

Working Paper 3
for
Afghanistan Public Expenditure Review 2010
Second Generation of Public Expenditure Reforms

**Expenditure Framework and Public Financial
Management**



Co-produced with the UK Department for International Development

Expenditure Framework and Public Financial Management¹

Key Findings

Afghanistan has made impressive progress building an effective expenditure management framework over the past several years. This Annex reviews these achievements but also identifies key challenges going forward. Its organization parallels that of the budget cycle, from budget formulation to budget execution and auditing. A summary of the analysis and recommendations appears in [Figure 1](#).

Budget Formulation. One measure of how much budget formulation has improved is reflected by the fact that it is approved before the start of the fiscal year. However, a link between national objectives and budget formulation remains weak. Although the Afghanistan National Development Strategy (ANDS) and the Medium Term Fiscal Framework (MTFF) are expected to provide policy and resource allocation guidelines, they are still rudimentary and cannot offer strategic direction. Part of the problem can be traced to donors failing to provide timely, quality information, particularly about the external budget, which makes the alignment of the budget with national objectives more difficult. Finally, a dual budget system in which operating and development expenditures use different classifications hinders the formulation of coherent expenditure policies.

Budget Execution. Despite the improvements in budget formulation (e.g. more detailed project proposals), the execution rates of core budget development expenditures remain low, leading to slower than expected development. Low execution rates are caused by a combination of the low absorption capacity of line ministries, late disbursements by donors and overly optimistic budget projections.

Audit. Despite the progress made by the Ministry of Finance's (MoF) own internal audit department, with few exceptions the internal audit departments of line ministries remain rudimentary. Low capacity and weaknesses within the legal framework have contributed to the problem, undermining the quality of external audits by the Control Audit Office (CAO), resulting in little follow up by the executive or legislative branches of government.

Policy Recommendations

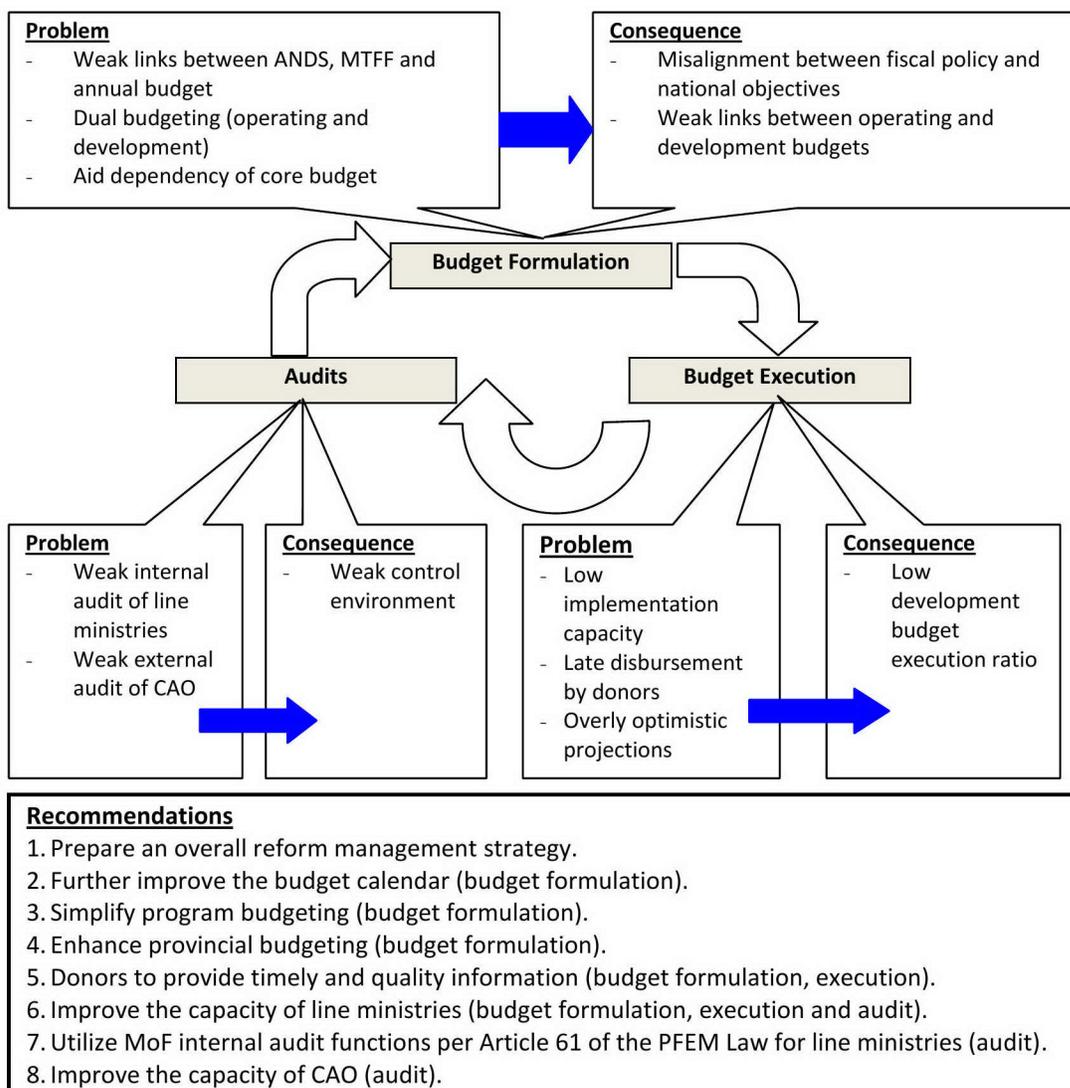
- **A comprehensive budget reform strategy should be prepared** to address the lack of strong linkages and to ensure adequate sequencing between the different elements in the reform program, including program budgeting, provincial budgeting, the ANDS and MTFF.
- **Further improvements to the budget calendar, especially providing the budget ceiling earlier,** will give line ministries more time to prepare their budget submissions enabling them to focus on policies and strategies.
- **Simplify program budgeting.** Program budgeting should take the capacities and resources of each line ministry into account. At least initially, allotment and expenditure controls could continue to be based on the existing structures, but the requirement for detailed activity-based costing should be removed.
- **Enhance provincial budgeting.** Modifications to the Afghanistan Financial Management Information System (AFMIS) and the Chart of Account (CoA) should enable provincial coding of payment transactions that will produce reliable provincial expenditure breakdowns. Links between provincial budgeting and other reforms should ensure consistency between Provincial

¹ This working paper was produced by Peter Jensen (DFID Consultant) and Sebastian Eckardt (World Bank, ECSPE) for Afghanistan Public Expenditure Review based on information available as of March 31, 2010.

Development Plans (PDPs) and ANDS priorities. Furthermore, plans should be developed to increase the budget authority of the provincial departments in the longer term.

- **Need for timely, quality information on external assistance.** Given Afghanistan’s fundamental dependence on external donor financing, it is critical the predictability and reliability of fund flows improve to enable sound public expenditure planning and execution.
- **Improve the capacity of line ministries.** The capacity of line ministries to produce and execute policy-based budgeting needs strengthening, in particular at the sub-national level and on procurement issues.
- **Utilize MoF internal audit capacity in line ministries.** The internal audit functions of MoF are strong compared with those of line ministries. Reinstatement of Article 61 of the Public Finance and Expenditure Management (PFEM) law in late 2009 will allow line ministries to benefit from MoF’s expertise.
- **Improve the capacity of CAO.** A strong legislative framework is a prerequisite for producing robust external audits. Strengthening of the institutional operations and development of staff capacities requires substantial technical assistance. Attempts should be undertaken to ensure all institutions properly follow-up on audit findings and recommendations.

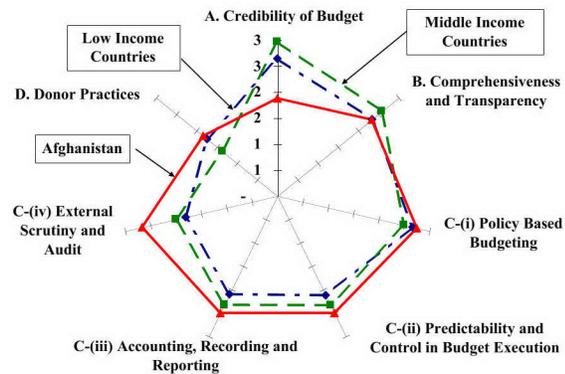
Figure 1 Afghanistan’s Expenditure Framework – Key Problems, Consequences and Reform Measures



A. Introduction

1. **Afghanistan has made significant strides towards establishing a sound public financial management (PFM) framework.** This is reflected in the results of a Public Expenditures and Financial Accountability (PEFA) Assessment in 2008. Afghanistan scores better than other comparable countries in most categories (Figure 2).² Budget cycle indicators (C-(i)-(iv)) are better than the average for those middle-income countries where PEFA assessments are available. The credibility of the budget (A) is lower than the average for other low-income countries, while comprehensiveness and transparency (B) is equivalent to their average.

Figure 2: International Comparison
(Afghanistan and other PEFA countries)

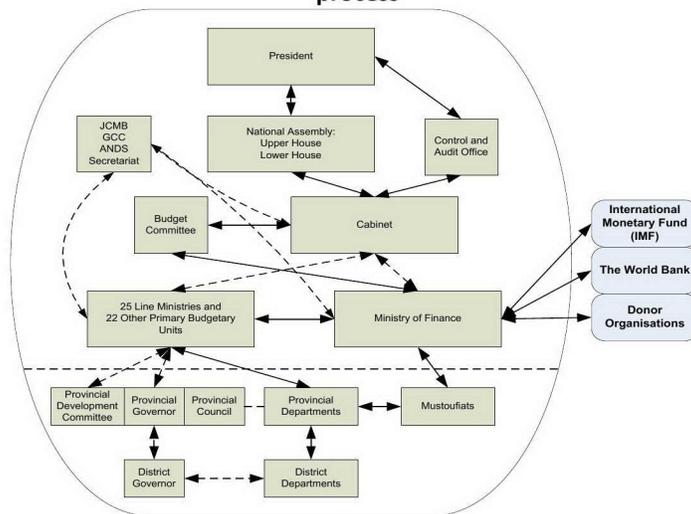


Source: PEFA website, World Bank staff

B. Budget Formulation

2. **In Afghanistan, as in other countries, budgeting is a multi-stakeholder process.** It includes repeated interactions between MoF, Ministry of Economy (MoEc), line ministries, the parliament and a large number of international donor institutions reflecting the country's continued reliance on outside financing (Figure 3). The current institutional framework contributes to checks and balances, however effective planning and coordination is essential to avoid duplication and confusion. The Constitution broadly stipulates the respective roles of the executive and legislative branches of government, while the specific procedures and responsibilities are detailed in the PFEM law and the Financial Regulations³.

Figure 3 Institutional framework of the budget formulation process



3. **Annual budget formulation** starts in April of the preceding fiscal year ahead of parliamentary approval the following March (Table 1). MoF initiates the budgeting process by setting the budget envelope (April-June). MoF subsequently issues a budget circular to the 48 primary

² Data on 23 countries (12 low income countries and 11 middle income countries) are available on the PEFA website: www.pefa.org. A summary table of Afghanistan's PEFA in 2005 and 2007 is found in Appendix 3.1.

³ Article 29 in the PFEM Law and Annex 2 in the Financial Regulations

budgetary units (ministries and agencies) that provide general budgeting guidance, the timetable and indicative expenditure ceilings for each unit. The budgetary units then prepare their budget requests (October-November). The budget submissions are initially reviewed by the budget department of MoF to help budgetary units define and prioritizing their needs within the ceilings, and to assess the reliability and soundness of the proposals. They are subject to a two-week budget hearing process overseen by the Budget Committee, an inter-ministerial body set up in accordance with the PFEM law, where representatives of the budgetary units (typically at the level of Minister or Deputy Minister) present their proposals.

Table 1 Budget Formulation Timetable

Steps	Period	Description
1. Budget envelope	April-June	Prepared by the MoF after consultations with the IMF (PRGF) on fiscal targets and donors on external assistance.
2. Budget circular	July-August	The budget department informs the primary budgetary units about procedures and timings.
3. Budget ceilings	September-October	The budget department in consultation with the Budget Committee of the Cabinet drafts a Fiscal Strategy Report that includes indicative budget ceilings.
4. Preparation of budget proposals	October-November	The primary budgetary units prepare their budget requests.
5. Appraisal of budget submissions	November-December	The budget department appraises the submissions followed by hearings of the Budget Committee with the ministries.
6. Consolidation and Cabinet approval	December-January	The MoF consolidates the budget document. The Cabinet in consultation with the Budget Committee approves it, including the final budget ceilings.
7. Enactment	February-March	The Assembly deliberates and approves the budget.

Note: The timings are indicative for a well-planned and -managed process, but as stated below there have been some deviations over the past three years.

- 4. The budget formulation process is orderly and compliance with the timetable has improved over the years.** While the budget is now passed on time, the time given to prepare detailed submissions appears too short. Ministries and agencies were given only four weeks to prepare their intended list of projects for the 2009/10 budget. The process involved linking projects to the ANDS priorities for 2009/10-2011/12, outputs, outcomes and indicative costs, and (through the Consultation Group mechanism) discussing these proposals with donors, provincial representatives, MoF and MoEc before finalization⁴. Despite a one-month deadline extension to late August 2008, it was early October before all line ministries had submitted the requested documents. The second budget circular was issued at the end October leaving line ministries just four weeks to prepare their detailed budget proposals, resulting in an unnecessarily compressed schedule similar to earlier years.

Table 2 Timing of the Budget Formulation Process, 2007/08-2010/11

	2007/08 (SY1386) Budget	2008/09 (SY1387) Budget	2009/10 (SY1388) Budget	20010/11 (SY1389) Budget
Draft budget to the Cabinet	25 January	22 January	22 January	16 January
Approval by the Cabinet	29 January	28 January	2 February	21 January
Submitted to the Assembly	6 February	2 February	3 February	1 February
Approval by the Upper House	21 February	21 February	18 February	14 March
Approval by the Lower House	22 April	15 March	18 March	1/
Presidential Decree	26 April	24 March	1 April	-

1/ As of March 31, 2010 the budget is not approved.

Source: MoF

⁴ The budget calendar for 2010/11 indicates that MoF plans to make improvements.

5. **The overall macro/fiscal framework is developed based on consultations with the IMF.** Under the IMF's Poverty Reduction and Growth Facility (PRGF) program, the Government has committed itself to adhere to a macro fiscal framework. The PRGF framework does not have an expenditure ceiling, but it sets targets for domestic revenues and the operating budget deficit thereby affecting core operating expenditures. In addition, almost 100 percent of the core development budget is financed by donors. The PRGF's medium-term macroeconomic framework includes five-year projections for both the core operating and development budgets, that provide MoF an indicative overall budget ceiling for the next fiscal year from the beginning of the budget formulation process in April. The PRGF framework is reviewed, adjusted and agreed upon biannually in consultation with the government.
6. **Line ministry planning will benefit from improved budget ceilings.**⁵ MoF issued indicative ceilings together with the first budget circular for the first time during the 2009/10 budget process. However, the ceilings were based on ANDS sector allocations rather than the available resources as determined under the PRGF. Unavoidable but predictable cuts were made later because the overall ceiling was almost US\$1 billion higher than the PRGF projection. In addition, donor-dependent ceilings for the development budget are sometimes received as late as January, further complicating the timely setting of the ceilings. The lack of clear budget ceilings set by the Cabinet prior to the preparation of detailed budget proposals leads line ministries to prepare their budget requests based on perceived needs rather than established availability of resources. This makes it difficult for line ministries to properly translate strategies into realistic resource allocations. It has also encouraged individual ministries to lobby for additional resources, undermining rational budgeting processes.

Key Issues on Budget Formulation

7. **A dual budget for operating and development expenditures hinders the formulation of coherent expenditure policies.** As a result of the prolonged internal discussions about the division of responsibilities between MoF and MoEc, the government decided that budgetary units must submit their Development Budget requests for 2009/10 through MoEc, which seems to be backtracking on institutional reforms aimed at integrating in MoF the operating and development budgets and centralizing budget scrutiny. Moreover, the operating budget continues to be presented and appropriated based on primary budget units broken down by major Government Financial Statistics (GFS) economic codes⁶, while the development budget is presented and approved based on projects under each primary budgetary unit. While both development and operating expenditures are classified according to ANDS sectors, there is no consistent expenditure control system applied across the entire budget. The program budgeting approach, currently under pilot implementation and discussed below, aims among other things at integrating development and operating expenditures related to achieving program objectives.
8. **Sub-national units have little say in the preparation of budgets**⁷. Many budgetary units have provincial and district departments where the actual services are provided, some of which help identify needs in their sectors. Their involvement is generally limited as most budgeting decisions are made at the central level in Kabul. There is no breakdown of ministerial budgets at provincial level, and provincial allocations are generally only made after the budget has

⁵ Annex 5 on Education also point out this issue from sector points of view. More explanations can be found in World Bank (2008a): "Afghanistan, Public Financial Management Performance Assessment"; June, p. 15.

⁶ Code 21 – Wages and salaries, Code 22 – Services and goods, and Code 25 – Acquisition of assets.

⁷ The Ministry of Education (MoE) is one of exceptions. The Ministry started to involve provincial education departments (PEDs) in budget formulation process.

been enacted. However, provincial budgeting approach, discussed in more detail below - is an attempt to increase the role of the provincial level.

9. **The current budget formulation process lacks policy focus and robust expenditure prioritization.** MoF's role in reviewing and assessing budget submissions is hampered by insufficient technical capacity to challenge line ministries, and limitations in the information submitted, including the lack of feasibility studies for investment projects. As a result, budget deliberations at all stages tend to focus more on negotiating inputs and ceilings rather than discussing the content and strategic orientation of the budget submissions with regard to achieving policy objectives outlined in the ANDS.
10. **Dependence on aid financing puts additional constraints on expenditure management.** More than two-thirds of the core budget (sum of core operating and development budgets) is financed by donors through a diverse set of financing instruments including, the Afghanistan Reconstruction Trust Fund (ARTF), Law and Order Trust Fund for Afghanistan (LOTFA), bilateral investment projects in the development budget, and to a more limited extent, direct budget supports. While aid programs are supposed to be the outcome of consultative processes between donors and the government, in practice expenditure management is not fully integrated. As donors tend to respond to the preferences of their own constituencies, external assistance does not align with the national objectives. This issue applies to the resources flowing through the core budget but is naturally more pronounced in the large external budget. The external budget accounts for roughly three-quarters of the total national budget. The alignment of national objectives with overall public expenditures is difficult because the government has little control over the external budget. In this environment line ministries tend to initiate expenditure measures without sufficient prior consultation with MoF based on the expectation that donors will ultimately provide the necessary funding.
11. **At the same time, donors are reluctant the change the way they deliver aid because of perceived weaknesses in expenditure prioritization.** Projects within the core budget are approved and budgeted by the government, but perceptions that budget formulation is reactive rather than strategic, and concerns about absorptive capacity leads donors to project financing so they have greater control over the types of projects to receive their funding. While the PFM environment has been strengthened significantly in recent years, it is clear that further major improvements in strategic expenditure prioritization as well as in the control arrangements, including internal and external audits (see Section D on Audit and Reporting), are required before a broader movement towards budget support can be undertaken.

Reform Initiatives

12. **The Government has initiated a number of reforms to improve the expenditure framework, including pilot program budgeting, the MTF, ANDS costing and provincial budgeting.** However, the linkages between these different technical reforms should be improved. Progress across the different reform areas has been uneven. A piecemeal implementation process responding to operational and donor pressures rather than to an overall strategic vision of budgetary reforms has led to a duplication of efforts and inconsistency of outcomes. The ANDS sets the overall policy framework for expenditure policy. The costing exercise and sectoral ceilings are supposed to have direct allocative implications but at the current time they neither coincide with the resource constraint in the MTF, nor translate into the annual budget allocations. The evolving program structure is largely consistent with ANDS priorities, but has yet to become the basis for allocative decision-making and expenditure control. While MoF insists provincial budgeting should be an integrated part of the program budgeting to ensure line ministries consider the provincial context in program design, in practice the linkages were limited. They are hampered by the fact that the Provincial Development Plans

(PDPs) that drive provincial allocations and hence budget submission did not relate to the departmental program structures.

Link with the ANDS⁸

13. **The ANDS is supposed to guide resource allocations in the annual budget, but prioritization is weak and integration with MTFF and the annual budget process is lagging.** The final ANDS costing figures are supposed to be reflected in the MTFF and the annual budgets of the budgetary units, but it is not clear at this stage how the government intends to align the ANDS priority ceilings with the annual national budget. Integration of ANDS costing and sectoral expenditure planning with the budget is hampered by the fact that the former were largely prepared without reference to the resource constraints. This has weakened prioritization and led to an overloaded and potentially unaffordable policy program in the ANDS. To avoid this tendency expenditure programs should be placed within the fiscal envelope and linked with the budgetary allocation in the MTFF and the annual budget. Institutionally the recent establishment of a dedicated ANDS and budget policy directorate under the MoF's budget department is expected to facilitate better coordination and articulation of the ANDS priorities in the annual budget process.

Medium-Term Fiscal Framework

14. **The PFEM law mandates that the preparation of the annual budget be based on a multi-year framework.** The MTFF is officially updated twice yearly by the Fiscal Policy Unit (FPU) of MoF with support from the IMF. The first MTFF covering the years 2007/8 through 2009/10 was prepared in October 2005. The MTFF provides projections of aggregate revenues and expenditures for all 48 primary budgetary units. The underlying economic assumptions and revenue forecasting rely to a large extent on the IMF estimates, although in practice the projections of the PRGF and the MTFF are not identical. The FPU plans to develop a financial programming model, initially replicating IMF's macro-economic projections, and later producing independent estimates that will be incorporated into the MTFF. Expenditure estimates are primarily based on parameter adjustments to the main cost items but major policy initiatives, for example the ongoing civil service P&G reform, or cost drivers like the upcoming elections, are costed and included in the forward estimates. The MTFF is part of the formal budget documentation that is submitted to parliament for approval.
15. **The MTFF has helped improve the strategic aspects of fiscal policy, but further efforts are needed to develop it into a key instrument of fiscal policy and to better integrate it into both the annual budget process and the ANDS.** The government wants to use the MTFF to enable fiscally sustainable and efficient expenditure choices in the annual budget process⁹. However, the MTFF currently plays a very limited role in setting the overall parameters of fiscal policy and prioritization because it is not prepared until relatively late in the budget formulation cycle. It also amplifies the duality of the annual budgeting procedures, with separate accounts for operating and development expenditures rather than programmatic or functional expenditure estimates. The government intends to better reflect ongoing operational and maintenance costs associated with investment spending in the forward estimates, but a lack of external budget data that accounts for large parts of capital spending weakens the fiscal analysis underlying MTFF in this regard¹⁰. Furthermore, although the MTFF now presents

⁸ The ANDS is explained more in Section D of Annex 1.

⁹ ANDS (2008, p. 50).

¹⁰ IMF (2008a): "Islamic Republic of Afghanistan: 2007 Article IV Consultation and Third Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criterion", February, IMF Country Report No. 08/76, p. 19 and pp. 25-26.

information by ANDS sectors, the actual links between the ANDS and MTFF are weak: it is unclear how the results of the ANDS costing exercise will be reflected in the MTFF.

16. **The capacity and institutional role of the FPU needs to be strengthened** to lay the foundation for a more effective MTFF. The unit has about five national staff supported by an international advisor, and is organizationally separate from the budget department, reporting instead to the Minister's office. Making the MTFF an effective policy tool requires that FPU becomes a pro-active unit with more personnel capacity and a stronger organizational role within MoF, including closer ties to the Minister of Finance and different departments of MoF, the budget department in particular.

Program Budgeting

17. **Pilot program budgeting is a technically demanding reform that has been poorly conceived and executed thus far until 2008/09.** The few positive results have not delivered significant outcomes. Instead, the impact of pilot program budgeting has been uniformly negative, absorbing scarce financial and human resources and creating unnecessary confusion. The problems experienced with the budget execution in early 2008/09 (SY1387) illustrated among other things, the weak capacity of most line ministries, something that should have been recognized from the onset. Preparation should have been made to develop the general capacities (planning, PFM, performance management) of civil servants and to properly prepare systems and procedures (CoA, AFMIS). A well-monitored and properly reviewed pilot phase should have been initiated and complexities only added later when ministries demonstrated the ability to cope with basic budgeting tasks. Instead, the rushed implementation process lacked planning and proper coordination because of inconsistent and poor quality external advice and unclear articulation by MoF of its expectations and the process. While the initial approach to program budgeting emphasized simplicity, in practice it soon became too complex, overstressing the limited resources and capacity in both MoF and line ministries. Sectoral strategies in some ministries were weak, so program structures focused on the existing departmental organization structures rather than service delivery and policy responsibilities. This led to a large number of programs, sub-programs and activities, particularly in ministries with complex provincial organizational structures.¹¹ The identification and costing of required resources at the activity level, which was requested in the 2008/09 (SY1387) budget circular, created substantial workloads: the lack of adequate cost accounting systems overburdened existing capacities in line ministries. It also appears that MoF neither analyzed nor used the activity-level cost information submitted by the line ministries in the review of budget submissions. More importantly, the activity costing approach pursued under program budgeting does not reflect the policy costing undertaken for the ANDS.
18. **Moreover, the downstream implications of program budgeting on budget execution were not addressed from the outset.**¹² The introduction of program classification needs to be embedded in CoA and requires related changes in the accounting and reporting systems, to ensure payment transactions can be recorded and consolidated on a program basis. Due to the limited involvement of the Treasury Department in the conceptualization and implementation of the program budgeting initiative, these important aspects of budget

¹⁰ Murray Petrie (2006a): "Integrating the Operating & Development Budgets through the Introduction of Expenditure Programs", Middle East Technical Assistance Center, IMF, July, p. 5.

¹¹ Richard Bontjer (2008): "Budget Integration and Program Budgeting Mission", Middle East Technical Assistance Center, IMF, August, p. 13..

¹² Murray Petrie (2006b): "Report on Budget Integration and Program Budgeting", Middle East Technical Assistance Centre, IMF, December.

execution were largely neglected during the initial implementation. As a result, pilot ministries undertook expenditure tracking through separate spreadsheets outside the AFMIS which had serious implications for the reliability and consistency of program-based financial data. To address these problems, the AFMIS coding structure was revised in 2008 to allow expenditure tracking on a program basis. These changes affected budget authority management and the allotment process, leading to a substantial increase in the transaction processing workload related to allotments and accounting¹³. As a result of this and some administrative delays in the issuance of allotment forms, budget execution in the seven pilot ministries came to a virtual standstill at the beginning of 2008/09.

19. **Insufficient emphasis is placed on performance monitoring.** The three participating ministries lacked a system or formalized procedure for recording, tracking and reporting of their performance measures early in the pilot project. While the AFMIS is now capable of recording expenditure data at the program level, data capture is limited to financial data and does not permit recording of program-related performance information.¹⁴ The Ministry of Rural Rehabilitation and Development (MRRD) created a database that, in addition to program budget formulation and expenditure tracking, could also be used for performance measurement and monitoring. While the AFMIS should become the accounting data repository, a separate database, similar to the one operated by MRRD, could provide performance management functionalities that are unlikely to be built into the AFMIS. The general application of the database would provide ministries that initiate program budgeting for 2009/10 with a useful tool as many are not covered by the current AFMIS roll-out.¹⁵
20. **While a large amount of technical assistance has been provided for pilot program budgeting, the lack of coordination has led to inconsistent advice and contributed to the growing complexity of the overall approach.** In addition to the IMF's ongoing technical assistance, technical support was provided by consultants from two projects in the budget department funded by DFID, UNDP and USAID.¹⁶ In the absence of clear leadership by MoF and the steering committee set up to guide the process, technical assistance contributed to the poor results. As described above for example, MoF and its advisors focused almost exclusively on the budget formulation side, neglecting the consequences for budget execution. It also appears that some of the technical assistance was directed towards a full-fledged program budgeting system, an overly ambitious and misconstrued target given the current state of Afghanistan's PFM system and the capacity of particular line ministries.

Provincial Budgeting

21. **Afghanistan is a unitary state, but the Constitution provides for the creation of elected provincial, district, municipal and village councils.**¹⁷ The overall legislative framework for the subnational administration lacks clarity: various old, new and often inconsistent laws and regulations affect sub-national institutions.¹⁸ The roles and responsibilities of provinces and their formal relationship with districts, municipalities and the central government are poorly

¹³ The number of forms to be processed for the execution of payments particularly was significant in ministries with a complex structure and many provincial activities.

¹⁴ Richard Bontjer (2008): op.cit., p. 21.

¹⁵ AFMIS coverage has been extended to 47 line ministries and agencies. Also, 28 provinces are now connected to the AFMIS.

¹⁶ The team consisted of 12 international and 15 national advisors. The MoE was supported by DANIDA and USAID.

¹⁷ Afghanistan is divided into 34 provinces, approximately 400 districts (rural districts and provincial urban centers), 217 municipalities and around 180 rural municipalities. Administrative units vary greatly in terms of population size, security situation, reconstruction needs and other social economic conditions.

¹⁸ World Bank (2007b): "Service Delivery and Governance at the Sub-National Level in Afghanistan", p. 6.

defined.¹⁹ At the same time, most of the major line ministries have provincial representation of varying size and structure depending on the size of the province and other circumstances that either directly undertake service delivery (e.g. in the education sector), or contract out to NGOs and other entities (e.g., large parts of the health sector). Provincial staff are appointed by and are employees of the central government and formally report to their respective ministries. In practice, however, the Provincial Governor and the Provincial Council also have considerable influence. Although the legality of the process is unclear, the Office of the Provincial Governor signs off on all provincial expenditures giving them considerable influence over budget execution. These overlapping lines of reference and accountability cause confusion.²⁰ Though centralized decision-making remains strong overall, the pace of the decentralization of departmental operations differs across the ministries, and serious capacity- and systems constraints characterize all ministries at the provincial level.²¹

- 22. There is a significant mismatch between actual spending and budget formulation authority.** In 2006/07 (SY1385) three-quarters of public resources were expended through the central treasury at the central administration level, provincial Mustofiats managed 17 percent, Community Development Committees, five percent, and municipalities, two percent (Table 3). A review of where expenditures were made on operations, service delivery and infrastructure, reveals that 69 percent of public spending was done at the sub-national level, mainly in the provinces.²² Despite these substantial responsibilities, provincial departments generally have little autonomy in budget planning and execution. Although they enjoy some flexibility in shifting expenditure allotments between minor budget codes, during execution, the allotment process imposes detailed expenditure controls. And, as discussed in Annex 2, there are large funding inequities, with the best-off province receiving six times more funds than the worst-off province.

Table 3 Vertical Allocation of Funds, SY1385 (2006/07)²³

	Where Funds are Registered as Spent	Where Funds actually Benefit
Central	76%	31%
Provinces	17%	61%
Municipalities	2%	2%
Community Development Councils	5%	6%
Sum	100%	100%

Source: World Bank (2008c): "Intergovernmental Fiscal Relations and Subnational Expenditures in Afghanistan", August, pp. 9-10.

- 23. The highly centralized budget system is a double-edged sword,** undermining allocative efficiency and service delivery, while helping to maintain overall fiscal discipline/control. Given potentially large variations in spending needs and service delivery costs across provinces, central line ministry officials might lack the information they need to make efficient budgetary decisions that cater to the heterogeneous conditions in the provinces. The vertical

¹⁹ Ted Dinklo (2008): "Provincial Budgeting – A comprehensive review of the provincial budgeting pilot and A way forward – an options paper how to design provincial budgeting in Afghanistan", Draft, Adam Smith International, September, p. 9.

²⁰ Ibid., p. 12.

²¹ World Bank (2007b): op.cit., pp. 6-11.

²² The differences between recorded and actual location are the result of existing accounting and disbursement procedures that record significant payments, including many multi-province development projects, at the central treasury as taking place in Kabul.

²³ The table is based on both core budget and external budget.

fiscal imbalance is therefore not necessarily a resource imbalance but is rather an imbalance of authority over provincial resources.²⁴ Aside from the allocative effects, centralized budget procedures also undermined local ownership and support for the reconstruction efforts.

- 24. The government has begun to facilitate more equitable and transparent resource allocations across provinces** while strengthening links to the ANDS priorities. Specifically, the initiative aims to improve the data and analysis underlying the regional distribution of expenditures through a provincial-level roll-out of the AFMIS to clarify roles and strengthen the participation of sub-national structures in allocative decision making.²⁵ The provincial budgeting reform process began as a pilot in the 2007/08 (SY1386) covering three ministries – the Ministry of Education (MoE), MRRD and the Ministry of Agriculture, Irrigation and Livestock (MAIL) - and three provinces - Balkh (as an example of a province with relatively good capacity), Panjshir (a newly-established province) and Kandahar (with security problems). It has gradually increased to include the participation of seven ministries in 18 provinces.²⁶
- 25. Provincial budgeting is expected to provide bottom-up planning** embedded in the annual budget process and a more robust framework and process for deciding provincial ceilings. Provincial ceilings should be based on a detailed analysis of the needs, objectives, programs and projects of the ministries in each province, and an analysis of PDPs and their links with the ANDS²⁷. In terms of process, provincial budget ceilings are supposed to be determined at the budget formulation stage during which line ministries must justify the basis for the allocations. The process begins with the ministries preparing detailed instructions to their provincial departments. Provincial departments subsequently prepare a budget proposal within an indicative ceiling that is discussed with and approved by the PDCs and the Provincial Governor before being submitted to the relevant line ministry. The ministries evaluate and revise the proposals as needed before preparing the final provincial budget.
- 26. Overall, the results of pilot provincial budgeting demonstrate that it is possible to improve the engagement of provinces.**²⁸ While the three pilot line ministries were able to disaggregate their ceilings by province and by program, a number of issues emerged. The quality of consultations with the provincial departments and PDCs should be improved. Some of the budget proposals submitted by the provincial departments appeared to be based on local political agendas rather than on proper needs assessments and identified priorities. MoF said that to ensure that line ministries consider the provincial context in program design, provincial budgeting should be an integrated part of program budgeting. In practice, the linkages were limited, hampered by the fact that the PDPs that drive provincial allocations and hence budget submissions, did not relate to the departmental program structures.²⁹
- 27. The draft policy paper on sub-national governance reinforces the provincial budgeting initiative, but goes beyond the intended budgetary deconcentration.** The policy paper prepared by the Independent Directorate for Local Governance (IDLG) is much broader, covering the overall institutional framework for sub-national governments. But the paper

²⁴ World Bank (2008c): p. 22.

²⁵ GoA (2007b): “Provincial Development, Provincial Budgeting and Integration of the Provincial Development Plans into the Afghan National Development Strategy (ANDS)”, Draft Discussion Paper for the ADF, April, p. 12. The objectives stated in the SY1386 Provincial Budgeting Circular were similar, but broader in scope.

²⁶ The eight new provinces are Jawzjan, Kunduz, Takhar, Parwan, Helmand, Paktia, Khost and Wardak.

²⁷ The process of establishing PDCs and develop PDPs started in 2006 and was driven largely by the MoEc which acts as PDC Secretariats at the provincial level.

²⁸ GoA (2007b): op.cit, p. 15, and Jean-Marc Lepain (undated): “Provincial Budgeting Pilot Project – Outcomes and Policy and Guidelines for Pilot Project Second Phase”, Maxwell Stamp Inc., p. 30

²⁹ However, it must also be noted that program budgeting has proven complex to implement and report on at the provincial level.

includes fiscal aspects and as such pertains to provincial budgeting.³⁰ The paper proposes to expand the provincial budgeting initiative to all ministries and provinces. Moreover, the paper outlines a process by which provincial planning process and the PDCs become the main instrument for budget allocation and service delivery. Unlike the on-going pilot, however, it proposes allocating up to one-quarter of the sectoral budgets directly to Provincial Councils and the Provincial Governors, implying a mix of sectoral deconcentration with some elements of devolution of allocative decision-making authority to the provincial level. The latter will need further consideration as the preconditions for effective fiscal devolution, like sufficient provincial capacity and a sound sub-national governance and accountability framework, are currently not in place.³¹ More generally, little consultation has taken place between IDLG and MoF, and given the limited fiscal space available to government, the fiscal feasibility of the proposals is very doubtful. Furthermore, the draft policy paper introduces the concept of minimum service standards but does not link these to the budget allocations or expenditure norms needed to ensure that sectoral resources are allocated based on the provinces' relative needs and financial norms.³²

C. BUDGET EXECUTION AND PROCUREMENT

Budget Execution

28. **MoF has the authority to issue allotments against the appropriations upon approval of the budget.** Allotments permit line ministries to make expenditures specified in the allotment forms. Allotment requests from line ministries are received and formally checked by the budget department, and then passed on to the Budget Execution Unit that monitors and approves allotments, and has them registered in the AFMIS. The process enables the budget department to manage budget authority and to assure that budget funds are spent according to the approved purposes. Operating budget allotments are made quarterly. The budget department uses development budget allotments as a commitment and cash management instrument. Allotments are made as per the conditions of the contract signed between the line ministry and contractor, and are only issued after a departmental review. This has contributed to the effective control of funds because disbursements are tied to duly approved contracts procured in line with prevailing rules, with payments limited to the contracted amount.
29. **The current procedures create rigidities during budget execution, but have also imposed budgetary discipline³³.** In particular, the use of allotments for commitment control and contract management complicate procedures and increases the budget department's workload as all contracts and amendments must be reviewed in order to track expenditure performance.³⁴ Furthermore, the allotment and payment processes link each project to a specific source of funding. This means that a shortfall in funding of one project cannot be financed by funding from another project, even in cases where the latter is not being implemented or where progress, and hence disbursement, is very slow. While this approach is prudent for non-discretionary funds (e.g. donor-funds dedicated to a specific project or project

³⁰ GoA (2008f): "Draft Sub-National Governance Policy", 10 September, pp. 40-41.

³¹ Hamish Nixon and Jamie Boex (2008a): *op.cit.*, p. 2.

³² Hamish Nixon and Jamie Boex (2008b): "Horizontal Allocations and Expenditure Norms in Afghanistan: Current Practice, International Experience and the Way Forward", World Bank, Draft Outline Technical Note 2, pp. 1-2.

³³ Current core development expenditure execution procedures are found in Appendix 3.2

³⁴ Janis Platais (2007a): "Improving Execution of the Development Budget", Middle East Technical Assistance Center, IMF, p. 16.

component), it constrains effective cash management.³⁵ Some flexibility in cash management has been introduced recently as discretionary funds have been advanced to bridge gaps in non-discretionary funding, if the projects are ready to disburse.

- 30. Over the longer term, both program budgeting and provincial budgeting could lead to more flexible budget management.** Expenditure controls are needed to ensure that funds are used in accordance with the budget appropriations, and to avoid excessive changes to the approved expenditure program.³⁶ At the same time, the requirement for budget discipline needs to be balanced against the need to allow some flexibility for desirable adjustments during implementation. In the context of program budgeting and provincial budgeting, important efficiency gains are possible if the changes to budget preparation procedures are accompanied by changes to the budget execution environment that delegate some expenditure controls and budget authority to budget users. This would provide line ministries or provinces greater discretion over the composition of inputs and replace detailed centralized line item control with controls over more aggregate program allocations linked to service outputs. At the same time, it would free up the budget department's resources to focus more on policy analysis and budget formulation. Such a change is only feasible over the longer term as it should proceed gradually and at a pace commensurate with the development of strong internal controls and financial management capacities at the line ministries and provinces. It will require preparatory steps, including the development of an annual financial plan and a procurement plan, as well as major improvements in the monitoring of new commitments within allotments.
- 31. The government has initiated some changes to the development budgeting process in response to low core development budget execution rates³⁷.** The changes aim to improve upstream selection and quality of projects at entry commensurate with implementation readiness and capacity. A new development budget presentation was introduced for the 2007/08 budget, that separated projects into an approved budget for which resources are available, and a project pipeline for projects that are conditionally approved upon funding being made available from external sources. This appears to have accelerated disbursements, but it is clear that further initiatives are needed to address the problems, especially with regard to realistic project formulation and greater implementation capacity. In addition, MoF in collaboration with MoEc developed a standard template for investment projects that was introduced in eight line ministries for the 2008/09 budget.³⁸ The template is comprehensive and includes a significant level of detail, but it is not evident how it will help increase the implementation capacity of line ministries. MoF also set aside a US\$4 million fund to finance technical assistance for feasibility studies and the development of project proposals. In addition, a simple monitoring tool has been developed to provide more systematic follow-up on the implementation progress of investment projects.
- 32. Procurement planning.** In order to execute core development budget expenditures, line ministries and agencies need to prepare plans including procurement planning/process up

³⁵ Ibid, p. 9.

³⁶ Within the operating budget, the ministries are, following authorization of the MoF in consultation with the Budget Committee, allowed to transfer funds from one budget line (main code or sub-code) to another up to a maximum of five percent of the appropriation with some restrictions (e.g. no transfer from code 21 – Wages and salaries). Non-discretionary development budget funds can be transferred if a no-objection certificate is obtained from the relevant donor and approved by the MoF. For provincial funds, the ministries are free to reallocate resources across provinces.

³⁷ Low core development budget execution rates are discussed in Annex 2.

³⁸ The ministries covered are: Public Works; Transport and Civil Aviation; Mines, Energy and Water; Telecommunications; Rural Rehabilitation and Development; Agriculture, Irrigation and Livestock, and Higher Education.

front. The Procurement Policy Unit (PPU) issued a circular requesting all line ministries and agencies to prepare annual procurement plans for goods/works and services immediately after communication of the annual budget and have to be submitted to PPU/MoF by the end of the first quarter of each fiscal year³⁹. This plan has to be prepared by the procurement office of the entity and verified by the procurement committee of the entity prior to submission to the PPU/MoF⁴⁰.

Procurement

33. **Procurement plays an important role in delivering quality services.** It is important that public expenditures follows good public procurement practices with due consideration to competition, economy, efficiency and transparency. Also, in the case of Afghanistan, procurement is identified as one of the main causes of low core development budget execution rates in the education and health sectors⁴¹.
34. **Afghanistan has made progress establishing a sound legal framework for public procurement.** The Public Procurement Law (PPL) was initially passed in October 2005 and then revised twice afterwards. The first revision was made in July 2008 and subsequent amendments were made in January 2009. The law has provisions for procurement appeals and reviews that allow bidders to seek redress, and the publication of awards to keep civil society informed about public expenditures. Under the terms of the law, MoF created the PPU to monitor policy, professional development and performance. The regulatory framework of procurement has also improved⁴². An assessment of the National Procurement System was carried out in September 2007 based on the Organization for Economic Co-operation and Development's Development Assistance Committee (OECD-DAC) and World Bank indicators. The assessment established that the legal and regulatory framework for procurement is broadly consistent with good public procurement practices. However the assessment indicated that improvements were needed in contract administration and the dispute resolution system.
35. **In the absence of relevant data, tracking actual procurement performance is a challenge.** A limited assessment was made of the major procurement actions carried out by various ministries with the assistance of MoEc's Procurement Facilitation Unit (ARDS-PU) based on OECD-DAC compliance and performance indicators. The assessment concluded that 94 percent of the contracts were open tender, but almost 50 percent of the bids were rejected due to non-compliance.
36. **Notwithstanding the achievements, there continue to be serious capacity shortfalls in the application of the new legal framework across government agencies.** While the legal and regulatory framework is compatible with good international public procurement practices, implementation and compliance remains a challenge. It requires intensive and extensive capacity building of the civil servants at all levels with more focus on the staff directly responsible for carrying out procurement functions. There is limited capacity to comply with sound procedures, identify needs, prepare technical specifications for bid documents and evaluate bids. As the anti-corruption law does not distinguish between corrupt procurement practices and mistakes or negligence, any breach of the procurement law is treated as corruption and is liable for prosecution. As a result, many staff refuse to get involved in procurement, further delaying the process.

³⁹ A circular PPU/C001/1385 in August 2006

⁴⁰ Article 74 and 75 of the Procurement Law

⁴¹ More discussion in Annex 5 on Education

⁴² PI-19 of World Bank (June 2008) "Afghanistan: Public Financial Management Performance Assessment" explains more about procurement performance.

37. **Only 13 of 41 line ministries and entities prepared procurement plans for 2008/09**, although developing the plan is mandatory following approval of the budget. This has led to consistent delays in the preparation of quality bidding/quotation/proposal documents, design and application of evaluation criteria, and contract negotiations. According to the ARDS-PU, the average time taken for the procurement cycle (from time ARDS-PU receives a line ministry request to SPC approval/contract signature) is between 2.8 months and 11.5 months. The average time is around seven months. Under these circumstances it is quite challenging to implement contracts (especially supply of goods) within 12 months.
38. **Procurement functions will gradually decentralized at a rate commensurate with the increasing capacity of line ministries.** Line ministries are required by law to carry out all procurement functions within their capacity. As an interim measure until the capacity of the line ministries is better developed, they are to seek the assistance of ARDS-PU for procurement contracts whose estimated values are higher than Af 10 million (US\$200,000) for goods and consultancy/non consultancy services, and Af 25 million (US\$500,000) for works. The PPL revised upwards the threshold limits for first grade award authorities by ministers in 2008. Any contract award above these thresholds has to be cleared by the three-member Special Procurement Commission (SPC), chaired by MoF, with the membership of both MoEc and the Ministry of Justice (MoJ).
39. **Ongoing training and assistance to increase the procurement capacity of line ministries.** With the upward revision of the threshold for first grade award authorities, it was felt that all line ministries should have a compliance monitoring system pending the creation of a web-based monitoring system. Twenty-four procurement controllers were selected following a competitive procedure and assigned to 41 line ministries. The coordinator responsible for procurement controllers was placed with MoF. The procurement controllers are required to submit monthly reports to MoF in an agreed format covering actions and issues. PPU and an international consultant have developed a three-stage training program to develop the competencies of civil servants. The basic and intermediate programs require 12 days each. The training program began in December 2007. By December 2008, the program had trained 473 staff from 32 central government entities, and 167 staff from the provinces of Balkh, Herat and Kunduz).

D. Audit and Reporting

Internal Audit

40. **The legal framework for internal audits has improved and is now largely on par with international good practices.** According to the Financial Regulations of the PFEM law, the primary task of an internal audit is to ensure that financial control systems and procedures are in place so that resources are used in accordance with the relevant rules and regulations. The Control and Audit Law in 2005/06 (SY1384) states that the internal audit function is part of the line ministries' organization but with a dual line of reference to CAO. The law requires CAO to evaluate the performance of the internal audit based on its own performance assessment. CAO has the right to recheck documents and reports. The internal audit departments in the line ministries refer to CAO, which follows international best practice and is in line with the International Organization of Supreme Audit Institutions' (INTOSAI) Lima Declaration⁴³,

⁴³ INTOSAI (1998): "The Lima Declaration of Guidelines on Auditing Precepts", Section 3.3: "As the external auditor, the Supreme Audit Institution has the task of examining the effectiveness of internal audit. If internal audit is judged to be effective, efforts shall be made, without prejudice to the right of the Supreme Audit Institution to carry out an

although the provisions in the current Control and Audit Law provide CAO with wider authorities than stipulated in the Declaration. CAO will introduce a new audit law that, inter alia, will align its authority with a modern Supreme Audit Institution, allowing CAO to set auditing standards and coordinate internal audit functions, but prevent the shared direct management with the ministries.

41. **The dispute over the role of the MoF's internal audit department has been resolved.** Article 61 of the PFEM law calls for MoF to establish "an internal audit administration and appoint auditors to audit the financial and accounting affairs of all State administrations". At the time it was enacted, internal audit units already existed in budgetary units so the financial regulations recognized these units and gave authority to the Internal Audit Department of MoF to provide guidance⁴⁴. Article 61 also grants the MoF's Internal Audit Unit unfettered access to relevant government documents and records and other information across government. The CAO Law (amended 1996) calls for the internal units throughout government to report both to the line management and to the CAO, and grants the CAO the right to evaluate their work. This control of internal audits by the external auditor is not in line with best practices and undermines the independence of the external auditor. Using this conflict as a basis, Article 61 was suspended in 2007. However, the CAO has now submitted a new draft CAO law to the MoJ that suspends the CAO's authority over internal audit functions in the budget units. It is expected that the bill will be sent to parliament in 2009/10. Upon enactment, there will no longer be any overlap in responsibilities for internal audit, and Article 61 can be reinstated.
42. **Capacities of internal audit departments across line ministries vary but most are weak.** Internal audit departments are organized along similar lines – consisting of coordination, planning, analysis and implementation units – and are managed by an audit director. With the exception of a few ministries however, the departments cannot be regarded as fully independent as they report to the deputy ministers responsible for administration rather than directly to the minister.⁴⁵ Auditors are typically recruited from within the ministry's own ranks and appointments are not made on the basis of independent selection panels. As a result auditors generally lack the skills and technological tools to carry out internal audits to any recognized standard. The ministries have begun to provide technical training, often with support from donor institutions, and collaboration with MoF is now being developed to ensure government-wide standards are the norm. Some like MoE, have received funding from donors such as the USAID CPC program, to hire and train national consultants as internal auditors. While these efforts have provided some quick results in terms of outputs, the sustainability of the approach is doubtful⁴⁶.
43. **Most internal audit departments base their activities on annual audit plans. However, these plans are typically not based on risk assessments and system audits are lagging.** The internal

overall audit, to achieve the most appropriate division or assignment of tasks and cooperation between the Supreme Audit Institution and internal audit."

⁴⁴ Annex 11 of the Financial Regulations includes the right for MoF to appoint "separate auditors" throughout government and would make MoF responsible for establishing the internal audit departments in the line ministries and organizing their activities, establishing methodologies, performing audits according to the plan and upon direction of the Minister of Finance, provide guidance and undertake capacity development. Furthermore, the internal auditors would, with authority issued by MoF, have access to any documents, records, statements, reports as well as information and explanation from any employee about any matter that is considered necessary for audit work, including access to the reporting functions of any information system and computers to check the reliability of financial data systems, and access to cash, stores and any other property.

⁴⁵ World Bank (2008a): op.cit., p. 36.

⁴⁶ Internal audit unit of the Ministry of Economy is explained in detail in Annex 5.

audit primarily focuses on the identification of irregularities and the investigation of potential corruption and fraud on a transaction basis while reviews of the internal control systems and processes are not carried out on a regular basis. Furthermore, audits do not comply with recognized international internal auditing standards. As a result, while reports are provided to ministry management and to the CAO for information, the external audit carried out by the CAO does not rely on the audit findings of the internal audit departments.

44. **The MoF's Internal Audit Department has forged ahead with organizational reforms and capacity building.** Following the decision of the MoJ commission, the Internal Audit Department currently audits only its own budgetary units. Given the particular importance of MoF operations to government-wide financial management and revenue administration, the department has received assistance from government and donors. This has yielded robust returns in terms of audit capacity and increased the quality of audit reports. The department was reorganized and its staffing boosted from 18 to 103 under the Priority Reform and Restructuring (PRR) plan. MoF has also set up an Internal Audit Committee to oversee the audit processes. Starting in 2007/08, audits have been planned and executed on the basis of risk-based audit plans in accordance with to an internal audit manual. Unlike other line ministries, MoF audits review the internal control systems and report on any control weaknesses and risks it identifies, although follow-up mechanisms on audit findings have yet to be fully developed.
45. **The Government has proposed establishing a National Audit Committee (NAC) under the cabinet** as a forum for MoF, CAO and line ministries to discuss internal audit findings and ensure follow-up on recommendations. The Internal Audit Department of MoF would function as a secretariat to the NAC. Furthermore, as Chief Internal Auditor, the director of MoF's Internal Audit Department would be responsible for coordinating both the preparation and implementation of the annual internal audit program as well as coordinating capacity development for internal audit across the government. Other issues that could be considered with the setting up of the NAC are, a charter of audit approved annually for each ministry to ensure their independence and a short-term, time-bounded measure, establishing an unified group of internal auditors inter-transferrable between the ministries under the control of the Committee to support building up capacities and the development of audit procedures and tools.

EXTERNAL AUDIT

46. **The existing legislative provisions for external audits are rudimentary and the institutional capacity of CAO remains weak.** Article 98 of the Constitution states that the government must submit the final account of the previous fiscal year's budget transactions to parliament. While there is no constitutional provision for an external audit, the PFEM law requires that MoF present a final budget reconciliation report and a set of audited financial statements to the government and the president⁴⁷. CAO has the right to acquire all information deemed necessary for auditing. It must submit a report to the government that includes certification of the appropriation accounts and recommendations for sanctions consistent with the PFEM law within six months of the end of the fiscal year. The government must present the report to the National Assembly after which it is to be made public⁴⁸. The Control and Audit Law

⁴⁷ The reports are reviewed by the Budget and Finance Committee though parliament plans to set up a Public Accounts Committee which will take over this task when it becomes functional. The Government presents to parliament the annual audit reports on the budget, which includes a certification of the appropriation accounts and recommendations for sanctions to be applied consistent with the PFEM Law.

⁴⁸ In most countries, Supreme Audit Institutions report directly to the legislative rather than to the executive branch [INTOSAI (2001): "Independence of SAIs Project", Final Task Force Report, 31 March, p. 8].

extends CAO's audit coverage to all ministries, departments, state agencies, banks and municipalities. CAO's independence however, does not fully comply with core INTOSAI principles relating to staffing, budget, mandate and discretionary authority, access to information, reporting and follow-up mechanisms.⁴⁹ This lack of independence from the government allows the executive to influence which reviews are undertaken and may limit openness in reporting. A new law drafted in 2009 that provides adequate independence for the CAO, was sent to the MoJ for consideration. It is expected that this law will be enacted in this fiscal year.

- 47. Statutory external audits are prepared in a timely manner but, with the exception of the donor grant audits, do not comply with international auditing standards due to capacity constraints.** In recent years, the statutory audits, Budget Execution Statement audit report and the compliance audit reports have, been completed and submitted by the president for remittance to parliament within the legally required period. Although this work is not done to a high standard, the CAO has taken steps to improve the quality of the compliance audit, including the preparation of an audit database and issuance of standardized reporting formats. In 2008, the CAO carried out a performance audit, providing an audit opinion certificate for the 2006/07 Budget Execution Statement. However, there remain significant systemic weaknesses relating to the weak institutional capacity of the CAO.⁵⁰ For instance, half of government expenditures are not audited in full compliance with international standards, and audit reports for donor-funded projects take up to nine months to prepare and require the technical support of a contracted international auditing firm.
- 48. A comprehensive organizational- and staff strengthening program is being implemented, but substantial progress especially in training and competency development is still required.** The training undertaken to date in the CAO has been insufficient to develop staff competence to a level where they are able to conduct audits to international standards independently. Recently however, substantial capacity building activities including comprehensive classroom and on-the-job training had been imparted to raise the quality of CAO's audits. This progress, and activities planned for the next two years, should permit all audit work to be carried out to acceptable standards with the support of qualified advisors. The three full-time audit experts are providing advice to support (i) the budget execution statement audit; (ii) the audit of enterprises; (iii) the audit planning and reporting function, and (iv) compliance audits specifically with respect to new procurement and environmental legislation.

E. Policy Recommendations

- 49. Afghanistan has made impressive progress building its expenditure management framework over the past years.** The budget formulation process is relatively well-planned. Although Afghanistan continues to depend on significant inflows of foreign aid to cover operating and development expenditures, the consultative process between the government and the IMF to set the annual budget envelope has created fiscal targets that help maintain overall fiscal discipline.
- 50. Several challenges remain.** The restrictive timeframe line ministries face compounds the weakness of the budget formulation process. While large parts of the expenditure program are executed in provinces, the process of setting provincial allocations within line ministries is

⁴⁹ World Bank (2007a): "Afghanistan, Public Sector Accounting and Audit", Report No. 41041-AF, p. 10.

⁴⁹ World Bank (2008a): op.cit., p. 43.

⁵⁰ World Bank (2008b): "Assessment of Vulnerabilities to Corruption in Public Finance Management"; Draft Report, March, p. 33.

largely discretionary, lacks transparency and has contributed to large fiscal variations across provinces. Pilot program budgeting has not yet created tangible results. Afghanistan also continues to operate a dual budget process with separate processes and structures for operating and development budgets that undermine the links between operating and development expenditures. Moreover, budget hearings thus far have mainly focused on negotiating budget ceilings rather than on policy and expenditure prioritization. In addition, the execution of development expenditure remains weak. Although internal audits occurs in all ministries, the departments' capacities are very weak, and there is generally little follow-up on recommendations. The legal framework for external audits remains weak as does the capacity of the CAO to conduct audit work to any recognized standard. Legislative scrutiny is limited and audit reports are not made public. The cumulative effect is that external audits are not sufficiently effective because a proper independent review of the government's financial statements with adequate coverage and quality does not take place.

51. **A number of important reforms to improve the budget process and PFM are already underway, including program budgeting, the MTFF, the ANDS and provincial budgeting.** These priorities are well reflected in the MoF strategic plan. Rather than suggesting additional areas for reform, the focus of the recommendations put forward here is to strengthen and focus the implementation of these initiatives and to improve their coherence and phasing.

The need for an overall strategy and reform management

52. **While designed to overcome some of the key weaknesses in the current system, implementation of the ongoing reform initiatives has lacked coordination.** Greater consideration is needed to address the strong linkages between the different elements in the reform program to avoid a duplication of efforts and inconsistency of outcomes. A common vision is especially important for line ministries so that they plan and systematically implement capacity and skills development efforts that ensure the interventions are properly implemented. In addition, various aspects of budget reform are supported by different donors and without a clear strategic framework. It is difficult to coordinate advisors and ensure reform ownership and consistency of approaches at the technical level, particularly given the high turnover of TAs. To ensure consistent, vigorous attention to and coordination of reform implementation, and the timely resolution of issues arising along the way, a high-level budget reform oversight and steering committee should be envisaged.

Further improvement of the budget calendar

53. **The timing of the budget formulation and enactment process has improved significantly** and no longer poses a problem to the start of the budget execution process at the beginning of the fiscal year. However, the detailed budgeting process for 2010/11 needs to be better planned and executed by the budget department to allow the line ministries a minimum of six weeks to prepare their detailed budget requests. All donors should provide information on their commitments for the coming fiscal year by the end of September to allow for the early determination of budget ceilings.

Simplifying program budgeting

54. **In order to shift to program-based appropriation within several years, program budgeting should be "simplified" as originally advised by the IMF.** As program budgeting has turned out to be a complicated technical reform, the hasty promotion of program budgeting risks the existing budget formulation process by absorbing the limited resources of line ministries. The government should "revaluate" the future schedule for the implementation of program-based appropriation due to the constraints identified during the pilot program budgeting.

55. **The process for 2010/11 “simplified” program budgeting processes should focus on budget formulation.** Longer-term measures should be implemented once simplified program budgeting produces tangible results. Some key short-term policy recommendations include
- **Improve information sharing by donors.** The government has to work on both regular budget formulation and program budgeting within a tight time schedule. As almost all core development expenditures are donor-funded, earlier information sharing by donors is essential. This will enable the government to focus on more strategic aspects of program budgeting, helping both the program- and regular budgeting process.
 - **Improve institutional arrangements for the formulation, execution, monitoring and reporting of program budgeting.** Each line ministry has different capacity constraints and receives different guidance from their technical advisers. The MoF’s budget department’s central coordinating role in pilot program budgeting will be further enhanced when it takes into account the varied issues facing each line ministry.
 - **Refocus program budgeting towards planning and performance management.** In order for tangible results to materialize, it should focus on planning and performance management. This will require that program classification become the primary unit for planning and budgeting, and that funding decisions be made on the basis of whether to increase or decrease program output at the margin. At least initially, allotment and expenditure controls could continue to be based on the existing structures, though changes to the CoA and AFMIS need to be adjusted to enable program-based reporting.
 - **Use programs for monitoring and evaluation.** Program budgeting could be used for monitoring and reporting of both key financial and non-financial performance information. The monitoring results should be utilized as inputs for subsequent planning and budgeting processes.
 - **Move toward programmatic discussions with donors.** Programs should also be introduced into the negotiations with- and reporting to donors. As they develop trust in the program structure, donors should consider shifting their commitments and disbursements from the current largely project-based approach to a more programmatic basis.

Realistic provincial budgeting

56. **Provincial budgeting has been rapidly rolled out. A review of the results of the pilot provincial budgeting process so far is advised.** Improvements ought to be made before broadening the sectoral or regional coverage of the initiative. Modifications in the AFMIS and CoA should proceed to enable provincial coding of payment transactions that is needed to produce reliable provincial breakdowns of expenditures⁵¹. At the same time, links between provincial budgeting, program budgeting and the ANDS need to be strengthened. It is important that PDPs with both evolving program structures and ANDS priorities be consistent. Capacity building should be provided to all participating provinces and line ministries and support offered to the preparation of a long-term monitorable implementation plan. Planning for increases in the budget authority of the provincial departments in the longer term should begin, and investments made in training the provincial budgeting unit that will lead the process.

Core development expenditure budgeting and execution

⁵¹ AFMIS and COA contain province codes since 2002/03. However, whether provincial codes represent the ‘expenditure occurred in a particular province’ or ‘expenditures may take place in the centre, but be for the benefit of particular provinces’.

57. **Procurement by line ministries should be greatly improved.** Inadequate procurement processes are the major constraint to the execution of core development expenditures by line ministries. Their capacities both in the center and regions should be greatly improved.
58. **The commitment control functionality in the AFMIS rather than the allotment process should be used for cash management and commitment control** to reduce the administrative burden in executing the payment and accounting processes. To improve core development budget execution it is also required that the donors ensure the treasury account is replenished in a timely manner so the budget can be implemented.

Internal Audit

59. **Use the MoF's internal audit department for line ministries by applying Article 61 of the PFEM law.** The NAC may be another step in the right direction, but it should reinforce rather than contradict Article 61 and leave the oversight role with CAO. A committee can set internal audit standards and prepare general guidelines for all ministries to ensure uniformity while at the same time avoiding duplication of efforts⁵². An overall review of the internal audit functions and staffing should be undertaken with a view to redesigning organizational structures and responsibilities where required. There is also a need to develop a merit-based recruitment and staff development program for the ministries

External Audit

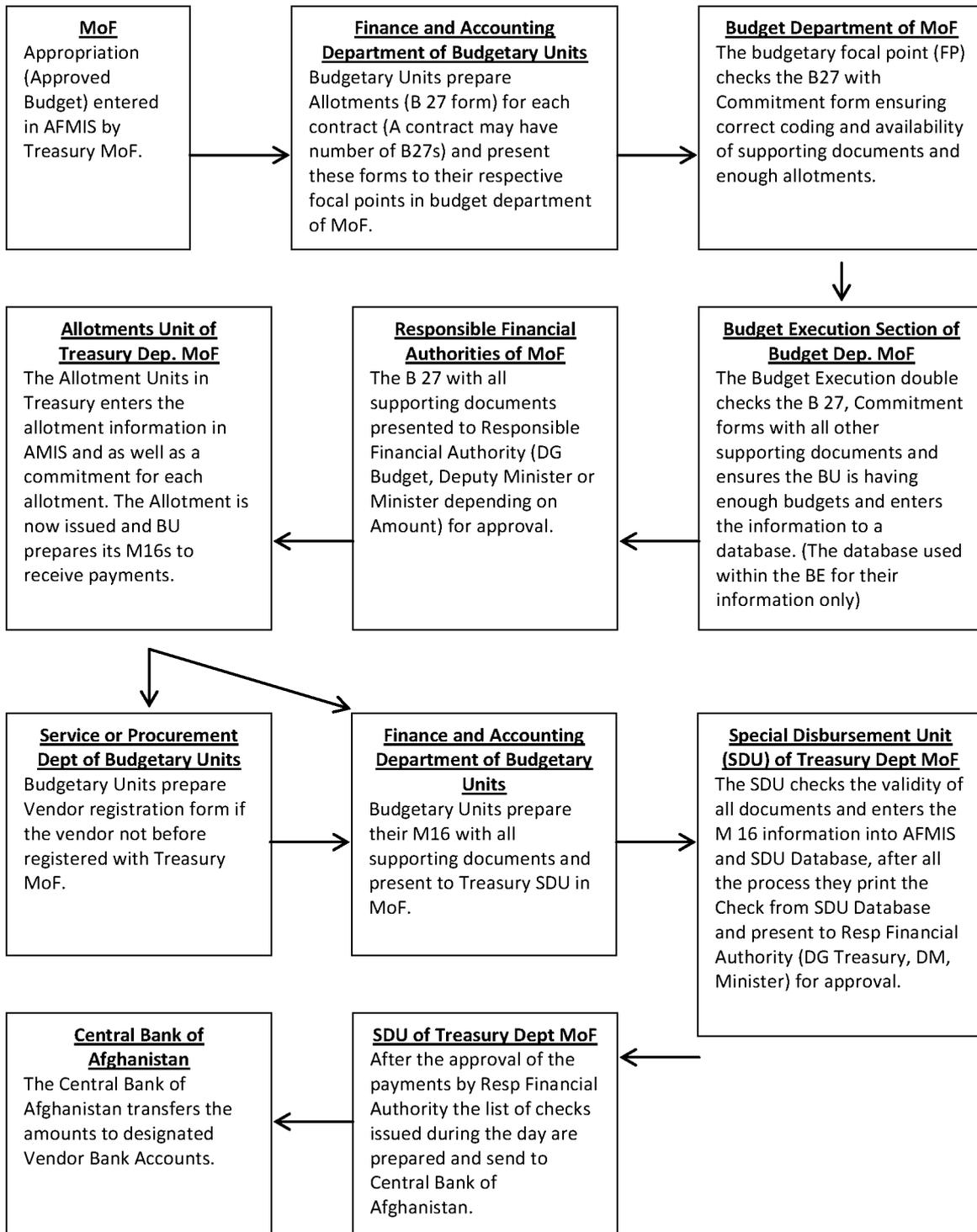
60. **A strengthened legislative framework is a prerequisite for developing the external audit function.** With a draft law in the MoJ, it is an opportune moment to improve the legal foundation of the external audit function. This should include ensuring effective independence of CAO and direct accountability to the National Assembly. Institutional and staff capacities need to be developed which will require substantial technical assistance and merit- and qualification-based systems implemented for the appointment senior managers and staff. Attempts should be made to ensure all institutions provide proper follow-up on audit findings and recommendations, guarantee that audit reports are public as required by law, and create a Public Accounts Committee of the National Assembly.

⁵² Other issues that could be considered with the setting up of a NAC are, for instance, a charter of audit approved annually for each ministry to ensure their independence as well as, as a short-term and time-bounded measure, establishing an unified group of internal auditors inter-transferrable between the ministries under the control of the Committee to support building up capacities and the development of audit procedures and tools.

Appendix 1 Summary of PFM Performance Assessment Indicators

		Jun 05	Dec 07	1	2	3	4
A. PFM-OUT-TURNS: <i>Credibility of the budget</i>							
PI-1	Aggregate expenditure out-turn compared to original approved budget	2	1				
PI-2	Composition of expenditure out-turn compared to original approved budget	2	1				
PI-3	Aggregate revenue out-turn compared to original approved budget	4	4				
PI-4	Stock and monitoring of expenditure payment arrears	1+	1+				
B. KEY CROSS-CUTTING ISSUES: <i>Comprehensiveness and Transparency</i>							
PI-5	Classification of the budget	2	2				
PI-6	Comprehensiveness of information included in budget documentation	2	3				
PI-7	Extent of unreported government operations	3	3+				
PI-8	Transparency of inter-governmental fiscal relations	1	1				
PI-9	Oversight of aggregate fiscal risk from other public sector entities.	1	1+				
PI-10	Public access to key fiscal information	2	3				
C. BUDGET CYCLE							
<i>C(i) Policy-Based Budgeting</i>							
PI-11	Orderliness and participation in the annual budget process	2	3				
PI-12	Multi-year perspective in fiscal planning, expenditure policy and budgeting	1+	3				
<i>C(ii) Predictability and Control in Budget Execution</i>							
PI-13	Transparency of taxpayer obligations and liabilities	1+	2				
PI-14	Effectiveness of measures for taxpayer registration and tax assessment	1+	2				
PI-15	Effectiveness in collection of tax payments	1+	1+				
PI-16	Predictability in the availability of funds for commitment of expenditures	1+	3+				
PI-17	Recording and management of cash balances, debt and guarantees	2+	3+				
PI-18	Effectiveness of payroll controls	2	2+				
PI-19	Competition, value for money and controls in procurement	2/3	3				
PI-20	Effectiveness of internal controls for non-salary expenditure	2	2+				
PI-21	Effectiveness of internal audit	2	2				
<i>C(iii) Accounting, Recording and Reporting</i>							
PI-22	Timeliness and regularity of accounts reconciliation	2+	3				
PI-23	Availability of information on resources received by service delivery units	1	1				
PI-24	Quality and timeliness of in-year budget reports	2	2+				
PI-25	Quality and timeliness of annual financial statements	2	3+				
<i>C(iv) External Scrutiny and Audit</i>							
PI-26	Scope, nature and follow-up of external audit	2	2				
PI-27	Legislative scrutiny of the annual budget law	1	3+				
PI-28	Legislative scrutiny of external audit reports	1	2+				
D. DONOR PRACTICES							
D-1	Predictability of Direct Budget Support	4	3+				
D-2	Financial information provided by donors for budgeting and reporting on project and program aid	1+	1				
D-3	Proportion of aid that is managed by use of national procedures	1	1				

Appendix 2 Core Development Budget Disbursement Process in the Center



Source: Prepared by Walid Qazizada