

Security sector financing and fiscal sustainability in Afghanistan

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This paper was prepared while I was based at ODI. The views expressed in this paper are entirely my own and do not necessarily represent DFID.

Acronyms

ANA	Afghanistan National Army
ANAP	Afghanistan National Auxiliary Police
ANDS	Afghanistan National Development Strategy
ANP	Afghanistan National Police
ARTF	Afghanistan Reconstruction Trust Fund
CG	Consultative Group
CSTC-A	Combined Security Transition Command Afghanistan
DAC	Development Assistance Committee
DFA	United States Office of the Director of Foreign Assistance
DFID	United Kingdom Department for International Development
DoD	United States Department of Defense
DDR	Disarmament, Demobilisation, and Reintegration
DIAG	Disarmament of Illegal Armed Groups
EC	European Commission
FAF	United States Foreign Assistance Framework
GAO	United States Government Accountability Office
GDP	Gross Domestic Product
HIPC	Highly Indebted Poor Countries Initiative
I-ANDS	Interim Afghanistan National Development Strategy
IMF	International Monetary Fund
ISAF	International Security Assistance Force
JCMB	Joint Coordination and Monitoring Board
LOTFA	Law and Order Trust Fund for Afghanistan
MCC	Millennium Challenge Corporation
MoD	Afghan Ministry of Defence
MoF	Afghan Ministry of Finance
MoI	Afghan Ministry of Interior
MTEF	Medium-Term Expenditure Framework
MTFF	Medium-Term Fiscal Framework
MDTF	Multi-Donor Trust Fund
NATO	North Atlantic Treaty Organisation
NDCS	National Drug Control Strategy
NGO	Non-Governmental Organisation
ODA	Overseas Development Assistance
OECD	Organisation for Economic Co-operation and Development
PFM	Public Financial Management
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PRT	Provincial Reconstruction Team
QUIP	Quick Impact Project
SAF	Securing Afghanistan's Future
SSR	Security Sector Reform
SWAp	Sector Wide Approach
USAID	United States Agency for International Development
UNAMA	United Nations Mission for Afghanistan
UNDP	United Nations Development Programme
USG	United States Government

Executive summary

Afghanistan is emerging from decades of strife, and the new Government faces several challenges. Arguably the most daunting of these is to make Afghanistan secure, and establish the rule of law. Approximately \$9 billion of foreign assistance has been spent on the security sector from 2003 to 2007, underscoring the important role the security sector plays in the wider reconstruction agenda. From 2007–10 a major scale-up to over \$14 billion is planned, to be funded largely from external assistance. This resource expansion should be accompanied by heightened scrutiny of how foreign assistance is spent and whether it is delivering the desired outcomes of peace and a stronger, more accountable Afghan state. One important question to ask is whether the current financing model employed is the correct one, and how it affects the incentives around the reform process.

This paper takes an aid effectiveness approach to judge whether the financing model is appropriate for Afghanistan and it finds that the current financing model falls short of good aid effectiveness practice:

There is insufficient reference to sustainability, for example by taking into consideration Afghanistan's fiscal resources, when making donor policy decisions.

The sector lacks a transparent, forward-looking and costed strategy that the Government owns and all active donors subscribe to.

Most resource flows are not aligned with national budget and accountability frameworks, and are unpredictable.

Most resource flows are not harmonised, by being channelled through a pooled mechanism, nor even jointly planned as part of a common strategy.

This assessment is of real concern: it implies that donors are perpetuating a high level of aid dependence; not setting strong incentives for institutional reforms; and generating fiscal risks for the state. Together these weaken the state further, are an additional source of insecurity, and damage the scope for genuine state building over the medium-term.

The drivers of these fiscal sustainability and aid delivery problems are unpacked in to three factors:

1. **The Government does not have the resources to finance the entirety of national security spending** given the current security context. The weak revenue base is due to economic, political and administrative factors.
2. **Government incentive structures undermine the potential for strong leadership and reform.**
3. **Donor incentive structures limit alignment and harmonisation.** The sector lacks an effective financing and planning mechanism, which means most aid flows are not channelled through the national budget and accountability frameworks, and lead to unpredictability of donor resources. The major donor to the sector prefers bilateral project aid over pooled mechanisms.

There are four factors that explain this situation. Firstly, the Karzai administration inherited a fiscally unsustainable state, which historically has relied either on external support in exchange for geopolitical alliances, or a strategy of co-opting local commanders to ensure a fragile peace. The capture of local revenue collection; constraints to economic development compounded by 30 years of instability; an entrenched and pervasive opium economy; weak

institutional capacity of the Government to administer a modern tax regime; and strong vested interests against tax reforms all block the acceleration in tax collection required to meet revenue targets.

Secondly, key security sector institutions have been captured by vested interests that will protect their rent-seeking opportunities at the expense of reform, transparency, and institution-building. Drug interests are involved in much of this. The major international players are operating with a political-military lens rather than a development lens, and are under pressure to deliver security on the ground over an impossibly short time horizon. This combination of factors, and the structural division of labour across the security sector, has meant that there is no single champion of reform to deliver and implement an overarching strategy.

Thirdly, as the only pooled funding mechanism for police spending, the Law and Order Trust Fund for Afghanistan (LOTFA) has the potential to play an important strategic and financial role. But a number of internal weaknesses mean that the LOTFA is closer to being a big project rather than a harmonisation mechanism or a driver of reform.

Fourthly, the US Government (USG) prefers bilateral aid to multilateral aid on a global level, and Afghanistan is no different. Sheer financial clout means that USG policy and decisions affect the entire sector and the interventions of other donors. Responding rationally to institutional incentives – to deliver security improvements in the near-term – implies a focus on maximum possible recruitment and retention, not institution-building, or dialogue with economic planners in the Afghan Ministry of Finance (MoF), or coordination with other donors.

To improve the quality of aid provided and ensure the sustainability of security sector reforms, these four issues need to be addressed. Many of the underlying incentives will change only as a result of deep-rooted political transformation, which is a long-term process linked to broader social and economic development. During the process of achieving full financial independence, it will be important to improve the external financing model for the security sector, to ensure aid is having the maximum impact and the Government is fully prepared to cover its medium-term liabilities. Four policy levers are available to tackle these objectives: expanding the revenue base; reforming government systems and processes; strengthening the aid modality; and improving donor behaviour.

The paper recommends in the short-term:

A viable sector strategy delivered as part of the Afghanistan National Development Strategy (ANDS), which applies a fiscal lens to the sector, and generates buy-in from key donors on the trajectory for reform.

Reforming the LOTFA to bring more aid on-budget and allowing for greater donor coordination in line with the Paris Declaration on aid effectiveness.

Stronger donor reporting of aid and compliance with the national budget cycle, which should boost the credibility of the Government's spending and planning frameworks.

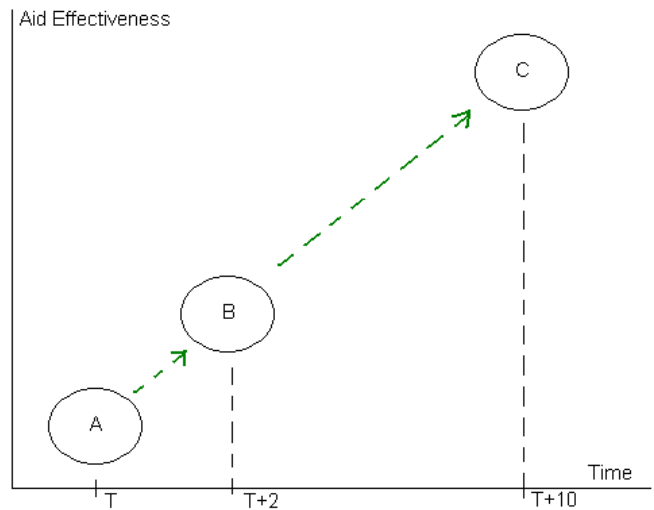
Stronger efforts to incentivise higher tax collection by provincial tax offices and their remittance to central authorities.

These are the critical first steps to ensuring improved resource management for the security sector, and a coherent plan for the Government to eventually take charge of its security responsibilities in the long run, which will also rely on a stronger revenue base to fuel government spending, independently of foreign assistance.

Long-run prescriptions include:

- Expansion of the tax base, which is the only route to fiscal sustainability.
- Improved fiduciary standards in the security sector ministries which will allow for more financial support to be managed and implemented by the Government.
- Development of a medium-term expenditure framework (MTEF) that guides resource allocation.
- Global changes to US donor practice which brings the US assistance more in line with the Paris Declaration principles.

This package of recommendations would set Afghanistan on a promising trajectory of reform, as depicted in the diagram. Point A represents the current situation, which is at the low end of the aid effectiveness scale. Point B is the proposed short-term solution, and point C the long-term aspiration, based on successful implementation of the above recommendations. In order to make this progression over time, donors will need to implement aid effectiveness reforms at the country level. This requires both a shift in institutional incentives to reward coordination and joint activities, and a commitment to making more financial and technical resources available for donors to invest meaningfully in shared mechanisms. This two-pronged approach would address both the will and capacity of donors to harmonise with each other and align with government systems.



Emerging policy options		
<i>Policy lever</i>	Short run (1–2 years)	Long run (3–10 years)
<i>Objective: Fiscal affordability and sustainability of the security sector</i>		
<i>Revenue base</i>	Published information on tax collection, and taxpayer education to improve compliance	Performance incentives to increase tax collection by provincial offices, and economic growth and development of the legal private sector and minerals industry
<i>Objective: Greater aid effectiveness of financing for the security sector</i>		
<i>government systems and processes</i>	Development of a costed strategy	Broader public financial management (PFM) reforms such as the development of a MTEF, and improved fiduciary standards in MoI and MoD
<i>Aid modality</i>	Reform and improvement of the LOTFA	Development of a comprehensive SWAp with a more advanced funding mechanism
<i>Donor behaviour</i>	Reform of selected aid delivery practices	Changes to USG’s global development assistance policy

Chapter 1: Introduction

Afghanistan emerged from over two decades of civil war and strife in 2001. After the toppling of the Taliban regime, the international community helped set up the Afghanistan Interim Administration under the leadership of Hamid Karzai, which became the Transitional Administration and then a democratically elected government in 2005. The new Afghan Government has a number of daunting challenges ahead: widespread poverty needs to be tackled, which will require concerted efforts to improve schooling and healthcare; the economy will need to emerge from its current dependence on illicit activity and aid-financed growth to deliver more job and business opportunities; war and the fragmentation of the state destroyed infrastructure, which will need to be rebuilt and rehabilitated to enable commercial activity in a landlocked country; and government institutions need to be reformed and restructured to deliver better public services.

Arguably the biggest challenge of all is the need to establish security and the rule of law. The security sector reform agenda is broad, and encompasses five separate pillars: establishing the Afghanistan National Army (ANA); setting up the Afghanistan National Police (ANP); reforming the judiciary to promise the rule of law; neutralising militias through disarmament, demobilisation and reintegration (DDR) and subsequent disarmament of illegally armed groups (DIAG); and eradicating the narcotics trade. For the purposes of this paper, security sector reform refers to rehabilitation of the army and the police force, vital for maintaining Afghanistan's territorial integrity and internal security.^{1,2}

The Afghan Government is not yet able to provide security for its citizens and maintain a monopoly on the use of force. This is one of the fundamental duties of a state. Not being able to deliver security undermines the Government's authority, and obstructs state building objectives. The security context has a two-way relationship with the legitimacy of the state: greater legitimacy of the state would imply lower insurgency activity and therefore reduced insecurity; while the ability to provide security strengthens legitimacy by demonstrating the capacity and moral authority of the state. Further, security is a precondition for development. All efforts to reform and modernise the Afghan economy are doomed to fail without lasting peace. It is therefore difficult to overstate the critical need for improved security to allow Afghanistan to emerge from a generation of warfare and instability.

To address this crucial need, foreign governments are providing support in two broad ways:

¹ This working definition is consistent with the Government's classification. Official statistics on security sector spending are composed mainly of the army and police, which fall under the remit of the Ministries of Defence and Interior respectively. Justice and rule of law institutions, including the Ministry of Justice, Attorney General and Supreme Court, fall under the Governance pillar of the interim Poverty Reduction Strategy Paper (PRSP) and are reported accordingly in the national budget. Counter narcotics falls under the Agriculture and Rural Development pillar. It is beyond the scope of this paper to give detailed consideration to the other security sector pillars.

² An alternative and not inconsistent approach is to define security *system* reform as advocated by the Organisation for Economic Co-operation and Development (OECD) in its recent Handbook on Security System Reform (April 2007), to emphasise the important and inter-connected roles played by core security actors (police, border guards, army), management and oversight bodies (ministries, financial management bodies, national security council), justice institutions (judiciary, prisons, traditional justice systems) and non-state security forces (private militia, private security armies, and guerrilla armies).

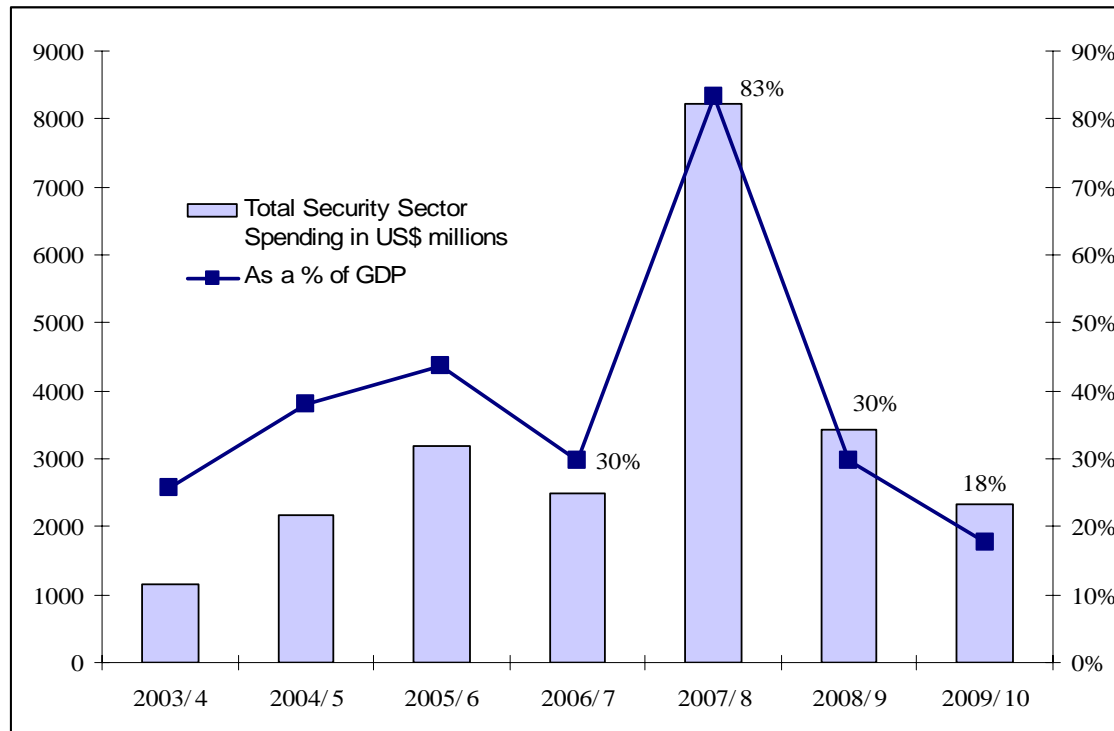
1. Military force to tackle insurgencies and deter violence, in the place of a fully trained and equipped local police force and army.
2. Financial and human resources to build state capacity to provide security and manage the development of a police force and army.

Both are essential for maintaining security in the short-term, and building capacity within the Government to manage security in the medium to long-term.

Around \$11.4 billion of aid has been spent in Afghanistan between 2002 and 2006 (OECD). This number is drawn from OECD data on overseas development assistance (ODA) commitments between 2002–05 in constant 2005 US\$, which is recorded at \$8454 million, and International Monetary Fund (IMF) estimates for donor assistance to the core and external budget in 2006 which comes to \$2923 million. ODA does not include spending on military operations such as NATO's International Security Assistance Force (ISAF) and the USG's Operation Enduring Freedom.

Approximately \$9 billion of foreign assistance (not strictly ODA) has been spent on the security sector from 2003 to 2007 as shown in figure 1, underscoring the important role the security sector plays in the wider reconstruction agenda. From 2007–10 a major scale-up to over \$14 billion is planned, to be funded largely from external assistance. This significant resource expansion should be accompanied by heightened scrutiny of how these resources are spent and whether they are delivering the desired outcomes of peace, stability and a stronger, more effective Afghan state. These numbers should be taken as indicative rather than exact, given the likely measurement errors. What is important here is the order of magnitude (for more on measuring security sector expenditures, see page 9).

One important question to ask is whether the current financing model employed is the correct one, and how it affects the incentives around the reform process. Answers to these questions will be valuable to stakeholders trying to effect change in Afghanistan; and more broadly to other post-conflict countries, for which Afghanistan can serve as an example for policy experience and transferring lessons learned.

Figure 1: Security sector spending 2003–2010

Source: Ministry of Finance, 2007

This paper takes an aid effectiveness approach to judge whether the financing model is appropriate for Afghanistan. The aid effectiveness paradigm, enshrined in the Paris Declaration signed by the OECD Development Assistance Committee (DAC) in 2005, highlights five tenets of good donor practice: alignment, harmonisation, ownership, managing for results and mutual accountability.³ All major bilateral donors to Afghanistan have signed up to the Paris Declaration. The Government of Afghanistan pledged its commitment to the Paris Declaration principles in 2006, to support a stronger platform for aid effectiveness within the context of the ANDS, and immediately initiated a baseline monitoring exercise against a set of aid effectiveness indicators. Applying an aid effectiveness lens to the security sector is therefore a relevant and useful exercise, and still a relatively new approach to evaluating post-conflict policy interventions. There are a few examples of aid effectiveness and public financial management principles being applied to the security sector, such as Afghanistan (World Bank, 2005); Sierra Leone (Middlebrook and Miller, 2006); and a review of DFID security and justice programmes (Ball et al., 2007).

³ What this paper does not attempt to do is offer a critique of aid effectiveness principles as framed by the Paris Declaration. A separate literature exists on this subject. Neither does the paper explore in detail the governance/state building dimensions of the aid effectiveness agenda, although these are brought out as relevant in the Afghan case study discussed.

Box 1: The Paris Declaration on aid effectiveness (March 2005)

Ownership is defined as partner countries exercising effective leadership over their development policies and strategies, and coordinating development activities. The existence and quality of a national development strategy is the primary indicator of ownership, as it reflects the ability of a recipient government to articulate a vision, set the development agenda, and coordinate donors and other actors around its plans.

Alignment refers to donors basing their support on partner countries' national development strategies, institutions and procedures. Indicators include the percentage of aid that is channelled through a recipient country's PFM and procurement systems, the share of untied aid, and the alignment with national budget cycles when providing aid statistics and discussing new initiatives.

Harmonisation requires that donors are better coordinated, employ a division of labour, and use shared and transparent procedures when providing aid. This is measured by the share of aid delivered through programmes rather than projects, and the extent of joint donor analysis and field missions.

Managing For results encourages a focus on the desired results of aid interventions – looking at outcomes rather than just inputs – and using evidence more effectively to make informed decisions. Results-oriented frameworks are a basis for judging the extent to which this is operationalised.

Mutual accountability reflects the idea that both donors and recipient governments are responsible for development outcomes. By signing the Paris Declaration, donors promised to help recipient countries plan and monitor aid, and link external assistance to their national budgets. Mutual assessment reviews are supposed to offer a way to measure progress against this principle.

Aid effectiveness is essentially a means to an end, where the desired goal is to maximise the beneficial impact of aid spent both in the short-term and in the long-term. In the short-term, impact can be maximised by ensuring that aid flows to those who need it most and for the desired purpose. In practice this means that the national budget process, which is responsible for allocating resources against national priorities, is transparent and functional; and that the PFM systems channel the funds appropriately and with due oversight. The impact of present investment is maximised over the long-term by ensuring that service delivery achievements do not stall or reverse when aid and donor interest declines. This is essentially about sustainability – 'the ability of a programme to sustain its activities – and thus its impact – after the programme or particular funding stream has come to an end' (Pearson, 2007). Political leadership and national ownership are equally important.

In Afghanistan, more effective aid will deliver stronger development results, and accelerate state building objectives. The more robust the social and political fabric, the earlier the exit strategy for the international community. The principles and practice of aid effectiveness are therefore of paramount importance to diplomatic, development and military interventions and actors alike. The term 'donor' is applied to any financier of SSR and includes non-traditional actors such as military agencies alongside traditional bilateral and multilateral agencies. Much of the security sector expenditure does not fall under the category of ODA, nevertheless the principles of aid effectiveness can be highly instructive.⁴

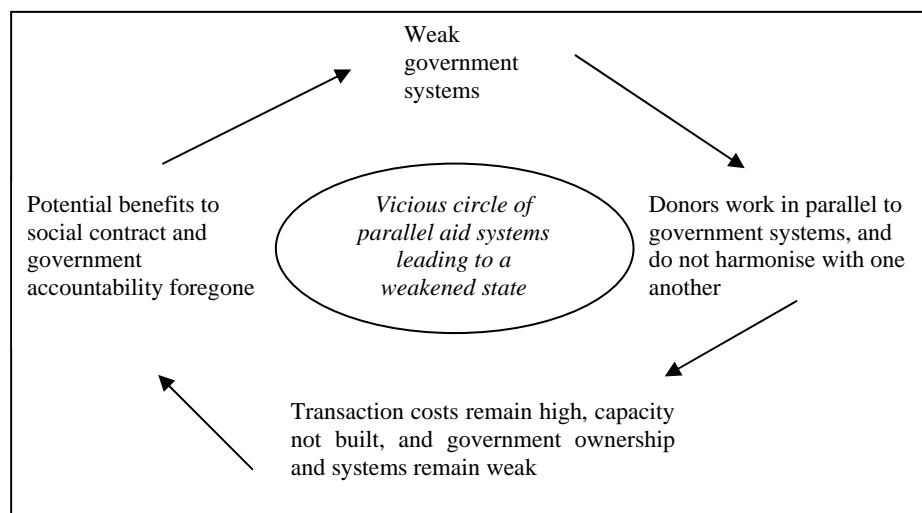
The Paris Declaration calls for the increased use of government systems to channel aid. By putting aid money in to the public system and through the national budget, 'alignment' is argued to strengthen domestic ownership of reforms and build capacity for the recipient government to manage service delivery in the long run – a win/win situation for donors, that is tempered by the fact that there may be considerable fiduciary risks to channelling money through weak systems in post-conflict states. This is where multi-donor trust funds

⁴ For types of security sector spending and their eligibility to be classified as ODA, see the OECD SSR Implementation Framework (SSR-IF) Table 8.3.

(MDTFs) are often used to provide additional fiduciary safeguards that protect against corruption and misuse of aid, and help strengthen national oversight mechanisms. Pooling resources with other donors strengthens the response behind a given intervention, and reduces the time needed for the government to coordinate different policies and activities. The choice and mix of aid instruments is an important issue, because different modalities have varying impacts on recipient governments based on the extent of capacity building, the transaction costs involved, the transparency and predictability of aid, and the level of country ownership (Foster, 2007; Williamson et al., 2008).

The diagram below shows how parallel aid flows – the conventional donor response to developing country need, which includes a heavy reliance on discrete projects – weaken domestic systems and contribute to a vicious cycle of aid dependence and low capacity. Conversely, aid that is channelled through government systems serves to reduce the transaction costs to government by harmonising with other donors, and by strengthening public systems, builds capacity. This, ultimately, supports the long-term sustainability of donor interventions.

Figure 2: Effects of aid on national systems



Source: Williamson et al., 2008

Complying with the Paris Agenda reinforces the need for strong public financial management. In post-conflict and aid-dependent countries this implies that donors will need to support institutional reforms and build capacity alongside the provision of financial aid, for the reasons outlined above: to ensure government systems can effectively manage the increased flow of resources; and build sustainable systems for managing the reform agenda after donor support tapers off. There is a growing literature which argues that the security sector should be treated like any other government sector: exposed to the same level of scrutiny and accountability, and reformed to improve the transparency of policy decisions and spending (Ball and Holmes, 2002; Middlebrook et al., 2005; Middlebrook, 2007; OECD DAC, 2007).

Against this policy and academic background, this paper's primary criteria for judging the current financing model for the Afghan security sector are the following:

How fiscally sustainable is the package of donor support, and how do donor policy decisions affect the time horizon over which the Government will be able to afford the security sector bill using domestic resources?

Is there a high-quality strategy that reflects the Government's vision for the sector and ownership of the reform agenda, which is also used to guide resource allocations?

How aligned is donor assistance to government systems? This is judged by the proportion of donor spending that is channelled through government systems.

How harmonised is donor assistance? This is reflected by the share of spending through multilateral mechanisms such as MTDFs.

The paper is structured as follows (see flow diagram). The next chapter describes how the security sector is currently financed, and offers a diagnosis of the problems this approach creates. Chapter 3 then looks at the drivers of these problems, and the entrenched incentives within government and donor agencies that explain the current financing model. The term 'donor' is applied to any financier of security sector reforms and includes non-traditional actors such as military agencies alongside traditional bilateral and multilateral agencies. Chapter 4 explores what in the short- and long-term is needed for the Government to manage better its security institutions and reform agenda.

Overarching problem

The Afghan state cannot provide security for its citizens or maintain a monopoly on force, thus failing in two of the fundamental duties of a state, both of which are essential preconditions for stability, growth and poverty reduction. This weakens state legitimacy, further undermines the rule of law, obstructs state building, and allows for illegal armed services to emerge and fill the security vacuum. It implies the need for foreign assistance, which is provided in large amounts to the security sector.



Concerns about the nature of external financing (Chapter 2)

Without external financing, there may not be a state at all. But the current financing model falls short of good aid effectiveness practice, such as alignment, harmonisation, predictability and sustainability. This assessment is of real concern: it implies that donors are perpetuating a high level of aid dependence; not setting strong incentives for institutional reforms; and generating fiscal risks for the State. Together these further weaken the State, undermine scope for genuine state building over the medium-term, and create a trade-off between short-term and long-term solutions.



What drives this sub-optimal financing model (Chapter 3)?

There are four factors that explain the above diagnosis:

1. The Government does not have the resources to finance security itself, which engenders a high level of aid dependence.
2. No Government or donor strategy exists for security sector reform.
3. There is no effective financing mechanism to respond to a strategy in a more aid effective way.
4. The major donor to the sector prefers bilateral project aid.

Chapter 3 examines *why* each of these factors persist, and identifies the underlying drivers as: a weak revenue base; government incentives that preclude strong leadership and genuine reform; and donor incentives that constrain alignment and harmonisation.

Chapter 2: Diagnosis of the Afghan security sector

The 2005 PFM Review, conducted by the World Bank at the MoF's request, provided the first systematic analysis of the security sector and identified a number of expenditure management challenges. These led to a set of policy recommendations, which were intended to have been taken forward by the Government and donors jointly. But there has been little progress on that reform agenda since the report was launched. This chapter elaborates on the current state of play in the security sector, taking the previous diagnostic work as its starting point, and applying four aid effectiveness criteria to judge the impact of current financing instruments, and the implications for effective expenditure management in the sector.

2.1 The level of security spending and fiscal sustainability (criterion i)

2005 PFM Review	State of play in 2007
<p>Concerns exist about the growing wage bill and ongoing pressures for fiscally unaffordable salary increases and staffing levels. Security sector policies and spending must be affordable in the short run and medium-term, fully incorporated in to the medium-term fiscal framework and the annual budget.</p> <p>Very high donor spending through the external budget presents a challenge to this.</p>	<p>Fiscal sustainability remains an important issue, and aid is set to rise sharply in 2007 which will threaten fiscal sustainability in the short-term further.</p> <p>The wage bill has increased as a result of pay and rank reforms, and decisions to accelerate recruitment and pay additional salary top-ups to retain personnel. Revenues meanwhile are not growing rapidly enough to offset expenditure pressures.</p> <p>Fiscal sustainability is still a major concern, but one that is politically acceptable in the short-term because the only alternative is a deteriorating security situation. It is economically acceptable in the short-term because the IMF has accommodated additional Government spending (if donor-funded) into the Poverty Reduction and Growth Facility (PRGF). The bulk of this aid scale-up will be channelled in parallel to the core budget, outside of pooled mechanisms.</p>

Fiscal sustainability refers to the point in time when the Government can cover its recurrent costs with its domestic resources, rather than relying on external assistance. Afghanistan's security sector spending is large, and will remain so over the medium-term. This is because:

The public place security high on their list of priorities, hence there is a strong demand for government action to improve security.

There is ongoing insurgency in parts of the country and a strong Afghan security force is required to restore stability.

The country is recovering from decades of occupation and civil war. The scale of the reform and rehabilitation agenda is massive, with a price tag to match. This applies equally to the security sector where a national army and police force are essentially being built from scratch.

The security sector is being allocated a significant share of the core budget and is being given priority by the largest bilateral donor (the US). In 2007/8 the security sector represents around 20% of the total core budget and accounts for almost 50% of total operating costs. Within security sector spending, operating costs account for over 90%, and this is likely to remain the case over the coming years as the costs associated with running the ANA and ANP are being shouldered substantially by the international community.

These characteristics reflect the Government's policy objective to increase staffing complements as a means of strengthening Afghan capacity to respond to insecurity, and increasingly to fund security sector costs through the national budget.

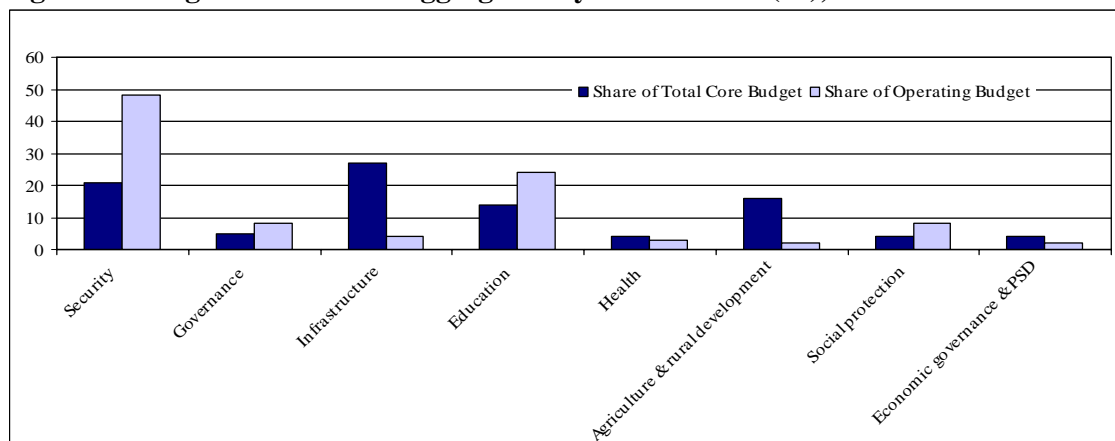
Box 2: Core and external budget: Definitions

The 'core budget' is the Government's national budget, which is financed from domestic revenues and budget support grants including trust fund contributions. This budget has to be approved by Parliament to become operational, and all funds are formally appropriated through the Treasury. Allocations are made by the Government on the basis of national priorities, framed by the ANDS pillars, and executed through national systems. Aid that is provided through the core budget is routed through the Treasury and is described as on-plan and on-budget.

The 'external budget', in comparison, is a compilation of donor interventions that are executed somewhat parallel to government systems through UN agencies, NGOs and private contractors, and therefore should be formally characterised as 'off-budget' from a PFM point of view because they do not form part of the national budget or flow through the Treasury or national procurement system. The external budget is prepared on the basis of donor information provided to the MoF and is less a strategic plan of donor investments, than an incomplete list of projects. Good reporting of donor activities will allow them to be brought on-plan even if not on-budget. External budget activities that are unreported are both off-budget, and off-plan (in common parlance referred to as 'off-budget'). A move towards sector wide programmes would go some way to resolving these problems, whereby external funds are ring fenced and programmed as a fungible resource.

Both core and external budgets have two components: 'recurrent' and 'investment' spending. Recurrent or operating spending refers largely to salaries including pensions, and operation and maintenance costs. Investment or development spending refers to initiatives, often one-off, designed to bring about some progress in service delivery and poverty reduction. While the core budget makes explicit distinctions between recurrent and development spending, the external budget does not, so it is not always clear what the recurrent component of donor funding is. This is a concern because recurrent costs are often effectively a long-term obligation that government needs to finance, and therefore should be explicitly incorporated into spending frameworks.

Figure 3: Budget allocation disaggregated by ANDS Pillar (%), 2007/2008



Source: Ministry of Finance, 2007

The large proportion of core budget resources devoted to the security sector is acceptable to both the Government and donors in the short-term. Although security sector spending is larger than education, health and other social priorities, it is widely recognised that persistent and rising insecurity is the fundamental threat to state building in Afghanistan, and any progress against development indicators could be rapidly reversed if the country was to slide back in to civil war.

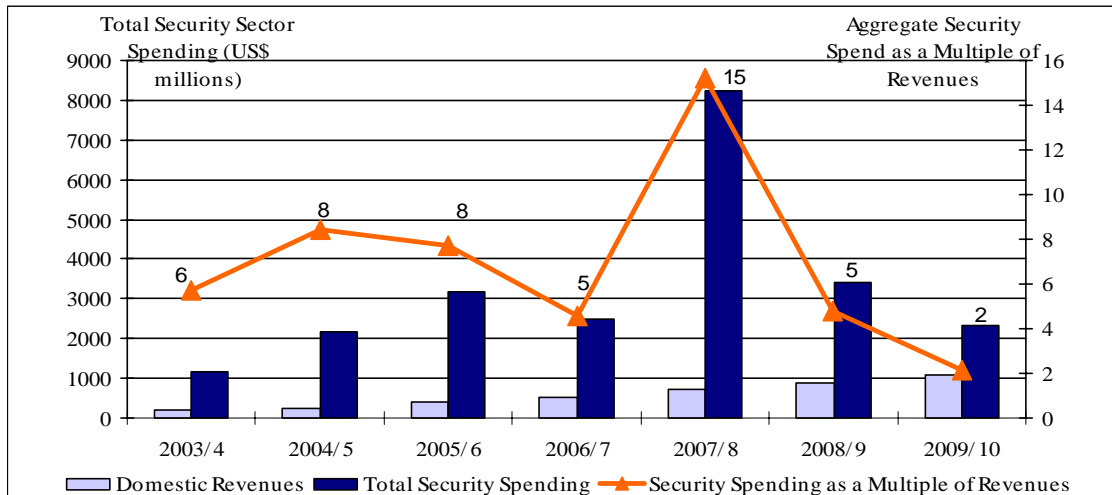
There are two opposing perspectives on the size of security sector spending. Some commentators argue there are not enough resources being provided by donors, and that past assessments underestimated the scale of need. On the other hand, the scale of spending is large enough to create sustainability problems because the Government's revenues alone cannot cover the costs of the expanding police and army. Were aid to decline, it is likely that the majority of security sector reforms would halt, and improvements to security would be impossible – this is the crux of the sustainability question.

These two views are based on different notions of what makes for an appropriate level of funding: the first looks at needs, while the second looks at what is feasible given the Government's resource constraint. In fact these two positions can be reconciled. Fiscal sustainability is, unquestionably, an issue: government revenues are extremely low, and Afghanistan will be aid-dependent in all sectors for a number of years to come. The security sector is especially dependent on external support, and current reform plans implicitly assume the high level of donor support will continue over the medium-term, pushing fiscal sustainability further in to the future (see graph below).

Measuring security sector spending

The numbers for total security spending are based on aggregated estimates of core budget, reported external budget and unreported external budget spending. Estimates have been compiled from various Afghan MoF statistical reports, and USG reporting supplied to the MoF, during 2007. Together this data provides a picture of core and external budget (both reported to the Government and unreported) financing. There are two main data sources for USG spending: a Government Accountability Report (May 2007) and figures provided by the USG to the MoF (February 2007). The CSTC-A (Combined Security Transition Command for Afghanistan) is the US military unit responsible for delivering assistance for army and police reforms, which is part of State Department and Department of Defense budgets. Forward-looking projections such as the 2009/10 figures are likely to change as donor commitments are firmed up closer to the time, and will of course be dependent on domestic policy influences on the key donors. Point estimates should be treated with caution because of potential measurement and estimation errors. It is also not clear from USG reporting what proportion of early support had been captured in the external budget. But the real story is in the orders of magnitude and the spike in spending during 2007, apparent in figure 4.

Total security spending has been far higher than available domestic revenues. Since 2003 total spending has been around five times more than domestic revenues. Government projections suggest that, with the planned expansion of funding for the army and police in 2007/8, this multiple jumps to a factor of 11 times the national revenue collection. But as revenue mobilisation accelerates and funding commitments taper off, this ratio falls, even in the short-term: by 2010 planned spending is double the amount of domestic revenues available. Although this is far short of being affordable, it represents significant progress towards the Government's goal of maintaining its own security forces. The graph underscores the fact that it will be at least ten years before the Afghan Government is able to fully fund its security forces.

Figure 4: Total security sector spending as a multiple of domestic revenue

Source: Ministry of Finance, 2007

The security sector is not unusual in this respect: the entire reconstruction and development agenda is aid dependent. The 2007/8 national budget amounts to some \$2.5 billion, with only \$715 million predicted domestic revenue financing. Donors are expected to provide \$1.8 billion as support to the core budget, with a further \$2.6 billion expected in the external budget. Of a total budget (core + external) of \$5.1 billion for recurrent costs and development spending, external financing accounts for approximately 72% of the core budget, and 86% of total spending by the Government and donors. Afghanistan is not exceptional: Sierra Leone's security sector is also fiscally unaffordable to its Government, and relies on external assistance.

These statistics are based on numbers that may be underestimating true donor spending (the external budget may increase during the fiscal year as donors approve additional commitments during the year and report spending more accurately to the MoF), so the percentages could be even higher. On the other hand, true spending could be overstated by the external budget data when disbursements fall short of commitments. Both factors point to the unreliability of external budget reporting, which is particularly worrying as the external budget has been as high as 35% of GDP in 2004, falling to 24% in 2006.

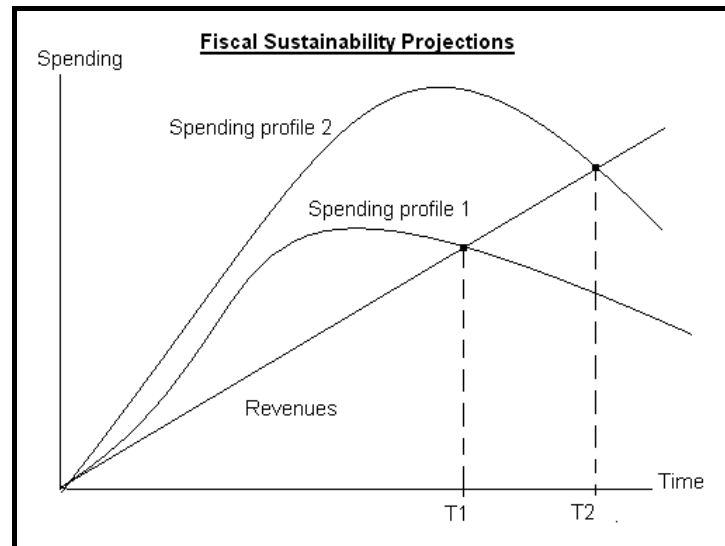
Box 3: 'Right-financing': Balancing fiscal stability and instability

The concept of right-financing helps bring together the economic and defence perspectives, with the objective of right-sizing security forces to meet both security threats and fiscal targets. An emerging approach to financing security sector reforms put forward by Middlebrook (2007), the concept makes explicit the conflict between the need to provide security with the need to ensure that the costs incurred (as contingent liabilities) can be absorbed by the state before donor resources are exhausted. An SSR reform programme needs to strike a balance between the risks of under-provision of security (due to stringent macro-fiscal rules) and the expansion of security spending to the extent of crowding out other public expenditures and delaying the exit of the international community.

Source: OECD Handbook on Security System Reform (2007)

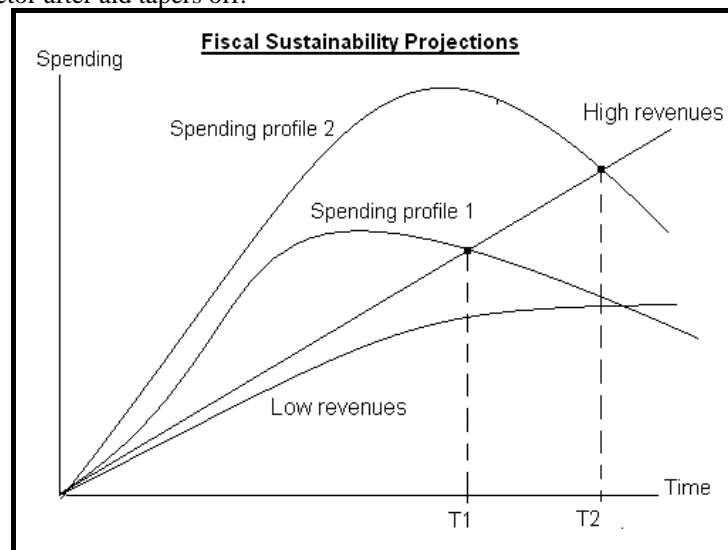
Box 4: Fiscal sustainability of the security sector – a moving target

The graph below depicts two of many possible scenarios, both assuming that revenue collection increases incrementally. The figure is illustrative only, not based on actual numbers. Spending profiles proxy the threat levels and overall insecurity in Afghanistan, to which donors and Government are responding. While revenues have a fairly predictable trajectory going forward, the spending profile for security could fluctuate considerably on the basis of available donor funding and events on the ground. Spending profile 1 is a rough estimation of the SAF cost estimates, with spending needs frontloaded and tapering off over time, implying that fiscal sustainability would be reached at time T1. New information shifts Afghanistan on to spending profile 2, where the peak of resources is greater because of the increased insurgency activity. This means that the security sector becomes fiscally sustainable at a point further in the future, time T2.



In general, the higher the peak in resources and the more slowly spending tapers off, the further away is fiscal sustainability for the Government. Even if staff numbers are intended to fall rapidly after the insurgency has been defeated, the costs of retrenchment will be high, maintaining the fiscal burden in to the medium-term, because it may not be easy or wise to shrink security sector costs at too rapid a pace.

An additional concern in Afghanistan is that revenues will not grow at the steady and respectable rate depicted here. As discussed in Chapter 3, there are deep-rooted obstacles to expanding revenues in Afghanistan, and if domestic tax collection were to plateau then this will clearly have an adverse impact on achieving fiscal sustainability, pushing that point even further in to the future and constraining the size of the security sector after aid tapers off.



The Afghan Compact, launched in January 2006, represents a renewed commitment between donors and the Government to deliver reconstruction and development. It was built around a series of benchmarks to monitor progress in each of the eight priority pillars of the interim-PRSP (the Afghan National Development Strategy or ANDS) which was launched simultaneously. Current fiscal sustainability targets outlined in the Compact require that government revenues cover 58% of the recurrent costs in the core and external budgets by 2010/11. Any planned increases in donor spending, or policy decision on the size of the security forces, affect the Government's capacity to meet these political targets. In this regard, the recent plan to increase the size of the ANP further undermines the ability of Government and donors to meet the Compact targets for security spending.

There are also macroeconomic targets to consider. Since 2006 Afghanistan has had a programme with the IMF, a \$120 million Poverty Reduction and Growth Facility (PRGF), which sets out an agreed macroeconomic reform agenda and establishes various policy anchors that will keep the economy on a stable footing. Three such anchors are of particular relevance for fiscal sustainability: a floor on fiscal revenue of central government; a ceiling on currency in circulation; and an indicative ceiling on the operating budget deficit excluding grants. These targets (respectively) create incentives for the Government: to proactively expand the revenue base; not to print money as a means of financing additional spending (which causes inflation); and to resist increasing its operating costs (such as salaries) beyond the level that aid money for the recurrent budget can support.

Together this fiscal framework aims to ensure that the Government spends prudently, and acts as a constraint to public sector recruitment and wage bill increases. The IMF agree an overall target for the level of government spending, but do not advise or prescribe sectoral allocations within this overall resource envelope. That is done through the national budget process, managed by the Ministry of Finance. The IMF have accommodated security-related expenditures within their programme during 2007 as a reflection of the exceptional circumstances in Afghanistan, by pushing the sustainability target of 'covering all core operating expenditures from domestic revenues' to 2010/11, one year later than envisaged at the start of the PRGF. There are in-built programme adjustors for exceptional security outlays, which at the start of 2007 was increased from Afs 1.3 billion to Afs 3.8 billion.

Breaking any one of the fiscal (or other) benchmarks implies that the Government is off track with the PRGF. This not only stops further IMF lending, it also sends a serious signal to the international community about the Government's macroeconomic management. In the Afghan case, being off track with the PRGF can also impede progress towards debt relief through the Highly Indebted Poor Countries (HIPC) initiative.

The solution, however, is not necessarily to curb donor spending (see box on 'right-financing'). This tactic – especially in the security sector – would have the much more destabilising effect of undermining state capacity and legitimacy. Needs are high and increasing in the short-term, and the international community's response has been to raise the level of resources available to accelerate police and army reforms. What Afghanistan has demonstrated since 2002 is that as threat assessments change in response to a fluid political and security environment, the optimal level of security sector spending will vary.

Afghanistan's exceptional status in the international community and its importance to Western governments means that donor conferences yield large and increasing pledges of assistance, particularly in response to a security crisis. So the overall resource constraint (including external assistance) has been expanding; on the assumption that as the insurgency diminishes, it will be less costly to maintain peace, so security spending needs

will fall over time. This will bring the security sector back within the fiscal envelope that the Government can afford independently of external support.

If donor support continues until security spending falls within the Government's fiscal capacity, then the two positions can be reconciled – fiscal sustainability will be achieved alongside security spending needs being met. This is the ultimate goal: an Afghan state able to provide security within its own means. *When* fiscal sustainability will be reached is an open question. The answer will depend largely on assumptions about, and actual progress made toward, minimising internal and external insecurity and raising the rate of revenue mobilisation. The Government's latest projections for the national police force are summarised in the following box.

Box 5: When will the ANP become affordable?

The analysis compares three different scenarios, which vary the size of the police force and the LOTFA resources between 2007 and 2013.

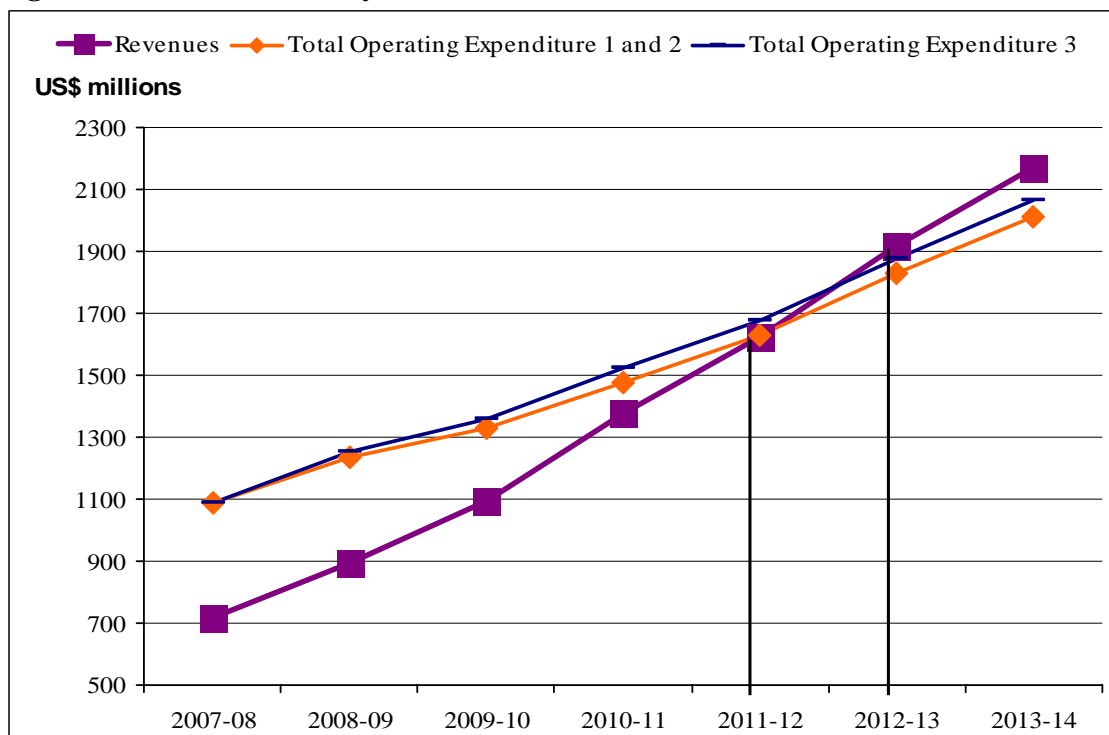
Projections for domestic revenues, ARTF resources and USG support (based on a September 2006 Memorandum of Understanding between the US and Afghan Governments) are constant between the scenarios. The aim is to identify when overall fiscal sustainability will be achieved, not just in the security sector, using the definition of domestic revenues covering total operating costs of Government. As the ANP force size assumptions are varied, the changes are incorporated in to the total operating costs. The analysis is limited by not covering the full security sector, the other sectors that the Government needs to respond to, the likely impact of off-budget donor support (which is scaling up), or the probability in the medium-term of increasing donor resources either through the LOTFA or the core budget. But it does provide an informative snapshot of fiscal scenarios for policy-makers over a long-term horizon.

Scenario (i): The ANP force is reduced from 73,000 to 62,000 by 2010 in line with the Compact target, and the LOTFA fully covers the cost of salaries to 2013. The fiscal impact is government spending for recurrent costs declines, and the overall burden of the ANP on the operating budget falls. Domestic revenues cover total operating expenditure in 2011/2012.

Scenario (ii): The ANP force declines to 62,000 and the LOTFA resources taper off to 0 as the Government progressively absorbs the costs of police salaries. The burden of the ANP falls as above, but the Government takes on additional responsibility because the LOTFA resources have dried up, so overall spending rises. Domestic revenues cover operating expenditure in 2011/12 as above, so fiscal sustainability is not harmed, but the Government's fiscal space is more constrained.

Scenario (iii): The ANP force increases to 82,000 in 2008 but the LOTFA resources taper off to 0. The Government has to absorb the higher costs of police salaries. The MoF think this scenario is most likely. The ANP costs rise considerably, and the burden falls entirely on the Government. Fiscal sustainability is achieved one year later in 2012/2013.

Figure 5: Fiscal affordability of the ANP



Source: Ministry of Finance, 2007

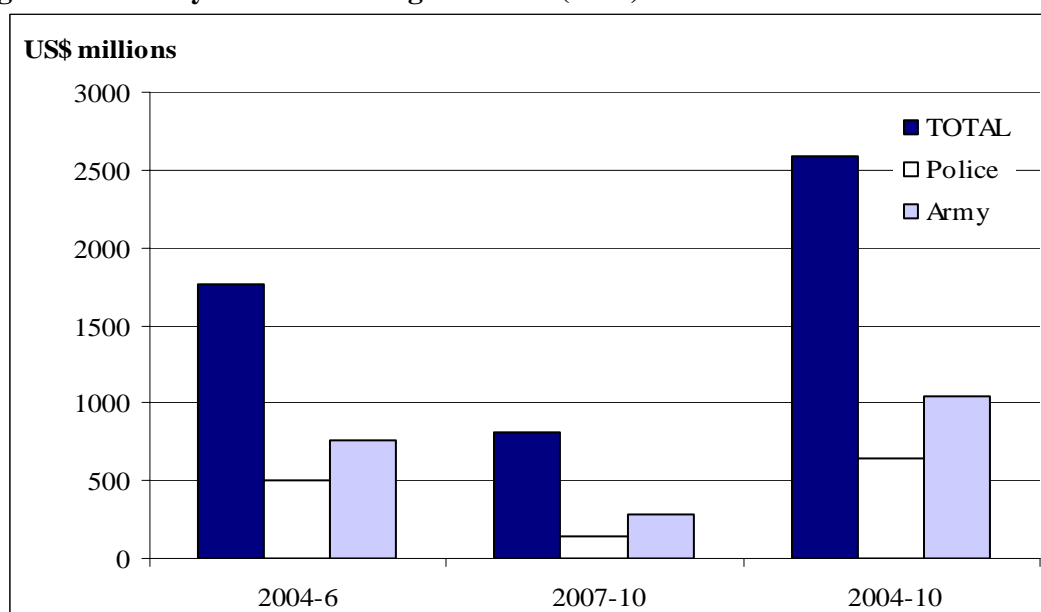
2.2 The role of a costed strategy to drive budget and aid allocation decisions (criterion ii)

2005 PFM Review	State of play in 2007
The security budget should be prepared against clear strategies at national and sectoral levels, fully owned by the Government.	<p>No such strategy exists yet. The five-pillar approach still dictates the nature of donor engagement, and coordination is poor. A fluid security situation on the ground compounds the need for a flexible policy framework and rapid donor responses, but this comes at the expense of transparent decision making shared with all donors and the MoF.</p> <p>The ANDS sector strategies are being prepared in late 2007, and represent the most promising opportunity yet for a sector wide, comprehensive approach, with due consideration of economic issues. But to be taken seriously, any spending plans for the security sector need to be regularly updated to reflect the security context.</p>

The last set of sector costings was undertaken in 2004 as part of the ‘Securing Afghanistan’s Future’ (SAF) report. These are based on a now outdated set of assumptions on security personnel numbers and pace of recruitment. The funding estimates in SAF are far lower than what was actually spent during 2004–6 (\$7.8 billion was spent, although only \$1.7 billion was costed), and what is now being proposed for the period 2007–10 (over \$12 billion, compared to less than \$1 billion costed). The SAF projection that security sector spending needs would peak in the 2004–6 period is also being overturned: spending over 2007–9 will be far higher.

The Compact proposed new headcounts for the army and police force in 2006, which are greater than those in SAF. As an agreed vision between the international community and the Government, they represent the most up to date strategy for the security sector.

Figure 6: Security sector financing estimates (2004)



Source: Securing Afghanistan’s Future, 2004

But the Compact and I-ANDS did not fill the strategy vacuum, for two main reasons. Firstly, no costings exercise was completed alongside these initiatives. In the security

sector, this meant that there was no shared understanding of how much the newly proposed staffing ceilings would cost. Instruments such as the LOTFA have not bridged this gap by offering multi-year work plans (more detail on this below). Secondly, the value of the Compact as a strategy is thrown in to doubt when the analysis is perceived to be outdated within a year of its launch. Not long after the launch of the Compact and I-ANDS, a threat assessment by the US Government suggested that threat levels had increased, and demanded a more robust response to, for example, the insurgency in the southern provinces. This led to the proposal of an accelerated recruitment plan and new spending profiles in the sector to retain staff and better motivate them. Details of the new allocations by CSTC-A are outlined below.

The development of a full PRSP, the ANDS, is supposed to bridge this gap. Sector strategies are being developed and costed under UNDP leadership in the autumn of 2007, with the aim of guiding future sector policy decisions and informing the national budget of annual and medium-term obligations. This is an important opportunity for the development agenda in Afghanistan and the security sector in particular; although the concern is that many of the core PFM issues that should guide such a costing exercise, particularly sustainability, may be underserved in this process. And there have already been significant delays to the development of the full ANDS.

A more fundamental question is whether any costings exercise will be viable in a context of ongoing war and instability, where threat levels and the appropriate government response varies from one year to the next. Experience since 2002 has shown that need assessments are quickly outdated by events on the ground. Without a costed strategy, the security sector is entirely guided by bilateral donor decisions, which undermines government ownership of its reform agenda, and removes any discussion of fiscal implications over the medium-term. The first step for the Government to take full responsibility for its security sector in the long-term will be to develop a vision for what the sector should look like; demanding at the very least consensus within the Government of risks, needs and prioritisation based on resource constraints. Chapter 4 considers the prospects and challenges for developing a credible costed strategy for the security sector.

Box 6: Budget allocations

Budget allocations are largely driven by political priority and spending capacity (based on budget execution rates in previous years), balanced against the other sectoral priorities and external budget spending. There is no medium-term expenditure framework yet, so the allocations are not responding to a set of three year spending plans based on costed programmes and strategies. Performance-based budgeting has not yet been tested, which would allow the Ministry of Finance to set budget allocations on the basis of service delivery outcomes. New programme budgeting reforms are a step in this direction, but there are other constraints to the MoF's ability to extract high performance from line ministries, such as weak capacity in line ministries and overriding political pressures. In any case, these budget reforms are not yet being rolled out to any of the security sector line ministries.

2.3 The proportion of donor expenditure channelled through government systems (criterion iii)

2005 PFM Review	State of play in 2007
Very high donor spending through the external budget presents a challenge to this.	The bulk of the aid scale-up in 2007 will be channelled in parallel to the core budget, outside of pooled mechanisms.

The bulk of financing for the security sector is in the form of aid rather than domestic revenues. A very small share of this is channelled through the core budget. Mechanisms for ensuring assistance to the security sector is on budget include:

The LOTFA (Law and Order Trust Fund for Afghanistan), which is administered by the UNDP and channels funds through the Treasury in the Ministry of Finance. The LOTFA primarily pays for police salaries and is included in the core budget.

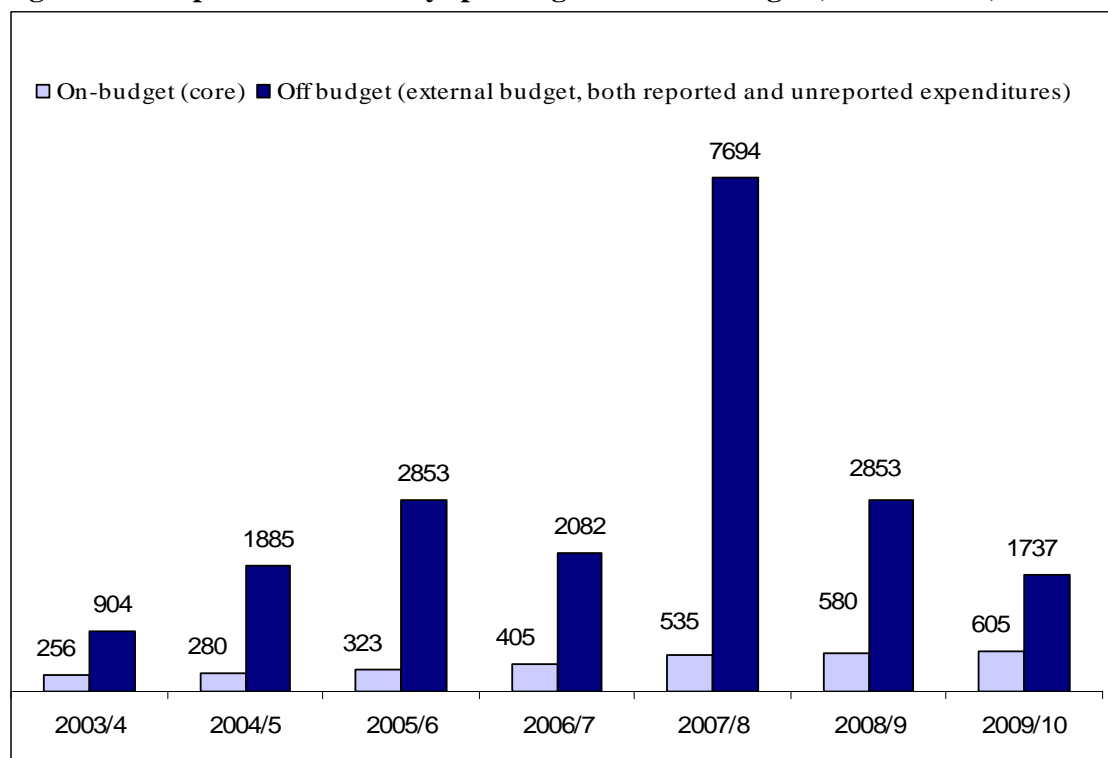
Direct payments from donors such as the US Department of Defense to the Treasury as part of the core budget.

The external budget which is not administered or monitored by the Government, but is shared with the Ministry of Finance Aid Coordination Unit. The external budget includes all projects and programmes that are implemented by private contractors, NGOs and UN agencies and managed directly by donors.

All other funding which is not channelled through government finance systems or reported to the Aid Coordination Unit is both off-budget and off-plan because it is neither channelled through the Treasury nor reported in the external budget.

Off-budget aid dwarfs on-budget aid. As Figure 7 highlights, on-budget spending (i.e. allocations captured in the core budget) is insignificant in comparison with off-budget support (which is the sum of external budget and USG spending on the security sector). A key driver of the scale-up of off-budget resources in 2007 is aid from the USG. These resources are expected to peak in 2007/8, partly as a response to the growing insurgency activity in 2006 which has allowed the US to successfully push for greater resources in a supplementary budget approved by Congress. The bulk of US funding for 2007–10 had not been confirmed at the start of the Afghan fiscal year 2007.

Figure 7: Composition of security spending: on- vs off-budget (\$US millions)



Source: Ministry of Finance and CSTC-A, 2007

There are two reasons why this amount of off-budget and off-plan financing is a concern. Firstly, it makes it very difficult for government planners to accurately assess spending needs and predict future spending obligations. The MoF has a medium-term fiscal framework which maps out expected revenues and expenditures over a three year period. For the MTFE to be credible, it needs to be based on accurate and comprehensive estimates of what donors are currently spending, as an indicator of what the Government will ultimately have to take financial responsibility for. Without a credible MTFE, the Government is unprepared for additional spending obligations that may arise, which could undermine macroeconomic management or crowd out social spending in the short-term. These issues are explored further in the chapter below on sustainability.

Secondly, large sums of off-budget financing that are paid directly to line ministries or personnel in the security sector (in the form of top-ups for example) undermine the accountability relationship between the MoF and line ministries. An effective state needs to be able to command accountability over the way line ministries spend resources and deliver services and tangible outcomes to the public. The national budget is a useful tool to facilitate this: if line ministries know they are competing for scarce resources held in the national budget, there are strong incentives for them to improve their performance and attract additional resources through the budget process. If the Ministry of Defence (MoD) is relying on external donors for the bulk of its spending, then the relationship with the MoF is severely weakened. The MoF cannot begin to move to performance-based budgeting when there are no financial incentives for the MoD to justify its performance and outcomes in the national budget process.

Box 7: Scale-up for security sector largely channelled off-budget and off-plan

The security sector has been one of the top priorities in the external budget since 2002, accounting for 28% of all spending. However, the 2007/8 breakdown of allocations estimated by the Ministry of Finance suggests only 3% of donor funds in the external budget going to security. The implication is that the massive scale-up in the current fiscal year is largely unreported in the external budget being and outside of MoF planning frameworks. The scale-up is therefore both off-budget and off-plan.

Figure 8: External budget expenditure to 2001– June 2007

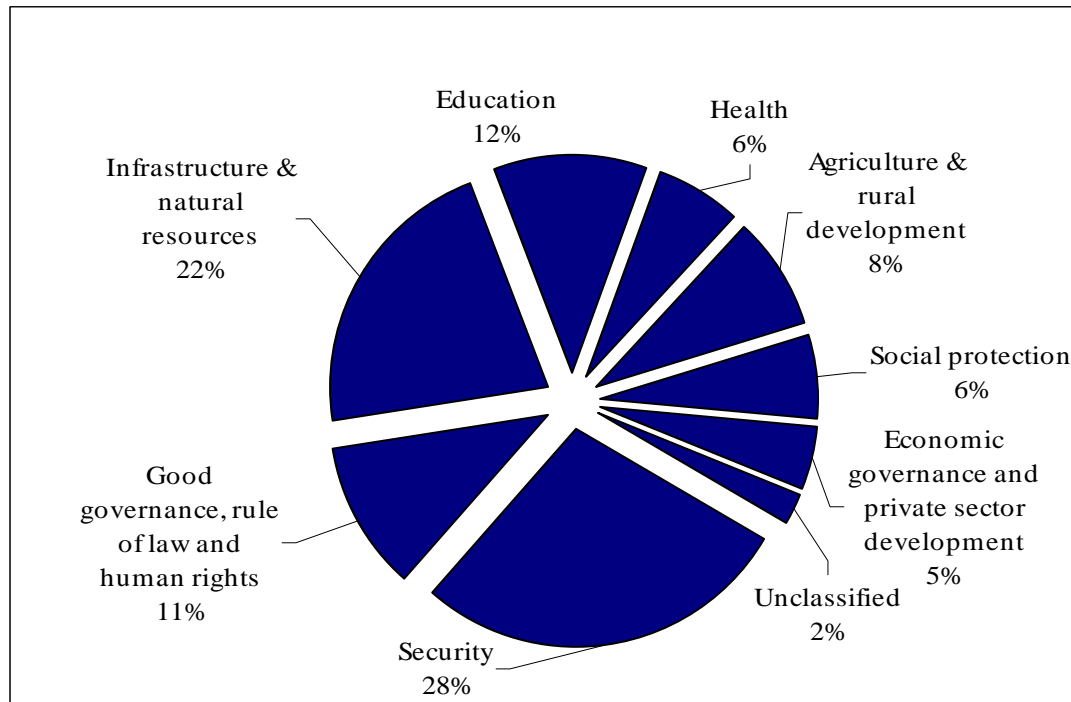
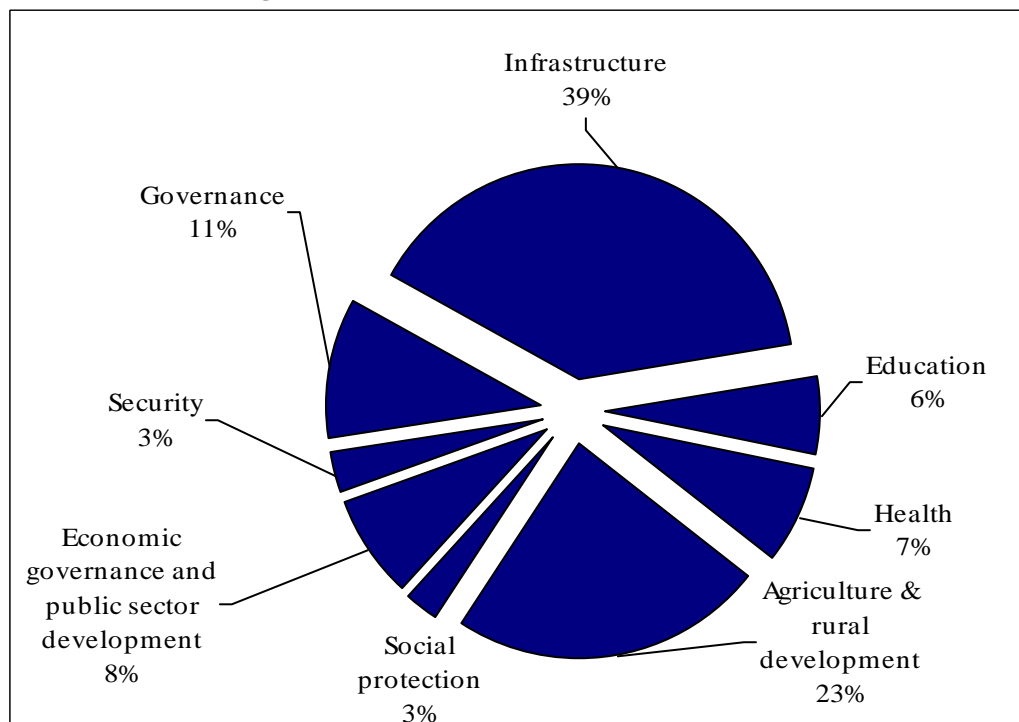


Figure 9: External budget 2007/2008



Source: Ministry of Finance, 2007

2.4 Fiscal shocks in 2006 and aid predictability

2005 PFM Review	State of play in 2007
There are difficulties in coordinating and prioritising security sector spending and actions. Once an overall resource envelope is agreed, resources should be allocated in line with strategic priorities.	The challenge of donor coordination is ongoing due to the fragmentation of the donor community and weak Government leadership. Without an overarching strategy or costings, resource allocations are largely determined by donors based on the strategic priorities they identify. The Ministry of Finance has a limited role to play outside of the national budget process, which is not always used as the basis for donor dialogue with security sector institutions.

A fiscal shock is an unexpected event that affects a government's fiscal position, by affecting revenues or expenditure. A series of adverse fiscal shocks occurred in 2006, which threatened the Afghan Government's hard won fiscal prudence and placed the spotlight on the many difficult trade-offs necessary to stay committed to their fiscal anchor. The security sector was affected by a number of these shocks, which were rooted in the growing consensus that the Government needed considerably more and higher quality security sector resources to adequately respond to the growing insecurity in the south of the country in particular.

11,000 auxiliary police (the ANAP) were added to the security sector. This coincided with the agreed Pay and Rank reforms which increased base pay for the police force. These changes led to an \$8 million increase in the police wage bill. The increase was relatively small compared to existing security sector spending, and was accommodated by contributions from the UN-administered Law and Order Trust Fund for Afghanistan (LOTFA). It did not, therefore, place any pressure on social sector spending. Because the increase was agreed early on in the fiscal year, it was incorporated in to the mid-year expenditure review and revised budget, and shared with the IMF.

CSTC-A and MoD signed an agreement in September for a new ANA pay plan, which would raise salaries and introduce bonuses to incentivise recruitment and retention. This agreement created a new pressure on the Government's operating budget, but was timely in that it could be discussed with the MoF and duly incorporated in to the budget following a mid-year expenditure review. The cost implications were therefore transparent and internalised by the MoF fiscal policy team, and also discussed with the IMF in the context of the Poverty Reduction and Growth Facility (PRGF).

A second agreement between CSTC-A and the Ministries of Defence and Interior proposed an accelerated expansion of the army and revised police numbers. This agreement seeks to raise the ANP headcount to 82,000 from a Compact target of 70,000, and accelerating the ANA recruitment of 70,000 soldiers. The Ministry of Finance were informed relatively late in the day: news of the agreement came after the mid-year expenditure review, following a PRGF monitoring mission, and crucially just as the 2007 budget was being finalised for Parliamentary approval. The process was opaque to most donors and the MoF, and partly contributed to the delay in budget submission to Parliament. As well as increasing the cost burden on the Government and squeezing fiscal space further, the latest agreement also undermined the leading role that the MoF should play in budget allocation decisions, with the national budget as a key policy-making tool.

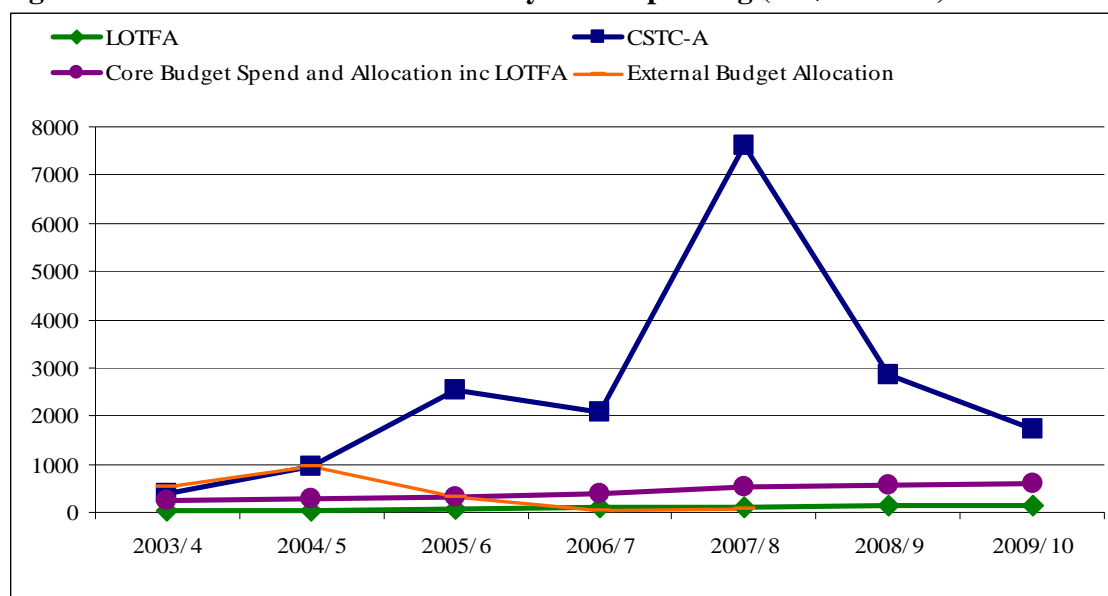
Low predictability of aid and spending needs increases the security sector's vulnerability to further fiscal shocks in the future. There is considerable evidence which highlights the unpredictability of aid provision. The LOTFA has consistently reported budget shortfalls

(see Chapter 3, part C). Commentators have suggested that the security sector has been under-funded from the beginning of the security process (Sedra, 2006). At the start of the fiscal year 2007, the IMF recorded \$76 million of security spending planned for 2007 which was as yet unfunded, a further \$125 million in 2007 and \$112 million in 2008. Spending plans (and the accompanying operational activities such as recruitment drives and salary top-ups) without firm donor commitments create risks to the Government being able to afford the security sector apparatus that donors are building.

2.5 Extent of harmonised donor funding (criterion iv)

Harmonised donor funding can be measured by the proportion of aid that is channelled through a programme approach such as a sector wide approach (SWAp) or through a pooled mechanism such as a MDTF. In the security sector, the majority of aid is delivered through bilateral projects. In the graph below, only the LOTFA and core spending by the Government from domestic revenues counts as harmonised donor funding. The external budget is directly managed by bilateral donors. Figure 10 highlights that the largest share of aid, from the US, is provided bilaterally. The trend shows a growing USG security sector budget, and a lower proportion of resources being channelled through a pooled donor mechanism, as shown by the comparison between the LOTFA (the only coordinated funding mechanism to the police) and the USG's resources. This precludes the potential advantages that a programme approach might bring for sector wide coordination and donor harmonisation.

Figure 10: Sources of finance for security sector spending (US\$ millions)



Source: Ministry of Finance and USG, 2007

Applying the aid effectiveness criteria suggests the current financing model falls short of good practice:

There is insufficient reference to sustainability, for example by taking into consideration Afghanistan's fiscal resources when making donor policy decisions.

The sector lacks a transparent, forward-looking and costed strategy that the Government owns and all active donors subscribe to.

Most aid flows are not aligned with national budget and accountability frameworks, and donor decision making can lead to unpredictability of donor resources.

Most aid flows are not harmonised, by being channelled through a pooled mechanism.

This assessment is of real concern, because it means the current donor approach to financing security sector reforms perpetuates a high level of aid dependence, does not set strong incentives for deep-seated institutional reforms, and generates fiscal shocks for the state. Together these imply a further weakened state, with limited scope for genuine state building over the medium-term.

Box 8: Implications of current aid delivery model to the security sector

‘External assistance often undermines the very state (re)building agenda that it is there to support almost from day one, which is counter to the Paris Declaration’ (Middlebrook, 2007).

The future of the sector is precarious because spending needs far outstrip Afghan capacity to raise revenues. Aid dependence is being entrenched further by the massive injection of financial resources planned by donors. Government ownership is weak, and unilateral donor decision-making further reduces the scope for it to lead the process or act as a driver of reform. In particular it limits the role of the MoF, and undermines its potential to demand accountability for the use of public and external funds by security institutions such as Ministry of Interior and Ministry of Defence. These ministries, if they receive large amounts of support from donors directly, are effectively operating outside the national budget and accountability framework. With the planned increases in spending already established, there is little incentive for them to deliver reforms and successes; and there is no incentive to comply with any performance criteria that would in a normal situation be imposed by the MoF in return for allocations through the core budget.

Un-harmonised donor interventions mean that aid may not be used to maximum effect, as it creates a risk of duplicating or conflicting donor interventions. Uneven progress between different pillars of the security sector prevents Afghanistan enjoying the full gains of security sector reform. This is both a waste of scarce resources and a delay in the critical task of reforming security sector institutions and capability.

Narrow fiscal space means that the Government faces hard choices between maintaining its fiscal anchor and staying committed to a prudent macroeconomic regime, and reducing expenditure on priorities in the I-ANDS framework. This is a necessary reality for Afghanistan, and economic shocks will not cease in the medium-term. However, they can be reduced, and wherever possible donors should try to avoid being the source of such shocks.

If aid tapers off too soon there are two main economic risks to the reconstruction and development process. The Government will have to maintain security spending to prevent a slide back into civil war. This means it will resort either to seigniorage financing (printing money) and inflation will rise (and may cause hyper inflation rates as experienced under the Taliban regime), or to reducing social sector spending, such as education and health. Both policy actions will weaken the economy and have a particularly adverse impact on the poor. This would reverse the gains made against poverty and eliminate what weak incentives currently exist for relying on legal livelihoods and complying with the State.

Chapter 3: Drivers of the sustainability and financing diagnosis

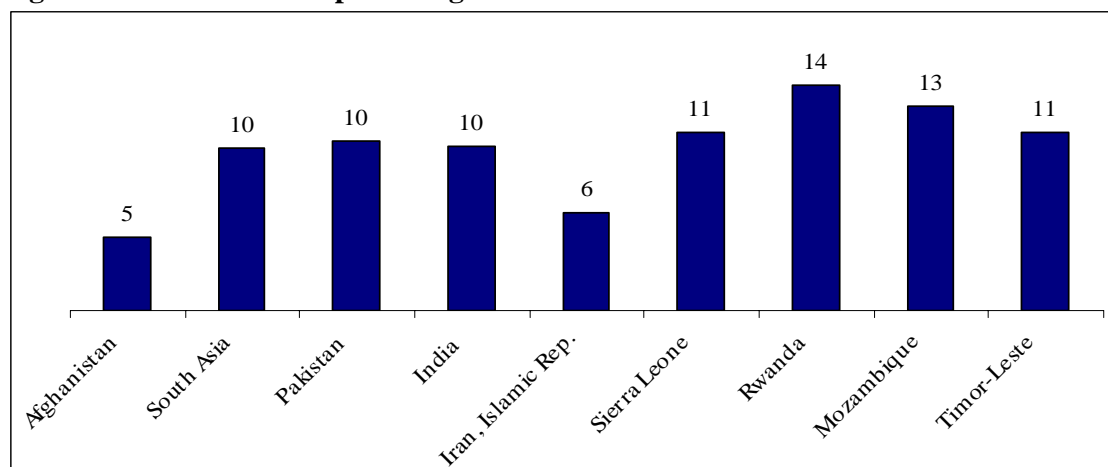
There are three underlying drivers of the problems highlighted in Chapter 2: a weak revenue base; government incentives that preclude strong leadership and genuine reform; and donor incentives that constrain alignment and harmonisation. This chapter analyses these drivers and is structured as follows.

Part A examines the two main reasons for the fiscal sustainability concern: the rate of expenditure (driven by donors) and the lack of domestic resources (a function of poor revenue mobilisation). Part B explores the incentive structures within the Afghan Government and the donor community, elaborating on government security sector leadership. Part C outlines the reasons why the financing mechanism through the budget – the Law and Order Trust Fund (LOTFA) – is not effective at harmonising donors and driving reform. Part D examines why the major donor to the security sector uses bilateral project aid to deliver assistance.

3.1 Part A: Why is the Government unable to raise enough revenue to finance its own security sector institutions?

Afghanistan has been described as a ‘fiscally stillborn state that will continue to draw upon the purse strings of international taxpayers for many years to come’ (Middlebrook, 2007). There are three broad factors that explain why revenue mobilisation in Afghanistan was as low as 6% in 2006, well below its neighbours and the sub-Saharan African average of 20%. These factors are political, economic and institutional.

Figure 11: Revenues as a percentage of GDP in 2004



Source: WDI Online (accessed May 2007)

Afghanistan has had low revenue potential since its creation as a ‘buffer state’ between British India and Russia. This change fenced off opportunities for Afghan tribal leaders to extract resources and financial power from neighbouring regions as had been the practice in the 18th century. Rubin (2007) states that ‘because the Government, then as now, was unable to extract enough revenue from this barren territory to rule it, its function had more to do with an elite subsidised by aid to control the territory as part of the defence of foreign empires than with providing security and governance to the people of Afghanistan’ (Rubin,

2007). This analysis demonstrates a historical precedent of Afghanistan leaders relying on external support, traded in return for the geopolitical advantages Afghanistan offered. More recently, the same trend can be identified in the State's dealings with the Soviets in the 1980s.

One conclusion which could be drawn from this – worryingly – is that Afghanistan is intrinsically unable to reach the point of being able to maintain a strong state on the basis of strong revenue collection. In 1975 the Government's budget exceeded domestic revenues by 60%, demonstrating a history of aid dependence due to weak economic performance and revenue mobilisation. Government revenue came to \$220 million, compared to \$350 million in the national budget, and \$140 million was expected in foreign assistance that year (World Bank, 1975). The goal of becoming fiscally and politically viable with domestic resources alone appears daunting against this background.

During the years of Soviet occupation and then civil war in the 1980s and 90s, a feudalistic structure of politics and society emerged as Afghanistan witnessed a growth in numerous private militias fuelled by both the Government and opposition parties. After state collapse in 1992 the feudalist structure became further entrenched with the breakdown of central authority: 'the power of local commanders further increased at the expense of that of their political patrons' (Giustozzi, 2004). Private armies (with no shortage of weaponry left by the Soviets or directly provided by foreigners) flourished.

This feudalistic political structure has serious implications for the State's present revenue collection capacity. During the 1990s, warlords needed to develop alternative sources of finance for their armies. External assistance helped, but after the ending of external finance against the Communist regime and the ending of Soviet support for the regime, domestic revenues were also necessary. Customs houses were a lucrative source of money, particularly in provinces with trading routes and more significant borders (such as Herat, with its Iranian border). Road levies were widely used. Opium smuggling and gem mining generated income too. Warlord control over the judiciary and local security forces meant it was possible to extract local 'taxes' from the population, especially businessmen.

This backdrop raises the following 'legacy costs' for the Karzai administration:

It highlights the capture of the revenue function by local commanders. The current government needs to generate a shift in incentives that enforces the transfer of revenues to central state coffers, or else it will be seen as no different to the old way of doing business. This requires the emergence of a state that provides tangible high quality services to its people and the private sector, to create an enabling environment for growth and to create a social compact between the centre and periphery over state functions.

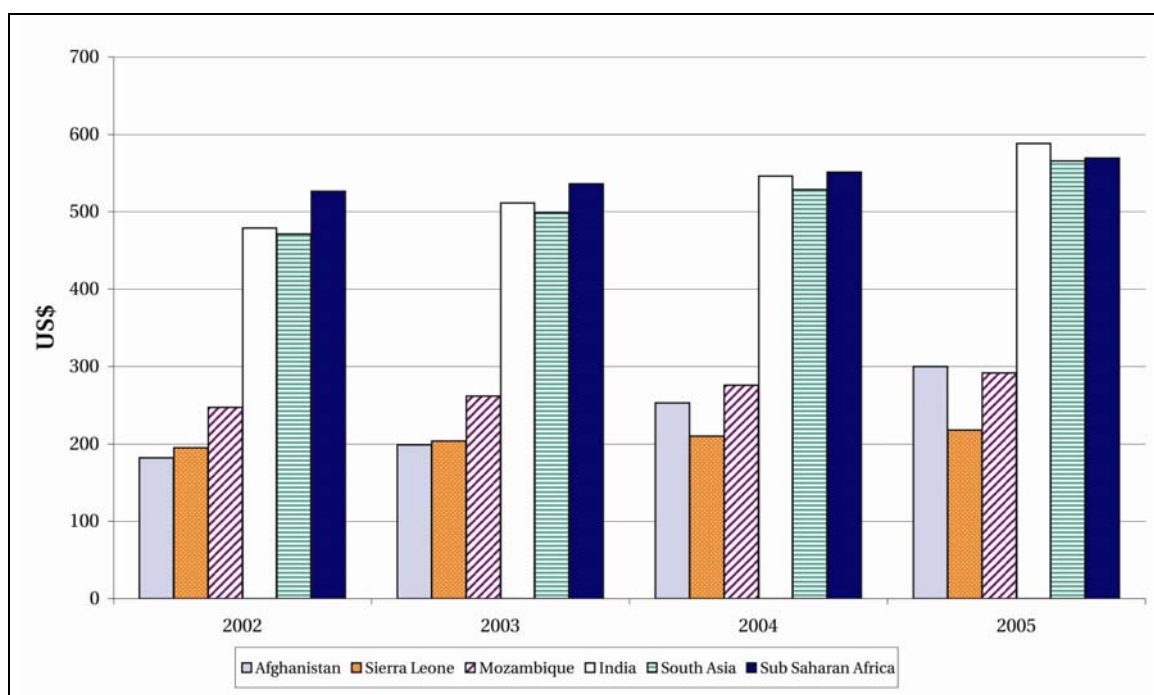
Taxation has been equated with extortion, and the benefits have been concentrated on the elite. There was no pattern of service delivery, and the population was not used to demanding accountability in return for taxes paid. The Government needs to rebuild a social compact – providing services including security, law and order, in exchange for taxes and support. This will help break down the image of taxes as rent-seeking and build state legitimacy and raise compliance. This will require service delivery and honest use of public resources, to demonstrate the value of a central state over the past neo-feudalist political setup.

Box 9: Conflict and economic development

As a result of conflict, a country's infrastructure is likely to be destroyed or damaged; the authority and legitimacy of state institutions are undermined and weakened; and there may be mass displacement of people and extreme pressure on social cohesion. The economy of a fragile state or a country enduring a civil war may be dominated by a narrow set of vested interests and warlords: 'conflict redirects economic activity towards rent-seeking and criminality while productive activity is suppressed' (Demekas et al., 2002). All of these factors deter growth and investment, and the economy is likely to shrink.

The Afghan economy has been damaged by almost 30 years of war and instability. Since the 1960s, growth has been low or negative, widening the gap between the Afghan economy and the rest of the world including developing countries (Guimbert, 2004). Conventional wisdom suggests a link between a country's GDP level and its recorded revenue/GDP ratios. Cross-country data suggests that developed countries raise revenues in the region of 38% of GDP, while developing countries raise around half this amount at approximately 18% of GDP in domestic revenues (Tanzi and Zee, 2000, based on 1995–7 regional averages). The graph below highlights Afghanistan's income status in comparison to the South Asia and Africa regions, and post conflict countries in Africa. Incomes in 2002 were very low, and although recent growth performance has led to improvements over a short period of time, Afghanistan is still far behind its South Asian neighbours. A disrupted long-run growth path has contributed to the present-day narrow revenue base.

Figure 12: Incomes per capita across selected countries and regions

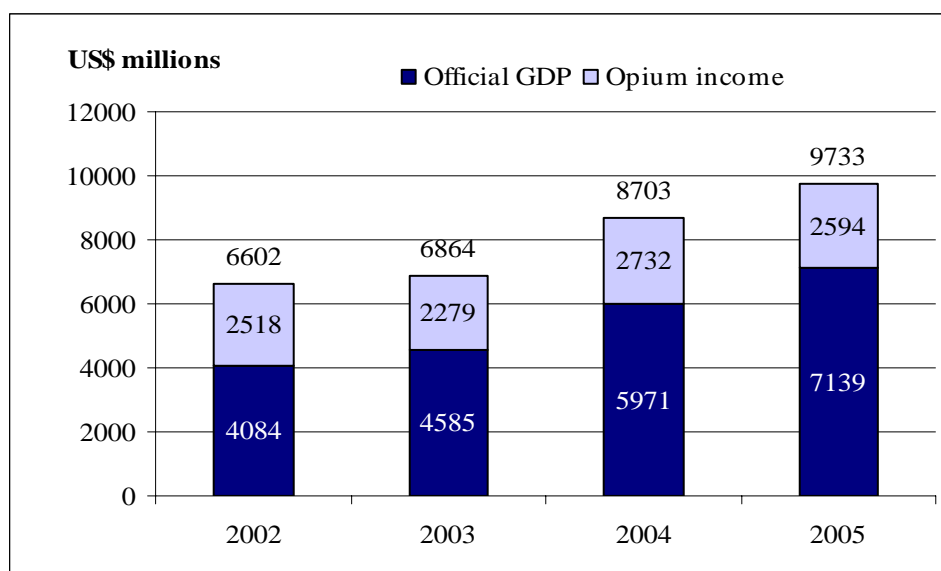


Source: WDI Online [accessed May 2007]

A further characteristic of the Afghan economy is its large informal sector. The World Bank estimates that up to 90% of total economic activity is 'informal', including the drug economy (World Bank, 2005). In addition, the opium sector accounts for one third of total legal GDP, and represents another large chunk of economic activity that is going untaxed. The narcotics sector imposes huge constraints to revenue collection, not least through undermining the rule of law by creating revenue opportunities at the periphery, but also through its corrupting influence over state institutions at all levels. In Figure 13, the light-

coloured bars represent opium income, and the darker bars represent official GDP as counted by the government. The light-coloured bars do not include other criminal activities such as smuggling, which further contributes to the relatively narrow legal tax base and loss of Government revenues from rent-seeking and illegitimate activity. The illicit economy coupled with the informal economy mean that only a small portion total economic activity lies within the tax base. This is a vicious cycle, as greater insecurity means weaker revenue collection and vice versa (World Bank, 2005).

Figure 13: Total GDP with estimated shares of official GDP and opium GDP



Source: IMF, 2006

The prospects for generating large amounts of revenue in the short-term are also constrained by the following:

There are no readily available natural resources which could be taxed most easily, at the point of production (in comparison to Sudan with its oil reserves, Sierra Leone with its diamonds, or Angola with both). The largest primary resource is poppy, which is not taxable because it is illicit; and it has the additional detrimental effect of undermining the rule of law and creating incentives to move or stay out of the licit sector.

The agricultural sector has historically accounted for a large portion of total GDP, although declining over time (most dramatically since 2002). This sector is difficult to tax for administrative and political reasons. Land taxes have been reinstated in 2007, but it remains to be seen how viable this policy is, given frequent droughts and the many exemptions the tax policy allows.

Customs revenues account for the bulk of domestic revenue collection as a result of large volumes of transit trade being routed through landlocked Afghanistan. The lucrative border with Iran gives Herat the highest customs revenue collection in the country. Increased trade will require progress on multiple fronts – improved infrastructure, changes to trade laws, and export development.

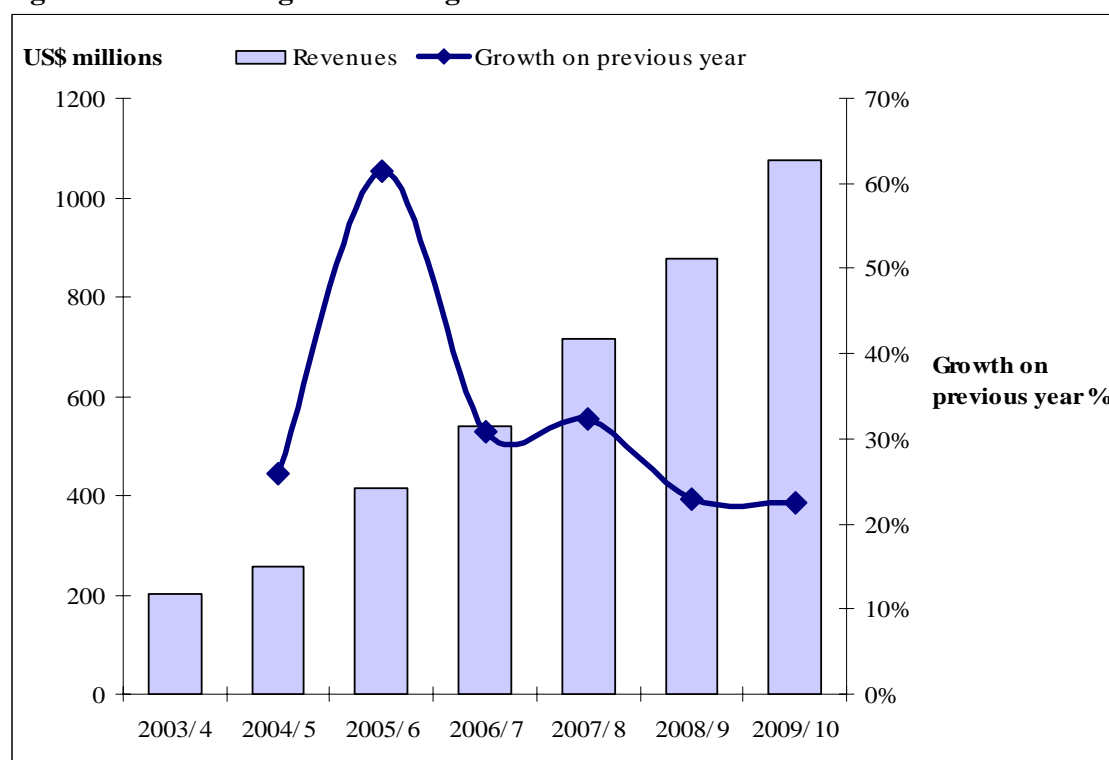
Domestic wealth is low and uneven: the majority of people are poor, and wealth is concentrated in the hands of a small elite minority. To raise significant revenues, this elite would have to accept a very high tax rate. But their financial status is linked to their political and social status, and they are likely to have informal veto power over such tax reforms (a particular example of such an interest group blocking change to the

tax code is discussed in further detail below). Income tax laws are new, and only cover the small proportion of people on payrolls in the formal sector.

The Karzai Government inherited a weak public administration with outdated management systems, a telling under-investment in human capital and recruitment based on patronage not merit. Waves of emigration had shrunk the skilled labour force leaving a small pool of professional staff. The Government could not compete with the compensation offered by donors, NGOs and the private sector, weakening prospects for capacity building. In the Ministry of Finance this has implied weak state capacity to formulate, enforce and monitor a modern tax regime.

Since 2002 the MoF has benefited from significant donor support to the revenues and customs departments. The technical assistance of the IFIs encouraged a ‘complete revamping of the tax administration’ in order to close the tax gap which was as high as 60% (Thomas, 2005). Early reforms brought in new tax laws including income tax, user fees and business taxes, and abolished others – the ‘nuisance taxes’. Modernised organisation and leadership structures were established under the ‘Priority Reform and Restructuring’ programme, which introduced merit-based recruitment. The Large Taxpayers Office was set up with the remit of ensuring appropriate tax payment by the largest private sector companies, mostly in the services sector. It has performed well, and its audit function is growing stronger year on year.

Figure 14: Revenues growth in Afghanistan 2003–2010



Source: IMF, 2007

These reforms have enabled an acceleration in revenue collection since 2002. Between fiscal years 2003 and 2006 revenues have grown 166%, with annual growth of over 30% in the past two years. But these are believed to represent the ‘quick wins’, the easy first round of measures that are applied to the tax sources of least resistance. To meet future revenue targets, the Government will need to introduce a second round of more radical reforms. In

particular need for reform are the Provincial tax offices (the *mustufiats*) and the tax policy itself. There will be attempts to block reform because of vested interests.

The *mustufiats* are the link between taxpayer and Ministry of Finance. They are the local offices of the Ministry of Finance, and cover revenue as well as budget functions. Pilot reforms to *mustufiats* have been introduced to improve capacity of the staff, introduce merit-based recruitment, and rehabilitate the offices. *Mustufiats* hold a number of politically and financially valuable positions. The heads of the provincial offices, *mustufis*, must enjoy the support of provincial governors to be effective. Equally, *mustufis* are often entrenched in these positions, making it near impossible to remove or replace them. The set up of medium-sized taxpayer offices may provide a way to skirt the inefficiencies of *mustufiats* without having to remove them completely. IMF recommendations on customs and domestic tax policy have not yet been adopted by the MoF, largely due to the vocal and influential traders lobby, who are also prominent in Parliament.

Corruption is rife throughout state institutions, and the tax collection process is no less vulnerable to abuse. With low pay rates, staff are open to the risk of corruption at a local level as well as at headquarters. Anti-corruption initiatives are gaining a high profile, but much remains to be done. From a tax administration perspective, central accountability over *mustufiats* is still inadequate.

In conclusion, there have been laudable gains in revenue collection in the post-conflict period. But these were largely based on the quick wins, and to maintain the successful record on revenue targets the Government will need to step up its commitment to tax collection by introducing a further round of reforms. These will have to be more radical and deep-rooted than the first round. Strong political lobbies against change, however, mean that the prospects for reform are mixed. But if completed, they will generate a more sustainable and equitable revenue base for the state, and create the much-needed fiscal space with which the Government can respond to security sector (or other) spending needs without jeopardising economic stability or increasing aid dependence. In Chapter 4 we consider possible medium-term solutions to improving taxpayer compliance and administrative efficiency in order to raise overall government revenues.

3.2 Part B: Why is there no overarching security reform strategy?

This broad question can be unpacked into the following lines of enquiry:

What prevents the Government from taking a leading role in the reform and management of its security institutions, starting with the endorsement and ownership of a visionary strategy?

If the Government is not able to take this role, why then do donors not develop an agreed strategy to guide their individual interventions and facilitate Government ownership?

What stops the donors from changing the existing incentive structures and extract stronger performance from Government leaders?

To understand why the Government does not take a strong leadership role in developing and managing the security sector, it is important to explore the political beginnings and undercurrents of the current Government. Giustozzi (2004) explains that Karzai's position was weak when he first came to office. His power base was localised in the south, and he needed to win the political alliances of warlords and commanders in the rest of the country. His strategy to achieve this was based on trading positions of power within the new

administration in exchange for political support for the new regime and the objective of centralising the state. Part of the problem lay in the fact that the Bonn Declaration was not a peace deal. The Taliban were not formally involved and a lack of consensus from the start undermined the credibility of the Government as a truly broad based political movement. Senior Pashtuns returning from the Diaspora were development smart but had no constituent base in the country. In the absence of a formal peace agreement, bringing in potential spoiler elements within state structures and giving them a stake in the new administration helped buy a fragile peace. Out of 27 ministers in early 2004, four were warlords or militia leaders; and a significant proportion of the governors appointed in 2002 were former commanders (Giustozzi, 2004).

The security sector institutions are prime examples of this strategy of co-opting commanders and powerful regional leaders. This is evidenced by the fact that key security sector institutions like Defence were placed in the hands of Mohammad Fahim, who 'stood out as the most successful warlord vis à vis the state' in June 2003, 'controlling the MoD with almost complete autonomy' (Giustozzi, 2004). His deputy Minister was Rashid Dostum, another significant warlord from the north. A significant proportion of the governors appointed in 2002 were former commanders. There are two adverse implications for the security sector reform process that follow from this method of choosing leaders: they instil vested interests within these institutions that will block reforms; and they prevent any real capacity development by ignoring the need for management and leadership skills. Together, these two factors undermine all prospect for government-led reform processes, that begin with the development of a strategy. Seen in this way, the new security sector institutions are burdened with the 'legacy costs' of conflict, driven by constituencies that grew powerful during the previous years of instability (Byrd and Guimbert, 2007).

Leadership positions in security sector institutions are viewed more as an opportunity to strengthen personal financial and patronage status than as a responsibility to deliver services. Holding office presents rent-seeking opportunities which can be exploited for large financial return and with less scrutiny. The Ministry of Interior is widely thought of as corrupt. It is responsible for appointing public officials in the provinces – governors, district managers, police chiefs and all policemen and border guards – which provides significant patronage power to those within it. Giustozzi (2004) reports of corruption and rent-seeking from the outset: 'Shura-i-Nezar, the faction in control of the armies that occupied Kabul in late 2001 did not waste time in placing its own men in key posts. This guaranteed that appointments would have been politically motivated...it proved impossible to remove corrupt officials who enjoyed the protection of politicians'. Ashraf Ghani estimated in 2003 that 10–30% of police salaries were being stolen. Rubin (2007) refers to the Ministry of Interior as one of the 'fatal weak points' in the Afghan Government today, 'deeply corrupt and plagued by a lack of skills, equipment and resources'.

There are strong vested interests to maintain the status quo, given the advantages to the influential and powerful elite. This structure of incentives effectively blocks any genuine institutional reform. A state of chaos and opacity allows rent-seeking to thrive, so any reforms designed to deliver transparency, accountability and scrutiny would be resisted. An overarching strategy that sets out a roadmap for reform and facilitates reforms to the methods of recruitment and salary payments, for example, would be counter-productive for those with the most to gain from rent-seeking. There is no political will to set in motion the necessary institutional reforms to the security sector which would make the Government able to provide security to the public.

Box 10: ‘Afghanistan is suffering from a lack of strong state institutions to cope with the insurgency’ (USAID, 2007a)

A recent report on Afghanistan’s economic performance highlights state capacity as a key weakness. The assessment is based on five state institutions including the security sector. Criteria include legitimacy, representativeness and professional capacity. On a scale of 1 to 5, the police and judicial system are given the lowest possible score 1, while the military is given a score of 2. Although the army seems to be judged more favourably than the police force, the report warns that the army is dominated by Tajik and other non-Pashtun ethnic groups and this lack of ethnic diversity is undermining legitimacy and representativeness. Another report states that although security sector institutions have been improving their operational capacity and the number of trained personnel is growing, ‘they, particularly the ANP, have had problems with retention, staff effectiveness, corruption and general oversight’ (USAID 2007b).

There may also be a genuine lack of capacity for public administration which also prevents reform from taking place. The characteristics necessary to become a successful commander are entirely different to those which make a successful government reformer. Strong leadership is required to deliver change to a system with public administration structures as entrenched and outdated as the present Government of Afghanistan has inherited. Recruitment that is not based on merit and qualifications, at all levels of Government, will mean that these institutions remain staffed by people unable to value the need for reform let alone deliver it.

In the past, the MoF has exercised its power as holder of the purse strings to encourage security sector reforms. In 2004, under the leadership of Ashraf Ghani, the MoF pushed the MoD to stick to Disarmament, Demobilisation, and Reintegration (DDR) deadlines and fully declare staff payroll numbers under the threat of withholding funds. But more recently, the MoF has not played as strong a role in driving forward reforms or using policy performance as a basis for budget allocations. The ANDS process, which aims to set out strategies and policies, may provide a renewed platform for the MoF to exercise this kind of authority again, and inject greater accountability across Government institutions.

In summary, the appointment of leaders to key security sector institutions has been driven primarily by the need to balance political alliances rather than on the basis of leadership and reform credentials. This has created strong incentives to resist reforms, which would remove the considerable rent-seeking opportunities that power-holders currently enjoy. This helps explain why the Government is not demonstrating a strong commitment to reform. The second line of enquiry turns to the role of donors, and asks why they too have not managed to deliver an agreed strategy against which to harmonise their activities.

Early on in the process donors agreed to a division of labour that split the sector in to five separate pillars, and assigned a ‘lead donor’ to each. This ‘silo’ approach encouraged a fragmentation of donor interventions. Without incentives or mechanisms for donors to coordinate with each other, each donor concentrated on their pillar and preferred methods of operating:

- The US took charge of setting up a new Afghan National Army,
- The Germans took responsibility for establishing the Afghan National Police,
- The Italians led on justice and the rule of law,
- The Japanese managed the DDR process, and
- The UK led on counter narcotics.

Box 11: Donor fragmentation across the five pillars of the security sector

The UK developed the National Drug Control Strategy (NDCS) to serve as the overarching policy framework for Government and donors. Alongside the NDCS they developed the Counter Narcotics Trust Fund to serve as a pooled funding mechanism for donors to support Government activities and implementation of the NDCS. Separately, the LOTFA had been set up early on to support police reforms only, primarily the payment of police salaries, with no read across to wider justice or rule of law activities. The US paid salaries and top-ups directly to the army recruits and was focused on the speed with which soldiers were being recruited and trained, while the Germans had a different approach to the pace of training. This highlights the diversity in approach across the various components of the security sector. Although strategies may have been prepared within individual sectors (such as the NDCS), without real Government ownership or wider dissemination it is questionable how meaningful they were or how much impact they had. There was no overarching strategy that had wide buy-in and momentum either amongst donors or Government.

The Consultative Group (CG) mechanism should improve donor-Government coordination through a web of technical working groups and reports to the Joint Coordination and Monitoring Board. Housed under the ANDS architecture and (re)launched in 2006, the UN have an important stake in ensuring that the CGs work well. But the CGs are still evolving, and got off to a patchy start. Early critique focused on the CGs being too much about bland reporting rather than genuine discussion about difficult policy decisions and ways forward, with trickier issues being referred upward to the Joint Coordination and Monitoring Board (JCMB) for resolution. This is the case with the debate over police numbers. The JCMB Task Force on Police has attempted to reach a joint Government-donor agreement on the appropriate size of the police force, following the US proposal to increase it from 70,000 to 82,000. Discussion so far has yielded no agreements. Meanwhile US funding proposals to Congress are already on track to increase the police force to 82,000, casting doubt on the value of the Task Force's exercise to discuss appropriate ANP force size.

There are two underlying reasons for the fragmentation of the donor group, both of which are rooted in the incentive structure that donor agencies are responding to, and the differential capacity of the donors themselves to finance and deliver on a very complex reform agenda. Firstly, donors' domestic political constituencies were pressing for evidence of change and for tangible results to the security context on the ground. Indicators such as the number of trained recruits and the number of militiamen demobilised are more palatable to political masters at home than indicators such as a harmonised approach amongst donors to push forward a government-owned sector strategy. The emphasis on short-term outcomes, again a result of the political spotlight being shone on Afghanistan by headquarters, means the incentives are very limited for donors to invest scarce resources (both time and financial) in joint ventures, coordinated policy decisions or institutional reforms that will only bear fruit in the medium-term.

Secondly, there were a number of non-traditional donor agencies operating in Afghanistan on security sector reform. Many of these actors did not employ at the core of their programmes the tenets of evolving aid paradigms – which amongst other things emphasise the need for a joined up donor community to reduce transaction costs on the recipient government and ensure coherence in taking forward reform processes. Donor harmonisation is particularly important for post-conflict states, where the outcomes are critical for shoring up the state's capacity, authority and legitimacy from a weak starting point. Responsibility for security sector reforms lay mainly with military and political actors, rather than development agencies which are the institutional home of aid expertise in most donor governments. The performance of these non-traditional donors was not being judged on the criteria of good donor practice. Instead they are judged by their headquarters on the delivery of security improvements in the immediate present. This partly explains why support could be provided in a fragmented manner, with little emphasis on longer-term horizons, an overarching strategy, or joined up donor working, with no criticism from headquarters.

These same factors help explain the third line of enquiry: why donors have not exerted more pressure on the Government to expunge illegitimate power-holders from official positions in the security sector. The major players from the international community are undertaking their interventions through a political-military lens rather than a development lens. This again implies a focus on short-term security and political objectives rather than longer-term institution-building, which is built on the challenging task of reshaping political and institutional incentives, the ‘rules of the game’ within Afghanistan’s Government. This emphasis comes at the expense of pushing for a clean-up of security sector institutions. In the short-term if it is more expedient to utilise the political alliances and military advantages that warlords and commanders offer, then external actors in the security sector may opt for the same strategy as Karzai: co-opting illegitimate Afghan power-holders for short-term security gains but trading off the long-term prospects for an effective state. As Nixon states, ‘while the formal benchmarks of the Bonn Agreement were mostly met, other important changes – such as the removal of corrupt officials or genuine reform of key ministries – did not take place’ (Nixon, 2007).

Without new leaders, external pressure for greater accountability, or a strong Government anti-corruption drive, there is little prospect of the Government taking responsibility for a security sector strategy and implementing deep-seated reforms. All hope for a strong Afghan state that provides security for its citizens is critically predicated on donors reconstructing the incentives for key players in the Afghan security sector institutions.

3.3 Part C: Why is the LOTFA not more effective?

The Law and Order Trust Fund for Afghanistan (LOTFA) was set up in May 2002 as a multi-donor mechanism to facilitate police salary payments and support law enforcement authorities. It has since disbursed \$314 million (to end-2006), with steadily increasing disbursements year on year.

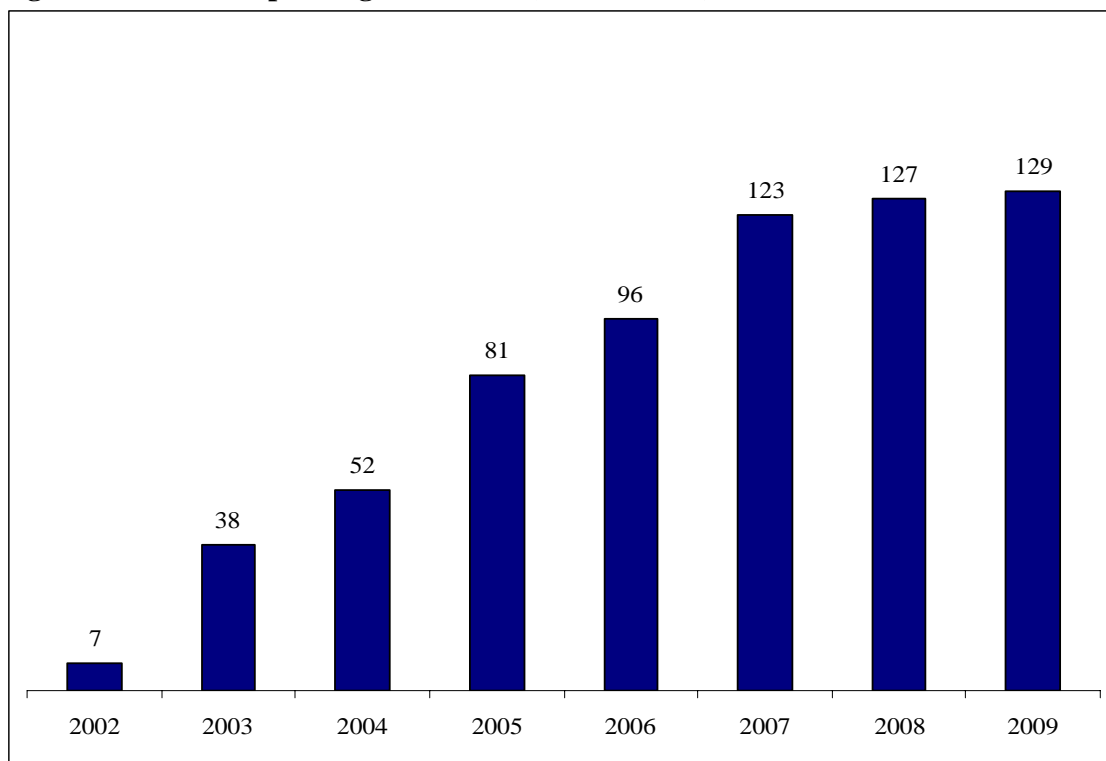
The UNDP took on the payment verification role which incorporated an oversight function in a very risky fiduciary situation. The LOTFA funds were paid to the Ministry of Finance Treasury department on a reimbursement basis upon verification, and this allowed police wages to be supported by external assistance from several donors. It also meant that police salaries were kept on budget from early on, and that the Government could include the recurrent costs of the police force in fiscal frameworks and planning. Germany was assigned as the lead nation for the sector, with responsibility for leading on police reform and coordinating external assistance to the sector. The UNDP was asked to administer the trust fund. Internal governance mechanisms include an Oversight Committee and a Steering Committee.

The UNDP describes the LOTFA as ‘one of the key capacity building projects in the UNDP Afghanistan portfolio’. The Fund has five priority activities:

1. Payment of police salaries nationwide
2. Procurement of non-lethal equipment, and covering other recurrent expenditure such as fuel and maintenance costs
3. Rehabilitation of facilities
4. Training
5. Institutional development

It has been explicitly recognised that activity 1 is the topmost priority, and should be addressed before the others. This transparent hierarchy of objectives adds predictability to the use of funds and the thinking behind disbursement decisions.

Figure 15: LOTFA spending 2002–2006 (\$US millions)



Source: Ministry of Finance, 2007

From the beginning there was no multi-year strategy for the LOTFA, only annual project documents which were generally based on a one year time horizon. This is startling for a sector in which the needs and nature of reform stretch over the long-term. Since 2002 the LOTFA has been through a number of reviews and had its mandate extended regularly. In 2007, the LOTFA is now in its 4th phase. The text box below describes the LOTFA's evolution since 2003. It builds a picture of last minute management decisions and short-term horizons that compound the projectised approach taken early on. The frequent but compressed reviews must have raised transaction costs for management of the Fund, and may have undermined the rigour of monitoring and evaluation. The repetition of challenges and constraints in each successive phase suggests that the lessons learned did not translate to a step change along the way, which might have raised the LOTFA's effectiveness significantly.

Box 12: LOTFA's Development 2003–2008

Phase I: 1 November 2003 to 31 March 2004. The Phase I document was signed in December 2002 as a framework for the LOTFA activities. The inception phase experienced start-up problems and disbursement was very low, but picked up considerably in 2003 when it paid out \$66 million. The Ministry of Interior requested a review of the LOTFA activities in early 2004. The review was supposed to consider the 'objectives, strategy, coordination, management arrangements, staffing and budget of the project', a comprehensive exploration of the workings of the trust fund. But it did not lead to any real change.

Phase II: 1 April 2004 to 31 March 2005. Following the above review, a Phase II document was signed in April 2004, which extended the LOTFA's mandate by just one year.

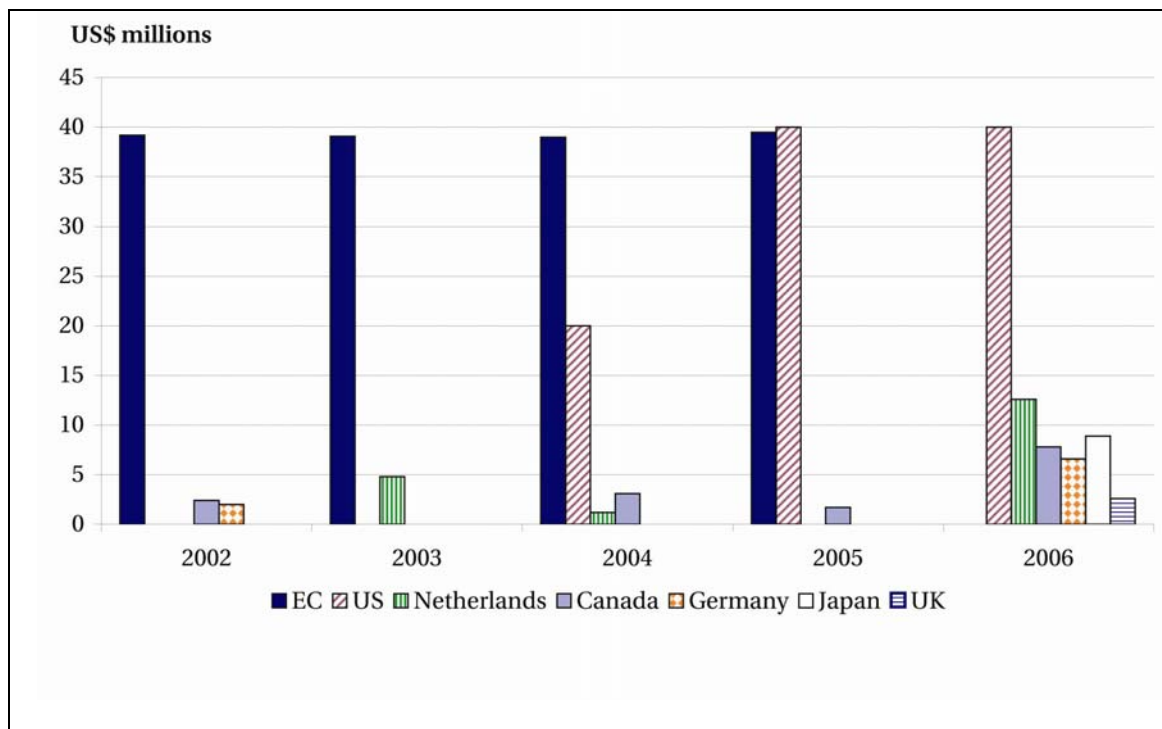
Phase III: 1 April 2005 to 31 March 2006. In March 05 the Steering Committee reviewed Phase II and extended the project to the end of fiscal year 2005/6, again adding to the time horizon by just one year with the extension arriving very close to the end of the earlier mandate.

Phase IV: 1 April 2006 to 31 March 2008. For the first time an extension has gone beyond the one-year pattern to two years, which might allow for a longer planning horizon. But the budget is to be reviewed on an annual basis (the budget for year 1 of phase IV, which is 2006/7, stood at \$169 million), so there is no call for donor commitments to start being made on a two-year framework to fit with the extended the LOTFA horizon.

Financial reports indicate that:

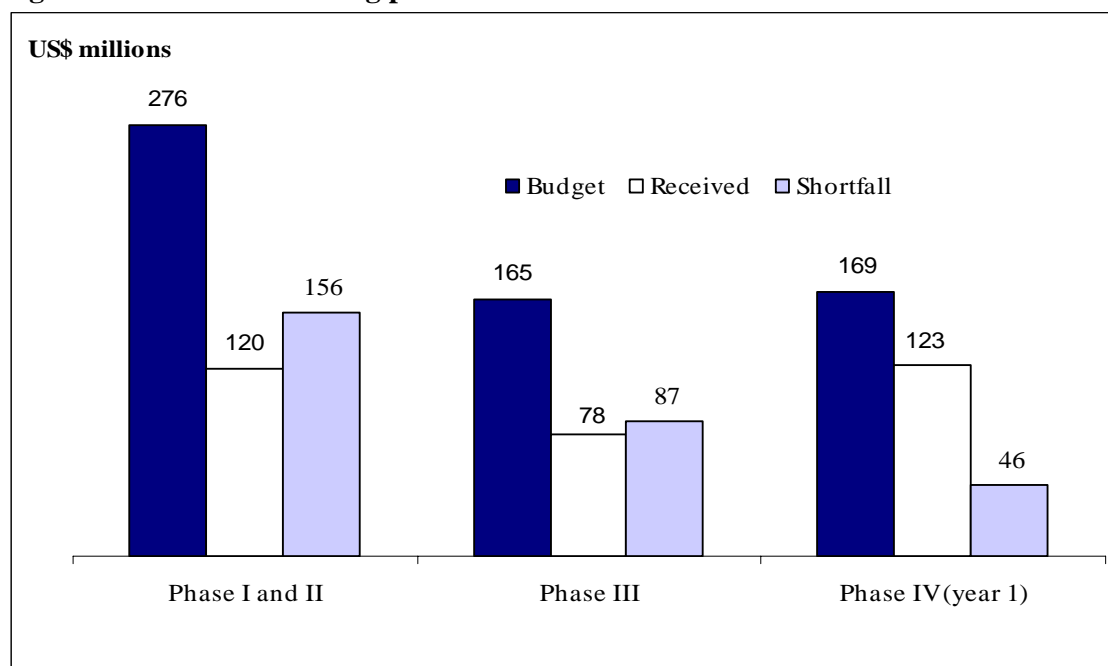
The top two donors are the EC and the US. The EC had paid in \$149 million as of December 2006, in steady tranches of around \$39 million per annum since 2003. The US had paid in \$100 million since 2004. The top five donors in rank order are the EC, US, ARTF, Netherlands and Canada. (The ARTF channelled money to the LOTFA at the very early stages of the LOTFA's inception, as a one-off expenditure. The size of this donation means it is still one of the largest donors to the LOTFA over the period.) All the other donors are far behind the EC and US in the size of contributions made. A total of 15 donors have contributed funding through the LOTFA since its inception, but each year a different constellation of donors pay in to the fund. The large number of donors with small payments underscores the need for a multi-donor instrument to coordinate these bilateral contributions and reduce transaction costs for the Government.

The smaller donations are volatile. This unpredictability makes it difficult to forecast future years' resource ceilings, and the LOTFA does not offer such projections.

Figure 16: LOTFA contributions by donor

Source: UNDP, 2006

The graph below highlights the LOTFA's performance in attracting donor resources over the four phases. During phases I and II, the LOTFA received only 44% of the resources it budgeted against. In Phase II the LOTFA's contributions again fell massively short of its budget at just 47%. Things are looking up in phase IV, but there is still a shortfall and it is not yet clear what the 2007/8 budget or donor appetite for using the LOTFA is. The increase in donor resources in fiscal year 2006/7 is a result of the Pay and Rank reforms to the police force, which increased the LOTFA's wage bill component from \$75 million to \$121 million. Open debate and donor expectation of this shift in the wage bill meant that donor resources could respond in a timely way to the agreed reforms.

Figure 17: LOTFA financing performance

Source: UNDP, 2006

Independent evaluation reports, internal progress reports and the World Bank PFM review all agree on the evidence and reasons for the LOTFA being less effective than it could or should be. There are four key areas where the LOTFA's performance falls short of expectations: uneven implementation of priority activities, monitoring and evaluation, coordination and stakeholder engagement, management and work planning and strategic voice. These weaknesses (expanded in the text box below) mean that the LOTFA does not hold the strategic position it was intended to. Beyond police salaries it does not add value as a mechanism for coordination or harmonisation, and donors deliver their aid through parallel channels even in support of activities that are identical to the LOTFA's broader objectives. Without a self-motivated drive to develop a strategy or detailed work plan for the capacity building and institutional development components, the LOTFA is unable to convince donors to act differently. Volatile funding and a history of shortfalls mean that the attention of UNDP managers is focused on ensuring that police salaries are covered rather than broader strategic issues, and as a result the LOTFA's voice is not as strong as it could be in the wider debates on security sector reform.

Box 13: The LOTFA's weaknesses

Uneven implementation of priority activities

Component 1, paying police salaries, has been largely delivered, and is one of the LOTFA's key achievements – especially in the early period when the MoI could not oversee its payroll. Pay packages are being delivered more punctually. The rollout of the electronic payment system is a key reform within the MoI that is being driven largely by the LOTFA funding and technical support. These changes are linked to moderate improvements in police reliability and integrity in the LOTFA's 2005 evaluation report. However, even in this area of work, there is clearly much still to be done to clean up police salary payments and ensure that the verified payroll system is engendering reform far and wide. There is a question mark over why the LOTFA does not engage a monitoring agent to independently verify payment invoices, as the ARTF does.

Beyond component 1 there is limited delivery of the LOTFA's objectives, primarily due to a lack of funding after police salaries are paid: 'the other components expended minimal or nil amounts due to non-availability of funds' (UNDP, 2005), which hinders progress in other activities. Capacity building initiatives have been ad hoc and not linked to any wider efforts – such as Microsoft Excel training for the MoI budget section, and funding for internet and website facilities in the MoI. Institution-building is closely linked to sustainability: without a stronger and more capable MoI, the Government cannot manage the police force independently.

Monitoring and evaluation focuses on resources rather than outcomes

There is a strong emphasis on monitoring financial flows rather than outcome indicators such as the integrity of police, the number of retrained police, the impact of the electronic payment system on reducing corruption etc. The narrow interpretation of the monitoring remit reinforces the LOTFA's image as a joint account for donors whose main purpose is to clear funds rather than to act as a strategic financing instrument that catalyses reform and delivers more than the sum of its parts.

Little impact on donor harmonisation

Although the major donors and Ministry of Interior are on the Steering Committee and take part in decision-making, the lack of funds and activity on the majority of the LOTFA's work plan components means that the need for major decisions against the current LOTFA activities is fairly limited. Donors such as the US, Germany and United Nations Mission for Afghanistan (UNAMA) run their own initiatives outside of the LOTFA, and even deliver the LOTFA priorities through parallel projects – for example police training delivered by the Germans, and salary top-ups delivered by the US. Coherence across the range of donor actors is low, and fragmentation high.

Management and work planning

No work plans were prepared for the project during phase II, which implies two things: firstly, it is difficult for the project managers to measure progress against agreed benchmarks and identify problems and concerns in good time. Secondly, imprecise work plans are not conducive to attracting donor resources, which will expect to follow an agreed timeline with clear lines of responsibility and activity. Without detailed project documents it is difficult to convince donors to invest additional resources, and might explain part of the funding gap the LOTFA has faced throughout its lifetime. Where activities are funded, such as the electronic payment system, implementation and planning has largely been guided by donor agreements. The EPS work plan was developed early on (2004) with the support of an EC-funded consultant. The Swiss development agency then took an interest and helped prepare work plans for later stages. Project management and planning has been driven largely by donors, both through the signal of funding availability and the provision of technical expertise. Without such intensive involvement, this kind of planning may not have taken place. This is an important signal for donors in Afghanistan who tend to be short-staffed on the ground and look for ways to provide support with minimum transaction costs. A multi-donor trust fund (MDTF) is supposed to deliver this. If donors are required to provide hands-on input on top of their resources and administrative fee to the UNDP, the attractiveness of the LOTFA as an aid delivery mechanism is reduced and the desirability of harmonised donor instruments over bilateral projects undermined.

A key factor underlying the poor work planning and strategy development by the UNDP relates to its own staffing constraints. Management of the LOTFA has been adversely affected by rapid staff turnover and delayed recruitment processes, which meant that there

was little stability in staffing and that vacant posts were left unfilled. THE UNDP filled the project management gaps in the short-term, and took on the role of directly monitoring the disbursements to the MoI as well as preparing progress and financial reports to the Steering Committee and donors.

A second factor driving the LOTFA's underperformance is its inability to lock in multi-year funding commitments from donors, which allow for both recurrent and development activities to be met. This is partly a function of UNDP staffing constraints. It is also a result of donor attitudes towards the LOTFA. Donors are prepared to work to the same objectives as the LOTFA but through bilateral channels, by-passing the multi-donor mechanism and the coordination and coherence advantages it offers. This may be a result of donor preferences:

- Wanting to maintain a greater degree of control over the use of their resources which is possible with a private sector contract that offers more accountability
- Wanting a greater degree of leverage through a bilateral relationship with Government
- A lack of trust in the UNDP's capacity to deliver high quality outcomes, which is based on little strategy or work plan development so limited scope to pass internal approvals process for new projects and spending
- Internal incentives to attribute success to bilateral rather than collective interventions
- Perception that transaction costs are greater when dealing with the LOTFA administration/multiple stakeholders rather than acting bilaterally

These are the standard set of reasons behind a donor's decision to deliver aid through bilateral mechanisms rather than a pooled fund. But experience with the ARTF demonstrates that there is some donor willingness to use trust fund mechanisms in Afghanistan, if trust fund administration capacity is deemed by donors to be equivalent to or better than their own bilateral systems.

As the sole pooled funding mechanism outside the Government for police spending, the LOTFA has the potential to play a large role in the police and rule of law sector. But given the weaknesses identified, it is not fulfilling this potential. So, what next for this instrument? This important question is addressed in Chapter 4.

3.4 Part D: How does the major donor deliver aid to the security sector?

To explore fully the financing of the security sector it is imperative to consider the largest donors and what drives their decision-making processes. This warrants a closer look at the US, which is the single largest donor to the security sector: how does the USG deliver aid globally, how does this model apply to support for the security sector in Afghanistan, and why, and what might encourage a shift in its model of aid delivery. The following chapter draws largely on the DAC peer review of US development assistance (OECD, 2006).

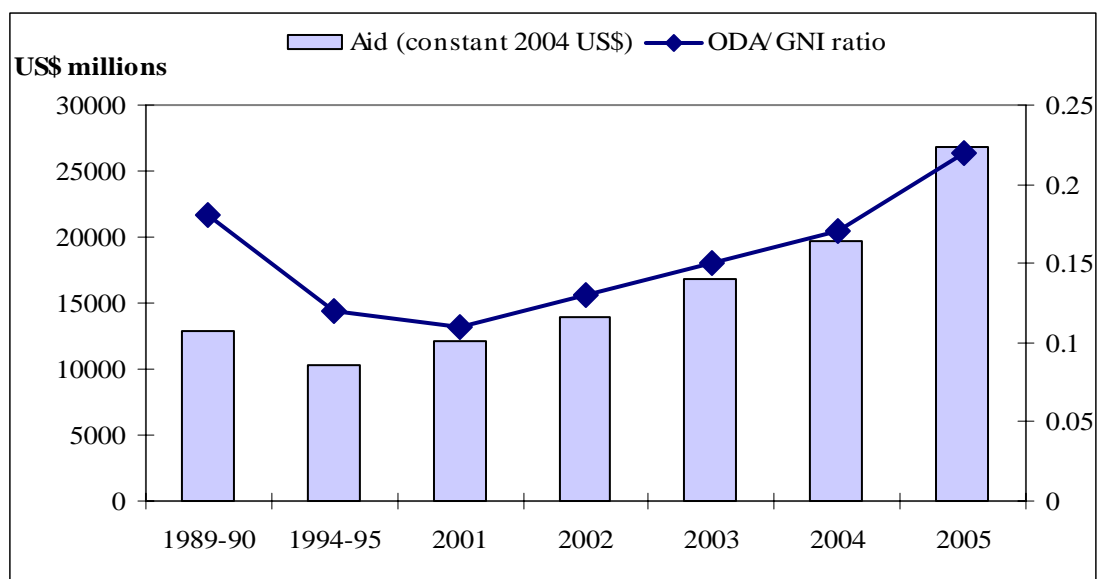
The US as a global donor

The US is the largest donor in the DAC, providing \$27.6 billion in 2005. This represented a staggering 40% growth in aid from the \$19.7 billion provided in 2004. As a result of the sheer volume of aid provided, the US can be characterised as a 'leader in international development because of the size of its economy, its ability to influence globally and presence within the international development community'. Aid in 2005 came to 0.22% of gross national income: although this was the highest ratio the US had seen since 1986, it

places it virtually at the bottom of a league table of OECD donors. While future aid volumes are likely to be lower, they are predicted to remain significant at approximately \$20 billion per annum. The US Government has experienced 'continued fragmentation of funding among government institutions and the continued redirection of ODA away from USAID'.

A quarter of 2005's aid was provided to Iraq in the form of debt forgiveness and reconstruction spending (\$6296 million); followed by reconstruction and counter narcotics efforts in Afghanistan (\$1060 million). Egypt is the top third recipient (\$750 million) with Sudan (\$575 million) and Ethiopia (\$552 million) the priority recipients in sub-Saharan Africa. The Middle East and North Africa region gets 42% of US aid (\$8371 million) followed by sub-Saharan Africa (\$3899 million).

Figure 18: Growth in US aid expenditure 1989–2005

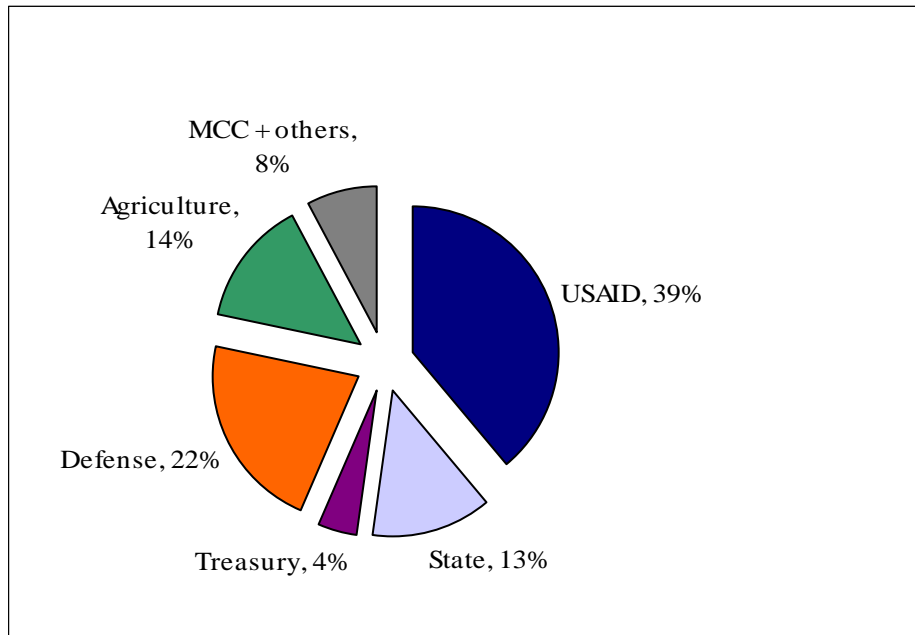


Source: OECD, 2006

Three important features of the US aid system are demonstrated below:

1. The multiple players involved in disbursing the overall aid budget. The largest flow of aid is through USAID in 2005.

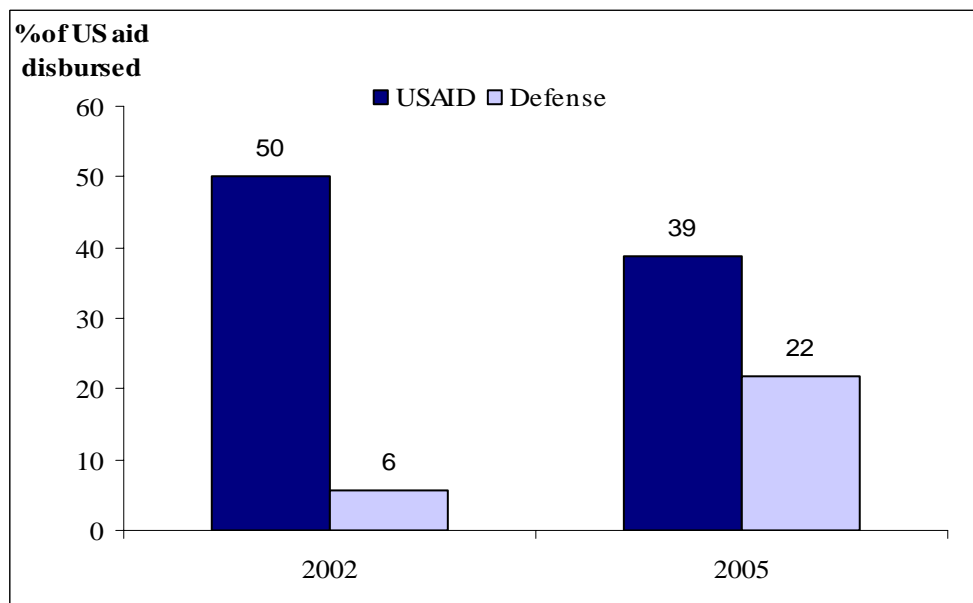
Figure 19: Share of aid through US agencies



Source: OECD, 2006

2. The dramatic shift in the period post-9/11 away from channelling aid through the Agency for International Development (USAID); which is largely explained by the increasing use of the Department of Defense (DoD). This is consistent with the growing budget for global security, with a focus on the Middle East.

Figure 20: Growing preference for Defense over USAID to disburse aid



Source: OECD, 2006

3. The preference for providing aid bilaterally rather than through multilateral channels.

Share of US aid provided through bilateral channels						
<i>1989-90</i>	<i>1994-5</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>	<i>2004</i>	<i>2005</i>
80%	75%	72%	80%	90%	82%	92%

Source: OECD, 2006

These trends demonstrate a close correlation with US foreign policy priorities. Congressional funding earmarks and Presidential initiatives are major drivers of how aid is allocated over time and across countries. This, and the shift from USAID to DoD to disburse aid resources, both stem from the evolving US approach to international development as a part of the national security agenda.

Two major policy evolutions have taken place since 2001. Firstly, the National Security Strategy in 2002 redefined development from a national security perspective. National foreign policy was based on three pillars – the three ‘D’s – defence, diplomacy and development. This places development firmly within the nexus of politics and military interventions. The structure was reaffirmed in the National Security Strategy in 2006 and is the basis for the model of ‘transformational diplomacy’ that is being tested by the Bush administration. The USG’s National Security Strategy (2006) states that ‘transformational diplomacy means working with our many international partners to build and sustain democratic, well-governed states that will respond to the needs of their citizens and conduct themselves responsibly in the international system.’ Foreign assistance budget requests by the US administration are explicitly linked to national security objectives: during a Congressional briefing on the 2008 budget submission, the then Director of Foreign Assistance, Randall Tobias, based the request for a 12% increase in the foreign assistance budget (on 2006 levels) on the critical role that security and development assistance plays in the National Security Strategy, stating ‘there is no doubt that foreign assistance makes the US safer’ (USAID, 2007).

Secondly, the Foreign Assistance Framework (FAF) was developed – to serve as an operational matrix for the strategy of transformational diplomacy. However, as a mechanism to harmonise the many aid actors in the US system, it falls short because it does not cover the DoD, it extends only to USAID and the State Department. This implies that one of the growing aid players is outside the main policy framework to deliver foreign policy objectives. It does not make explicit the potential for conflict among these different actors within the US Government, which as in any government may need active management to ensure policy coherence. It also means the FAF fails to articulate *how* development can work with diplomacy and defence as a means for extending national security. The FAF also lacks strength as a mechanism to support international development as a policy objective. It does not explicitly highlight poverty reduction as a policy goal (although the DAC, optimistically, believe there is scope for it to do so in the future).

Alongside these policy initiatives, institutional reform led to the creation of the Office of the Director of Foreign Assistance (DFA) with a remit to coordinate U.S. assistance programmes and thus reduce fragmentation across the USG. Located within the State Department, the DFA is supposed to serve as an overarching leadership structure for Department of State (DoS) and USAID bringing together diplomacy and development. Again, the absence of Defence within this structure is conspicuous. The DFA was set up in 2006 and has experienced leadership turnover since then. It is yet to be seen how effective it will be at bringing together different agencies, mandates and paradigms to implement transformation diplomacy. One promising signal is the integrated DoS and USAID foreign assistance budget request for 2008. This is the first ever joint budget, and aims to promote

coherence across the US Government's fragmented aid agencies. To provide a more comprehensive budget in the future it will need to include DoD funding on security sector interventions. The DFA will also need to clarify the division of labour with the Coordinator for Reconstruction and Stabilisation.

A key influence over aid policy is Congress. Congress places earmarks on funding allocations, tying aid to US sources and defining the ways in which it can be spent. This is a considerable constraint on the efficiency and flexibility of aid, and it also limits the amount of discretion country offices can apply in using recipient government procurement and public financial management systems. The system of earmarks and directives amounts to supply-driven aid, which undermines recipient government ownership. The need for Congress to approve budgets on an annual basis is a key driver of the unpredictability of US aid, which in some cases is also a source of frustration to aid agencies themselves who face volatility in their budgets from one year to the next.

Box 14: Evaluations of the US as a global donor

The following table presents global findings on the US as a donor from the Paris Declaration baseline monitoring exercise, with a comparison to the UK as a benchmark. They characterise the US as a donor that is hesitant to rely on what may be perceived as weak government systems for managing external assistance and does not emphasise the practice of working with or through other donors.

Paris Declaration Baseline Monitoring Exercise 2006: Selected Results from US Survey (UK benchmark)

Aid flows aligned on national priorities	90%	(84%)
Coordinated technical cooperation	47%	(61%)
Use of country PFM systems	10%	(75%)
Use of country procurement systems	12%	(76%)
In-year predictable aid	45%	(90%)
Untied aid	7%	(100%)
Joint country analytical work	39%	(69%)

Recommendations from the DAC peer review on aid provision:

- The US should establish a clearer development vision with poverty reduction at its core. Development is firmly within the 3-D's framework, but now needs to have the same status as the other two pillars.
- To implement this vision, the USG needs to construct an organisational structure, leadership and supporting resources. The FAF needs to extend to all USG aid actors, and make more reference to initiatives such as the Paris Declaration and Fragile States Principles.
- The USG should develop a longer-term aid plan, improving predictability and making more strategic allocations across countries and instruments.
- Allocations could be balanced between the use of aid in crisis countries that reflect current US policy priorities, and those where long-term and significantly increased development efforts are required.
- A stronger role should be played in the multilateral system by putting more finance through these channels and developing a performance framework to inform allocations.

The Centre for Global Development, a Washington-based think tank, has created a Commitment to Development Index (CDI), which ranks 21 rich countries on the basis of various policies including aid, trade, environment and migration. The aid indicator for the index goes beyond looking at the quantity of aid and assesses the quality of aid. It penalises tied aid, aid that is provided to corrupt or non-poor countries, debt payments received from poor nations, and a preference for project aid. In 2006, the US was at the bottom of the rankings against the aid indicator, only Italy and Japan scored worse. However, the US is one of the most improved nations since 2003.

http://www.cgdev.org/chapter/initiatives/_active/cdi

The US as a donor in Afghanistan

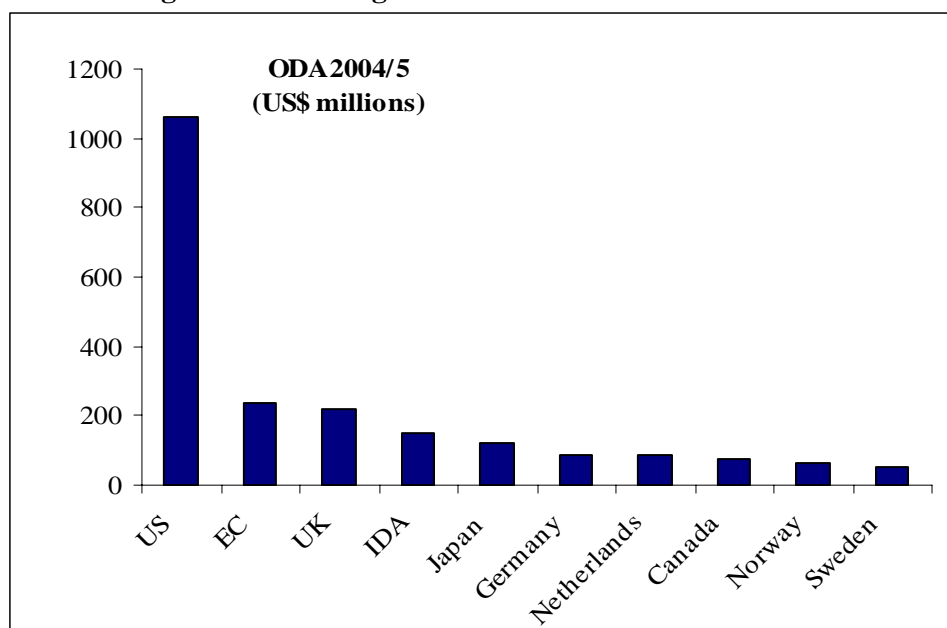
The US is by far the largest donor to Afghanistan, and dwarfs the other players with its sheer financial might. Latest ODA estimates suggest US aid flows to Afghanistan were roughly the same as the contributions of all other top 10 donors put together including multilaterals such as the World Bank and European Community. DAC statistics for 2004/5 record \$1,060 million in ODA from the US, compared to \$1,085 million from the nine other donors in the top 10 league.

Nearly \$3 billion was provided for reconstruction and security sector reform in 2006: \$778 million spent by USAID, and \$2,062 million by State and Defence on the army and police (this compares to \$19 billion spent in military operations in 2006). Assistance is predicted to rise sharply in 2007. This is driven by large increases in security sector spending by the Departments of Defence and State. USAID's spending has been increasing at a slower rate and is projected to plateau over the coming years.

US spending is highly volatile from one year to the next. USAID faced a 50% budget cut in 2006, and total spending dipped by over \$1 billion between 2005 and 2006. Budgets are set on an annual basis, and current planning frameworks for foreign assistance only go to the end of fiscal year 2008. The DoD does provide estimates of spending beyond 2008, but these projections have not been approved by Congress. It is a spending profile that the DoD has estimated on the basis of their 2006 threat assessment. This creates fresh challenges for the aid-dependent Afghan Government to plan its expenditure when there is such low predictability over US funding from one year to the next, and the horizon for projected funds ends in the short-term.

A large portion of US aid is provided bilaterally, through private contractors, which places it outside the core budget. Some multilateral and on-budget assistance is channelled through the ARTF and the LOTFA, but this is a marginal share of total US expenditure in Afghanistan: of a total \$2.8 billion in foreign assistance in 2006, just 3% was spent through the MDTFs (\$94 million).

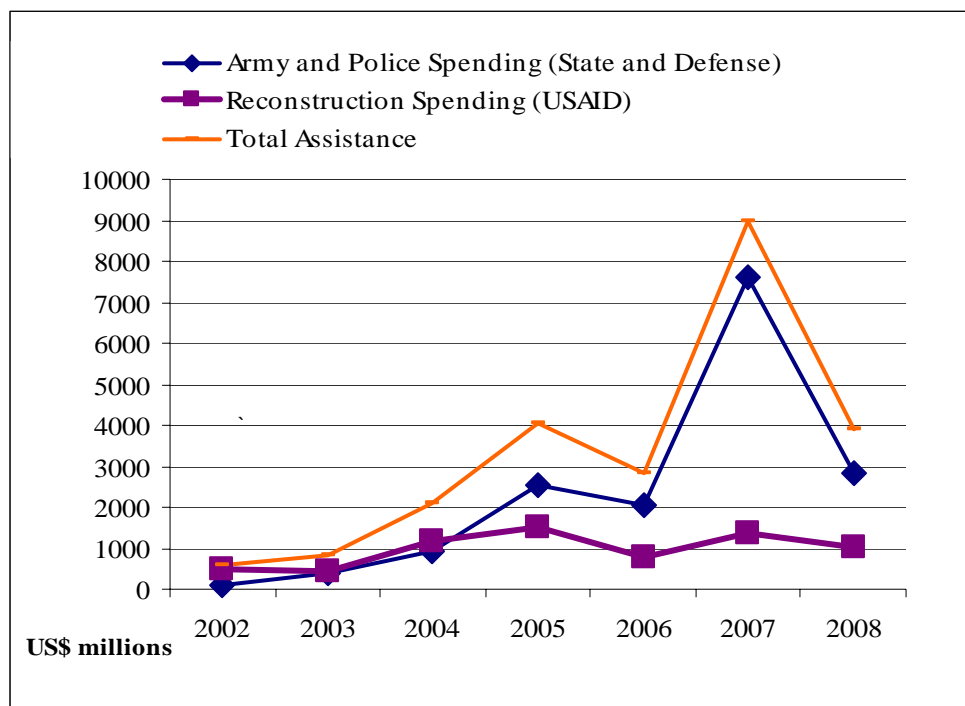
Figure 21: The largest donor to Afghanistan is the US



Source: OECD, 2007

In summary: the US is an important player in Afghanistan because of its huge financial power. However, the US as a global donor diverges from best practice aid delivery, and the same is true in Afghanistan. This is explained by the following institutional, political and economic factors.

Figure 22: US Assistance to Afghanistan 2002–2008



Source: Government Accountability Office, USG, 2007

Firstly, the US's overarching strategy for foreign assistance is largely built around US foreign policy objectives. Although development is one of the three 'D's, it does not have the same status as defence or diplomacy. Development resources are largely seen as a means to improve the security of the US. The underlying incentive to use aid in the most effective way to reduce poverty is weakened by this overarching statement of strategy.

Secondly, recent aid trends demonstrate the growing role of the Department of Defense (DoD), largely at the expense of USAID. USAID is the institutional home of development expertise, and the 'owner' of the Paris Declaration on aid effectiveness.⁵ As more aid is disbursed through alternative US agencies, less is being exposed to the tenets of best practice, which the US signed up to as a member of the OECD DAC. The DoD is judged on the basis of short-term security objectives, which are measured by the number of soldiers recruited, the number of police armed and trained, etc, not whether The DoD is sharing its spending plans in a timely way with the Afghan Ministry of Finance (MoF). There are few institutional incentives within the USG to improve coordination with other US players. Although the Office of the DFA is encouraging a more coherent approach for the DoS and USAID it does not have any real influence over the DoD. This implies that as more aid is provided through the DoD, the less realistic it is that it will be channelled

⁵ A caveat – although the US has signed up at HQ level to the Paris Declaration, there is a disconnect between policy and field offices. Evidence suggests that the incentives within donor agencies are not strong enough to encourage genuine aid effectiveness reform in country offices. This is the case with most if not all donors.

through joint donor policy and funding initiatives, involving dialogue with the MoF and other planning ministries, and in synchrony with the national budget process.

Thirdly, because of the scale of resources the USG has available in Afghanistan, there is no economic incentive for it to change its aid delivery practice. There is little to gain in financial terms from collaborating with other donors when US resources are four times greater than the top two donors.

Fourthly, the ways in which foreign assistance budgets are compiled and approved in the US also makes it difficult for the USG to comply with the Paris Agenda. The need for Congress to approve budgets on an annual basis, which is often done with heavy earmarking, means that US aid becomes inherently supply-driven. The rising use of Presidential Initiatives has the same effect. The important role of Emergency Supplemental Funds means that there is significant volatility in US budgets for Afghanistan from one year to the next, as the 2005–7 period has shown. The supplemental budget in 2006 favoured security sector interventions by virtue of being part of the War on Terror supplemental, implying that assistance to the security sector is particularly vulnerable to large shocks.

Box 15: Take-up of the Paris Agenda by donor agencies

Buy-in to the Paris Declaration at headquarters level has not guaranteed the same at the level of field missions, which limits the implementation of the aid effectiveness agenda at the country level. In post-conflict states key donors may not even have any buy-in at the HQ level so no policy directive to incorporate the Paris Declaration in to their programming. This is particularly true for defence and political agencies in donor governments. (OECD, 2005, 2006)

What might change the current incentive structure, and who might act as a driver of that change?

Congress: The DoD and State Department performance is judged by Congress partly on the basis of how well they work with the recipient government, consider future sustainability, and coordinate with other donors. This creates institutional and financial incentives to invest more time and energy in coordination and harmonisation activities. There is evidence that Congress is asking the right questions. A report by the US Government Accountability office scrutinises aid spending plans, the level of coordination with other NATO partners, and the extent to which sustainability and institutional reform has been incorporated in to army and police reform efforts. Although Congress is often seen as a constraint to the effective and efficient delivery of aid, it is also a potentially powerful driver of change to US practice in the Afghan security sector if it focuses on how aid is delivered, not just on how much (USGAO, 2007).

Government of Afghanistan: Mutual accountability is supposed to empower recipient governments to stand up to unhelpful donor practices. In Afghanistan, however, the Government is unlikely to serve as a driver of change. This is because it is fragmented – and the security sector institutions have no incentive to refuse the generous financial resources that are being supplied to them. Not having to answer to the MoF through the budget process is a particular bonus for the security sector institutions. The MoF might be a natural driver of change, but when US resources account for such a large portion of overall aid, and US political support is perceived to be critical, the incentives are stacked against economic planners making controversial policy decisions about how to manage US resources.

Donors: In the context of a weak recipient government, donors should take on the role of holding each other to account in a form of peer review. However, there is little incentive for the US to take much notice of constructive criticism in a context where it provides more resources than other donors combined (non-UN). Several donors are glad that the US is providing so much support to the security sector, which is fundamental to the success and sustainability of all other development efforts across the board. It is also perceived to be politically damaging to take a vocal line that critiques US practice, particularly for multilaterals with influential US executive board members. This is partly because donors' influencing strategies have not got it right. The messages must be delivered in a way that highlights the advantages to the US of providing their aid more transparently, more predictably, and accompanied by a drive for reform in security institutions.

Box 16: US Government Accountability Office (GAO) scrutiny of spending in Afghanistan

The GAO is the audit, evaluation and investigative arm of Congress, and supports Congressional committees to oversee and scrutinise the work of USG agencies. This means it has the power to influence USG aid allocation and spending decisions, and to restructure institutional incentives for US donor agencies.

The GAO has written five reports on Afghanistan since 2003, and over the course of the past four years has identified the need for better planning and development of strategies with measurable goals, specific time frames, cost estimates and risks. The 2007 report criticises the Departments of Defence and State for not delivering strategic plans on army and police reforms, which the GAO had requested in 2005. A consistent message delivered by the GAO is the need for even progress against all pillars of the security sector. In the current report, Congress is encouraged to scrutinise performance against other security sector pillars, notably counter-narcotics and the judicial system. The plans to scale-up the police force and accelerate army recruitment are recognised as 'ambitious'. The mounting costs of security sector reform efforts in Afghanistan – a three-fold increase in spending in 2007 relative to 2006 – is creating difficult trade-offs for USG decision-makers.

The GAO recommends lines of enquiry for Congressional oversight meetings, and these are a promising lever to effect change in the way that US donor agencies operate; for example by encouraging greater coordination with other donors, attention to building local institutions and systems, and thinking about longer-term sustainability of current interventions in both financial and management terms. All of these issues are of paramount importance for the USG's eventual exit strategy from Afghanistan. Although there is no reference to the Paris Agenda on aid effectiveness, the language strikes similar notes regarding harmonisation and sustainability.

Question from GAO	How it affects incentives for the DoD and the Department of State (DoS)
How do the DoD and DoS track funding for the ANA and ANP?	Incentive to improve Government capacity to monitor and contain fiduciary risk and support an anti-corruption drive across key line ministries in the security sector.
What plans are in place for Afghanistan to take programme and financial responsibility for the army and police? What measures are used to assess progress in reforming the MoI? What progress has been made in developing Afghan army-sustaining institutions?	Incentive to pay greater attention to institutional reform by removing obstacles to change, and emphasising the need for systems and processes to be strengthened in order to effectively absorb the scale-up of resources. Further incentive to apply a fiscal sustainability lens to policy decisions, and ensure that economic planners in the Ministry of Finance are aware of spending decisions and their implications for Government resources in the future.
How does US Coordinate its Provincial Reconstruction Teams (PRTs) with others? How are Quick Impact Projects (QUIPs) coordinated?	Incentive to better harmonise with other donors to be able to demonstrate coordination between PRTs and the design and implementation of QUIPs.

Chapter 4: Short- and long-term prospects for financing the security sector

In the interests of ‘right-financing’ the security sector in Afghanistan, spending must remain high over the short- and perhaps medium-term to tackle the many, pervasive, sources of instability in the country. The impact of security spending on security outcomes, and their sustainability, are paramount. This is why it is in the interests of both the international community and the Afghan authorities that the Government is able to provide adequate security services funded entirely from domestic resources.

Afghanistan must demonstrate progress now, to cement the fragile gains since 2001 and accelerate progress towards a peaceful and prosperous society. The process of achieving full financial independence is no substitute to political reform, but is a key ingredient to improve the financing model for the security sector. Aid will have a lasting impact on the security sector only if the Government is fully prepared to and capable of covering its long-term liabilities.

Achieving this goal depends critically on changing the underlying incentive structures of the political system, so as to increase leadership and ownership of the security agenda in Afghanistan. Arguably, this kind of social and political transformation will take place over the long-term, linked to broader social and economic development; and, unlike regime change, cannot be imposed from the outside. So what can donors do?

On the basis of the preceding analysis in Chapter 3, four policy levers are identified: expanding the revenue base; reforming government systems and processes; strengthening the aid modality; and improving donor behaviour. Some measures are feasible in the short-run, while others face more entrenched obstacles to reform and are represented as long-term reform measures. This chapter elaborates on these recommendations.

Emerging policy options		
Policy lever	Short run (1–2 years)	Long run (3–10 years)
Objective: Fiscal affordability and sustainability of the security sector		
i) Revenue base	Published information on tax collection, and taxpayer education to improve compliance	Performance incentives to increase tax collection by provincial offices, and economic growth and development of the legal private sector and minerals industry
Objective: Greater aid effectiveness of financing for the security sector		
ii) government systems and processes	Development of a costed strategy	Broader public financial management (PFM) reforms such as the development of a MTEF, and improved fiduciary standards in MoI and MoD
iii) Aid modality	Reform and improvement of the LOTFA	Development of a comprehensive SWAp with a more advanced funding mechanism
iv) Donor behaviour	Reform of selected aid delivery practices	Changes to USG’s global development assistance policy

4.1 Expanding the revenue base

Chapter 3 highlighted the constraints to high revenue collection, including opposition to reforming the tax regime. There are other policy levers the Government can utilise: strengthening tax administration to make collection more efficient, and strengthening the economy as a whole so that the revenue base expands.

Box 17: Increasing ‘fiscal space’ for security sector spending in Afghanistan

Fiscal space refers to the capacity of a government to increase expenditure without jeopardising its fiscal sustainability. A government might want to increase its fiscal space to finance a new spending programme or provide tax cuts, both of which might be popular with voters, or to provide public investment that boosts medium-term growth and revenues. Investing in the security sector requires fiscal space.

Heller (2005) describes five ways to create fiscal space:

2. Raise revenues by introducing new tax policies or making tax administration more efficient. Heller’s prescription for low-income countries is to raise the tax take to 15% of GDP at least. The Government collects less than half of that share at present – although revenues are projected to increase in the short-term as discussed in Chapter 3. But what measures might bring about a step change in revenue potential over the long-term? There are two broad policy issues discussed below: breaking the local capture of tax revenues, and encouraging stronger growth and economic development at the provincial level.
3. Cut low priority programmes to make room for higher priorities. The Government has made efforts to cut back some public spending, e.g. through large scale staffing audits that aim to eliminate ghost workers and improve payroll systems in the education and security sectors; but on the whole spending is on the increase in all sectors because of the dire state of public sector capacity and incentives for high performance, and the massive development agenda.
4. Borrow resources (take on debt) either internally or externally. This option is not feasible in Afghanistan. The Government cannot borrow externally because it has just emerged from a large debt overhang worth \$10.5 billion which was written off by Russia and the Paris Club in 2006. The Afghan Government is also now signing up to the Highly Indebted Poor Countries Initiative (HIPC).
5. Print money (seigniorage) and borrow from the Central Bank. This option too is not viable because the Government has a no-overdraft rule which prevents it from using seigniorage financing, and this is a key pillar of its macroeconomic strategy to maintain stability (and prevent the high inflation rates experienced in the late 1990s).
6. Accept more aid and grants from external sources. Afghanistan is already heavily aid-dependent, but this aid does not take sufficient account of the medium-term spending implications. Heller states that ‘greater predictability and reduced volatility [of aid] is enormously important in creating fiscal space’, and ‘assuming there is scope for easy downsizing of a programme is risky’.

The Government can increase the effectiveness of official revenue collection and the transfer of those revenues to the central state coffers through a number of policy measures – all of which could contribute to the gradual transformation of the political relationship between the central Government and provincial power-holders. The Government is already setting in place a reform process to **improve the capacity of provincial tax offices** both in terms of physical infrastructure (new buildings and IT equipment) and human capital (implementing a merit-based recruitment system as part of wider civil service reforms). But these measures risk missing the crux of the problem: diverging interests between central and provincial authorities, which continue because of poor information and monitoring capacity of the former over the latter.

Publishing tax collection data improves transparency across provinces and between citizen and tax office, and could increase grassroots demand for better tax collection services at the local level. An education campaign to advise taxpayers of the benefits of their taxes for public investment and service delivery can increase local pressure on tax offices to be more effective, increase compliance with tax rules, and discourage taxpayers from engaging in rent-seeking behaviour with local tax officials. **Local demand for improved tax collection** as a means of enhancing local services could align the interests of local tax authorities with central government. This policy measure would be relatively easy to implement, and could deliver enhanced revenue mobilisation in the short-term.

The implementation of the central Government's tax policies by provincial authorities is essentially a Principal-Agent problem: the central Government's (the Principal's) objective is to maximise revenue collection under a given tax regime, but it relies on provincial tax offices (the Agents) to carry out the function of collecting taxes and sending them to the Ministry of Finance. The Principal cannot monitor tax offices perfectly, so does not know how productive the Agents are being nor how much tax is collected until it is transferred to them. The information gap means there is scope for the Agents to shirk their responsibilities – they might spend less time collecting taxes than they are supposed to (they are inefficient), or they might retain some of the taxes they collect (they are corrupt). Both lead to sub-optimal revenue collection, and lower resources for the central Government.

Principal-Agent theory recommends that incentive structures be changed to align the Agent's interests better with the Principal's interests. This would compensate for the information gap and allow the Principal to achieve its objectives. Applied to tax collection in Afghanistan, the theory would imply that **central Government rewards provincial authorities for the amount of tax they collect**.

Such a system could be designed in several ways – for example, the Government gathers data on each province's tax collection, and uses this to compare progress on an annual basis. Tax offices which exceed their baseline targets (perhaps the previous year's mobilisation rate) are paid performance bonuses, creating a financial incentive for greater efficiency and integrity. But if low revenue collection is due to rent-seeking behaviour, then the performance bonus will need to be set higher than the expected rent – which may in itself be costly for the central Government. Local governors can also be brought in to this framework and encouraged to maximise tax revenue, for example with the financial incentive of additional discretionary funds for provincial spending. The central government could spur competition between provinces to improve performance, for example by rewarding top performers.

These are examples of 'carrots', but a 'stick' might be equally effective. For example, any tax office that does not exceed its baseline target is subject to a thorough investigation, with a credible threat of removing inefficient or corrupt staff. The baseline target is an important ingredient to this approach. It will need to vary by province to reflect their diverse revenue potential based on borders with other trading nations, topography and agricultural development, infrastructure quality, and population. It will also need to take account of exogenous events such as drought or war which reduce tax collection unexpectedly.

A second factor affecting future revenue collection is GDP. Even if revenue mobilisation increases as a share of GDP, only if the **licit economy** is growing rapidly can this result in significant increases in domestic resources. The Government needs to support private sector development in all provinces, which will require a mix of the following measures:

Improved infrastructure including transport links and power.

Less red tape and bureaucracy.

Building the capacity of local firms to compete with international contractors for aid programmes and service delivery.

A stronger legal framework and investor protection.

Improved security plays an important role in attracting investment. These reforms are on the Government's agenda and are the focus of considerable donor support already. But progress will need to be accelerated if the Government is to deliver the job creation and private investment necessary to boost tax collection rates.

In the long run there are **strong prospects for economic development** in the mining sector, which would deliver a much-needed boost to revenues growth as well. The World Bank estimates that Afghanistan's mineral production of copper, iron, coal, oil and gas could be worth around \$800 million by 2015. The sector would then be able to raise up to \$150 million of annual revenues, which is around 25% of total Government revenue in 2006. Tapping in to these reserves will require a strong enabling policy environment that attracts private investment and of course far greater security conditions than currently prevail – a 'catch-22' situation.

Successful counter-narcotics efforts would also, in the long-term, broaden the legal sector and taxable economic activity, and could add up to a third of GDP to the revenue base. This is assuming that financially successful activities replace those that currently take place in the opium sector (estimated to be one-third of legal sector activity). Narcotics data presented by the United Nations Office on Drugs and Crime (UNODC) in 2006 and 2007 indicates, however, that the opium economy is in fact experiencing record yields and undermining the emergence of a strong formal or informal sector, a factor that has direct implications for fiscal sustainability.

4.2 Reforming Government systems and processes

The Government of Afghanistan is currently preparing a full Poverty Reduction Strategy (PRS) – the Afghanistan National Development Strategy (ANDS) – which will involve the preparation of **costed sector strategies**. The UNDP is leading this process. A security sector strategy is expected to be prepared and costed in autumn 2007. The kind of questions the costings exercise should answer include (Middlebrook, 2007):

What is the resource envelope of core and external finance?

What is the likely trajectory of threat levels and, accordingly, security sector spending needs?

How is the cost burden likely to be profiled over time?

What are the implications for recruitment and retrenchment?

The sector strategy should present clear cost implications and set in place financing arrangements. Donor policy decisions which alter the total resource ceiling – either upwards or downwards – should be incorporated at the earliest opportunity. This would enable new finance from an emergency supplemental budget for example to be factored in to the trajectory of security sector reforms.

Experience since 2002 suggests that cost estimates are at risk of becoming rapidly outdated because of the fast-changing security situation on the ground. The lesson learned is that a

credible costed strategy for the security sector reform agenda will need to be frequently evaluated and updated, and agreed by all the major players in the sector. Costing the sector strategies should be an ongoing process rather than a one-off exercise. Such a process will allow a balance to be struck between responding flexibly to a fast-changing security environment, and allocating resources on the basis of transparent policy decisions and realistic budget constraints. Ball and Holmes (2002) highlight the importance of a well-defined resource constraint for effective public financial management: ‘an easily expanded resource envelope makes it possible to avoid firm decisions on the prioritisation of policy objectives. In the absence of a firm floor to the expenditure envelope, resources are not predictable with adverse consequences for operational performance.’

The risks to achieving this flexible and credible costings process include: delays in the development of the ANDS sector strategy; a leadership vacuum amongst Government and donors; and lack of donor reporting on new resource and policy decisions. The ANDS process has been subject to delays since it was initiated in 2006, but a delay by a matter of months will not affect the effectiveness of the strategy in the medium-term. Ongoing support from the UK Department for International Development (DFID) and other bilateral donors to ensure the UNDP is able to deliver the strategies and costings will help prevent these delays. The other two issues are more challenging, being entrenched in the donor incentive structures discussed in Chapter 3.

Box 18: Security sector financing in Uganda

Donors provide considerable support to the Government of Uganda in the form of general budget support. Uganda is expected to receive \$975 million in donor assistance in 2007, and about \$340 million in the form of budget support (6% of GDP). In the wake of a decision by the Ugandan Government to increase its defence sector spending (linked to events in the DRC), donors strongly discouraged it from pursuing this action. The ensuing policy debate led to a freeze in defence spending at around 3% of GDP, and triggered a defence sector review. The review generated a broad agenda of security sector reforms: it created a defence sector working group with key development partners (a select group of donors – US, UK, Irish and Dutch), and initiated a clean-up of the payroll and procurement systems. The working group is an important forum for policy dialogue, and is chaired by a senior civil servant. Budget issues are resolved through the national budget process.

Uganda is several years ahead of Afghanistan in having a large budget support mechanism that covers several donors. A unified donor mechanism of this kind stacks up the incentives for more deep-seated reform that changes government architecture and systems. Budget support is some way off for the majority of donors in Afghanistan; but in the near term a large donor like the US could with its large bilateral funding create sufficient incentives for genuine reform of government systems and processes. Alternatively, a multilateral vehicle could shore up pressure to reform and raise fiduciary safeguards, if it is used strategically by donors.

In the longer-term a range of **wide-sweeping PFM reforms** are necessary to ensure alignment of aid behind Government systems. The conventional wisdom on public expenditure management advocates the development of a medium-term expenditure framework (MTEF), to provide a basis for incorporating donor finance into a national development strategy and guiding resources in line with Government priority and fiscal affordability. In due course this could incorporate performance-based budgeting, which would place strong incentives for line ministries to focus on service delivery outcomes to maintain resources allocations (Fozzard and Foster, 2001).

The development of a **medium-term fiscal framework** (MTFF), which projects over five years aggregate spending and resource inputs, is a first step towards developing an **MTEF**. The comprehensiveness and credibility of both rely crucially on donor reporting, as noted

above. Donor behaviour, and the prospects for changing the underlying donor incentives, is explored in greater detail below.

Box 19: Features and advantages of a Medium-term Expenditure Framework (MTEF)

A MTEF is developed in the following way: the Ministry of Finance imposes a resource constraint on the basis of financing considerations and macroeconomic stability. This implicitly incorporates fiscal sustainability issues. Line ministries provide budget requests to the MoF based on their sector strategies, which include output indicators. The top-down resource constraint and bottom-up budget submissions are discussed between the MoF and line ministries, and the results of the negotiations form the expenditure plan. The framework for year one is the basis for the annual budget, and the following years are indicative. The framework for year two becomes the annual budget in due course, and this facilitates a rolling spending plan.

Experience in Africa suggests that MTEFs can improve budget outcomes. They focus attention on policy rather than the minutiae of budget submissions, because expenditure projections are presented in an aggregate format based on sector and programme. This format supports informed decision-making and allows for costs and benefits to be compared transparently, and for resources to be allocated in line with government priorities. It also provides for a longer time horizon, and creates an incentive for line ministries to take account of the operating and maintenance costs of investments, while the MoF is able to focus on tracking the overall fiscal trajectory.

Source: Fozzard and Foster, 2001

An additional area of reform is in **strengthening financial controls and reducing vulnerability to corruption** in the security sector institutions. High-quality and strategically targeted technical assistance for PFM and anti-corruption reforms may be a promising entry point for a donor, even with limited financial resources, to make a significant impact on the sector. Stronger fiduciary standards are vital for attracting more donor funding through government systems, and are an essential precondition for the longer-term goal of empowering Government to manage and execute donor assistance alongside their own resources. This will increase alignment and harmonisation, as budget support provides an alternative aid delivery mechanism to projects. But for these reforms to be undertaken in a meaningful and lasting way, strong Afghan leadership and high-level pressure for change is fundamental. Without a wider review of the leadership of security sector institutions by Karzai, this is unlikely to happen. Stronger fiduciary management will require the Government to remove control of security sector institutions by vested interests.

Box 20: Sierra Leone's fund for SSR implementation

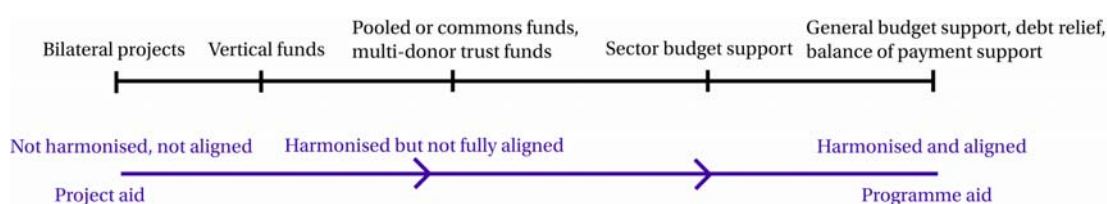
The Government of Sierra Leone created a policy think tank for the security sector composed of Government actors from key security agencies and ministries, under the umbrella of the Security Sector Reform (SSR) Implementation Monitoring Group. This Group was charged with management of a fund (set up in 2006) to help deliver the SSR Implementation Programme. This fund does not cover recurrent costs, which the Government takes direct responsibility for. Management duties include processing proposals for expenditure, allocating funds, tracking activities, and coordinating with donors and NGOs. The fund's focus on security allows for a division of labour and harmonisation with a separate financing vehicle that funds PRS priorities. Ownership of the fund is entirely local, and alignment is easy because there is a costed Government plan that articulates spending priorities. Oversight is undertaken by the National Security Council.

The fund received just £750,000 in 2006, from the UK only, and a similar amount is expected in 2007. Low levels of resources to this fund partly reflects constraints to absorptive capacity, and partly the fact that considerable support from the lead donor in the security sector – the UK – is provided in the form of budget support directly to (and is reallocated by) the Ministry of Finance. The MoF's seat on the National Security Council means that they are well informed about how much is allocated to the fund, and in the future this information will be included in the budget. The fund faced a learning curve on financial management processes, but the benefits of coordination and cooperation across all major Government actors offers a significant capacity building advantage over project funding.

4.3 Strengthening the aid modality

Choices of aid modality range from conventional project aid to programme aid provided as unearmarked general budget support. Between the two are modalities such as vertical funds, which are earmarked and target specific activities or sectors; pooled or common funds including MTDFs; and sector budget support. The new aid paradigm discussed in Chapter 2 has encouraged a shift rightwards along the spectrum, because programme aid can deliver the additional benefits of strengthening domestic institutions and empowering recipient governments, improving both alignment and harmonisation of aid. Williamson et al. (2008) report that this trend towards programmatic aid is taking place, but the Paris Declaration Monitoring exercise in 2006 reports a large proportion of project aid.

Figure 23: Spectrum of aid modalities



The diagram is illustrative only, and there may be instruments which do not fit so neatly in to any one category. For example, the ARTF's investment window is arguably more like project aid, because it implements a number of World Bank projects. It is therefore further left on the spectrum than the recurrent window, which is fully aligned with the budget and very close to being general budget support. The ARTF's recurrent window contributions would therefore sit at the programme end of the spectrum. It is also important to note that an aid instrument is only as good as the strategy it supports. If a government is weak, or its strategy is poorly developed, unearmarked budget support will not be effective, no matter how well it harmonises donors and aligns behind national priorities.

Aid modalities: Pros, Cons and the ‘Afghan Fit’			
Modality	Advantages	Disadvantages	Afghan realities
Bilateral project aid	<p>Greater donor control over resources</p> <p>Greater leverages over bilateral policy dialogue with Government</p> <p>Earmarking allows for easier reporting and accountability for donor</p>	<p>Fragmented aid delivery</p> <p>High transaction costs</p> <p>Risk of duplication or conflicting donor support</p> <p>No capacity building spillovers captured by Government</p> <p>Can create contingent liabilities for Government if interventions are not on budget, and recurrent cost implications of development activities are excluded from Government spending frameworks</p>	<p>As Chapter 3 highlighted, much of the aid provided to the security sector falls under this category, and the associated disadvantages follow. The advantages are largely captured by donors.</p> <p>The major donor to the sector is likely to weight the advantages over the disadvantages. Realistically, the majority of future aid to the security sector is likely to remain in this category.</p>
Multi donor trust funds (MTDFs) and other pooled mechanisms	<p>Donor harmonisation</p> <p>Additional fiduciary safeguards that improve accountability, strengthen government systems and encourage donors to increasingly use government systems</p> <p>Useful stepping stone towards budget support in fragile states</p> <p>Beginnings of sector and general policy dialogue</p> <p>Could easily link to and align behind a sector strategy, reinforcing a SWAp</p> <p>Brings aid on-budget and effectively helps donors apply a ‘fiscal lens’ by incorporating their spending into Government planning frameworks</p> <p>Being on-budget improves domestic accountability over aid spending</p>	<p>Parallel systems can develop and become entrenched if no exit strategy is used, meaning programme aid does not materialise as the next step for donors</p> <p>Benefits for Government capacity and institution building are foregone</p> <p>Focus on modality and how it works rather than on policy or outcomes</p> <p>Predictability of funds across and within years is not guaranteed, depends on donors’ institutional incentives and constraints</p> <p>Can behave like ‘big projects’ rather than strategic funding vehicles, and do not always deliver benefits for harmonisation and alignment (see text box on Mozambique health sector common funds)</p>	<p>Afghanistan already has three MDTFs working alongside the Government and each other: the ARTF, the LOTFA, and the Counter-Narcotics Trust Fund (CNTF). This demonstrates donor willingness to pool funds in Afghanistan, partly as a means to reduce their own transaction costs given staffing constraints for country offices in fragile states; and partly to reduce the burden on the Government.</p> <p>The three trust funds demonstrate varied success in pooling funds. The ARTF has helped drive significant improvements to public financial management through the MoF, and is an important forum for donors to discuss wider policy issues such as civil service reforms and development outcomes. the LOTFA and CNTF exhibit many of the disadvantages listed, which suggests that the success of MDTFs is as much about management and Government leadership as it is about the modality design.</p> <p>There is unlikely to be much appetite for a new, fourth trust fund. ARTF cannot fund security sector costs, because it is administered by the World Bank, whose Articles of Agreement prevent this.</p>

<p>Sector/General budget support</p>	<p>Alignment with government systems, which should strengthen the PRS process or SWAp Empowerment of Government, allowing it to set the agenda Brings aid on-budget and effectively helps donors apply a ‘fiscal lens’ by incorporating their spending in to Government planning frameworks Being on-budget improves domestic accountability over aid spending</p>	<p>Fiduciary risks heightened Less donor control over the destination of its funds Policy dialogue may focus on inputs rather than outcomes and service delivery Predictability not guaranteed, especially as this type of aid flow is the easiest for donors to turn off at short notice</p>	<p>Few donors are ready to provide budget support to the Afghan Government at present, and even fewer would consider providing budget support directly to ministries such as Interior or Defence whose PFM systems are notoriously weak and vulnerable to corruption.</p> <p>Without a sector strategy, there is limited alignment or ownership advantages to reap from these approaches.</p>
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Different modalities offer a different mix of advantages and disadvantages, these are summarised in the table above, along with a commentary on the likely ‘fit’ in the Afghan context. Based on the analysis, which incorporates the current incentive structure for donors and Government, we can expect in the short-term that:

Large amounts of aid will remain in the form of projects, which is the rational result of donors’ institutional constraints and preferences;

The furthest step towards programme aid is likely to be a MDTF or pooled mechanism at this stage in Afghanistan’s development and institutional capability.

Wider governance problems of rent-seeking and clientelism will remain until there is a much broader anti-corruption drive and a change of leadership in key ministries.

Against this context, one interim solution is to **reform the LOTFA so that it delivers its full potential as a pooled funding mechanism for the security sector**. In the short-term this is the most feasible way to move along the spectrum of aid modalities towards a more harmonised approach that has the potential to resolve some of the financing and sustainability concerns outlined in Chapter 2. It also reflects the fact that three MDTFs already operate in Afghanistan, of which two are in the security sector. Another trust fund would create an additional parallel mechanism, and fragment the security sector further.

Box 21: Learning lessons from the LOTFA 2002–2006

Money talks: the fact that the LOTFA has been consistently under-funded, and four out of five priorities are ignored by donors, leads to the conclusion that the LOTFA’s comparative advantage in Afghanistan is in delivering police salaries and not in managing projects designed to build the MoI’s institutional capacity or procuring non-lethal equipment and delivering police training. Donors are opting to undertake these activities directly.

To respond to the donor system in Afghanistan, the UNDP must do more to highlight what value it will add and what gaps it will fill by being an additional player in this arena. Without the staffing resources to develop work plans and strategies and convince donors that it can deliver sustainable capacity building, this LOTFA objective seems doomed to failure. With high administrative costs accompanied by the need for hands-on technical inputs from donors, the overall costs of using the LOTFA are much higher than the alternatives. These alternatives include outsourcing training and equipment provision to private companies or using in-house resources. The UNDP, the Government and donors need to consider where, in this market of SSR aid provision, the LOTFA could best add value and leverage to its role.

The LOTFA’s comparative advantage is in delivering punctual police salaries, but within this function there could be improvements to the oversight of payment systems and an increased push for higher fiduciary standards in the MoI. If donors were to provide multi-year commitments, this would allow the LOTFA to spend more time on strategy and less on fund raising, and would open the planning horizon beyond annual budgets. It would also offer the Government much greater financing predictability, and contribute to a costed, medium-term expenditure framework and strategy.

What should a transformed LOTFA look like? **Five reforms should be introduced.** Firstly, management and day-to-day administration of the fund should be outsourced to a private firm. This firm would report to the Steering Committee, i.e. a selection of Government and donor stakeholders, and performance criteria would be explicitly defined to ensure strong management. Criteria could include adequate fund-raising over multiple years, effective disbursement against agreed priorities, and effective facilitation of donor-Government dialogue on security sector reforms. This arrangement will deliver the added advantage of freeing up UNDP resources to engage more strategically in policy dialogue rather than fundraising and administration duties. The role of the UNDP would evolve in to an advocate for reform and a watchdog on issues such as corruption. This change would enhance the UNDP’s capacity to challenge donors on their aid delivery practice and to

encourage Government to accelerate institutional reforms. This has a good fit with other UNDP priorities and workstreams, for example on anti-corruption, civil service reform, and sub-national governance.

Secondly, the LOTFA's priorities should be stripped down to the fund's comparative advantages of providing salaries in a predictable and timely way to police. Thirdly, an external monitoring agent should take on the role of verifying payments and undertaking monitoring visits to the provinces (separate to the private management firm). The monitoring agent should reports to the administrator of the fund. This will allow for improved benchmarking of the direction and rate of progress in Government fiduciary standards. An external verification function for a trust fund that works on a reimbursement basis raises incentives for improving government systems (demonstrated by the ARTF's experience with non-uniformed civil service recurrent costs paid by the MoF), and thus acts as a driver of reform. The MoI and the MoD could also benefit from targeted technical assistance for budget units and local level payment units, either through the LOTFA or other pooled funds available for this purpose.

Fourthly, if the LOTFA's performance improves, then donors should consider bringing the ANA within the LOTFA's remit, which would ensure that police and soldier salaries are paid through a single instrument. This should be entirely dependent on the LOTFA strengthening its track record both of paying security sector personnel, and also demonstrating sustained increases in MoI capacity to oversee payroll management effectively and with minimal fiduciary risk. Appointing an external monitoring agent would be a considerable step forward to achieving this. And fifthly, an exit strategy should be prepared over an approximate ten-year horizon, benchmarked against delivery of outcomes, ANP reforms, and a gradual transition to government financing.

If operating successfully, the reformed LOTFA could deliver improved donor harmonisation and stronger alignment of aid with government systems. But a number of practical arrangements would need to be worked out – for example what kind of firm would manage the new LOTFA, who would contract them, and how would this affect reporting relationships and ownership amongst the international community and Government. There is also a question mark over whether donors and Government would permit the ANA costs to fall under the LOTFA's remit. And finally, the largest factor determining the success of a reformed LOTFA, is whether the lead donor to the ANA – the US – would be prepared to put more money through a multilateral channel. Each of these presents a considerable challenge.

For the reformed LOTFA to materialise, there will need to be:

- Agreement from the UN to step back from administration responsibilities for the LOTFA.

- Agreement on the short-run priorities amongst donors and Government that paying salaries and improving payroll systems and fiduciary safeguards are the priorities in the short-term, and that these are more efficiently delivered through a trust fund mechanism than through bilateral projects (partly because bilateral projects do not give institutional strengthening enough weight, and because it is a low transaction cost method of building in incentives for improved financial management that allows greater flows of donor resources);

- Strong Government and donor-to-donor advocacy to encourage large donors to support a reformed aid instrument.

This is a daunting set of ‘asks’; however, on the positive side, it is likely that there will be donor pressure, particularly from the European donors who currently operate through the LOTFA, for a stronger mechanism that better fulfils their needs.

Box 22: Moving toward a justice SWAp in Afghanistan

Plans to create a justice SWAp could lead the way for further reforms to the security sector. The donor lead is shifting from the Italians to the EC, who are designing a new programme of support that will be financed through the ARTF investment window. The programme will bring together three strategies for the Attorney General, Supreme Court and Ministry of Justice under one umbrella, improving government and donor coordination as a result of this more comprehensive approach. While the Ministry of Justice is the focal point, the MoF has been playing a strong role from the start. This has facilitated a reasonable degree of government ownership. Being channelled through a multi-donor mechanism raises the level of donor harmonisation, and ensures that this aid is on-budget: planned and accounted for as part of the core development budget.

The justice sector received the least funding of the five security sector pillars in Afghanistan, but the new programme will trigger increasing resource flows. This financial incentive may explain why justice sector institutions have accepted a more comprehensive, programme approach with considerable MoF influence (over the alternative – a projectised silo approach with a nominal donor lead). The fact that no one donor can afford comprehensive reforms to the justice sector is an additional financial incentive to use a multi-donor pooled mechanism. These features mean the justice SWAp may not be replicable in the security sector in the short-term, but if it can be shown to work then it will form an important part of the evidence base for lobbying the US.

As the Government develops the capacity and will to manage a costed sector strategy, Afghanistan should move towards a comprehensive sector wide approach (SWAp), or what is now being called a **Security System Wide Approach**.⁶ This SWAp would cover the army and police, and the LOTFA or an advanced version of it would be best placed to provide financing. This represents a shift rightward along the spectrum of aid modalities, delivering greater harmonisation and alignment, with the prospect that eventually the pooled mechanism could evolve into a sector budget support instrument. What are the benefits of a SWAp over and above an effective recurrent financing mechanism? In this case the main value-added from a SWAp centres on the aid instrument growing beyond being a clearing house for aid that supports recurrent expenditure, to a strategic investment vehicle with a long-term horizon, and a clear plan of action, that builds capacity and leadership within Government. Donor appetite for such a move will rest on the extent of PFM reforms that enable Government to account for spending, protect public resources from corruption, and deliver services efficiently.

⁶ The OECD DAC Handbook (April 2007) offers a useful summary on page 77 of what a SWAp should include.

Box 23: The health SWAp and common funds in Mozambique

A case study of the health sector in Mozambique highlights what kind of process a post-conflict country can expect to travel through, and demonstrates the lengthy process of change: 15 years after the civil war, aid delivery had improved but had a long way still to go.

The 15-year civil war ended in 1992, leaving Mozambique the poorest country in the world. The early donor response was to projectise whole districts and provinces. Mozambique became a heavily aid-dependent country, with a fragmented aid system and low local ownership. A health SWAp was launched in 2000 under the umbrella of the first Poverty Reduction Strategy Paper (PRSP), but no costed strategy exists. The SWAp covers 23 donors and has set up mutual accountability, harmonisation and alignment mechanisms.

Common funds were a popular modality for donors, and three now exist. But only one of these is on-budget (on-plan, on-treasury, and on-audit). The intention is to merge the three common funds eventually, but there are institutional disincentives and capacity constraints in the way. The use of common funds has mitigated aid predictability problems to some extent. Donors, by providing multi-year financing agreements, have expanded the Government's horizon planning – but intra-year predictability of disbursements is still poor. The level of funding through common funds has risen in absolute terms, and the Global Fund for AIDS, TB and Malaria is now on-budget and operates through one of the common funds. This sets a useful precedent for the other vertical funds that operate in Mozambique, such as the Clinton Foundation and the President's Emergency Plan for AIDS Relief (PEPFAR).

However, the share of aid through joint mechanisms has not increased, and project financing is still significant through NGOs and UN agencies. Estimates suggest that 30% of all health sector spending is off-budget, and is therefore not captured in the national budget process or provincial investment plans. Budget systems are still weak, and common funds may be undermining the incentives for line ministries to participate in the national budget process and justify their budget submissions to the MoF, who in turn hold line ministries to account and allocate future resources on the basis of their performance.

Although common funds are a step in the right direction towards programme-based approaches, they do not guarantee full harmonisation, alignment, or integration of donor efforts behind a single costed strategy. But they can help to move towards those goals, particularly in post-conflict states which require significant capacity building to raise absorptive capacity and give donors the necessary fiduciary reassurances to use government systems. They can also help absorb earmarked sector funding in ways that minimise the distortions that arise from supply-driven aid.

Source: Williamson et al. (2008)

4.4 Improving donor behaviour

In the short run, there are a number of tenable changes to donor practice that could make a large impact on aid effectiveness. Firstly, **donors should raise the quality, frequency and timeliness of their reporting on aid, particularly external budget expenditure. Multi-year projections**, even indicative rather than firm, would contribute to spending forecasts. These actions would help the Afghan Government keep better control of the total resource ceiling and the allocation of resources across the eight priority sectors in the ANDS framework.

Donors should **make explicit what their aid is buying** – resources spent on increased recruitment and wages are recurrent costs that will affect the Government's medium-term obligations, whereas one-off expenditures may have much smaller recurrent cost implications for maintenance and repair only. The medium-term operating costs of all present expenditure needs to be factored in to donor decision-making. **Assumptions about retrenchment and downsizing should be made cautiously**, given the likely obstacles to, and dangers of, a compressed process of discharging trained and armed security sector personnel. Large medium-term costs should not necessarily deter donor spending at the

present time, but transparent planning will ensure the Government is better able to pick up the costs in due course. This benefits donors both by making an exit strategy more viable, and by increasing the impact of their investment in Afghanistan (as it is more likely to be sustained after aid ceases).

Policy dialogue should be extended beyond the conventional security sector counterparts (MoI, MoD) to include the economic planners in the MoF and fiscal specialists in donor agencies. This improves the predictability of aid, and will ensure a fiscal lens is applied to policy discussions. To some extent this is taking place, but non-traditional donors such as the DoD and the DoS could better comply with the national budget calendar, and ensure that intra-year changes in funding commitments or supplemental budget requests are shared with the MoF at timely opportunities during the budget formulation and review process.

Making greater use of the LOTFA as a pooled mechanism that puts donor funding on-budget would increase donor harmonisation and alignment.

The actor most likely to be successful in encouraging the US to follow these prescriptions is Congress, because it holds the US budget purse-strings and scrutinises the delivery of aid. There is also scope for the international community to become more effective at influencing the US, by initiating dialogue with non-traditional donors such as the Combined Security Transition Command Afghanistan (CSTC-A) and exercising mutual donor accountability.

In the long-term, change in USG policy is needed to achieve the **greatest return in aid effectiveness**. Bazzi et al. (2007) prescribe an eight-step plan for delivering ‘smart power’ through the US budget, which includes measures to protect and expand the foreign assistance budget; rebalance geopolitical and development aid, and develop a cabinet-level Department for Global Development that raises the status of development alongside defence and diplomacy. As well as these structural reforms, greater collaboration with other donors and a shift towards multilateral aid delivery is also highlighted as an area for improvement. Restructuring the incentive structures across a range of US donor agencies will be a significant challenge, and will require strong and high-level leadership to effect change.

For these changes in donor practice to take place, donor agencies need to ensure that their **staff and systems are adequately resourced to enable more time to be spent in planning, dialogue and coordination within and across their priority sectors of engagement**. A focus on disbursement rates or other quantitative performance indicators alone will skew incentives away from improving the quality of aid provision.

4.5 Summary: Policy conclusions

Improving the financing model and fiscal sustainability of the security sector will be a long-term process, and there will be numerous challenges. This chapter outlines a set of short-term steps that will provide an interim solution to some of the problems outlined in Chapter 2. The diagram below presents some idealised solutions, with the short-term solution, serving as a stepping stone towards a more comprehensive solution for the longer-term:

Point A represents the current situation, which is at the low end of the aid effectiveness scale.

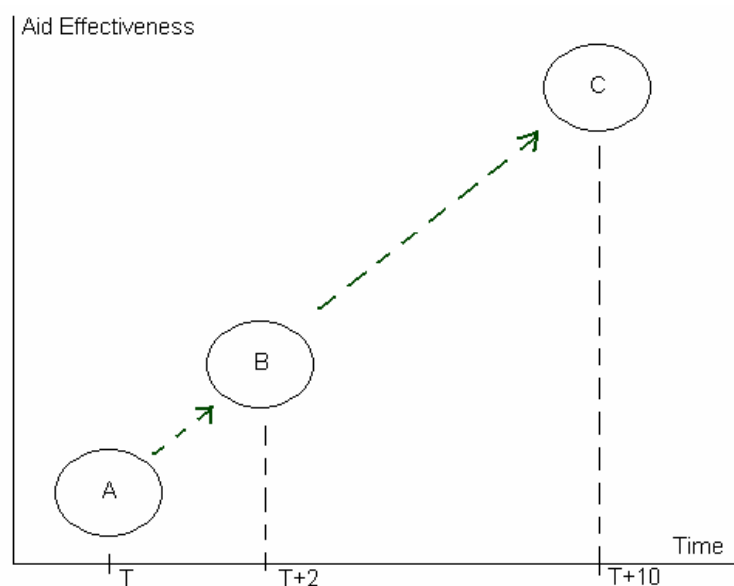
Point B is the proposed short-term solution, based on reforming the LOTFA; improving donor reporting on pipeline and disbursed aid; strengthening donor compliance with the budget cycle, to allow a more credible medium-term fiscal framework and annual budget; and preparing a strong costed, prioritised and sequenced strategy to be put in place. There is still significant project spending and costs are well above Government affordability. But with increased dialogue amongst development and defence actors, and economic planners within Government, a fiscal lens is applied to spending plans which represents an improvement on point A (our starting point).

Point C is the long-term aspiration, based on a credible MTEF; improved fiduciary standards in security sector institutions; a sector budget support instrument serving as a financing instrument for a SWAp covering the majority of donor support for the sector; and a stronger revenue base allows for improved fiscal sustainability of the sector.

In order to make this progression over time, donors will need to implement aid effectiveness reforms at the country level. This requires:

A shift in institutional incentives to reward coordination and joint activities, and
More resources available for donors to invest meaningfully in shared mechanisms.

This two-pronged approach would address both the will and capacity for donors to harmonise with each other and align with government systems. These changes need to be affected within donor agencies, to improve the quality of their aid delivery.



Fiscal year 1386 (2007/8) promises to be a year of great significance, with both challenges and opportunities. The preparation of the ANDS, and a costed security sector strategy as part of this exercise, should provide a basis for strategic policy dialogue, aid allocation and aid profiling decisions against a five-year vision for Afghanistan. Growing Joint Coordination and Monitoring Board (JCMB) attention to security sector reform and its economic dimensions should lead to higher quality dialogue across development, diplomacy and military actors, and promises the beginnings of transparent decision-making and mutual accountability between donors and Government. EU harmonisation in the form of a European Security and Defence Policy (ESDP) mission on police reform is a first step towards bringing donors together. The International Police Reform Coordination Body might also contribute. The joint justice sector programme housed in the ARTF sets a

precedent for more comprehensive security sector approach through pooled mechanisms, on-plan and on-budget. And as US funding peaks in 2007, their experiences might evidence the advantages to the USG of investing in stronger national systems as well as increasing the number of soldiers and police. The likely increase in Congressional oversight could facilitate a more receptive USG audience to the aid effectiveness agenda.

Each of these factors has the potential to generate momentum for a change in the way donors do business in Afghanistan. A stronger emphasis on response and effective aid for the security sector will build a more capable Afghan state. And a more effective Afghan state is a necessary prerequisite of an exit strategy for donors, and genuine ownership of security sector reform by the Government of Afghanistan.

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