

Annual Donors Meeting Afghanistan Reconstruction Trust Fund

Gulkhana Building (Sederat), Kabul, May 1 2007

Background Note for Discussion

1. Introduction

The ARTF has been in operation for over five years and in the coming year, will have raised over US\$2 billion. In 1385 (2006/07), two more donors joined the ARTF (total 18 in 1385), contributions increased by 12 percent and all pledges were paid in during the same fiscal year for the first time. The ARTF funded around 40 percent of the GoA's operating budget in 1385. This includes supporting the activities of around 200,000 non-uniformed civil servants, mostly outside of Kabul.

The ARTF has successfully mobilized pooled financing for the GoA's operating and core development budgets. This has coordinated and consolidated donor activities. It has also served to strengthen fiduciary controls in national systems and has helped enable the state to function effectively.

Despite the successes achieved critical challenges remain. The Administrator is committed to flexible and responsive management of the trust fund. This background note sets out some ongoing challenges in the fiscal environment in Afghanistan as well as some options for ARTF donors to consider.

2. Operational challenges in the fiscal environment

- **Fiscal sustainability.** While revenue increased in 1385 to more than 6 percent of GDP, this is still among the lowest ratios in the world. Moreover, the ratio of domestic revenue to budgetary operating expenditures did not rise due to increases in the latter. While it is important to continue the progress toward fiscal sustainability that was made in earlier years, Afghanistan will continue to rely on high levels of external financing for some time to come, in particular for the core development budget, as well as for some years for the operating budget.
- **Off-budget external assistance.** The share of external assistance on-budget reached 29 percent in 2005/06, up from 15 percent in 2003/04 and 24 percent in 2004/05. While improved, this means that two thirds of external assistance is still outside of the budget system, reducing GoA ownership and accountability and rendering meaningful coordination quite difficult.
- **Unpredictable financing.** Donors have different fiscal years, and for many of them there are year-to-year fluctuations in the level of funding, as well as in the timing of funding within the year. While progress has been made with ARTF funding, this can result in a significant degree of unpredictability in external assistance, and exacerbates the difficulties faced by the GoA in planning its budget. Moreover, development activities funded in the external budget generate unknown and unfunded future liabilities for the operating budget.

- **Weak GoA capacity.** In fiscal terms this has in the past been weak, but improving (aggregate expenditure of 71% of Budget in 2006/07). The GoA is to present a capacity development strategy to the ADF, which includes building weak financial management capacity, particularly in line Ministries and provinces.

3. Some discussion points

a) Can the ARTF smooth and clarify the transition of externally-financed recurrent costs to the core budget?

The external budget still represents the vast majority of development expenditures in the country. This reflects the constraints on donors to channel their assistance through GoA systems, the overall fragmentation of donor assistance, the (actual or perceived) weakness of GoA systems to absorb significant resources rapidly and an emerging tendency of donors to align resources geographically with their military presence. Assistance to the external budget often contributes to sustaining critical development operations such as the provision of security, healthcare, education and energy that under ‘normal’ circumstances would be financed through the operating budget.

- Beyond the issues these expenditures raise for proper coordination of development assistance, these expenditures also represent future financial liabilities to the operating budget.
- There is no clarity and little predictability on when such expenditures get dropped from donor budgets and will have to be picked up in the GoA’s core budget.
- There is a lack of precise information on the size or sectoral concentrations of the recurrent expenditures in the external budget.

Recent discussions regarding Afghan National Army salaries and fuel costs have highlighted these issues and have sharpened the concerns of the international community regarding the fiscal sustainability of the budget. There needs to be clarity on the equivalent core budget cost of activities in the external budget, how much will need to be transferred to the operating budget, when and for what.

Some possible approaches for ARTF donors to consider:

- Donors supporting activities through the external budget that represent liabilities for the operating budget will ultimately want to exit from supporting these activities while also wanting to ensure their sustainability. Could these donors be persuaded to increase their contributions to ARTF to offset the impact on the operating budget caused by their exit from supporting activities off-budget?
- Donors and GoA could also try and assess the equivalent core budget cost of activities in the external budget. Such assessment would help policy-makers set a limit on what is to transition to the core budget; to see which sectors account for the bulk of the liabilities and to initiate discussions on which activities would transition to the operating budget with concomitant increases in external financing of the operating budget, through the ARTF as described above.

b) Can the ARTF help establish a meaningful link between ANDS sector strategies and the budget?

The ANDS is scheduled to be completed in March 2008, around the time the 1387 budget will be passed. Ideally the ANDS process will have firmed up coherent and prioritized sector strategies

against which annual budget processes will allocate resources. The ARTF represents resources available for the GoA's budget priorities, and would therefore ideally be as closely linked as possible with the ANDS through the budget.

This raises some questions about the investment window and preferencing in the ARTF:

- Donors currently preference investments (\$148m in 1385, compared with \$110m in 1384). Although the GoA considers that preferencing is a distinctly second-best practice in the first place, as the GoA gains clarity on its own priorities (through the ANDS) the justification for donors to preference resources is further reduced. However, where preferences fit within the GoA's priorities and can be a catalyst for more assistance to the ARTF, the Administrator (on behalf of the GoA) is likely to continue to accept such preferences.
- If GoA can more clearly articulate programs for which there is a funding gap and engage donors early in matching preferences to financing gaps, a more efficient deployment of resources can be achieved.

c) How can the ARTF adapt itself to better integrate with the budgetary cycle?

There are three aspects to better integration:

1. As it prepares its budget (October/November), the GoA wants to hear from the MC what the ARTF financing envelope will look like. For this to be feasible, donors will have to communicate a sense of their likely contributions early in the fiscal year. To do this, donors may need more information on the amounts required for investment programs / projects. The GoA should take an active role in coordinating these resources, articulating needs early in the year and requesting funds for the programs soon after budget approval.
2. As already mentioned, donors could base contributions to the investment window on the GoA's budget submissions once the budget is agreed. However, for this to be feasible, the development budget would need to become more credible and more prioritized.
3. Finally, the GoA's Medium Term Fiscal Framework (MTFF) should continue to reflect the medium-term reality as much as possible. As it currently stands in the MTFF, disbursements from the ARTF are expected to remain at around US\$390 million per annum (US\$270 million from the recurrent window and US\$120 million from the investment window). The MTFF enables the GoA to plan for expenditure increases (currently driven by teacher hires, pay & grade reforms, ANA troop levels as well as the externally-funded activities already mentioned in point a above). Therefore continuing close integration of the MTFF and the ARTF is an important component of budget planning as well as ensuring its fiscal sustainability.

Two questions:

- How much predictability is actually possible for ARTF donors? What can the Administrator do to assist?
- While the ARTF is therefore already incorporated in the GoA's medium term framework it may make sense to schedule one of the meetings of the ARTF donors around the time when the GoA updates the MTFF.

d) More predictable transfers to support a better budget process.

Proper facilitation of the GoA's budget process also calls for a different approach to ARTF cash management and disbursement. Currently ARTF disbursements are lumpy and necessitate a conservative approach to making ARTF investment allocations which ties up ARTF funds to avoid cash shortfalls. While financing of the ARTF recurrent window is already on a reimbursement basis, it would make sense for ARTF funding of large national programs (e.g. NSP) to be through relatively smooth program support rather than in discrete large lumps, and preferably early in the year after budget approval.

A possible model to improve cash planning would be to divide the \$270 million of recurrent budget support into a number of equal tranche disbursements, eg monthly. Actual expenditures would continue to be monitored and reported on, however, the MC and the MoF could agree upon a schedule of transfers early in the year. Such early planning would provide predictability and facilitate GoA's making other domestic resources readily available. A further benefit of an agreed installment plan would be that it reduces the need for such a large 'cushion' from a cash planning perspective. However, the cushion could be maintained as a contingency for emergency security / political events.

- This requires more predictability for mobilizing resources from donors.

e) How can the ARTF increase the results-orientation of the GoA budget?

Results orientation is a priority for all donor activities and not just in the ARTF. However, given the pooled structure of ARTF finances, attribution of results is not straightforward and therefore it can be more difficult to judge the effectiveness of the inputs. This raises challenges for donors domestically as well as making resource allocation for GoA itself more difficult. Through the PAM, ARTF donors will be supporting greater transparency in the performance and allocation of resources.

The program budgeting initiative being piloted in three ministries offers a promising approach for aligning resources programmatically within a whole sector and for monitoring the effectiveness of a sectoral package of resources (as opposed to project-level). These efforts can eventually form the basis of a better monitoring system of line ministry performance. They are thus critical for a more accountable cabinet.

It is noteworthy that the program budgeting pilots in education and healthcare pick up a very detailed set of indicators, more detailed than those in the PAM.

- How can the 1387 budget forge a stronger link between the ANDS and the budget and to what extent should the ARTF support a roll out of this approach to more sectors?

f) Are fiduciary controls adequate?

It has been noted that corruption is perceived to be on the rise in Afghanistan. Increasing vulnerability to corruption will put greater pressure on bilateral donors to reassure domestic taxpayers that their resources, and particularly resources made available through national systems, are being used for their intended purposes and with appropriate fiduciary controls.

Are fiduciary controls adequate? Should the ARTF invest in more fiduciary controls itself?

See annex overleaf for full discussion.

Annex:

Fiduciary Framework Summary Note

Background

From the outset of re-engaging in Afghanistan, it was obvious that the operating environment presented high risks, including risks related to the management of public funds. From the earliest days of re-engagement in Afghanistan the World Bank was aware of the need to take extraordinary measures to ensure adequate fiduciary controls were put in place.

Country Level

The Bank supports, strengthens and uses Government systems to disburse ARTF funds, as well as its own, in Afghanistan. Fiduciary arrangements for prudent stewardship of ARTF and Bank funds are anchored in several inter-related components financed by the Bank. Fiscal agents in the area of financial management, treasury, procurement and audit strengthen and monitor fiduciary aspects of Government systems, support the public financial management and provide the control framework for funds disbursed for investment and recurrent cost financing. These mutually reinforcing programs strengthen fiduciary measures and enhance transparency and accountability of Bank and Donor funds.

Besides diagnostic work on systems and financing improvements, the Bank also produces a variety of analytical and advisory reports. Reviews of Public Financial Management and Civil Service/Governance guide efforts in broadening reforms in these areas. Ongoing studies in Anti-corruption and Service Delivery and Accountability will be concluded in 2007.

Project Level

Investment projects

ARTF investment projects are subject to the same fiduciary arrangements as all Bank-financed projects in Afghanistan. At the project level, prior to commencing implementation of activities, the Bank requires that each project maintain a financial management system capable of accurately reporting on use of funds, linking funds flow to project activities and providing timely and reliable financial reporting. These systems (encompassing budgeting, accounting, internal control, funds flow, financial reporting, and auditing arrangements) are assessed for each new project and must be satisfactory prior to disbursing. A comprehensive fiduciary risk assessment is likewise conducted for each new investment. Where satisfactory financial management capacity does not exist, the Bank requires implementation of needed improvements, as a condition of disbursement for new operations.

During implementation, through ongoing supervision, the Bank ensures that the systems are maintained and continue to produce reliable information. Financial management and procurement missions are scheduled as part of normal, ongoing project supervision during which quarterly interim unaudited financial reports, annual audited financial statements and auditors' management letters, and financial management and disbursement arrangements are all reviewed to ensure compliance with Bank's minimum requirements. At the same time, agency performance in managing project funds is reviewed to ensure that it is timely, accurate, and accountable. Risk ratings are updated as necessary and review of compliance with financial and legal covenants is assessed. The Auditor General conducts the annual financial statement audits of all the ARTF funds to international auditing standards with the support of an international firm of public accountants. Audit findings are reviewed in detail and action plans established where the need for remedial improvements is detected. Improvement of system gaps is a condition of

continued disbursement. Where audits reveal non-project-related expenditures, the Government must make full and prompt refund. Government has a prompt record for doing so to date.

Expenditure scrutiny occurs in parallel with the attention on and improvement of systems. Large-value expenditures are subjected to detailed examination by Bank staff accountants prior to payment. Smaller-value expenditures are normally honored based on a statement listing such expenditures which is then subject to post-review, spot checking and periodic audit by Bank fiduciary staff.

At project closure, “lessons learned” are captured and provide feedback for new investments.

Recurrent Cost Financing

For the recurrent cost window, we have the extra control of having the Monitoring Agent, funded by the ARTF, who takes a risk-based approach in reviewing expenditures (desk reviews and site visits) and determines the pool of eligible expenditures for each monthly transfer. A written attestation, signed by the Monitoring Agent, accompanies each request for reimbursement of recurrent expenditures. This attestation provides the basis for Bank disbursement of funds back into the Government financial system. The Monitoring Agent’s work product is supervised by the Bank.

Additionally, all government expenditures are subject to review by the Auditor General. Any ineligible expenditures identified by the Monitoring Agent or during the annual audit of the recurrent cost component are deducted from future eligible expenditures submitted to the Bank for reimbursement.

The Bank’s Kabul office has at present 3 procurement experts; 6 full-time fiduciary specialists and staff.

The above control framework is working satisfactorily on the ARTF-financed portfolio of investment projects and on the recurrent cost window.

Overall Management of Donor Funds

For the ARTF at the fund level, there are 4 quarterly financial reports going to Donors each year. In these reports, information regarding budget execution and the gradual improvements in fiduciary controls is discussed. Information on the monitoring of rates of ineligible expenditures is also presented with trend analysis.

A monthly financial report is reviewed and approved by the Management Committee and provided to Government and Donors.

An annual ‘single audit’ done by the Bank’s auditors on our overall administration and management of Donor funds is conducted and the results of which are communicated to ARTF Donors and posted on the ARTF website.