

## REFORMING THE FISCAL SYSTEM AND ACHIEVING FISCAL SUSTAINABILITY

### BACKGROUND AND STRATEGY

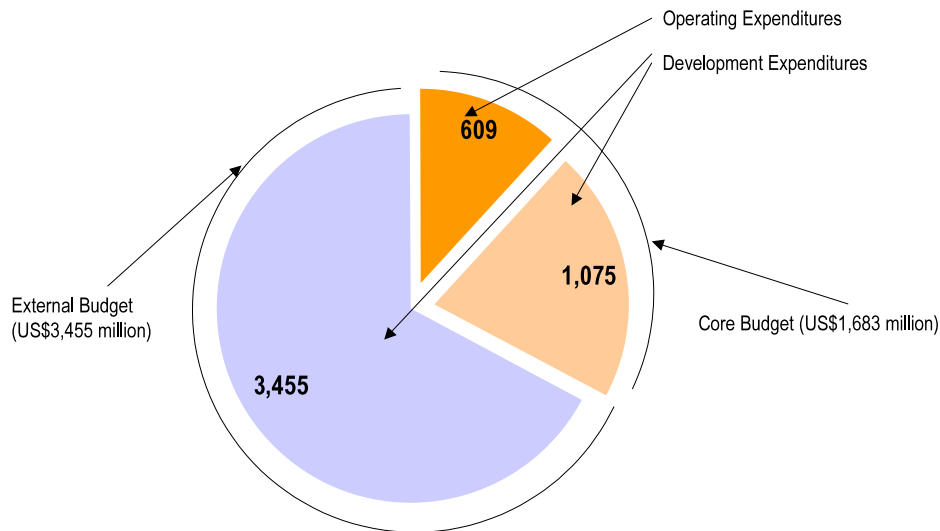
1.01 The Importance of Fiscal Reforms and Sustainability: Improving Afghanistan's fiscal system and putting our country's public finances on a stable, sustainable basis is at the core of our reconstruction and longer-term development agenda. This is a cornerstone of state-building – the state needs adequate funding, well-managed, in order to effectively carry out its functions and ensure delivery of services to the Afghan people. Fiscal self-sufficiency – i.e. domestic revenues high enough to finance the bulk of the operating budget – will be essential in this regard over the longer term. Second, fiscal stability and sustainability is critical for maintaining macroeconomic stability. Third, the national budget needs to be the central instrument of policy and reform. Fourth, sound prioritization of public spending through the budget process is essential, taking fully into account the resource envelope and fiscal sustainability. Fifth, the ultimate test of the fiscal system is service delivery. Sixth, the fiscal system – both the tax system and expenditures – is an important element of the business environment for private sector development. And seventh, fiscal transparency and accountability are extremely important, not least for reassuring our people as well as external partners that public funds are being put to good use.

1.02 Accomplishments and Constraints: The fiscal situation inherited at the end of 2001 was dire – revenues were extremely low and mostly diverted by regional and local powerbrokers; the civil service was ineffective, having been decimated by the long period of conflict and having largely lost its skill base; public services were largely unavailable for the people; government infrastructure was dilapidated and destroyed; transparency was lacking; etc. Moreover, uncontrolled currency issuance had resulted in hyper-inflation and a highly unstable currency. Despite difficulties, major progress has been made, including in the following areas:

- i. Overall public expenditure has been kept within reasonable limits (no-overdraft rule), and large increases in the size of the civil service avoided (except where well-justified in the case of the security sector and teachers).
- ii. This has contributed to the maintenance of a remarkable degree of macroeconomic stability, with the currency reform completed and inflation under control (unlike the situation in many other post-conflict countries.)
- iii. The budget process has been progressively improved, including most recently the timely preparation and approval of the ordinary (operating) budget for 1384.
- iv. Unlike the situation at the outset, most civil servants, wherever they are located in the country, are being paid regularly and on time, and there have been other improvements in budget execution particularly in the case of the ordinary budget.
- v. National programs have been initiated, funding is beginning to flow through budgetary channels, and in some cases initial successes have been achieved.
- vi. There have been substantial increases in domestic revenues in the past two years (with further significant growth programmed for 1384), and Customs reforms are being implemented and other tax reforms developed. In terms of policy, Afghanistan has the most liberal Customs and trade regime in the region, and the rates of corporate and personal income tax are low (20% flat rate).
- vii. The Government has committed itself to and to a considerable extent has achieved a high degree of transparency and accountability in fiscal processes.

1.03 The structure of the 1383 budget in terms of both broad expenditure categories and financing is summarized in Charts 1.1 and 1.2 below. Afghanistan’s National Budget is divided in two parts. The Core Budget (approved budget of US\$1,683 million in 1383) includes all funds flowing through the Government’s accounts. It is financed by Government revenues (US\$309 million) and external aid (grants, e.g. the Afghanistan Reconstruction Trust Fund, and loans, e.g. the World Bank Programmatic Support for Institution Building). The External Budget (US\$3,455 million in 1383) includes all external assistance funds not flowing through the Government’s accounts, i.e. those directly disbursed by donors to implementing agencies (Non-Governmental Organizations – NGOs, private firms). Expenditures are divided into two broad categories. Operating expenditures are primarily recurrent and continuing, and include all civil servants’ wages and pensions, plus goods and services for operations and maintenance (O&M); however, this component also includes some small investment expenditures. Development expenditures include projects that finance mainly capital goods (e.g. roads), but also some recurrent expenditures such as technical assistance, training, health services, and grants like those under the National Solidarity Program. In terms of financing, the budget is dominated by external financing, and moreover most donor funds do not pass through Government channels and the Treasury but rather are part of the external budget. Actual expenditures in the external budget fall far short of budgeted levels (in part because financing of the external budget is typically on a commitment basis, whereas the budget ideally should be on a cash basis)

**Chart 1.1: The 1383 National Expenditure Budget**



*Note:* The core budget figure includes US\$304 million shown as unallocated in the published budget.

*Source:* World Bank (2005) *Public Finance Management Review*

1.04 In 1383, the wage bill comprised 59% of total budgeted operating expenditures in the Core Budget (US\$362 million, Table 1.1), roughly equally split between security and civilian staff. Other operating expenditures are mainly for purchase of goods and services (around 20%), while capital spending within operating expenditures represents less than 10% of the total operating budget. The allocation of the 1383 budget by program is shown in Table 1.2.

1.05 Although the progress made so far is significant and Afghanistan is moving forward, there is still a very long way to go for us to develop and fully operationalize a sound fiscal system

and put our public finances on a sustainable basis. A key constraint is domestic revenue, which despite recent increases is still less than 5% of GDP, compared with a normal level of 11-14% in poor developing countries. Although there have been improvements in the budget process, the development and recurrent budgets have not yet been integrated, and the development budget has too many fragmented projects with lack of prioritization. The multi-year implications of public expenditure decisions – critical for fiscal sustainability – are in most cases not taken into account when those decisions are made. This problem is aggravated by donors not adequately taking fiscal sustainability considerations into account in their funding decisions related to the external budget (for example in the security sector). Building capacity in the Ministry of Finance and other core economic institutions of government has made progress, but there are still major gaps and our work is overly reliant on external technical support.

**Table 1.1: The National Budget (US\$ million)**

	1381 Est.	1382 Budget	1383 Est.	1383 Budget	1384 Est. a/ Budget	1384 Budget
<b>(In millions of US dollars)</b>						
<b>Domestic Revenue</b>	<b>120</b>	<b>183</b>	<b>207</b>	<b>309</b>	<b>259</b>	<b>333</b>
<b>Donor Assistance Grants (to operating budget) b/</b>	<b>192</b>	<b>321</b>	<b>213</b>	<b>300</b>	<b>317</b>	<b>342</b>
ARTF	-	229	167	252	235	280
LOTFA and Army Trust Fund	-	92	39	48	60	62
Other grants	192	-	8	-	22	-
<b>Operating Expenditure</b>	<b>317</b>	<b>504</b>	<b>447</b>	<b>608</b>	<b>579</b>	<b>675</b>
<b>By Economic Classification</b>						
Wages and Salaries c/	-	264	281	362	364	401
Purchase of goods and services	-	132	86	97	105	142
Debt service and Interest payments	-	-	1	6	1	8
Other recurrent	-	20	18	41	45	19
Capital expenditure	-	34	61	35	41	47
Reserves and Contingencies	-	53	-	67	23	57
<b>By Program</b>						
Human Capital Development	-	187	123	213	196	218
Physical Infrastructure	-	24	41	43	43	40
General Administration	-	48	50	40	61	60
Security	-	192	233	244	261	303
Reserves and Contingencies	-	53	-	67	23	57
<b>Operating budget balance (excluding grants)</b>	<b>(197)</b>	<b>(321)</b>	<b>(240)</b>	<b>(299)</b>	<b>(320)</b>	<b>(342)</b>
<b>Operating budget balance (including grants)</b>	<b>(4)</b>	<b>-</b>	<b>(27)</b>	<b>-</b>	<b>(3)</b>	<b>-</b>
<b>Core budget development spending d/</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>1,074</b>	<b>296</b>	<b>n/a</b>
<b>Donor Assistance Grants (to core development budget)</b>	<b>-</b>	<b>-</b>	<b>93</b>	<b>740</b>	<b>-</b>	<b>n/a</b>
<b>Core budget balance</b>	<b>(4)</b>	<b>-</b>	<b>(27)</b>	<b>-</b>	<b>(3)</b>	<b>n/a</b>
<b>(In share of GDP)</b>						
Revenues	2.9	4.0	4.5	5.7	4.8	5.1
Donor Grants	4.7	7.0	4.7	5.6	5.9	5.3
Operating Expenditure	7.8	11.0	9.8	11.3	10.7	10.4
of which wages	-	5.8	6.1	6.7	6.8	6.2
Operating budget balance (including grants)	(0.1)	-	(0.6)	-	(0.1)	-
<b>Memorandum item:</b>						
External Budget	503	1,951	1,226	3,455	2,551	n/a
Exchange Rate (AFA per USD)	49.0	49.1	49.1	49.8	49.8	48.5
GDP (US\$ million)	4,084	4,585	4,585	5,392	5,392	6,478

a/ Revenue and financing estimates based on IMF reports. Expenditure estimates based on mid-year review.

b/ Financing data based on IMF reports (ARTF data us estimate for 1383 and budget target for 1384).

c/ For 1382-1383, this includes an estimate of in-kind food given to employees of the Ministry of Interior, Defense, and National Security (this amount is shown under "purchase of goods and services" in the budget documents).

d/ The 1383 budget includes US\$304 million shown as "unallocated" in the original budget.

**1.06 The Government's Fiscal Strategy:** Fiscal sustainability is at the heart of Afghanistan's approach to reconstruction and development, as outlined in the *National Development Framework* and *Securing Afghanistan's Future*. The latter document put forward a growth and fiscal strategy whereby strong revenue efforts complemented by sound expenditure management were projected to enable the Government to finance its wage bill from domestic revenues within five years and its entire operating budget within nine years. These ambitious targets, although

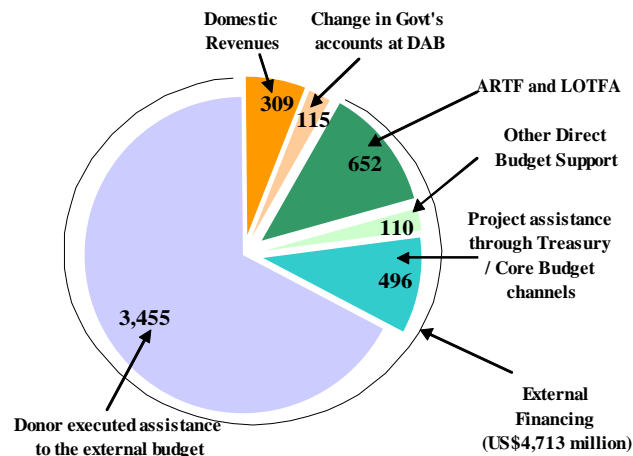
they may need to be adjusted in the light of subsequent developments, underline the Government’s strong commitment to achieving fiscal sustainability as a key objective.

**Table 1.2: 1383 National Budget by Program (US\$ million)**

	Core Budget			External Budget	Total Budget	
	Operating Exp.	Development Exp.	Total	Development Exp.	Total	of which develop.
<b>Human Capital Development</b>	<b>213</b>	<b>248</b>	<b>461</b>	<b>892</b>	<b>1,353</b>	<b>1,140</b>
1.1 Refugees and IDP return	3	-	3	83	85	83
1.2 Education	128	24	152	253	405	277
1.3 Health	25	22	48	267	315	289
1.4 Livelihood and Social Protection	45	202	247	255	502	457
1.5 Culture, Media, Sport	12	-	12	34	47	34
<b>Physical Infrastructure</b>	<b>43</b>	<b>335</b>	<b>379</b>	<b>1,058</b>	<b>1,437</b>	<b>1,394</b>
2.1 Transport	15	175	190	628	818	802
2.2 Energy, Mines, and Telecom	16	106	122	221	342	326
2.3 Natural Resources Management	12	32	43	155	198	187
2.4 Urban Management	1	23	24	55	79	78
<b>General Administration</b>	<b>40</b>	<b>87</b>	<b>127</b>	<b>349</b>	<b>476</b>	<b>436</b>
3.1 Trade and Investment	2	25	27	26	53	51
3.2 Public Administration and Economic Management	38	62	100	323	423	385
<b>Security</b>	<b>244</b>	<b>99</b>	<b>344</b>	<b>1,155</b>	<b>1,499</b>	<b>1,255</b>
3.3 Justice	18	-	18	41	60	41
3.4 National Police and Law Enforcement	119	99	219	274	493	374
3.5 Afghan National Army	107	-	107	679	785	679
3.6 Mine Action	-	-	-	81	81	81
3.7 DDR	-	-	-	80	80	80
<b>Unallocated</b>	<b>67</b>	<b>304</b>	<b>371</b>	<b>-</b>	<b>371</b>	<b>304</b>
<b>Total</b>	<b>609</b>	<b>1,074</b>	<b>1,683</b>	<b>3,455</b>	<b>5,137</b>	<b>4,529</b>

1.07 On the expenditure side, prioritisation, quality, and sustainability are key components of the fiscal strategy. Spending must fit within a sensible medium-term fiscal resource envelope, and given limited resources, directed toward the highest-priority needs. Ensuring high quality of expenditures and that public services reach the people will be critical. All of these point to the central importance of a sound budgetary process including all of its elements – preparation, approval, review and revision, execution.

**Chart 1.2: Financing of the 1383 Budget**



Source: World Bank (2005) Public Finance Management Review

1.08 A key part of the fiscal strategy is reform of the Ministry of Finance, which will be a foundation for realizing the Government's vision of making the budget the central instrument of national policy and reform as well as public sector resource allocation. Building on past and ongoing improvements, we envisage transforming the Ministry and its component parts into a world-class institution that smoothly carries out its core functions while phasing out its dependence on heavy amounts of external technical assistance and promoting good financial management, budget discipline, and transparency and accountability throughout the Government.

1.09 Finally, fiscal sustainability is complementary to the economic growth strategy. A sound fiscal system, maintaining sustainable fiscal balances, will facilitate private sector-led growth. By the same token, economic growth that expands the tax base is an essential prerequisite for putting Afghanistan's budget on a sustainable path over the medium term. Public investments in essential infrastructure, financed on a fiscally sustainable basis, as well as in human capital development, are critical for supporting sustained economic growth over the medium term.

### KEY ISSUES OF FISCAL SUSTAINABILITY AND THE WAY FORWARD

1.10 Revenue Mobilization: Afghanistan's revenue-GDP ratio, despite considerable improvement in the last couple of years, at 5% is still far below international norms for poor developing countries (11-14%), and falls far short of financing the present operating budget (10% of GDP) let alone necessary increases in the future. As in many other developing countries, Afghanistan's existing revenue base is concentrated in a small number of taxes – most notably import duties (accounting for around half of total domestic revenues) – and is collected from a few locations. The bulk of revenue is collected by five central ministries (mainly in Kabul) and in just five of the country's 34 provinces. Other ministries, provinces, and taxes collect small or minimal amounts of revenue. The indirect tax system suffers from serious deficiencies, including a narrow tax base leading to low revenue yield, serious potential cascading (albeit at a low rate), and disincentives to export. There are some 90 active taxes, but half of them generate such small amounts of revenue (less than Afs 1 million – about \$21,000 – each in the first half of 1383), that they are essentially “nuisance” taxes whose costs of collection most likely exceed the receipts and whose costs to the private sector (in terms of time, attention, and possible corruption) are disproportionately large.

1.11 Revenue mobilization deserves the highest priority, and the Government's approach recognizes that limited capacity needs to be taken into account while expanding capacity over time, and that the available capacity needs to be focused on the tax sources with the greatest near-term potential. Key elements of the Government's approach to generate sustained rapid growth of domestic revenue, along the lines of the SAF target, include the following elements (implementation of many of which is already well underway):

- i. **Establishment of the Treasury Single Account (TSA) in 2004** and its implementation throughout the country. This is intended to ensure that all government revenues, wherever they are collected, accrue to the Treasury.
- ii. **Consolidation of taxes.** The large number of small “nuisance taxes” can be drastically reduced, providing relief for the private sector from the administrative burden and enabling the tax authority to focus on the major revenue sources.
- iii. **Policy of no tax holidays.** International experience demonstrates that tax holidays are not very effective in attracting foreign or domestic investment (other than investments that would have been made anyway) and can be fiscally very costly. The key

- determinants of investment lie in the more general business environment. Hence in 2004 tax holidays were stopped. Afghanistan maintains relatively low corporate and personal income tax rates (flat 20% of net taxable income), with provisions for accelerated depreciation (and unlimited loss carry-forward).
- iv. **Implementing reform of the Customs administration**, to complement the major overhauling of import tariff structure already completed. A five-year reform plan is in place, whose short-term focus is to extend the coverage of Customs operations in the provinces and enhance overall compliance.
  - v. **Focusing on larger taxpayers to enhance revenue**. A Large Taxpayer Office (LTO) was established in 2004, whose capacity is being built and which might be expected to collect a large proportion of total non-Customs domestic tax revenue within two years.
  - vi. **Pursuing ambitious goals for revenue mobilization but setting conservative revenue targets for budgeting purposes**.

1.12 In addition, maintaining rapid economic growth, in particular growth of the “formal” (registered, taxpaying) part of the private sector, will be essential for sustained expansion of the tax base. This requires, among other policies, that tax rates be kept at reasonable levels. However, given urgent revenue needs there is no room for any rate reductions for major taxes.

1.13 Over the longer term, Afghanistan needs to move toward a broad-based consumption tax. This could be done most easily by progressively introducing a single-stage sales tax for manufacturing and services.

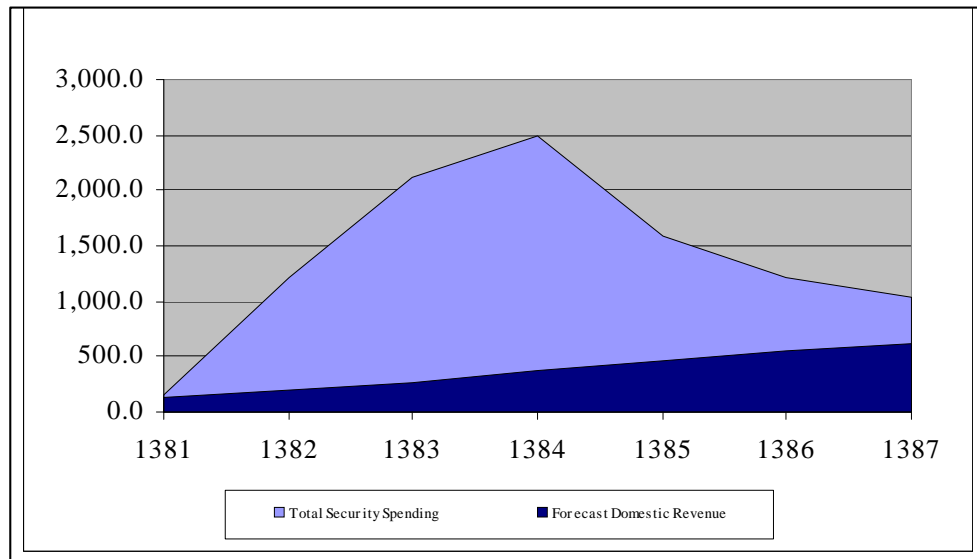
1.14 Security Sector Expenditures: Security has been called “the number one issue and constraint for Afghanistan’s reconstruction” (*Securing Afghanistan’s Future*, p. 78). After a somewhat slow start, security investments have accelerated over the past year, mainly directly funded by donors through the external budget. Good progress has been in staffing up the Afghan National Army (ANA); police training; disarmament, demobilization, and reintegration of militias (DDR); development of Provincial Reconstruction Teams (PRTs); etc. However, these gains have been expensive and have not occurred within the overarching framework of a national security strategy that takes into account fiscal sustainability. Hence there is a serious risk that the security institutions and forces being put in place will not be affordable for Afghanistan over the medium term within the domestic resource envelope.

1.15 Specifically, the issues facing the security sector from a fiscal standpoint include the following:

- i. The policy framework has not yet been fully developed, including the national security strategy; thus major security expenditure decisions and institutional investments have tended to be made in isolation by ministries heavily influenced by donors.
- ii. The wage bill in the security sector is growing rapidly and is expected to continue to increase at a fast pace – driven by staffing up the ANA (at current high salary rates), increases in the size of the police, a proposed police salary increase, development of the counter-narcotics infrastructure, etc.
- iii. Occurring mainly in the external budget and in the absence of an agreed overall national security strategy that takes into account fiscal considerations, security expenditures are less subject to budget discipline and in particular do not take into account downstream implications of investments now. Progress in improving financial management in the security sector may also have been slower than in the rest of the government administration.
- iv. Despite progress in many areas, reforms and capacity building in the civilian oversight institutions of the security sector (i.e. the various ministries concerned) have tended to lag

- behind improvements and expansion in the security forces themselves. What administrative improvements have occurred have not been part of the broader public administration reform process (led by the Independent Administrative Reform and Civil Service Commission).
- v. Overall, during the foreseeable future and based on planned force sizes, staffing patterns, and salaries, the ordinary budget for the security sector will exceed projected domestic revenues (see Chart 1.3). This raises critical issues of fiscal sustainability and public resource allocation.

**Chart 1.3: Forecast SS Spending Against Forecast Domestic Revenues (US\$ million)**



Source: World Bank (2005) *Public Finance Management Review*

1.16 These issues will need to be addressed in a holistic manner by the national security strategy which the Government is currently developing. Fiscal management of the security sector will need to involve subjecting security expenditures to the normal rigors of public expenditure management and fiscal discipline. Some broad approaches include the following:

- i. **Building policy capacity and a strong policy review function** at the central level (i.e. in the National Security Council).
- ii. **Accelerating administrative reforms and capacity building in civilian oversight institutions** in the security sector, and improving financial management.
- iii. **Reviewing the fiscal implications of ongoing security sector reforms and future security investments**, and making any necessary adjustments in the interest of fiscal sustainability.
- iv. **Rigorously limiting staffing size in the security sector** to agreed and approved levels.
- v. **Setting salary rates in the security sector based on future fiscal absorption capacity**, as in the rest of the government administration.

1.17 With respect to the overall level of spending in the security sector, there needs to be an intensive dialogue between different parts of the Government and the international community, to work out based on an agreed national security strategy and threat assessment the trajectory of future expenditure needs and their financing requirements, so that these are consistent with a sustainable fiscal path and adequate fiscal resources for other priority expenditures.

## THE CIVILIAN OPERATING BUDGET:

1.18 Civilian government wage bill. Afghanistan's public administration and especially its civilian government wage bill have been relatively small by international standards, and the Government has exercised strong fiscal discipline since the end of 2001 in resisting pressures for unwarranted expansion of the civil service and for ad-hoc across-the-board or sector-specific pay increases. The dilemma faced at the end of conflict was that the public administration lacked essential skills, capacity, and management to deliver services to the public, reflecting among other problems the following:

- i. Attrition and atrophy during the long period of conflict, with many civil servants killed or forced to flee, and those who stayed in government lacking opportunities for training and learning, and often not permitted to carry out their professional duties. There was also considerable recruitment of unqualified and low-skilled staff into government at various times during the conflict.
- ii. Extremely limited supply of and very tight labor market conditions for professional, technical, and managerial human skills, aggravated by the high demand for qualified people (at high rates of pay) from the international community.
- iii. Low salaries (averaging around \$50 per month including benefits) with enormous compression (i.e. a negligible difference between the pay package of top grades and bottom grades in the civil service). This meant that whereas the pay package for unskilled positions was near to or possibly even above the market wage level, pay for top management and technical positions – requiring well-qualified people – was so low relative to the market that such people could not be retained, let alone attracted into the civil service. It also meant that across-the-board pay increases, for which there has been considerable pressure, would not have a significant impact in terms of improving the quality of the civil service or attracting well-qualified people.

1.19 Facing these severe problems and tight fiscal constraints but also the urgent need to build essential capacity in the civil service, the Government has pursued a multi-pronged approach. Right from the beginning international capacity was brought in to handle some critical functions (like centralized procurement). Strong efforts have also been made to ensure that civil servants are paid regularly on time, which have achieved considerable success, while improving monitoring of the payroll. Pressures for ad-hoc pay increases have been resisted for the most part successfully, but in order to build more sustainable capacity the Government initiated the Priority Restructuring and Reform (PRR) process. The PRR allows core departments and ministries of the Government to restructure and, based on transparent selection of qualified people for designated positions, pay them much more (up to \$300 per month), based on a decompressed salary structure). In addition to the PRR there are several other schemes with even higher pay (up to \$2,000 per month maximum) to attract top managerial and technical talent into the government. The PRR and these other mechanisms are transitional devices to build capacity in the short run until a comprehensive pay and grading review is undertaken to revise the civil service salary structure while also addressing the issue of staff lacking necessary skills and qualifications.

1.20 In terms of fiscal sustainability, a key issue is that in order to build an effective civil service, the government wage bill will need to grow significantly and continue to rise modestly as a share of GDP in coming years, as projected in *Securing Afghanistan's Future*. This will need to be carefully managed in view of fiscal constraints. Specific approaches include the following:

- i. **There is a firm commitment to avoiding excessive recruitment into Government and ad-hoc pay increases** that don't yield results in terms of greater effectiveness of the civil service.
- ii. **The progress of the PRR process and associated issues will be reviewed, with the objective of ensuring that the PRR is fully aligned with its objectives** in terms of implementation.
- iii. **The pay and grading review for the civil service is underway.**
- iv. **Decisions affecting the government wage bill will fully take into account the fiscal implications** within a sustainable medium-term fiscal framework.

1.21 Operation and maintenance (O&M) and its sustainable financing. In addition to human and physical resources, effective delivery of public services requires that these public sector assets have the non-salary resources needed to carry out activities and deliver services (i.e. non-wage O&M). This category of budget expenditures is often neglected in many developing countries, leading to ineffective service delivery – deteriorating roads and irrigation systems, power shortages due to lack of fuel and spare parts, agricultural research institutions whose staff do not have resources to conduct research and experimentation, teachers without teaching materials, health facilities without essential drugs, dilapidated government buildings, and the like. The factors behind chronic under-spending on non-wage O&M can include the following:

- i. Investments in large infrastructure and service networks without full consideration of how the downstream O&M requirements will be financed.
- ii. Lack of cost recovery for public services, whether through low pricing (or free provision) of the service or due to inefficient, non-commercial functioning of the public entity providing the service.
- iii. Short-run protection of the wage bill at the expense of non-wage O&M in the face of fiscal resource shortfalls, which is understandable but detrimental to service delivery.

1.22 In Afghanistan the long period of conflict when public facilities were destroyed or not maintained; especially severe fiscal constraints; lack of capacity; slow budget execution; and hyperinflation which sharply eroded the real value of charges and fees for public services, along with other factors, have combined to make this problem even worse. While the physical and human capital investment requirements arising out of the conflict and the urgent need for development in Afghanistan are obvious and much discussed, the associated non-wage O&M requirements which are critical for success do not get as much attention. Despite some improvements in the last year, provinces still have small non-wage budget allocations and even lower actual expenditures, while in the districts the problem is even worse. The large public investment program in the highway sector which is well underway will generate substantial requirements for road maintenance in coming years, as will other public investment programs still in their infancy, such as irrigation and power. And in social services, ensuring that service providers have adequate complementary material inputs to do their jobs is a prerequisite for successful expansion of service delivery with adequate quality.

1.23 Key approaches to ensure that the public assets and service delivery networks created by public investments are well-maintained and deliver results include the following:

- i. **Enhancing the multi-year dimension of the budget (including ordinary budget components) and giving expenditures a medium-term profile**, including a medium-term fiscal resource envelope to guide the budget process.

- ii. **Moving over time toward integrating the budget process for the ordinary and development budgets.**
- iii. **Taking fully into account the downstream recurrent cost implications of public investment projects**, at the time decisions on whether to move ahead with the projects are being made.
- iv. **Improving management of public sector service providers**, including commercialization where appropriate.
- v. **Enhancing cost recovery for public services where this makes sense economically and socially**, e.g. for power, highways, and irrigation.

1.24 In many cases, public infrastructure and other services are delivered by state-owned enterprises (SOEs). The Ministry of Finance is responsible for financial oversight of most SOEs and has moved forward with identification of 71 SOEs, information gathering, and categorization of SOEs in terms of whether they are candidates for privatization, liquidation, or continuing as SOEs with necessary improvements.

### **THE DEVELOPMENT BUDGET**

1.25 Although there have been improvements in the budget process in recent years, major problems remain with the development budget, which faces the following key issues and constraints from the perspective of the fiscal system and fiscal sustainability:

- i. Although the development budget is organized along programmatic lines, in many programs it still lacks cohesion, consisting of isolated projects funded by different donors.
- ii. The sheer number of projects in the development budget (some 900), and the lack of prioritization among them, constitute a serious problem, with adverse implications for the role of the budget as central instrument of policy, for the efficiency of spending, and potentially for fiscal sustainability due to downstream recurrent cost implications.
- iii. There is considerable unevenness in the quality of the development budget in different sectors, which then may influence donors' funding decisions in directions not fully consistent with national priorities.
- iv. The development budget includes a large component of normal recurrent costs of government, notably in the security sector; this raises serious fiscal sustainability issues as these costs, currently externally funded, will sooner or later find their way into the ordinary budget, with major implications for fiscal sustainability.
- v. Although three-year Public Investment Programs (PIPs) have been developed, the multi-year dimension of the development budget is still weak, and linkages with the ordinary budget extremely limited.
- vi. The development budget suffers from highly fragmented financing most of which does not go through Government channels, as well as uncertainty about financing which typically leads to late approval of the development budget well into the fiscal year; being to a large extent un-financed at the beginning of the fiscal year, the external development budget is not subject to a clear resource envelope.

1.26 Factors behind these problems include, among others, very limited capacity in many line ministries; fragmented donor financing with limited Government and Ministry of Finance control especially in the case of the external development budget; and severe timing problems due in part to differing financial years and budget cycles across donors. All of these problems contribute to slow and delayed implementation of the development budget.

1.27 The way forward in improving the development budget includes the following key elements:

- i. **Aligning the development budget with the National Development Strategy** that the Government will be preparing in coming months, which will improve the development budget's coherence and prioritization.
- ii. **Enhancing the multi-year dimension of the development budget** and moving over time toward integration of the budgetary process for the development and ordinary budget as indicated above.
- iii. **Building the capacity of lagging line ministries** to develop sector programs and improve the quality of their development budget proposals (as well as their capacity to ensure implementation of their development programs).
- iv. **Sharply reducing the number of projects listed in the development budget**, initially by removing those that have been repeatedly submitted over several years and have little or no prospect of getting funding, and in the future using clear and transparent criteria to prioritize among development project proposals.
- v. Ensuring that as part of the budget process, **public investment decisions are made with downstream recurrent cost implications fully taken into a consideration** as noted earlier.

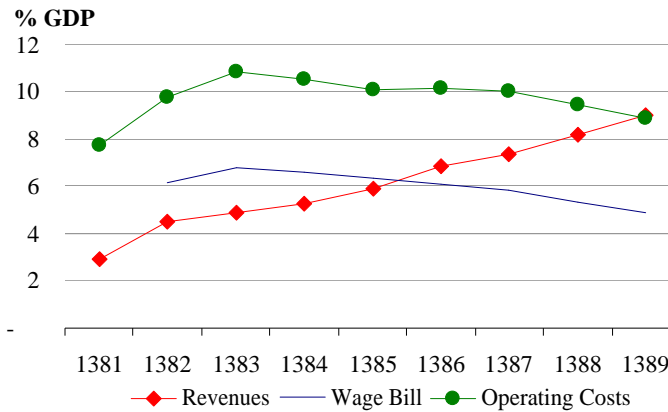
1.28 Support from the international community will be essential for a better development budget, taking into account that it will continue to be entirely externally financed in the immediate future. While an adequate level of external financing is critical, the modalities by which that financing is provided will be equally important. Harmonization both procedurally and with Afghanistan's national priorities, flexibility, and over time increasing the share of development assistance that is in the core budget as opposed to the external budget – all of these will enhance the effectiveness of foreign assistance.

#### **A PARTNERSHIP TO ACHIEVE FISCAL SUSTAINABILITY**

1.29 More generally, addressing the issues outlined above and moving toward fiscal sustainability will require a continuing strong long-term partnership between Afghanistan and the international community, building on the very good partnership that already exists. This not only will involve financial support but also cooperation and the strongest possible efforts by all stakeholders to make the assistance work better.

1.30 The dilemma of fiscal sustainability for Afghanistan is illustrated by some rough projections of overall budgetary aggregates, shown in Figure 1.4. Without a major revenue mobilization effort, with planned scaling up of the size and cost of the security sector, and with large increases in the cost of civilian government (e.g. through generalization of PRR salary scales throughout the civil service, contrary to the intention of PRR), progress toward fiscal self-sufficiency will be extremely slow with long-term dependence on external financial support for the ordinary budget. This is a fiscally unsustainable scenario over the long run.

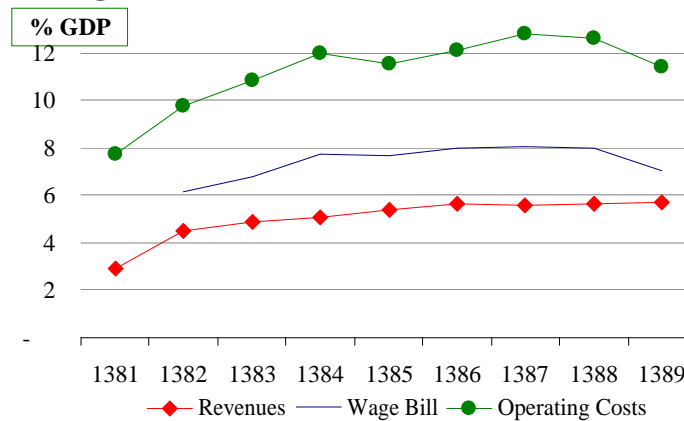
**FIGURE 1.4: AN OPTIMISTIC FISCAL SCENARIO**



Source: World Bank (2005) Public Finance Management Review

1.31 At the opposite extreme (and optimistically), with strong efforts to mobilize revenue and over time bring Afghanistan toward a normal pattern of revenue generation by poor developing country standards, with ultimately a considerably smaller and less costly security sector, and with slower growth of the civilian government wage bill, Afghanistan moves steadily toward a situation where the entire public sector wage bill (including security) can be financed by domestic revenues relatively soon and fiscal sustainability is attained within the seven-year projection period (Figure 1.5).

**Figure 1.5: An Unsustainable Fiscal Scenario**



Source: World Bank (2005) Public Finance Management Review

1.32 While taken as a whole this latter scenario is probably unrealistic (and too low civil service salaries would be inconsistent with sustainable government capacity building), these projections do illustrate some key points:

- i. **The importance of revenue mobilization.**
- ii. **The large impact of the security sector on fiscal sustainability.**
- iii. **The need to maintain control over the civilian government wage bill** and for wage increases to be cost-effective in terms of building sustainable capacity in government.

- iv. **The need for consistency of expenditure plans across government with the medium-term resource envelope** (including external budget support, in particular for the ordinary budget); for example if a security sector along the lines envisaged is to be developed as a matter of top priority, this has significant implications for the ordinary budget and for external budget support.

1.33 We look forward to an intensive and open dialogue with the international community on fiscal sustainability, and to building the long-term partnership that this requires.

## **PUBLIC ADMINISTRATIVE REFORM**

### **INTRODUCTION**

2.01 The Government's reconstruction and development vision requires an effective central government that re-establishes the national unity of the country on the basis of strong institutions and the rule of law. The Government has set out several specific goals in this regard:

- i. A well functioning and well structured security sector, based on institutions that facilitate a return to normalcy in the political, economic and social spheres;
- ii. An effective public administration that is small and focused on core functions, more diverse and decentralized, better skilled, equipped and managed, more accountable and more representative in terms of gender and ethnicity; and,
- iii. A budget that is affordable and sustainable on a multi year basis and enables delegation of authority based on strong accountability mechanisms.

2.02 Building an effective public administration is critical to the achievement of a strong and stable state for Afghanistan. The effective design and delivery of government services and infrastructure in Kabul - but particularly in the provinces and districts - requires an administrative structure, supported by a professional civil service, that is capable of managing and supervising public resources for the achievement of the government's objectives. Achievements in the area of public administration reform are essential to be assured that Afghans are in charge of running the state – i.e. of both making policy and implementing it throughout the country. Conversely, a weak and ineffective civil service threatens to be the binding constraint to the Government implementing its reconstruction and development strategy as quickly and comprehensively as needed.

### **A "VISION" FOR THE FUTURE CIVIL SERVICE**

2.03 Planning to date for civil service reform has been based on four key assumptions:

- i. Afghanistan is aiming for 'small government' whose role will, as far as possible, be limited to ensuring the security and safety of citizens, creating an enabling but properly regulated environment for the private sector, and ensuring that all citizens have access to basic services;
- ii. The civil service serves the executive branch of government. The role of civil servants is to assist Ministers to formulate and implement policies, but responsibility and authority for policy decisions (and, ultimately, for implementation) rests with Ministers. Ministers and other political officials are not civil servants;
- iii. Civil servants are employed by the state, not by the individual government Ministries and agencies to which they may be appointed. The body or bodies designated to recruit and appoint civil servants act on behalf of (and are answerable to) the state, not the executive; and,
- iv. Within the civil service there will be a number of broad categories of employees. Terms and conditions of service may vary between these categories.

2.04 Based on these assumptions, discussions to date have offered a vision for the future civil service along the following lines:

- i. The civil service will remain small, as at the present, but more focused. Non-core functions will have been hived off, including state-owned enterprises and functions that can be equally or better carried out by private sector contractors or NGOs;
- ii. It will gradually become more diverse and decentralized. Structures and management systems will be designed around the tasks to be performed;
- iii. It will be driven by an accountable, results-based ethos and will be progressively better skilled, equipped and managed, and will become more representative of Afghan society in terms of gender and ethnicity; and,
- iv. The civil service will be bound by common ethical principles that are rigorously enforced.

### **THE PUBLIC ADMINISTRATION REFORM PROGRAM**

2.05 The Government's Public Administration Reform Program (PAR) describes a framework for a series of programs and projects that, together, will build a sound legal, administrative and physical environment in which civil servants can function efficiently and effectively, and be held to account for their performance. The Independent Administrative Reform and Civil Service Commission (IARCSC) is taking the lead in coordinating and monitoring implementation of activities under the PAR program. The PAR Program, consists of six major components (as outlined in Table 2.1 below) complementing the work of the Ministry of Finance in improving financial management and accountability. A Ministerial Advisory Committee (MAC) supports the Chairman of the IARCSC in managing the reform program. The Committee provides an important degree of political legitimacy for the difficult choices that must inevitably be made.

2.06 The IARCSC comprises a Civil Service Management Department, with responsibility for developing a new Civil Service legal framework (including a Code of Ethics) and modern human resources management policies and procedures, the Independent Appointments Board, charged with the protection of merit in appointment, the Independent Appeals Board that will hear complaints from civil servants against unfair, illegal or discrimination in the workplace, and an Administrative Reform Secretariat to coordinate the overall program of reform.

### **ACHIEVEMENTS TO DATE**

2.07 Achievements on the public administration reform agenda have been impressive (Box 2.1), particularly given the weak administration in place when the Interim Administration took control of government in early 2002. In brief: the size of the civil service has remained relatively small and contained; senior level appointments are handled by an Independent Appointments Board (IAB) and subject to open competition and merit-based procedure; an Independent Appeals Board has been established to handle complaints from civil servants; a draft Civil Service Law and employment Code of Conduct has been prepared; civil service reforms are moving through a Priority Reform and Restructuring (PRR) process, under which core departments can reorganize themselves, build capacity and pay qualified staff higher salaries; a Pay and Grading Review has commenced; work is ongoing to establish a new and permanent pensions system, a coherent capacity building framework for the civil service has been introduced and includes the Lateral Entry Program (LEP), the Afghan Expatriate Program (AEP), the Technical Assistance and Feasibility Studies Unit (TAFSU) and a framework for training and development; a Parliament Secretariat has been established; and cabinet rationalization reducing the number of ministries has been agreed.

Table 2.1: Public Administration Reform (PAR) Program

Component	Priorities
<b>Policy Development and Machinery of Government</b>	(i) Establish Cabinet Secretariat; (ii) Rationalize Office of Administrative Affairs; (iii) Strengthen policy development capacity within ministries through senior staff training program; (iv) Develop and implement procedures for reporting to the legislature; (v) Develop and implement framework to support Cabinet incorporating existing decision-making bodies; and, (vi) Implement framework for rationalization of ministries/agencies.
<b>Institutional Streamlining and Development</b>	(i) Enforce budget caps on headcount; (ii) Increase number of employees under Priority Reform and Restructuring (PRR); (iii) Establish Healthcare as a separate service with specialized employment conditions; (iv) Establish Education as a separate service with specialized employment conditions; (v) Develop and implement a plan to shift balance of civil servants from Kabul to the provinces; (vi) Develop and implement a framework for outsourcing non-core functions (e.g. catering, maintenance); (vii) Develop and implement a framework for state-owned enterprise (SOE) reform (viii); Establish a Government Land & Property Commission and, (ix) Implement a support structure for Parliament (i.e. infrastructure and support staff).
<b>Civil Service Law</b>	(i) Establish a new civil service law; and, (ii) Implement new employment regulations.
<b>Personnel Management</b>	<p><b>(a) Payroll and Establishment Control Systems:</b> (i) Implement HR database, with complete data set for all civil servants; (ii) Implement an HR management system linked to the government payroll system; (iii) Conduct a civil servant census to verify completeness and accuracy of HR data; (iv) Reform the bonded trustee system – replacing it with formally contracted agents or with individual accounts, as feasible; and, (v) Decentralize the HR management system and delegate maintenance to provincial government.</p> <p><b>(b) Policies, Procedures and Practices:</b> (i) Issue interim guidance on merit-based appointments accompanied by civil service-wide training; (ii) Issue further interim guidance on other aspects of personnel management, including principles of equity and special needs of working women; (iii) Issue a personnel management handbook based on new employment regulations; and, (iv) Complete service-wide training on all aspects of personnel management.</p> <p><b>(c) Employment Contracts:</b> (i) Develop standard civil service employment contracts; (ii) Transfer all PRR staff onto new employment contracts; and, (iii) Transfer all remaining staff onto new employment contracts.</p> <p><b>(d) Appointments Procedures:</b> (i) Strengthen the IARCSC Appointments and Appeals Boards with additional, trained staff; (ii) Ensure all senior appointments follow merit-based procedures, including IARCSC audit; (iii) Develop and implement procedures to audit non-senior appointments; and, (iv) Implement a rolling audit program of non-senior appointments in 3 ministries/agencies per year.</p> <p><b>(e) Capacity Building, Training and Development:</b> (i) Review possibility of appointing a secretary-general in each ministry with overall responsibility for performance and resources; (ii) Appoint 400 interim contract staff to plug critical senior and middle management-level capacity gaps; (iii) Appoint 1,000 entry-level civil servants on fast-track program; (iv) Conduct a civil service training and development needs analysis (focusing initially on senior PRR staff); (v) Develop and implement a civil service-wide training program (focusing initially on senior, PRR staff); and, (vi) Establish a permanent institution to train and develop senior civil servants and including accelerated opportunities for women.</p> <p><b>(f) Gender and Ethnicity:</b> (i) Establish gender and ethnicity targets in the civil service workforce; and, (ii) Develop and implement a 10-year plan for achieving gender and ethnicity targets.</p> <p><b>(g) Civil Service Pay and Grading:</b> Implement a new pay and grading structure based on realistic labor market comparisons.</p> <p><b>(h) Pensions and Other Post-Service Benefits:</b> (i) Conduct a review of existing pension arrangements; and; (ii) Implement new pension and other post-service benefit arrangements.</p> <p><b>(i) Retraining, Re-skilling and Redeployment (RRR):</b> Agree and implement a scheme for Retraining, Re-skilling and Redeployment (RRR) (target: 60,000 civil servants).</p>
<b>Administrative Efficiency</b>	(i) Implement annual reporting of improvements in efficiency and services (starting with PRR functions); and, (ii) Implement performance appraisals for all senior civil servants (starting with those on PRR pay scale).
<b>Physical Infrastructure</b>	(i) Basic office facilities package delivered to districts; (ii) Infrastructure enhancement for all provincial centres; and, (iii) Infrastructure upgrading for central government.

**Box 2.1: Achievements on Public Administration Reform (PAR) To Date**

**Small and Stable Public Employment**

- By international standards, public employment in Afghanistan is relatively small and stands at 380,000;
- Civilian employment has remained stable over the last two years (except for teacher recruitment) and the Government has shown discipline in maintaining a lean public service.

**Independent Appointments Board**

- Committed to open competition and merit-based recruitment;
- All Grade Two posts and above are filled through merit-based recruitment by the IAB;
- All Grade Three appointments and below are monitored by the IAB;
- Development of a three-year Strategic Business Plan;
- Nearly 2000 civil servants have been recruited through merit-based procedures.

**Independent Appeals Board**

- Establishment of an Independent Appeals Board for the first time in Afghanistan;
- Evaluation of 107 appeals in areas of recruitment, termination of employment and transfers to different government department/agency.

**Civil Service Law**

- Draft Civil Service Law and employment Code of Conduct prepared and awaiting Cabinet approval;
- Draft Civil Service Law Regulations being written.

**Pay and Grading**

- Pay and Grading Review has commenced and hundreds of civil service positions and job descriptions evaluated;
- Gathering of data for pay comparator purposes from a representative selection of donors/NGOs and private sector employers in Kabul and the region has begun.

**Pensions Reform**

- Short-term temporary policies and long-term permanent pensions system being devised.

**Capacity Building Framework**

- *Priority Reform and Restructuring (PRR)*: 100 departments from various at central and sub-national level have been restructured and reformed and 12,100 posts had received PRR approval for the new pay scale’;
- *Lateral Entry Program (LEP)* has been approved by the ARTF Management Board and the pilot phase is soon to commence;
- *Afghan Expatriate Program (AEP)*: 30 Afghan expatriate experts have been recruited in specialist advisory positions.

**Training and Development**

- Preparations are underway for the establishment of a civil service training institute;
- A comprehensive plan has been agreed and implementation has commenced to renovate and equip training rooms for over 30 ministries, agencies and municipalities and a draft training and development strategy for the civil service at central and sub-national level in accordance with the government’s standards, rules, regulations and procedures has been developed with leadership training for 550 civil servants over two years to commence in May;
- Nearly 2000 civil servants have received training in IT, English and management and a plan has been produced to provide training to 4000 civil servants over the next 12 months in IT, English, basic office skills, project management, procurement, communication, financial management and other specialized areas.

**Parliament Secretariat**

- Interim Parliament Secretariat has been established;
- Senior Management Team has been appointed and recruitment of remaining 100 posts is in process.

**Reform of the Office of Administrative Affairs (OAA)**

- A group of experts has been trained to Conduct Cabinet business;
- A plan has been developed to incorporate the existing central decision-making bodies within a more coherent framework and a plan has been developed to rationalize the OAA.

**Sub-national Administration**

- Governor’s office in Balkh has been PRRed and a plan has been developed to PRR Governor’s offices in the north, northeast and west of Afghanistan;
- Civil Service Commission has established regional sub-offices in Mazar-e-Sharif and Herat.
- 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 mostly being submitted on time; and, the single expenditure and revenue accounts are working well.

**Rationalization, Re-skilling and Retraining (RRR)**

- Presidential decree has been signed granting salaries for two years for employees for whom a position has not been found following PRR and a paper on RRR has been prepared and is being discussed by the Cabinet.

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## CAPACITY BUILDING FOR IMPROVED SERVICE DELIVERY

2.08 **Overall Approach:** As government has regained its legitimacy, and as public and donor expectations rise, the government finds itself inevitably with very limited capacity. In addition, and perversely, it finds itself competing for skilled staff with some of the same international agencies that are funding the recurrent expenses of the civil service for staff. As *Securing Afghanistan's Future* noted, "action is needed on the issue of the twin public sectors". That is, donors simultaneously fund their own and the international agencies' bureaucracies, while also underwriting the civil service bill for the government. This requires coordinated action including major investment in human capital and a commitment to invest in innovative schemes to level the playing field between the international agencies and the government as competing employers.

2.09 In response to this challenge, and in order to meet critical capacity gaps in the civil service, in as coherent a manner as possible, the government has developed a capacity building framework (see Table 2.2 below). The capacity building framework provides mechanisms for attracting skilled staff from three separate labor markets. First, the enhanced salaries available under the Priority Reform and Restructuring (PRR) program (referred to below) provide a vehicle for encouraging skilled staff within the public sector to remain. Second, a range of programs, including the Afghanistan Expatriates Program, seeks to attract expatriates from the international labor market. Finally, the Lateral Entry Program, along with the PRR super scale provides a mechanism for attracting skilled staff from the private sector and the regional labor market including staff in NGOs and international agencies. These programs have been designed to make the Government/Civil Service more attractive as an employer in the short term until such time as a full pay and grading review is completed and takes effect.

2.10 The Lateral Entry Program is particularly distinctive in that it places staff in line positions within Ministries and agencies. Hence although it's primary purpose is to attract and retain staff from the private and NGO sectors, nationally and in the region, it could also have some value in placing skilled internationals directly into key managerial or technical positions. The LEP complements the PRR super scale posts as it is primarily targeted at ministries/departments and agencies where the PRR process has been slow to take off. LEPs will therefore assist in moving forward the government's PRR effort.

2.11 The Capacity Building Framework enables Government to compete successfully for skilled staff, strengthening critical departments and reducing the need for external technical assistance and for donor top-ups that undermine staff loyalties to government.

**Table 2.2: Capacity Building Framework**

	<b>Existing civil servants who want to be retained</b>	<b>Expatriates, brought in on advisory positions for a limited period of time</b>		<b>Skilled Afghans working in the NGO and private sectors and in the region<sup>1</sup></b>	
<b>Key design features</b>	<b>Interim Additional Allowances under PRR</b>	<b>Afghan Expatriate Program</b>	<b>TAFSU</b>	<b>Lateral Entry Program</b>	<b>PRR Super scale</b>
Parameters	Key officials in PRR approved agency	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 - \$7000 and exceptional levels	\$100 - \$700 per day and DSA at UN rates	Up to US \$ 2,000	Up to \$2000
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	TAFSU with international advertisement/ recruitment, clear focus on the region, sole sourcing exceptional.	Appointments confirmed by the IAB and then contracted to ARS.	IAB assisted by TA's and dedicated IAB commissioners.
Numbers	1383, possibly 15,000 civil servants will be transferred to IAA scale	60 in total	80 in 1383	Year 1: 500; Year 2: 1,450; Year 3: 968; Year 4: 135 <sup>2</sup>	Year 1: 1000 Year 2: 500 Year 3: 500
Indicative Costs	US \$ 35 million in 1383 Civil Service Reform Fund	US \$ 5.0 million from ARTF and other donors	US \$ 4 million from ARTF and other donors	US\$ 64.7 million	US \$ 10 million from CSRF
Reporting and accountability	Line ministry with individual contracts	Line minister and monthly reports to EC and MAC. End of contract sign off by Executive Committee	To line minister	Line Minister, performance 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 TOR.	Ministry makes a request with a detailed TOR to TAFSU	Ministry to write to ARS once to justify numbers requested under LEP	Write to MAC where PRR is approved and justify each position. Justify new position with new PRR.

<sup>1</sup> PRR super scale 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.

<sup>2</sup> These totals are the target numbers actively working in each year – taking into account attritions and extensions.

**2.12 Priority Reform and Restructuring (PRR):** The PRR program is a key component of the capacity building framework and of the overall administrative reform and restructuring effort within government. It was introduced as an attempt to solve three inter-related problems within civilian government (i) Ad-hoc, fiscally unconstrained wage increases (ii) perverse pay incentives due to extreme compression of the pay structure and (iii) civil service pay seen as social safety net rather than performance-based. PRR sought to mitigate these problems by establishing a system of pay reform that is (i) subject to a hard budget constraint; (ii) decompressing; and (iii) intrinsically linked to improvements in efficiency and service delivery. The PRR process (as outlined in Box 2.2) allows the staff of entire ministries and agencies or selected departments undertaking particular, high-priority functions to be placed on an elevated pay scale for a fixed term in exchange for restructuring. PRR status is to be granted on the basis of the quality of the proposed restructuring strategy.

**Box 2.2: The PRR Process**

**Applications for PRR status undergo a two-stage process:**

In Stage One, proposals to be considered for PRR status must be made in writing to the Chairman of the Independent Administrative Reform and Civil Service Commission (IARCSC), with relatively simple documented evidence that urgent reform of the agency's function is required, and that a suitably skilled task force is available to lead and manage the reform and restructuring process. The Administrative Reform Secretariat (ARS) of the IARCSC evaluates the application and submits its recommendation for approval or rejection to the Chairman. In consultation with the Ministerial Advisory Committee on Administrative Reform (MAC), the Chairman makes the final decision on whether or not to allow the application to proceed to stage two.

Stage Two requires a more detailed proposal, including the expected improvements in efficiency and cost-effectiveness, with documented evidence that the relevant function has been comprehensively reviewed, identification of the posts recommended for transfer to the IAA scale, and a full costing of the proposed changes, with evidence that these have been discussed and agreed with the Ministry of Finance. These procedures have been recently strengthened to ensure that Stage Two proposals are evaluated and either approved or rejected through the same formal channels as Stage One applications.

**4.13** Although PRR should be seen in the context of the broader direction for civil service reform, first and foremost it is a pragmatic short- and medium-term measure for attracting some capacity back into government and for keeping capacity in government. The intent was that PRR would provide interim pay and capacity relief until a substantive pay and grading review takes effect. When the pay and grading review is completed, it is anticipated that the Interim Additional Allowance (IAA) scales created under the PRR will cease and the PRR upper scales will represent the top of a new civil service pay scale. Thus the pay and grading review will rationalize all temporary structures created through the PRR process, and will bring to an end the other programs that provide higher pay rates.

**4.14** A large number of ministries/agencies have gone, or are going, through the reform process in order to achieve PRR status. By the end of 1383, 12,100 posts had received PRR approval for the new pay scale. Between 10,000-15,000 could realistically be approved by the end of 1384 with adequate technical assistance. Some examples of specific reform initiatives achieved through PRR are set out in Box 2.3.

### Box 2.3: Restructuring for improved performance under PRR

Initially, the required performance bar under PRR was set intentionally low as basic changes in agencies were desperately needed both in order to re-start administrative systems and to signal across the public sector that change was possible. In some cases, as in the Road Maintenance Department, PRR helped to merely kick-start basic maintenance that had virtually ceased during the war years. In others, like the Treasury Department, PRR provided an opportunity to create a new organizational shell aligned to modern computerized treasury functions, which is being progressively filled through fresh appointments and transfers. As PRR has been rolled out, some more promising developments are observable:

**Large Taxpayers Office (Ministry of Finance):** A new entity has been created with clear management structures and streamlined functions, to focus on tax revenue from 150 large taxpayers.

**Treasury Department (Ministry of Finance):** Comprehensive systems re-engineering has been undertaken with reduced number of departments, major changes to management structure and streamlined functions.

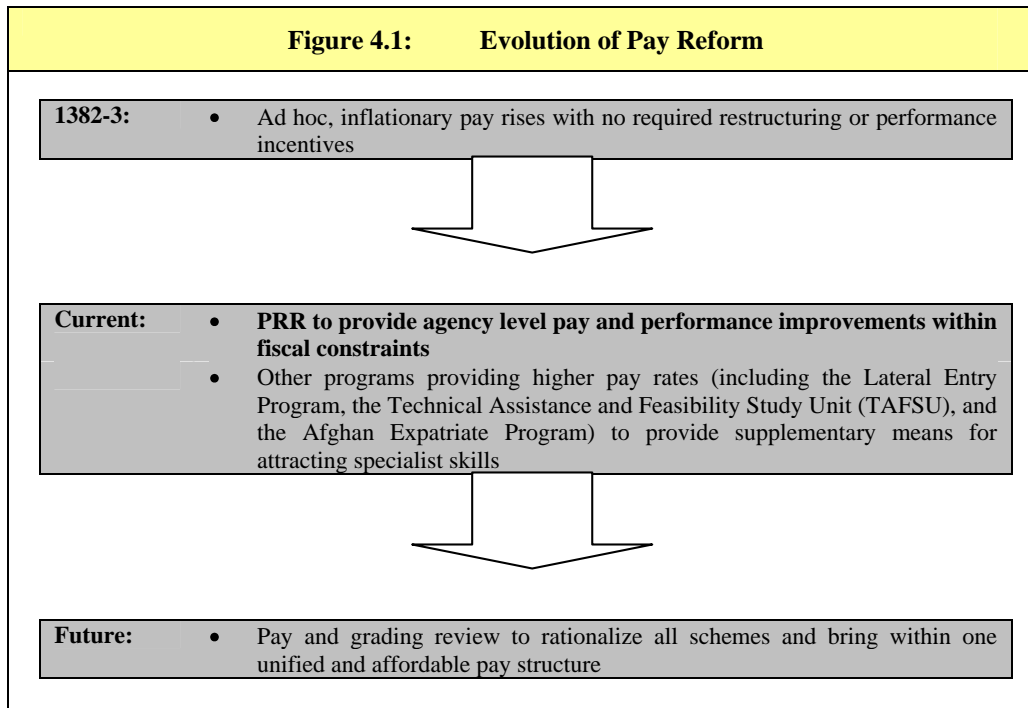
**Road Maintenance Department, Kabul (Ministry of Public Works):** Functions have been reduced and streamlined reporting and management introduced.

**Water Resources Department (Ministry of Water Resources and Energy):** A new entity with new function of water resource management has been created.

**Telecommunications Department (Ministry of Communications) and Customs Department (Ministry of Finance):** Changes to management structure, streamlined functions and improved staff training have been introduced.

4.15 PRR is intended to bridge the gap between the previous uncoordinated approach to pay and wage increases, which were seriously threatening fiscal stability, and a comprehensive, government-wide pay structure, based on market comparators and the available fiscal envelope. The evolution of pay reform in Afghanistan is shown in Figure 4.1.

**Figure 4.1: Evolution of Pay Reform**



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## REFORM PRIORITIES FOR 1384 AND BEYOND

2.16 **Continuing to make Progress on the Capacity Building Strategy.** Rapidly improving the capacity of government to manage and implement policies and programs is of paramount importance if other reconstruction and development objectives are to be achieved. Tools have been put in place to help build this much-needed capacity within the civil service. Government attention will now turn to accelerating implementation of these initiatives in addition to ensuring quality, effectiveness and fiscal sustainability of the programs themselves.

2.17 The Afghan Expatriates Program is under implementation with 30 Afghan Advisers already placed within Government ministries/Agencies. Government plans rapid implementation of the Lateral Entry Program accompanied by upgrading of capacity within the IARCSC – including the Independent Appointments Board – in order to rapidly and effectively manage recruitment under these programs.

2.18 PRR is the key tool to improve capacity within government in the short term and has led to many successes in the reform and restructuring of government ministries. However, concerns have been raised about possible weaknesses in the quality of the PRR process. The Government intends to address this issue in the immediate future.

2.19 Improving the *quality of PRR approvals* and monitoring implementation closely is essential to the credibility of the program. Strengthening the specificity of the performance targets, and ensuring that they are in fact monitored and that under performing PRR departments risk losing their status, would go a considerable way towards improving quality. This might require a review of the performance of departments that are already under PRR. In addition, for new applications, applying agencies could submit a simple list of performance benchmarks against which they will be evaluated nine months following the approval of the reforms. These benchmarks will enable MAC to decide on options, including the option of suspending an agency's reform status if performance is unsatisfactory.

2.20 Criteria for the assessment could include indicators on the size of the department before and after restructuring, or on the proportion of recruitment undertaken by open competition through the Independent Administrative Board. Ideally, and where feasible, indicators might measure service delivery. In some cases, PRR departments might be asked to develop indicators that show how reliance on other donor-funded technical assistance is diminishing as capacity increases. Such performance indicators could be provided to the MAC within the context of a strategic plan for the concerned department or ministry.

2.21 For provinces, there is likely to be a need for a slightly different approach towards improving quality and helping shift provincial administrations towards more unified and coordinated entities. This might mean a greater focus on promoting coordinated proposals that either look at a particular province as a whole or take a systematic approach to reform of Governors' Offices and Mustoufiats, rather than a ministry-by-ministry approach.

2.22 A strengthened Ministerial Advisory Committee (MAC) will be critical to ensuring and sustaining improvements in the quality of PRR proposals. MAC must have the capacity and authority to:

- i. Grant PRR status only on the basis of strong proposals with clear monitoring criteria and robust implementation plans, including the identification and mobilization of necessary resources;
- ii. Withdraw the PRR status of agencies which have clearly failed to implement modest reforms – as a last resort; and
- iii. Restrict the number of staff benefiting from Interim Additional Allowances under PRR.

2.23 **Extending Reforms to Sub-national Administration:** The provinces and districts are the administrative arms of central government outside Kabul and responsible for delivery of the government’s agenda throughout the country. Strengthening capacity at this level and extending reforms to the sub-national level, where services are actually being delivered, is critical in this regard. Many of the areas the Government had earlier identified as priorities for action for sub-national reform (see Box 2.4) are progressively being addressed. 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 mostly being submitted on time; the single expenditure and revenue accounts are working well.

**Box 2.4: Priority Areas of Action for Sub-National Reform**

- (i) **Overcoming central government bottlenecks:** resolving the problems caused for the provinces and districts by Kabul-based delays in salaries and staff appointments, under provision of the non-salary budgets, and a high-handed central administration are key to strengthening sub-national administration, building loyalty to Kabul and improving the dignity of sub-national Government
- (ii) **Enhancing on-budget sub-national transfers:** enhancing the ratio of sub-national to central Government expenditures is vital, as is improving provincial equity. This would include enhanced payroll and non-payroll transfers and the increased utilization of the Provincial Stabilization Fund as an instrument of rewarding reform effort. Increasing Treasury authority over payroll, by providing procedural guidance from the Ministry of Finance, and by enhancing oversight of the ordinary and development budget is also required;
- (iii) **Extending PRR to the provinces and districts:** extending PRR to a greater number of provincial and district departments of major ministries, and to provincial Governors and district administrators offices, is essential;
- (iv) **Developing the ASP as a ‘provincial based reform program’:** a demand driven provincial based reform program, integrating the IARCSC PRR process with the ongoing ASP and PRT program will need to be urgently established. This requires adoption of an integrated approach, within which a clearly outlined reform sequence is adopted;
- (v) **Targeting human resources and training, not just infrastructural reform incentives:** improving sub-national Governance primarily requires upgrading of administrative rules, improved staffing and improved administrative structures and buildings. It is vital that the ASP has its focus on both upgrading human capital as well as physical infrastructure in the provinces and districts;
- (vi) **Completing the ongoing pay and pension reform:** building an effective civil service requires providing a decent pay package for competent staff. The results of the ongoing pay and grading review will be the basis for establishing an affordable and acceptable pay reform package.

2.24 But there are still significant issues to be addressed:

- i. Low pay continues to be a major complaint;
- ii. The takhsis and tashkeel arrive late in many cases, and in the case of the takhsis it causes delays in pay;

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- iii. 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;
  - iv. Non-salary allotments are still low, and there continue to be inequities between provinces; and,
  - v. There is a still a lack of written manuals, and more training is needed in addition to improved physical facilities.

2.25 In terms of recruitment and staff appointments, improvements are still needed. Senior appointments are going through the IARCSC, but further efforts will be made to ensure merit based recruitment is widely practiced. There have also been movements towards introducing PRR at the provincial level, but the Government is examining the options for doing this on a more strategic basis.

2.26 While recognizing that the pace of change has to be realistic, seeking further improvements in administrative reforms at the provincial and district levels, and building capacity, is a key objective for Government so that roles, responsibilities and accountability structures among central units and local administration better reflect the Government's service delivery model. The Afghanistan Stabilization Program offers a vehicle in support of this, in a way that responds to needs and readiness in an integrated manner.

2.27 **Implementation of the Pay and Grading Reform.** In parallel with the PRR process a comprehensive pay and grading review, underpinned by a major program of job evaluation, has been launched to end the practice of "personal grades" and ensure that all position grades are realistically related to job content. In principle, such pay and grading work could have been completed prior to the launch of the PRR scheme – and in that case PRR would have amounted to a phased implementation of the comprehensive salary reform. However, pay and grading reviews are very labor-intensive and time consuming, and the likely time-scale for such a major exercise precluded this approach.

2.28 When the pay and grading review is completed, it is anticipated that the IAA scales will cease and the PRR upper scales will represent the top of a new civil service pay scale. Thus the pay and grading review will rationalize all temporary structures created through the PRR process, and will bring to an end the other programs that provide higher pay rates, including the Lateral Entry Program and the Technical Assistance and Feasibility Study Unit (TAFSU) providing short-term consulting services, and the Afghanistan Expatriate Program providing 6 month or 1 year contracts for Afghan expatriates. The pay scales emerging from the pay and grading review will be adjusted to fit within the available fiscal envelope, and will take into account labor market conditions and so would not result in significant increases for unqualified and/or low-skilled staff, as the current pay structure already provides market-level or above-market wages for such staff.

### **Fiscal Implications of PAR Reforms**

2.29 Government is particularly conscious of the fiscal implications of its Public Administration Reform program, including the various Capacity Building initiatives that have been launched. Other than the PRR and PRR Super scale, all other programs under the Capacity Building Framework are funded via donor contributions through the development budget. As such their implementation is directly related to the availability of financing from donors.

2.30 With regard to the broader public sector wage bill, Government plans to move very carefully so as not to undermine fiscal stability. The non-security Government wage bill, at US\$182 million, represents 30% of total operating expenditures for 1385. The Government has remained disciplined in its approach to recruitment into the public administration and in avoiding/minimizing across-the-board pay increases. Nevertheless, the wage bill is likely to increase, for two reasons:

- i. *Higher salaries*: the administration needs to greatly enhance its capacity to manage itself and deliver results. In addition to administrative reform, this will require attracting and retaining skilled and dedicated staff. The Government's strategy in this regard is to allow targeted pay increase in core departments and ministries that are being restructured. The Priority Reform and Restructuring program currently covers about 12,000 positions, but not all of these positions have been filled yet. Its cost is approximately US\$9 million annually per 10,000 covered positions. In parallel, and as mentioned above, a pay and grading exercise has started to prepare a more comprehensive solution to the structure of the civil service. However, it is extremely important that the higher salaries under the PRR program or that may be proposed through the pay and grading exercise, should not be applied across the board but rather only for qualified staff; and,
- ii. *Teacher recruitment*: based on projected numbers of pupils, the number of teachers would need to increase from around 110,000 currently to more than 194,000 by 1389. The annual salary cost of the larger number of teachers would be about US\$50 million (if there is no change in the average salary of teachers). The Government's intention is to keep a lean civil service, and as such there would be no other recruitment.<sup>3</sup>

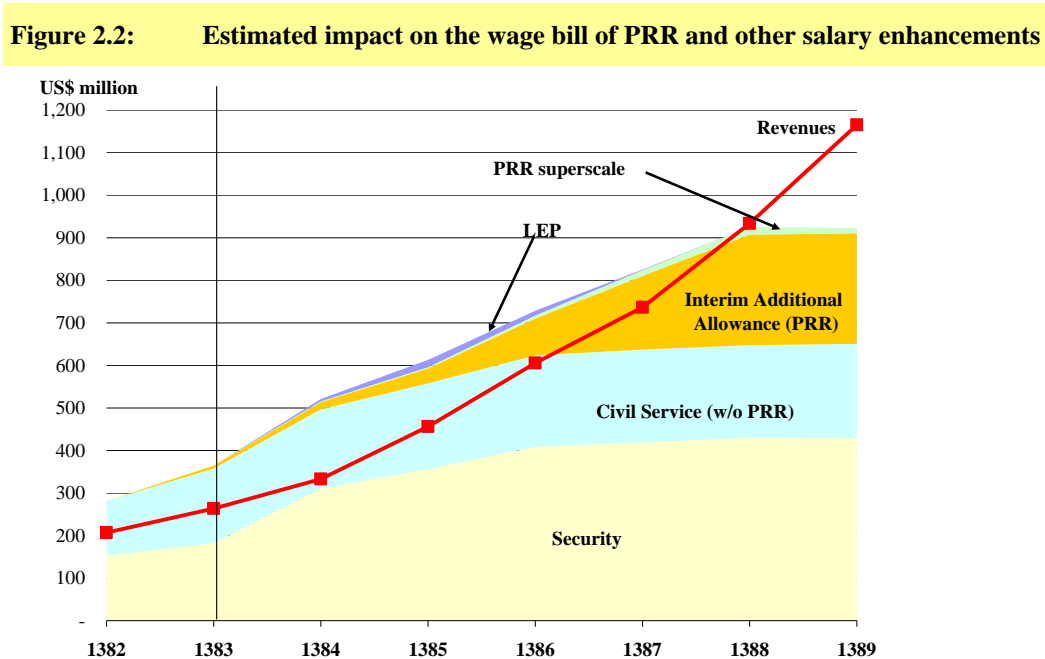
2.31 While the above drivers of the civilian wage bill are potentially significant, they represent important priorities for restoring effective governance and improved services throughout the country. At the same time, the Government is fully aware that maintaining recruitment discipline and avoiding ad-hoc across-the-board or sectoral pay increases is critical to maintain the fiscal balance.

2.32 Some concerns have also been raised that the fiscal impact of PRR, although fully costed in *Securing Afghanistan's Future* and endorsed by the donors at that time, is not in fact sustainable in the short term due to uncertainties over revenue generation. PRR was explicitly designed to ensure that ad hoc pay reforms were undertaken in the context of a hard budget constraint. Under section 8J of the schedule to the PRR decree, applicants must provide: "A full costing of the proposed changes, with evidence that these have been discussed and agreed with the Ministry of Finance." To provide the hard constraint, the budget decree sets up a "Civil Service Reform Fund" (CSRF). The purpose of the fund is "placing specified posts on an Interim Allowance scale within departments which have been granted priority reform and restructuring upgraded status". As per the PRR decree, the budget decree also indicates that amounts will be authorized for use by Ministries "only when that ministry has met the requirements set forth by the IARCSC for the use of these funds." The CSRF provides salaries for the PRR until the following year's budget when the takhsis is reassessed. New PRR applications cannot be agreed to if the fund is exhausted.

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<sup>3</sup> An exception is the creation of Parliament. Members of Parliament as well as their staff will be added to the Government's wage bill.

2.33 Figure 2.2 shows the estimated contribution of PRR and the PRR super scale (described below in more detail) to the overall wage bill.



2.34 The Government is considering several further options to ensure conservative management of the costs of PRR including:

- i. Limiting the costs of “surplus staff” by establishing separately funded "surplus pools". The staff identified as surplus during the PRR exercises must be rigorously excluded from any resulting pay rises. Keeping salaries low within this pool would reduce the pressure for new hiring, and would encourage attrition as staff leave for private sector positions or merely hold onto their current positions, without promotion, until retirement;
- ii. Reducing the cost of each PRR approval by increasing the proportion of staff that remains on the existing pay scales. PRR approvals do not imply that all staff are placed on higher salaries. For lower graded staff, the existing pay levels are probably appropriate for current labor market conditions. This proportion can be increased; and,
- iii. Identifying departments and agencies for closure. Now that the structure of the government has been decided, the MAC could list departments and agencies that are to be excluded from the PRR process on the basis that they are being wound down or merged.

2.35 Managing the transition between the current arrangements and a new pay and grading structure in a way that does not undermine fiscal stability will be essential and will require high level guidance. The government is closely examining how and whether PRR needs to be modified so as to ensure such a smooth transition takes place. Some of the proposals being considered are as follows:

- i. *Abandon the PRR super scale:* Although the numbers of staff expected to receive PRR super scale are very small, there is a risk that this program could grow beyond fiscally sustainable levels and/or that it could be perceived as an upper end to the new

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- government pay structure. This would clearly be fiscally unsustainable. Since the numbers of staff that Government envisaged would come under this program is so small, finding alternative ways to address this particular cadre of staff e.g. Lateral Entry Program, may be a less risky strategy to pursue at this stage.
- ii. *Slow down PRR approvals until some the key parameters of the new pay structure are better understood.* Moving forward with the restructuring efforts under PRR is essential. However, it is also important that PRR implementation does not lead to pay awards being granted that do not fit into a likely comprehensive, reformed pay scale for the whole of government. Until such time as there is greater clarity on the likely government wide pay scale, it could be helpful to slow down the PRR approval process.
  - iii. *Accelerate labor market surveys and amend PRR scales as necessary.* Labor market surveys are being conducted under the IARCSC's guidance to support the pay reform process. These could be accelerated and early data utilized to revise PRR scales to take into account the abandonment of the PRR super scale as well as the need to ensure close alignment of PRR pay rates with a potential new pay structure.
  - iv. *Develop standard templates and guidance for reforming departments under PRR to ensure longer-term fiscal sustainability.* While PRR is necessarily a ministry up approach to reform, there is a need for some guidance to be given to ministries with regard to the broad grading structure and numbers of staff at each grade that can feasibly be accommodated within each ministry so as to ensure a fiscally sustainable whole. Some broad templates could be developed to provide ministries with this guidance. This would also allow for central review of individual reform efforts to ensure that all proposals collectively are affordable.
  - v. *Provide Fiscal Scenarios within which the pay and grading reform can be developed.* This will primarily be the responsibility of the Ministry of Finance in liaison with the IARCSC and will be necessary to enable a pay structure to be developed that is realistic and affordable.
  - vi. *Engage the Ministerial Advisory Committee to guide the process.* The Ministry of Finance and the IARCSC will seek the guidance of the MAC in setting the parameters of the pay and grading review and guiding its implementation. High-level guidance is critical in both these areas. Implementation of the new pay and grading structure is likely to be a comprehensive reform across government. Ministries are likely to be brought into the reform on a rolling basis which may take 2-3 year years to implement. High level, and sustained leadership from MAC in all respects of this process will be needed.

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