



Budget Circular 1 - 1391 Budget Formulation

1. Purpose

The purpose of this circular is to ask all budget units to indicate their baseline costs and proposed new activities for 1391-93. The information will be used to allocate budget ceilings in accordance with Government priorities and available financial resources. As there are never sufficient funds to fulfill all budget requests, budget units are advised that quality submissions will result in higher budget ceiling allocations from limited financial resources.

At this point, it is not necessary to submit detailed project documents and budget costing information. A separate circular, including approved budget ceilings, will be issued in mid August, requesting detailed budget submission and project information.

2. Budget Process

The annual budget is the primary tool for implementing Government policies and priorities. Budget units are required to align their program structures, outputs and indicators to their ANDS results frameworks. This will ensure individual budgets reflect ANDs priorities and result in improved service delivery in all sectors.

3. Information Requested from Budget Units

BC1 requires your Ministry/Agency to complete two important tasks:

- Calculate the Baseline cost of your ongoing level of activities and identify existing output levels; and
- Identify and estimate costs for a maximum of five 'new activities' (expansion of existing activities or completely new activities) to respond to output targets stated in your ANDS results framework.

Budget units are required to provide baseline funding requests by program. New activity requests should also be by program. All requests should separate operating and development budget requirements. Before preparing budget request, it may be necessary to review and modify program structures, based on revised ministry results frameworks.

4. Steps in Developing BC 1 Submissions

The Budget Implementation Team (BIT) of each budget unit needs to carry out the following steps in preparation of the BC 1 submission:

- i. **Review ministry/agency results framework.** The review must be performed by all members of the BIT. You may also wish to include Department or Program Managers in this review process, as they may have a better knowledge of what can be achieved.
- ii. **Make changes to the results framework,** if required. Any changes must be agreed by the management of your ministry/agency and with your Sector Coordinator.
- iii. **Revise program structure,** if required. Based on your result frameworks, some deficiencies in your program structure may be identified. If so, changes to the existing program structure may be required. In doing so, please take into account your existing organizational structure and the need to map each of your departments to one of your programs and sub-programs. Please involve Program Managers in this step. Any changes must be agreed by the management of your ministry/agency and the Ministry of Finance budget department.
- iv. **Determine baseline costs.** For each program, identify the current level of outputs (level of outputs achievable if you continue with the existing level of activities) and calculate the required financial resources needed to continue your existing level of activities – for both operating and development budget.
- v. **Identify new activities.** Identify new activities (completely new activities or expansion of existing activities) required to support one or more of the output targets defined in your ministry/agency results framework. You can identify a maximum of five activities per budget unit.
- vi. **Calculate costs and determine output targets for each new activity.** For each new activity, identify output targets and calculate the required financial resources – for both operating and development budget needs.
- vii. **Develop a Concept Note for each project related to a new activity.** For each project: (i) define purpose, (ii) define objective, (iii) define beneficiaries, (iv) identify outputs, (v) conduct demand analysis, (vi) describe methodology, (vii) conduct costing, including operating and maintenance costs, (viii) describe economic benefits and (ix) specify timelines.
- viii. **Prepare a Pre-Feasibility Report.** For each project costing \$25 million or more, prepare a Pre-Feasibility Report, covering technical, market, human resource, financial and economic analyses.

As part of the process of preparing BC 1 submissions, budget units should consult the relevant special Parliament Commission. The Ministry of Economy will assist budget units to determine priorities based on their results framework.

If budget units engage in discussions with donors, the Ministry of Finance Budget Department needs to be informed and involved.

5. Budget Tables

All budget units are required to submit information using the prescribed forms (see below). Only information received using the prescribed forms will be accepted. Failure to submit the requested information by the specified deadline will result in the allocation of lower budget ceilings for BC2 submissions.

(a) Form 1: Baseline Costs

Baseline costs reflect the funding required to maintain the existing level of activity. No provision is made for the addition of new activities or expansion of existing activities or projects. As the existing level of activity is being maintained, no new employees can be included. *The maximum number of employees is the number employed during 1390 or the 1390 Tashkeel.* Only ongoing development projects can be classified as baseline; new projects must be part of a new activity, with a specified output.

For example, a program to roll out polio vaccinations may currently operate in 5 provinces. Only expenditure (and employees) related to the ongoing vaccination campaign in these 5 provinces represents baseline expenditure. The extension of the program into 6 additional provinces next year represents a new activity, as additional funding is required and new output targets are being determined.

A request for additional funds to complete the construction of an on-going road project represents baseline expenditure. On the other hand, where several roads are currently being constructed in a province, costs associated with a request to construct other new roads (even in the same province) or additional km of the existing road (not included in the original on-going project) represent new activities.

Additional examples will be provided during the BC1 workshops.

Baseline essentially means:

- **Operating Budget:** estimated expenditure for current year¹ (1390), increased for macro-economic adjustments expected in the next year: (i) any PAR reform (PRR or P&G) for wages and salaries and (ii) inflation for goods and services. Any one-off spending, primarily acquisition of assets, such as the purchase of cars should be deducted from the baseline. A forecast inflation rate and forecast USD exchange rate are supplied with this instruction.

Operating budgets are usually determined by closely reviewing existing costs and using known facts or assumptions to estimate future costs. For example:

- Salaries: general or specific increases in civil service salaries or allowances as per Government decision (information provided by Ministry of Finance).
- Salaries: increase or decrease in wages and salaries cost resulting from continuation of the public administration reform implementation (PRR or Pay and Grading reform), as per earlier determined schedule
- Tashkeel: In exception to the Security Sector, Ministry of Education (MoEd), Ministry of Public Health (MoPH) and Ministry of Higher Education, no ministry or budgetary unit is allowed to increase the number of their tashkeel.
- Goods & services: an announced % increase in electricity prices.
- Goods & services: a general increase in prices to reflect expected inflation (rate provided by Ministry of Finance).
- Goods and services: foreign currency exchange rate (US\$ rate provided)

¹ In order not to artificially inflate current spending projections, instead of using budget figures as a basis for calculating the baseline, it is realistic to use the estimated budget execution by year end.

- **Development budget:** existing projects that will continue to be implemented and financed in the next year(s), in accordance with the project schedule – meaning on-going multi-year projects.

The baseline cost of the development budget is simpler to calculate as only projects which are already in operation and for which funding will continue into the following fiscal year. In the vast majority of cases, the costs of such projects will be fixed and already determined in the project agreement and there is no requirement to apply inflation or salary adjustments.

It is essential that the operating and maintenance cost implications of development projects (whether funded from core or external budgets) are included in the operating budget as part of the baseline costing.

Form 1 lists existing programs and reflects current activities and projects. The form specifies for each program:²

- (i) Actual expenditure in 1389, budget for 1390 and requested budget for 1391-1393 – for both operating budget (disaggregated by object codes 21, 22 & 25), and each on-going development project.
- (ii) Outputs (one output for each sub-program): actual outputs in 1389, budget outputs for 1390 and planned outputs for 1391-93, assuming the existing level of activities is to continue.
- (iii) Number of employees by structure (permanent: regular, PRR-ed, P&G and contracted: development budget funded vs. operating budget funded). Separate columns are provided for teachers and the armed forces.
- (iv) Existing number of employees in 1389 and 1390.
- (v) Approved Tashkeel number of employees for 1390.
- (vi) Number of employees, by structure, planned to perform existing activities after any current recruitment or reform processes (e.g. PRR) are complete, 1391-1393. Only the structure may change over time – the number of employees is fixed as the lower of the number employed during 1390 or the 1390 Tashkeel.

It is important that operational and maintenance costs associated with past or on-going development projects are included in the cost calculation and specified in the operating budget submission.

(b) Form 2a: New Activities – Basic Information

Form 2a provides a listing of new activity requests which the budget unit wishes to submit for consideration by the Ministry of Finance and Government.

‘New Activities’ include: (i) completely new activities to be funded through additional operating budget or development budget resources, or (ii) the expansion of existing activities (increase in the level of activities and outputs) to be funded through additional operating budget resources or the expansion of on-going development projects. Examples are given in the Annex to these instructions. Additional examples will be provided during the BC1 workshops.

A new activity may consist of (i) an operating budget request only (e.g. additional teachers for existing schools), (ii) a development budget request only (e.g. construction of school toilet blocks) or (iii) both

² Number of completed Tables 1 forms should correspond to the number of the ministry/agency's programs.

operating and development budget requests (e.g. construction of a new school, together with teachers' salaries and maintenance costs).

Cluster ministries should note that National Priority Programs need to be broken down by ministry and program, with each ministry submitting the portion it is responsible for as a new activity.

Each budget unit can submit a maximum of five new activity requests, ranked in order of priority (New Activity 1 for highest priority). Budget units may submit separate supplementary requests (in excess of the initial 5 activity requests) but these will only be reviewed in the event of funds being available.

Where a budget unit needs (based on changes in the strategy) to include a new program (not to exceed maximum of five programs in overall ministry / budget unit) or new sub program requiring a number of additional activities, a special request may be made to the Ministry of Finance. The reasons must be fully explained in writing.

Each new activity must relate to one specific program and have a clearly defined output target. Where a ministry or agency wishes to submit a list of unconnected activities, such as multiple road projects (and consequently do not have one clearly defined output target), it is recommended that only priority projects are included in the new initiative requests. Other requests should be included in a separate supplementary request. Where multiple unrelated activities are included in one new activity request (e.g. a number of unconnected road or power generation projects), the entire request will be rejected.

New activity requests relating to different programs must be submitted as separate requests – i.e. they cannot be combined in one request. For example, an activity to build primary education schools is separate from an activity to build vocational education schools. Similarly, an activity to increase general school enrolment is separate from an activity to increase enrolment for girls.

To improve a new activity request's likelihood of receiving funding, the activity needs to be consistent with the Government's overall strategic policy objectives, as identified in the ANDS. The initiative also needs to be directly supported by performance targets (output and outcomes).

Given that the major objective of the ANDS is poverty reduction, it is necessary to integrate poverty reduction policies into the Budget to ensure an increased focus on poverty reduction. Budget units should give priority to poverty reduction oriented new activity requests.

Form 2a specifies for each New Activity request:

- Brief description or a name of activity.
- The program under which the activity comes under.
- The program outcome that is supported by the activity.
- State (Yes or No) if this activity is part of the National Priority Program approach. If yes, name the National Priority Program.
- State (Yes or No) if the activity will contribute to the implementation of the poverty reduction policies of the Ministry. If yes, elaborate how it will decrease poverty.
- State (Yes or No) if the activity will impact any of the ANDS defined cross-cutting issues (anti-corruption, institutional reform and capacity building, environment, regional cooperation, counter narcotics, gender). If yes, briefly describe how.

- Outputs that will result from implementation of the activity and targets for each year (1391-93). Identify which sub-program the output comes under; as described above, each output must be derived from the ANDS Result Framework
- The additional budget request for the new activity:
 - Requested financial resources for the period 1391-1393 for operating budget, disaggregated by object code (21, 22 or 25) and
 - Requested financial resources for each new or expanded development project.
 - Operational and maintenance cost requirements of new development projects need to be included in the cost calculation and specified in the submission under operating budget.
- Number of new employees by structure (permanent: regular, PRR and P&G and contracted: development budget funded vs. operating budget funded) for the period 1391-93
- The 4 ministries participating in the provincial budgeting pilot (Ministry of Education, Ministry of Public Health, Ministry of Rural Rehabilitation & Development and Ministry of Agriculture, Irrigation & Livestock) are also required to analyse expenditure by province. A modified Form 2a will be issued for this purpose. Detailed instructions for the pilot ministries are contained in a separate annex to this circular

(c) Form 2b: New Activities – Concept Note

An individual Form 2b is to be prepared for each development project included in the new activity requests. The form provides essential information in relation to each activity and will assist the Ministry of Finance and Government to select priority activities and identify which activities and projects are ready for implementation (thereby improving execution rates).

Form 2b specifies for each New Activity:

- Description or name of activity (as in form 2a).
- Introduction
 - Define how the project fits with the agency’s mission and goals;
 - Identify interests from stakeholders and any involvement from other partners (including international financial institutions).
- Purpose
 - Outline the problem to be addressed, using quantifiable data (e.g. 190,000 households and 10,000 small business without access to water from waterworks);
 - Define the achievements by the agency to date in applying engineering solutions to these problems (where relevant).
- Project Description
 - Describe the objective: e.g. to ensure that 90% of the population in Kabul, Herat and/or major cities has access to clean water from water works (thus contributing to achieving the medium-term priority ANDS of the government);
 - Describe outputs: e.g. to provide access to water from waterworks for 190,000 households, 10,000 small business or other non–residential customers;
 - Describe demand analysis: (e.g. volume or cubic meters of water required per day, or per week and the current supply);
 - Describe methodology: (e.g. a major water works and pipelines);

- Make sure to include 3 years of operational-maintenance costs so the line ministry and agency will have time to put it in the budget;
- Describe economic benefits, timelines and estimated costs based on existing data: identify both capital and recurrent expenses on a multi-year basis.
- Other
 - The agency may also include information about the implementation plan (e.g. outsourcing the design and construction) and any risks (e.g. right of way acquisition for the pipelines) and how to manage the risks.

Note: For all new projects in excess of \$25 million, a pre-feasibility study is also required. Pre-feasibility studies cover technical, market, human resource, financial and economic analyses, enabling the selection of the most viable option. Studies may be internally conducted or externally commissioned. Additional information is included in Appendix 8.

(d) Table 3 – Summary of Budget Request

Forms 3a, 3b and 3c consolidate the information provided in Tables 1 and 2:

- Form 3a: Summary of total request by program.
- Form 3b: Summary of total request by object code
- Form 3c: Summary of total request by baseline, prioritized New Activity and object code

6. Macroeconomic Adjustments

Where appropriate, the macroeconomic factors in the table below are to be applied when calculating budget requests. No alternative figures are to be used. Any questions may be directed to your Ministry of Finance focal point.

	1391	1392	1393
Goods & Services (Code 22) inflation adjustment	5%	5%	5%
Multi-year capital formation (Code 25) inflation adjustment	5%	5%	5%
Exchange rate = Afs / US\$	47	47	47

7. Action Required

All budget units are required to submit the requested information to the Ministry of Economy and Ministry of Finance focal point no later than 22 May 2011. Where desirable, detailed responses may be given on separate sheets of paper, attached to the completed tables.

As only one budget submission will be accepted by the Ministry of Finance, budget officials need to ensure that submissions are approved by senior management. It should also be noted that BC1 submissions will be used to determine the budget ceilings and priorities notified in Budget Circular 2.

If you have any questions or need assistance, please do not hesitate to contact your Ministry of Finance focal points.

Dr. Mustafa Mustoor
Deputy Minister of Finance

Annexes

1. Budget Circular 1 Forms
2. Agenda and timetable for line ministry workshops.
3. Budget calendar.
4. Budget Committee Agreement.
5. Ministry Results Framework
6. Instructions for Ministry Results Framework
7. Pre-feasibility Study
8. Provincial Budgeting Approach – Pilot Ministries

Pre-Feasibility Study

For all new projects in excess of \$25 million, a pre-feasibility study is required, together with the BC1 submission. Where a pre-feasibility study is not submitted, the new activity request will be immediately rejected. Pre-feasibility studies cover technical, market, human resource, financial and economic analyses, enabling the selection of the most viable option. Studies may be internally conducted or externally commissioned.

Needs / Demand Analysis

1. Analyze current and future demand-supply gap for the services to be provided over the life of project.
2. Special factors may significantly affect demand for service:
 - a. Government regulatory policies (emission controls);
 - b. Public sector monopoly pricing (tariffs for electricity or water).
3. This analysis will determine the project scope, costs and benefit calculations in the Financial and Economic Analyses.

Technical/Engineering Analysis

1. Estimate the quantities and prices of inputs required under different technical solutions (size of project; quantities of outputs; design, location, and proposed technology).
2. Estimate inputs required to operate and maintain asset after construction.
3. Assess thoroughly the technical alternatives: their costs, expected benefits/outputs.
4. Ensure that data and prices of inputs are updated and inflation-adjusted.
5. Identify the preferred technical solution.

Human Resources Analysis

Analyze the prevailing labor market to ensure:

1. Availability of necessary skills and technical expertise for the design, construction, installation, commission and operation of the project—either from nearby or international markets; and
2. Correct pricing of labor in the cost estimates.

Financial Analysis

1. Develop benefit and cost estimates for construction of the cash flows over life of project.
2. Use this data to determine financial viability of the project.
3. Calculate Financial Net Present Value (FNPV) and Financial Internal Rate of Return (FIRR) to assess financial viability.

Economic Analysis

1. Analyze different alternatives by comparing their economic costs and benefits—translated into monetary terms.
 - a. Calculate the Economic NPV and Economic Rate of Return (ERR).
 - b. For an economically viable project, NPV should be positive and ERR should be greater than the Economic Cost of Capital.
2. Using these results, make a rational economic choice between the alternatives.

Stakeholder Analysis

Identify equity issues and ways to address them:

1. Determine who will benefit and by how much (income changes); and
2. Determine who will pay and by how much.

Definitions:

Net Present Value is the difference between the total discounted economic benefits and the total discounted economic investment and operations/maintenance costs.

Economic Rate of Return (ERR) is the discount rate which makes the NPV of a project zero.

Based on these six analyses, the agency's pre-feasibility report will assess and recommend a preferred solution.

Further information on pre-feasibility studies can be found in the Ministry of Economy document "Guidelines 2 for the Preparation and Development of Public Investment Project Proposals"

Provincial Budgeting Approach – Pilots Only

The 1391 budget will pilot a new provincial budgeting approach to better integrate provincial priorities into the national budget and facilitate communication between central line ministries and their provincial departments. At the BC1 stage, the 4 ministries participating in the pilot (Ministry of Education, Ministry of Public Health, Ministry of Rural Rehabilitation & Development and Ministry of Agriculture, Irrigation & Livestock) are required to consult their provincial departments, incorporate provincial priorities into the budget submissions and analyse expenditure by province. A modified Form 2a is being issued to facilitate the analysis of budget expenditure by province.

The new approach will involve:

Budget Circular 1

- BC1 to include indicative ceilings for provincial inputs, set by the Ministry of Finance, based on available funds – and only for one main program delivering services under each ministry (overall total of 5 programs per budget unit). For 1391, a meeting will be arranged with the four pilot ministries to discuss the indicative ceilings.
- Pilot central ministries are required to communicate BC1 requirements and deadlines to their provincial departments.
- During the preparation of BC1 submissions, pilot central ministries and provincial departments (where applicable) to work closely with donors to ensure budget submissions contain all the details donors would require to make a decision on funding specific priorities.
- Pilot ministries to integrate specific provincial priorities into their budget submission.
- BC1 submissions form the basis for the Ministry of Finance to approach donors, requesting them to realign their funding with specific Government priorities, reflecting provincial needs.
- Assuming funding is available, the Ministry of Finance will assess BC1 requests for the new activities from the pilot ministries and approve only those activities that are properly developed, costed and justified as per MoF's requirements .

Budget Circular 2

- Budget Circular (BC2) will aim to: (i) provide detailed costing of the approved program activities and (ii) ensure projects are well designed and fully developed.
- Upon receipt of BC2 from the Ministry of Finance, pilot ministries are required to communicate to their provincial departments the approved priorities, ceilings and requirements for costing of those priorities and development of project documents.
- During the period of budget submission preparation, central ministries are to direct technical support to provincial departments.
- Pilot ministries are to integrate provincial department inputs into their budget submissions and submit a breakdown by province to the Ministry of Finance.
- Ministry of Finance to assess budget submissions, requesting pilot ministries to provide justification for the provincial distribution of funds during the budget hearings.

- Upon approval of the budget by Cabinet and Parliament, pilot ministries to communicate an approved program budget, including related performance targets, broken down by provinces, to their provincial departments.
- Additional workshop will be for four pilot ministries to discuss provincial budget reform implementation and issues.