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USAID/AFGHANISTAN FISCAL ROADMAP ANALYSIS/CONCEPT PAPER

.

CONTENTS

ACRONYMS

AFMIS	Afghanistan Financial Management Information System
ANDS	Afghan National Development Strategy
BRT	business receipts tax
DFID	UK Department for International Development
EGAT	Bureau for Economic Growth Agriculture and Trade
FY	fiscal year
GDP	gross domestic product
IMF	International Monetary Fund
LTO	large taxpayer office
MOED	Ministry of Economic Development
MOF	Ministry of Finance
MTO	medium taxpayer office
NPP	National Priority Program
PFM	public financial management
RIA	regulatory impact assessment
STO	small taxpayer office
USAID	United States Agency for International Development
VAT	value-added tax

INTRODUCTION

The United States Agency for International Development (USAID) Bureau for Economic Growth Agriculture and Trade (EGAT) created the Financial Sector Knowledge Sharing Project (FS Share) to collaborate with USAID missions to develop effective and efficient financial sector programs that increase access to financial services and develop well-functioning markets worldwide. USAID awarded Chemonics International Inc. the FS Share delivery order under the Financial Sector Blanket Purchase Agreement. FS Share has a four-year period of performance, July 2008 through July 2012. Through the FS Share task order, USAID/EGAT and Chemonics proactively collaborate with missions to identify financial-sector priorities and develop strategies and programs for growing the financial sector. FS Share identifies financial-sector best practices and aggregates them through model scopes of work, primers, diagnostic tools, best practice case analyses, and other tools. These deliverables are disseminated to USAID missions for use in financial sector programs. FS Share can assist with implementation and connect mission staff to external resources on best practices. In response to mission demand, FS Share delivers presentations and other knowledge-sharing endeavors.

OBJECTIVE OF THIS REPORT AND AUTHOR

The objective of this report is to review the current public financial management (PFM) assistance and recommend a series of next steps harmonized with other donors and in support of the U.S. government's Transition 2014 planning.

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EXECUTIVE SUMMARY

The fiscal balance/sustainability position of Afghanistan is precarious but salvageable. For the 2010-11 budget period, total on-budget expenditures equaled about 22 percent of gross domestic product (GDP), and total revenues a little more than 11 percent of GDP. With off-budget donor grant expenditures estimated at about three-quarters of all international contributions, that implies a total fiscal deficit of 40-45 percent of GDP. At the moment, Afghan government revenues cover only about 70 percent of operational expenditures — still far away from satisfying the narrow definition of fiscal sustainability being applied in Afghanistan by the International Monetary Fund (IMF) and the broader donor community. However, revenue effort has improved substantially over the past several years, and there appears to be significant additional margin for enhanced revenue intake.

Under reasonable assumptions regarding accelerated tax administration reform progress, total revenues as a share of GDP could be raised to at least the 15 percent range over the next few years, a target the Ministry of Finance (MOF) has been discussing with the IMF. There is also the longer-term prospect of IMF/UK Department for International Development (DFID)-supported value-added tax (VAT) implementation, and of mining revenues coming on board as a major source of total revenues over the next decade or so. The latter prospect, however, depends upon stabilization of the security environment and an improved investment climate.

It should also be noted that a considerable portion of current off-budget spending is almost certainly allocated to imports, so the impending decline in donor funding need not cause as drastic a contraction in aggregate demand and economic performance at the national level as has been popularly assumed.[1] In light of this, assuming 1) minimum donor grant funding could be maintained at roughly 10-12 percent of GDP over the medium-term and 2) the downward trajectory in total international spending smoothed out to the maximum degree possible, then the fiscal transition process could be regarded as manageable over a 7-10 year period. "Manageable" in this sense refers to the process being implementable without a drastic contraction in vital public goods and services.

USAID can jumpstart progress toward achieving this goal through its medium-term fiscal governance support strategy, which it has sculpted to match critical fiscal governance reform and related technical and training support areas defined in the Afghan government's Public Financial Management (PFM) Roadmap. In the revenue enhancement area, USAID will support strategic procedural and institutional strengthening reforms designed to dramatically improve the revenue management performance of the network of local tax offices, particularly in relation to the grossly underperforming profit tax regime. USAID will also provide support, as needed, to help establish a sound mining industry profit-sharing/royalty regime that would help to stabilize investor expectations and ensure significant revenue inflows from major prospective mining investments.

In the area of budget-planning and management, USAID will do the following:

[1] Despite that its impact at the local level could be very harsh in sub-regions/localities where this spending has been heavily concentrated.

- Support full implementation of critical reforms in the program budgeting and integrated recurrent/capital budgeting areas that are designed to drastically improve the cost-effectiveness and efficient targeting of major expenditure programs.

- Promote the initial development of a basic regulatory impact assessment (RIA) system, which will facilitate the practical costing-out of new economic governance-related legal and regulatory guidelines that, if implemented, might impose a heavy prospective fiscal burden and stifle private economic activity.

- Provide strategic technical support and capacity-building assistance to buttress and promote effective rollout of the path-breaking provincial budgeting process. USAID will do this in a manner that will help ensure greater correspondence between expenditure priorities and local socioeconomic development needs.

- Promote the design and iterative implementation in major selected ministries/line agencies of a well-designed rules-based allocative mechanism to help reduce current disparities in budget allocations across provinces in key service provision sectors (e.g., health and education).

- Support the critically important reform of the procurement regime by promoting implementation sound procurement procedures and galvanizing institutional capacity to implement a transparent, efficient, and time-effective procurement system in selected major line ministries/agencies.

An overarching objective of USAID's budget-planning and management support programs will be to promote the effective de-facto integration of on- and off-budget expenditure programs and projects. This will, in turn, promote better-targeted and more cost-efficient overall public expenditure patterns. It will also provide the upward flow of accurate budgetary information required to help the Afghan government and the donors work together to avoid sudden, severe drops in sub-regional and local public expenditures that could severely disrupt local economic performance, and have negative social stability and security consequences. The overall goal of this suite of strategic fiscal governance intervention programs will be to 1) promote a smooth fiscal transition process and 2) promote the efficient and cost-effective provision of critical public goods and services to the Afghan people. Achieving these goals is, in turn, directly and cogently related attaining the U.S. government's broader socio-economic development and security stabilization objectives in Afghanistan.

USAID conducted a wide round of consultations while developing its fiscal governance support strategy. This included intensive consultations with MOF, the principle PFM Roadmap interlocutor, and a broad range of other relevant government stakeholders. In addition, USAID incorporated the results of intensive discussions with other U.S. government agencies working in fiscal governance and other major donors in devising an approach that hits strategic "gaps" in the fiscal governance policy/institutional framework without duplicating the work of other major support institutions. USAID will work effectively at the implementation stage, together with core Afghan government and donor actors, to ensure that its fiscal governance support strategy has the strongest possible synergistic impact on attaining medium-term fiscal transition and service delivery goals.

SECTION I. PROBLEM AND ANALYSIS

A. Introduction

The sustainable improvement of fiscal governance is critical achieving the U.S. government's transition strategy in Afghanistan. This entails two critical elements: building fiscal sustainability and dramatically improving the coherence, cost-effectiveness, and allocative efficiency with which budgetary resources are managed. We know that total public expenditure in Afghanistan (on- and off-budget combined) is currently unsustainable. This is not in and of itself an unusual situation for a post or in-conflict country.

The typical physical and social infrastructure and displacement-related catch-up expenditure needs usually encountered in such situations have been dramatically magnified in Afghanistan by two decisive factors: 1) the challenging security environment and 2) the extremely high poverty rates and endemically disadvantaged socio-economic living conditions. Together, these factors generate a massive fiscal imbalance that must be addressed in the medium-term to ensure the transition process does not result in a fiscal crisis and a breakdown in service delivery financing capacity.

In this regard, the numbers are quite stark. For fiscal year (FY) 1389 (i.e., 2010-11), on-budget public expenditure was approximately 22 percent of GDP and total domestic revenues were 11.3 percent, leaving a deficit of almost 11 percent of GDP. Moreover, considering total donor-financed expenditures are commonly estimated to be up to 80 percent of all spending, this implies that the overall deficit was approximately 44 percent of GDP, a jarring figure. Development expenditures, which are reportedly split about evenly between capital and recurrent expenditures, represent approximately 30 percent of the budget (about 6.2 percent of GDP), and approximately two-thirds of these are financed by the donor community. The operating budget is dominated by wage and salary expenditures (about 75 percent of total operating expenditures), with goods and services representing just under 15 percent of total operating expenditures.

Furthermore, total domestic revenues only covered approximately 70 percent of operating expenditures for FY 1389, meaning that the government is nowhere close to meeting the very narrow and generous definition of "fiscal sustainability" being applied by the IMF and, by extension, the donor community. Total tax revenues were approximately 9.7 percent of GDP; though this has improved substantially in recent years, it is still feeble by developing country standards and is significantly less than what would be necessary for a smooth fiscal transition process as donor funding begins its inevitable steep medium-term decline. The Afghan government has transitioned from an almost total reliance on customs revenues to a more balanced revenue structure, with customs and sales/excise taxes each generating around 40 percent of revenues and direct taxes (primarily wage-withholding-based personal income tax revenues) generating about 15 percent of total tax revenues. The profit tax, levied via the idiosyncratic large, medium, and small taxpayer system, continues to perform feebly, generating just under 0.3 percent of GDP (and only 3 percent of total tax revenues) in FY 1389. Clearly, the overall efficiency of the direct tax administration system remains low.[2] In essence, all tax revenues — including transfers from state companies (e.g., mining, energy, and telecom enterprises) — go to pay public-sector wages and salaries. This underscores the magnitude of the gap between revenue intake and prospective post-transition expenditure need.

It should be noted, however, that other post-conflict countries have managed to pass through similar fiscal adjustment circumstances without dire economic performance consequences. For example, Kosovo managed to maintain reasonably robust growth rates for the first decade after conflict ended. Growth continued even after the huge donor inflows had dramatically wound down[3] — inflows that initially drove major physical and social infrastructure recovery programs and financed government operations in the early post-conflict period.

The Kosovo example is relevant to the situation in Afghanistan. A significant component of the foreign capital in-flows that went into Kosovo went right back out of the economy in the form of import demand/leakage. As a result, a significant amount of donor spending did not have direct stimulative impact on aggregate demand[4] and its withdrawal, therefore, had no direct contractionary impact on economic performance. Also, Kosovo managed to rapidly establish a post-conflict tax policy framework and robust tax administration system that began to generate a significant share of GDP in government revenues a few years after the transition process began. This meant that by the time donor inflows were significantly decreasing, the government was generating almost 20 percent of GDP in tax revenue (with VAT as the largest revenue source). In turn, this meant that an orderly decline in donor grant financing could be achieved without throwing the provision of basic public services into crisis.

Kosovo was also able to find alternative sources of financing for needed imports as donor financing was withdrawn, primarily remittances and foreign direct investment in key sectors. Furthermore, Kosovo rapidly put in place a modern, functioning banking system. This dramatically expanded the domestic deposit base and created institutional capacity for expanding small and medium enterprise investment, thereby spurring increased private investment (which reached about 21 percent of GDP by 2010).

All these factors enabled Kosovo to weather the major downscaling of donor grant support from the perspective of investment finance and government service provision. The Kosovo experience appears to have clear implications for efforts to develop an effective transition strategy in Afghanistan. It underscores the importance of creating an institutional framework that stimulates a significant upswing in local and foreign private investment, which can supplant declining donor inflows and indirectly bolster public revenue inflows in a manner that protects capacity for public service provision. In turn, this signals the importance of rationalizing the public

[2] Despite recent significant USAID-driven upgrading of the institutional capacity and procedural efficiency of selected medium taxpayer offices in Herat and Mazaar, which dramatically improved revenue collection performance in those offices over the past year.

[3] These inflows fell from the equivalent of approximately 100 percent of GDP during 1999-2000 to about 1 percent of GDP in 2010. Donor grants went from financing virtually 100 percent of public expenditures during the first year of the transition to just more than 3 percent in 2010. Yet the economy has continued to grow at an average annual rate of about 5 percent over the past five years.

[4] Although it may nonetheless have been helping to permanently improve economic competitiveness (e.g., infrastructure investment) and/or societal welfare (e.g., medical imports)

expenditure policy framework in a way that ensures public resources are used to bolster long-term economic competitiveness, not frittered away in a politically expedient manner. This cannot be achieved when wages and salaries are the only expenditures being financed from domestic revenues. The importance of this objective is further underscored by the fundamental role well-targeted, cost-effective delivery of public services can play in enhancing government legitimacy in the eyes of the local citizenry (critical to the U.S. government's core local empowerment and institutional transition goals in Afghanistan).

In short, options for improving the PFM policy and institutional framework must be analyzed, and support strategies formulated and fine-tuned. This must be done from the perspectives of fiscal sustainability and maximizing the capacity of the public sector to 1) contribute to the private sector's enhanced competitiveness and job creation capacity, and 2) provide basic social services to the citizenry in a manner that earns their respect and loyalty. If USAID's PFM support strategy is to contribute to attaining the U.S. government's fundamental foreign policy goals in Afghanistan, it must be formulated in a manner that cogently reflects these factors.

B. Fiscal Sustainability

As referenced above, even in terms of the narrowly defined sustainability concept being applied by the donor community in Afghanistan, the fiscal imbalances the country faces are extraordinarily challenging. Considering that the IMF usually targets the primary deficit[5] to be no more than 3 or 4 percent of GDP in a non-recessionary environment, this indicates just how endemically imbalanced the Afghan government's fiscal accounts are. In this regard, total revenues cover little more than 50 percent of the overall core budget (recurrent plus developmental), and only 20-25 percent of total expenditures (including off-budget spending). Total revenues are less than 12 percent of GDP, and tax revenues are just under 10 percent of GDP (see Tables 1 and 2, next page).

So, at the moment the Afghan government is essentially incapable of financing the provision of any capital projects or any goods and services through own-source revenues; it is totally dependent on donor financing for the provision public services that will enhance its legitimacy. With limited near-term debt issuance capacity and prospects,[6] and the seemingly inescapable and continuing need to meet the burden of extraordinarily high security expenditures in a post-transition context, the Afghan government must create the core fiscal space required to 1) deliver basic goods and services; 2) meet the indeterminate but presumably massive operational and maintenance expenses associated with current off-budget donor and U.S. military projects/programs[7]; 3) increase domestic security expenditures; and 4) finance at least a few new moderately sized capital projects designed to help meet the population's basic physical and social infrastructure needs.

Today, the public sector spends about 22 percent of GDP on-budget. Eventually, it must also absorb at least part of the current off-budget donor spending on-budget. These facts imply a

[5] Defined as current revenues minus total (i.e., recurrent and capital) expenditures.
[6] Although the IMF has referenced plans to initiate government bond issuances over the next year or so.
[7] Another FS Share-supported effort is focusing on projecting medium-term budgetary shortfalls under a variety of economic and fiscal performance scenarios.

daunting medium-term fiscal deficit. Presumably, part of the solution will entail adopting as gradual a donor grant reduction strategy as possible in relation to the domestic political constraints and/or funding pressures that major donor institutions face.

Table 1. Revenue Breakdown by Source (FY 1388/89)

Revenue Source	% of GDP	
	FY 1388	FY 1389
Profit tax	0.27	0.29
Personal income tax	0.94	1.16
Sales taxes	3.36	3.57
--- Business receipts tax	2.02	2.29
--- Fixed	13.4	1.28
Customs	3.56	3.89
Social contributions	0.18	0.25
Property transfer taxation	0.03	0.03
Miscellaneous tax revenue	0.40	0.4
Total tax revenue	8.75	9.68
Non-tax revenue	1.68	1.63
Total revenue	10.43	11.31

Table 2. Share of Major Taxes in Total Tax Revenues (FY 1388/89)

Share of Total Revenues	%	
	FY 1388	FY 1389
Customs Revenues	41	40
Sales Tax	38	37
Personal Income tax	11	12
Profit Tax	3	3
Social Security Contributions	2	3
Other	5	5

Source: MOF, USAID/Economic Growth and Governance Initiative Project

It also signals the importance of adopting tax policy and administration framework reforms that can significantly increase revenue for service provision, and that do so in a manner that will not distort private investment choices and discourage private capital formation. In addition, it will require budgetary planning and administration reforms that dramatically improve the targeting and cost-effectiveness of core public expenditure programs. Furthermore, if mining production and exports — and related tax and royalty revenues — expand over the medium term, it should help fill the sizeable revenue gap in the long term.

However, assuming major additional efforts and progress in the revenue-raising and expenditure rationalization spheres, the Afghan government is still likely to be facing a fiscal imbalance of at least 10-12 percent of GDP over the medium term. This will need to be met with grant financing, and/or large-scale access to highly concessional donor lending facilities. In this scenario, the fiscal transition process should be manageable over roughly a 7-10 year time frame, depending on when natural resource-related revenue streams begin to emerge. Without further significant reforms in revenue enhancement and expenditures, however, the fiscal management situation will remain extraordinarily difficult, and be a massive potential source of political and security instability.

The government's PFM Roadmap recognizes this hard reality, and establishes an ambitious agenda for reforming the core policymaking and institutional oversight elements of the fiscal management system. Effectively prioritizing and following through on critical fiscal policy and institutional reform actions will determine if a transition process can proceed smoothly and focus on public service provision.

C. Revenue Policy and Administration Framework

The revenue structure in Afghanistan is diversifying, but problems remain. Though customs are no longer the major source of revenue, its share in overall revenues is still about 40 percent. Afghanistan's reliance on a network of inefficient sales and excise tax mechanisms puts it at a competitive disadvantage with most developing countries, where VAT is the predominant indirect source of revenue. The Afghan government has committed to the IMF to begin implementing VAT in 2014 at the earliest, with projected policy formulation and implementation support to be provided by DFID through the Adam Smith Institute. [8] In the meantime, the sales and excise tax system is currently yielding about one-third of tax revenues.

Afghanistan's most important source of indirect tax revenue is the business receipts tax (BRT), which collects 2 percent for basic consumption items, 5 percent for other consumption goods, and 10 percent for "luxury" goods. This structure is inefficient and complex, and invites evasion. BRT can be deducted from corporate income tax, which should encourage a degree of VAT-like self-enforcement. However, because corporate income tax provisions and the oversight system do not encourage compliance, deductibility does not always promote self-enforcement.

As noted earlier, direct taxes and personal income tax (with 0-,10-, and 20-percent rates) generate about 15 percent and 80 percent of total tax revenues, respectively. The performance of the automatic wage withholding-based personal income tax system has reportedly improved significantly over the past few years, largely as a result of enhanced compliance efforts within international organizations operating in Afghanistan. On the other hand, the performance of the corporate income tax (synchronized with the personal income tax at a flat rate of 20 percent) has remained anemic. The tax generates just 3 percent of revenues and 0.3 percent of GDP; this appears to signal endemic under-registration and non-filer issues. Improved performance of the profit tax system is clearly critical from the perspective of further enhancing revenue performance over the medium term.

The structure of Afghanistan's overall tax administration regime is idiosyncratic. Rather than a unified national tax administration structure based on functional organization and implemented in accordance with unitary administrative oversight principles,[9] the tax system is administered in a segmented manner across three groupings: small taxpayer offices (STOs), medium taxpayer offices (MTOs), and large taxpayer offices (LTOs). The STOs cover companies with less than $30,000 in annual sales; the MTOs include companies between $30,000 and $1.5 million in annual sales; and LTOs include companies whose sales exceed $1.5 million. Each category has understaffed branch offices at the local level, plus a number of zonal offices in each province or

[8] In Kosovo the VAT was adopted within 18 months of the initiation of the transition process. This underscores the sluggishness with which a market-friendly tax policy framework has been introduced in Afghanistan.
[9] This is standard international practice and is the structure utilized in most developing countries.

municipality. This has created a system lacking the specialization and economies of scale of a more traditional functional specialization-based approach. Instead, the structure of administrative oversight and core tax administration practices vary considerably across and within categories.

Many developing countries have established LTOs, usually resulting from a special ad-hoc oversight arrangement designed for a small group **of** high-profile, large-scale taxpayers who, for reasons of political visibility and/or economic clout, are difficult to effectively incorporate within the "normal" tax administration network/system. Such LTOs are adjunct features that buttress rather than replace the normal functional administrative oversight regime. Therefore, the regime can be implemented without sacrificing advantages of the standard system (e.g., task specialization, economies of scale, and minimization of corruption incentives through compartmentalization of tasks and responsibilities). Detailed procedural guidelines or practices do not appear to have been established under this system, which has further hampered the development of specialized tax administration skill sets. In addition, the combination of under-allocated operating budgets (frequently budgetary allocations are reported to "disappear" within the local *mustofiats*) and ongoing proximity to taxpayers has created strong incentives for corrupt practices.

With these caveats, the current system has generated improved results over the past few years. (Keep in mind that this system arose from a combination of administrative reforms and related training from USAID-supported programs to major MTOs and DFID/Adam Smith Institute-supported programs to LTOs.) Over the past several years, tax revenue has almost doubled as a share of GDP. Granted, there were significant one-off tax regime reforms that helped improve revenue performance (e.g., the application of the BRT to imports and automation of related collection systems, and the tightening of the fuel importation regime). At the same time, improvements in the organizational structure, procedures, and training in selected LTOs and MTOs have also yielded significant benefits. The administration procedural oversight regime is guided by Adam Smith Institute, which has more than 10 full-time expatriate specialists in Kabul and an extensive group of local advisors who travel across the zonal offices.

The network of STOs reportedly generates almost no revenue. The LTOs have been generating more robust revenue inflows over the past few years. In 2010, a USAID-financed expatriate advisor initiated intensive support for a number of the MTOs, and implemented a series of organizational and procedural reforms designed to significantly improve the efficiency and probity characterizing tax administration practices. These included introducing a quasi-functional reorganization of activities; developing detailed procedural guidelines for core functional areas of responsibility (e.g., taxpayer registration, returns processing, audit, collections, and taxpayer service); introducing a more competitive premium-pay structure to reduce corruption incentives; and engaging in intensive mentorship and on-the-job training for MTO staff and management. A special non-filer program was also introduced and implemented, which significantly raised the filing rates for registered taxpayers. (In Herat, the rate increased from approximately 5 percent to 60 percent.) Furthermore, in light of the inadequate staffing levels in the MTOs, staff rotation was introduced to facilitate adequate coverage of core functions in accordance with seasonal needs.

Overall, this support program resulted in a significant expansion of case coverage and a major improvement in revenue intake for the Herat and Mazaar MTOs. However, the overall volume of revenues coming from the network of STOs, MTOs, and LTOs remains muted. LTOs' revenue intake for the first half of FY 1390 (2011-12) appears to be very low (less than 20 percent of annual projections). Overall, the system is characterized by understaffing and a pervasive lack of standardization in procedural guidance, practices, and related training programs. In addition, the coverage of the profit tax system is again woeful. The Revenue Department does not have a systemic strategy and related training program to track non-filers or effectively promote taxpayer registration. Across the MTO and LTO network, only about 10 percent of registered taxpayers are reportedly filing returns, which provides a strong indication of the pervasive inefficiency of the direct tax administration system**.** The internal audit system is deeply flawed: the technical capacity of the audit staff is limited; and procedural guidelines for effectively carrying out internal control functions are inadequate. In addition there appears to be an endemic lack of political will to support establishing a strong, credible internal audit investigatory framework and system, and to follow-up effectively on audit results.

Improving tax information management is key to improving tax administration practices and performance; this must be done as quickly as possible. The Afghan government has since 2007 focused on developing an automated tax information system, under DFID-supported technical programs. To date, however, only one module — for taxpayer registration — has been developed and partially implemented (for Kabul). The other core system modules (e.g., returns processing, audit, and collections) have yet to be implemented. This is greatly limiting the capacity of the tax administration offices to significantly improve the time- and cost-efficiency of tax administration oversight activities, as well as the ability of the tax authorities to develop a strategically focused audit and enforcement strategy. It is also limiting the Revenue Department's ability to effectively minimize direct contact between taxpayers and tax administration officials, a core element of the tax enforcement strategy. Senior Revenue Department officials report that development of the remaining core modules has accelerated recently, and that troubleshooting simulation exercises were conducted recently. These officials also reported that full application of the standard integrated government tax administration system could be initiated over the next few months, though this is a highly ambitious time frame.

The BRT and changes in the direct taxation regime have bolstered revenue performance over the past several years and decreased the government's dependency on customs revenue. However, the overall performance of the revenue system remains deficient in terms of revenue buoyancy and the distortive structure of key elements of the tax system. Prioritizing and remedying these deficiencies will be critically important for effectively addressing the government's broader fiscal sustainability and public governance reform objectives.

The good news is that with some seemingly manageable reforms of the procedural framework and enhanced progress in tax information automation systems implementation, prospects appear reasonably good for enhancing the ratio of tax revenues to GDP by another 2-3 percent in the reasonably near term. This indicates that the Afghan government could reach its reported medium-term target of 15 percent of GDP in total revenues over the next three years or so without making sensitive changes in the overarching tax policy framework. If VAT, with its self-enforcement features, is phased in starting in the 2014-15 time frame, and if mining-related revenues begin to flow in over the next five to seven years, then the longer-term prospects for consolidating total public revenues in the 20-25 percent range (the probable domestic revenue range necessary to begin meaningful phase-out of major levels of donor grant funding) a decade or so from now do not seem as unattainable as might appear at first glance. Much progress would of course need to be made across a number of tax policy/administration and investment climate reform areas to achieve that loftier goal, but in a fundamental sense it does appear to be achievable under the right institutional circumstances. The areas of potential priority engagement laid out below will reflect the regulatory reform and institutional strengthening areas that need to be most urgently addressed to help make this set of goals a reality. Their implementation will require tight coordination and integration of reform recommendations and institutional strengthening efforts of the key donors involved. This is discussed later.

D. Budget Policy and Management

The Afghan government's and the international community's overriding political and security stabilization goals will be extremely difficult to achieve if the public sector is not able to establish its bona fides as a legitimate and efficient provider of basic public services to the population. In this regard, the government clearly faces compelling challenges on the budgetary allocation and control side. With 75 percent of government-financed operating expenditures going to wages and salaries, and almost another 10 percent split between subsidies and pension payments, the government has extraordinarily limited capacity to provide core goods and services. Under the realistic assumption that approximately half of the development budget is actually for operating expenditures (again mostly wages and salaries), this implies that on-budget capital expenditures amount to only about 3.5 percent of GDP (see Tables 3 and 4, below). Overall, the government is able to finance only about 70 percent of its operating budget (or about 60 percent, considering the recurrent expenditures reported under the development budget), and virtually all domestic revenues are actually going to cover the public-sector wage bill.

Table 3.Public Expenditure Breakdown – FY 1388/89

Public Expenditure	% of GDP	
	FY 1388	FY 1389
Operating expenditures	14.3	15.5
Development expenditures	7.2	6.2
Total expenditures	21.5	21.7
Domestic financing	10.4	11.3
Foreign financing	11.1	10.4
Share of domestic financing	48.0	52.0
Share of domestic financing for operating expenditures	73.0	73.0

Table 4. Breakdown of Operating Budget – FY 1389 (% of Total)

Wages and salaries	75.0%
Goods and services	14.5%
Pension payments	4.4%
Subsidies	3.4%
Other	2.6%
Total	100%

Source: MOF, USAID/Economic Growth and Governance Initiative Project

In addition, the government must also effectively address the looming prospect of a massive increase in operation and maintenance expenditure needs over the medium term as it assumes responsibility for financing the upkeep of internationally financed capital projects.

Because approximately 75 percent of international spending is off-budget, and virtually the entire capital budget is now covered by donor funding, a major contortion of spending patterns — resulting in disruption of service provision at the grassroots level — is possible as donor funding recedes. To prevent this will require a concerted and efficient effort to improve integrated budget-planning and control functions in the near term. In this context, it is extraordinarily important for the government to develop the budget-planning and management policy, and institutional framework and related capacity to 1) dramatically improve the allocative efficiency and cost-effectiveness with which critical on-budget public services are provided to the population and 2) smoothly manage a transitional process of reallocating expenditures from off- to on-budget in a manner that limits the disruptive impact of changing levels and regional/sectoral expenditure allocations at the macro and regional/community levels.

It is equally important that the government begin — as rapidly as possible — to incorporate donors' plans for additional off-budget spending over the next few years into its own incipient medium-term budget-planning/forecasting efforts. This will be important for maximizing the effective integration of government budget allocation and program funding decision-making processes and the ultimate effectiveness and sustainability of service delivery at the community level. In effect, it will help incorporate "off-budget" expenditures into the "on-budget" planning process, even if the majority of the referenced funds never pass through the MOF treasury. Given the ongoing predominance of off-budget funds as a percentage of public-sector spending, this is a fiscal policy "must" in order to ensure a smooth budgetary transition process and maximize the economic development and social welfare enhancement impact of public spending.

E. Budget-Planning Framework

Significant progress has been made in establishing an orderly and coherently structured and managed annual budget-planning cycle and process. The core budget management provisions of the Public Financial Management and Expenditure Planning Law (2009) are broadly consistent with best practice standards. The MOF initiates the annual budget process by establishing the basic budget by the end of the first quarter of the preceding FY (April-June). It then releases the core budget circulars, which provide basic budget preparatory guidance, to all line ministries and agencies by the end of the second quarter. The line units then have about one month (October to November) to prepare submissions. After the MOF's Budget Department reviews the submissions, a supra-ministerial Budget Committee conducts a two-week budgetary review process to assess and finalize budgetary priorities and set final parameters. This is followed in the last quarter of the FY with cabinet approval and submission to the Assembly. As this process reveals, involvement at the provincial and municipal levels has, to date, been quite limited. Furthermore, though significant progress has been made in establishing an improved budget classification system, some issues remain in the misclassification of some elements of the development budget.

Recent government and donor efforts have focused on shifting from a mechanical plus-up-based annual budgeting process to an integrated medium-term budgeting process. Within this context, the budget-planning framework is being re-engineered to relate expenditure prioritization and sectoral allocation processes to the overarching socioeconomic development goals of the government, as articulated in the Afghan National Development Strategy (ANDS) and the related National Priority Program (NPP) strategy.[10] It is critically important that such efforts be undertaken in a manner that realistically reflects the local developmental context and related institutional capacity. In this sense, with very basic socio-economic development needs to be met (e.g., high poverty and illiteracy rates, and abysmal performance across a range of basic Millennium Development Goals indicators), it is neither necessary nor helpful to develop complex program goals, performance targets, and cost breakdowns. Similarly, given the limitations in local institutional capacity, such efforts can easily over-absorb scarce budgetary planning and management resources into nonproductive esoteric budget development exercises. In fact, the initial program budgeting technical support efforts carried out by the donor community tended to run in this direction (e.g., they featured elaborate activity costing methodologies). As a result, they were criticized by the donor community (e.g., the IMF and World Bank) and met with frustration from the Afghan government. However, the donors have moved toward a more streamlined and practical program budgeting approach over the past two years, and this year's budget circular guidance appears to focus clearly on establishing basic expenditure goals and related performance targets that are tied to core developmental objectives. The costing elements may still be a bit more cumbersome than necessary, but the basic approach is sound.

In addition, the government is for the first time making a serious effort to involve lower levels of government in the budget-planning process. This is being implemented initially through a special pilot program involving five line ministries (agriculture, rural development, education, health, and the Independent Directorate of Local Governance) and seven provinces, with support from USAID and advisors from the United States Treasury Department. The relevant line ministry offices are to proactively engage provincial and community councils in the pilot provinces to ensure concrete local involvement in the development of a series of pilot programs (up to $500,000 per pilot province). All programs must be consistent with established NPP priorities. This program is important from the perspectives of allocative efficiency and fiscal sustainability.

Proactive engagement of local institutions is also critical from the perspectives of effective expenditure prioritization and empowering the institutions. It is also the first small step toward incorporating greater awareness and understanding of the impact regional and local off-budget expenditures by international institutions can have on the optimal planning of on-budget expenditure programs. Presumably, participating local institutions will be more aware of and interested in promoting coordinated budgetary decision-making than centralized ministries and their provincial offices. As a result, the pilot programs provide a better opportunity than a completely centralized budget-planning process to introduce an element of coherence and

[10] The Afghan government has, with support from USAID and DFID, developed a basic analytical expenditure framework for the medium term and an Excel-based model (which it has used for the past six years) to establish overall budgetary ceilings and ground-truth sectoral allocations. However, due to staff turnover, current institutional capacity to implement a sound medium-term expenditure framework is limited. The ongoing technical assistance efforts by ex-IMF resident representative Dr. Steven Symansky, supported by USAID, the United States Treasury Dept., and DIFID, will help upgrade and systematize the process and local oversight capacity. It will also facilitate a more realistic and comprehensive assessment of the implications of current off-budget expenditures for future on-budget recurrent spending.

prioritization to the overall budget process — which at least takes into account the local impact of off-budget spending in delineating community-level expenditure priorities. It is still unclear whether full funding for the pilot programs will be provided during FY 1390.

Another aspect of the budget-planning process that requires significant refinement is the process of allocating regional and local funds. Because Afghanistan has a unitary budgetary policy framework, there is no coherent intergovernmental finance framework in place. This is underscored by the vast differences in per capita funding allocations across provinces that have emerged. It would appear that the primary approach to address this important budgetary targeting issue would be to establish at the sectoral level relevant expenditure targeting formulae or norms that reflect differences in objectively defined needs indicators across provinces and localities. This could be achieved by developing sectoral policy norms established by the MOF Budget Department in collaboration with the relevant line ministry. Of course, such a policy and its related set of targeting norms must not create a dramatic shift in resource allocations across provinces at a single point in time. This would create a severe political backlash against the application of what, in principle, would be a policy reform consistent with the spirit of the ANDS and NPP strategies.

Finally, to make integrated medium-term budgeting a meaningful applied concept, it will be critically important to establish basic capital budgeting and feasibility analysis capacity in 1) the Ministry of Economy, which is nominally in charge of capital budgeting, but reportedly extremely passive in its fiscal planning role, and 2) major line ministries and agencies. It is understandable that, to date, there has been little or no emphasis on developing such capacity, because virtually all project financing has been done off-budget by the international community. However, as efforts begin to incorporate more donor financing on-budget and move toward an integrated expenditure planning process, it is now important to 1) begin to develop basic cost/benefit analysis capacity and 2) apply basic and relevant feasibility analysis concepts to the budget prioritization process within and across sectors. This should over the medium term take the form of the development of sectoral public investment plans.

For now, the key is to build basic pre-feasibility analysis capacity among a core group of staff in the Ministry of Economic Development (MOED) and in key line ministries and agencies charged with developing and monitoring capital projects. Indeed, the 1390 budget circulars make explicit reference to the conduct of pre-feasibility analysis for projects valued at more than $500,000. While this may be overly ambitious, it is a step in the right direction.[11] At the very least, there should be a core group of staff in MOED and relevant line ministries that can review and ground-truth the feasibility work done by donors whose programs are going "on-budget." This can then be expanded to more proactive, in-depth work on new locally driven capital budgeting projects as the government's role in the development budgeting process becomes more proactive over the next three to five years. In the end, for local ownership and meaningful rationalization of budgetary allocation outcomes to occur in Afghanistan, organized project analysis process must become integrated in a tangible way into the overall medium-term budget-planning framework. Small steps in this direction are being taken, but there is a long, long way to go.

[11] In fact, the budget preparation guidance in this area reflects targeted one-off technical support provided to the MOED by USAID implementers.

F. Budget Management

The Afghan government has made significant progress in establishing and operationalizing disciplined and systematic budgetary tracking and control procedures. The budget allotment process established by Treasury facilitates efficient control of commitments and payments authorizations against allocated funding. Allotments against budgetary ceilings are made on a quarterly basis. At the same time, the allotment and subsequent payment authorization processes tightly link program expenditures to a specific source of funding, which in the case of discretionary expenditures (i.e., spending not associated with or financed by a particular donor program) can introduce budgetary rigidities. Indeed, some of the issues related to the low expenditure rates associated with the development budget can be tracked to this source.[12] Payments are made through the unified single treasury account system, consistent with best practice procedures. In addition, a systematic budgetary reconciliation process is carried out by the MOF on a monthly basis.

Significant complementary progress has been made on the development of an automated budget management/tracking system, the Afghanistan Financial Management Information System (AFMIS). This has occurred through the application of FreeBalance software for budget tracking/control purposes. In this regard, the core General Ledger Module has been implemented, and real-time connectivity established between the line ministries and the MOF, and between provincial line ministry offices and the *mustofiats*. The MOF Treasury Department has also developed detailed plans for implementing other core AFMIS modules through FreeBalance, including ones for budget-planning, revenue-tracking, procurement, asset management, and payroll. According to senior Treasury officials, these changes will cost approximately $10 million. In reality, it is somewhat surprising that, seven years into the planning and implementation of the AFMIS system, only one core FreeBalance module has been installed. While progress on establishment of a basic budget tracking/control system has been impressive, the absence of the adjoining core modules does significantly limit the contribution of the automated treasury tracking system to efficient and transparent budget-planning and execution.[13]

Unfortunately, progress in the budget tracking/control process has not been matched by progress in the processes that determine the transparency and efficiency of contracting processes. The procurement system, though characterized by a sound overarching legal and regulatory framework, is seriously marred by:

- limited technical capacity to comply with core procedures related to bidding document preparation and evaluation procedures
- lack of e-procurement capacity
- absence of an organized compliance monitoring system for procurement actions at the ministry/line agency level.

[12] They are also reportedly traceable in part to inadequacies in project planning and limited local institutional implementation capacity.
[13] For example, the installation of the payroll module would be extremely useful to help effectively and comprehensively implement efforts to root out ghost workers in line ministries and agencies at different levels of government.

Under the anti-corruption law, any violation of the procurement law is a criminal offence. The law does not distinguish between intentionally corrupt practices and simple mistakes or negligence. This, along with the rampant political pressure associated with major procurement actions, has led many professional staff to try to avoid involvement in procurement processes. This series of institutional and legal rigidities has delayed procurement actions and dramatically eroded the transparency and credibility of procurement processes. Attempts have recently been made to initiate procurement decentralization down to the provincial line department and agency levels, but financial authority for such actions remains severely limited. Overall, the recent mandate for line ministries to generate organized financial and procurement plans as part of the FY 1390 budget process was a step toward enhanced budget management transparency and efficiency; if implemented effectively, this should also significantly speed up budget execution.

Furthermore, the legitimacy and transparency of contracting actions is marred by the virtual absence of any type of legitimate internal and external audit function. The core legal and regulatory framework for internal audit is in line with international standards, with strict requirements to be exercised by line ministry and agency internal audit departments, subject to the guidance and oversight of the MOF's central internal audit department. However, institutional capacity and political will to design and transparently implement systematic internal audit plans remain extremely limited.

The independent external audit office (CAO), initially established under the Presidency and since appropriately transferred to the Assembly, is charged with carrying out independent external audits of government budget programs and preparing a comprehensive set of audited financial statements for the prior FY budget within six months of the end of that FY. In practice, however, at least half of annual expenditures are not subject to full and effective annual audits, and audit reports often take longer to prepare and issue than the statutorily mandated six-month limit. Staff capacity is extremely limited, and the political will to plan, conduct, and issue systemic findings on audits of major government programs is almost entirely absent.

The World Bank is initiating major technical assistance and training programs to improve institutional capacity in procurement and internal and external auditing. However, such technical and training assistance is daunting, and the political commitment in these areas continues to be subject to considerable doubt. Without significant progress in contract monitoring and review, it will be difficult to translate progress in budget-planning and treasury management into lasting, systemic improvement of the quality of public service delivery and improving the legitimacy of the government as a provider of vital public goods and services.

SECTION II. PFM PROGRAM STRATEGY IMPLICATIONS FOR USAID: SCULPTING THE ROADMAP

A. Introduction

The analysis in Section I suggest that the fiscal governance reform challenges facing the Afghan government and the donor community are multifold and complex, and that addressing them is likely to have an impact on rent-seeking behavior, which has become endemic across all levels of government. At the same time, we can also see that key institutional reforms have taken hold, up to a point, in core aspects of fiscal policymaking and administrative oversight activities, and that building additional momentum in a number of these areas does not seem to be a counterintuitive proposition. We can also see that overall fiscal balance goals, while they will require considerable institutional effort and additional bureaucratic and political risk-taking on the part of reformist officials, are not unattainable under reasonable assumptions with regard to revenue enhancement, budget rationalization, and donor resource curtailment schedules. As USAID assesses its strategic focus in PFM, it should examine potential areas of collaboration across three core dimensions:

1. What are the most severe policy and institutional constraints to improved fiscal governance performance?

2. What fiscal governance reform support areas provide the strongest prospects for success (i.e., where is government buy-in and commitment likely to be the strongest)?

3. Where can USAID provide critical technical and training support that will reinforce, not duplicate, joint donor fiscal reform support efforts?

When viewed from this strategic yet practical perspective, a number of critical priority intervention areas tend to emerge. These are elaborated below.

B. Revenue Policy and Administration

The primary goal here is to increase total revenues from the 11.5 percent of GDP range to the 15-16 percent range over the next few years. This implies at least a 3-4 percentage point of GDP increase in tax revenues. It is important to do this in a manner that meets core transparency and fairness criteria, and does not distort economic incentives. The prospects for additional forward movement in this area are reasonably strong; they do not involve major reforms of the overarching tax policy framework. They do, however, involve core procedural reform and capacity-building support, which will improve the institutional rigor and transparency with which lynchpin tax administration oversight activities are carried out. It will also entail corollary progress in tax policy framework and tax information management systems support areas, which are being implemented by DFID and World Bank, respectively, so that effective donor coordination and synergistic dovetailing of policy analysis and institutional reform/strengthening support activities will be critical to maximizing program impact.

B1. Enhance the Administrative Oversight Capacity and Performance of Decentralized Tax Administration Offices

As noted earlier, the basic regulatory structure of the Afghan tax system is second-best and creates challenges from of its need to limit contact between taxpayers and tax officials, and achieve economies of specialization/scale for training and implementation purposes. At the same time, the system has begun over the past few years to perform more effectively, and the opportunity appears to exist for significant additional performance gains, without recourse to overarching changes in the tax policy framework. Such changes would be difficult due to Afghanistan's complex political and bureaucratic situation, and the litany of pressing political issues to be addressed over the next few years. Given these factors, the core support strategy moving forward should to significantly improve operational efficiency, administrative integrity, and human resource capacity of the decentralized tax office structure (i.e., the STOs, MTOs, and LTOs).

Within the broader context of this approach, a critical target of opportunity is to improve the administration of the direct tax regime in general and the profit tax in particular. The latter represents just 3 percent of total revenues and 0.3 percent of GDP — exceedingly poor compliance performance by any standards. In this regard, it appears that in principle the core aspects of the direct tax policy regime are reasonably robust. As noted earlier, the critical issues relate to effective administrative oversight, particularly under-registration and non-filer issues. Key reforms in the administrative procedural framework are required, and significant additional training activities are required to strengthen local STO, MTO and LTO administrative capacity.

The improvements in core functional areas — taxpayer registration, returns processing, audit, taxpayer services — will facilitate better administrative oversight of the personal income tax regime. They will also help promote further improvement in the efficiency and transparency with which the main indirect taxes (i.e., BRT/fixed tax) are administered. In particular, high impact can be expected from improved audit selection and case-management procedures and practices, which will help systemically address chronic non-filer issues. In addition, effective technical and administrative coordination with customs administration support initiatives implemented through USAID and other donors (e.g., the United Nations Development Programme) will be important to maximizing the informational and enforcement leveraging impact of enhanced automation and procedural reform. This can be achieved by focusing on structured administrative interfacing on audit procedures and automated case file sharing between the customs authority and relevant tax offices.

This will also require 1) communicating with experts from the World Bank who are focused on implementing the standard integrated government tax administration system and 2) ensuring the effective synchronization of manualized core procedural guidelines with automated tax information flows and structures. In this regard, applied information technology-related support may be required at the tax office level, which complicates the overarching software development support being provided by World Bank consultants.

Furthermore, in mapping out an overall strategy for supporting procedural reform and capacity-building across the network of LTO, MTO, and STO branches, USAID will need to reinforce a clear framework for collaboration with the other major donors involved, especially DFID.

USAID’s advantage is its institutional capacity to work intensively at the field level to build administrative integrity and professional rigor into core tax administration processes. This means that additional refinement of overarching tax policy reform work at the national level in the direct and indirect tax administration area would essentially fall to DFID. This is a sensible and workable delineation of responsibilities, provided effective coordination and dialogue with relevant national authorities at the central level occurs when critical “interface” issues linking efficient policy with effective administrative oversight performance (e.g., best practice-consistent procedural guidelines on audit and returns processing) arise and require expeditious follow-up.

It will also be necessary to effectively determine the division of labor with regard to local tax office oversight. DFID appears to be focused on managing all support activities in the Kabul LTO and MTO branches. A robust and efficient strategy for improving performance could be to have one donor handle overarching tax policy framework activities and issues with the MOF while another donor builds and refines a coherent, consistent procedural framework, organizational structure, and training network and system across the regional network of tax offices. This structure should lend itself to effective specialization of support task and efficient/synergistic coordination. The ultimate goal of this support program would be to ensure that a network of functionally organized tax offices is operating in a manner consistent with basic administrative efficiency and probity standards. In that same spirit, the program should strive to ensure that core taxpayer registration, case management, returns processing, audit, enforcement, and taxpayer outreach activities are carried out in a transparent and efficient manner on a reasonably standardized basis across all categories of tax offices. Through these reforms and synergistic coordination with other core donor efforts in the tax policy and tax automation area, these support programs should target an increase in total revenues as a share of GDP to 15-16 percent by 2015.

B2. VAT Implementation

As noted above, the IMF and the Afghan government are in active discussions to introduce a VAT system between 2014 and 2015. In the long term, this should have significant compliance-enhancement and economic efficiency benefits, because it will replace the current BRT/fixed tax system. However, passage and initial implementation will likely be arduous, and consume time and resources — with the ultimate outcome open to doubt. The revenue enhancement needs the government is facing are immediate and drastic, and the prospects for successful adoption and introduction of the VAT uncertain. As a result, there would appear to be a significant opportunity cost to diverting technical resources toward VAT consensus-building and away from focusing on fine-tuning limited policy aspects of the current tax regime and driving dramatic improvements in the tax administration oversight regime. Therefore, USAID should consider focusing on strategy and programs to support tax administration oversight, and coordinating with IMF and DFID as the dialogue on VAT introduction proceeds. Furthermore, if VAT is introduced, USAID, IMF, and DFID should focus support, as needed, on effective procedural introduction and implementation through the network of local tax offices.

B3. Mining Industry Revenue-Sharing Regime

In the medium to long term, natural resource extraction could provide a major source of revenues for the Afghan government. This, of course, assumes that the security situation will stabilize adequately and a concessions/investor rights regime will be established that encourages the interest of major international investors. Given mining's potential for long-term sustainable economic growth and a fiscal balance, USAID's next-phase PFM support program should emphasize 1) specialized technical support for fine-tuning the regulatory regime for natural resource-based concessions and revenue-sharing arrangements, and 2) the design of best practice-compliant royalty and broader revenue-sharing procedural guidelines. USAID should also consider training to build administrative oversight and enforcement capacity in natural resource extraction-based revenue-sharing and royalty contractual arrangements. The intensity of procedural reform and training support activities would be tied to progress toward basic regulatory framework reforms and concrete expressions of investor interest.[14]

C. Budget-Planning Reform

Procedural and institution-building reforms in budget-planning are necessary to promote more effective prioritization, targeting, and cost-effective provision of vital public goods and services — and reinforcing the legitimacy of the government in the eyes of the population. The good news is that the policy framework for an efficient and transparent budget-planning system is essentially in place. As we have noted, the task at hand — and the main focus of the next generation of support programs — should be to operationalize the new procedural framework and facilitate the implementation of an efficient and inclusive budgetary information-sharing and decision-taking system in a manner that greatly improves the quality and comprehensiveness of budgetary allocation decisions. This must be done in a manner that takes advantage of and, where necessary, "stretches the envelope" of meaningful government commitment. It must also be done in a manner that considers and maximizes synergy with related U.S. government and other donor initiatives. Specific priority areas of technical/training engagement are detailed below.

C1. Program Budgeting

USAID has a compelling opportunity to help guide a systemic improvement in expenditure allocation and performance impact. With the core legal and regulatory framework for program budgeting in place, and initial rollout across line ministries and agencies underway, USAID will work to solidify a transparent and efficient process of defining tangible programmatic goals and tying them to cost-efficiency targets across all major sectoral expenditure areas. Through a formal training exercises focused on practical case studies and informal on-the-job training and mentorship activities, USAID will permanently transform the government's institutional capacity to develop sound annual and multi-year program-based budgeting structures, and to analyze results and take appropriate program strategy adjustment actions.

This will also entail ensuring an appropriately rigorous tie-in with programmatic goals established through the iterative budget process and the overarching socio-economic development objectives outlined in the ANDS and NPP strategies. It will also entail an effective and comprehensive tie-in between recurrent and capital expenditure planning. The latter is of

[14] Should the Afghan government attract mining investment that warrants technical and training support over the medium term, USAID should also be prepared to provide support to establish and operationalize a sound rules-based framework for safeguarding and promoting economically rational allocation of extraction-based revenues.

fundamental importance for purposes of ensuring the rationality and sustainability of expenditure planning processes. The goal of these support efforts should be to establish a program budgeting process that is systematically leading to the formulation and prioritization of expenditure programs with tight, well-defined, and appropriately ambitious performance goals and related targets, and whose performance over several years confirms the rationality, cost-efficiency, and incentive-friendliness of the program budgeting structure. In this regard, USAID will work with key line ministries and line ministry offices at the provincial level, and will coordinate with other relevant donors.[15]

C2. Capital Budgeting and Feasibility Analysis

Budget circular instructions now reference pre-feasibility assessments for larger-scale project activities. USAID has a vanguard opportunity to help create basic integrated budget-planning capacity for the first time in Afghanistan. USAID will take advantage of this opportunity by working with the MOED to develop its internal capacity to understand and conduct cost/benefit and cost-minimization analysis for major projects across a range of important sectors. USAID will also work with the MOED to extend this knowledge and capacity to relevant budget-planning staff from key line ministries. The focus will be on practical capacity-building support emphasizing developing capacity to undertake sound pre-feasibility analyses in critical physical and social infrastructure sectors. Capacity-building will also focus on facilitating joint program-planning exercises in which capital and recurrent expenditure elements are analyzed and related to anticipated program outcomes. Furthermore, training will build capacity to establish cost estimates, including rigorous estimates of operation and maintenance expenditures. Over the longer term, this expanded institutional capacity and programmatic awareness should guide the development of effectively prioritized multi-year public investment plans at the sector level, which would in turn be integrated into the annual and multi-year program budgeting process.

C3. Provincial Budgeting

The allocative efficiency and responsiveness of the budget-planning process cannot be adequately improved without “bottom-up” information-sharing and feedback loops with meaningful local-level involvement in the budget process. In this regard, USAID will build FY 1390 pilot programs addressing provincial budgeting in five ministries and seven provinces. This will entail intensified and expanded implementation of inclusive program budgeting-based budget-planning exercises with the pilot ministries and municipalities, building beyond the small pilot project budgets currently allocated by MOF. It will then expand to at least one additional round with three to five major ministries and coverage in all provinces over a three- to four-year period.

The expanded provincial budgeting focus will also provide a striking opportunity for the first attempt to leverage greater coherence and cohesiveness in the allocation of off-budget resources and the conduct of on-budget annual and multi-year planning exercises. We will build on initial progress made by pilot USAID and the United States Treasury Department training programs at the local level. A focused and systemic technical outreach and training effort will be conducted

[15] Especially DFID, which again is expected to provide overarching program budgeting policy assistance through advisory support to the MOF’s Budget Department.

to establish a more complete and detailed inventory of off-budget projects and programs in pilot ministries and provinces (and, subsequently, in additional provinces). The main goal will be to leverage integrated planning between off- and on-budget expenditure planning processes in a manner that will maximize programmatic synergies and allow local socio-economic development needs and perspectives to play a more determinate role in shaping off-budget expenditures on the part of the international community and prioritized on-budget spending.

The expenditure planning linkages that result from this process should achieve a number of key budgetary transparency and efficiency objectives. First, it should maximize the complementarity and joint socio-economic development impact of future on- and off-budget expenditure priorities and programs. Second, it should allow greater community involvement in the design of off-budget spending programs. Third, it should incorporate a greater awareness of and capacity to effectively plan for the future recurrent cost implications of past and prospective off-budget capital spending. Very importantly, it will also provide the Afghan government with much more detailed and precise information about the prospective phasing-down of international (e.g., Provincial Reconstruction Teams) expenditure support at the sub-regional and community levels. This could prove critically important in helping the government to proactively plan for at least partially supplanting that reduced spending over some transition period with domestic and/or other donor-provided resources, thus minimizing socio-economic disruption and negative political impacts.

Finally, USAID will focus at the local level on supporting improved representation of women in provincial budgeting processes. USAID will do this in a manner that, over time, helps promote enhanced gender sensitivity and balance in expenditure outcomes.

C4. RIA

As the government focuses on improving core aspects of the budget oversight process in manner that enhances sustainability, an important area of medium-term institutional upgrading will be to develop capacity to analyze the impact of proposed economic governance measures on budgetary performance. This can prove important in allowing transparent consideration of policy measures — ones that may impose future budgetary costs — that would not otherwise be considered at the time they are adopted. This will also support the broader objective of streamlining enabling environment legal and regulatory parameters in a way that encourages the significant growth in private investment necessary to enhance productivity and job creation, and sustain economic growth as donor resources are curtailed. This will need to be phased into legal and regulatory guidance on the legislative and regulatory approval process. USAID will also promote incorporation of a gender-impact focus in this analysis. The analytical procedures and related training materials applied to building RIA capacity should focused and practical, and avoid complex cost/benefit analysis techniques. The initial focus of capacity-building work could include the Fiscal Policy Analysis Unit and/or MOED technical staff, and should also include technical staff from the National Assembly's Commission on Budget and Financial Affairs, whose participation should also be encouraged in program budget training initiatives.

C5. Inter-Governmental Finance Reforms

Under its new PFM, USAID will support strategy to support a rationalized and equitable allocation of budgetary resources across provinces and localities. USAID will do this in a manner that reflects objectively defined needs indicators to a much greater degree than at present. Given Afghanistan's unitary fiscal governance system, this cannot be achieved through explicit grant-formula-based sub-national revenue allocations. Instead, USAID will promote the application of sound needs-based analysis and key indicators (per capita-driven in principle) at the sectoral level within key line ministries and agencies (e.g., education and health). The indicators will then be transparently factored into overall budgetary ceiling requests at the ministry level, and into planned budgetary allocations at the provincial line ministry level. This will be done in agreement and coordination with the MOF, and represent a major step toward rationalized, transparent budgeting at the regional and local levels, to be implemented in a coordinated manner with the program budgeting and provincial budgeting processes.[16]

Taken together, these budget-planning reform support programs provide an opportunity to fundamentally reshape and improve the transparency and efficient targeting of the budgetary allocation process. This is a difficult but achievable goal, assuming consistency of purpose on the part of the government, and appropriately practical and vigorous technical and training outreach activities on the part of USAID programs. It will also require effective coordination with DFID, which will be providing backbone budget policy support through the MOF.

C6. Budget Management

The significant progress attained across a number of component budget execution-related process areas, as well as the important initial progress achieved in the budget automation area, represent important first-generation achievements that the Afghan government intends to build upon with donor support over the medium term. It appears the World Bank is poised to provide major additional technical support in further refinement of core budget allotment, commitment, and payment authorization procedures, payroll verification reforms, and related implementation and rollout of the remaining core budget automation modules of AFMIS.[17]

Despite this considerable progress, however, the ultimate integrity of the budget management system remains in doubt. The primary reason is that, though the reforms create rigorous and transparent capacity to control budgetary allocations and monitor execution to ensure spending patterns and levels conform with the approved budget, they do not provide any meaningful protection against allocation of funds to inefficient or illegitimate service providers. Therefore, the reforms do not ensure the quality of service provision activities. In this fundamental sense,

[16] As noted earlier, the Fiscal Policy Unit will also play a broad role in the budget-planning process. It will establish overall medium-term expenditure framework budgetary parameters and related macro-modeling tools designed to establish meaningful expenditure ceilings at the macro and sectoral levels under a range of macro/fiscal performance scenarios (and based on inter-ministerial guidance on sectoral prioritization of expenditures). At the same time, this unit is receiving — and will apparently continue to receive — major technical assistance and training support from DFID. Therefore, and due to its essentially indirect role in the program-level budget-planning and goal-setting process, USAID does not plan to focus intensive assistance in this area over the medium-term.

[17] The World Bank is apparently not, however, going to pay for the hardware and software costs of full installation and rollout of AFMIS, which senior MOF officials have estimated will cost approximately $10 million.

they cannot prevent further erosion of public confidence in the government's capacity to deliver services. In addition, lack of understanding and complexity of core budget management procedures in certain key areas (e.g., procurement), lack of full budget automation, and limited training at the line ministry and field levels have slowed down budget execution performance. In light of these factors, further progress is required in key adjoining budget management areas to build upon momentum and encourage improved performance by public service providers. An important area in this regard is improved performance of the public procurement system.

C7. Public Procurement

The sound legal and regulatory framework of the public procurement system belies its almost total failure to operate efficiently and transparently. USAID intends to play a significant role in improving the integrity and efficiency of public procurement outcomes. The World Bank is planning to provide more procedural support for streamlining and further improving the tendering, evaluation, and notification guidelines, and developing related e-procurement capacity with the MOF's Central Procurement Unit. The World Bank also plans to follow through on implementation in line ministries and at the provincial level. However, given the daunting institutional dimensions of the required technical support and training effort, and the need to prioritize resource allocation for implementation purposes, there is a strong need — and opportunity — for complementary donor support to build further momentum for procurement reform and progress. In this regard, USAID will provide intensive technical assistance and training outreach support to 203 key line ministries and agencies (e.g., agriculture, education, and public works) to drive decisive and comprehensive reform of public procurement planning and implementation processes in those units, including developing detailed annual public procurement plans. USAID will also follow through on supporting improved procurement practices and providing related outreach efforts in the local offices of these line ministries. This will have a direct impact on the integrity and efficiency of service delivery activities and help speed up budget execution rates. It should also have a salutary demonstration effect on procurement reforms more widely within the government.[18]

C8. Internal/External Audit

Developing improved procedural guidelines and dramatically expanding institutional capacity to perform meaningful performance and financial audits is vital to improving performance incentives and driving efficient and transparent delivery of public goods and services. Performance in this area has been wholly inadequate to date. The World Bank is planning a massive technical and training support program in this area that will focus on procedural and capacity-building improvements in internal and external audits. As a result, USAID will not plan to focus intensive technical and training resources in this area under its next-phase PFM support strategy. However, USAID should maintain a vigilant and proactive monitoring focus on progress in these areas, because progress is crucial for efficient and cost-effective public service delivery. USAID should be prepared to provide institutional "gap-filling" assistance, particularly with training side.

[18] This game plan has been discussed with the World Bank, which feels that it could have a powerful complementary impact on the success of its own prospective procurement reform support efforts.

SECTION III. ILLUSTRATIVE PFM ROADMAP RESULTS AND INDICATORS

A. Project Goal

- Strengthened governance and service delivery at national and sub-national levels (Mission Level IR 1.3)
- Effective fiscal and monetary policy implemented (Mission Level IR 4.1)
- Core functions of selected ministries improved (Mission Level IR 8.1)
- Afghan First advanced (Mission Level IR 8.2)
- Increased utilization of on-budget development assistance (Mission Level IR 8.3)

B. Project Objectives

- The policy and institutional framework for the government's budget-planning and management system will be strengthened to promote a smooth fiscal transition process and significantly enhance fiscal sustainability.

- The government will significantly improve overall tax efficiency.

- The government will significantly improve direct income tax compliance and revenues.

- The government will establish a sound legal and regulatory framework profit-sharing and royalty arrangements in the mining industry.

- The government will significantly improve the cost-effectiveness and allocative efficiency of the budgetary system to better respond to the needs of citizens.

- The government will effectively integrate on- and off-budget expenditures in the annual and multi-year budget-planning process.

- The national budget will better reflect major provincial development priorities/needs.

- The government will significantly enhance the efficiency, transparency, and timeliness of the public procurement system.

C. Expected Life-of-Project Outputs

- The share of total revenues to GDP reaches at least 15 percent.

- Systemic tax administration procedural reforms are implemented across STOs, MTOs, and LTOs in key population centers across the country, including Kabul.

- Non-filer rates are systematically reduced across all major STOs, MTOs, and LTOs, with an average across all offices of no more than 20 percent.

- The number of registered taxpayers increases across the network of STOs, MTOs, and LTOs by at least 50 percent.

- Sound legal and regulatory and (where/as relevant) detailed procedural guidelines for mining industry profit-sharing and royalty arrangements will be developed.

- Systematic and inclusive program budgeting procedures and processes are implemented and core results indicators defined across all line ministries and agencies in the national government.

- Systematic medium-term budgeting and basic capital budgeting procedures and processes are implemented across at least 10 major ministries and agencies in the national government.

- Systematic and inclusive provincial budgeting procedures and processes are implemented across at least 20 provinces, representing at least 80 percent of the population.

- Effective tracking of progress against results indicators is systematically undertaken and incorporated within the subsequent budget cycle planning process.

- Provincial budgetary allocations are made on the basis of objectively defined needs indicators in at least five major sectoral areas.

- A sound legal and regulatory framework is developed for RIA procedures.

- RIA methodological practices are effectively applied to all major new legislative and regulatory initiatives.

- Core budget-planning and RIA procedural requirements and practices reflect an explicit gender-impact focus.

- Major best practice-compliant public procurement-related procedural reforms are applied within at least two or three major line ministries and agencies and their local offices.

- Efficient, transparent, and timely procurement practices (including e-procurement processes) are systematically implemented within at least two or three line ministries and agencies and their local offices.

- Annual budget execution rates for the operating and development budgets reach at least 80-85 percent.

- Joint de facto planning processes for off- and on-budget expenditures are systematically applied at the provincial level across all provinces.

- Improve staff capacity across all project objectives, including in the provinces (MOF, *mustofiats*, ministries, ministries' provincial staff, and provincial and district councils).

- Improve internal and external communication in the budget-planning and procurement and related public outreach processes. “Internal” refers to intra-governmental communication, between Kabul and the provinces; “external” refers to communication with civil society and other NGOs.

- Systematic and inclusive program budgeting procedures and processes are implemented across all line ministries and agencies in the national government.

SECTION IV. CONTRIBUTION TO STABILIZATION AND DEVELOPMENT STRATEGY

A. Objective

The Afghan government has articulated its priorities for stabilization and development through the Kabul Process and ANDS. This program is intended to support these Afghan goals and President Obama's Afghanistan strategy by strengthening key Afghan governance capacity for more efficient and transparent budget-planning and management practices that better reflect and meet the critical socio-economic development needs of the Afghan people. This project aligns with the NPP strategy by improving cost-effectiveness and service delivery impact of public spending, increasing domestic revenues in a sustainable manner, and building sustainable institutional capacity to effectively implement the Afghanistan PFM Roadmap.[19]

This U.S. government assistance program is also aligned with the Integrated Civilian-Military Campaign Plan for Support to Afghanistan. It improves capacity for budget prioritization and management at the national level while increasing the effective role of provincial directorates in budget-planning and facilitating more effective integration of off- and on-budget expenditure programs. Creating a more transparent, inclusive, and effectively integrated budget prioritization process and system in Afghanistan will also improve public, private, and civil society institutional dialogue and interaction throughout the budget cycle, further aligning with the principles of aid effectiveness and civic empowerment. In underserved and less stable areas, any improvement in budget allocation and management processes at the provincial, district, or village levels will prove important in increasing popular support for the government among the population.

[19] The PFM Roadmap was published by the MOF on July 14, 2010, and remains its central strategy relating to PFM.

SECTION V. CONTRIBUTION TO AFGHANIZATION AND CAPACITY-BUILDING

This project will work through and strengthen internal MOF revenue collection and budgeting systems. The project's overarching goal is to build Afghan capacity in revenue collection and budget formulation and management. The project will build the capacity of budget department employees at the MOF; the budget policy staff at the MOED; the 54 government budget entities; and 34 provincial line directorates of all government ministries. It will equip them with the knowledge and skills of annual and multi-year integrated budgetary planning and analysis. It will also improve the knowledge of implementation capacity of procurement unit staff in a number of key line ministries, whose procurement planning activities cover a significant portion of the government budget. It will also develop basic RIA-related analytical capacity within the MOF and MOED.

The project will also selectively upgrade institutional capacity in budget policy and RIA within the Commission on Budget and Financial Affairs in the National Assembly. It will systematically enhance the capacity of staff in STOs, MTOs, and LTOs in Kabul and around the country to effectively administer the tax system in an efficient and transparent manner. On-the-job and classroom-based technical training will be provided across all of the capacity-building areas referenced above.

Gender: The project will focus on gender as a key crosscutting issue, including the following themes:

1. Increase women's participation in government
2. Strengthen the capacity of women to acquire jobs in fields related to PFM
3. Increase women's participation in the budget process, especially in the provinces
4. Ensure that women's priorities are effectively reflected in budget-planning and RIA processes

SECTION VI. ON-BUDGET/OFF-BUDGET

USAID is currently exploring two options for placing some of the assistance described in this concept paper on-budget: the Civilian Technical Assistance Programme and the United Nations Development Programme’s Making Budgets and Aid Work Project.

As USAID continues the project design process, it intends to advance discussions with the MOF regarding the results to be achieved in this project and the best mechanisms to achieve them. The off-budget technical assistance will be contracted through an indefinite quantity contract.

SECTION VII. TRANSITION

Transition 2014 provides an opportunity for the U.S. government to focus its attention on the aspects of the economic governance process that are critical to effectively and smoothly cross from intensive short-term stabilization activities to a longer-term development support approach across Afghanistan. This analysis indicates that the fiscal transition process can be manageable over the medium term. This in turn assumes:

1. Revenue-enhancement reforms will facilitate an increase in the ratio of revenues to GDP to approximately 15 percent over the next few years.

2. The improvement in integrated budgetary planning, including de facto integration of on- and off-budget planning processes, will facilitate an efficient transition of expenditure responsibilities within the context of a reasonably smooth decline in international spending on development-related programs and projects.

3. International commitment to maintain at least 10-12 percent of GDP annually in grant development expenditures over the medium term.

Within this overarching fiscal adjustment context, this project focuses on core elements of the PFM institutional framework essential to successful fiscal transition and the successful overall transition of Afghanistan to a modern state. USAID can seize this significant opportunity and harness political will to lay the foundations for a more capable, accountable, and responsive state. This project will further orient USG economic governance efforts to help Afghan institutions to effectively and accountably perform the roles they must play if they are to significantly improve the cost-efficiency, quality, and sustainability of service provision activities for the population. Strengthening the capacity of the MOF, MOED, line ministries, provincial line directorates, and other economic governance institutions to participate in these processes is one of the keys to sustainable Afghan governance and successful transition.

As Afghanistan moves toward transition in 2014, it is crucial that the required fiscal governance regulatory and institutional reforms are in place so Afghanistan can continue to reach its strategic goals in revenue collection, and budget-planning and management.

SECTION VIII. PARTNERING WITH AN AFGHAN GOVERNMENT MINISTRY OR AGENCY

Extensive discussions with Afghan government officials have shaped this concept paper. (See below for a list of MOF counterparts with whom we have discussed ongoing assistance in these areas.) We will work in direct partnership with MOF in support of its PFM Roadmap reform effort and revenue action plan. MOF leadership has been and will continue to be a driving force behind these reform efforts, and this project will provide support and capacity-building to all levels of MOF staff, as well as to relevant staff in MOED, line ministries and agencies, and other relevant provincial and local institutions whose governmental duties affect sound budgetary and revenue collection outcomes.

- Deputy Minister for Finance Mustafa Mastoor
- Deputy Minister for Finance Said Mubin Shah
- PFM Team Lead under Deputy Minister for Finance Nematullah Bizhan
- Director General for Revenue Ahamad Shah Zamanzai
- Director General for Budget Jawid Jalali
- Director General for Treasury Muhammed Aqa
- Fiscal Policy Unit Head Zia Halimi

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IX. PROJECT MONITORING AND EVALUATION

The implementing partner will submit a comprehensive monitoring and evaluation plan before the start of the project, to include a comprehensive list of indicators describing the expected project output and impacts at different stages for a specific period of time. The responsible USAID program manager will track the project activities based on this plan by visiting project sites, making general assessments, and meeting with project implementing staff, and government counterpart employees and departments. The findings and recommendations of annual monitoring and evaluation reports will be reviewed and analyzed broadly with the implementing partner, USAID's responsible chain of management, government counterparts, and other stakeholders.

X. INTERNAL U.S. GOVERNMENT CONSULTATIONS, COORDINATION, AND LEVERAGE

We have been involved in ongoing internal U.S. government discussions relating to future work in this area, including a dialogue with the Office of the Coordinating Director for Development and Economic Affairs, the Departments of State and Treasury, the International Security Assistance Force, Interagency Provincial Affairs, and U.S. Forces Afghanistan. Our analysis for this concept paper was drawn from current thinking of the wider U.S. government, the international development community, and Afghan sources, as reflected in the MOF's PFM Roadmap, IMF and World Bank reports, the U.S. government Reorienting of Governance Orientation Paper, and other think pieces from the DFID-led Governance Retreat for donors in January 2011.

The USAID Offices of Economic Growth, Agriculture, and Democracy and Governance have mutually supportive programs in these areas and will continue to coordinate efforts. USAID PFM assistance has been and will continue to be part of a multilateral effort with the World Bank and DFID. USAID shared pre-design research papers with DFID and exchanged working papers with World Bank staff in Kabul. This project will actively coordinate with all appropriate U.S. government stakeholders throughout its implementation. We will also maintain effective coordination with donor stakeholders at the program implementation stage. This will be achieved through a combination of:

1. Regular donor-to-donor fiscal governance coordination meetings with key individual donors (e.g., World Bank and DFID) to ensure proper coordinated project support and avoidance of overlap in critical fiscal reform support areas (e.g., public procurement, tax policy and administration reform, and program budget reform)

2. Thematic meetings, on an as-needed basis, with relevant donors and technical assistance implementing organizations, to ensure appropriate coordination and unified approaches to core fiscal governance-related policy issues

3. Quarterly donor coordination meetings to discuss general progress on and issues related to ongoing implementation of fiscal governance and transition programs with all relevant donor organizations and key Afghan government representatives

XI. DOCUMENTATION OF CONCEPT PAPER

1. U.S. government Integrated Civilian-Military Campaign Plan for Support to Afghanistan 2011
2. Afghanistan National Development Strategy 2010-2013
3. U.S. Foreign Assistance for Afghanistan Post Performance Management Plan 2011-2015
4. National Priority Program for Financial and Economic Reforms
5. MOF's Public Financial Management Roadmap, July 14, 2010; www.mof.gov.af
6. May 2011 Afghanistan Economic Update, World Bank
7. Project Paper —Second Public Financial Management Reform Project, May 2011, World Bank
8. Public Financial Management Framework: Key Issues and Next Steps, Dec. 2010, IMF
9. Sixth Review Under the Arrangement Under the Poverty Reduction and Growth Facility, 2010, IMF
10. Afghanistan Public Expenditure Review 2010, World Bank/DFID
11. MOF Revenue Action Plan, June 2009
12. Local Governance in Afghanistan: A view from the ground, June 2011
13. 1388/89/90 National Budget of the Afghan government
14. MOF Weekly Revenue Reports
15. Embassy Kabul Cables: 10 Kabul 4017, 11 Kabul 742, and 11 Kabul 2674
16. Economic Growth and Governance Initiative Project Fiscal Data