. As will be discussed

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37 The total population estimate is provided by the Central Statistics Office for SY 1384 (2005/06). Different official and semi-official data sources cite widely different population numbers for Afghanistan, ranging from 17.8 million to 22.6 million. This foreshadows the data problems endemic to the policy environment in Afghanistan.

38 Consistent with the definitions and terminology provided in this appendix, and notwithstanding the use of the terminology in the Constitution, we will refer to the provinces as ‘provincial administrations’ and the ‘provincial level’ (unless noted otherwise) rather than adopting the constitutional term ‘local administration’.
further below, many line ministries have constituent departments at the provincial level which are an integral part of the vertical structure of the respective ministry.

Until recently, within the central administration, the Ministry of Interior was formally responsible for intergovernmental relations, including provincial and municipal affairs. To a large extent, this role has now shifted to the new Independent Directorate for Local Government (IDLG). In addition, the Ministry of Finance has a clear stake in the debate surrounding intergovernmental fiscal relations, as it is the steward of the country’s public finances. In this role, it executes the national budget across the central and provincial administrative levels, and would have to execute (either directly or indirectly) any intergovernmental transfers to the local government level. The Finance Ministry is currently pursuing several initiatives related to the provincial level, including a provincial-based budgeting pilot, as well as efforts to strengthening the role of the provincial treasury offices (Mustoufiats) in financial administration in the context of the AFMIS integrated financial management system.

In addition to IDLG and the Ministry of Finance, line ministries have an important stake in the intergovernmental fiscal system, as the delivery of public services largely takes part at the provincial level, and is partially funded through allotments and disbursements to the provincial level. Among line ministries, the Ministry of Reconstruction and Rural Development (MRRD) plays an important role in rural development in the provinces. Two key ‘subnational’ programs implemented under MRRD include the National Area-Based Development Programme (NABDP) which supports institutional development below the provincial level, and the National Solidarity Programme (NSP), which promotes local development and governance through the establishment and funding of Community Development Councils (CDCs).

**Provincial Administration**

Territorially, Afghanistan is divided into 34 provinces, the latest two of which (Daikondy and Panjsher) were created in early 2004. The functioning of provinces in Afghanistan’s intergovernmental system is not always clear, particularly as there are several relevant actors and stakeholders at the provincial level, including Provincial Governors, Provincial Councils, and Provincial Development Committees (PDCs).

The main point to bear in mind is that the Constitution defines provinces as administrative units of the central government (or state administration). Consistent with this definition, provinces are strictly deconcentrated units of the central government rather than a separate level of government. As such, they do not have their own budgets. Any control or influence they have over public resources must therefore come either through their ability to shape the national budget or through their influence on budget execution, to the extent that resources actually flow through the provincial level.

Provinces (and districts) are assigned gradations by IDLG (from Grade 1-3), which is determined largely by their population size. The grade of a province or district guides the size of the jurisdiction’s administration (i.e., the Governor’s Office), as well as the grade levels of the staff. This formal provincial staffing structure is complemented by capacity building initiatives through PRTs, IDLG, and other initiatives.

Although exact figures are difficult to come by (as the staff of district offices are formally included in the headcount of the Governor’s Office), the provincial governor’s office typically has a staff of between 20-55. PGs receive very limited non-salary budget allocations. In general, governors’ offices also have limited capacity, particularly in terms of managerial capacity, organizational infrastructure and systems.

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39 In addition, there are ‘external’ provincial actors such as Provincial Reconstruction Teams (PRTs).
Provincial Governors. Consistent with the deconcentrated nature of the provincial level in Afghanistan, Provincial Governors are appointed by the President as his representative in the province. Whereas Governors until recently reported to the centre through the Ministry of Interior, this function has now shifted to IDLG. Governors predominantly have a coordination and oversight function at the provincial level, as provincial line directors technically report to their respective line ministries.

However, in practice, a dual subordination of provincial line departments exists. One of the key mechanisms through which governors exercise their influence is as chair of the Provincial Administrative Assembly (PAA). PAAAs have long existed in many provinces as coordinating entities between the heads of department and the governor, although they vary in membership and function across the country.

Furthermore, the governor has significant authority over the police in the province, and direct authority over the district governors. Likewise, municipalities are required to have budget approved by IDLG through the Provincial Governor. Furthermore, Governors have considerable political and administrative powers, including signatory powers over most procurement that takes place at the provincial level and certain powers of appointment.

Provincial Councils. In contrast to the status of provincial governors as appointed officials, Provincial Councils (PCs) are in fact elected. Despite their status as elected representative bodies, Provincial Councils have only limited powers. Their functions are largely limited to oversight of the Provincial Governor and the provincial line departments.

Provincial Departments. Most key central line ministries have representation at the provincial level in the form of provincial departments. For instance, each province in Afghanistan has a Provincial Education Department which is an integral part of and reports to the Ministry of Education. The budget of the provincial line department is included in the overall budget of its parent ministry.

While some provincial line departments follow a standard structure and size across the provinces, the composition of other departments varies across provinces. Most provincial departments are led by a department head (a grade 1 or 2 official), with deputies under him/her responsible for different areas. In Kapisa, for example, the education department has a total administrative staff of 280, and 2617 teachers. The health department, which in this province directly delivers health services, has a total staff complement of 396.

Similarly, each province has a provincial finance department or treasury office (known as a ‘mustoufiat’) and a provincial planning department, which are part of the Ministry of Finance and the Ministry of Economy, respectively. The main function of the provincial mustoufiat is to process financial transactions within the province as part of the Ministry of Finance’s central treasury system. The provincial department of the Ministry of Economy is in charge of coordinating the preparation of the Provincial Development Plan (PDP).

Provincial Development Committees. Provincial Development Committees (PDCs) are chaired by the Provincial Governor and include the directors of the provincial line departments, as well as representation from the PC. PDCs have only limited coordinating and planning functions in the preparation of provincial plans and the budget requests of provincial departments. There is significant duplication and overlap in the planning and implementation responsibilities of the various entities at the provincial level (for instance, between the PDC, the PC and the PAA). The overlapping responsibilities at the provincial level add to the major challenges encountered in ensuring proper central-provincial coordination.

Absence of provincial budgets. The presence of an elected provincial council and a provincial executive results in a common misunderstanding: that provinces are (or alternatively, should be, or might become) separate governance entities with their own budgets. From a budgetary
and institutional point of view, however, it is again important to emphasize that provinces are exclusively envisioned by the Constitution to be an administrative tier of the central government, and that there is no concept of a consolidated provincial administration or a consolidated provincial budget. It can be said that provincial departments are vertically deconcentrated units of their respective (central government) line ministries as the allocations that they receive are fully at the discretion of each of their line ministries.

**BOX A.1: SECTORAL VERSUS TERRITORIAL DECONCENTRATION**

Conceptually, a deconcentrated administrative system can be organized either as a vertically (or sectorally) deconcentrated system or as a horizontally or territorially deconcentrated system.

Under the vertical or sectoral approach to deconcentration, each line ministry operates ‘vertically’ in a deconcentrated manner, with limited or no harmonization of planning and budgeting at the provincial or district level. From an institutional and budgetary viewpoint, this means that every line ministry follows a ‘silo-structure’ from the central level down to the province level (and possibly to the district level). Vertical deconcentration allows line ministries a strong role in the planning and implementation of sectoral services.

In contrast, under horizontal or territorial deconcentration, sectoral departments at each administrative level are administratively subordinate to the Provincial Governor or to the District Governor, respectively. While this allows for greater coordination at the territorial level, this structure may weaken the links between the subnational line departments and the respective line ministries. This organizational arrangement is reinforced if there is strong accountability at the subnational level, for instance, through elected subnational leaders. Furthermore, horizontal deconcentration is facilitated if the line departments within the subnational administrations are funded from a unified provincial or district budget rather than from vertical budget allocations from each sector line ministry.

At this stage, Afghanistan is pursuing a vertically (sectorally) deconcentrated system. This is an appropriate stage for the country to be given the weak state apparatus it inherited from the previous regime. If the Government would seek to gradually move to a territorially deconcentrated system, this policy would have to be endorsed at the highest political levels and an implementation plan would have to be included in the country’s intergovernmental strategy in order to build towards such a transition.

Whereas the budgetary allocations for a province in Afghanistan could theoretically be aggregated across all line ministries into a ‘provincial budget’ for presentation purposes, for all intents and purposes the ‘provincial budget’ is simply the sum of the budgetary decisions made by the different line ministries that have a presence at the provincial level. However, the central government budget does not make any concerted effort to show the provincial break-down of sectoral budget, nor does it seek to present public expenditures by province. No provincial official or entity (neither the Provincial Governor, Provincial Council, nor Provincial Departmental Directors) have any authority or control during the budget formulation process over the budgetary allocations made to their province within the various sectors. In fact, in some instances, provincial officials state that they are not even properly informed regarding the budgetary resources that line ministries intend to spend within their provincial boundaries. The limited discretion given to the provincial level during budget planning and formulation clearly limits the provincial ownership over activities implemented at the provincial level.

However, to the extent that the national budget is executed and disbursed within a province, the Provincial Governor along with the Mustoufie and the directors of the provincial line departments have certain signatory powers with respect to the procurement of goods, the appointment of public servants within the province, and the disbursement of expenditures at the provincial level. This means that while the provincial level has little or no input into the budget allocations made available to the province, it is burdened with administering and overseeing provincial level plans. In fact, provincial officials (particularly, Provincial
Governors) have certain signatory responsibilities and powers for centrally-procured projects, thereby giving them considerable powers, which can be used either positively or negatively. Indeed, the assignment of responsibility for these aspects of budget implementation takes place in the absence of appropriate accountability mechanisms at the provincial level, as top-down accountability mechanisms are inadequate at best, and neither the Provincial Governor nor provincial directors can be held accountable by the Provincial Council or any other provincial organ.

There is widespread recognition that the role and organization of the province in the public sector’s (financial) structure needs to be clarified and properly integrated. As further discussed in Appendix B, a provincial budgeting exercise is currently being piloted within the Ministry of Finance with the intention of improving the provincial allocation of budgetary resources by the central government to achieve its national priorities as articulated in the Afghanistan National Development Strategy (ANDS). At the same time, the Treasury is piloting the roll-out of the AFMIS system at the provincial level, which would improve the financial administration capacity of the provincial mustoufiat offices. This initiative is also discussed in greater detail in Appendix B.

District Administration

For administrative purposes, provinces are further subdivided into districts. Provinces range considerably in population, geographical size and administrative structure, containing from 4 districts (Laghman, Nimroz) to 27 districts (Badakhshan). Although there are some inconsistencies in the reporting of the numbers and boundaries of districts, the Central Statistics Office considers that there are 398 districts in Afghanistan, of which 34 districts are considered provincial urban centres while 364 districts are classified as rural districts.

District governors (uluswals/woluswals) are appointed by the President and represent ILDG (until recently, the Ministry of Interior) at the district level. District governors report to the provincial governor and their role is primarily to represent the government at the district level and to coordinate ministerial activities at the district level. They are also responsible for civil registration of births, deaths and marriages. Although they do not have primary authority over the district police (who report to the provincial police chief), they may also assist in conflict resolution, through referral to the police or the local council (shura).

Districts are generally very poorly resourced and capacity at the district level is extremely weak. Many have no staff and no real operating budget. Furthermore, it is reported that an estimated 40 percent of district governors have less than an elementary school education. Although some administrative offices are being constructed at the district level (for instance, through the ASP and individual donor and PRT initiatives), numerous districts still have no offices.

Although mandated in the constitution, district council elections have been postponed until further consideration.

The district is the main service delivery level for several key public services. As a result, the Ministry of Reconstruction and Rural Development (MRRD), Ministry of Education, Ministry of Public Health, and the Ministry of Agriculture are commonly represented at the district level.

Similar to the hierarchical relationship between the central government and provinces, districts have no autonomous status and no autonomous budget: they are merely deconcentrated units of the province. However, district-province relations are complicated as provinces themselves have only limited decision-making authority, since provinces in turn are themselves deconcentrated units of the centre. For instance, district staff allotments (‘tashkeels’) are determined by the central line ministries rather than by the provinces. This means that rather than the Provincial Governor deciding on a district-level request for
additional teachers, the province merely acts as a middle-man, as this request will have to be passed to the central (ministerial) level for a centralized decision.

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**BOX A.2 : PROLIFERATING DISTRICTS IN AFGHANISTAN: THE CASE OF BADAKHSHAN**

Until the early 1990s, Badakhshan was divided into 13 administrative districts plus the municipality of Faizabad. When Professor Rabbani was president, 14 new districts were created in Badakhshan (his home province), reportedly based on population size as well as the time required to travel to the district center. Political considerations, such as the need to accommodate influential local commanders or different political factions, also played a part as some districts were created (for example, Zebak) that certainly did not meet the criteria on population size or distance to the district center. These 14 new districts have now been officially recognized.

The advantages of becoming a district include getting a school, clinic, and market. It also reduces the travel distance for many villages to the district headquarters and to access government services. The downside, however, is that these additional districts, especially those with very small populations, will be an added financial burden on the state. In Badakhshan, there was a stark contrast between the older, more established districts, which generally have government buildings and basic furnishing, and the newly established districts that have virtually nothing.


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**Representative structures at the district and village levels**

According to Article 140 (Chapter 8, Art. 5) of the Afghan Constitution, councils are set up in districts and villages ‘in order to organize activities involving people and provide them with the opportunity to actively participate in the local administration, in accordance with the provisions of the law. Members of these councils are elected by the local people through, free, general, secret and direct elections for a period of three years.’

In contrast to the constitutional mandate, no representative bodies currently exist at the district or village level, though the CDCs are elected in most cases. It is understood that IDLG is taking steps to develop a strategic and legislative framework for putting in place such subnational representative bodies.

In practice, however, various traditional community-based decision-making structures and local councils exist in Afghanistan. These traditional local councils vary in function, composition, nature and name in different parts of the country, but often focus on local conflict-resolution. However, these traditional mechanisms are not part of the formal governance structure and do not receive financial resources from the public sector. As such, they fall beyond the scope of the current study.

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**A.3 Subnational (local) governments and local service delivery entities**

In contrast to the deconcentrated tier of state administration, Afghanistan also has ‘real’ local governments. Whereas the Constitution provides guidance as to the structure of the subnational administrative structure of the public sector in Afghanistan, relatively little constitutional guidance is provided with respect to the subnational (or local) government structure.

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\[40\] Given the absence of formal governance structures in certain conflict areas, IDLG may pursue providing public funding to such areas through traditional leaders and other traditional councils and power structures. Assessing this possibility lies well beyond the scope of the current document.

\[41\] In some countries, proper local governments are sometimes referred to as local self-government, in order to emphasize their autonomous status from the state apparatus.
The defining characteristics of a ‘real’ local government include that the entity is (i) an autonomous body corporate, which is (ii) not-for-profit, and has an obligation to serve all members of the community within its jurisdiction, and (iii) has some degree of authoritatively binding decision-making power (including over its financial resources), and which is (iv) legally recognized to be part of the public sector. It should be noted that often the main decision-makers of a local government are popularly elected, and frequently, but not always, local governments have coercive power to raise certain own resources through local taxation. Based on this characterization of local governments, this means that there is only one type of local governments in Afghanistan, notably municipalities.

In addition to municipalities, Local Service Delivery Entities (LSDEs) – such as Community Development Councils (CDCs) and similar community-based service delivery organizations (such as School Management Committees) exist and operate at the subnational level in Afghanistan.

**Municipalities**

Municipal governments have a long history in Afghanistan, and the existence of municipalities was confirmed in the 2004 Constitution, which states that ‘[m]unicipalities shall be set up in order to administer city affairs. The mayor and members of the municipal councils are elected by free, general, secret, and direct elections. The affairs related to municipalities are regulated by law’ (Chapter 8, Art. 6).

Municipalities are formally divided into two main categories: provincial municipalities and rural municipalities. Each of the 34 provinces has a provincial municipality, of which six have a population exceeding 500,000 (Jalalabad, Herat, Kabul, Kandahar, Kunduz, and Mazar-i-Sharif). Almost three-quarters (72 percent) of the country’s urban population resides in these six municipalities, and the administrative capacity of these municipalities should be considered higher than most other municipalities in the country. Of these major municipalities, Kabul Municipality has a special legal status: the mayor of Kabul is directly appointed by the President, which serves as a Cabinet-level position.

There are approximately 123 rural (non-provincial) municipalities in Afghanistan which have a population of 5,000 or more, although the exact number of municipalities is somewhat unclear and has been steadily increasing. While all municipalities now formally report to ILDG, in some provinces the provincial municipality supervises (or even controls) the activities and finances of rural municipalities. Despite historical precedents and the Constitutional mandate for locally elected municipal councils and elected Mayors, in matter of fact, the Ministry of Interior (and now IDLG) has been responsible for appointing mayors of provincial municipalities. In doing do, the central government generally does not seek any recommendation from the Provincial Governor.

Specific functions and revenue sources are assigned to municipalities in the Municipalities Act (2000), the City Charges Act, and several other related Acts and decrees. Fiscally, municipalities are largely self-sustaining entities that fund the provision of urban services (refuse collection, recreation and parks, and other such services) with local revenue collections from property taxes, local service charges and retail licenses. Despite this high degree of fiscal autonomy, all municipalities are required to seek approval for their annual budgets and staff establishments (municipal ‘tashkeel’) through the Provincial Governor’s Office from IDLG (and hitherto, from the Ministry of Interior). Beyond the approval of their annual budgets, municipalities are supposed to be (largely) fiscally autonomous and operate independently.
Municipalities are required to have their annual budget approved, through the Provincial Governor, by IDLG. In large part, this review is perfunctory, and consists of ensuring that municipalities do not charge unauthorized revenue sources. However, the multiple layers of administration involved in securing approval for the municipal budgets provide an administrative obstacle to the municipal level, as the budget cannot be executed until approval is received. Until such approval is received, municipalities are forced to operate under the previous year’s budget.

The current Municipal Law (and the remainder of the legislative framework surrounding subnational government) pre-dates the Constitution, often resulting in an inconsistent and sometimes contradictory legal framework. Municipal expenditure responsibilities are quite limited and ill-defined; their revenue sources are fragmented and arguably inadequate; municipalities are frequently subject to political interference from provincial officials and administrative micromanagement from central officials; and line ministries frequently engage in infrastructure development in areas of municipal responsibility. While municipalities have the right to make budget proposals to Cabinet for infrastructure, municipalities do not receive any recurrent or development grants from the central government budget, with the exception of Kabul Municipality.

It is expected that municipal (finance) reform will feature prominently in the upcoming strategic work plan for IDLG. Such a work plan might envision the formulation of a municipal policy framework; the introduction of a new legislative framework for municipalities, and the election of municipal councils. In addition, support might be provided to the municipal level to strengthen municipal revenue collections, other areas of municipal finance, as well as the delivery of local government services.

Local Service Delivery Entities (LSDEs) and Community Organizations
In contrast to (non-elected) municipalities, Local Service Delivery Entities (LSDEs) provide a local service delivery mechanism that has a high degree of community ownership. LSDEs do not find their origins in history or in the Constitution. Instead, LSDEs derive their authority and budget resources from national programmes.

The most important category of LSDEs is the Community Development Council (CDC). CDCs were established as part of the National Solidarity Programme (NSP), which was designed and initiated in 2003 by MRRD to target the needs of rural communities by employing community-driven development. By the end of March 2007, NSP had established over 16,500 elected CDCs in 279 districts (more than two thirds of Afghanistan’s districts) across all of the country’s 34 provinces. In the context of Community Development Plans which were developed by these CDCs, over 26,600 community development projects have been approved for funding under the CDC block grant mechanism funded by NSP.

Based on the definition set forth above as to what constitutes a local government in Afghanistan, Community Development Councils (CDCs) or School Management Committees (SMCs) should not be considered local governments, as they are not legally recognized as being part of the public sector. In contrast to municipalities, CDC and SMC elections are not regulated by the electoral commission; they lack a constitutional and legal foundation; and perhaps politically more importantly, CDCs do not report to IDLG like provinces and municipalities. For instance, MRRD’s institutional ‘ownership’ over CDCs is an important challenge in the broader positioning and political acceptance of CDCs. As such, this study recognizes that CDCs are not local government authorities, and categorize CDCs here as Local Service Delivery Entities.
In addition to the weakness in their legal and political / institutional position, the nature of CDCs as a local service delivery mechanism is not without problems. One of the problems with CDCs as local infrastructure and service delivery providers is that they are very small (with a minimum size of 25 families and financial incentives not to exceed 300 families), which limits the size of the development projects that they can implement. One option that has evolved from practice is the establishment of ‘CDC Federations’: voluntary associations of CDCs formed to implement larger development projects, and in some cases now receiving specific donor support. Such constructs are specifically permitted under Article 33 of the CDC bylaw. These federations offer a promising up-scaling mechanism for CDCs to engage in larger development activities while maintain a close community connection, as long as the associations are voluntary in nature.

Although there is a natural tendency for one to wish to structure CDCs in a way that links them structurally to the district level, this carries a particular risk in the context of Afghanistan. Formalizing arrangements to link CDCs to Districts (or potentially other structures of the state) could reduce the autonomy currently enjoyed by CDCs and risks for them to be co-opted by higher-level governments. This concern notwithstanding, District Development Assemblies (DDAs) have been established in 234 districts in 28 provinces under the National Area-Based Development Program (NABDP) to ensure community consultation and participation in the preparation of comprehensive rural development plans. In districts where NSP is operational, DDA members are selected by a forum of CDC chairpersons and vice chairpersons; in districts where NSP is not active, traditional (non-elected) district councils are relied upon.

A final concern with respect to CDCs as local service delivery entities in their current form is the existence of urban CDCs. Currently, CDCs exist in rural as well as in urban areas. This means that there is a potential overlap or duplication between the service delivery functions of municipalities and CDCs. It would be appropriate for this overlapping sphere of responsibility to be recognized and resolved in order to prevent duplication and competition between municipalities and CDCs for service delivery functions.

In addition to CDCs, there are a number of community-based service delivery organizations present at the local level. These include School Management Committees, water user groups, and other traditional community structures that have the aim to organize communities or user group in order to maintain local infrastructure or to deliver specific public services. Such traditional councils, user groups and community organizations generally do not receive public funding and are considered outside the scope of the formal public sector.42

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42 For instance, an initiative by the Ministry of Education to provide direct funding to School Management Committees for school operating costs was declined by the Ministry of Finance in 1386.
APPENDIX B: BUDGET STRUCTURE AND SUBNATIONAL FISCAL PROCESSES

Recognizing the distinction between the state administration (i.e., central, provincial and district administration) and local governments and local entities (i.e., municipalities and LSDEs) is a critical starting point in understanding the structure of Afghanistan’s public sector budget and subnational finance.

Whereas local governments and LSDEs (municipalities and CDCs, respectively) have their own, separate budgets, all government revenues and expenditures at the central and provincial (including district) levels are contained in the central government budget. As noted in Chapter 1 and Appendix B, all public expenditures within the central government are planned for and budgeted centrally, as there are no separate provincial or district budgets. As we will discuss in greater detail below, there is limited, if any, input from the provincial level into the central budget formulation process.

Broadly speaking, the central government’s budget has three components: first, an ordinary (core) operating (i.e., recurrent) budget; second, an ordinary (core) development budget; and third, an external development budget. The recurrent budget further comprises of two distinct components: payroll and other (non-wage) recurrent expenditures. In addition, certain off budget or extra-budgetary funds exist which are used to finance public sector activities, but which are not acknowledged in any of the formal (core or external) components of the budget.

This appendix reviews the structure of the public sector budget and the (ongoing reform of) relevant subnational budget processes. Section B.1 considers the overall structure of the central government budget. Sections B.2 through B.4 discuss specific details of the three main components of the budget (the recurrent budget, core development budget, and external budget), respectively. Section B.5 discusses the extent of off-budget financing of the public sector, whereas Section B.6 deals with the financing of local governments (municipalities) and local service delivery entities (CDCs). Finally, Section B.7 discusses current reforms of (intergovernmental) budgetary processes.

B.1 The overall structure of the Central Government Budget

Central government revenues and the central treasury system

During the first years after the transition, revenue administration and fiscal management were de facto decentralized at the provincial level; Afghanistan’s provincial governors collected most public revenue sources, including Afghanistan’s main revenue source, customs revenues. As such, Governors were in a position to remit only part of their revenue collections while retaining a share of the revenues collected within the province for discretionary provincial spending.

In the summer of SY1382 (2003), the Karzai government centralized revenue collections by introducing a single revenue account at the provincial level. With this system, all revenues formally collected within each province are deposited by the provincial mustoufiat into a deposit account with Da Afghanistan Bank.

This revenue deposit account flows into the single treasury account of the central government, which is controlled by the Ministry of Finance in Kabul; provincial officials are unable to withdraw funds from this account. Provinces can only draw funds from their expenditure accounts with the DAB (one for recurrent expenditures and one for development expenditures); the allotments and deposits into these accounts are controlled by the Treasury Department within the Ministry of Finance. The result of this reform has been to cut

43 For a more detailed discussion, see Evans and Osmani (2005).
provinces off from discretionary access to officially collected revenues, while provincial spending is limited by the allotment and cash management controls of the Ministry of Finance within the central treasury system. Although it is unclear to what extent the provincial level continues to retain certain informal revenue sources (which are not deposited in the official account) and other extra-budgetary funds, in principle, all financial resources used at the provincial level are now contained in the central government budget.

Budget Year and Budget Cycle
Afghanistan’s budget follows the Afghan solar year (see box). The Afghan budget follows a typical annual budget cycle, with a budget formulation process led by the Ministry of Finance, and budget approval by Parliament preceding the beginning of the budget year.

**BOX B.1 : THE AFGHAN FISCAL YEAR AND THE SOLAR YEAR CALENDAR**

The fiscal year in Afghanistan is based on the solar year (SY), which starts from the first day of Hamal (21 March) and ends on the last day of Hoot (20 March). For instance, SY 1385 started on March 21, 2006 and ended on March 20, 2007. Likewise, SY 1386 started on March 21, 2007 and ends on March 20, 2008.

The twelve months of the solar calendar (starting with the first month of the solar year in March/April) are: Hamal, Saur, Jawza; Saratan, Assad, Sunbula; Meezan, Aqrab, Qaws; Jadi, Dalwa and Hoot.

While the Ministry of Finance –through its External Finance Department – attempts to capture and report on the External Development Budget’s planning and execution in as accurate a manner as possible, the external development budget is in fact not part of the regular government budget. As a result, the external budget is excluded from the regular budget formulation processes (such as the programme-based budget process) and the external development budget is not executed through the treasury. In its reporting on the external development budget, the Ministry of Finance is largely dependent on the quality of reporting by the donor agencies funding external projects.

In addition to regular ex-post budget scrutiny process, the core government budget is also monitored by the World Bank, which acts as a Monitoring Agent on behalf of the donor community for the Afghanistan Reconstruction Trust Fund (ARTF), which is an important funding source for the core budget.

**Structure of the Budget Document**

Like most budgets, Afghanistan’s ordinary recurrent budget (or core operating budget) is structured by primary budget organization (i.e., ministry, department or government agency) and by main economic classification (including wages and salaries; goods and services; acquisition of assets; Code 21, 22, and 25 respectively). The recurrent budget is presented to parliament at this high level of aggregation. The development budget is presented at the project level, sorted by Ministry.

Ministerial budgets are not broken down at the provincial level during budget formulation, as provincial line departments are not considered separate cost centres or sub-votes in the budget. Provincial allotments are not made until after the budget is approved by parliament.

With the exception of the ministries engaged in the programme-budgeting pilot (as noted further in Section B.7), ministerial budgets lack any further departmental or programmatic breakdown. The government’s budget classification system only provides sub-organization and unit codes for selected organizational units of the larger ministries. The absence of a detailed sub-organization or sub-vote classification makes it impossible to determine a link between the budgeted resources for a ministry and the ministry’s different (provincial) departments or the ministry’s different programmatic objectives.
Changes to the Chart of Accounts are currently under discussion for SY 1387, but these revisions do not envision the systematic establishment of provincial departments as secondary organizational budget units in the budgets of their parent ministries.

**Budget execution through the central government treasury / AFMIS**

As noted above, central government finances (covering all finances at both the central as well as the provincial administrative levels) are managed through a single treasury account. Although the treasury operates provincial offices (Mustoufiats), the provincial offices do not operate their own accounts. These provincial mustoufiats are merely branches of the national treasury, and assist the central treasury in the record-keeping for provincial-based expenditures, distributing allotments, and preventing provincial over-spending.

Once the budget is approved, the approved ministerial budget ceilings (by ministry and economic type) are broken down into allotments by department (at the central level) and by provincial department. The budget is then executed through the Afghanistan Financial Management Information System (AFMIS). Recurrent allotments and expenditures are reported on by the treasury on a monthly basis. The recurrent side of the budget follows the annual budget plan reasonably well. On the other hand, the execution of the development budget is highly variable.

**B.2 The Central Government’s Ordinary (Core) Recurrent Budget**

**Structure of the recurrent budget.** The recurrent budget is prepared and approved preceding the beginning of the financial year. The recurrent budget is only revised once thereafter, during the mid-year review. With the exception of the ministries engaged in the program-budgeting pilot (as noted in Section B.7), ministerial budgets lack any departmental or programmatic breakdown.

**Funding of provincial-level departments.** In addition to planning and executing the funding requirements of the line ministry’s central administration, line ministries are also responsible for financing their provincial departments. While geographical budget classification codes exist to track spending that is executed in the different provinces (through the provincial mustoufiats), ministerial budget plans are currently not prepared or approved with provincial break-downs. With the exception of the pilot ministries and provinces involved in the provincial budgeting exercise, only after the budget plan is approved by parliament are the ministerial budgets divided and executed by dividing the ministerial budget into the share for the central ministry’s headquarters and allotments for each of the provincial departments. Allotments for the recurrent funding of provincial departments are disbursed on a monthly basis through the provincial mustoufiats.

**Size and funding of the budget.** The approved core recurrent budget for SY1385 is approximately US$ 884 million (AfS. 44.2 billion). Roughly two-third of recurrent expenditures is spent on payroll, with the remainder spent on non-wage (operation and maintenance, or O&M) expenditures. Approximately half (48 percent) of the core operating budget is spent on security (largely ANA and ANP), although substantial additional recurrent resources are provided to the Afghan National Army and the Ministry of Interior for the operation costs of security functions through external sources. Nearly one-quarter (24 percent) of the operating budget is spent on education. In principle, this leaves only one-quarter of the recurrent budget for all other government services, including the provision of basic health services, agricultural extension services and rural development, the maintenance of roads, and so on. A more detailed analysis of the budget’s sectoral composition takes place in Section 2.3.
Whereas during the initial years of the Interim Administration even the ordinary recurrent budget was highly donor-dependent (exceeding 50 percent), the core recurrent budget is increasingly funded from own domestic revenues (currently approximately 75 percent).

Contributions from the international donor community to the Government Budget have been funnelled predominantly through the Afghanistan Reconstruction Trust Fund (ARTF), which essentially provides a multilateral modality for general budget support (GBS). The trust fund is funded by numerous international donors (including United Kingdom, United States, EC, Canada and Netherlands) and is administered by the World Bank. Since commencing operation, the ARTF has successfully mobilized US$1.36 billion in grant contributions from 25 donors and is the primary instrument for financing the civilian operating budget. In addition to providing financial support to the government’s core (recurrent and development) budget, ARTF also funds selected projects as part of the external development budget.

B.3 The Central Government’s Ordinary (Core) Development Budget

The total size of the Core Development Budget is US$ 1,540 million (or approximately Afs. 77 billion). Much of the core development budget is funded by programme-earmarked funding from donors, in addition to funding from the Government’s own resources and ARTF whether ‘preferenced’ to particular programmes or not. The composition of the development budget is different from the recurrent budget, with 43 percent of the core development budget dedicated to infrastructure and natural resources, and 25 percent to agriculture and rural development. In contrast, education and health only receive 14 percent of the total core development budget. It is not unusual for differences to arise in the relative shares of recurrent versus capital (development) spending, since different sectors have different capital requirements. However, the current pattern of capital spending in Afghanistan may be as much a function of the ability of certain sectors to implement large-scale capital projects, as a reflection of the relative infrastructure needs in different sectors.

Resources for the Core Development Budget are part of the regular Government Budget, and as such are run through government accounts. However, owing to its heavy reliance on external funding, the core development budget is denominated in US dollars. These amounts are then converted into Afs. as they are entered into AFMIS.

While the core development budget is produced as part of the same budget document as the recurrent budget, it is hard to speak of a unified (integrated) budget approach, as the budget processes for recurrent and development spending are substantively different, which prevents a strong link between the two budgets from arising. The programme-based budgeting pilot, further discussed in Section B.7, is trying to address this problem.

Like the government’s ordinary recurrent budget, the core development budget is organized by line ministry. While the core development budget (as published by the Ministry of Finance) is further merely broken down by project, increasing efforts are made to track the geographic incidence of the development budget. However, since virtually all development projects are funded through the central treasury (rather than through provincial mustoufiats) it has been difficult to track core development expenditures across provinces.

In contrast to the recurrent budget, the core development budget is updated on a regular basis throughout the budget year. For this purpose, the core development budget (starting in SY 1386) is divided into the Approved Budget and ‘Projects in the Pipeline’. As funding is secured for projects in the pipeline and the Budget Committee approves the additional funding, these projects are added to the approved budget during the budget year.

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44 Separate trust fund resources and external resources are available for the Afghan National Police and Army, other security expenditures, and counter-narcotics operations.
B.4 The External Development Budget

In contrast to the Core Development Budget, the External Development Budget does not flow through Treasury accounts, although ministries coordinate the external development projects within their respective areas of responsibility and typically have an oversight function. The External Development Budget accounts for US$ 2,445 million in planned development spending for SY1386, making it roughly equivalent in size to the entire Core (Recurrent and Development) Budget.

The External Development Budget is roughly similar in sectoral composition to the Core Development Budget, with a heavy emphasis on infrastructure and natural resources (40 percent) and agriculture and rural development (23 percent).

Details on external development spending are less consistently available, as these resources are not captured by the treasury system. As such, the coverage of the External Development Budget is highly dependent on the reporting by donor agencies, as the coordinating role of line ministries varies significantly. Either way, it is a difficult task for the Ministry of Finance to coordinate such a large external budget, and this inevitably leads to spending priorities being set outside the ANDS, the government’s policy framework.

At one extreme, some ministries are only notionally involved in externally funded projects which may or may not coincide with sectoral priorities, but ministries may be reluctant to turn away the international aid, even if it is spent on a relative non-priority. While in some cases these donor agencies are good at reporting these external expenditures to government, in other cases (particularly in the case of smaller bilateral agencies) reporting on external development activities appears to be problematic.

At the other extreme, some ‘external’ development projects actually seem to be an integral part of a ministry’s strategy, but donors and the relevant ministry may prefer to keep the funding external to the government budget, because (i) it may allow the money to flow more quickly, (ii) it reduces the administrative burden on the ministry, and/or (iii) because external funding can supplement resources received from the core budget. However, the external nature of this part of the development budget is distorting budget priorities as the Afghan government has no control over which sectors get support from donors and which sectors do not. Furthermore, the existence of an ‘external budget’ makes the overall budget process less transparent. For instance, the health sector delivers a majority of its (recurrent) basic health services through the private sector and NGOs, which are predominantly funded through the external budget. As a result, the government’s core budget gives a rather distorted picture of the relative size and distribution of health spending.

B.5 Off-budget (extra-budgetary) resources

It is almost inevitable given the level of development activity in Afghanistan that some of the financial resources used for public sector activities are not caught by either the recurrent or (either the core or external) development budget. Nonetheless, in order to obtain a complete picture of the level of public finances in Afghanistan—and how these public resources are distributed among different government levels—it is important to try to have at least a basic idea of how big these extra-budgetary resources are. Of course, this is a difficult question to answer, since these resources by their very nature are off-budget.

Based on selected comparisons between the External Development Budget and the project portfolios of the main international donors, it appears that the support provided by the major donor agencies and international financial institutions is largely captured by the External
Development Budget. Anecdotal evidence suggests that projects funded by smaller international donors are likely not to be reported to the Ministry of Finance. However, even if the amounts of extra-budgetary resources are nominally large, they are not likely to have a major impact on public and intergovernmental resources flows in relative terms when compared to the (combined core and external) Development Budget of approximately US$ 1.4 billion.

The main avenue for extra-budgetary development funding in Afghanistan is CIMIC (civilian-military cooperation) funding that is provided directly to local communities by international forces in support of their security efforts. However, the U.S. Commander’s Emergency Response Program (CERP), which is the largest CIMIC funding source in Afghanistan, is actually reported as part of the External Development Budget. CERP is funded by the U.S. Department of Defense and provides development funding for (non-military) community projects as directed by military officers. However, to the extent that U.S. CERP spending is classified, or to the extent that CIMIC expenditures by the military forces of other countries goes unreported, it is likely that this constitutes a major off-budget funding source.

**BOX B.2: CERP AND CIMIC SPENDING**

According to data from ISAF’s *Afghanistan Country Stability Picture* (September 2007), cumulative CERP spending since the inception of the programme is US$ 616.2 million (largely covering the past three years). Over this period, cumulative spending on completed CERP projects was US$ 91.7 million, of which US$ 62.4 million was completed in SY 1385. Clearly large sums of financial resources are involved in CERP (and other CIMIC) projects. This fact notwithstanding, when expressing the annualized CERP budget as a percent of the formal development budget, this amount still only account for no more than 5% of total development spending.

Difficulties arise in matching CERP resources to specific financial year, as the ISAF data set provides beginning and completion dates for projects, but –unlike traditionally budgeted projects- no reference for the budget year. Furthermore, the reported project data contained in the database is often incomplete (for instance, missing project cost or project dates), making it difficult to assess the exact amount of total resources involved for each respective budget year.

The *Afghan Country Stability Picture* also reports CIMIC spending by other international military forces; such spending amounts to approximately US$ 270 million over the same period. While it is beyond the scope of the current study to track this spending, it is likely that a sizeable share of these resources is not included in the external budget (and therefore are fully off-budget). In fact, since the U.S. military supports only 12 out of the 25 PRTs operating in Afghanistan (with other international forces supporting the remaining 13 PRTs), it is quite likely that the amount on non-US CIMIC reported is even considerably under-reported in the ACSP.

Of course, there are surely many other sources of extra-budgetary spending. Given the difficulty in identifying off-budget resources, making a complete listing of these sources is beyond the scope of the current study. We did identify several sources of off-budget public spending that shed additional light on the possible relative size of extra-budgetary funding:

- We identified several instances where external funding sources for development programs were erroneously excluded from the Core or External Development Budgets. For instance, the budget for SY 1386 accidentally failed to include most of the US$ 60 million for the National Area-Based Programme (under MRRD) in the Government

45 In this analysis, we exclude extra-budgetary security assistance. To the extent that this support is provided in an extra-budgetary manner, we assume this support will most likely remain off-budget for quite some time in the future.

46 Although, one could argue that reporting US$125 million of CERP spending as a single line item in the external budget for 1385 does not truly constitute a sound budget practice.
budget for that year. While the omission was corrected during the course of the budget year, the size of the error does indicate the relative degree of accuracy (or inaccuracy) of the development budget.

- Payments of user fees and charges to selected utility companies are explicitly off-budget. For instance, an exception was granted to the Central Authority for Water Supply and Sewerage (CAWWS) not to remit its revenue to the Single Treasury Account but rather directly use them against operational expenses in the provinces. The aggregate amount of revenue collected by CAWWS over the 20-month period from August 2005-March 2007 was US$ 1.8 million (Afs 92.2 million).

- To the extent that Provincial Governors collect ‘informal taxes’, these amounts are off-budget. Although there are claims that the Government has put an end this practice, significant amounts of extra-budgetary resources were previously involved. For instance, Kandahar’s (semi-official) Tax on Imports and Exports collected approximately US$ 30 million (Afs. 146 million) during the first seven months of 1383 (Evans and Osmani, 2005: 7).

B.6 Local government (municipal and LSDE) budgets

Municipal and CDCs have autonomous budgets, and are therefore not included in the national (central government) budget. While IDLG approves each municipal budget, no formal consolidated financial statement is prepared for the municipal government level.

Municipalities in Afghanistan are basically envisioned to provide municipal residents with urban infrastructure and services (such as roads, water and sanitation, and so on) through funding from user fees and local taxes. This is consistent with the idea that local governments provide so-called ‘club goods’, where local residents pay local taxes as a fee for municipal services received, much like a club or association provides services for its members on a fee-basis. In practice, municipalities are indeed largely or wholly self-funded, although existing municipal resources provide an inadequate and declining revenue base. Municipal budgets are more straightforward in nature that the central government’s budget structure, but include the same basic elements.

While in principle municipalities are allowed to receive transfers or allocations from the central government, in reality only Kabul Municipality receives some resources from the national budget. Even in this case, however, the transfer is made in-kind, as the payments for the development projects in Kabul are disbursed directly by the Treasury. As such, no intergovernmental fiscal transfers are provided from the central government budget to the municipal level.

By their very nature, CDCs have simple financial accounts which are either funded from NSP grants, or from community contributions. Since most CDC spending is grant-funded, MRRD tracks CDC spending under NSP.

B.7 The reform of (intergovernmental) budget processes

Attempts are currently underway to introduce two major improvements to the national budget process in Afghanistan, notably the introduction of Programme Budgeting as well as the piloting of Provincial Budgeting. These two reforms have important implications for the intergovernmental aspects of the budget process. In addition, the Treasury Department is seeking to strengthen treasury administration, including treasury administration at the provincial level.

The introduction of Programme Budgeting

While advanced programme-based budgeting reforms (for instance, in developed economies) often seek to introduce performance-oriented and result-based programs in the budget
process, the initial purpose of the programme-budgeting exercise in Afghanistan has simply been to introduce meaningful programmatic divisions into ministerial budgets.

Currently, it is not possible to determine from ministries’ budgets how resources are being applied within the ministry beyond a very rudimentary breakdown of resources into a few high-level economic classifications. As noted earlier in this Appendix, the budget classification system indicates that only a handful of ministerial budgets are organizationally broken down into more than one department. As such, it is impossible in Afghanistan’s budget to establish a link between the amount that is being spent by a ministry and the public services or outcomes that might be achieved by such spending by a specific department.

Furthermore, because the Government’s core budget remains effectively divided into separate operating and development budgets, it is very difficult to formulate a coherent set of expenditure policies. In order to fill this void in Afghanistan’s budget structure, the government is moving to integrate the operating and core development budgets and has started piloting a Programme Budgeting approach. As part of this program, an additional budget classification dimension was introduced in 1386 that focuses on the policy impact of expenditures and serves a mechanism for unifying the presentation of the two budgets.

In the context of Afghanistan’s Programme Budgeting reform, a Programme is defined as a group of activities that have the same policy objective. The advantages for moving to incorporating a programme-classification in the budget process include:

- Encourages ministries to think of its funding in terms of what it is achieving rather than the inputs focus that tends to exist currently.
- Provides better information on what ministries are doing with their inputs and how their activities relate to national priorities.
- Assists with the development and costing of sector strategies, thereby supporting the further development of the Medium Term Fiscal Framework.
- Makes it more attractive for donors to provide support through the core budget rather than the external budget.

The budget integration and programme budget introduction pilot stage commenced in August 2006. Initially three ministries (Ministry of Education, Ministry of Public Health and Ministry of Rural Rehabilitation and Development) were selected as pilot ministries. The three pilot ministries were required to present their 1386 budgets in a program format with provincial allocation for each programme. These submissions were attached to the 1386 National Budget Document as supplementary information for the Parliament.

A review of the initial progress on programme budgeting suggests that the approach was quite successful. For instance, the Ministry of Education presented its budget in a programmatic form, by separating its budget into eight program areas, including General Education, Teacher Education, Development of Education Infrastructure, Curriculum Development, Islamic Education, Technical and Vocational Education, Literacy and Non-Formal Education, and Education Administration Reform and Development.

Planning in a unified manner (across the divide of recurrent and development budgets) and adding a Programme Budget dimension to Afghanistan’s budget process are important steps forward in linking public spending with the intended objectives of public spending. However, the introduction of Programme Budgeting can be administratively burdensome, as it requires sectoral finance officials to classify every single outlay or expenditure based not only on its economic type and programmatic objective, but potentially also by sub-programme and/or by activity. Such requirements can place a considerable (and potentially excessive) burden on the existing financial administrative structures, particularly in the context of a transitional public sector such as Afghanistan.
Beyond the initial success of introducing a programmatic dimension to the budget, implementing an increasingly detailed programme budgeting approach will become incrementally more difficult. In order to implement a sophisticated programme budgeting approach in a sustainable manner, changes to the Chart of Accounts and AFMIS would be needed to accommodate the need for the line ministries to track expenditures by programmes, sub-programmes and activities.

Furthermore, successfully implementing a Programme Budgeting approach would require a careful integration of Programme Budgeting and Provincial Budgeting, so that the programmatic aspects of budgeting are integrated at all levels of budget discussion. For instance, if the Ministry of Education seeks to improve the delivery of primary education (as part of its General Education Program), it would have to first spread the resources for this purpose across the ministry’s 34 provincial departments before it can engage in programme-budgeting at the provincial level. However, it may be premature at the current stage to engage in programme-based budgeting by activity at the provincial level.

The piloting of Provincial Budgeting
The term ‘provincial budgeting’ in Afghanistan is not used to connote the formulation of actual provincial budgets which are separate from the central government budget. Instead, the term is used to refer to the development of socio-economic development plans at the provincial level with the provincial stakeholders. A provincial budgeting approach was introduced in 1386 (together with a program-based budgeting approach) and is being implemented in a phase wise manner. During its first year, the approach was piloted in three provinces (Kandahar, Panjsher and Balkh) and within four ministries (the Ministry of Reconstruction and Rural Development (MRRD), Ministry of Agriculture, Irrigation and Livestock, and the Ministry of Education). The progress of the initial pilot project seemed encouraging and seven more provinces (Logar, Nangrahar, Ghazni, Bamyan, Herat, Faryab, and Badakhshan) have been added from 1386 with an intention of covering all the 34 provinces within next two-three years.

The overall goal of provincial budgeting is to enable the provincial authorities to contribute more effectively to formulating, executing, monitoring, steering and improving the budget in their area of jurisdiction. Specific objectives for the programme incorporate a number of sound budget practices, include:

- Link the budget to the Millennium Development Goals (MDGs) and the Afghanistan Development Strategy (ANDS) as the major policy instrument defining government priorities for local development;
- Facilitate a criteria based, equitable and transparent resource allocation across the provinces leading to effective public service delivery;
- Reduce inter/intra-provincial development disparities and eventually achieve balanced development across the country;
- Empower provincial authorities by involving them as active stakeholders in the budgetary processes in order to better reflect provinces’ development needs and priorities;
- Ensure that resources made available to provinces are used more effectively;
- Measure the level and quality of government services by provinces;
- Identify the roles of different provincial structures in terms of their future role, responsibility and authority;
- Increase predictability of budget execution rate in the provinces;
- Identify expenditures by provinces and provide to the concerned agencies like Parliament, Donors etc.; and

The provincial budgeting pilot that was conducted during the 1386 budget preparation process was more limited than the broader program’s objectives indicate. As a first step, the initial year of the provincial budgeting pilot sought to analyze available data and identify
information, procedures and system impediments to facilitate transparent and comprehensive reporting to the Parliament both Government and donor expenditures in the provinces. Furthermore, the initial provincial budgeting exercise sought to ensure that provincial stakeholders increased their participation in the budget preparation process to better reflect provinces’ development needs in the context of a defined and limited fiscal envelope assigned to the line ministries. For this to be accomplished, the provincial budget process had to identify the current roles of provincial structures such as the Governor, the Provincial Development Committee, and so on, in order to elicit inputs into the development of their future role, responsibilities and authority over the provincial budget process. As such, the pilot exercise sought to identify provincial development priorities and provide linkages between these priorities on one hand and the National Development Strategy and annual budget process on the other hand.

The main lessons learnt from the provincial budget formulation process for 1386 can be divided into two broad categories. A first lesson was that provincial budgeting requires an appropriate institutional context at the provincial level. In other words, effective planning processes have to be put in place at the provincial level in order for provincial budgeting to bring about its expected results. For instance, capacity building is needed at the provincial level and more emphasis should be paid to the linkages between Provincial and Programme Budgeting, and – at the provincial level – both Provincial and Program Budgeting should be implemented in the wider context of budget integration (achieving a unified budget that covers both the recurrent and development budgets). Furthermore, it was noted that more institutional clarity is required about provincial-level planning responsibilities.

Second, the first year’s experience also highlighted the need to have a consistent approach to provincial (and programme) budgeting at the central government level. Given that half of all public expenditures are provided through the external budget, information from donors on provincial activities needs to be significantly improved. In addition, good provincial budgeting should have a strong link to policy and planning to ensure Government priorities are implemented. For instance, the current inequitable distribution of resource among the provinces cannot be tackled at the provincial level (nor can a meaningful provincial planning exercise take place) without providing each province up-front with indicative planning ceilings. Since the provincial distribution of resources is as much a political decision as it is a budgetary decision, information to Parliament on (and eventually, parliament’s oversight over) provincial allocations and expenditures should be improved. Once further capacity is built at both central and provincial levels, future financing mechanisms should be considered, for instance, by setting objective, formula-based provincial resource ceilings or budget norms in order to divide resources among the provinces for each sector.

**Deconcentration of the AFMIS system to the provincial level**

A final finance-related activity at the provincial level involves the roll-out of the AFMIS system to provincial mustoufiats. Under the current system, most of the data exchanges transacted by provincial mustoufiats and the central treasury are done manually (on paper). At times, the current situation is resulting in slow information flows between treasury, line ministries and provincial line departments, which can complicate budget execution at the provincial level. As such, using a phased approach, the Treasury Department at the Ministry of Finance is seeking to strengthen the capacity of the provincial mustoufiats by rolling out AFMIS to the provincial level. Hence, the roll-out of AFMIS to the provincial level is a matter of the operational strengthening of treasury administration.

Although there are some linkages between the provincial and program budgeting on one hand and treasury administration on the other hand, it is important to recognize that provincial mustoufiats are not involved in provincial budget formulation, as their functional responsibilities are limited to budget execution / treasury functions. Nonetheless, to the extent that provincial mustoufiats are expected to implement the programme and provincial budget approaches, the existing capacity constraints – both in terms of the human resource
constraints as well as the constraints imposed by the existing manual treasury systems at the provincial level – should be taken into account, particularly in determining the appropriate pace for implementing a highly detailed program budgeting approach.
APPENDIX C: INTERGOVERNMENTAL FINANCE IN AFGHANISTAN: DATA SOURCES AND LIMITATIONS

Recognition should be given to the fact that measuring the vertical and horizontal allocation of public resources in Afghanistan is constrained by data availability, and that any attempt to gain a general sense of the degree of vertical and horizontal fiscal imbalances will require imputing or estimating certain fiscal flows. Rather than disrupting the main report by frequent references to the data sources used and the resulting limitations for the conclusions drawn, the description of the data sources used (and the implications for the analyses) is concentrated in this appendix.

Actual expenditure data for SY 1385

Whenever possible, the analysis in this study relies on actual budget expenditures (executed budget data) rather than on budget plan data (i.e., Budget Estimates). There are several shortcomings of using budget plan data as opposed to actual budget outcomes in order to analyze intergovernmental fiscal conditions. Most importantly, it would be naïve (in most countries) to presume that the budget is executed exactly as planned, and therefore relying on budget plan data may draw a distorted picture of actual resources allocations. By, relying on actual expenditure data, the analysis is able to capture the impact of budgetary decisions that are implicitly or explicitly made during the budget year.

Therefore, whenever possible (and unless otherwise noted), the analysis in this study relies on actual expenditures for Solar Year 1385 (2006/07). This year was chosen for the analyses in this study because it is the latest year for which such data are available at the time of writing.

Data sources and considerations in analyzing the vertical allocation of resources

In analyzing and interpreting the vertical allocation of resources, a clear distinction has to be made between the disbursement metric and the expenditure metric, as defined in Section 1.4.

**Recurrent expenditure data.** Data on recurrent government expenditures for 1385 – broken down by economic type and disbursement level (central or province) – was extracted from the Treasury Execution report for the last month of 1385. Further details on recurrent expenditures (expenditures by ministry, economic type and by disbursement location) were extracted from AFMIS. The division between central and provincial administrations in the treasury accounts for recurrent expenditures is strictly based on the geographical location of the disbursement.

**Payroll expenditures.** For both the disbursement metric as well as the expenditure metric, the geographic division of salary disbursements provides a reasonable link between the benefits of subnational services and payroll disbursements, which are either routed through central treasury (for ministerial staff) or through the provincial treasury branch in which the staff is employed (for provincial staff). For instance, analyzing the provincial staffing levels and central versus provincial payroll expenditures for the Ministry of Education allows us to say something meaningful about the distribution of public education resources between the central administration level versus provincial education services, as well as the allocation of education personal (i.e., teachers) across the provinces.

**Non-wage expenditures.** The vertical division between ‘central’ and ‘provincial’ operations and maintenance (O&M) expenditures in the recurrent budget is also driven by the point of disbursement of these resources. However, in contrast to payroll expenditures, the geographic division of funding flows for O&M spending does not provide as good a link between the delivery of subnational services (benefits) and O&M disbursements. This is the case because
procurement for O&M spending can be done at the central government level and transfers can be made in-kind. It is often difficult to detect such in-kind transfers.

**Core development expenditures: expenditure metric.** Actual development expenditures for 1385 by ministry were extracted from the Development Budget Execution Report prepared by the Ministry of Finance. In the absence of the break-down of the actual expenditures between central and provincial levels for each ministry, each development project contained in the Development Assistance Database (DAD) for 1385 was reviewed and assigned to either the central administrative level or the provincial level in line with the criteria established for the ‘expenditure metric’. Subsequently, actual development expenditures for each ministry were assigned to the central or provincial level in proportion to the planned development expenditures contained in the DAD.

The primary basis for assigning projects to either the central or provincial level was the DAD for 1386, which was the first year to indicate the allocation of project resources between the central administration and provinces. However, the accuracy of the coding in the Development Assistance Database was imperfect. For instance, the DAD indicated that all development projects for the Ministry of Education were being executed by the central ministry, with none of the expenditures (including several engaging in classroom construction) providing benefits to any of the provinces. A careful review of education development projects in the core development budget was therefore needed in order to allocate these development resources more appropriately between the different government levels.

A similar problem was encountered in the health sector, where a large share of development expenditures was actually used for recurrent purposes. Therefore, in order to get a reasonably accurate picture of the intergovernmental distribution of the benefits of actual recurrent versus development spending in the health sector, the (core and external) development health budgets were reviewed, and numerous health care programs were reclassified as recurrent activities (including the National Immunization Program, BHPS, malaria programs, and maternal health programs). Despite what the raw data shows, this reclassification confirms that more than half of the spending in the health sector is indeed spent on recurrent programs.

**Core development expenditures: disbursement metric.** No data were available for subnational disbursement of core development expenditures for 1385. The estimate of the subnational disbursement of core development expenditures for 1385 was therefore based on 1386 treasury release data; in line with the 1386 disbursement pattern, it was estimated that 2 percent of core development expenditures in 1385 were disbursed through provincial mustoufiats (see Box C.1).

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**BOX C.1 : FUNDING FLOWS FOR DEVELOPMENT SPENDING**

Although virtually all core development spending is funded directly through the central treasury, provincial mustoufiats maintain a development account in addition to the regular recurrent account. The provincial development account is predominantly used for donor-funded project in the education sector (EQUIP), while there are also a few other projects funded from the development budget (including with funding from DFID) which are executed from these development accounts. Other than these accounts, all development spending is managed centrally. No funds of the external budget flow through the development bank accounts which are managed by the mustoufiats.

The total amount of funding flows to the provincial development accounts for the first ten months of FY 1386 is Afs 620 million, which constitutes approx 2% of the total development budget execution to date.
**External development budget.** There are no data available for actual external development expenditures for 1385. However, the Donor Assistance Database (DAD) for 1385 does contain planned external development expenditures by ministry and project. However, the DAD for 1385 did not provide any indication for externally funded projects whether project resources were intended to be used at the central level or at the provincial level. Therefore, for the purpose of the vertical analysis in this study under the expenditure metric, the division of the external development budget between the central and provincial level was performed manually by the authors based on the project description for each project contained in the external development budget.\(^47\) Furthermore, planned external development expenditures from the DAD for 1385 were multiplied by each sector’s budget performance ratio for 1386 in order to adjust for sectoral differences in the budget performance of the external development budget.

The vertical analysis of resources of the external development budget under the disbursement metric is informed by the fact that all external development expenditures are disbursed at the central government level (typically by the international donors agencies directly, or through a program- or project-specific account). None of these resources are disbursed through the provincial level.

**Municipal and CDC finances.** To the extent that the necessary data are available, the financial resources available at (or flowing to) the municipal level and CDCs are relatively clear-cut, since these local government entities have separate budgets.

Since municipal expenditures are largely funded from own source revenues, the estimate of municipal (recurrent and development) expenditures for 1385 is based on self-reported municipal revenue and expenditure data. This data set – as well as the concerns about the quality of the data – is discussed in Chapter 4. Under the disbursement metric, only these self-funded expenditures are considered as ‘municipal’.

Under the expenditure metric, the development expenditures made from the central budget on behalf of Kabul Municipality were also counted as municipal expenditures, as were the development expenditures made on municipal activities by the Ministry of Urban Development and Housing.

Under the disbursement metric, CDC resources comprise the amount of resources transferred to them through NSP, plus the value of own contributions made (in monetary form or in-kind) to community projects. The cost of the NSP’s Facilitating Partners (who facilitate and organize community election and build the capacity of CDCs) or the overhead/management costs of the NSP program are specifically excluded. In contrast, these resources are counted as CDC-level financial resources under the expenditure approach to attributing resources across different government levels.

**Data sources and considerations in analyzing the horizontal allocation of resources**

**Recurrent expenditures.** Details on the horizontal allocation of recurrent expenditures were extracted from AFMIS, allowing recurrent expenditures to be analyzed by ministry, economic type and by disbursement location (i.e., province). This means that in the case of recurrent expenditures (payroll and O&M spending), it is possible to observe the level of disbursements made in each province for each sector. In accordance with the definition of expenditure metric, the outlay of operational expenditures across provinces is also assumed to reflect the level of ‘benefits’ received from this spending across the different provinces.

\(^{47}\) Another anomaly that both the core and external development budgets were coded for was for the presence of recurrent expenditures within the development budget.
Development expenditures. Data availability was much more constrained for the horizontal analysis of the development budget. There is no indication in the budget documents for 1385 with regard to the planned distribution of development spending across different provinces, as the Ministry of Finance started a serious effort to track (core and external) development spending across provinces in 1386.

However, since all core development spending is executed through the central government treasury, the treasury does record the location of spending to the extent that this is reported by the spending ministry. Although the data may be reported imperfectly by the spending ministry, the reported provincial breakdown of core development spending does provide an indication how development resources are allocated across the respective provinces for the different ministries. Because of the time-cost of extracting these data, core development expenditures were only extracted from AFMIS by province for the eight line ministries that were felt to be particularly relevant for the discussion on intergovernmental (fiscal) relations. Together, these eight ministries account for two-third of public spending in Afghanistan.

In addition to the inherently lower quality of the fiscal data that links development spending programmes to individual provinces (as it is based on the reported location where the resources are used, rather than the actual location where the disbursement is made), the link between provincial expenditures and benefits is also more tenuous than was the case in the analysis of the vertical allocation of public spending. In fact, in many cases it is simply impossible to accurately allocate the benefits from development programmes across different provinces. For instance, when drugs and medical supplies are purchased centrally by the Ministry of Public Health and then distributed in-kind across provincial health departments, it is possible to identify this irregularity in the analysis of the vertical allocation of health resources, but it is essentially impossible to track the horizontal allocation of these in-kind resources across different provinces.

The level of inaccuracy of reporting the location of a project particularly impacts Kabul Province: according to the location indicated in AFMIS, Kabul Province accounts for Afs. 13 billion (or more than two-thirds) of all provincial development spending. It is quite likely that in many cases, these expenditures reflect either central government (ministerial) projects or multi-province spending that is not properly allocated across the different provinces. An indication that the location code for Kabul Province in AFMIS provides a poor indication that the money is actually employed in the province (as defined under the expenditure metric) is the fact that Afs. 6 billion of MRRD’s expenditures are coded to have taken place in Kabul. The impact of this outlier was deemed so large that all development spending in Kabul Province was removed from the analysis of the horizontal allocation of fiscal resources in Chapter 3.

External development budget. Finally, while it is possible to assign external development resources for each sector (albeit imperfectly) either to the central administration level or to the provincial administration level in aggregate, it is impossible at the current time to assign external development spending to individual provinces. Although the External Finance Department at the Ministry of Finance is working to improve the data reporting in this regard, no detailed provincial-level data is currently available for the external development budget. Therefore, external development spending is excluded altogether from the analysis Chapter 3.

Other considerations with regard to the horizontal allocation of resources. In addition to the inaccuracies introduced as a result of the reporting process, another source of data distortion

48 These ministries consist of the Ministries of Education; Public Health; Agriculture; Interior; Public Works; Urban Development and Housing; Energy and Water; and MRRD. When the descriptive statistics for this group of ministries is compared to the overall descriptive statistics for total recurrent expenditures, variations in per capita provincial recurrent spending for this subgroup of ministries closely resemble the variations in total recurrent spending.
is the fact that development projects in Afghanistan are frequently an alternative source for recurrent spending. Furthermore, the data censoring which results from the absence of data on external development spending by province provides a further source of data volatility. In addition, by its very nature, capital development spending is more lumpy and variable than recurrent spending.

In the context of the analysis of recurrent spending in isolation from development spending (as is done in Section 3.2 and 3.3), it should be noted that doing so actually generates a risk of spurious horizontal imbalances. Although this is probably not a major concern when considering the horizontal allocation of all recurrent spending together, the risk is more pronounced when analyzing sectors or spending programs where a significant portion of recurrent expenditures are actually financed through the development budget (as in the case of the health sector).

In the case of the health sector, an analysis of the recurrent budget alone would give an incorrect picture of the overall horizontal (im)balance of provincial spending because a large share of recurrent spending in the sector is financed through the development budget. In fact, the same problem might persist even if detailed core budget data were available, since BPHS is extensively funded through the external development budget, for which information on the horizontal allocation of resources is not available.