

AFGHANISTAN RECONSTRUCTION TRUST FUND

ARTF INCENTIVE PROGRAM FY1391 – 93 (2012-2014)**ADMINISTRATOR'S 1ST TECHNICAL REVIEW**

NOVEMBER 21, 2012

Preamble

1. In July 2012, ARTF Donors agreed with the Government of Afghanistan on a new ARTF Incentive Program within the Recurrent Cost (RC) Window of the ARTF. The overall objective of the Incentive Program (IP) is to support the Islamic Republic of Afghanistan (“Afghanistan”) with a reform program that aims at improving fiscal sustainability through increasing domestic revenue mobilization and strengthening expenditure management.
2. The IP funding will be allocated through two schemes: the revenue matching grant scheme (accounting for one quarter of the available incentive funds) and a structural reform scheme (accounting for three quarters of the available incentive funds). Detailed information on both schemes, a description of the structural benchmarks, and the timetable are laid out in annexes 1- 3 of the MoU. This review should therefore be considered in conjuncture with the MoU and its supporting annexes.
3. The timeline for the implementation of this incentive program is July 2012 – 2014 (i.e. FY1391 – 1393). Table 1 indicates the indicative allocation of the IP.

Table 1: Indicative Allocation through the ARTF Incentive Program since Inception

	2009/10	2010/11	2011/12	2012	2013	2014
	FY1388	FY1398	FY1390	FY1391	FY1392	FY1393
Baseline ARTF RC support	\$250	\$225	\$200	\$175	\$150	\$125
ARTF Incentive Program	\$40	\$60	\$70	\$50	\$150	\$175
<i>Structural Benchmarks</i>	\$40	\$45	\$53	\$37.50	\$112	\$130
<i>Revenue Matching Grant</i>		\$15	\$18	\$12.50	\$38	\$45
Potential Ceiling for ARTF RC/IP support	\$290	\$285	\$270		\$300	\$300

Note: Figures for SY1393 are rounded.

4. The basis for this technical review is the Memorandum of Understanding (MoU), signed on July 12, 2012 by the Ministry of Finance and the Administrator. The MoU and its annexes include all the benchmarks and the review protocol. It stipulates that Technical Reviews of the Incentive Program will be held every four months. Each review will report on progress and development of the

program, and assess the achievement of actions under the structural reform scheme against the agreed deadlines. To this end, Afghanistan is required to submit all documents evidencing the completion, fulfillment or achievement of any such actions, goals or targets at least 10 days prior to the commencement of each scheduled review meeting.

5. This Technical Review has been undertaken by the World Bank as Administrator, with collaboration of sector experts from ARTF donors. Part I of this Technical Review describes progress on revenue mobilization and collection. Part II includes a detailed assessment of the 1391 structural reform program based on the evidence provided and reports on progress against 1392 and 1393 IP commitments. Part III of this Technical Review summarizes the status on the IMF supported ECF and Part IV assess the viability and changes to the program proposed by the Government, Donors or the Administrator, and part V summarizes the recommendation to the ARTF Management Committee with regard to the disbursement of the Incentive Program.

Part I: Progress on Revenue Mobilization and Collection

6. The Revenue Matching Grant Scheme under the Incentive Program incentives improved performance in revenue mobilization and collection. It is anchored in the annual revenue targets agreed between the Ministries of Finance the International Monetary Fund (IMF) within the context of the Extended Credit Facility (ECF), approved on November 2, 2011.
7. **Progress on meeting revenue targets:** The revenue target agreed for SY1391 between the Ministry of Finance and the IMF is Afs 85.1 billion. The Second ECF review, undertaken in October 2013, reviewed the revenue performance of the first two quarters of FY1391 and indicates that revenues reached Afs 48.8 billion. This is 5.7 percent more than in the same period of the last year but Afs 1.7 billion below the cumulative end-August target. The shortfall appears to be the result of lower than expected collection of customs duties (see also Part III).

Part II: Performance Assessment against FY1391-1393 Benchmarks

8. This part provides the performance assessment against the SY1391 structural benchmarks of the ARTF Incentive Program. This includes the implementation of government commitments (ten per year) under four reform areas: Public Financial Management, Governance and Civil Reform, Investment Climate and Trade Facilitation and Sub-National Finance. The benchmarks were negotiated with close involvement of the relevant line ministries/agencies and the ARTF IP Working Group between March and June 2012. Line agencies involved included the Ministry of Finance, the Ministry of Commerce and Industries, the Independent Administrative Reform and Civil Service Commission, Da Afghanistan Bank as well as the Ministries of Education and Health.
9. In early November 2012, the Government started submitting verification material to demonstrate the fulfillment of structural benchmarks. The delivered evidence was then assessed by the Administrators and in some cases went through several rounds of clarification and adjustment. World Bank experts have also been continuously engaged with the authorities on progress made in implementing the agreed commitments for FY1392 and 1393.

10. **Performance Assessment against FY 1391 Benchmarks:** The Administrator's Technical Review assesses that, overall, progress is moderately satisfactory. Based on the evidence received until November 26, the Government of Afghanistan implemented six out of ten commitments under the structural reform scheme. These include the actions on internal audit, procurement performance, budget transparency, AML/CFT, business licensing and norm-based budget allocation.
11. The implementation of two other commitments is very advanced. These include the development and publication of EFS guidelines as well as the publication and dissemination of an inventory on all fees and administrative procedures required to trade across borders. For the most part, these benchmarks have been largely implemented with a few finalizing actions pending (e.g. donor consultation on the EFS guidelines, or the dissemination of the inventory). Their full implementation can be expected by end-December 2012.
12. The implementation of the two remaining, pending benchmarks relate to carrying out external audits and the development of a customs actions plan which appear to be both lagging. A more consolidated effort would be required to avoid that these benchmarks will be carried over and their incentives discounted.
13. Table 1 below provides more details regarding the performance assessment of the individual benchmarks and the Administrator's recommendations to accelerate the implementation of the pending benchmarks or, more generally, ensure their sustainability.
14. **Progress on FY 1392–93 Benchmarks:** Progress on the implementation of the FY 1392-93 benchmarks is equally encouraging and mirrors the performance of the implementation of 1391 benchmarks. The authorities have started the implementation of several of the FY 1392-93 benchmarks. In many instances technical assistance is being mobilized to support the authorities with a timely implementation. Table 2 discusses progress in more detail. However, some risks to the implementation of a few benchmarks emerged:
 - **External Audit:** there is lack of evidence that the FY1391 external audit benchmark has been achieved. It is unclear how much of total expenditures have been subjected to rigorous audits to date, if any at all. The benchmarks for FY 1392-93 reflect cumulative, quantitative targets in terms of audit coverage of total expenditures, meaning that it will require more efforts by CAO to achieve the FY1392-93 benchmarks if the 1391 target is underachieved. In this context, it will be critical that the draft external audit law of 2012 is being approved by parliament in order to hold the CAO to its responsibilities.
 - **Internal Audits:** The internal audits required for the 1391 IP have been carried out at satisfactory standards. However, existing plans for the provision of technical assistance and the time table for roll-out in FY1392 has been upset by proposed changes to article 61 of the 2005 PFM law. The changes suggest diminishing the role of MoF to extend assistance to Line Ministries in undertaking the audits. While principally in line with prevalent practice in more advanced country, the provision ignores the huge capacity gaps within Line Ministries to carry out audits and the capacity building approach taken by the PFM road map which is based on good practice for low-capacity countries (improve capacity within MoF first, then extend to Line Ministries). The provision appears to be therefore impractical within the Afghanistan context since Line Ministries currently depend on the capacity and assistance of MoF to properly carry out their audit responsibilities. The fulfillment of the FY1392-93

benchmarks would be seriously threatened if the proposed amendments were to become law.

- **Customs:** The importance of addressing deficiencies at customs has been highlighted by the recent shortfall in customs revenue collection. The agreements achieved at the Dubai Customs workshop in June 2012 implied a swift follow-up on formalizing the action plan for future customs reforms. The fact that until end-November no agreement on the customs action plan has been achieved poses a risk to a timely implementation of the action plan itself.

Part III: Progress on IMF Program and Implications for IP

15. The ARTF Donors and Afghanistan have agreed that it is a precondition for the Incentive Program that an on-going IMF supported program be in place (currently the Extended Credit Facility – ECF which represents an active engagement on managing the macroeconomic environment). The ARTF Recurrent Costs Window disbursements pursuant to the Incentive Program are intended to accompany the IMF disbursements under the ECF. Accordingly, the Incentive Program allocations to the Recurrent Cost Grant would be withheld by the Administrator if at any point in time a review of the IMF's ECF program lapses.
16. The second review of the ECF was carried out during an IMF mission between October 29 and November 11, 2012. On November 10, 2012, the IMF reported in a meeting to Donors that, overall, the implementation of the ECF is showing good progress. However, the quantitative benchmarks for domestic revenue collection and the accumulation of foreign reserves have been missed. Moreover, the deadline for the submission of the new draft banking law to parliament has passed and the law is still pending cabinet approval. The reason for the delay appears to be a combination of (i.) limited capacity to review financial sector legislations within the Ministry of Justice and (ii.) emerging priorities related to the amendments of the electoral law.
17. The IMF team is currently discussing with the authorities countervailing measures and expects to conclude the review by mid-December. However, the IMF team is also considering combining the second with the third review (upcoming in March) for administrative reasons.

Part IV: Proposed Changes and Assessment of Adequacy

18. Upon request of Donors, the Administrator developed a facility to finance and support the operation and maintenance of public infrastructure in key development sectors. The proposal for an O&M facility, to be placed under the ARTF IP, was presented and discussed at several occasions with the Government and Donors. The ARTF Steering Committee endorsed the proposal on November 10, 2012. The Administrator therefore proposes to amend the MoU of July 12, 2012 in order to include the new O&M facility which will be in place starting FY 1392.
19. The Administrator reviewed the FY1392-93 benchmarks and deems the benchmarks still relevant and adequate with respect to the objectives of the program and within the context of on-going

reform developments. No specific proposals from the Afghan authorities or ARTF donors were put forward.

20. The international community and the Government of Afghanistan have begun operationalizing the Tokyo Mutual Accountability Framework (TMAF). In support of this effort, the Administrator is looking into using the ARTF IP as a framework for the achievement of selected TMAF indicators.

Part V: Recommendation on Incentive Fund Allocation for SY1391

21. The Administrator's Technical Review recommends to the ARTF Management Committee to disburse US\$ 22.5 million out of a total of US\$ 50 million ARTF IP incentive funds.¹
22. The final assessment and recommendations based on the calibrated schedule of the Revenue Matching Grant Scheme will take place once actual revenue numbers are confirmed by the Treasury - i.e., after the solar year end (around Dec 20). This means the Revenue Matching Grant will be calculated and confirmed at the next technical review.

¹ Based on the achievement of six benchmarks, with an allocation of \$3.75 million each (see MoU, p. 7)

Table 1: SY1391 Structural Reform Matrix with Evidence Assessment

	Benchmarks	Progress of Implementation	Status	Next Steps and Recommendations
A. Public Finance Management				
1.	External Audit: The Control and Audit Office carries out and publishes at least one external audit done to acceptable standard of the central government entities that represent 5% of the total expenditures	According to MoF, CAO has conducted compliance audits of the main spending Ministries (e.g. Ministry of Education) which in total exceed 5% of the total Budget of Afghanistan. While CAO reports that the audits have been done to acceptable standards, the Administrator was not in the position to verify this. Publication of the audit report is expected to be done before end-December.	pending	In order to assess the compliance of the audit with good standards, the World Bank or another third party needs to assess the audit process. CAO is requested to submit audit statements and other relevant information the Administrator for a preliminary assessment.
2	Internal Audit: Five ministries undertake internal audits which substantially meet professional standards set by the Internal Audit Dept. of the Ministry of Finance based on the IIA Standards.	The Administrator has received evidence for the completion of five completed internal audits in MoJ, MoHE, MoR, MoE, and MoD. The Administrator verified that all audits have been done in observance of acceptable standards.	Met	
3	Procurement Performance: 3 Line Ministries implement institutional arrangements and develop capacity sufficient to meet the stand alone procurement criteria set by the Procurement and Policy Unit (PPU) of MoF	WB verified that six Line Ministries to date have been certified by PPU; 3 were certified in FY1390 (MAIL, MoEd, MPH). In 1391, additional three Ministries were certified (MEW, MoLSA and MUDA).	Met	
4	Budget Transparency: MoF implement at least 3 recommendations from 2012 Open Budget Assessment for Afghanistan by the	The Ministry of Finance has made considerable progress in providing budget documents. It has published	Met	

	<p>International Budget Partnership Initiative. This could include;</p> <ul style="list-style-type: none"> • MOF publishes the 1392 budget planner on the MoF website • MoF publishes a pre-budget statement for the 1392 budget on the MoF website • MoF organises consultation workshops with CSOs and media on 1392 budget and publishes proceedings on the MoF website 	<p>the draft 1392 budget prior to the parliamentary hearings, published a citizen budgets for 1391 (in three languages), improved the reporting on budget execution (relatively timely monthly bulletins, published a report on budget execution) as well as medium-term expenditure framework (pre-budget statement) and issued a budget planner for 1392. Efforts have also been made to enhance public participation in the budget process. Two workshops with CSO's and media were held (April and June 2012) to explain budget structure, processes and reforms, as well as to consult on the 1392 budget. Media and CSO's have also been permitted to observe legislative budget hearings. These actions exceeded the IP 1391 requirements and should lead to an increase of the rating in next open budget index.</p>		
B. Governance				
5	<p>EFS Guidelines: MoF and the IARCSC issues guidelines with recommendations on EFS salaries & allowances to the donors. As a part of the benchmark, MoF and IARCSC establish a monitoring and reporting mechanism for EFS salaries and allowances in consultation with the ARTF Administrator</p>	<p>The NTA guidelines, including suggested salary scale, provision for allowances and a description of the monitoring mechanism, have been drafted. The NTA Commission (OAA, CAO, HOO, CSC, MoF) will meet next week to revise or agree to the guidelines. Donor Consultations will take place in December.</p>	pending	<p>The process could be accelerated in order to ensure that the benchmark is met within the 2012 deadline.</p>

6	AML/CFT: Da Afghanistan Bank (DAB) develops a comprehensive Anti-Money Laundering (AML) and Combating Financing of the Terrorism (CFT) action plan to address the most significant deficiencies identified in the AML/CFT Assessment of Afghanistan (2011) agreed with the Financial Action Task Force (FATF) and establishes mechanisms for policy and operational-level coordination on AML/CFT.	As part of the FATF/ICRG Targeted Review, DAB developed an action plan to address the most significant deficiencies identified in the AML/CFT Assessment of Afghanistan (2011). The action plan was agreed on June 2012. Following the action plan, DAB established a high level committee and a working group to oversee the implementation of the action plan.	Met	
C. Investment Climate and Trade Facilitation				
7	Business Licensing: Ministry of Commerce and Industry (MoCI) abolishes the need for criminal record check for licensing of businesses	After consultations with MoI, MoCI issued a directive to all license issuing departments to abolish the need for criminal record check. The Administrator received a copy of the Ministry order (MoCI) which clearly states that the need for criminal record check for business licensing has been abolished. The order will be disseminated to relevant offices and a publication in MoCI's next newsletter is planned.	Met	The Administrator will verify the sustainability of this action over the next two years through surveys.
8	Trading across borders: MoCI produces conclusive inventory as the official reference point to clarify documentation and fees required to trade cross borders. MoCI will publish the inventory online and all clearance points. MoCI will begin with a Public Private Dialogue combined with trainings between traders, agents, freight forwarders and officials on trade related requirements and trade facilitation issues. Outreach activities should be extended to Regional Custom Houses	Draft inventories have been submitted to the Administrator for review.	pending	The inventories need to be published on the web. The benchmark also requires the organization of training or dissemination events with representatives of the private sector.

9	Customs: Customs Action Plan has been prepared and relevant parts have been agreed with MoF, MoCI and MoI	A customs workshop was held in Dubai with high level representation from relevant Ministries. Workshop participants agreed on the problem definition of customs reforms and worked out different reform options. Based on these discussions a draft action plan was prepared.	pending	The customs action plan needs to be discussed with different stakeholders and agreement by cabinet or relevant members needs to be documented.
D. Subnational Finance				
(10)	Norm-based budget allocation: Ministries of Finance and Education agree to include, on a pilot basis, a norm based approach to the formulation of the MoEd's operating budget for the 1392 budget. The expansion to be formally announced by end August 2012.	MoF and MoE agreed on a norm for the allocation of the operating budget and allocated O&M expenditures in the 1392 budget accordingly. The Administrator verified the norm which is based on school enrolment and the existence of buildings, dormitories, hostels, libraries and labs. There are some concerns regarding the using the student enrolment as one of the determining factors since this could potentially lead to an over-reporting of students in following years. However, The Administrator agrees that at this moment the agreed norm was the most practical until a proper asset registry is in place and other factors such as e.g. the year of construction could be used to refine the norm.	Met	Within the context of the budgeting pilot, the EQUIP team will monitor the adequacy of the current norm and provide recommendations for changes, if needed, prior to the next budget cycle.

Table 2: Progress Report on FY1392-93 Benchmarks

A. Public Financial Management		
1392 Benchmarks	1393 Evidence	Progress
(1) External Audit Performance: CAO carries out and publishes external audits done to acceptable standard of central government entities that represent at least 20% of total expenditures.	(1) External Audit Performance: CAO carried out in the year and publishes external audits done to acceptable standard of central government entities that represent at least 25 % of total expenditures (Audits covering 50% of the average annual total expenditures in the life of the IP).	There is lack of evidence that the FY 1391 external audit benchmark has been achieved. It is unclear how much of total expenditures have been subjected to rigorous audits to date, if any at all. The benchmarks for FY 1392-93 reflect cumulative, quantitative targets in terms of audit coverage of total expenditures, meaning that it will be require more effort by CAO to achieve the FY 1392-93 benchmarks if the 1391 target is underachieved. In this context, it will be critical that the draft external audit law of 2012 is being approved by parliament in order to hold the CAO to its responsibilities.

<p>(2) Internal Audit: Five (5) ministries undertake internal audits which substantially meet professional standards set by the Internal Audit (IA) Dept. of the Ministry of Finance (MoF) based on IIA Standards.</p>	<p>(2) Internal Audit: Additional five (5) Ministries undertake internal audits which substantially meet professional standards set by MoF IA based on IIA Standards.</p>	<p>The internal audits required for the 1391 IP have been carried out at satisfactory standards. However, existing plans for the provision of technical assistance and the time table for roll-out in 1392 has been upset by proposed changes to article 61 of the 2005 PFM law. The changes suggest diminishing the role of MoF to extend assistance to Line Ministries in undertaking the audits. While principally in line with prevalent practice in more advanced country, the provision ignores the huge capacity gaps within Line Ministries to carry out audits and the capacity building approach taken by the PFM road map which is based on good practice for low-capacity countries (improve capacity within MoF first, then extend to Line Ministries). The provision appears to be therefore impractical within the Afghanistan context since Line Ministries currently depend on the capacity and assistance of MoF to properly carry out their audit responsibilities. The fulfillment of the 1392-93 would be seriously threatened if the proposed amendments were to become law.</p>
<p>A. Public Financial Management</p>		
<p>1392</p>	<p>1393</p>	<p>Progress</p>
<p>(3) Procurement Performance: An additional three (3) Line Ministries will implement institutional arrangements and develop capacity sufficient to meet the stand alone procurement criteria set by PPU.</p>	<p>(3) Procurement Performance: An additional three (3) Line Ministries will implement institutional arrangements and develop capacity sufficient to meet the stand alone procurement criteria set by PPU (at least 9 over the life of the IP).</p>	<p>Technical Assistance provided by the ARTF PFM project lined up to further support the PPU with the certification of procurement units in other Line Ministries.</p>
<p>(4.) Budget Transparency: MoF implements at least 4 (four) recommendations from the 2011 Open Budget assessment for Afghanistan by the International Budget Partnership (IBP) initiative.</p>	<p>(4) Budget Transparency: MoF implements at least 4 (four) recommendations from the 2012 Open Budget assessment for Afghanistan by the International Budget Partnership (IBP) initiative.</p>	<p>The next IP requires continuity of the 1391 actions throughout 1392 and 1393. In addition, the Administrator suggest to focus more strongly on OBI recommendations related to improving budget oversight, especially by the CAO. The external audit law is still pending parliament approval and is essential clarifying CAO's mandate and responsibilities.</p>
<p>B. Governance</p>		

1392	1393	Progress
<p>(5) Civil Service Reform: The Council of Ministers approves amendments to the civil service law.</p>	<p>(5) Civil Service Reform: The authorities issue relevant regulatory instruments which enable the recruitment of professional staff.</p>	<p>1392 benchmark: The civil service law is currently in MoJ Taqneen. In early Dec, the Administrator plans to host a workshop on the civil service model in Delhi which includes discussion on the law. The participants include CSC Chairman, CSC officials, MoJ, MoF, and OAA. An underlying point of this workshop is to help those outside CSC (who need to review/approve the law) understand the law and what it will do.</p> <p>1393 benchmark: no report on progress.</p>
<p>(6) AML/CFT: The Council of Ministers approve the amendment of the law No. 840 of October 2004 on “Anti-Money Laundering and Proceeds of Crime” and the law No. 830 of October 2004 on “Combating the Financing of Terrorism” to align with international standards (FATF Recommendations on AML/CFT) and submit to parliament.</p>	<p>(6) AML/CFT: DAB amends the following regulation to address deficiencies identified in the AML/CFT Assessment of Afghanistan (2011), taking into account the suggested amendments of the AML/CFT laws as above and the revised FATF standards (February 2012):</p> <ul style="list-style-type: none"> - Responsibilities of Financial Institutions in the Fight Against Money Laundering and Terrorist Financing issued by DAB in March 2006; - Money Service Providers issued by DAB in March 2008; and - Foreign Exchange Dealers issued by DAB in July 2008. 	<p>The AML and CFT laws are both currently in MoJ Taqnin. The administrator is following through her engagement on FATF process.</p>
C. Investment Climate and Trade Facilitation		
1392	1393	Progress

<p>(7) Business Licensing: MoF and MoCI take necessary action to streamline the renewal for trade and investment licenses (including tax clearance). Action will be further clarified prior to FY1392</p>	<p>(7) Business Licensing: The Council of Ministers issues a road map which includes a description of all required institutional and regulatory changes for the establishment of a unified business registration system within 18 months which provides the right to invest, trade and conduct usual business activities.</p>	<p>1392 benchmark: The Administrator will issue the REI for a consultancy to undertake a problem analysis, including survey and legal opinion. The result will be presented at the next technical review.</p> <p>1393 benchmark: The Administrator mobilized TA for January/February 2013 to assist MoCI to develop and review options for the establishment of a unified business registration system.</p>
<p>(8) Trading across borders: MoCI makes verification of the commercial invoices and the certificate of origin voluntary for exporters and enforce the elimination of mandatory export quality certificates.</p>	<p>(8) Trading across borders: MoCI in collaboration with MoF reduces the number of required documents for trading across borders and align process with international good practice, including the elimination of product specific export permits other than negative list.</p>	<p>On track. MoCI will issue the Ministry orders necessary for the implementation of these benchmarks during the course of next year.</p>
<p>(9) Customs: Government of Afghanistan makes satisfactory progress in the implementation of the customs action plan in 1392 (as agreed at first technical review in 1391)</p>	<p>(9) Customs: Government of Afghanistan makes satisfactory progress in the implementation of the customs action plan in 1393 (as agreed at first technical review in 1392)</p>	<p>A customs workshop was held in June 2012. A draft action plan was developed by MoF, based on the recommendations of the workshop, and is currently pending clearance by the Minister of Finance. The draft has not yet been shared with the Administrator. The recent shortfall in customs revenue collection highlights the importance of addressing deficiencies at customs. The agreements achieved at the Dubai Customs workshop in June 2012 implied a swift follow-up on formalizing the action plan for future customs reforms. The fact that until end-November no agreement on the customs action plan has been achieved poses a risk to a timely implementation of the action plan itself.</p>
<p>D. Sub-national Finance</p>		
<p>1392</p>	<p>1392</p>	
<p>(10) Norm-based budget allocation: MoF applies the norm-based formula for the operating budget to further 2 key ministries. Identity of the ministries to be announced by last quarter of 2012</p>	<p>(10) Norm-based budget allocation: MoF applies the norm-based formula for the operating budget to further 4 key ministries. Identity of the ministries to be announced by last quarter 2013</p>	<p>MoF and MoH have already developed a basic norm for the health sector which was applied to the 1392 budget. However, the norm still shows important weaknesses. MoF and MoE will refine the norm over the course of the next FY, supported by the ARTF SAHAT project.</p>

