AFGHANISTAN RECONSTRUCTION TRUST FUND

ARTF INCENTIVE PROGRAM FY1391-93 (2012-2014)

ADMINISTRATOR'S 6TH TECHNICAL REVIEW

MARCH 25, 2015

Preamble

1. The Incentive Program (IP) 1391-1393, part of the Recurrent Cost Window (RCW) of the ARTF, is a three-year operation supporting a series of economic policy reforms deemed critical to achieving Afghanistan's development objectives. The IP supports reforms in the areas of public financial management, investment climate and trade facilitation, governance, and revenue mobilization. The reform program aims to improve Afghanistan's fiscal sustainability by strengthening domestic revenue mobilization and expenditure management and bolstering growth prospects.

2. Financing for the IP is allocated across three complementary facilities: (i) the revenue matching grant facility; (ii) the structural reform facility; and (iii) the operations and maintenance (O&M) facility. Detailed information on each of these facilities, description of the structural benchmarks, and timetables are contained in the Memorandum of Understanding (MoU), along with its annexes 1- 4, originally signed July 12, 2012 and subsequently amended December 9, 2012 and June 1, 2014.

Table 1: Indicative Allocations and Disbursements for the ARTF Incentive Program (US$ million)

	Indicative Allocations			Disbursements to Feb. 2015		
	2012 FY 1391	**2013 FY 1392**	**2014 FY 1393**	**2012 FY 1391**	**2013 FY 1392**	**2014 FY 1393**
Structural benchmarks	$38	$112	$130	$29	$75	$65
Revenue Matching Grants	$13	$38	$45	$0	$19	$0
O&M facility		$32	$100		$32	$34
Total – Incentive Program	**$50**	**$182**	**$275**	**$29**	**$126**	**$99**
Baseline RC Support	$175	$150	$125	$175	$150	$125

Note: Disbursements are listed against the year for which they are disbursed, rather than the year in which they are disbursed.

3. The timeline for implementation of the incentive program is July 2012 - end 2014 (i.e., FY1391-1393), although substantive assessments of progress are expected to continue through end-2015. Table 1 shows the indicative allocations for the IP for each year, along with disbursements through November 2014. It is expected that a new incentive program covering reforms for the period 2015-2017 would be discussed starting in the spring of 2015.

4. The basis for this technical review is the MoU signed on July 12, 2012 (amended on December 9, 2012 and June 1, 2014) by the Ministry of Finance (MoF) and the World Bank (as Administrator). The MoU and its annexes include all the benchmarks and the review protocol. It stipulates that technical reviews of the IP 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, MoF 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 review describes progress on revenue mobilization and collection. Part II provides an assessment of progress on the pending structural reform benchmarks from FY1393 structural reform benchmarks based on the evidence provided. Part III assesses progress on the O&M facility. Part IV discusses other disbursement conditions, including the adequacy of the macroeconomic framework. Part V concludes with the recommendation to the ARTF management committee regarding disbursement of the IP.

Part I: Progress on Revenue Mobilization and Collection

6. The Revenue Matching Grant Scheme under the IP provides an incentive for improved performance in revenue mobilization and collection. It is anchored in the annual revenue targets agreed in advance between the Ministry of Finance and the International Monetary Fund (IMF). The amount of the incentive grant payable is determined according to a calibrated scale depending on the percentage of the revenue target agreed with the IMF that is met. If Afghanistan achieves 99% or more of the revenue target, the full amount of the incentive grant is payable. On the other hand, if 90% or less of the target is achieved, no incentive is payable.

7. **Revenue performance in FY1393 (2014):** The revenue target for FY1393, as agreed under the IMF's ECF program, was Afs 128 billion. However, revenue collection fell significantly short of the target as a result of the economic slowdown, increased governance vulnerabilities and weaknesses in tax and customs administration. Domestic revenues were recorded at Afs 100.1 billion - this is 8.5 percent lower than actual revenues in FY1392 and 22 percent lower than the revenue target for FY1393. The decline in revenues has occurred across all sources of revenue, including customs, tax and non-tax revenues. At 78 percent of the target, the minimum threshold in the Revenue Matching Grant scheme is not met. Hence, **no incentives on revenue performance are triggered for FY1393.**

Part II: Performance Assessment of FY1391-1393 Benchmarks

8. This part focuses on the performance assessment for FY1393 structural benchmarks. The Fifth Technical Review completed on December 15, 2014 assessed that three additional FY1393 structural benchmarks (Procurement, budget transparency and norm-based budget allocation) had been achieved, with five pending (Internal Audit, Civil Service, AML/CFT, and Customs). Since then, the administrator has engaged on an ongoing basis to facilitate progress.

9. As of March 25, 2015 neither MoF nor other government counterparts have furnished verification material to demonstrate the fulfillment of the pending structural benchmarks for FY1393. **Hence, no disbursements against structural benchmarks will be triggered.**

10. **Five benchmarks for 1393 are still pending completion**. The benchmarks on Civil Service Reform (#5), Business Licensing (#7), and Trading Across Borders (#8), AML/CFT (#6) and Customs (#9) are flagged as being associated with a risk of delay. The matrix in annex 1 provides additional details regarding the assessment of these benchmarks. The authorities are encouraged to pro-actively follow up on implementation of these remaining five benchmarks to ensure that the associated disbursements are received with the minimum possible penalty of delay. **As of March 31, 2015 the incentive funds for the five pending triggers will be discounted by 25%.**

Part III: Operations & Maintenance (O&M) Facility

11. The O&M facility incentivizes higher civilian O&M spending. The facility also promotes improved O&M management and systems within MoF and in select "participating" line ministries. The indicative allocation for the O&M facility was $100 million for 1393. The basic principle underlying the facility is as follows. For each quarter, a baseline is defined using the average of O&M spending (civilian operating budget code 22) for the last two years. The baseline is defined for both aggregate civilian O&M spending and for the sum of the participating ministries. For each dollar spent above the baseline, the facility provides an incentive payment of 1.5 dollars up to a maximum of the indicative allocation for that year. The participating ministries for 1393 are the Ministry of Education (MoE), Ministry of Public Health (MoPH), Ministry of Public Works (MoPW), and the Civil Aviation Authority (CAA). Once the actual O&M spending for each quarter is recorded and vetted, the incentive amount is calculated at both the aggregate level and at the level of the participating ministries, but only the greater of the two incentive amounts is payable. This provides an ex ante incentive at both levels without any ex post double counting.

12. Table 2 below presents the quarterly baselines for 1393 for both aggregate civilian O&M and for the sum of the participating ministries. The table also presents actual O&M spending at each level for all quarters in 1393, as well as the calculated incentive amount at each level. As indicated, the baseline

for 4Q1393 – subject of this review - was exceeded for the participating ministries level but not at aggregate level. **This triggers disbursement of incentive funds of $33.6 million**.

Table 2. Quarterly O&M baselines for 1393 and actual expenditures					
	1391 Actual Prorated	1392 Actual	Baseline 1393	Actual 1393	Incentive
	Millions Afs	Millions Afs	Millions Afs	Millions Afs	Million US$
Aggregate Civilian O&M					
Q1	1,486	1,756	1,621	2,152	14.2
Q2	3,130	3,591	3,361	3,906	14.6
Q3	4,716	6,041	5,378	4,142	
Q4	6,388	6,631	6,509	6,107	
Participating (MoE+MoPH+MoPW+CAA)					
Q1	388	452	420	619	5.3
Q2	818	1,012	915	1,333	11.2
Q3	1,232	1,361	1,297	1,536	6.4
Q4	1,669	2,610	2,140	3,395	33.6

Part IV: Other Disbursement Conditions

13. The MoU of the IP contains the following language to ensure that the macroeconomic framework is acceptable for the purposes of IP disbursements:

"Adequacy of the Macroeconomic Framework and Linkage with IMF Program

The ARTF Donors and Afghanistan have agreed that it is a precondition for the Incentive Program that an adequate macroeconomic and fiscal framework be in place, as assessed by the World Bank in coordination with the IMF. One of the factors that would be taken into account in the assessment of the macroeconomic framework is whether or not an IMF supported program is in place and whether engagement under the IMF program is ongoing.

The Incentive Program disbursements would be withheld by the Administrator if at any point in time it assesses that an adequate macroeconomic policy framework for the purposes of IP disbursements is not in place. Afghanistan may continue to furnish evidence for completed actions to the Administrator during any such withholdings, so that subsequent disbursements can be immediately resumed once the macroeconomic framework is assessed as adequate."

14. The implication of this language (as discussed by the IP Working Group at the time of the Fourth Technical Review completed in June 2014) is that if an IMF program is not in place, the Administrator

would ascertain, in coordination with the IMF, whether there exist prohibitive concerns about the adequacy of the macroeconomic framework or whether the circumstances are such that IP disbursements would support macroeconomic stability. Furthermore, it is relevant to note that the design of the IP is different from that of all-or-nothing budget support operations: by selectively disbursing against benchmarks achieved and withholding disbursements for benchmarks not achieved, the IP incentivizes progress.

15. **Assessment of macroeconomic policy framework**: Economic growth fell sharply to 2.0 percent (estimated) in 2014 from an average of 9 percent during 2003-12. This is a result of: (i) uncertainty from the protracted elections process, compounded by the subsequent difficulties to quickly form a full-fledged government; (ii) flat growth in agriculture; and (iii) medium term headwinds from the drawdown in aid. The economy has so far not shown any credible sign of recovery and unfavorable weather conditions point toward a contraction in agriculture. Growth is projected at 2.5 percent in 2015.

16. Afghanistan continues to face serious medium term fiscal challenges. Domestic revenues fell from a peak of 11.6 percent of GDP in 2011 to 8.4 percent in 2014, because of the economic slowdown and weaknesses in tax and customs enforcement. As a result, the authorities faced a financing shortfall of about $500 million in 2014, managed by drawing down cash reserves, accumulating arrears, and exceptional donor assistance. The authorities also curtailed civilian operations and maintenance (O&M) and discretionary development expenditures, which were both lower even in nominal terms in 2014 compared to 2013. However, overall expenditures increased in 2014 because of higher security and mandated social benefit spending. The government's fiscal position remains vulnerable a weak cash reserve position ($150 million) and significant arrears (around $200 million) at the start of the fiscal year. The first two months of 2015 have seen some cautious growth in domestic revenue (3.5 percent over last year's outturn); however, this was solely due to an increase in non-tax revenue. Taxes and customs collection was lower than in the first two months of 2014.

17. The Government recognizes that restoring fiscal stability requires accelerating revenue enhancing reforms which have considerably slowed down over the past two years. To this end, an agreement was reached on an IMF Staff-Monitored Program (SMP) which will include a set of macroeconomic policies and structural reform measures to be implemented over the course of 9 months.

18. Under the SMP, authorities have committed to a reform agenda that would address macroeconomic vulnerabilities and balance the budget in 2015. Reforms on the fiscal front include measures to mobilize domestic revenues to finance projected expenditures and rebuild the treasury's cash balance. A revenue package has been agreed that could bring in around Afs 10 billion in additional fiscal resources by the end of the year. Financial sector reforms will deal with the implementation of the new banking law, amendment of the central bank law, strengthening banking supervision, and addressing weaknesses in state banks.

19. Disbursement of IP funds will support on-going efforts to restore macroeconomic stability. For one, the government needs adequate financing to balance its budget and create fiscal space for critical public services delivery. If the financing needs of Afghanistan are not adequately met, the government

may need to further tighten public spending, which, in turn could slow economic recovery, particularly in an environment where private investment is limited. But more importantly, the ARTF IP rewards the accelerated implementation of reforms that are specifically geared towards restoring macroeconomic and fiscal stability. **Based on these considerations, and progress made in concluding an IMF SMP, the Administrator recommends disbursement**.

20. Risks to macroeconomic stability remain high**.** First, the security situation could deteriorate and undermine economic recovery and efforts to improve revenues. Second, actual implementation of the new government's ambitious reform program could be slow, which would result in continued weak economic growth, revenue underperformance, and low incentive-linked grants. Third, the authorities may be unable to sufficiently prioritize expenditures in light of constrained resources, which would lead to larger accumulating arrears. Some of these risks would be mitigated by accelerating reform implementation under the SMP as well as the ARTF IP. As such, the disbursement recommendation is accompanied by a strong recommendation to urge the authorities to continue their close engagement with the IMF and the ARTF IP Working Group.

Part V: Recommendation on Incentive Fund Disbursement

21. The administrator's Sixth Technical Review recommends to the ARTF management committee to disburse **US$ 33.6 million** in incentive funds out of the ARTF Incentive Program allocations for 1393 based on achievements under the O&M facility.

Annex 1: Progress Report on FY1393 Benchmarks –Status as of March 25, 2015

A. Public Financial Management		
1393 Benchmarks	**1393 Evidence (from MoU)**	**Progress**
(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)..	**(1)** Evidence of the coverage would be the semi-annual audit reports provided to Parliament which include the specific reports. The audits must be comprehensive of the entities' operations and not limited to one or two processes or units within the entities. Acceptable standards are provided, both by the INTOSAI and ISSAI.	**Achieved.** For 1393, SAO conducted the compliance audit of four ministries (M/o Rural Rehabilitation and Development, M/o Education, M/o Defense, and M/o Interior) representing 60% of total FY1392 expenditures. The scope of compliance audit includes assessment of internal control and internal audit functions, evaluation of compliance with applicable statutes and regulations, reviewing compliance with laws and regulations; whether the statutes, laws and regulations are being followed, whether they are having the desired results, and, if not, what revisions are necessary which is as reflected in the plan document. The field work in the Central Budgetary Units and provinces of three of the ministries (MRRD, MoD, and MoI) has been completed and observations (Estellam) issued. The audit reports of these three ministries were signed by the Auditor General and a summary of the findings of each of the reports were posted on the SAO web site. The audit reports for MRRD, MoD, and MoI were provided to the Administrator between Nov 12 and Nov18. An expert consultant has completed a review of the three audit reports and found these comprehensive and satisfactory. The review of the underlying working papers took place Dec 13-15 and was satisfactory, thus leading to the overall assessment that the audits are of an acceptable level of compliance with INTOSAI ISSAIs. For MoEd, given media reports in November of ghost workers in MoEd, the scope of the audit was expanded to include detailed payroll testing in five provinces, which is underway. However, the 3 ministries (MRRD, MoD, MoI) for which reports have been submitted account for 48.2% of FY1392 expenditures, far surpassing the benchmark requirement of 25% of expenditures. While the benchmark is achieved, it will nevertheless be important to follow-up on the MoEd audit.

(2) Internal Audit: Additional five (5) ministries undertake internal audits which substantially meet professional standards set by MoF IA based on IIA Standards (15 audits of different Ministries in the life of the IP and after the date of signing the IP).	**(2)** Report describing the work, attesting to compliance with standards and reporting the action taken by management to be prepared by the IA Dept of MoF and the audit reports themselves.	**Achieved.** The Ministry of Finance Internal Audit department (IAD) provided the WB (in the week of Dec 8th) English versions of the reports and the underlying working paper files for the internal audits of the following five (new, additional) line ministries, which were initiated in June 2014: 1) M.o. Mines and Petroleum 2) M.o. Information & Culture 3) M.o. Border & Tribal Affairs 4) M.o. Agriculture 5) M of Hajj and Piligramage The review of the plans, risk analyses, and the reports indicated that the work was done to an acceptable standard. The review of the underlying working papers also supported the assessment that the internal audits substantially meet professional standards and that the benchmark is achieved.
A. Public Financial Management		
1393 Benchmarks	**1393 Evidence (from MoU)**	**Progress**
(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).	**(3)** Certification reports by the PPU	**Achieved.** The PPU reports that nine line ministries have been certified. Furthermore, the PPU submitted the Line Ministry Stand Alone Procurement Certificates for MoD, MAIL, and Office of State Minister for Parliamentary Affairs as evidence of achievement of this benchmark for 1393. The evidence was reviewed by WB staff on Sept 23, 24 at PPU in the MoF. WB staff concluded that the methodology was adequate and that the certificates for MOD, MAIL and the Office of State Minister for Parliamentary Affairs were supported by assessments in line with the stated methodology and support the related certificates.

(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. This could include: - MoF publishes the 1394 budget planner on MoF website - MoF prepares and publishes a 1393 Citizen Budget on the MoF website - MoF publishes a pre-budget statement for the 1394 budget on the MoF website - MoF organizes consultation workshops with CSO's and media on 1393 budget and publishes proceedings on the MoF website	**(4)** Administrator verifies publications	**Achieved.** Based on the recommendations from the 2012 Open Budget Assessment for Afghanistan, the Ministry of Finance: - Published the 1394 budget planner on its website; - Published a Citizen Budget for the 1393 budget in its website; - Published the pre-budget statement for 1394, under the Medium-Term Budget Framework, in its website; - Organized a consultation workshop on July 23, 2014 with the Civil Society Organizations (CSOs) on 1393 budget, and published the proceedings in the website; The Administrator has reviewed the evidence, and assesses the benchmark as achieved.
B. Governance		
1393 Benchmarks	**1393 Evidence (from MoU)**	**Progress**
(5) Civil Service Reform: The authorities issue relevant regulatory instruments which enable the recruitment of professional staff.	**(5)** Administrator will review and verify issuance of the regulatory instruments.	**Delayed.** The relevant regulations are pending until the Civil Service Law is approved by Parliament. The law will provide the legal basis for the issuance of regulatory instruments. The Civil Service Law is currently under review at the Ministry of Justice to be re-sent to the Council of Ministers for review. It is not clear whether the law would be reviewed by the Cabinet.
(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): - Responsibilities of Financial Institutions in the Fight Against Money Laundering and Terrorist Financing issued by DAB in March 2006;	**(6)** Administrator will review and verify issuance of the regulatory instrument.	**Delayed.** The AML and CFT laws were enacted in (respectively) June and July 2014. The President further approved the CFT regulations in October 2014. The October 2014 FATF review meeting concluded that the AML and CFT laws, with the accompanying CFT regulations, are considered satisfactory. However, the relevant regulations on the responsibilities of financial institutions, money service providers, and foreign exchange dealers – as required under the 1393 benchmark – have not yet been amended. The February 2015 FATF statement highlights the five deficiencies that

- Money Service Providers issued by DAB in March 2008; and - Foreign Exchange Dealers issued by DAB in July 2008.		Afghanistan still need to address as part of its AML/CFT action plan. FINTRACA has noted that it is working on amendments to the 3 regulations included in this benchmark, as well as other regulations, to effectively implement the new AML / CFT laws. The benchmark is not achieved as of March 2015 but can be declared as achieved when the amendments to the priority regulations are completed.
C. Investment Climate and Trade Facilitation		
1393 Benchmarks	**1393 Evidence (from MoU)**	**Progress**
(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.	**(7)** MoCI provides the Administrator with a copy of the Roadmap and Minutes of the cabinet meeting.	**Delayed.** High level ownership within MoCI and the government is critical for progress in this area. The new government, through its paper "Realizing Self-Reliance: Commitments to Reforms and Renewed Partnership" for the London Conference on December 3-4, 2014 has committed to improving the investment climate by significantly reforming licensing and registration procedures and establishing a unified business registration system. However, a formal roadmap for this purpose will need to be prepared. Furthermore, Cabinet approval of the roadmap will be needed to deem the benchmark as met. A consultant was mobilized in 2013 to develop a strategy paper for the unification of business licensing and registration processes, including an implementation roadmap for the transfer of AISA's licensing services to MOCI's Afghanistan Central Business Registry. The report was prepared in November 2013 and was shared with the Ministry of Commerce and Industries. The report can inform the government's roadmap toward establishing a unified licensing system. The report remains to be discussed in a workshop with all stakeholders including the MoCI, AISA, and MoF. The Administrator and MoCI have discussed that such a workshop would be most productive pending high level ownership within both MoCI and the government for a unified business registration system. However, the workshop is unlikely to take place before the new Minister assumes office.

(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.	**(8)** MoCI provides the Administrator with a copy of the relevant directives.	**Delayed.** The MoCI is awaiting the approval of the Afghanistan National Trade Policy 2013-2017 which is expected to provide guidance on reducing the number of required documents for trading across borders. Further, the policy is expected to endorse the elimination of all unnecessary export authorization requirements in both the public and the private sector, including certifications from the MoCI, other ministries and various industry associations. The MoCI has submitted the Afghanistan National Trade Policy and an Implementation Roadmap to the Cabinet, following meetings with the Ministry of Economy, ACCI and MoF. It is currently being reviewed by the High Commission on Economy, prior to be reviewed at the Cabinet for approval.
(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)	**(9)** to be determined once action plan is received	**Delayed.** The new government has declared strengthening enforcement and fighting corruption in customs one of its critical priorities. The Customs Action Plan was agreed and signed by all concerned ministries in October 2014, thus removing a key bottleneck to its effective implementation, and providing high-level government ownership for customs reforms. This sets the stage for the authorities to meet the customs benchmark for 1393 at a future point in time based on successful implementation of a set of substantive reform actions. The Administrator and the ACD have discussed a number of priority customs reform actions identified for implementation by the government to make a substantive impact in improving customs revenue mobilization. These include strengthening enforcement powers of customs by placing the Customs Police under the supervision and direction of ACD; enhancing customs controls by reassigning customs officials based on traffic patterns, introducing additional randomized post-inspections, and mobilizing post clearance audit in major customs houses; revision in procedure for clearance of Miscellaneous (bilti) cargo; decreeing mandatory certification of new as well sitting customs officials by the customs academy; and roll-out of new Valuation Module to all customs houses that are equipped with ASYCUDA World.
D. Sub-national Finance		

1393 Benchmarks	1393 Evidence (from MoU)	Progress
(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	**(10)** MoF submits a report to the Administrator with a summary of the provincial budget distribution and copies of the provincial transfer sheets. The Administrator will review the report for compliance with the benchmark.	**Achieved.** The Ministry of Finance has developed norms for the allocation of the 1394 operating budget for five new ministries (one additional to what is required by the benchmark). These include Ministry of Agriculture, Irrigation and Livestock (MAIL), Ministry of Energy and Water (MoEW), Ministry of Higher Education (MoHE), Ministry of Rural Rehabilitation and Development (MRRD), and Ministry of Communications and Information Technology (MCIT). Furthermore, MoF has also refined the norms for the Civil Aviation Authority (CAA), which had initially been developed as part of the 1392 benchmark but were assessed during the 3rd Technical Review in November 2013 to be not well defined. The revised norms for CAA are now better defined. Depending on the availability of administrative data, the new norms for MoEW, MRRD, MCIT, and particularly MAIL, are comprehensive and well defined. However, the norms for MoHE need to be improved further. The Administrator recommends that, going forward, the norms for the MoHE be refined for the 1395 budget. The MoF has submitted to the Administrator the copies of the issued guidelines for the norms-based allocation of the O&M budget, and the summary of the provincial budget distribution. The Administrator reviewed the evidence and – based on the norms of four new ministries as required by the benchmark – recommends the benchmark as achieved.