

**ISLAMIC REPUBLIC OF AFGHANISTAN  
MINISTRY OF URBAN DEVELOPMENT AND HOUSING**

**INDEPENDENT DIRECTORATE OF LOCAL GOVERNANCE  
AFGHANISTAN URBAN DEVELOPMENT SUPPORT PROJECT  
(UDSP)**

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**FINAL INCEPTION REPORT**

Submitted to:

H.E. Abdul Baqi Popal  
Deputy Minister of Municipalities  
Independent Directorate of Local Governance (IDLG)

Submitted by:

Hernando Garzón, Ph. D.  
Senior International Municipal Finance Advisor  
Urban Development Support Project UDSP-CIP/World Bank

Kabul Afghanistan  
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## **OUTLINE**

- A. Background**
- B. Main Objectives**
- C Rationale**
- D. Scope of Work**
  - 1. Municipal Financial Assessment & Performance Indicators Design
  - 2. Support for Policy Formulation
  - 3. Capacity Building & Training
- E. Deliverables**
  - 1. Municipal Financial Assessment Report
  - 2. Municipal Financial Improvement Action Plan.
  - 3. Training and Training Materials for Institutional capacity building
  - 4. Municipal Finance Policies and Regulatory Tools.
  - 5. Municipal Fund Concept Note
  - 6. Quarterly Reports on Work Program Progress
- F. Summary of Lessons Learned on MF from Previous Studies**
- G. Challenges and Opportunities for Local Development**
- H. First Set of Performance Indicators to be analyzed**
- I. Methodology, Data Sources, Approach, Policies and Plan of Action**
- J. Project Mobilization of Team Members and Municipal Counterparts**
- K. Summary of IDLG/ DMM Current Priorities in Municipal Finance**
- L. Timeline of Proposed Work Plan**

## **ANNEXES**

- Annex A** Lessons Learned from Municipal Development Funds
- Annex B** List of Key Inputs to Be Prepared to Support Main Activities
- Bibliography**

# INCEPTION REPORT

## A. Background

As per TOR, the UDSP (financed through a World Bank grant to the IRoA) will provide technical assistance, capacity building and systems development at both the Ministry of Urban Development and Housing (MUDH) and in five participating municipalities under the leadership of the Deputy Minister of Municipalities of the Independent Directorate of Local Governance (DMM - IDLG). The five participating UDSP municipalities (under the guidance and oversight of DMM-IDLG) are Khost, Mazar, Herat, Kandahar and Jalal-Abad.

The program will promote effective transversal urban management in the context of rapid urbanization (about 4.7% per annum) and increasing poverty, and will finance the development of an Urban Management Information System (UMIS). Urban policies will include regeneration, planning and land management, housing and municipal finance policies, and spatial planning and feasibility studies at the city level to facilitate catalytic investments. These will be aimed at promoting local economic development and improved municipal service delivery. The UDSP was launched at a four-day technical workshop in Istanbul from August 13 through 17, 2017.

The fairly comprehensive effort of this assignment benefits from and builds upon the existing knowledge regarding Municipal Finance in Afghanistan. Previous studies on municipal finance include the contributions of Goga, S. (2006) "Municipalities in Afghanistan: A Brief Review of their Framework for Operations", De\_Zeeuw, M. (2011). *Proposal to Reform Afghanistan's Urban Services Charges Law 2000*. Garzón, H. (2014). *Municipal Finance in the Largest Cities of Afghanistan*, Malek, AA, Garzón, H. and Zhu, D (2015). *Afghanistan: Governance, Municipal Finance, and Revenue Options for Better Services*, Garzón, H. (2017). *Review of Legal Framework and Actual Practice for Property Related Taxes*, and World Bank (2017) *Urban Strategy for Afghanistan*. Other relevant literature that will also be taken into account is listed in the bibliography of this report.

## B. Main Objectives

This assignment attempts to gain a greater understanding regarding how municipal finance is managed in five of the largest cities, and to analyze their performance over the last five fiscal years. The main objective of the above analysis is to identify the main issues, specific constraints and the associated challenges. Subsequently, and based on strong empirical evidence, the next objective is to determine policy actions that could enhance both financial management and fiscal performance. As part of this main objective, other specific activities will cover the identification of key MF training needs, that will be addressed in order to further develop municipal institutional capacities in financial management and fiscal performance. The implementation of the adopted MF policies will be supported by the selection of specific fiscal performance indicators and

the establishment of a system of incentives to improve municipal services provision and increase local public investment in urban infrastructure.

### **C. Rationale**

At the current annual urban growth rate of 4.7% (substantially higher than the country's population growth rate of 2.4%), it has been estimated that the urban population in Afghanistan will double in the next 15 years. Currently about 25% percent of the country's population lives in urban areas, and larger cities are experiencing fairly high rural-urban migration. As such, Afghan cities are facing the enormous challenge of meeting a rapidly growing demand for additional municipal services. Consequently, it has become critical to rapidly enhance performance of municipal revenue collection as well to substantially improve the execution of O&M of municipal services, together with making larger investments in public urban infrastructure. Therefore, it is important to start applying performance indicators, developing a system of performance incentives, and establishing benchmarks. Current municipal finance practice in Afghanistan, including the largest cities, does not systematically measure performance in revenue collection and expenditure management and there is no system of incentives. Given the above, there is a critical need to introduce a system of performance indicators and rewards in municipal/city financial management.

### **D. Scope of Work**

As per TOR, the overall assignment includes, among other activities, the following tasks:

#### **I. Municipal Financial System Assessment & Design of Performance Indicators**

1. Building on work carried out previously, lead the process of the municipal financial system assessment in five municipalities in cooperation with municipal finance analysts based in provinces. This work includes assessment of budget, expenditure, and revenue management, CG fiscal transfers (if any) and/or other external transfers of funds, asset management systems and internal audit/control systems. The assessment will include a review of options for an Integrated Financial Management System (IFMS) in the municipalities.
2. Contributing to the gap analysis regarding municipal financial performance covering all budgets, including current and capital expenditures, expenditures in services (O&M), and capital expenditures in urban infrastructure, as well as revenue and asset performance areas.
3. Conducting an assessment of the municipal finance policy environment including systems, procedures, relevant municipal finance laws and regulations, policies, processes, guidelines, and human capacity. The current procurement process for local public investments will be included in this assessment.
4. Setting a baseline for existing municipal financial performance and establishing benchmark performance improvement indicators based on relevant good international practice and in consistency with both, the results of the

comprehensive MF assessment to be conducted, as well as the legal assessment results – to be determined, as illustrated in numeral 3 above.

5. Based on the analysis and performance improvements above, designing a performance-based system for annual municipal grants that will complement other fiscal transfers (in kind or in cash). Indicators will be clear, measurable, reasonable and appropriate for Afghanistan.
6. Preparing an initial concept note for a Municipal Fund in Afghanistan in which the following will be detailed: (i) rationale/justification; (ii) source funding for an annual distribution pool; (iii) allocation formula and allotments based on reasonable assumptions about the total annual pool and distribution amount; (iv) eligibility criteria; and, (v) reporting and monitoring tools geared toward enabling the MF to serve as an effective policy instrument to promote performance improvements over time. The above steps refer to essential practical elements that need to be in place to make the MF operational. This task constitutes deliverable 5 of the TOR, and its vital activities are illustrated in numeral (V) of the Work-Plan (in Section L of this Report).
7. Evaluating national and international good practices for municipal financial management systems and contributing to benchmarking indicators for municipal finance performance for the five participating municipalities.
8. Contributing to the development of an action plan to address the gaps in municipal financial management, including but not limited to budget management, operating expenditure management, capital investment planning, revenue management, assets management and internal audit/control mechanisms, and making recommendation on improving IFMS in municipalities.
9. Providing hands-on training and advisory services on-demand by developing short, structured training sessions with training materials on topics to be discussed, agreed upon, and reflected in the Quarterly Work Program, including development of an action plan for capacity building of key personnel in target municipalities.
10. Contributing to the data collection process and development of the Urban Management Information System (UMIS) with the cooperation of municipal finance analysts, DMM-IDLG, and the municipalities.
11. Contributing to the UDSP operations in the areas of UMIS, strategic development planning/capital investment planning, and feasibility study and design, as appropriate.

## **II. Support for Policy Formulation**

12. Reviewing and preparing a report recommending improvements to policy, legal and regulatory areas of municipal finance.
13. Contributing to the development of tools, systems, manuals, guidelines, procedures, and policies to improve the financial performance of the municipalities. Also, supporting and supervising the pilot testing, and

mainstreaming/institutionalizing of the newly developed tools, processes and policies.

14. Continuous monitoring and evaluating policy and regulatory measures and making recommendations to improve municipalities' performance.

### **III. Capacity Building & Training**

15. Building the capacity of municipal finance personnel to analyze budgets and forecast budgetary operating expenditures (O&M), as well as capital/development expenditures and their corresponding revenues; and overseeing effective execution of the operating and development budgets.
16. Building the capacity of municipal finance civil personnel in expenditure management, including payroll management, procurement activities, and other operating-expenditures, as well as for municipal investment or development budgets.
17. Building the capacity of municipalities' audit/financial control sections to ensure transparency in their operations.
18. Building the capacity of municipal finance civil servants in revenue management and collection efficiency of existing as well as new sources of revenue, and improving their accounting and financial record management and tracking capacities.
19. Building the capacity of municipalities to manage and maintain their assets (including, among other things, lands, buildings and other municipal properties, public infrastructure, and inventories).
20. Developing a system to measure municipality financial performance based on MOF criteria and other standards, as well as on good international practices.
21. Ensuring the translation and dissemination of the documents, policy notes, guidelines, processes and other documents developed under UDSP in local languages.
22. Performing any other tasks assigned by DMM-IDLG.

### **E. Deliverables**

The main reports (other than this Inception Report) that will be delivered within the next five months are described below along with the proposed activities associated with each topic. The sequencing of such activities is illustrated in the Work Plan, which is included in Section L of this report.

1. **Municipal Financial Assessment Report.** Lead and prepare a comprehensive assessment of municipal finance in the five participating UDSP provincial capital cities over the last five years. The report will build upon prior work, analyzing gaps and preparing a gap analysis section, which will include, among other topics, the municipal finance legal/regulatory framework, service responsibilities, capital investment planning, and a review of the current IFMIS situation along with options going forward.

2. **Municipal Financial Improvement Action Plan.** A multiyear action plan will be developed including a specified timeline to strengthen municipal finance systems in the participating municipalities.
3. **Training Materials.** These will be prepared, and structured training seminars and workshops will be delivered in agreement with the client. The capacity of municipalities will be increased in the areas of budget, revenue, expenditure, asset management, internal control, and audit. A proposed list of the main training topics may be consulted in the timeline of the Work Plan.
4. **Municipal Finance Policies and Regulatory Tools.** Policy and regulatory tools will be developed in the form of "Notes" required for improving financial management performance in the five provincial capital cities with proposed strategies for rollout to other municipalities. The outline of report IV and the sequencing of its activities may be seen in the draft of the Work Plan.
5. **Municipal Fund Concept Note.** A preliminary concept note report will be prepared for a Municipal Fund with specific and robust performance indicators (including tentative thresholds) and the preliminary rationale and design. This Inception Report already offers a summary of lessons learned from international practices on the operations of Municipal Development Funds. This summary is a first step in the preparation of this Concept Note, and may be found in Annex A of this Report.
6. **Quarterly Work Program and Progress Report Documents.** A first version of the two quarterly work programs have already been developed and may be found in Section L of this report. The respective quarterly progress reports will be delivered at the times specified in the proposed current Work Plan that covers the six months period.

## **F. Summary of Lessons Learned from Previous Studies**

### **On the revenue side**

The situation has been characterized by *low revenue mobilization*, primarily due to lack of effective oversight, fairly weak accountability, manual systems and processes, corruption, and no incentives for performance in revenue collection. For example, in 1390 (2011) the per capita revenue collection in Kabul Municipality was about US\$12.32, in contrast to US\$37.60 in Herat (3 times greater), while the per capita average revenue collection for the cities studied at that time was US\$18.56.

### **On the expenditure side**

Previous empirical results have indicated *overspending in O&M*, particularly due to: limited transparency in the operating executed budget and significant weakness in the expenditure control function. This situation is generally compounded by little or no accountability, corruption, a *soft-budgetary constraint* (in actual practice) in O&M (posing a *moral hazard* for good financial management), lack of implicit institutional

incentives to reduce operating costs, and no rewards to encourage expenditure efficiency.

### **On the investment side**

*Low investment execution* seems to be due primarily to the following factors: uncertainty regarding the capital budget, a relatively long procurement process, limited investment autonomy, corruption, no medium-term CIP, weak accountability, and limited participation of the main stakeholders. However, this situation characterizes Kabul Municipality, and there are no published studies that document the actual situation in the five selected cities, which makes it imperative to assess their current state of affairs regarding this important function.

This assignment will produce the first comprehensive study to examine the investment side and associated issues in the five selected cities. The figures that indicate that other large cities invest a relatively larger proportion of their budgets (on average 65.58%), in contrast to the low figure in Kabul (33.95%) are fairly old (corresponding to 1390/2011), and refer to only one fiscal year. Therefore, the current situation regarding investment patterns and associated issues in the five large cities merits careful examination.

### **On financial/budget reporting**

The current state of financial reporting in Kabul Municipality may be characterized as a case of *little or no transparency in financial performance* due to, among other factors, reluctance to report, corruption, inadequate budget reporting formats (including those that cover revenues, operating expenditures, and execution of the development budget), and weak or no accountability. It is anticipated, based on initial empirical evidence, that similar factors affect the five selected cities as well. However, some of these factors need to be either confirmed or rejected based on broader empirical evidence, which is part of the objectives of this assignment.

## **G. Challenges and Opportunities for Local Development**

Assuming Kabul Municipality (KM) is representative of what happens in other large Afghan cities, potential and tentative policy recommendations to improve performance in investments (through the Municipal Development Budgets) should consider, among other things, the options listed in this section.

These preliminary policy recommendations will be directly examined in the five selected cities, as part of the objectives of this assignment. Empirical evidence from each city will be examined in order to determine whether or not all the recommendations below would be also suitable for the selected five large cities. In addition, it will determine which other policy options should also be considered to achieve the development objectives. The preliminary policy recommendations are as follows:

1. Make the municipal development budgets and Capital Investment Plans (if any) accessible to city residents (taxpayers). **Transparency** brings accountability.



2. Specify the taxes and any other revenue sources that are financing the capital budget and the multiyear Capital Investment Plan (CIP). **Certainty** on the availability of specific financial sources contributes to performance in investment planning.
3. Make public the **amounts of financial funds for specific projects** in the investment plan. City residents (taxpayers) generally are more willing to pay their taxes when they know what their money is financing – i.e., the specific public works in urban infrastructure and municipal services.
4. Perform participatory budgeting in specific cases, **letting residents (taxpayers) decide** their priorities among the public works they need and want, subject to a clear list of alternatives projects to be built over time. Clearly, this option would enhance accountability and willingness to comply with payment of the corresponding taxes.
5. **Do not use the capital budget as an emergency fund** for the ordinary budget. This compromises the performance in both the development and the ordinary budgets and creates a soft budgetary constraint in the ordinary budget, which may turn into a perverse incentive to performance in budgetary execution, and ultimately may become a moral hazard in terms of wasteful spending.
6. **Separate management of the capital budget (CB)** and the CIP from the management of the ordinary budget. This should enhance performance in investments in urban infrastructure and other municipal services, reducing gaps in access to basic public goods. In addition, it would enhance accountability in performance in the development budget and the multiyear CIP (if any).
7. **Allocate operational fiscal surpluses to the CB and the CIP**, considering that the main objective of a local government is to ensure the provision of local public goods and public services. Surpluses in operations and the CB should be allocated to priority investments to close gaps in access to such services.
8. **Ensure consultation and ownership in decision-making.** Include main stakeholders in key processes of the budget cycle. Clearly, decision-making regarding both the operating and development budgets affects stakeholders either at the planning or execution phase. **Better outcomes and more efficient and equitable allocations usually occur when affected parties can provide their input.** This seems even more important to consider when in practice there is no systematic or formal role for elected city council members to overview, debate, and approve yearly city budgets.
9. Report on **performance in execution** of the operating and capital budgets with respect to the planned and approved budgets at the beginning of the fiscal year. Without transparency in performance, there may be insufficient or no accountability.

10. **Reward performance in per capita expenditures in development.** Potential future transfers (independent of the source of funding) could in principle play this role.

#### H. **First Set of Performance Indicators to be analyzed**

A first set of indicators that would be considered regarding financial management performance include the following:

1. **Per capita revenue collection and per capita Investments.** Fiscal figures in per capita terms will allow for a direct comparison of performance across different large cities in Afghanistan, because the current legal framework regarding revenue sources and investment responsibilities is the same for all cities. Therefore, from this legal perspective, and in terms of their population range, comparisons might be considered appropriate.

However, these comparisons would also assume that differences in per capita personal income as well as in income distribution may be fairly marginal and, if so, such inter-city comparisons would still reveal differences that may be primarily attributed to differences in actual performance.

By contrast, international comparisons may not be quite straightforward, because of possible differences in types of revenue sources, functions in expenditure responsibilities, level of income, and socio-political differences in context, or other factors.

2. **Efficiency in revenue collection.** This indicator is defined as the yearly ratio between revenue collected (RC) and planned or approved revenue (PR), for each of the revenue sources in each city  $[(RC/PR)*100]$ . This indicator measures revenue collection performance, which may be primarily determined by two main factors: the quality of the revenue projections for each revenue source and the actual revenue collected, and a combination of these two main elements. Comparison and analysis across fiscal years may suggest which factors are the main determinants of the empirical results.
3. **Efficiency in expenditure execution.** This is calculated as the yearly ratio between executed expenditures (EE) and planned expenditures (PE) for each of the main expenditure categories of the operating budget  $[(EE/PE)*100]$ . Similar to the above revenue indicator, there are two main factors that may explain the empirical results in performance: actual expenditure execution effort, and the quality of expenditure projections. Which of these two main factors has affected performance will be determined by analysis of these figures over time for each city
4. **Efficiency of yearly investments in projects.** This will be estimated by the annual ratio between executed investments (EI), and planned investments (PI) for each of the yearly investment project categories in the development budget

$[(EI/PI)*100]$ . As already noted, the results of this indicator may be due to the actual effort made in execution of investments, or to the quality of the estimates of the investment cost of the respective projects, among several other possible factors that could be involved in determining performance in investment execution.

- 5. Surplus or deficit in ordinary and capital budgets.** This is defined as the difference between the yearly approved operating revenue (AOR) budget (i.e., expenditure ceilings for operations) minus the yearly-executed operating expenditures (EOE). The equivalent definition will be applied to the capital budget; that is, the annual approved allocation for the capital budget (ACR) minus the executed capital expenditures (ECE). The surplus or deficit in the ordinary and capital budgets will then be calculated as a percentage of the approved appropriations for each of these two budgets. These indicators will not only measure performance in execution of recurrent operations and investments plans, but may also indicate how the deficits are financed, and what is being done with any surpluses. These are implicit incentives, or disincentives, to fiscal performance that would need to be addressed by the appropriate policy options.
- 6. Overall surplus or deficit in the annual total budget.** This indicator will be computed as the percentage of the absolute amount of the surplus or deficit with respect to the total budgetary allocations for the ordinary and development budgets. This performance indicator may also show how a possible overall deficit is financed, as well as the opportunity cost of potential idle fiscal balances.
- 7. Expenditures in general administration and in public services.** These indicators would in principle calculate the percentages of the operating yearly budget spent in “general administration” and in operation and maintenance (O&M) of “municipal services,” respectively.

It is important to note that in good practice of financial management and budget reporting, the above information is considered standard. However, it is expected that these budgetary concepts might not be readily available (transparent) in the selected five cities. This is anticipated because it is the current situation in Kabul Municipality, where this type of budgetary data is not planned or reported. KM generally limits its financial reporting only to what is required by MoF standards. Regarding this issue, some MoF budget officials have indicated in the past that municipalities are free to expand their internal financial reporting system (i.e., their accounting and budget forms and procedures) to serve their own needs.

It was further elaborated that expansions to the current reporting system would be justifiable considering that municipalities have their own revenue sources, are financially self-reliant, have their own functions, and their own municipal reporting needs beyond what the MoF reporting system requires. However, any expansion in accounting and budget reporting would, of course, need to meet internationally recognized standards.

Finally, it is important to highlight that it is part of the objectives of this assignment to determine, based on empirical evidence (taken directly for each of the five cities), whether or not these two indicators are quantifiable (i.e., applicable) in these cities.

- 8. Cost efficiency of municipal administration.** The objective here is to try to measure the financial performance of each of the five municipal administrations, not only in terms of the services they maintain and operate, or the yearly investments they make in new services, but also in terms of how much they spend in *general administration*. This performance indicator will be calculated as the per capita expenditure in general administration of each of these cities. However, as noted above, this assumes that the cost of general administration is known, or can be quantifiable with the existing information.
- 9. Number of employees per capita.** In the event of potentially limited information regarding “general administration” costs, an alternative would be to adopt an easily quantifiable indicator that can also be a good proxy to the most accurate indicator. Employees per capita or workers per capita would be potential alternatives.

Other sets of performance indicators will be identified, and their merits discussed, during the execution of this assignment. Last, the overall technical readiness, together with the political will of the municipal mayor and the Finance and Administration Directors to embark on the CIP project will be imperative.

## **I. Methodology, Data Sources, Approach, Policies and Plan of Action**

In order to accomplish the different objectives of the scope of work described above, this assignment, as part of its methodological approach, distinguishes between the different types of information and data needed. Briefly, the different tasks require quantitative data, and qualitative information, which will be collected through questionnaires and will be analyzed through percentages, and legal and regulatory norms and procedures.

The above typology is comprised of: (i) municipal fiscal budgetary data; (ii) demographic statistics (mainly urban population data); (iii) numerous questionnaires (listed in Annex B and in the Work-Plan); and, (iv) legal and regulatory norms and procedures related primarily to revenue sources, expenditure responsibilities and financial management covering key financial functions. A distinction will be made between what is mandated, what illustrates actual practice, and what would be desirable for better financial performance.

**Data Sources:** Specifically, the above types of information refer to and cover the following subjects:

- i. Municipal fiscal **budgetary data** collection refers to the period from 1390 (2011) through 1396 (2017). These data will cover: (a) all revenues and all expenditures (current and capital) as reported in the ordinary and development budget formats; (b) yearly *planned* and *executed* figures for each of the reported budgetary entries for each of the above years; and, (c) the total amounts reported in the revenue and expenditure budgets, including the balance in the ordinary and capital budgets at the end of the each FY (if any).

**On September 13th the office of Revenue Accounting of the DMM/IDLG made available the budgetary data for the five cities for the last 5 fiscal years. This data is in Dari, and it is being translated into English. In parallel the formats of the tables to do MF analysis are being prepared. The above budgetary data is readily available to the five MF analysts and the Senior MF specialist, once they are hired. Also, the MF analysis will proceed as soon as the information is available in English.**

- ii. The **legal framework** information refers to: (a) the municipal law currently in force, and all legal reforms made and proposed to this law; (b) the city services and charges law, and any recent and/or proposed reforms; (c) the Safayi Charge Law and its regulations; (d) the public finance and expenditure management law (PFEM), including any reforms or proposed changes; (e) the procurement law, taking into account any recent or proposed reforms; and, (f) the civil service law together with any recent or recommended changes.

**I have collected most of the above legal and regulatory information. I have listed the most relevant pieces of legislation and regulations at the end of this inception report, in the bibliography section. I will expand this list, if necessary, at the relevant time. This information is readily available to the national team.**

- iii. Qualitative information on current practice regarding key **financial management functions** will be acquired through the application of specific **questionnaires** related to each of the relevant functions, such as each of the steps of the annual budget cycle, investment decision-making, and procurement. These questionnaires will be filled out primarily by the directors of the main departments directly linked to financial management, in each of the five selected municipalities.
- iv. **Population figures** for the five cities will be collected from the United Nations Population Fund (UNFPA), and from the most recent publication of the Central Statistics Office (CSO).
- v. Other quantifiable information may include current access (and gaps) in the provision of basic **municipal services**, which could represent a possible *baseline* for this topic.

**Analytical Approach:** The analysis of what is desirable in financial management would refer to fundamental principles of good municipal finance and good governance, as well as good and best international practices in financial management, and their associated performance.

No less important will be information that can only emerge from a careful and detailed analysis to identify **issues** in financial management. This analysis will be complemented by the identification of the corresponding **policy implications** of each existing situation. The next step in this logical process will be structuring the associated **plan of action** to implement the corresponding policies in each of the five selected cities.

Other key element of the analysis will determine the fiscal balance in the city budgets at the end of each fiscal year, covering a five-year period. The empirical result will be an indicator of the cities' ability to **plan** and/or **execute** their **revenues** and **expenditures**, in both their **current** and their **capital** budgets. Significant **negative fiscal imbalance** (deficits) could indicate poor projections (in revenues or expenditures), unforeseen **exogenous factors**, **corruption**, weak **managerial capacity**, or inadequate budgetary norms and procedures, among other possibilities.

From another perspective, **moderate surpluses** could be an indicator of prudent financial management, efforts to generate operating savings (surpluses) to support future growth in local investments and/or rigorous fiscal discipline (due to an overall hard budgetary constraint). In practice, a combination of different factors would most likely be an explanation of the final results. However, the challenge here will be to identify the main drivers of the empirical findings.

**Policies and plan of action:** Once the issues are clearly identified and analyzed, it will then be possible to move into the identification of policy implications, and the different types of policies that could effectively address and resolve these issues. Specific policy options and recommendations will be put forward for managers and policy-makers to consider, enabling them to make careful and informed decisions. The policy options analysis will identify current opportunities, their associated constraints, and alternatives to overcome obstacles. The challenges that would need to be faced will be put forward, together with the associated strategies to overcome them. Furthermore, a set of **tasks and activities** would need to be followed, as part of an **action plan**. This plan would have a sequence over a given timeline in order to effectively implement the tasks and activities.

Last, but not least important, the above plan of action will include different options for indicators to reward performance in financial management and to monitor performance in their implementation in each of the five cities. The Work Plan (Section L) illustrates the different activities of the Plan of Action and when they will be executed.

## **J. Project Mobilization of Team Members and Municipal Counterparts**

The shortlisting for Municipal Finance international advisors began in June 2017. H.E. Abdul Baqi Popal, Deputy Minister of Municipalities, at the Independent Directorate of Local Governance (IDLG), interviewed me on the 5th of July. Dr. Abdul Sami Abduraheemzay, Director of UDSP at MUDH, communicated my selection to the World Bank team on July 6th. Subsequently, on July 10<sup>th</sup>, H.E. Hamid Jalil, Deputy Minister of Urban Development and Housing (MUDH) contacted me to start negotiations of the contract terms and conditions in coordination with Dr. Sami. Contract negotiations and interactions extended over the rest of July. H.E. Sadat Naderi, Minister of Urban Development and Housing signed my contract on August 16 at the Technical Workshop in Istanbul. As per invitation of Dr. Sami, Director of UDSP at MUDH, I attended this workshop and presented a PowerPoint on the “Main Challenges and Opportunities for Municipal Finance in Afghanistan”.

The preparation of this Inception Report began on August 19, which was the first working day of this contract. After my arrival in Kabul on Sept 1<sup>st</sup>, I met on Monday September 4<sup>th</sup> (after the Eid holiday) with H.E. Abdul Baqi Popal, Deputy Minister of Municipalities, and Eng. Sayed Moharam "Sadat", Technical Director of IDLG for our first coordination meeting. Subsequently, I met with Mr. Masoud Doust, Director of HR at IDLG, to determine the status and current needs for the procurement of the national support team. After this meeting I met with Dr. Abdul Sami Abduraheemzay, Director of UDSP at MUDH. As a result of this team effort, the recruitment of five financial analysts and one senior MF specialist were quickly expedited by MUDAH and IDLG/DMM. Based on the identified needs I prepared and submitted the questions for both the exams and the interviews.

**The exam was announced and took place on Sept. 11<sup>th</sup>, quickly followed by interviews conducted by the panel members during this same day. The pending steps for the recruitment of the five finance analysts and the senior specialist include: negotiations of contractual terms and conditions, NOL from the World Bank, and contracts signature. Every effort is being made to ensure that negotiations and signature of the contracts of the six team-members is hopefully finalized by the end of next week, September 20<sup>th</sup>.**

I am very grateful for the direct and effective assistance currently being provided to me by Mr. Parwaiz Qarizada, Municipal Finance Adviser at DMM/IDLG, and Mr. Ahmad Farid Azizi, head of Planning and Development at DMM/IDLG; and look forward to our continuous and important team-work.

## **K. Summary of IDLG/ DMM Current Priorities in Municipal Finance**

Last and no least important, below is the list of IDL/DMM current priorities in MF, as briefly pointed out by Eng. Sayed Moharam "Sadat", IDLG Technical Director.

- 1- Implementation and updating of Municipal Revenue Generation Action Plans (RGAPs) and monitoring of their implementation.
- 2- Entry to the IFMIS system of data on billing and collection of Safayi tax.
- 3- Assisting in the implementation of the six modules of the IFMIS software designed in 2010.
- 4- Developing of a mechanism for participatory planning, budget execution and accountability. Budget reform and budget forms have already been developed.
- 5- Specific SOPs need to be developed. Financial procedure, Laws and regulations are already in place.
- 6- Municipal asset management needs to be established. No previous effort on this regard has been made.
- 7- Capacity building in procurement, contract management, budget preparation, reporting, and IFMS usage needs to be addressed.

**The above priorities will be examined in regard to their current status, scope, relationship to the Work Plan (as per TOR), associated constraints and challenges for their implementation, and the corresponding next steps on each of them. The results of this review, and the main options, will be discussed with IDLG/DMM leadership.**



## L Timeline of Proposed Work Plan

The following four tables comprise a continuous sequence of the overall timeline of the work plan for a six months period.

URBAN DEVELOPMENT SUPPORT PROJECT (UDSP)																									
PROPOSED TIMELINE OF WORK PLAN FOR THE ASSESSMENT OF MUNICIPAL FINANCE AND POLICIES																									
	ACTIVITIES	Aug19 Sept18				Sept19 Oct18				Oct19 Nov18				Nov19 Dec18				Dec19 Jan18				Jan19 Feb18			
		1	2	3	4	5	6	7	8	09	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24
A.	<b>INCEPTION REPORT WRITING</b>																								
1	Background, Objectives, Rationale,	X																							
2	Scope, Data, Methodology, Approach	X																							
3	Lessons Learned from existing studies	X																							
4	Challenges & Opportunities	X	X																						
5	Performance Indicators (First Set)		X																						
6	Int. Experiences with Municipal Funds		X	X																					
7	Work Plan Timeline		X	X	X																				
8	Delivery of Inception Report (Draft)			X	X																				
I.	<b>MUN. FIN. ASSESSMENT REPORT</b>																								
	<b>Fiscal Performance</b>																								
1	Outline of the FM Assessment Report					X																			
2	Budget Data Collection 5FYs 5Mun	X	X	X	X																				
3	Report's Tables & Charts					X																			
4	Computation performance indicators					X																			
5	Analysis of Empirical Results					X	X	X																	
6	Establish Baseline and Benchmarks						X	X																	
7	Good Inter. Practice in Benchmarking						X	X																	
8	Design Perform Based Grant Syst.							X																	

**URBAN DEVELOPMENT SUPPORT PROJECT (UDSP)**

**PROPOSED TIMELINE OF WORK PLAN FOR THE ASSESSMENT OF MUNICIPAL FINANCE AND POLICIES**

	ACTIVITIES	Aug19 Sept18				Sept19 Oct18				Oct19 Nov18				Nov19 Dec18				Dec19 Jan18				Jan19 Feb18							
		1		2		3		4		5		6		7		8		9		0		1		2		3		4	
		1	2	3	4	5	6	7	8	9	0	1	2	3	4	5	6	7	8	9	0	1	2	3	4	5	6	7	8
	<b>Management Performance</b>																												
9	Preparation Questionnaires on:					X																							
9.1	FM Assessment					X																							
9.2	Capital Investment Cycle					X																							
9.3	IFMS Assessment					X																							
9.4	Procurement Process					X																							
10	Completion Questions in 5 cities						X	X																					
11	Review info collected in 5 cities						X	X																					
12	Tabulation & data analysis						X	X	X																				
13	Discussion of Empirical Findings						X	X	X																				
14	Delivery of Assess. Draft Report								X																				
II.	<b>MF ACTION PLAN</b>																												
1	Preparation of Questionnaire									X																			
2	Interviews of Upper level Mgt.									X	X																		
3	Tabulation of answers										X																		
4	Analysis of empirical results										X	X																	
5	Discussion of MF Policy Options										X	X																	
6	Input Urban Mgt. Info. System										X	X																	
7	Input UMIS Operations & Projects										X	X																	
8	Timeline for AP Implementation										X	X																	
9	Writing & Delivery of Action Plan											X	X																
B.	<b>QUARTERLY REPORT (1 + 2)</b>											X																	

URBAN DEVELOPMENT SUPPORT PROJECT (UDSP)																									
PROPOSED TIMELINE OF WORK PLAN FOR THE ASSESSMENT OF MUNICIPAL FINANCE AND POLICIES																									
	ACTIVITIES	Aug19 Sept18				Sept19 Oct18				Oct19 Nov18				Nov19 Dec18				Dec19 Jan18				Jan19 Feb18			
		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24
III.	<b>CAPACITY BUILDING / TRAINING</b>																								
1	Identification of Training Needs:												X												
2	Preparation of Questionnaire on CB&T												X												
3	Tabulation of Answers												X	X											
4	CB Training Needs, Priorities & Scope:														X										
4.1	On the job training (national team)					X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
4.2	Forecasting O&M, Invest. & Revenue														X										
4.3	Oversee Exp. Execution (Ord. & Dev.):														X										
4.4	Payroll, procurement (O&M, Invest.)														X										
4.5	Audit & Internal Control														X										
4.6	Revenue Mgt and Collection Efficiency														X										
4.7	Assets Mgt (land, bldg. Infr. Inventory)														X										
4.8	MF Performance Indicators																X								
4.9	Knowledge Dissemination																X								
5	Preparation of Training Materials																X	X							
6	Delivery of Training Sessions																X	X	X		X				
7	Key Inputs for IFMS operations																X	X							
8	Key Inputs for UMIS Operations																X	X							

**URBAN DEVELOPMENT SUPPORT PROJECT (UDSP)**

**PROPOSED TIMELINE OF WORK PLAN FOR THE ASSESSMENT OF MUNICIPAL FINANCE AND POLICIES**

	ACTIVITIES	Aug19 Sept18				Sept19 Oct18				Oct19 Nov18				Nov19 Dec18				Dec19 Jan18				Jan19 Feb18			
		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24
<b>IV.</b>	<b>MF POLICIES &amp; REGULATORY TOOLS</b>																								
1	Current Legal & Reg. Framework																	X							
2	Questionnaire on MF Policy																	X							
3	Outline of MF Policy Report																	X							
4	Main Issues (and gaps) in MF Policy																	X		X					
5	Recommendations for Improvements																	X		X					
6	Setting Baseline and Benchmarks																	X		X					
7	Policy tools to improve performance																	X	X	X	X				
8	Implementation Monitoring indicators																			X	X				
9	Strategy to roll out tools to other PMs																			X	X				
10	Delivery of Policy Report (Draft)																				X				
<b>V.</b>	<b>MUNICIPAL FUND CONCEPT NOTE</b>																								
1	Background																					X			
2	Mission, Vision and Objectives																					X			
3	Performance Based Financing Concept																					X			
4	Rationale & Expected Econ. Benefits																					X			
5	Relevant International Experience																						X		
6	Expected Economic Benefits																						X		
7	MDF's Design options & Benchmarking																						X		
8	Performance Indicators & Thresholds																						X		
9	Stakeholders and Consensus Building																							X	
10	Next Steps towards implementation																							X	
11	Delivery of Preliminary Concept Note																								X
<b>C.</b>	<b>QUARTERLY REPORT (3 + 4 + 5)</b>																								X

## **ANNEX A**

### **Municipal Development Funds (MDFs)**

#### **Lessons Learned Relevant to Afghanistan from international Experiences**

Prepared by Hernando Garzón

September 8, 2017

#### **RATIONALE**

**Municipal Development Funds (MDFs) emerged as an effort to reduce market failures in the supply of capital financing, with more adequate terms and conditions, for investments in urban services and municipal infrastructure.** In low-income countries (like Afghanistan) MDFs have often started as donor funded operation providing capital grants for the financing of urban infrastructure projects. However, MDFs at a more advance stage of economic development are envisioned as transitional instruments in an effort to develop domestic municipal credit markets and strengthen the capacity to prepare and evaluate projects. They also encourage sound financial/fiscal performance in service providers for self-sustaining municipal credit systems that can tap domestic and international capital markets. MDFs may contribute to poverty reduction objectives, through providing access, for example, to basic transport infrastructure, water distribution networks, sanitation systems, etc. -- in urban and rural low-income areas.

#### **EVOLUTION**

**MDFs, as noted above, usually start as an intergovernmental approach supported by donors to address the need for financial resources for municipal investments in services and infrastructure.** MDFs are generally structured as autonomous organizations, which in most cases subsequently evolve to become financial intermediaries focusing on municipal credit. Some form of MDFs has been established in more than 60 countries -- typically with the support of bilateral or multilateral donors.

**The establishment of MDFs has been a gradual and fairly long process that usually has materialized into three different models or phases.** A first-generation MDF usually relies on donor-financed grants (which would be the most suitable arrangement for Afghanistan), while a second-generation MDF may be characterized by a combination of grants and loans, and is typically financed by both donors and the central government. In some cases, it may include local co-financing through direct contributions from beneficiaries. In contrast, a third-generation MDF regularly operates as a financial intermediary that *on-lends* to sub national levels of government (and/or

local public utilities). Lending terms and conditions of third generation MDF are generally fairly favorable, relative to those of ordinary credit from commercial banks. The operational design of each of these models may range from quite simple and expeditious rules to fairly complex procedures.

## **BEST PRACTICES**

**Some of the best international practices, currently in operation, have evolved through these three general phases.** This is the case for example of the Tamil Nadu Urban Development Fund (TNUDF) in India and the “Financiera de Desarrollo Territorial” (FINDETER) in Colombia. FINDETER started as an urban development account funded by a bilateral agency (USAID) and managed by a central government institution (The Central Bank). It evolved, at the pick of its performance, to become a financial intermediary supported by World Bank lending and on-lending to sub-national levels of government. The most sophisticated MDF may be India’s TNUDF which is characterized by features such as: (a) Lending: Based on municipal operational surpluses, (b) Performance: 100% repayment, and (c) Capacity building: strong indirect support to local capacity building. It may, however, need simplification in the sub-projects’ approval process, design, and procurement, in order to expedite subproject implementation.

## **LESSONS LEARNED AND WAYS TO MITIGATE ASSOCIATED RISKS**

In order to design and establish a successful MDF it is imperative to have clear answers to some fundamental questions, as well as to consider the basic elements that characterize a well performing MDF and/or projects that play an equivalent role.

### **Key questions**

- Is the assignment of revenue sources to municipalities adequate to provide O&M for the services they are required to provide?
- Is there a statutory classification of municipalities? Is this classification relevant for the purposes of the MDF or equivalent project? For example, is the assignment of functions and revenue sources different across primary and secondary cities and in small and rural municipalities?
- How does the fiscal capacity of municipalities vary with respect to their ability to make contributions to capital financing?
- Which types of local governments LGs/municipalities have or do not have the capacity to make capital contributions? And if they have the capacity, in what order of magnitude?
- What services and local economic infrastructure municipalities are required to provide that are *revenue* and *non-revenue generating*?

- Should the terms and conditions of the MDF's grants (and loans, if any) be different for revenue and non-revenue generating sub-projects?
- Based on a small representative sample of municipalities, what is their current financial situation? Do they operate balanced budgets? Do they generate surpluses ('savings') or deficits in their yearly operations?
- Which of the representative municipalities could absorb debt service obligations, if any? If so, of what order of magnitude is the average absorption capacity? Though, most probably, this is not yet expected to be the situation of the largest cities in Afghanistan.
- Do the different types of municipalities have local development investment plans?
- Do the representative municipalities have the operating capacity to implement and administer investments in both services and infrastructure? Which of them have actual experience in sub-project implementation?

Answers to this questionnaire will be provided in the first deliverable, that is, by the "Municipal Finance Assessment Report".

### **Key elements**

- A ranking of LGs in terms of their financial and operating performance will facilitate the design of realistic rules, which are tailored to the particular circumstances of the MDF's clients, thus enhancing the likelihood of a successful operation.
- Before an adequate municipal ranking may be established, a computerized database (with financial/fiscal and relevant qualitative client information) needs to be in place and operating.
- The corresponding ranking of municipal performance in the most recently executed fiscal year will practically identify the baseline to measure relevant performance by the end of the subsequent fiscal years.
- Based on current reality, explicit milestones (for graduating ranks) should be established as part of a clear road map for municipal institutional development and capacity building.
- A clear set of incentives in terms of capital grants to reward performance among municipalities, should be specified, as part of the MDF operational design.
- Specific features to ensure equity in access to grants (and/or loans in the future) across all eligible municipalities should be included in the operational design.
- Good practices generally include technical assistance (TA) and training packages for municipal capacity building.
- Successful MDFs usually start small and subsequently scale up their operations, subject to their actual performance.

- Best performing clients are often rewarded with the possibility of accessing larger grants (and/or loans).
- The inclusion of Public-Private-Partnerships arrangements to mobilize private capital and managerial capacity in project implementation characterize best practices.

## **OTHER GENERAL CONSIDERATIONS GOING FORWARD**

**Objectives.** It is important to have clarity regarding the intended objective of the MDF. For example is it about: (a) coordination and harmonization of financing across donors operating in the relevant sectors? Or, (b) making financing available to municipalities and local service providers to ensure the expansion of specific services? Or, (c), developing local institutional capacities? Or, (d), encouraging financial performance among service providers? Or, is it a combination of a few specific objectives such as the four listed above? Typically, there is a trade-off between a larger number of objectives and actual effectiveness in achieving them. Therefore, in principle, the lesser number of objectives at one point in time (e.g. during a first phase) the greater the likelihood of a successful operation.

**Political Economy.** It is essential to understand the political context and the political institutions in which a MDF needs to operate. The operational rules of an MDF are generally subject to the influence of the relevant political institutions. To ensure a sound design and mitigate potential distortions in MDF's operations, it is essential that a policy dialogue be held among stakeholders. This has been the experience, for example, in the MDF in Palestine and the FINDETER in Colombia.

**Local level Institutional Capacity.** Local institutional capacity usually has been a main constraint to the successful implementation of fiscal decentralization and other forms of supporting local development, such as MDFs. The importance of managerial capacity has been recognized and has become an important investment in the financial support provided through MDFs. This institutional capacity is also vital in the apex institutions (at the central government level) and in the associated financial intermediaries.

## **BRIEF SUMMARY OF RELEVANT CASES FOR AFGHANISTAN**

As will be illustrated in the following section, the model of Palestine is perhaps the most suitable for Afghanistan, at this stage of economic development. Much later, in the next few years, and depending on performance and economic growth, the model of Bangladesh (which is a lower middle-income economy) may be worth considering, at least for the group of the largest municipalities of Afghanistan.

The designs and experiences in Palestine and Bangladesh with these two different models are summarized below, as basic background for future decision-making. The combination of some of the features of these two models could also be possible, but only after having strong evidence of the performance of the MDF in its most simplified version.



**PALESTINE**  
**(West Bank and Gaza)**

**Municipal Development and Lending Fund (MDLF)**

The Palestinian Fund was created in 2005 and originated from a Project Coordination Unit of a World Bank (IDA) project. Over the years the MDLF has been assisted by several other donors including: GIZ, AFD, KFW, BTC, Sida, and Danida. It operates with grants for investments in municipal services, urban infrastructure, and municipal capacity building with the long-term objective of developing creditworthiness for possible future lending. In 2009 MDLF began the implementation of a Municipal Development Program (MDP) supported by the World Bank and six other donors.

One of the main features of the Palestinian MDP is that it rewards performance in institutional capacity building and municipal financial management. All local government units (LGUs) are eligible for differential grants that increase with their level of performance. LGUs are classified into a ranking system of six categories according to objective indicators of their level of performance.

Once the total pool of donor grants is determined, specific investment ceilings are determined for each of the 132 LGUs based on their population, needs for services and infrastructure and their actual performance. Specific variables and corresponding verifiable indicators are applied to establish the level of performance. The ranking of LGUs is reviewed every year to determine which of them have moved (“graduated”) to upper ranks. Higher ranks reward performance with larger per capita grants. Mid-term review of project implementation confirmed that a significant number of LGUs have improved their institutional capacity and financial performance and have moved to the upper ranks.

MDLF operates four windows: (a) grants for municipal capital investments, (b) supports to municipal innovations and efficiency, (c) Capacity building for both municipalities and MDLF, and (d) MDP’s management (7% of the grants as an administrative fee).

Several lessons may be learned from this experience, among them: (a) the willingness of participating donors to establish a common set of rules to allocate financial resources to LGUs, (b) the political will of the MDLF board of directors to adopt objective and transparent financial resources’ allocation rules – which insulates the process from discretionary decision-making, and (c) the vision and technical capacity of MDLF’s human resources to enter into a technical dialogue with international TA for the design and development of a mechanism that reflects and responds to the specific needs and circumstances of LGUs in Palestine. Part of this vision was to link the financing of demand-driven physical investments to measurable performance indicators of standards with *clear rules of the game*. Empirical data from project implementation has shown that performance related incentives work.

## **BANGLADESH**

### **Bangladesh Municipal Development Fund (BMDF)**

The BMDF operates as a financial intermediary funded by IDA and GoB. It provides grants and loans to local governments (Urban Local Bodies -- ULBs), which must contribute 10% of the project cost. Many small and medium-sized municipalities use their central government grants to secure funding. BMDF only finances 90% of the project cost through a grant-loan mix in which grants represent 85% and loans 15% of the financed amount. The current repayment rate of loans is at 80%. BMDF charges 1.5% fee for TA. No distinction seems to be made between revenue- and non-revenue generating sub-projects for the purposes of establishing current grant-loan terms and conditions. Also, no ranking of LGs/ULBs seems to be made, regarding their fiscal capacity, for the purposes of establishing grant-loan terms and conditions.

The net revenue from interest on the loans is insufficient to cover BMDF's operating costs. The lesson learned seems to be that with highly subsidized interest rates (i.e., 85% grants) the repayment obligation of the 15% loan is generally met by most LG/LGBs, as it might be expected. However, the main concern of BMDF seems to be that operating costs are not yet sustainable. In other words, the current levels of repayment, together with the relative magnitude of the loans, and the interest rate of 9%, in addition to the 1.5% fee, do not yield enough revenue to cover BMDF's operating cost. At this time the main concern of the BMDFs seems to be the identification of needed actions to make its financial sustainability viable. Though this probably could be achieved (in the short term), with the appropriate adjustments and policies, it seems that the main focus of attention should be more on services, and urban infrastructure to support local economic growth, and on developing local institutional capacities. These two have proven to be a much greater challenge, and ultimately would contribute to the operating sustainability of the BMDF.

## ANNEX B

### LIST OF KEY INPUTS TO BE PREPARED TO SUPPORT MAIN ACTIVITIES

#### I. **Municipal Financial Assessment and Design of Performance Indicators**

- 1a. Questionnaire on Financial Management and Investments
- 1b. Questionnaire on IFMS assessment
- 1c. Outline of IFMIS Assessment and Recommendations
2. Outline of Financial Management Assessment
- 3a. Questionnaire on Municipal Finance Policy Legal Framework
- 3b. Outline of Municipal Finance Policy and Procurement
4. **Baseline** on Existing Financial Performance and **Benchmarking**
5. Outline of Performance-Based System for Annual Municipal Grants
6. Outline of Concept Note for a Municipal Development Fund
7. Outline of Good International Practices on Benchmarking
8. Action Plan for Training Human Resources in Financial Management and preparation of Training Materials
9. Questionnaire on Human Resources and Training Needs
10. Key Information for Urban Management Information System (UMIS)
11. Key Elements for Both UMIS's Operations and the Project Cycle

## **II. Municipal Finance Policy Formulation**

- 12a. Questionnaire on Municipal Finance Policy and Current Legal and Regulatory Framework
- 12b. Outline of Report on Municipal Finance Policy and Opportunities for Improvement.
- 13. Proposed Contributions to Improve Municipal Financial Performance
- 14. Monitoring and Evaluation of Implementation of Adopted Policies

## **III. Capacity Building and Training**

- 15. Budget Analysis and Forecasting: Scope and Selected Training Materials
- 16. Current and Capital Expenditure Management: Scope and Selected Training Materials
- 17. Municipal Audits and Financial Controls: Scope and selected Training Materials
- 18. Revenue Management: Scope and Selected Training Materials
- 19. Municipal Asset Management: Scope and Selected Training Materials
- 20. Measuring Municipal Financial Performance: Scope and Selected Training Materials

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