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Local Budget and Treasury Processes

Afghanistan
Sub-National Governance Study Paper No. 2

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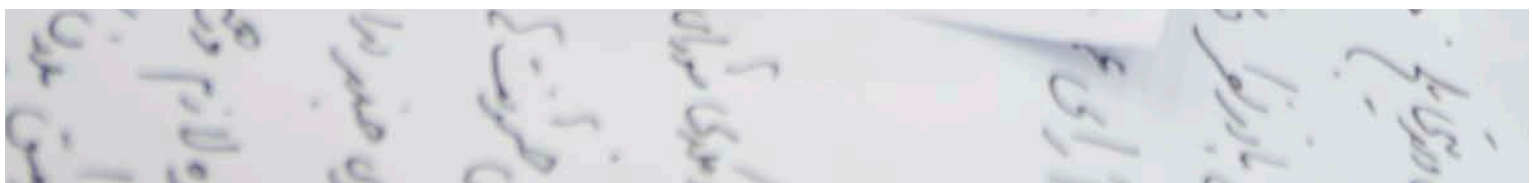


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A. Acronyms and Abbreviations

AFMIS	Afghanistan Financial Management Information System
ARTF	Afghanistan Reconstruction Trust Fund
ASGP	Afghanistan Sub-National Governance Programme
BC1	Budget Circular 1
BC2	Budget Circular 2
DCC	District Coordination Council
DfID	Department for International Development (UK)
DG	District Governor
DGO	District Governor's Office
GIRoA	Government of the Islamic Republic of Afghanistan
IDLG	Independent Directorate of Local Governance
MAIL	Ministry of Agriculture, Irrigation & Livestock
MoF	Ministry of Finance
MRRD	Ministry of Rehabilitation and Rural Development
MTBF	Medium Term Budgeting Framework
NABDP	National Area-Based Development Programme
O&M	Operations and Maintenance
PAA	Provincial Administrative Assembly
PC	Provincial Council
PDC	Provincial Development Council
PDP	Provincial Development Plan
PEFM	Public Expenditure and Financial Management
PG	Provincial Governor
PGO	Provincial Governor's Office
PRT	Provincial Reconstruction Team
SNGDS	Sub-National Governance and Development Strategy
UNDP	United Nations Development Programme

B. Executive Summary

The United Nations Development Programme (UNDP) commissioned this study to provide input for the operationalization of its Sub-National Governance and Development Strategy (SNGDS) for Afghanistan. The objective is to describe budget and treasury operations at provincial and district levels and how they relate to the central government, and to propose possible ways to improve their functioning.

Current system. Afghanistan's central administration consists of 54 government ministries, departments, agencies, offices, independent directorates, and other budgetary units. These ministries and other institutions receive budgets approved by parliament, as part of the annual national budget.

Most key central ministries are represented at the provincial level through provincial line departments. Funding for provincial line departments is included in the overall budget of their central ministries. Some ministries (like the Ministry of Education and the Ministry of Health) have departments in all 34 provinces, while others have departments only in selected provinces. The role of provinces in Afghanistan's intergovernmental system is not always clear, in part because there are several relevant actors and stakeholders at the provincial level with unclear or partially overlapping mandates, including Provincial Governors (PG), Provincial Councils (PC), and provincial line departments.

Each province has a provincial finance department or treasury office (*Mustoufiat*), which represents the Ministry of Finance (MoF). The *Mustoufiat*'s main function is to process and record financial transactions within the province as part of the MoF's central treasury system. *Mustoufiats* do not provide expenditure functions at district level, but a revenue officer is typically present.

PGs are appointed by the President, and report to the center through the Independent Directorate of Local Governance (IDLG). As a formal matter, PGs mainly have a coordination and oversight function, since the directors of provincial line departments report to their line ministries. In practice, provincial line departments face a dual line of accountability since PGs have considerable political and administrative powers, including signature authority over most procurement that takes place at the provincial level and certain powers of appointment. Furthermore, the PG has significant authority over the police and direct authority over the district governors (DG).

For administrative purposes, the provinces are subdivided into 398 districts. DGs are appointed by the President, and their primary role is to represent the government (via IDLG) and coordinate ministerial activities at the district level, insofar as their limited substantive responsibilities permit. They are also responsible for civil registration of births, deaths, and marriages. Although they do not have primary authority over the district police, they may assist in conflict resolution, through referral to the police or a local *shura*.

Some line departments are represented at district level and have permanent staff based in the districts. The Ministries of the Interior (police), Education, Health and Agriculture are represented in most of the districts. Other line departments manage district affairs from the provincial capital and visit the districts on a regular basis.

Because historical patterns are the most important factor determining the allocation of the operational budget across provinces, in many cases the distribution of funds is considered inequitable. The MoF and the donor community are supporting recent initiatives to promote a more equitable distribution of funds. For instance, the operational budget for health services is now expected to be based on the population in a province and the Ministry of Education is piloting a horizontal distribution of education funds based on the number of students. GIRoA in close collaboration with the development partners is also pushing ministries to transfer more funds for operations and maintenance (O&M) costs to their provincial line departments. The Afghanistan Reconstruction Trust Fund (ARTF) is piloting an incentive programme to increase the O&M budget, through which extra funding for the provinces is supplemented by extra money from the ARTF.

Although the recording of expenditures has been fully computerized through the Afghanistan Financial Management Information System (AFMIS), all other financial management processes are paper-based. Financial management processes in Afghanistan are in general considered to be time consuming and complicated, seriously delaying budget implementation.

Budget execution is highly centralized in most respects. Payment of staff and operational expenses for provincial departments is made on the basis of checks issued by the Mustoufiats. Employees with bank accounts receive their salary directly into their bank accounts by electronic transfer, while others receive their salary in cash (or, in some cases, through mobile money transfers).

Districts do not receive a budget allotment, and provincial offices determine which part of their budgetary funds will be used for districts' operational expenses. Provincial line departments process payments of salaries and wages to district employees. Most government employees stationed at district level are paid in cash and, given the logistical problems, in some districts this takes place only once every three months.

For O&M costs, districts may request funding from provincial offices. However, discussions with district and provincial officials suggest that O&M funding received at district level is very limited or negligible. Because the Mustoufiats do not have offices at district level and because the provincial line department's director has to sign off on all expenditure, all payments are processed at provincial level.

Reform of sub-national finance. Since 2005/06 the MoF has had a provincial budgeting unit in its Budget Department. Training has been provided to provincial staff, including PC members, in planning, prioritizing and budgeting issues. Without any discretionary funds for use in the provinces outside of the

normal budget process, the objective has been to train provincial staff and PC members to discuss and influence the central ministries' budgetary allocations and advocate for local needs. In this way, planning and budgeting would become more of a bottom-up process.

In practice the results have been limited. There is little sharing of information between different levels of government and many central ministries do not involve their provincial departments in any phase of the budget cycle, let alone representative bodies such as the PC or the DDA.

One way to break the deadlock would be to hand over real power and responsibilities to local bodies, paving the way for accountable sub-national institutions as envisaged in UNDP's SNGDS. Local authorities could receive their own discretionary budget envelope or block grant at either provincial or district level. An elected body—either the PC or the DCC—appears to be more likely to be responsive to the public. This body would decide how to use the funds, and either the PGO or the provincial line departments would carry out implementation.

Development partners have supported the local authorities substantially in the previous years but their funds were mainly provided off budget. Key mechanisms used for this purpose (especially Provincial Reconstruction Teams (PRTs)) are being dismantled and the flow of funds is drying up. To promote sustainability, donor funding for local authorities should be provided through on-budget mechanisms, within the Afghan system.

It is likely that the implementation of block grants or provincial budget envelopes would need to proceed in a phased manner, in view of the challenges:

- Unfamiliarity with the budget process on the part of the PC and DCC;
- Poor communication among levels of government, compounded by the limited time between the release of BC2 and the deadline for ministries to submit their proposals;
- Weak procurement capacity at local levels;
- Lack of reporting at local level, including by provincial Mustoufiats;
- Limited capacity in key line ministries as well, including MoF and IDLG, to take on the administration of such a complex new system; and
- Lack of a clear description of the allocation of resources in the budget proposal, to the extent that block grants are part of the budget of IDLG or another entity.

These challenges would be much greater if the intention were to introduce block grants or budget allocations at District level. This is due both the volume of budget allocations and transactions (for 398 Districts as compared with 34 Provinces) and the current lack of capacity at the District level.

C. Background

Role of this study in implementing the SNGDS

In August 2012, the UNDP released a draft Sub-National Governance and Development Strategy (SNGDS) for Afghanistan. The SNGDS is built on two pillars¹:

- Pillar A - *Building Capable and Responsive Subnational State Institutions for service delivery*; and
- Pillar B - *Empowering the population, subnational civic groups and subnational elected bodies to hold SN governments accountable, ensuring peacebuilding and inclusion.*

Pillar A aims to promote the capacities of sub-national state institutions (both local executive departments and representative bodies) at Province, District and Municipal levels to provide basic services in an accountable, inclusive, responsive manner.

The UNDP is in the process of finalizing its strategy and beginning to design an operational programme for pillar A whose goal is to provide, to the extent possible, on-budget support at the provincial and district levels. In order to do this, UNDP needs a better understanding of the current Public Expenditure and Financial Management (PEFM) processes (budget, procurement, and treasury procedures and operations at the sub-national level). UNDP therefore commissioned this study to assess and report on the full range of budget and treasury operations at provincial and district level, how these relate to the central government, and possible ways to improve them.

Objectives, Scope of Work, and Methodology

The objectives of this study are:

- To provide a clear overview of current local treasury, budget and procurement operations and procedures in Afghanistan at provincial level (and if relevant, at district level); and
- In line with the draft SNGDS, to provide a list of options how for delegating budget authority to provincial and district representative bodies. These are expected to identify:
 - Necessary adjustments in the current fiscal framework;
 - Feasibility of the options given the current constraints on capacity and financial means at local level; and
 - Related capacity building activities at local level.

¹ See UNDP *Sub-National Governance and Development Strategy* (August 2012).

The study is expected to provide a detailed and comprehensive overview, documentation and mapping of all the processes in the budget cycle at sub-national level, including an overview of applicable laws and regulations at provincial and district level. The processes to be documented are:

- Budget preparation and approval;
- Procurement; and
- Budget execution and accounting.

An important focus is on the link between the national and sub-national levels. In particular, the study was expected to explain how the central line ministries interact with their local departments and how to ensure that the local needs and priorities are incorporated in the central budget, so that central ministries and agencies present an inclusive budget document.

To this end, the study reflects a wide ranging consultative process at national and sub-national levels with involved stakeholders, including at central level representatives from the MoF, IDLG, and Ministry of Rural Rehabilitation Department (MRRD), and local stakeholders such as the Provincial Governor's office (PGO), Mustoufiat, provincial line departments, the Provincial Council (PC), and representatives from the district level.

Consultations have also taken place with relevant donors and donor projects, such as the National Area Based Development Programme (NABDP), National Security Programme (NSP), World Bank, Department for International Development (DfID) and USAID. Extensive reference has been made of existing Government of the Islamic Republic of Afghanistan (GIROA) laws, regulations and manuals, such as newly developed Treasury manuals. The study has also drawn on existing and relevant analysis and reports commissioned by development partners.

In preparing the study, three of Afghanistan's 34 provinces (Herat, Kapisa, and Kandahar) were visited and consultations held with relevant stakeholders. Afghanistan has a highly centralized public administration and, in principle, the governance framework, administrative set up, mandate, and delegated authority as well as the financial rules and regulations are expected to be similar for all provinces. Therefore, the findings for these three provinces are taken as representative for all 34 provinces.

The author recognizes that regional differences exist and that processes and procedures could be interpreted and implemented differently among the provinces. There is no evidence to suggest that the provincial dissimilarities are such that the findings and conclusions in the study are not broadly applicable to all provinces. It is nevertheless important to bear in mind the possibility that experiences and practices in other provinces or districts could be different from what is described in this study.

The responsibility for the contents and views expressed in this study rests exclusively with the author and does not reflect any other commitment.

D. Sub-National Institutions and Structures in Afghanistan²

1. Legal Basis and Role of the Central Government

The constitution provides the primary legal foundation for the public sector's sub-national administrative structure. It declares that the administration of the Islamic Republic of Afghanistan shall be based on central and local administrative units, where the central administration is defined to comprise the ministerial level ("The central administration is divided into a number of administrative units, each of which shall be headed by a minister"), while the 'local' administrative unit of the state is defined as the province.

The Constitution states that "[t]he government, while preserving the principle of centralism, shall delegate certain authorities to local administration units for the purpose of expediting and promoting economic, social, and cultural affairs, and increasing the participation of people in the development of the nation"

Afghanistan's public sector has been structured as a vertically (or sectorally) deconcentrated system, where provincial line departments are organizationally units of their respective ministries. The Public Expenditure and Financial Management (PEFM) Law defines central administration units ("state administrations") as the only budgetary units that are recognized in the budget process and the only entities that receive appropriations³ from the national budget.

The country's central administration level currently consists of 54 government ministries, departments, agencies, offices, independent directorates, and other organizations. These central government ministries and institutions are considered primary budgetary units, and they receive a budget approved by parliament.

2. The Provincial Level

Most key central ministries are represented at the provincial level in the form of provincial line departments. A provincial line department's budgetary funding is included in the overall budget allocation of its central ministry. While some provincial line departments follow a standard structure and size in all provinces, the composition of other departments varies across provinces. Some departments (like the Ministry of Education and the Ministry of Health) have departments in all 34 provinces, while other ministries have departments only in selected provinces.

Territorially, Afghanistan is divided into 34 provinces, the latest two of which (Daikundi and Panjshir) were created in early 2004. The functioning of provinces in Afghanistan's intergovernmental system is not always clear, in part

² For a detailed description of subnational structures and institutions see Boexx (2012).

³ *Appropriation* refers to an authorization made by law or legislative enactment directing payment out of government funds under specified conditions or for specific purposes.

because there are several relevant actors and stakeholders at the provincial level with unclear or partially overlapping mandates, including PGs, PCs, and provincial line departments.

Provincial Governors. Consistent with the deconcentrated nature of the provincial level in Afghanistan, each PG is appointed by the President as his representative in the province. Governors report to the center through IDLG. As a formal matter, PGs mainly have a coordination and oversight function, since the directors of provincial line departments report to their line ministries. In practice, provincial line departments face a dual line of accountability since PGs have considerable political and administrative powers, including signature authority over most procurement that takes place at the provincial level and certain powers of appointment. The PG also has significant authority over the police and direct authority over District Governors (DG). Likewise, municipalities are required to have their budget approved by IDLG through the PG.

Provincial Councils. While PGs are appointed officials, PCs are elected. Nevertheless, despite their status as elected representative bodies, PCs have only limited powers—mainly oversight of the PG and the provincial line departments.

Mustoufiat. Each province has a provincial finance department or treasury office (*Mustoufiat*), which is a representative of the MoF. The main function of the Mustoufiat is to process and record financial transactions and to collect revenue within the province as part of the MoF's central treasury system. Mustoufiats have limited presence at district level: expenditure functions are not available and, in most cases, only a revenue officer is present.

Provincial Development Committees (PDCs). PDCs are chaired by the Provincial Governor and include the directors of the provincial line departments, as well as members of the PC. PDCs have only limited coordinating and planning functions, related to the preparation of Provincial Development Plans (PDPs) and of budget requests of provincial departments (neither of which typically has had a direct bearing on the central budget).

Provincial Administrative Assembly (PAA). PAAs are chaired by the PG, and include the directors of the provincial line departments, provincial prosecutor, and Deputy Governor. DGs may also propose members of the PAA. The purpose of the PAA is to discuss administrative matters at local level and resolve any outstanding issues related to administrative financial management processes. While there is some overlap with the PDC, the PAA deals mainly with administrative and security-related coordination, while the PDC is concerned with development coordination.

3. The District Level

For administrative purposes, provinces are further subdivided into districts. There are currently 398 districts in Afghanistan. District Governors are appointed by the President and report to the PG. Their role is primarily to represent the government at the district level (through IDLG) and to coordinate

ministerial activities within the district. They are also responsible for civil registration of births, deaths and marriages. Although they do not have primary authority over the district police (who report to the provincial police chief), they may assist in conflict resolution, through referral to the police or a local *shura*.

Some line departments are represented at district level and have permanent staff based in the districts. The Ministries of the Interior (police), Education, Health, and Agriculture are represented in most of the districts. Other line departments manage district affairs from the provincial capital and visit the districts on a regular basis.

E. Local Budget and Treasury Processes

1. Budget Preparation

i. Overview

In accordance with the PEFM Law, the budget department of the MoF is responsible for organizing, coordinating, and overseeing the budget process and compiling the national budget. The cabinet's budget committee, consisting of the Minister of Finance, the Minister of Foreign Affairs, the Minister of Economy and one other Minister appointed by the President, provides close guidance. The process is carried out under a budget calendar drafted by the budget department and approved by the Cabinet. Afghanistan has recently changed its fiscal year from the solar year to the Gregorian year; as a result, the fiscal year now runs from January to December instead of April to March.

The budget process and budget in Afghanistan could be described as highly centralized. Afghanistan has a unitary budget with all expenditures and revenues from all primary budgetary units consolidated in a single budget and a single budget document. The only exceptions are the expenditures occurred and the revenues raised by municipalities.⁴

Currently the country has 54 government agencies, which are recognized as primary budgetary units⁵ and which receive appropriations from the central government. There are no primary budgetary units at the sub-national level. Provincial line departments, the governors' offices, and other sub-national institutions rely on funds provided by the central institutions for their resources.

Core budget. Afghanistan's core budget consists of two parts, the operational budget and the development budget. The operational budget covers the government's operational expenses, mainly salaries and wages and O&M costs. The development budget funds infrastructure and rehabilitation work (mainly roads, schools, electricity, and hospitals), small-scale projects at district and village level, and other programmes and projects focussing on service delivery, including many activities financed by development partners.

Some 67 percent of the operational budget is funded by tax revenues, customs duties and non-tax revenues raised by government.⁶ The rest of the operational budget and most of the development budget are funded by grants from multilateral and bilateral development partners. The bulk of the funding provided by development partners is earmarked to finance specific sectors, programmes, and projects.

⁴ Municipalities are outside the scope of this study. They receive no fiscal transfer or any other resources from the central government. In principal, they are self-sufficient. They have the authority to raise taxes to cover their expenses and finance investments. Their budget is through the governor's office approved by IDLG. They have to follow the normal financial management procedures and processes and the Mustoufiat checks to see whether they comply with them.

⁵ See annual budget 1392.

⁶ From the Annual Fiscal Bulletin 1391, published by the MoF's fiscal policy department and available at www.budget.mof.af.

The budget execution rate for the operational budget was 87 percent in 1391 for the government as a whole, with minor variations among the government agencies. The overall execution rate for the development budget was 50 percent in 1391,⁷ but some agencies performed significantly better than others.

One of the main reasons for the low execution rate is a lack of proper planning and budgeting. Many government agencies' budgets are artificially inflated. They include carry forwards of previous year's activities as well as new ones, and Ministries are typically overoptimistic about what they will be able to implement. Other reasons typically cited are weak capacity at ministerial level and the withdrawal of commitments by development partners.

Off-budget funds. A substantial part of all government institutions, infrastructure, activities, and public services at national and sub-national level is financed by so-called off-budget funds. These funds are not captured in the annual budget and are not channelled through or recorded in the Afghan financial management systems. Activities funded in this manner are implemented in a wide variety of modalities. In some cases, off budget-funds are fully owned by a government agency and only the flow of funds is outside the regular systems. On the other end of the spectrum, there are development funds financing public services without the direct knowledge and involvement of any government agency.

Particularly Important suppliers of off-budget funds financing public services at provincial level are the Provincial Reconstruction Teams (PRTs). With the withdrawal of most foreign troops scheduled by the end of 2014 and the ongoing closure of PRTs, these flows of funds will probably dry up, undermining the continuation of the corresponding public services. With limited financial resources at central level, the government will struggle to find the funding necessary to maintain the current level of services to provinces.

Budget calendar. The country's budget preparation process is guided by a comprehensive budget calendar prepared by the MoF's budget department. The calendar for preparing the 1393 budget (2014) has been published on the budget department's website⁸ and showed that the budget process would start on 5 March with the issuance of the budget calendar to the budget units and development partners. The internal process was to be finished 6 November with the presentation of the budget to Parliament.

Other important dates on the budget calendar are:

- 13 April deadline for Budget Circular 1(BC1) submissions;
- 15 May presentation of government priorities to development partners to obtain Fiscal Year 1393 commitments;
- 22 June MoF issuance of Budget Circular 2 (BC2) together with budget ceilings for budget units; and

⁷ see note 5.

⁸ www.budgetmof.gov.af.

- 24 July deadline for BC2 budget submissions.

Budget circulars. The budget process is steered by two budget circulars, BC1 and BC2. BC1 instructs all primary budget units to submit a budget proposal for the next year, containing the level of funding they need to continue their current activities and to service and operate any new infrastructure completed during the current fiscal year. Budget units also have the possibility to bring forward new priorities and spending initiatives. These new activities should be properly justified and should be in line with Ministerial and GIRoA strategy. The proposal should also contain the government's agency actual expenditure for the financial year ended, the current budget and a forecast for the two outer years.

MoF uses the BC1 submissions as input for several purposes:

- Calculation of budget ceilings for all primary budget units;
- Securing funding from development partners for new priorities and initiatives;
- Allocation of any discretionary funding across sectors and agencies; and
- Development of the Medium Term Budget Framework (MTBF).

Each ministry has a budget committee chaired by the responsible deputy minister or director general for Administration and Finance. The committee is responsible for managing and overseeing all tasks related to the internal budget process.

For many Ministries the preparation of the BC1 submission is a time-consuming process, involving all units in the ministry. However, provincial departments and provincial priorities and requirements do not seem to play a major role.

A comprehensive review of fourteen key spending Ministries in 2012⁹ revealed that in most cases a Ministry's BC1 budget submission is many times larger than the current year's budget. BC1 submissions are thus wish lists disconnected from what a Ministry realistically could absorb and implement, or what the government or donor agencies would be willing and able to finance. This makes it challenging for the MoF to use BC1 submissions as a basis for approaches to donors and consultations on how to distribute funding across the primary budget units.

Based on the BC1, deliberations in cabinet, and discussions between GIRoA and donors, the MoF prepares BC2. This circular contains the budget ceiling for each government agency, distributed between the operational and development budget and allocated across the main economic categories (salaries and wages, O&M costs, and capital investment). Ministries are required to formulate a budget proposal within those sub-ceilings, or it will not be accepted by the MoF.

Because of the wide differences between the BC1 submissions and the BC2 ceilings, the 2012 budget review cited above recommended that the BC1

⁹ See PKF (2012), *Line Ministries Review of Fourteen Key Spending Ministries, End of Phase II Report*.

process in its current form be abolished. Instead, the first stage of the budget process would be based on a high level workshop for all government agencies, with the goal of setting agencies' budget ceilings within the boundaries of a fiscal framework determined by the MoF.

ii. Provincial Input and Involvement

In principle, during the internal budget preparation process, government agencies with offices at provincial level consult their provincial staff. Most ministries call representatives from those offices for a few days to Kabul to discuss budgetary issues. They organise workshops and meetings to discuss previous and current year's budget implementation issues and the budget for the next year. Provincial departments are invited to bring forward their priorities for next year and also advocate their needs for extra staff or operational budget.

In order to be effective, provincial requests for extra funding should be properly justified, consistent with the Provincial Development Plan (PDP), and aligned with ministerial and GIRoA strategic plans. Some ministries provide training to the provincial staff on how to formulate those requests (e.g., MRRD) and some ministries have special programmes to help them during this process (MAIL). There do not seem to be official guidelines specifying how line ministries should organize this process.

In practice the input from provincial offices in the budget process varies quite significantly from province to province and from Ministry to Ministry, with limited overall impact. The main reasons typically provided for this limited input are:¹⁰

- Some provincial offices do not submit any proposal at all, even after repeated requests from the central ministry;
- A number of provincial departments submit wish lists with too many projects not properly prioritized or justified, with no clear contribution to the agency's overall strategy; and
- Others ask for items not always relevant for service delivery, such as extra offices, cars and fuel.

Another reason that Ministries find it difficult to incorporate provincial needs and priorities is that there are only four weeks between the release of the BC2 and the deadline for the submission of Ministerial budget proposals to the MoF. Thus, much of the interaction with provincial representatives takes place during the preparation of BC1 submissions. Partly as a result, provincial departments do not receive any budget envelope to guide them during this process. It is difficult to assess to what extent provincial line departments' budget proposals are discussed within the PDC, coordinated with other departments, or approved by the PC or governor's office, and it is likely that this differs from province to province. It is also not unclear whether the PDPs play a role in the preparation of provincial departments' proposals; they do not appear to have any role in budget formulation at the central level.

¹⁰ See the reference in footnote 9.

In practice, a Ministry's internal budget process is highly centralized. The headquarters in Kabul decides on any changes or increases in provincial allocations. It is difficult to draw firm conclusions for 34 provinces and an even greater number of line departments represented at provincial level, but the overall impression from available evidence and discussions is that the influence of provinces on the budget process is very limited.

Provincial development plan. Every province has a PDC, of which provincial line department directors are members. One of the main tasks of the PDC is to prepare and update annually the Provincial Development Plan (PDP). PDPs are in principle viewed as a potential starting point for resource allocation by GIRoA, and the PDP is expected to ensure that the needs of provincial residents are taken into account.

Visits to the provinces revealed that a bottom up, comprehensive, and inclusive process typically exists to develop and update the PDPs. Starting at the village level, the provincial priorities are identified and a substantial list of projects is prepared. Lengthy discussions take place between the directors of the different departments to identify next year's priority projects and a final short list is approved by the PDC reflecting those priorities.

It was unclear during the visits to the three provinces what criteria are applied to identify and select the priority projects. The PDPs that have been shared consisted mainly of a list of projects, without an underlying rationale that could be described as a real development plan. It was thus not possible for this consultant to assess the quality of the PDPs that were shared.

Following the preparation of a PDP, it is submitted to the Ministry of Economy in Kabul by the local representative from the corresponding line department. The Ministry is expected to send the relevant part of the PDP to appropriate GIRoA agencies and donors in Kabul to secure funding. For the provincial authorities the process stops once they have sent the PDP to Kabul, and they do not receive any systematic feedback or information about which projects are selected and funded by the Ministries, or why. Some provincial line department directors take the relevant part of the PDP with them to Kabul during meetings on budgetary issues.

The PDPs also play a separate role at provincial level. PDCs and PGOs use the PDP to approach the donors in their provinces to advocate their needs and secure funding. PRTs in particular use PDPs as an instrument to select projects to fund. With PRTs closing down and the reduction of external resources at provincial level, the relevance of the PDP at local level will decrease and PDCs will have to strengthen their ties with the center to remain effective.

Operational budget. A provincial line department's budget for salaries and wages is based on the approved *tashkeel* and the actual number of staff on the ground. Any increases in a provincial taskheel have to be approved by the central ministry and the civil service commission in Kabul. The budget for O&M costs is typically based on the current and previous years' allocations. Extra

allocations for O&M costs would in principle be based on extra funds needed to service new infrastructure and equipment.

In some cases, line departments apply a unit cost approach to calculate their request for budgetary funding to cover O&M costs. To do so, they count the number of cars, air-conditioning systems, and other items such as printers and multiply those by estimated unit costs on a yearly basis.

Other allocations are based on decisions taken by the President's office, which may impinge in detail on the budget process. For instance, at Presidential instruction each DG and provincial line department director receives 200 litres of fuel per month. In addition, budgets from non-spending provinces may be moved to other provinces.

Visits to the provinces revealed that in most cases, budgetary funding for O&M costs is very limited and most provincial line departments use this allocation fully. In contrast, most departments do not utilize their full budget allocations for salaries and wages, due to vacancies.

Vertical and horizontal distribution of the operational budget.¹¹ Both the vertical and horizontal distribution of funds is within the authority of a Ministry. There are no regulations from the MoF, IDLG, or the President's office describing how Ministries should allocate their funds across the provinces or the overall amount that should be given to the provinces. In practice, historical decisions and allocations are the main factors determining future operational budget allocations across the provinces, leading to a distribution of funds that is often considered to be inequitable. Although all data in Afghanistan should be treated with care, some provinces appear to receive more funding than would be expected based on population figures, while others seem to be underfunded.

The MoF and the donor community are supporting recent initiatives to promote a more equitable distribution of funds. For instance, the operational budget for health services is expected to be based on the population in a province and the Ministry of Education is piloting a horizontal distribution of education funds based on the number of students. GIRoA in close collaboration with the development partners is also pushing Ministries to transfer more funds for operations and maintenance (O&M) costs to their provincial line departments. The Afghanistan Reconstruction Trust Fund (ARTF) is piloting an incentive programme to increase the O&M budget, through which extra funding for the provinces is supplemented by extra money from the ARTF.

Vertical and horizontal distribution of the development budget. The allocation and distribution of development budget funding is in principle decided by headquarters in Kabul as well. As is the case with operational funding, it is difficult to assess to what extent provincial inputs play a role in this process.

¹¹ The vertical distribution of funds refers to the distinction between the part of a Ministry's budget that is retained at central level and the part that is allocated to the provincial level. The horizontal distribution of funds refers to the distribution of funds across a sub-national level—in the case of Afghanistan, across the provinces.

However, in contrast with the operational budget, three other stakeholders influence the distribution of 'on budget' development funds quite substantially: (i) donors; (ii) members of the national assembly; and (iii) PGs.

Individual donors may have strong preferences for certain provinces. In many cases their development funds have to go to provinces in which their troops are stationed, and/or where they have an important role in PRTs. It is not possible for the Ministries to reallocate these funds to other parts of the country.

Parliamentarians and PGs approach Ministers directly to secure development funding for their province or even district, based on their personal relationships with a Ministry's leadership or other power brokers, and are able to secure projects for their constituency or region. The Ministry of Public Works was quite open about this process.

Provincial breakdown and annex to the budget. A ministry's final budget proposal submitted to the MoF contains its core budget allocations for each of the 34 provinces, broken down between the operational and development budgets. Because development funds implemented at central level but beneficial to a province are included in the budget line for the central ministry, this presentation can underestimate the overall budget expenditures for a province.

After the budget hearings and discussions in the cabinet, the consolidated budget is submitted to parliament for approval. The final draft submitted to parliament does **not** contain the core budget allocation across provinces by ministry.

For information purposes an annex to the budget document is produced listing all the development projects by province. Parliamentarians can use this annex to check the number of projects and the amount of money available for their province. If the allocation is below current or previous year's levels, parliamentarians may request Ministries to include more projects to bring funding at the same level as the previous year. Ministries sometimes agree to these requests even if they know they are not able to implement the projects, inflating their budget proposals and negatively impacting budget execution rates.

Budget approval and appropriation. The final budget is approved by parliament and promulgated by the President. Government agencies receive an annual appropriation with their budget, distributed across the operational and development budget and across the major economic codes, 21 (salaries and wages), 22 (O&M costs), and 25 (capital).¹² Because the approved budget reflects only central agencies that are primary budgetary units and receive an appropriation, it does not show the distribution of funds across the 34 provinces.

¹² Afghanistan has a programme based budget and a Ministry's budget is also broken down across their programmes. However, the budget for the provinces is in all Ministries listed as part of one program. Thus, programme based budgeting is not relevant at provincial level and is not discussed in this study.

iii. Role of the Districts

The formal involvement of the districts in the budget preparation process is even more limited than that of the provinces. First, only a small number of ministries are represented at district level. Second, districts' inputs into the budget process are expected to be part of a bottom up process, in which their inputs should go first to the provincial level and from the provincial level to the central level. Lack of capacity, time constraints (especially after the issuance of the BC2), and the absence of a proper consultative process all constrain this in practice. Districts are not mentioned as separate budget lines in any budget document.

2. Budget Execution

Appropriation. As noted above, the internal budget proposals from ministries include information on the distribution of funds across provinces, while the final budget approved by parliament contains the appropriation for a government agency as a whole without the provincial allocation. The appropriation for the operational budget is allocated across all three of the major object codes 21 (salaries and wages), 22 (O&M), and 25 (capital), while the development budget covers only codes 22 and 25. The annual appropriation is recorded in GIRoA's AFMIS system (see below) without any location code.

Provincial authorities reported that they do not receive systematic information from most Ministries on their annual operational budget, or on development projects and development funds to be allocated to and implemented in their province. Exceptions exist, such as for the Ministry of Education and the Ministry of Communication and Information Technology.

Afghan Financial Management Information System (AFMIS). AFMIS is a fully computerized accounting system and it is the sole official system in Afghanistan for recording the government financial transactions. All the information in the official publications from the Government with information on budget spending is based on the information in AFMIS. Some Ministries have developed their own systems to record expenditure, but these systems are for internal use only and the information has no official status.

The Treasury department of the MoF operates and manages AFMIS. The financial system has been rolled out to the Mustoufiats in all 34 provinces. The central treasury and the Mustoufiats are the only ones with the authority to save data permanently into the system. The local AFMIS systems in most provinces are connected to the central system in Kabul, providing real time data on budget execution.

AFMIS has been rolled out to all central government agencies in Kabul. The administration and finance departments have the authority to temporarily save operational budget expenditure. The Treasury in the MoF enters all the financial transactions related to the development budget. Ministries have full access to core budget execution data but due to the limited number of site licenses in each Ministry, only a few staff members have real access. Budget execution

data are not widely available outside the finance and administration department. Provincial line departments do **not** have access to the AFMIS.

Although the recording of expenditures has been fully computerized, all other financial management processes are paper based, and all the forms for financial transactions have to be completed on paper before they can be approved and recorded in AFMIS.

The financial management processes in Afghanistan are in general considered as time consuming and complicated. Ministries and provincial officers struggle to comply with all requirements, guidelines, and financial regulations from the MoF. Every financial transaction consists of many steps and the involvement of many staff members at the concerned Ministry and the Ministry of Finance is required. As a result, financial processes take a long time, seriously delaying budget implementation.

Among the major impediments mentioned are the following:

- payment processes for low value purchases are as detailed and comprehensive as high value purchases; and
- the lack of delegation of authority and responsibility to lower levels within the organisation. Everything has to be signed off by the highest authority and every level in between, leading to a great number of signatures on every document (a requirement for forty plus signatures on one document is not uncommon). This is not only time-consuming, but also seriously undermines transparency and accountability within the Ministries. With everyone signing a document, no one is responsible.

i. Operational Budget¹³

There are important differences between the ways that the operational budget and the development budget are executed at provincial level. This section provides a detailed overview of the operational budget execution procedure at the provincial level.

Budget allotment.¹⁴ The first step in the budget execution process is an allotment (B27 form) prepared by the MoF allotting a quarterly budget to the Ministry as a whole. This allotment does not distribute the budget internally or across the provincial departments. Based on this allotment the line ministries prepare 34 sub-allotments (B20 forms), one for each provincial department. These forms include a two digit-coding block for the location. B20 forms are shared with the MoF and approved by the Budget department. It is within the responsibility of the central line ministry to decide on the vertical and horizontal distribution of the operational budget. There is in this process no check to

¹³ A detailed description of the accounting processes is contained in the accounting manual released by the Treasury Department of the MoF in Kabul.

¹⁴ An Allotment is the portion of an appropriation available to a department for expenditure at the present time. Allotments are cumulative: the allotted amount represents year-to-date funds that are available for expenditure as of a given period of time.

determine whether the sub-allotments are in line with original budget proposals or if the horizontal distribution is fair and equitable.

The Treasury in Kabul enters information from the B20 forms into AFMIS and the relevant B20 forms are shared with the provincial line departments and the Mustoufiats. Once a provincial department has received its B20, it is able to start spending. A provincial department receives four allotments a year. One of the reasons mentioned for the low execution rate at provincial level is provinces receive their first allotment only after approval of the budget by Parliament and the preparation of B20 forms, quite some time after the fiscal year already has started.

Minor object code. The B20 allocates the available budget not only across the major expenditure object codes 21, 22 and 25 but also across minor expenditure object codes, essentially micro managing a provincial department's budget. Ministries are allowed to move funds between the major object codes only with permission from the MoF. However, movement of funds between minor object codes is permitted without MoF approval, with a few restrictions determined annually. In 1392 the following sub-codes were not transferable to other sub-codes: costs of electricity, water, cleaning, communications, vehicle maintenance, and building maintenance.¹⁵

As noted above, provincial offices do not receive systematic information on their annual operational budget, but quarterly allotments are in general equal and equivalent to one-fourth of the annual operational budget. Some central line ministries try to take into account seasonal differences in spending.

Location code. Afghanistan's chart of accounts contains a segment that provides for using up to four digits to identify the location. Use of two digits identifies the province, while four digits identify a district. On a B20 form, a central government agency uses a two-digit code, which ensures that the funds may be spent only by the provincial office in that specific province. Neither the central ministry nor other provinces are allowed to use these funds.

Ministries do not use all four digits in B20 forms for the location code to distribute funds across districts. Thus, they effectively hand over responsibility to their provincial representatives to determine the amount of resources transferred to the districts, including how the budget will be distributed across the districts.

Approval by the Mustoufiat. To have their staff and operational expenses paid, the provincial departments have to go to the Mustoufiat. For salary and wage payments, they required to complete a series of documents, including an M41 form and supporting documents such as attendance sheets. After approval from the Mustoufiat, checks are issued which can be cashed by provincial line departments. Local employees with bank accounts receive their salary directly into their bank account by electronic transfer, while others receive their salary in cash (or in some cases, through mobile money transfers).

¹⁵ See page 25 of the annual budget for 1392.

For O&M expenses, provincial officials have to complete an M16 form along with supporting documents. The Mustoufiat checks whether all forms are completed correctly and, once correct information and procedures have been used, it either deposits the money directly into a supplier's bank account, issues a check that the line department can hand over to the supplier, or gives the line department cash to pay the invoice.

Provincial offices do not have access to AFMIS. Separate from AFMIS, they maintain a system using M20 forms to check any payment request against the allotment to ensure that there are enough budgetary funds left in the specified line item to cover the expenses. Despite this system, one of the most common reasons for Mustoufiats to reject a payment request is a lack of budgetary funds in the specified budget line. In most cases coding is incorrect and adjusting the code to a budget line that has funding left solves the issue. If provincial departments want to double-check whether sufficient funding is available, they have to approach the Mustoufiat to check availability in the AFMIS system.

Provincial Governor's signature. All operational expenses have to be signed off by the provincial line department's director. Below a modest threshold (Afs 20,000 in some cases),¹⁶ it is within the authority of a provincial line department's director to sign off on all expenditure. Above this threshold, the PG signs off on all expenditure (the legal or regulatory basis for this is unclear but it happens anyway). In principle, this gives the Governor strong control over expenditures occurring at provincial level. However, provincial officers consulted for this study indicated that PGs rarely withhold their signature.

Disbursement. Each Mustoufiat has a designated bank account for operational expenditure with the provincial branch of the Da Afghanistan Bank (the central bank of Afghanistan). It is the central Treasury's responsibility to ensure that enough financial resources are transferred to the provincial bank accounts to cover their allotments. Provincial line departments are not allowed to have their own bank accounts,¹⁷ and are completely reliant on the Mustoufiat for their financial resources.

Recording in AFMIS. The Mustoufiat records all operational expenditures by provincial line departments in AFMIS, which usually ensures the availability of real time information. Provincial line departments send monthly expenditure reports (on paper) to their ministries in Kabul, and the Mustoufiats also send monthly expenditure reports. Some ministries reconcile the monthly expenditure reports with the information in AFMIS, highlighting any differences between the paper-based reports and the information in AFMIS. As AFMIS is regarded as the only reliable source of financial data on budget execution, the usefulness of reconciling the information on paper with AFMIS has been questioned.

Unspent balances. Budgetary funds allotted but not used during a quarter by a provincial line department will not be automatically carried forward to the next

¹⁶ This threshold is not included in any regulation and seems to differ from province to province.

¹⁷ Some donor-funded projects, such as the UNDP funded ASGP, set up bank accounts at provincial level for the provincial authorities to channel their support to the local level.

quarter. Instead, it is up to the central line ministry to decide what happens with any unspent balances. In principle the options include:

- Adding any unspent balances to a provincial line department's allotment for the next quarter;
- Using any unspent balances to cover central ministry expenses; or
- Transferring unspent balances to other provinces.

It is within the authority of a central ministry to move funds from one province to another province even within a quarter; however, this requires formal approval from the MoF in Kabul. Following approval, the Treasury department will make the necessary adjustments in the AFMIS. It is the ministry's responsibility to inform its provincial offices.

ii. Execution at District Level

In principle every district has a District Governor, a merit based appointment. A limited number of ministries have representative offices at district level responsible for overseeing coordinating and delivering services in their respective districts. Usually the Ministries of Education, Health, Agriculture and Interior (police) have offices and staff at district level. As noted, districts do not receive a budget allotment, and provincial offices determine which part of their budgetary funds will be used for districts' operational expenses.

Salaries and wages. Provincial line departments process payments of salaries and wages to district employees, based on the Tashkeel, the filled positions at district level, and the government's pay and grading system. District employees with bank accounts will receive their salary by electronic payment directly in their bank account. Most government employees stationed at district level are paid in cash, a process that involves the withdrawal of funds from the Mustoufiat's account at Da Afghanistan Bank, and the physical transport of cash to the district. Given the logistical problems, in some districts this takes place only once every three months.

Operational expenses. For O&M costs, districts may request funding from provincial offices. However, discussions with district and provincial officials suggest that O&M funding received at district level is very limited or negligible. Because the Mustoufiats do not have offices at district level and because the provincial line department's director has to sign off on all expenditure, all payments are processed at provincial level.

Provincial offices have several options for providing O&M funding to the districts: (i) providing small amounts of cash to district offices as a sort of petty cash fund to cover limited expenses; (ii) direct payment to suppliers on the basis of invoices submitted by the districts; (iii) in kind support, especially for stationary and office equipment; (iv) vouchers given to district officials for specific expenses (especially for fuel) that can be used with designated suppliers; and (v) reimbursement of district offices that have advanced those expenses. Discussions suggested that only options (iii) and (iv) are used in practice.

Budget recording. AFMIS has the possibility to record expenditure up to district level. The four digits in the location segment could be used to record in which district the expenditure has occurred. However, Treasury guidelines do not require line ministries and Mustoufiats to do so, and generally only the first two digits (identifying the province) are used.

iii. Development Budget¹⁸

The majority of ‘on budget’ development funds beneficial to the provinces are procured, implemented, processed and paid at central level. Involvement of provincial authorities in utilization of those funds varies from Ministry to Ministry and from project to project. In some cases provinces are involved in the whole process, from feasibility study to project identification, procurement, implementation, monitoring and evaluation and project completion. These projects could be seen as a co-production between the center and the provincial authorities. At the other extreme, in some cases the central ministry implements projects without any local involvement. In either case, the development funds are recorded in AFMIS as spent at central level although the investments, goods and works delivered are beneficial to the population in the province.

GIRoA recognizes that improving budget execution, transparency, accountability and taking into account local needs, may require increasing the responsibility of local authorities. As a step in this direction, the government has delegated the authority to the provincial authorities to implement certain development projects, including procurement and payment authority. The following table shows the procurement and payment authority delegated to the provinces (this is discussed further in the section on procurement).

Table 1: Budget Authority at Local Level¹⁹

Provinces	Grade 1	Grade 2	Grade 3
Works	Afs 40 million	30 million	20 million
Goods and services	Afs 15 million	10 million	7.5 million

Financial transactions related to development spending at provincial level.

There is an important difference between the way the operational budget is spent and the procedures used for the development budget. As described above for the operational budget, the provincial department receives a quarterly allotment. Within those three months the department is able to use the allocated funds.

For every development project implemented by a provincial department, a provincial department receives a separate allotment specifically for that development project. A B27 form is prepared by the line ministry in Kabul and submitted to the MoF in Kabul for approval. After approval by the MoF, the line

¹⁸ Further information is contained in the MoF’s *Handbook for Accounting and Reporting of Development Transactions*.

¹⁹ Presidential Decree 18.

Ministry sends the allotment to the concerned provincial line department. Based on the B27 form, the line ministry prepares an M16 form, requesting an advance payment from the MoF. The MoF processes the M16 form and after approval, transfers the amount as an advance payment to a Mustoufiat's bank account. The amount transferred is similar to the amount on the B27 form.

For every provincial department that receives development budget funds, the Mustoufiat opens a special bank account ensuring that funds from different development projects are not mixed. The Mustoufiat informs the concerned provincial line department within five working days that the funds have arrived. After being notified by the Mustoufiat, the provincial line department can start to utilize the funds and implement the development project. The advance payment is not necessarily for a single financial transaction and may be used to cover several payments.

The procedures for the financial transactions are similar to the procedures for the operational budget. The provincial department is responsible for completing all forms (including the M16) and getting all the necessary signatures and relevant documentation among others a signature from the PG. They submit all the relevant forms to the Mustoufiat, which checks whether all the documents are completed and if all the procedures are followed correctly (especially procurement). The control from the Mustoufiat is a paper-based control, and there is no on-site verification. One of the more important controls carried out by the Mustoufiat is to check if there is enough money left in the project's special bank account to make the requested payment.

It is a provincial line department's responsibility to check whether a contractor has fulfilled its contractual obligations. Where appropriate, a central line ministry may also verify whether the obligations have been met. The Provincial Council could play a role in this process as well, based on its responsibility to monitor and evaluate development projects implemented in their province. However, discussions with PC members revealed that they do not carry out such on site controls. If they become aware that there are certain issues with the project they will discuss these issues with the concerned provincial line department, leaving it up to the department to take action. After the Mustoufiat has approved the M16, the relevant check will be issued and the provincial line department is able to pay the contractor.

The Mustoufiat does not record these transactions in AFMIS. Seven working days after the end of the month, the Mustoufiat is required to send all the relevant documentation regarding development transactions to the Treasury in Kabul. The provincial line departments are required to sign these documents as well, ensuring that outstanding commitments and remaining balances recorded by the Treasury are similar to the information available to them.

The Treasury department in Kabul carefully scrutinizes all documents and, after approval, enters the transaction into AFMIS. Advances are cleared and new advances may then be transferred to development budget's bank account.

Implications of the different procedures for Development Expenditure.

Because development funds are transferred to the provinces as advance payments, a provincial department does not have to use these funds within a quarter. Instead the resources remain allotted to them throughout the fiscal year. However, if they fail to use these funds within the fiscal year the advances are liquidated.

Another difference is that the M16 advance payment form records the transaction only at major object code (22 for O&M costs or 25 for capital). This provides greater flexibility than is the case for the operational budget, which is already distributed by the MoF across both major and minor object codes.

Because development budget spending is not entered into AFMIS by the Mustoufiat, but instead by the central Treasury in Kabul, information on the execution of the development budget in the AFMIS is not always up to date. The data in AFMIS could easily underestimate budget execution.

At present there is only limited experience with implementing the development budget at provincial level. A recurring problem is that documents are not completed correctly or submitted late, meaning that advances are not cleared on a timely basis.

iv. Procurement

The procurement process at provincial level is aimed at ensuring that significant spending on goods and services for the provinces is carried out effectively and efficiently, in compliance with the Procurement Law of 2008 and rules and procedures as proscribed by the Procurement Policy Unit guidelines of 2010.

The procurement department of each provincial line department has the responsibility for procurement planning; preparation and publication of tenders; evaluation of bids; contract or purchase order creation and awards in line with delegated authorities; administering the Procurement Committee; and assessing the quality of procured goods and services. For every purchase or procurement, a procurement committee of three staff is selected consisting of a staff member of the involved provincial line department, a staff member of the Governor's office, and a staff member from the Mustoufiat.

The procurement departments deal with procurement for both the operational and development budgets. The purchasing and procuring of goods and services involves two distinct processes, one for purchases valued below Afs 500,000 and one for those valued above Afs 500,000.

Procurement under Afs 500,000. For procurements with a value below Afs 500,000, three quotations are requested from three different suppliers. The bidder with the lowest price will be selected. After a contract is awarded, it must be approved and signed by the PG. According to Presidential Decree 18, provincial line departments have the delegated authority to award and sign the contracts for purchases not exceeding Afs 100,000 (grade 1 provinces), Afs 75,000 (grade 2 provinces), or Afs 50,000 (grade 3 provinces).

Procurement above Afs 500,000. For works, goods and services valued at more than Afs 500,000, a bid document is prepared by the Procurement department and advertised. The provincial authorities follow the procurement law and the guidelines published by the MoF, requiring the submission of both technical and financial bids. Bids are opened and evaluated by a procurement committee. Technical bids are opened first and vetted for technical competence. Following short-listing of technically competent bidders, the financial bids of these bidders are opened. A comparative chart is prepared by the committee based on the lowest priced bids. Successful bids require approval from the PG. Table 1 above summarized the levels of procurement authority delegated to the PG; works, goods and services valued above these thresholds are procured by the central ministry.

In Herat province, the Mustoufiat indicated that purchases below Afs 5,000 are directly procured by the line department without involvement from the procurement committee.

v. Budget Reporting and Audit

Data on provincial spending, by provinces and by line departments, are available through AFMIS in Kabul. It is possible to extract data from AFMIS on core budget allotment by province against the actual expenditure. It is not possible to compare budget execution at provincial level against the originally approved budget by parliament, because that budget does not include any provincial distribution of funding and that can be entered into AFMIS. Data on provincial spending are available but the information is not systematically used for reporting. Fiscal reports produced by the MoF focus on core budget execution at ministerial level.

Some central Ministries, such as the Ministry of Education, monitor the performance of their local offices regularly based on the information in AFMIS. Underperforming provinces are held accountable and they are requested to take action and measures to improve their performance. There was no indication that provincial line departments are held accountable by the representative bodies at provincial level—the PC and PGO.

Internal and external audit at provincial level. No officials are present at local level to carry out any internal or external audit. The internal audit departments of central Ministries audit the provincial line departments; in most cases these are compliance audits. External audits at provincial level are carried out by GIRoA's Control and Audit Office, which reports to the Presidency. In addition, the ARTF's monitoring agent monitors expenditure at local level.

F. Improving Local Accountability

The SNGDS seeks to build accountable sub-national government institutions. In particular, such institutions should be able to act as a voice for citizens, to hold implementing agencies at sub-national level accountable for their performance and responsiveness, and to be transparent and accountable themselves.

Current Policy and Consultative Process. As part of the Tokyo Mutual Accountability Framework published on 8 July, 2012, GIRoA has made specific commitments in the area of sub-national governance, including commitments: (1) to enact a legal framework to clarify roles and responsibilities of government agencies at national, provincial and district levels, in line with the 2010 Sub-National Governance Policy; and (2) to develop a provincial budgeting process that includes provincial input into the relevant ministries' formulation of budget requests, linked to a provincial planning process in which PCs have consultative roles.

Since 2005/06 the MoF has had a provincial budgeting unit in its Budget Department. Training has been provided to provincial staff, including PC members, in planning, prioritizing and budgeting issues. In the absence of any discretionary funds for use in the provinces outside the normal budget process, the objective has been to train provincial staff and PC members to discuss and influence the central ministries' budgetary allocations and advocate for local needs. The representative, elected body, the PC, would also be involved in coordinating and monitoring the implementation of development projects and service delivery. In this way, planning and budgeting would become more of a bottom up process.

In practice the results of all these efforts have been limited. There has been little sharing of information between different levels of government and many central ministries do not involve their provincial departments in any phase of the budget cycle, let alone representative bodies such as the PC and the DCC.

According to the provincial budgeting unit's strategy and the recently released policy for DCCs,²⁰ in the next couple of years GIRoA will pursue a role for DCCs in development planning and coordinating, overseeing, and monitoring local development activities. Provincial line departments and Mustoufiats remain responsible for budget implementation and execution, while the representative bodies, the PCs and DCCs, should monitor their efforts and results.

The Way Forward. Afghanistan is a highly centralized country, and central ministries (including the MoF) are reluctant to share power on a voluntarily basis with their provincial offices or provincial authorities. Strengthening the consultative processes between the center and local layers of government is thus not seen as a realistic option to improve local accountability and strengthen sub-national institutions.

²⁰ As described in the National Policy for Unified District and Village Governance and Development, released in March 2013.

A way to break the deadlock would be to hand over real power and responsibilities to local representative bodies, paving the way for accountable sub-national accountable institutions as envisaged in the UNDP's SNGDS. Finance should follow function and local authorities should receive their own discretionary budget envelope or block grant, at either provincial or district level. It should be the responsibility of the local representative body, either the PC or the DCC, to decide how they use these funds. Either the PGO or the provincial line departments would carry out implementation.

On-Budget Assistance. Development partners have supported the local authorities substantially in previous years but their funds were mainly provided off budget. Key mechanisms used for this purpose (especially the PRTs) are being dismantled and the flow of funds is drying up. To promote sustainability, funds should be provided through on-budget mechanisms, within the Afghan system. All the options discussed in the following section take this as a starting point.

Representative body versus executive body. Since a major objective of the UNDP's SNGDS is to strengthen local accountability, it seems appropriate that the focus should be on the role of representative, elected bodies. At the provincial level, this should probably be the PC. For instance, while the PGO and/or provincial line departments could be responsible for proposing an allocation and distribution of funds at provincial level, the PC should be responsible for final approval. At district level the DCC could play a similar role.

G. Provincial Level Reform

The policy reform that appears to be most feasible within the current legal and fiscal framework is for the provinces to receive a **provincial budget envelope or a (non-earmarked) block grant** from the central government. The utilization of these funds would be determined by the PC, on the basis of proposals by the PDC under the leadership of the PG. In particular, the PDC would draft a policy proposal indicating how the funds are to be allocated across sectors, projects, and programmes and which services will be funded in line with local needs and requirements. The proposal would be shared with the representative body, the PC, and after thorough scrutiny and discussions within the PC and between the PC and the PDC, adjustments could be made based on the consultation process. The PC would officially endorse the final proposal.

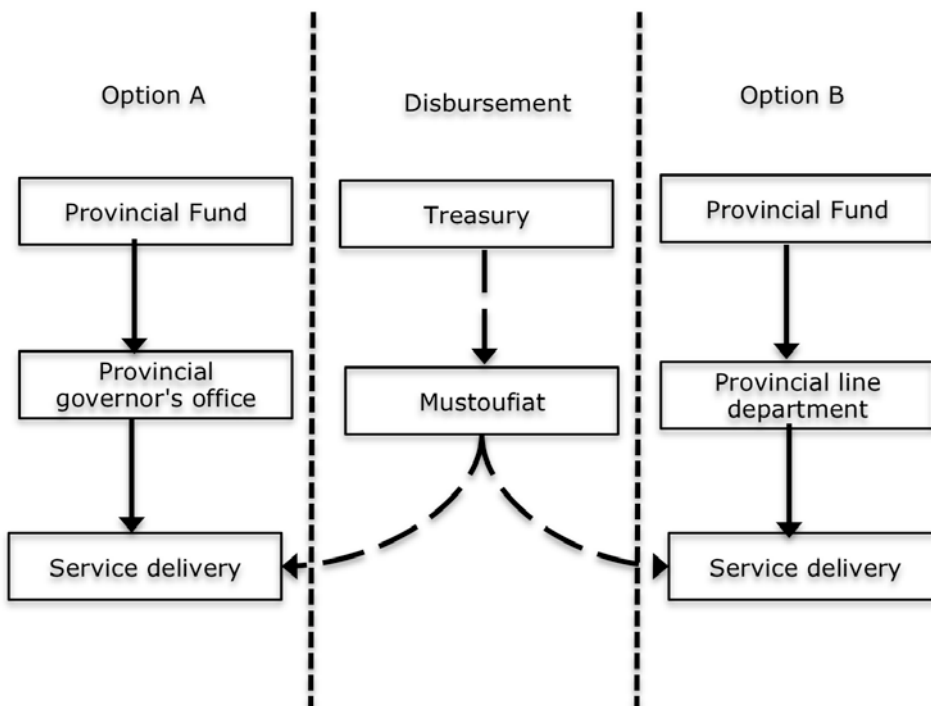
Flow of funds and implementing arrangements

This section examines options for implementing a provincial budget envelope or a block grant, either:

- a. By the PGO, or
- b. By provincial line departments.

The flowchart below shows a simplified version of the two alternative implementation arrangements including the flow of funds.

Flowchart 1: Implementing a provincial block grant



Budget preparation. Under either option, the provinces would be informed during the budget preparation process at central level what their block grants will be for the next fiscal year. This would take place as early as possible in the budget cycle, but in any event the provincial block grants should be included in the BC2 released in June by the MoF. IDLG in turn would inform the PGO of the block grant's ceiling. The block grants could either be part of newly established provincial fund, recognised as a primary budget unit and managed by IDLG, or become part of IDLGs budget. Based on the information from IDLG, the PDC and PC would start the budgeting process at provincial level and develop a proposal for using the funds, as summarized above.

The annual budget approved by the cabinet and Parliament would include the provincial block grant for every province. The total resources available for the provincial block grant would be a Cabinet decision. The allocation across the provinces should be formula-based to avoid political interference.

The block grant could be part of the operational budget or the development budget, or split between them. The block grant would be allocated across the major expenditure object codes, either by the central ministries under the coordination of IDLG or based on information provided by the provinces. The latter could be challenging, however, given the limited time provinces have to prepare a proposal. They could use a preliminary allocation based on past experiences but this could mean that the information in the annual budget is incorrect.

Implementing arrangements, option A (PGO)

1. After the annual budget has been approved, the PGOs share the province's final approved proposal for using these funds with IDLG. The proposal shows the budget allocation disaggregated across the operational and development budgets, with a breakdown by major and minor object codes for the operational budget and across major codes only for the development budget.
2. Based on the proposal and the existing procedures for operational and development budget spending at provincial level, IDLG prepares a B27 form and M16 for every province and a quarterly B20 form.
3. Based on the B20s and the M16s, the MoF transfers funds to the designated bank accounts of the Mustoufiats and IDLG informs the provincial offices accordingly.
4. The PGOs implement the block grant in close coordination with the concerned provincial offices. The PGO is responsible for management, overseeing, and coordinating, while the provincial line departments do project implementation and/or service delivery. Where appropriate, private companies are contracted to do this work.
5. All procurement and payment processes related to the block grant are carried out by the PGO.

6. Insofar as possible, the procedures for financial transactions, including procurement, are similar to the existing procedures described in the accounting manuals, the procurement law, and other relevant guidelines. Transactions are recorded in AFMIS.
7. PGOs report to the PDC and PC on a regular basis on what the funding has been used for, and to be held accountable for any issues or results.

Implementing arrangements, Option B (Line Departments)

The process is similar to Option A, but with a few important differences.

1. Based on the provincial proposals and the allocation across sectors, IDLG informs the concerned line ministries.
2. The concerned line ministries prepare the B20, B27, and M16 forms and, upon approval, the MoF transfers funds to the designated bank accounts at provincial level.
3. Provincial line departments follow the existing financial, procurement, and accounting laws, procedures and guidelines for budget execution.
4. Provincial line departments report to the PDC and PC on budget spending, implementation, and issues or results.

Adjustments to existing laws and regulations

The existing financial laws and regulations and the accounting framework support the possibility of providing a block grant to the provinces. As described above, the budget is approved for a central agency, and the vertical and horizontal distribution is within the authority of that agency.

In order to ensure that a block grant is firmly allocated to the intended province, it would be necessary to eliminate the authority currently provided to ministries to transfer funds from one province to another. The block grant would be recorded in the AFMIS, including a two-digit location code.

Alternatively, provincial offices could be recognized as primary budget units. Provincial offices would then be included in the budget with a unique organisational code, instead of receiving subsequent allocations from the ministries based on a combination of organisational code and location code. This would effectively ring-fence provincial allocations. It would also subject them to the parliamentary approval process, as part of the annual budget.

Challenges to implementing option A

Option A would be a simpler and more direct way of implementing a provincial block grant. However, there are a few challenges using this option.

- It would not be possible to track budget execution across sectors. AFMIS would record block grant funds as being spent by the PGO, rather than line ministries or departments. It would thus underestimate investment and expenditure in certain sectors, particularly if the block grant is substantial. This problem will not arise under Option B.
- An extra step would be introduced in the payment process. Implementing agencies would first have to submit their invoices to the PGO instead of directly to the Mustoufiat.
- The financial and procurement officers in the PGO could be overstretched, since their budget would increase substantially.

Challenges implementing both Option A and Option B

More broadly, there are challenges related to both options which could seriously hamper the introduction of a block grant or a provincial budget envelope.

- Introducing a block grant would require extra efforts at both central and provincial levels, for which they may lack sufficient capacity. The finance and administration departments of the MoF, IDLG, and other line ministries already seem to be overstretched and, especially at the beginning, they would need strong support to become familiar with the new processes and procedures.
- The PDC and the PC are not familiar with budgeting processes. PDCs have been involved mainly in drafting and updating PDPs, while PCs have even less involvement with the budget cycle.
- The provinces and the center would need to communicate more with one another. Since communication in Afghanistan is difficult, this could seriously hamper the introduction of a block grant.
- This would be compounded by the limited time between the release of BC2 and deadline for the submission of ministerial proposals on the distribution of funds. There is probably not enough time for provinces to discuss the block grant allocation and report the result back to the center.
- Procurement capacity is not well developed at local level. Although the current system allows line ministries to channel development funds through their provincial offices, in practice the amounts have been limited and the results have not been very promising.
- To the extent that block grants were treated as part of IDLG's budget, the budget would not provide clear information on the utilization of funds and would underestimate the allocation across certain key sectors.

A particularly binding constraint is the lack of capacity at local level. Capacity varies across provinces but in general it is assessed as weak. It will take time

before the local institutions understand their new role and responsibilities and develop the ability to fulfil them.

Another issue is the sustainability of funds. If in the first year a province decides to build a few schools or health clinics, in subsequent years either block grant funding should be used to service the new infrastructure or the line ministry should provide the funding. If the block grant is decreasing or the PC's priorities change, the province could end up with unused, brand new infrastructure.

Phased approach

It may therefore be necessary to consider ways to simplify and phase in the introduction of a block grant. For instance, instead of giving the provinces the possibility to allocate the block grant between the operational and development budget, during the first few years the decision could be taken that the block grant can only be used only to cover O&M costs. The block grant would thus be part of the operational budget.

This is an approach currently piloted by a DfID funded programme. A selected number of provinces receives extra budget to top up their current funding for O&M costs. The programme follows more or less the implementation arrangements described for Option B. The advantages are that provinces are not involved in complicated procurement processes and that normal operational budget channels are used. Provincial line departments generally know how this channel works and are familiar with using it to implement the operational budget.

H. Reform at District Level

The UNDP's SNGDS also envisages to development of accountable institutions at district level. This section describes possible procedures and issues that could arise in connection with the provision of block grants for districts.

The budget procedure could be similar to the ones proposed at the provincial level. The DGO and representatives from line departments would prepare a budget proposal and the representative body (most likely the DCC) would review and approve the proposal. Implementation options could be similar to those proposed for the provincial level, although there are some serious issues that have to be addressed:

- There is no Mustoufiat at district level. District offices are not involved in the financial processes and the accounting procedures. Salaries and wages are processed at provincial level and mostly handed out in cash; funding for O&M costs is typically given to the district offices in kind.
- There is also very limited experience in budgeting or procurement at district level. The budget is not prepared or approved by district, budget allotments are not provided at district level either, and in general budget spending is not recorded at district level.
- Most line departments are not represented at district level, and neither provincial nor district staff will necessarily have the time or qualifications to conduct newly assigned tasks related to the budget process.

Implementing a block grant at district level

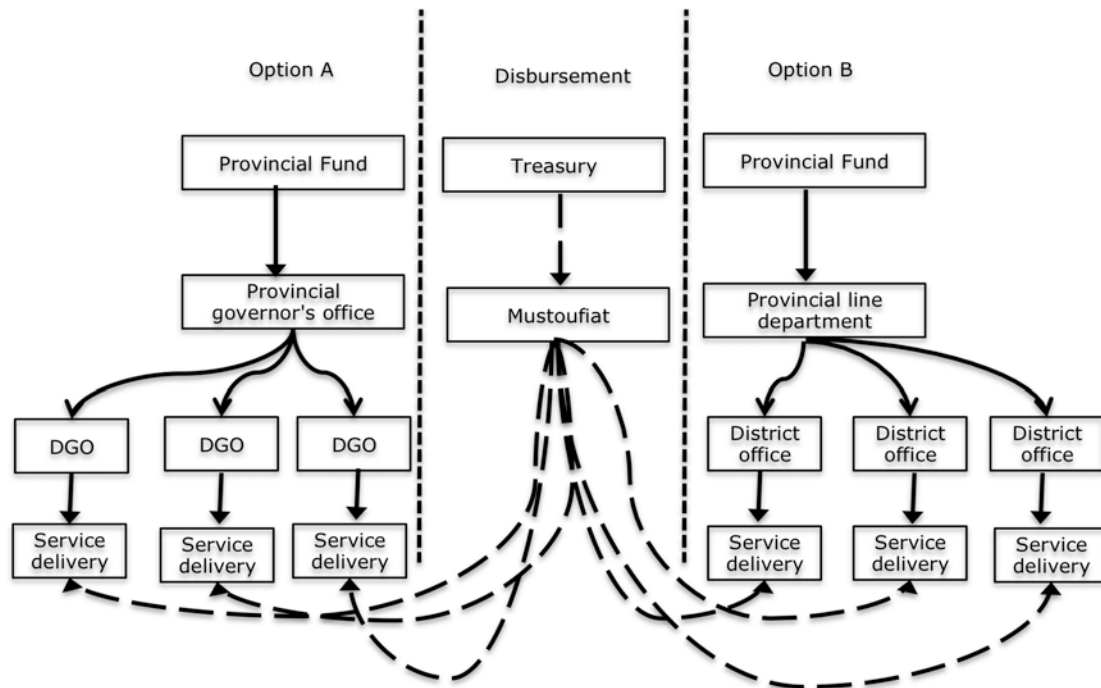
If the districts were to receive a block grant, the following procedures might be used (as summarized in Flowchart 2, below):

1. PGOs inform the DGOs how much they will receive next year.
2. A proposal for the utilization of the block grant is prepared by the district representative body (DCC) and sent to the PGO.
3. After the budget has been approved the IDLG or the line departments, depending on the implementation arrangements, they prepare budget allotments by district.
4. On behalf of the districts, the provincial offices carry out budget execution, including the payment processes and the reporting.
5. Results and issues are reported to and discussed with the representative bodies at district level.

No changes would be needed in the financial regulations and accounting procedures to implement block grants in this manner. AFMIS and the chart of accounts support budget implementation at district level. Experience so far with

the DfID funded project suggests that it is possible to allocate and spend a block grant at district level. However without a Mustoufiat or financial officers at district level, strong and continuous support from advisors would be needed.

Flowchart 2: Implementing a District Block Grant



For implementation purposes, a phased approach would be preferable. In particular, a district block grant could be focused on a few sectors or specific expenses, such as O&M costs.

Apart from the risks and challenges that would complicate the implementation of provincial block grants, there are a few issues specific to the district level.

- The number of allotments to be prepared by the central line ministries and communicated to sub-national offices would expand dramatically, from 34 provincial allotments to 398 district allotments. The number of budget execution reports would increase commensurately.
- The number of financial transactions and procurement actions would explode as well, since every district would now purchase items that were previously procured in one transaction by the provincial officers for the province as a whole and distributed in kind. This could also influence the price once items are procured in smaller quantities. This issue could be tackled by pooling procurement, but extra coordination would be needed.
- Numerous new financial officers would need to be recruited at central, provincial, and district levels to carry out these tasks. It is unclear whether sufficient qualified staff could be found; it is also possible that increased overhead costs could exceed the funds available for service delivery.

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