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# Afghanistan Managing Public Finances for Development

(In Five Volumes) Volume II: Improving Public Financial Management  
and Procurement

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## ABBREVIATIONS AND ACRONYMS

AACA	Afghanistan Assistance Coordination Authority	IPSAS	International Public Sector Accounting Standards
ABA	Afghan Builder's Association	LOTFA	Law and Order Trust Fund
ACC	Afghanistan Chamber of Commerce	LTO	Large Taxpayer Office
ACD	Afghanistan Customs Department	MA	Monitoring Agent
ADB	Asian Development Bank	MoF	Ministry of Finance
ADF	Afghanistan Development Forum	NDF	National Development Framework
AGO	Auditor General's Office	NPP	National Priority Programs
AFMIS	Afghanistan Financial Information System	NGO	Non-government Organization
AICC	Afghan International Chamber of Commerce	OAA	Office of Administrative Affairs
AISA	Afghan Investment Support Agency	OECD	Organization for Economic Cooperation and Development
ANDS	Afghanistan National Development Agency	PA	Procurement Agent
ARDS	Afghanistan Reconstruction and Development Services	PBU	Primary Budget Unit
ARTF	Afghanistan Reconstruction Trust Fund	PEFA	Public Expenditure and Financial Accountability
BWG	Budget Working Group	PFEM	Public Finance and Expenditure Management Law
CAO	Control and Audit Office	PFM	Public Financial Management
CG	Consultative Group	PFM PR	Public Financial Management Performance Report
COFOG	Classification of Functions of Government	PIU	Program Implementation Unit
DAB	Central Bank of Afghanistan	PLO	Procurement Liaison Officers
DAC	Development Assistance Committee	PRR	Priority Restructuring and Reform
DAD	Donor Data Base	PSIB	Programmatic Support for Institution Building
DAU	Defense Acquisition University (US)	RFP	Request For Proposals
DMU	Debt Management Unit	RFQ	Request for Quotation
ERC	Expenditure Review Committee	SAF	Securing Afghanistan's Future
EPAP	Emergency Public Administration Project	SAI	Supreme Audit Institution
FY	Fiscal Year	SDU	Special Disbursement Unit
GLAD	Grant and Loan Database	SOE	State Owned Enterprises
GDP	Gross Domestic Product	SPA	Strategic Partnership with Africa
GFS	Government Finance Statistics	TIN	Taxpayer Identification Number
GPR	General Presidency of Revenue	TISA	Transitional Islamic State of Afghanistan
IARCSC	Independent Administration Reform & Civil Service Commission	TSA	Treasury Single Account
IDA	International Development Association	UK	United Kingdom
IMF	International Monetary Fund	WB	World Bank

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# **PART I. THE PERFORMANCE OF AFGHANISTAN'S PUBLIC FINANCIAL MANAGEMENT SYSTEM**

## **Executive Summary**

i. Part I of this volume presents an initial Public Financial Management (PFM) Performance Assessment for Afghanistan.<sup>1</sup> It is based on a performance measurement framework developed by the Public Expenditure and Financial Accountability (PEFA) partnership program<sup>2</sup> which identifies a set of critical objectives of a PFM system and a standard set of high-level PFM indicators to assess performance against those objectives. The 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. The ratings for Afghanistan are summarized in a table at the end of this Executive Summary. After providing some background and a description of Afghanistan's PFM system, the main body of this assessment discusses each PFM indicator separately and outlines the reasoning behind the rating assigned to Afghanistan. The assessment ends with a roadmap for strengthening PFM performance.

ii. The situation in Afghanistan has some special features which need to be kept in mind when interpreting the ratings. First, some ratings reflect temporary factors (for instance the absence of a Parliament in the past). Second, some ratings are based on changes made recently, and it is still uncertain whether these changes will be sustained. Third, the ratings assess the current situation in which significant external support (both advisory and operational) for the PFM system is being provided to the Government; in several areas, this raises sustainability issues as the external support will have to be reduced over time, especially in relation to financial management operations. And finally, a new Public Finance and Expenditure Management (PFEM) Law and a new Procurement Law were approved after this assessment was conducted; hence some ratings would be expected to change as a result of this major improvement in the legal framework.

iii. Public financial management in Afghanistan as depicted through the PFM Performance Indicators as of June 2005 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 the table below.

### ***Credibility of the budget (Performance Indicators 1-4)***

iv. Maintaining fiscal discipline all along has been a key Government priority. While the budget, before foreign grants, is always in deficit given the low level of domestic revenues, over the past three years the out-turn of the deficit has been below planned levels. Three mechanisms have contributed to this outcome: (i) strong progress in revenue mobilization, although as a share of GDP it remains at well below half of the level found in other low-income countries; (ii) a formal mid-year review process that monitors

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<sup>1</sup> An earlier draft of this report was presented at the Afghanistan Development Forum in Kabul in April 2005. See [www.adf.gov.af](http://www.adf.gov.af). This version incorporates additional analysis and a revision to the set of performance indicators.

<sup>2</sup> The members of PEFA include the World Bank, International Monetary Fund, European Commission, UK Department for International Development, French Ministry of Foreign Affairs, Royal Norwegian Ministry of Foreign Affairs, Swiss State Secretariat for Economic Affairs, and Strategic Partnership with Africa (SPA). The analytical framework, indicator set, and detailed instructions for ratings are in PEFA (2005). Also see [www.pefa.org](http://www.pefa.org).

execution and may adjust appropriations; and (iii) a strictly applied no-overdraft policy that prohibits central bank financing of the budget.

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

Note: The ratings for all indicators are on a 1 to 4 numerical scale, with 4 being the highest possible rating and 1 the lowest.<sup>3</sup>

<sup>3</sup> The methodology behind the ratings system is set out in the Public Financial Management Performance Measurement Framework, produced by the Public Expenditure Working Group (World Bank, IMF and Joint Donor Public Expenditure and Financial Accountability Unit), available at <http://www.pefa.org/Documents.htm>.



v. Despite continuing improvements in budget processes, the credibility of the budget is hampered by optimistic budget projections, particularly for development expenditures, mainly attributable to a lack of realism at the budget formulation stage and limited capacity to implement the budget. Moreover, the External Budget (accounting for roughly three-quarters of total public spending in the country) remains effectively outside the Government's control, further reducing the credibility of the budget. There are two specific issues: (i) the External Budget is to a large extent outside the Government's control (and so to that extent cannot be used as an instrument of policy); and (ii) the gap between donor commitments reported in the budget and actual expenditures is large. A detailed analysis shows large deviations between budgeted amounts and actual out-turns (Table 1.1).

***Comprehensiveness and transparency of budget information (Performance Indicators 5-10)***

vi. The Government is committed to share budgetary information transparently. The annual budget for the national government is impressive, with coverage of most public spending of the general Government sector, whether implemented by the Government or directly by donors. The budget is a useful public document relating expenditures on specific projects to National Programs. Revenue and expenditure records for the Core Budget are maintained through the budget implementation system known as AFMIS (the Afghanistan Financial Management Information System). Comprehensive reports on budgetary aggregates are produced monthly and are now available on the Ministry of Finance's (MoF) website. This information is generally reliable but is affected by lags in recording provincial operations and weak reconciliation. There are also uncertainties about the quality of reported information on the External Budget. In addition, fiscal risks which could arise from the activities of state-owned enterprises and municipalities are not effectively monitored because the financial information is unverified and too limited for fiscal risk management in these areas.

***Policy-based budgeting (Performance Indicators 11-12)***

vii. Some progress has been made toward the Government's key objective of making the national budget the central instrument of policy and reform, but there are still major constraints. The full implications of policy decisions, including for fiscal sustainability, are not taken into account due to lack of capacity in Government to develop policy, agree on trade-offs among investments and recurrent costs, and match resources with policies. Multi-year planning is also constrained by the complexity of aid coordination. Budgeting for recurrent and investment expenditures is carried out separately, raising the fiscal sustainability risks from recurrent cost implications of investments. The budget process is orderly and well understood within the Government, but it needs to be linked more closely with the Government's strategy; more widely owned politically, including by Cabinet and the Parliament; and more reflective of sector issues with more engagement by sector agencies, provinces, and civil society.

***Predictability and control in budget execution (Performance Indicators 13-21)***

viii. Much progress has been made in improving the implementation of the budget (in particular with respect to the allotment process and cash management), but there is a need to enhance predictability of funding for service delivery units. Line departments at the provincial level often cannot predict with accuracy the funds that will be available to them because of delays in communicating with the provincial offices of MoF and the complexity of the allotment process; this has led to cash rationing at the discretion of the Treasury and the Mustoufiats. Many adjustments are made during the year, in particular through allotment transfers and use of contingencies. No information is available at the level of service delivery units (e.g. primary schools) on actual resources available.

ix. A particular weakness in the budget execution cycle is related to revenue collection. The overall system is not very effective, as demonstrated by the large gap between revenues that could be collected and actual collections. In addition, despite some progress with taxpayer registration, the control framework on the revenue side remains weak. Nevertheless, clarification of the legislation and strengthening of financial management (banking arrangements to ensure a steady flow of collected revenues to the Treasury Single Account, TSA) have generated some improvements in revenue performance.

x. Much progress has been made in implementing the control framework, as reflected by a significant increase in the eligibility rate for reimbursements of expenditures by the Afghanistan Reconstruction Trust Fund (ARTF). There is a division of duties between the line ministries, which approve expenditure, and MoF, which keeps records and makes payments. These arrangements include external operational support in the Treasury and review by the ARTF Monitoring Agent. The controls also include effective cash management, allotment control on budget uses, and reconciliations of records of the Treasury and the line ministries. Significant weaknesses remain, however, compounded by the lack of internal audit to provide feedback on performance and systems. Further improvements in the internal control framework are needed for both payroll and non-payroll expenditures and for revenues. The recent approval of a new PFEM Law and planned financial regulations will help further strengthen the control framework.

xi. Most procurement at present is carried out under standards agreed with donors. Procurement carried out under national rules, however, has been subject to an outdated regulatory framework which lacks institutional support adequate for effective enforcement. There is insufficient competition as the basis for contract awards and no guarantee of value for money. The new Procurement Law, approved in September 2005, provides a strong foundation for improving the regulatory and institutional framework.

#### ***Accounting, recording, and reporting (Performance Indicators 22-25)***

xii. Considerable improvements have been made in this area. The recording of expenditures and revenues has been strengthened by partial computerization of AFMIS, notably in MoF (also piloted in two line ministries). Accountability of line ministries and of MoF to the Cabinet is supported by frequent reporting on budget implementation by the Government, but improving accounting and reporting capacity in line ministries is required. Significant progress has been made toward consolidation of bank accounts under a system of TSA. However, much remains to be done to improve standards of accounting, frequency of bank reconciliation, and usefulness of reporting for line ministries' management.

#### ***External scrutiny and audit (Performance Indicators 26-28)***

xiii. Government accountability generally is sought through the publication of audited financial statements on the state budget and specific donor funds. The Auditor General is working to international auditing standards with operational support from an audit advisor. However, the final audit of the 2003/04 annual statements has not yet been released. In addition, the absence of a Parliament (until the elections held in September 2005 and initial meeting of Parliament in December) has limited the extent of external scrutiny of the budget and its performance.

#### ***Donor practices (Donor Performance Indicators 1-3)***

xiv. Donors have mobilized a considerable amount of external support for Afghanistan's budget. In particular, support to the Government's recurrent budget through the ARTF has been large and predictable. However, direct budget support still accounts for only a very small percentage of total external assistance to Afghanistan, and the proportion of aid that is managed under national procedures remains low, with most aid executed by donors through their contractors. Financial information provided

by donors on donor-executed assistance activities, while reasonably comprehensive, is subject to delays, usually relates to disbursements rather than to actual expenditures, and may be partial and suffer from inaccuracies and inconsistencies.

### ***Impact on development outcomes***

xv. The strengths and weaknesses of Afghanistan's PFM system as summarized above have an important impact on the country's development. First, the strong achievements in terms of fiscal discipline, cash control, and aggregate transparency have contributed to macroeconomic stability, as well as to sustained external assistance. There is need for more progress, however, in broadening the comprehensiveness of the Core Budget, in addition to efforts to improve the monitoring of other fiscal activities, such as State-Owned Enterprises, municipalities, and external assistance outside the Core Budget. Second, weak sector strategies, inadequate prioritization, and lack of information on results have made it difficult to allocate resources across and within sectors appropriately. Third, weaknesses in procurement, insufficient financial data given to line managers, and initial delays in making payments outside Kabul have been a constraint on the efficiency of public expenditures. These problems, along with difficulties in getting specific data from donors on expenditures of externally-implemented projects and a lack of realism in publicly available budget numbers, have exacerbated the disconnect between public expectations and actual delivery of services.

### ***Concluding summary and way forward***

xvi. Afghanistan's ratings against the PFM performance indicators generally portray a public sector where financial resources are, by and large, being used for their intended purposes as authorized by a budget which is processed with transparency and has contributed to aggregate fiscal discipline. The expenditure and financial position of the resources under the authority of the Government are reported reliably in an understandable format, although there is some uncertainty with respect to revenue reporting. Performance regarding the allocative efficiency of spending across programs and the efficiency of operations is not as good, however.

xvii. Given that performance most likely would have been rated "1" on all dimensions in 2001 or 2002, this assessment highlights the significant achievements of the last four years. In most dimensions, the ratings are now comparable to other low-income developing countries (for instance African countries). Areas of relative weakness include tax collections (indicators 13-15), as well as legislative oversight (27-28) due to the absence of a Parliament hitherto. Payroll control (18) and predictability of budget-support (D1) are areas of relative strength. The Government is making further progress in improving the PFM system by implementing a number of reforms. A new Public Finance and Expenditure Management (PFEM) Law and a new Procurement Law have been approved by the Cabinet; tax amendments are under implementation; customs and tax administrative reforms are moving ahead; and the MoF is moving ahead with further structural improvements. All these developments are positive.

xviii. Using the ratings of this report as a baseline, future progress in improving the performance of the PFM system can be monitored. However, the nature of the indicators and ratings means that measurable progress in terms of changes in ratings is more likely to occur over periods of a year or longer than on a short-term basis. Moreover, since the ratings assess the system's performance with significant external support (both advisory and operational), questions arise about the sustainability of current levels of PFM performance. This may mean that further improvements will be manifested only in maintenance of current ratings based on sustainable national capacity and with declining levels of external support.

xix. The ratings against the PFM performance indicators also provide an assessment for the donor community of the potential capacity of Government systems (currently supported by external assistance) to implement the operations which are now occurring outside Government systems.

xx. Annex 1.1 provides initial suggestions for a comprehensive, high-level roadmap of policy and operational reforms required to sustain and further strengthen PFM performance. Concrete actions are recommended for the current Afghan fiscal year (2005/06), and medium-term priorities are identified that should be developed into action plans later. The roadmap also highlights a few cross-cutting issues. In particular, strengthening the core capacity of the MoF is vital, as MoF is the chief custodian of the PFM system and to a large extent responsible for its performance.

## A. Introduction

1.1 This Public Financial Management (PFM) Performance Report is organized into three sections. The country background, objectives, and scope of this study and the overview of the PFM framework of the national government are provided in this introduction. The second section – Overall Performance of the PFM System – provides the analysis and ratings for 28 PFM indicators and three donor activity indicators. The final section outlines a roadmap to improve PFM performance. Annex 1.1 provides a detailed matrix of concrete actions that would form part of this roadmap.

### BACKGROUND

1.2 **Political Context.** As mandated by the Bonn process set in motion in December 2001 and reconfirmed at the Berlin Conference in March 2004, the Government has carried out Presidential elections in October 2004 and Parliamentary elections in September 2005. A new Cabinet was formed in December 2004. The Government is committed to implementing a new legal and institutional PFM framework, and a new Public Finance and Expenditure Management (PFEM) Law and a new Procurement Law have recently been approved.

1.3 **Economic Context.** Afghanistan is a poor country devastated by a quarter-century of conflict. The GDP was \$6.0 billion in 2004/05 (excluding income from opium roughly estimated at \$2.3 billion). With a population of around 24 million, social indicators and income per capita of around \$250 per year rank among the lowest in the world. Afghanistan's economy has performed very strongly in the past three years with non-drug GDP increasing by more than 50% (29% in 2002, 16% in 2003, and 8% in 2004), albeit starting from a very low base. This mainly reflects the recovery of agriculture from a protracted drought in the late 1990s, revival of economic activity after major conflict ended, and the initiation of reconstruction. Recent growth performance has been supported by sound macroeconomic policies – a highly successful currency reform in late 2002, a prudent “no-overdraft” policy prohibiting central bank financing of the budget deficit, and conservative monetary policy.

### PFM PERFORMANCE MEASUREMENT

1.4 **Objectives and Scope.** This assessment is designed to measure Public Financial Management (PFM) performance in Afghanistan as of June 2005 using a methodology developed by the World Bank/IMF/PEFA Working Group.<sup>4</sup> The methodology gauges the soundness of the PFM framework by rating 31 indicators using specific criteria provided in the guidelines. The scope of the assessment covers fiscal and debt management, budget formulation, budget execution, internal controls, procurement, accounting and reporting, auditing, transparency, and external scrutiny. The methodology draws on standard expenditure tracking benchmarks where appropriate, while also taking a wider perspective including, for example, fiscal risk and predictability of funding. This standardized methodology is designed to allow meaningful inter-temporal and international comparisons. The ratings for all indicators are on a 1 to 4 numerical scale, with 4 being the highest possible rating and 1 the lowest.<sup>5</sup> Specific criteria for ratings for each indicator are provided in the methodological document referred to above.

1.5 It should be noted that this assessment focuses on the central or national level of government; it does not cover the municipal level of government (with the exception of Indicator 8, see below) or

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<sup>4</sup> Public Financial Management Performance Measurement Framework, by Public Expenditure Working Group (World Bank, IMF and Joint Donor Public Expenditure and Financial Accountability Unit), available at <http://www.pefa.org/Documents.htm>.

<sup>5</sup> The methodological paper referred to earlier, prepared by the World Bank/IMF/PEFA Working Group, uses a rating scale of A to D, with A being the best rating and D the worst rating. In the PFM performance assessment for Afghanistan presented here, 4 corresponds to A in the World Bank/IMF/PEFA scale, 3 to B, 2 to C, and 1 to D.

arrangements for State-Owned Enterprises (with the exception of Indicator 9, see below). This assessment also does not cover donor funding implemented outside the government's financial management framework (the External Budget, see below). In addition, it should be noted that the Government's PFM arrangements currently employ extraordinary measures through the use of international firms for operational and advisory work in Treasury, procurement, and external audit. The assessment includes these extraordinary arrangements and puts forward issues for consideration as the Government transitions away from such support.

## **PFM FRAMEWORK (RULES, ROLES, AND INFORMATION)**

1.6 Afghanistan's public spending is highly dependent on donor support for financing and implementation. In 2004/05, total public expenditures amounted to \$3.4 billion, of which \$0.9 billion was implemented by the Government. Domestic revenues amounted to \$269 million.

1.7 Since 2002 the rules, roles, and information on public financial management have evolved and have largely satisfied donors' fiduciary and operational requirements. Significant steps were undertaken by the Government with donor support to implement emergency arrangements for public financial management, which at the same time aimed to build capacity in key areas of Treasury and budget implementation, procurement, and external auditing. These reforms are still underway and will expand to include capacity building for financial management in line ministries and internal audit.

1.8 **Roles.** Afghanistan is a unitary state and includes a Presidency and Supreme Court as Constitutional bodies, 26 Ministries, and various other agencies and commissions. The National Assembly, re-established by the 2004 Constitution, has the authority to ratify, modify, or abrogate laws and legislative decrees, thus placing the laws that it passes at the top of this policy hierarchy. The National Assembly has the exclusive power to approve economic plans and state budgets, and to grant and obtain loans. The Wolesi Jirga or lower house, once convened, will grant spending authority through the annual budget submitted by the executive. If no budget is approved, the new financial year operates under the budget of the prior year. The Government is required to present a budget proposal and a preliminary accounting of the current year in the fourth quarter of each year. The Government must present its final accounts for each year in the first half of the following year for approval by the lower house.

1.9 Central government ministries and institutions are primary budgetary units with specific budgets set in the annual budget law. The provincial departments of the central government ministries are secondary budgetary units, and receive allocations at the discretion of the primary budget unit.

1.10 Primary responsibility for implementing the Budget Law lies with the Ministry of Finance (MoF). The Ministry is organized under three Deputy Ministers: Revenue, Finance (comprising Treasury and Budget), and Administration (comprising the oversight of the Provincial offices of the Ministry, Internal Audit, and General Services).<sup>6</sup> Operations in Kabul are executed by the Treasury Department through its financial management information system (AFMIS) on the basis of requests from the budgetary units. Fiscal operations in the provinces (both revenue and expenditure) are processed by the provincial offices of the MoF (Mustoufiats). This arrangement provides a basic segregation of duties between authorization of uses and recording and custody of funds.

1.11 **Legislative Framework.** As of June 2005, there are four main pieces of permanent legislation which govern Afghanistan's fiscal mechanisms. These include: the Budget Law (1983), the Accounting

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<sup>6</sup> A recent decision has transferred the Accounting Department from a separate department under the Deputy Minister for Administration to a part of the Treasury Presidency.

Manual (circa 1964, date uncertain), the Control and Audit Regulation (issued under the Budget Law in 1985), and the Procurement Regulations (1987). The first of these laws was replaced in late June 2005 by a new Public Finance and Expenditure Management (PFEM) Law, and the last of them by the new Procurement Law in September 2005.

1.12 The **1983 Budget Law** provides appropriate checks and balances and assigns the key roles for fiscal management. It requires a pre-audit to be conducted by representatives of MoF (the Financial Controllers, who currently report to the Accounting Department), who must pre-approve expenditures prior to distributing salaries, procuring and purchasing supplies, and prior to signing any contracts. It also provides a requirement that the full cost of donor projects be reflected in the Government's budget. It does not cover critical issues related to public monies, treasury operations, or the basis for accounting, among other dimensions. The law makes a separation between the "development" and "ordinary" budgets, rather than the more straightforward distinction between recurrent and capital budgets. The development and ordinary budget approach does not isolate recurrent costs from capital costs, which is a critical distinction that should be provided in the budget preparation and approval process. Neither does the Law reflect the current budget or organizational structure of Afghanistan; it divides spending into central and rural, development and social welfare budget, and a confidential budget. Frequent references are made to the Revolutionary Council (an institution from the Soviet occupation era) as the budget appropriation and amendment institution. No provisions are made for budget financing.

1.13 The **Accounting Manual** is considered to be the official accounting regulation, although the legal basis for it has yet to be clarified. It establishes the "legal requirements, organization, policies, procedures, and rules concerning the accounting system" of the Government of Afghanistan. It can be said that the application of the Accounting Manual was partially abandoned because the last full set of financial statements drawn up by the Accounting Department in the MoF date from 15 years ago.

1.14 The **Control and Audit Regulation** recognizes the General Control and Inspection Presidency of the Council of Ministers as the supreme audit authority for the whole of government, under the auditor general, providing ex-post external audit. This authority audits the Final Account of Revenues and Expenditures of the MoF. The "Final Account" contains the appropriations of the primary budgetary units, allocations issued during the fiscal year, revenues collected, and expenditures made by government entities. The Final Account is prepared by the accounting, treasury, and revenue departments of MoF and in the past has been the primary source of information for the preparation of the budget for the following fiscal year. It also provides for ministries to have their own internal audit departments which must coordinate with the General Control and Inspection Presidency.

1.15 Most public procurement in Afghanistan is conducted through reliance on **donor procurement procedures**. The portion conducted under government rules is governed by a series of provisions: (i) a Law on procurement of 1987; (ii) a Purchase Regulation adopted as a Decree of the Islamic Emirate of Afghanistan in 2001, both of which apply to the procurement of goods (and routine works and maintenance); and (iii) Rules and Regulations for the procurement of works adopted sometime after 1989 (since it replaces the rules adopted on that date). The Purchase Regulation effectively replaces the Law on Procurement. These regulations are reviewed in detail in Part II of this Volume.

1.16 **Current Decrees and Regulations.** In addition to the permanent laws described above which predate the current Constitution, the PFM legal framework also includes the annual budget decree which makes provisions on maximum levels of new debt to be incurred, prohibits overdrafts, and authorizes MoF to issue instructions regarding finance and budget implementation. Furthermore, Presidential Decrees are used to provide specific PFM guidance and prohibitions. MoF has also, in the last three years, issued a number of Budget and Treasury Circulars. Some of the recent practices remain to be

coded (for example the decision for Treasury to prepare the Final Accounts or the decision to merge the Treasury and Accounting Departments; or the return of the Financial Controllers to line ministries).

1.17 **Conclusion.** The current legal framework for PFM comprises multiple laws and regulations which are applied selectively and do not fix clear responsibility for PFM in the line ministries. The partial application of the Budget Law and regulations led to the imposition of contravening provisions in the annual budget decree and undermined the demand for compliance with the emerging legal framework supported by Presidential Decrees.

1.18 To address these issues, the Government has enacted a Public Finance and Expenditure Management (PFEM) Law in June 2005. The Law provides clear rules and roles for the exercise of financial management, requires adequate reporting, provides for independent review, and holds public officials accountable. It covers the entire general (non-financial) government sector; as such, it does not apply to the SOEs which operate under a SOE (Tassady) Act. Responsibility for framing financial policy, regulating the use of public money, and applying the PFEM Law is vested with MoF. The law has been gazetted and regulations to implement it are now being drafted.

## INFORMATION SYSTEMS

1.19 There are multiple information systems which record and process information on PFM in Afghanistan. Key systems include:

- *AFMIS.* The core financial management system is the Afghanistan Financial Management Information System (AFMIS), which integrates budget control (appropriations and allotments), accounting, and treasury systems using FreeBalance software. The system operates under the control of Treasury, records all budget uses, and is the platform for reporting the financial position of the Government on a cash basis. AFMIS is not integrated with the budget database or the debt management database.
- *Budget Database.* The Budget Department of MoF keeps an unofficial budget appropriations and allotments database for the Core Budget. This is a stand-alone system, and transfer of information to AFMIS is not automated. The official budget and allotment record is considered to be in AFMIS. The current approved budget is in the two systems and is regularly reconciled; however, eliminating this redundant database would eliminate the need for such reconciliation.
- *Donor Assistance Database.* Although the implementation of the External Budget is not MoF's responsibility, the agreed plans and execution reported by the donors are recorded in the Donor Assistance Database in the Budget Department. This is a stand-alone system that is focused on recording donor pledges, disbursements, and commitments. Annual donor commitments are contained in the GLAD (Grant and Loan Database).
- *Manual Accounting System.* There is a residual manual accounting system called for in the Accounting Manual that is still partially maintained. The line ministries and the Accounting Department of the MoF record allotments and expenditures in the system; it is considered their base for checking the balances reported in AFMIS.<sup>7</sup>
- *Debt System.* The Debt Management Unit in MoF maintains a debt register which records terms of all new obligations, disbursements received, and the debt service on each operation. This register is a stand-alone application in Excel.

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<sup>7</sup> MoF has decided to merge the Accounting Department with the Treasury Department, which will result in no longer keeping such manual accounting records. This approach will be supported by the new PFEM Law and its regulations.



1.20 Systems are in place to cover the key minimum requirements for budget control and external reporting. Management control and more timely reporting depend on adding modules to the AFMIS and connecting both the line ministries and the provincial offices of the MoF. For the Government of Afghanistan to more effectively plan, manage, and track its resources, an overall systems architecture needs to be defined that portrays the long-term vision of a fully integrated automated information system with the medium-term plan of implementing specific functional modules on a priority basis. Such a study was initiated in October 2005.

## **B. Overall Performance of PFM System**

### **PFM OUT-TURNS: CREDIBILITY OF THE BUDGET**

1.21 The Government of Afghanistan has developed a track record of fiscal discipline over the last three years. However, its capacity to develop meaningful, policy-based budgets is still weak, and as a result the budget remains an imperfect policy tool. Beyond the lack of capacity in the Government (to develop policies, agree on trade-offs, and match resources with policies), this reflects the challenges of aid coordination in a country where external assistance finances most public expenditures (see the indicators on donor practices below). PFM out-turns are measured in Indicators 1-4.

#### ***Indicator 1: Aggregate expenditure outturn compared to original budget***

1.22 The Core Budget is divided into the Operating Budget and Development Budget. The Operating Budget includes expenditures funded by domestic revenues and external assistance (fast-disbursing assistance, reimbursements from ARTF and the Law and Order Trust Fund for Afghanistan, LOTFA) and covers operating expenditures including the wage bill, most non-salary recurrent costs, and investments funded through the Operating Budget. The Development Budget includes investment operations (as well as recurrent costs) implemented by the Government. External Budget expenditures include technical assistance, most capital expenditures, and significant donor-financed recurrent expenditures. Because the development expenditures include both Core and External components, this has implications for the extent to which budget discipline is applied to different expenditures. In essence, the core budget is established around the need for aggregate fiscal discipline and allocative efficiency whereas the external budget is not (see Indicator 12).

1.23 Public spending in Afghanistan is very high, which is the result of donor-funded reconstruction activities. Operating expenditures in the recurrent budget, excluding municipal expenditures, are slightly below 10% of GDP, a rather modest level by international standards (however, substantial operating costs are funded by donors through the external budget – see below – e.g. in the security and health sectors). On the other hand, development expenditures reached 47% of GDP in 2004/05. Revenues have been increasing over the past three years but are still below 5% of GDP. The deficit is covered by external assistance, as the Government has consistently refrained from overdraft financing. Most external assistance is provided in the form of grants. A small portion of external assistance supporting development expenditures flows through the Government's accounts (in the Core Budget), while the rest is directly transferred from donors to non-Government implementing agencies (the External Budget).

1.24 The Government has laid out its medium-term fiscal strategy in the Securing Afghanistan's Future (SAF) report. Its objective, announced at the Berlin Conference in March/April 2004, is for domestic revenue to cover the wage bill by 2008/09 and all operating expenditures by 2013/14. Achieving this medium-term objective will require careful macroeconomic and expenditure management and substantial efforts to increase revenues.

**Table 1. 1: Budget Out-turns**

	2002/03	2003/04	2004/05
<b>Revenue</b>			
Budgeted (Af million)	2,822	9,000	15,380
Actuals (Af million)	5,864	10,168	12,812
Difference (Af million)	3,042	1,168	-2,568
Difference (% budget)	7.8	13.0	-16.7
<b>Expenditures (Operating Budget)</b>			
Budgeted (Af million)	15,649	24,750	30,332
Actuals (Af million)	15,514	22,151	26,605
Difference (Af million)	-135	-2,599	-3,727
Difference (% budget)	-0.9	-10.5	-12.3
<b>Expenditures (Core Development Budget)</b>			
Budgeted (Af million)	-	-	36,882
Actuals (Af million)	-	9,455	15,104
Difference (Af million)	-	9,455	-21,778
Difference (% budgeted expenditure)	-	n/a	-59.0
<b>Expenditures (Total Core Budget)</b>			
Budgeted (Af million)	15,649	24,750	67,214
Actuals (Af million)	15,514	31,606	47,709
Difference (Af million)	-135	6,856	-25,505
Difference (% budget)	-0.9	27.7	-37.9
<b>Total Development Expenditures (Core and External)</b>			
Budgeted (US\$ million)	306	1,955	4,342
Actuals (US\$ million)	503	1,419	2,806
Difference (US\$ million)	197	-536	-1,536
Difference (% budget)	64.4	-27.4	-35.4

Source: MoF, IMF

1.25 Maintaining fiscal discipline has been a key Government priority. As documented in the World Bank publication *Reforming Fiscal and Economic Management in Afghanistan*, fiscal management today stands in stark contrast to the situation in 2001, when the public sector deficit was financed through currency printing and Central Bank borrowings in addition to covert direct external assistance to line ministries, all under a budget comprising mostly contingency funds. While the budget is always in deficit given the low level of revenues, MoF has over the past three years managed to keep the operating deficit below the planned level. The operating deficit is defined as the difference between operating expenditures and domestic revenues, before external grants. Three important mechanisms have contributed to this positive outcome: (i) a very strong commitment to revenue mobilization; (ii) a mid-year review process and re-allocations; and (iii) the strictly applied no-overdraft policy.

1.26 **Rating 1: 2.** The ability to implement the budgeted expenditure is a key factor in supporting the Government's ability to deliver services as expressed in policy statements. In this assessment, the rating is based only on the operating budget, as Core development expenditures was a concept introduced during

2004. Based on operating expenditures only, the rating is “2” because operating expenditures have deviated from budget by a percentage higher than 10% but lower than 15%, in more than one year

**Indicator 2: Composition of budget expenditure out-turn compared to original approved budget**

1.27 The quality of budget implementation, as measured by changes in expenditure composition, is weak. A detailed analysis of deviations between budgeted amounts and actual out-turns demonstrates that deviations by functional classification were very large in 2003/04, as shown in Table 1.2, but have been reduced in 2004/05. Overall, this suggests that the Government has the ability to achieve fiscal discipline, but has a weaker capacity to achieve a satisfactory, policy-based allocation across sectors. The use of large contingencies (much reduced in the 2005/06 budget) also explains this variance.

**Table 1. 2: Expenditure Composition Variation**

	2002/03	2003/04	2004/05
<b>Operating Budget Only</b>			
Variance of total expenditures a/	0.9	10.5	12.3
Sum of variance by 9 main functions	n/a	24.4	12.9
Difference	n/a	13.9	0.6
<b>Core Budget (Operating and Development)</b>			
Variance of total expenditures a/	0.9	27.7	37.9
Sum of variance by 9 main functions	n/a	53.1	46.4
Difference	n/a	25.4	8.5

a/ this differs from Table 1.1 since this is based on the operating expenditures only.

Source: MoF (annual budgets and annual financial statement), Staff calculation.

1.28 **Rating 2: 2.** Where the composition of expenditure regularly varies considerably from the original budget, that budget will not be a useful *ex ante* statement of intent. The rating criteria calls for a “2” where the variance between budgets and outturn by function does not exceed 10 percentage points above the variance of total expenditures in more than one year over the last three years.

**Indicator 3: Aggregate revenue out-turn compared to the original approved budget**

1.29 Revenue collection has been somewhat lower than expected in 2004/05, but higher than anticipated in the previous two years (Table 1.1). This reflects the nature of the projections, which were largely indicative targets given the weak capacity in the Government to develop more analytical projections (weak data, limited analytical capacity). The revenue outcomes also reflect the reality that actual collection depends on the degree of compliance and remittances to the central Government, two factors which are still subject to considerable uncertainty.

1.30 **Rating 3: 4.** Strong revenue collection is critical for Afghanistan to achieve its development objectives. In addition, accurate forecasting of domestic revenue is a critical factor in determining budget performance, because budgeted expenditure allocations are based on it. A comparison of budgeted and actual revenue provides an overall indication of the quality of revenue forecasting. Although there is significant variance between projections and actuals, the rating is “4” because actual revenues were below 97% of budgeted revenue in only one year (83% in 2004/05), and this indicator is not measured symmetrically.

#### ***Indicator 4: Stock and monitoring of expenditure payment arrears***

1.31 The strong centralized nature of payment controls appears to have prevented any substantial build-up of arrears. Even though it creates delays in payments (see below), there is no evidence of a significant accumulation of arrears. It is known that there are no arrears on debt servicing for reconciled debt, and at the end of 2003/04 the Treasury gathered information on payroll arrears and concluded that the level was very low.<sup>8</sup> This exercise was repeated recently for non-salary expenditures with a similar finding of a low rate of arrears. The recent sub-national administration analysis indicated the possibility of payroll arrears in the education sector building up in some provinces (see Volume III, Chapter 3), but these are not significant in the total expenditure picture. As pressure on domestic financing grows, there will be a need to improve the recording of commitments and accounts payables, which will be addressed by improvements in financial management processes and systems. In addition, a number of claims that pre-date this Government (domestic and external) will need to be reconciled.

1.32 **Rating 4: 2.** The rating on this indicator is “2” because there may be a stock of expenditure arrears but it is likely to be below 10% of total expenditure; the accumulation of new arrears is low and the net stock level declined in the last year. However, there is no track record yet of an annual process to gather data on all arrears.

#### **KEY CROSS CUTTING FEATURES: COMPREHENSIVENESS AND TRANSPARENCY**

#### ***Indicator 5: Classification of the budget***

1.33 Spending classification in the budget appropriations for the Operating Budget is formulated by major economic code for each budget entity. Until 2004/05, the Development Budget was structured around national programs, in many cases cutting across Ministerial mandates. As a consequence, it was not possible to present consolidated budget figures by economic classification or organizational unit for the total. This has been corrected for the 2005/06 Budget. MoF has introduced a modernized Chart of Accounts in 2005. This new system: (i) conforms with the structure of the GFS classification system and (ii) enables combined reporting on the Development and Operating Budget.

1.34 In expenditure recording for the Core Budget, the classification is made for both operating expenditures and development expenditures at the level of the organizational unit, source of funding and specific contract, expenditure type (economic classification), and location (province). Bridging tables from the program classification to the functional (COFOG) classification are being used for 2005/06. The economic classification now follows the Government Finance Statistics (GFS) classification structure, produced by the International Monetary Fund (IMF). Difficulties arise in classifying Government functions, however, where activities of a single organizational unit cover more than one function (e.g. Ministry of Labor and Social Affairs, which encompasses the two functions of economic affairs and social protection). Another significant departure (corrected in the 2005/06 budget) had been due to in-kind benefits (food) given to employees in the security sector and recorded as goods instead of wages and salaries. There remain issues with regard to revenue classification (existence of redundant codes and issues with treatment of financial assets and liabilities).

1.35 **Rating 5: 2+.** A robust classification system enables the tracking of spending on the following dimensions: administrative unit, economic, functional, and program. Where standard international classification practices are applied, tracking poverty-reducing and other types of spending can be facilitated. The rating is “2+” because the existing operating budget classification is based on major

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<sup>8</sup> Moreover, there is no incentive in the system to finance expenditures through running up arrears because the principal source of financing the civilian recurrent budget is the ARTF, which makes reimbursements on the basis of settled invoices.

administrative and economic classifications, i.e. using GFS standards or a standard that can produce consistent documentation according to these standards. The new Chart of Accounts (initiated for 2005/06) should result in a higher rating as it will allow consistent administrative, economic, and sub-functional classifications for the entire Core Budget.

***Indicator 6: Comprehensiveness of information included in budget documentation***

1.36 Among other things, the annual budget documentation for 2005/06 included (i) a clear definition of the fiscal deficit (compatible with international standards); (ii) deficit financing and its composition (even though there are doubts as to whether the budget is based on expected cash or commitments); (iii) estimates of the current year's (2004/05) budget outturn; and (iv) summarized data for both revenue and expenditure according to the main heads of the classification (see previous indicator). However, the budget documentation includes very little about macroeconomic assumptions, nothing about the debt stock, no information about financial assets or the previous year's (2003/04) budget out-turn, and little explanation of major revenue policy changes and major changes in expenditure program.

1.37 Another issue is related to the Government accounting systems, including budget accounting, which should be organized and operated on a fund basis. A fund is a fiscal entity which is governed by specific regulation or restrictions. The major fund in Afghanistan is the operating or general fund. This fund groups all the revenue, grants, and borrowings not restricted (earmarked) to individual project expenses. Expenditures funded from these sources would be appropriated under this fund. The other operations in the central government relate to administered funds which are held in trust while specific operations are carried out; these should be presented separately from the general fund since their resources are not fungible. The annual financial statements make this distinction and present a net result and the cash position of the two separate entities: cash of the Government which is fungible and cash of the administered funds which is not fungible. The Budget Decree and the MoF Financial Report, on the other hand, mix general fund operations and administered funds so the net borrowing requirement (or surplus) for the general fund is not presented in the budget documentation.

1.38 **Rating 6: 2.** Annual budget documentation (the annual budget and budget supporting documents) should allow a complete picture of central Government fiscal forecasts, budget and out-turns. As well as revenues, expenditures, and financing, it should include debt level and composition, financial assets, and the fiscal impact of contingent liabilities. It should also provide information comparable to the budget for the out-turns for the two preceding fiscal years, and forecasts of the main budget aggregates for the two years following the budget. The rating is "2" since the 2005/06 budget documentation includes some but not all the elements listed above.

***Indicator 7: Extent of unreported Government operations***

1.39 The Government has demonstrated real commitment to present all public expenditure in the budget. The annual budgets comprise most sources and uses of public funds of the general Government sector, both those implemented by the Treasury through the Core Budget and those implemented by donors in the External Budget. There are no funds administered by the national Government for expenditure outside the budget.

1.40 Two issues arise, however. First, there are a few donor initiatives, mainly in the security sector, which are not in the budget. They provide no reports to the Government on these expenditures, and the budgetary impact is not quantified. Second, reporting on the execution of the External Budget depends on reporting by donors, which is somewhat incomplete and unverified. Related to this, the Government can only retrieve and report information on disbursements; there is no information on actual expenditures.

1.41 **Rating 7: 3.** Budget reports (annual budget documentation, year-end financial statements, and other fiscal reports for the public) should cover all budgetary and extra-budgetary activities of central government to enable a complete picture of central government revenue, expenditures across all categories, and overall financing. The rating is “3” because, while the level of extra-budgetary activities of central government is most likely insignificant, complete income/expenditure information on donors’ grant-financed projects is not included in the fiscal accounts. Moreover, for some operations in the External Budget executed by donors, the data made available are not considered highly reliable, are limited to disbursement information, and are very aggregate (in particular for the security sector).

***Indicator 8: Transparency of Inter-Governmental Fiscal Relations***

1.42 Afghanistan has a unitary state, with provinces and districts being de-concentrated units of the central Government. The only exceptions are the municipalities, which have some fiscal autonomy and a potential for delivering urban services (such as water and sanitation).<sup>9</sup> Revenues and expenditures of municipalities are outside the national budget. Municipalities manage their own tax and fee base (although rates are agreed with the national Government) and must fund all of their expenditures from this base. The Ministry of Interior (MoI) approves the budgets and staffing complements of all municipalities. Oversight is provided by MoI through the provincial governors; MoF approves the budget of the municipality of Kabul. However, there is very little reporting from municipalities to MoF and no overall assessment of their fiscal situation by MoF. There is very little information on financial flows and fiscal positions of the municipalities, but this should change with the implementation of the new PFEM Law which requires municipalities to comply with the financial reporting requirements established by MoF. Even the existence of transfers from the central Government (through MoI) to municipalities is unclear, and if such transfers exist they would not appear to be very transparent.

1.43 **Rating 8: 1.** Information on the level of transfers to subnational governments is important for the management of both the central and subnational governments – and this should be communicated in a timely fashion. A clear allocation criteria, such as a formula, for the allocation is needed to ensure transparency and predictability. Finally, sectoral information on expenditures at the subnational level is also important to have a comprehensive view of public spending and the quality of its allocation across sectors. Keeping in mind that Afghanistan is a unitary state and hence that this rating applies only to municipalities and does not have a wide scope, the rating is “1” on the three dimensions of the indicators: (i) transparency and objectivity in the horizontal allocation among subnational governments; (ii) timeliness of reliable information to subnational governments on their allocation; and (iii) extent of consolidation of fiscal data for general Government according to sectoral categories.

***Indicator 9: Oversight of aggregate fiscal risk from other public sector entities***

1.44 The Government budget comprises all ministries and agencies of the executive branch, the legislature (when formed), judiciary, decentralized operations of the central government (provincial operations), and other agencies of the central government (IARCSC, CAO). The budget does not include state-owned enterprises (although there may be some payroll of SOEs mixed with line ministries’ payrolls, and, in some cases, commercial-type activities are handled by government departments). The annual budgets from 2003/04 onward are exhaustive in that they include all sources and uses of public funds – both those which are implemented by the Treasury through the Core Budget and those implemented by donors in the separate External Budget. There are, however, some donor-funded (and donor-executed) operations, particularly in the security sector, outside the annual budget.

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<sup>9</sup> See Evans et al. (2004) and Volume III, Chapter 5.

1.45 **SOEs.**<sup>10</sup> Revenues and expenditures of the SOEs are considered to be fiscal activities outside the national budget. However, there is very limited information on these entities. The Government oversees 71 SOEs assigned to 15 line ministries. The significance of the revenue, expenditure, and the financial position of the SOEs is not precisely known because of their poor financial reporting. The operations and management of SOEs are governed by the State Owned Enterprise Law (Tassady Law, 1991) which defines SOEs as legal entities with an independent balance operating with 100% capital of the state.<sup>11</sup> It does not cover companies partially owned by the state (e.g. Ariana Airlines) which are governed by the Commercial Law (1955). For most SOEs, ownership rests with line ministries.

1.46 The SOE Department in MoF has an extensive role under law to analyze, monitor, and oversee financial operations of SOEs. This has not taken place systematically due to weak financial control by the MoF and lack of financial reporting by SOEs. There is no consolidated information on the transfer of public funds to and from SOEs partly due to lack of information, but also because there are inconsistencies in the way SOEs are treated across Government despite legislative provisions in this area. Regarding financial reporting, the SOE Department of MoF indicated that there are agreed fiscal plans with the majority of SOEs and that most are submitting quarterly income statements. This information is manually recorded. Nevertheless, there are questions about the level and quality of compliance. Fiscal transfers from and to SOEs are regulated by the SOE Law and are paid through transfers to the Treasury Single Account. Although SOEs are classified as independent legal entities, the SOE Law has provisions that give line ministries and the MoF significant control over SOE finances. However, fiscal risks arise with SOEs because they implicate the state in their financial dealings, as the sole or majority owner, and as a group they represent a significant financial operation. Given the poor reporting and the fact that the SOEs operate outside of the Government budget and internal control mechanism, the fiscal risk management in place is weak.

1.47 **Rating 9: 1.** Central government should monitor and manage fiscal risks arising from its own activities and fiscal risks that will impact nationally that arise from SOEs and municipalities. In good practice: (i) central government should require and receive quarterly financial statements and audited year-end statements from parastatals and SOEs, and monitor performance against financial targets and (ii) sub-national governments can generate fiscal liabilities for the central government, so their fiscal position should be monitored, at least on an annual basis. The rating is a “1” because, while there is oversight and monitoring by the national government of parastatals and municipalities, the financial information is too limited and unverified to serve to manage fiscal risks.

#### ***Indicator 10: Public access to key fiscal information***

1.48 **Fiscal.** Government policy toward budget systems design has focused on accountability and transparency in both policy making and information sharing. This has been one of the great successes of Afghanistan’s budget process. To increase awareness among stakeholders, the Government has convened since the 2003/04 budget an annual Afghanistan Development Forum (ADF) to enable Government, the press, international donors, and NGOs to review the national budget. Transparency and accountability have also been enforced through the Consultative Groups (CG) for both the Operating and Development budget.

1.49 Fiscal information available to stakeholders and the public generally through the Government website includes all budget documents, plans and detail on budget revenue and expenditure for current, and estimates for future years. Detail on economic and monetary policy, assumptions, and forecasts are also available publicly on the IMF website in the form of the periodic reports on the Staff Monitored

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<sup>10</sup> This section draws on Volume III, Chapter 4.

<sup>11</sup> There is even less information on public enterprises with less than-100% state participation.

Program, but not directly in the budget document. Also, the budget document on the operating expenditures offers limited information on the role and objectives of each ministry.

1.50 In October 2004 the Government published a Financial Report prepared by MoF to June 2004 on its website. This provides comprehensive information in an understandable format on budget execution and the financial position; the information is appropriately summarized, and is available in Dari and English. It provides accumulated revenue and expenditure figures for the Core and External Budgets (disbursements only) for 2001/02 to 2003/04 of the transitional government and separately for 2004/05 to end of the first quarter against budget. The report presents debt by creditor for debts prior to 2001/02 and by operation under the transitional government. It also presents complete information on the status of donor pledges and performance against those pledges. However, this report lacks data by function and data suffers from the unreliability of the figures on execution of the External Budget, as recognized in the report, and the lack of coordination with Treasury to use final accounting data.

1.51 Since March 2005, monthly financial statements are also posted on the MoF's website (see also indicator 24). Annual financial accounts have not been made public.

1.52 **Audits.** Beginning in 2004/05, annual audit reports on the results of the Auditor General's review of the state budget and financial statements are to be distributed to Cabinet and divulged generally through press releases. Audit results on the ARTF are available to all donors and effectively to the public. Reports on work relating to compliance and special investigations are presented only to the Cabinet in the semi-annual report of the Auditor General (see indicator 26).

1.53 **Procurement.** Large-value contracts for goods are subject to competition (national and international) based on open tender following proper advertisement and subject to time limits. There is public bid opening, recording, and measures in place to guide the process. For works as well, the regulations provide for open competition through advertisement in the newspaper. The regulation provides for the publication of large contract awards. These awards are not made public by the central procurement unit, however, while decentralized procurement units have rarely the opportunity to procure large contracts (see also indicator 19).

1.54 **Rating 10: 2.** The general level of transparency that exists regarding the fiscal plans, position, and performance of the government depends on (i) annual budget documentation, (ii) within-year budget execution reports, (iii) year-end financial statements, (iv) external audit reports, (v) public procurement information on major contracts, and (vi) resources available to primary service units (such as schools). The rating is "2" because two of these elements (budget documentation and within-year budget execution reports) are published without major delays and the format is understandable. Improvement is needed, however, notably with respect to external audit reports.<sup>12</sup>

## **BUDGET CYCLE**

### **a. Policy-Based Budgeting<sup>13</sup>**

#### ***Indicator 11: Orderliness and participation in the annual budget process***

1.55 **Legal Framework.** The new Constitution adopted by the Grand Council (Loya Jirga) on January 3, 2004 provides the legal authority for budget formulation, approval, and execution. Responsibilities are

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<sup>12</sup> There is, however, the regular audit report on the ARTF, which reports on financial control issues affecting the state budget.

<sup>13</sup> The discussion on planning and budget formulation is drawn from Volume I, Chapter 6 and "Budget Formulation in Post Conflict Afghanistan (2004/05)", a background paper for the World Bank Public Finance Management Review.



clearly established between the Government (for formulation) and the bicameral legislature (for approval). Upon the establishment of Parliament, the budget will be submitted through the upper house (Meshrano Jirga) with an advisory comment from the lower house (Wolesi Jirga), although final approval will rest with the lower house. A number of articles in the Constitution (art. 137 and 139) would allow linking budget management responsibilities with sub-national administration in the years to come. The recently approved PFEM Law – and its regulations – will further specify the legal framework (importantly, the law also details the procedure for budgetary approval and amendment between the MoF, the Budget Committee, and the Parliament). However, as the Parliament has yet to be formally established, the Cabinet approves the national budget through Presidential decree.

1.56 ***Institutional Framework.*** The Cabinet establishes the budget envelope, although in reality the MoF is responsible on behalf of Cabinet, based on domestic and external revenue forecasts, and with the assistance of the IMF. MoF also sets the overall financial policy of the Government, drafts the budget and appropriations law, and issues call circulars and budget guidance notes to the line ministries. Line ministries and agencies are responsible for formulating their expenditure plans for both the operating and development budgets, as appropriate. The line ministries and other first-level line agencies deliver their assigned public services mainly through their second- and third-level departments stationed at provincial and district administration, although these units are not responsible for their own budget formulation. In essence, the extent to which sub-national administration is actively involved in budget formulation is regulated by the central line ministries and is currently very low.

1.57 ***Participation.*** Donors are not directly involved in the formulation of the operating budget, although it is obvious that donor decisions on the development budget have implications for operating expenditures. Through the Consultative Groups (CGs), donors are involved in determining the formulation of the development budget which has direct implications for each successive operating budget. Donors and NGOs are requested to provide information regarding the forthcoming year's expenditure plans, and integration with the various areas of Government public investment. As noted, an annual Afghan Development Forum enables donors to communicate pledges and expected commitments by budget channel (direct support, Core Budget, or External Budget). Currently civil society has no formal role in budget formulation or in the development of public policy.

1.58 ***Calendar.*** The annual budget cycle runs from March 21 – March 20. Following the annual mid-term review, budget formulation takes place in the last quarter of each year in a well-organized process for both the operating and the development budgets simultaneously, beginning with the issuance of Budget Guidance documents. The operating budget has regularly been approved in a timely manner before the start of the budget year, but there have been significant delays in the case of the development budget, in large part related to difficulties in getting clarity on external financing, particularly for the External Budget. The 2004/05 development budget was approved four months into the budget year, whereas in 2005/06 an interim development budget was approved a few days after the start of the budget year.

1.59 A Guidance Note provides an overview of the complete formulation process for both budgets, although with a greater focus on the development budget. The note details activities related to: (i) formulating Ministerial Budget Working Groups (BWGs); (ii) setting policy results in terms of objectives, outcomes, and outputs; (iii) selecting sub-programs and clustering projects around coherent objectives; (iv) assessing donor pledges, commitments, and disbursements in a given budget year; (v) setting existing expenditure requirements and new project proposals including the completion of Project Summary Sheets for years 1-3; (vi) ranking projects according to highest priority; (viii) detailing institutional arrangements for implementation; and (ix) mainstreaming cross-cutting issues on Gender, the Environment, Human Rights, Humanitarian Affairs, and Counter Narcotics.

1.60 Following Budget Committee endorsement of individual expenditure plans, both the operating and development budgets are submitted for Cabinet (Council of Ministers) approval on separate dates. The discussion focuses on whether the set of proposals presents a coherent policy framework and provides for aggregate budget discipline.

1.61 The Presidential Decree formally approves the total budget with reference to the Council of Ministers Approval. The Decree provides a breakdown of the operating and development budget, by core and external category. It outlines sources of domestic and external revenue, concessional loans, and appoints an ERC committee under the Budget Committee to oversee review and scrutiny of programs. The decree also outlines the national priority programs and project financing mechanisms.

1.62 **Rating 11: 2.** Effective participation in the annual budget process impacts on the extent to which the budget reflects fiscal and sectoral policies. This requires an integrated top-down and bottom-up budgeting process, involving central agencies, spending agencies, and the political leadership in an orderly and timely manner, in accordance with a pre-determined budget formulation calendar. Clear guidance on the budget process should be provided in the budget circular and budget formulation manual. Negotiations on allocations should be transparent and systematic. The indicator is assessed along three dimensions. The rating is “2” along the first dimension, “existence of a fixed budget calendar”, because there is a calendar, but delays occur and there is little time for ministries and the Cabinet to make adjustments (this was in particular the case in 2004, as the mid-year review was postponed into the tenth month of the year). The rating is also “2” along the second dimension, “guidance on the preparation of budget submissions”, as there is a budget circular with ceilings for each ministry (for the operating budget), but these have not been approved by the Cabinet in advance. The rating is “2” along the third dimension, “timely budget approval by the legislature”, because the operating budget consistently has been approved by the President – who so far has had legislative powers – in a timely manner but there have been delays in the approval of the development budget. The overall rating is therefore “2”.

***Indicator 12: Multi year perspective in fiscal planning, expenditure policy, and budgeting***

1.63 ***Financing Framework.*** Economic growth assumptions for the medium term have been presented in some budget documentation.<sup>14</sup> Nevertheless, projections of domestic revenue are more targets than forecasts since they do not flow from proven forecasting models incorporating the economic assumptions and results of specific policy actions. Donor contributions are projected for two outer years.

1.64 ***Operating Expenditures.*** There is no projection of operating expenses beyond the budget year. Overall, the operating budget is not developed in any economic or fiscal multi-year framework (the only framework was developed for the Government’s *Securing Afghanistan’s Future*, SAF, report).

1.65 ***Development Expenditures and Investment Program.*** Development expenditures, both in the Core and External budgets, are presented on a three-year basis. Linking the investment budget to policy is challenging in Afghanistan because virtually all investments are donor funded. The *National Development Framework* (NDF) published by the Government in 2002, established three broad pillars of concentration and within these 16 national programs, is meant to provide a strategic framework for donor-funded investment projects. The development budget arises from public investment proposals under each program.

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<sup>14</sup> Overview of the 2004/05 Afghanistan Operating Budget and Minister of Finance’s address to Cabinet for the 2005/06 Operating Budget. The rating for this indicator does not take into account the Medium-Term Fiscal Framework developed in October 2005.

1.66 However, to date investment plans in most cases have involved little more than assembling a project shopping list. As such, the Development Budget tends to assemble donor financing around Government-determined investment priorities, but not as integral components of Government programs. Projects financed by donors are largely aligned to national program areas such as education or health. However, in many cases high-priority Government projects do not receive financing if they fail to attract donor interest. Moreover, no formal mechanisms have been put in place to stop donors from programming projects outside of the budget framework.

1.67 To address the gap, in 2004 the Government prepared a seven-year investment program in the SAF report, which attempted to reconcile the availability of resources with priorities for reconstruction and development in fulfilling the objectives set by the strategy framework, through detailed sector studies for areas of public investment under the budget. In addition, the PFEM Law requires the budget to be anchored in a multi-year framework.

1.68 ***Integration of Operating and Development Budgets.*** The operating and development budgets are prepared largely in parallel, even though the processes are coordinated by the Budget Department. Since the budget for 2004/05, there has been an attempt to assess the operating costs implications of projects in the development budget, but this has not been very successful so far given low capacity in line ministries. Because of the recurrent expenditure component in the Development Budget (both direct, such as the cost of providing basic health services and grants to communities, and indirect, such as the cost of operating and maintaining new investments), better integration of the Operating and Development Budgets can only occur after such spending is formally identified so that the operating costs embedded within the development budget can be progressively transferred to the core recurrent budget, assuming revenue availability. Another constraint to integration of the budget is that the Recurrent and Development Budgets are not presented under one view; the recurrent budget is presented around the Government's organizational units whereas the Development Budget is prepared based on programs which in many cases cut across organizational units. Finally, both the formulation and execution of the External Budget are largely determined and implemented by the donors, outside of constraints Government may suggest, and not necessarily in response to the specific investment proposals identified by the line ministries.

1.69 ***Rating 12: 1+.*** Policy decisions have multi-year implications. Multi-year fiscal forecasts and estimates of forward expenditures (including expenditures both of a recurring nature and those involving multi-year investment commitments) are required to determine whether current and new policies are affordable within aggregate fiscal targets. At the same time, national and sectoral strategies are needed to guide the development of forward estimates. The extent to which estimates are integrated into the annual budget formulation process will complete the policy-budget link. Finally, decisions on investments and recurrent funding for a particular sector or ministry should be consistent and not be taken independently. This indicator is assessed along four dimensions. The rating is "1" along the first dimension, "multi-year fiscal forecasts and functional allocations", because there are no forward estimates in the budget (projections on the development budget mainly reflect multi-year commitments). The rating is "2" along the second dimension, "scope and frequency of debt sustainability analysis", as one such analysis was conducted recently (by the IMF). The rating is also "2" along the third dimension, "existence of costed sector strategies" since such strategies exist for several sectors (often developed as part of the SAF report) but they have not been reconciled with fiscal forecasts. The rating is "1" along the fourth dimension, "linkages between investment budgets and forward expenditure estimates", because no such linkage has been established yet (some progress has been made on road maintenance in the revised 2005/06 budget). The overall rating is therefore "1+".

## **b. Predictability and Control in Budget Execution**

### ***Indicator 13: Transparency of Taxpayer Obligations and Liabilities***

1.70 ***Clarity and comprehensiveness of tax liabilities.*** Concise and easily accessible tax laws are critical if tax policy is to be legally enforceable. The legal framework in Afghanistan became progressively fragmented over the past decade by countless amendments and decrees by various administrations, and compliance rates diminished. Recent revenue reforms have tried to establish a clear and more modern legal framework that will enable the Government to gradually extend coverage in the provinces, enhance compliance rates, and also remove the plethora of illicit charges and “taxes” that arose in the administrative and policy vacuum.

1.71 A new customs code and the consolidated Income Tax Law, which cover the majority of tax liabilities, were published on the official MoF website in March 2005, along with some new income tax measures. The new customs code provides the enabling legislation for implementing the revised tariff structure, introduced in 2004. Recent amendments also assert the supremacy of revenue laws in revenue-related matters, including the removal of some tax concessions and exemptions which had been introduced through other statutes.

1.72 While the new legislation provides a more robust and transparent framework for revenue mobilization, it will take time for the Government to disseminate information about the new regime and to develop the requisite administrative capacity, procedures, and systems. For example, the enabling customs regulations and procedures, such as the compulsory use of licensed customs brokers, are still being developed and rolled out to key provinces. Income tax provisions are also not applied evenly throughout the country as there is currently no legal basis (or administrative capacity) for the tax administration – e.g. enforcement and collection procedures and powers, and penalty regimes have yet to be developed. The Afghan International Chamber of Commerce (AICC) has reported instances of illicit taxes, double taxation, and areas where the law may be interpreted inconsistently or is ambiguities.

1.73 ***Taxpayers’ access to information on tax liabilities and administrative procedures.*** The new customs code and the consolidated Income Tax Law, which cover the majority of tax liabilities, were published on the official MoF website in March 2005. MoF has also started to publish advice and interpretative rulings for taxpayers (see Article 96 of the Income Tax Law and Article 17 of the customs code). In addition, MoF has launched a number of initiatives aimed at taxpayer education, including holding consultations with the private sector and the publication of various “tax guides” on the official website. However, coverage of the tax guides, public rulings, education campaigns, and administrative procedures is still far from complete, partly because new taxes are still being implemented and the procedures are still being developed and/or rolled-out to the major provinces.

1.74 ***Tax appeals mechanism.*** The tax appeals system is in the process of being established as part of the customs and tax administration reform programs, but it is unlikely to be functioning until after the proposed administrative restructuring of the Afghan Customs Department (ACD) and the General Presidency of Revenue (GPR) within MoF. The new customs code sets out the procedures for the review of customs decisions (Article 18) and arbitration (Article 19), although the administrative and procedural arrangements to support the law have yet to be fully developed. The Income Tax Law does not include such provisions. Currently, if taxpayers wish to dispute the amount of their income tax liability, their formal rights allow only that the matter be taken to court, which can be costly and time consuming. Consistent with a modern tax administration, the authorities are proposing to amend the Income Tax law to allow persons who wish to dispute their tax liability to give notice in writing to MoF explaining their grounds for dispute. MoF will be required to review the matter. Should a dispute not be resolved to the

person's satisfaction, the dispute may then be taken to a court for resolution. The amendments to the Income Tax Law have subsequently been approved.

1.75 **Rating 13: 1+.** This indicator is composed of three components. On the first dimension, "clarity and comprehensiveness of tax liabilities", the rating is "2" since the recent amendments to the income tax law and the adoption of a new customs code have made the legislative framework relatively comprehensive and clear for some major taxes. However, not all aspects of the legislative framework are being implemented in practice, and the supporting administrative procedures, human capacity, and physical infrastructure need to be developed. The fairness of the tax system is also questioned by many taxpayers due to the reported existence of many illicit taxes, the lack of comprehensive coverage, and discretionary powers of the government entities involved. On the second dimension, "information on tax liabilities and administrative procedures", the rating is "2" since taxpayers have access to some information on tax liabilities and administrative procedures, but the usefulness of the information is limited mainly due to the coverage of selected taxes only and limited geographical coverage, and the ongoing development of the administrative procedures and tax rulings. On the third dimension, "existence and functioning of a tax appeals mechanism", the rating is "1" as there is no such system. The overall rating is therefore "1+."

***Indicator 14: Effectiveness of measures for taxpayer registration and tax assessment***

1.76 **Controls in the taxpayer registration system.** In order to make tax administration more efficient and to ensure proper crediting of taxes paid to taxpayer accounts, MoF introduced a unique taxpayer identification number (TIN) program in September 2003. All individual persons, companies, and organizations which are, according to the Income Tax Law and Customs Law, required to pay taxes or customs duties, including social, non-profit, and welfare organizations that are withholding taxes from the salaries of employees or from rental payments are required to obtain a TIN.

1.77 As of March 22, 2005 19,341 TINs had been issued in Kabul with a further 5,377 in provinces (total 24,718), resulting in partial coverage. The Nationwide roll-out of the TINs to provinces commenced in April 2004 with the inclusion of the four largest provinces: Herat, Kandahar, Mazar-e-Sharif, and Jalalabad (plus Kunduz).

1.78 In coordination with the Afghan Investment Support Agency (AISA), all new investment license applicants receive a TIN as part of AISA's concept of a one-stop shop. TIN registration will also be required as part of the Money Changers and Customs Brokers licensing processes. These agreements highlight the cooperation fostered with AISA (investors), Da Afghanistan Bank (Money Changers), and the Customs Department (Brokers).

1.79 **Effectiveness of penalties for non-compliance with registration and tax declaration.** Currently, MoF has no powers to enforce compliance with respect to the Income Tax Law. In particular, revenue officers do not have power to access taxpayers' premises to collect information regarding income tax matters or to collect unpaid taxes. These powers may be exercised by the Ministry of Interior but there are no formal arrangements with the tax authority. The tax system therefore relies on taxpayers voluntarily meeting their tax obligations, and as a result tax compliance is very low.

1.80 Enforcement powers were introduced in the new customs code (Chapter 14), including a provision for the establishment of a Customs Police Administration and new provisions for penalties. The Government is taking a gradual, risk management approach in establishing mobile customs teams to restrict smuggling and tax evasion. The mobile customs teams are being trained and deployed first to the major customs offices (e.g. Herat, Mazar-e-Sharif, Jalalabad, Kandahar, etc). It will take some time before the customs police and processing and control procedures are established.

1.81 For both tax and customs administrations, enforcement capacity needs to be developed in conjunction with the implementation of improved processing and control procedures to respond to the current situation of widespread non-compliance.

1.82 **Planning and monitoring of tax audit programs.** The new revenue systems being introduced will increasingly rely on self-assessment and the use of risk targeted auditing of taxpayers as a key activity to improve compliance and deter tax evasion. However, the Government is at a very early stage of developing the capacity and processes that will enable the collection and analysis of information on non-compliance and other risks that are necessary for focusing tax audit activities and resources toward specific sectors, and types of taxpayers with the highest risk of revenue leakage. It is hoped that the establishment of a dedicated Large Taxpayer Office (LTO), which began in 2004, will help to pilot many of the reforms associated with monitoring, auditing, and enforcing collection for taxpayers. However, in the short-term capacity constraints and the absence of a well-functioning legal system will severely limit the ability of either the ACD or the GPR to investigate and successfully prosecute major evasion and fraud cases on a regular basis to ensure that taxpayers comply with their obligations.

1.83 **Rating 14: 1+.** This indicator has three dimensions. On the first dimension, controls in the taxpayer registration system”, the rating is “2” because, while taxpayers are registered with a unique TIN in a database system, the coverage is currently partial (in addition, the linkages to other registration/licensing functions – AISA, DAB, Brokers – are being strengthened and may be supplemented by occasional surveys of potential taxpayers). On the second dimension, on penalties, the rating is “1” since penalties for non-compliance are generally ineffective and rarely imposed due to the lack of enforcement powers and the need to develop capacity and processes for both the tax and customs administrations. On the third dimension, audit programs, the rating is “1” as tax audits and fraud investigations are undertaken on an ad-hoc basis if at all. The overall rating is therefore “1+”.

#### **Indicator 15: Effectiveness in collection of tax payments**

1.84 In Afghanistan, the tax gap is extremely large – broadly, this is the difference between the current tax level, around 4.5% of GDP in 2004/05, and the potential, which given the existing laws and statutes, is assumed to be closer to 11% of GDP.<sup>15</sup> As there are few effective enforcement mechanisms, compliance is largely voluntary, and the compliance rates are assumed to be extremely low. This results in the accumulation of significant tax arrears, although because there is no comprehensive system of tax assessment precise figures are unknown. The main emphasis of the tax and customs administration reforms is to develop the capacity and processes to collect current tax liabilities and there is little effort made to collect tax arrears from previous years.

1.85 A major fiscal reform was the establishment of the Treasury Single Account (TSA) in 2004. The TSA helps to integrate Government accounts into an account or set of linked accounts through which the Government collects revenues and transacts all its payments. The apex of the system is a single account held by the MoF (Treasury) at the central bank. The TSA is designed to ensure that all Government revenues, wherever they are collected, are transferred to the Treasury. Once funds have been deposited in provincial revenue accounts they are automatically swept to the Treasury, at least on a monthly basis. Funds collected in the major urban centers are swept into the TSA at least on a weekly basis.

1.86 Reporting on tax collections is done monthly by the revenue department and Treasury in MoF. The revenue authority and the Treasury generally report on revenue collections, and a system has recently

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<sup>15</sup> See Volume III, Chapter 1.

been introduced to reconcile the cash balances with collection reports on a monthly basis. However, there is no system in place to reconcile tax assessments, collections, arrears, and transfers to the Treasury.

1.87 **Rating 15: 1+**. The effectiveness of tax payments is a critical factor in a country that seeks to increase its revenues from a very low base. Key factors toward this goal consist of avoiding the accumulation of tax arrears, promptly transferring revenue payments to the Treasury, and ensuring adequate reconciliation between payments, tax assessments, arrears, and bank account statements. The effectiveness of tax payments is very low, with very little reconciliations and a low level of collection. However, considerable progress has been made over the last few months in consolidating the TSA arrangements and ensuring periodic transfers of funds to the Treasury. The rating is therefore “1+”.

***Indicator 16: Predictability in the availability of funds for commitment of expenditures***

1.88 The existing PFM laws and recent legislation through the annual budget decrees and budget circulars are clear that all budget uses are subject to annual appropriations and quarterly allotments approved by MoF. The objective of these mechanisms is to support budget execution within the cash resources of the Government and to provide a predictable flow of cash to executing units. The PFEM Law and the annual budget decree establish the budget’s role as the single authority for expenditure, through appropriations and ceilings to public employment which are provided with the appropriations. The annual budget decree also provides the Treasury with full control over public banking and cash and calls for all receipts to be turned over to the Treasury. The Treasury and provincial Mustoufiats are the sole authority to control the flow of Core Budget expenditure payments from official Government accounts. Hence the instruments for expenditure control are in place. The execution of the External Budget, the part of the budget that is not implemented by the Government, is more difficult to assess because reporting on these activities is limited to disbursements.

1.89 ***Appropriations and Revisions.*** For the operating budget, appropriations expressed in the budget law are made to primary budgetary units (the ministries). Many adjustments are made during the year including the assignment of contingency funds to budgetary units. Contingency funds are available in the appropriations to deal with unforeseen demands, but these must be re-appropriated to specific budgetary units and provided allotments before use. Annex 1.1 of the Budget Decree specifies the uses permitted and who has authority over each fund. These funds are usually allocated in numerous tiny amounts, causing frequent – though small – changes to appropriations. In addition, since mid-2003/04 the Government has prepared a major mid-year review which seeks to reallocate budgets when appropriate. Otherwise there are no revisions to the appropriations.

1.90 The External Budget is contained in the Budget Decree but does not constitute spending authority since these funds are under the control of the donors; spending and reporting are governed by the agreements between the respective donors and the Government.

1.91 ***Allotments.*** Allotments assign the spending authority over the four quarters of the fiscal year. These quarterly allotments are in turn assigned by each ministry to locations (which include the provincial offices of the line ministries), all of which are recorded in AFMIS. The last step in the expenditure process is the availing of funds under the allotments so payments may be made. Allotments, however, do not reflect the quarterly pattern of expenditures as they are usually set at 25% of the annual appropriation regardless of expenditure patterns. Allotments can therefore constrain expenditures where the expenditure pattern does not follow the 25% per quarter distribution allowed by allotments. Second, allotments in total do not take into account cash availability, so there is uncertainty as to whether they will be funded.

1.92 For provincial operations, evidence from the Mustoufiats indicates that there are two sets of allotments approved at their level: the allotments advised from Treasury and in AFMIS and the allotments duly approved and supported by B-20 advices but which may not all be in AFMIS and which have been advised to the provincial line ministries' offices (see Volume III, Chapter 3). Mustoufiats are empowered by the B-20s to spend, and these are the amounts expected by the provincial spending units. However, funding from the Treasury is in line with the AFMIS recorded allotments which are necessarily of a lower amount in total. The causes for the discrepancies could not be precisely determined. These differences imply that allotments advised to the provincial offices cannot all be funded, and that the Mustoufiat must apply his own criteria in rationing the available funding. Given the different cycles of allotment approvals (seven advices per year plus those due to adjustments in appropriations) and cash transfers (monthly), and given the disconnect between allotments advices to provincial spending units and cash transfers at the Mustoufiat level, the provincial departments cannot ascertain the true funding status of their allotments. While cash constraints have not been significant for the Government as a whole, there are many allotted expenditures which are delayed or never funded because of perceived cash constraints. The 2005/06 Budget Decree has established AFMIS as the sole source of allotment information to address this issue.

1.93 Development expenditures in the Core Budget, on the other hand, are allotted annually and managed through the Special Disbursement Unit (SDU) on the basis of availability of cash in the Special Accounts concerned.

1.94 **Cash Management.** Treasury uses the information available in AFMIS to prepare daily calculations and consolidation of all the Government's cash balances supporting the operating budget and matches this against the requests for payments and transfers (see next indicator). Since the end of 2004, forecasts of all cash inflows and outflows under the operating budget are also prepared for the fiscal year and updated monthly. Revenue information is input from the actual to date and the difference required to meet the target agreed with the IMF. Donor contributions to the recurrent budget are identified for the balance of expenditures based on existing commitments. Expenditure forecasts are only based on approved allotments; these, however, do not arise from procurement plans which may result in the current level of idle balances in the provincial accounts.<sup>16</sup> Difficulties are also faced in establishing the pattern of expenditures given that the prior year's recording by period was affected by delays in recording on the one hand and the use of advances to suppliers on the other hand. The poor communications infrastructure with the provinces results in both delays in recording of expenditure and limited effectiveness of the single treasury account since it cannot support expenditures ordered by the provincial offices.

1.95 **Rating 16: 1+.** Predictability in the availability of funds is critical for line management to operate effectively. The rating is "1+" because some progress has been made with regard to cash flow forecasts (now prepared by the Treasury, but at an aggregate level and with limited analysis on actual cash inflows and outflows), but more progress is required with regard to the allotment process and within-year adjustments. The current allotment procedure in Afghanistan does not support effective budget execution because of the difference between the executing unit's records and the controlling unit's records of authorized amounts. Also, rationing of cash in line with transparent rules has yet to be achieved. Similarly, the use of a year-end decree to regularize expenditures over appropriations indicates that there are uncontrolled within-year deviations from allotments.

#### ***Indicator 17: Recording and management of cash balances, debt, and guarantees***

1.96 **Cash management.** Cash management is the responsibility of the Treasury, although much of its execution depends on the provincial offices of MoF (Mustoufiats). The main tools for cash management

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<sup>16</sup> Idle balances in the provinces stood at two months of expenditures in January 2005.



are the Treasury Single Account (TSA) in the Central Bank of Afghanistan (DAB) and the integrated financial management system (AFMIS) under Treasury. These operate under a policy of no overdrafts (i.e. no financing by the Central Bank) and the use of external budget support and ARTF to finance the shortfall between planned operating expenditure and domestic revenue.

1.97 According to the Constitution, all public revenue must be transferred to the TSA, including cash collected by the Treasury and by other agencies, and deposits made to DAB. Expenditures for the operating budget all originate in the TSA, either as payments to suppliers or as transfers to provincial Mustoufiats, which in turn operate single treasury accounts for expenditures and a separate account for revenues. The provincial revenue accounts are swept weekly or monthly (depending on the revenue generation capacity of the province) and transferred to the central TSA. Cash related to donor earmarked funds (investment operations financed by donors) are deposited in Special Accounts outside the TSA (278 of these accounts are operated by the SDU in Treasury).

1.98 Regulations for cash management are set by Treasury and communicated through Treasury circulars. Within the operating budget, the flow of funds for expenditures follows two routes:

- For headquarters line ministries, expenditures are made from the TSA in response to payment requests from line ministries. There is no specific authorization or cash allotment because budget allotments are expected to be funded. Shortfalls in cash availability result in postponing payment but not canceling expenditures; the decisions on what is postponed are made on an *ad hoc* basis by the Director of Treasury (paying salaries invariably is assigned high priority). There is no data available on the amount or frequency of such delays (see above on arrears). Advances to line ministries for purchases from suppliers are common; these are charged to the related budget sub-allotment and followed up by Treasury for timely settlement. Payments made by Treasury to suppliers are made by direct deposit to supplier bank accounts, i.e. a check is generated in AFMIS which serves as payment instructions to DAB for effecting a deposit in the commercial bank account of the supplier. As of February 2005, approximately \$11 million of advances to line ministries were outstanding (1% of Core Budget expenditures).
- For provincial operations, expenditures are paid through provincial Mustoufiats. These offices are provided an advance at the beginning of the year equal to one or two months of expenditures based on allotments;<sup>17</sup> then each month during the year funds are requested to match the expenditures forecast on the basis of the approved allotments. Funds are transferred in line with the request and cash availability, but these transfers do not identify specific uses. They are assigned to payment requests by the Mustoufiats in line with their priorities and within the rules on budgetary uses.

1.99 **Debt and Guarantees.** Authorization and negotiation of debt is the responsibility of MoF, with new debt specifically authorized through provisions in the annual budget law. The PFEM Law specifies that the annual budget documentation should include how the annual appropriations will be financed and designate a maximum amount of borrowing and guarantees that can be entered into. The Debt Management Unit (DMU) in the Treasury is responsible for maintaining a debt register and for budgeting debt service. The Unit is also the repository for the debt legal agreements. The Financial Report published by MoF, available on the Government's website, contains information on credit terms and amount of debt by creditor for pre-2003/04 debt, and by specific loan for post-2003/04 borrowing. Given the lack of records, there remain however a few unconfirmed claims. Similarly, while the Government is

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<sup>17</sup> There are uncertainties about the calculation of this initial amount and the extent to which it has constrained expenditures in provinces. See Volume III, Chapter 3.

not granting any guarantees, the poor state of financial control over SOEs does not permit conclusions to be drawn on the existence or amounts of these.

1.100 The debt register is an Excel spreadsheet application used to record loan terms, movement on principal and debt service, and the running balance payable. The DMU established the debt position in 2003/04 from the records in Treasury and from a circular and other contacts with donors. The DMU participates in the negotiation of all new lending and receives a copy of all loan agreements which comprise the basis for establishing a new entry in the debt register. The register is updated for new disbursements from the advices received from creditors and from consulting the websites of the creditors where all disbursements on specific loans can be viewed. This is complemented by confirmation with DAB on receipt of the disbursement. Recording in the accounting of Treasury, however, is not initiated by the DMU and may or may not coincide with the movement reported in the DMU. Reconciliation is complicated because Treasury accounting is on a cash basis. Debt service payments are initiated in the DMU; these are prepared manually outside the register and are not recorded in the register until DAB and the creditor confirms payment. Again, these are recorded separately in Treasury accounting and not integrated with the debt register.

1.101 There is no automation under the debt register for budgeting of debt service for existing loans, forecasting for new loans and disbursements, analysis under different scenarios, or query reporting and costing. Similarly, the system does not offer the requisite data integrity or audit trails to support integration with AFMIS or reliance on its reports without manual verification.

1.102 There is no formal debt strategy, but developing such a strategy is a structural benchmark in the IMF's SMP. MoF has never conducted any debt sustainability analysis itself, but such analysis has been conducted by the IMF (which suggests that the level of debt will remain sustainable if there is strong economic growth, complete forgiveness of all old debt and claims, robust increases in revenues, and external assistance overwhelmingly in the form of grants).

1.103 **Rating 17: 2+**. Good cash balance, debt, and guarantee management is required to make most effective use of public financial resources, avoid unnecessary costs, and guarantee predictability and sustainability. This indicator is rated along three dimensions. The rating is "1" on the first dimension, "quality of debt data and reporting", since the unreconciled amount of debt remains substantial (even though spreadsheet records are now maintained on reconciled debt, and reports on debt stock and service are prepared periodically). The rating is "2" on the second dimension, "extent of consolidation of the Government's cash balances", because, although there is daily calculation and consolidation of government cash balances, a number of provincial accounts are reconciled and consolidated only monthly and development funds for the most part remain outside the cash planning and consolidation arrangements since they are not fungible. The rating is "4" on the fourth dimension, "systems of contracting loans and issuance of guarantees", since the system for loans is transparent and effective (with authority given to the MoF and policies set in the Budget Decree). This rating assumes that no guarantee has been issued recently in the Government. Overall, the rating is therefore "2+".

#### ***Indicator 18: Effectiveness of Payroll Controls***

1.104 Wages are the most significant cost element in the operating budget, representing more than 50% of the actual operating budget. Controls over payroll are based first on the staffing establishments (*Tashkeels*) which are proposed by the Ministries and approved by the Office of Administrative Affairs (OAA) during the annual budget process. The *tashkeel* provides the organizational chart for the ministry, detailing staffing positions and levels. In the absence of a nominal roll, actual headcount is estimated through a database kept by the ARTF Monitoring Agent on the basis of summary reports of monthly payrolls in the provinces and detail provided by the Kabul ministries. The other component needed by

ministries and departments for processing payrolls is the *takhsis* (the salary allotment for the budgetary units)

1.105 **Staffing, personnel records, and pay scales.** The Independent Administrative Reform and Civil Service Commission is responsible for oversight of appointments and promotions (for positions at grade 2 and above), civil service management, and administrative reform. Historically, the line ministries held personnel files for all staff, but these are no longer maintained, and nor do the ministries have information on the position and grade for all hiring. Hence the payroll arises from the staffing and attendance records maintained by the individual budgetary units.

1.106 Every public employee has a personnel grade. Civil servant wage rates and pay policy are established centrally for all public employees in Afghanistan. Two base pay scales – one for contract staff and another for permanent staff – apply equally everywhere in Afghanistan. There are separate pay scales, however, for teachers, the army, and police. In addition, several new programs allow higher pay rates, based on a clear vision of core responsibilities, structural reorganization, and merit-based appointments.

1.107 **Payroll processing** (see also Volume III, Chapter 2). Payrolls are usually prepared manually by line departments. They may also be prepared from stand-alone automated payroll systems, for instance in the MoF (MS-Access database). Central authorities do not impose any standard for this processing or establish any minimum requirement to link to personnel records. The request for funds to pay payrolls follows the procedure used for any payment, with the payroll sheet used as support. After the requisite authorizations in the budgetary unit, including MoF's controllers within the budgetary unit or in the Mustoufiat, the requests are reviewed by MoF in Kabul or by the Mustoufiats.<sup>18</sup> This review is limited to matching the payroll sheet to the request for funds, viewing the allotment ceiling for salary and for positions (Tashkeel), but does not extend to underlying records. Except for those covered by the Individualized Salary Program in Kabul (see below), payment of payroll depends on a bonded trustee who receives a check for the payroll amount for a budgetary unit, withdraws cash from the bank, and makes the settlement with each staff member who evidences receipt by signing the payroll sheet.

1.108 MoF is leading an initiative to verify the national payroll. The program aims to cover all civil servants in Kabul ministries and agencies (200,000) and comprises three stages: issuance individual salary payments monitored by Treasury staff, salary payment from the list in DAB (requiring an ID), and deposit of salary to the bank accounts of Government employees. To date, 13 ministries have been processed through the first stage, and individual salary payments are being processed for 26,000 employees in Kabul, but the rate of transition to more advanced stages is limited by the low capacity for issuing identification cards. Individual salary payment implies witnessing the payroll distribution by a team comprising the budget unit representative, a representative of the DAB, bank staff, and a representative of the MoF. Significant savings will accrue to the Government from the full implementation of the program, as duplicate and unauthorized payments will be eliminated.

1.109 **Monitoring.** The payroll cost for the recurrent budget (except for Ministry of Defense, the security forces, and the uniformed staff of the Ministry of the Interior) is subject to review by the ARTF Monitoring Agent. This review relates the payroll sheet entry back to the accounting entries and to personnel and attendance records. It also includes witnessing individuals who are in the payroll records. The record of compliance is very high (95%), but it is not determined if the individual receives his full payroll or if his attendance records represent time at work. In any case, the sample tested out of the three

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<sup>18</sup> In 2002/03 and 2003/04, this control was centralized in Kabul, which created delays in payroll processing, as provincial representatives had to travel to Kabul every month, without improving the controls, as the central Treasury had no capacity to review the paperwork in detail.

million annual payroll transactions is too small to provide full assurance of the non-existence of “ghosts” on the payroll, or that actual work is being done by those who are paid.

1.110 **Effectiveness of controls.** There is evidence that controls on establishment are effective, as the observed headcount in the Monitoring Agent database has remained flat over the last three years (with the exception of teachers). Although controls are manual and decentralized, this is compensated for by the centralized controls on positions, paper documentation of payroll expenditures, and the concurrent review by the ARTF Monitoring Agent. The accuracy of the provincial data on headcount, however, is affected by difficulties in reporting head count where payroll delays or back pay occur, so the payroll for a month may not coincide with the head count. Significant risks in payroll remain, related to: (i) weak oversight of payroll support in areas not covered by the Monitoring Agent (most notably in the security sector); (ii) decentralized personnel records; and (iii) limited reviews by internal audit and central authorities in terms of matching payroll to personnel records and evidencing of final settlement with the employees.

1.111 **Rating 18: 2.** Controls exist over payroll expenses in aggregate through the tashkeel and the allotments (takhsis). In addition, audits have been undertaken, including by the ARTF Monitoring Agent, showing good results. The link between the payroll and the nominal roll is a key control which is decentralized to the operating units and is not closely supervised, but as explained above, payroll integrity is not undermined due to the existence of other controls. Hence although manual personnel records may be incomplete, and there may be delays in processing of payroll changes, the rating is “2”.

#### **Indicator 19: Procurement<sup>19</sup>**

1.112 Currently, most procurement of any significant scale is conducted through reliance on donor procurement procedures. Very little procurement is conducted by line Ministries themselves; where it is, the tendency is to recruit outside consultants, generally NGOs, to carry out the work on their behalf. Only a very small proportion of total procurement (by value) appears to be conducted on the basis of a series of national provisions regulating procurement: (i) a Law on procurement of 1987; (ii) a Purchase Regulation adopted as a Decree of the Islamic Emirate of Afghanistan adopted in 2001, both of which apply to the procurement of goods (and routine works and maintenance); and (iii) Rules and Regulations for the procurement of works adopted sometime after 1989 (since this replaces the rules adopted on that date). The Purchase Regulation effectively replaces the Law on Procurement.

1.113 **Goods.** The national provisions relating to goods are clearly in need of significant amendment to provide further detail and clarification. Nevertheless, the direction of these provisions is acceptable, if a little confused, suggesting that the basic concepts of a good procurement system are understood. Large-value contracts are subject to competition (national and international) based on open tender following proper advertisement and subject to time limits. There is public bid opening, recording, and measures in place to guide the process. Contracts of smaller value are subject to direct purchasing methods under which one to three officials will purchase the required goods depending on their value. Smaller value contracts for international procurement are to be procured by way of a Request for Quotation (RFQ) procedure. The main problems with the provisions are lack of detail and clarity in the qualification (as opposed to eligibility) requirements, setting of specifications, drafting of bidding documents, and award criteria, particularly with the apparent predilection for negotiation and the tendency to re-open bidding to attract better prices.

1.114 **Works.** In the case of works, the Government is currently operating on the basis of regulations adopted in 1989. The main difficulty with these regulations is that they resemble much more a set of bid and contract preparation guidelines than they do a regulation to ensure competitive bidding. Hence they

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<sup>19</sup> This section draws on Part II of this Volume. The rating does not take into account the approval of the new Procurement Law.

require significant updating. The regulations provide for open competition through advertisement in the newspaper. The regulations are inadequate in terms of setting out qualification criteria, requirements as to specifications, award criteria, processes, and minimum time limits.

1.115 **Controls.** There are, in effect, no controls over the public procurement system. There is no formal complaints or appeals mechanism in the existing rules, although there appears to exist a commonly understood system of sequential complaints to the contracting authority, the Government, and the Attorney General. There are, however, no documented cases of complaints, successful or otherwise. Annual audits of procurement are possible in theory but few have been conducted. Auditing staff lack the capacity to conduct appropriate procurement audits.

1.116 **Rating 19: 3/2.** Public procurement is a major component of the PFM system which directly impacts on the efficiency and economy of expenditures and also contributes to the budget formulation and expenditure management process. This indicator has three dimensions. The rating along the first dimension, “use of open competition for award of contracts that exceed the nationally established monetary threshold for small purchases”, is “1” for decentralized procurement under national procedures as there is insufficient data to assess this; it is “4” for procurement done by ARDS as there is accurate data showing that more than 75% of contracts above the threshold are awarded on the basis of open competition. The rating along the second dimension, “justification for use of less competitive procurement methods”, is “4” for procurement through ARDS and “3” for national systems (both justify the use of less competitive methods in accordance with regulatory requirements, but these requirements are not fully clear for national systems). The rating along the third dimension, “existence and operation of a procurement complaints mechanism”, is “1” as no such mechanism exists. The overall rating is therefore “3” for ARDS procurement and “2” for procurement carried out directly by Government.

#### ***Indicator 20: Effectiveness of internal control for non-salary expenditures***

1.117 To the extent that public spending is implemented by the Government, the public financial management control system comprises the budget, allotment and reporting procedures, and release of funds executed by the central authorities and their delegates in the provinces. In addition, controls in line ministries that relate to authorization of expenditure and approval of services rendered and internal audit are important.

1.118 **Internal Control Framework.** Under the 1983 Organic Budget Law, MoF had the responsibility to pre-audit expenditure; this is carried out by their representatives in the line ministries, where all payment requests are reviewed for allotment availability, adequate supporting documentation, and compliance with authorization procedures. At the same time, the Control and Audit Regulation provides line ministries with “Domestic Auditors” who conduct *ex post* audit under a reporting relationship to the line ministries and to the Auditor General. MoF delegates in line ministries do not have access to the allotment ledgers, so review and approval of these is perfunctory. In the case of the Mustoufiats, allotment information from AFMIS distributed by the Treasury frequently does not reconcile with information in the line ministries, because of different timing in communicating changes approved in the center from two different sources (see above).

1.119 In 2002, an integrated public financial management system (AFMIS) was set up in MoF. AFMIS is a cash-based financial system using FreeBalance software, which was initially configured to accept expenditure information and to produce checks. Treasury currently handles all data entry and check runs for MoF and line ministries in Kabul. It records in summary the operations of the Mustoufiats based on their monthly reports on expenditure and revenue. The structure of AFMIS was modified at the beginning of 2003/04 to enable recording of the Approved Budget, Primary Budget Unit (PBU) allotments, and location allotments. The system provides facilities to ensure that for each economic major group item: (i)

spending of the budget agencies is within the limits of relevant unspent location allotments; (ii) allocation of location allotments is within the limits of the relevant unused PBU allotments, and (iii) allocation of PBU allotments is within the limits of the relevant unallocated approved budget. Similarly, under the reforms in Treasury all processes are well documented, there are job descriptions for all positions, and staff are trained in their respective duties. AFMIS records revenue in the accounts of the Chart of Accounts and enables budget revenues to be recorded and reported under appropriate classifications. New procedures have been developed for posting and recording revenues and reconciling revenue receipts with bank statements. AFMIS can now produce regular and *ad hoc* reports on revenue performance of the budget for each revenue type and class, for each revenue collection center, for each province, and for each accounting period.

1.120 Internal controls in the central government are currently strengthened by the presence of an independent Monitoring Agent paid for by ARTF that pre-approves requests for reimbursement of recurrent expenditures to be funded by the ARTF. The ARTF finances a large part of the Government’s recurrent budget including civil servant salaries, but not including defense and security expenditures. The Monitoring Agent’s review helps to verify compliance with procedures and witnesses evidence of services or goods received. Defense and security payrolls are reviewed by MoF under a special project on payroll verification (see below on payroll controls).

1.121 **Effectiveness.** The effectiveness of controls – including pre-audit and internal audit – can be inferred from the results of the MoF review of payment requests, form M-16, and the Monitoring Agent’s report on eligibility for recurrent expenditures. The error rate incurred by ministries and agencies in Kabul on the submissions of M-16 (payment requests) to the Treasury has been improving over time (Table 1.3), but non-compliance remains high. The ex-post review by ARTF shows drastic improvements from last year to the current year (Figure 1.1). However, ARTF’s Monitoring Agent finds that capacity and understanding of the control framework remain weak in line ministries.

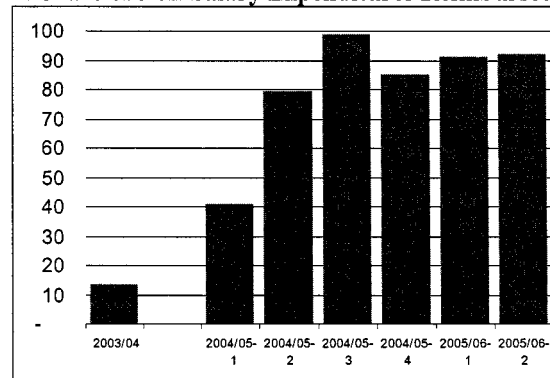
1.122 **Rating 20: 2.** Internal control has several dimensions. An effective internal control system is one that is: (i) based on an assessment of risks and the controls required to manage the risks; (ii) incorporates a comprehensive and generally cost-effective set of controls which address compliance with rules in procurement and other expenditure processes which are widely understood and complied with; (iii) prevents and detects mistakes and fraud; (iv) safeguards information and assets; (v) ensures quality and timeliness of accounting and reporting; (vi) is circumvented only for genuine emergency reasons; and (vii) for which top management takes full responsibility. Evidence of the effectiveness of the internal control system should come from regular audits. Internal control goes beyond formal rules and procedures to include the attitude, awareness, and actions regarding internal control.

**Table 1.3: Error Rate on Submissions to Ministry of Finance**

	2003/04	2004/05
M 16	37.0%	24.0%
ARTF MA	69.4%	34.5%

Source: MoF.

**Figure 1. 1: Share of Non-Salary Expenditures Reimbursed by ARTF**



Source: ARTF Monitoring Agent.

Note: Ratio of non-salary expenditure approved for reimbursement on non-salary expenditure submitted to ARTF.

1.123 The problems with the control environment in Afghanistan can be inferred from the problems with revenue remission to the center by the provinces, confusion with and access to authorized allotments, and general variance from formal rules and regulations. The rating for internal control is “2” because the system consists of a basic set of rules for the processing and recording of transactions which are rather well understood by those directly involved in their application, and which audits indicate are observed in a significant majority of transactions. In particular, effective controls are in place in Treasury with the computerized financial management system. Commitment controls are ad-hoc, manual, and not integrated in the budget, but there is evidence of improving and most recently adequate effectiveness of controls. However, capacity in line ministries remains weak. Finally, the work of the Monitoring Agent forms a key element of the internal controls today, but it should be rendered redundant over time with advances in systems, training, and clarification of the regulatory framework.

***Indicator 21: Effectiveness of Internal Audit***

1.124 **Legal and Institutional Framework.** The Control and Audit Regulation provides for the internal audit function as part of line ministries’ organization and calls for coordination with the external auditors. There is no regulation, however, to support the work of the auditors. Internal Audit Departments exist in 12 major Ministries, including Finance, Defense, Interior, Education, Higher Education, Health, Public Works, Telecommunications, and Commerce. Each Internal Audit Department is organized along similar lines and is under the control of an Audit Director, with separate audit units for relations – to co-ordinate and supervise audit work; planning – to plan audit work; analyses – to carry out analysis of the work done by the audit groups; and audit groups – to carry out the financial and accounting audits.

1.125 **Audit Activity.** Audits are carried out for all entities on an annual basis. Field work in provinces also reveals significant audit activity (see Volume III, Chapter 3). Audit plans are submitted to the Control and Audit Office (CAO) to coordinate effort across departments and prevent duplication of work. A Director in the CAO is tasked with coordinating work with the Internal Audit Departments. Internal audit work is focused on the identification of irregularities and the investigation of potential corruption and fraud. When a potential crime is identified, cases are passed to the Attorney General for legal action. Summaries of audit results are submitted to CAO for information. However, audit plans are not based on risk-related factors. Reviews of internal control processes are not carried out, so the external audits carried out by CAO place no reliance on the work done by the Internal Audit Departments.

1.126 Despite this lack of activity, the ARTF Monitoring Agent provides reports to MoF with data on performance of line ministries with regard to fiduciary standards. Even though this mechanism should be seen as temporary, it provides feedback to management on performance and progress in meeting these fiduciary standards, and shows that actions have been taken as a result of that. There is Government response and follow-up on the observations of the Monitoring Agent to address specific uses of budget funds which were disallowed, and also on the trends in quality of submissions which are tracked by unit.

1.127 **Audit Capacity.** All Internal Audit Departments recruit staff from within their own Ministries. It is common for Internal Audit staff to have in excess of 20 years' experience within the ministry concerned. Ministries carry out training themselves mainly through the use of internal seminars to discuss problems and resolve issues. No formal academic or professional training for internal audit is available in Afghanistan. Internal auditing manuals do exist, but these are 30 years old and only refer to work methods and not to modern internal audit practices. The level of information technology knowledge and experience in the Internal Audit Departments is very low or non-existent, and there is no attempt to carry out internal audits using computer aided audit techniques.

1.128 The Internal Audit Departments cannot be regarded as independent because they are heavily influenced by the ministries within which they function. They do not carry out work that would be considered to comply with recognized international internal auditing standards.

1.129 Under the new PFEM Law, MoF will establish an internal audit administration and appoint internal auditors in the line ministries; this provision will have to be coordinated with the emerging amendments to the Control and Audit Law. A reform is underway in MoF to reorganize its own Internal Audit Department and those of the line ministries, develop an internal audit regulation, and, at the same time, bring their work into line with international internal auditing practices.

1.130 **Rating 21: 2.** Regular and adequate feedback to management is required on the performance of the internal control systems through an internal audit function (or other systems monitoring function) that is appropriately structured; has adequate independence, breadth of mandate, and power to report; utilizes appropriate professional standards; and reports on systemic issues. Specific evidence of an effective internal audit function would also include assessment and monitoring of error rates in procurement and expenditure transactions, a focus on high-risk areas, reporting on correction rates, reliance by the external auditor on the internal audit reports, and actions taken by management on internal audit findings.

1.131 Monitoring of the internal control system is in place through the extraordinary arrangements relying on the FM Advisor, Procurement Advisor, and Monitoring Agent (even though these operations examine only transactions which are reported through AFMIS and do not formally examine compliance or evaluate the internal control system in the central government). The rating is therefore "2" as some monitoring of the internal control framework is provided by these arrangements.

### **c. Accounting, Recording, and Reporting**

#### ***Indicator 22: Timeliness and regularity of accounts reconciliation***

1.132 Reliable reporting of financial information requires constant checking and verification of the recording practices of accountants; this is an important part of internal control and a foundation for good quality information for management and for external reports.<sup>20</sup>

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<sup>20</sup> In addition to accounts reconciliation, two other types of reconciliation are important. First, reconciliation with line ministries budget figures is critical for application of the segregation of duties between authorization of use of funds, which rests with the line ministry, and recording and custody of funds, which is concentrated in Treasury. Line ministries keep records of both their



1.133 With regard to the reconciliation of bank accounts, the official budget control and accounting records of the Core Budget are those of AFMIS operating under Treasury, which apply the cash basis of accounting. The movement of the TSA in the DAB is now compared daily to the accounting records in an Excel application; however, full automation in AFMIS is yet to be developed. All differences are identified although not all of the corresponding adjustments in the accounting records or DAB records have been effected. Also, the opening balance of this account for the current fiscal year was not reconciled with the DAB balance, so there is no external corroboration for the financial position reported in the financial statements. The unreconciled difference carried forward from prior years is significant, and the required adjustments (or recovery from DAB) are pending. This issue has recently been addressed for the preparation of the 2004/05 annual statements. Procedures have also been put in place for monthly reconciliation of the bank accounts of the Mustoufiats, but reconciliations of provincial accounts remain weak.

1.134 Related to the line ministries and the Mustoufiats records is the issue of cash advances. At any given time, there is \$11 million of outstanding advances to the line ministries for payment to suppliers. Treasury has introduced a system to control these through the use of a holding account and reconciliation of each holding account is done periodically.

1.135 **Rating 22: 2+.** Timely and frequent reconciliation of data from different sources is fundamental for data reliability. This indicator has two dimensions. Along the first dimension, “regularity of bank reconciliations”, the rating is “2” because bank reconciliation takes place at least quarterly, usually within eight weeks after the end of each quarter. Along the second dimension, “regularity of reconciliation and clearance of suspense accounts and advances”, the rating is “3” as the Treasury has established and implemented new procedures by which these accounts are cleared at least annually. The overall rating is therefore “2+”.

***Indicator 23: Availability of information on resources received by service delivery units***

1.136 All public spending in the central Government is subject to the budget, which is expressed in appropriations and authorized through the allotment process under the responsibility of MoF. For the Core Budget, there is good information on what resources are received by provincial departments. This does indicate that funds are being used for the intended purposes and that by and large the budget is made available to the authorities under the appropriations.

1.137 While the reporting on actual uses of funds is available and reliable, the supply of funds to front-line service units is undermined by problems with the allotment procedure (see above). As a result, the distribution of resources to provincial offices for non-salary items is delayed and often affected by discretion applied at the Mustoufiat level. Information on the receipt of resources by service units (at the facility or district level) is often lacking. Front-line service units (e.g. primary schools) have little or no information on resources allocated to them (beyond employees). A small public expenditure tracking was piloted in the education sector under the World Bank Public Finance Management Review (see

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direct revenue, which is deposited into the TSA, and expenditure payments authorized via forms M-16. The accounting of these in AFMIS, however, originates in Treasury for Kabul operations and with the Mustoufiats for provincial operations. Treasury circulates a report of revenue and expenditure from AFMIS to all line ministries monthly and follows up on the replies for reconciliations. Average compliance by the Ministries is 70% for expenditures and 80% for revenues. Second, it is also important to reconcile revenue and debt. Revenue collected through the Mustoufiats, largely deposited directly in DAB, is recorded in revenue suspense accounts in AFMIS when transferred to the TSA revenue account, until the corresponding accounting by exact revenue code is received from the Mustoufiat. Loan transactions reported under the DMU and those recorded in AFMIS are reconciled monthly.

Volume I, Chapter 6 and Volume IV, Chapter 2). Also, communities do not have access to information on budget implementation outside of the aggregated reporting available in Government publications.

1.138 With respect to the External Budget, no verified information is provided by the Government on the extent to which reported disbursements are reaching the beneficiaries. There is no record of these expenditures in the Government accounting, and donor reporting on expenditures is not regulated, monitored, or aggregated for management or external reporting. The Auditor General does not access the external audit reports on the performance of the service delivery contractors financed by the investment operations of the External Budget.

1.139 **Rating 23: 1.** This indicator rates information on the provision of goods and services to front-line service delivery units which were intended for their use. Information on the receipt of resources by service units is critical; it can be provided through the accounting system, if sufficiently extensive, reliable, and timely. Overall, despite good information on Core Budget execution, the rating is “1” because there is no data collection on resources to service delivery units (except the pilot expenditure tracking survey in education).

***Indicator 24: Quality and timeliness of in-year budget reports***

1.140 Information for MoF on budget execution is on-line for Kabul operations because it is processed by the Treasury in AFMIS. Such information is available monthly for provincial operations through the summary report provided by the Mustoufiats, although 30% of this is rolled up with a month’s delay. Revenue from the provinces is recorded in the cash position and to a revenue holding account on a weekly basis. Funds are swept from the revenue accounts, but specific accounts are only assigned after summary reports from the Mustoufiats are received (see above). The Treasury has been posting monthly fiscal reports on its website since March 2005, but they focus on the aggregate fiscal position.

1.141 As noted, line ministries keep their own records of revenue and expenditure based on the requests made for payments by Kabul and from information received from their provincial offices. Reporting to line ministries from AFMIS is done monthly through a report of revenue and expenditure which is followed-up for replies on reconciliations between the line ministries’ own records and AFMIS records. Line ministries are responsible for disseminating this information to their secondary budgetary units.

1.142 Effective reporting is hampered, however, by the delay in submission of information on transactions effected through the Mustoufiats, because 30% of these are only recorded in the month following the transactions. Revenue is not fully coded until a month after collection. Moreover, for both Kabul and provincial operations, the heavy use of supplier advances distorts the exact timing of the reporting since they are reported as expenditures in the period of the advance and not in the period of the service. Because there is no month-end cut-off, information for a given month may change with entries made long after month-end.

1.143 **Rating 24: 2.** The ability to monitor the budget requires timely and regular information on actual budget performance to be available to MoF to monitor performance and, if necessary, identify actions to get the budget back on track. Line ministries need this information to manage the activities for which they are accountable. The role of MoF is both to effect payment and maintain the primary budget execution records. The line ministry is responsible for reconciling MoF data with their own records. Efforts are being made to achieve effective two-way flow of information between MoF and line ministries.

1.144 The rating is “2” because budget reports, with classification that allows comparison to the budget at some levels and which incorporate expenditure and revenue data, are disseminated in the Government within four weeks after the end of each quarter. Although there are some problems of accuracy (e.g.

when data from a large province is missing), these do not fundamentally undermine the usefulness of the reports, since the sources of inaccuracies (e.g. omissions) are known and can be taken into account.

***Indicator 25: Quality and timeliness of financial statements***

1.145 The 2004 Constitution requires the Executive to report on the execution of the budget in the first semester following the end of the fiscal year. Under the Organic Budget Law, the MoF is responsible for reporting. The system for budget execution reporting is AFMIS under Treasury (since the Accounting Department has been amalgamated with the Treasury).

1.146 ***Timeliness.*** For 2003/04, audited copies of the state budget financial statements were required to be submitted to the Afghan Government's council of Ministers by 20 September 2004. The statements were submitted to and approved by the Council on 27 September 2004, subject to evaluation and approval by the Auditor General. These statements were subsequently revised on 7 November 2004. While the timeliness does not meet the deadlines of the Constitution, improvements were made as compared with the prior year, and the results were in time to be considered in the development of the 2004/05 budget, comparing well to international practice.

1.147 ***Quality.*** External reporting for the Government-implemented Core Budget to the Cabinet (which has final approving authority until the legislature is formed), the donor community, creditors, and the public arises from two separate processes, which are not reconciled. Requisite reports on donor-financed projects, annual audited financial statements, and annual financial reports of donor-financed investment operations are prepared from bank accounts and related supporting expenditure documents and from donor advices on disbursements, which are also duly reconciled to the related bank statements. These accounts are prepared on a modified cash basis in that they reflect operations pertaining to 2003/04 even if cash movement took place after the end of the fiscal year.

1.148 On the other hand, reports on the state budget and financial position are prepared from the accounts in AFMIS, on a cash basis. These are presented in line with international public sector accounting standards, except that they do not reflect donor contributions under direct implementation which, under the standard for cash accounting, are payments by third parties on behalf of the central government. These operations should be presented in a separate column in the financial statements as sources and uses. The difficulty arises in that the Government does not have verified information on the exact uses, although it does have information on the sources.

1.149 ***Rating 25: 2.*** Consolidated year-end financial statements are a critical element of transparency in the system. In addition, the ability to prepare year-end financial statements in a timely fashion is a key indicator of how well the accounting system is operating, and of the quality of the records maintained. A complete set of financial statements (but without information on financial assets and liabilities) was presented to the fiscal authorities within 12 months of year-end. However, given the significance of donor in-kind contributions which are not reflected in the cash statements, the financial statements are not presented fully in accordance with international accounting standards. With the delay in reporting on 2003/04, the quality of the financial statements presented to the highest fiscal authority must be rated "2".

**d. External Scrutiny and Audit**

***Indicator 26: Scope, nature, and follow-up of external audit***

1.150 ***Legal Framework.*** The 1985 Control and Audit Law recognizes the General Control and Inspection Presidency of the Council of Ministers (now the Control and Audit Office, CAO) as the supreme audit institution which is responsible for attesting to the veracity of the annual accounts,

evaluating the performance of the “domestic auditors”, and reviewing the State Owned Enterprises. A Presidential Decree of Oct 17, 2002 established the Control and Audit Office (CAO) to implement the 1985 law and provides that Ministries, offices, banks, enterprises, governmental organizations, and related social organizations will assist the Audit Groups. The Presidential Decree of November 30, 2002 named Dr. Sharif Sharifi as the Auditor General, reporting to the President. In line with the audit law, the CAO audits the “Final Account” of MoF and also undertakes external audits in the provinces.

1.151 Under the 2004 Constitution, the Executive must present to the National Assembly a final account of the prior year’s budget transactions, but there is no provision for an external review of this rendering. The PFEM Law supports the external audit function under the CAO, and a draft external audit law is under preparation.

1.152 **CAO Activities.** To support the fiduciary framework for donor funding to Afghanistan in the immediate post-conflict period, the first World Bank-supported Emergency Public Administration Project funded technical assistance to the CAO through an audit advisor to assist in the conduct of the external audits of the ARTF, LOTFA, investment operations administered by the Government, and state budget financial statements. This has enabled the CAO to upgrade the capabilities of its staff and to complete the audit of these operations in 2003/04 to international standards, except for the state budget review of 2003/04 where the opinion does not follow international standards of auditing. The Auditor General offered an opinion with qualifications on the statements of the ARTF relating to issues on bank reconciliations in 2003/04 and 2004/05. The CAO is currently undergoing reorganization as part of the Priority Reform and Restructuring (PRR) program within the framework of a special salary re-structuring already granted to the CAO by the President. Since 2002, most senior staff in the organization have been replaced, more qualified persons have been recruited at lower levels, and there are plans to increase staff from 160 to 300 through further recruitment of graduate junior staff in accordance with new selection criteria. Because local graduates with modern accounting knowledge are generally unavailable and also because many of the recruits will have law or other degrees, there is a need for additional professional audit training on entry. There is still inadequate capacity to conduct financial statement audits without the support of the audit advisor.

1.153 **Follow-up on findings.** MoF has been closely involved in responding to CAO audit reports, including the observations in the management letters on World Bank grants and trust funds, especially the multi-donor ARTF. For example, a matrix of corrective measures itemized the actions to be taken following the 2002/2003 audit. Other Ministries, however, are less responsive, and overall only 2% of Government bodies respond to audit reports on their activities. The Auditor General does prepare reports on departments and special reviews which are presented to the Cabinet semi-annually. These reports are not public, and no response or action is offered by the reviewed administrative units.

1.154 **Rating 26: 2.** For the Government to fulfill its fiduciary responsibility, external audit has to be carried out to acceptable standards, with the participation of the audit advisors to plan, supervise, and execute core components of the audit. There should be direct follow-up on audit findings by the Executive, which may include follow-up by MoF and follow-up by the individual audited entity. Evidence of effective follow-up of the audit findings includes the timely reduction in uncleared findings, and the provision by the Executive or audited entity of a formal written response to the audit findings, indicating how these have been and are being addressed. The rating is “2” because over 50% of government expenditures are audited annually, reports are issued within 12 months of year-end, and significant issues are identified. All the financial statement audits include an assessment of internal control systems and reports on systemic issues as well as irregular transactions. The response by MoF to the observations on internal control made in the annual audit of financial statements is thorough and supported by an action plan, whereas responses in other areas on compliance audits are practically non-existent.

***Indicator 27: Legislative scrutiny of the annual budget law***

1.155 The 2004 Constitution provides the legal authority for budget formulation, approval, and execution. As was stated earlier, responsibilities are clearly established between the Government (for formulation) and the bicameral legislature (for approval). However, as the Parliament has only just been formally established, the Cabinet currently approves the national budget through Presidential decree; the decrees are issued by the President, after agreement of the Council of Ministers. Upon the establishment of Parliament, the budget will be submitted through the upper house (Meshrano Jirga) with an advisory comment from the lower house (Wolesi Jirga), although final approval will rest with the lower house. The Constitution (art. 137 and 139) allows linking budget management responsibilities with sub-national administration in the years to come. Importantly, the law also details the procedure for budgetary approval and amendment between MoF, the Budget Committee, and Parliament.

1.156 **Rating 27: 1.** The power to give the government authority to spend will rest with the legislature after this body is convened. If the legislature does not rigorously examine and debate the law, that power is not being effectively exercised and will undermine the accountability of the government to the electorate. A rating of “1” is given since so far legislative scrutiny has not occurred. This rating is obviously temporary as it reflects the absence of a Parliament as of June 2005.

***Indicator 28: Legislative Scrutiny of External Audit Reports***

1.157 The state budget financial statements are formally approved by the Cabinet, but these may be considered before the audit is finalized as was the case in 2003/04, when financial statements were approved by Cabinet but subject to subsequent presentation of the auditor’s report. This does indicate that the auditor’s report on the financial statements is critical to the review by the Cabinet. A formal evaluation of options for developing an overall framework for the scrutiny and follow-up of audit reports based on models in other comparable countries will be made and a system for Afghanistan designed. The Government is planning to form an interim *ad hoc* scrutiny committee to examine responses of heads of agencies to recent audit reports and subsequently to help the National Assembly in forming a Public Accounts Committee.

1.158 **Rating 28: 1.** The legislature plays a key role in exercising scrutiny over the execution of the budget that it approves. A common way in which this is done is through a legislative committee/commission that examines external audit reports and questions responsible parties about the findings of such reports. The operation of the committee will depend on adequate financial and technical resources, and on adequate time being allocated to keep up to date on reviewing audit reports. The committee may also recommend actions and sanctions by the Executive. This indicator is rated “1” since the National Assembly has not yet reviewed the public accounts (as in the case of indicator 27, this rating is temporary).

**e. Indicators of Donor Practices**

1.159 The PFM performance measurement framework includes three indicators reflecting donor practices, measuring: (i) the predictability of direct budget support; (ii) the predictability of donor flows (based on how closely actual aid flows correspond to donor forecasts and the comprehensiveness and timeliness of information); and (iii) the portion of aid managed under national procedures.

***Indicator One: predictability of direct budget support***

1.160 Direct budget support has consisted of two multi-donor trust funds (ARTF and LOTFA) and program loans/budget support operations (from the Asian Development Bank and the World Bank). It should be noted that this rating does not pertain to the amount of budget support provided, its share of total external assistance, or its adequacy in relation to national external funding requirements; instead it rates whether the budget support that is provided occurs in a predictable manner.

1.161 ***Rating One: 4.*** The rating is “4” as the Government has been able to fully rely on these sources, ARTF in particular, to meet its recurrent budget financing requirements in a flexible and predictable manner. There have, however, been some delays in disbursements from LOTFA due to donor delays in replenishing that trust fund. Moreover, external budget support (from program loans/budget support operations) that the Government has designated for use in financing development projects in the Core Budget also has been predictable on a year-to-year basis.

***Indicator Two: Financial information provided by donors for budgeting and reporting on project and program aid***

1.162 Donors provide significant information to MoF on external assistance. Also, the coverage is estimated to be relatively high, with most donors giving some information to MoF so that the Government can monitor donor activity. However, the main issues are (i) the absence of data on expenditures (most donors only focus on disbursements from their own account to the implementing agency), (ii) concerns often raised about the accuracy and consistency of the data, and (iii) delays in providing information to the Government.

1.163 ***Rating Two: 1+.*** Donor practices can support or hinder PFM in partner countries. This indicator captures two key aspects of donor practices: (i) the extent to which donors provide in a timely manner adequate information to the Government about the funds that are to be provided and on the funds or other forms of development assistance that have been provided, and (ii) the extent to which donors provide quarterly reports. The rating is “1+” because, while there is a good record of providing financial information, for the 2005/06 budget not all major donors provided budget estimates at least three months before the start of the fiscal year.

***Indicator Three: Proportion of aid that is managed by use of national procedures***

1.164 Out of the total public spending of \$3.4 billion in 2004/05, all but \$269 million was donor financed. And of the \$3.4 billion, only \$0.9 billion was Government implemented (Core Budget). These resources flow through accounts controlled by MoF and thus at least partially follow national procedures. The oversight by the Government of the operations implemented under donor responsibility is limited, which MoF recognized publicly (MoF Financial Report in June 2004). From the perspective of budget implementation, some recurrent spending and most public investment occurs outside national budgetary channels and procedures. The Government’s control over planning of total public spending, implementation of public spending, and reporting on its execution is rendered more difficult by the large portion which occurs outside of Government control. Donors are not subject, through their donor agreements, to plan, report, and operate in line with Government procedures.

1.165 ***Rating Three: 1.*** The requirement that national authorities use different procedures for the management of aid funds diverts capacity away from managing the national systems. This is compounded when different donors have different requirements. Conversely, the use of national systems by donors can help to focus effort on strengthening national procedures. The use of national procedures would not mean that donor funds cannot be kept separate from government funds, but that the banking, authorization,

procurement, accounting, disbursement, and reporting arrangements are the same as those used for government funds. The rating is “1” because less than 50% of aid funds to central government are managed through national procedures.

### **C. Sustaining and Strengthening PFM Performance: a Roadmap**

1.166 Afghanistan’s ratings against the PFM performance indicators generally portray a public sector where financial resources are, by and large, being used for their intended purposes as authorized by a budget which is processed with transparency and has contributed to aggregate fiscal discipline. The expenditure and financial position of the resources under the authority of the Government are reported reliably in an understandable format, although there is some uncertainty about revenue reporting. Performance regarding the allocative efficiency across programs and agencies as well as the efficiency of operations is not as good, however.

1.167 Reforms which have contributed to the progress to date have been externally supported, including the commitments under the IMF Staff Monitored Program, the World Bank’s Programmatic Support for Institution Building operations, and externally-supported operational functions and capacity building (in Treasury, Government procurement, and external audit, with IDA’s Emergency Public Administration Projects). The objectives of MoF under these reforms include providing a strong legal foundation for the reforms, extending current systems to line ministries and provincial offices (Mustoufiats), and most important replacing the external operational advisors with core Government capacity over time. Further technical assistance operations are intended to address some of these issues.

1.168 Given that performance most likely would have been rated “1” on all dimensions in 2001 or 2002, this assessment highlights the significant achievements of the last four years. In most dimensions, the ratings are now comparable to other low-income developing countries (for instance African countries). Areas of relative weakness include tax collections (indicators 13-15), as well as legislative oversight (27-28) due to the absence of a Parliament hitherto. Payroll control (18) and predictability of budget-support (D1) are areas of relative strength. The Government is making further progress in improving the PFM system by implementing a number of reforms. A new Public Finance and Expenditure Management (PFEM) Law and a new Procurement Law have been approved by the Cabinet; tax amendments are under implementation; customs and tax administrative reforms are moving ahead; and the MoF is moving ahead with further structural improvements. All these developments are positive.

1.169 MoF has developed a vision to guide it in identifying and implementing a wide range of actions required for strengthening its current functions and capacities and moving forward from the emergency efforts of the last two years toward a modern and effective public financial management organization.<sup>21</sup> Using the ratings of this assessment as a baseline, future progress in improving the performance of the PFM system as a result of continuing reforms can be monitored. The indicators also reveal to the donor community the potential capacity of Government systems to implement the operations which are now occurring outside Government systems. However, the nature of the indicators and the scale of the deficiencies highlighted by the ratings means that measurable progress, in terms of improvements in ratings, is more likely to occur over periods of at least a year and more likely several years rather than on a short-term basis. Moreover, it should be kept in mind that the ratings assess the current situation in which significant external support (both advisory and operational) for the PFM system is being provided to the Government; hence in some areas, future improvements may be manifested not in higher ratings but in maintaining adequate ratings while phasing out external capacity and replacing it with core Government capacity.

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<sup>21</sup> “Afghanistan Ministry of Finance – The Way Forward”, background paper for the World Bank PFM Review.

1.170 Annex 1.1 seeks to provide *a comprehensive, high-level roadmap of policy reforms* required. It is comprehensive in the sense that all areas of PFM are covered. It is high-level in the sense that some concrete next steps for the coming few months are identified, but many actions are less specific and will need to be converted into detailed action plans by the responsible government departments. Finally, the roadmap focuses on policy actions, which means that for the most part it does not cover issues of institutional development, such as training, recruitment practices, pay structures, organizational structures, detailed business processes, specific IT systems, etc. These issues also will need to be addressed and will be closely associated with the overall process of strengthening MoF and other key institutions.

1.171 This roadmap highlights a few critical cross-cutting issues:

- *Enhancing the capacity of MoF is vital to improve PFM performance.* Since MoF is chief custodian of the PFM system, its capacity to develop and implement policies is at the core of this action plan. Progress toward a Five-Year Strategic Plan – initiated in May 2005 – will be key to developing MoF’s capacity and performance.
- *Certain high-level policy and institutional parameters require careful analysis and Cabinet ownership.* The Public Finance and Expenditure Management Law brings some clarification with regard to line ministries’ responsibilities, but more work is required to flesh out these responsibilities (for budget formulation, internal control and audit, extent of delegation, payment authority, commitment and fixed asset controls). With regard to the center / province relationship, the Constitution has established a unitary state: with the exception of municipalities, subnational administration only has the powers that the center delegates to it. Also, in terms of financial management, the system is at present “MoF-centric” in the sense that most budget implementation issues are dealt with directly between provincial departments and Mustoufiats (as opposed to within line ministries). The Cabinet needs to consider whether (and for how long) this is most appropriate, and to fully own the approach chosen.
- *The success of the reform program will also depend on the sustained support of donors.* The content, mode, and capacity-building elements of technical assistance will be very important. It is hoped that discussions around this action plan can help align donor support and identify gaps in assistance.

1.172 The next steps of an effective action plan would include the following: (i) prioritize the actions around a set of mutually supportive measures that are feasible, realistic, and sustainable, and that can generate a step change in PFM performance during each year; (ii) develop support for these reforms (among staff of MoF, the Cabinet and other Government agencies, with the Afghan people, and with the international community); (iii) reinforce the policy agenda with a solid organizational and institutional development plan; (iv) prepare detailed action plans with a clear assessment of technical assistance requirements; and (v) develop a process to monitor actions and performance, review progress, and adjust the program as required.



# ANNEX

## ANNEX 1. 1: ROADMAP TO STRENGTHEN PFM PERFORMANCE

Area	Short-term (Next 6 to 12 Months)		Medium-term (Beyond 6 to 12 Months)	
	Actions	Ind	Actions	Ind
A. Revenue Mobilization	A1. Implement agreed policy decisions on income tax A2. Consolidate / simplify tax measures (reducing small 'nuisance' taxes) A3. Develop revenue projections and publish underlying assumptions as part of budget documentation (see B1)	3, 13, 14, 15	A4. Develop policy proposals for modern tax policy (e.g. consider excise taxes, convert Business Receipts Tax into a simple broad-based consumption tax) A5. Enact modernized tax laws A6. Review and modernize tax policy for municipalities	3, 13, 14, 15
	A7. Improve focus of Large Taxpayer Office and its performance monitoring A8. Develop enforcement powers of customs and revenue administration A9. Strengthen accounting mechanisms of revenue collection	3, 13, 14, 15	A10. Implement 5-year tax plan (and revise as needed) A11. Implement 5-year customs plan (and revise as needed) A12. Prepare and implement plan to modernize revenue collection by municipalities	3, 13, 14, 15
B. Budget Formulation	B1. Strengthen medium term fiscal projections (in particular wage bill, revenues, donor contributions) in light of the ANDS B2. Use clear standard budget definitions in new budget (e.g. cash budget vs. commitments) B3. Define clear criteria for investment program prioritization and establish link to the ANDS and Budget B4. Set budget ceilings for all major sectors based on policy orientation and allocative efficiency (as informed by mid-year review)	12	B5. Deepen link between National Development Strategy and Budget B6. Develop sector strategies and medium-term expenditure framework in selected sectors B7. Roll-out preparation of sector strategies and medium-term expenditure framework B8. Develop monitoring and evaluation system B9. Move gradually toward an output-based budget system and, over the longer-term, a results-oriented system	12
	Strategic, realistic, predictable multi-year framework			

Area	Short-term (Next 6 to 12 Months)		Medium-term (Beyond 6 to 12 Months)		
	Actions	Ind	Actions	Ind	
Comprehensive, fully integrated budget	B10. Enforce requirement to estimate recurrent costs implications of proposed investments for largest investments B11. Further integration of off-budget activities	9, 11	B12. Clarify definitions of ordinary and development budget and present core budget under a fund structure and fully unify classifications B13. Further develop linkages between investments and recurrent costs (starting with key sectors such as education, health and road development) B14. Further integrate external assistance in budget (see below) B15. Develop the budget along policy goals and objectives (program budget) supported by the budget classification B16. Identify poverty-reduction related expenditure in the budget based on functional classification B17. Include data on municipalities in budget documentation B18. Include data on State-Owned enterprises in budget documentation (requires program to strengthen SOE PFM capacity, see D11) B19. Include data on pensions in budget documentation	9, 11	MoF Budget and Treasury  MoF/ Budget, donors
	B20. Introduce new budget calendar (starting early in the year with the budget envelop, e.g. with a Budget Policy Statement, and sending budget circular in advance) B21. Introduce notion of sector ceilings (see B4) B22. Review provincial expenditures by Cabinet and publish the report B23. Solicit input from provinces on 2006/07 budget and review their role on budget formulation B24. Reduce frequency of transfers across budgets and reliance on contingencies	11, 12  11 2, 16	MoF/ Budget (and donors) Cabinet Secretariat	B25. Develop capacity in line ministry to articulate budget proposals (see C26) B26. Continue and strengthen practice of mid-year review  B27. Formalize role of provinces in budget formulation process (encouraging higher participation, including on investment programs)	11, 12  11

Area	Short-term (Next 6 to 12 Months)			Medium-term (Beyond 6 to 12 Months)		
	Actions	Ind	Resp.	Actions	Ind	Resp.
Adequate legislative scrutiny of the annual budget law	B28. Prepare 2006/07 Budget for parliamentary approval, with a focus on enhancing transparency in provincial allotments for both the operating and development budgets	27	MoF/ Budget	B29. Develop support for the Parliament to carry-out informed review of the budget	27	MoF / Budget Committee
<b>C. Budget Execution</b>						
Effective Cash Management	C1. Develop monthly forecast for TSA flows and provincial flows C2. Create Cash Flow Management Committee (Treasury / Budget/ Revenue/ DAB/ MoE) C3. Further consolidate banking arrangements toward TSA	17 17, 19	MoF/ Treasury	C4. Refine monthly cash flow forecasts C5. Introduce cash management and payment scheduling procedures for line ministries and Mustoufiats  C6. Fully consolidate TSA	17, 19	MoF/ Treasury
Effective Debt Management and Guarantees	C7. Conclude review of existing debt C8. Develop external debt strategy	17	MoF/ Treasury	C9. Develop requirements for debt management system consistent with AFMIS architecture C10. Implement debt management system C11. Review internal debt policy ("no overdraft") and link with cash management C12. Develop domestic debt instruments as appropriate C13. Develop and implement policy on guaranteees	17	MoF/ Treasury; DAB Budget; Treasury
Smooth, predictable Budget Implementation	C14. Capture and report expenditure by province under all appropriations (including development budget) C15. Repeat simple survey of arrears at year-end	16 4	MoF/ Treasury (with budget)	C17. Improve allotment system to ensure transparent assignment of scarce resources C18. Develop a strategy for enhancing financial management information systems and implement outcome of system study C19. Initiate roll-out of AFMIS to line ministries and Mustoufiats (see D4 and D5)	16	MoF/ Treasury (with budget)
	C16. Develop an asset registry to be established under each budgetary unit and develop related procedures for incorporating assets received through operations implemented outside the government systems	9		C20. Develop commitment control (processes; regulations; systems) which will form basis for monitoring arrears C21. Develop expenditure tracking surveys C22. Roll-out asset registry to the budgetary units	16, 4 23 9	MoF

Area	Short-term (Next 6 to 12 Months)			Medium-term (Beyond 6 to 12 Months)		
	Actions	Ind	Resp.	Actions	Ind	Resp.
Internal controls	C23. Align MoF control staff with PFEM Law (Financial Controllers to stop pre-approval of expenditure and to be integrated in budgetary units or MoF Internal Audit) C24. Review and streamline internal controls for contracts to speed up implementation while strengthening accountability	20	MoF MoF/ Treasury  MoF, Office of the President	C25. Develop standards of internal control and adopt related PFEM regulations C26. Carry out reforms of line ministries' administrative units and implement the PFEM provisions for Chief Financial Officers	20	MoF/ Treasury  CAO MoF/ Treasury
	C29. Use Monitoring Agent to provide feedback to MoF and line ministries on compliance with fiduciary standards C30. Implement PRR in MoF's internal audit department C31. Carry out training and certification of internal audit staff C32. Develop internal regulation, audit manual, and audit programs for key typical reviews	21	MoF/ Treasury  MoF IA	C27. Roll-out AFMIS for on-line recording and editing to the budget units and Mustoufiats (see D4 and D5) C28. Develop control framework for municipalities C33. Roll-out implementation of MoF's internal audit department reform and annual internal plan	21	MoF IA
Payroll	C37. Expand coverage of Individualized Salary Payments (including pay from the list and payment by bank transfer)	18	MoF Treasury	C34. Develop internal audit activities in line ministries C35. Coordinate all internal audit activity from the MoF C36. Develop internal audit for municipalities  C38. Develop a human resources management system for the budgetary units and means to consolidate information centrally for personnel, pension and other needs (see C18) C39. Extend verified payroll program to whole of national government	18	MoF Treasury
Procurement	C40. Adopt regulations to implement the new Procurement Law (and clarify rules regarding projects in development budget) C41. Establish Procurement Policy Unit	19	MoF / MoE	C42. Line ministries progressively take responsibility for procurement transactions C43. Train private sector in tendering procedures C44. Prepare a needs analysis in respect of product standardization, building codes C45. Establish an independent review mechanism and an appeal mechanism C46. Develop and implement standards of transparency	19	MoF / MoE

Area	Short-term (Next 6 to 12 Months)			Medium-term (Beyond 6 to 12 Months)		
	Actions	Ind	Resp.	Actions	Ind	Resp.
Accounting, in-year reporting Transparent and Accessible External Financial Reporting	D1. Automate reconciliation of government accounting records with banking data, particularly the Treasury Single Account (TSA)	22, 25	MoF/ Treasury; DAB	D2. Develop public accounting standards and clarify role of line ministries (regulations to implement PFEM Law) D3. Enforce use of modern budget classification and increase capacity to issue timely monthly reports D4. Complete roll-out of AFMIS to line ministries for complete and timely in-year reporting D5. Undertake roll-out of AFMIS to Mustoufiats D6. Develop accounting capacity of municipalities D7. Develop accounting capacity of SOEs D8. Move towards modernized accounting standards over time	22, 25	MoF/ Treasury and Budget  MoF/ Treasury / SOE dpt
	D9. Develop the means to capture and report accurately expenditures of donor implemented projects D10. MoF to commit to preparing formal accounting period cut-offs at least quarterly	25	MoF/ Budget with Treasury  MoF/ Treasury	D11. Disclose state enterprises annual financial results and financial position, company objectives, ownership, governance structure and information on employees. All information should be audited. All SOEs (regardless of form of public ownership) should be covered D12. Establish the procedures and requirements for the line ministries for collection, review and follow-up of the external audits of donor implemented projects	9, 25	IARCSC  MoF/ Line Ministries CAO; MoF/ Budget
	E1. Carry-out accounting and auditing certification process for all professional staff E2. Develop audit work of whole-of-Government annual accounts	26	CAO CAO; MoF/IA	E3. Finalize draft and gazette new Audit Law E4. Develop external audit regulation, implement Audit Law E5. Develop external audit of procurement E6. Create Public Accounts Committee and its processes E7. Develop the system for scrutiny and response to audit reports including responses by involved ministries and scrutiny by a Public Accounts Committee of Parliament E8. Develop role of media and civil society in the scrutiny of the budget (formulation and execution)	26, 28	CAO
<b>E. External Accountability, Audit, and Scrutiny</b>						
External Audit						

Area	Short-term (Next 6 to 12 Months)		Medium-term (Beyond 6 to 12 Months)	
	Actions	Ind	Actions	Ind
Donor Funding	F1. Develop medium – term expenditure framework to which donor financial support can respond (see B1) F2. Donors to provide timely information on actual expenditures following Government’s definitions (see D9) F3. Donors to provide information on planned disbursements early in fiscal year	1, D1, D2	MoF  Donors	D3
			F4. Government to regularly publish internal and external assessment of PFM performance  F5. Support enhanced alignment of donor funding for priorities established under the ANDS F6. Donors to further move toward support through Treasury and budget support	MoF  Donors
G. Reform Management	G1. Revise PRR applications for MoF and start implementation; coordinate with Government-wide public administration reform G2. Adopt Government-wide PFM Action Plan G3. Create taskforce(s) to oversee reform process and monitor implementation G4. Develop an approach to communicating on PFM reforms within and outside government G5. Prepare detailed plan by MoF department G6. Plan and initiate training activities		G7. Initiate and roll-out reform of budget and administrative departments in line ministries  G8. Implement public administration reforms  G9. Monitor progress and adjust plans  G10. Continue to implement communications strategy  G11. Continue training activities	

## **PART II. PUBLIC PROCUREMENT FOR DEVELOPMENT EFFECTIVENESS**

### **Executive Summary**

- i. The overriding objective of a national public procurement system is to deliver efficiency and value for money in the use of public funds, while adhering to fundamental principles of non-discrimination, equal treatment, and transparency. Procurement is therefore at the core of the Public Finance Management (PFM) system and contributes greatly to several of its objectives, including efficiency, transparency, and accountability. The state of procurement in Afghanistan suggests that the regulatory framework has been in need of improvement. While fiduciary standards are reasonable (though in need of further improvement), procurement focuses excessively on prices at the expense of quality. In addition, there is a lack of implementation regulations, such as handbooks, operational procedures, and standard contracts. And the absence of monitoring, complaint, and appeals mechanisms weakens the overall performance of the procurement system. The recent passage of the new Procurement Law, and its implementation through specific regulations (currently being prepared), will address many of these issues.
- ii. Besides the legal framework, the first key issue is lack of ownership and a procurement champion in the Government. This is a serious impediment to reform and to inter-Ministerial dialogue. There are a number of obstacles to such ownership, for example: (i) lack of adequate training (both in the public and private sectors); (ii) misunderstanding of the scope of the procurement function (i.e. the belief that only major works or purchases are “procurement”); (iii) inappropriate regulations; (iv) lack of common internal structures to deal with procurement in the line Ministries; (v) lack of communication between trained procurement staff and senior administrators; and (vi) no clear incentives for improvement and ownership.
- iii. A second, related issue is the lack of capacity in the line Ministries, as evidenced by their inability to define and communicate effectively their desired technical specifications in procurements conducted with the assistance of the procurement consultant. Lack of capacity is also evident in the local private sector: while the number of bids is reasonably high, there is limited understanding of and capacity to implement the public procurement rules.
- iv. Finally, a number of mechanisms, such as monitoring of performance, complaints, appeals, procurement audits, are missing, therefore reducing the effectiveness of the procurement system.
- v. Priority actions should include the following:
  - Create a Procurement Policy Unit;
  - Adopt regulations to implement the new Procurement Law
  - Develop and implement a large-scale capacity building program for procurement officers in the Government; and
  - Create a training program for the local private sector to enhance its capacity to participate to bids.

## **A. Introduction**

2.1 As part of the broader review of Afghanistan's Public Finance Management (PFM) system, this assessment of procurement procedures and performance focuses on the legal framework applicable to the conduct of procurement in Afghanistan as well as on the performance of those responsible for applying the procurement procedures. Procurement in Afghanistan is conducted under a multiplicity of procedures of greater or lesser sophistication and by various public and private sector entities. It comes as no surprise, therefore, that performance has been uneven and dependent on the precise procedures which are applied and by whom they are applied.

2.2 The assessment seeks to identify the applicable rules and to assess their appropriateness and suitability for the task of making the most efficient use of the resources available. It further seeks to assess the performance of those responsible for applying the procedures, either within the Government or external agents acting on behalf of the Government. In doing so, this assessment also seeks to take a holistic approach to the procurement environment by investigating both sides of the procurement equation: not only the quality and competence of the purchaser (Government) but also the ability and preparedness of suppliers and contractors to tender for and provide the Government with the goods, works, and services it needs at competitive prices and at satisfactory levels of quality.

2.3 The ultimate objective of this assessment is to guide and assist MoF and more generally the Government in identifying and implementing actions required for strengthening the functions and capacities of those involved in procurement and the procurement function itself. It will also help MoF to move forward from the "emergency" needs and approaches of the last three years of political and economic transition, toward a modern and effective national public procurement system with the emphasis on sustainability and national public and private sector development.

2.4 Section B below outlines the structure of the procurement system as it relates to the budget. Section C reviews the performance of the system, focusing on the portion for which performance data are available (funds channeled through the procurement agent). Section D assesses the national rules and institutions for public procurement. Section E reviews procurement rules for implementation of donor-assisted projects in the Core Development Budget. Section F outlines key issues related to the legal framework and the lack of capacity in the Government. Section G analyzes issues facing the private sector with respect to participating in public procurement. The final section concludes and summarizes recommendations.

## **B. The Budget and Procurement**

2.5 Procurement for expenditures using funds from the national budget will usually be subject to procurement rules set by the Government. Procurement for expenditures using donor funds will usually be subject to the procurement rules of the donor organizations (for example, the World Bank's or ADB's procurement guidelines). This may apply to both loans and grants. A distinction needs to be drawn, however, between donor funds which are used directly and those which are provided indirectly through various budget support mechanisms. In the former case, the funds remain identifiable with the donor organization. In the latter, they become "fungible" and are considered to be an integral part of the national budget. Procurement expenditure using such fungible funds will, absent any agreement to the contrary, be spent according to the procurement rules applicable to the national budget.

2.6 The emergency situation in Afghanistan in the immediate post-conflict period led to a plethora of donor funds and mechanisms for providing and using those funds. This generated confusion, since the

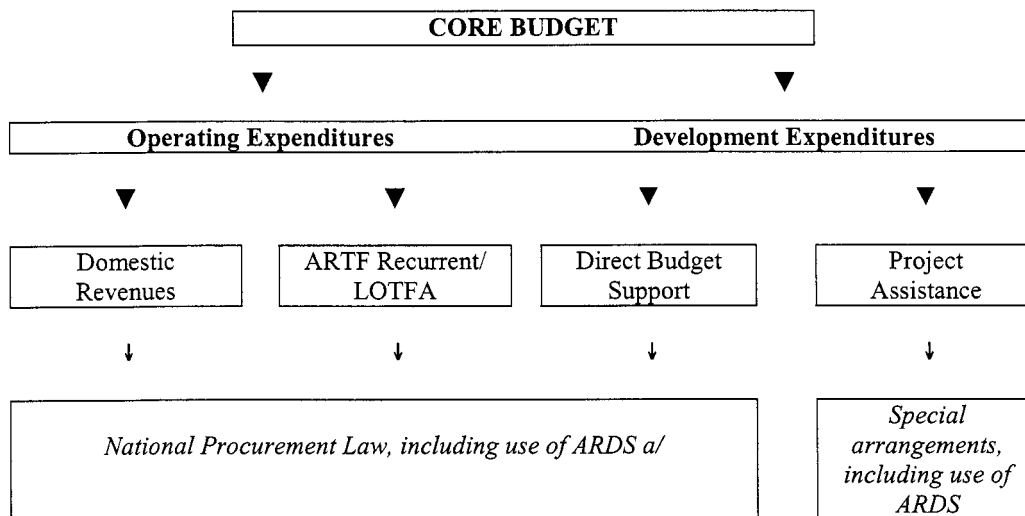


multiplicity of funding sources led to a multiplicity of applicable procurement rules, sometimes in conflict with each other. This resulted in inconsistencies, reduced capacity in the sense that knowledge was dispersed unevenly, and prevented the emergence of a common process capable of being applied consistently throughout the country.

2.7 Afghanistan’s national budget is divided in two parts (see Part I of this Volume). The **Core Budget** includes all funds flowing through the Government’s accounts. Within the Core Budget, expenditures are divided into two broad categories. **Operating expenditures** are primarily recurrent and continuing, and include all civil servants’ wages and pensions, plus goods and services for operations and maintenance (O&M); however, this component also includes some small investment expenditures. These expenditures are financed by both Government revenues and external aid, notably grants through the Afghanistan Reconstruction Trust Fund (ARTF) and the Law and Order Trust Fund for Afghanistan (LOTFA). **Development expenditures** include projects that finance mainly capital goods (e.g. roads), but also some recurrent expenditures such as technical assistance, training, health services, and grants. These expenditures are financed through direct budget support such as the World Bank Programmatic Support for Institution Building (PSIB) and ADB Program Loans and through external project assistance channeled through the Core Budget, mainly IDA or ADB funded projects as well as investment projects financed by ARTF. The **External Budget** includes all external assistance funds not flowing through the Government’s accounts, i.e. those directly disbursed by donors to implementing agencies (Non-Governmental Organizations, private firms).

2.8 The **External Budget** inevitably is subject to the procurement rules applied by the donors, although donors may chose to apply the National Procurement Law provided it is deemed acceptable. **Core Budget** procurement is a more complicated matter, but despite a certain lack of clarity in the practical application of the procurement rules (to be discussed in the various sections below), the procurement implications of the various budget components can, based on the broad categorization given above, be represented schematically by Figure 2.1:

Figure 2. 1: Procurement Implications of Source of Funds



a/ When ARDS mechanism is used, World Bank Guidelines are often used, even if the National Procurement Law applies

2.9 This assessment is concerned with procurement under the Core Budget. As such, it needs to address the various procurement systems which may apply. Because of its crucial role, the assessment will begin with considering the way in which procurement is conducted under the Procurement Agent

(ARDS mechanism). This will be followed by consideration of the national procurement system. Finally, the assessment will consider the procurement rules applicable to external project assistance other than that which uses the Procurement Agent.

2.10 This assessment thus concentrates on the national budget. Some expenditures, however, are made at a lower administrative level. The municipalities have some measure of fiscal autonomy in that revenues collected remain at the municipal level in order to fund municipal expenditures. For non salary expenditures under the national budget, provinces have the authority to make purchases according to the national procurement procedures. That is the same for municipal procurement expenditure. In practice, very little in the way of non salary budget has been sent to the provinces or districts. The issue of provinces and municipalities is reviewed in Volume III, Chapters 3 and 5 of this PFM Review.<sup>1</sup>

## **C. Procurement through the Procurement Agent**

### **ROLE OF THE PROCUREMENT AGENT**

2.11 Following various pledges of donor support for the massive reconstruction and development program required in Afghanistan, mechanisms were put in place to coordinate donor funds and to ensure capacity to procure, disburse, and account for their expenditure. One such mechanism is the Afghanistan Reconstruction Trust Fund (ARTF), which provides financing for priority expenditures including recurrent costs. The ARTF is administered by the World Bank.

2.12 At the same time and to cope with the urgent task of reconstruction, the Transitional Islamic State of Afghanistan (TISA), with the help of the donor community, established the Afghan Assistance Coordination Authority (AACA) in May 2002. Responsibility for the AACA lay with the Ministries of Finance, Planning, Reconstruction, and Foreign Affairs. AACA has since been dissolved (in September 2003), and the part responsible for procurement was renamed Afghanistan Reconstruction and Development Services (ARDS) and made responsible to the Ministers of Planning and Reconstruction, now the Minister of Economy. As the capacity to plan and implement reconstruction projects in the Government ministries was weak, arrangements were quickly put in place to provide 'centralized' technical assistance in such critical areas as financial management, procurement, and auditing.

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<sup>1</sup> Given the constraints in Afghanistan at the time of the missions, it was difficult to collect extensive information regarding procurement at sub-central level. Nevertheless, some visits were possible, which largely provide confirmation of the general impression that the existing regulations are followed. It would appear that the same processes are respected in the provinces, with similar difficulties.

Decentralization of the procurement function is not advanced. While many municipalities and local offices (presidencies) of the various Ministries which operate in the field do conduct their own procurement, that procurement is of very low value. Responsibility for procurement is given only for contracts with a value of a maximum of about Afs 10,000, although in some cases that can be extended to Afs 30,000. In all other cases, officers must seek the approval of the provincial governor. Even then, expenditure will only be authorized by the Ministry concerned in Kabul or, in the case of the municipalities, by the Ministry of the Interior.

National shopping is the most common procurement method at this level, although competitive bidding is not unknown. There is no experience of international competitive bidding given the low value contracts involved. Any large contracts will be awarded centrally. The information collected (by way of interview) suggests that the local officers follow the existing regulations and carry out their duties in the same way as the officers in the purchasing departments of the central Ministries. This means that there is compliance (even if the regulations themselves are inadequate), and it would also appear that local officers understand the importance of the integrity of the process, with actions being taken in the event of conflicts of interest and instances of corruption. However, this work suffers from the absence of any standard bidding documents and are not provided with any systematic or formalized training. What training there is involves on-the-job training, which is likely to perpetuate any inefficiencies that exist. It is clear that, with the new Procurement Law there will be a significant need of re-training at this level.

2.13 Under the “Procurement Strengthening Component” of the IDA-financed Emergency Public Administration Project (EPAP), the Crown Agents was contracted as the country's central Procurement Agent (PA) to put in place emergency procurement capacity to facilitate rapid, transparent utilization of donor resources for reconstruction and development. The PA is not, however, a true agent in the sense that it does not actually purchase on behalf of the Government but rather facilitates purchasing by the Government. The Crown Agents contract became effective on August 15, 2002. It came to an end, following an extension, toward the end of 2004 when a new PA was appointed (RITES India Ltd). The role of the PA is to handle procurement for all goods, works, and services under operations financed directly by IDA, as well as activities financed under the ARTF. In addition, the PA facility can be used (i) for budgetary expenditures from domestic resources and (ii) for the Government-executed expenditures funded by other donors. Where these options are chosen, the implementing agencies would provide technical inputs for the process, but they would not be responsible for any procurement actions during the course of the project. Annex III of EPAP-I provides that procurement under IDA grants will be carried out in accordance with the World Bank’s procurement Guidelines. Similarly, all procurement done under the ARTF Investment Window should follow the Bank's procurement guidelines.

2.14 The scope of the services contracted with the PA originally was limited to the provision of advice and assistance in procurement procedures, even though this would cover nearly 100% of the procurement work of the Government, which would simply be signed off by the Government. In terms of training, the PA was required to carry out a training needs analysis and to develop a framework for training. This all proved to be significantly less than what was required during contract implementation. As a result, the contract was subsequently renegotiated and amended in December 2002 to take into account the increased resources required to cope with the rapidly rising workload and to accommodate a greater focus on capacity building. The contract was further amended to include hiring ten local procurement staff and a National Counterpart Manager. In addition to handling procurement work for IDA and other donor funded items, the updated terms of reference included staff training/capacity building in ARDS and line Ministries and a review/recommendations on the legal and institutional framework. These activities have a significant bearing on the national procurement system discussed in the following section.

## PROCUREMENT SERVICES TO DATE

2.15 The PA has worked mainly on procurement for IDA-financed projects (Table 2.1). It has started work on some ADB and EU projects, and a few applications on projects financed directly by the Government (own resources or budget-support proceedings). As of November 9, 2005, the PA has facilitated Government procurement with the placement of 243 contracts valued at \$496 million. In addition, the PA is working on 151 new contracts with a total value of \$477 million.

**Table 2. 1: Funding by Donor**

Donor	No. of Contracts (in progress / completed)	Value (in Millions of US\$)	No. of demands in preparation/ pipeline	Value (in Millions of US\$)
World Bank	195*	313.0*	52	182
ARTF	29	45.5	74**	91**
ADB	7	125.0	13	158
European Commission	7	1.0	1	1
Danish Aid	3	11.4	1	2
Japanese Social Development Fund	1	0.1	0	0
Govt. of Afghanistan	1	0.5	10	43
<b>Total</b>	<b>243</b>	<b>496.5</b>	<b>151</b>	<b>477</b>

Note: \* includes 1 contract under signature; \*\* includes 55 demands under ARTF funding (around \$16 million) received in November 2005. Source: Procurement Agent.

## STATISTICAL PERFORMANCE<sup>2</sup>

2.16 To assess the performance of these procurement activities, this Volume uses a methodology under development by a group of institutions led by the World Bank and OECD/DAC (Table 2.2). However, not all of the performance indicators developed by this group are used here, because they are designed to be applied to national procurement systems rather than procurement activities for specific donor-funded projects. For example, under a national procurement system it would be expected that a complaints review mechanism would be in place, which allows tenderers to bring complaints against alleged breaches of the national system. No such mechanism applies to donor-funded projects, which instead use prior and post review mechanisms. There is, additionally, the possibility to complain, but this is a rarer occurrence in the case of donor projects as a result of the close monitoring. Nevertheless, one complaint was lodged against the activities of the original PA and was dealt with appropriately (with a finding that the complaint was unfounded).

**Table 2. 2: Summary of Procurement Performance Indicators**

Indicator name	Indicates	Measured by	Satisfactory threshold <sup>3</sup>
Advertisement of bids and publication of awards	Transparency and openness of system	Number of bids (in %) for which invitation to bid and contract award results are publicly advertised	95% or more
Time for preparation of bids	Real opportunity for bidders to submit bids	Number of days between invitation to bid and bid opening	21 days or more for open bidding, 10 days or more for restricted bidding, and 3 days or more for shopping
Time for bid evaluation	Efficiency of bidding process	Number of days between bid opening and publication of award	90 days or less
Bidders participation	Level of confidence of private sector in the process	Average number of bidders submitting bid in each bid process	5 bids or more (calculated as the average for the sample of transactions)
Method of procurement used	Level of competition	Number of bidding processes using a method less competitive than the process recommended for the estimated contract amount.	1% or less
Direct contracting	Transparency and level of competition	Percent of contracts (by number and value) awarded on a sole-source basis	10% or less of number of contracts and 5% or less of total value of contracts
Processes cancelled	Quality of bidding process	Number (in %) of bid processes declared null before contract signature	5% or less
Late payments	Quality and consistency of payment process	Number (in %) of payments made more than 45 days late	10% or less
Contract amount increase	Quality of bidding and contract management	Percentage increase of final contract amount due to changes and amendments	15% or less (calculated as the average for the sample of transactions)
Restricted competition for consultants	Quality of advice	Number (in %) of processes for the selection of consultants using open competition instead of a restricted competition or shortlist methodology	5% or less
Selection method for consultants	Weight of quality to price ratio used in selection	Number (in %) of processes for the selection of consultants having price weighted more than 20% of the total scoring points	15% or less

<sup>2</sup> It should be pointed out that this current assessment applies only to the performance of the original PA, since the replacement PA has not been working on the task sufficiently long for any data to be meaningful.

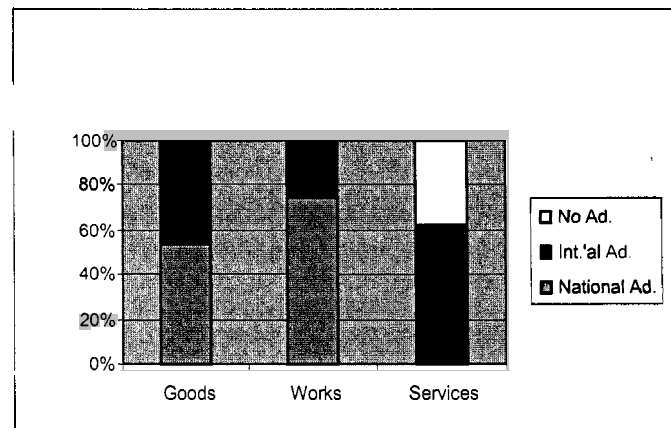
<sup>3</sup> These thresholds values are currently only tentative and not yet approved by the Bank's Board. Even then, they may be amended following a series of pilot projects based on these performance indicators.

### *Advertisement of bids and publication of awards*

2.17 From the available figures, it would appear that, in the case of goods and works at least, all contracts have been advertised either nationally or internationally. With respect to services, around 60% have been advertised internationally, although none appear to have been advertised nationally. It may be that national consultancy contracts had a value which was below the threshold for advertising and did not, therefore, require advertising.

2.18 The 95% threshold has been achieved in the case of both goods and works for advertisement of contracts. However, no contract award has been advertised (this has recently be initiated).

**Figure 2. 2: Advertised Contracts**



### *Time for preparation of bids*

2.19 In the case of consultancy services, there is an average of 44 days for the preparation and submission of proposals, which is satisfactory. No data was available for goods and works, however.

### *Time for bid evaluation*

2.20 The threshold is met in most cases: 76 days for large works (above \$100,000 equivalent), 74 days for large goods contracts (above \$50,000 equivalent), and 30 days for small goods contracts (below \$50,000 equivalent). Only in the case of consultancy services can the time be judged excessive (101 days).

### *Bidders' participation*

2.21 The threshold is achieved only in the case of works, and then only barely (5.3 bidders on average). This is a rather surprising result given the information otherwise collected on the availability of local contractors. The reasons are not clear, but certainly point to a lack of contractor capacity (see below). On large goods contracts (above \$50,000 equivalent), the number is only three, and only 2.5 on small goods contracts. For consultancy services contracts let by a competitive method, the outcome is only three bidders on average.

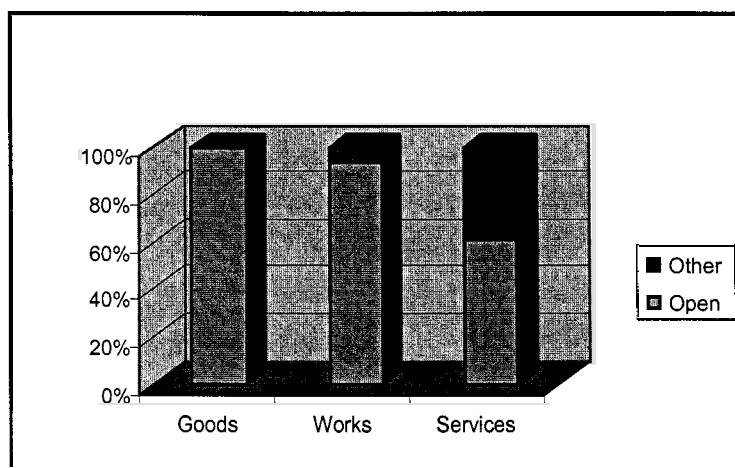
### ***Method of procurement used***

2.22 With respect to the methods used, the open procedure has been used in 100% of cases for goods and in 94% of cases for works. Instances of methods other than open procedure in the case of works arose only in contracts whose value was above the threshold of \$100,000 equivalent which is the trigger for international competitive bidding using Bank guidelines in Afghanistan. Of the eighth above this threshold, two were let by single source method.

2.23 In the case of goods, the threshold was met. In the case of works, it should be recalled that the designed to cover mature systems, and the level of procurement activity in this instance may not be sufficient to enable firm conclusions to be drawn. In the circumstances, this assessment considers that the threshold is also met in the case of works.

2.24 The threshold has not been met in the case of consultancy services contracts, as competitive procedures were used in only 62% of cases.

**Figure 2. 3: Procedures Used**



### ***Direct contracting***

2.25 This was used in 6% of cases in respect of international works contracts (the value of these is unknown, however) and appears to meet the threshold.

### ***Other data***

2.26 No data was available on: Processes cancelled; Late payments; Contract amount increase; Restricted competition for consultants; Selection method for consultants.

### ***Overall Performance***

2.27 Given the post-conflict emergency situation in Afghanistan, the PA has managed to perform its contracted tasks well. However, the overall performance of this arrangement is more nuanced given a number of operating constraints that the PA has faced:

- Lack of appreciation of donor requirements by the counterpart ministries, which have delayed procurement processing.
- Lack of competence of counterpart line ministry staff in providing inputs on the technical aspects/specifications of procurement.
- Lack of procurement knowledge and capacity of counterpart staff, making their participation in any procurement process less effective.
- Non-coherent requirements and procedures of different donors.
- Lack of capacity of the local private sector to follow donor procedures and international best practices in bidding.
- Lack of overall Government ownership in the procurement process.
- Agreements made with technical staff in line ministries being changed by heads of departments.

2.28 At the same time, implementation raised a number of issues with the PA, including that:

- They were understaffed at the outset, leading to delay.
- They should have included more experienced procurement specialists in its team.
- The processing of procurement has sometimes been slow.
- The training courses could have been better designed.
- The training emphasized donor procurement procedures more and current country procurement regulations less.
- They are overly bureaucratic.
- They do not appear to have established a good dialogue with the big procuring ministries, which has not facilitated implementation and has worked against capacity building.

2.29 The constraints and weaknesses identified above indicate that the Government should become both more involved in the procurement process currently conducted by the PA and more educated in procurement matters generally to enable a transfer of functions and capacity.

## **D. Procurement under the National Procurement Law**

2.30 There is much less data available on procurement processed under national procurement rules. The main indicator comes from the ARTF's Monitoring Agent, as one of ARTF's fiduciary standards is the availability of adequate procurement documentation. This indicates very strong improvements (see Part I). However, while the amount of ineligible expenditures is decreasing, approximately a third remains ineligible because of procurement issues.

2.31 In addition to this crude measure of performance, procurement under the existing procurement rules and regulations in Afghanistan may be assessed using the benchmark indicators developed by the group of institutions led by the World Bank and OECD / DAC, the same forum which developed the performance indicators used in the previous section. The purpose of using benchmark indicators is, however, different. These are used to assess the acceptability and appropriateness of the national system. The methodology is based not on a comparison of the national system with any other given set of procurement rules such as the Bank's or other donors' own guidelines, but rather on an assessment of the quality of the system against benchmarks that are designed to gauge whether the objectives of comparable systems and the principles that underlie them are met and whether the methods employed, the organization of procurement, and market conditions are able to meet those objectives and principles. The benchmark indicators provide greater flexibility for countries to achieve an internationally acceptable standard in their own way and taking account of their own particular legal or constitutional environment.

2.32 The benchmark indicators used are set forth in Table 2.3, and the assessment is based on two key assumptions:

- First, the activities of the PA are not taken into account in this exercise because they are not based on the national procurement system but on the Bank’s and other donors’ procurement guidelines.
- Second, the assessment is based on the national rules and regulations in place at the time of the assessment (June 2005, before the adoption of the new Procurement Law). This new Law will bring the legal framework in line with international standards and the indicators for Pillars I and II will be fully achieved. At the same time, it will imply a significant change in the procurement environment and therefore will require a substantial capacity building effort.

**Table 2. 3: Summary of Procurement Benchmark Indicators**

Pillars and Indicators	Assessment <sup>4</sup>
<b>I. Legislative and Regulation Framework</b>	
Indicator 1: Public Procurement legislative and regulatory framework complies with applicable obligations with regard to national and international requirements	2 PA
Indicator 2: Availability of Implementing Regulations and Documentation	1 NA
<b>II. Central Institutional Framework and Capacity</b>	
Indicator 3: Mainstreaming Procedures into Public Financial Management	2 PA
Indicator 4: Functional Normative Body at the Centre	1 NA
Indicator 5: Existence of Institutional Development Capacity	1 NA
<b>III. Procurement Operations and Market Performance</b>	
Indicator 6: Efficient Procurement Operations and Practice	1 NA
Indicator 7: Functionality of the Public Procurement Market	2 PA
Indicator 8: Existence of Contract Administration and Dispute Resolution Provisions	2 PA
<b>IV. Integrity of the Public Procurement System</b>	
Indicator 9: Effective Control and Audit System	1 NA
Indicator 10: Efficiency of Appeals Mechanism	1 NA
Indicator 11: Degree of Access to Information	2 PA
Indicator 12: Ethics and Anti-Corruption Measures	1 NA

Source: Staff assessment.

**a. Pillar I - The Legislative and Regulatory Framework**

2.33 Afghanistan currently has a series of provisions regulating procurement: (i) a Law on procurement of 1987; (ii) a Purchase Regulation adopted as a Decree of the Islamic Emirate of Afghanistan in 2000, both of which apply to the procurement of goods (and routine works and maintenance), and (iii) Rules and Regulations for the procurement of works adopted sometime after 1989 (since this replaces the rules adopted on that date). The Purchase Regulation effectively replaces the Law on Procurement. However, it is very much a copy of the Law with very few amendments, mostly of a religious nature.

<sup>4</sup> The assessment is based on the following measures:

Baseline Achievement	Score	Assessment Key
Fully Achieved (FA)	4	Almost all benchmarks met
Substantially Achieved (SA)	3	Some procedural deficiencies, but most benchmarks met
Partially Achieved (PA)	2	Procedural deficiencies and less than 50% of the benchmarks met
Not Achieved (NA)	1	Serious procedural deficiencies and only a few benchmarks met.



2.34 In general terms, the provisions relating to goods are in need of significant improvement to provide further detail and clarification. Nevertheless, the direction of these provisions is acceptable, if a little confused, suggesting that the concepts of a good procurement system, at least, will not be new. Large-value contracts are subject to competition (national and international) based on open tender following proper advertisement and subject to time limits. Smaller value contracts with international procurement are to be procured via an RFQ (“Request For Qualification”) procedure. The main problems with the provisions are the lack of detail and clarity in the qualification (as opposed to eligibility) requirements, the setting of specifications, drafting of bidding documents and award criteria, particularly with the apparent predilection for negotiation, and the tendency to re-open bidding to attract lower prices.

2.35 In the case of works, the Government is currently operating on the basis of regulations adopted in 1989. The main difficulty with these regulations is that they resemble much more a set of bid and contract preparation guidelines than they do a regulation to ensure competitive bidding. As such, they clearly require significant updating. The regulations provide for open competition through advertisement in the newspaper. But they are inadequate in terms of setting out qualification criteria, requirements as to specifications, award criteria, processes, and minimum time limits.

***Indicator 1: Public Procurement legislative and regulatory framework complies with applicable obligations with regard to national and international requirements***

2.36 Overall, the current legal system offers a reasonable, though confused, framework. The key issues are: (i) regulations are not comprehensive or user-friendly and are in need of considerable modernization; (ii) they over-emphasize prices to the detriment of quality and transparency; (iii) they create the possibility of opening bids before the end of the process; and (iv) they include no complaint review process

*a) Scope of application and coverage of the legislative and regulatory framework*

2.37 Though not stated explicitly in the Purchase Regulation, a number of provisions make reference to the full range of Government entities including Government authorities, municipalities, regional authorities, and state-owned enterprise. There is a clear presumption that the rules apply to these entities. No mention is made of the entities covered by the works regulations. The rules apply to all contracts of whatever value, subject to different procurement methods.

2.38 Procurement of works, goods, and services are all included, although no specific reference to consultancy services is made in the Purchase Regulation which also applies to services more generally. These services are, however, explicitly included within the scope of the works regulations.

2.39 In summary, the basic principles of an acceptable procurement system may be discerned from the applicable legislative and regulatory framework. However, this framework is not well structured, consistent, user friendly, or easily accessible to users and all interested stakeholders.

*b) Procurement methods*

2.40 Overall, acceptable procurement methods are recognizable but not properly defined. Furthermore, the overemphasis on price has a negative impact on quality and possibly technical standards.

2.41 There is a stated preference, in the case of both goods and works, for open, competitive procurement. There appears to be no alternative in the case of works contracts other than in cases of emergency or when the contract is declared secret (by the contracting authority). In the case of goods and services, open bidding is mandatory above certain thresholds and, where these are not met, alternative

procedures such as requests for quotations and direct contracting may only be used in very few, well-defined cases: emergency situations, where the contract has been declared secret by the Council of Ministers, and where spare parts may only be purchased from the original manufacturer.

2.42 The regulations foresee the use of competitive bidding for contract values above Afs 1 million.

2.43 In the case of goods and services, two open procedures are envisaged, although both appear to fall short of international best practice. What is referred to as “open bidding” is effectively a live reverse auction which is held at a determined time and place where the bidders will deposit a sample of their products. “Closed bidding” or “sealed-envelope” bidding approximates more closely to the internationally accepted open bidding procedure and is used (implicitly) in the case of more complex goods and services where the services of an ad-hoc evaluation committee are required. Very little is said, however, about the evaluation process. Where the prices offered by two or more bidders (offering acceptable quality) are the same, they are all asked to submit a further bid, within five days if not all are present. Where bid prices are again the same, the decision is made by lottery.

2.44 In both cases, bidders and non-bidders are given the opportunity of bettering the prices achieved at the live auction or following the sealed bidding process. Whenever another party offers to provide the goods or services at a reduction of at least 15% of the winning price and where the winner does not agree to match that price, the other party will be awarded the contract.

2.45 There is clearly an overemphasis on price to the detriment of quality, which is largely neglected in all of the regulations. The poor quality specifications are frequently criticized by both the public and private sectors.

*c) Advertising rules and time limits*

2.46 Where competitive bidding applies, there is mandatory publication of opportunities for competitive procurement, and the relevant regulations set out acceptable information requirements for publication. Publication takes place more than once in national newspapers and on national radio, and invitations are delivered to Embassies of foreign missions in Afghanistan. There is, however, no central organ for publication.

2.47 The regulations set out minimum time limits in the case of goods and services. These are 10 days in the case of national procurement (which appears a little low) and 2 months in the case of international competition. Where international bidding is used, notices may also be sent directly to bidders.

2.48 Although not explicit, it appears that contract awards are also published but at the expense of the winning tenderer.

*d) Rules on participation and qualitative selection*

2.49 There is a serious lack of rules on qualification criteria. Even if foreign firms are not too heavily penalized, there is a stated preference for State Owned Enterprises (SOEs) that is detrimental to the efficiency of the outcome.

2.50 There are no rules which discriminate directly against foreign bidders in terms of participation or qualification, though there are domestic preferences. Domestic preferences of 15% are applied where the goods offered are of the same quality. Furthermore, if foreign bidders do not have local representatives who are taxed in Afghanistan, their bids are increased, for evaluation purposes, by an additional 8%.

2.51 Even more fundamentally, however, at least in the case of goods and services, there are no indications of what qualification criteria may be used or how qualifications are to be evaluated. The works regulations are marginally better but still do not set out a clear and objective set of qualification criteria.

2.52 Where SOEs operate, procuring entities are obliged to purchase goods and services (including routine maintenance and other works in the case of the works regulations) from such entities even where their prices are higher. The rules state that they may be as high as 10% more, but in practice the price preference for SOEs is often as much as 20% more. SOEs are also exempted from the requirement to provide bid and performance securities in the case of works procurement.

*e) Tender documentation and technical specifications*

2.53 The regulations contain some basic references to the content of tender documentation, but this is not supplemented by any additional guidelines or forms, except in the case of works where these are contained in the regulations themselves.

2.54 Neither set of regulations provides any adequate guidance on technical specifications or the use of standards, international or otherwise. This is also related to broader issues such as lack of capacity and absence of standards: frequent complaints have been made on the level of technical competence of procurement officials and on the general absence in Afghanistan of accepted standards and technical specifications. The result is that evaluations take place in respect of very different products with the resulting absence of a level playing field.

*f) Tender evaluation and award criteria*

2.55 Both sets of regulations state that award should be based on quality and price, although there is no mention of what quality elements may be taken into account. But for several reasons there is an over-emphasis on prices. First, no criteria are mentioned and no mechanism introduced to enable the evaluation of non-price criteria. No procedures are provided to the evaluation committee on the conduct of the valuation, although the works regulations do attempt a rudimentary set of tables which might assist.

2.56 Second, despite the stated combination of quality and price, the remaining provisions of the regulations place emphasis on price, notably in the provisions relating to the live auction and the continuing price bids invited following the sealed bidding procedure. Given the absence of any significant qualification criteria and of consistency in technical specifications, it is difficult to see how awards would be made on anything but lowest price.

*g) Submission, receipt, and opening of tenders*

2.57 Bids are opened publicly (and the auction takes place) at a prescribed time and place. However, the procuring entity has the option to re-conduct bid opening if it is not satisfied with the bids or, in the case of the works regulations, not all bids have been received, which is not acceptable. There are few provisions relating to the conduct of bid opening, and other than in cases where the oral submission of illiterates in the auction procedure is reduced to writing, no requirement to record and keep information disclosed at the bid opening. There is no requirement to keep information confidential.

*h) Complaint review procedures*

2.58 No complaint and remedy procedures are included in the current legislation.

## ***Indicator 2: Availability of Implementing Regulations and Documentation***

2.59 The availability of a series of implementing procurement regulations, such as operational procedures, handbooks, model tender documentation, and standard conditions of contract, is important for correct and consistent application of the legislative and regulatory framework as well as for effective handling of procurement operations.

2.60 None of the following benchmarks have been achieved, in part because of the deficiencies in the legislation itself, and also because there is no organization (policy unit) which is able to provide the necessary assistance in this area (see Pillar II below):

- Implementing regulation that provides defined processes and procedures not included in higher level legislation.
- Model documents for goods, works, and services.
- Procedures for evaluation of tenders and award of contracts.
- Procedures for pre-qualification.
- Procedures for contracting for consultant services, if not defined in high-level legislation.
- User's Guide or manual for contracting entities.
- General Conditions of Contracts for public sector contracts covering goods, works and services consistent with national requirements and international requirements when applicable.

2.61 The State structures are subject to the national provisions, although in some cases such as mining and hydrocarbons there may be specific measures in effect for SOEs.

### **b. Pillar II - Central Institutional Framework and Capacity**

2.62 Modernizing and maintaining a country's public procurement system is an on-going and complex process. It benefits strongly from the existence of a focal point within the Government administration with sufficient capacity and qualifications to manage the procurement system and the monitoring of public procurement implementation. All bodies with legitimate interests in public procurement, such as the contracting entities, private sector entities, the Government, and the judicial system, will require central support of varying nature and degree.

2.63 At present, a critical issue for the Government is the lack of a central body to lead the effort on public procurement reform (i.e. oversee, manage, and support efficient implementation as well as provide leadership in modernizing and maintaining the public procurement system). The issue is the lack of any comprehensive initiative in respect of long-term reform and capacity development (see below).

2.64 While ARDS has been assigned the role of managing the PA contract, it is not designed as a central procurement policy unit. Furthermore, its functions and location are, to a large extent, incompatible with such a role, and it has insufficient capacity to take on such a role. Under the IDA-financed EPAP project, the PA has been starting to carry out activities (such as training, documentation preparation, drafting of a new law, etc.) which would normally fall within the remit of a central policy unit. It has been doing so, however, only in the absence of any Government lead in this sphere, and this is not its proper function.

### ***Indicator 3: Mainstreaming Procedures into Public Financial Management***

2.65 At a basic level, procurement is well integrated in the overall public finance management framework (for instance, adequate procurement documentation is one of the requirements of financial controls). However, due to weaknesses both in the procurement system and in the overall PFM system, procurement processes are not fully integrated in the PFM system.

a) *Procurement planning and data on costing are part of the budget preparation process*

2.66 Budgeting and planning are functions which are not yet fully developed, with budget formulation remaining largely incremental for operating expenditures. Procurement officials state that requisitions are made to the accounting departments as and when necessary and that, if there is sufficient budget available, the requisitions will be approved.

b) *Budget law supports effective procurement, contract execution, and payment*

2.67 It appears that from a formal point of view at least, procurement expenditures are subject to scrutiny ensuring that payments are made only when the correct documentation has been presented. There is an external monitoring agent in place for expenditure from the donor trust fund (ARTF) which monitors payroll and O&M expenditure before reimbursement by the ARTF. However, the monitoring is confined largely to checking the quality and existence of the appropriate documentation used for requesting money, advances, and payment. There is no effort to monitor the effectiveness of procurement, contract execution, and payment. Nevertheless, although control is mechanical, there is a control.

2.68 There has been significant improvement in the eligibility of expenditures for ARTF reimbursement in the last few years. In 2003/04, some 75% of expenditures were rejected by the Monitoring Agent. By the end of 2004/05, that figure was closer to 10% (see above). Of the ineligible, an estimated 30% were due to the procurement procedures. The Monitoring Agent has conducted some 12 workshops each year dealing with the relevant procedures but considers that the improvement has less to do with increased understanding and more to do with strong disincentives to manipulation brought about by the sanction of loss of future budgets tied to ineligible expenditures.

2.69 Similarly, the new Public Finance and Expenditure Management Law makes no mention of procurement activities.

c) *Initiation of procurement operations is dependent on sufficient budget appropriations for the duration of the contract*

2.70 Procurement expenditures will be sanctioned once accounting departments have verified the existence of sufficient funds. There are, however, two limits to this rather strong control. First, there is no commitment recording or control. Therefore, authorization to proceed with a purchase might create arrears if it is later found that there is not enough cash to settle the payment. Second, long-term or multi-annual projects are not taken into account properly in the system. However, most such projects are conducted using donor funds and are not subject to local laws and regulations.

d) *Contract execution is linked to budgetary controls*

2.71 Payment (as opposed to contract execution) is made based on the presentation of the correct documentation and availability of financial allotments. As such contract execution is linked to budgetary controls.

#### ***Indicator 4: Functional Normative Body at the Center***

2.72 The absence of a functional normative body is one of the major issues raised by this analysis. No such body exists at the central level. While the absence of such a body does not necessarily mean that there is no guidance for procurement reform, the clear lack of ownership of the Government for procurement reform means that the reform process has no direction and little substance.

2.73 In a properly functioning system, such a body would have the following features:

- The status and basis for the functional normative body at the center (the Body) would be covered in the legislative and regulatory framework.
- The responsibilities of the Body would address a well-defined set of functions which would include, but would not be limited to: the provision of advice to contracting entities; drafting amendments to the legislative and regulatory framework and implementing regulations; providing oversight and monitoring of public procurement; providing procurement information; reporting on procurement to other parts of Government; developing and supporting implementation of initiatives for improvements in the public procurement system; and providing implementing tools and documents to support capacity development of implementing staff.
- Organization and staffing of the Body and its level of independence and authority (formal power) to exercise its duties would need to be determined in a trustful and credible manner and in a way that is sufficient to implement the responsibilities.
- Responsibilities of the Body would provide for sufficient separation and clarity so as to avoid conflict of interest.

#### ***Indicator 5: Existence of Institutional Development Capacity***

2.74 Overall, institutional development capacity is weak in the following four dimensions.

a) *A system exists for dissemination of procurement information, including tender invitations and tender result information*

2.75 Tender invitations are published in national newspapers, broadcast on national radio, and sent directly to foreign missions in Kabul. However, there is no central system for the collection, publication, and dissemination of such information. The PA is responsible for disseminating tender invitations for the procurements handled by them, mostly donor funded. For new projects, subject to the Bank's latest Procurement Guidelines, the PA is also publishing the tender results as per the requirement. It is unclear whether information on other procurements, not handled by the PA, is available to the general public, as there is no central body or institution which has the responsibility for dissemination of such information for all procurements by the Government. There is no information website. However, the new National Procurement Law requires creation of a procurement website by the Procurement Policy Unit which will ensure dissemination of procurement information, including bidding opportunities, bid results, etc., for all procurement by the Government.

b) *Training, advice and assistance is provided to develop the capacity of Government and private sector participants to understand the rules and regulations and the how they should be implemented*

*in order for the system to provide the required service within the public expenditure management system*

2.76 There is no systematic plan to train procurement officials throughout the Government. The PA provided some limited training programs to procurement officials at the national level. In addition, it provided intensive formal and on-the-job training to 10 national staff - the Procurement Liaison Officers (PLOs) - who are intended to form the core procurement capacity within the Government. Currently, however, these PLOs are used for the purposes of the Procurement Agent and are not integrated within the Government. The national training program reached up to 200 people, but this is inadequate as a national training program. It is unclear what has happened to this training program with the replacement of the procurement agent. Given the lack of central responsibility for the procurement reform process (see above), these initiatives are now well behind schedule.

2.77 One of the tasks of the PA is to provide procurement assistance to line Ministries on request. This process implies, however, that it is the procurement agent which conducts the procurement. This is, indeed, the way in which this facility is being used in practice. This process does not, therefore, develop the capacity of the Government (see also section below on capacity).

c) *Systems and procedures exist for collection and monitoring of national procurement statistics*

2.78 No such system exists.

d) *Quality control standards are disseminated and used to evaluate performance of staff and address capacity development issues*

2.79 No such standards exist. However, there is a plan to develop performance standards as a basis for gradually transferring responsibility for procurement to the line Ministries against milestones achieved. At the outset, these would be based on completion of training programs, but thereafter the performance standards would depend on performance, based on an attestation given by independent attesters (assisted by auditors) and using a benchmarking system.

### **c. Pillar III - Procurement Operations and Market Performance**

2.80 There are some encouraging signs that procurement operations are functioning and that the performance of the market could be good enough. However, lack of data makes the evaluation of performance very sketchy and, by itself, suggests underdevelopment of procurement in Afghanistan.

#### ***Indicator 6: Efficient Procurement Operations and Practice***

2.81 The regulations and processes could support effective procurement practices. However, capacity (both of people and of systems) severely limits the actual efficiency of procurement operations.

a) *The level of procurement competence among procurement officials is consistent with their responsibilities*

2.82 It is clear that most procurement officials are aware of the existing rules and regulations applicable to their functions. There is also an apparent willingness to apply those rules and regulations. The absence of any clear central guidance on the interpretation of these rules and regulations means, however, that procurement officials in different branches of the Government tend to provide their own interpretations, leading to inconsistency and some instances of questionable practices. The difficulties lie

less with the competence and willingness of procurement officials to apply procurement laws than with the inadequacy of the rules themselves. Hierarchical approvals are just that, approvals. Decisions are often taken at high levels, with an overemphasis on price.

b) *The training and information programs implemented for procurement officials, as well as for private sector participants, are consistent with demand*

2.83 There is no evidence to suggest that, other than in the case of the limited training programs initiated by the PA (see indicator 5b), there is any coordinated approach to the dissemination of information in relation to procurement or to the conduct of any training programs whatsoever. This is a neglected area of activity. It is also likely that this inaction is due, at least in part, to the lack of recognition of public procurement as a core activity of Government. This is reflected in the failure of the Government (line Ministries) to benefit from the improved abilities of procurement specialists who have obtained some training through the ARDS program and in the more general the lack of ownership of the procurement reform process.

2.84 A further problem raised by the procurement officials themselves is the severe lack of language skills, which means not only that they are ill-equipped to conduct international competition but also that they are unable, in setting specifications, to take account of standards and specifications which are adopted and used internationally.

2.85 There has been no training of the private sector, resulting in its inability to respond to public calls for competition. Both procurement officials and representatives of the private sector raised this as an issue which needs to be addressed urgently.

2.86 Unusually, procurement training has been taking place in the Ministry of Defense, with the assistance of the US military. With support from independent consultants, it is expected that up to 500 procurement officers will be trained before the end of 2006. This is also being done in cooperation with the US's Defense Acquisition University (DAU), which will ensure recognition of the qualifications achieved (DAU level 4 equivalent).

c) *The existence of administrative systems for public procurement operations, and information databases to support monitoring of performance and reporting to and responding to the information needs of other related Government systems*

2.87 There is no formal system in place to report procurement activities and, as a result, no system for monitoring performance in respect of public procurement activities. On the other hand, requests and authorizations are prepared in writing and kept in files, suggesting that there is at least a paper trail which, with adequate provisions and implementation, could be turned into a record-keeping and reporting system capable of permitting monitoring functions to take place.

d) *The existence and implementation of internal control mechanisms for the undertaking of procurement operations at the contracting level, including a code of conduct, separation of responsibilities as a check/balance mechanism and oversight/control of signature/approval authority*

2.88 There are few internal control mechanisms in place. The only consistent reference is to ex ante budgetary control through the accounting departments of the line Ministries where there is usually a



representative of the MoF.<sup>5</sup> There is no suggestion, however, that this control considers the procurement operations conducted. It appears to be restricted to financial control.

2.89 Procurement contracts are signed by the Minister or Deputy Minister depending on thresholds. Ministers have the authority to approve and sign contracts up to a value of Afs 20 million in the case of the development budget and Afs 7 million in the case of the operational budget.<sup>6</sup> Above these thresholds, contracts are approved by the President. There is no suggestion, however, that this provides any technical control over the procedures used. There is also an approval committee in MoF. The danger with such a committee, at the present time, is that its role and functions appear to cut across the attempt to impose accountability on line Ministries and may confuse the roles of purchaser and regulator.

### ***Indicator 7: Functionality of the Public Procurement Market***

2.90 Despite widespread concerns about insufficient numbers of bidders, there are a number of producers and suppliers in the private sector who could help make the public procurement market work. However, their capacity to follow regulations and submit quality bids is weak. In addition, the private sector has very limited confidence in the system.

- a) *The public procurement market in the country has sufficient numbers of producers/suppliers to provide for competition and comparative pricing for goods, works, and services when compared to prices paid for similar requirements in local, regional, or international markets as applicable*

2.91 There is very little data on which to base the assessment of comparative price, although there is little to suggest that the prices achieved by public purchase are radically different from those obtained privately.<sup>7</sup> However, there is one significant exception (see indicator 1d). It would appear that, where there is an SOE which offers specific products for sale that have the same quality as those offered by private suppliers, Government purchasers are obliged to purchase from the SOE. This appears to happen even where the prices offered are higher than those obtained in the otherwise private market place (up to 20% higher).

2.92 On the other hand, it appears that there is a sufficient number of domestic companies to provide adequate competition for a number of products (see also Section G). Purchasing departments report consistently high numbers of bidders for most large-value contracts, with numbers reaching up to 50 in the case of works maintenance contracts. The tendering base is made up not only of domestic tenderers but also returning Afghans, predominantly from Pakistan. These bring with them capital for investment and some know-how. There is significant technical expertise in some areas, and large returning Afghan companies report no lack of qualified sub-contractors. However, local tenderers face a series of structural difficulties. They are largely unable to offer volume, standardized products as local manufacture to the extent it exists (such as sash or furniture factories) is fragmented. Inputs are largely imported. It was reported that there is some local pipe manufacturing and some quarrying, but little else. This goes for most basic materials (cement, steel, etc) as well as virtually all equipment. The situation is exacerbated by a lack of product standardization and incomplete or non-existent technical specifications. There is little formal structure to domestic contracting or materials supply markets. Industry associations are limited, although there is a chamber of commerce.

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<sup>5</sup> This line of reporting is expected to be changed, see Part I.

<sup>6</sup> These thresholds have recently been increased.

<sup>7</sup> The case of the highway sector is discussed in Volume IV. Chapter 5.

- b) *The quality and consistency of submissions by the private sector to the Government enables the application of the process leading to the award and completion of contracts*

2.93 The problems with the market would appear to be qualitative rather than quantitative: local tenderers face difficulties in meeting the formal (procedural) requirements of the bidding process. There are a number of reasons. First, there has been insufficient training of the private sector in terms of operating within a system of regulated procurement. Training is certainly required in this respect in terms of completing bid forms and preparing tenders. Second, it is clear that procurement officials are unable to adequately set or evaluate technical specifications, qualification criteria, or award criteria. A third issue is the lack of product standardization as noted above.

2.94 While it would appear, therefore, that contracts are awarded according to the (outdated) process currently applied and are completed without too much difficulty, the quality of the requirements set by the public purchaser is fundamentally deficient, leading to unsatisfactory results overall.

- c) *The participation rate of tenderers in response to competitive tender invitations is consistent with the capacity of the marketplace*

2.95 There is no lack of bidders responding to calls for competition. The difficulties lie elsewhere. The private sector's lack of confidence in the legal and regulatory framework governing the procurement process is evidenced by their submission of complaints or protests, through an informal mechanism described consistently by many procurement officials (although none could identify any case which had been filed, let alone any case which had been successful – see below on appeals and complaints mechanisms).

#### ***Indicator 8: Existence of Contract Administration and Dispute Resolution Provisions***

2.96 While there are contract administration provisions, they need to be made more explicit, notably by developing more detailed implementation regulations (which should be done once the new law is approved). There is a lack of dispute resolution mechanisms.

- a) *Procedures are defined for undertaking contract administration responsibilities to include inspection and acceptance procedures, quality control procedures, and methods to review and issue contract amendments in a timely manner*

2.97 In the case of works, these procedures are contained in an annex to the regulations which apply to works contracts. While they are not complete, they are nonetheless based on acceptable provisions found elsewhere. In the case of goods, inspection and acceptance provisions are contained in Purchase Regulation.

- b) *Dispute resolution procedures are included in the contract document providing for an efficient and fair process to resolve disputes arising during the performance of the contract*

2.98 Given the absence of any standard form contracts in the case of goods, there are no such provisions. In the case of works, the standard form contract contained in the regulations themselves includes a very brief dispute resolution clause which calls for amicable settlement in the first place followed by recourse to the courts. No attempt is made to provide a timely and efficient alternative to the court system which is considered to be slow and unreliable.

- c) *Procedures exist to enforce the outcome of the dispute resolution process*

2.99 There is no alternative system to the court procedure and, consequently, no other outcome to enforce. The degree of enforcement of court decisions is unknown, but presumed very low.

#### **d. Pillar IV - The Integrity of the Public Procurement System**

2.100 The overall framework of control and audit is largely centered on financial issues, with little on the performance of procurement activities. The latter should be developed over time, but without developing such controls and audits as a way to second-guess systematically all decisions or to penalize weak capacity. The problems of the anti-corruption commission highlight the risk of an excessive focus on prosecution. This issue is compounded by lack of publicly available information on public procurement and the absence of an appeal mechanism.

##### ***Indicator 9: Effective Control and Audit System***

2.101 There is an effective control and audit system, but it focuses on financial matters.

a) *A legal framework, organization, policy, and procedures for internal and external control and audit of public procurement operations exists and operates to provide a functioning control framework*

2.102 At present, there is a legal requirement that any procurement be audited by the Auditor-General's Office (AGO). The Auditor General's Office has the theoretical power and duty to conduct external audit of the procurement function but has not yet done so other than, in a limited sense, in respect of externally funded contracts. These are currently ex-post controls, with the reports communicated to the President (see Part I).

2.103 There are a number of audit activities, including at the provincial level,<sup>8</sup> but they mainly focus on financial controls. No procurement-specific audits have been conducted at the national level. The AGO is given the power of auditing the regularity of procurement and intends to do so by way of sampling (proposed at 10% of contracts, although it is not yet clear whether they intend to do this by value or by number). During interviews conducted in 2004 with the AGO, it was apparent that there is a lack of capacity within the AGO to conduct audits of procurement. Current training initiatives are concentrated on core audit functions and do not contain any training targeted specifically at procurement *compliance* audits. During interviews, it was also clear that there was no understanding of the difference between *compliance* and *performance* audits and that, were audits to be conducted, it is likely that attempts would be made to second-guess the decisions of procurement officials. This would imply failing to carry out a relatively straightforward compliance audit and replacing it with a corrupted performance audit.

b) *Enforcement and follow-up on findings and recommendations of the control framework provide an environment that fosters compliance*

2.104 There has been some follow-up to financial audits.<sup>9</sup> Since there are no procurement-specific audits, the issue of follow-up is moot..

c) *The internal control system provides timely information on compliance to enable management action*

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<sup>8</sup> See Volume III, Chapter 3.

<sup>9</sup> See Part I of this Volume.

2.105 The exceptional mechanisms set in place by the ARTF (Monitoring Agent) provide timely information on compliance. However, this is not part of the Government's own system, and the internal control system itself does not generate such information.

d) *The internal control systems are sufficiently defined to enable performance audits to be conducted*

2.106 Currently, it is unlikely that even compliance audits are capable of being conducted.

e) *Auditors are sufficiently informed about procurement requirements and control systems to conduct quality audits that contribute to compliance*

2.107 There is a significant lack of capacity in this respect.

#### ***Indicator 10: Efficiency of Appeals Mechanism***

2.108 There is no formal complaints mechanism provided for in the existing rules and regulations. It is reported consistently by those interviewed that there is an informal mechanism which consists of a first-level complaint to the procuring entity which may set up an investigation committee to hear the complaint, followed by a second-level complaint to the "Government". In some cases, it was said to be a complaint to the auditor general whose office had set up a specific committee. This could be followed by a third-level complaint to the attorney-general, although it was not clear whether this could be independent of the decision of the auditor general or whether it was in the form of an appeal from that decision. In any event, this informal mechanism would appear to be hypothetical: none of those interviewed could identify any instance of a complaint having been filed or progressed.

2.109 A proper appeals mechanism would have the following properties:

- The existence and operation of a complaint review system that gives participants in the public procurement system a right to file a complaint within the framework of an administrative and judicial review procedure.
- The decisions are deliberated on the basis of available information and the final ruling can be made by a body with judicial capacity under the law.
- The complaint review system has the capacity to handle lodged complaints efficiently and a means to enforce the remedy imposed.
- The system operates in a fair manner, with outcomes of decisions balanced and justified on the basis of available information.
- Decisions are published and made available to the public.
- The administrative review body is separate from the regulatory body.

#### ***Indicator 11: Degree of Access to Information***

a) *Access to information is supported by publication and distribution of information through available media with support from information technology when feasible*

2.110 There is an official Government gazette which contains information regarding laws, including procurement, but its availability and distribution is unknown. In the case of procurement, there is no information website or other means of accessing information related to procurement. Procurement officials have copies of the rules and regulations but they are otherwise difficult to come by. It is not known whether they are available to the general public.

b) *Systems exist to collect key data related to performance of the procurement system and to report regularly*

2.111 No such systems exist.

c) *Records are maintained to validate data*

2.112 Procurement officials keep a file of the paper requisitions, etc. There appears to be no formal record-keeping requirement, however.

### ***Indicator 12: Ethics and Anti-corruption Measures***

2.113 The procurement system should be perceived to operate with integrity, providing for clear definitions of unacceptable practices and stating the consequences for participants in the procurement system who engage in fraudulent, corrupt, or unethical behavior.

a) *The legal and regulatory framework for procurement, including tender and contract documents, includes provisions addressing the issue of corruption, fraud, conflict of interest and unethical behavior and states actions which can be taken with regard to such behavior (either directly or by reference to other laws).*

2.114 There are no such provisions in the existing legal and regulatory framework. However, the new Procurement Law will provide a strong basis in this area.

b) *Special measures by the Government to prevent and detect potential fraud and corruption in public procurement is addressed in an anti-corruption program*

2.115 Although not specifically referred to, corrupt practices in the context of public procurement would fall within the ambit of recent anti-corruption initiatives. These, however, appear to be inadequate. A new anti-corruption law was introduced in 2004 and is implemented by a senior official in the President's office rather than by a commission or task force. The implementing office was set up only toward the middle of 2004 and suffers from lack of staff and facilities. For the purposes of procurement, there is a serious issue with the law in that it does not distinguish between corrupt procurement practices and mistakes/negligence in applying the procurement law. Any alleged breach of procurement and/or other laws would be perfunctorily investigated and, regardless of hard evidence of corruption (a breach gives rise to a barely rebuttable presumption of corruption), would be sent to the attorney-general for prosecution and the courts would be expected (without guidance) to make the appropriate decision. Despite the stated number of corruption cases before it (60), none were specifically related to procurement. When cases were cited, it was clear even from a first impression that these were cases where a breach of the rules had taken place (at least as a result of incompetence) but where the charge of corruption lacked evidence.

c) *Stakeholders (private sector and civil society) take active measures to support the creation of a procurement market known for its integrity and ethical behaviors*

2.116 There is no evidence that this is the case.

## **E. Procurement under External Project Assistance through the Core Budget**

2.117 IDA and ARTF use the services of the PA (see above). Other donors are increasingly using the same approach, but with variations. For instance, ADB does not apply its normal procurement guidelines to program loans and requires only that procedures generally adhere to principles of economy and efficiency. The only specific requirements are compliance to country eligibility (procurement must originate in a member country) and compliance with negative lists. When using the PA, the arrangements are project-specific. So far, for the procurement related to the roads sector, the PA at ARDS advertises the SPN, issues bidding documents, undertakes bid opening, and evaluates the proposals along with a team from ministry, prepares the evaluation report, and submits to ADB on behalf of the ministry. The same process is followed for the Ministry of Civil Aviation. In the case of energy projects (power transmission), the plan is for the PA to do everything except for evaluation of proposals, which will be handled by staff from Ministry of Energy and Water.

## **F. Addressing Structural Weaknesses**

### **DEVELOPING CAPACITY IN THE GOVERNMENT**

2.118 During its mandate, the original PA, through ARDS, trained more than 100 procurement staff from various ministries. The training was conducted in a three-stage sequential process. Stage 1 represents the most basic level. Stage 2 begins to look at specific procurement rules for goods and works. Stage 3 focused on the process of selection of consultants. Participants received a certificate of completion, but this certificate is not akin to a qualification. The training appears to have been based on World Bank rules rather than on the national system.

2.119 In addition to the more general procurement training program for line ministry staff, 10 individuals were selected for intensive procurement training which included on-the-job training and mentoring with the PA's staff. These 10 individuals are intended to provide core Government procurement capacity which will ultimately assist the line Ministries in building their own capacity. They are known as the Procurement Liaison Officers (PLOs). Currently, the plan is to retain them within ARDS in the short term in order to provide centralized procurement and then to place a number of them in the procurement units to be set up in the key line Ministries pursuant to the new Procurement Law (see below). Their current salaries are significantly higher than those available in the line Ministries. Training of the PLOs began in January 2004 and has resulted in a number of well-trained and competent PLOs.

2.120 Besides the availability of central procurement facilitation services under the ARDS, some of the line ministries have established Program Implementation Units (PIUs), which include international procurement consultants, and all procurements under these line ministries are carried out by its internal experts, involving the Ministries' own procurement staff. This is a possible short-term solution; however, sustainable procurement capacity building will be addressed through the Public Administration Capacity Building Project. This project aims to develop and implement (i) a sustainable nationwide capacity building strategy to take into account the requirements not only of central government but also provincial and municipal government as well as the private sector; (ii) a program to assist and facilitate the achievement of PRR status for a number of key Ministries to be identified; (iii) a plan to transfer procurement capacity and responsibility to line Ministries according to a set of milestones; and (iv) a system of attestation whereby the performance of Ministries can be assessed against identified benchmarks as part of the milestone mechanism.

## LEGAL FRAMEWORK

2.121 A new National Procurement Law has recently been approved. The purpose of this law is to establish an open, transparent, competitive procurement system, based on effective budgetary and expenditure controls and reporting requirements designed to achieve efficiency, economy, the prevention of abuses, and a fair opportunity for participation by all potential contractors, including small enterprises and individuals. In terms of policy, the law has three main features: (i) the creation of a Procurement Policy Unit and a review mechanism; (ii) the introduction of a common organization of the procurement function in all Ministries and Government departments in Afghanistan; and (iii) the introduction of procurement methods and procedures in line with the international standards. The law introduces a number of new approaches and processes; hence its implementation will require significant training.

### G. Private Sector Issues

2.122 Surprisingly, a number of contractors and suppliers of varying capability, including some large companies, can be found implementing works in Afghanistan. Although not well organized and facing constraints related to availability of materials, transportation limitations, power outages, and security concerns, they provide a good base for the implementation of public works and reconstruction.

2.123 Private sector firms include foreign contractors capable of implementing large contracts; some are implementing contracts exceeding \$50 million annually. Many of these companies are owned or managed by Afghans returning from Pakistan, the US, and other countries. Others include Turkish and Pakistani companies seeking opportunities in the Afghan reconstruction boom. Collectively, these firms bring capital, technology, equipment, and skills.

2.124 In addition, there are a significant number of domestic companies offering a range of construction services and products. This is shown in the large number of companies competing for smaller contracts, reaching up to 50 in the case of a recent bidding of works maintenance contracts. These companies offer technical expertise in a number of areas, and the larger firms (returning Afghan companies and others) are able to draw upon them as a source of qualified sub-contractors.

2.125 Three organizations support the structuring of the local contracting industry.

- ***Afghan Builders' Association*** (ABA) is an industry association with a current membership of 160 companies working in all aspects of the construction sector. Membership fees are \$200 per year. It has established links to other international organizations (such as the Turkish Builders' Association) and intends to expand these. Although it is an association of Afghan companies only, it recognizes the business importance of joint venturing and subcontracting with foreign firms. ABA acts primarily as an industry liaison and lobby group but is also involved in capacity building of its members.<sup>10</sup> It maintains a database of its members and classifies them according to capability (see Table 2.4). ABA's planned future activities include establishment of an equipment pool and materials laboratory.

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<sup>10</sup> Capacity building focuses on training for members employees. These include short courses in engineering and management done in cooperation with Kabul University Engineering school and a trades training and certification program consisting of six months of training (classroom theory plus on the job training) in carpentry, plumbing, etc.

**Table 2. 4: ABA Registration and Classification**

Category	Number of Firms	Annual
Category A	20	Large (more than \$50 million)
Category B	32	Medium
Category C	108	Small

Firms are categorized based on turnover, experience, assets, personnel skill levels, and machinery

- *Afghan Investment Support Agency* (AISA), an investment department under the auspices of the Ministry of Commerce, has taken over the company registration system. Approximately 8000 companies were registered by the Ministry of Commerce, and it is an objective of AISA to reduce such registrations to a realistic number. High registration fees are expected to help; they have been set at \$700 for small, \$1,500 for mid sized, and \$2,000 for large companies.
- The *Afghanistan Chamber of Commerce* (ACC) has been operating for eight years. It has 18,000 members, about 25% of which are foreign. ACC is a member of the International Chamber of Commerce, Islamic Chamber of Commerce, and ECO (a regional economic development organization that works in neighboring countries such as Iran and Pakistan as well as Central Asia). ACC fulfills an industry development role, assisting its members through seminars and information dissemination. It also represents its members vis-à-vis the Government on issues of taxation, importation of goods, and development of commercial regulations.

2.126 Contractors and suppliers face a series of constraints and structural limitations. Suppliers are unable to offer volume, standardized product as there is no established manufacturing capacity in areas related to the construction industry (plumbing fixtures, electrical materials, sash or furniture fabrications). This applies also to basic materials such as cement and steel, and to construction equipment. Contractors must therefore rely largely on imported materials, goods, and equipment. Add to this the difficult circumstances of Afghanistan related to security, transportation, and inadequate infrastructure, and the construction environment becomes quite difficult. The following summarizes the concerns reported by the private sector:

- The reliance on imported goods introduces uncertainty of supply related to unreliable importers, transportation constraints, and importation requirements.
- Even when imported, there is a general problem in obtaining quality materials. Cement from Pakistan and Iran were cited as examples. There is a need for local testing facilities.
- For locally produced goods and materials there are concerns about inconsistent quality. The situation is exacerbated by lack of product standardization and incomplete or non-existent technical specifications.
- Trades skills are available locally, but that there is a shortage of management capability and inconsistency of technical skills. There is a need for certification of trades.
- Government procedures are seen as outdated and in need of modernization, especially with respect to payment procedures. Some believe the Government is too focused on price, which is resulting in below-cost bids and the attendant results of low quality.
- There is no suitable bid challenge procedure. Bribery exists, and there is no accepted formal process for lodging complaints.

2.127 In addition to the external constraints identified by the private sector, it also faces internal limitations, especially the smaller locally owned and operated companies. Although there are usually sufficient numbers of bidders involved in procurement, their ability to follow regulations and submit



quality bids is weak. The difficulties relate mainly to compliance with procedural requirements. This is exacerbated by lack of confidence in the public procurement system.

2.128 Not much has happened so far in terms of training the private sector. In January 2004, the Ministry of Commerce facilitated a meeting with the Afghan business community to identify ways in which Afghan participation in donor funded procurement could be enhanced. Little has been done since.

2.129 The following recommendations are put forward to address the constraints facing the private sector and its internal capacity limitations (see the previous section on the public sector side). These recommendations could feed into a curriculum to be developed by the new Procurement Policy Unit and contracted out to firms or institutions specialized in delivering training.

- Development of general business capabilities, to help smaller local contractors with the basics of managing a company.
- Training private sector firms to function within a system of regulated procurement – preparing bids, pricing works, implementing contracts, managing variations, payment procedures, etc. This would include training in Government procurement practices as well as in international best practices and those of the main multilateral and bilateral donors.
- Assistance to develop a system of trades training and accreditation to promote both availability and consistency of skills in the private sector.
- Assistance to develop capability within Afghanistan to secure a reliable supply of inputs (primarily construction materials) and to assess the quality of those inputs. This could include review and possible revision to importation procedures, establishment of a national testing laboratory, and information dissemination on availability, price, and quality of products.

## **H. Conclusions and Recommended Actions**

2.130 The overriding objective of a national public procurement system is to deliver efficiency and value for money in the use of public funds, while adhering to fundamental principles of non-discrimination, equal treatment, and transparency. Procurement is therefore at the core of the Public Finance Management (PFM) system and contributes greatly to several of its objectives, including efficiency, transparency, and accountability.

2.131 This assessment suggests that the rules before the new Procurement Law were not providing an acceptable framework for public procurement in Afghanistan. While fiduciary standards were reasonable (though in need of improvement), procurement focused excessively on prices – at the expense of quality – and absence of a number of monitoring, complaint, and appeal mechanisms weakened overall performance. This means that the donor community, despite its commitment to rely increasingly on national systems, was not able to rely on the national system for procurement of goods, works, and services funded by them. Regardless of the position of the donors, the failure of the current rules to provide a framework which will ensure efficiency and value for money was of serious concern to the Government. With scarce resources, it is imperative to ensure that resources available are spent to the greatest advantage. The new Procurement Law is a significant step toward a modern procurement system.

2.132 Moving forward, the key issues can be summarized as follows:

- There is currently no procurement champion at any level in Afghanistan. This is a serious impediment to reform and to inter-Ministerial dialogue. Ways must be found to create

interest in this reform at the highest political level as well as at the operational level. The creation of a Procurement Policy Unit (PPU) is therefore a very urgent priority.

- There is also clearly a lack of ownership in procurement. In a sense, this was inevitable in the early stages of the reconstruction process. The early stages are now over, however, and thought needs to be given to ways of creating local ownership. A way must be found of moving the procurement function from ARDS and external agents to the Government itself. This is a question of capacity transfer but also a question of creating an appropriate environment for such a transfer in the line Ministries.
- There are a number of obstacles to such ownership, for example: (i) lack of adequate training (in both the public and private sectors); (ii) misunderstanding of the scope of the procurement function (i.e. the belief that only major works or purchases are “procurement”); (iii) inappropriate regulations; (iv) lack of common internal structures to deal with procurement in the line Ministries; (v) lack of communication between trained procurement staff and senior administrators; and (vi) no clear incentives for improvement and ownership.
- One critical aspect of the lack of capacity in the line Ministries is their inability to define and communicate effectively their desired technical specifications in procurement conducted with the assistance of the PA. This needs to be addressed as a matter of urgency, whether coordination continues at the level of the procurement agent or whether responsibility for procurement is transferred to the line Ministries.
- The new law sets out a system of review by a Review Committee chosen from a Standing Review Panel to be established and maintained by the director of the PPU. Again, the desirability of a review mechanisms is not in question. Care needs to be taken, however, that the solution chosen is both appropriate and workable. For any such system to succeed, it is critical to identify a procurement champion in the Government capable of making it work.

2.133 The priority actions should thus be as follows:

- Create a Procurement Policy Unit;
- Finalize regulations to implement the Procurement Law;
- Develop and implement a large-scale capacity building program for procurement officers in the Government; and
- Create a training program for the local private sector to enhance its capacity to participate to bids.

## REFERENCES

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