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ABBREVIATIONS AND ACRONYMS

AACC	Afghan American Chamber of Commerce	IARCSC	Independent Administration Reform & Civil Service Commission
ACD	Afghan Customs Department	IDP	Internally Displace People
AFMIS	Afghanistan Financial Information System	IMF	International Monetary Fund
AICC	Afghan International Chamber of Commerce	ISP	Individualized Salary Payment
AISA	Afghanistan Investment Support Agency	LTO	Large Taxpayer Office
ANA	Afghan National Army	LTU	Large Taxpayer Unit
ANP	Afghan National Police	MAC	Ministerial Advisory Committee
APEM	Afghanistan Pay and Employment Model	MoC	Ministry of Commerce
AREU	Afghanistan Research and Evaluation Unit	MoD	Ministry of Defense
ARTF	Afghanistan Reconstruction Trust Fund	MoF	Ministry of Finance
ASP	Afghanistan Stabilization Program	MoI	Ministry of Interior
ASYCUDA	Automated System for Customs Data	MoJ	Ministry of Justice
BRT	Business Receipts Tax	MRRD	Ministry of Rural Rehabilitation and Development
CIT	Corporate Income Tax	MUDH	Ministry of Urban and Housing
CAWSS	Central Authority for Water Supply and Sewerage	NGOs	Non-government Organizations
DAB	Central Bank of Afghanistan	NSP	National Solidarity Program
DFID	Department for International Development	OECD	Organization for Economic Cooperation and Development
EC	European Commission	O&M	Operation and Maintenance
ECSOE	Evaluation Commission of State-Owned Enterprises	PFEM	Public Finance and Expenditure Management Law
ERO	Economic Restructuring Office	PRR	Priority Restructuring and Reform
DID	District Infrastructure Development	PRT	Provincial Reconstruction Team
DoS	Department of Sanitation	SAF	Securing Afghanistan's Future
FDI	Foreign Direct Investment	SOE	State Owned Enterprises
GDP	Gross Domestic Product	TAFSU	Technical Assistance and Feasibility Study Unit
GPR	General Presidency of Revenue	TIN	Taxpayer Identification Number
HRM	Human Resources Management	TSA	Treasury Single Account
HOD	Head of Department	USAID	US Agency for International Development
IAA	Interim Additional Allowance	VAT	Value Added Tax

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CHAPTER 1. DOMESTIC REVENUES: STRUCTURE, POLICIES, ADMINISTRATION, AND PROSPECTS

"In developing countries, tax policy is often the art of the possible rather than the pursuit of the optimal"[1]

Executive Summary

i. With a revenue to GDP ratio of 4.5% in 2004/05, Afghanistan has one of the lowest revenue effort levels in the world. With many features common to countries with a low tax base (e.g. a large informal and agriculture-based economy, sectors which are difficult to tax), the revenue potential of Afghanistan in the medium-term nevertheless is substantial,probably toward the lower end of the 11-14% range observed in other developing countries.

ii. The current revenue base is very concentrated. Even Afghanistan has one of the most liberal trade regimes in the region, as in other low-income countries customs duties account for more than half the total revenues. And 93% of total revenue is collected by central ministries in Kabul or in just five of Afghanistan's 34 provinces. There are in addition a number of "nuisance" taxes (taxes generating small revenues, expensive to administer, and economically not effective), as well as illegal taxes.

iii. From a policy point of view, the main priority is to implement a number of changes introduced in the income tax and customs codes. New investment tax incentives have been introduced; by replacing tax holidays with accelerated depreciation and unlimited loss carry-forward, Afghanistan has managed to provide incentives for new investment with much less shortcomings (revenue loss and economic distortions) than tax holidays. In the medium term, Afghanistan will have to expand its tax base through the introduction of a broad-based consumption tax. In addition, mineral taxation could provide a substantial source of revenue.

iv. More importantly in the coming years, Afghanistan needs to increase compliance with existing taxes. Some progress has already been made, notably by the creation of a Large Taxpayer Office and the introduction of a system of Treasury Single Account. Forceful implementation of the five-year strategic plans in Customs and in Tax Administration require in particular: (i) substantial civil service and administrative reforms to build a professional cadre of customs and tax officials; (ii) continued implementation of equipment and systems improvements in the customs area (including computerization of the recording and management system); and (iii) a strong focus on the Large Taxpayer Office.

v. A baseline scenario is outlined in this chapter, under which the revenue to GDP ratio reaches 8% in 2010. This assumes gradual implementation of the five-year customs and tax administration reforms and the implementation of existing tax measures. In a high-case scenario, assuming stronger increases in compliance (resulting from faster progress in administrative reforms) and introduction of a broad-based consumption tax, this ratio rises to above 11.5%. On the other hand, under a low-case scenario of weaker reform implementation, this ratio remains below 7% in the medium term.

[1] Tanzi and Zee, (2001).

A. Introduction

1.1 ***Mobilizing domestic revenues in Afghanistan is complicated by the limited tax base and the fragmented economy.*** Many studies have noted the strong relation between revenue, as a proportion of GDP, and the level of GDP. While in industrialized countries the revenue to GDP ratio is typically in the 45-55% range, for the least developed countries the ratio is closer to 20%.[2] Afghanistan's economy shares many of the features associated with a low tax base, including: (i) a large informal sector (often proxied by a low degree of monetization) that tends to imply a narrow tax base; (ii) the dominance of the agriculture sector, which is hard to tax for both administrative and political reasons; and (iii) capacity constraints that hinder the ability of the Government to collect taxes and of the business community and individuals to comply with the regulations.[3] Revenue mobilization is further complicated by the large opium economy that cannot be taxed directly, the need to further consolidate the central government's control throughout the country, and the heavy reliance on donor and NGO funds that may qualify for tax exemptions.

1.2 ***Afghanistan's revenue potential may be toward the lower end of the 11-14% of GDP range.*** One of the most common statistical methods of assessing the appropriate aggregate tax level is to compare the tax level in a specific country with the average tax burden in a representative group of countries (see Tables 1.1 and 1.3 for selected regional and developing country comparisons).[4] Recent studies have suggested that "for low income countries, raising the tax share to at least 15% of GDP should be seen as a minimum objective. International experience suggests that some increases beyond this are certainly reasonable and desirable".[5] In addition, Afghanistan has historically had extremely low levels of domestic revenue mobilization—in the 1970s the domestic revenue to GDP ratio was around 7%, one of the lowest in the world.[6] This method does not attempt to determine the "optimal" level or composition of revenues, and while it may provide a perspective on the need for increased revenue effort it does not provide grounds for setting a specific revenue target. Nonetheless, given the low level of development in Afghanistan and limited natural resources, the current tax potential is likely to be toward the lower end of the range of revenue to GDP ratios in other low-income developing countries.

1.3 ***The significant tax gap suggests that Afghanistan needs to drastically improve its tax administration.*** The tax gap is the difference between the taxes actually paid and the taxes which should be paid according to existing laws and statutes. In Afghanistan, the tax gap is extremely large (as there are few enforcement mechanisms function compliance is largely voluntary and the compliance rates are therefore likely to be extremely low). International experience suggests that the larger the tax gap, the more radical are the changes that are needed.[7] With a tax gap of more than 40% Afghanistan should adopt a strategy that is "quite comprehensive with a complete revamping of the tax administration" to obtain significant improvements in compliance.

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[2] Developing countries with large natural resource sectors, such as oil, tend to have higher tax/GDP ratios.
[3] Keen et al (2004).
[4] Although this statistically based approach has no basis in theory, and choosing the relevant countries is necessarily subjective, it is a commonly used approach in countries like Afghanistan where the statistical base is extremely limited.
[5] Heller (2005)
[6] See World Bank (1978).
[7] See Baer and Silvani's (1997) review of tax administration reforms.

Table 1. 1. Total Tax Collection Performance-Regional Comparison
(Percent of GDP)

Country	1999	2000	2001	2002	2003
Afghanistan	-	-	-	**3.2**	**4.5**
Average 1/	**12.8**	**12.7**	**12.9**	**14.1**	**14.4**
Pakistan	13.1	12.9	13.0	13.5	13.7
India	14.2	14.7	13.8	14.9	15.1
Iran 2/	5.6	5.8	6.3	5.5	5.7
Kyrgyzstan	12.2	11.7	12.4	13.8	-
Tajikistan	11.8	11.5	12.3	-	-
Uzbekistan	35.6	33.2	30.1	29.5	29.6

Source: IMF, Government Finance statistics and staff reports
Notes: Consolidated general government tax revenue.
1/ Excludes Uzbekistan and Iran.
2/ Excludes oil sector revenue

B. Revenue Structure

1.4 ***Revenue mobilization is critical achieving fiscal consolidation.*** Domestic revenues have significantly increased over the last two years from an extremely low base. In 2002/03, they reached $131 million, equivalent to 3.2% of GDP. The Government has progressively reestablished basic control over domestic revenues, particularly in the provinces where there was reportedly considerable leakage through avoidance and illicit charges. In 2003/04, revenue collection reached $208 million, equivalent to 4.5ercent of GDP. In 2004/05, revenue reached $269 million, equivalent to around 4.5% GDP (Table 1.2 and Figure 1.1). The 2005/06 budget projects a modest increase in domestic revenue to $333 million, equivalent to around 4.7% of GDP.

1.5 ***The increase in revenue in 2004/05, compared to the previous year, has been attributed to improvements in the coverage and compliance rates for the main tax categories.*** Major revenue reforms in 2004/05 included arrangements to ensure that provincial revenue is regularly swept into the Treasury Single Account (TSA) and other administrative reforms – such as the simplification of customs procedures, the introduction of a market-based exchange rate for valuing imports, the gradual introduction of customs brokers and the harmonization of corporate tax rates. There has also been a significant improvement in the collection of fees and taxes on goods and services.

1.6 ***The domestic revenue base is concentrated in a relatively small number of taxes*** (see Tables 1.2 and 1.3). Box 1.1 summarizes the major tax instruments currently being used in Afghanistan. As in many less developed economies, import duties are the main source of revenue because they are relatively easy to monitor and collect, comprising over 50% of the total (see also Table 1.3). The pattern is not significantly different from that of the mid-1970s, when around 78% of tax revenue was derived from trade taxes.[8]

[8] See World Bank (1978).

Table 1. 2: Domestic Revenue Collection

	2002/03	2003/04	2004/05
Domestic Revenue (percentage GDP)	3.2	4.5	4.5
Domestic Revenue (Afs)	5,865	10,168	12,812
Domestic Revenue ($)	129	208	269
Domestic Revenue (percentage shares)	na	**100**	**100**
Tax Revenues	na	62	75
Taxes on income, profits and capital gains	na	4	8
Domestic taxes on goods and services	na	3	9
Taxes on international trade and transactions	na	53	57
of which: Import duties	na	52	54
Non Tax Revenues	na	38	25
Admin. fees & charges, non-industrial sales	na	35	20
Central Ministries (percentage shares)	na	**29**	**21**
Provinces	na	**71**	**79**
of which (in percent of total revenue),	na		
Herat	na	41	34
Kandahar	na	7	11
Nangarhar	na	7	12
Kabul	na	5	5
Balkh	na	3	9

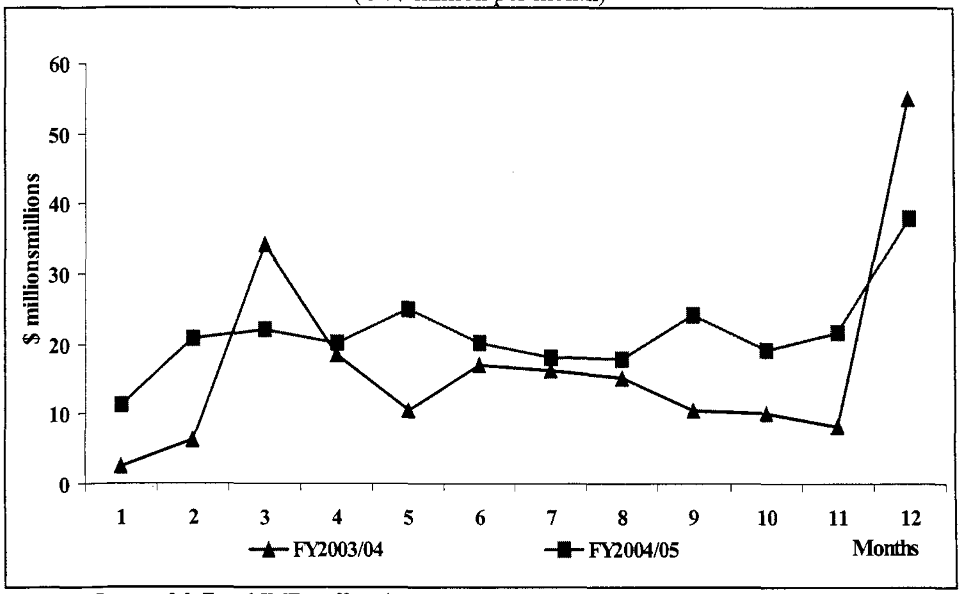
Source: MoF, Fund staff estimates.

1.7 ***More than 93% of total revenue is collected by Central Ministries (mainly in Kabul) and just in five of Afghanistan's 34 provinces***: Herat, Nangarhar, Kandahar, Balkh, and Kabul.[9] Four ministries account for 88% of the total revenue reported by central ministries. These include the Ministry of Finance (MoF), the majority of revenue for which is customs duty collected in Kabul and one-off payments such as over-flight charges ($16 million in 2003/04). The Ministry of Communications derives significant revenue from the sale of telephone services, while the Ministry of Commerce derives revenue from commissions on imported goods and the Ministry of Interior from the registration of motor vehicles. With the exception of the revenues collected by the Ministry of Commerce, whose revenue base should be rationalized in favor of the customs department, most of these revenues are generated in Kabul.

1.8 ***The remaining provinces and ministries either have much lower revenue capacity or suffer from poorer collection rates.*** Many ministries and provinces collect a minimal amount of revenue. With around 90 different active taxes – half of which generated less than Afs 1 million, equivalent to less than $21,000, during FY2004/05 – it is highly likely that the administrative costs of some taxes outweigh the revenue gain.

[9] Afghanistan is a centralized fiscal system and the provincial government refers to a de-concentrated level of central government, rather than to a subnational level. Municipal governments are relatively more autonomous but comprise only a small part of the overall fiscal picture.

Figure 1. 1: Revenue Collection 2003/04 and 2004/05
(US$ million per month)



Source: MoF and IMF staff estimates

1.9 ***There is considerable scope for rationalizing the number of taxes collected to remove "nuisance"' taxes.*** The income tax law provides for a variety of taxes, usually referred to as fixed taxes, which comprise presumptive taxes on small businesses (sometimes expressed as fixed amounts, but also as percentages of presumed turnover), as well as a cascading turnover tax known as the business receipts tax (BRT). The law also identifies 170 tax categories of business establishments. Removing many of these small "nuisance" taxes and simplifying the tax collection system is likely to be cost-effective from the perspective of the revenue authority, and it should also help to promote the private sector. Indeed, it may increase revenues if compliance improves as a result.[10] MoF undertakes a revision of the classifications and rates every three years, and a process of consolidation and simplification is underway.

1.10 ***Illicit taxes and instances of double taxation or ambiguities in the tax laws should also be eliminated.*** The business community has noted numerous instances where illicit taxes have been charged for both customs and domestic taxes, adding to the cost of business.[11] For example, additional "transport taxes" may be levied on the owner of the goods rather than on the transport, and provincial or municipal authorities may charge other ill-defined taxes. The tax authority of the Municipalities (see Chapter 5 of this volume) is also unclear, and there maybe instances of double taxation – for example the central government introduced a new rent withholding tax in 2004, but Municipalities may also collect property taxes. Business organizations have also complained that the legal code is often unclear; for example tax-deductible expenses are often not clearly specified (the tax code specifies "all normal and necessary business expenses") and the interpretation may vary over time and between *mustoufiats*. This lack of transparency and accountability can lead to disputes over the interpretation of the law and is a potential source of administrative corruption.

[10] The removal of such nuisance taxes was a one of the main recommendations of a joint conference of the Afghan American Chamber of Commerce (AACC) and the Afghan International Chamber of Commerce (AICC) in January 2005.

[11] Various AICC reports have documented instances of illicit taxes, double taxation and areas where the law may be interpreted inconsistently or is ambiguities.

Table 1. 3: Central Government Revenues by Group (in percent of GDP)

Country/region	GDP per capita (USD) 1/	Total revenue	Total tax revenue	Total	Corporate	Personal	Total	General sales, turnover or VAT	Excises	Trade	Other
Afghanistan (FY2004/05 est.)	253	5.0	3.2	0.4	0.2	0.1	0.4	0.2	na	2.4	0.1
Sub-Saharan Africa	765	19.7	15.9	3.9	1.9	1.3	7.9	5.5	2.2	1.9	2.2
Asia and Pacific	1,447	16.6	13.2	4.6	2.9	2.0	5.3	2.7	1.9	2.1	1.2
Low-income countries	na	18.0	14.9	3.9	2	1.9	5.9	3.5	2.0	3.7	1.4
Low- middle income countries	na	21.8	15.8	3.8	1.8	2.1	6.3	4.8	2.1	3.6	2.1
Non-OECD average	na	na	15.2	4.5	2.1	2.2	10.1	4.9	2	3.1	na
Selected countries average	na	17.4	14.8	4.8	3.0	1.4	6.4	3.2	2.0	1.9	1.6
Pakistan	420	16.4	12.4	3.0	2.7	0.5	4.7	2.3	2.4	3.6	1.2
Iran	1,700	20.5	8.6	3.3	2.2	1.1	1.8	0.1	1.4	3.2	0.3
India	470	18.5	14.3	2.8	1.5	1.2	8.1	0.0	3.2	2.6	0.8
Kazakhstan	1,520	22.3	18.4	5.4	1.7	2.0	6.2	4.0	0.5	0.6	6.2
Kyrgyz Republic	290	19.1	15.0	3.2	1.1	1.5	11.1	5.4	2.1	0.7	0.0
Azerbaijan	710	20.5	19.4	5.0	1.9	1.5	8.2	3.4	1.5	1.5	4.7
Uganda	240	11.5	10.7	1.8	na	na	4.8	1.2	3.7	1.8	2.3
Rwanda	na	10.4	na	na	na	na	na	na	na	na	na

Sources: Government Finance Statistics (IMF)

Figures refer to country averages 1997-2001, where data is available.

1/ Country data refers to GNI per capita (World Bank)

Box 1. 1: Summary of Major Tax Instruments in Afghanistan

Annex 1.1 details the current structure of taxation, which can be summarized as follows.

Customs duties constitute the largest source of revenue in Afghanistan, as in many developing countries, largely because they are relatively simple to administer. While domestic taxes tend to grow in importance as countries develop, with consumption-based taxes eventually taking on the primary revenue raising role, these are more difficult to administer and will be a long-term objective for Afghanistan. In the interim, the average import tariff should be kept relatively low, with a limited dispersion of rates to reduce arbitrary and excessive effective rates of protection as well as to minimize incentives for corruption. The recent reforms to Afghanistan's tariff schedule should achieve many of these aims.

Export taxes should generally be avoided, since they tend to cause an outflow of resources from the export sector toward less efficient uses, compromising growth objectives. The recent tax reforms have significantly lowered the tax rates for exporters. Following the introduction of the new tariff regime, the Business Receipts Tax (BRT) rate for importers and exporters who are also subject to fixed taxes was set at 0%. In addition, the fixed tax on importers and exporters was lowered to 0.5% for 2004/05.

Income Taxes. Income taxes should ideally be levied on a global basis, and include all forms of income. The corporate and top personal tax rates have been aligned at 20%, which is relatively low by international standards. New collection enforcement powers and penalty provisions are pending. The planned restoration of the wage withholding tax and the simplification of personal tax rates, with only two non-zero personal rates, should help to improve compliance. The level of exemption has been set to effectively remove most civil servants from taxation (and which should ensure a progressive system). The tax brackets need to be regularly reviewed, particularly when inflation is high, to maintain the desired link to relative incomes.

Sales taxes. These taxes should be consolidated as a simple to administer and broadly based tax on final domestic consumption. However, Afghanistan currently has a complex and cascading system of BRTs based on turnover and numerous presumptive (fixed) taxes for smaller traders, which is far from ideal. While a single rate Value Added Tax (VAT), with crediting provisions and zero-rating of exports, is one of the most efficient taxes, it would be administratively too complex to implement at this time. Over the medium-term Afghanistan should expand the BRT toward a more broad-based consumption tax that broadens the tax base and avoids cascading.

Excise taxes. There are currently no excise taxes in Afghanistan.

1.11 ***The Government's strategy should focus on improving compliance for those taxes and locations where the revenue yield appears highest.*** Without undertaking a detailed analysis of economic activity in each province and for each type of tax, which would provide an indication of the underlying revenue potential but is extremely complicated to do in Afghanistan, it is not possible to determine whether the current geographic distribution of revenue collection reflects differences in the underlying revenue potential of each province or varying effectiveness of revenue collection practices. However, improvements that can be made in the effectiveness and efficiency of revenue administration and collection targeted at the current high-yield taxes and in high-yield locations are likely to yield more significant revenue than anywhere else.

C. Revenue Policy and Administration

1.12 ***The ideal tax system is designed to raise revenues required to achieve a sustainable fiscal position while minimizing distortions and is generally perceived as being fair*** (see Box 1.2). The tax system should: (i) minimize interference with individual consumption, saving, and investment decisions;

(ii) be relatively simple, transparent, and rules-based to encourage compliance with the limited capacity available and discourage corruption; and (iii) be stable and predictable to reduce the economic costs of uncertainty.

Box 1. 2: Desirable Properties of Revenue Instruments

A central objective of the tax system is to raise revenue to finance government spending, without resort to inflationary financing. The tax system should generate revenue increases (at least in line with the growth in nominal income), without frequent changes in tax rates or introduction of new taxes. Reliance on specific (quantity-based) taxes in times of inflation, or on tax bases that are shrinking in relation to the rest of the economy, should be avoided because they contribute to low tax elasticity (i.e. low responsiveness of revenue growth to economic growth.

Efficiency. Taxes influence relative prices in the economy and, therefore have an impact on the pattern of production, consumption, and income. The objective should be to gradually establish a tax system that minimizes distortions. In practice, efficiency is achieved by levying simple taxes on as broad a tax base as possible and at fairly low and uniform rates. This also implies keeping tax exemptions to a minimum.

Equity. Taxes should be levied in a fair and equitable manner. Vertical equity refers to differentiation of the tax burden according to ability to pay (as measured by income, wealth, or consumption), while horizontal equity refers to equal treatment of those in similar economic circumstances. However, expenditure policy is likely to be a more efficient instrument than taxation for influencing income distribution, through transfers, social services, and targeted social assistance.

Transparency. Tax codes should be clearly drafted, well defined, and easily understood by the tax-paying community. For private investment, it is especially important to have tax rates that are both stable and predictable. Once tax laws are established that can generate buoyant revenue growth, it is preferable to minimize the frequency of discretionary modifications to these laws. If changes are planned over a reform period, taxpayers ideally should know in advance the tax implications of their production and consumption decisions. A simple, transparent tax system is also relatively easy to administer and promotes compliance.

Reasonable tax burden. There are constraints on how much a government can raise in taxes. Too high a tax burden will undermine the system's effectiveness by encouraging tax evasion and distorting the structure of relative prices in the economy. An "acceptable" level will be determined to some extent by public choices concerning the level of government expenditure.

Source: DFID Economists Handbook

1.13 ***Tax policy reform and tax administration reform will be closely linked.*** In designing Afghanistan's strategy for revenue mobilization, consideration needs to be given to the very weak state of the institutions and the extremely limited capacity of the administration to implement policies after the end of the conflict – as reflected in the large tax gap. Tax policy needs to provide a suitably modern framework within which the tax administration can be built. International experience suggests the following guiding principles for administrative reform:[1]

- Reducing the complexity of the tax system, by streamlining the system through reducing the number of taxes, harmonizing rates, reducing exemptions, and eliminating illicit charges and double taxation;
- Encouraging taxpayers' voluntary compliance with new, simplified self-assessment procedures and better taxpayer education;

[1] From Baer and Silvani (1997).

- Differentiating the treatment of taxpayers by their revenue potential, commonly through the creation of a Large taxpayer Office and risk management strategies; and
- Ensuring effective management of the reform.

1.14 ***Customs and tax authorities have both adopted comprehensive five-year reform plans, through 2007 and 2008 respectively.*** The revenue raising function is located in MoF, and responsibilities are divided between the Afghanistan Custom Department (ACD) and the General Presidency of Revenue (GPR), which both report to a Deputy Minister. The ACD is historically a much more distinct entity, with functions that include collection and the management of a customs service. The GPR has traditionally been in charge of domestic taxation policy, with collection being handled by the provincial Treasury office (Mustoufiats). The ACD and GPR are currently implementing comprehensive reform plans that have been designed with, and implementation is being supported by, considerable external technical assistance. The short-term focus is to extend the coverage of customs operations in the provinces, to reform the tax collection system, and to enhance overall compliance. In order to maximize effectiveness, implementation of these reform plans needs to be closely monitored, regularly evaluated, and revised as required. However, MoF currently does not have a steering committee to make strategic decisions and oversee the reform programs, and there appears to have been little monitoring and evaluation of implementation of the plans.

1.15 ***A major complementary reform was the establishment of the Treasury Single Account (TSA) in 2004.*** A TSA is the integration of 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 Ministry of Finance (Treasury) at the Central Bank. The TSA is designed to ensure that all Government revenues, wherever they are collected, are transferred to the central government (once funds have been deposited in provincial revenue accounts they are transferred directly to the Treasury).[2]

1.16 ***Civil service reforms are also required to develop a motivated and skilled cadre of revenue staff.*** The customs and tax administrations face unique challenges in having to collect government monies, which increases the need to address the potential for corruption (corruption can take many forms, from the levying of additional charges to the arbitrary waiving of taxes). A key component of the customs and tax reform programs is the development of professional (dedicated) tax and customs services within the Afghanistan Custom Department (ACD) and the General Presidency of Revenue (GPR). This entails specialized training programs and institutions, a career development structure within the service and, as and when appropriate, a performance-based remuneration system unique to revenue administration needs and conditions of work. These reforms are currently being undertaken as part of the Government-wide Priority Reform and Restructuring (PRR) program that allows the progressive restructuring of the MoF, starting with reorganization of the central policy and management functions.[3]

1.17 ***The ACD and GPR are both in the process of implementing major reform programs that will require further organizational consolidation and will absorb considerable energy and resources.*** To address some of the human resource issues, some countries have adopted a semi-autonomous "revenue agency" model, to enable staff to be recruited, trained, and paid outside of the civil service structure. This

[2] The deposit of all revenue into the TSA is a separate issue from the question of earmarking. Even if an agency deposits revenues into the TSA, the Government can still earmark these revenues to the agency's budget. Such earmarking is expected to be a strong incentive for the agency to mobilize resources. However, earmarking breaks the key public finance principle according to which trade-offs should be made between all expenditures: in other words, it distorts expenditure allocations toward potentially non-priority areas.

[3] See also "Afghanistan Ministry of Finance – The Way Forward", background paper for the *World Bank Public Finance Management Review*.

approach may have benefits in terms of freeing the agency from some of the normal budget constraints, weak management, and poor terms and conditions that affect government departments. However, while it is important to provide the right incentives for staff, these benefits can probably be better achieved within the current governance structure and the PRR given the established priorities – like re-creating the headquarters function, consolidating control over provincial revenue collection and improving the reconciliation with Treasury. A change in status might be an additional complication and a diversion of effort in the present situation.

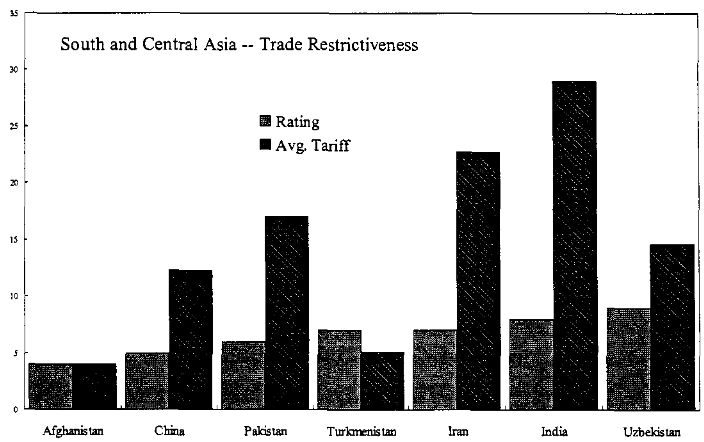
1.18 ***Customs administration reform*** will continue to dominate the revenue mobilization effort over the medium-term. During 2004 the ACD implemented measures to: (i) simplify the tariff system (see Box 1.3), including use of market exchange rates for import valuation and transfer of responsibility for customs valuations from the Ministry of Commerce to the Ministry of Finance; (ii) introduce simplified customs clearance documentation and procedures, including a monitoring system for duty-exempt imports, notably aid-related; and (iii) establish an effective system of customs brokers to facilitate a speedier and more robust transit process (the brokerage system is designed to expedite the clearance process but needs to be carefully supervised by the ACD to ensure that it does not create additional administrative barriers).

1.19 ***Ongoing reforms in the customs area include***: (i) the recently adopted customs code should be implemented; (ii) a major program to improve customs infrastructure throughout the country is being supported by USAID, the World Bank, and the EC; (iii) a computerized recording and management system is being gradually introduced (this is a standard international program for customs, know as ASYCUDA); (iv) the re-organizing and re-building of human capacity in the central and regional customs offices is being supported by an extensive DFID and World Bank funded training program; and (v) legislation is being prepared to establish effective enforcement mechanisms, combined with an effort to reduce illegal charges and to consolidate and rationalize the number of charges being applied.

Box 1. 3: Afghanistan – Trade Regime

Establishment of an open and transparent trade regime has been a consistent priority of the Government – moving in tandem with sweeping reforms the tariff regime and customs administration. The result has been a significant improvement in transparency and simplicity, leaving Afghanistan as one of the most open economies in the region.

Under the trade regime inherited by the transitional government, there were 25 tariff bands, with rates ranging from seven to 150% – with a simple average of about 43%. An overhaul of the tariff system brought the number of rates to six (2.5, 4, 5, 8, 10, and 16%), with a relatively low level of dispersion. By virtue of this rationalization, the average tariff also declined to 4% (weighted by the number of items in each rate category). Even with the addition of a range of "fees" (both legitimate and illegitimate), the estimated average applied tariff is only 5.3% – the lowest in the region. Afghanistan maintains bans on only a few products (largely for religious purposes), and imposes no seasonal restrictions, quotas, or other non-tariff barriers. Furthermore, licensing requirements – reformed effective April 2004 – have been drastically simplified. The import license application process, which previously involved 42 steps, 58 signatures, and several weeks of processing, now involves only three steps, six signatures, and two days to process. As a result, Afghanistan's trade regime currently rates as a "4" on the Fund's Trade Restrictiveness Index, the same as in the EU and the United States (see Figure below).



Notwithstanding these improvements, numerous problems remain. Local administrations in a few provinces reportedly prohibit the use of foreign-owned trucks in their regions, and trucking cartels also increase transit costs. There are also other *ad hoc* fees imposed by local governments, warlords, and commanders, but these appear to be evenly applied to all transport, and not just levied on imported goods. Customs clearance in some areas (for example, in some of the more problematic areas on the border with Pakistan) can also be cumbersome. From a government policy perspective, however, substantial progress is being made to simplify customs administration – including computerization and the introduction of a customs single administrative document.

With regard to international trade policy, the emphasis thus far has been regional – reflecting the potential for immediate gains from facilitating transit trade with such countries as India, Pakistan, and Iran. This process is expected to continue, with the Government of Afghanistan seeking to codify relationships with other neighboring economies. On the multilateral level, Afghanistan has recently initiated the WTO accession process.

Source: International Monetary Fund, Article IV Consultation, January 2005.

1.20 ***The Customs administration faces many challenges in its efforts to meet the expectations of the Government for much needed revenue.*** In this regard, its efforts are hampered by the poor security environment, which reduces access to many parts of the country, in addition to a lack of experienced managers, poorly trained staff, inadequate facilities and equipment and outdated and cumbersome operating policies and procedures. Customs regulations reportedly are not applied consistently throughout the country, and the lack of an automated system undoubtedly impacts negatively on revenue performance.

1.21 ***Tax administration reform (GPR).*** The tax base is likely to remain relatively narrow for some time,, and reforms being implemented will focus on large taxpayers. The current set of reforms includes: (i) the adoption of a tax reform package in June 2004;[4] (ii) creation of a Large Taxpayer Office (LTO) and restructuring of the headquarters and provincial tax organizations; (iii) the nationwide roll-out of a new Taxpayer Identification Number (TIN) to the major provincial centers; and (iv) consolidation of tax legislation amendments to address the excessive use of tax holidays, exemptions and "special agreements" that were in danger of eroding the tax base. Full implementation of the tax reform package and consolidation of tax legislation were severely delayed, partly because of delays in the legislative process.

1.22 ***A focus on large taxpayers can significantly enhance revenues.*** Many countries have found that a small number of taxpayers (perhaps 5%) may account for 75% or more of total tax collection (Table 1.4). This approach has been adopted in many post-conflict countries (e.g. Albania, Kosovo, Liberia, Serbia and Montenegro, Timor-Leste, and West Bank and Gaza). In Afghanistan, the case for establishing a dedicated LTO to monitor, audit, and enforce collection for large taxpayers is further strengthened by the low level of compliance and extremely scarce administrative capacity.

Table 1. 4: Concentration of Domestic Tax Collections in Selected Countries

Country	Number of Large Taxpayers Nationally	As a Percent of Total Taxpayers	Percent of Collections
Australia	50,000	0.50	40
Argentina	2,450	0.25	51
Azerbaijan	1,040	1.00	64
Bulgaria	1,350	0.21	68
Brazil	30,000	0.33	92
Côte d'Ivoire	550	6.25	70
Kenya	600	0.40	61
Mongolia	46	0.20	54
Nicaragua	400	0.67	75
Peru	1,600	0.14	58
Sri Lanka	2,024	2.02	92
Tajikistan	185	0.30	43
Togo	581	2.40	81
Uganda	317	2.10	36

Sources: Dos Santos (1994), IMF 2002 and IMF staff estimates. Iran established an LTO in 2001.

1.23 ***The LTO can also contribute to the longer-term development of tax administration by piloting new systems and procedures, but it may take time for the LTO to become fully functional.*** Afghanistan established an LTO in 2004 within the GPR. However, a fully functional LTO requires a high degree of

[4] This included the reintroduction of a wage withholding tax, introduction of a BRT tax on selected "high-value" services, a reduction in the corporate tax rate to 20% for all businesses, and a new rent withholding tax. See Annex 1.1 for details..

preparation and training to build staff capacity and to establish more efficient procedures. Staff need to develop a sound understanding of the tax laws, regulations, and taxpayer service activities, such as regular visits to client business premises to support improvements in compliance (through both support and enforcement mechanisms). In order to become fully effective, it is important that the newly created LTO focuses on selecting and then developing appropriate relationships with the largest taxpayers. An appropriate selection criteria has been developed by the Government (see Box 1.4).

Box 1. 4: Selecting the Largest Taxpayers

It is important to carefully determine the LTO's clients in order to ensure that scarce resources are effectively targeted toward those taxpayers that will yield the highest revenue. In Afghanistan, criteria have been developed and approved to select the largest taxpayers, estimated at around 100 (in order):

- Foreign-owned entities with capital investments in Afghanistan exceeding US$10 million;
- Foreign-owned entities (not included above) operating in oil and gas, banking and finance, and international air transport;
- State-owned enterprises operating in oil and gas, banking, and air transport; and
- Other entities ranked by annual sales/ turnover (over Afs 50 million or $1 million).

1.24 ***Within about two years, the LTO can be expected to be collecting at least 60% of total domestic tax revenue.*** Within this period the LTO should become fully functional, and operated by officials who have a good knowledge of all LTO large taxpayer clients and the sectors in which they operate. Collection enforcement procedures should be operating effectively, and audit operations based on risk-management principles should have commenced. A higher proportion of total collections can be achieved as the LTO expands its client base, but plans to do so should wait until the office is fully functional. It is also important that the newly created LTO focuses on its main clients and is not diverted to collect revenues from smaller clients.

1.25 ***Reform of the provincial tax offices will require a long-term capacity building effort.*** Although the LTO should in due course start to collect a considerable proportion of total tax receipts, the provincial offices, currently based in the Mustoufiats, will continue to collect a substantial share, which will be important to ensure that taxes are derived from a relatively broad a base. In contrast to the ACD, the GPR has never been the headquarters of the tax administration, as the provincial Mustoufiats report to the Treasury. The GPR was originally conceived as a tax policy body with a revenue analysis and statistics function. However, in order to develop a more professional service the aim of the current Priority Restructuring and Reform (PRR) program for GPR is to build a new tax administration headquarters and operational tax offices in the provinces that report to it. Given the degree to which the physical infrastructure and human capacity have deteriorated in recent years, a sustained effort over many years to build capacity is required.

MOVING TO A BROAD-BASED CONSUMPTION TAX

1.26 ***The current indirect tax system contains serious deficiencies:*** (i) a narrow tax base leading to low revenue yield; (ii) serious potential cascading (albeit generally at a low rate);[5] and (iii) disincentives to export. These features could be addressed in the medium term by moving toward a broad-based manufacturers sales tax in 3 - 5 years, as an intermediate step in moving toward a value-added tax (VAT).

[5] Tax cascading occurs when the tax at one stage of production or distribution is included in the price on which further tax is imposed at later stages of production or distribution. This is sometimes referred to as tax-on-tax.

1.27 ***A broad-based sales tax, which can generate a significant amount of revenue, is likely to be necessary to ensure budget sustainability in the longer term.*** VAT is the most common form of consumption tax imposed by central governments. It is in use in more than 100 countries around the world. The basic characteristics of a VAT are that all persons or businesses, throughout the production and marketing chain that are engaged in the supply of taxable goods and services, are required to register for the VAT and charge VAT on all taxable sales. Their actual liability, however, is only the net of the VAT charged on their sales (output tax), reduced by the VAT paid or payable by them in respect to goods and services purchased for use in their taxable activities (input tax). However, introduction of a VAT through to the retail level represents a radical reform of the tax system and is constrained by the generally low level of record keeping and accounting, so most probably VAT would be a realistic prospect only in the medium-to longer-term.

1.28 ***A single-stage sales tax at the manufacturing level may be a simpler option and could be operated in conjunction with taxes on selected services.*** The phased extension of the recently introduced taxes on selected services could pave the way for development of a broader-based consumption tax as administrative capacity permits. A manufacturing sales tax imposes the tax at the point where goods are first sold in the case of domestically produced goods, and at the point of customs clearance in the case of imported goods. A single tax rate applicable to all goods would be simpler to administer and would not distort relative prices. A single-stage manufacturers sales tax has been employed in many countries, particularly in the earlier stages of their tax development, and can be expanded to further trade levels with a minimum of disruption.

TAXATION AND INVESTMENT INCENTIVES

1.29 ***Granting tax incentives to encourage investment is a common practice in many countries,*** despite the available evidence suggests that their effectiveness in attracting incremental investment (above and beyond that which would have occurred in their absence) is often questionable, and their revenue cost potentially high. For foreign investors, the primary target of most tax incentives – the decision to enter a country – normally depends on a host of factors, such as security, infrastructure, a stable and predictable political legislative/regulatory and macroeconomic environment, and an open trade regime. If these factors are favorable, and the country's tax system is in line with international norms, then tax incentives are likely to play a marginal role at best in influencing an investor's decision.[6]

1.30 ***In 2002, the Government introduced a new investment incentive law, the Law on Domestic and Foreign Private Investment, containing a number of tax provisions.*** The law allowed for tax holidays (both income tax and business receipts tax) for qualified investments by both domestic and foreign investors, for periods ranging from four to eight years from the date of licensing, or three to seven years from the start of production, whichever comes first. Almost 6,000 licenses were granted by the Ministry of Commerce (MoC), without much scrutiny, before approvals were centralized in Kabul under a new organization, the Afghanistan Investment Support Agency (AISA), a corporation under the leadership of MoC.

1.31 ***Tax holidays are one particular type of tax incentive that are widespread in developing countries despite their well known shortcomings.***[7] They basically consist of applying a rate of corporate income tax lower than the regular rate – often zero – to companies in a certain sector or region for some pre-specified period. As with other forms of tax incentives, the main objective of tax holidays is to

[6] For a comprehensive review of tax incentives in developing countries, see Shah (1995).

[7] Furthermore, the practice of granting tax holidays also appears to have grown during the 1990s, particularly among the lowest-income countries (see Keen, 2004, for a limited survey).

increase the overall level of investment, including investment by foreigners. They raise a number of issues:

- By exempting profits irrespective of their amount, tax holidays tend to benefit an investor who expects a high rate of return and hence probably would have invested even if there had been no incentive.
- Tax holidays provide strong incentives for tax avoidance, as taxed enterprises could enter into economic relationships with exempt ones to shift their profits to the latter through transfer pricing. The duration of tax holidays also is prone to abuse.
- Time-bound tax holidays tend to attract (if they have any impact at all) short-run projects, which are typically less beneficial to the economy and could even be a disincentive to long-term investment in the absence of loss-carry forward provisions. In the case of Afghanistan, over 40% of tax holidays granted before mid-2004 were reportedly awarded to construction companies, which should not be considered as "investors" for the purpose of such incentives.
- The revenue cost to the budget is seldom transparent, unless enterprises are required to file proper tax returns and the aggregate fiscal "loss" is calculated. Conservative estimates published by MoF put the revenue loss of the exemptions and concessions granted prior to July 2004 at $14.6 million in 2005/06, with a total of $30.2 million between 2003/04 and 2005/06.
- Tax incentives could be of questionable value to a foreign investor because the benefits may be undone when profits are repatriated, through an increased tax charge in the country of residence. The true beneficiary may end up being the Treasury in the investor's home country.

1.32 ***In 2004/05, the system of tax holidays and exemptions was replaced.*** Considerable concerns had been raised that the previous system was eroding the tax base without encouraging sufficient additional investments. It was also acknowledged that revenue measures are best consolidated within the appropriate tax laws. A new Law on Private Investment was developed that did not contain any tax measures. The Income Tax Law was amended to provide two types of tax incentives: accelerated depreciation and unlimited loss carry-forward.

1.33 Providing tax incentives in the form of accelerated depreciation (and unlimited loss carry-forward) has the least of the shortcomings associated with tax incentives. Since merely accelerating the depreciation of an asset does not increase the total allowable nominal depreciation beyond its original cost, little distortion in favor of short-lived assets is generated. Neither is there much incentive for an enterprise to engage in the kind of tax abuse noted above with respect to tax holidays. Accelerated depreciation also does not share the negative elements associated with tax credits: a bias toward short-lived capital since further allowances or credits become available each time an asset is replaced; and attempts to abuse the system by qualified enterprises selling and purchasing the same asset to claim multiple allowances or credits.

Box 1. 5: International Experience Tax Incentives

The main message from the research on tax incentives in developing countries is that they may influence investment, but they are rarely cost effective.[8] The research suggests that tax incentives may stimulate investment, but that a country's overall economic characteristics – such as a secure, stable macroeconomic and business environment – are more important for the success or failure of industries than any package of tax incentives. A summary of selected country studies includes the following observations:

- As in the case of developed countries, even if tax incentives stimulate investment, they are generally not cost-effective. For instance, for a range of developing countries Shah (1995) found that tax incentives significantly eroded the tax revenue base without substantive effects on investment.
- ***Malaysia*** (Boadway, Chua, and Flatters, 1995): tax holidays failed to promote investment in desirable activities or assist infant industries and disadvantaged economic and social groups. Instead, broadly based taxes, levied at low marginal rates, were identified as one of the most effective forms of investment incentives. A similar conclusion was reached for ***Thailand*** (Halvorsen, 1995), where corporate tax holidays were found to be ineffective as an investment incentive. The various incentives granted in several projects were unjustified, since their rate of return was so high that the investments would have taken place in any event, regardless of the incentives.
- ***Transition Economies*** (OECD 1995): this study found that, on balance, tax incentives are unlikely to affect significantly the decision of investors to engage in FDI. Also, for *Central Europe* (Mintz and Tsiopoulos, 1995), tax allowances and credits were found to be probably more cost effective than tax holidays in attracting FDI, without undue revenue losses.
- Foreign investment decisions a survey of 75 ***Fortune 500 companies*** (Wunder, 2001) found that non-tax factors were the main determinants of their location decisions. Only four of the 75 companies surveyed identified tax factors as being the most important variable.
- ***Brazil*** (Estache and Gaspar, 1995): tax incentives, rather than being a decisive factor in the decision to invest, are in fact more efficient at reducing revenue than at stimulating investment, and have significantly distorted the tax system.

- ***Mexico, Pakistan and Turkey*** (Bernstein and Shah, 1995): discriminatory tax incentives, such as investment tax credits, investment allowances, and accelerated depreciation, are more cost effective in promoting investment than more general tax incentives, such as corporate income tax rate reductions.

1.34 ***Afghanistan currently has one of the lowest corporate income tax rates in the region.*** The reforms in 2004 reduced the corporate income tax rate to a flat tax of 20% of net taxable income. Cross-country comparisons of tax rates are difficult because of the complexity of tax rules found in many countries (particularly regarding deductions and exemptions) and the need to present similar "effective" tax rates. However, a sample of regional tax rates include the following: in Pakistan, the rates range from 35% to 50%; Iran charges a flat rate of 25%; in China, the rate is 30%; in India the rate is 36.75% for domestic companies with a more complex schedule for foreign companies; and in Uzbekistan, the corporate tax rate ranges from 20% to 35%. Furthermore, a roundtable organized by the Afghan American Chamber of Commerce (AACC) in conjunction with the Afghan International Chamber of Commerce (AICC) in Washington, DC in January 2005 did not conclude that a reduction in the corporate

[8] For a review of the empirical literature on the effectiveness of tax incentives in encouraging investment, see Zee et al, (2002).

income tax rate was a high priority. Instead, the meeting highlighted the need to continue to simplify the tax regime and to remove the plethora of 'nuisance' taxes and illicit charges as key priorities for the tax authority. Other issues to consider are summarized below:

- The first-best strategy for sustained investment promotion invariably consists of providing a *secure, stable and transparent legal and regulatory framework* as well as adequate supporting institutions, including a tax system in line with international norms. The latter strongly suggests avoiding use of tax exemptions or concessions, except those contained in revenue legislation (as this greatly simplifies tax administration).
- Available evidence suggests that the cost-effectiveness of providing tax incentives for investment promotion in attracting incremental investments (over and above the level that would have occurred without the incentives) is questionable and *that the revenue cost is potentially significant*. The problem of revenue loss is particularly acute in Afghanistan where tax compliance rates are extremely low and the current revenue base, at around 5% of GDP, is one of the lowest in the world.[9]
- The provision of tax incentives in the form of accelerated depreciation and loss-carry forward has the most comparative merits. Tax holidays, reduced tax rates, and investment subsidies are among the least meritorious.
- As a general rule, indirect tax incentives should be avoided (as inefficient), and discretion in granting incentives should be minimized as this can encourage corruption.

TAX TREATMENT OF THE PETROLEUM AND MINING SECTORS

1.35 Afghanistan is reasonably well endowed with exploitable natural resources. There is potential to increase the production of minerals such as coal, quarries, sand, copper, and gemstones, in addition to prospects for natural gas products. The international mining companies are expected to show some interest in these sectors, which could lead to a degree of energy independence, foreign exchange earnings, and employment.

1.36 Moreover, mineral exploitation is likely to generate some tax and other revenue for the government. A World Bank study suggests that the gross annual market value of solid minerals produced could increase from an estimated $60 million currently to $253 million per annum within a 4-5 year time horizon. At that stage the sector could generate value added of $108 million and yearly royalties and other taxes of around $18 million.[10] For this to materialize, significant reform measures are required, such as the establishment of a sound legal and regulatory environment, in addition to significant public and private sector investment.

1.37 The basis for the legal and regulatory framework, in the form of a modern Minerals Law, was being prepared with international assistance and approved in July 2005. If the legal and regulatory environment are properly structured, with economic pricing principles established, the hydrocarbon sector could also become a source of Government revenue over time. However, in both mining and oil and gas, the Government will not see income tax for a significant period of time after the initial investment is made because it will take firms a long time to accumulate taxable income. Royalties will be the first revenue stream.

[9] Considerable academic literature has focused on the cost-effectiveness of such tax investment incentives, for example see: Shah (1995).

[10] For a detailed review of the mining sector see: World Bank (2004). Given the provisions for depreciation and loss-carry forward, which would provide adequate incentives for investment, the tax regime that applies to mineral companies would be consistent with the standard provisions set out in the recently amended revenue legislation.

1.38 A pipeline through Afghanistan is a potential route for carrying natural gas from Eastern Turkmenistan (Daulatabad gas field) to Pakistan and beyond. This pipeline, which would cost several billion dollars to construct, could earn significant revenue and generate employment. International oil and gas companies explored the feasibility of the Turkmenistan-Pakistan route in the 1990s, but interest subsequently waned with the discovery of new gas reserves in Pakistan and due to security concerns in Afghanistan. However, as conditions in Afghanistan continue to stabilize, interest in constructing the pipeline has been renewed. As a transit country, the fiscal side of a pipeline agreement might include (i) payment of a transit fee (estimated at anywhere between $100 million and $300 million annually), (ii) taxation of the profits from the pipeline, and (iii) possible benefits in kind. However, completion of this project is highly uncertain and even in the best circumstances is likely to be some years away in the future; hence it would be unlikely to generate revenues over the medium-term.

LAND TAXES

1.39 Agricultural taxes were traditionally collected at the district and local levels and were reportedly a major source of revenue. However, they have been suspended in most provinces for several years, and any attempt to reinstate them is likely to be severely hampered by the ongoing security situation and the widespread prevalence of opium cultivation. Moreover, the prolonged drought that has affected significant parts of the country, combined with the aftermath of the conflict, has resulted in widespread poverty. It would be difficult to implement land and agriculture taxes in this situation.

1.40 Nonetheless, given the importance of agriculture to the economy, it may be important to revitalize agricultural and land taxes. Planning for this should begin now, in order to prevent agriculture from evolving into a privileged sector of the economy, which will be hard to reverse. To prepare for the possible re-introduction of redesigned agricultural taxation, it will be necessary first to collate current regulations, decrees, laws and rulings on all aspects of taxation of land, including land registration and transfer, and prepare a consolidated law. This exercise could be considered as an element of a medium-term reform strategy.

D. Medium-term Revenue Forecast

1.41 ***The priority for the Government is to fund the growing operating budget.*** In order to maintain aggregate fiscal discipline, the Government has committed not to use Central Bank financing for the budget, i.e. the no-overdraft rule, and not to fund recurrent costs with loan resources.[11] Operating expenditures are therefore constrained by the availability of domestic revenues and external (grant) resources. Given the large weight of salaries and wages in total operating expenditures, medium-term funding requirements are likely to be largely driven by an ambitious public administration reform – under these reforms the wage bill is expected to grow faster than the projected increases in GDP over the next few years, and to remain significant over the medium term.[12]

1.42 ***The Government has targeted domestic revenues to be able to finance the wage bill by 2008/09 and total recurrent spending around 2012/11.*** In the interim, the Government would be highly dependent on donor funding but anticipates that the operating budget's financing needs will be fully met though donor grants. Over the next seven years, development spending would be entirely funded by external assistance.

[11] There is currently also no domestic debt market, which adds another condition effectively constraining fiscal expenditures.
[12] The medium-term fiscal strategy is elaborated in *Afghanistan Government (2004).*

1.43 ***Projecting domestic revenues is associated with a high degree of uncertainty, particularly in such a rapidly changing environment.*** The weak statistical base underlying key macroeconomic variables such as GDP, and the lack of reliable information regarding the structure of dutiable imports or domestic taxpayers, are a matter of concern given that revenue projections rely on such figures. Moreover, the large structural shifts that are emerging as Afghanistan moves ahead with macroeconomic stabilization and restructuring – such as security, control over provincial transfers, the impact of opium production and eradication, and significant tax policy reforms – obscure the outlook and raise questions regarding the precision of any revenue forecast.

1.44 ***To ensure that Afghanistan moves toward a more sustainable fiscal position over the longer-term, analysis of the possible path of revenues is both timely and warranted.*** However, the constraints and limitations noted above call for considerable caution in interpreting the results. The Government also needs to remain vigilant to ensure that the reform program remains on-track.

1.45 ***Reaching the Government's ambitious medium-term revenue targets will require robust economic growth and continuing strong implementation of a number of policy and administrative reforms.*** The projections presented below follow broadly the same methodology as used by the MoF and are driven by four elements:

- *Economic growth and inflation.* The tax base is expected to grow in line with nominal GDP growth, or for import duties in line with the growth in dutiable imports. These variables are particularly susceptible to the effects of exogenous factors, such as the prolonged drought, and also could be negatively affected in the short term by an opium eradication campaign. Non-tax revenues are assumed to grow only with inflation: with the potential exception of over-flight fees,[13] there is hence little growth to be expected from these administration fees.
- *Customs and tax policy reforms.* The Government enacted a sweeping reform of trade taxes toward the end of 2003/04 and has at least partially implemented a wide range of tax reforms aimed at mobilizing revenue (see above).
- *Customs administration reforms.* Measures to improve customs administration have been discussed earlier and will focus on improving enforcement and compliance, including rebuilding of physical and human capacity, new international standards for classification of goods, progressive recovery of customs functions from other agencies (e.g. valuation of goods), and replacement of multiple customs declaration forms with a single form for all types of imported goods.
- *Tax administration reform.* Measures to improve tax administration (also discussed above) will focus on enforcement and compliance. Important developments include the establishment of a Large Taxpayer Office (LTO) and restructuring of headquarters and provincial tax organizations.

1.46 Several alternative scenarios are used to illustrate the implications of different reform paths over a ten-year period. The underlying macroeconomic assumptions are similar for each scenario, with real GDP growing at around 10% per year over the first four years, falling to around 7.5% p.a. thereafter. Inflation also falls from an initial rate of 10% per annum to stabilize at 5%, while the nominal exchange rate remains stable. The alternative scenarios include the following changes to key variables:

- *Scenario 1 (the baseline case) assumes the implementation of the five-year customs and tax administration reforms.* Under this scenario, there is gradual implementation of the proposed

[13] Afghanistan currently receives around $16 million per year as overflight fees. With some additional investment in the sector and more air traffic, these fees could increase.

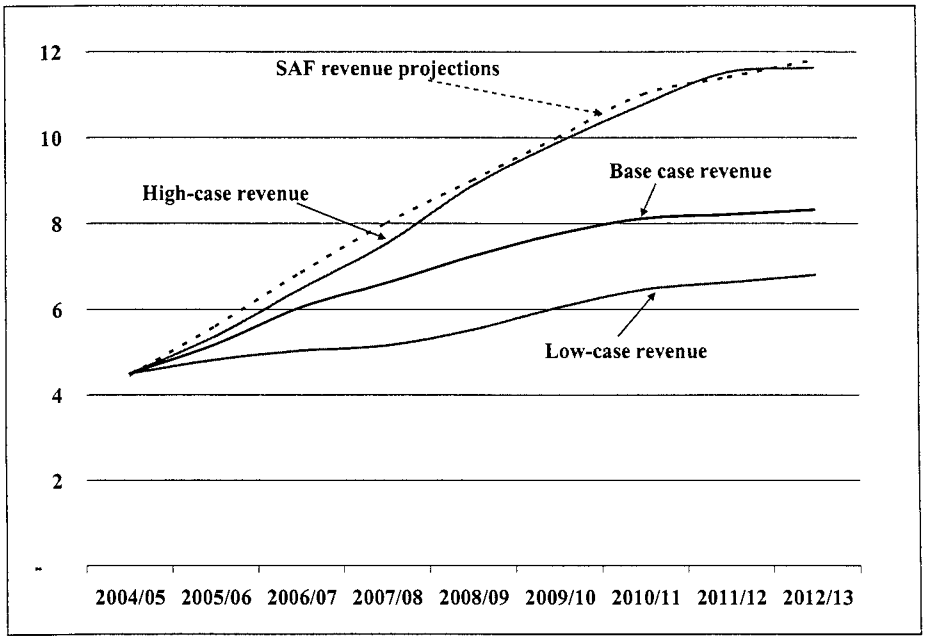
tax policy reform measures, including the wage withholding tax (raising a total of $120 million over the first three years); selected service taxes, including roll-out to other urban centers (raising a total of $36 million over the first five years); and the airport tax ($2.7 million over three years). The improvements in compliance rates are substantial, assuming that the Customs administration and the LTO's performance is good, improving by 10-15% per annum over the first six years before falling to 5% per year for the remainder of the projection period.

- *Scenario 2 (high-case) assumes slightly accelerated implementation of the five-year customs and tax administration reforms combined with some additional revenue measures.* Under this scenario the improvements in compliance rates are slightly higher than the base case, assuming stronger performance from the Customs administration and the LTO, with compliance improving by 20% per annum over the first four years before gradually falling to 5% annually for the remainder of the projection period. In addition to the policy reforms elaborated in scenario 2, there is a gradual move toward a consumption tax, which broadens the tax base, and toward the end of the projection period royalties from the mineral sector and the gas pipeline gradually come on stream.
- *Scenario 3 (low case) assumes no further tax policy reforms.* Under this scenario, based on the reforms so far, compliance rates improve by around 10% per annum over the first six years before falling to 5% per annum for the remainder of the projection period. No additional major policy reforms are implemented, such as the wage withholding tax or an extension of the current service taxes.

1.47 The revenue ratios for each scenario are shown as a percentage of GDP in Figure 1.2, along with the expenditure assumptions outlined in the government's *Securing Afghanistan's Future* report. These ratios may provide useful benchmarks for assessing Afghanistan's revenue path, depending on the progress made with the customs and tax reform programs (see Volume I, Chapter 3).

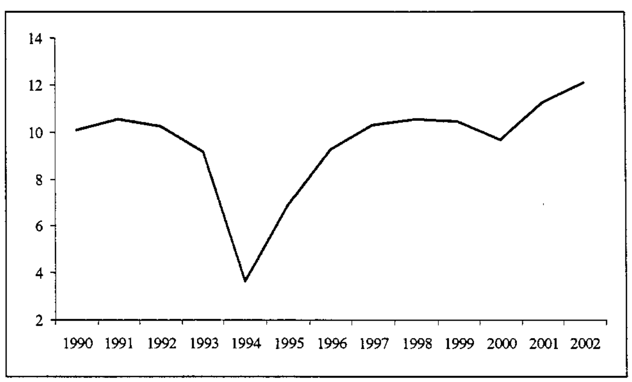
1.48 While the high-case scenario would require considerable efforts and thorough reform implementation, experience in other post-conflict countries suggests that it can be achieved. Although the revenue increases projected under the high-case scenario could be considered ambitious, with the revenue share of GDP rising by in excess of 1 percentage point per year for the first four years, this might be considered an obtainable goal if compared to the experience of some other post-conflict countries. For example, the creation of the revenue authority in Uganda helped to double the tax revenue/GDP ratio from around 6% in the base case, at the start of the 1990s to around 12% in the late 1990s, before a period of relative stagnation (Figure 1.4). Similarly, in Rwanda the tax revenue/GDP ratio increased sharply from a low of 3.6% in 1994 to around 12% in the late 2002 (Figure 1.3).

Figure 1. 2: Medium-term Revenue Forecast
(as a percent of GDP)



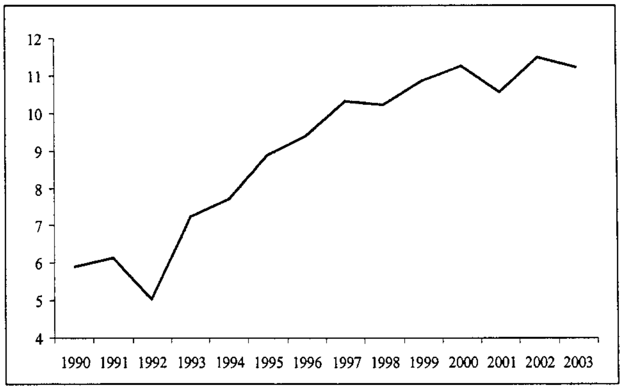
Sources: Afghanistan Government (2004) and IMF estimates.

Figure 1. 3 Rwanda, Revenue as a Percent of GDP



Source: IMF, Government Financial Statistics and Staff reports.

Figure 1. 4: Uganda, Revenue as a Percent of GDP



Source: IMF, Government Financial Statistics and Staff reports

1.49 ***However, Afghanistan's particular context and the inherent risks it faces should be kept in mind.*** The country's GDP, for example, depends to a large degree on agricultural output, which has demonstrated a high degree of volatility. The exchange rate, while relatively stable since the introduction of the new Afghani (and assumed to remain so under all scenarios), may also be subject to bouts of instability in the face of underlying shifts in demand, uneven donor flows, or attempts at eradication of the opium economy. Even prior to the conflict dating back to 1978, Afghanistan had relatively low tax revenue collection rates, below 10% of GDP. This was attributed to a narrow tax base, low compliance, and a weak administration. Furthermore, institutional capacity is still weak, and the quality of policy-making (while strong thus far) is uncertain over the medium term. These factors suggest that the revenue ratios, and consequently the margin of safety, might be considerably lower than shown here. Nevertheless given the very low level of government revenues – especially compared to expenditure needs – fiscal sustainability is a critical concern over the longer-term.

E. Summary Recommendations

1.50 The recommendations summarized below are broadly consistent with the five year reform plans adopted by the Afghanistan Customs Department (ACD) 2003-2007 and the General Presidency of Revenue (GPR) 2004-2008. The recommendations also draw from various technical assistance reports from the IMF and donors. Short-term recommendations are those that should be enacted within the next six to twelve months, while medium-term actions are those that could be enacted in 12-30 months.

Table 1. 5: Summary Recommendations

Issues	Recommendations	Concrete Next Steps	Timing
1. Modernizing the legal framework	The legal system for customs and tax revenues needs to be consolidated, streamlined, and modernized to facilitate a more efficient and transparent system that will improve compliance and enforcement.	Internal legislative procedures need to be streamlined and inter-ministerial consultation improved. Taxpayer education and consultation over the development of legislative proposals should also be enhanced.	
a. Revenue laws should be the only potential source of tax incentives, exemptions and concessions. However, recent legal amendments to introduce a more efficient regime for tax incentives, including exemptions and concessions, have not been fully implemented.	The regime for tax incentives, exemptions and concessions should be contained exclusively in revenue legislation. Investors should be granted depreciation and loss-carry forward provisions. Grandfathering of tax incentives should be strictly limited to cases that can demonstrate full compliance with the prevailing laws and regulations and the budgetary cost should be transparent.	The implementation of these measures should be complemented with official and taxpayer education. Other legislation, such as the Public Investment Law and new mineral sector laws, must be consistent with this ruling.	Short-term and ongoing
b. The customs legislation needs to be rewritten and streamlined procedures implemented.	Implement the revised customs code. New regulations and operational orders will also be required.	The customs code should be well publicized with educational information, regulations and operational orders provided to customs officers and taxpayers before it is implemented.	Short-term
c. The income tax legislation needs to be rewritten and streamlined procedures implemented. However, recent tax policy measures have been seriously delayed during the legal process.	The initial focus of tax reform has been to amend the existing income tax legislation to streamline procedures and to introduce new tax measures. The July 2004 tax reform package was eventually published in the official Gazette in March 2005.	The process of preparing and enacting such amendments needs to be streamlined, with improved coordination between the MoF and Ministry of Justice and other relevant ministries. Amendments also need to be supported by a well publicized implementation plan with relevant educational information, regulations and operational orders provided to GPR officials and taxpayers in advance.	short-term

Table 1. 5: Summary Recommendations

Issues	Recommendations	Concrete Next Steps	Timing
	In the medium term the Government should enact a revised income tax code consistent with international standards. New regulations and operational orders will be required.	GPR to develop an overall plan to modernize the tax laws, setting out objectives, priorities and a timeframe for reform. The plan should be aligned with other ongoing reforms, such as the functioning of the large-taxpayer office (LTO).	Medium-term
d. Currently, the Ministry of Finance has no powers to enforce compliance with the revenue laws. With little coordination across ministries the system relies on taxpayers voluntarily meeting their obligations, which results in low compliance rates.	In order to more effectively mobilize revenue collections, revenue law needs to be complemented with a set of modern enforcement powers consistent with international standards that are to be exercised directly by officers of the Ministry of Finance or jointly with officers from other ministries, such as the Ministry of Interior (police) and Ministry of Justice.	Agree policy between ministries and enact amendments to legislation and regulations. Implementation will require improvements in administrative capacity in the relevant ministries. The advantages of reformed administrative powers will be the better co-ordination of the process of assessment of tax liability and tax collection.	Short-term and ongoing
2. Building modern Customs and Tax Administrations.	In designing a strategy for revenue mobilization, consideration needs to be given to the very weak state of the institutions and the extremely limited capacity of the administration to implement policies.		
a) Creating a suitably professional customs services is a pre-requisite for a sustained increase in customs performance. Customs revenues are extremely low and the systems suffers from a weak administration that leads to poor compliance.	Implement new ACD headquarters organizational structure, and complete the human resource plan with an assessment of the staff requirements based on simplified, automated procedures.	Implement Priority Reform and Restructuring (PRR) of headquarters organization and senior staff. The human resource reforms should be progressively rolled-out to other provincial centers. Renovate or rebuild the key customs buildings of key provincial offices and border posts to a suitable standard to enforce customs controls.	Short-term for the HQ. Medium-term in the provinces. Medium-term and ongoing

Table 1. 5: Summary Recommendations

Issues	Recommendations	Concrete Next Steps	Timing
	Enforcement should focus on strengthening mobile inspection and detection capacities and on inland controls on the transportation, distribution, storage and retail facilities.	Implement anti-smuggling teams at major customs centers (focusing on priority border posts with maximum revenue loss first). The mobile teams should be under the control of the ACD (but may be Ministry of Interior staff)	Immediate decision. Medium-term implementation
b) Tax revenues are extremely low and the system suffers from weak administration that leads to poor compliance.	A focus on large taxpayers can significantly improve revenues, so the priority is to establish a fully functioning LTO to implement planned tax measures.	The staff of the LTO has been recruited through use of the PRR process. The GPR should: • Maintain the focus on the LTO as the spearhead for wide-ranging reforms in tax administration, particularly the move toward self-assessment. • Identify the largest taxpayers to be administered by the LTO according to agreed criteria and prepare detailed compliance profiles for each taxpayer.	Short-term
	To improve compliance for medium-sized taxpayers, provincial tax collection needs to be further integrated under the control of the GPR and the administration and facilities need to be strengthened.	• Implement Priority Reform and Restructuring (PRR) and refurbishment/construction of buildings for the 'model' provincial tax office in Kabul. • Role-out model offices to Mazar-i-Sharif, Herat, Jalalabad and Kandahar.	Short-term Medium-term
c) A number of priority tax reform measures have been approved but not enacted, or measures are not being enforced.	The General Revenue Presidency (GPR) to publicly endorse and then implement a plan to introduce priority tax reform measures as efficiently as possible.	GPR to publish an implementation plan with the provision of official and taxpayer education. Implement wage withholding tax, tax on high-end services, tax on money changers, airport tax, and fixed taxes on money changers.	Short-term

Table 1. 5: Summary Recommendations

Issues	Recommendations	Concrete Next Steps	Timing
3. Reforming Revenue Policy Policy needs to be focused on the following:	• Reducing the complexity and streamlining the tax system, e.g. reducing the number of taxes, harmonizing rates, and reducing exemptions; • Encouraging taxpayers' voluntary compliance with new, simplified self-assessment procedures and better taxpayer education; • Differentiating the treatment of taxpayers by their revenue potential and risk management strategies.		
a) Continue to consolidate and simplify the implementation of the new customs tariff regime.	The various fees and charges levied on imports and exports should be integrated into the customs tariff. Illicit charges should be eliminated and the number of low yielding taxes, fees, and charges should be reduced.	The customs code should consolidate much of the customs related powers in the ACD. Enforcement of the new streamlined procedures at all major offices—including the improved transit procedures, the customs brokers program, self-assessment and the computerization project (ASYCUDA)—should facilitate this process along with the creation of a more skilled professional customs service.	Short-term and ongoing
		Fees and charges collected by other agencies, such as the Ministry of Commerce, should also be rationalized and where possible removed.	Short-term
		The customs exemption monitoring system needs to be strictly enforced to control legitimate exemptions and reduce leakages. Estimates of revenue forgone as a result of duty exemptions should be regularly published as part of the budget documentation.	Short-term

Table 1. 5: Summary Recommendations

Issues	Recommendations	Concrete Next Steps	Timing
b) Continue to consolidate and simplify the implementation of the domestic tax regime.	Removing many of the small 'nuisance' taxes (mainly the "fixed taxes"), simplifying the tax collection system and eliminating unauthorized taxes, fees and exemptions is likely to be cost-effective from the perspective of the revenue authority, and should help to promote the private sector. The MoF should conduct a survey of other Ministries to identify all taxes, charges and license fees with a view to placing all taxes under MoF administration.	Measures include: • GPR/MoF to complete the regular 3-yearly revision of the classifications and rates of fixed taxes to remove low yielding and other 'nuisance' taxes; • Provision of training and up to date guidance to revenue staff, particularly in Kabul and the major provincial offices (including professional training and in ethics); • GPR to enforce compliance with new tax law and regulations, including the use of penalties for noncompliance; • Fees and charges collected by other agencies or Ministries should also be rationalized; and • Increase the dissemination of taxpayer education material and develop functioning dispute resolution mechanism. • Exemptions and concessions, including holidays, have been costly, and a system needs to be developed to strictly control legitimate exemptions and reduce leakages. Estimates of revenue forgone as a result of tax exemptions and concessions should be regularly published as part of the budget documentation.	Short-term and ongoing

Table 1. 5: Summary Recommendations

Issues	Recommendations	Concrete Next Steps	Timing
c) Over the medium-term it would be desirable to move away from a revenue regime that is predominantly based on trade (i.e. customs) taxes to one that is more broad based and focused on consumption – as this can be a more efficient and more equitable form of taxation.	Convert the business receipts tax into a simple, broader-based consumption tax under which imports are taxed and exports are not (possibly with a high enough threshold to be administered mainly by the Large Taxpayer Office).	Bring large unincorporated businesses into the business receipts tax (BRT) net. With this move, the BRT and the fixed taxes on traders, which are levied on the same base, could be integrated, yielding a single domestic tax on each of imports and exports. Taxes on exports should eventually be eliminated.	Medium-term
		The Government should expedite the implementation of the high-end services tax, initially in Kabul but also expanding the coverage to the main provincial centers.	Short-term
		The revenue policy unit and LTO should also develop a strategy for the implementation of a broad based consumption tax . This should involve internal and external consultations and taxpayer education.	Long-term for full implementation
d) Excises taxes are a common way to raise revenue and are also a normal way of applying supplementary taxes to goods the consumption of which governments wish to discourage, e.g. for health or environmental reasons or luxury goods.	Duty rates should be increased on goods that would generally be considered excisable and attract higher rates, e.g. gasoline, diesel, cigarettes and automobiles which are all imported and not produced domestically. This may also help offset the revenue losses associated with lowering of the average tariff rate.	A high duty rate can initially substitute, in the short-term, for excises. Until an excise tax can be introduced such items should be subject to a reasonable customs duty.	Short-term
	Excises should be restricted to a short list of products that typically would include tobacco and petroleum products, particularly gasoline and diesel. These goods are generally seen as good revenue raisers because of relatively inelastic	The revenue policy unit should develop a plan to review the implementation of an excise tax. This should involve internal and external consultations.	Medium-term implementation

Table 1. 5: Summary Recommendations

Issues	Recommendations	Concrete Next Steps	Timing
	demand and have a broad base. Excises should apply equally to goods that are imported or domestically produced.		
e) MoF should further develop its revenue policy and revenue forecasting capabilities.	A unit separate from the ACD and GPR should be established to focus on revenue policy and revenue forecasting issues. In-year monitoring and forecasting of tax revenues is currently weak and technical assistance has been sporadic.	Technical assistance should be provided to help create a dedicated unit that is independent of the ACD and GPR. The unit will need to coordinate closely with the ACD and GPR and build strong analytical and policy capacity.	Short-term
f) The regime for tax incentives should be transparent and as efficient and equitable as possible.	Enforce the provisions for loss-carry forward and capital depreciation contained in the amended income tax and customs laws.	All enterprises undertaking business in Afghanistan, including those with grandfathered tax holidays, must file tax returns and provide other financial information. The MoF should be able to determine the cost of existing exemptions and concessions and ongoing tax incentives.	Immediately.
g) The Government needs to provide a conducive fiscal regime for the petroleum and mining sectors.	The Government needs to develop a transparent strategy that is consistent with international norms to facilitate the development of these sectors.	The World Bank is assisting the Government in the development of a comprehensive strategy for the petroleum and mining sectors, which includes the policy and legislative frameworks. MoF, and the relevant revenue bodies, should be closely consulted during this process.	Medium-term
h) The Government needs to provide a conducive fiscal regime to facilitate possible development of any (gas) transit pipelines as well as transmission of electricity through Afghanistan	Pipeline agreements commonly include the payment of transit fees, the taxation of profits and possible benefits in kind. The agreements are complex legal documents involving a wider range of stakeholders.	The Government needs to develop a transparent strategy that encompasses a wide range of interests both from within government, including the MoF, and also the private sector. Afghanistan may want to engage experts to help in negotiating any pipeline agreement.	Long-term
i) Given the importance of agriculture to the economy, it may be important to	This issue is likely to be highly contentious. The merits and possible implementation	The revenue policy unit to produce a consultation paper reviewing the pros and cons	Medium-term

Table 1. 5: Summary Recommendations

Issues	Recommendations	Concrete Next Steps	Timing
revitalize agricultural and land taxes, particularly for municipal authorities.	arrangements need to be carefully considered in advance of any reintroduction.	and institutional arrangements needed for the reintroduction of land taxes. Widespread consultation will also likely be required.	
4. Managing the reform and modernization programs			
a) Planning, management and coordination of the reform program is vital to ensure optimum returns on the large amount of technical assistance and donor funding provided.	Establish a steering committee to make strategic decisions and oversee the reform program. The ACD and GPR reform programs should be regularly monitored and evaluations should help to refine the strategies to correct for slippages or to take advantage of new opportunities. Updates to the five-year plans could be published on a regular basis.	Both the ACD and GPR have established steering committees, with a lead advisor, to help implement their five-year reform plans. However, this process could be strengthened with more dedicated resources set aside to assist project management, donor and TA coordination and to advise on policy matters for the revenue department as a whole.	Short-term

Annexes

Annex 1. 1: Description of Afghanistan's Tax System
as of January 2005, all amount in Afghanis

Tax	Nature of Tax	Exemptions and Deductions	Rates
1. Taxes on income, profits and capital gains			
1.1 Individual income tax Law of Income Tax (Law introduced in 1965 but has been significantly modified) Last modification: March 2005	Income tax imposed on individuals earning salaries or wages, persons having net income from self-employment, and other individuals. The tax is imposed on net income, defined as the difference between gross income and deductions permitted by law. *Residents* (natural persons and legal persons such as companies etc.) are taxed on income from all sources (including from abroad). *Non-residents* are taxed on income from Afghanistan sources. Wage withholding tax will be restored in FY2004/05 (Article 64), with the withholding being a final tax in the case of employees with no other sources of income. A wage earner who has a single employer is not required to file a tax declaration. An employee with two or more employers or with other sources of income will be required to file an annual declaration. Annual lodgment and payment within 4 months of year end. Dividends and other distributions of profit are taxed at the individual level in Afghanistan. Dividend withholding *(Art. 51)* non-final (i.e. credit against annual income tax liability).	***Exemptions:*** Foreign governments, international orgs and their non-resident employees in accordance with existing treaties and contracts with the State of Afghanistan. (Art. 10) Approved applicants for exemption being orgs legally organized under Afghan law and organized and operated exclusively for educational, cultural, literary, scientific or charitable purposes. (Art. 11) Agencies and departments of the State and municipalities. (Art. 12) Non-residents provided that the respective foreign country grants a similar exemption to residents of Afghanistan. (Art. 7) Foreign airlines if reciprocal exemption for Afghan airlines in the respective foreign jurisdiction. (Art. 9 (3)) ***Deductions:*** Most expenses incurred to derive gross income are deductible when computing taxable income (Article 19). The calculation of tax withholding spread the income rates applicable to wage income over each pay period (Article 65).	Taxable annual income (in Afs) / Marginal Tax rates (percent) 0 to 150,000 — 0 150,001 to 1,200,000 — 10 1,200,000 and above — 20
1.2 Corporate income tax Law of Income Tax Last modification: March 2005	A flat rate income tax imposed on legal persons—corporations, limited liability companies, and some types of partnerships. The tax is imposed on taxable (net) profits, defined as the	***Exemptions:*** As for 1.1 above. ***Deductions:*** Expenses incurred to derive gross income are deductible when computing taxable income	Taxable annual income (in Afs) / Marginal Tax rates (percent) Afs1 and above — 20

Tax	Nature of Tax	Exemptions and Deductions	Rates
	difference between gross income and deductions permitted by law. New administrative procedures were introduced in FY2004/05, including the introducing of a tax rulings system and new penalty provisions.	(Article 19). The Income tax law contains provisions for depreciation, of buildings and other capital assets, and loss carryover (Article 53). For qualifying businesses, accelerated depreciation and losses carried forward indefinitely apply.	
1.3 Taxation of Capital Gains	For corporations or limited liability companies, the sale price from disposal of property less the cost not depreciated and other expenses. Capital losses are deductible. For individuals, the sale price of a trade or business, a factory or shares in corporations will be taxable A fixed tax applies to the sale of immovable and movable property owned by an individual. This is a final tax in lieu of income tax.	***Exemptions:*** Immovable property that is: 1. inherited, or 2. a trade or business, including goodwill, or 3. a factory including equipment, machinery, buildings and land, or any part of such assets, or 4. shares of stock in corporations or limited liability companies. For items 2-4, the annual income provisions regarding capital gains apply but with certain modifications. (Art. 34 and 27)	Corporate tax rate – 20% Individuals – gain taxable in full at marginal income tax rates. If the property is held 18 months or more, the gain is averaged over the period held and taxed at the average rate applicable for that part of the gain in the year of disposal. Gain on the sale of immovable property – 1% of the market value Gain on the sale of movable property – 2% of market value
2. Taxes on goods and services			
2.1a Business receipts tax (BRT) Law of Income Tax (Article 73) Last modification: March 2005	A cascading turnover tax, levied on limited liability companies, corporations and partnerships on gross receipts (before deductions) from the provision of goods and services whether or not a profit or loss is made during the year (Art 75). Paid annually within six months of end of year either before or at same time as income tax (Art. 74)	***Exemptions:*** BRT applies only to legal persons and not individuals. Agencies and departments of State and of municipalities are exempt, except income derived from commercial activities. (Article 12). New business approved under Foreign Investment Law. ***Deductions***: No deductions are allowed. BRT is deductible when calculating the taxable income of a legal person for annual income tax. (Art. 77)	2% rate in principle on sales of all goods and services.* Receipts of commissions, fees, interest, dividends, rent, royalties, and similar incomes are taxed at 5%.
2.1b BRT on selected services Last modification: March 2005	This measure imposes a BRT on the gross receipts of service providers in telecommunications, international airlines, restaurants, cafes and bars and hotels and guest houses where the threshold of 50,000 Afs per month has been met.	***Exemptions***: Income from services other than designated services is not included in the calculation when considering if a taxpayer has met or exceeded the threshold. If the taxpayer is a legal person and derives less than the Afs 50,000 threshold in a month	Businesses with a total sales value (turnover) per month on designated services at the following rates: Afs 1 – 50,000 2% over Afs 50,000 10%

Tax	Nature of Tax	Exemptions and Deductions	Rates
	The tax commenced in Kabul in 2004 and will be progressively introduced in other provinces as the administrative capacity improves. The tax is to be paid quarterly but calculated on a monthly basis.	from providing designated services, the existing 2% BRT will apply to that person. If the taxpayer is an individual and derives less than Afs 50,000 in a month from providing designated, no BRT is payable on the receipts from those services. ***Deductions:*** As above, BRT is deductible when calculating the taxable income of a legal person for annual income tax. (Art. 77)	
2.2 Rent Withholding Tax Last modification: March 2005	Withholding tax payable on the gross rent from rental services provided by a landlord for the use of land and/or buildings where the payment for the service exceeds Afs *15,000* per month. The tax is imposed on the landlord who is entitled to receive payment for the rental services but the tenant withholds the tax from the rent or lease payment and pays it on behalf of the landlord to the government.** Rental services for the provision of land and buildings includes, but is not limited to, rental or lease payments made for the rental or lease of land, houses, guest houses, office buildings, office-cum-living space, shops, shops-cum-houses, warehouse and industrial space. The renting, leasing or subleasing of any of these properties will give rise to a rent withholding obligation.	***Exemptions:*** Rent income not taxed under this provision, because it falls below the monthly threshold of Afs 15,000, remains taxable under the income tax law. Deductions: No deductions As a non-final withholding, the landlord is required to file an annual income tax return declaring gross rental income, may claim deductions and credit for the amounts withheld.	20% of gross payments for rental services where those rental services exceed Afs 15,000 per month. ***Example***: A landlord receives Afs 40,000 per month for rental services. Additionally, the tenant has made Afs10,000 in repairs and improvements to the property during the month. The rent withholding tax is calculated as follows: Monthly rental income 40,000 Plus: Repairs and improvement 10,000 Amount subject to tax 50,000 Rent withholding tax 20% X Afs50,000 Afs10,000
2.4 Fixed taxes Law of Income Tax (articles 78-95) Last modification: March 2005	Articles 78 – 95 of the income tax provide for a variety of taxes, usually referred to as fixed taxes. They comprise presumptive taxes on small business (sometimes expressed as fixed amounts, but also as percentages of presumed turnover); a tax on the value of imports and exports for all	***Exemptions:*** None All individuals selling goods and services from established places of business are subject to taxes specified in the schedule of tax categories of businesses. **These taxes are in lieu of income taxes from the sale of such goods and services.** The tax due from an	Fixed taxes are levied on importers and exporters without a business license (or those with an interim business license that do not provide a business declaration form to the MoF) as a percent of the value of the transaction inclusive of customs duties. On the former, the rate is 3% and on the later, the rate is 2% (Articles 80 and 81). As a

Tax	Nature of Tax	Exemptions and Deductions	Rates
	traders without a business license (which is in addition to the BRT on international trade for legal persons); and a sales tax in lieu of income tax for individuals who supply goods and services to the government. A fixed tax is imposed on business establishments which do not have complete accounting documents. There are identified in the current law 170 tax categories of business establishments. The fixed tax of business establishments is set by a committee is to be approved by the Minister of Finance every three years. A process of consolidation and simplification is underway.	individual owner (or owners) of a fixed place of business is the amount specified for the related category and grade of such establishment.	transition measure associated with the tariff reforms, the rate on both importers and exporters was lowered to 0.5% in 2004/05. Presumptive taxes in lieu of the income tax include: 1. Tax on shops and traders with no fixed business premises (Articles 88, 92 and 94): The rules for imposing fixed tax on shops are very complicated, based on the classification of a business by reference to a list of more that 170 categories of taxpayers. The amount of tax levied on each category of shops is determined using a range of factors including the type of goods sold and the size and location of businesses. A committee comprising representatives from the provincial Mustoufiat, the Ministry of Commerce, and municipalities decides upon the level of presumption tax to be levied on each category of shops. Fixed tax applicable to traders with no fixed place of business is levied according to the type and size of the business. 2. Tax on turnover (Article 85, 86): This tax is applied to specific businesses (e.g., cinemas) at a rate of 10% on turnover. 3. Lump sum tax (Articles 83, 86, 87 and 90 of the income tax law and 90.1 of the income tax manual): It is applied on selected businesses (e.g., transportation businesses, kilns, mills and medical practitioners) at very low to moderate amounts. 4. Tax on contracts (Article 84): When the government purchases goods or services from an unincorporated contractor or individuals who provide construction services, at 7% of the purchase price is withheld as a creditable withholding tax (there is a final settling up at the end of the year).
2.4a Fixed taxes for money changers	As with shopkeepers, there is a schedule of fixed taxes for	***Exemptions***: None	The highest level is Afs 93,320 per day and above paying an

<table>
<tr><th>Tax</th><th>Nature of Tax</th><th>Exemptions and Deductions</th><th>Rates</th></tr>
<tr><td>Last modification: Presidential Decree of December 2003

This measure is yet to be fully implemented.</td><td>moneychangers (Article 94). A new fixed tax on money changers, with 10 classifications, was passed in June 2004 to simplify compliance with the law.</td><td></td><td>annual fixed tax of Afs 700,000.</td></tr>
<tr><td>2.5 Sales tax on consumable goods of domestic manufacturing organizations

Published in the Official Gazette in 1980 and amended in 1982

This tax does not appear to be being applied at the current time</td><td>Manufacturing organizations are required to pay an ad-valorem tax on income they receive from the sale of their products inside Afghanistan.

All organizations including corporations, general partnerships, limited liability companies and state owned enterprises that manufactures, processes, assembles or undertakes mining activities are subject to the provisions of this Law. Organizations approved and established under the Foreign and Domestic Private Investment Law are required to pay tax.</td><td>Exemptions: Bread, flour, stationery, forms, books, notebooks, ink, chalk, pencils, movies, newspaper, magazines, coal, medications, medical items and chemical fertilizer are exempted from payment of the consumable goods tax</td><td>Consumable goods tax collected as an ad valorem tax on the sales price of various manufactured goods according to a schedule. The tax rates range from 1% to 10% of the sales price.</td></tr>
<tr><td colspan="4">3. Taxes on international trade transactions</td></tr>
<tr><td>3.1 Customs duties

Customs Law (1984) has been updated with a new Customs Code promulgated in 2005.

Last modification: March 2005</td><td>An ad-valorem export and import duty.

The Customs Tariff is a document enacted in accordance with this law which determines the import and export duty of goods based on their classification. The Customs Tariff is approved by the Minister of Finance, upon the recommendation of the General Director of Customs.

From January 2005, the customs valuation service was relocated from the Ministry of Commerce to the Ministry of Finance under General Director of Customs.

Pursuant to Presidential Decree of July 14, 2003, only Customs Brokers licensed by the Ministry of Finance will be authorized to clear imported or exported goods through Customs in Afghanistan. This requirement was initially enforced in Kabul, and then</td><td>Exemptions: Exemptions based on treaty, international law, law, regulation etc shall be implemented through an amendment or annex to the tariff. The following import goods shall be exempted from paying customs duty:
1- Goods imported by officials of the State during official travels not in excess of Afs. 100,000 as provided by the Customs tariff..
Office materials and equipments of political representatives and International Agencies, materials intended to be used in residency of representatives of foreign countries in Afghanistan, after confirmation of competent authorities.
2- Items intended for personal use by foreigners working in Afghanistan according to the terms and conditions of their contract.
3- Allowed books, gazettes, magazines and newspapers.
4- Goods provided for government projects funded</td><td>Under the trade regime inherited by the transitional government, there were 25 tariff bands, with rates ranging from 7 to 150% – with a simple average of about 43%.

An overhaul of the tariff system reduced and simplified the number of ad-valorem and regionally specific customs duty rates to the following six:
<table>
<tr><th>Rate (%)</th><th>Type of product</th></tr>
<tr><td>2.5</td><td>essential food and non-food products</td></tr>
<tr><td>4</td><td>Capital goods, Machinery</td></tr>
<tr><td>5</td><td>raw materials and capital good</td></tr>
<tr><td>8</td><td>Petroleum, diesel, aviation fuel</td></tr>
<tr><td>10</td><td>semi-manufactured products</td></tr>
<tr><td>16</td><td>non-priority products, luxury products, arms and ammunition</td></tr>
</table>
The tariff uses the single national official exchange rate published by Da Afghanistan Bank for the purpose of valuation of goods.</td></tr>
</table>

Tax	Nature of Tax	Exemptions and Deductions	Rates
	in four other major provincial jurisdictions in a staged process throughout 2004.	by loans or imported to the country by or for public and private foreign and International relief and development agencies. 5- Personal effects used by Afghan delegations or Afghan international workers and their family members abroad. 6- Travelers' personal goods in accordance with the Customs Tariff. 7- Commercial samples and advertising gifts. 8- Post parcels valued at Afs 5000 or less. 9- honorary decorations or awards; 10- samples sent to organizations protecting copyrights or industrial or commercial patent rights; 11- Used movable property belonging to natural persons, who transfers their normal place of residence from another country to the State, as provided in the Customs Tariff; 12- a consignment of less than Afs 1000 value; 13- Pure-bred breeding animals and insects and laboratory animals, biological or chemical substances needed for scientific researches; 14- therapeutic substances of human origin and blood grouping and tissue typing reagents,; 15- substances for the quality control of medicinal products; 16- Fuels, lubricants and equipments carried with and necessary for the normal functioning of transport vehicles in accordance with the relevant procedure. Other goods may be exempted upon recommendation of Minister of Finance and approval of Council of Ministers.	The General Directorate of Customs is responsible for carrying out the tariff classification of goods concerning description and coding in accordance with the Harmonized System of the World Customs Organization and for assessing any corresponding duty under the Customs Tariff. In order to combat false valuation of certain goods with suspicious values, their minimum value shall be determined by General Directorate of Customs – with the new system is based on international norms.
4. Other taxes			
Airport Departure Tax	A flat rate tax charged levied on passengers at the airport prior to departure. This measure is to be enacted	***Exemptions:*** Air crew on the departing aircraft, members of the defense force of the United states and of the	***Proposal:*** $12 for international passengers is envisaged.

Tax	Nature of Tax	Exemptions and Deductions	Rates
	through the Department of Civil Aviation.	peacekeeping forces of NATO, persons being extradited from Afghanistan and domestic passengers.	
Extractive Industries Taxes – special provisions for Royalties and deductions (covered by sector-specific legislation).	Details are being prepared with the assistance of the World Bank.	Details being prepared with the assistance of the World Bank and IMF.	TBD
Land Taxes	Land assessed according to grade and size. Cultivated land divided into 3 categories and 7 grades. Because of the drought conditions and compliance problems, this tax has yielded zero for the past 10 years. Government plans to extend exemptions because of the continuing drought.	***Exemptions:*** Land of less than half an acre, land uncultivated or ruined by unexpected circumstances, land owned by agricultural co-operatives, or government, or used for religious, educational, or research activities. Land used as a cemetery. ***Deductions*** – none	Acres Afs/acre 2 to 10 45 11 to 20 60 21 to 50 85 51 to 100 120 101 to 200 175 201 to 500 400 A co-efficient of 1 is used for prime land. The co-efficient is reduced depending on the category and grade of the land.
Toll tax	Reports together with a decision matrix have been received from a consultant engaged by ADB. This proposal has progressed to a stage where discussions need to occur with other Ministries on the various options. Historically, there were 48 road toll stations set up across the country. Currently there are only two that could be set up for operational use along the Kabul-Kandahar road.		TBD

* Following the introduction of the new tariff regime, the BRT rate for importers and exporters who are also subject to fixed taxes was set at 0%. In addition, the fixed tax on importers and exporters was lowered to 0.5% for FY2004/05.

** A tenant is a legal person, or natural person who uses the rented property in the course of business. "Legal person" is defined to include corporations, foundations, limited liability companies, partnerships, unincorporated associations, clubs or organizations, non-profit institutions, charities, Afghanistan and foreign government and their agencies, international organizations.

CHAPTER 2. THE GOVERNMENT OF AFGHANISTAN'S PAYROLL

Executive Summary

i. This chapter covers a range of issues related to the payroll of the Government of Afghanistan. Salient points include:

- *Small and stable public employment.* By international standards, public employment in Afghanistan is relatively small. Civilian employment has been stable over the last two years, except for teacher recruitment. The Government has articulated its strategy to maintain a lean public service, while only recruiting teachers: this relatively small size is important given the Government's strategy to increase salaries to build capacity.
- *Gradual increase in average salary.* The average salary has been increasing as a result of the pay increase in 2003. Much-needed gradual increases will continue to be phased in as the Priority Reform and Restructuring (PRR) scheme is implemented. Subsequently, the pay and grading review may result in further pay increases which have to be coordinated and sequenced with the overall public administration reform program, including measures to deal with those civil servants who lack the necessary qualifications for their jobs. Together, these reforms should increase Government's capacity to implement policies that will lead to growth.
- *Increase in the wage bill.* The wage bill increased from $281 million in 2003/04 to $374 million in 2004/05. The increase reflected recruitment of teachers, full-year impact of the 2003 pay increase, and implementation of the PRR. These various ongoing payroll reform efforts, including implementation over time of the pay and grading review, together with additional teacher recruitment, will result in continuing increases in the wage bill. The Government's *Securing Afghanistan's Future* (SAF) report roughly projected that the annual wage bill would reach $900 million in six years. Even if actual growth of the wage bill is lower, there will continue to be a large operating budget deficit in the short to medium term, which will require significant external financing. Given strong economic growth and domestic resource mobilization, this should be sustainable.
- *There are undoubtedly fiscal risks.* Limited Government capacity, schemes to attract talented professionals, and the relatively high salary level and programmed rapid growth of the Afghan National Army, as well as a proposed large pay increase for the Afghan National Police, generate significant pressures for increases in salary levels. However, sizable sector-specific or generalized salary and pensions increases that are not part of the public administration reform program, or loss of recruitment discipline, would have severe adverse fiscal consequences, as would failure of domestic revenues to increase rapidly.
- *Improvements in payroll processing.* The re-decentralization of payroll processing in March 2004 has expedited the process. The Individualized Salary Payment program has improved effectiveness in Kabul. Issues remain, however, with respect to further facilitating payroll processing and improving controls, especially in provinces, and in particular for security sector Ministries where both headcount and payroll reporting remain weak.
- *Uncertain pension policy.* Pensions for civil servants have been increased in 2004 but remain low; important policy and administrative reforms are needed but their fiscal implications need to be assessed.

ii. In summary, the Government needs to:

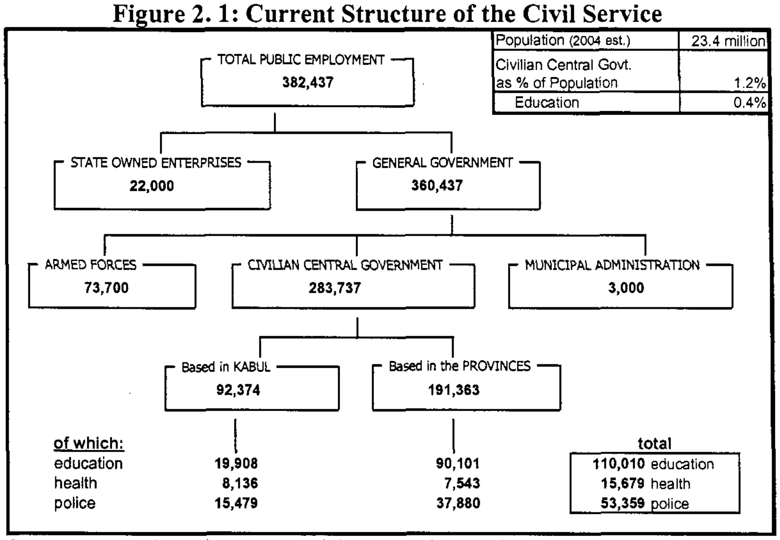
- *Implement pay reform strategy carefully*: Although the strategy set out in the SAF report implies that the wage bill will grow in a programmed manner despite a large operating deficit, this must not be interpreted as a softening of the hard constraints within which the Government operates. The Government will need to monitor the wage bill and revenues closely, and make trade-offs between its sector policies as part of its Medium-Term Fiscal Framework (MTFF). It should use the annual budget as an instrument to state its policies with regard to the wage bill. Maintaining strict discipline over staffing levels in the Government will be critical.
- *Provide full information to donors to secure their continued support*: The Government wage bill will be a key driver of Afghanistan's fiscal aggregates and balance. Following the SAF projections in 2004, the MTFF recently prepared and approved provides a welcome statement of the Government's medium-term fiscal stance. In a situation characterized by a continuing large operating budget deficit financed by external assistance, the Government will need to provide full information to donors and take them into confidence about its fiscal policy including wage policy. While adjustments may be required in the light of subsequent developments, it would not be advisable to allow the gap between core budget operating expenditures and revenues to widen significantly in an unprogrammed manner. The Government should alert donors to any departures from its fiscal policy stance if it is to maintain the support that donors have so far provided to the operating budget.

A. Size of the Civil Service

2.1 This chapter describes and analyzes a range of issues related to the payroll of the Afghan Government. It first in this section, reviews recent trends in the size of the civil service, highlighting its overall stability. Despite issues with data quality, this suggests that the Government is retaining control over the total size of the civil service. Second, the chapter describes the pay increases decided in 2003/04[1] Third, it reviews the Government wage bill, concluding that it is increasing, as predicted, mainly as a result of pay increases rather than recruitment. The fiscal sustainability of the current trajectory is explored. Fourth, the chapter reviews the improvements in payroll processing that have been made. Finally, it considers the situation regarding pensions – concluding that pensions for civil servants have been increased in 2004 but remain low and that important policy and administrative reforms are needed.

2.2 ***Total public employment is around 380,000 (Figure 2.1).***[2] In theory, SOE staff (estimated at 19,000) and from the Central Bank (estimated at 3,000) are excluded from general government employment, although the distinction is in practice less clear.[3] General government employment includes the army and other uniformed staff (on the order of 70,000 employees, see below) and municipal employees (a tentative estimate of 3,000). The rest, civilian central Government, includes central ministries and provinces: of the 284,000 employees, two thirds are in provinces.

Figure 2. 1: Current Structure of the Civil Service



Source: Pay and employment model; staff estimates (January 2005).

2.3 ***The size of the civil service is relatively low by international standards (Table 2.1).*** It comprises around 1% of the total population, compared to the regional average of about 2.6%. This is an important advantage for the Government given its strategy to increase the average salary (see Table 2.1).

[1] The 1382 Afghan fiscal year started on March 21, 2003 and ended on March 20, 2004.

[2] The estimate has been developed for the Afghanistan Pay and Employment Model (APEM), prepared by the World Bank, based on a detailed analysis of trends from the headcount database (first developed by Adam Smith Institute and now maintained by the ARTF's Monitoring Agent). The database relies on M16 forms (summary of payroll) received by the Treasury and provides the number of employees for each department (each ministry in each province) every month. More recent data suggests that this number could have increased due to recruitment of teachers (see below).

[3] Apparently, the Department of Oil and Gas in the Ministry of Mines and Industry has staff on the Government's payroll, while part of it (e.g. Oil and Gas Exploration Development and Afghanistan State Gas Enterprise) should be considered as separate entities; a recent analysis by the ARTF's Monitoring Agent indicates that there could be other such examples (Chapter 4).

Table 2. 1: Size of the Civil Service
(% total population)

Region	Total Civil Service	Teachers	Health staff
Afghanistan	**1.2**	**0.3**	**0.001**
Africa	2.0	0.6	0.2
Asia Pacific	2.6	0.8	0.2
Central and Eastern Europe and the FSU	6.9	3.0	2.1
Latin America and the Caribbean	3.0	0.8	0.3
Middle East and North Africa	3.9	1.2	0.4
OECD	7.7	2.1	1.4

Source: Afghanistan: staff estimates for 2004; other countries: Schiavo-Campo et al. (1997) for various years in the 1990s.

2.4 ***Overall, the size of the civil service remains largely stable*** although the volatility from one month to another requires careful interpretation of the data. This conclusion is based on the observation of actual payments (in Annex 2.1). A detailed analysis suggests:

- *A move from Kabul to provincial employment, largely concentrated in education*: during 2003/04 and 2004/05,[4] some 42,000 persons have been recruited in the provinces while 5,000 fewer people were on the payroll in Kabul. This mainly reflects recruitment in education, while other provincial and district departments have kept employment levels at a similar, even sometimes lower, level.
- *Overall stability in numbers but an increase in teachers*: over the same period, while the number of employees in the Ministry of Education was increasing by 50,000, the number of other employees was declining by 13,000.
- *Uncertainty about police*: over the same period, the number of uniformed staff paid by the Ministry of Interior has increased by 4,000. Although headcount volatility suggests that the quality of data is problematic (see below), this increase might indicate a trend as an increase in the number of positions (23,000) was agreed through Presidential Decree during 2003/04.

2.5 ***Discipline in recruitment has largely been achieved through the* tashkeel *system.*** Decisions on the establishment are size validated by the Office of Administrative Affairs of the President's Office (see Evans et al, 2004). This department maintains the *tashkeels* (detailed lists of authorized positions). Changes in the *tashkeels* are usually decided annually, in advance of the budget. To process payroll, departments also need to receive their *takhsis* (an allotment for payroll payments), sent on a quarterly basis by the Ministry of Finance. *Tashkeels* and *takhsis* are sometimes inconsistent, but have been improvements as the Office of Administrative Affairs now participates in the budget hearings. Some discrepancies remain however, such as the significant increase in the *tashkeel* for the Ministry of Interior approved two months after budget approval during 2003/04.

2.6 ***Discipline in recruitment has enabled the Government to implement its policy of a lean civil service.*** There is a planned increase in education staff, but this is bringing Afghanistan in line with regional average (see Afghanistan Government, 2004). There remains uncertainty concerning security sector employment totals, however.

[4] These trends compare the first three months of 2005/06 to the corresponding period of 2003/04.

- *Teachers*[5]. Based on projected number of pupils, the number of teachers would need to increase from around 110,000 to above 194,000 by 2010/11. The cost is about $50 million (with no change in average salary, see below).
- *Other Civil Servants*. The rest of the civil service would stay the same size.[6]
- *Police*. A recent exercise in the Ministry of Interior indicated that there were 53,400 uniformed staff, of which 37,000 were provincial police and 7,000 were border police.[7] However, the *tashkeel* for uniformed staff in the MoI is almost 82,000 staff. The size of the police force is expected to increase, as will the counter-narcotics sector (which could add a few thousand policemen, see Box 2.2).
- *Army*. Currently the Afghanistan National Army (ANA) stands at around 26,000 and is projected to grow to 70,000 by 2009/10. The Afghan Militia Force have been phased out through the DDR process (Box 2.1).

Box 2. 1: Staffing in the Security Sector

Headcounts. Current estimates put security staffing (mainly including the army, police, and justice sector) at 175,000, but this is likely to increase to over 200,000 during 2005/06 once recruitment following Presidential decrees has been implemented.

Wage Bill. Currently, a substantial proportion of the wage bill for the security sector is funded outside of the core operating budget. **ANA** operating costs for 2005/06 are believed to be in the order of $140-170 million. Food allowances of $2.7 per ANA soldier per day show food costs for ANA of $34 million for 2005/06 alone. In total, a wage bill of approximately $74 million is paid off-budget. MoI is considering adoption of a new pay and grading structure for the **ANP**, which will increase salaries to match (and for a few of the higher grades exceed) the current pay structure for the ANA. MoI also pays $33 monthly for food to each member of staff.

Financial Management. While there has been good progress in reporting both wage and non-wage recurrent costs and staffing numbers for security institutions, significant information gaps continue to undermine the integrity of the overall analysis. These largely result from the rather fluid nature of staffing and the restructuring of security institutions. For example, the Afghan Militia Force, estimated by MoD at around 100,000 have been demobilized, but their number turned out to be only 63,000. On the other side, significant numbers of new ANA soldiers are being recruited every month, and a force size of around 26,000 has been built up. Furthermore, analysis indicates some disparity in actual staffing numbers for MoI and MoJ. MoI is currently in the process of approving an increased staffing size for the ANP from 53,400 up to 62,000 for 2005/06, although this has yet to be agreed. MoJ currently reports staffing "actuals" of 10,502, but only 4,701 are shown on the payroll. The Attorney General's Office has an agreed staffing establishment of 4,923, but reports actuals almost 50% higher. The staffing of the National Defense Secretariat is assumed at 10,000, but no actual payroll figures are available.

Volume V reviews public finance management in the security sector.

C. Pay Scales

2.7 ***Over time, the average paid salary has increased***, from around Afs 1,800/month ($36) in early 2003/04 to above Afs 3,000/month (almost $60) in the most recent months (Figure 2.2, based on actual payments). A detailed analysis indicates different trends as between the center and the provinces. The

[5] A census of all school facilities and teachers has been conducted in 2004. A total of 105,000 teachers were recorded and, given the number of schools not recorded, the total could be around 110-120,000.

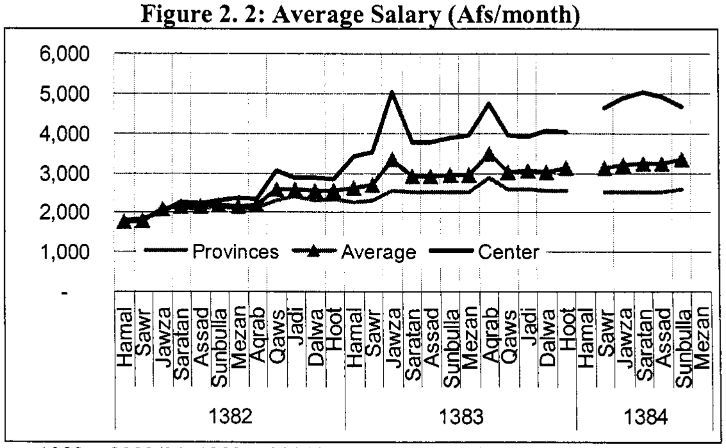
[6] There will, however, be an increase with the formation of Parliament. The staffing for Parliament could include around 300 parliamentarians, a secretariat of probably 500 staff, and 500 additional support staff.

[7] This is based on LOTFA accounts. However, headcounts recorded in the MoF database varied between 37,000 and 50,000 policemen in 2004/05.

gap appears to be increasing over time, possibly reflecting implementation of the Priority Reform and Restructuring (PRR) scheme (see below).[8]

2.8 ***Pay policy decisions are made by the Cabinet.*** The Cabinet has decided that pay scales would be proposed by the Independent Administrative Reform and Civil Service Commission (IARCSC), after review by the Ministry of Finance (MoF). This has provided an effective mechanism for the Government to implement a consistent approach to pay policy. There is currently no pay policy unit.

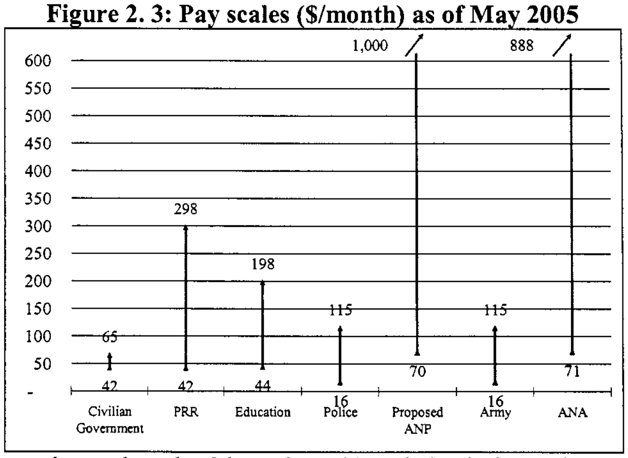
Figure 2. 2: Average Salary (Afs/month)



1382 = 2003/04; 1383 = 2004/05; 1384 = 2005/06
Note: Total wage bill divided by headcount for non-uniformed staff.
The unusual level in Jawza 2004/05 is due to a high payment in the Ministry of Interior. Source: Headcount database (updated in November 2005).

2.9 ***There are several pay scales (Figure 2.3).*** Most civil servants are on the "general pay scale". Teachers have their separate pay scale. There are also specific scales in the security sector.

Figure 2. 3: Pay scales ($/month) as of May 2005



Lower and upper bounds of the scales. This includes the base salary and an estimate of cash allowances

2.10 ***The general pay scale for civil servants, despite a pay increase in 2003, is low and compressed.*** Before the 2003 pay increase, the average salary was on the order of $38 per month, with the ratio of the

[8] While the PRR allowances recorded in the Government's information system are low, it is possible that they are misrecorded. The increase at the central level could then in part be explained by the fact that, at mid-year in 2004/05 , around 3,000 employees (4% of Kabul-based civil service) was in the PRR scheme, and they received on average a monthly allowance of Afs 5,000.

highest to lowest grades (compression ratio) only 1.09:1. This was largely driven by the payment of large and flat allowances that amounted to 95% of the salary. In November 2003 base pay was multiplied by seven, bringing the average salary level to $48 per month and increasing the compression ratio to 1.6:1, a substantial de-compression. These ratios in theory include all allowances, which are now paid in cash. In practice, some in-kind benefits are in addition granted to civil servants (most notably food,[9] but also transport). In November 2005, a modest pay increase was granted to civil servants: as it was equal for all of them, the compression ration slightly worsened to 1.5.

2.11 ***Teachers have their own pay scale.*** In 2003 a new allowance was created for teachers (based on qualification instead of grade), which increased teachers' salaries from about $30 to $50 per month. For university teachers (estimated to number about 1,700), options to give them a one-time cash or in-kind transfer (e.g. research grant or IT equipment) were reviewed in 2004 and could cost $2 to 3 million.

2.12 ***There are several pay scales for the army and the police.*** The police has its own salary scale, and police wages were increased in 2003. A new pay scale was created for the new Afghan National Army, much higher than what had previously been in effect for the Afghan Militia Forces. For both the police and the army, employees also receive in-kind benefits (food). Differences between these scales have created significant pressures for further pay increases in the security sector, i.e. for the Afghan National Police (ANP) and the National Directorate of Security. As a result of such pressure, MoI has proposed adoption of a new police pay scale similar to the ANA scale. Placing policemen on the proposed scale would cost a total of close to $180 million per year. There has also been discussion in MoD about increasing the current ANA scale.

2.13 ***The average salary probably needs to continue to increase over time.*** Currently, the average salary is similar to that of other countries in terms of GDP per capita (Table 2.2). However, income per capita in Afghanistan is very low and is expected to increase significantly in the next decade. In addition, the lack of capacity in the current civil service and competition in the labor market (mainly from donors and NGOs currently, but potentially later from the private sector) mean that the Government has to rely on expertise paid by donors (either through the provision of technical assistance or, for line positions, by provision of top-ups).[10] In the *Securing Afghanistan's Future* (SAF) report, the Government's has stated its strategy to increase the average salary faster than per capita GDP over the next few years (Figure 2.4).

Table 2. 2: Average Salary (as multiple of per capita GDP)

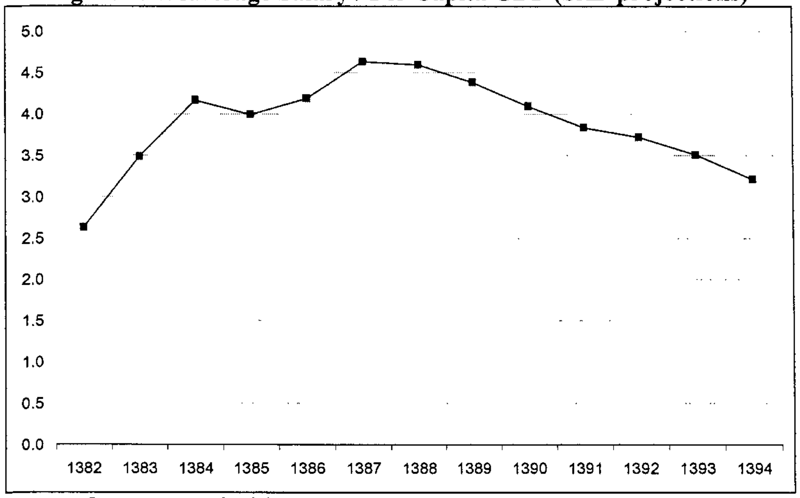
Region	Salary
Afghanistan	**3.1-3.5**
Africa	5.7
Asia Pacific	3.0
Central and Eastern Europe and the FSU	1.3
Latin America and the Caribbean	2.7
Middle East and North Africa	3.4
OECD	1.6

Source: For Afghanistan: unweighted average pay scale for general civil service (3.1) or 2004/05 budgeted wage bill (3.5) divided by the non-drug GDP. For Regions: Schiavo-Campo et al. (1997).

[9] According to the Government's accounts, more than $50 million were paid for food in 2003/04. It would appear that a large part of it is not for employees (for students, patients in hospitals, conscripts, and prisoners in jails) and that most employees receiving lunches pay for it (even though with a subsidy).

[10] This is particularly true in the health sector. A top-up decree was approved by the President to ban top-ups. It is not yet implemented and the Government's plans are to phase them out, using the capacity-building framework.

Figure 2. 4: Average Salary / Per Capita GDP (SAF projections)



Source: Government of Afghanistan (SAF report).

2.14 ***The Government's policy has been to grant pay increases only through its capacity-building framework in the short term and, in parallel, to review the structure of the compensation system.*** There are however strong pressures, both for general increases and for increases targeted to specific skills (i.e. in the health sector). Such pressures resulted in an across-the-board increase in the cash allowance for civil servants of Afs 350 per month in mid-2005/06. Giving in to these pressures would quickly erode the Government's ability to engage in comprehensive coherent reform of the pay structure.

2.15 In July 2004, the Ministerial Advisory Committee (MAC) approved ***a framework for capacity building***, which introduces a number of other programs to allow higher pay rate either for specific positions in the civil service or for external consultants temporarily hired (Annex 2.2)

- *Priority Reform and Restructuring program.* Individual departments reform their structure and are allowed to pay higher salaries to qualified staff (see scales in Figure 2.3, with the higher rate at almost $300 for the PRR scale compared to $65 for the regular scale). The 2003 pay increase (for the general scale) has somewhat reduced the premium to staff placed under PRR. For 2004/05, the objective was to bring 15,000 employees under the program: as of November 2004, however, only 8,000 positions were covered. In the 2004/05 budget, $35 million was set aside in the Civil Service Reform Fund for the PRR allowances. Only $1.5 million has been spent, reflecting slow implementation.[11] There has been little implementation so far at the provincial level to date (Chapter 3).
- *PRR superscale.* For a limited number of officials in PRR agencies, a 2-3 year contract is envisaged to place them at a higher level than the existing PRR scale. Budgeted for 500 positions at an average of $600 per month (up to $2,000), this could cost $4 million annually. The MAC has already approved several such positions. It can be assumed that it will be difficult to return these positions to the existing PRR scale later, and therefore that this cost is likely to be lasting.
- *Lateral Entry Program.* For agencies where there are no immediate prospects for the PRR process, lateral entrants could be brought in to help launch the reform process. Budgeted for 1,500 entrants, at an average of $1,000 per month, this could cost $18 million per year. The program is designed with explicitly non renewable, fixed term contracts. But it is possible that it could have some longer term fiscal implications.

[11] Slow implementation reflects: backlog in reviewing PRR applications; delays in recruitment; and lack of capacity and leadership to implement programs, especially when they imply moving staff.

- *Other programs*. These include the Technical Assistance and Feasibility Study Unit (TAFSU), providing short-term consulting services, and the ARTF Expatriate Window, providing one or two year contracts for expatriates. The cost of these programs is assumed to be borne by external assistance without long-term impact on the civil service wage bill.

2.16 In parallel, IARCSC has initiated a pay and grading review for all civilian employees. The first phase seeks to evaluate the current system, prepare job descriptions, and develop a consistent grading structure. The second phase will consist of developing a pay structure to be attached to the new grading structure, based on local labor market conditions for the skills and qualifications required. Anecdotal evidence suggests that pay scales at the lower end of the civil service are already about in line with market rates, but the upper end will have to increase in order to attract and retain staff with appropriate qualifications. However, it is important that staff lacking necessary skills and qualifications are not paid higher salaries that may be called for by the pay and grading review. In addition, all PRR position holders will be required to re-apply for the permanent positions when the pay and grading review is implemented (PRR contracts have been issued for 12 months, and renewals are supposed to be based on a satisfactory performance review). Close coordination between the IARCSC and the MoF will be required in this matter.

2.17 ***Although ongoing PRR and related reforms are not fiscally costly, implementing the pay and grading review would carry significant costs***. The implementation of the pay and grading review will be very costly if it leads to a salary structure close to PRR scale levels. Bringing all civil servants (120,000 employees, excluding teachers and policemen) to the PRR salary level would cost more than $100 million (the cost is about $9 million per 10,000 employees). Another $160 million would be required for teachers (assuming 194,000 teachers). The temporary schemes (i.e. PRR superscale and lateral entry program) require careful management to avoid creating additional pressures on the general salary scale. Finally, the creation of the ANA scale has generated pressure at least on the entire security sector.

D. The Wage Bill

2.18 ***The wage bill accounts for 67% of the operating budget or 6.3% of GDP*** (2004/05 actuals).[12] This is somewhat higher than the international average.

2.19 ***The wage bill in 2003/04 was close to budget,*** at $282 million against $264 in the budget (Table 2.4). This reflected two partly offsetting factors. First, the civil service wage bill was lower than budgeted. Indeed, headcounts were below the budgeted ceilings both because information in the *tashkeels* was weak and because some recruitment targets were too ambitious (e.g. in education). However, the average salary was above the budgeted amount due to salary increases granted during the fiscal year (the general increase was decided at mid-year, after the mid-year review had identified potential savings). Second, the wage bill for the security sector was higher than expected, with in particular spending in the Ministry of Interior 30% above the plan.

2.20 ***In 2004/05, the wage bill was also close to budget, at $374 million against $377 million budgeted***. The $92 million increase over 2003/04 resulted from two factors:

[12] To compare with other countries, in-kind food given in the police and the army is included in this number. By contrast, the Government's budget document does not include these benefits – and is therefore lower – while IMF tables include in the wage bill all food paid by the Government, including food for students, patients, and prisoners – and the wage bill is thus estimated at a higher level.

- *The increase in headcount largely reflected the recruitment of teachers.* For the civilian Government, the headcount ceiling in the budget was set at almost 370,000, above the level estimated in the Government's 2003/04 mid-year review (301,000).
- *The average salary is now budgeted at $61 per month, up from the previous year's budget and actuals.* This reflects the full-year impact of the pay increases decided in 2003 (see above) as well as implementation of the PRR program.

Table 2. 3: Wage Bill (% GDP)

Region	Wages
Afghanistan	**5.3**
Africa	6.7
Asia Pacific	4.7
Central and Eastern Europe and the FSU	3.7
Latin America and the Caribbean	4.9
Middle East and North Africa	9.8
OECD	4.5

Source: For Afghanistan: civil service only (includes justice and police, but excludes the army). For Regions: Schiavo-Campo et al. (1997).

2.21 ***In 2005/06, the wage bill is budgeted at $460 million.*** This reflects some minor recruitment, some pay increases (security sector, university teachers, and PRR implementation for the civilian side), and the transfer of part of the Afghan National Army's costs to the budget.

2.22 ***The Government articulated in the SAF report its strategy to increase salaries in a responsible manner, while maintaining a lean civil service.*** The Government also indicated in the SAF report its intention to cover its civilian wage bill by 2008/09. The scenario outlined would raise the wage bill to 8% GDP by 2010/11. At the same time, conservative projections suggest that without new tax policy measures and other major improvements, revenues would barely reach 7% of GDP in 2010/11 (compared to 11% in the SAF report).[13]

2.23 ***Monitor wage bill and revenues.*** Although the strategy set out in the SAF report implies that the wage bill will increase over time despite a sizable deficit in the operating budget, this must not be interpreted as a softening of the hard constraints within which the Government must operate. The Government will need to monitor the wage bill and revenues closely, and make trade-offs between policy options as part of its medium-term fiscal framework (MTFF). The upcoming preparation of the 2006/07 budget, along with its multi-year framework, provides an opportunity for the Government to specify its policy direction and restate its commitment to public administration reform combined with fiscal responsibility. This requires careful attention to the three main risks that might affect the wage bill side (a fourth risk is related to the capacity of the Government to mobilize domestic resources):

- The required changes in skills mix might necessitate a temporary small increase in staff (recruitment of new skills, without being able to retrench obsolete skills other than by retirement), but given the strategy to increase salaries to build capacity, the Government cannot afford to lose the advantage of a relatively small civil service; however, undisciplined recruitment and significant increases in establishment size must be avoided.
- The PRR scale, PRR superscale, and LEP cannot be allowed to exert significant pressures on the rest of the pay and grading scale; pressures for generalized wage increases will have to be resisted in order to avoid serious adverse fiscal consequences.

[13] Volume I, Chapter 3 outlines fiscal scenarios (including a projection of the wage bill).

- Wage increases in the security sector could have major adverse fiscal consequences, reducing the space to create a civil service with adequate capacity.

2.24 ***Provide full information to donors to secure their continued support.*** The Government wage bill will be a key driver of Afghanistan's fiscal aggregates and fiscal balance. Following the SAF projections in 2004, the MTFF recently prepared and approved provides a welcome statement of the Government's medium-term fiscal stance. In a situation characterized by a continuing large operating budget deficit financed by external assistance, the Government will need to provide full information to donors and take them into confidence about its fiscal policy including wage policy. While adjustments may be required in the light of subsequent developments, it would not be advisable to allow the gap between Core Budget operating expenditures and revenues to widen significantly in an unprogrammed manner. The Government should alert donors to any departures from its fiscal policy stance if it is to maintain the support that donors have so far provided to the operating budget.

E. Payroll Processing

2.25 ***There are shortcomings in the existing arrangements for payroll*** (failures to pay government employees on time, in full amount, and with clear identification of receiving individuals), which undermine the integrity of the process and the motivation of civil servants. These include: (i) delays in confirming employment and authorizing quarterly budget allotments by line ministries to provinces and districts and in preparing lists of established positions (*tashkeels*), (ii) errors and existence of "ghost" employees due to manual calculation of payroll and lack of supervision over salary distribution, and (iii) delays and payment of less than 100% of salary associated with the use of *bonded trustees* contracted by the budget institutions for collection of cash from the Central Bank and for disbursement of salaries in cash to individuals. The ARTF conducts spot checks on payroll distribution, but the Government's financial controls and audit are inadequate to rectify such problems.

2.26 ***The Government has already made progress in addressing these issues.*** The two key reforms have been: (i) re-decentralization of payroll and (ii) Individualized Salary Payments (ISP) in Kabul. First, the salary payment process has been re-decentralized to provinces (after having been centralized between 2002 and March 2004). This has reduced delays (before, all the paperwork was sent to Kabul).[14] The impact on compliance remains unknown however. Second, the ISP was piloted in Kabul in 13 agencies and ministries in December 2004. The program involves giving a list of employees to the partner bank (DAB, Millie Bank, and Pashtany Tejaraty Bank) and requesting the employees to come personally to the bank to receive their salary. This requires three supervisors to be physically present (one from the department, one from the Treasury, one from the bank), and as they need to reach each employee, this solution might be difficult to roll out to the provinces, and in particular to districts. As part of the ISP project, a stand-alone database is being piloted to computerize the payroll.[15]

2.27 ***Monthly payroll processing now consists of five main steps (Table 2.4 and Table 2.8).***[16] First, every month each unit (at the local level) prepares a payroll form (M41) with the list of all employees, their attendance, and their pay: this form, together with the summary form (M16), is sent to the Treasury (either in Kabul or to the Mustoufiat in provinces). At about the same time, the Treasury gives the order to transfer cash to provinces based on allotments, and DAB physically transfers this cash to provinces. The local or central Treasury then processes the payroll, checking that sufficient allotments are available.

[14] Data collected in Kabul reflect limited change (Box 2.3), but these data do not capture a consistent part of the process over time (payments were made after data was collected in Kabul before the decentralization, while they are now made in provinces, before the data is collected in Kabul).
[15] In addition, MoI is developing its own payroll and personnel database.
[16] See Evans et al. (2004), which also includes the other steps of payroll processing (e.g. employment confirmation, Table 2.9).

Payments are then made to individuals, often through the bonded trustees (who cash the payroll at the bank and then distribute it to individuals) or through ISP. Finally, for provincial payrolls, Mustoufiats send a summary of salary payments (M23) to the central Treasury, which enters it in AFMIS (and update the Headcount database).

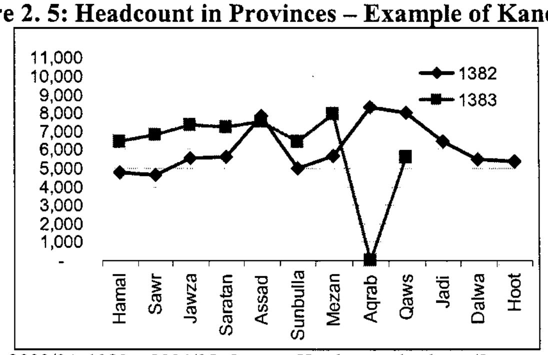
Table 2. 4: Steps for Monthly Payroll Processing

	Deadline	Responsible unit	Action
1	15th	Sub-budget organizations	Prepare M41 (payroll form)
2a	20th	Treasury department	Transfer cash to all provinces based on allotment
2b	25th	DAB	Transfer physical cash to all provinces based on the above cash transfer advice from the Treasury Department
3	26th	Treasury (local or central)	Process provincial salary payments
4	7th (next month)	Treasury (local or central)	Salary payments to individual employees
5	10th	Treasury (local)	Send monthly Payment Reports – M23 for provincial salary payments and non-salary payments – and payroll summary reports to Treasury

Based on Finance Circular 8/1383 (2004/05). Deadlines are targeted deadlines.

2.28 ***The re-decentralized payroll process is considered a significant improvement by provinces; the most significant remaining obstacles are the receipt of takhsis, and the timing and adequacy of the Treasury order to transfer cash.*** The provinces visited during the updating work on subnational administration consistently reported major improvements in the timing of pay, and most staff are paid on a monthly basis, before the end of the current month. The Mustoufies reported that the main reason for delays in pay were delays in receipt of takhsis, which can be received as late as the third month in the quarter. When this happens, the affected staff cannot be paid. The second significant reason for provincial delays in pay is the delay in the Treasury's order to transfer cash, or an amount that is inadequate to cover the payroll and other non-salary expenditures. Provinces reported that the Treasury order could come as late as the 28th of the month, too late to process the pay in the current month. Provinces will not process M16s (required in order to issue checks) until enough cash to cover the checks is available. Finally, the delay in receiving the tashkeel (as much as six months) is also a problem, but it has not materially affected processing the payroll as provinces have used the 2003/04 tashkeel as authorization.

Figure 2. 5: Headcount in Provinces – Example of Kandahar



1382 = 2003/04; 1383 = 2004/05; Source: Headcount database (January 2005).

2.29 ***The Government has developed a plan to further improve the payroll process (Annex 2.2).*** The plan relies on computerized systems (integrated between human resource management, budget, and financial management) and individual identification systems (picture ID). In the next few years (March 2006 for Kabul and main provincial centers, March 2008 for the rest of the country), the Government intends to make direct deposits to its employees' bank accounts.

E. Pensions[17]

2.30 ***Pensions for civil servants are low, despite a recent increase (Table 2.5).*** The current pension is a defined benefit pension (retirement benefits based on the employee's final pay – including only the base pay, not allowances – and length of service). The scheme covers civil servants, workers on contracts, military, police, and SOE employees. Until recently, civil service pensions were so low that most people entitled to receive them did not pick them up. But a substantial increase took effect in March 2004, following the general pay increase passed a few months before (see above). The pension adjustment is said to be an interim measure, which does not apply to those retiring after the beginning of 2004/05.

Table 2. 5: Pension after increase (Afs/month)

Grade	Pension	Salary	Ration
'beyond'	2,100	3,279	64
'above'	1,900	2,975	64
1	1,600	2,688	60
2	1,400	2,548	55
3	1,300	2,443	53
4	1,200	2,324	52
5	1,100	2,268	49
6	1,000	2,212	45
7	950	2,177	44
8	900	2,135	42
9	850	2,100	40
10	800	2,058	39

2.31 ***Most recently, from around 69,000 accounted eligible beneficiaries in Kabul and the provinces (including civil servants, military, and survivors) close to 30,000 were paid.***[18] Accounting of the flow and stock of active retirees as well as assessment of the short and longer-term financing needs, however, are complicated by the fact that pensions are reportedly paid on an annual basis and can be collected retroactively for several years. Therefore any current increases in expenditure may partially be reflective of the process of clearing the backlog of outstanding liabilities. Lack of sound record-keeping arrangements and any automation makes the task of financial analysis and planning extremely difficult. (A separate scheme managed by the Central Bank covers over 4,500 insured employees of various public banks and pays benefits to over 1,500 pensioners.)

2.32 ***Administrative capacity to implement any policy changes at present is very limited.*** Operations of the pension scheme clearly require modernization. Urgent measures should include investment in basic infrastructure and record-keeping systems, comprehensive inventory of the current records, assessment of operations and procedures, staff training, and survey of beneficiaries of the system. A longer-term objective should be automation of the processes, full connectivity of the local branches, and implementation of the sustainable and transparent record-keeping mechanisms.

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[17] This section is based on "Afghanistan's Pension System: Policy Issues and Options for Reform", July 2, 2004, World Bank; and report of the pension mission to Kabul in October 2005.

[18] The Pension Office, Ministry of Labor and Social Affairs.

2.33 ***Pension financing is a pay-as-you-go system***. Each covered organization[19] is supposed to contribute 8% of each employee's pay, and each employee is supposed to contribute 3% (plus 25% of his/her salary in the first month of employment and 50% of the incremented portion on every salary increase). The employer contribution is currently not collected, while the employee contribution is unevenly collected. The gap is financed by the budget. The original 2005/06 allocation of $15 million was supplemented by another $4 million in the mid-year budget review. The cost of the recent increase is actually carried by the budget: this is supposed to be a short-term mechanism, while the Government prepares a plan to make the regime sustainable. The system used to work as a partially funded system. In principle, the pension fund has assets (mainly land and buildings) to generate income that would finance pensions; however, in practice the fund faces difficulties in regaining control of these assets, which were taken out of its control under the Communist regime.

2.34 ***Various public sector reform initiatives create urgency for coordination of with the program of the pension reform***. Public sector reform proposals basically include:

- *Changes in the scale and composition of pay.* With increased overall pay in the civil service, pensions would have increased as well, leading both to rise in current financing needs and to a very considerable increase in pension liabilities to individuals who retire after that measure gets implemented (given that it currently excludes various allowances). Analysis of options and provisions ensuring fiscal sustainability and cross-generational equity is clearly needed.
- *Demographics of the civil service.* The demographics of the civil service (Figure 2.6) will lead to retirement of many civil servants in the coming years. In addition, various compensation packages may stimulate rapid resignations of some employees who are close to the retirement age, leading to increased pressure on the budget to provide and sustain both regular and various lump sum pension payments.
- *Hires of new employees (e.g. in the education sector).* When new employees start joining the reformed civil service, it is essential that they start contributing to and accumulating stakes in the new and reformed pension system.
- *SOE restructuring, privatization, and liquidation.* Given that coverage of the pension system includes various SOEs and other state-operated entities, reforms aimed at their structural transformation will have implications for finances of the national pension scheme.

2.35 ***Comprehensive analysis of various reform measures directed to pensions or other public sector provisions requires full-scale financial projections***. At present, analysis of both short- and longer-term implications for liabilities of the pension system appears to be lacking. Availability of quality data is essential for this task. IARCSC recently launched the process of capturing the data on active civil servants and retirees to be used in pension projections.

2.36 ***Preliminary analysis of demographic data for civil servants reveals that even without active downsizing measures, fiscal pressures to pay pensions may significantly grow in the short- to medium term***. The most recent sample with over 12,000 records provided by IARCSC indicates that the cohort of males aged between 50 and 59 represents close to one-third of all the employed in civil service; those aged 60 and over represent another 10% of total employment. Some of these individuals will start retiring fairly soon (Figure 2.6). Furthermore, in the same sample, over 80% of both men and women have likely completed the minimum required 10 years of service qualifying them for some regular pension benefit at some point of time in future. Close to 40% of men and around 10% of women have completed a service that could qualify them for the benefit equivalent to 80% or more of their last drawn wage.

[19] Actually, large private sector organizations are currently, in principle, required to participate in this pension program.

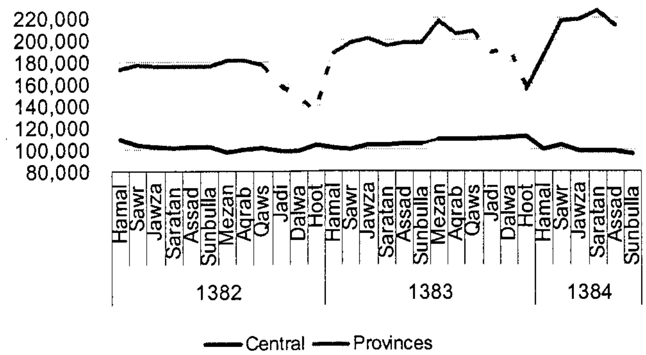
Figure 2. 6: Sample age distribution of the civil servants

Source: Staff estimates based on the data provided by IARCSC.
Notes: Based on 12,000 electronic records covering Kabul province.

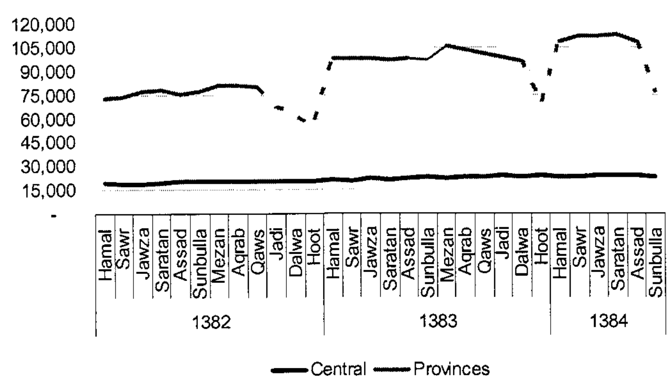
Annexes

Annex 2. 1: Size of the Civil Service A/

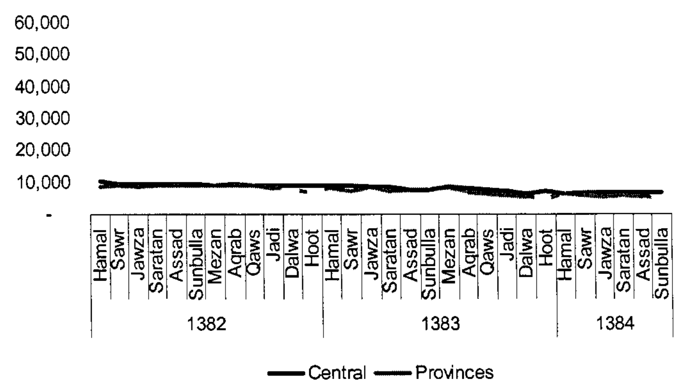
Overall Civil Service



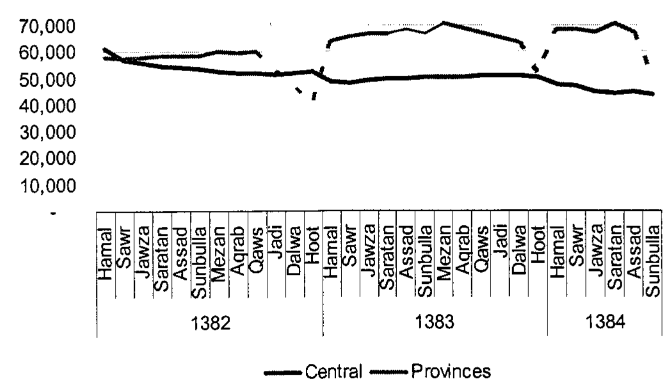
A/ Teachers b/



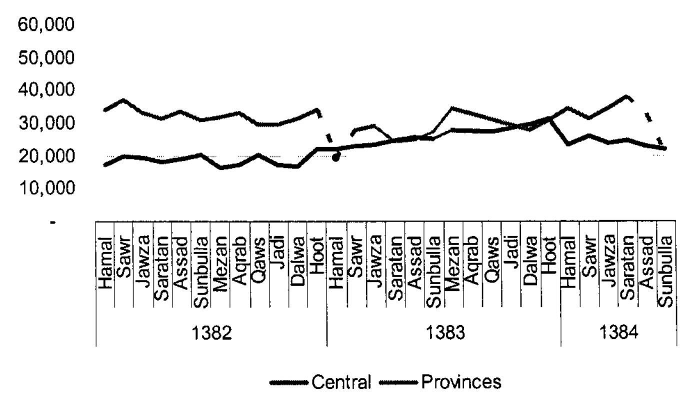
B/ Health c/



C/ Police d/



D/ Other Civil Service



1382 = 2003/04; 1383 = 2004/05; 1384 = 2005/06. Note: Data reflect the number of persons to whom payments were made, not the number of positions. The decrease at the end of each fiscal year and at the end of the reporting period reflects lack of reports, not a real decrease in headcount. a/ Herat has not reported payroll in 2003/04 (the headcount was around 21,000 in 2002/03 and 18,000 in the first months of 2004/05). b/ Teachers = 80% of Ministry of Education and Higher Education (assumption that 80% of employees are in classrooms), c/ Health = Ministry of Public Health, d/ Police = uniformed staff of Ministry of Interior.

Source: Headcount database / MA (updated November, 2005), Staff estimates.

Annex 2. 2: Framework for Short-Term Capacity Building

	Existing Civil Servants Who Want to be Retained	Expatriates, Brought in on Advisory Positions for a Limited Period of Time		Skilled Afghans Working in the NGO and Private Sectors and in the Region[i]	
Key Design Features	**Interim Additional Allowances under PRR**	**Afghan Expatriate Program**	**TAFSU**	**Lateral Entry Program**	**PRR Super scale**
Parameters	Key officials in PRR approved agency	In exceptional circumstances where the case is clearly made and exceptional candidate available	Short term consultants where the need is clearly justified and a terms of reference submitted to TAFSU	Key positions in each ministry through basic capacity assessment	Restricted to key officials in PRR agencies
Salary range	Up to $300	$500 - $7,000 and exceptional levels	$100 - $700 per day and DSA at UN rates	Up to US $ 2,000	Up to $2,000
Other benefits	Same as other civil servants,	Travel, insurance, housing,	Travel, insurance, logistics	Initial travel and housing be built into the salary	Same as other civil servants
Contractual	One year initially, extension subject to performance evaluation	6 month to 1 year non renewable contracts. In advisory position only. Clear training plan.	Short term only, 25 days per month and no more than 120 days per calendar year	2 years, renewable once only for one year	2-3 years and then to revert to normal position based on pay and grading recommendations.
Recruitment	Grade B and above through open competition under the IAB, grade B and below by the agency through an internal competition.	Executive Committee reporting to MAC, IOM for logistics	By TAFSU with international advertisement/ recruitment and a clear focus on regional markets. Sole sourcing in exceptional cases only.	Appointments confirmed by the IAB and then contracted to ARS.	IAB assisted by TA's and dedicated IAB commissioners.
Numbers	15,000 civil servants to be transferred to IAA scale in 2004/05 (target not met)	60 in total	80 in 2004/05	Year 1: 500 ; Year 2: 1,450; Year 3: 968; Year 4: 135[ii]	Year 1: 1000 Year 2: 500 Year 3: 500
Indicative Costs	US $ 35 million civil service reform Fund in 2004/05	US $ 5.0 million from ARTF and other donors	US $ 4 million from ARTF and other donors	$ 64.7 million	US $ 10 million from CSRF
Reporting and accountability	Line ministry with individual contracts	Line minister and monthly reports to Executive Committee and MAC. End of contract sign off by Executive Committee	To line minister	Line minister, perf. assessment reports to be approved by ARS. Probationary period: 6 months	Line ministry and performance based contract. Probationary period: 3 months
How to initiate request	Agency seeks approval of the MAC for PRR	Case by case as per approved procedures. Ministry initiates request to MAC with detailed TOR.	Ministry makes a request with a detailed Terms of Reference to TAFSU	Ministry to write to ARS once to justify numbers requested under LEP	Write to MAC where PRR is already approved and justify each position. Justify new position with new PRR.

[i] PRR superscale might also have some utility on occasion in retaining very skilled and marketable staff within government - although the numbers are likely to be very low indeed as any such staff have mainly left already.

[ii] These totals are the target numbers actively working in each year – taking into account attritions and extensions.

Annex 2. 3: : Obstacles and Remedies in the Payroll Process

	Stage [i]	Responsibility for Taking Action (*Common problems are in italics*)		Associated Fiduciary Risk	Government's Strategy	
		Kabul Ministry	Provincial Departments		Short-Term	Long-Term
"Wholesale"	Staff confirmed in position	Kabul ministry	Kabul ministry *Some provincial staff, who are not confirmed in their position, are rejected from the payroll.*	Might be a source of rents to have positions confirmed.	Complete systems study to augment AFMIS with the payroll/HRM facilities and HRM strategy feasibility study	
	Tashkeels provided for the year [ii]	Department of Administrative Affairs, Line ministries *Tashkeels are often provided late: this is supposed to stop departments from processing and payrolls. For 2004/05, departments were authorized to use 2003/04 tashkeel to process payroll.*		Tashkeels could be a source of rents Using the previous year's tashkeel means that this instrument of position control is not linked anymore to budget preparation	No specific action. However, Government should consider introducing a mechanism to maintain linkages between tashkeels and budgets	Ensure adequate budget procedures to coordinate the budgets, establishment, and staffing levels in the government
	Budget allotment provided for the quarter	Accounting and Budget Departments, Ministry of Finance	Accounting and Budget Departments, Ministry of Finance *Payrolls cannot be submitted unless the allotment has been received; these are reportedly sometimes inconsistent with the tashkeel at the provincial level, although this problem is has been reduced in most cases.*	Quarterly allotments could be a source of rents	No specific action. However, the Government should develop a strategy to simplify the allotment process and clarify communication channels so that allotments are communicated in time.	
	Payroll preparation (M41)	Individual organizational units within ministries	Districts and provincial departments			Roll-out payroll system according to the established schedule (extend coverage to Kabul and provincial centers)
	Payroll pre-audit and verification (1)	M41s sent to the comptrollers within the ministry prior to authorization by the relevant minister	M41s sent to the comptrollers under the mustoufiat prior to authorization by the governor	No nominal roll maintained at the ministry or provincial level – fictitious staff could be placed on the payroll.		
		Ministry of Finance department prepares M16s (summaries)	Drafting department of the mustoufiat prepares M16s (summaries)			
	Transfer to Treasury Presidency	Ministry sends one complete set of M41s & M16s to the Ministry of Finance.				

Annex 2. 3: : Obstacles and Remedies in the Payroll Process

	Stage [1]	Responsibility for Taking Action (*Common problems are in italics*)		Associated Fiduciary Risk	Government's Strategy	
		Kabul Ministry	**Provincial Departments**		**Short-Term**	**Long-Term**
	Payroll pre-audit and verification (2)	Treasury Presidency in the Kabul Ministry of Finance checks the accuracy of the M16s.	The Mustoufiat checks the accuracy of the M16s against allotments.	Possible that rents are being charged (levies on the payroll) in exchange for having the payroll approved.		
"Retail"	Preparation of checks	Ministry of Finance prepares checks for each ministry.	Mustoufiat issues a check for each M16			
	Moving cash within the DAB	Central bank	Provincial branch of the Central bank *In some cases there delays in moving the cash to the provincial branches.*	Possible that rents are being charged (levies on the payroll) in exchange for having the cash made available in the provinces.	Initiate pilot for direct salary deposits to bank accounts for the employees of pilot ministries (finance, communications, commerce)	Ensure development of national payment system and adequate retail facilities to reach government employees for salary payment
	Payroll pre-audit and verification	Comptrollers within the ministry confirm that the checks correspond with M16s.	Comptrollers in the mustoufiat confirm that the checks correspond with M16s.		Review procedures for accounting and reconciliation of accounts with the Treasury	
	Distribution to departments	Bonded trustees collect their checks. Trustees cash the check at the DAB, and return to the departments with the cash.	Mustoufiat's disbursement office issues checks for each provincial department and district. Bonded trustees of the departments and districts receive their checks. Trustees cash the check at the provincial branch of DAB, and return to the departments/ districts with the cash.	Possible rents are being charged by the bonded trustees for their role in the process.		

Annex 2. 3: : Obstacles and Remedies in the Payroll Process

Stage [i]	Responsibility for Taking Action *(Common problems are in italics)*		Associated Fiduciary Risk	Government's Strategy	
	Kabul Ministry	**Provincial Departments**		**Short-Term**	**Long-Term**
Distribution of individual payments	Trustee disburses the salaries to the staff in front of witnesses. Employees sign on M41 for acknowledgement.		It is not clear whether identification is required at the time of collecting pay – and whether identification is robust – raising the possibility of ghosts and double payments. It is also not clear that employees are fully aware of their entitlements.	Establish schedule and action plan for extending ISP process for all budget entities in Kabul city (2) Establish schedule and action plan for establishing identification standards, assigning national ID numbers, and issue photo IDs for all government employees covered by ISP	Ensure assigning national ID numbers and issue photo IDs for all government employees covered by ISP

[i] The payrolls for some departments are not processed through the normal process, in particular the police, the national security department, and foreign affairs.

[ii] A joint committee comprised of the Office of Administrative Affairs and the respective ministry reviews the proposed tashkeels. Then, the tashkeels are signed off by the head of the IARCSC.

CHAPTER 3. UPDATE ON AFGHANISTAN'S SUBNATIONAL ADMINISTRATION

Executive Summary

1. A detailed analysis of Afghanistan's subnational administration was conducted by the World Bank and AREU in 2003/04. This chapter provides an update of this study. One of the main conclusions of this update is that financial management at the provincial level has improved significantly since the original study was done:

- In most cases pay is now received monthly, and on time.
- Access to cash balances for non-salary expenditure is much improved, particularly in the very poor provinces.
- Financial reports are being submitted on time (mostly).
- The single expenditure and revenue accounts are working well.
- Audits are being done – although it was unclear what effect these audits were having.

2. But there are still significant issues to be addressed:

- Low pay continues to be a major complaint
- The *takhsis* and *tashkeel* arrive late in many cases, and in the case of the *takhsis* it causes delays in pay; there are also disconnect between the line ministry's version of the *takhsis* and the Mustoufiat's version.
- The system of transferring positive balances into the provincial single expenditure account, while effective in getting cash out to provinces, is still placing unnecessary constraints or delays on spending.
- Non-salary allotments are still low, and there continue to be inequities between provinces.
- There is a still a lack of written manuals, and more training is needed.
- Management of the education budget is still a major issue.

3. In terms of recruitment and staff appointments, however, little has changed. Senior appointments are going through the civil service commission, but still, political and ethnic considerations appear to feature prominently in recruitment. There has also been some small movement towards introducing the Priority Reform and Restructuring (PRR) scheme at the provincial level, but so far it is only seen as a means to increase pay, and those left out are resentful.

4. As an overarching recommendation, this chapter concludes that the package of reforms in the areas of financial management and staffing administration should continue, and efforts should be focused on ensuring effective implementation. While the improvements that have been seen at the subnational level are encouraging, there is still a risk that the gains will be effectively lost if growing reliance on mechanisms outside the provincial administration's budget and planning processes begins to marginalize these structures.

A. Introduction

FINDINGS AND RECOMMENDATIONS FROM THE ORIGINAL STUDY

3.1 In 2003, the Afghanistan Research and Evaluation Unit (AREU) and the World Bank jointly undertook a study of subnational administration in Afghanistan. A central part of this study included missions to six provinces – Badakhshan, Bamyan, Faryab, Herat, Kandahar and Wardak. The study results were published in Evans et al. (2004a and b).

3.2 The overarching conclusion of the study was that, despite the many political challenges, there was a basic bureaucratic structure at the subnational level that could be made to function. But this opportunity was time limited; if no action were taken soon, the skills, experience and commitment to public service would have completely drained from the system. Key issues addressed by the recommendations include:

- Inadequate salaries – too low and too late
- Delays in staff appointments
- Outdated tashkeel
- Lack of training and knowledge of procedures
- Low-levels of non-salary cash flow
- Lack of central government presence in the provinces & districts
- Lack of adequate office facilities
- Central policy decisions bypassing existing structures
- Changing district and provincial boundaries
- Need for 'new blood' in the civil service

3.3 The report proposed a two-pronged strategy. One strand called for the center to commit itself to delivering some basic support for provinces, districts, and provincial municipalities in their functional role as service provider or commissioner, and in their political role as local representative of the unitary state. The second strand of the strategy was comprised of tailored incentives for subnational administrations that reflect their institutional and historical roots. Effective incentives at the subnational level would entail providing valued resources that are triggered by simple measures of administrative effort, and tailoring the incentives to suit the different circumstances faced by provinces, districts, and provincial municipalities.

3.4 Specifically, the report proposed commitments from the national government in Kabul to:

- Complete the pay and pension reform.
- Build confidence in the central agencies by demonstrating progress in the Independent Administrative Reform and Civil Service Commission (IARCSC) and by increasing Treasury authority over payroll, by providing procedural guidance from the Ministry of Finance (MoF), and by enhancing oversight of the ordinary and development budgets.
- Build loyalty to Kabul by removing delays in processing the payroll and in staff appointments, by updating the *tashkeel*, increasing the levels of non-salary cash flow, by improving Kabul presence in the field and re-orienting Kabul ministries, and by stabilizing district jurisdictions.
- Restore provincial dignity and capacity by physical reconstruction and priority support for provincial health and education departments.
- Revive districts by physical reconstruction and support for a return to written procedures.

3.5 The study proposed matching these commitments with conditional incentives for subnational administration, based on a combination of grants, modest delegation, and technical assistance, with triggers based on simple measures of administrative effort. The underlying approach proposed was one of modest and selective deconcentration to give the center more practical control over local operations.

THE GOVERNMENT'S RESPONSE

3.6 Since the original subnational study was conducted, the Government has taken a number of actions that address issues in the report. For example:

- It has launched the Afghanistan Stabilization Program, which will provide funding for priority provincial projects through the Provincial Stabilization fund, provide buildings for district administrations, and support capacity building at the provincial and district levels

- It approved the Priority Reform and Restructuring (PRR) Decree, which provides a packaged approach to restructuring government units and providing improved pay levels for key leadership positions.

- It has introduced a number of reforms in the MoF, such as:
    - re-decentralization of the payroll
    - improved cash management
    - clarified budget procedures and
    - revenue collection reforms

- It has established the IARCSC to oversee the administrative reform agenda, and manage merit-based recruitment for staff at grade 2 and above.

3.7 In addition, the MoF is reviewing the Mustoufiat's structure, roles and responsibilities. Although some elements are still undecided, such as the reporting structure for the revenue and treasury functions, it appears one of the innovations being considered will be to establish a budget coordination unit, that would support provincial departments in preparing budget requests, and more generally would help with coordinating provincial planning.

3.8 While these actions are important, positive steps, in other areas issues raised in the original report persist. In particular, there are several ongoing initiatives at the provincial and district levels, that operate outside the subnational administrative structures of government. For example,[1] there are Provincial Reconstruction Team (PRT)-related processes at the provincial level, including Provincial Reconstruction Offices in some provinces, and proposed Provincial Development Committees developed with the Ministry of Finance to coordinate National Priority Programs. There are now also provincial and district planning/coordination mechanisms being set up as part of the counter-narcotics effort. Although there is some coordination between these various structures and subnational administration, in many cases the linkages are very weak.

3.9 Issues related to district and provincial boundaries also remain. In Faryab in particular, the four districts along the border continue to operate largely through the province of Jawzjan. The tashkeel for these districts is sent to Faryab province, but their takhsis is sent through Jawszan, the payroll and non-salary expenditures are processed through Jawzjan, and the revenues are also collected through Jawzjan. Since the original report was published, the government has also created two new provinces.

[1] For a fuller discussion see Lister (2005).

SUMMARY OF MAIN FINDINGS

3.10 One of the main conclusions of this update is that financial management at the provincial level has improved significantly since the original study was done:

- In most cases pay is now received monthly, and on time.
- Access to cash balances for non-salary expenditure is much improved, particularly in the very poor provinces.
- Financial reports are being submitted on time (mostly).
- The single expenditure and revenue accounts are working well.
- Audits are being done – although it was unclear what effect these audits were having.

3.11 But there are still significant issues to be addressed:

- Low pay continues to be a major complaint
- The takhsis and tashkeel arrive late in many cases, and in the case of the takhsis it causes delays in pay; there are also disconnect between the line ministry's version of the takhsis and the Mustoufiat's version.
- The system of transferring positive balances into the provincial single expenditure account, while effective in getting cash out to provinces, is still placing unnecessary constraints or delays on spending.
- Non-salary allotments are still low, and there continue to be inequities between provinces.
- There is a still a lack of written manuals, and more training is needed.
- Management of the education budget is still a major issue.

3.12 In terms of recruitment and staff appointments, however, little has changed. Senior appointments are going through the IARCSC, but still, political and ethnic considerations appear to feature prominently in recruitment. There has also been some small movement towards introducing PRR at the provincial level, but so far it is only seen as a means to increase pay, and those left out are resentful.

3.13 There is some coordination going on at the provincial level, but it is unclear how effective it is. And the NSP appears to be successful, especially in building community identity.

3.14 Many of the issues identified in this chapter can be addressed relatively easily. A summary of the study's recommendations is contained in the concluding section of this chapter.

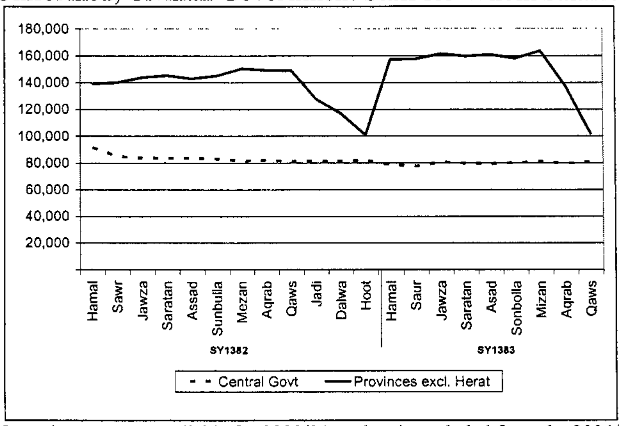
B. Overall Support for Provinces

3.15 As noted above, the original study was critical of the central government in terms of its support to subnational administration, and by extension, to mechanisms supporting service delivery. A starting point for assessing the extent to which the central government has improved its overall support for the subnational administration is to look at trends in staffing and in the provision of non-salary expenditures.

3.16 Figure 3.1 shows that, after discounting for end of year anomalies and lags in reporting at the provincial level, the general trend in staff numbers seems to be a reduction of staff based in Kabul, and an increase in staff at the provincial level. However, as Figure 3.2 shows, the increase in staff numbers at the provincial level is in fact only happening in Education, and for other departments the trend is flat or slightly downwards. This conclusion was supported in interviews conducted in the case study provinces. And, once Education figures are taken out, there continues to be more staff employed at the center than in all the provinces combined. While there is no doubt that education is an important priority for the

government, there is clearly still scope to shift the balance of staff numbers in other ministries closer to the points of service delivery.

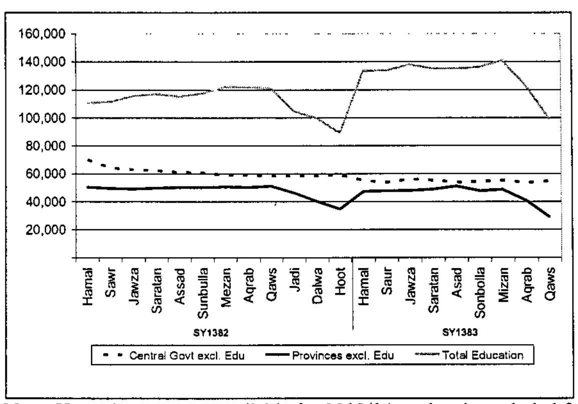
Figure 3. 1: Non-Uniformed, Civilian Government Staff for Whom Salaries Have Been Paid



Note: Herat data was not available for 2003/04, and so is excluded from the 2004/05 data
Source: Headcount database, ARTF Monitoring Agent

3.17 A major issue identified in the original sub-national study was the lack of access to non-salary expenditures, particularly in provinces without access to revenues, and in districts generally. The adequacy of allotments was discussed, and evidence suggested that a disproportionate share of non-salary expenditures was kept at the center. Still, the overriding issue was the lack of physical cash; provinces without access to revenues were not able to spend even the low level of allotment they were given, because the limited amount of physical cash that was transferred was only received at the very end of the year.

Figure 3. 2: Non-Uniformed, Civilian Government Staff for Whom Salaries Have Been Paid – Excluding Education



Note: Herat data was not available for 2003/04, and so is excluded from the 2004/05 data
Source: Headcount database, ARTF Monitoring Agent

3.18 The issue of availability of physical cash has largely been resolved. There are still issues with respect to access to positive balances in the province's single expenditure account, which are discussed later in the paper. But still, non-salary spending has improved significantly since 2002/03, for the "revenue-poor" provinces. Table 3.1 summarizes the reported spending on non-salary expenditures 2002/03 and 2003/04, along with allotments for 2004/05, and Figure 3.3 shows the change in non-salary spending as a share of total expenditure in each of the six case study provinces.

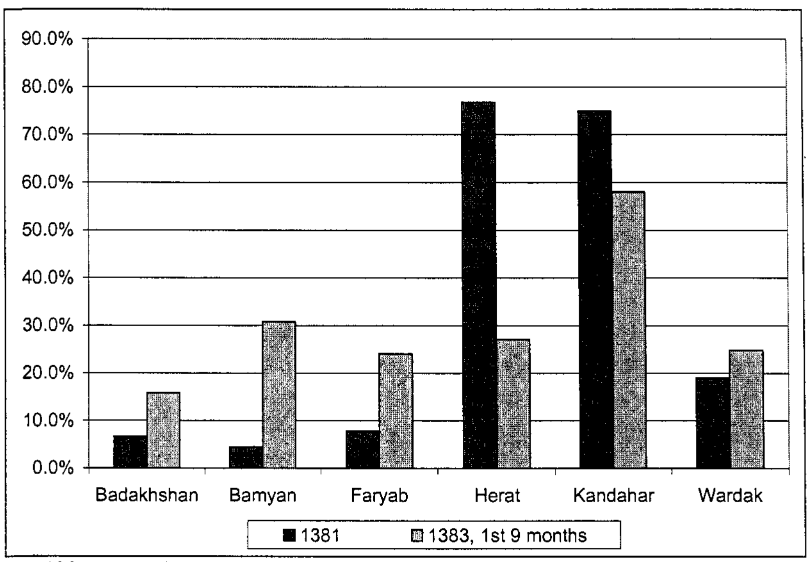
Table 3. 1: Non-Salary Expenditures, 2002/03 – 2004/05 (Afs million)

	2002/03 Expenditures	2003/04 Expenditures	2004/05 Full Year Allotment
Badakhshan	16.0	49.2	76.7
Bamyan	2.8	40.3	35.4
Faryab	6.2	28.2	48.8
Herat	745.0	*1549.1	111.3
Kandahar	508.0	646.8	121.8
Wardak	11.6	33.9	29.7

* In Herat, in 2003/04, a large payment was made in the Ministry of Reconstruction before the implementation of the Treasury Single Account.
Source: Ministry of Finance Ministries' B10 forms and AFMIS database

3.19 In other respects, support from the center to subnational administration has improved, particularly in the area of financial and fiscal management. Through the issuance of budget and treasury circulars, Finance is providing clearer instructions to the Mustoufiats. Training seminars are taking place, particularly where new or changes procedures are being introduced. And a BearingPoint consultant has been placed in each Mustoufiat to facilitate the introduction of new procedures and computerized technologies. While there is certainly room for improvement in the quality of these support mechanisms, they have been beneficial.

Figure 3. 3: Non-Salary Expenditures as a Share of Total Expenditure by Province 2004/05 compared to 2002/03



Note: 1381 = 2002/03; 1383 = 2004/05.
Source: Evans et al (2004); Ministry of Finance AFMIS database, as of December 15, 2004

C. Provincial Allotments and Budget Execution

THE SINGLE REVENUE AND EXPENDITURE ACCOUNTS

3.20 In the original subnational study, one of the main findings was that the pattern of expenditures at the provincial level varied dramatically depending on whether a particular province had access to revenues. An analysis of 2002/03 data from that report showed that for those provinces that were largely

or completely dependent on Kabul for cash, most expenditure went to salaries; in the case of Bamyan, the ratio was as high as 95.1%. Only those provinces that had access to customs duties incurred substantial non-salary expenditures, *and significantly overspent their allocation.*

3.21 However, in the summer of 2002/03, the Government introduced single revenue and expenditure accounts.[2] With this system, all revenues formally collected in a particular province are now deposited into a single revenue account. This revenue account is controlled by the MoF in Kabul, and the provincial administration has no authority to access these funds. Provinces can only draw funds from the expenditure account, and the balance in this account is controlled by the Treasury presidency in the MoF. The result of this reform has been to cut provinces off from any access to the officially collected revenues, and their spending is limited by the allotment and cash management controls of the MoF.

3.22 While this is a significant step forward, it does not mean that these provinces no longer have any access to 'unofficial' revenues. But the general view is that these reforms have made it much more difficult to access additional sources of revenues. Still, these activities do go on, with examples found during fieldwork.

3.23 On the expenditure side, the overall impact of introducing the single revenue and expenditure accounts has been to reduce dramatically the inequities in spending that were documented in the original study. Table 3.2 shows the actual expenditures for each of the six provinces in the study for the first nine months of 2004/05.

Table 3. 2: Total Provincial Expenditure Shares by Category, 1st 9 Months of 2004/05

	Badakhshan	Bamyan	Faryab	Herat	Kandahar	Wardak
Personal Emoluments	**84.2%**	**69.2%**	**75.9%**	**72.9%**	**41.9%**	**75.1%**
Services	0.5%	2.1%	0.7%	2.5%	0.5%	1.1%
Tools & materials	12.1%	10.2%	13.1%	22.8%	15.7%	6.2%
Maintenance & repairs	1.6%	1.8%	1.9%	1.0%	0.5%	11.2%
Land, structures and equipment	1.4%	1.4%	2.6%	0.8%	39.9%	1.7%
Subsidies, grants, contributions, & pensions	0.2%	15.2%	5.9%	0.1%	1.4%	4.6%
Total, non-salary expenditures	**15.8%**	**30.8%**	**24.1%**	**27.1%**	**58.1%**	**24.9%**
Grand Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: Ministry of Finance AFMIS database, as of December 15, 2004.

3.24 Similarly, the pattern for budget execution has also improved. Table 3. 3 and Table 3. 4 show budget execution (actual expenditures as a percentage of the allotment) by category for the six provinces for 2003/04 and 2004/05, respectively. While in 2003/04 there continued to be significant overspending in the 'revenue-rich' provinces of Kandahar and Herat, for the first nine months of 2004/05 all six provinces show a more comparable rate of expenditure. Figure 3.4 compares total budget execution to 2002/03, as reported in the original study. Table 3. 5 shows budget execution for the first nine months of 2004/05 for the six provinces, broken down by ministry.

[2] The provinces do have other accounts, but these must be approved by the Ministry of Finance. Typically, there will be separate accounts for pension payments (through the Ministries of Labor and Social Affairs, and Martyred and Disabled), and an account to hold deposits of merchants involved in the procurement process. Although the DAB holds other accounts such as NSP or other development budget funds, the mustoufiat is not involved.

Table 3. 3: Provincial Budget Spending as a Percent of Allotment by Expenditure Category, 2003/04

	Badakhshan	Bamyan	Faryab	Herat	Kandahar	Wardak
Personal Emoluments	**77.3%**	**91.4%**	**88.9%**	**92.4%**	**87.7%**	**80.8%**
Services	31.7%	56.3%	38.8%	850.7%	130.4%	75.7%
Tools & materials	108.3%	101.9%	68.2%	243.7%	102.5%	111.3%
Maintenance & repairs	98.2%	93.9%	74.8%	859.8%	2054.7%	108.7%
Land, structures and equipment	57.1%	98.5%	59.2%	1389.2%	276.6%	84.9%
Subsidies, grants, contributions, & pensions	44.8%	99.8%	102.0%	225.3%	127.3%	101.1%
Total, non-salary expenditures	**96.1%**	**96.8%**	**69.2%**	**663.1%**	**235.5%**	**101.5%**
Grand Total	**80.0%**	**92.8%**	**85.0%**	**232.0%**	**134.5%**	**85.1%**

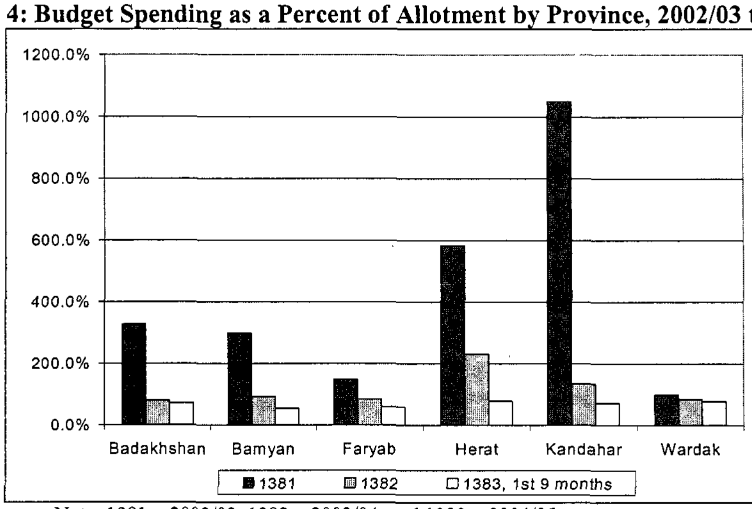
Source: Ministry of Finance AFMIS database

Table 3. 4: Provincial Budget Spending as a Percent of Allotment by Expenditure Category, 1st 9 Months of 2004/05

	Badakhshan	Bamyan	Faryab	Herat	Kandahar	Wardak
Personal Emoluments	**73.5%**	**49.4%**	**58.3%**	**79.9%**	**58.9%**	**73.1%**
Services	33.5%	65.7%	19.0%	62.5%	37.3%	56.0%
Tools & materials	96.3%	80.4%	71.1%	97.6%	100.1%	74.7%
Maintenance & repairs	59.1%	39.9%	43.2%	44.1%	34.1%	153.4%
Land, structures and equipment	68.4%	72.7%	93.1%	49.3%	84.3%	66.0%
Subsidies, grants, contributions, & pensions	2.3%	72.5%	66.0%	1.5%	64.5%	75.6%
Total, non-salary expenditures	**60.5%**	**70.9%**	**63.6%**	**73.5%**	**85.3%**	**94.6%**
Grand Total	**71.1%**	**54.5%**	**59.5%**	**78.1%**	**71.8%**	**77.5%**

Source: Ministry of Finance AFMIS database, as of December 15, 2004.

Figure 3. 4: Budget Spending as a Percent of Allotment by Province, 2002/03 to 2004/05



Note: 1381 = 2002/03; 1382 = 2003/04; and 1383 = 2004/05.
Source: Ministry of Finance AFMIS database, as of December 15, 2004; Evans et al (2004).

3.25 While this analysis points to a significant improvement in budget execution over the last two years, there are still major issues that continue to constrain or delay budget execution at the provincial level. Specific issues related to payroll are discussed in a separate section. The balance of this section deals with the timeliness of the receipt of the provincial allotment, and the adequacy of transfers into the single expenditure account. In addition, the impact of providing provinces with more flexibility to manage their allotments is discussed, as well as improvements in provincial reporting practices.

Table 3. 5: Provincial Budget Spending as a Percent of Allotment by Ministry, 1st 9 Months of 2004/05

	Badakhshan	Bamyan	Faryab	Herat	Kandahar	Wardak
110 Supreme Court	87.5%	67.3%	61.2%	76.1%	71.8%	98.4%
200 Ministry of Finance	78.8%	86.2%	66.6%	66.1%	71.3%	98.6%
220 Ministry of Defense	93.4%	41.9%	53.2%	101.7%	40.8%	93.9%
230 Ministry of Foreign Affairs		60.0%		75.0%	10.7%	
240 Ministry of Religious Affairs and Hajj	75.7%	78.5%	64.1%	56.1%	48.1%	63.2%
250 Ministry of Commerce	95.6%		49.8%	55.6%	50.5%	
260 Ministry of Interior	89.1%	72.3%	84.9%	83.3%	92.6%	105.1%
270 Ministry of Education	73.0%	51.0%	55.6%	77.2%	76.9%	77.2%
280 Ministry of Higher Education	64.5%	60.6%	40.8%	68.4%	61.7%	
290 Ministry of Return of Refugee	60.4%	68.3%	57.7%	56.2%	44.4%	65.7%
310 Ministry of Planning		65.8%		42.4%	58.4%	
320 Ministry of Mines and Industry				78.7%		
330 Ministry of Food and Light Industry				73.5%		
340 Ministry of Communication	51.5%	51.9%	42.1%	61.5%	36.0%	36.9%
360 Ministry of Information and Culture	57.0%	35.6%	45.4%	72.0%	33.3%	69.2%
370 Ministry of Public Health	49.1%	33.2%	38.5%	78.6%	43.3%	17.8%
380 Ministry of Women's' Affairs	55.5%	67.2%	51.8%	53.8%	43.5%	42.8%
390 Ministry of Agriculture	92.9%	84.5%	77.7%	92.6%	82.0%	71.3%
400 Ministry of Irrigation and Water Resources	70.1%	51.5%	50.9%	70.5%	43.3%	67.0%
420 Ministry of Public Works	90.0%	92.3%	32.6%	58.0%	42.0%	
430 Ministry of Rural Development	42.3%	34.7%	40.9%	57.5%	44.4%	50.0%
440 Ministry of Martyrs and Disabled	2.9%	73.1%	65.2%	2.7%	65.7%	73.9%
450 Ministry of Transport	74.2%	66.9%	63.8%	86.9%	60.4%	59.5%
460 Ministry of Borders	20.2%	55.9%	43.7%	38.8%	67.0%	60.5%
470 Ministry of Labor and Social Affairs	63.4%	95.0%	28.4%	78.6%	64.7%	33.7%
480 Ministry of Civil Aviation	40.1%	73.4%	74.2%	64.1%	21.3%	
490 Ministry of Urban Development				53.2%	60.7%	
500 Ministry of Justice	73.4%	39.0%	61.5%	129.3%	138.9%	75.0%
510 Attorney General	78.4%	65.4%	57.6%	77.6%	79.8%	76.6%
803 National Olympics Committee	81.5%	72.4%	53.9%	49.5%	28.5%	40.5%
805 Geodesy and Cartography Office	57.8%		52.6%	56.0%	81.6%	
806 Central Statistics Office (CSO)	57.8%	88.0%	38.6%	61.4%	55.6%	60.1%
808 Disaster Management Organization				5.6%	25.8%	
Total	**71.1%**	**54.5%**	**59.5%**	**78.1%**	**71.8%**	**77.5%**

Source: Ministry of Finance AFMIS database, as of December 15, 2004.

TIMELINESS OF RECEIPT OF TAKHSIS (ALLOTMENT)

3.26 As documented in the original study, provinces cannot execute any expenditure until they have received their quarterly allotment (takhsis) from the center. Past practice had been for each ministry to send the quarterly allotment to each of their provincial departments on form B20. At the same time, the line ministry would send a copy of the form B20 to the provincial mustoufiat. The Mustoufiat would only authorize payments once it had a copy of this form. While the timing of the receipt of the takhsis was not identified as an overriding problem in the original study given other issues at the time, delays in communicating the takhsis was a constraining factor.

3.27 One of the improvements implemented for 2004/05 is that the MoF is now responsible for sending the form B20 directly to the Mustoufiats, whereas in the past, this was the responsibility of the line ministries. However, ministries continue to be slow in submitting the B20 form to Finance. Based on interviews with provincial officials, very few ministries manage to submit forms before the start of the quarter, as required. Some provincial departments receive their allotments during the first month of the quarter; a significant number are sent the allotments during the second month, and a few even receive them only in the last month of the quarter. This is further complicated by the fact that allotments for the 2nd, 3rd and 4th quarters are issued in two parts. As a result, MoF must send monthly updates to the allotment to the Mustoufiat. Officials from the mustoufiats consistently cited the delays in receipt of the takhsis as the most common reason for delays in processing both the payroll and non-salary expenditures.

3.28 Once the allotments are sent to provincial departments, provinces reported that the allotment data received by the department (from the line ministry) differed from the details in the form B20 received by the mustoufiat (from the MoF). It is not clear why this has been occurring, but it may be due to the timing of when various forms are sent. However, the form B20 that the mustoufiat receives is the official record of the allotment, and the Mustoufie enforces this amount. (However, it was reported in one instance that the Mustoufie used whichever figure was lower.)

3.29 The practice of sending the takhsis through the MoF to the Mustoufie is a significant improvement over past practice, but to be truly effective it is essential that all ministries comply with the deadlines, and ideally, the takhsis should be communicated to provinces in advance of the quarter. The background paper on "Operating Budget Allotment Control" (see Volume I, p. 99) makes specific recommendations on allotments that would address this issue. For 2005/06, it proposes that the MoF create an annual financial plan for each secondary budget unit (includes provinces) based on ministry input, and then using this plan, issue the quarterly allotments directly to mustoufiats at the start of each quarter. Ministries could make adjustments during the year, but these would not delay the issuing of each quarterly allotment. Implementing this process would effectively eliminate the issue of late allotments to provinces.

ADEQUACY OF POSITIVE BALANCES IN THE SINGLE EXPENDITURE ACCOUNT

3.30 Once the mustoufiats have received the quarterly allotments for the provincial departments, the mustoufiats can proceed to process payroll and non-salary expenditures. However, before checks can be issued against the allotment, mustoufiats must also confirm that there is an adequate balance in the single expenditure account to cover the amount of the check.

3.31 The Treasury in the MoF is responsible for transferring positive balances into the single expenditure account.[3] According to Finance Circular No. 8/2004/05, the Treasury is to transfer positive balances based on the allotment to the province's single expenditure account no later than the 20th of each month. Based on this transfer advice, the DAB is to ensure that physical cash is available no later than the 25th of the month. In order to ensure provincial compliance with reporting requirements, the timing of transfer of positive balances is also dependent on mustoufiats submitting monthly expenditure and revenue reports on time.

3.32 In fact, the set of procedures put in place by the Treasury to regularize the flow of funds and support budget execution at the provincial level is a very significant improvement compared to 2002/03 and early 2003/04. As part of implementing these new procedures, the Treasury has developed a monitoring system which tracks provincial payments based on monthly expenditure reports (form M23), the dates these forms are received, and accumulated positive balances in provincial expenditure accounts. The Treasury uses this data to adjust the amount transferred to the expenditure account to also take into account actual spending patterns.

3.33 The intent underlying this monitoring system – to ensure adequate positive balances while minimizing the accumulation of excess balances – is clearly a sound one. However, during the provincial missions, it quickly became apparent that the implementation of this system was causing serious problems for some of the provinces. Their complaint was that in some months the transfer of positive balances was too little to cover all expenditures for the month, or the transfer happened so late in the month that all payments for the month could not be processed. In analyzing the flow of payments, it became clear that

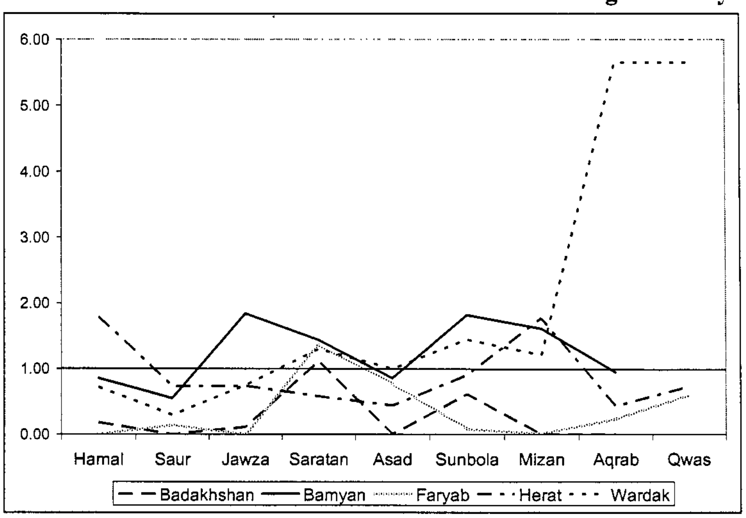
[3] Provincial officials referred to this transfer of positive balances as *darai* or "spending authorization."' It does not refer to physical cash.

the problem with Treasury's monitoring system was that it did not take into account current expenditures. Because the system relies on the monthly reporting form (M23) to record expenditures, which comes in after the end of the month, there is always a delay in reported expenditures, while the information on positive balances is current. So the monitoring system will always be reporting more cash balances than the reality. When this fact is coupled with substantive swings in month to month spending levels, it becomes a very poor predictor of cash flow needs in the provinces. To document this problem, data on monthly expenditure reports and transfers of positive balances to provincial single expenditure accounts were collected from the case study provinces.[4] From this data, it was possible to calculate the actual positive balances at the end of each month (Figure 3.5). This shows that for the five provinces for which data was collected, seven times out of 10, the positive balance at the end of the month was lower than the average monthly spending. On average, the transfer of positive balances was received on the 18th of the month, but in many cases it was only received within the last five days of the month.

3.34 Some of the Mustoufies felt that transfers of positive balances to the expenditure accounts equal to the quarterly allotment should occur at the beginning of the quarter. While this solution would make it difficult for the Treasury to manage account balances effectively, even transferring amounts equal to the monthly allotment would ease the problem considerably.

3.35 The World Bank's draft paper on allotments (referred to earlier) acknowledges this problem, and also proposes that the MoF move towards fully-funded allotments. If issuing fully-funded allotments on a quarterly basis is likely to cause cash flow problems, allotments could be issued for shorter periods, but this would be a preferred solution to withhold funding of approved allotments.

Figure 3. 5: Positive Balances at Month End as a Ratio of Average Monthly Spending



3.36 The remaining problem, which is a very important concern for the Treasury, is the significant degree of fluctuation in spending levels from one month to the next. This fluctuation can be explained to some extent by delays in receipt of takhsis and constraints caused by low expenditure account balances, but not entirely by these factors. For all of the five provinces for which data are available, for example, there was no or virtually no spending reported for the first month of the fiscal year. Lack of takhsis cannot explain all of this. An analysis of monthly spending patterns by provinces is necessary, but such an analysis will be more informative once these two major influences are taken out of the equation.

[4] Data are not available for Kandahar.

GREATER FLEXIBILITY TO MANAGE EXPENDITURES

3.37 One of the significant changes that affected provinces this year[5] has been the decision to give provinces greater flexibility to shift expenditure allotments between minor codes.

3.38 Historically, allotments to provinces have been broken down into major codes (babs) and minor codes (fasils). These allocations are determined by the parent ministry in Kabul, with no input from the provincial department or mustoufiat. If provinces wanted any changes to these allotments during the year, they had to request permission through their ministry, and ultimately, the MoF in Kabul. This approval procedure could cause significant delays and other problems for provincial officials and could even lead to disruptions in service delivery. And given the number of requests for adjustments that come through each year, this process placed a considerable administrative burden on the MoF. There is also the belief that controls of this sort provide opportunities to elicit rents or bribes.

3.39 To address this issue, the MoF is now issuing allotments at the major code level only. It is then up to provincial departments to decide how these funds are to be allocated to the minor spending codes. Reporting on actual expenditures, however, is still required at the fasil (or minor code) level.

3.40 To facilitate the introduction of this change, training seminars were given for all affected staff in the provinces. Despite this, implementation has varied considerably across provinces and ministries. Kandahar, for example, requires its departments to submit to the Mustoufie their allocation at the fasil level at the start of the quarter, and then enforces this allocation during the quarter. Other provinces generally leave this up to the departments. In Bamyan, the Mustoufie requires departments to submit and 'register' their allocation of allotment to fasils with the Mustoufiat, and to submit requests for changes, but the Mustoufie does not reject any requested changes. In a few cases, ministries continue to provide their allotment at the fasil level. In Faryab, for instance, it was noted that the Ministries of Education and Interior continue to issue allotments at the fasil level, so the Mustoufiat does enforce these allocations. In Badakhshan, MRRD and Education were cited as ministries providing allotments at the fasil level. In these cases, the Mustoufiat enforces the allocation, and any changes to the allocation between fasils must be approved by the respective ministry.

3.41 The provincial perspective on this change was very mixed. While some officials liked the change, most often those in line departments, the officials in the Mustoufiat generally viewed this change negatively, as it was believed to lead to abuse. For example, a head of department could allocate extra funds to his or her office at the expense of more pressing needs. Within bab 10000 (Salaries and Allowances), there is potential to switch funds from basic salaries to bonuses and overtime. While provincial departments have not normally had funds to pay staff overtime or bonuses, during the missions we found that in at least two provinces, the same provincial department was paying both overtime and salary bonuses to staff. During the course of the provincial missions, some alternatives were suggested, where the allocation at the fasil level could be controlled at the provincial level, by the Mustoufie or even the governor, but still concern was raised that the decision-makers could be influenced by the opportunity for personal gain.

3.42 Nevertheless, this move to less central control over line items is in place, and will soon be extended further by consolidating the non-salary, non-capital babs into a single classification. This practice is consistent with international standards, is also consistent with the principle that local managers know better what their mix of expenditures needs are. In addition, it eliminates the transaction costs of

[5] This change was formally introduced for the 2003/04 budget year; however, provinces did not report any change in practice until 2004/05. It is possible that ministries, who were still responsible in 2003/04 for transmitting the B20 forms to provinces, continued to provide allotments in fasils.

getting approval from Kabul for every small adjustment. However, delegating control over the distribution of expenditures to different fasils is challenging in a context where there is a lack of alternative accountability mechanisms and good management practices at the provincial level. Equipping managers with the skills needed to take on this type of delegated authority should be an important focus for future training programs. In addition, mechanisms for building accountability are needed; in it will be important to monitor spending patterns across ministries and provinces to ensure that no gross abuse is happening.

TIMELY REPORTING TO THE CENTER

3.43 Another finding from the original study was that provinces were doing a poor job of reporting on revenues and expenditures in a timely and accurate way. This was viewed in Kabul as a very serious problem, especially given the lack of other controls and information sources at the provincial level.

3.44 This situation has improved dramatically. The Treasury has issued clear instructions on reporting procedures, including a requirement that reports be submitted by the 10^{th} of the following month. In the absence of receiving these reports, transfer of positive balances to the single expenditure account is withheld. As a result, in most cases provinces are submitting reports on time. This was confirmed both by provincial officials and officials in the Treasury. In some cases, delays in submitting reports continue to result from the lack of modern communications facilities, but in most cases provinces are able to send reports in with someone who is traveling to Kabul anyway, often the Mustoufie himself or the BearingPoint consultant who has been assigned to each Mustoufiat. Still, this is not a sustainable solution, and efforts are needed to modernize communications arrangements.

D. Executing The Payroll

3.45 One of the most compelling issues reported in the original study was the delay in processing the payroll, particularly at provincial and district levels (see also Chapter 2 of this Volume). That report identified seven main reasons for payroll delays. Many of these reasons for delays have been addressed by re-decentralizing the payroll (provinces are no longer required to submit payroll documents to the Ministry of Finance for approval before receiving authorization to process the payroll), and to a large extent reinstituting procedures that had been in place for many years.

3.46 As a result, the current procedures for processing the payroll are well understood and work smoothly. As long as the takhsis has been issued, and there are adequate balances in the expenditure account, staff are paid each month, usually before the end of the month. Even in districts, once the physical cash is received from the Mustoufiat, it takes at most 4-6 days for staff in remote areas to receive their pay. In the six case study provinces, there were only a few exceptions. In Bamyan, all district staff have agreed to be paid quarterly, due in part to logistical constraints, but also because of equity concerns when some departments have their takhsis and others do not. In Badakhshan, monthly pay is still not feasible in the very remote districts of Darwaz, Wakhan and Keranmunjan. And in winter, conditions may pose some additional delays. But in all six provinces, including Bamyan, it was consistently reported that staff are happy with the current payroll arrangements.

3.47 In re-decentralizing the payroll, it could be argued that the controls on payroll processing have been weakened, despite the fact that the added controls imposed by a centralized process were in practice ineffective. But by ensuring that regular audits of the payroll are conducted as part of the Auditor General's normal audit agenda serve to address this risk.

3.48 Table 3.6 summarizes the actions that have been taken to address the seven main reasons for payroll delays, as identified in the original study. The reasons for delays in processing the payroll now center on the delays in issuing the takhsis, and the lack of adequate balances in the expenditure account; these issues have already been discussed in the preceding section.

3.49 While the improvements to date in processing the payroll comprise a very positive development, more needs to be done to ensure that government employees receive their full salary entitlement. In Kabul, the Individualized Salary Payment (ISP) program is being phased in, where staff can receive their pay directly from the DAB. While there is optimism in some quarters that the ISP program can be extended to provinces and even districts, on-the-ground circumstances dictate that such a roll-out is a long way off, with the possible exception of a few of the larger provincial centers. It may be more realistic in the short to medium term to build up the bonded trustee model by formalizing the relationship and strengthening the rules, so that the risk of abuse is reduced.

Table 3. 6: Addressing the Delays in Processing the Payroll

Reason for Delays from the Original Study	What Has Been Done	
1. Some provincial staff, who are not confirmed in their position by their parent Kabul ministry, are rejected from the payroll	✓	While no specific action has been taken to address this, it is no longer viewed as a significant issue
2. The tashkeels (staffing establishment) are issued late	✓×	Departments can use 2003/04 tashkeels to authorize payroll if the 2004/05 tashkeel is not available
3. The line ministries issue takhsis that are inconsistent with the tashkeels, at least at the provincial level	✓×	In 2004/05, the inconsistency has been minimized, but a serious problem still exists within Education
4. Provinces and districts are under the impression that they should only be preparing the M41s (payroll) every quarter	✓	With very few exceptions, payrolls are now processed monthly, facilitated by the re-decentralization of the payroll
5. The mustoufie must make what is often a laborious and time-consuming journey to take the payrolls to Kabul	✓	The re-decentralization of the payroll has eliminated this issue
6. Provinces report that many forms are repeatedly rejected by the Treasury Presidency for very minor reasons	✓	The re-decentralization of the payroll has eliminated this issue
7. There are extensive delays in the DAB moving the cash to the provincial branches.	✓	Improved systems in the DAB have virtually eliminated this issue

TIMELINESS OF RECEIPT OF TASHKEEL (STAFFING ESTABLISHMENT)

3.50 The formal rules for approving the tashkeel for a ministry require that all ministries submit their proposed tashkeel to the Tashkeelat Office[6] three months prior to the start of the fiscal year. The Tashkeelat Office is then to approve all tashkeels before the start of the fiscal year. The tashkeel includes organizational structures, number of posts and job descriptions for each position. The review of the tashkeel is coordinated with the budget process. The head of the Tashkeelat sits in on budget discussions, and part of his responsibility is to check that the total tashkeel and the total takhsis for a ministry are consistent. Based on reports from the case study provinces, the tashkeel and takhsis do in fact match in most cases. The major exception to this is the Ministry of Education, which will be discussed below. Once the tashkeel has been approved, it is the responsibility of each ministry to communicate the tashkeel to each provincial department. The departments then give a copy of the tashkeel to the mustoufiat, which checks the payroll against the tashkeel as part of its pre-audit process.

[6] The Tashkeelat Office is part of the Office of Administrative Affairs, reporting directly to the President.

3.51 However, despite the requirement to meet the deadlines noted above, many ministries are very late in issuing their tashkeel. According to the Head of the Tashkeelat, as of December 2004, some ministries, including the ministries of Borders, Interior, Education, and Labor and Social Affairs had still not submitted their proposed tashkeel for 2004/05 to the Tashkeelat Office. The provinces also reported that in many cases the tashkeels were received very late. The tashkeel for the Mustoufiat only arrived in the sixth month of 2004/05 in some provinces.

3.52 This delay in issuing the 2004/05 tashkeel has not affected the processing of the provincial payroll. Budget Circular No. 7/2004/05, issued on May 10, directed provinces to process the payroll based on the 2003/04 tashkeel until the 2004/05 tashkeel is received (this was repeated at the beginning of 2005/06). This process was reasonable given that provincial departments have no control over the issuance of the tashkeel. But it did pose some risk if the new tashkeel resulted in a reduction of staff. In practice, however, in cases where there was a reduction in posts, it was possible to reassign staff to vacant posts.

3.53 Nevertheless, the delays in issuing the tashkeel are a problem that needs to be addressed. While the impact this year may have been minimal, when more extensive restructuring starts to take place the impacts could be significant. The requirement for ministries to submit their tashkeel on time needs to be enforced; given its relation to the budget process, it could be a required part of the overall ministry budget submission, and once received by Finance, the proposals could be redirected to the Tashkeelat Office for review. In addition, a copy of the approved tashkeel could be sent to the mustoufiats from the MoF, as is currently done with the B20 forms (allotment). A proposal would be that the Office of the Tashkeelat should be moved to the MoF. On its own, this move does not guarantee that the tashkeel process will move any faster, but it would reinforce efforts to integrate the process into the budget cycle, and dramatically increase compliance by ministries.

3.54 Over the longer term it will be desirable to reform the tashkeel process more generally, but it plays such a fundamental role in administrative practices that for now the better course is to make it work as effectively as possible. In the future, delegating some of the more detailed aspects of the tashkeel (that do not affect the number of staff) to ministries and even provincial departments could be considered.

MANAGING THE PAYROLL FOR TEACHERS

3.55 In the case study provinces, the review team encountered significant payroll problems per teachers. One problem was a general lack of qualified teachers, which means there are large number of unqualified teachers being put on contract, instead of filling permanent posts. More significantly, from a financial point of view, the number of teachers in many cases greatly exceeded the provision for salaries in the allotment. The reason for this was that there was excess demand for teachers in these provinces, and the departments felt they had no choice but to hire. The Ministry of Education's position on this is not clear, but based on interviews in the provinces, it appears that the Ministry is sympathetic at a minimum, and has done little to discourage this hiring.

3.56 The manifestation of this issue varied in each province. In Faryab, for example, the excess number of teachers was offset by vacancies in administrative and agir posts in the Education department, so that overall the salary allotment for Education was adequate, even if the specific number of teaching posts were not approved.

3.57 In Herat, the excess teacher issue was more significant. According to figures provided by the local education department, there are 10,629 teachers and administrative staff in the department. But the salary allotment is based on a tashkeel of only 7,970. They have temporarily managed the situation by

not paying district teachers for as many as three months. However, all city teachers and HQ staff have been paid to date. The estimate we received was that there was an outstanding payroll liability of around 95 million Afs as of the date of the mission.

3.58 In Bamyan, it was reported that Education had officially given them a tashkeel of 2,250 (teachers and administration) which matches current employment, but the salary allotment only covers a staffing level of around 1,823. All 2,250 staff have been paid to date, but they have done so by "borrowing" from the next quarter's allotment (see Box 3. 1). The Mustoufiat staff were fully aware of this, and agreed there is no obvious solution to this short of getting more allotment from the Ministry of Education. In Badakhshan the situation was similar to Bamyan, where the excess teachers were paid by 'borrowing' from the next quarter's allotment. However, by the time the Badakhshan visit took place, they had received an additional allotment of 50 million Afs, sufficient to pay for the excess teachers.

Box 3. 1: Managing Bamyan's Education Payroll

For the 1st quarter of 2004/05, according to Bamyan's Education Department, they had an approved tashkeel of 1,823 staff, including teachers, administration and agirs. The actual number of staff was the same. The HQ staff and city teachers were paid for three months in the 3rd month, because they did not receive their takhsis till then, District staff and teachers were paid for 3 months in the 4th month.

In the 2nd quarter, they reported that they received a revised tashkeel of 2,251 from the Ministry of Education, and quickly hired new teachers (presumably on contract) up to that level. But, the salary allotment was not increased to match the new tashkeel. Still, the HQ staff and city teachers were paid each month, and the district staff and teachers were paid for three months in the 6th month. But with the increase number of teachers, it was necessary to 'borrow' from the 3rd quarter allotment.

As of the 8th month, the HQ and city teachers had been paid up to date. The Department was planning to process the M41s for three months' pay for the district staff and teachers, but there is not enough salary allotment, so did not know what the Mustoufie would do.

3.59 While this issue of hiring more teachers than provided for through the allotments was consistent across the six provinces, varying only in degree, overall the Ministry of Education has been unable to spend its budget, and in fact the budget for Education was cut at the Mid-Year Review. Clearly, there is a need for better planning on the part of Education at the provincial level, and making a more realistic assessment during future budget deliberations of the provincial distribution of salaries and staff. In addition, there is a need for implementing better monitoring and enforcement mechanisms to ensure that only an affordable number of teachers are hired.

REPORTING ON NUMBERS OF PAID EMPLOYEES

3.60 With the re-decentralization of the payroll, the MoF instituted a new reporting requirement dealing with summary payroll data, to be submitted as an attachment to the monthly expenditure report (form M23). This reporting requirement covers numbers of staff who have been paid each month, by department. Previously, this information had been submitted to Kabul as part of the payroll data required for payment authorization. Among other uses, this data is used to create a headcount database managed by the Afghanistan Reconstruction Trust Fund (ARTF) Monitoring Agent. This database provides valuable information that can usefully inform planning and budgeting processes.

3.61 However, during the provincial missions, numerous problems were encountered when trying to reconcile information on staffing levels provided by provincial officials with figures produced by the headcount database. Although there was not sufficient time to resolve these issues, it was possible to

conclude that the monthly fluctuations in the headcount database are not due to changing staff levels. In most cases, staff levels do not change significantly from one month to another. In Education's case, additional teachers may be hired, but they do not experience significant drops from one month to the next. The most likely explanation for these fluctuations in the data is that provinces are having considerable difficulty filling out the new form and are creating errors, particularly when dealing with situations where pay is delayed, and therefore individuals are being paid for two or more months at once. It is strongly recommended that this form be reviewed so that it more clearly deals with situations where staff are paid for two or more months at once. In addition, it would be beneficial to provide clear written instructions on how to fill out this form.

E. Non-salary Expenditures

ADEQUACY OF ALLOTMENTS

3.62 With the exception of only one department, where staff acknowledged that their allotments were sufficient, provincial officials in the case study provinces reported that the non-salary allotment to provinces and districts is still very low. While there has been some improvement in some areas, this is still a big issue. And for Herat and Kandahar, lack of access to revenues collected within the province has had a dramatically negative impact by forcing them to keep spending levels within their allotment. The lack of non-salary expenditures is especially problematic for those ministries that have little assistance through the development budget (core or external) to, for instance, refurbish their offices.

3.63 The availability of non-salary expenditures in districts varied somewhat in the case study provinces, but generally they continue to receive little or no allotment. District officials recounted many examples of lack of firewood, and lack of vehicles and/or fuel for transportation. What they do receive is either in kind, or they might get some cash for a particular purchase. In these cases, they do not submit monthly expenditure reports (except for payroll), but instead provide documentation for each purchase as it occurs.

3.64 As was the case in the original study, it is very difficult to assess from the data available whether the current provincial allotments for non-salary expenditures is in fact adequate. For this, a more detailed review at the ministry level is necessary. However, an examination of the share of non-salary expenditures that is allocated to provinces, compared to the share of salary expenditures allocated to provinces, did strongly point to a disproportional distribution. In the original study, the only data available were the allotments for the first quarter of 2003/04; these data indicated that provinces received only 14% of non-salary expenditures, compared to 41% of salaries.

3.65 Figure 3. 6 provides more current comparisons. This chart indicates that the provincial share of non-salary expenditures has increased, but it also suggests that there is still room to improve. As noted already, the only way to truly assess the appropriate level of non-salary expenditures at the provincial level is to do a detailed review in each ministry, which is well beyond the scope of this paper.

3.66 One of the innovations of the 2004/05 budget preparation process was to present to the government an analysis showing the distribution of the then proposed budget to provinces, by ministry. Although the decision on how much provinces receive remains with the respective ministries, this increase in transparency may be motivating ministries to better justify their decisions on provincial allocations. For the 2005/06 budget, this practice of examining the provincial impacts of ministry budget decisions should continue.

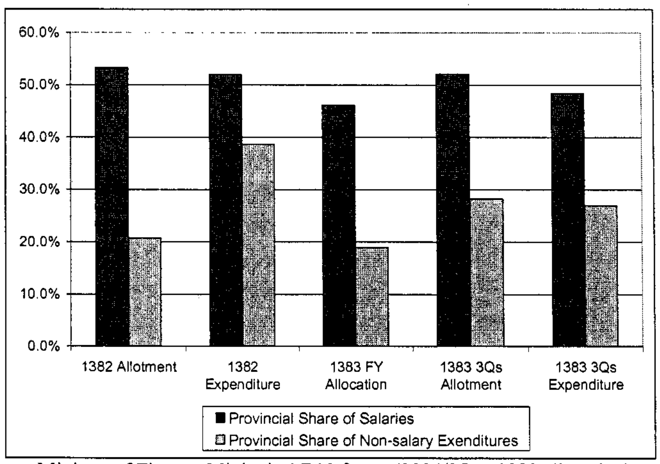
Table 3. 7: Share of 2004/04 3Q Salary and Non-Salary Allotment Provided to Provinces, by Ministry

Ministry	Provincial Share of Total Salaries	Provincial Share of Non-Salary Allotment
Administrative Affairs	0.7%	0.1%
Supreme Court	50.6%	8.6%
Finance	51.1%	9.1%
Defense	38.0%	18.3%
Foreign Affairs	0.6%	2.3%
Religious Affairs and Hajj	64.4%	50.0%
Commerce	3.2%	1.6%
Interior	48.0%	41.8%
Education	82.8%	50.5%
Higher Education	39.6%	35.4%
Return of Refugee	40.0%	21.6%
Planning	17.2%	23.7%
Mines and Industry	66.6%	0.0%
Food and Light Industry	29.7%	0.0%
Communication	47.0%	26.8%
Information and Culture	34.5%	28.8%
Public Health	58.5%	19.5%
Women's' Affairs	54.0%	35.7%
Agriculture	58.4%	13.0%
Irrigation and Water Resources	47.6%	50.4%
Public Works	33.4%	22.9%
Rural Development	62.9%	41.6%
Martyrs and Disabled	48.2%	77.6%
Transport	31.1%	30.3%
Borders	25.8%	35.7%
Labor and Social Affairs	31.7%	14.0%
Civil Aviation	20.3%	13.4%
Urban Development	12.9%	9.1%
Justice	49.8%	26.6%
Attorney General	56.3%	38.3%
National Olympics Committee	16.6%	3.8%
Geodesy and Cartography Office	31.7%	24.7%
Central Statistics Office(CSO)	22.7%	13.9%
Disaster Management Organization	18.0%	6.0%

Source: Ministry of Finance AFMIS database, YTD figures as at December 15, 2004. Note that only ministries with a provincial presence are listed.

3.67 The government should also be strongly encouraged to publish the annual allocations and expenditures by province as well as by ministry. An implicit requirement in the new Public Finance and Expenditure Management Law. The need to be more transparent about spending patterns on a provincial and even district level will only grow, especially once parliament and local councils are established.

Figure 3. 6: Share of Ordinary Budget Allocated to Provinces



Source: Ministry of Finance Ministries' B10 forms (2004/05 or 1383 allocation) and AFMIS database (for 3Q allotments and expenditures, used YTD figures as of December 15, 2004).

PROCUREMENT

3.68 The procurement procedures are detailed in regulation, and have not changed in the last two years, except to amend the limits relating to the types of purchases. The current procurement procedures are outlined in Table 3. 8.

3.69 These procedures have been in place with little change for many years, as a result, provincial and district officials are well versed in these rules, and generally adhere to them. Nevertheless, some of the rules are regularly 'bent.' For instance, it is common practice to obtain three quotes from the same merchant, under different names.

3.70 While the bulk of the procurement activity occurs at the provincial level, districts do undertake some smaller purchases. They do not in practice receive their own allotments as such, but if a purchase is required, and the province feels it makes more sense to make the purchase locally, the districts will be given funds for the purchase. In these cases, the districts will go through the procurement procedures, and will send in the documentation for the completed purchase to the mustoufiat.

Table 3. 8: Process for Executing Non-Salary Payments

Stages	Provincial Department	District Office
Establishing the allotment	Provincial departments receive their quarterly allotments (usually after the start of the quarter).	*Districts receive their quarterly allotments (usually after the start of the quarter). (See note.)*
	An adequate positive balance is transferred into the single expenditure account, and the physical cash is received in the provincial branch of the DAB.	*Cash for the district quarterly allotment is sent to the district finance office and held by the treasurer in a safe. (See note.)*
Authorizing the purchase	The provincial department prepares a proposal and submits it to the governor.	The district office prepares a proposal and submits it to the uluswal.
	For 'retail' purchases, a purchasing mission of up to five people is appointed, one appointed by the department head, one by the Mustoufie, and three by the governor. 1. If the price of a commodity or the cost of a required service is up to Afs 10,000, the purchase can be done by a single member of the purchasing mission. 2. If the price or the cost is from Afs 10,000 to 50,000, the purchase can be done by two members of the purchase mission. 3. If the price or the cost is from Afs 50,000 to 200,000, purchase can be done by three members of the purchasing mission. 4. If the price or the cost is from Afs 200,000 to 1,000,000, purchase can be done by all five members of the purchasing mission. For 'bulk' purchases, the Governor appoints a commission to oversee an open bidding process	Districts follow the same procedures as provinces, if they make purchases at all.
	The governor authorizes the proposed purchase.	The uluswal approves the proposed purchase and appoints a representative from the uluswal's office to participate in the purchase.
	The proposal also goes to the mustoufiat, where the audit department does a pre-audit of the purchase proposal. The mustoufie authorizes the proposal.	The proposal also goes to the finance office, where the audit department does a pre-audit of the purchase proposal. The finance office authorizes the proposal and appoints a representative to participate in the purchase.
Executing the purchase	Usually, the mustoufie issues a check to the department in advance of the retail purchase so that the purchase can be made in cash. Sometimes, purchases are made before the cash has been received in the province; in this situation, the mustoufiat might issue a check for the purchase, but the seller must wait for the cash to arrive in the bank before check will be honored. Alternatively, a purchase contract might be signed with a merchant, but no payment made until the cash arrives.	Usually, the treasurer gives cash to the department in advance so that the purchase can be made in cash.
	In the case of retail purchases, the mission goes to the market and gets three quotes for the purchase. See earlier notes about the limits.	In the case of retail purchases, the mission goes to the market and gets three quotes for the purchase. If the purchase is under Afs 10,000, only one quote is needed.
	Based on the lowest quote, the purchase is made.	Based on the lowest quote, the purchase is made.
	Sometimes the purchase is done in the form of a contract to supply goods or services over a period of time. These contracts may be reviewed and approved by the administrative council of the province.	

Table 3. 8: Process for Executing Non-Salary Payments

Stages	Provincial Department	District Office
	For 'bulk' purchases over 1,000,000 Afs, an open bidding process is conducted by a commission appointed by the governor. As part of the bidding ceremony, participants have to deposit 3% of the whole estimated price of the purchase in a specific account on a temporary basis. The winner is announced on the radio, and anyone can choose to make a lower bid. After this second round, the bidding mission will sign the contract with the winner, and is finalized with the approval of the authorized authority (as defined in the procurement regulation).	
Settling the accounts	The receipts are taken to the mustoufiat, and the account is settled (if the purchase price was less than the advance, the difference is returned, if it is more, the difference is reimbursed).	The receipts are taken to the finance office, and the account is settled (if the purchase price was less than the advance, the difference is returned, if it is more, the difference is reimbursed).

Note: The receipt of district quarterly allotments and cash is traditional practice, and does not happen currently.
Source: Updated from Evans et al (2004).

F. Audit Practices

3.71 There are a number of audit activities happening in the provinces. First, there is a pre-audit function in the Mustoufiat that checks every salary and non-salary transaction before it is executed. This pre-audit unit is separate from the drafting unit, which keeps the tashkeel and takhsis documentation, reconciles the M41 forms (detailed payroll prepared by line departments) with the tashkeel and prepares the M16 form (summary payroll). The pre-audit process rechecks the accuracy of all forms, including whether the expenditure is allowed within the specific bab (major code) within the takhsis, and in the case of payroll, whether it is consistent with a department's tashkeel.

3.72 In addition, a number of ministries have conducted internal audits of their provincial departments in the last year, including the Ministries of Finance, MRRD and Education. Presumably other ministries have done the same.

3.73 The Auditor General's office has sent out audit teams to the provinces. These teams have been trained with the assistance of PKF Consulting. Their audit methodology has been simplified, and they use a check-list form that focuses on specific standards of performance and other points of compliance. While in a province, the team will audit procedures of 11-12 departments at a time. The results of the audit are later sent back to the departments, and during follow-up visits the team will check to see if deficiencies have been corrected.

3.74 However, there was no clear evidence that any of these audit processes were resulting in improved practices. In the case of Bamyan municipality, for example, where improper expenditures were knowingly being paid (see Box 3. 4), the results of an audit by the Auditor General's office carried out six months before the mission had still not been communicated.

3.75 In addition, it is worth noting that the governor of Faryab has authorized the provincial prosecutor to conduct audits of any department in the province, although this function is not formally within the prosecutor's area of responsibility.

G. Budgeting and Coordination Mechanisms

3.76 There continues to be very little involvement by the subnational administration in budgeting and planning activities. In the case of the ordinary budget, departments have been asked to propose tashkeels, but their view is that this information has been ignored – their recommendations are not accepted, and they receive no response or explanation. However, both Education and Health departments reported that they have already prepared and submitted a budget request for the 2005/06 budget year, at the request of their ministries. This is an improvement, the budget preparation instructions have directed ministries to do this, but there is no enforcement mechanism.

3.77 The development budget process also does not involve the provincial authorities, not only in terms of budget preparation, but also in terms of execution, which continues to be predominantly donor-managed or coordinated. The Provincial Stabilization Fund of the ASP was intended to give some development funds to the Governor to be spent on local priorities, but even here final approval of the projects rests with the Cabinet. Beyond this, programs have been launched that use parallel administrative structures not necessarily coordinated with the provincial administration; most prominent among these is the National Solidarity Program (NSP) (see Box 3. 2).

3.78 In addition to these various budgeting and program processes – and arguably to provide some linkages between them – there are a number of coordinating mechanisms at the subnational level. There continues to be an administrative council of all heads of department in each province, led by the governor. It meets weekly or every two weeks to deal with administrative issues cutting across provincial departments. Beyond this, some provinces have a sectoral coordination committee, comprised of the main NGOs and international organizations, the main department heads, and the governor. This group deals with various planning and coordination issues; in some cases, ASP projects have been discussed. There are also Provincial Reconstruction Team (PRT) processes in place or proposed, various shura structures and ad hoc initiatives. Box 3. 3 describes one such example from Bamyan. But these coordination mechanisms often have their own agendas, and are generally not focused on strengthening the role of subnational administration.

3.79 The negative impact of these various disconnected mechanisms to date has probably not been profound, as reforms efforts within subnational administration have been focused on reestablishing normal procedures, centering on the ordinary budget. Going forward, however, efforts at the center to integrate the ordinary and development budgets will demand parallel actions at the provincial level. To prepare subnational administration, and particularly the Mustoufiat, efforts should be made to channel program funds that fall outside the ordinary budget through provincial channels. That was the original intent of the ASP; but there was no indication during the provincial missions that this was to happen. In fact, most Mustoufies had very little knowledge of the ASP program details.

3.80 While the intent of the ASP and various other coordinating mechanisms is to give governors and other local leaders some say in provincial priorities, these mechanisms are outside the main decision process for the development budget. Rather than giving governors a say over a separate budget, it would be more effective in the longer term to engage the governors in discussions on the whole development budget, as it pertains to their province. And with the establishment of the Parliament, as well as local councils, the pressure for this broader engagement will only grow.

Box 3. 2: Two National Initiatives Focused on Subnational Development

Afghanistan Stabilization Program
Generally, the first pillar of the Afghanistan Stabilization Program (ASP) – the Provincial Stabilization Fund – is underway in all provinces visited. Under the fund, each province is to receive $1 million for large development projects that fit certain criteria, with no one project to exceed $250,000. The original concept was to give governors some discretionary funding to address local priorities, to be identified through a consultative process involving local leaders. Although the practice has varied somewhat across provinces, generally there has been a coordination committee in place to review the projects, and a consultant from the Ministry of Interior assigned full-time to the program. The coordination committee typically involved representatives from international organizations and NGOs, as well as the key ministries involved in the program. As of the dates of the provincial missions, the status was that provinces had identified projects for funding, but they were still waiting to hear which projects had been approved by Kabul, and in fact it was understood that Cabinet would make the final approvals.

The second pillar is the District Infrastructure Development (DID) program, which will provide funding and support for the construction of district government offices. Across the country, 78 districts had been assessed at the time of the missions, and construction was either being planned or underway. Under the third pillar, capacity building, some preliminary activity has begun, with forms being distributed to staff in departments and districts. Based on this information, training programs will be developed. The fourth pillar, dealing with PRR, is still some time off.

National Solidarity Program
The National Solidarity Program (NSP) provides funding for small infrastructure projects in local communities. To obtain funding, communities must form Community Development Committees (CDCs), and the CDCs propose projects and manage implementation. NSP was active in all provinces visited. Reaction was generally very positive, particularly in terms of the community involvement aspect of the program. However, concerns about implementation were also voiced.

The program is managed through the provincial MRRD office. NGOs, usually with experience in the particular region, are employed as facilitating partners and assist in developing Community Development Committees (CDCs) that identify projects and manage their implementation. Projects that are proposed by the CDCs are reviewed by the supervising NGO, and then forwarded to the provincial MRRD office. They must then go to Kabul for final approval, which can normally take a couple of months. (In Badakhshan, MRRD had not received approval of their projects until the ninth month of the year, too late to begin work until the spring.) Apart from MRRD, there is no provincial or district involvement in the program. However, if projects are being considered that have some connection to other government departments, there should be some consultation. But for most projects, such as wells, ditches, bathrooms, etc, the ongoing upkeep would be minimal and could be done by the local community without additional financial support, so consultation was not necessary. For each project that is approved, an account is set up in the DAB, and the representative of the CDC can withdraw funds.

Box 3. 3: Bamyan's 'Fair Futures' Council

In Bamyan, there is a broad, community-based council that meets once a year, called 'Fair Futures.' It is comprised of senior provincial and district officials, and community leaders from the villages. They discuss priorities for the province, and at some time following the meeting a delegation will take their conclusions from the meeting to Kabul and meet with President Karzai. What is not clear is how various planning decisions around such programs as ASP fit with this group, as the ASP projects had already been agreed to at the provincial level at the time of the mission to Bamyan, while this council was scheduled to meet a few weeks later.

3.81 As it now stands, consideration is being given to increase funds flowing to the subnational level through the ASP, a consolidation of NSP, and/or through new counter narcotics efforts. If no action is taken to integrate these processes into the existing financial mechanisms within the mustoufiat,

subnational administration will become increasingly less relevant as a national government presence at the local level.

3.82 The Ministry of Finance is currently reviewing the structure, role and responsibilities of the provincial Mustoufiat offices. One of the innovations being considered is the establishment of a budget unit within the Mustoufiat, which would provide support to provincial departments in preparing budget requests, and more generally would help with coordinating provincial planning. This reform could provide the vehicle for incorporating these separate programs into the single expenditure account, and should be actively supported.

H. Staffing Administration

3.83 The original subnational study identified a number of issues in the area of staffing administration. In particular, the selection and appointment process was viewed as cumbersome and centralized, subject to nepotism and staffed with many unqualified personnel. Some responses to these issues are under development, such as the capacity building component of the ASP, but generally, very little has changed in this area. The rules regarding appointments of staff remain unchanged; all karmand appointments at grade 6 and above, and agir appointments at grade 2 and above, must still be sent to Kabul, and all others must be approved by the governor. The delays in getting approval from Kabul vary significantly, but probably the average is about one to two months, and some take up to five or six months. However, there were not as many complaints about this issue as before, with many interviewees saying that they realize the process does take time. However, there was support for implementing the recommendation in the original study that a two month time limit be placed on approving appointments.

3.84 The staffing reforms being implemented at the center, regarding merit based appointments managed by the IARCSC and PRR program, are just beginning to move out to the provinces, but very slowly.

Merit-Based Appointments

3.85 In most of the provinces visited, staff had some awareness that senior appointments (grades 2 and up) are to be done on the merit basis, and supervised by the IARCSC; but in many cases, there had been no recent appointments at this level. In some provinces, a representative from the IARCSC had visited, and explained the new recruitment procedures. (Reportedly, in a few provinces a local representative of IARCSC had established an office, but only recently, and apparently to review the structure of the governor's office, not to deal with recruitment.)

3.86 The study team did interview some newly appointed heads of department who had gone through the new process. In Bamyan, for instance, the head of the Education department had been appointed three months earlier. His appointment was first proposed by the governor, and this proposal was sent to the Ministry of Education, and then to the IARCSC. Apparently, the Commission did an analysis and checked the incumbent's background and qualifications. They also interviewed him. Finally, his appointment was approved by President Karzai. In Faryab, the Uluswal in the district of Pashtun Cote said he was recruited through the IARCSC.

3.87 But the general view was that most appointments are still based on factors other than merit, such as ethnic or regional connections.

PRR

3.88 The level of awareness about the PRR program was mixed; some senior officials had no knowledge at all about the program. This is not entirely surprising, as the PRR process has barely started in the provinces. It is clear based on discussions in provinces and in Kabul that rolling-out PRR in the provinces will require strengthening the IARCSC's presence in provinces to review / support PRR applications and make appointments. Moreover, it remains unclear whether a fully demand driven scheme like PRR is appropriate in the subnational context or whether an approach where the governor's office and the Mustoufiat are first reformed would be preferable.

3.89 Based on discussions with the IARCSC staff in Kabul, there is a view that more work needs to be done on how PRR is applied in provinces. Efforts have begun to look at restructuring the governor's office, by developing a model that can be applied across provinces in a more coordinated fashion. This would certainly be an improvement over the apparent ad hoc approach experienced to date. Looking forward, applying PRR in provinces must recognize the close connections across the various departments that exist at the provincial level.

I. Municipalities

3.90 The functioning of municipalities has not changed since the last round of provincial visits. In the provinces where the district municipalities were subservient to the provincial municipality (Herat and Kandahar) this practice continues, and in those provinces where the district municipalities were operating independently, that too has not changed.

3.91 According to the Ministry of Interior, the current legislation stipulates that all municipalities are independent units, and are responsible for the execution of their budgets, including both revenue collection and expenditures. Ministry officials were not aware of the situation in Herat and Kandahar, where those provincial municipalities collect the revenues from the district municipalities, approve their budgets and process their payrolls. They told the study team that they would immediately send a directive to these two provinces to comply with the law, but it is not known what the impact has been.

3.92 There has also been some question about whether the wording in the new Constitution, which says that "every kind of tax, duty and income collected shall be delivered to the State account," changes the financial independence of municipalities. The view of the Ministry of Interior was that municipalities will continue to have access to their revenues, and that any new legislation will confirm the assignment of municipal revenues to municipalities. However, the new Public Finance and Expenditure Management (PFEM) Law appears to be silent on this issue. The Law does say that municipalities can impose taxes and fees, and that their expenditures must not exceed the total of taxes and fees collected, and the budget issued by the central government, but it does not say that municipalities can keep any revenue that they do not spend, and how these excess revenues are to be spent. This should be clarified.

3.93 During the provincial visits, comments were frequently made that municipal revenues were being used by the governor or others in the province for their own purposes. And as provinces find it increasingly more difficult to access provincially collected revenues, the municipal revenues become increasingly attractive. Box 3. 4 gives examples of the sorts of expenditure that municipalities are being required to pay. To help avoid this occurring, clear instruction should be given to governors and mustoufiats on rules regarding municipal revenues, and regular audits should be conducted.

Box 3. 4: Examples of Provincial Expenditures Funded by Municipal Revenues

- An eight-person foreign mission visited a province; the governor gave each person a rug worth $120, and sent the bill to the municipality
- Meals for guests of the governor or deputy governor are routinely paid by the municipality
- The hotel costs ($1,380) of a mission from the Ministry of Interior was paid by the municipality, by order of the governor
- Costs of the inauguration of a provincial university were paid by the municipality

3.94 Table 3. 9 provides a summary of revenues and expenditures for the six provincial municipalities, for 2003/04. It should be noted that based on the data provided by Herat and Kandahar municipalities, they both show deficits for 2003/04. The mission team was not able to confirm why this occurred, but it is likely that both were able to draw on surpluses from previous years. Table 3. 10 provides a summary of staffing in each provincial municipality. Because the size of municipalities varies significantly, and consequently the available revenues, the types of activities that municipalities are able to perform also varies considerably. But there appear to be a number of core functions across all municipalities, even if the extent of the activity may differ. These core functions include: cleaning the city, construction and repair of municipal buildings and infrastructure, provision of water, municipal planning, supervision of transport services, and tax collection.

Table 3. 9: Provincial Municipalities: Revenues and Expenditures, 2003/04

	Faizabad (Badakhshan)*	Bamyan City (Bamyan)*	Maimana (Faryab)	Herat City (Herat)**	Kandahar City (Kandahar)***	Maidan Shahr (Wardak)
Revenues	3,780,337	1,856,000	na	30,169,244	74,338,836	**737,295**
Expenditures	2,552,862	1,856,000	3,501,093	33,261,931	78,157,644	**484,010**
Surplus/(deficit)	1,227,475	0	na	-3,092,687	-3,818,808	**253,285**

* 2003/04 figures were not available, 2004/05 forecast provided
** Note that Herat expenditures include 2,064,551 Afs in respect of district municipalities
***Kandahar revenues & expenditures includes figures for the district municipalities
Source: Provincial Municipalities

Table 3. 10: Provincial Municipalities Staffing Structure for 2004/05

	Positions Filled	Tashkeel
Faizabad (Badakhshan)	34	40
Bamyan City (Bamyan)	22	na
Maimana (Faryab)	na	66
Herat City (Herat)	567	567
Kandahar City (Kandahar)*	537	635
Maidan Shahr (Wardak)	59	59

* Data is for 2003/04
Source: Provincial municipalities

J. Conclusions and Recommendations

3.95 As stated at the beginning of this paper, the main conclusions of this review are that financial management at the provincial level has improved significantly since the original study was done, but there are still important issues to be addressed. Some of these issues, such as the management of positive

balances in the single expenditure account, have only arisen now that the system has been implemented, and can be fixed relatively easily.

3.96 In terms of recruitment and staff appointments, however, little has changed. Senior appointments are going through the IARCSC, but still, political and ethnic considerations continue to feature prominently in recruitment. There has also been some small movement towards introducing PRR at the provincial level, but so far it is only been seen as a means to increase pay, and those left out are resentful.

3.97 As an overarching recommendation, the conclusion of this study is that the package of reforms in the areas of financial management and staffing administration should continue, and efforts should be focused on ensuring effective implementation. While the improvements that have been seen at the subnational level are encouraging, there is still a risk that the gains will be effectively lost if growing reliance on mechanisms outside the provincial administration's budget and planning processes begins to marginalize these structures. Specific recommendations contained in this report are summarized in Table 3. 11.

Table 3. 11: Summary of Recommendations

Objective	Issue	Early Actions (within the next six months)	Actions Beyond Six Months
Overall Support to Provinces			
	Insufficient participation of provinces in budget formulation	• Build a consultative mechanism that allows provinces to review the provincial implications of the development budget, and identify their priorities. This mechanism could be fashioned based on the coordinating mechanism used for the Provincial Stabilization Fund.	• For the 2006/07 budget, enforce the requirement that ministries seek input from provincial departments on their budget submission – both for the ordinary and development budgets.
	Training/ documentation	• Require, with the introduction of all new procedures, that written instructions be provided in addition to training seminars; for more significant changes, assessment of implementation and follow-up training where necessary be undertaken.	• Accelerate the planned training of provincial staff that is currently tied to the 3rd and 4th pillars of the ASP program.
	Inadequate non-salary allotments	• During the 2005/06 budget process, provide Cabinet with an analysis of the distribution of ministry expenditures across provinces.	• Publish the annual provincial allotments as part of the budget documentation.
	Use of parallel planning/ program mechanisms bypassing provincial administration	• Ensure that the execution of the Provincial Stabilization Fund is managed through the Mustoufiat and governor's offices, as originally planned.	• As existing programs such as the NSP are expanded, or new program proposals developed, program design should avoid any parallel structures, and instead build on the existing structures within the Mustoufiat.
Smooth Budget Execution			
	Delays in receipt of takhsis	• Ensure that the quarterly allotments (takhsis) are issued through the Ministry of Finance at the beginning of each quarter, for all provincial departments.	
	Low balances in single expenditure account	• Increase the transfer of positive balances into provincial single expenditure accounts to more closely reflect monthly or quarterly allotments.	• Once the issues of delays in issuing takhsis and inadequate cash balances has been addressed, undertake a review of provincial spending patterns in order to improve the predictability of expenditure cash flows.
	Inconsistent implementation of authority to move funds across fasils	• Issue clearer directions to ministries and provinces on the procedures for managing allotments across fasils at the provincial level.	• Develop mechanisms for accountability for department heads to minimize the potential for abuse in allocating funds. For example, publicize the allocation of expenditures at the provincial and district level.
	Delays in receipt of tashkeel	• Enforce requirement that tashkeels be distributed to provinces before the start of the fiscal year. • Consider requiring that the proposed tashkeel be submitted as part of the ministry's budget submission; the proposed tashkeel could then be	• Begin a review of the tashkeel process, with the objective of delegating some of the detailed decisions encompassed by the tashkeel to subnational administration.

Table 3. 11: Summary of Recommendations

Objective	Issue	Early Actions (within the next six months)	Actions Beyond Six Months
		directed to the Tashkeelat Office for review. • Consider distributing the approved tashkeel to provincial Mustoufiats through the Ministry of Finance, as is currently done for the quarterly allotments. • These latter two recommendations could be facilitated by moving the Tashkeelat Office to the Ministry of Finance.	
	Hiring teachers beyond available takhsis	• During the 2005/06 budget deliberations, require the Ministry of Education to make a realistic assessment of the number of additional teachers required in each province. • Require the Ministry of Education to impose controls on provincial education departments, to ensure that in future no teachers are hired beyond the approved limits.	
	Inaccurate reporting of monthly headcount data and reliance on BP staff for reporting	• Review the Summary Payroll form that accompanies the monthly expenditure report (M23). Develop instructions that clearly explain how to complete the form, particularly with regards to the reporting of payments of two or more months of pay for individual employees.	• Implement plan to integrate BP staff into regular MoF staff
Sound Control Framework			
	Limited follow-up to audit findings	• Require audit findings to be communicated to provincial departments within two months of the completion of the field visit.	• Once the Parliament and local councils have been established, provide reports to these bodies on audit results produced by the Auditor General
Municipalities			
	Inappropriate access to municipal revenues	• Provide clear instruction to the governors and other provincial officials that they have no authority to access municipal revenues	Conduct regular audits of municipal revenues to ensure funds are used appropriately.
Sound HR management			
	Merit-based appointments	• Build on the progress made to date on reviewing senior appointments through the IARCSC by enforcing the requirement that all provincial appointments at level 2 and above be supervised by the IARCSC	
	Application of PRR in the provinces	• End the practice of 'ad hoc' ministry applications. • Reassess the application of PRR on the provinces. Require IARCSC oversight of coordinated proposals that take a systematic approach across provinces, beginning in strategic areas such as the governor's office or the Mustoufiat.	

CHAPTER 4. STATE OWNED ENTERPRISES

Executive Summary

i. ***Overview of SOEs***: The Government has made good progress in mapping the status of SOEs in Afghanistan. A total of 71 SOEs have been identified (with two additional ones identified under the Ministry of Transportation) under 12 line ministries. There is now a good basis on which to further expand and improve the information available on SOEs, particularly on the finances of those recommended for privatization and on employment figures to prepare a comprehensive social safety response. *It is strongly recommended, however, that the existing legislative framework within which SOEs operate be reviewed.* It may be better to repeal the SOE Law and corporatize all SOEs so that they can be governed under the same legislative provisions as other companies. *SOEs would still, however, have to report to the Government on financial and operational affairs. In addition, more attention should be paid to the oversight of public enterprises that are currently not classified as SOEs (often because State ownership is below 100%).*

ii. ***Financial regulation of SOEs***: The Ministry of Finance (MoF) took important steps in 2004/05 to restore financial reporting by SOEs, their fiscal obligations, and eligible transfers through the Budget. However, there is little consolidated information on SOE finances, the quality of information is poor, and reporting and auditing are not systematically carried out or enforced. *With the economic restructuring process underway, the SOE Department of MoF should carefully consider its evolving role.* Emphasis of activities will shift from financial regulation to economic restructuring. *But it is essential that MoF retains oversight of SOE finances and financial management in order to protect public finance and public assets.* Part of the SOE Department's responsibility includes monitoring capital investments. Currently, however, neither line ministries nor SOEs are reporting these to the SOE Department.

iii. ***Fiscal and budget issues***: Measures taken by the Government in 2004/05 seem to have brought fiscal transfers to SOEs under control. Freezing of SOE bank accounts has meant that transfers would only be made on the basis of financial reports from SOEs. As a result, official subsidies through the Operating Budget have gone down and transfers to meet operating expenditures do not seem to be of major fiscal significance. *Investments in SOEs have been roughly estimated at around $150 million since 2002/03, with the majority going to the utilities sector. The SOE Department needs to monitor these as part of its regulation of capital expenditures on SOEs, but also to ensure that investments are consistent with its recommendations on individual SOEs.*

iv. In general, there needs to be a stronger link between the SOE Department and the Budget Department of MoF. SOEs are not budgetary units, however. *In responding to budget proposals relating to SOEs, MoF could take the following approach:* (i) use of public funds should be limited to existing SOEs that will remain for some time under public ownership; (ii) budget proposals should be accepted only for SOEs that have an acceptable minimum level of financial oversight (iii) MoF in general should not respond positively to proposals for budget funding of SOEs' operating costs; and (iv) MoF should consider the multi-year fiscal implications of SOE proposals, and the value for money (compared with other budget proposals) within a limited fiscal resource envelope.

v. ***Economic restructuring policy and process***: The Cabinet has recently adopted a privatization policy. It has also approved a Decree setting out amendments to the SOE Law, which grants MoF the authority, in consultation with the relevant ministry, and under oversight of an SOEs Evaluation Commission (Ministers of Finance, Commerce, Economy, and the Senior Economic Advisor to the President), to make recommendations and implement transfer of control and/or ownership of SOEs to the private sector. The revised SOE Law also has provisions for publication of Government decisions on SOEs in the media. *The process in terms of soliciting private sector*

interest, preparing documents for sale, valuation methods, negotiation, proposal, and approval by the Government needs to be clear and transparent. Unrealistic expectations should not be attached to the privatization potential of some SOEs. Considerable time and effort could be spent soliciting investor interest in enterprises that have little business viability. The Government should also avoid making new investments in SOEs, particularly on the basis of vague or tentative investor interest, and should not establish any new SOEs.

A. Introduction

4.1 There are currently 71 State Owned Enterprises (SOEs) in Afghanistan.[1] This does not include SOEs in the financial services sector (e.g. state-owned banks) or joint stock companies (e.g. Ariana Airlines). Most have been operating at a fraction of capacity or not at all for a number of years, and many had significant assets destroyed due to conflict. As a result few SOEs, if any, have been able to function within the legislative framework that governs their operations. There have also been inconsistencies in the way financial affairs of SOEs are treated across different line ministries. For most SOEs there is a lack of: (i) accurate and up-to-date financial information; (ii) accounting standards and capacity to implement them; and (iii) State oversight of their financial affairs.

4.2 MoF started to address these issues recently by undertaking a review of all SOEs, including updating of employment and financial information. The Ministry has also taken steps in the 1383 (2004/05) Financial Year to try to bring SOEs into line on financial reporting, fiscal obligations, and eligibility for transfers through the Budget. The prime responsibility for this falls under the Presidency of the State Owned Enterprise Department of MoF (SOE Department), which is also responsible for SOE reform and privatization (Economic Restructuring Office, ERO, of the SOE Department). This chapter reviews recent developments and future plans with regard to SOEs, with particular emphasis on fiscal and budgetary issues. It makes recommendations on how SOEs could be treated and regulated within the Government's fiscal and budget frameworks, and reviews the proposed process for sale of SOEs to the private sector.

B. Overview of State Owned Enterprises

Overview of SOEs

4.3 The SOE Department has undertaken a review of the operational and financial status of all SOEs. Through actual site visits, this exercise rationalized an earlier attempt by Adam Smith Institute, which had estimated that there are more than 140 SOEs.[2] It provides narrated information on current activities, finances, assets, and employment of SOEs. Although the information is not very comprehensive, it is the most up-to-date and complete available. A separate exercise was also carried out on employment levels and workforce composition. Based on this initiative, the total employment figure for SOEs has come to around 18,500.

4.4 The following table classifies line ministries in terms of the number of utilities, large non-utility SOEs, and small and medium non-utility SOEs they have under their control. Large non-utilities are SOEs with more than 500 employees. This is not an official method of classification and ideally should have used financial information. Nonetheless, given lack of business activity and massive depreciation in the value of working assets, employment provides a good criterion for categorizing SOEs by size. Moreover, the implications of SOE reform, liquidation, or privatization are likely to be greatest in terms of impact on employment.

[1] Two additional SOEs have been identified under the Ministry of Transportation: (i) Millie Bus 2; and (ii) Liquid Gas Transportation Enterprise, bringing the total to 73 SOEs. Government is also investing in cement and coal mine projects, but these are treated as budgetary units and not classified as SOEs.

[2] Adam Smith Institute, "Consolidated Plan for State Owned Enterprise Reform in Afghanistan," A Consultation Document (April 2003)

Table 4. 1: Classification of SOEs

Classification	No. of SOEs	Approx emp	SOEs with no data on emp	Operations			
				Full	Semi	Non	Unknown
Utility							
Ministry of Urban Dvpt and Housing	1	434		1	-	-	-
Ministry of Mines and Industry	1	1,029		1	-	-	-
Ministry of Energy and Water	1	5,432		1	-	-	-
Sub-total for utilities	*3*	*6,895*		*3*			
Large non-utility							
Ministry of Commerce	2	1,494		1	1	-	-
Ministry of Urban Dvpt and Housing	1	560		-	1	-	-
Ministry of Mines and Industry	4	4,847		2	2	-	-
Sub-total for large non-utilities	*7*	*6,901*		*3*	*4*		
Small/Medium non-utility							
Ministry of Transportation	10	620	1	1	9	1	-
Ministry of Public Health	1	234	0	-	1	-	-
Ministry of Commerce	5	355	1	1	2	2	1
Ministry of Education	1	210	0	-	1	-	-
Ministry of Urban Dvpt and Housing	3	783	0	2	1	-	-
Ministry of Justice	-	-	1	-	-	-	1
Ministry of Mines and Industry	12	1,926	4	3	9		4
Ministry of Defence	2	193	0	2	-	-	-
Ministry of Culture and Information	3	655	1	2	-	1	1
Ministry of Energy and Water	4	584	0	-	2	-	2
Ministry of Finance	-	-	1	-	-	-	1
Ministry of Agriculture	9	1,069	1	4	2	1	3
Municipality	-	-	1	-	-	-	1
Sub-total for small/medium non-utility	*50*	*6,629*		*15*	*27*	*5*	*14*
Total	**60**	**20,425**	**11**	**21**	**31**	**5**	**14**

Source: SOE Department (Review of SOE operational and financial status + Employment figures)

4.5 At the time of writing, employment data was available for 60 out of the 71 SOEs, and not all of these had yet been verified, which is why the figure in the table (20,425 employees) is higher than the estimate of actual employment (18,500). The employment figures include permanent employees and workers hired on contract. SOE Department data show that nearly two thirds of workers are on contract, but in discussions it was noted that this is likely to be a gross over-estimate. A more accurate breakdown will be available when employment figures have been verified in detail. Over 90% of the SOE workforce is claimed to be skilled (engineering, mechanical, or other), just over 60% have at least primary education, and on average employees have over 23 years of work experience with SOEs across the board.

4.6 Of all the SOEs visited by the SOE Department, around eight claimed to be in arrears on salary payments, but no detail was obtained on the level and structure of pay. It is unlikely that any SOEs are following set procedures on recruitment, promotion, termination of employment, and remuneration. In addition to the 71 SOEs, the Government owns enterprises in the financial services sector (e.g. Millie Bank, Afghanistan National Insurance Company – ANIC), and has joint stock ownership of the national Airline, Ariana. There are also some disputed cases of joint ventures and joint stock companies (e.g. Torghandy Enterprise claiming it is a subsidiary of another SOE and the Afghan Textile Enterprise claiming it has more than 4,000 investors).

4.7 The Ministry of Mines and Industries has the largest number of enterprises, with 21 SOEs. It inherited 11 SOEs when the Ministry of Light Industry and Food was disbanded in December 2004. Eight other enterprises (food related) under the Ministry of Light Industry and Food were transferred

to the Ministry of Agriculture, which along with the Ministry of Transportation has the second largest number of enterprises with 10 SOEs. Based on available data, nearly 50% of all SOEs are only semi-operational, just under 30% of them are fully operational, and the rest are not operating.

LEGAL FRAMEWORK

4.8 The operation and management of SOEs are governed by the State Owned Enterprise Law (Tassady Law, 1991), which is administered by MoF and defines SOEs as legal entities with independent balances operating with 100% capital of the state. For most SOEs, control rests with line ministries, but proceeds from any sale revert to MoF. The SOE Law has provisions on: (i) establishment of an SOE; (ii) use of SOE financial resources; (iii) financial management including reporting and fiscal obligations to the State; (v) auditing arrangements; (vi) governance, including management and business decisions; and (vii) liquidation.

4.9 Although SOEs are classified as independent entities, the SOE Law gives line ministries and MoF significant control over SOE operations and finances. Some provisions are quite prescriptive, for example on the duties and authorities of the "Conducting Delegation". This is defined as the functional organ of an SOE and acts as the management board of the SOE. The primary legislation could perhaps have been more general, with more detailed regulations applying to specific sectors. The Law as it currently stands may be quite onerous and create inflexibilities in particular sectors, weakening productive and allocative efficiency.

4.10 The Government may wish to review the relevance of the SOE Law and consider whether it may not be better to repeal it and corporatize both SOEs that will remain under Government ownership and those that will be sold to the private sector. For enterprises that remain under State ownership, there were provisions on financial management and reporting to MoF in an earlier draft of the Public Finance and Expenditure Management (PFEM) Law, but these were omitted in the final text. There are provisions in the Income Tax Law on the tax obligations of SOEs to the Government

4.11 The SOE Law has specific provisions on financial management (chapters II and III), which state that SOEs can use their capital for recurrent costs ("upgrading production standard and paying rights of employees") but capital investments ("expansion of basic possessions") require MoF approval. MoF also sets minimum profit targets on the basis of annual fiscal plans, which are discussed in more detail in paragraphs 4.19 and 4.20 below. The SOE Law states that auditing of SOEs will be carried out by MoF, and that SOEs will be required to submit productive, financial, and annual balance reports to their line ministries, MoF, and the Central Statistical Department – every four months for the functional report, and by June of the new fiscal year for the annual balance report. If the SOE Law were to be repealed and SOEs corporatized, financial reporting would have to be in accordance with the Commercial Law, but some provision would need to be made for SOEs reporting on financial activities to MoF.

4.12 Under the Income Tax Law, SOEs are liable to pay income tax like any corporation or limited liability company. The SOE Law has its own provisions on transfers to the State. Under the Income Tax Law, SOEs must withhold taxes on income and pay to the Government business receipts tax, rent tax, contract tax, and income tax, among others. All SOEs will be classified as large taxpayers. They will be responsible for filing their returns with the Large Taxpayer Office (LTO). The LTO is in the process of registering all SOEs, but currently it has only 10 SOEs on its books. Only one enterprise to date has submitted a tax return (Millie Bank).

4.13 The Commercial and Insurance Laws also apply to other Government-owned enterprises (i.e. not the 71 SOEs registered under the SOE Law). ANIC and Ariana Airlines, for example, are registered under the Commercial Law of 1955 (The Code), which governs their formation, management, and dissolution. This creates some difficulty for companies such as ANIC because they are 100% Government owned and therefore also governed by the SOE Law. In the case of Ariana, its Articles of Incorporation state that "Dissolution and liquidation of the Company shall be achieved in

accordance with the Commercial Law of Afghanistan." In the case of ANIC, the Insurance Act states that dissolution will be in accordance with both the Commercial Law and directives of MoF.

4.14 If SOEs are corporatized, they will be governed by the provisions of the Commercial Law, like other companies in Afghanistan. This will mean less management control over SOEs by the Government, even though SOEs would still be obliged to report regularly on financial and operational affairs. This would be a positive outcome, although an earlier report by the Adam Smith Institute recommended "a wholesale revision of the present Code (Commercial Law) with the aim of creating a legal and business environment which is more responsive to the present needs of Afghanistan."(Adam Smith Institute, 2003, p. 12). It would be preferable to corporatize after any revisions are made, although this should not delay corporatization of SOEs.

4.15 The Labour Code (1987) also applies to SOEs and other Government owned enterprises, covering provisions on: (i) financial assistance on retirement; (ii) assistance to workers when they are not capable of working; (iii) maternal leave; (iv) assistance to family of deceased for burial arrangements; and (v) retirement pension. In case workers are involuntarily separated from their SOEs, the Ministry of Labour and Social Affairs has an obligation to find them work in the Government within six months. The SOE Department is seeking to propose an amendment so that retrenchment packages currently being developed can be accommodated within the existing legislative framework.

C. Regulation of Financial Affairs of State Owned Enterprises

ROLE OF THE MINISTRY OF FINANCE

4.16 The SOE Department in MoF has an extensive role under law to analyze, monitor, and agree on financial operations of SOEs. This includes responsibility for auditing, reviewing capital investments, and monitoring debt accumulation by SOEs. Line ministries' responsibilities cover mainly operational oversight and presiding over the main governance body of an SOE (the High Council, which sits over the Conducting Delegation).

4.17 There are currently 38 staff and 14 contractors in the SOE Department, who are divided broadly between three sub-departments covering the sectors within which enterprises operate: (i) Commercial and Services; (ii) Construction and Transportation; and (iii) Industrial. For each sub-department there are meant to be two sector specialists and two finance specialists.

4.18 There is also the Economic Restructuring Office (ERO) under the SOE Department, which has recently applied for Priority Reform and Restructuring (PRR). The ERO has taken over the responsibilities of the Evaluation Commission for SOEs established soon after the end of the conflict, which was disbanded in May 2004.

FISCAL PLANS AND FINANCIAL REPORTING

4.19 Enterprises, through their line ministries, are meant to agree annual fiscal plans with the SOE Department. This is based on an overall revenue target for the SOE Department (i.e. net income to the SOE Department from taxes and fees collected from SOEs), set by revenue authorities in MoF. The net income to the SOE Department from individual SOEs is agreed on the basis of the latter's operational plans.

4.20 Implementation of fiscal plans is monitored by the SOE Department through quarterly reports submitted by the enterprises to line ministries. This may be quite onerous for line ministries, particularly if they consider this as the core of their activity or because SOEs have limited capacity to provide reliable reports. This may detract line ministries from their core functions, particularly those

that have significant SOE activities under them. MoF has the responsibility of auditing SOEs, but this has not been carried out systematically (or at all) for several years. The SOE Department, claims that audits are carried out "when the need arises."

ACTUAL REPORTING

4.21 SOEs were asked to fill out a general financial questionnaire on balance sheet and income statement items. The SOE Department has broken down assets between short-term (working capital related) and fixed assets and liabilities along the same principles. They found that SOEs have very limited long-term liabilities outside of some possible loans to the line ministries or to MoF. But the information is not very reliable or consistent, so the SOE Department does not plan to use it further. The SOE Department indicated that there are agreed fiscal plans with the majority of SOEs and that most are submitting quarterly income statements.

Table 4. 2: Summary Statement of Revenue and Expenditure from SOEs by Line Ministry (1st 2 quarters of 2004/05, 000's of AFS)

Ministry	No. of SOE Reports	Total Revenue	Total Expenditure		Balance
			Salaries	Other	
Ministry of Transportation	5 out of 10	157,882	61,546	115,316	-18,980
Ministry of Water & Power	1 out of 5	4,319	219	1,212	2,888
Ministry of Irrigation	2 out of 3	976	1,000	2,152	-2,176
Ministry of Urban Dev & Housing	3 out of 5	44,176	13,770	28,606	1,800
Ministry of Commerce	5 out of 7	67,837	18,747	39,493	9,597
Ministry of Health	1 out of 1	18,580	3,275	1,115	14,190
Ministry of Culture & Information	1 out of 3	8,747	1,874	506	6,367
Ministry of Aviation & Tourism	2 out of 2	18,685	1,683	7,741	9,261
Ministry of Agriculture	2 out of 2	13,441	2,684	13,824	-3,067
Total	**22 out of 37**	**334,643**	**104,798**	**209,965**	19,880

Source: SOE Department

4.22 Table 4.2 was compiled using income statements (although in reality the statement only had aggregate information on revenue and expenditure) of SOEs for the first two quarters of 2004/05. The data are presented according to ministries, before the Cabinet reorganization in December 2004 because it shows actual reporting. The data are poor and not very reliable (e.g. data was presented using different formats, there were basic arithmetical mistakes), probably reflecting lack of accounting standards in SOEs but perhaps also lack of capacity in the SOE Department. Revenue figures are reported in gross terms, based on achievement of operational targets. The concept of net income is not clearly understood by the SOEs or by the line Ministries.

4.23 Based on Table 4.2, twenty-two SOEs reported financial information in the first two quarters of 2004/05, which includes three large non-utilities (Millie Bus, Housing Construction Enterprise, and Fuel and Liquid Gas Enterprise) but does not include the utilities. Reporting may be a result of the MoF having frozen the bank accounts of most SOEs since April 2004 in order to regain oversight over their financial affairs. Although data are available on SOE revenues and expenditure up to 2002/03 on the Central Statistics Office website, the SOE Department was not aware of this.

4.24 With the freezing of the bank accounts of SOEs, the SOE Department now has to approve disbursements after requests have been verified against fiscal plans. Any expenditure above Afs 100,000 has to be approved by the Deputy Minister of Finance for Administration, and anything above Afs 1 million has to be approved by the Minister of Finance. This micro-management creates major inefficiencies for SOEs by impinging on their financial independence. However, given that they are not operating under normal circumstances, the benefits (e.g. enabling MoF to re-establish SOEs' fiscal obligations and financial oversight over them, preventing poor investment decisions) may outweigh the costs in the short term.

4.25 There needs to be a clearer idea about the quality and compliance of financial reporting to the SOE Department, and it is recommended that the SOE Department consolidate this information. Information for 2003/04 and previous years is apparently archived, and given the reporting format and likely small volume of information, it should not be a time consuming exercise to prepare this electronically for 2003/04 and the first two quarters of 2004/05. The data provided already helps to identify line ministries and SOEs operating in accordance with the system but also those that are detached and how they are treated in the public finance system. In the longer term, better information can help make improvements in the financial relationship with the SOE Department and in accounting standards particularly for enterprises that will, at least temporarily, remain under Government ownership.

4.26 It is important that MoF retains oversight of SOE finances and financial management standards in order to protect public finance and public assets. Currently this is not taking place systematically. Part of the SOE Department's responsibility includes monitoring and analyzing capital investments. At present, however, neither line ministries nor SOEs are reporting these to the SOE Department. The information also is not readily extractable from the Development Budget. Projects are classified according to National Programs, with details on lead ministries which are also often the implementing agency. Project Summary Sheets need to specify whether or not the investment concerned is intended for an SOE.

D. Fiscal and Budget Issues

OFFICIAL SUBSIDIES THROUGH THE ORDINARY BUDGET

4.27 Due to patchy financial reporting and inconsistent treatment of SOEs across line ministries, MoF has little consolidated information on the transfer of public finances to SOEs. The 2002/03, 2003/04 and 2004/05 Budgets, however, did have a provision for line ministries to report specifically on subsidies to SOEs (sub-code 7020 in Treasury Reports covering '"Subsidies to SOEs").

4.28 The Ministries shaded in grey are those that actually have SOEs under them (before reorganization). Out of 15 of them, 11 ministries officially reported subsidies to SOEs. The largest recipient by far was the Ministry of Light Industry and Food. But official subsidies in 2004/05 have been insignificant. This is probably a result of Government's policy of controlling transfers to SOEs.

OTHER TRANSFÈRS TO SOES THROUGH THE ORDINARY BUDGET

4.29 There may be "hidden subsidies", a potentially significant one being salaries because some SOE staff may be counted as part of the Ministry payroll. However, the six Ministries that have the largest number of SOE employees were interviewed, and only in two cases were there found to be salary transfers to SOEs through the Ordinary Budget: (i) Ministry of Mines and Industry is paying 1,800 people in Jawzjan province (in addition to the 353 staff approved for the Ministry there), and (ii) Ministry of Light Industry and Food is paying 125 staff in Herat and 190 staff in Kapisa (in addition to the 320 staff approved for the Ministry). But in both cases MoF agreed that the Ordinary Budget would meet staff costs of projects and commercial enterprises for one year pending review.[3]

[3] Transitional Islamic State of Afghanistan, Ministry of Finance: Afghanistan Operating Budget, An Overview (p. 5)

Table 4. 3: Subsidies to State Owned Enterprises (2002/03-2004/05, Afs)

Ministries and Departments	2002/03	2003/04	2004/05 (1st 6 months)
Ministry of Irrigation	-	-	-
Ministry of Transportation	1,073,532	-	-
Ministry of Aviation and Tourism	46,700	-	-
Ministry of Commerce	1,656,039	-	-
Ministry of Education	291,298	1,688	-
Ministry of Defence	-	-	-
Ministry of Justice	-	-	-
Ministry of Mines and Industry	1,782,305	-	-
Ministry of Health	-	-	-
Ministry of Urban Dev and Housing	3,843,739	-	-
Ministry of Agriculture	206,277	-	-
Ministry of Culture and Information	-	1,020	3,000
Ministry of Water and Power	-	-	
Ministry of Finance	1,000,000	-	5,465
Ministry of Light Industry and Food	14,264,854	109,181,043	-
Ministry of Irrigation and Water	325,792		
Ministry of Women's Affairs	422,578	-	-
Central Statistics Office	88,935	-	-
Ministry of Foreign Affairs	-	19,134,762	-
Ministry of Interior	-	-	3,353
Refugees Return	-	-	9,504
Ministry of Frontiers and Tribal Affairs	-	-	5,028
Audit Office	-	-	2,030
Total	**25,002,049**	**128,318,513**	**28,380**

Source: Treasury Department, Ministry of Finance

4.30 In Table 4.4, not all institutions listed are SOEs. Some are projects, classified as budgetary units (e.g. Herat Cement Project), and it is not clear whether some are departments within the concerned Ministry or SOEs (e.g. Afghan Geological Survey). There was no evidence of salary payments to SOEs under the Ministries of Urban Development and Housing, Transportation, Water and Power, and Information and Culture. They indicated that SOE staff are outside the Ministry *Tashkeel*. There may be other hidden subsidies, for example through Government guarantees, obligations for ministries to buy from SOEs, or preference granted to SOEs when bidding on Government contracts, no information could be obtained on these aspects.

Table 4. 4: Salary Transfers to SOEs through the Ordinary Budget In 1st 2 quarters of 2004/05 (Afs)

Ministry	SOE/Project/Dept	Ordinary Budget
Ministry of Mines & Industry	North Gas and Oil Screeching	26,728,954
	Herat Cement Project	176,168
	Herat Zabsak Coal Mine Project	225,243
	Afghan Geological Survey	7,721.138
Total		**35,851,503**
Ministry of Light Industry & Food	Bagrami Textile Projects	643,760
	Gul Bahar Textile	2,674,554
	Cotton Textile Project Herat	1,765480
Total		**5,083,794**

Sources: Budget Departments in MMI and MLIF

4.31 The national water utility (Central Authority for Water Supply and Sewerage, CAWSS) currently does not receive any subsidies through the Operating Budget, but it is facing significant financial difficulties. "Due to low revenues (or even no revenues at all in some cities) salaries and

other operational costs are partly and irregularly paid."[4] Provincial branches of CAWSS function outside the Operating Budget. They have opened their own bank accounts and cover part of their operational costs (primarily wages) through revenues.

4.32 CAWSS is undergoing a restructuring process, to be implemented in two phases. The two-year short-term program envisages $3 million worth of financial support to meet operation and maintenance costs of CAWSS including salaries in headquarters and 13 branches; enable recruitment of new staff for expanded operations; and provide incentive bonuses to motivate staff. The subsidy will be phased out as revenues become sufficient to cover operational costs.

4.33 The electricity utility company (Da Afghanistan Brishna Mussessa, DABM) is also undergoing a restructuring and commercialization process. As in the case of CAWSS, it is in poor financial condition and depends heavily on Government support for operational and investment funds. Until 2003/04, salaries of staff were paid through the Ordinary Budget of the Ministry of Water and Power (see Volume IV, Chapter 3).

SOEs and the Development Budget

4.34 There have been planned (and some realized) investments in SOEs through the Development Budget, particularly in the Electricity sector. The latter has also benefited from 'in kind' subsidies in the form of fuel supplies through USAID ($40 million per year according to latest information). Table 4.5 is based on a selection of projects in the Core and External Development Budgets that were targeted to SOEs.

4.35 The majority of commitments, and the highest level of disbursements to SOEs in the Development Budget, are for DABM. There are other investments through the Development Budget as well, for example a $10m loan available from the Asian Development Bank to rehabilitate public sector construction industries – these probably include Banaye Construction Enterprise, Afghan Construction Enterprise, and Housing Construction Enterprise in the Ministry of Urban Development and Housing. This loan has not yet been budgeted or committed, but the Government should ensure that any investment plans in public sector construction enterprises (or other SOEs) are consistent with the privatization list, because Banaye Construction Enterprise has been recommended for privatization and the latter two have been recommended for liquidation. The expenditure review of the Ministry of Mines and Industry also identified a number of additional projects worth $26.7 million (see Volume IV, Chapter 4). This data was obtained directly from the Ministry (shaded grey in Table 4.5), but the Development Aid Database shows that although some of these projects are in the pipeline, they have not yet been budgeted for or committed.

4.36 CAWSS has also received significant investments through the Development Budget (not in Table 4.5) for feasibility studies and short-term rehabilitation of water supply systems. Around $35 million has been contributed by the World Bank and KfW (German Reconstruction Bank) since 2002 for the Urban Water Supply and Sanitation Program. A further investment of nearly $100 million is envisaged for the Water Supply and Sanitation Sector over the coming three years through the Afghanistan Reconstruction Trust Fund ($36m for CAWSS only), USAID ($30 million) and KfW (around $45 million). The majority of this will most likely be for restructuring and expanding CAWSS. These investments will bridge the gap until the start of a medium-term investment program, which will be in excess of $200 million.

4.37 Taking into account investments made in CAWSS, a very rough estimate of actual investments on SOEs through the Development Budget since the end of conflict would stand at around $150 million. Roughly in the range of 70-80% of this has been channeled to the water and electricity utilities. Certain line ministries, including Mines and Industry, have shown interest in

[4] Proposal for funding to the Afghanistan Reconstruction Trust Fund, "Short-term Support to the Urban Water Supply and Sanitation Sector," 10 December 2004 (Annex 1E).

raising public investments for SOEs – not least because they form such a large part of that Ministry's activities. However, there have not been significant investments in non-utility SOEs since the end of conflict. This may partly be due to the Government's policy on economic restructuring and recent measures taken to review the status of SOEs before proceeding further; general lack of information on SOEs; and other priorities for donors.

Table 4. 5: Planned and Actual Investments in SOEs Based on Selection of Projects in Development Budget ($m)

Line Ministry and SOE	Main Donors	2002/03 - 1st 6 months of 2004/05		
		Budgeted	Committed	Disbursed
Ministry of Water and Power				
DABM	ARTF, WB, ADB, EC, Ger	139.37	324.69	88.14
Ministry of Transportation				
Millie Bus	India, Iran, Japan	39.02	85.39	22.62
Ministry of Mines and Industry				
Hydrogeological Eng Services	Japan	2.1	4.1	-
Geological Survey	UK	10.64	4.54	-
Afghan Gas Enterprise	USAID	-	1.1	-
Herat Textile Factory		0.15	-	-
Afghan Carpentry Factory		0.08	-	-
Afghan Industries		0.59	-	-
Faryab Gin and Press Factory		4.5	-	-
Spin Zar Factory Agencies		2.67	-	-
Balkh Textile Factory		1.13	-	-
Pul e Charkhi Factory		10.51		
Mazar Power and Fertiliser Enterprise		10		
Ghori Cement Enterprise		0.1		
Jabal Seraj Cement Enterprise		2		
Jangalak Factory Enterprise		0.5		
North Coal Mines Enterprise		10		
Herat Zabsak Coal Mine Project		4		
Herat Cement Project		0.1		
Ministry of Culture and Information				
Azadi Printing Enterprise	USAID + PRT	0.5	0.5	0.5
Ministry of Urban Dvpt and Housing				
Housing Construction Ent.	USAID	-	1.2	-
Microrayon		1.4	-	-
Total		**239.36**	**421.52**	**111.26**

Source: Project documents on Afghanistan Government website and Development Budget data from Development Budget and External Relations Department, Ministry of Finance

4.38 There are no clear indications that total state transfers to SOE operations are of a major fiscal significance. This may be due to a combination of the steps taken by the Government in 2004/05 and the fact that a large number of SOEs are not fully operational. The Mid-Year Review shows a significant reduction in official subsidy transfers to SOEs, but there may be other "hidden subsidies". . Salary transfers do not seem to be significant, but there may be support to non-salary operating and maintenance costs, subsidized prices, subsidized user charges for utilities, etc. – in particular in Ministries such as Commerce, and (former) Light Industry and Food.

DEALING WITH SOEs IN THE NATIONAL BUDGET

4.39 SOEs are not budgetary units; therefore any transfers of public resources to SOEs should be recorded as subsidies in the Budget. Budget submissions from line ministries must clearly separate expenditures on SOEs (if any) from other line items, and this should come out of fiscal plans agreed with the SOE Department. Currently there is no link between the Budget Department and the SOE Department, but a strong relationship needs to be established between the two. Budgetary appropriations should only be allowed as subsidies if there is a genuine need, which the SOE Department is meant to oversee. The SOE Department should feed into the budget formulation and review processes to inform any subsidy appropriation on the basis of financial statements from SOEs. These links are also essential to ensure consistency between recommendations of the SOE Department on privatization and liquidation and line ministries' plans with regard to SOEs. Out of the SOEs listed in Table 4.5 for which there are planned investments, the Housing Construction Enterprise and Jangalak Enterprise have been recommended for liquidation. Even in other cases, the Government must be cautious about investing public funds in SOEs in the hope that this will improve prospects for privatization.

4.40 The following steps are recommended for responding to budget proposals from SOEs:

- First, the use of public funds (whether domestic resources or external assistance in the form of grants or loans) should be limited to existing SOEs that will remain for some time under public ownership. MoF should first confirm whether the Government has full ownership of the firm, to avoid potential claims by private parties. The Ministry should then use the SOE Department's prioritized list, in which the SOEs that will remain under public ownership are identified as well as those recommended for privatization or liquidation. This requires close cooperation between the Budget Department and the SOE Department. Based on this list, MoF could consider the following approach:

    - Fresh investment in utilities could be considered, as utilities are likely to remain under public ownership for some time, as long as these investments are accompanied by necessary reforms and improvements in financial management in the public utilities concerned, including a sound business plan.
    - No investment should be made in SOEs on the privatization list. The Government could consider some labor or financial restructuring, but other investments (e.g. new equipment or technology) are not appropriate as international experience shows that Governments usually do not recover these investments in terms of a higher sale price for the privatized firms.
    - No investment should be made in SOEs that are to be liquidated.
    - No investment should be made to create new SOEs because, first, this would send an adverse signal to the private sector and, second, the creation of new SOEs would generate additional fiscal risks and potential liabilities for the Government;
    - Finally, some investments of a rehabilitation nature could be considered for SOEs that will stay for some time in the Government's portfolio.

- Second, budget proposals should be considered only for SOEs that have an acceptable minimum level of financial oversight. A first requirement is a certain level of administrative reform in the parent ministry of the SOE concerned, so that it has the capacity to supervise its SOEs' operations. A second requirement is a minimum level of financial management capacity (accounting and reporting in particular) in the SOE itself. In particular, being able to assess regularly the cash flow of the SOE is important. Ideally, there should be audited accounts available. If these conditions are not met, budget proposals should be directed at such improvements and major investments held back.

- Third, MoF in general should not respond positively to proposals for budget funding of SOEs' operating costs, as opposed to investment proposals. In exceptional cases, the budget may have to finance operational costs of certain SOEs (e.g. wages or non-wage operating costs) in the short run, but MoF should tie such funding to improvements in cash flow – for instance an increase in cost-recovery. This is necessary for MoF to have some confidence that the multi-year fiscal implications of such budget proposals will be manageable, i.e. that the costs will be contained and declining over time. An important principle should be that any budget funding of SOEs' operating costs should be in the form of explicit subsidies rather than hidden subsidies in other budget lines.

- Finally, in reviewing SOE proposals, MoF should consider the value for money within a limited resource envelope and the multi-year fiscal implications. First, MoF should seek to compare the benefits and value of SOE proposals with other budget proposals. It is critical that the projects technically meet a critical level of economic rate of return, since allocating resources to SOEs diverts scarce funds from other growth-enhancing spending. Second, MoF should take into account the multi-year fiscal implications of the proposals. These proposals will have direct (e.g. need for sustained investment or subsidies in future years) and indirect (e.g. creation of contingent liabilities if the project fails) fiscal impacts; they will also raise expectations about public investment, further increasing fiscal risks.

REVENUE FROM SOEs

4.41 The SOE Law has provisions on transfers from SOEs to the State, namely up to 37.5% of net profits (after deducting 25% for special expenditures and 37.5% for working capital and other). The SOE Department, however, also referred to a 2% levy on gross revenue and 20% tax on gross profits (which is the corporate income tax). The SOE Department indicated that all revenues are remitted to SOE accounts, and liabilities to the state are calculated by the SOE Department and then transferred into the Treasury Single Account (TSA). SOEs would ordinarily be liable for paying taxes directly to the revenue authorities, and the SOE Department's role would be limited to monitoring compliance. The current arrangement was probably put in place as part of the Government's efforts to impose stricter financial controls over SOEs.

4.42 Information on the amounts that the SOE Department has transferred to the TSA in 2004/05 was not immediately available. The General Presidency of Revenue (GPR) was not aware of any transfers from the SOE Department. The SOE Department gave a presentation to the GPR on this issue, but this did not provide any further clarity on how SOE obligations to the State are being treated.

4.43 The Large Taxpayer Office will be providing training on accounting to both the SOE Department and some SOEs, using a basic bookkeeping program and looking at basic budgeting, revenue forecasting, and submission of income statements. The GPR is also following up on 11 enterprises that claim to be current on tax payments, based on information from the SOE Department's review). From a quick review, GPR found evidence of only one enterprise having submitted a tax return of 300,000 AFS directly into state accounts (Millie Bank – which is not on the SOE Department's list of enterprises). Existing tax records do not show that SOEs are either current or compliant with tax payments.

4.44 It is doubtful that the SOE Department is calculating SOE liabilities to the State according to the formula in the SOE Law (paragraph 4.41), largely because of lack of reliable financial information. The revenue formula is another aspect of the SOE Law that makes it quite restrictive. The formula will, however, probably no longer be applicable once the Income Tax Law comes into effect – SOEs will be liable for income taxes like any other corporation or limited stock company.

The GPR is already making efforts to bring SOEs under the new system by having all of them registered under the LTO.

4.45 It would be useful to consolidate the information on revenue transfers from SOEs to state accounts. In the short run it may be difficult to ensure that SOEs comply with the new tax administration system, although the training planned by the LTO should help. The SOE Department could therefore carry on its short-term functions, but on the basis of the new tax policy measures (i.e. tax measures contained in the draft income tax law including business receipts tax, rental tax, etc.).

E. Economic Restructuring Policy and Process

POLICY STATEMENTS

4.46 Pillar 3 of the National Development Framework (promulgated in April 2002) indicated that the privatization process is a medium-term objective and not a short-term priority.[5] The stated goal was to reduce state presence in the economy by privatizing "appropriate state assets including: state hotels, state cement factories and other state owned enterprises." The privatization process falls broadly under Sub-Program 3.1.1 "Trade, Investment and Private Sector Development Policies" and Sub Program 3.1.2 "Administrative Reform and Restructuring."

4.47 In "Securing Afghanistan's Future" there is no explicit mention of privatization, but the poor state of SOEs is highlighted as a key issue to address in strengthening infrastructure and service delivery (Afghanistan Government, 2004, Chapter 3). There are large public investment programs envisaged for (i) the transport sector (including in state-owned bus companies); (ii) the energy sector (including investment in DABM, rehabilitation of gas production and transmission, investment in oil storage tanks); (iii) the mining sector (including investments geared toward regularizing existing production of quarry materials and gemstones, rehabilitation of some coalmines, and investment in coal and copper production and exploration); and (iv) the urban development/management sector. But the state will act as facilitator and regulator rather than service provider.

4.48 More recently, in November 2005 the Cabinet adopted a privatization policy, which states that "the Government is committed to expanding the private sector through the efficient and rapid transfer of State-Owned Enterprises."[6] The responsibility for preparing proposals on economic restructuring and divestiture will rest with MoF and will be based on the review of SOEs completed in December 2004. The policy statement is an important step to help promote Government-wide coordination in taking forward the privatization process. But MoF will need to work closely with line ministries in developing proposals to ensure buy-in for, among other issues, recommendations on type of divestiture, post-privatization responsibilities, and use of privatization proceeds.

RECOMMENDATIONS ON RESTRUCTURING, PRIVATIZATION, AND LIQUIDATION

4.49 Based on their review of SOEs, the SOE Department recommended in November 2004 that: (i) 10 enterprises should remain under Government ownership (with possible privatization at a later date); (ii) 41 enterprises should be privatized as going concerns; and (iii) 20 enterprises should be liquidated. They then revisited their assessment and recommended that out of the 41 to be privatized, seven are likely to attract interest from foreign investors. These include: (i) Mazar Power and Fertiliser Enterprise; (ii) Jabalseraj Cement; (iii) Ghuri Cement Enterprise; (iv) Afghan Gas Enterprise; (v) Kabul Silo; (vi) Mazar-e-Sharif Silo; (vii) Brishna Organisation Enterprise. The SOE Department suggested that these seven SOEs be privatized through international tenders.

[5] See Afghanistan Government (2003, Annex 3, Pillar 3).
[6] http://privatization.mof.gov.af

4.50 The SOE Department's recommendations are based on: (i) operational activity; (ii) state of the equipment and degree of economic obsolescence; (iii) capability of senior management; and (iv) formulation and quality of a business plan. The SOE Department recognizes the weaknesses in the available information and will help potential investors to obtain as much financial information as possible. But the Government must undertake comprehensive valuations itself, particularly for some of the larger enterprises recommended for privatization, in order to ensure a sound basis for negotiation.

4.51 With the new privatization policy, the Government has decided to classify SOEs under two rather than three categories, which are:

- Enterprises currently recommended to remain in State ownership, which are mainly SOEs in the utilities sector or those that must remain in Government ownership by law; and
- Enterprises recommended for divestiture, with method of transfer to the private sector (e.g. transfer of assets, sale of shares, long-term leases, or management contracts) to be determined on a case by case basis.

4.52 Privatization and other reforms and restructuring of SOEs can lead to important gains in terms of growth and therefore revenues, as well as lower public expenditures. In addition to the net gain from higher tax revenues and lower fiscal transfers, the Government can also benefit at the time of sale from improved performance of privatized concerns. Fiscal gains will be reduced, however, if sales are not transparent and SOEs are undervalued, or excessively favorable terms are granted to investors (e.g. in the form of tax concessions). In addition to the direct fiscal cost, these may also lead to indirect costs to the Government (and society) in the form of reduced incentives for efficient and profitable operation. The privatization policy states that "transfers shall take place in an open, fair, and transparent manner with the objectives of maximizing sales revenues balanced against employment preservation and creation and encouragement of investments and technological development."

4.53 A number of enterprises recommended for privatization as going concerns from the November 2004 list may also need further investigation. In particular, these may include the Mazar Fertiliser and Power Enterprise, for which a study by Hill Enterprise has shown limited economic viability, and Afghan Gas Enterprise, for which it may be better to go through a restructuring exercise first before privatization.

4.54 The Government should exercise caution in offering too many enterprises for privatization and may instead begin with a few enterprises where enough information exists to indicate that these are strong candidates for privatization. Qualified transactions advisors should help the Government to identify potential buyers and negotiate deals. It is important that the Government does not invest considerable sums of money in SOEs in the hope of making them attractive privatization candidates. The classification of SOEs should be considered tentative, and there should be processes in place to move enterprises from the "privatizable" category to the "to be liquidated" category if additional information establishes that these are not genuinely sellable as going concerns.

4.55 For the SOEs that remain under the Government's control, performance and transparency can be improved in a number of ways. A first tool is to enforce *hard budget constraints*. This requires sound financial management and transparency. This means that SOEs should have no access to hidden subsidies (e.g. loans from Government, privileges to bid on Government contracts, requirements from Government agencies to buy SOE outputs, rent-free access to Government land or buildings), and no preferential access to credit. Any explicit subsidies should be limited and tied to improvements in the finances of the SOE concerned over time (e.g. through enhanced cost recovery). A second tool is to *reform the institutional relationship between SOEs and the Government to change the incentive structure*. Some countries have instituted various forms of corporatization, contracting between SOEs and the Government, introduction of signed management contracts (which may or may not be performance-based), new oversight bodies, and increased managerial autonomy. A third tool is

to *increase competition*, by opening up markets to trade, easing restrictions against entry, and unbundling large enterprises. A fourth tool is to *move toward privatization* through various options such as subcontracting (the SOE subcontracts execution to a private party), leasing (of the entire SOE, or its equipment or assets, sometimes in the form of lease-and-operate contracts in infrastructure sectors), or concessions (as well as build, operate, and transfer, BOT, contracts, often used for the privatization of infrastructure sectors with monopolistic characteristics – see Volume IV, Chapter 3).

ECONOMIC RESTRUCTURING PROCESS

4.56 The SOE Department under Presidential Decree 45/4 (12 April 2004) has the sole responsibility to assess the economic viability of SOEs and to recommend and execute the necessary economic restructuring of enterprises. This responsibility was previously with the Evaluation Commission of State-Owned Enterprises (ECSOE), established in June 2002. The ECSOE was dissolved in May 2004.

4.57 In November 2005 the Cabinet approved a Decree setting out amendments to the SOE Law, which grants the Ministry of Finance the authority, in consultation with the relevant ministry, and under the oversight of an SOEs Evaluation Commission (Ministers of Finance, Commerce, Economy, and the Senior Economic Advisor to the President), to make recommendations and implement transfer of control and/or ownership of SOEs to the private sector. The revised SOE Law provides for different forms of transfer (e.g. change of legal form, reorganization, restructuring, liquidation and dissolution, transfer of ownership through sales of shares or assets, management contracts, lease contracts). There are also legal requirements for publication of any decisions in the media, which is key in ensuring transparency and accountability.

4.58 A balance needs to be struck between ensuring an efficient privatization and liquidation process, and ensuring transparency and accountability for decisions taken on SOEs. A proposal on promulgation of a Privatization Act was turned down earlier – the preference was to proceed with privatization on the basis of the existing legislative framework. The SOE Law previously had provisions on liquidation but not on privatization as a going concern or other private sector participation such as management contracts. For sale of shares, an SOE would have to be corporatized first.

IMPLEMENTATION OF THE ECONOMIC RESTRUCTURING STRATEGY

4.59 Key components of the Government's strategy include (USAID, 2004):

- Designing a social safety net for employees that may be retrenched as a result of privatization or rationalisation of staffing levels.
- Designing a public awareness campaign on the economic restructuring process.
- Strengthening of the information base on SOEs by building on the initial due diligence and refining where needed the list for SOEs to be retained, privatized, or liquidated.
- Developing a detailed strategy and implementation procedures for disposition of each class of SOE.
- Establishing essential institutional infrastructure, including necessary legislation, accounting standards, training in corporate governance, development of capital markets, and information technology.
- Designing of an enterprise support program for privatized and corporatized firms;
- Providing technical assistance to local counterparts for specific transactions, including preparing necessary documentation, undertaking the tendering process, and providing post-privatization support.

4.60 A draft work program has been prepared for the first year, during which one of the major tasks will to develop and establish essential institutional and legal frameworks for restructuring.

4.61 A second major task will be to design and pilot a social safety net program for employees affected by the economic restructuring program. A Social Safety Net package has now also been approved by the Cabinet. This has two components: (i) the first includes monetary benefits such as severance payments; and (ii) the second includes non-monetary benefits such as retraining and redeployment services. Details of the package or its costs have not yet been published. But MoF, with the help of the Ministry of Labour and Social Affairs, is in the process of reviewing the status of SOE workers and finalizing the total registry (with detailed breakdown by each SOE) to appropriately target severance and training packages. Severance packages may have important fiscal implications, particularly when factoring in payment of accrued pensions. The SOE Department is working closely with the Civil Service Commission (IARCSC) to ensure that severance packages are not inconsistent with what would be offered elsewhere in the civil service. They have very roughly estimated that around 6,000-7,000 workers may be dislodged in the economic restructuring process.

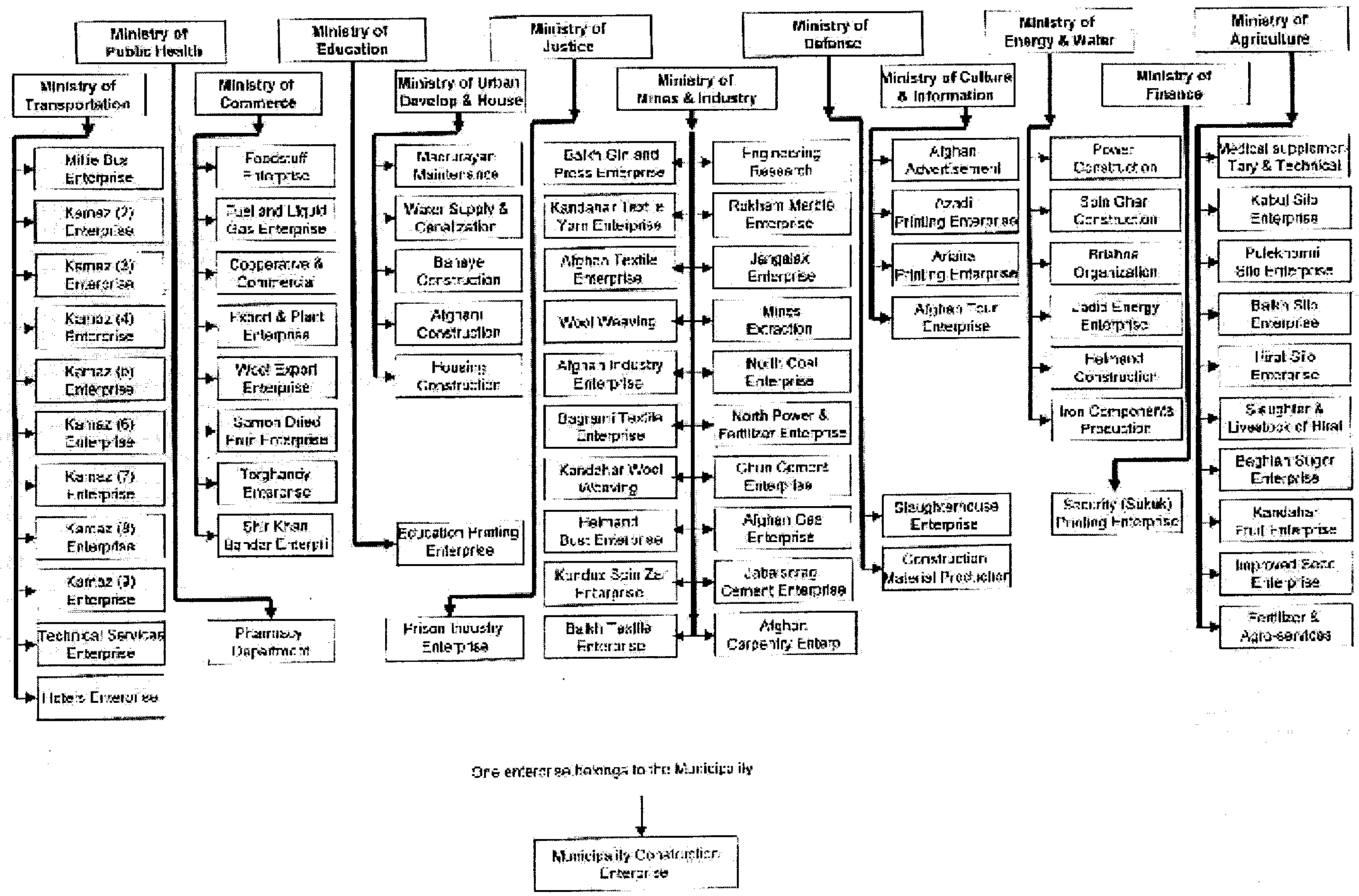
4.62 The recommendations of this chapter are summarized in Table 4.6 below.

Table 4. 6: Summary of Recommendations		
Issues	**Recommendations**	**Concrete Next Steps**
Legislative framework for SOE operations inflexible and onerous for line ministries	• Implement the new legislative framework for SOEs and privatization recently approved. • SOEs should continue to report on finances and operations to the MoF.	• Set out obligations of SOEs and other companies, and ensure that these are consistent across all legislation. • Review institutional responsibility and capacity within line ministries to report on operation and finances of SOEs.
Structure and capacity of the SOE Department may not be in line with its evolving role	• The role of the SOE Department needs to be reviewed in line with progress on the economic restructuring process and clarified to line ministries. And an administrative reform plan (covering both the "economic restructuring" and the "monitoring / reporting" functions should be adopted • The SOE Department's accounting and sector capacity need to be strengthened in line with SOEs that will remain in Government ownership.	• Adopt and implement PRR plan for SOE department.
Lack of consolidated information on financial reports submitted by SOEs to the SOE Department	• All financial information submitted by SOEs over the past two years should be taken out of archives, reviewed, consolidated, and transferred into electronic files.	• Retrieve and consolidate financial information. • Feed information into ERO analysis and use it to review financial reporting capacity in SOEs recommended to remain under Government ownership and those to be privatized as going concerns. • Review financial reporting formats and recommend changes to meet agreed standards.
Lack of SOE Department oversight for SOE investments through the Development Budget	• Investment projects for SOEs should be marked as such in the Development Budget and should be reported to the SOE Department as part of their monitoring role.	• Introduce requirement in Budget formulation guidelines and agree with relevant departments in line ministries.
Lack of linkage between the SOE Department and the Budget and Revenue Departments	• The SOE Department should feed into the Budget formulation and review processes to inform any subsidy appropriation on the basis of financial statements SOEs.	• Budget and Revenue Departments and SOE Department to discuss how the latter's input can be regularly integrated into Budget formulation and review processes.
Inconsistencies in provisions on transfers to the State between the SOE Law and the Income Tax Law	• Tax returns of SOEs should be calculated on basis of tax policy set out in the Income Tax Law. • The SOE Department may want to administer this in the short-term, but responsibility to comply should eventually rest with SOEs directly.	• Review SOE and Income Tax Laws and introduce new tax policy measures in regulation work of SOE Department.

ANNEX

Annex 4. 1: State-Owned Enterprises by Ministries

State-Owned Enterprises by Ministries



CHAPTER 5. MUNICIPAL FINANCES AND MANAGEMENT IN KABUL

Executive Summary

i. In Afghanistan's highly centralized institutional context, municipalities have a unique degree of autonomy, especially Kabul. There are several institutional mechanisms available to municipalities to allow for close co-ordination with citizens. This makes them potentially a very effective tool to deliver services to the people. The unique history and current position of Kabul Municipality, including its resources (land and potential financial resources), the presence of administrative systems (albeit with room for improvement), and an existing legal framework that accepts a measure of its independence, provide an opportunity for the Government of Afghanistan to implement systems for the delivery of services at the city level. There are a number of challenges to realize this potential however.

ii. First, the existing municipal laws require review and revision. Two aspects are of notable importance: the particular position and regulations for Kabul (as opposed to other municipalities) and the issue of functions devolved to municipalities (as opposed to line ministries of the central Government).

iii. Capacity will need to be developed for municipal functions. This will require adequate financial and human resources. Capacity development will require public administration reforms as well as training and other efforts to build up human capacity. Further administrative reorganization of Kabul Municipality should occur on the basis of the functions that it is required to undertake. Kabul Municipality is fortunate in that it has independence in hiring its own staff, below a certain level. This system is useful in that it allows for the municipality to determine its own staffing requirement based on need. However, the capacity constraints of the municipality are enormous. Addressing these constraints will take a number of years.

iv. Moving to financial aspects, a priority is to clarify taxes available to the municipalities (in coordination with the national Government), update tax rates, and review and reform the tax administration systems. In addition, financial management must be enhanced, by strengthening the existing manual accounting system first, before moving to a more complicated computer based system. Improvements in the budget process will be required. Improvements in the development budget process need to be linked to the development of a plan for Kabul. Such a plan should identify key service deficiencies for the city and key growth areas. This should be followed by identification of projects and their prioritization. The process of deriving this plan should take into account new methodologies of planning and its links to the budget process.

v. In terms of delivering services, a clear priority is to address the issue of land development. In addition, Kabul Municipality needs to turn its attention to the way in which is it servicing the city, particularly in solid waste management and operations and maintenance. While this will be a long-term effort, it is critical to think through the specific services that should be delivered by or under the oversight of Kabul Municipality, and what institutional and financial arrangements will be needed to maximize effectiveness.

A. Introduction

5. 1 In Afghanistan's highly centralized institutional context, municipalities have a unique degree of autonomy, especially Kabul. There are several institutional mechanisms available to municipalities to allow for close co-ordination with citizens. This makes them potentially a very effective tool to deliver services to the people. However, the current set of municipal laws, the 2004 Constitution, and some central Government policy decisions appear to be inconsistent, reflecting lack of consensus about what municipalities should focus on and how they should operate. If municipal laws are to be changed, the Government will have to decide on the functions and accountability relationships of municipalities in general, and also as to whether it wishes to allocate different functions and accountability relationships based on size of municipality and other factors. Significant organizational changes and efforts to reform and develop capacity will be required. This chapter first looks at the legal basis and issues relating to Afghanistan's municipalities, in particular Kabul. It then discusses the functions of Kabul Municipality and its relationship with other levels of Government. The core of the chapter is devoted to administration and finance in Kabul Municipality, broader municipal planning and development in Kabul (especially related to land), and service delivery. The chapter closes with some recommendations for improvements.

B. Legal Framework – Past and Present[1]

5. 2 ***The Legal Standing of Municipalities.*** Afghanistan's various earlier Constitutions (1964, 1976, 1987 and 1990) only briefly mention municipalities. All stipulate that municipalities shall be ruled by law. The most distinctive features of the various Constitutions are in the 1987 Constitution which calls for local elected councils (Chapter 11) and the 1990 Constitution where Kabul City is given equal status as provinces in the Loya Jirga (Article 131).

5. 3 Although the Bonn Conference adopted the 1964 Constitution, the municipalities have been regulated in accordance with the 1990 Constitution, through the Municipal Law of 1369 (1990), amended in 1379 (2000), hereafter referred to as the Municipal Law.[2] The law provides an overall framework for municipal status, authority and functions including General Orders (Chapter 1), Organization (Chapter 2), Financial Affairs (Chapter 3), Responsibility and Authorities (Chapter 4), and Final Orders (Chapter 5). Ten other laws, all passed or amended in 2000, also regulate the municipalities. These include the (i) Municipal Law, (ii) City Service Tax Law, (iii) Land Acquisition Law, (iv) Hoarding Prevention Law, (v) Greenery and Sanitation Rules, (vi) Safai Tax Law, (vii) Provincial Vehicle Parking Tax Rule, (viii) Rental Fixing Rule of Municipal Property, (ix) City Projects Settlement Rule (25^{th} Year Plan), (x) Implementation Rule of Master Plan, and (xi) Rule of Distribution and Selling of Residential, Commercial and High Rise Building Lands in Kabul City.

5. 4 According to the Municipal Law, provincial municipalities[3] are accountable to the local (provincial) administration in that the Governor assumes responsibility for their structure, approval of staff, and budget but under the overall control of the Ministry of Interior (MoI). The exception is Kabul.

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[1] See Pathak (2004).

[2] Islamic Emarate (Government) of Afghanistan, Ministry of Justice, Decree No. 29 on Municipal Law, 1369 (2000).

[3] Afghanistan's municipalities are graded into provincial municipalities and rural municipalities. Distinctions include (i) MoI and provincial municipalities having some level of intervention in the organizational structure of the rural municipality, whereas the Governor and the MoI approves structure of provincial municipalities; (ii) no formal budgetary allocation other than salaries are made, and development budget expenditures are agreed on an ad-hoc basis for rural municipalities. The ordinary budget and development budgets of provincial municipalities are approved by MoI.

5. 5 ***The special status of Kabul.*** The Municipal Law interpreted Article 130 of the 1990 Constitution as giving Kabul Municipality a great degree of independence in its functioning. Article 6 of the Municipal Law designates Kabul Municipality as a part of the national Government. Consequently, Kabul Municipality's legal standing and its operations are more autonomous since authority for decision making, operations, finance, and management rests with it. However, this has not been accompanied by a clear and legally recognized jurisdiction over which Kabul Municipality exercises its authority, within which it performs public functions, and to whose constituents it is accountable. Kabul Municipality's apparent status as a Ministry-level entity has a number of implications:

- The Mayor and top managers are appointed by the President. The rest of the staff are appointed by the Municipality (unlike other Municipalities where staff are appointed by MoI).
- The salary scales used are the same as the national scale.
- Unlike other municipalities, Kabul Municipality's budget is approved by the Ministry of Finance (MoF), not MoI.
- The municipality also has a separate budget head (approximately $10 million) in the 2005/06 national budget.
- However, like other municipalities Kabul has independence in revenue generation, budgeting and planning, and expenditure control and procurement.
- It has various systems in place for administration of the urban area.

5. 6 There is an argument for a special status for Kabul, based on its size, its level of economic activity, its history, and the fact that it is the capital city. Several countries have used size and economic activity to differentiate cities. For example, South Africa divides its municipalities into categories A, B, and C. **Category A** municipalities are designated based on (i) conurbations which include high population density, intense movement of goods and people, extensive development, multiple economic centers, diverse economy; (ii) a single area where integrated planning is desirable; and (iii) strong economic and social linkages within the area. Such an area has exclusive municipal executive and legislative authority in its area. All other municipalities are classified as **Category B,** which shares municipal executive and legislative authority with a Category A municipality within whose area it falls, and **Category C,** which has municipal executive and legislative authority in an area that includes more than one municipality.

5. 7 Afghanistan's cities can be distinguished in a similar manner. Kabul's population currently stands at approximately three million people or 15% of total Afghan population (Bertaud, 2005). The population of Kabul far exceeds that of the second largest city, Herat, which has an estimated population of about 700,000 (Afghanistan Government, 2004). The cities of Herat, Kandahar, Jalalabad, Mazar and Kunduz form a second category with populations ranging from 300,000 to 700,000. The rest of Afghanistan's urban centers are smaller, and form a possible third category.

5. 8 There is also an argument for continuing special treatment of Kabul because it is the capital city. This is the case for several capital cities including Washington DC, Islamabad, and Berlin. The territorial administration of capital cities varies across countries, with at least three possible types of arrangements: (i) a separate, special administrative district (e.g. Islamabad and Washington); (ii) dual status as city and province or federal state (e.g. Berlin); and (iii) incorporated into the federal or national political geography like other cities in the nation (e.g. Pretoria and Bonn).

5. 9 The internal political structure of the nation (including the level of centralization) certainly plays a major role in determining administrative relationships. But a capital city's territorial-administrative arrangement, like the location of the capital city itself, is also the product of chance, historical legacy, the

relative political and economic power of the capital city, and the relative strength of regional and national political forces. The evidence strongly suggests that no one arrangement is inherently better than the other two. Consequently, Kabul's historical and administrative past may be used as a strong argument for continuing special status of some sort.

5. 10 ***The 2004 Constitution and the Municipal Law: some contradictions.*** The 2004 Constitution, although consistent with the 1964 Constitution regarding the status of municipalities, does remove some of the powers that municipalities had under the 1990 Constitution, which the current municipal law is based on. In particular, the 2004 Constitution does not appear to entirely support the current administrative arrangement whereby the Kabul Municipality has the status of a line ministry.

5. 11 Article 136 of the 2004 Constitution defines the administration of Afghanistan as being based on central and local administrative units in accordance with the law. Provinces are defined as the local administrative units (Article 138). The President appoints ministers (Article 64, 11) and high-level officials (Art 64, 13). Ministers are defined in the Constitution as heads of administrative units and of government. Kabul Municipality would arguably not be included in each of these definitions.

5. 12 Municipalities are mentioned in Article 141: "Municipalities shall be set up in order to administer city affairs. The Mayor and members of the City Council are elected by free, general, secret and direct elections. The affairs related to municipalities are regulated by law."

5. 13 The apparent contradictions between the current law governing municipalities – particularly Kabul Municipality – and the 2004 Constitution require clarification. The unclear legal framework is currently the source of tensions between Kabul Municipality, the Infrastructure Ministries (especially MUDH and Ministry of Public Works), and the Ministry of Finance MoF). Kabul Municipality has interpreted its current legal standing and its independence strictly. It argues that it is accountable directly to the President. It refuses to accept a degree of accountability and coordination between it and the line ministries. It has accepted that its budget should be approved by MoF, but it does not use the MoF budget template, follow budgetary regulations, or meet deadlines for budget approval. Kabul Municipality's strict interpretation of its independence has also brought it into conflict with the central government on the Procurement Law and the Public Expenditure and Financial Management (PFEM) Law – both of which have attempted to address the role of the municipality in these two substantive areas. Consequently, there are contradictory practices in financial administration, especially budgeting and procurement, as between national regulations and those of Kabul Municipality.

5. 14 The PFEM Law (Articles 23 -26) clarifies some of the accountability and reporting relationships for municipalities, and curtails their independence in certain ways. First, it allows transfers to municipalities from the national budget. Consequently, it appears that municipalities are no longer constrained by their ability (or inability) to collect taxes to cover their operations and maintenance budgets. Second, it states that the amount and the manner for collecting the revenues of municipalities shall be determined and specified by law. Third, it also gives permission for municipalities to borrow, albeit only from the State. Finally, it insists that municipalities shall provide budget execution reports at least every six months to MoF through the appropriate Mustoufiat. However, it is not yet clear whether Kabul Municipality will recognize that the PFEM Law supersedes the provisions of the Municipal Law that stipulate its independence. There is also a degree of confusion on taxation. For example, the national government has implemented a rental tax that is also collected by the municipalities.

5. 15 Quite apart from the constitutional discrepancy, the need for a new municipal law also arises because the old laws are not quite clear in their description of functions to be undertaken by municipalities and in the accountability relationships for Kabul Municipality. Currently, municipalities in Afghanistan are in an unusual position regarding their financing and accountability relationships. They

have some level of fiscal autonomy vis-à-vis the national government and limited service delivery functions, but are creatures of MoI. The system therefore may be characterized as "delegation", whereby a central government transfers responsibilities for decision-making and administration of public functions to local governments or semi-autonomous organizations that are not wholly controlled by the central government but are accountable to it, i.e. a principal-agent relationship (Litvak, Ahmad, and Bird, 1998).

5. 16 The lack of clarity and differentiation of functions has led to confusion in service delivery in Kabul in several sectors, including planning, roads, and water. Clarification also is needed, particularly given the current perceived independence of Kabul, as to whether or not municipal functions, funding, and accountability relationships should differ depending on the size (or any other relevant characteristics) of a municipality. As discussed earlier, there is a case for continuation of the special treatment of Kabul and for its autonomy, but this would need to be agreed across Government and clarified.

5. 17 In sum, a Municipal Law needs to clarify the functions of municipalities, their funding sources, and their accountability relationships in delivering services and in reporting. A Municipal Law should also address the need for differentiation in municipal administration for different types of municipalities. However, given their lack of capacity, Municipalities should stay focused on a limited number of services that they can deliver well. Delineation of the financing mechanisms for municipal services should follow the definition of these tasks.

C. The Functions of Kabul Municipality

5. 18 The basis of ***designating functions*** to local government, and consequently, the functions themselves, differ across countries. Generally, however, they adhere to the following principles (see also Table 5.3):

- Federal states are characterized by having functions assigned between the federal and formative unit (state, province, Länder) in the constitution; unitary states rarely specify the functions of lower levels of administration in the constitution.
- Federal nations generally leave the matter of local government (i.e. levels of government below the formative unit) to their formative units, explicitly or by residual power.
- While unitary countries rarely assign local government functions in the constitution, principles or safeguards relating to local government are commonly found in unitary constitutions.
- However Italy, and even more so South Africa – both unitary states – have principles as well as lists of functions for subnational levels of government enshrined in the constitution itself (Italy just for the regions).
- Older federal constitutions have rather shorter lists of functions than newer constitutions (for the federal and formative unit levels). Formative units in federal states can have their own constitution, and if so, local government principles and sometimes functions are addressed in these constitutions (see Ferrazi, 2002).

5. 19 Typically, infrastructure functions such as water, waste water, solid waste, local roads, and local regulatory functions for public health are most often allocated to local governments. Public (e.g. police) and social (e.g. health) services are also sometimes local functions[4] (see Table 5.4). A useful general concept in the allocation of functions is that of subsidiarity – the idea that functions should be handled by

[4] See Goga (2002).

the lowest appropriate competent authority. This would mean that the central authority should perform only those tasks which cannot be performed effectively at a lower or local level. The converse is that the municipality should be *competent* to deliver the services assigned to it. Consequently, Kabul Municipality for example should focus on a limited number of services that it can deliver well.

5. 20 Kabul Municipality has functions similar to other municipalities internationally. Consequently, the current recommendations of the PRR program for the Municipality are for it to retain its existing functions but to review these to ensure better service delivery. Chapter 4, Article16 of the Municipal Law presents a list of 44 wide-ranging responsibilities and authorities of municipalities (See Annex 5.1). These include infrastructure development and service delivery, public health, environmental protection, land and buildings, management and tax collection, involving people in city services, complaints and redressal, setting and controlling prices, prevention of illegal construction, licensing, data collection, strengthening society building, providing legal support, and assisting in maintaining law and order.

5. 21 ***Relationship with other levels of Government.*** In spite of the long list responsibilities assigned to it by law, there is immense confusion about the relationship between Kabul Municipality and other levels of government in terms of delivery of services and actual functions to be carried out by Kabul Municipality. The Municipal Law states that in cooperation with Government line ministries, the municipality is indirectly involved in the construction of the city sewerage system, water supply, construction of prefabricated apartments, city power, communications, public health, education, and sport. However, the lack of clarity in the accountability and reporting relationships has meant that coordination is minimal.[5]

5. 22 There are also several issues that require further attention in the list of municipal functions as presented in the law:

- The list of functions confuses the substantive functions of the municipality (e.g. provision of water, sanitation, etc.) with its administrative functions (e.g. leadership of relevant subordinate departments, inviting and convening meetings on service delivery).
- The municipality does not have the capacity to perform several of its mandated functions. For example, regulation of underground water is a municipal function that is currently not being performed by Kabul Municipality. However, the definition of "regulation" is unspecified. Theoretically it could include public health regulation, education, permits for borehole drilling, monitoring the level of the aquifer, etc.
- Several functions are obsolete – harking back to the era of the Soviet occupation. The most obvious of these are "setting prices of houses, based on regulation, supervision and control of prices, distribution of price list based on law, strict implementation of price list."
- Several key functions are unclear or are not fully covered. Environmental sanitation is generally an important local government responsibility. In Article 16 passing references are made to the "cleanliness of the areas" in Function No.3 and to construction of public toilets in Function No.4. Construction, repair, and cleaning of public drains and ditches in the city is also included (No.30). No specific mention is made of household sanitation or solid waste management.
- Land and property management is a crucial responsibility, which can generate significant revenues for municipalities. But the Municipal Law provisions are limited only to

[5] For example: KfW has been integrally involved in assisting the Central Authority for Water Supply and Sanitation in repairing and expanding the current water network in Kabul. The engineering designs thus rest with CAWSS. KfW has come across a number of examples where Kabul Municipality has planted trees directly on top of water mains – resulting in damage to pipes.

distribution of plots and land acquisition (Nos. 9 and 10). The legal authority should be given to municipalities to do much more to obtain optimum benefits from this valuable asset.[6]

- Several other crucial functions are absent. The range of urban challenges facing Afghanistan includes rampant urban growth and the growth of informal settlements, massive service delivery backlogs, land tenure confusion, and poor urban management. These give rise to several policy concerns including (i) housing; (ii) new settlements and informal settlements; (iii) service delivery including standards and options (particularly for informal areas); (iv) options for planning and land use; (v) urban land tenure and management; (vi) finance and revenue generation; and (vii) local public administration and civil service reform. Several of these functions are not being handled by the municipality.

D. Administration and Finance in Kabul Municipality

THE ORGANIZATION OF KABUL MUNICIPALITY

5.23 Kabul Municipality has been restructured several times during the past two years. The most recent restructuring was in April/May 2004 (see Figure 5.1). The municipality is also undertaking a Priority Restructuring and Reform Process (PRR). However, the structure has, as yet, not been finalized under this process. The April 2004 structure embodies some improvements over the previous structure (represented in Figure 5.3). Although the basic structure of the municipality – its organization into two essential components of the Head Office and the 18 Nahiya (District Offices) – remains, there has been some restructuring at the Head Office level. Nevertheless, further improvements are needed such as further refining the institutional structure and ensuring adequate staff, systems, and capacity and financing for service delivery.

5.24 ***The Head Office.*** The 2004 restructuring streamlined the municipality, consolidating the four Vice Mayor Positions into one. The single Vice Mayor now effectively acts as a CEO. There also appears to have been a logical effort to separate the administrative functions of the municipality from its service delivery functions through the creation of two General Directorates, i.e. City Services and Technical Work and Construction. However, the separation of the administrative from the service delivery functions is not always clear. For example, the Technical and Construction Department is under the "Technical Division" although it does undertake construction. The Property Department is under the City Services Division, although it does not deliver traditional services.

5.25 The creation of a City Services Directorate nevertheless represents a move to turn the municipality into a more service-oriented entity. This Directorate now has a sewerage section and a water supply section which are both new to the organizational structure. Staff are currently being recruited for both of these sections, and the objectives and tasks of these sections are being formulated. Unfortunately, however, the establishment of these two sections overlaps with the functions and responsibilities of the Central Authority for Water Supply and Sanitation and the newly formed Kabul Authority for Water Supply and Sanitation. These overlapping responsibilities require resolution.

5.26 The Municipality has also formed a Policy and Coordination Department. This is a laudable attempt to manage the development of the city more strategically. Currently, however, the mandate of this department is unclear.

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[6] Pathak (2004) describes some of these: (i) land information system; (ii) land regularization and titling program; (iii) street names and numbering; and (iv) land development regulations.

5.27 Kabul Municipality needs to also turn its attention to updating the functional descriptions of divisions, departments, and sections. The existing operational and organizational manuals pertain to the previous organization of the Municipality during the Taliban period. The updates that exist often lack consistency in the framework of the overall organization. The organizational processes and procedures also are not formalized and documented. Finally, there are no job descriptions or specifications (see Gauff Engineering, 2005).

5.28 ***The Districts/Nahiya.*** Structurally, the district/nahiya offices appear to be de-concentrated administrative units of the Municipality. At the local level, each district has a president and vice president, below whom are five offices: Planning, Cost Control, Administration (under which sanitation falls), Direct Income, Markets, and Technical Services, which are branches of the head office functions (see Figure 5.2).

5.29 Operationally, however, it appears that the district president has somewhat greater power than this would imply. While this can have a positive effect on infrastructure provision and service delivery – as emphasized by several international studies on decentralization – this is not occurring in Kabul. Several aid agencies working in Kabul have reported that they are unable to undertake infrastructure works without explicit permission from the nahiya administrator/president. Furthermore, it also appears that, unfortunately, the Municipality (at Head Office or centrally) is not aware of what infrastructure is currently under construction by donor agencies in different parts of the city and where it is located. This makes coordination and operations and maintenance extremely difficult.

5.30 Below the district level, residential areas or neighborhoods are currently organized administratively by the municipal government in all cities into *gozars* (neighborhoods) with distinct physical boundaries, each with a *wakil-e-gozar* (neighborhood level representative). Typically, about 15-20 *gozars* form a single district. There is a strong relationship between the *wakil i gozar* and the district administrator. This level of de-concentration can provide some impetus for responding to community needs, particularly in the provision of local urban infrastructure. Such improvements have not occurred, however.

REVENUE GENERATION IN KABUL MUNICIPALITY

5.31 The key departments for revenue generation in Kabul Municipality are the Revenue Division (under the Policy Co-ordination Department), and the Property Department. Both of these units face serious capacity constraints, compounded by the numerous small taxes and levies they attempt to collect, many of them with very low revenue yields – actual and potential.

5.32 Kabul Municipality has access to several sources of revenues, which it collects in accordance with a reasonably clear system of administration. There are several improvements required, however. First, municipal revenue sources need to be reviewed to ensure a consistent framework between municipal and national levels. Second, tax rates require review. Third, tax administration is onerous, in particular due to collection of a number of taxes with low returns. Fourth, Kabul Municipality has no right to engage in enforcement actions against non-payment. Finally, the reporting classification system requires updating.

5.33 ***Sources of Revenue.*** Sources of revenue for Kabul Municipality include rental tax (one month of rent per year), safiyi tax (a service charge and a property tax), market rental, business permits, a levy on imports, 1% tax on profits of traders and business establishments, sale of municipal property, fines, documents, the Kabul Zoo, income from cinemas and public bathrooms, and NGO Tax. Overall, roughly 25% of revenues come from taxes, 25% from land sales, 25% from rents, and 13% from construction revenues.

5. 34 The sources of revenue of Kabul Municipality require review:

- Several taxes are not levied in their most efficient form e.g. the safiyi tax acts as a proxy for a property tax and yet is a cleaning tax.
- The tax on profits of traders – which appears to be a sales tax – normally is not an appropriate revenue source for local government.
- The most serious concern, however, relates to the current rental tax. This has historically been a tax levied by Kabul Municipality. A similar tax has recently been added to the list of national taxes by MoF; thus the same base is taxed twice, once by the Municipality and again by the national government. International experience strongly suggests that real estate taxes are more appropriately kept as local government revenue sources, rather than accruing to the national government.
- Currently, there is no significant cost recovery in the Municipality.

5. 35 In reviewing municipal taxes, the Government should keep in mind what are the "best –practice" (i.e. most appropriate) municipal government taxes. These include fees and user charges, real estate property tax, betterment and improvement levies, vehicle and transportation taxes, and possibly a piggyback flat-rate personal income tax

5. 36 ***Revenue Collection.*** Kabul Municipality has undertaken a major drive to increase revenue collection, and revenues have more than tripled since 2002/03 (see Table 5.1). However, current collection is far below potential. For example, the estimated potential revenue collection for the safiyi tax is Afs 450 million, compared with Afs 22 million collected in 2004/05 and Afs 50 million budgeted for 2005/06.

Table 5. 1: Kabul Municipal Revenues, 2002/03 to 2004/05

	2002/03+	%	2003/04*	%	2004/05+	%
Safayi tax	5,400,000	4.58	22,000,000	8.48	50,000,000	12.71
Rental tax	4,813,000	4.09	2,300,000	0.89	35,000,000	13.98
Business license, contracts, price list, engineering	1,513,000	1.28	4,910,000	1.89	23,000,000	5.85
Duties on markets, parking lots, and rents	32,164,120	27.30	94,600,000	36.45	97,600,000	24.81
Fees for cleaning septic tanks	600,000	0.51	800,000	0.31	3,000,000	0.76
1% tax on property deeds	300,000	0.25	3,000,000	1.16	10,000,000	2.54
1% profit taxes, price control fines, former claims	3,410,000	2.89	6,512,000	2.51	730,000	0.19
Sell of land, duties on animal markets, etc.	12,123,000	10.29	19,300,000	7.44	104,100,000	26.46
Construction Revenue	-	-	50,000,000	19.26	50,000,000	12.71
Other revenues	57,476,800		56,129,789			
TOTAL	**117,799,920**	**100**	**259,551,789**	**100**	**393,430,000**	**100**

Note: * actuals; + budget.
Source: Report by TAFSU Advisor, J.M. Le Pain

5. 37 The Safiyi Tax is paid by renters and owners in both formal and informal areas. The tax is recorded in a book (the Safiyi) which also records the property and the name of the head of household and the payment amount which is based on a property valuation. The safayi tax is a sanitation tax that is supposed to guarantee service delivery for those who pay. However, informal settlers also pay the tax in the hope that it will provide some form of security of tenure with the Municipality – although the document specifically states that it is not a legal document of land ownership.

5.38 The tax is based on a building valuation, not a land valuation, and vacant land is not taxed. The tax in residential areas is calculated at 0.3% of the total building value, in commercial areas at 0.75% of total value. The property valuation is based on a formula which includes location, size of land, and services. However, tax rate has not changed in the last five years (at least), and the building valuation was last undertaken in 1978. Furthermore, it has been noted that properties owned by the Government are not paying taxes.

5.39 The payment of the Safiyi Tax is relatively simple. The home owner/renter visits the Central Bank and pays the Safiyi Tax into the Bank Account of the Municipality, and receives a certified stamp/letter. This is taken to the District Office, which then provides a stamp of payment in the Safiyi Book. Tax collection does occur. The Municipality does not, however, have any means of enforcement against non-payment of the Safiyi. Instead a list of "offenders" is sent to MoI which is responsible for law enforcement. It is unclear whether any follow-up occurs on that side.

5.40 The reporting and classification system currently used for municipal revenue also makes it extremely difficult to collect detailed income information. It is difficult, for example, to disaggregate among items such as land sales, rents, and engineering fees.

Financial Planning and Budgeting in Kabul Municipality

5.41 Financial planning in the municipal government is minimal. The former "Planning Department" – renamed "Policy and Coordination Department" – supervises the Budget Sub-Department (in practice totally independent and reporting directly to the Mayor) and the Investment Department.

5.42 The budget formulation process is simple – each department submits its staff estimates (tashkeel) and its budget estimates to the Policy and Coordination Department in the eighth month of the financial year (this budget estimate does not include new projects). The estimate is usually based on last year's budget plus an increment. A form outlining increases from the year before does exist. A covering letter from the Head of Department to the Head of Finance and Planning explains the needs for the increase. The budget is submitted to an administrative meeting of the municipality, which endorses it before it is sent on to the President's Office for approval. The President's Office submits the budget to MoF for coding and approvals about 10 days before the end of the year. MoF then sends the budget back to the President's Office for final approval. The implication is that the budget of the municipality is not part of the unified national budget.

5.43 The approved budget has two components; cash (*nakdi*) and payroll. There are two budget lines under the cash component: the ordinary budget (for O&M and including any ordinary repairs and maintenance) and the development budget (for new constructions/projects as sanctioned by MoF). O&M includes general expenses, fuel, and vehicle costs. This is prepared for the entire municipality – not by department. However, the Municipality also has a departmental breakdown based on what was submitted by the Department.

5.44 There are several problems in this process.

- Departmental budget plans are usually based on last year's budget plus an increment. Consequently, the municipal budget risks being merely a compilation of documents prepared by the different departments on the basis of the previous year's budget, with little policy content or evaluation of past expenditures.

- The budget is never revised during the financial year. Revenues are usually overestimated, so money cannot be allocated on the basis of the budget.
- Expenditures are made on the basis of cash available at the bank after the Mayor's approval.
- The Mayor can stipulate expenditures that are not in the budget. In 2004/05 the Mayor approved asphalting of roads and beautifying the city for the President's inauguration, without reference to the budget.

5. 45 New projects and new allocations are not included in the regular budgeting process of Kabul Municipality. Instead, new projects are – in theory – formulated through a consultative process between the Municipality, the Ministry of Urban Development and Housing, and the Ministry of Economy. Once all three institutions are in agreement, this is sent to MoF for approval and allocation of resources. In practice, this has not occurred with the projects submitted by the Municipality. In 2003 the Municipality submitted a list of 421 needed projects to MoF for approval. None of these projects were approved.

5. 46 The planning process is very much top-down, with limited assessment of development needs and strategic planning. The only investment plan that exists is several years old and consists of a list of 25 roads that need to be built on the basis of the old Master Plan. That list has never been revised, and the financial evaluation is simply based on a notional cost. The District Officers also have an evaluation of District needs, based on weekly meetings between the *Wakils, Shuras,* and district officers, and sent to the Planning Department every year. However, engineering designs and consequent costings of these needs do not exist.

EXPENDITURES AND ACCOUNTING

5. 47 The key departments in Kabul Municipality for financial management are the Administration Department, the Income Department, the Control Office, and the Accounting office. The Cash budget and the payroll budget are controlled by the Accounting Unit, which is located at Kabul Municipality's main office.

5. 48 Bookkeeping and accounting systems are in place but require strengthening. The Municipality's accounting system is a budget execution control system based on a very simple form of book-keeping. There is no double-entry accounting. Each department has a budget line, and the accounting department deducts expenditures from each budget line, only to ensure that the department does not go over budget. When the budget does not have a line item for a certain type of expenditure (like computer maintenance), the bill is paid but not written in the ledger. The system of expenditure management is paper-based.

5. 49 Salary expenditures are controlled by the Salary Unit, which receives attendance sheets from all departments and from the districts between the 15^{th} and 20^{th} of the month. The Salary Unit confirms these against the tashkeel. After the 20^{th}, it prepares the payroll, which is then submitted to the disbursement unit (under the Income Department). Based on approved payroll, a Payment request (M16) is prepared. The relevant department will then visit the Bank to get the checks issued. The checks are signed by the Head of Disbursement and the Head of Income. Each department head (including each District Head) gets one check. A "Trustee" then cashes the check, accompanied by two others. These three then distribute the money to employees. Each employee's payroll has his/her name, grade, serial number, basic salary, special allowances (for technical staff), and food allowance.

5. 50 O&M expenditures undergo a similar process. Once the budget and its codes are approved by MoF, these are given to the Disbursement Unit. When a department head requires an expenditure, he/she prepares a list which is submitted to the Mayor, Deputy Mayor, or a delegated person for approval. On

approval, the list is sent to the purchasing department and is then submitted to the Procurement Committee.

5. 51 The Procurement Committee receives three quotes for each purchase. In the case of high-value purchases, advertisements are placed in the newspapers. The winning bid is evaluated through a comparative analysis normally based on the lowest bidder. Once these are obtained, a Purchase Order (M3) is prepared. The winning bid is sent to the Purchase Department, and then to the Accounts Department. The Accounts Department reviews the items and checks with the original budget as to whether or not there is an allocation for that item. An M16 is prepared and submitted to the Disbursement Unit. A check is .prepared for an authorized person. The Purchase Department keeps a record of expenditures. A system of registered vendors does exist.

E. Managing, Planning, and Developing the City

5. 52 Kabul faces several major development challenges. The city, with its population of three million people, has grown at an exceptionally fast pace over the last 10 years, with a rate of population growth of around 17% p.a. over several years. About 80% of the city now lives in unplanned settlements. Construction in informal settlements represents a private investment in fixed capital of around $1.3 billion (not including land value). There are reported to be only about 4,000 homeless families in the city (Bertaud, 2005).

5. 53 Consequently, Kabul's major development problem is not housing but rather the provision of infrastructure and access to legally subdivided land. Kabul Municipality is not responsible for the provision of all types of required infrastructure. However, it does have a role in planning and coordination of development, and, more importantly, it controls large tracts of land. Thus the Municipality controls access to land and its sub-division.

5. 54 Currently, development planning is not an activity of Kabul Municipality. The municipality does have a Master Plan which was first issued in 1964, updated in 1970, and finally adopted in 1978. Since the adoption of the 1978 Plan, the city has seen 23 years of war, population growth from 700,000 to three million, and six changes in government. The Master Plan does not take into account the vastly different circumstances and key development issues that have arisen since 1978. The plan requires updating, including extensive consultation with communities. This will be possible through the existing *Nahiya, Wakil e gozar,* and other community development forums that have been established throughout the city.

5. 55 An additional source of confusion is that, according to a Presidential Decree, it is the Ministry of Urban Development and Housing which is responsible for formulation of the city plan, with the Municipality responsible for its implementation. This is in contradiction to the current best-practice recommendation that urban planning is best done at the local level. It is the City Planning Department that is responsible for implementation of the Master Plan, and also for the design of buildings.

5. 56 Consequently, this department should be responsible for the formulation of a development plan for the city. However, skills in the City Planning Department require updating. For example:

- The "Master Plan" that is referred to is the "map", not documentation that supports the reasoning behind the map.
- Related to the outdated framework, planners in MUDH and the Municipality view planning as a "graphic design" and not as a strategy. For these planners, the "picture" is the end

product, not the reality on the ground. Reading and drawing plans are not based on realistic analysis of urban development and service delivery issues.

- This notion of the "plan as design" is entrenched because most of the planners in MUDH and Kabul Municipality are structural/civil engineers and not urban planners. The concept of the plan needs to shift from "graphic design" to strategy.

5. 57 The City Planning Department will remain relevant if it can adapt to new circumstances and improve its functioning. More specifically, several relevant issues for Kabul's spatial development need to be addressed. These include:

- *Secure tenure.* Many settlements fall outside the Master Plan of Kabul or are not identified as residential according to the Master Plan. Most often, these areas house poor residents, internally displaced persons, and refugees who have returned. Residents in these areas do not have formal security of tenure. One of the barriers to granting tenure in these areas is that they lie in areas not legally recognized as residential by the Master Plan.
- *Provision of services.* The lack of recognition of these informal settlement areas is also a barrier to the provision of services by the municipality.
- *Identification of vacant land.* The plan will also need to identify suitable vacant land for housing development. This is crucial to accommodate further development for the substantial numbers of IDPs and returning refugees.
- *Environmental sensitivities and water problems.* Kabul is growing at an extremely rapid rate. There is a daily influx of more people into the city. However, some of the land in Kabul is environmentally sensitive. Furthermore, water resources in the city are scarce. Development in these areas will be detrimental to settlers and to the environment of Kabul. The right to land should therefore be balanced against environmental issues.
- *Ad-hoc and piecemeal development.* Currently in Kabul, there are several piecemeal and ad-hoc developments – many supported by donor agencies. A proper urban development plan will help identify where these initiatives are, what they are, and what other initiatives are required in which locations.

5. 58 ***Land and land development*** are an especially critical issue in Kabul. The Municipality has substantial power and resources with respect to land development. Its power stems from two sources. First, in accordance with the Municipal Law, one of its functions is to acquire private property (at open market rates) and reallocate this to persons able to construct their own houses. Second, a significant amount of real estate within the City (original Master Plan limits) is owned by the Government and has been made available to the Municipality to plan and allocate. Estimates of 1,000 ha are given, with several thousand additional hectares of State land outside the original Kabul Master Plan area.

5. 59 Kabul Municipality, at least until March 2004 when Mayor Noorzad was appointed, continued to allocate plots of land to individuals.[7] Although not technically illegal, the allocation of these plots contains the seeds of urban conflict. Municipal officials estimate that a minimum of 26,000 plots have been paid for and allocated on land which the Municipality is yet to purchase or develop (see Table 5.2); one official intimated that the true number could be double this figure.

[7] Historically, the price of these plots has been deliberately kept below the open market rate, to enable poorer persons to acquire building land and to ensure that construction falls within formally planned areas (projects). Currently, a minimum of Afs 25,000 – 35,000 ($500 - $700) is payable to acquire a plot number (for a 100 sq meter plot), and a fee of $1,050 for provision of services (roads, water, drainage, electricity etc).

Table 5. 2: Examples of Number of Plots Allocated by Municipality on Already-Owned Land

	PROJECT	No. of Plots
1	Khushal Khan District 5	No data
2	Khair Khana District 11 Project 5 (1995-96)	2,100
3	Ahmand Shah Baba	No data
4	Arzan Qimat District 12	9,000
5	Qala Zaman Khan District 16	7,000
6	Rahman Mina District 8	5,500
7	West of Kabul Airport District 10	1,000
8	Ayub Khan District 7	"several thousand'

Source: World Bank. (2005).

5. 60 Often the land on which the plot numbers are indicated is already privately-owned land. Sometimes houses already exist on the land and are occupied by their owners. Since March 2004, the current Mayor has resolved about 5,000 of what are estimated to be around 14,000 disputed plots. This was achieved through purchase of other land and reallocation.

5. 61 The ways by which plots were formally acquired were heavily tainted with what current officials now say was outright corruption. Many plots were sold for which there was simply no real plot. Others were indicated on land already occupied and owned. In addition to the fees lost by applicants, bribes often had to be paid, doubling or tripling costs to them.[8]

5. 62 In the past, the Municipality has at times been party to unjustified cancellation of building plot allocations. Legally, the failure to build upon a plot within one year can result in loss of the plot allocation. Most cancellations occurred during the 1992-2001 period, but they also continued up until March 2004. Some cases of alleged wrongful cancellation have been submitted to the Property Department since March 2004.

5. 63 Kabul Municipality also plays a role in controlling development through land ownership. A significant amount of real estate within the City (original Master Plan limits) is owned by the Government, and variously made available to the Municipality to plan and allocate. Estimates of 1,000 ha are given, with several thousand additional hectares of State land (or Government Land) falling outside the original Master Plan area. It is in these areas that most unauthorized informal housing construction has occurred, including on steep hillsides. Most of this construction has been entirely illegal, but the fact that this land is owned by the state, and not the private sector, provides an easy opportunity to deliver security of tenure to the unplanned settlements. However, there is not yet any commitment from the Government that this will occur.

5. 64 The vast ownership of state land also creates an opportunity for the Municipality to put in place the frameworks to facilitate the development of such land and consequently create income. But on the contrary, officially the Municipality has attempted to tightly control land. This has left scope for illegal

[8] Note however that outside the official project-bound plot planning and allocation of land which is not in the power of the Municipality to allocate are allegedly a host of other cases where plots have been acquired, and legal letters of allocation and court entitlement issued, for plots which fall well beyond planned areas. Kabul residents cite a common practice until at least March 2004, in which an influential individual secured an allocation of State land plots directly from the leadership, or simply through force (commanders). Such persons used their military power to construct houses and offices on such properties, and coerced or colluded with others to secure court documents demonstrating title. Municipal officials have by no means always colluded in these developments; on the contrary, some key officials have received violent beatings from commanders when attempting to challenge building activity on such sites.

construction of houses – with collusion of senior officials. In these instances, beneficiaries have not always been the urban poor.

5. 65 The most common of these illegal practices has been where a commander has appropriated a land area and proceeded to sell one *beswa* plots, at ever-inflating prices. Once the house is constructed, owners frequently resell the house, and for significant sums. The Sai Sang *Wakil-e-Gozar* reports that the price doubles with each sale. A chain of evidentiary documentation of purchase is set up, removing the original land developer from detection without determined pursuit of the case. No trustworthy *Wakil-e-Gozar* will witness such transactions, although neighbors in similar situations readily do so. While disputes at the time of transaction or post-transaction may arise in such cases (for example where a brother with a claim to a family home has not been party to the sale), these disputes do not enter the formal arena (courts or even the *Wakil-e-Gozar*). This is because even the most recent buyer of the house is perfectly aware that his occupancy is illegal given the status of the land as belonging to Government. However, the fact that prices nonetheless soar suggests that there is widespread confidence that occupancy will in due course be regularized. Should this not be the case, then literally thousands of cases will result, in this instance launched by the Government seeking restitution of its properties. The fact that by no means all house owners are poor, or without choice, gives rise to concern. There are significant numbers of owners who build speculatively (for sale) and/or build to rent out, not to provide themselves and their families with desperately needed shelter. These are, however, numerically in the minority.

F. Delivering Services in Kabul

5. 66 The newly formed City Services Department focuses on the actual delivery of services (sanitation, greenery, parks, etc.) but also contains the Operations and Maintenance (O&M) Department which currently acts as the main construction implementation arm of Kabul Municipality. The O&M Department consists of the following units: (i) building construction; (ii) road construction (construction of roads and streets, bridges and culverts, repair and overlay of roads); (iii) drainage systems (for construction of drains along the sides of roads); (iv) city transport (taking care of the machinery and equipment of the department); (v) water supply (newly established); (vi) sewerage (newly established); (vii) workshop and networks (repair of Municipal equipment and vehicles, extension of electrical networks in the city); and (viii) health clinic.

5. 67 According to the approved structure for the O&M Department, it has a total of 1,078 staff/posts. Of these 226 are permanent staff positions (188 staff are present, out of which 31 persons are technical and the remaining 157 administrative, financial, and other staff). There are also 852 posts for fixed-term staff, of which 329 are employed. These include project staff like mechanics, drivers, masons, carpenters, bar benders, etc. In addition, the O&M Department hires an average of 15 day laborers per day.

5. 68 This Department has substantially changed under the new structure, taking on new functions. In addition to its traditional road construction role, water supply and sanitation and sewerage have been added to its mandate. The water supply and sewerage sections are still not fully operational, however. These operations will have to be closely coordinated with CAWSS.

5. 69 The O&M Department has also apparently lost its independence. Until 2004, it was a State Owned Enterprise (SOE), whereas it is now a budget unit of Kabul Municipality, based on a Presidential Decree. However, it is still on the SOE list recently prepared by the MoF. It needs to be ascertained whether this change in status has resulted in any deterioration in the functioning of the Department.

5. 70 Irrespective of its formal organizational structure, the O&M Department reports directly to the Mayor of Kabul. Currently, its main task is to act as an implementation agency for the Municipality. Consequently, its main responsibilities include road construction; asphalt overlay and repair of the existing roads; construction of public and residential buildings in urban areas (such as mosques, cinemas, public halls, residential apartments, markets, etc.); and construction of drainage systems, bridges and culverts, pathways, retaining walls, and maintaining the existing buildings of the Municipality.

5. 71 The Department of Sanitation (DoS) is under the City Services Division. It is responsible for solid waste collection and disposal as well as some basic wastewater services such as cleaning roadside ditches and open drains, removing sludge from culverts, and evacuating septic tanks of private houses and buildings. It has over 60 employees and about 1,300 workers, equivalent to about 4.5 employees/workers per 10,000 population. DoS owns a small fleet of solid waste collection vehicles, in addition to some water trucks and earth moving equipment. With the exception of 24 waste collection trucks recently donated by the Government of India, most of the fleet is Russian, worn out, and obsolete.

5. 72 DoS collects 300 tons of solid waste from the streets of Kabul every day. This is well below the average rate of waste generation in Kabul (about 1,280 tons per day). Moreover, waste collection by Kabul Municipality is ad-hoc. There is no specific routing plan assigned to each of the 40 vehicles and crew belonging to the Municipality. Furthermore, the existing collection vehicles are small in size (3-5 cubic meter capacity), and drivers currently conduct only two trips per day. In the most accessible and visible parts of Kabul, waste is collected once per week. In other parts of the city, where streets are narrow and generally unpaved, the frequency of collection drops to as low as once per month.

5. 73 Since the establishment of the new dumping site at *Gazak*, the costs recorded for solid waste removal have increased to almost $20,500 per year (from $15,000), principally due to increased fuel consumption. This sum does not reflect total expenditures such as salaries, insurance, depreciation of collection vehicles, etc. DOS's only billable service is the provision of septic tank cleaning services to clients. The total average tariff per trip to a client's premises is around $12, whereas the tariff applied by private companies is about $18-24.

5. 74 There are several different options for delivery of solid waste management services in Kabul, which require further study and subsequent decisions. These include:

- Formation of an independent municipal corporation, either separately from the water supply and sewerage function or merged with either the sewerage function or the water supply and sewerage function.
- Outsourcing/privatization of selected sanitation functions regardless of which legal status is chosen.
- Full privatization either as a Sanitation Company or as a Water Supply and Sanitation Company

G. Summary of Recommendations

5. 75 The unique history and current position of Kabul Municipality, including its resources (land and potential financial resources), the presence of administrative systems (albeit with room for improvement), and an existing legal framework that accepts a measure of independence, provide an opportunity for the Government of Afghanistan to implement systems for the delivery of services at the city level. However, in order to ensure success, a number of legal financial, administrative and service delivery changes are required. Recommendations for improvements are summarized below:

5.76 ***Improve the Legal Foundation.*** The existing municipal laws require review and subsequent revision. Two aspects are particular importance:

- First, the anomalous position of Kabul Municipality in terms of its reporting processes and its accountability requires serious consideration. The key problem that should be addressed at this point is not necessarily to force Kabul Municipality to report to another line Ministry. Indeed, as this chapter has shown, there is precedent for capital cities to have a special status. What is needed is to introduce a measure of fiscal responsibility for Kabul Municipality so that it is at the very least accountable for its finances to MoF. This issue should be considered within a broader debate that addresses the role of municipalities in Afghanistan.
- Second, the functions of the municipalities as they currently stand require further review to address the key concerns raised in this chapter. To recapitulate, these include the confusion of substantive and procedural functions; the presence of functions which are no longer relevant; and the absence of functions which are required for improved service delivery in Kabul.

5.77 Further reorganization of Kabul Municipality should then occur on the basis of the functions that it is required to undertake.

5.78 ***Develop core capacity on a sustainable basis.*** For any municipality or government body, successful fulfilment of functions and delivery of services must be based on adequate resources. These include financial resources (discussed later) and human resources i.e. capacity. Capacity development will require public administration reforms (initially through the PRR) as well as training and other efforts to build up human capacity. Kabul Municipality is fortunate in that is has independence in hiring its own staff, below a certain level. This system is useful in that it allows the Municipality to determine its own staffing requirement based on need. However, the capacity constraints of the municipality are enormous. Addressing these constraints would take a number of years.

5.79 ***Clarify taxes, update tax rates, and review and reform tax administration systems.*** Currently, Kabul Municipality appears to have a potentially strong fiscal base. However, clarifications and further actions are required on the following issues related to revenue generation and collection:

- Most important, the national government should clarify the taxes that should be available to the municipalities as opposed to those available to the national government. These should be based on the lessons from international experience.
- Kabul Municipality should review and update its existing rates and valuations to ensure that they reflect current price realities.
- The Municipality should review its tax administration and tax collection systems to ensure that it is collecting the maximum out of its existing base; this may require review of the current registry of properties and land ownership in Kabul.

5.80 ***Strengthen the existing manual accounting system, before moving to a more complicated computer-based system.*** Kabul Municipality has a logical paper-based system of accounting. The systems do work, although they have a number of loopholes. The recommendation for the short run is to strengthen the existing manual system of accounting, and to focus on the generation of a series of reports on the state of the Municipality's finances to improve their transparency. The current capacity of staff in the Municipality precludes immediate implementation of a computer-based system. The latter could,

however be implemented in the medium term, after strengthening the existing manual system and development of the capacity of municipal staff in accounting.[9]

5. 81 ***Formulate a development plan for Kabul, linked to the development budget.*** Improvements in the development budget process need to be linked to the development of a plan for Kabul. Such a plan should identify key service deficiencies in the city and key growth areas. This should be followed by identification of projects and their prioritization. The process of deriving this plan should take into account new methodologies of planning and its links to the budget process.

5. 82 ***Addressing Land Development.*** There are several actions that should be undertaken in addressing land development in Kabul, including:

- Determination of a process/procedures/criteria to legalize unplanned settlements.
- Determination of a process/procedures/criteria to deal with the 26,000 families on the land allocation list of the municipality.
- Develop a framework for alienation and development of existing lands held by Kabul Municipality. This will alleviate land invasions, help control the rising process of land, and help address burgeoning land conflicts.

5. 83 ***Improve service delivery.*** Kabul Municipality needs to turn its attention to the way in which is it ***servicing the city, particularly in solid waste management and operations and maintenance.*** While this will be a long-term effort, it is critical to think through the specific services that should be delivered by or under the oversight of Kabul Municipality, and what institutional and financial arrangements will be needed to maximize effectiveness.

5. 84 With respect to solid waste management, the Government needs to take an informed decision on institutional arrangements. There are currently several different options for solid waste management in Kabul, including:

- Formation of an independent municipal corporation, either separately from the water supply and sewerage function or merged with either the sewerage function or the water supply and sewerage function.
- Outsourcing/privatization of selected sanitation functions regardless of which legal status is chosen.
- Full privatization either as a Sanitation Company or as a Water Supply and Sanitation Company.

5. 85 In addition to clarification of functions and accountability relations, enhancing the ability of Kabul Municipality to manage its finances, deliver services, and administer the City will be essential for successful service delivery. Currently, this is seriously constrained by lack of capacity, an institutional and administrative structure not responsive to current development needs, and a financial and taxation system that does not meet the development needs.

5. 86 Finally, Afghanistan would benefit from a sector-wide approach to municipalities which would review the existing laws, suggest policy changes, and then use incentives of development grants to encourage municipalities to institute reforms for improved service deliver.

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[9] The Kabul Urban Reconstruction Project will take this approach.

Figure 5. 1: Organization of Kabul Municipality, April 2005

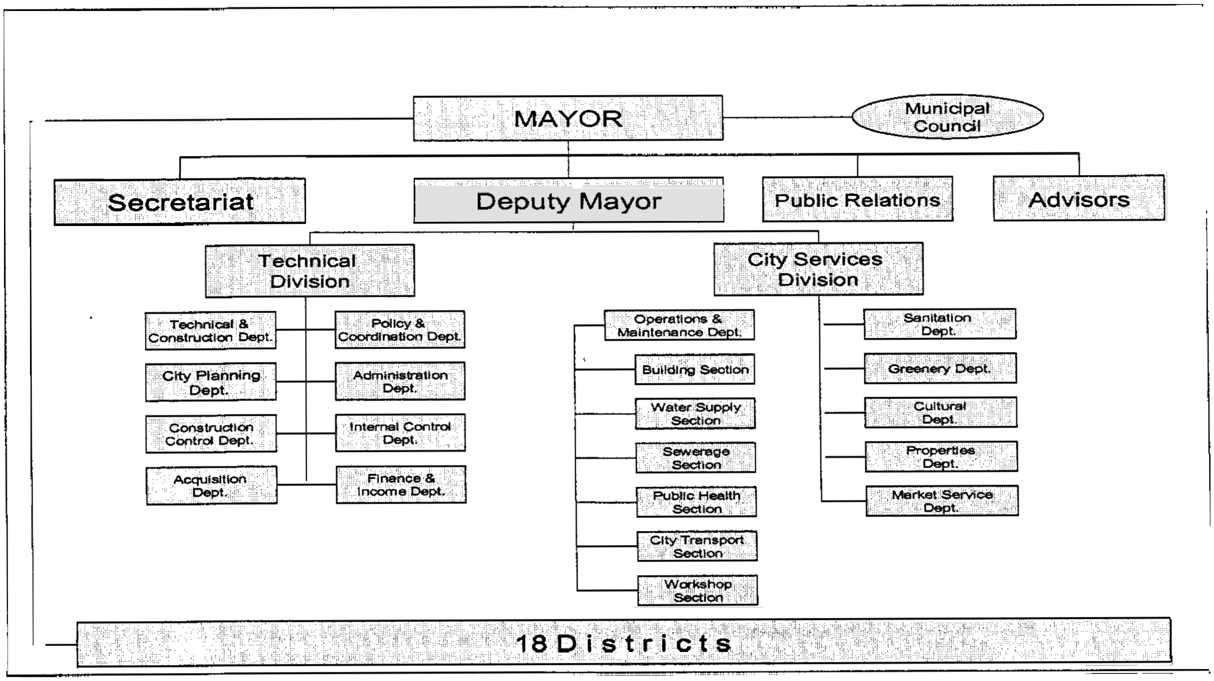

Figure 5. 2: Organization of Gozars (Districts)

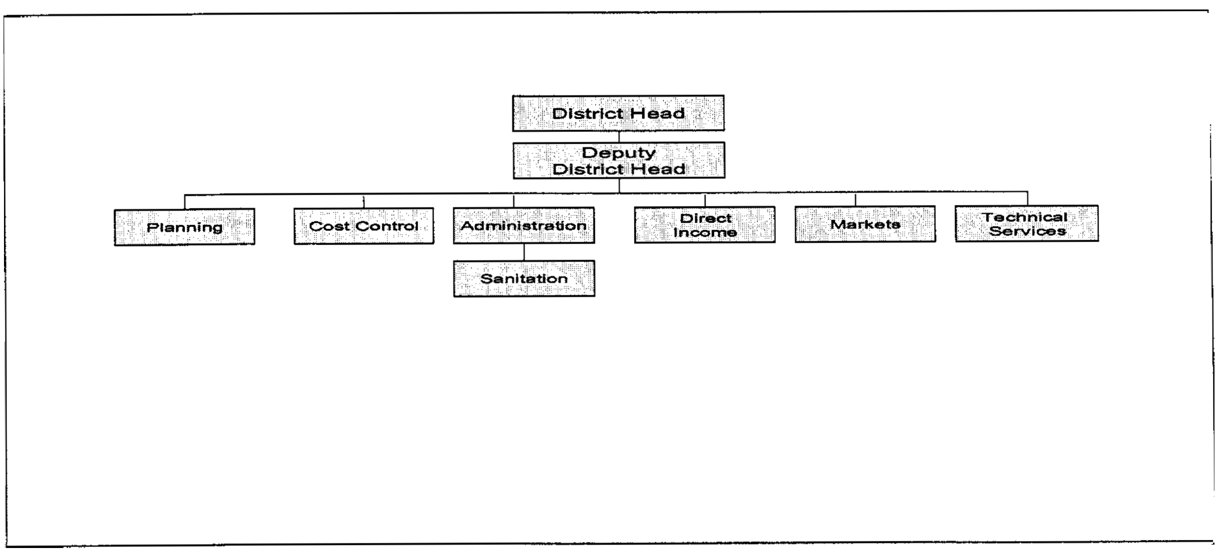

Figure 5. 3: Organization of Kabul Municipality, March 2002

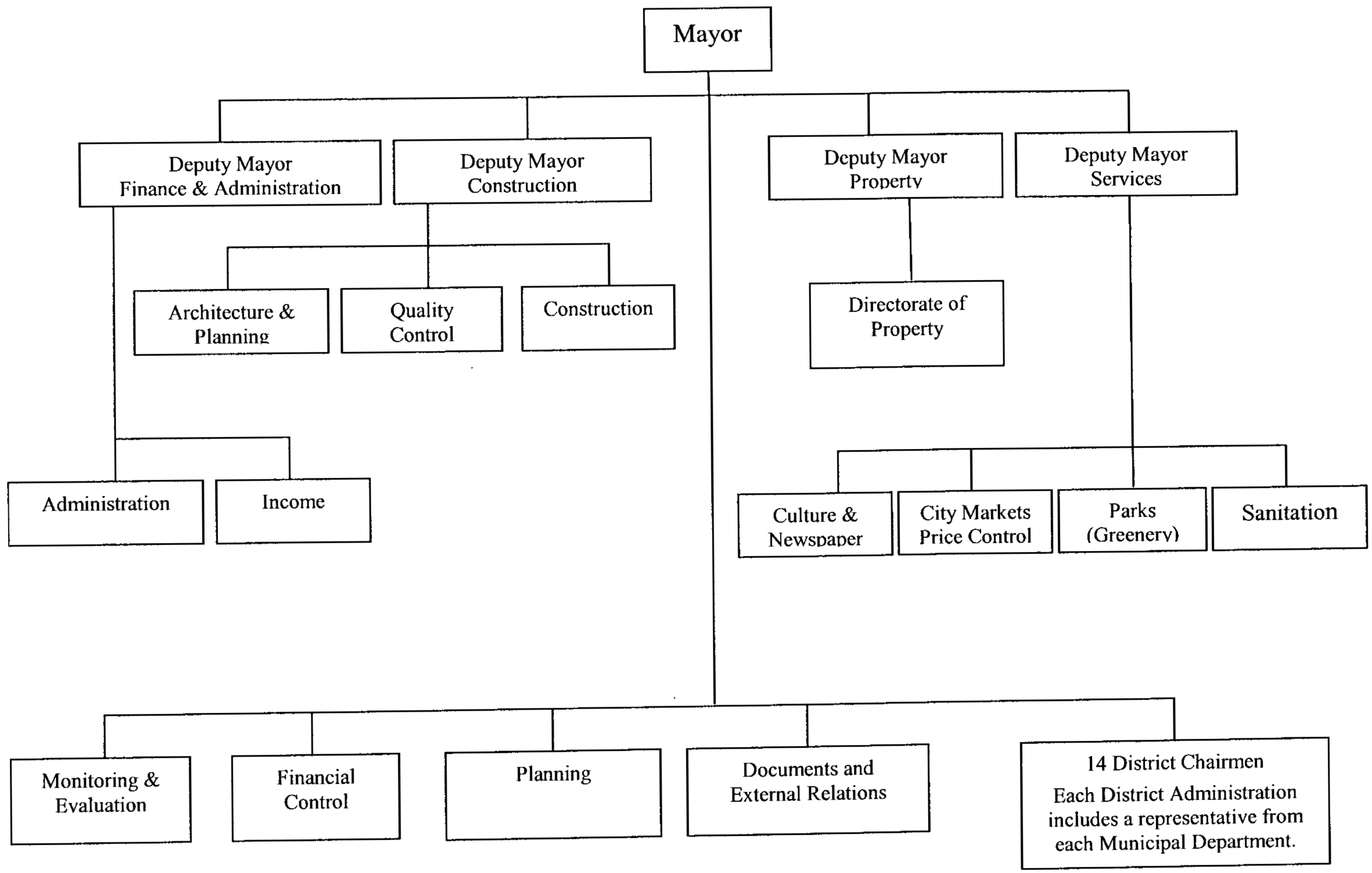

Table 5. 3: Findings on Allocation of Functions from the Review of Selected Country Constitutions and Laws[i]

Country	LG Status in national or state constitution	LG status in national or state law	Pattern of Functions	Use of SPM or similar tool
Canada	The 1867 constitution lists the functions of the federal government, and a few concurrent functions with the provinces, as well as exclusive provincial functions (residual is with the federal level). It lists local government as a provincial function with a spare formulation: "Municipal Institution in the Province."	Municipal Acts of the provincial governments set out workings of municipalities, including functions; e.g. Municipal Act of Ontario 2001. Additional provincial laws and federal laws impinge on municipal functions although this is not always well acknowledged in the municipal acts.	Municipal acts are being revised to be less restrictive (away from an ultra vires approach), toward a hybrid formulation with a "general competence" orientation accompanied by a list of specific spheres of jurisdiction. The formulation of these lists do not always clearly differentiate obligatory from discretionary functions, but where there is ambiguity the functions are most likely viewed as being obligatory in a general sense (without necessarily being linked to specific instructions on how the functions must be performed). As an example, the new municipal act of the Province of Ontario gives general competence within 10 broad fields, and prescribed functions where provincial interest is at stake, e.g. economic development, health, safety.	As an example of a government initiative, the Ontario Ministry of Municipal Affairs and Housing is implementing a mandatory program, in which all Ontario municipalities will measure their performances in nine core service areas (35 indicators) and report on their performances to both the Ministry of Municipal Affairs and Housing as well as the taxpayers. Municipal associations and other actors are also active in encouraging benchmarking and other ways of spurring local government performance.
Germany	Federal functions and concurrent functions with Länder are listed; with right to legislate others functions falling to Länder (as long as it is not legislated by the federal level). Right to municipal (gemeinden) self-government also included; by virtue of not being in federal lists, the gemeinden fall to the Länder to regulate.	Länder laws set out in a variety of ways the principles of gemeinden and kreis (country) autonomy. Some laws include a list of functions. Generally the laws differentiate between these listed functions and those imposed on the gemeinden through Länder laws (delegated tasks).	It appears that the pattern is one in which, the gemeinden have a "general competence" mandate, but they are also expected to perform some functions listed in Länder laws on gemeinden roles, as well as delegated tasks that have more detailed instructions (assistance tasks in the Indonesian context).	Assistance tasks are to be accompanied with instructions (to be as light as possible) on how the task is to be carried out. It is not clear how the discharge of autonomous but obligatory functions is to be rendered accountable. In any case, as in other OECD countries, the role of municipal associations and other stakeholders is strong in encouraging an orientation toward performance tracking and enhancement.

[i] Ferrazi, Gabe. 2002. Legal Standing And Models Of Local Government Functions In Selected Countries: Implications For Indonesia. Prepared for GTZ.

Table 5. 4: Local Functions Across Countries[i]

County & Type	Description of Local Functions	Joint Functions
Canada, Federal Local government appointed by province	***Infrastructure***: roads, sidewalks, transportation (including airports, harbors, taxis, traffic, parking), water and sewage. ***Public and Social***[ii]: police, fire, ambulances, health, ***Regulatory***: urban planning, land use, construction safety. ***Other:*** economic development.	
Czech Republic, Unitary, national government + 2 local levels Municipal responsibilities specific and delegated.	***Infrastructure Services***: public hygiene, refuse collection, street cleaning, water & wastewater, fire protection, public transport. ***Public and Social Services***: public order, police corp, culture social relief, health care, education. ***Regulations:*** only listed cities have spatial planning power. Planning rules issues, building permits granted by district office – unless delegated. ***Other:*** adopting development program, local referendums, modification of boundaries. ***Delegated***: Differ from local to local but must include police regulations concerning sale of alcohol, tobacco, environment	Education: Local maintains school buildings
Denmark, Unitary , two tier local government	*County*: ***Public & Social:*** public transport across municipal boundaries, hospitals, secondary education. ***Public Space Management***: regional physical planning, some environmental issues. *Municipalities*: ***Infrastructure***: water & waste water, local roads. ***Public and Social Service:*** education, social, technical environment and cultural sectors including day care, services for the elderly, social benefits administration, libraries, subsidies to sports clubs. ***Regulatory:*** town planning, environmental protection. ***Other***: local industry and employment policy	Counties deal with tasks concerning a bigger population than present in the municipality.
Turkey, unitary, national departments, deconcentrated provinces and local government	***Infrastructure***: roads, drainage, water & waste water, garbage, passenger and freight terminals, ***Public & Social***: public transport, social housing, fire protection, parks, clinics, welfare, traffic management. ***Regulations:*** land use and development control, environmental heavy, pollution, conservation of natural cultural and historical areas, price regulation and consumer protection master plans. ***Other,*** investment plans and programs, consumer predict testing labs, fire and protection, veterinary services, wholesale markets, slaughter houses, cold storage	
France	***Infrastructure***: lighting, water, garbage. ***Public & Social***: public transport, education (primary school construction and maintenance, policing. ***Other***: housing, aid to employment & businesses.	Education – state determines curriculum. Local build & maintain
UK, unitary, single tier of local government	***Public & Social Services:*** education, personal social services, police, road, maintenance, recreational and cultural facilities, libraries and environmental services	
South Africa, Federal, national, provincial & local government	***Infrastructure:*** bulk infrastructural development of water, electricity, solid waste, sewage, Municipal roads. ***Public & Social***: regulation of passenger transport services, health services, fire fighting, Municipal parks and recreation , street lighting ***Regulation***: noise pollution, traffic, billboards, control of public nuisances, liquor licenses, animal control, fencing and fences, licensing of restaurants, street trading, planning controls. ***Other***: fresh produce markets and abattoirs, cemeteries and crematoria, local tourism, beaches and amusement facilities, Municipal airports,	Health, economic
Mexico, federal, national provincial and municipal levels of government	***Infrastructure***: water electricity ***Public & Social***: decision making in social, economic and cultural areas. ***Regulatory***: urban development plans and metropolitan co-ordination, land holding legalization, granting of construction permits, by-laws. Other: training of civil servants.	

[i] Goga, Soraya. 2002. Minimum Standards: A Conceptual Introduction and Country Examples

[ii] Health, social services and education are being transferred to provincial due to costs.

ANNEX

ANNEX 5. 1: RESPONSIBILITIES AND AUTHORITIES OF MUNICIPALITIES AND DISTRICT OFFICES
(Chapter 4, Article 16, Municipal Law)

1. Taking measures for provision of living facilities for the residence within their area.
2. Taking measures on construction and maintaining of wells, underground water ways *(karizes)*, ponds and drinking water reservoirs through relevant offices.
3. Taking measures for protection, development and preservation of green areas, maintenance of cleanliness and sanitation, and conservation of environment within city and districts.
4. Taking measures to construct streets, playgrounds, public toilets, public bath *(Hamam)*, markets and civil and cultural centers through private investments in planned areas.
5. Setting prices of houses based on regulation.
6. Fixing the rent of the municipal properties based on regulation.
7. Taking measures to monitor cleanness of public baths, restaurants, hotels, guesthouses, teahouses, swimming pools, saloons and other food stuff sellers in collaboration with relevant departments.
8. Taking measures to maintain collaboration with health institutions to prevent the outbreak of diseases and protection of environment.
9. Taking measures for distribution of land for construction of houses and commercial areas based on relevant regulation.
10. Land acquisition based on land acquisition law.
11. Taking measures towards participation in construction of residential areas, and maintenance of roads, streets and residential areas.
12. Taking measures for improvement of city transportation through relevant departments.
13. Taking measures to assist food stuff distribution and improve livelihood services.
14. Supervision and control of prices and tools of measurement, managing and universalizing the metric system in their areas.
15. Taking measure to promote sports and physical education based on Islamic tradition.
16. Seeking voluntary assistance of people for taking part in sanitation, greenery and other useful urban services.
17. Taking measures to assist preservation and maintenance of historical and cultural monuments with the cooperation of concerned departments.
18. Taking measures to assist in collection of statistics and demographic data.
19. Collecting taxes for city services according to the law.
20. Taking measures for effective cooperation in the fight against illiteracy, improving the general education and culture level, vocational training, development of social services networks, schools for general and vocational education and libraries in their areas through relevant departments based on Islamic criteria.
21. Approval of bills according to this law.
22. Leadership of relevant subordinate departments and sections.
23. Inviting and convening meeting on delivery of city services.
24. Managing implementation of annual budgetary revenue and expenditures plans and taking measures for excess expenditure control.
25. Supervision and control of implementation of decisions of the Administrative Council.
26. Making suggestions in regards to constructions of traffic infrastructure in the city.
27. Establishment of slaughterhouses and better regulation of butcheries from sanitary point of view.

28. Distribution of price list based on Islamic law.
29. Assessment of bids, agreements, obligations, contracts for lease of municipality properties.
30. Construction, repairing and cleaning of public drains and ditches in the city.
31. Arrangement for receiving people and resolving their complaints in timely and just manner and taking supervision decisions within their authority.
32. Cooperation in eliminating primary and emergency socio-economic needs in the area in collaboration with relevant departments.
33. Demarcation of graveyard sites.
34. Taking decision for burial of unknown and heirless dead body free of charge in collaboration with Red Cross.
35. Taking measures on demolition of dilapidated buildings based on the report of the technical committee.
36. Acceptance of assistance, funds and donations on behalf of municipality and its proper documentation.
37. Prevention of constriction of unauthorized buildings in collaboration with security forces in the region.
38. Giving business licenses.
39. Issuing work permits to workers of foreign organizations.
40. Collection and registration of reliable statements of marriage, birth, death and change of residence in collaboration with relevant offices departments.
41. Strict implementation of the price list.
42. Assist in law enforcement, strengthening of security, civil order and safety of society.
43. Assist in defending the legal rights of residents in the area.
44. Full cooperation in construction of society and strengthening of Islamic rule.

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