

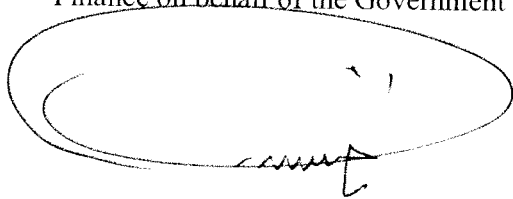
June 12, 2010

H.E. Dr. Omar Zakhilwal  
Minister of Finance  
Ministry of Finance  
Islamic Republic of Afghanistan

Excellency:

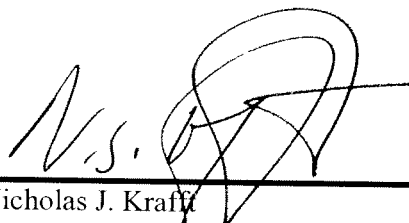
*Memorandum of Understanding: ARTF Incentive Program*

With regard to the attached Memorandum of Understanding (MoU) for the ARTF incentive program, this letter confirms agreement to the benchmarks in the MoU signed by the World Bank as Administrator of the ARTF and Ministry of Finance on behalf of the Government of Afghanistan.



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H.E. Dr. Omar Zakhilwal  
Minister of Finance  
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Nicholas J. Krafft  
Country Director for Afghanistan  
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## AFGHANISTAN RECONSTRUCTION TRUST FUND

**ARTF INCENTIVE PROGRAM SY1390 (2011/12)****MEMORANDUM OF UNDERSTANDING**

JUNE 12, 2010

1. This Memorandum is the basis for agreement between the World Bank, as Administrator of ARTF, and the Minister of Finance, as the representative of the Government on the management of the SY1390 ARTF Incentive Program. Throughout this document, the SY1390 ARTF Incentive Program relates to a program of reforms that are carried out during SY1389 but for which ARTF incentives are available in the SY1390 budget as part of the Incentive Program.

2. The Memorandum has two parts: Part I gives an overview of the ARTF Incentive Program. Part II of this Memorandum describes in detail the benchmarks for the SY1390 structural reform program and the required evidence to demonstrate their fulfillment, as part of this year's operation of the scheme.

**Part I: The ARTF Incentive Program Background and Summary**

3. In December, 2008, ARTF Donors agreed with the Government of Afghanistan to establish the ARTF Incentive Program within the Recurrent Cost (RC) Window of the ARTF. The objective of the Incentive Program is to support the Government's reform agenda and to support progress toward fiscal sustainability. It was agreed that the baseline financing of the operating budget provided through the ARTF RC Window will decline by US\$25 million per annum, starting in SY1388.

4. As illustrated in Table 1 the budgeted ARTF RC support baseline for SY1390 is US\$200 million. The Incentive Program offers incentive funds to top-up the ARTF RC Window baseline financing for SY1390 in the amount of US\$70 million. The funding will be allocated through two schemes: a structural reform scheme (accounting for three quarters of the available incentive funds) and the revenue matching grant scheme (accounting for one quarter of the available incentive funds).<sup>1</sup>

**Table 1: Potential allocations through the ARTF Incentive Program**

	<b>Preliminary Actual</b>	<b>Potential</b>			
	<b>SY1387</b>	<b>SY1388</b>	<b>SY1389</b>	<b>SY1390</b>	<b>SY1391</b>
<b>Baseline ARTF RC support - fixed</b>	\$276	\$250	\$225	\$200	\$175
<b>ARTF Incentive Program *</b>	\$0	\$40	\$60	\$70	\$70
<i>Structural Benchmarks - 75%</i>	\$0	\$40	\$45	\$53	\$53
<i>Revenue Matching Grant - 25%</i>	\$0	\$0	\$15	\$18	\$18
<b>Potential ceiling for ARTF RC Support</b>	\$276	\$290	\$285	\$270	\$245

\* Numbers reflect the maximum pot available. Revenue scheme is calibrated, based on performance.

<sup>1</sup> The Incentive Program is funded by the ARTF donors in the same way that the Recurrent Cost Window is funded. Where Incentive Funds are not allocated due to underperformance on revenue or against benchmarks, funds are allocated through ARTF's Investment Window as decided by the ARTF Management Committee as per its normal procedures.

**Revenue Matching Grant Scheme:**

5. The Revenue Matching Grant Scheme is designed to incentivize improved revenue performance, and therefore progress toward fiscal sustainability. It is anchored in the annual revenue targeting negotiations between the Ministry of Finance and the International Monetary Fund (IMF). This Scheme started in SY1389, based on revenue performance in SY1388, and a year later than the first ARTF structural incentive program of SY1388. The Revenue Matching Grant Scheme for the SY1390 ARTF Incentive Program will be calculated based on the Government's revenue performance in SY1389.

6. The Revenue Matching Grant Scheme is automatically calculated, according to a calibrated scale shown in Table 2. It is targeted at 25 percent of the total ARTF Incentive funds available in any year.<sup>2</sup> In SY1390, the Revenue Matching Grant Scheme will have a targeted allocation of US\$17.5 million. The full value of the grant is available only if the government achieves 99 percent or more of the IMF revenue target. If government achieves 90 percent or below of the IMF revenue target the grant is not available. Above 90 percent, matching funds are available on a calibrated scale. This scale goes up to 5 percent above the IMF target – ensuring incentives are in place to outperform the target. However, release of funds for this scheme beyond 100 percent of the IMF revenue target also requires achievement of all benchmarks. The IMF has advised on the design of the mechanism. It is important to recognize that in the event of an adjustment to the IMF revenue target during the fiscal year, the Matching Grant mechanism will adopt the revised target to avoid confusion.

**Table 2: The Revenue Matching Grant Calculator<sup>3</sup>**

% of IMF Target Achieved	Calibration	Matching Grant 1389	Matching Grant 1390	Matching Grant 1391
90%	0%	\$0.0	\$0.0	\$0.0
91%	25%	\$3.8	\$4.4	\$4.4
92%	25%	\$3.8	\$4.4	\$4.4
93%	25%	\$3.8	\$4.4	\$4.4
94%	25%	\$3.8	\$4.4	\$4.4
95%	50%	\$7.5	\$8.8	\$8.8
96%	60%	\$9.0	\$10.5	\$10.5
97%	70%	\$10.5	\$12.3	\$12.3
98%	80%	\$12.0	\$14.0	\$14.0
99%	100%	\$15.0	\$17.5	\$17.5
100%	100%	\$15.0	\$17.5	\$17.5
101%	105%	\$15.8	\$18.4	\$18.4
102%	110%	\$16.5	\$19.3	\$19.3
103%	115%	\$17.3	\$20.1	\$20.1
104%	120%	\$18.0	\$21.0	\$21.0
105%	125%	\$18.8	\$21.9	\$21.9

**Structural Reform Scheme:**

7. The overall thematic thrust of this year's structural reforms is increased transparency and the promotion of good governance. Structural reforms for the SY1390 Incentive Program will be organized under the three reform areas (with benchmarks under each theme): Enhancing Domestic Revenue

<sup>2</sup> However, the Scheme is capped at 5 percent above the revenue target. Where government over-performs the revenue target, incentive funds allocated towards the Scheme will be around 29 percent of the total incentive funds.

<sup>3</sup> Release of funds more than 100 percent of the IMF revenue targets requires achievement of all benchmarks.

Generation, Improving Public Sector Governance and Enabling Private Sector Development. These reforms will be implemented during SY1389.

8. **Theme A: Enhancing Domestic Revenue Generation.** In SY1390 the agreed reforms under this theme will focus on increasing transparency in revenue collection and improving governance in revenue administration. In particular, the theme will support in the Afghanistan Customs Department (ACD) the roll-out of a pilot ASYCUDA evaluation model and the establishment of an automated exemption process at ACD Headquarter. In the Afghanistan Revenue Department (ARD) it will support the improvement of audit processes and the implementation of direct reporting mechanisms between provincial revenue agencies and ARD Headquarter. This theme will be complemented by the Revenue Matching Grant Scheme.

9. **Theme B: Improved Public Sector Governance.** Theme B is the central theme of this year's structural incentive scheme. Under this theme, the program is seeking to support three reforms in SY1389. As a follow-up to last year's benchmark on internal audit, the first benchmark will focus on further improving public financial management and fiduciary standards, by clarifying the legal framework for external audit and starting to implement the Internal Audit Action Plan. As a continuation to the asset declaration benchmark of 1388, a second benchmark will track further progress in the expansion of asset declaration among senior government officials and will support the verification process of asset declarations by the High Office of Oversight (HOO). The third benchmark will support the ongoing roll-out of the Public Administration Reform, i.e. the Pay and Grading (P&G) reform, and improvements in the merit-based appointment process for senior government officials.

10. **Theme C: Enabling Private Sector Development.** For SY1389 Government committed under this theme to progress towards establishing the Da Afghanistan Breshna Sherkat (DABS) as a functioning and efficient power utility. The benchmark will support the improvement of customer care and will track key indicators which measure progress in loss reduction and revenue generation. This theme also supports increasing transparency in the mining industry with the Government's commitment to publish (at least executive summaries) of all large mining contracts. This is connected to last year's benchmark of fulfilling all requirements for Afghanistan becoming a candidacy country for the Extractive Industries Transparency Initiative (EITI). This new benchmark will support the Authorities to prepare the implementation of the EITI.

11. The ARTF donors and the government agreed for the SY1390 Structural Reform Scheme that the reform progress under the scheme would be assessed by theme and not for the reform program in its entirety. Incentive Program funds for the Structural Reform Scheme in SY1390 would be equally distributed across the three themes. Therefore, of the US\$52 million for the Structural Reform Scheme in SY1390, each theme would have US\$17.3 million allocated. It was also agreed that granting the allocation of US\$17.3 million for each theme will be conditional on the fulfillment of **all benchmarks** within the respective theme (i.e. 100 percent compliance). However, the final decision on granting the allocations for the Structural Reform Scheme will be determined by the ARTF Management Committee, based on the recommendations of the Technical Review by the World Bank.

#### **Verification Process:**

12. The World Bank, as ARTF Administrator, will be responsible for the annual Technical Review of the ARTF SY1390 Incentive Program. The Revenue Matching Grant Scheme will be automatically calculated, according to a calibrated scale (see Table 2). Since actual revenue numbers are confirmed after the year end, the Revenue Matching Grant will be calculated only after the SY1390 budget is passed. The Structural Reform Scheme will need verification evidence for each benchmark, to be provided by the Government of Afghanistan to the World Bank team (see Part II). All incentive funds are made available

as commitments under the Recurrent Cost Window in the year following the Technical Review: in other words in the SY1390 budget.

13. It was agreed that all supporting evidence for the fulfillment of the structural reform benchmarks will be delivered to the World Bank not later than **November 30, 2010**. Based on this verification evidence the Administrator will undertake the Technical Review. The Technical Review will be provided for information to the ARTF donors of the Working Group<sup>4</sup> and will be delivered to the Government of Afghanistan within 15 business days after the submission of all supporting evidence for all benchmarks or no later than end-December 2010. In undertaking the Technical Review the World Bank may draw on the technical competencies of other agencies as necessary.

14. The World Bank will also report the results of the Technical Review to the ARTF Management Committee and will accordingly advise the Management Committee on SY1390's ARTF Incentive Program allocation. If necessary, further consultations with the wider ARTF donor group (i.e. during the following Quarterly Donor Meeting) will be considered. The Management Committee retains final decision-making authority for setting the overall envelope (or ceiling) for the ARTF RC Window at the start of every fiscal year and for approving each transfer to the ARTF RC window.

15. The Technical Review will also be shared with all ARTF donors as part of the Management Committee's regular quarterly reporting.

#### **Preconditions for the Incentive Program:**

16. In order for the Government to be eligible for the ARTF Incentive Program in SY1390, the ARTF Administrator will verify at the time of the Technical Review the:

- Maintained commitment by Government to quality standards of public expenditure auditing;<sup>5</sup> and
- Maintained commitment by Government to the agreed macro-fiscal framework: verified by staying on track with the overall (i.e. not just revenue target) IMF Poverty Reduction and Growth Facility (PRGF) program.

#### **Commitments and Disbursement of the Funds under the Incentive Program:**

17. Commitments: The Management Committee approves transfers of funds or 'commitments' on a quarterly basis to the Recurrent Window trust fund that disburses to the Government. Each transfer or commitment is calculated as one quarter of the agreed total ceiling. Under the Incentive Program, in agreeing on the ceiling at the start of SY1390, the Management Committee will be informed by the results of the Technical Review (as described in paragraph 12). Quarterly transfers, or commitments, will be calculated accordingly by the Administrator.

18. Disbursements: Funds allocated under the Incentive Program will disburse according to the same procedures as all other funds under the ARTF Recurrent Cost Window. The existing fiduciary and disbursement arrangements will remain in place, including the Administrator's oversight of the Monitoring Agent that verifies the eligibility of disbursements against agreed fiduciary standards. Disbursement will continue to be made to the Single Treasury Account held by Da Afghanistan Bank, based on eligible non-security expenditures.

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<sup>4</sup> EC, Germany, Italy, UK, and US.

<sup>5</sup> Following discussions with CAO, the proposed indicators of this commitment are: (a) maintaining satisfactory audit of donor activities annually; (b) the audit report on the Qatia being issued within 6 months of year end.

## Part II: The SY1390 Structural Reform Scheme

19. The Structural Reform Matrix in Table 3 is the result of in-depth discussions between the government (led by the Ministry of Finance) and ARTF donors, represented by the five donors on the Working Group. It has also resulted from internal, cross-departmental discussions within government. It details the benchmarks under each theme and the required verification evidence to be delivered to the World Bank by November 30, 2010. The discussions and negotiations for the SY1390 Structural Reform Scheme took place between March and June 2010 and were facilitated by the World Bank. The following is summarizing the main parameters of the SY1390 Structural Reform Scheme.

- The overall Structural Reform Scheme will comprise US\$52 million.
- The package is allocated across the three themes as follows: Theme A: US\$17.3 million; Theme B: US\$17.3 million; Theme C: US\$17.3 million.
- The World Bank will be responsible for concluding agreement with the Ministry of Finance with regard to the achievement of benchmarks in the Technical Review of December, 2010.
- The World Bank will draw on technical competencies of other donors and the IMF as necessary.
- The World Bank will submit its Technical Review of the SY1390 Structural Reform Scheme to the ARTF Management Committee.

**Table 3: SY1390 Structural Reform Matrix**

<b>Theme A: Enhancing Domestic Revenue Generation *</b>		
	<b>Benchmarks</b>	<b>Monitoring and Evaluation</b>
A1.	<b>Increasing transparency in customs:</b> (i) implementation of a pilot ASYCUDA valuation module for 200 revenue earning commodities, and (ii) establishing automation of the Exemption Process in the Afghan Customs Department (ACD) Head Quarter (HQ).	<ul style="list-style-type: none"> <li>• The MOF/ACD will track the implementation of the pilot ASYCUDA valuation module. It will provide the Administrator with a progress report on the implementation and confirm the list of 200 items for which it becomes operational.</li> <li>• The MOF/ACD will track progress on the automation of the Exemption Process and inform the Administrator of it. The ACD will confirm to the Administrator the finalization of the automation of the Exemption Process in the ACD HQ.</li> </ul>
A2.	<b>Improving governance in revenue administration:</b> (i) establishing a functional Post Audit Unit in the Afghan Revenue Department (ARD) legal office to improve quality control of audit processes, and (ii) establishing and implementation of the direct and exclusive reporting of Medium Taxpayer Offices in the Provinces of Herat and Balkh to ARD HQ.	<ul style="list-style-type: none"> <li>• The MOF/ARD will certify the establishment of a functional Post Audit Unit by providing evidence to the Administrator on staffing, resource / funding allocations, and evidence of functioning business. A list of first audits to be undertaken will be provided, as selected by the selection committee.</li> <li>• The MOF will provide the Administrator with a decree/ordinance/circular which establishes the new reporting regime. It will also provide evidence for publication of this instrument (e.g. on the MOF web-page). The MOF will provide the Administrator with samples of initial reports. If electronically done, it reserves the right for physical inspection to get first-</li> </ul>

	hand confirmation of the reporting system.

- a. Theme A is complemented by the automatic quantitative revenue scheme in SY1389. The quantitative scheme is based on SY1389 revenue performance, according to the previously agreed schedule.

<b>Theme B: Improving Public Sector Governance</b>	
<b>Benchmarks</b>	<b>Monitoring and Evaluation</b>
<p>B1. <b>Improving Public Financial Management and Fiduciary Standards:</b> (i) Cabinet approval of an Audit Law in line with international auditing standards (and consistent with Article 61 of the PFEM Law that gives MoF purview over Internal Audit) clarifying the role of CAO as an independent external audit agency both in mandate and reporting, and (ii) start implementing the Internal Audit Action plan by providing inception reports for an audit in 4 line ministries, on the basis of a risk analysis across Government.</p>	<ul style="list-style-type: none"> <li>• The Authorities will provide the Administrator with the Audit Law as approved by Cabinet and the Cabinet minutes, confirming the approval. The World Bank will review the Law and determine if it fulfills international standards, i.e. if it is in accordance with the Declaration of 8 principles for Supreme Audit Institutions by INTOSAI.</li> <li>• The Authorities will provide the four inception reports for the audits in the Ministry of Public Health, Ministry of Transport and Civil Aviation, Ministry of Rural Development, Ministry of Energy and Water. The World Bank team will work closely with the Authorities on the initiation of the implementation of the Internal Audit Action plan.</li> </ul>
<p>B2. <b>Progress in asset declaration implementation:</b> (i) roll-out of asset declarations with at least 20 (out of the total 34) provincial governors submitting their asset declarations to the HOO; and (ii) the implementation of the first phase of the verification process, i.e. the administrative review (also referred to as the preliminary verification<sup>b</sup> of in-country assets) of the asset declaration of 5 Cabinet ministers and 12 senior officials.</p>	<ul style="list-style-type: none"> <li>• The HOO confirms in a formal signed statement to the Administrator the number of provincial governors who provided an asset declaration by November 30, 2010, and it will also provide list of the respective provincial governors to the Administrator.</li> <li>• The HOO will provide the Administrator with evidence of all steps in the preliminary verification process (as defined in the footnote) and will notify the Administrator of all cases of mis-information/false information.</li> </ul>
<p>B3. <b>Implementing the P&amp;G reform and improving merit-based appointments:</b> (i) completion of the re-grading phase in 5 ministries/agencies: Ministry of Labor, Social Affairs, Martyrs and Disabled; Ministry of Parliamentary Affairs; IDLG, Ministry of Higher Education; Ministry of Transport and Civil Aviation, (ii) develop and approve simplified procedure for the recruitment of senior civil servants (i.e. grades 1 and 2) that increase transparency, fairness and openness in the appointment process (including vetting, short-listing, interviewing and selection procedures), and (iii) develop and pilot a mechanism to observe and</p>	<ul style="list-style-type: none"> <li>• The Independent Administrative Reform and Civil Service Commission (IARCSC) will deliver to the Administrator an implementation report on the progress of re-grading in the 5 ministries. The IARCSC will work closely with the World Bank Public Administration Reform Team during the preparation of the report. The IARCSC will confirm the completion of the re-grading process in the 5 ministries to the Administrator.</li> <li>• The IARCSC will provide the Administrator with a copy of the simplified procedures and the approval letter by the Chairman of the Commission.</li> </ul>

	<p>provide external scrutiny to senior appointment panels by having an independent resource person from universities and civil society sit on a sample of 20 senior appointments during the reporting period and a final approval of the mechanism by the Chairman of the Commission.</p>	<ul style="list-style-type: none"> <li>The IARCSC will provide the Administrator with a report on the pilot, plus the new annex describing the mechanism added to the recruitment procedure as approved by the Chairman of the Commission.</li> </ul>
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<sup>b</sup> Definition of administrative/preliminary verification:

Upon submission, the asset form is reviewed by a unit within the Asset Declaration Department at HOO. The review includes the following:

- examining the form (checking for signatures, initials, family members list, blank areas, contact info, etc),
- cross-checking the information on each column (assets, references, document/licenses numbers, sources of assets),
- corrections and clarifications (this will include having the public official go through the form for corrections/mistakes and re-submit,
- analysis of the declared wealth e.g. comparison of income against wealth,

In case of identification of mis-information/false information after the review and delays in responses by the public official, the public official will be formally notified e.g. by an official letter from HOO.

<b>Theme C: Enabling Private Sector Development</b>		
	<b>Benchmarks</b>	<b>Monitoring and Evaluation</b>
C1.	<p><b>Progress towards establishing DABS as a functioning and efficient power utility:</b> (i) improving customer care by (a) establishing 3 fully functional Customer Care Centers (CCCs) (from baseline 1), and (b) shifting 180,000 Kabul Electricity Directorate (KED) customers from manual to a computerized billing system (from baseline 41,500 at end of billing cycle 4 in 1388), and (ii) improving key indicators for measuring loss reduction and revenue generation: (a) revenue from billed energy in Afs (from baseline of a cumulative total of Afs 1.504 billion for the first six months of the year 1388 to target 1.15 *baseline for the first 6 months of year 1389), and (b) cash realized per kWh energy supplied (i.e., cash collected/total energy input to the system) (from a baseline 2.557Afs/kWh using cumulative data for the first six months of the year 1388 to target: 1.10*baseline using cumulative data for the first six months of the year 1389).</p>	<ul style="list-style-type: none"> <li>The DABS management will confirm to the Administrator the establishment of the 3 CCCs and will provide evidence of functioning business. The DABS Board will provide and confirm evidence for a computerized billing system functioning for 180,000 KED customers. The Administrator will review submitted evidence with input from the World Bank Power Team.</li> <li>The DABS management will confirm and publish key indicators for measuring loss performance (as stated in the benchmark). The Administrator will review submitted evidence with input from the World Bank Power Team.</li> </ul>
C2.	<p><b>Increasing transparency in the mining industry:</b> (i) publishing the executive summary of the Aynak contract and the public announcement to commit to publish at least the executive summary for the forthcoming Hajigak contract, and (ii) publishing the results of the review of 8 existing small-to-medium scale mining contracts.</p>	<ul style="list-style-type: none"> <li>The Administrator will verify the publication and posting of the executive summary of the Aynak contract on the Ministry of Mines (MOM) web-page. The Authorities will provide the Administrator with a copy of the announcement of the commitment to publish at least the executive summary for the forthcoming Hajigak contract. The Administrator will verify the publication of that announcement on the MoM web-page and will be provided with a copy of the press release.</li> </ul>



		<ul style="list-style-type: none"><li>• The results of the review of 8 mining contracts by the government will be posted on the MOM web-page. The Administrator will verify the posting.</li></ul>