Citizen-Centered Approaches
to State and Market

The Budget as the Linchpin of the State: Lessons from Afghanistan

PEACE AND THE PUBLIC PURSE CHAPTER 6

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Maintaining a monopoly on the use of force is often cited as the fundamental attribute of states. More than a thousand years ago, however, the philosopher Ibn Qutayba wrote of the equal importance of two additional attributes of a state: fiscal sustainability and justice. Summarizing what has come to be known in Islamic thought as the "circle of justice," he wrote, "There can be no government without an army, no army without money, no money without prosperity, and no prosperity without justice and good administration."[1] This notion neatly captures the ideas that no force can be created without a fiscal basis and that an endurable and enduring fiscal basis in turn requires justice and fair play. In postconflict settings, where establishing the monopoly on the means of force often remains a challenge, the budget can be a critical instrument of statebuilding. This chapter examines the role of the public finance system in Afghanistan in the 2001–2004 period.

The Budget Cycle as the Linchpin of the State

To become an instrument of legitimacy, a public expenditure system must be predictable. This in turn has a number of prerequisites. First, resources necessary for making payments must be available on time and in full. When a postconflict country is dependent on donor flows for much of its revenue, before domestic revenue sources have been consolidated, it is incumbent on donors to provide that predictability. Second, the rules for allocation and transfer of funds must be agreed upon. Third, criteria of accountability and reporting must be agreed upon in order to establish trust in the capacity of the recipients across levels and functions of the government. Fourth, decision rights at various levels of government must be made clear. Fifth, when new systems are being created, the balance between short-term centralization to create accountability and medium-term delegation of authority that is necessary for sustainability must be kept clearly in view.

A revenue system is the other side of the coin. To satisfy the minimum condition of being a state, a country must generate sufficient revenue to meet its recurrent expenditures. Collection of revenue on a transparent, effective, and accountable basis is an even stronger challenge than constructing the payments system. The payments system is redistributive, whereas the revenue system is extractive. Opportunities for corruption and collusion are even greater. Authority here can be fragmented if various levels of government turn into autonomous centers of revenue extraction, thereby undermining the unity of the state and imposing unpredictability on economic actors. A clear strategy for establishing a sustainable fiscal basis from domestic revenue, therefore, must be a critical part of statebuilding.

The willingness of the citizens to contribute to the public exchequer depends on their appreciation of the state's effectiveness in delivery of services and public investment to improve their well-being. Social justice—across various provinces or districts or across social groups, be it among men and women or young and old—can be measured through budgetary allocations and expenditures. Only if these are reflected completely and transparently in a budget can citizens hope to begin to hold their governments accountable. Thus the circle of policy and practices again closes on the centrality of the budget as the instrument of policy.

The exercise of preparing and agreeing upon a budget can be an important tool in capacity building for governance, particularly in situations where resource allocation among ethnic or social groups is hotly contested in an atmosphere of distrust and where a coalition government is in place. The agreement on a budget by the cabinet is an important mechanism in shifting conflicts over resource allocation into the arena of a transparent political process.

Developmental expenditures can take the shape of either budget support to state expenditure or donor-managed projects. The central criterion for evaluation of public expenditure must be the extent to which it becomes the vehicle for creation of wealth and bonds of solidarity and trust among the citizens. Given that leadership and management are critical constraints in most postconflict conditions, the aid system should be harnessed to maximize the impact of the existing leadership and management. Today, however, the bewildering variety of requirements that the current unharmonized aid system imposes on postconflict countries necessitates that the bulk of the energies of people put in positions of leadership of the economy is devoted to translating the aid pledges into commitments and disbursements, rather than to the creation of wealth and generation of revenues that would provide the true basis of sustainability.

For resource flows to reinforce and sustain the legitimacy of governance, the locus of decisionmaking must reside in the government. If, instead, the government is merely one of multiple centers of autonomous decision rights in the allocation of resources, then stakeholders pursuing their immediate interests rather than long-term goals will seek patronage from these alternative centers. This will further fragment the authority of the new government and jeopardize its quest for legitimacy.

Public Finance Reform in Afghanistan: The Context

On December 22, 2001, power was transferred to Hamid Karzai as chairman of the interim administration, an institutional arrangement agreed to in a conference convened in Bonn in late November 2001 by Lakhdar Brahimi, the Special Representative of the United Nations, and backed by the United States and major powers.

The Bonn Agreement, signed by an unrepresentative group of Afghans, envisaged a series of institutional transitions. The goal was a process that would culminate in direct election of the head of state by the people of Afghanistan, a first in the history of the country. The benchmarks of the Bonn process were (1) creation of the interim administration, to be followed within six months by convening of an Emergency Loya Jirga (Grand Assembly), whose representatives were to be elected with supervision by the United Nations; (2) election of a head of state by the Emergency Loya Jirga for a period of two years; (3) drafting of a constitution; (4) convening of a Constitutional Loya Jirga to modify and improve the constitution; and (5) the holding of elections. This ambitious schedule was to be underwritten by deployment of the International Security Assistance Force (ISAF), the first deployment of which took place in December 2001 in Kabul, and supported by a flow of resources pledged in a conference held in Tokyo in January 2002. ISAF's presence was intended to preempt the possibility of recourse to force by armed groups to change the rules of the game agreed to in the Bonn process.

Between the Communist coup of April 1978 and the collapse of the Taliban in December 2001, Afghanistan had been the scene of a brutal Soviet invasion, ten-year occupation, civil war, and proxy regional war. The cost to the country in destroyed infrastructure and lost opportunities during this period was estimated by the World Bank to have been US$240 billion.[2]

As is common during prolonged conflicts, norms of legality were seriously compromised in Afghanistan, as most of the combatants operated through networks on the margins of established legal norms. Currency was printed outside the country and included multiple printings with the same serial numbers. Its value eroded severely. At times it took a basket of currency notes to buy a basket of goods. Deficit financing through orders at times literally written on the back of envelopes destroyed any notion of fiscal accountability. Two distinct currencies functioned in the north and the south, the northern one trading for roughly half the value of that in the south.

Neither the Soviet-backed regime, nor the mujahadeen, nor the Taliban had been able to gain control over the entire territory of the country. Large swaths were under the control of individual big men or loose and shifting alliances of commanders. Formal revenue mobilization was among the lowest in the world, but individual power holders were able to tax trade, farmers, mining, and other extractive industries. Years of drought further exhausted the coping strategies of the ordinary people, and Afghans acquired the distinction of being the largest refugee population in the world.

Resistance to the Taliban was carried out by a significant but small force around the leadership of Ahmed Shah Massoud, who was assassinated on September 9, 2001. In the wake of the September 11 bombings, the US-led coalition made an alliance with these opposition commanders and supplied them with both cash and matériel to spearhead the drive for ousting the Taliban. As a result, Afghanistan witnessed the reemergence of individual strong men in positions of authority in a number of key provinces.

Despite the years of conflict, a body of administrative rules survived as well as a number of people with a strong identification to a functioning unitary system of government. National sentiment was quite strong, and there were no separatist movements. The Afghan population defined the crisis as one of the absence of a legitimate state that would satisfy their aspirations for security, order, and prosperity. It took time to persuade other actors, ranging from Group of 8 nations and the development and humanitarian agencies to the international security presence, to embrace the goal of statebuilding.

Despite this difficult context, the benchmarks established in Bonn were completed on time, and Hamid Karzai was elected president in a contested election in October 2004. The remainder of this chapter outlines the policies and reforms that were implemented in the public finance system in Afghanistan from October 2001 to the end of 2004.

The Aid System: An Asset and a Constraint

The aid system currently exists as a parallel series of bureaucracies, each with its own revenue, expenditure, and reporting systems. These multiple and fragmented systems are not linked through a budget process that would ensure accountability either to the citizens of donor countries or to the citizens of beneficiary countries. Only the policy process embodied in national budgets can provide this coherence and accountability. When aid is channeled through the budget process, it can be a great asset in the statebuilding process. When channeled outside the budget process, however, it can instead become a constraint. This section sketches the multipronged strategy adopted by the Afghan government in raising international resources.

External Debt Arrears

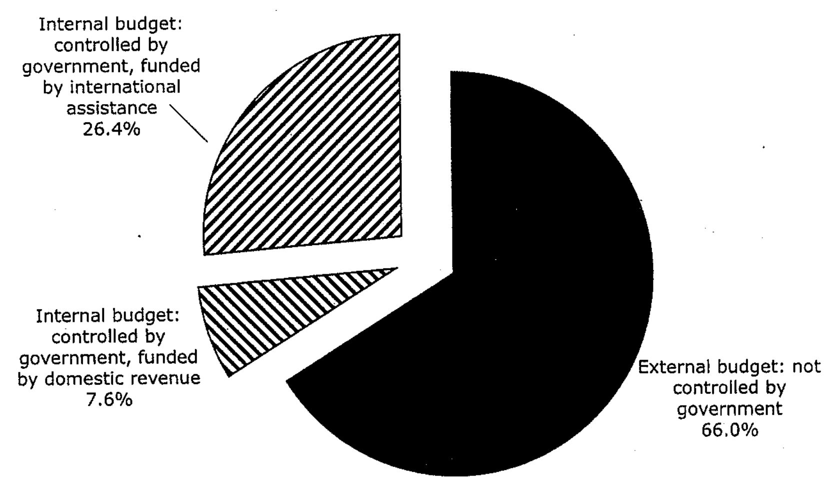
An initial priority was to clear Afghanistan's arrears to the international financial institutions (IFIs) to make the government eligible to receive grants and highly concessional loans from these organizations. The government met this objective by persuading bilateral donors to contribute US$47.3 million in grants to clear these arrears. These payments were made directly by donors to the lenders, with no financial involvement by the Afghan government.[3] The government also sought forgiveness of past debts owed to bilateral donors.[4]

Multilateral Trust Funds

The bulk of the aid pledged at the January 2002 Tokyo conference was spent on humanitarian assistance, with UN agencies, nongovernmental organizations (NGOs), and private contractors in the position of direct implementers and decisionmakers. The result can be described as a "dual public sector"—one controlled and managed by external actors, the other by the Afghan government (see Figure 6.1 and Table 6.1).

The strategy of the Afghan government was to secure a greater share of external funds and decision rights for the government. To this end, the Ministry of Finance strongly advocated the creation and use of multilateral trust funds: the Afghanistan Reconstruction Trust Fund (ARTF), administered by

Figure 6.1 Afghanistan's Dual Public Sector: Expenditure Budget 2002–2004



Source: Government of Afghanistan, Ministry of Finance, "Financial Report 16/7/1381 (October 2004)," Kabul, 5.

Table 6.1 Expenditure in Afghanistan, 2002–2004

	US$ million	Percent
Internal budget	1,581.1	34.0
Funded by international assistance	354.8	7.6
Funded by domestic revenue	1,226.3	26.4
External budget	3,075.0	66.0
Through United Nations	1,957.0	42.0
Through nongovernmental organizations	413.0	8.9
Through private companies	705.0	15.1
Total expenditure budget	4,656.1	100.0

Source: Government of Afghanistan, Ministry of Finance, "Financial Report 16/7/1381 (October 2004)," Kabul, 4, 6, 32.

Note: Data refer to January 2002 through March 2004.

the World Bank for civilian expenditures, and the Law and Order Trust Fund (LOTFA), administered by the United Nations Development Programme for payments to the police and expansion of the security infrastructure. Ensuring that these multilateral trust funds were supported was critical to the government's goal of bringing predictability, transparency, and accountability to its recurrent expenditure. A number of bilaterals, led by the Netherlands, the Scandinavian countries, Canada, and the UK, channeled a substantial part of their contributions through these trust funds. India, Oman, and Pakistan also provided budget support to the government at an early stage.

When the Minister of Finance assumed the post in July 2002, there were no funds in the Treasury to meet either recurrent or development expenditures, and more than half of his time had to be spent on advocacy with donors to provide resources to ARTF or the budget to meet basic salary payments. This diverted time and energy from internal management issues. Drawing on the reports of the ARTF monitoring agent hired by the World Bank, however, the government was able to analyze leaks in the expenditure system, and the Ministry of Finance aggressively pushed for accountability and transparency. The success of this approach was shown when the European Union and Canada agreed to enhance their contributions to the ARTF and Japan broke precedent by making its first payment into the Trust Fund, followed by Saudi Arabia and several other Arab countries.

A distinctive feature of the ARTF is a clear commitment to design and enforcement of rules that promote transparency and accountability at all levels of government, helping to set the parameters of law-bound behavior in the future. This strategy entailed bringing all recurrent government expenditure, regardless of whether it was from domestic revenue or international sources, within the purview of monitoring arrangements of ARTF. Expenditures were classified by the external monitoring agent as eligible for reimbursement or as ineligible and nonreimbursable. The allocation of ARTF expenditures through

the budget helped to entrench the budget as the central instrument of policy. The system required a government float to undertake the initial payments; reimbursement by ARTF funds was quick but conditional upon satisfactory implementation of the rules. Breach of rules not only risked freezing the flow of resources to the government collectively but also could result in a deduction in allotment for the particular department. After a three-year period of operation, the percentage of ineligible expenditures had fallen substantially, and the regularity, detail, and accuracy of reporting had increased dramatically. Resource allocation became completely transparent, as the Ministry of Finance had no discretionary power: its role was simply to enforce the rules. All major policy decisions were taken through the budget process at the cabinet level and in the ministries once the budget was set.

Program Loans

The Ministry of Finance also reached agreements with the Asian Development Bank (ADB) and the World Bank to give program loans to Afghanistan. This proposal was initially received with a high degree of skepticism, as even well-functioning governments in developing countries have difficulty in meeting the conditions of program loans. Afghanistan, however, quickly established a stellar reputation not only for meeting the conditions of program loans but also for meeting ambitious targets on revenue generation and reform agreed upon with the International Monetary Fund. The program loans were made available to the government in cash, enabling the cabinet to exercise decision rights over the disbursement of the funds. The first program loan from the ADB provided an insurance mechanism for meeting expenditure commitments, as the World Bank–administered Trust Fund would only reimburse expenditures after they had been certified as eligible by the monitoring agent. As the process of reimbursement usually entailed a minimum of ninety days, access to program loans enabled the government to avert being shut down a number of times.[5]

National Programs

The Ministry of Finance formulated the notion of national programs to ensure that the flows of donor resources would meet the priorities announced in President Karzai's speech in Tokyo. The National Transport Program, National Emergency Employment Program, National Solidarity Program, National Health Program, National Education Program, National Irrigation and Energy Program, and National Stabilization Program were among the first to be translated into realities on the ground. At the heart of these programs was the approach of empowering the poor directly through investing in social solidarity and institutional development at the village level. In each of these programs, a small group of core donors had to be initially persuaded to fund the program, agree on the strategy, and translate the overarching strategy into procedures, processes, and organizations on the ground.

From the perspective of the heightened expectations of the Afghan population, the programs were slow to develop. The challenge is that the people expect delivery of services by a fully functioning state that both represents them and is accountable to them. The government, however, is not only burdened by the institutional legacy of the past but also faced with the task of coordinating an international aid system that cannot coordinate itself.

A Compact for Development

The government sought donor funds for a medium-term compact for development, presenting the document *Securing Afghanistan's Future* to the Berlin conference on March 31–April 1, 2004. The conference resulted in a pledge of US$8.2 billion for the next three years and an acknowledgment by the international community that Afghanistan needed US$27.5 billion in public investment between 2004 and 2011 to launch it on a path of sustained growth of 9 percent per annum.[6] This stood in sharp contrast to the donor-driven "needs assessment" that had provided the basis for the US$4.5 billion pledged in Tokyo in January 2002. Based on a visit to the country of less than one week, the needs assessment had not only proved unrealistic in its cost estimates—erring in some infrastructure projects by a factor of ten—but also failed to grasp the centrality of the task of statebuilding. A team of more than 100 people worked on *Securing Afghanistan's Future*, with Clare Lockhart, Michael Carnahan, and Ashraf Ghani providing day-to-day coordination and producing the final synthesis. The cabinet debated the document, and after the incorporation of President Karzai's final directions, it was subjected to a month of intense scrutiny by donors prior to its final release at the Berlin conference.

The most significant achievement of President Karzai and his team was to produce a consensus with the donors that the goal in Afghanistan was to build a state geared to the delivery of value to a citizenry that would hold it accountable. At the beginning of 2002, the international partners had other goals, such as providing humanitarian assistance or supporting pet programs. By December 2004, the visions of the international community and the Afghan government were aligned around the centrality of statebuilding. One result was that actions to coordinate security and revenue generation, hitherto considered impossible, became the subject of serious attention and the focus of collaboration.

Coordination of Aid Flows

Knowing that it could not persuade the donors to channel all their resources through the government, the Ministry of Finance confronted the challenge of coordination of the flows. A number of mechanisms were devised to achieve this. A rule on selectivity was put in place, whereby donors were asked to focus on three critical sectors each. If a donor wanted to engage in more than three sectors, it had to contribute US$30 million to each of the sectors and make a minimal contribution of an additional US$30 million to enter another sector. A number of consultative groups, chaired by cabinet ministers, were formed around each of the national programs with the participation of the relevant donor agencies, to provide strategic direction and coordinate implementation. In addition, a monthly coordination meeting chaired by the minister of finance provided the donors and the government with a forum to review challenges and celebrate accomplishments. The annual Afghanistan Development Forum, convened and chaired by the government in Kabul, became the mechanism for providing the government and the donors with a setting in which to engage in a productive dialogue on the strategy of statebuilding pursued by the government. The budget process provided the government with the vehicle to make its preferences explicit to the donor community and to channel donor resources to the priorities of its citizens.

Problems with US Aid

The Ministry of Finance made a concerted effort to persuade the US government that the time for investment in Afghanistan was the current moment, arguing that US$1 million at that point could save US$10 million in the future. This lobbying effort proved successful in 2004 when, at the recommendation of a US Treasury team that worked closely with the Afghan Ministry of Finance, President George W. Bush recommended and obtained from Congress an exceptional mid-term allocation of US$1 billion for Afghanistan and then sought other supplemental funds. This success proved to be a mixed blessing.

Implementation of the enlarged US commitment was entrusted to the US Agency for International Development (USAID). After having been reduced in size and importance over several decades, USAID suddenly faced the task of administering exceptionally large programs simultaneously in Iraq and Afghanistan. Severely limited in the number of people it could place in Afghanistan and essentially becoming a contracting agency, USAID's reach exceeded its grasp. It desired to enter into program after program, promising large sums of money and asking other donors to shift their priorities elsewhere. Yet USAID could neither mobilize the funds in time nor establish control over its layers of contractors. To take one example, a significant number of school buildings that were supposed to be constructed by September 2004 were not actually completed. Although Afghan firms that were the ultimate subcontractors would be paid around US$50,000 for a school, the cost to USAID could be as high as US$250,000.[7]

Continuity was another problem, as USAID went through at least four managers of its country office in a three-year period. It should be mentioned, however, that the US embassy also assembled in the Afghanistan Reconstruction Group (ARG) an exceptional team of talented individuals from the private and public sectors that has worked closely with the Afghan government to put forward a planning framework for devising and implementing strategies. There is a need to draw lessons from the past to enhance the effectiveness of aid provided by the United States and to ensure that it becomes a magnet for trade and investment and not the mechanism for producing a syndrome of dependency.[8]

Domestic Revenue Generation

True sovereignty is inconceivable without a sustainable, internally generated fiscal base. This can be provided only through a strategy for generation of wealth coupled with a social contract on rights and obligations of citizenship. The Staff Monitored Program with the International Monetary Fund (IMF) linked the generation of specific revenues to well-defined institutional reforms in the Central Bank and Ministry of Finance. The government continuously defined a "stretch revenue target" that exceeded the agreed target with the IMF, and meeting these stretch targets became an important vehicle for moving toward self-sustainability. The Afghan team has been clear that the donors must see the light at the end of the tunnel, a period within which the security costs, civilian salaries, and operational and maintenance costs of the development programs can be met fully from domestic revenue. Projections made in preparation for Berlin indicated that the recurrent budget in seven years would be around US$1.5 billion. Only by relentless rationalization of existing revenues and creation of new sources of revenue can such a stretch target be realized. Internal and external stakeholders must realize that the target can be met, but that this will require careful attention to political economy and the types of resistance that will be mobilized by narrow groups bent on advancing their own interests at the expense of national sustainability.

Currency and Banking

In early 2002, the afghani, Afghanistan's currency, far from being the dominant means of exchange, had conceded ground to other currencies from the dollar to the Pakistani rupee and the Iranian rial. Having declined nearly 1,000-fold in value, a basket of afghanis was needed to acquire a basket of goods. Deficit finance had reigned supreme for over a decade, with notes being printed in the Soviet Union and then in Russia. Finding sets of notes with the same numbers was not uncommon. Furthermore, in the northern provinces, notes printed in Europe—called the Jumbesh currency—were trading for half the value of the notes circulating in Kabul. In some valleys in central Afghanistan, a third form

of currency was also in circulation. The Central Bank had no deposits of currency, and the Interim Government was put in the ironic situation of buying afghanis for dollars in the open market and using the currency thus acquired for payment of salaries.

International experts presented the government with three options on the currency front: full dollarization, meaning that the dollar would become the sole currency of the realm; partial dollarization, meaning that the dollar would be legal tender until a new afghani was issued; or issuing a new currency. They recommended partial dollarization, arguing that a new currency could not be issued in a period of less than two years and that there were major logistical and social risks entailed in issuing a new afghani. President Karzai chaired daily meetings of the coordination committee of the cabinet for a week on this issue. He posed the key problem of how the government would explain partial dollarization to the Afghan population. His relentless focus on the symbolic importance of the currency for statebuilding forced a reexamination of the assumptions upon which the recommendation of the international experts was based. The committee recommended that a new Afghan currency be introduced, with the reduction of three zeros from the old currency.

The finance minister was assigned the role of chairing a task force to delineate the time line and recommend mechanisms for implementation. The task force met every day for a month until it reached consensus. On the legal front, a key issue was the amount of old currency that could be exchanged by a single individual. The task force decided against an imposition of limits, arguing that this would simply result in long lines, as those with money could simply hire their dependents to satisfy the limit.

The search for mechanisms focused on finding existing resources that could be harnessed without creation of a major new infrastructure. The solution was found in the networks of the *hawala,* dealers who were specialists in currency exchange and transfer. Consultations with representatives of these networks quickly revealed that they had a sophisticated infrastructure spanning the length and breadth of the country and that they could be quickly persuaded that a new currency would simplify their transactions immensely. In addition, pride in putting their networks at the service of a national cause was an important enabling factor. A small commission to enable them to bear some of the additional expenses was also agreed upon. An international donor agreed to provide the resources to hire the planes and helicopters needed for the logistics. On this basis, an initial period of three months was delineated as the time of exchange.

The other critical decision involved printing. As the adoption of the euro had created surplus capacity in the printing presses of European countries, the Central Bank carried on intensive discussion with a number of printers, choosing several who could guarantee a security level to the new afghani matching that of the euro.

Once the task force had achieved consensus, the results were presented to the cabinet, which endorsed the approach and passed the enabling decree. The governor of the Central Bank then took over the task of implementation.

Several challenges were successfully faced during implementation. First, as the logistics support from the donors did not materialize in time, the timetable had to be set back by one month, and the resources of the Afghan security forces had to be mobilized.[9] Second, the rate of exchange of currency was so rapid that organizing the burning of old notes in a timely manner posed a challenge. A dedicated incendiary had to be constructed by artisans in Kabul and manual processes of burning had to be organized in the provinces—not a small task, as the equivalent of sixteen tons of notes was collected. To ensure transparency, teams of ministers and members of the international community were sent to the nodal points across the country to supervise the burning of old notes. Third, to ensure that no further notes were being printed, the old facilities in Russia had to be destroyed. Fourth, there were fears that people in remote areas would not be able to participate in the process of exchange, but the public relations campaign, coupled with the ability of the *hawala* dealers to mobilize their networks, proved more than equal to the task. The currency exchange was completed one month after its initial target date.

Success in the currency exchange served as a symbolic means of unification of the country. It also established the credentials of the transitional government with its international partners and with the population, who greeted the reform with spontaneous celebrations. Children flashed the new notes as a sign of national pride and a harbinger of a stable currency.

Banking sector reform proved more difficult. Four major issues needed to be addressed: a legislative basis for defining the functions of the Central Bank and for the entry of the private sector into banking needed to be established; the state-owned banks needed to be reorganized; the Central Bank needed to be strengthened, both to perform as the banker of the government and to regulate the banking sector effectively; and financial institutions, ranging from microfinance to venture capital funds, were needed to support the legal economy in general and small and medium enterprises in particular. A clear vision on building the banking system as a credible payments system and a mechanism of providing access to credit is essential to stability and unity of the country.

The IMF was the major interlocutor in formulation of the necessary legislation. Two constraints emerged that would be repeated across other arenas. First, international partners insisted upon a legislative model that was largely derived from theoretical precepts, rather than a clear analysis of institutional constraints and mechanisms that would satisfy the requirements of theory. Second, when the legislative department of the Ministry of Justice was confronted with a complex piece of legislation taken off the shelf from another legal tradition, it had serious difficulties rendering it into the traditions and language of the country. Granting of licenses to a number of international banks was carried

out rapidly after the decision by the cabinet to accept the English text of the legislation as binding, thereby considerably easing transfer of money to and from Afghanistan.

Reform of the state-owned banks moved very slowly, and this task still needs to be confronted. The government faced severe constraints in adopting an effective system of payments across the country. Difficulty in paying security forces and civil servants across the country was later identified as a key constraint to stability. Two of the state-owned banks had cash assets of more than US$100,000,000, but the government was unable to utilize these assets to ease the severe shortage of credit for entrepreneurs or to reshape these banks to provide an effective payments system. Many branches of the Central Bank remained effectively under the control of local commanders and provincial governors.[10] The Ministry of Finance and the governor of the Central Bank repeatedly raised the issue of security of branches in the provinces and requested support from the international community, but the request was not met.

A clear vision on a financial architecture has been slow to emerge. Although some schemes were initiated on microfinance, and the government sponsored the creation of a venture capital scheme and sought risk-guarantee mechanisms,[11] a comprehensive credit system did not emerge. As a result, latent assets cannot be tapped. The use of mortgages to unleash the capital inherent in housing assets was not tackled credibly, impairing efforts to develop livelihoods as a linchpin of the counternarcotics strategy. The inability of the Central Bank during its first two years to open letters of credit for developmental projects caused significant delays in implementation of key infrastructure projects.

Treasury Reform

Treasury was a domain where informal rules had subverted the formal rules of the game, creating an organized culture of corruption. The formal rules required submission of payment forms to the Ministry of Finance. After approval by the Budget and Treasury departments, these were to be sent to the Central Bank for payment to the government ministries, and from the ministries' departments of finance to the secondary budget units in the central government or the provinces. The informal rules of the game required that at each of the critical nodes, queues were developed, and facilitation arrangements were required to move the process forward. When a government employee received her or his pay in cash from a bonded trustee at the end of the process, the amount usually would be as much as 25 percent less than the entitlement. An analysis of payment of customs duties in July 2002 revealed that an Afghan citizen who needed to pay two dollars in duties usually ended up paying eight dollars in bribes and spent as much as seven days running between different government departments to obtain the necessary signatures.

Transformation of the Treasury into a predictable and transparent organization required a number of major changes. A financial management firm was brought in to computerize the process within the Ministry of Finance, and similar computerization was undertaken in the Central Bank. The technical process was achieved rapidly, enabling the Ministry of Finance to issue printed checks to the Central Bank. The introduction of new technology resulted in an organized Luddite movement to incite employees against the computers, blaming them for the breakdown in the well-honed networks of corruption. The real tasks then became mapping and remapping of the existing processes and recruiting new personnel with the necessary commitment to a culture of accountability and transparency. As a result of the reengineering of processes, the previous organization in which a number of individuals were continuously assigned to the accounts of specific ministries was disrupted, and Treasury personnel were separated from the facilitators and bonded trustees who would require illegal commissions to carry out their work.

The assumption of the Treasury post by Nargis Nehan launched the department on a rapid process of systematic transformation. She brought a number of elements into a coherent strategy. First, she streamlined the payments process by setting a deadline of four days for processing any request from a ministry and by assigning dates for issuing checks to the ministries on a predictable schedule, thereby eliminating the queues and processes of facilitation to move a request to the top of the queue.

Second, reporting from the ministries and provinces to the Ministry of Finance and from the Ministry of Finance to the cabinet was organized in a systematic manner. The Treasury required and obtained information from all the line ministries on the payments of salaries to all government employees, enabling the cabinet to track the degree of success and failure in the predictability of payments across the country. By linking processing of future allotments to submission of timely reports, the Treasury was able to create a system of rule-bound behavior. A marker of the degree of success of this process is that by December 2004, fully 65 percent of the provinces were reporting their incomes and expenditures within the first ten days of every month to the Ministry of Finance. Key requirements were the organization of data into categories that reflected citizens' concerns, collecting these by geographic unit to ensure evenhandedness in distribution of resources, and regular reporting.

Third, the system of allotment to the provinces was made predictable. A turning point in the transition to formal rules came in a meeting with the directors of the departments of health, education, and finance from the provinces, where in response to queries and criticism, Nehan provided charts that showed the amount of funds in each of the provincial accounts and the method of allocation based on a computerized program. The meeting ended with a full endorsement of her leadership.

The restoration of the payments system was a key element in reassertion of the authority of the state. Given the complex logistics and the terrain of the country, the goal of paying all employees of the government on the same day across the country remained unfulfilled and will take significant investments in the banking system and information technology to be achieved. This goal was formulated in July 2002, and technical assistance was mobilized to study its feasibility. The report by an international consulting firm argued that it would take at least five years. Internal brainstorming in the Ministry of Finance, however, produced a series of recommendations for changing the existing manual systems and reorganizing the staff of the Central Bank and two state-owned banks to deliver direct payments to employees. By December 2004, ten ministries and other central government organizations were being paid through this new method. For the first time, an employee received her or his salary in an envelope containing the exact amount of the payment. The process not only enhanced the effective pay of the employee but also resulted in a significant reduction of the number of ghost workers in whose names bonded trustees were previously collecting salaries. As part of its reform initiative, the Ministry of Finance also formulated a strategy to enhance the capacity of the post offices across the country, as a mechanism for both payments and savings.

To enable the flow of finances from donors through the government account, international firms had been contracted through the World Bank's first postconflict grant to exercise key functions in financial management, audit, and procurement. The challenge became to build capacity to ensure that these responsibilities were transferred to Afghan leaders, managers, and officials. Nargis Nehan led a "localization" initiative to update skills of existing staff and to recruit new staff through a transparent and merit-based process. She also led an initiative to reexamine the use of information technology and systems, investigating the borrowing of information management systems from Iran that were already in Persian, rather than continuing with systems imported via Western firms that were unsuitable in terms of complexity and language.

Although reform of the Treasury entailed centralization within the Ministry of Finance, the medium-term strategy required the creation of systems in both the provinces and the line ministries, where decision rights would be delegated, and integrated information management systems would allow monitoring to check adherence to the rules. In the spring of 2005, the process was inaugurated in the provinces. Creation of the capacity in the ministries has been much slower, as a fiscal management project for the whole government is dependent on clarification of functions of each ministry and removal of overlapping functions. As different donors are working as lead nations with different ministries, there is a risk that information management systems and organizational models are being created that will require considerable expense and effort to integrate subsequently into a unified system.

In contrast to the fragmented picture on information management systems, the creation of the Single Treasury Account is one of the enduring accomplishments of the transitional government. Creation of this account and adherence to it has been enshrined in the constitution. All government flows now are organized into subaccounts in the Central Bank, and the Ministry of Finance is able to keep track of the revenue and expenditures on a timely basis. Prior to the creation of the Single Treasury Account, there were hundreds of separate government accounts in the Central Bank and state-owned banks. A single department of the Ministry of Finance, for instance, had more than forty accounts. As different individuals had decision rights over the withdrawal from these accounts, the budgetary rules could constantly be subverted in practice. The existence of these multiple accounts also enabled various organizations to collect money in the name of the government without reporting it as part of the revenue of the state. The resulting degree of opaqueness is captured by the fact that in Afghan year 1382 (2003–2004), more than US$40 million was brought to the revenue of the government through closure of these accounts. The entire revenue of the government in that year was US$207 million. Creation of the Single Treasury Account also limits potential abuse of rent from natural resources, as any agreement to divert royalties from natural resources would be a violation of the constitution.

Reform of Revenue

Consideration of domestic revenue mobilization brings the economy of state-building into sharp relief. In Afghanistan, the period under review was characterized by widespread violations of the constitution and other laws and by informal systems subverting the formal rules of the game. Customs illustrates the first, and taxation illustrates the second.

Customs and Tariffs

The collection of tolls or customs has always been an important part of the revenue of governments ruling over the current territory of Afghanistan. Between 1929 and 1978, customs revenue provided the most important component of the domestic revenue. Depending on the trading partners, a few provinces have loomed particularly large in collection of customs revenue. The Afghan government found itself in a situation in which provincial governors or militia commanders, sitting astride border points, collected the revenue, determined policy, gave preferential treatment to their favorite merchants, and spent the money as they wished. By contrast, provinces that were not on transit routes had practically no resources. From 2002 to 2004, Iran was the key conduit of the transit trade—the overland shipment of goods from the Gulf to south

Asia—making Herat the most important gateway for collection of revenues. At the same time, the large number of military units who had gathered under Commander Massoud and were stationed in and around Kabul could not be paid, as the international community refused to provide the resources to pay these men.

President Karzai addressed this problem in May 2003, convening first the National Security Council and then the cabinet to produce a consensus on the need for centralization of revenue. He then addressed the nation and a gathering of the *ulema* (religious scholars), making it clear that he made his own continuation in service dependent on progress on this issue. After this public declaration, he ordered all the governors and commanders with major customs revenue to come to Kabul. Having kept them waiting for four days, he then drafted a decree on centralization of revenue, obtained the signatures of all of the commanders and provincial governors, and promulgated it as public policy. The Ministry of Finance was tasked with implementing the presidential decision. Teams from the ministry were sent to all the provinces in June and July, and the minister of finance undertook an intensive tour of the revenue-producing provinces. By July 2003, more than US$20 million in cash had been brought from the provincial deposits to the Central Bank, and formal restoration of a unitary system of government in the fiscal area was established on the ground.

The success of the process is rooted in history. As studies of provincial-level administration by the World Bank reveal, Afghans across various walks of life, including those serving in provincial administrations, considered restoration of the unitary system to be highly desirable.[12] Despite the disappearance of manuals of administration, the memory of rules was extremely strong. In addition, the Afghan public associated local control over customs with unaccountable if not outright despotic or predatory individuals and groups. There was a consensus in the country that centralization of the revenue was a marker of the reemergence of the Afghan state. The issue as framed by the Ministry of Finance was one of restoration and implementation of rules rather than imposition of arbitrary centralization. The Islamic theory of governance in Afghanistan has been unitary, and the election of President Karzai by the Emergency Loya Jirga in June 2002 was a key enabling factor in centralization of revenue. In mosque after mosque, the Ministry of Finance asserted that the edict of a legitimate ruler, from whose legitimacy the governors and commanders derived their authority, was being implemented. Therefore the issue was not a one-time handover of "tribute" from the provincial treasuries of some local big men but rather the implementation of the constitution and laws of the land.

The reassertion of formal rules had its limits, however. Even though all formally registered customs revenue was submitted to the government, three significant areas of departure from the formal rules persisted in practice. First, in some of the key border points, a double bookkeeping system emerged, with one set of books submitted to the capital but another kept on the ground. Second, at least ten border crossings became points of entry for very large quantities of goods without having been recognized as customs posts. Revenue collected in these locations went to militia commanders and various networks of big men. Third, discriminatory local-level policies favoring groups of merchants aligned with militia commanders or local big men persisted, allowing cronies of these power brokers to compete on terms very unfavorable to honest merchants. The net effect of these three practices was that significant amounts of potential revenue did not find their way to the coffers of the government. Discussions with the international security forces persistently focused on a strategy whereby deployment of coalition forces and their Provincial Reconstruction Teams (PRTs) would be aligned with the goal of government control of customs and border crossings. These problems have yet to be fully resolved. The amount at stake is not small: preliminary assessments indicate that an additional US$300–600 million per year can be garnered from removing these three constraints. This compares to an estimated domestic revenue in 1384 (2005–2006) of about US$320 million (International Monetary Fund 2005a).

In parallel to centralization of customs revenue, the Ministry of Finance embarked on an ambitious program of tariff reform. The major issues were simplification of the complex system of classification into a transparent system, promulgating an exchange rate based on the market rather than administrative fiat, simplification of customs procedures and practices, creation of modern infrastructure for customs, crafting a customs law aligned with best international practice, and building information management systems and human resources. After a fair amount of groundwork had been done to formulate the elements of the strategy, Jelani Popal assumed the post of the director general of customs and deputy minister of finance for revenue and customs and galvanized the process that moved it forward.

Prior to the reform, the rules of the game were extremely opaque. The Customs House in Kabul, for instance, in 2002 was producing three different tariffs in response to inquiries. Up to twenty-four signatures were required, every step of the process entailing the payment of a "gift." There was a high degree of unnecessary centralization, requiring, for instance, signatures from the office of the director general of customs on various items of imports. The biggest problem was the artificial exchange rate, for although the dollar was trading in the open market for fifty afghanis, the rate of exchange at the customs house was six afghanis, leading to dramatic undervaluation of imports. The reform process had to face the challenge that simplification of tariff categories, which should have been welcomed by importers, could also involve an effective increase in rates of payment. Therefore, the work had to be done with considerable care and analysis. In the policy proposal to the cabinet, the tariff structure was reduced from more than 120 categories to 4, with rates of 5, 8, 10, and 14 percent. The president ordered the introduction of a new category of 4 percent

on all imports of machinery for private investment projects, to signal the special attention of the government to this group of potential investors. After a one-week trial period resulted in a protest movement, discussions between the government and merchants prompted the introduction of a further category of 2.5 percent covering most food imports and construction materials such as cement.

The process of reaching agreement on the new tariff structure reveals the complexity of the dynamics of interaction among importers, and the toll that the absence of credible representative organizations in the private sector exacts from bargaining over such issues with the government. Prior to submission of the new tariff to the cabinet, the Ministry of Finance engaged in extensive consultations with various categories of merchants. Some merchants, however, insisted that they had not been consulted, construing the willingness of the government to openly and transparently consider all their inputs as tantamount to the right of veto over the decision of the government. It is interesting that those individuals who voiced the loudest concerns over not being consulted did not show any records of having imported anything during the previous year or having paid any substantial amounts in customs. There was also the issue that some of the merchants considered 200 or 400 percent margins of profit to be their natural rights. Others wanted the tariff to be geared exclusively to their short-term interest in reexporting goods illegally to the neighboring countries, a practice that led the government of Pakistan to impose a unilateral ban on a list of imports from Afghanistan, in violation of international conventions and the Afghanistan Transit Trade Agreement between the two countries.

On the other hand, some of the merchants voiced legitimate grievances when the tariff was implemented on a trial basis. One week of discussions between government and merchant representatives produced an agreement: the new exchange rate and the simple tariff categories would be retained, but the government would agree to the introduction of a category of 2.5 percent, shift certain items within the tariff categories, and put the new system into effect on March 21, 2004, the beginning of the Afghan calendar and fiscal year. The new system went into effect on the agreed date, and except for a minor protest in Khost, where the erstwhile Communist government had granted special concessions that were now removed, there was no hitch in implementation. Afghanistan now has the simplest tariff system in the region and is in a position to use the tariff as an instrument of developmental policy and revenue collection. The rise in revenue has been substantial (International Monetary Fund 2005a), but realizing the full customs revenue potential awaits the removal of three constraints identified above.

Preparation of a new customs law internalized the lessons learned from the preparation of the banking laws. Instead of presenting the legislative department of the Ministry of Justice with an off-the-shelf product, the team from the Ministry of Finance, assisted by international advisers, worked closely with colleagues from the Ministry of Justice to reach agreement. By December 2004, when Popal, who had contributed his services as a volunteer without pay, resigned from his post, a coherent strategy for the next five years was in place. At the heart of this strategy was creation of information management systems that went beyond enabling Afghanistan to adhere to the best international practice. Investing in people was a very significant part of this strategy, and the customs department obtained approval from the Civil Service Commission to recruit staff on a transparent basis and to pay them on an enhanced scale of salaries. The draft law also provided special incentives for customs officials to seize illegally imported goods and to combat corruption in the export of narcotics.

In sum, customs and tariff reform followed a holistic strategy that combined attention to a complex range of policy issues, relentless management of details, and patience to deal with stakeholders who would shift their positions or claim that those who had provided inputs and dialogue were unrepresentative. Over the decades, the official Chamber of Commerce has become an organization whose leadership is appointed by the Ministry of Commerce. Some new organizations have come into existence, but these are led by Afghans who have lived many years abroad and are fluent in foreign languages, and it is not clear that they actually represent the consensus of the merchant community in general. The challenge for the merchant community is to acquire an organizational infrastructure, with transparent systems of selection and representation; to agree on mechanisms of consultation with the government; and to understand both the potential and limits of a consultative process, as the government in the end must make policy decisions based on the interests of the entire nation rather than one segment.

The Telecommunications and Fuel Sectors

The government has been clear that although centralization, simplification, and consolidation of revenue from customs are necessary to fiscal sustainability, they are by no means sufficient. The goal is to increase total revenue on the basis of a wealth-creation strategy and to reduce the proportion contributed from customs and foreign assistance. The first manifestation of this approach for diversification of revenue sources was carried out in the area of telecommunications. The transitional government decided to issue licenses for a mobile telecommunications operator, on the basis of careful work by a team of international experts who were led by the ministers of communications and finance. After approval of the policy by the cabinet, the process of awarding the license was entrusted to a group of international experts, who were provided complete autonomy in their evaluation of bids. Two bids nearly matched each other on technical grounds, but the Roshan group offered nearly US$3 million more than its rival and consequently was awarded the license.

An important issue of discussion was whether the government would give customs concessions or exemptions for the import of telecommunications machinery. The government team insisted that Roshan's projection of potential demand was vastly underestimated and was not willing to provide exemptions. Negotiations were tough, nearly resulting in award of the license to the next bidder. As it transpired, Roshan had indeed underestimated substantially the demand of the Afghan population for mobile phones. The agreement with Roshan provided the precedent on the basis of which the government renegotiated the licenses granted to the Afghan Wireless Communication Company by the Taliban and confirmed by outgoing president Burhanuddin Rabbani prior to the transfer of power to Karzai. Taxes from the telecommunications sector can provide an important source of revenue in the future, provided that the government acquires the capacity to maintain a level playing field and hold the players to international standards of accounting and auditing.

In contrast to the successful strategy adopted in the telecommunications sector, efforts to introduce a transparent regulatory system for the import of fuels, which would have had substantial health, safety, and revenue benefits, did not materialize, as powerful interest groups successfully mobilized against it. Instead, there were attempts to secure concessions, eighteenth-century-like privileges that would have violated the constitution and the laws of the land. Substantial progress was achieved in 2004 on new minerals and oil and gas laws, as the Ministries of Mines and Industry and Finance reached agreement with the World Bank and other international partners on these important policy domains.

Taxation

The most important arena for realization of the goal of fiscal sustainability is taxation. This is a complicated domain, because of the complexity of inherited rules and regulations, the lack of clarity of functions within the government, and the substantial human resources required for simplification as well as conflicting ideas regarding fairness, incentives for development, and creation of a culture in which rights of citizenship go hand in hand with the obligations of citizenship.

An analysis carried out in the Ministry of Finance revealed that there were about 113 laws on the books in the area of taxation, some entailing expenditure of US$1,000 to collect one dollar in revenue to the government. Of course, this did not mean that the revenue collected by the government was the amount paid by the people, as those acting in the name of the government often acted in their own interest or that of local power holders. Simplification of the laws and enforcement of new procedures required a substantial one-time mobilization. Changing the antiquated rent law, for instance, required mobilization of more than 200 individuals to collect more than US$100 million in revenue and taxes from several districts of the city of Kabul. Change of the vehicle registration tax in Kabul would require a three- to six-month mobilization of around 400 individuals and would bring a net benefit of US$20 million to the government.

With the large international presence in Afghanistan, an issue in implementing various taxes, including rental taxes and vehicle registration fees, was whether international agencies and their employees should be tax exempt. In principle, the payment of taxes by the international community not only could help increase domestic revenue capacity but also would provide a demonstration effect that wealthy and powerful people must pay their fair share of taxes. Moreover, the existence of a separate set of rules goes against the principle of equality of all before the law and provides loopholes through which goods could enter under one category and be resold under another, undermining fair competition in the market. Yet the international community's declarations on the importance of enhancing domestic revenue mobilization have not been matched by willingness to consider new initiatives to tap the revenue possibilities generated by their own presence. For example, the introduction of the rental tax in Kabul, which captures some of the windfall profits generated by the foreign presence, although supported by the IMF, was resisted by some in the international community.

A challenge that remains to be settled in taxation policy in Afghanistan is clarification as to whether the Ministry of Finance, alone or in conjunction with one or more other authorities, is the locus of policy and implementation in the area of taxation. Practically every ministry now performs a role not only in collecting revenue but also in setting policy. Such a structure not only suffers from undue complexity but also contains the risks of double or triple taxation as well as unpredictability. The risk is particularly high in the case of municipalities, whose decision rights need to be clarified as part of a holistic strategy on taxes and revenue mobilization.

The Ministry of Finance was able to eliminate export taxes, reduce corporate and individual taxes from 25 to 20 percent, create a large taxpayers' unit, and introduce tax identity numbers for all importers and corporate taxpayers. The number of taxpayers at the end of 2004, however, was fewer than 14,000. Despite this, a group of vocal individuals in the private sector, some of whom have received heavy subsidies for their initiatives from donors, insist that the taxes in the country are too high. Examination of both tariffs and taxes of the neighboring countries reveals that Afghanistan's are the lowest in the region, and among the lowest in the world. But given the shrill nature of the debate, there is need for a mechanism to review the developmental aspirations of the country and to forge a consensus around taxation policy. A key task for the future is substantially reducing, if not eliminating, the gap between the informal and the formal rules. The Afghan people today are taxed for both legal and illegal activities. It is clear that both production and trafficking of drugs are subject to various informal mechanisms of taxation. Further, merchants are subject to informal tolls across the roads. A truck, for instance, was subject in early 2004 to illegal collection as many as twenty-four times from the border town of Hairatan in the north to the city of Jalalabad in the east. Unless the cost of protection is centralized and the flow of legal transactions is subject to an honest system of taxation, creation of a culture of formal and transparent taxation will remain a distant goal. Equally significant, of course, is a transparent system of expenditure where citizens are able to see the value derived from their taxes at work.

The Budget

The Ministry of Finance put forth the concept of the budget as the central instrument of policy. The essence of this strategy was to initially bring all the stakeholders in the government, and then all the stakeholders in the country and the international system, into the same arena and to make the cabinet the center of decisionmaking. This conception is deeply rooted in Afghan history, where government officials desired a predictable system and one locus of decisionmaking, linked directly to flows of resources. Having obtained the president's endorsement of this national objective, the Ministry of Finance devised a number of mechanisms to achieve it.

No-Deficit Financing

First, the ministry enforced the policy of no-deficit financing. This meant a complete break with the practices of the past, as it required strict adherence to rules of budget, procurement, and reporting for release of funds. The magnitude of the task can be appreciated by noting that in the first quarter of 1383, beginning on March 21, 2004, fully 40 percent of applications for cash advances were rejected by the Treasury for lack of compliance with existing rules. A corollary of the policy of no-deficit financing was that the government should be able to project its cash requirements to the Central Bank with advance notice of at least one month. The Central Bank was completely right in requiring this type of notification. Despite considerable progress, however, the Ministry of Finance has been unable to meet this objective.

Centralization of Allocation and Reporting

The underlying reason for the failure to meet the first objective has to do with a second objective of the Ministry of Finance: to make the budget not only its business but also that of all levels of government at first, and ultimately of the citizens at large. Progress in this area was painfully slow. Although coordination between the Ministry of Finance and line ministries improved substantially, the internal reorganization of the budgeting and administrative systems within most ministries progressed only marginally. Neither the information management systems nor the human resources required to ensure that allocations and expenditures were based on priorities and accurately reflected the cost of activities were in place by the end of 2004.

At the heart of this problem was the neglect of the budget as a central instrument of policy in the aid system. It was now common practice for different donors and groups of technical experts to take the lead in recommending changes in parts of complex systems, a practice that contributed to fragmentation and waste of resources. What was required was a coherent program for building the internal budgeting systems across levels and functions of government. Only on this basis could the right balance be achieved between the centralization of allocation and reporting and the delegation of authority to instill ownership and responsibility to the lower levels.

Identification of Personnel

A third focus was the need to tackle the problem of differences between the number of authorized positions and the actual number of staff in a particular ministry or organization. The Ministry of Finance created a database with the help of the British Department for International Development (DfID), entering all the details of government staff who had received salary in a particular month. On this basis, Salam Rahimy, the deputy minister of finance, was able to transform consideration of the recurrent budget from shrill arguments to discussion of figures, numbers, and priorities. It is a credit to his leadership and management skills that the 1383 (March 2004 to March 2005) recurrent budget was a consensus document with the exception of one ministry, which unsuccessfully pressed its case for a much enhanced appropriation in the cabinet.

The staff size issue reflected the so-called 20–80 rule, meaning that 20 percent of the organizations usually account for 80 percent of the expenditures and thereby 80 percent of the problems. In the case of the recurrent expenditure, the organizations that were on the top of the list were Defence, Education, Health, Interior, and the Secret Service. The discussions between Ministries of Defence and Finance for preparation of the 1382 (March 2003 to March 2004) budget were particularly intense, with the Ministry of Defence insisting that the various militia forces within their structure amounted to 250,000 officers and soldiers, and the Ministry of Finance, relying on publicly available intelligence systems, maintaining that the number was closer to 50,000. The process of verification entailed in Disarmament, Demobilization, and Reintegration (DDR) has revealed that the intelligence estimates were quite close to the mark. In the end it was decided that the Ministry of Finance would accept a figure of 100,000 for the Ministry of Defence, provided that

the Ministry of Defence agreed on a systematic downscaling during 1382 and 1383 (2003 and 2004). By November 2004, the Ministry of Defence was requested to provide in the 1384 (March 2005 to March 2006) budget for a maximum of 10,000 officers and soldiers from its former ranks.

Discussion with the other major interlocutors in the 20–80 category was equally intense. By the end of 2004, the health ministry had substantially reduced the number of its employees by contracting with the private sector; the secret service was undergoing a systematic reform of procedures and verification of its employees; and the education ministry was receiving substantial help from donors to create databases and systems to verify teachers and personnel on the ground. Nonetheless, it is worth repeating here that the absence of a national biometric database of employees was still severely constraining the ability of the government to know the number of its actual employees and thereby to implement increases in their salaries.

Although the number of authorized positions gradually is being brought under control, and the number of actual positions is being verified manually, it is still impossible to ascertain the number of people who draw multiple salaries simultaneously under different names from different ministries and departments. The Ministry of Finance saw a great opportunity in the presidential and parliamentary elections of 2004 and 2005 to harness modern technology to address this problem and pushed to create a biometric national database or to persuade the UN agencies and donors at least to fund such a database for the civilian and military employees of the government. Its efforts were unsuccessful, however, as the election experts were strongly committed to a manual procedure based on the use of paper cards and verification by ink.

Database on Donor Assistance

A fourth focus was building a database on all donor assistance. Aidan Cox, a United Nations Development Programme (UNDP) staff member seconded to the government at the request of Ministry of Finance, recruited an Afghan team and invested his considerable energies in building its skills and confidence. When Seema Ghani Massoumi accepted the post of the director of the budget in the Ministry of Finance, she not only strengthened this remarkable team but also enlisted it for preparation of the mid-year budget review, the annual budget preparation process, and information sharing and dissemination with the donors and the Afghan public. The workshops that she and Nargis Nehan organized with various groups of Afghan stakeholders were a very important mechanism for ensuring transparency and accountability. These workshops were the pilot for undertaking the preparation of a poverty-reduction strategy paper in 2005, with the goal of using the process to build a national consensus around achievable goals with the available means.

Development Expenditure

Fifth, in budgeting for development expenditure, the 20–80 problem applied to ministries charged with provision of infrastructure. Here a key constraint was the absence of feasibility studies and a lack of understanding of what a fundable project required. As development is the legitimate business of all citizens, everyone in the country has a proposal on the best location of dams for irrigation or generation of power, construction of roads, building of hospitals or transmission lines. Regardless of financial costs or environmental and social impacts, when most ministries proposed projects, they were at best dusting off the proposals of the 1970s, ignoring the changed technologies and design practices or putting forward a one-page proposal for expenditure of tens of millions of dollars. There was also difficulty in grasping the fact that donors were unwilling to fund the expansion of the government sector to implement developmental projects. Older officials, fondly recalling their collaborations in the 1970s with international financial institutions in the creation of state-owned enterprises, were often shocked to learn that these institutions now advocated the dismantling rather than expansion of these enterprises. This tension regarding functions to be performed by the government remains unresolved.

Procurement

A sixth area of work related to the budget was procurement, which has been a severe constraint in both project implementation and timely attention to operations and maintenance. The government hired an international firm to handle procurement for development projects, which made a substantial contribution to ensuring that international procurement was carried out effectively. At the very beginning, however, the firm ignored the advertisement rules of the existing procurement laws, compliance with which would have required a minimal expenditure of less than US$1,000 for the advertisements. This seemingly small incident cast a public shadow—inflamed by a number of newspapers and interest groups within the government—on the government's commitment to transparency.

The most significant challenge, however, was to find a champion for preparation and passage of a new procurement law through the cabinet. The Ministry of Reconstruction took charge of management of the procurement firm and responsibility for preparation of a new procurement law, but passage of the law was delayed until 2006. In the absence of a procurement law that met international best practice, the government's desire to channel more money through the budget remained unfulfilled. Adoption of a new procurement law also was needed to change the relation between Ministry of Finance and line ministries, from one of opposition and constant scrutiny to one of trust based on adherence to accepted rules. Given the ninety-day period of reimbursement from the ARTF and the fact that the weather and logistics put severe limits on the number of days when construction work can be carried out in different parts of the country, adoption of a new law to streamline procurement should have been an urgent task.

Budget Law

Afghanistan had inherited a budget law that received a very favorable review from international experts. Therefore, the task was seen initially as improvement of the existing procedures and introduction of information management systems, rather than preparation of a new law. Subsequently, however, different experts from the same international institutions recommended adoption of a new budget law. Seema Ghani Massoumi prepared a draft budget law that was ready for discussion by the cabinet by the end of December 2004. The shift in the advice of international experts should serve as a reminder that few people in international agencies or bilateral donors have a clear view of the building blocks of a sustainable fiscal system. In each of the reforms carried out by the Afghan government, Afghans had to invest substantial amounts of time to tailor the recommendations of international experts to the context and to build on existing traditions rather than beginning with an off-the-shelf law that had been recently applied in some other context. Major policy decisions were required, in particular, in the area of accounting and auditing. These are highly technical fields where the existing system completely fails to meet international standards, but decisions on which parts of the international system to adopt need considerable attention and thought.

Equity and Equality of Opportunity

An eighth concern was the impact of the budget on equity and equality of opportunity. This issue could not be faced with the existing rules and organizational capabilities. Obtaining the figures on provincial expenditures from line ministries required months of intense discussion and analysis of manual systems of recordings. When the figures were first presented to the cabinet, it came as a shock that the ten poorest provinces of the country were receiving the smallest amounts of allocation. The explanation lies in the investment pattern of the 1960s through the 1980s: provinces that had received investments in those periods required the largest budgets for operation and maintenance and for salaries of staff assigned to provide social services. It is only through collection of relevant data and detailed analysis that the principle of geographic equity, which was unanimously adopted by the cabinet in the 1382 (2003–2004) budget, can be given concrete substance in the procedures and practices of all departments of government.

Reporting

A final area is reporting, both as an instrument of discipline within the government and as a means of binding the citizens and the state as a community. The Ministry of Finance submitted a weekly report on the fiscal condition of the country to the cabinet from July 2002 to December 2004. Using data on expenditures ineligible for ARTF reimbursement that were gathered by the World Bank–appointed monitoring agent, the Ministry of Finance was able to keep the attention of the president focused on this issue and to provide inputs on fiscal matters to cabinet members. The ministry also devised the mid-year budget review as a mechanism to provide monitoring and to establish adjustments between different ministries.

The Finance Ministry relied on three key mechanisms for reporting to the citizens at large. First, in a series of regular press conferences, the ministry team reported on all the categories of income and expenditure. Second, a website was created where all the information was posted and the information on the Donor Assistance Database was disclosed. Third, in response to the questions of the delegates of the Loya Jirga, the minister of finance provided an hour-and-a-half-long report that was broadcast on national television. As the right to information is enshrined in the Afghan constitution, it is hoped that the practice of disclosure and reporting begun during the transitional government will become a routine input into public discussion of how public money creates value.

Security and Public Finance

Transparency of expenditure on the security sector is going to be a particularly important aspect of building trust between the citizens and the government and between the government and the international community. A unified budget cannot be established without full incorporation of the cost of security; and a monopoly on the means of violence cannot be established without the predictability and order created through the accountabilities of a public financial system. Because there was no establishment control in the spring of 2002, the security sector rapidly expanded from a force of fewer than 20,000 in 2001 to a claimed force of more than 400,000 by the summer of 2002, based on patron-client relationships. The international community decided not to support these forces—which they called Afghan militia forces (AMF)—instead choosing to support the newly formed Afghan National Army. Accordingly, domestic revenue had to be mobilized to pay for the militia forces as well as the police. To establish accountability to the Afghan population, it had to be demonstrated that these people existed, leading to the negotiations between the Ministry of Finance and Ministries of Defence and Interior on validation of numbers and

people. Although agreement was eventually reached on a target number of 100,000 soldiers and officers to which to reduce the AMF, it became evident as the DDR started that the numbers were not in fact there and that various commanders were diverting the resources. Hence by December 2004, budget discussions concluded that the maximum number of people from AMF that could be retained on payroll in the 1385 (March 2005 to March 2006) budget would be between 8,000 and 18,000. A similar verification process was followed with the Ministry of Interior, but because formal DDR for the police had not begun by the end of 2004, reductions were much slower.

An iris-based identification system would have enabled verification of identity to ensure that one person had only one government job. Anecdotal evidence and data gathered through a pilot program indicated that some individuals were drawing multiple salaries under different names, thereby inflating the number of actual employees of the government and creating distrust regarding transparency of hiring and payments. The database required for such a purpose would have cost around US$100 million. Despite the Ministry of Finance's effort to convince the election team to create a national voter registration database, the UN resorted to a one-time manual database for elections and a separate one for DDR. Currently, there is a proliferation of separate databases in different ministries without compatibility or integration into an overall database. Both accountability and security require investment in information capital. It is imperative that the costs and benefits of such investment are analyzed within a clear framework of statebuilding rather than being dictated by the preferences of individual agencies.

Although President Karzai's policy of no-deficit financing was strictly followed by the Ministry of Finance, deficit financing remained widespread in the northern provinces until June 2003, when revenue was centralized. During this period, a number of profitable state-owned enterprises were being subsidized by the government, yet their workers were not receiving wages and benefits. In implementing the law on state-owned enterprises, the Ministry of Finance cut off subsidies to profit-making enterprises nationwide. Some of the northern commanders threatened to take funds from the banks and allocate them to the enterprises under their control. The Ministry of Finance informed them that if they did so, all payments for salaries would be stopped and that the cause of the nonpayment would be disclosed to teachers and government employees. As a result, subsidies to profitable enterprises and deficit financing were stopped, and the special status of some commanders in overriding the authority of provincial directors of finance was ended.

Revenue from customs and other domestic sources could have been significantly raised had there been international support for protection of customs posts and the branches of the Central Bank and the state-owned banks in the provinces. Requests for such support initially were not acceded to, but thanks to strong backing from the US Department of the Treasury, the US Department of Defense reached agreement toward the end of 2004 on mechanisms to support the efforts of the Afghan government in this regard.

Current plans for a 70,000-strong army, based on discussions with the US military, would require a recurrent expenditure of around US$500 million per year by 2009. When plans for the national police and secret service are taken into account, the recurrent expenditure for security forces could exceed US$1 billion per year. From a fiscal perspective, the question of sustainability of such expenditure is paramount. Even under very optimistic projections for domestic revenue, such an expenditure on security would imply a totally inadequate allocation of resources for human capital, infrastructure, and other vital functions of government. Noting that US expenditure on the coalition and NATO expenditure on ISAF were estimated at US$12–15 billion per year, the Ministry of Finance took the position that since any reduction in the presence of external forces would entail a substantial saving for the international community, there must be a medium- to long-term commitment of security assistance for the Afghan institutions. This would both create the enabling security environment for investment and growth and allow the government to use domestic revenues for enhancing its legitimacy by fulfilling its vital functions. In the absence of such a commitment, current assumptions about the size of the army, police, and secret service will have to be reexamined and more affordable security strategy agreed upon.

Conclusion

The public finance accomplishments in Afghanistan are due to the remarkable teamwork and shared goals pursued by individuals with a high dedication to public value and empowerment of the citizens. It was often remarked that the Ministry of Finance during the transitional government contained a very large number of unpaid volunteers.[13] In the words of Deputy Minister Jelani Popal, they viewed this as service undertaken in return for the investment that the nation had made in their education.

Afghanistan's strategy of dealing with public finances as a critical dimension of statebuilding demonstrates that reforms can take place under difficult circumstances. At the same time, it shows the need for fundamental changes in the international aid system to create sustainable development. In an environment of persistent tensions and great mistrust, the goal of movement toward a state that delivers citizenship rights is best served through processes that are not only technically sound but also politically transparent.

Notes

1. For a discussion of the "circle of justice," with a focus on its historical role in south Asian governance, see Darling (2002).

2. World Bank press release ("Two Decades of Conflict Cost US$240 Billion; Now Afghanistan Will Need $27.5 Billion to Recover") issued on March 30, 2004, for Berlin conference "Securing Afghanistan's Future" held on March 31 and April 1, 2004.

3. Donors included the United Kingdom (US$520 million), Norway (US$10.7 million), Japan (US$8.4 million), Sweden (US$5 million), and Italy (US$3.2 million). Loans from the Asian Development Bank, the World Bank, and the International Monetary Fund were paid off in this manner. Government of Afghanistan, Ministry of Finance, "Financial Report 16/7/1381 (October 2004)," Kabul, 28.

4. The government obtained debt forgiveness from China (9.6 million pound sterling), Denmark (5 million Danish kroner), and Germany (34.5 million pound sterling) (Ibid.). A number of other claims remain to be resolved.

5. As the Central Bank had not yet been reformed, and the funds of the government were not drawing any interest in accounts at the Central Bank, the Asian Development Bank agreed to deposit the proceeds of the first program loan in a special interest-bearing account opened in the name of the government. Withdrawals from this account required the simultaneous signatures of the president and the minister of finance. ADB and international consultants chose the bank where the account was opened. Funds were then transferred to the Central Bank as the need arose for payment.

6. It is worth remarking that the demands voiced by about 225 members of the constitutional Loya Jirga in December 2003 that were costed by the Ministry of Finance amounted to at least US$80 billion. This figure is not high, in comparison to the World Bank's estimate of at least US$240 billion in war-related losses between April 1978 and December 2001 (see World Bank press release, "Two Decades of Conflict Cost US$240 Billion; Now Afghanistan Will Need $27.5 Billion to Recover," March 30, 2004).

7. For an account of this situation, see Rohde and Gall (2005).

8. For an account of US assistance in Afghanistan in the 2001–2004 period, see Ghani, Lockhart, and Carnahan (2005b).

9. The problem arose because the insurance required by the donor's internal procedures could not be secured in time, as it required fulfillment of too many complex conditions. This highlights the need for rapid procedures if donor organizations are to provide timely responses to governments in the immediate wake of conflict.

10. The situation was particularly problematic in northern provinces, where bank branches participated in a series of transactions that in any other context would have constituted crimes.

11. A risk-guarantee facility was secured from the Overseas Private Investment Corporation (OPIC) in early 2002 by the Ministry of Finance; other facilities were sought from the Multilateral Investment Guarantee Agency (MIGA), which took a couple of years to activate, and from other countries, which were not forthcoming.

12. See Afghanistan Research and Evaluation Unit and World Bank (2004).

13. These included Temor Anwaryah in revenue, Wafi Amin in state-owned enterprises, Tareq Formoli as deputy minister of administration, Jelani Popal as deputy minister of revenue, and Ashraf Ghani as minister, among others. None of them drew salary or benefits for their public service.