February 24, 2009

AFGHANISTAN RECONSTRUCTION TRUST FUND

ARTF INCENTIVE PROGRAM AND SY1388 (2009/10) BENCHMARKS

MEMORANDUM OF UNDERSTANDING

Part I: The ARTF Incentive Program

Introduction:

On December 17th, 2008, ARTF Donors agreed with the Government of Afghanistan to establish the ARTF Incentive Program within the Recurrent Cost Window of the ARTF. The Incentive Program seeks to support the Government's reform agenda, with a focus on fiscal sustainability and economic governance. The Program is based on an annual automatic decline in baseline ARTF Recurrent Cost Window financing – but offers an offsetting incentive package, based on concrete progress in the reform agenda. The objective is not only to support the reform process but also to allow for increased allocations towards the financing of government's core development programs through the ARTF Investment Window.

Following ARTF donor and Government endorsement of overall Program design at the Quarterly meeting in December 2008, Part I of this Memorandum establishes the procedures and operational guidelines of the ARTF Incentive Program. This Memorandum therefore 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 Program. In addition, Part II of this Memorandum includes the final structural benchmarks for SY1388 which are the basis for agreeing the first year's operations of the scheme.

ARTF Incentive Program Summary:

As agreed at the December 17th meeting of ARTF Donors and Government, the baseline financing of the operating budget provided through ARTF Recurrent Cost Window will decline by US$25 million per annum, starting in SY1388. This means the baseline, budgeted for in SY1388, is US$250 million.

The Incentive Program offers incentive funds to top-up the ARTF Recurrent Cost baseline financing. The funding is allocated through two schemes: a structural benchmarks 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). [1]

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

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

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[1] 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 to well-performing national priority programs.

In SY1388, its first year of operation, the Incentive Program consists only of structural benchmarks detailed in Part II. The SY1388 package is worth US$ 40 million. Starting in SY1389 the Program will consist of the structural benchmarks and the Revenue Matching Grant.

Process – Negotiation & Verification:

While the Revenue Matching Grant mechanism is automatically calculated, according to a calibrated scale, the structural benchmarks require donor engagement with the Government to agree on benchmarks. The World Bank, as ARTF Administrator, will facilitate this process, by convening the donor/Government Working Group to decide on the structural benchmarks. The process should aim to be transparent, not unduly lengthy and should avoid adding unjustified burdens on the Government. Donors and Government have agreed to ensure an independent review of the Incentive Program is undertaken in 2010.

The World Bank is also responsible for the annual Technical Review of benchmarks. The date of the Technical Review is fixed at the same time benchmarks are agreed upon. In undertaking the Technical Review the World Bank may draw on the technical competencies of other agencies as necessary. The World Bank will report the results of the Technical Review to the Donor/Government Working Group and the Donor/Government Working Group will make a recommendation to the Quarterly Donor Meeting on whether the benchmarks have been met. The Quarterly Donor Meeting will have the final authority to decide if benchmarks have been fulfilled.

The World Bank will report the results of the Technical Review to the ARTF Management Committee and will accordingly advise the Management Committee on next year's ARTF Incentive Program allocation. The Management Committee retains sovereign final decision-making authority for setting the overall envelope ("ceiling") for the ARTF Recurrent Cost Window at the start of every fiscal year.

The incentive funds are made available as commitments under the Recurrent Cost Window in the year following the Technical Review (T+1). Since actual revenue numbers are confirmed after the year end, the Revenue Matching Grant will be calculated only after the budget is passed. Therefore the funds will have to be reflected in the supplemental budget or the mid year review of the budget, which will then be confirmed by the ARTF Management Committee.

Commitments and Disbursement of the Incentive Program:

Commitments: The Management Committee makes transfers of funds or 'commitments' four times a year to the Recurrent Window trust fund that disburses to the Government. In the past, each transfer or commitment was calculated as one quarter of the agreed total 'ceiling'. Under the new Program, in agreeing the "ceiling" at the start of the year, the Management Committee will be informed by the results of the Technical Review. Quarterly transfers, or commitments, will be calculated accordingly by the Administrator.

Disbursements: Funds allocated under the 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.

'Cushion': In the past the Administrator has managed the ARTF cash flow to ensure a 'cushion' of US$70 million is in place at all times. This system ensures some predictability in cash flow for the

Government. This system will not change, unless the Management Committee agrees otherwise with the Government, based on a change in circumstances.

Preconditions of the Incentive Program:

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

- Maintained commitment by Government to quality standards of public expenditure auditing;[2] 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 PRGF program.

Structural Benchmarks Scheme:

Structural benchmarks will be organized under three reform areas: Sustaining Domestic Revenue, Improving Public Sector Governance and Enabling Private Sector Development. The ARTF Incentive Program seeks to support the Ministry of Finance in its stewardship of improved economic governance in Afghanistan. With the benefit of its annual cycle, ARTF Incentive Program benchmarks will pursue multi-year agendas such as revenue collection, public administration reform in the education sector, implementation of transparency across government and the establishment of a level playing field for business.

In the first year, at the request of the Government, it has been agreed to allocate the incentive funds across the three themes in order to compensate for the absence of revenue matching grant scheme and for the short time available to achieve the benchmarks. In the future years, this allocation will not be applied.

Theme A: Sustained domestic revenue generation. The Poverty Reduction and Growth Facility (PRGF) program supervised by the IMF is the core framework for the Government's revenue generation program, in addition to broader macro-fiscal stability. In addition, various donor agencies support the Ministry of Finance revenue department through technical assistance. Discussions with the authorities, the IMF and donors indicate that the ARTF Incentive Program can further support the Government's revenue measures, through strategic strengthening of existing benchmarks & commitments. This will bring the ARTF into closer alignment with the reform agenda. This policy objective will be complemented by the Revenue Matching Scheme.

Theme B: Improved public sector governance. Public administration reform (PAR), public finance management (PFM) and anti-corruption are all critical for the improved delivery of services and the broader state-building program in Afghanistan. Specifically with respect to the ARTF, PAR will be important for developing the sustainable core capacity in Government that will enhance the impact of external assistance through the Core Budget and from a longer-term perspective will reduce Afghanistan's dependence on expensive and unsustainable technical assistance. The Government's reform of PFM systems has demonstrated genuine improvements, as indicated by the 2008 Public Expenditure & Financial Accountability (PEFA) study. These gains must be sustained if further progress is to be achieved, especially with regards to operationalizing the Afghanistan National Development Strategy programs. Theme B benchmarks will also focus on improved expenditure management, critical in the context of the phase out of ARTF recurrent support.

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[2] 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.

Theme C: Enabling private sector development. Private sector development is critical to transition the Afghan economy from a public sector-led to a stable private-sector led growth path. This is crucial for job creation and poverty reduction as well as for increasing the productivity and competitiveness of the Afghan economy. A broad-based economy will also support a broader tax base. ARTF Donors and Government propose to target the critical policy measures, including legislation, that underpin the enabling environment. Recognizing this is predominantly an input-based approach, as the Program develops, this policy area could develop stronger links with outputs indices, such as the doing business indicators.

Revenue Matching Grant Scheme:

The Revenue Matching Grant Scheme is designed to incentivize improved revenue performance, and therefore fiscal sustainability. The Scheme will start in SY1389, based on revenue performance in SY1388. It is anchored in the annual revenue targeting negotiations the Ministry of Finance and the IMF.

The Revenue Matching Grant scheme is capped at 25 percent of the total ARTF Incentive funds available in any year.[3] Thus in its first year, SY1389, the Revenue Matching Grant will have a pot of US$15 million (60 x 25%). 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 more than 100 percent of the IMF revenue target 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 new target to avoid confusion.

The Revenue Matching Grant Calculator[4]

% 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

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[3] In fact, as explained in the Calculator, 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.

[4] Release of funds more than 100 percent of the IMF revenue targets requires achievement of all benchmarks

Part II: The SY 1388 Package

Part II of this Memorandum explains in detail the first year's package, worth US$40 million in ARTF incentive funds. It has been decided to allocate funding only towards the structural benchmarks in the first year of the new Program, and not to implement the Revenue Matching Grant Scheme until the first full year of revenues (SY1389). The benchmark matrix below is the result of in depth discussion between the Government and ARTF donors, represented by the five donors on the Working Group, as well as internal discussions within Government between departments. [5]

Parameters:

- Overall Incentive Package is US$40 million.
- The package is allocated across the three themes as follows: Theme A: US$20m; Theme B: US$10 million; Theme C: US$10 million. ***This split will not apply to future years..***
- The World Bank will be responsible for concluding agreement with the Ministry of Finance with regards the achievement of benchmarks in the Technical Review May 1st, 2009.
- The World Bank will draw on technical competencies of other donors and the IMF (especially for benchmarks related to the PRGF program) as necessary.
- The World Bank will submit its report from the Technical Review of SY1388 benchmarks to ARTF Donors for the June Quarterly Meeting and to the ARTF Management Committee.

SY1388 Structural Benchmark Matrix

	Theme A: Sustaining Domestic Revenue Generation	
	Benchmarks and Indicators	**Target Date**
A1.	**Enactment of the amendment to tax legislation to introduce business receipt tax on imports.** Background: This is an IMF PRGF prior action for the 5th review. The amendment of the income tax law is an essential pre-requisite to implement policy measures for improved revenue performance starting in SY1388. Verification: The IMF and World Bank will verify the law has been enacted.	March 21, 2009: as per PRGF.
A2.	**Ensuring increased resourcing of the Revenue & Customs departments in the Ministry of Finance.** Background: Increased staffing and resourcing of the revenue & customs departments in the Ministry of Finance is critical to improve the ability & capacity of the two departments to perform their function.	April 21, 2009

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[5] EC, US, UK, Italy, & Germany. IMF was also an observer. Ministry of Finance represented Government of Afghanistan.

Verification
World Bank/USAID against the following three indicators:

(a) Increase in the approved SY1388 Tashkeel over SY1387 for Revenue and Customs departments in MoF. The schedule below sets out the proposed increases in Tashkeel in the SY1388 budget.

Department	1387 Tashkeel (Baseline)	Response from MoF on additional Tashkeel (1388)	1388 Tashkeel (Proposed)
Tax Revenue (HQ+Provinces)	**2045**	**423**	**2468**
Customs (HQ+Provinces)	**1672**	**77**	**1749**
Budget	60	56	116
Treasury(HQ+Provinces)	1115	11	1126
HRM	78	0	78
Properties	25	5	30
State Owned Enterprises	62	3	65
Insurance	13	2	15
Chief of Staff	67	0	67
Internal Audit	135	0	135
Admin(HQ+Provinces)	828	103	931
Total MoF Staff	**6100**	**680**	**6780**

(b) Approved (by DM Administration) Procurement Plans from Revenue and Customs Departments including the Original Procurement List communicated by respective Departments.

(c) Guidelines for internal MoF Budgeting Process: A Report outlining the steps, tools, and documentation required for budget formulation and execution prepared and disseminated to Revenue and Customs Departments.

A3. **Verification that the memorandum of understanding between Ministry of Finance and Ministry of Commerce and Industry has been implemented, with regards the access of customs officials to the Fuel and Liquid Gas Enterprise (FLGE).**

March 21, 2009: as per PRGF.

Background:
This benchmark is the same as the IMF prior action for the 5th review. The MoU has been signed but demonstration of its implementation is pending. The implementation of the MoU is important as it grants access to FGLE depots for customs officials.

Verification:
IMF/World Bank. The indicator is therefore confirmation by IMF that the first implementation status report has been submitted by MOF.

<table>
<tr><th colspan="3">Theme B: Improving Public Sector Governance</th></tr>
<tr><td></td><td>**Benchmarks and Indicators**</td><td>**Indicative timeline**</td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td>B1</td><td>**Documented policy established on teacher competencies and agreed to by Minister of Education**

Background:
The teacher competency assessment is one stream in the package of reforms which the MoE has committed to undertake, following the ARTF Donor Meeting, December 17, 2008. The ARTF Management Committee, on January 17, 2009, endorsed these reforms and will be holding the MoE to account for progress on teacher registration, literacy testing and pay & grading.

Next year’s set of ARTF benchmarks will include a follow-up on the competency testing.

Verification:
An approved policy is submitted by MoE to MoF & World Bank.</td><td>March 21, 2009</td></tr>
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<tr><td>B2.</td><td>**Initiate the Asset Registration process.**

Background:
Following the promulgation of the new Anti-Corruption Law in 2008, the High Office of Oversight & Anti-Corruption was established to coordinate and lead on anti-corruption work. The Asset Declaration process is one of its first tasks.

Verification:
World Bank will verify using documentation provided by the High Office.

a) Asset declaration form completed and sent out by the High Office of Oversight
b) Guidelines developed by the High Office of Oversight for filling in the asset declaration forms.
c) Technical note setting out the future direction for a fully 'operationalized' asset registration system, i.e. what the Government commits to doing in the coming year. To be prepared by the High Office of Oversight.
d) Completion of asset registration by at least four ministers (target pilot group will include the HOO, MoF, MoI, and the supreme court).</td><td>April 21, 2009</td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><th colspan="3">Theme C: Enabling Private Sector Development</th></tr>
<tr><td></td><td>**Benchmarks and Indicators**</td><td>**Indicative timeline**</td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td>C1.</td><td>**Submit Memorandum of Trade Regime (MTFR) in draft to World Trade Organization for official review.**

Background:
Submitting the memorandum is the first step towards joining the WTO.

Verification:
World Bank: Documentation submitted to World Bank, demonstrating the draft MFTR has been sent to WTO.</td><td>21 March, 2009</td></tr>
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C2	**Submission of DABM/S audited financial statements for 2006/07–07/08** Background Strengthening fiscal control over the DABS (formally DABM) remains a focus of the Ministry of Finance’s reform agenda. The submission of the audited financial statements for DABM is a prior action for the PRGF 5th Review – and builds on the corporatisation of DABS in March 2008. This will provide a sound basis for clarifying the fiscal relations between DABS and the Ministry of Finance as well as a review of subsidies. Verification: IMF	March 21, 2009: as per PRGF.