

Afghanistan Reconstruction Trust Fund: Incentive Program

Supporting a Government-led Reform Agenda: Results from the first two rounds

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Introduction

The ARTF Incentive Program (IP) provides a platform for a coordinated multi-donor dialogue with the government of Afghanistan. The objective of the IP is to support a Government-led reform agenda with a particular emphasis on improved revenue performance and economic governance. The main counterpart for negotiation and implementation of the IP is the Ministry of Finance (MOF) in its role as the main champion of cross-government reforms.

The IP is a part of the broader ARTF Recurrent Cost Window. An important part of the agreement between donors and government in December 2008 was the start of a phased decline of \$25 million annually in the provision of ARTF financing for recurrent costs. Partially off-setting that decline was the initiation of the IP which offers additional resources to Government on the basis of fulfillment of certain measures. 25 percent of the value of the IP is related to quantitative revenue targets and 75% to structural reforms.

Since inception, two reform cycles have been agreed, implemented and reviewed (the second concluded in early January 2010). The IP provided US\$40 million in the first year and US\$60 million in year two. It is set to increase to an available pot of US\$70 million in the next round whose negotiation will be initiated in the first quarter of 2010. At the same time, baseline recurrent cost support decreased from \$276 million to \$250 million and to an expected \$225 million in SY1389. Both Government and donors have been satisfied with this shift from guaranteed recurrent cost support to a performance-based system that recognizes and supports Government's own reform results.

Result Highlights

The first two years – building a platform for the future

The reforms covered by the structural reform component of the IP have been in three areas: Enhancing Domestic Revenue Generation (Theme A); Improving Public Sector Governance (Theme B); and Enabling Private Sector Development (Theme C). The program will continue to focus on these three areas of reform. Going forward, Government and donors will look towards developing benchmarks that support sequential reforms over the medium-term. In that way, the program will build reform momentum around core areas, supporting capacity building and strengthening relationships across different areas of government.

Theme A: Enhancing Domestic Revenue Generation.

Fiscal sustainability is a key policy objective of MOF in order to reduce the Government's heavy reliance on external financing (including that provided by the ARTF). The IP has supported this objective by

including among its benchmarks the introduction of a Business Receipt Tax (BRT) on imports, and the establishment of a more transparent protocol for fuel imports which also provided leverage for similar benchmarks under the IMF Poverty Reduction and Growth Facility (PRGF) program.

In the second year, the IP focused on increased transparency and compliance in the collection of tax and non-tax revenue. This included the signing of a Memorandum of Understanding on revenue collection between MOF and the Ministry of Transport and Civil Aviation, the publication of detailed revenue data by customs stations, and the installation of the automated customs tracking system (ASYCUDA) at the Sher Khan Bandar border crossing with Tajikistan. To support tax compliance, the IP set a benchmark for reducing the number of BRT non-compliant companies by 10 percent. This not only improved revenue collection, but also highlighted the need for better record keeping of company tax information by the Afghanistan Revenue Department.

The government met all of its Domestic Revenue Generation benchmarks in the first two IP rounds despite the fact that the roll-out of the ASYCUDA system to Sher Khan Bandar in Kunduz took place against the backdrop of deteriorating security and the evacuation of international workers from the province. These reforms showed impressive results – with revenue some 60 percent higher in the first half of SY1388 compared to the same period in SY1387.

Theme B: Improving Public Sector Governance

After eight years of its operation, the ARTF still finances around one half of the non-security recurrent costs of the Government. Good public sector governance, therefore, is of central importance to ARTF donors and to the IP. In the last year and a half, IP benchmarks have supported the implementation of the comprehensive Public Administration Reform (PAR) in Afghanistan centered on a Pay and Grading (P&G) reform component. PAR is a critical long-term reform effort of Government to bring in a more merit-based civil service and better public service delivery. Given the long-term nature of reforms in public administration, the IP has encouraged the Government to pursue key milestones for PAR and P&G implementation. For example, the first IP cycle supported the introduction of a teachers' competency testing framework upon which the transfer of teachers from the old to the new P&G scale is conditioned. This framework represents a fundamental shift in focus from simple education delivery (which was essential in the immediate post-Taliban years) to one increasingly focused on educational quality including appropriate incentives for teachers to obtain additional training. The competency tests are currently being administered country-wide.

A second area of reform under this theme relates to Government's anti-corruption efforts. Following the promulgation of the new Anti-Corruption Law in 2008, the High Office of Oversight and Anti-Corruption (HOO) was established to coordinate and lead anti-corruption work. The implementation of an asset declaration program was one of its early tasks and the IP set benchmarks in both its cycles to encourage this. While the HOO, and the legal and regulatory environment for its work, are still at a relatively elementary stage, the IP is being used to help focus HOO on developing an implementation strategy and other time-bound milestones to operationalize and roll-out the asset declaration process. For example, a second cycle IP benchmark stipulated that the majority of current Cabinet Ministers

should complete and submit their asset declaration to HOO. This benchmark was fulfilled with a 72 percent compliance rate among Cabinet Ministers. This initial step establishes an important precedent for other senior officials.

With considerable attention being paid to this area by Government and donors, the IP offers a proven mechanism for strengthening the regulatory framework over the coming years.

Theme C: Enabling Private Sector Development

Providing an enabling environment for private sector development is the third theme of the IP given the private sector's central role in creating employment and broadening the revenue base. IP benchmarks supported, among other measures, the establishment of a one-stop shop for business registration to make it easier for new businesses to open and operate in Afghanistan. It also supported improvements to the regulatory framework for the mining sector since mining is set to become a key growth sector for Afghanistan's economy. The second IP cycle also sought to strengthen Government's efforts to promote greater transparency in mining revenues by focusing on the steps necessary for Afghanistan to reach candidacy status in the Extractive Industries Transparency Initiative (EITI).

This theme also covered reform efforts for the gradual transformation of State Owned Enterprises – particularly the public power utility – into corporate entities. Unreformed public enterprises pose a significant risk to macroeconomic stability and could jeopardize fiscal sustainability in the context of Afghanistan's limited fiscal space.

The Government was successful in fulfilling all benchmarks under this theme. The roll-out of provincial Central Business Registry offices was accelerated. Key mining related laws were gazetted and now provide a reasonable basis for attracting investment to the mining sector and for the sustainable development of mining operations. The Government took all required actions for becoming a candidacy country for the EITI and documentation was forwarded to the EITI Secretariat in Oslo in a timely manner. The former state-owned power utility achieved key milestones for its corporatization process including the preparation of adequate financial statements and board approval of a plan to establish commercial activities and better customer service.

It can be expected that future cycles of the IP will include new benchmarks to build upon these successes.

The Revenue Matching Grant Scheme

In its first cycle, the IP consisted only of structural benchmarks. In the second cycle, these structural benchmarks were enhanced by the introduction of the Revenue Matching Grant Scheme. This program is based around a formula which rewards improved revenue performance by Government as measured against annual revenue targets negotiated between the Ministry of Finance and the International Monetary Fund (IMF) under the PRGF. At the time of writing, the assessment of the Revenue Matching Grant Scheme was outstanding and actual revenue figures will need to be confirmed by the Afghan Treasury after the close of the solar year (March 20, 2010). Nevertheless, all indications are that the

SY1388 revenue target will be reached. If so, the Revenue Matching Grant Scheme would provide up to US\$19 million in incentive funds.

Conclusion

Government's achievements in meeting the ARTF IP benchmarks reflect its commitment to a robust economic governance reform agenda and underline the leading role played by MOF in this regard. These achievements are particularly encouraging given the compressed timeline between benchmark negotiations and reform implementation. Even in a period of rising insecurity and political uncertainty around the Presidential elections, Government has been able to implement very meaningful reform.

These early successes set the stage for continued action. Despite the improved revenue performance over the last year and tightly managed non-security expenditures, the anticipated increase in security spending will complicate, and likely delay, efforts to achieve fiscal sustainability in the medium-term. Future IP benchmarks, therefore, will be needed to focus on reform measures to decrease reliance on external recurrent cost financing.

Donors will continue to look to the ARTF IP to play an important role in coordinating policy dialogue with Government. Looking ahead, the program can help Government by agreeing on realistic timeframes to implement reforms, taking into account uneven capacity across institutions. By working to embed results-oriented benchmarks within a multi-year Government reform program, the IP can support efforts by the authorities to establish a track record of success.