AFGHANISTAN RECONSTRUCTION TRUST FUND

ARTF INCENTIVE PROGRAM SY1389 (2010/11)

MEMORANDUM OF UNDERSTANDING

JULY 28, 2009

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 SY1389 ARTF Incentive Program.[1] Part I of this Memorandum gives an overview of the ARTF Incentive Program. Part II of this Memorandum describes in detail the benchmarks for the SY1389 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

2. 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. As illustrated in Table 1 the budgeted ARTF RC support baseline for SY1389 is US$225 million. The Incentive Program offers incentive funds to top-up the ARTF RC Window baseline financing for SY1389 in the amount of US$60 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).[2]

Table 1: Potential allocations through the ARTF Incentive Program

	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.

[1] Throughout this document, the SY1389 ARTF Incentive Program relates to a program of reforms that are carried out during SY1388 but for which ARTF incentives are available in the SY1389 budget as part of the Incentive Program.

[2] 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:

3. The Revenue Matching Grant Scheme is designed to incentivize improved revenue performance, and therefore progress toward fiscal sustainability. This Scheme will start in SY1389, based on revenue performance in SY1388. It is anchored in the annual revenue targeting negotiations between the Ministry of Finance and the International Monetary Fund (IMF).

4. 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.[3] Thus in its first year, SY1389, the Revenue Matching Grant Scheme will have a targeted allocation 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 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[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

Structural Reform Scheme:

5. Structural reforms for the SY1389 Incentive Program will be organized under three reform areas (with three respective benchmarks under each theme): Enhancing Domestic Revenue Generation, Improving Public Sector Governance and Enabling Private Sector Development. These reforms will be implemented during SY1388.

[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

6. **Theme A: Enhancing Domestic Revenue Generation.** In SY1388 the agreed reforms under this theme will focus is on improving tax compliance and strengthening transparency in revenue collection. This theme is also supporting the implementation of a better monitoring system for progress in customs administration reforms through regularly monitored customs performances indicators, which will ultimately provide a better basis for customs resource decisions. This theme will be complemented by the Revenue Matching Grant Scheme.

7. **Theme B: Improved Public Sector Governance.** Under this theme, the program is seeking to support three reforms during SY1388. The first is the strengthening of the government's internal audit function, through the reinstatement of the government-wide purview for internal audit to the Ministry of Finance. It is also supporting the commitment made by the High Office of Oversight (HOO) to progressively expand and strengthen the asset declaration process. Given the critical role of the Afghan public administration for public service delivery and the broader state and capacity building agenda in Afghanistan, progress in the implementation of the Pay & Grading (P&G) reform will be tracked with one benchmark.

8. **Theme C: Enabling Private Sector Development**. Government committed under this theme for SY1388 to progress in the corporatization and governance reforms of the power utility (Da Afghanistan Breshna Sherkat, DABS) and the roll-out of the Central Business Registry to one province. This theme also supports improvements of the regulatory framework and transparency in the mining sector with important steps towards Afghanistan becoming a candidacy country of the Extractive Industries Transparency Initiative (EITI).

9. The ARTF donors and the government agreed for the SY1389 Structural Reform Scheme that the reform progress under the scheme would be assessed separately, by theme, and not for the reform program in its entirety. Incentive Program funds for the Structural Reform Scheme in SY1389 would be equally distributed across the three themes. Therefore, of the US$45 million for the Structural Reform Scheme in SY1389, each theme would have US$15 million allocated. It was also agreed that granting the allocation of US$15 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:

10. The World Bank, as ARTF Administrator, will be responsible for the annual Technical Review of the ARTF SY1389 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 SY1389 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 SY1389 budget.

11. 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, 2009**. Based on this verification evidence the Administrator will undertake the Technical Review. The Technical Review will be delivered to the ARTF donors of the Working Group[5] before it 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

[5] EC, US, UK, Italy, & Germany.

than mid-December 2009. In undertaking the Technical Review the World Bank may draw on the technical competencies of other agencies as necessary.

12. 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 SY1389'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.

13. 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:

14. In order for the Government to be eligible for the ARTF Incentive Program in SY1389, the ARTF Administrator will verify at the time of the Technical Review the:

- Maintained commitment by Government to quality standards of public expenditure auditing;[6] 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:

15. 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 SY1389, 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.

16. 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.

Part II: The SY1389 Structural Reform Scheme

17. 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, 2009. The discussions and negotiations for the SY1389 Structural Reform

[6] 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.

Scheme took place between May and July 2009 and were facilitated by the World Bank. The following is summarizing the main parameters of the SY1389 Structural Reform Scheme.

- The overall Structural Reform Scheme will comprise US$45 million.
- The package is allocated across the three themes as follows: Theme A: US$15m; Theme B: US$15 million; Theme C: US$15 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, 2009.
- 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 SY1389 Structural Reform Scheme to the ARTF Management Committee.

Table 3: SY1389 Structural Reform Matrix

	Theme A: Enhancing Domestic Revenue Generation [a]	
	Benchmarks	**Monitoring and Evaluation**
A1.	**Customs reforms:** (i) The customs department at MOF reports quarterly on an agreed set of key output indicators, which will allow better assessment of general progress made within customs administration [b], and (ii) ASYCUDA roll-out to Sher Kahn Bandar.	• The Afghan Customs Department (ACD) will provide the World Bank team with the quarterly reports of the defined output indicators and together with the World Bank Customs Experts will calculate the customs performance indicators. These indicators will be posted on the ACD web-page. • The MOF/ACD will track the ASYCUDA roll-out to Sher Kahn Bandar. It will provide the World Bank with a progress report on the roll-out.
A2.	**Tax and Non-tax revenue transparency:** (i) A MOU on revenue collection is signed between MOF and Ministry of Transport and Civil Aviation (MOTCA); (ii) Publication and posting on the MOF/ACD webpage of all fees and processing charges at the Revenue and Customs Offices; (iii) Monthly posting of detailed customs collection data (by customs station [c]) on the MOF/ACD web-page.	• The MOF will provide the World Bank with a copy of the signed MOU between MOF and MOTCA. • The World Bank will verify the posting of fees and processing charges and the monthly detailed customs collection data on the MOF/ACD web-page.
A3.	**Improving tax compliance**: The number of companies that are non-compliant with the Business Receipt Tax (BRT) or Income Tax at the start of SY1388 is reduced by 10 percent by the third quarter of SY1388. [d]	• The MOF/Afghan Revenue Department (ARD) will provide the World Bank with a list of compliant companies (with blacked out names) for the beginning of 1388 and for Q3 1388 to allow for verification of increase in compliant companies.

a. Theme A is complemented by the automatic quantitative revenue scheme in SY1388. The quantitative scheme is based on SY1388 revenue performance, according to the previously agreed schedule.
b. This will lead to a regularly monitored set of performance indicators used as: (1) a management tool, (2) a basis for comparisons, and (3) a way of measuring productivity gains, which will also provide a better basis for customs resource discussions and decisions. A background note with definitions for this benchmark is presented in the Annex of this MOU.
c. The report will be listed by customs station, for some locations there is combined reporting.
d. The number of non-compliant companies (those who have not filed a required return) in both MTO and LTO reached 680 at the beginning of 1388. The Government will work with all companies, but expects to achieve the largest increase with restaurants, airlines and wedding halls.

Theme B: Improving Public Sector Governance		
	Benchmarks	**Monitoring and Evaluation**
B1	**Asset declaration:** (i) Asset declaration roll-out (with no less than 60 percent of the current Cabinet Ministers submitting their asset declarations), and (ii) A draft implementation strategy for asset declarations (including verification procedures) is developed for Cabinet approval and shared with donors.	• The HOO confirms in a formal signed statement to the World Bank team how many Cabinet members provided an asset declaration by November 30, 2009, if possible it lists the respective Cabinet members. • The HOO will circulate to ARTF donors and World Bank Experts a draft implementation strategy for asset declarations (including verification procedures). The World Bank Experts will stand ready for assistance in developing and refining the strategy.
B2.	**Strengthening GOA's Internal Audit function**: Reinstatement of Article 61 of the Public Expenditure and Financial Management (PEFM) Law regarding MOF's government-wide purview over Internal Audit through a Presidential Decree.	• The MOF will provide the World Bank with a copy of the Presidential Decree on the reinstatement of Article 61 of the PEFM Law.
B3.	**Progress in P&G implementation:** A progress report of P&G implementation is prepared covering MOF, Ministry of Rural Rehabilitation and Development (MRRD), Ministry of Education (MoE) (including teachers), Ministry of Justice (MoJ) and Ministry of Agriculture, Irrigation and Livestock (MAIL), featuring: (a) progress of P&G by line ministry as of October 31, 2009, including analysis on re-grading; (b) comparison with the timetable for that ministry set earlier; and (c) action plan for each ministry implementing P&G for the remainder of the year 1388.	• The Independent Administrative Reform and Civil Service Commission (IARCSC) will deliver the P&G implementation progress report to the World Bank and will work closely with the World Bank Public Administration Reform Team during the preparation of the report.
Theme C: Enabling Private Sector Development		
	Benchmarks	**Monitoring and Evaluation**
C1.	**Progress in DABS corporatization and governance reforms:** The DABS Board approves a plan to reduce commercial and technical losses within the next two years; including a timetable and action plan for the establishment of commercial activities and better customer services, including the Kabul region, previously known as the Kabul Electricity Directorate, KED.	• The DABS Board will provide to the World Bank the approved plan and the minutes of the Board Meeting during which the plan was approved – alternatively a signed cover letter with the approved plans attached is acceptable. The World Bank Power Specialist will review the plans and, upon request, assist DABS during the drafting period.
C2.	**Roll-out of the Central Business Registry to provinces**: A pilot Central Business Registry will be launched in Jalalabad.	• The Ministry of Commerce and Industry will confirm in a formal letter the opening of the Central Business Registry in Jalalabad.

C3.	**Improvement of the regulatory framework and transparency in the mining sector:** (i) The Minerals Law and the revised Hydrocarbon Law (Petroleum Law) are enacted through gazetting; and (ii) A fully-costed and timed action plan for EITI implementation is endorsed by a multi-stakeholder working group and submitted to the EITI secretariat.	• The government will provide the World Bank with the Gazettes of the Minerals Law and the revised Hydrocarbon Law. • The government will provide the World Bank with a copy of the submission letter to the EITI secretariat, including the endorsed action plan of the multi-stakeholder working group. The World Bank Mining Team will work closely with the government and provide advice as needed.

Annex: Customs national level indicators and benchmarks.

National indicators were initially designed by cstoms administrations to be used in three ways:

- Measure evolution form one year to another;
- Establish regional comparisons; and
- Make a comparison between a specific site and another, or with national average values. This can show the need for re-assigning resources to locations with heavier workloads.

When later refined for use in countries working with some international organizations, the purpose of these indicators was not to measure specific performance, but to assess general progress made within the administration. This category was designed to provide the client countries with (i) a management tool, (ii) a basis for comparisons, and (iii) a way of measuring productivity gains. Like any indicator, they are average values, and should be used with circumspection, compared to other data, and combined with external factors. Most of the values are abstract, and do not reflect the real situation at a specific work position, but provide a benchmark for subsequent reviews of the work process.

Revenue collected/ Customs staff	Total revenues collected/Total number of customs employees	Information to be obtained from records maintained by the Customs administrations.
Total Customs administration cost/ Revenue collected	Total budget of the administration (including salaries, overtime, bonuses, and benefits)/Total revenue collected irrespective of its destination.	Information to be obtained from records maintained by the Customs administrations.
Salaries/ Revenue collected	Total agency salaries, overtime, bonuses, and benefits/Total revenue collected irrespective of its destination	Information to be obtained from HR.
Trade Volume/ Customs staff	Trade Volume/number of customs employees	Information to be obtained from country statistical data.
Annual number of declarations/ Customs staff	Total number of declarations (import, export, suspense regimes, but excluding transit), irrespective of the number of items/Total staff employed by Border Customs Administration.	Information to be obtained from records maintained by the Customs administrations.

To establish the ratios ACD should record the following base value figures every year, for the elapsed year:

- Total revenue collected (in Afs)
- Total cost of Customs (in Afs)
- Total number of staff
- Total salaries (in Afs)
- Annual number of declarations
- Value of recorded imports (in Afs)
- Value of recorded exports (in Afs)

1. Definitions

Revenue collected

The revenue collected is the total revenue taken by Customs, irrespective of the budget line to which it is credited. It includes (because the indicator shows how much the organization contributes to the State budget):

- Customs duties,
- BRT collected on imports,

- All other fees collected by Customs on behalf of any other administration,
- Proceeds of sale of confiscated goods, when such sales are done by Customs,[7]
- Re-assessments of duty subsequent to post release reviews, investigations, or Court decisions (these should be indicated for the year when they are actually paid), and
- Fines and penalties, when they are actually paid. Even when some of the proceeds of the fine are allocated directly to Customs, they should be considered as revenue collected.

Customs staff
Customs staff corresponds to all the employees on the payroll of Customs.

Total Customs cost
This is the total cost to the State for running the Customs service. It consists of the budget of the department, including:

- Salaries,
- Overtime,
- Bonuses and rewards, paid out of the budget (including rewards paid out of the proceeds of fines and sale of confiscated goods because they are captured under component a. above),
- Running costs, and
- Sums directly taken out of fines and used for maintenance and small repairs.

It does not include capital investment, because such expenditure is usually spread over several years, and its benefits may only appear in the medium or long term. (A specific indicator could be derived to assess the marginal efficiency of capital expenditure.)

Salaries
This is a sub-set of total Customs cost. It includes all payments made to people working in Customs.

[7] There may be a slight distortion, because it can be argued that, even though Customs did not make the sale, they provided the merchandise, and therefore the revenue, so they should be credited with the budget revenue. However, there is a cost to (i) keeping the goods, and (ii) organizing their sale, so if Customs were to dispose of confiscated goods, they may still not be able to generate the economies of scale produced by a specialized agency.