

Promoting Second Generation of Public Expenditure Reforms¹

Background Paper: Afghanistan Reconstruction Trust Fund

29 January 2010, London UK

INTRODUCTION

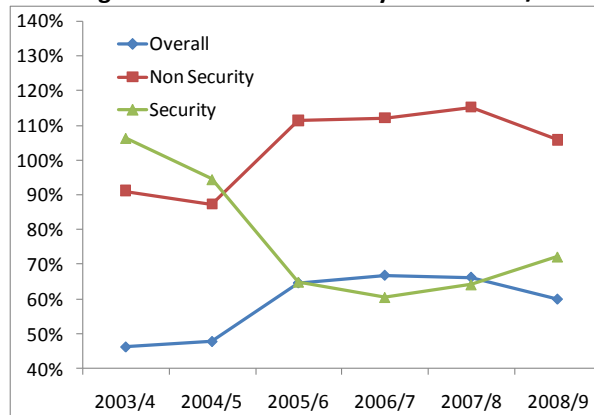
1. Afghanistan and its donor community face a dilemma that demands to be resolved: how to channel foreign aid through the government's budgetary system (core budget) that lacks the capacity to properly administer such expenditure. For without more money on budget, national objectives such as poverty reduction and the building of a stable state cannot be fully realized.
2. Currently, 90 percent of the national budget² is externally financed. Overall aid in 2008/09 amounted to US\$6.3 billion or 45 percent of GDP. The critical issue, however, is not so much the amount of aid, but weaknesses in its mode of delivery and impact. Two-thirds of the aid bypasses the core budget, moving through what is known as the "external budget". This dual budgetary system means that most economic activity in Afghanistan takes place outside the government's fiscal control, thus undermining the government's legitimacy and relevance to the Afghan people and weakening the budget's primacy as the tool of national policy. The aid needs to be on-budget and aligned with Afghan priorities.
3. If the success of foreign aid can be gauged by the extent to which it enables a recipient country to free itself of the need for that aid, then the Afghanistan foreign assistance program, as currently structured, is failing its mission; Afghanistan's fiscal sustainability, after having risen to a plateau in recent years, regressed in 2008/09 due to rising operating expenditures, mainly for security, and the country remains one of the world's most aid-dependent.

THE SEARCH FOR SOLUTIONS

4. The government has made some notable fiscal advances in recent years; core budget expenditures doubled nominally in the last three years to reach US\$2.2 billion in 2008/09, demonstrating rising absorption capacity for funding channeled through the core budget. But more far-reaching reforms are urgently needed for public expenditures to better serve the government's goals. Prioritization and sequencing are prerequisites for successful implementation of reforms for the government and donors in a country where capacities and resources are limited.
5. Four major challenges must be addressed to enable more "external" budget expenditures to be shifted to the core budget:

(1) **Precarious fiscal sustainability** (Figure 1): The fiscal sustainability indicator improved to 67 percent in 2006/07 from 38 percent in 2002/03, due mainly to the sharp **increase in domestic revenues** (to 7.5 percent of GDP from 3.3 percent). However, the faster increase in core operating expenditures relative to domestic revenues risks fiscal

Figure 1 Fiscal Sustainability Indicators 1/



1/ Domestic revenues / operating expenditures

Source: MoF, World Bank

¹ This background paper is based on the forthcoming Public Expenditure Review of Afghanistan by the World Bank

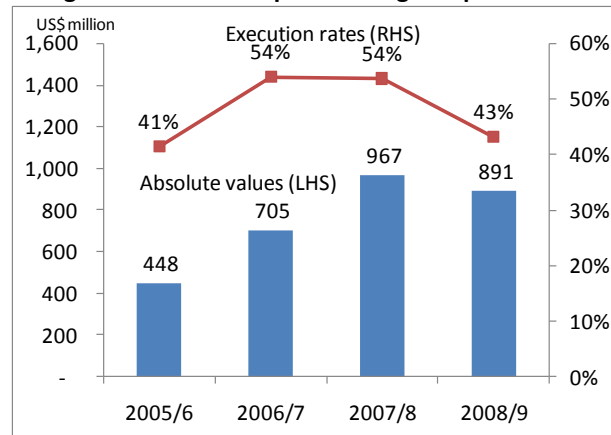
² The national budget includes the core budget (i.e. on-budget) and the external budget (i.e. off-budget).

sustainability and hence macroeconomic stability. The goal is fiscally sustainable core operating expenditures without jeopardizing core government functions. The indicator of fiscal sustainability deteriorated to 60 percent in 2008/09 from the peak of 67 percent in 2006/07. Pressure on operating expenditures, in particular those related to security, amplifies the challenge of achieving fiscal sustainability. The security sector is the largest sector in the national budget, accounting for more than 40 percent of operating expenditures, a reflection of the inescapable security challenges facing the country.

(2) **Low execution rates of core development budget expenditures**

(Figure 2): Core development budget expenditures are essential for infrastructure investment as well as service delivery. These expenditures increased by almost 500 percent between 2002/03 to 2007/08. However, core development budget expenditures equivalent to 9 percent of GDP remain undisbursed each year. Both execution rates and absolute values deteriorated in 2008/09 from the year before; execution rates fell to 43 percent from 54 percent, and absolute values fell to US\$0.9 billion from US\$1 billion.

Figure 2 Core Development Budget Expenditures

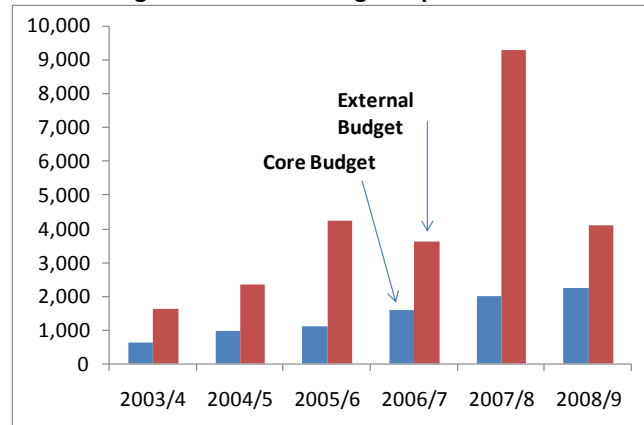


Source: MoF, World Bank

(3) **Large size and poorly aligned external budget**

(Figure 3): Challenges relate to the large external budget expenditures outside the core budget, which has arisen in response to slow implementation and poor quality of core development expenditures as well as issues of corruption and governance. Between 2002/03 and 2008/09, about three quarters of public expenditures were channeled through the external budget.

Figure 3 National Budget Expenditures



Source: MoF, World Bank

(4) **Weak governance of public expenditures:**

Public expenditure governance is critical to improving the efficiency and effectiveness of public resources. Concerns about poor governance and accountability relating to public expenditures is one of the main reasons for the large share of donor assistance channeled through the external budget, as donors seek to bypass weak government systems and deliver resources to projects and programs directly and outside the core budget.

6. The response to meeting these challenges, based on the findings of the PER and building on previous analysis, recent encouraging reforms, and ongoing programs and policy directions, is to implement a set of selected prioritized and sequenced actions. The overarching goal of the proposed action program embodied in a roadmap is to ensure that public expenditures better serve the national objectives of poverty reduction and state building. Further reforms to attract more aid flows to the core budget from

the external budget are critical while ensuring fiscal sustainability, increasing absorption capacity and project quality, and improving public expenditure governance.

STRATEGIC OBJECTIVES

Strategic Objective 1: Improved (Non-Security) Fiscal Sustainability

Together with further increases in domestic revenues, better management of the operating budget by both the government and donors will be needed to achieve fiscal sustainability. Currently, the Ministry of Finance (MoF) is not fully involved in the security sector operating budget (mainly salaries). Given this context, in addition to the full fiscal sustainability indicator, the non-security sector fiscal sustainability indicator should also be used to measure the performance of the MoF. Key reform outcomes are (i) Unanticipated increase in non-security wages and salaries contained; (ii) Predictability of security sector operating budget improved; (iii) Medium-Term Fiscal Framework (MTFF) evolved into MTEF; and (iv) Predictability of grant financing for the core operating budget ensured.

Strategic Objective 2: Higher Execution Rates and Better Quality Core Development Expenditures

The low execution rates are among the causes preventing donors from shifting their aid delivery from the external budget to the core budget (Strategic Objective 3) as donors question the absorption capacity of the government. However, the core development budget is almost entirely financed by donors. Actions should be taken by both the government and donors. Key reform outcomes are (i) Budget formulation improved; (ii) Execution levels increased; (iii) Alignment between budget and the Afghanistan National Development Strategy (ANDS) improved; (iv) Performance monitoring and evaluation of projects initiated.

Strategic Objective 3: Better Aligned External Budget with Core Budget

In the short-term, information sharing by donors should be accelerated. In the medium-term, the alignment between the core and external budgets should be improved based on the revised sector strategies. In the long-term, along with the further improvements in public financial management (e.g., procurement), donors should shift from the external budget to the core budget. The weak links between the core operating, core development and external budgets undermine public expenditures and risk sustainability. The goal is to consolidate the three budgets, but immature implementation carries risks. Depending on reform progress and capacity building, partial consolidation between the core and external budgets can be implemented or at least full conceptual consolidation reflected in the MTEF. Progress towards Sector-Wide Approaches (SWAPs) can be the foundation of the links between the three budgets. A word of caution is necessary here: While the core development budget could absorb additional funds from the external budget without affecting macro-economic stability, the many contingent liabilities for the operating budget in the development budget (both external and core) such as operation and maintenance expenditures would inevitably delay fiscal sustainability.

Strategic Objective 4: Improved Governance of Public Expenditures and Sustainability of Reforms

Afghanistan is perceived to be one of the most corrupt countries in the world with very poor governance. The sustainability of reforms and the ability to implement policies are effectively entwined with the need to improve governance and capacity-building in both the civil service and private sector in order to ensure transparency and accountability, strengthen public procurement and undertake meaningful decentralization. Key reform outcomes are (i) Progress made on Verified Payroll Program (VPP); (ii) Improved oversight by external and internal audits; (iii) Procurement process strengthened; (iv) Government-led capacity review formulated; and (v) Provincial rollout of the Afghanistan Financial Management System (AFMIS).