

Afghanistan
Public Financial Management Performance Assessment

Executive Summary

May 2008

Acknowledgements

This is the second PFM Performance Assessment, based on the information as of December 2007, two and half years after the first assessment as of June 2005. This second assessment aims to measure reform progress during this period and to identify outstanding issues. Comparison between the first and second assessment shows significant improvements within the area of PFM. The process of carrying out the Performance Assessment involved extensive interactions with the Ministry of Finance (Budget Department, Treasury Department, Revenue Department, Fiscal Policy Unit and SOE Department) and other government agencies, whose valuable cooperation and support was indispensable for completing this Performance Assessment and also greatly benefited this report.

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Executive Summary

Key Findings

Overall: Afghanistan's public financial management (PFM) system achieved significant improvements between June 2005 and December 2007. Among 28 performance indicators, 18 indicators improved, two indicators deteriorated (however, the 2005 ratings for these two indicators were based on limited information), and eight indicators remained unchanged. Among three indicators of donor practices, two deteriorated and one remained unchanged.

International comparison: In relation to other countries for which PEFA assessments, have been conducted, Afghanistan's ratings are better than the average for other low-income developing countries and in some areas better than the average for middle-income countries.

Legal framework: The Public Finance and Expenditure Management (PFEM) Law of July 2005, the Income Tax Law of November 2005, and the Procurement Law of October 2005 and their supporting regulations have provided solid legal foundations for PFM.

Technical expertise: The technical expertise of the Ministry of Finance has been significantly improved in several areas, although additional emphasis on sustainable staff development through targeted recruitment and training will be needed.

Credibility: The operating budget is credible as funding from domestic revenues and donors (e.g. ARTF and LOFTA) has been stable. However, the gap between budget and realization remains significant in the development budget expenditures.

Comprehensiveness: The comprehensiveness of the budget is generally good, although reporting and especially transparency should be improved. However, fiscal risk oversight of state-owned enterprises and municipalities is practically non-existent and thus problematic.

Process: The budget process is based on multi-year fiscal planning and comparatively detailed budgeting at the level of ministries and agencies, but so far has lacked the necessary strategic prioritisations of resources by the Cabinet early in the process.

Long-term fiscal planning: Long-term fiscal planning remains uncertain since there are few well-prioritized and costed sector strategies (though this is being addressed) and a continuing lack of proper linkages between investments and future recurrent expenditures.

Effectiveness: Payroll processing is highly decentralized which contributes to timely updates of payroll and reconciliation of personnel and payroll records. However, centralized oversight of payroll is weak, and the extension of the verified payroll program to the provinces has not progressed in line with plans. Access to a number of provinces by the external auditor and the ARTF Monitoring Agent is hampered by security concerns.

Audit: External audit of donor funding is conducted to acceptable standards, but the quality of review of the annual budget statement and of regulatory audits needs to be improved. Arrangements are in place for effective internal audit of treasury and revenue operations of government, but capacity for internal audit in the line ministries is still very weak.

Donors: Donors have good practices for budget support, as this support is well communicated and disbursements are in line with forecasts. Other donor practices continue to undermine effective budgeting, as limited and unreliable information is provided on forecast and most assistance is handled outside of government's procedures and budget.

Public Financial Management (PFM) Performance Assessment Framework

Fiscal policy and the budget comprise a central tool for achieving Afghanistan's development objectives. The quality of the PFM systems and procedures has an important impact on development performance. First, fiscal discipline and transparency contribute to macroeconomic stability and sustained external assistance. Second, inadequate prioritization and lack of information would make it difficult to allocate resources across/within sectors appropriately. Third, weaknesses in procurement and insufficient financial data would constrain the effectiveness and efficiency of public expenditures.

This paper presents an assessment of the performance of Afghanistan's PFM systems, based on a performance measurement framework developed by the Public Expenditure and Financial Accountability (PEFA) partnership program (see <http://www.pefa.org/index2.htm> for more information) which identifies a set of critical objectives of a PFM system and a standard set of high-level PFM indicators to assess performance against the objectives (Figure 1).

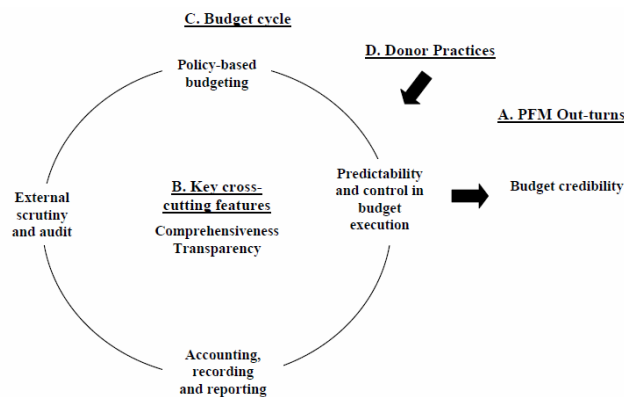
The 28 PEFA indicators of PFM performance are structured in three categories namely: (A) PFM out-turns; (B): Key cross-cutting features; and (C) Budget cycle. In addition, three indicators relate to donor practices (D). This methodology provides a consistent framework for analysis and a monitoring tool for the Government to manage reform and demonstrate progress to domestic and international stakeholders.

This assessment builds on and updates an earlier PEFA assessment of Afghanistan's PFM performance as of June 2005. Changes in the ratings for the various PEFA indicators between 2005 and 2007 thus can provide insights into changes in the performance of Afghanistan's PFM systems during this period of time. Comparisons between Afghanistan and other countries for which PEFA assessments have been conducted also are possible.

The limitations of the PEFA framework need to be kept in mind when reviewing the results. First, the ratings reflect very substantial external technical support (advisory and to some extent operational) to PFM in Afghanistan. Although the results accurately depict what is happening now, the challenge for the future will be to progressively replace this external capacity with sustainable core domestic capacity over time. Supporting this transition is a very important element of current external assistance to PFM functions.

Second, the PEFA ratings apply to the government's PFM systems which are used in formulating and implementing the core national budget, whereas most aid to Afghanistan is executed by donors and their contractors or implementing agencies outside the national

Figure 1: The Structure and Coverage of PEFA System



Source: "Public Financial Management: Performance Measurement Framework, 2005, p.4"

budget and PFM systems. This assessment therefore does not provide any insights into or confidence about the performance of systems for off-budget aid which constitutes most of the total assistance to Afghanistan.

Third, the PEFA framework does not evaluate whether expenditures have the desired effect in promoting national objectives like reducing poverty, or whether there is value for money achieved in service delivery. The PEFA assessment rates PFM performance per se, which is very important in its own right but is not a sufficient condition for achieving development outcomes. An open and orderly PFM system is one of the critical enabling elements for aggregate fiscal discipline, strategic allocation of resources, and effective and efficient service delivery.

Fourth, and more specifically with respect to the sub-national level, Afghanistan is a unitary state with a centralized government structure. Therefore, except for municipalities (which have separate budgets of their own), sub-national fiscal operations occur as part of a single legal entity which is the national government of Afghanistan. The PEFA indicators thus relate to PFM processes for the government as a whole (including sub-national levels). However, as indicated above, PEFA cannot measure the effectiveness of service delivery or outcomes achieved at sub-national level or national level.

Fifth, the four-level PEFA scale of ratings and the nature of most of the performance indicators being rated mean that changes in PFM performance generally would become evident in terms of changes in PEFA ratings only over multi-year periods. It is for this reason that PEFA assessments for Afghanistan are being conducted approximately every two years. More frequent monitoring of PEFA indicators would not provide much in the way of useful additional information.

Finally, the PEFA indicators do not assess government revenue mobilization in relation to the level of potential revenues, only in relation to the budget target for revenues. This is a very important issue for Afghanistan, since the country's revenue-to-GDP ratio is quite low by international standards.

Key Results

Out of total 28 PFM performance indicators, 18 indicators improved and two indicators deteriorated, while eight indicators remained unchanged. This signifies a major improvement in PFM performance overall. Moreover, it should also be noted that some of the 2005 assessment were based on limited information, so some indicators are not really comparable between the first and second assessments (including notably the first two indicators, which declines between 2005 and 2007). Second, while the ratings are based on the information as of December 2007, some progress since then is explained in narrative parts of each indicator.

PFM in Afghanistan as depicted by the PFM Performance Indicators is summarized below under the six critical attributes of a PFM system. The ratings against each of the 28 individual PFM Performance Indicators and for the three indicators of donor performance are shown in a table at the end of this Executive Summary.

Credibility of the Budget (Performance Indicators 1-4)

These indicators measure whether the budget is realistic and is implemented as intended.

Strong revenue performance in the past few years and donor support to operating expenditures through the Afghanistan Reconstruction Trust Fund (ARTF) and Law and Order Trust Fund (LOTFA) have enabled the government to maintain budgeted operational expenditures (about 60 percent of which is salaries and wages). The centralized nature of payment controls prevents a build-up of arrears, although Afghanistan has not yet established an arrears monitoring mechanism. By contrast, the credibility of the budget is hampered by the existence of a significant volume of reserve funds in the budget, which affects outcomes in terms of expenditure composition as compared to the budget targets. More importantly, the sizable gap between the budgeted and actual core development expenditures is of significant concern. The gap mainly attributes to a lack of realism at the budget formulation stage and limited capacity to implement the budget.

Comprehensiveness and Transparency (Performance Indicators 5-10)

These indicators measure whether the budget and fiscal risk oversight are comprehensive and whether fiscal and budget information is accessible to public.

Significant progress has been made in improving transparency and comprehensiveness, although some weaknesses remain. The government has developed a robust classification system which to some extent facilitates the tracking of expenditures on organizational, economic and functional, and program basis. However, the Chart of Accounts needs to be further developed and amended to support and facilitate program budgeting. The government is committed to share budgetary information transparently, and the annual budget documentation has been improved in terms of quality and comprehensiveness. The extent of unreported government operations in terms of extra-budgetary funds appears to be very low, and all donor funding to the Core Budget is included in fiscal reports. Municipalities, which are fiscally autonomous from the national government, report on their fiscal and financial status on an annual basis, although information is currently not being fully consolidated or reported. Fiscal risk oversight of the commercial activities of the government, including state-owned enterprises (SOEs) and state corporations, is lacking due to low reporting compliance and quality, requiring urgent action. Public access to fiscal information has improved but needs further attention to ensure full transparency for the public, especially with regard to audit reports.

Policy Based Budgeting (Performance Indicators 11-12)

These indicators measure whether the budget is prepared with due regard to government policy.

Progress has been made in planning and organizing the annual budget process with a longer and more realistic budget formulation schedule as well as political guidance needed to ensure strategic prioritization in the resource allocation process. The Cabinet approved a rough inter-sectoral prioritization of the ANDS, which is planned to be integrated in the budget

process beginning in 2009/10 (SY1388). Further initiatives are needed to ensure the successful implementation of program budgeting in additional ministries during the coming years. The budget approval process of the National Assembly has been greatly improved, and the 2008/09 budget was approved by parliament before the start of the fiscal year.

The multi-year perspective of the budget process has been enhanced since 2005 with the linking of budget and national strategy and regular updating of the Medium-Term Fiscal Framework (MTFF), which is gradually emerging as a multi-year budgeting framework through the estimation of budget ceilings. Debt sustainability analyses have been undertaken annually by the IMF and the World Bank for the past three years, but the Ministry of Finance needs to develop its capacity in this area. Three sector strategies are being costed, and additional sectors are planned to be costed in 2008/09 (SY1387). However, linkages between investment budgets and forward expenditure estimates generally remain very weak and need to be strengthened in the interest of future fiscal sustainability.

Predictability and Control in Budget Execution (Indicators 13-21)

These indicators measure whether the budget is implemented in an orderly and predictable manner and there are arrangements for the exercise of control and stewardship in the use of public funds.

Budget predictability has been greatly improved both for revenues and expenditures, while budget control has room for further improvement. On the revenue side, the income tax law (November 2005) provides clarity on tax liabilities and procedures, although enforcement remains a concern. The establishment of the Large Taxpayer Office (LTO) in 2004 and its operationalization are important steps to improve enforcement. On the expenditure side, predictability of funds availability has improved through better cash flow forecasts where there has been improved information on actual cash balances and commitments.

However, and despite the improvements in most indicators, there has been no progress on internal audit, except in the Ministry of Finance. Internal audit is operational for most national government entities but, except in the Ministry of Finance, this work is not done to any recognized professional standard, and there is little follow-up of audit recommendations.

Accountability, Recording and Reporting (Indicators 22-25)

These indicators measure whether adequate records and information are produced, maintained, and disseminated for purposes of decision-making, control, management, and reporting on operations.

Progress has been made in improving these indicators since 2005. Reconciliation of bank and advance accounts is regularly conducted at least on a quarterly basis, within four weeks after the end of the month. The Treasury Department has established and implemented a procedure by which advances and suspense accounts are cleared at least annually. The computerized Afghanistan Financial Management Information System (AFMIS) enables the Ministry of Finance to produce monthly reports (which are put on their website) within a month. A consolidated government statement is prepared annually with a complete set of information. This is sent to the President's office within six months of the fiscal year end.

Despite good information on Core Budget execution, data are not specifically collected on resources utilized for service delivery. Also, AFMIS does not record/report commitments.

External Scrutiny and Audit (Indicators 27-28)

These indicators assess the arrangements for scrutiny of public finances and follow up by the executive.

With the enactment of the PFEM Law in July 2005 and the subsequent formation of the National Assembly, the legislature started its involvement in budget scrutiny. The PFEM Law provides clear rules such as for budget amendments within the financial year. Nevertheless, the legislature's procedures for scrutiny are rather weak and need to be documented and formalized. Also, legislative scrutiny of audit reports needs to extend beyond the review of only the audit of the traditional accounts (Qatia). Currently, over 50 percent of expenditures are audited annually and reports are issued within 12 months of year-end with significant issues being identified. However, there has been no significant improvement on the quality of review from the 2005 Assessment.

Donor Practices (Donor Practices Indicators 1-3)

Afghanistan's great reliance on donor financing requires means that donor practices are very important for PFM and development performance. Actual budget support reached at least 90 percent of budgeted figures in two of the last three years, and quarterly disbursements do not deviate from the original disbursements schedule. The Aid Coordination Unit (ACU) of the Ministry of Finance now plays a bigger role in collecting financial information from donors. The ACU has initiated a "donor financial review" in late 2007, which will enable the Ministry of Finance to acquire forward looking information for the next five years.

However, the continuing pattern whereby most aid funds do not go through the national budget and PFM procedures hampers fiscal policy as the government has limited control of the related expenditure. Furthermore, donor practices need be improved to support properly and correspond to a reasonable extent with the budget process of the national government, especially with regard to the Development Budget which in past years has been finalized very late in the process, due among other reasons to a lack of timely communication from some donors with regard to their spending priorities.

International Comparison

Comparison with other countries¹ shows that PFM performance in Afghanistan as of December 2007 is better than that of many other comparable countries in most categories (Figure 2). Indicators on budget cycle (C-(i)-(iv)) outperform even average the average for those middle income countries for which PEFA assessments are available, which suggests that there have been major improvements in this area.

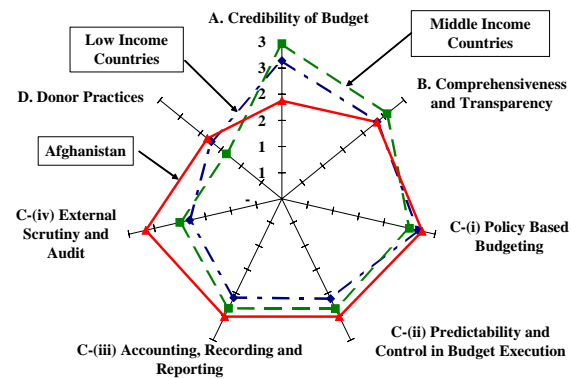
¹ Data on 23 countries (12 low income countries and 11 middle income countries) are available on the PEFA website: www.pefa.org.

However, the credibility of budget (A) is lower than the average for other low income countries for which PEFA assessments have been conducted, while comprehensiveness and transparency (B) is equivalent to the average of these low income countries.

Conclusion: Improving the PFM System in Afghanistan

This report depicts significant positive developments in Afghanistan's PFM system since the 2005 PEFA-based PFM review. The comparison with other countries also shows that the PFM system in Afghanistan performs relatively well. Nevertheless, a number of weaknesses exist which must be addressed, including areas where progress in improving the PFM system and processes has been slow. Additional improvements in the following areas would contribute to further improving future PEFA ratings:

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



Source: PEFA website, World Bank staff

- Credibility of the Budget:** The gap between budget and realization remains substantial especially for core development expenditures, although there has been an improvement in recent years. Measures for further improvement would include, first, further strengthening the link between the annual budget and MTF. This includes, for example, systematically estimating future recurrent costs implications of investments. Second, there needs to be a proper link between the ANDS and fiscal policy.
- PFM capacity outside the Ministry of Finance:** Capacity development in line ministries, as executing agencies of expenditures, is critical. Compared with the progress in the Ministry of Finance, developments in most line ministries lag behind. For example, cash management and payment scheduling procedures in line ministries have not improved. Capacity of internal audit in line ministries should be developed. Also, capacity building on public procurement (now underway) should be accelerated so that line ministries can progressively take greater responsibility for procurement activities.
- Comprehensiveness, transparency, accounting, and reporting:** The centralized nature of Afghanistan's fiscal system has helped to prevent exposure to significant contingent liabilities. However, in order to mitigate future fiscal risks, accounting and reporting of the State Owned Enterprises (SOEs) and municipalities should be strengthened through developing their capacities. Related to this, the monitoring of the stock of expenditure payment arrears should be improved.
- Internal and external audit:** PEFA ratings related to audits remain low. Although internal audit is operating in most of the government entities, the work does not yet meet recognized professional standards, especially in line ministries. In addition to in-house training in the ministries, formal academic/professional training in auditing should

be made available for staff in internal audit departments. Also, most internal audit manuals are very outdated and need to be revised based on modern internal audit practices that also take into account the current context in Afghanistan. Likewise, capacity for external audit needs to be further developed along with a revised legal foundation based on international standards. However, the Audit Law is not yet in effect. Acceleration of the accounting and auditing certification process for all professional staff is commendable.

Table 1: Summary of PFM Performance Assessment Indicators

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

