Navigating Risk and Uncertainty in Afghanistan

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Key Messages

Navigating Risk and Uncertainty in Afghanistan

1 | Afghanistan will remain heavily resource constrained and aid-dependent through to 2030 and beyond

- Growth will remain slow under any scenario (averaging 3% over the next 4 years)
- New sources of growth are required to improve living standards over the long-term
- Increased aid (or more aid on budget) is needed now to achieve a higher long-term growth trajectory

2 | Agriculture and human capital investment can drive broad-based growth

- Agriculture has the potential to drive strong growth and improve livelihoods
- Human capital underpins any growth strategy – especially for women and the current workforce
- Managed migration offers opportunities to reduce labor market pressures

3 | Macroeconomic sustainability requires new sources of revenues and exports

- With declining aid, Afghanistan's economy must generate more foreign exchange and government revenues
- Extractives represent important opportunities despite risks

4 | Fragility will persist for some time – policies are needed that help households and firms manage risks

- A social transfer program, complementing the Citizens' Charter Initiative, could mitigate household risks and a risk sharing facility for firms should be introduced to encourage investment
- Institutional strengthening efforts should be targeted towards agencies and functions that matter most for development
- Compromises will be needed to expand coalitions for reform

Development outcomes have improved substantially since 2001

GDP per capita

from $120 to $624

Revenue

from 3.3% to 10.2% of GDP

Life expectancy

70+

from 44 to 60 years

School Enrollment

from 0.8 million to over 8 million

Maternal Mortality

from 1600 to 324 (per 100,000 births)

Gender equity

no women holding seats in parliament to 27% of all seats

Infrastructure

From almost none to over 18 million mobile phone subscriptions

PFM

Stronger PFM system than other fragile states and many low-income countries

Afghanistan’s development progress slowed during transition

- Development progress was supported by high levels of aid during the reconstruction phase.
- The transition process posed huge risks and challenges on all fronts. A deteriorating security situation, difficult political transition, and rapid decline in aid severely affected the economy and deterred investment.
- Economic growth fell to 1.3% and 0.8% respectively in 2014 and 2015, compared to an average 9.4% over 2003-2012.
- Resulting fiscal pressures were well-managed
    - Forceful reforms increased revenues to 10.2% of GDP in 2015 from 8.7% in 2014
    - Expenditure controls were implemented.
- Aid was relied on to finance around 60% of budget expenditure and a trade deficit of around 40% of GDP.

Real GDP and sector contributions to growth

Past gains are being eroded

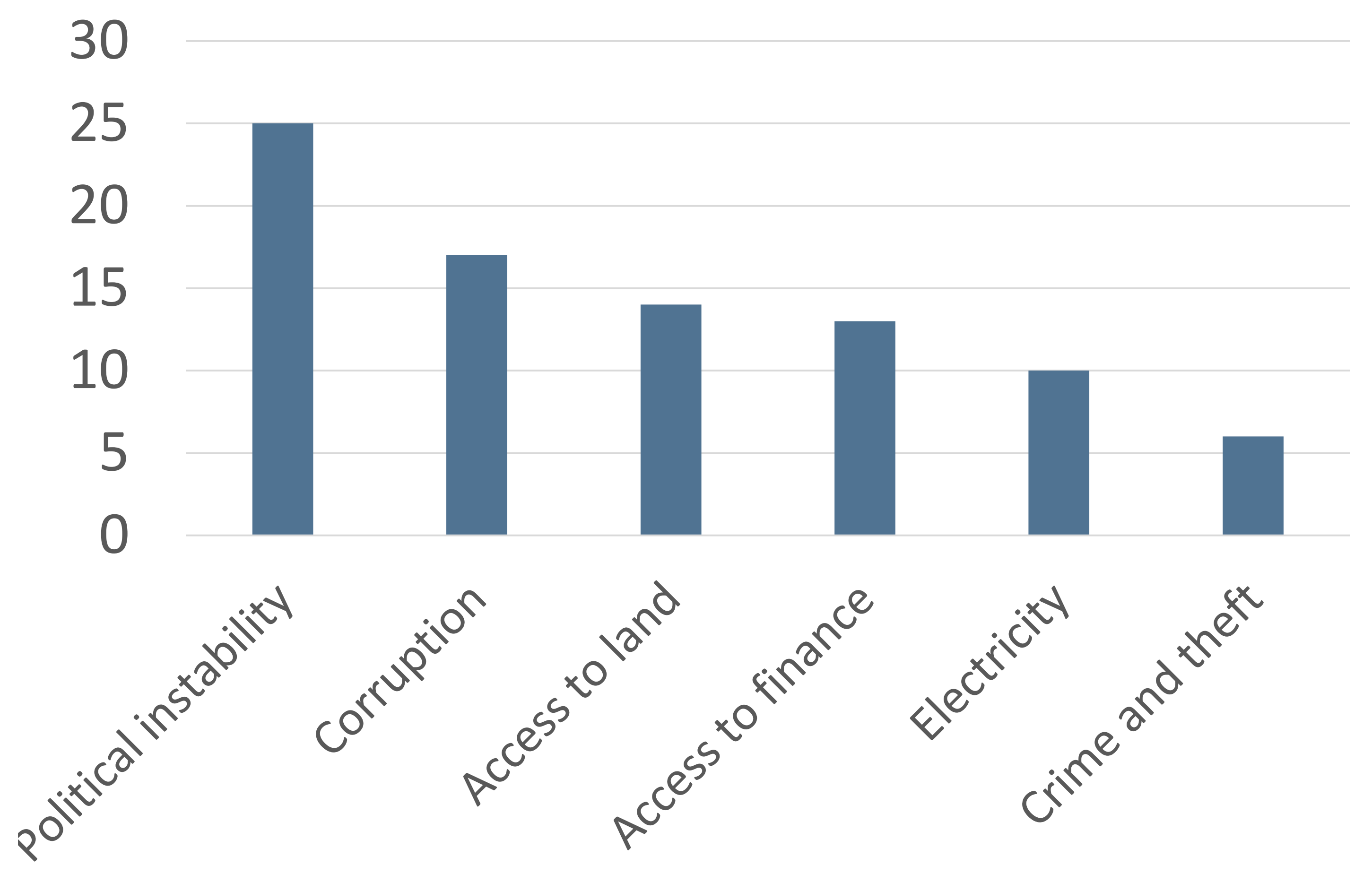
Poverty	Poverty increased from 36% in 2008 to 39% in 2014.
Employment	Unemployment and underemployment increased from 25% in 2008 to 39% in 2014.
Violence	Annual civilian casualties increased from 6025 in 2012 to 6791 in 2014.
Migration	Afghans seeking asylum in the EU increased from 38,000 in 2014 to 180,000 in 2015.
Services	Primary attendance rates declined by 1.2% overall and by 2.2% for girls between 2012 and 2014.
Gender	The gender gap in school attendance increased. For every 2 boys, less than 1 girl attends secondary education.
Private Investment	The number of new investment activities declined by almost 50% between 2012 and 2015.
Displacement	Flows of returning refugees increased, exacerbating population pressures. The number of internally displaced reached 1.2 million.

Institutions, demography, and limited productive capacity constrain the development path

Weak institutions undermine service delivery, deter private investment, and drive conflict.

- High levels of crime and corruption deter investment.
- Perceptions that state institutions are corrupt, partisan, and predatory undermine support for government in the context of insurgency.
- Institutional strengthening is a long-term process: any growth strategy must be robust to fragility.

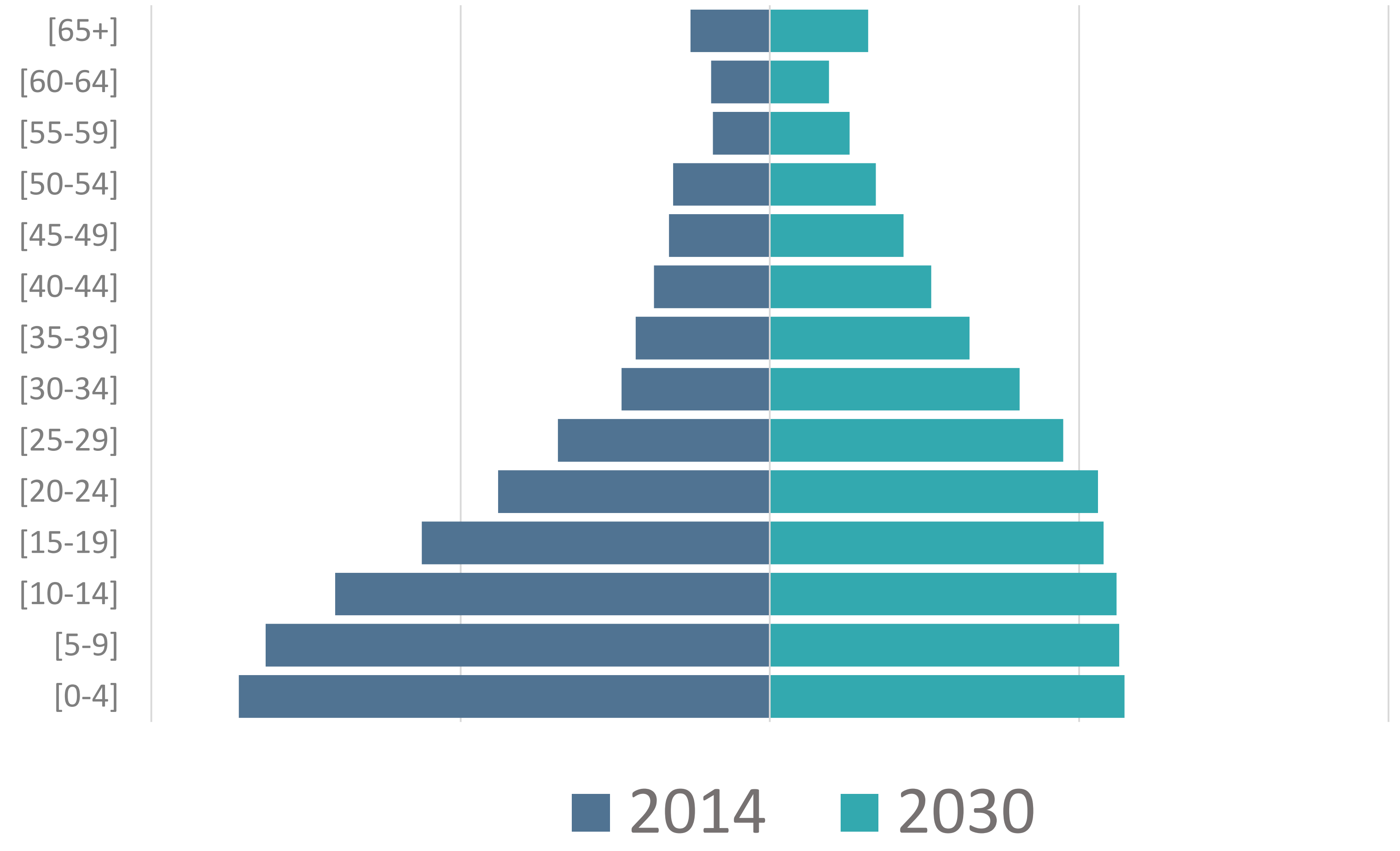
Main obstacles to doing business cited by firms (%)



High fertility rates (5.3) will continue to drive rapid population growth (3% per annum).

- A growing and already under-served population places pressure on the budget.
- High dependency ratios mean households are unable to save, constraining savings available to finance private sector investment.
- Afghanistan's youth bulge is the third-largest in the world and the labor force will need to absorb 400,000 new workers every year.

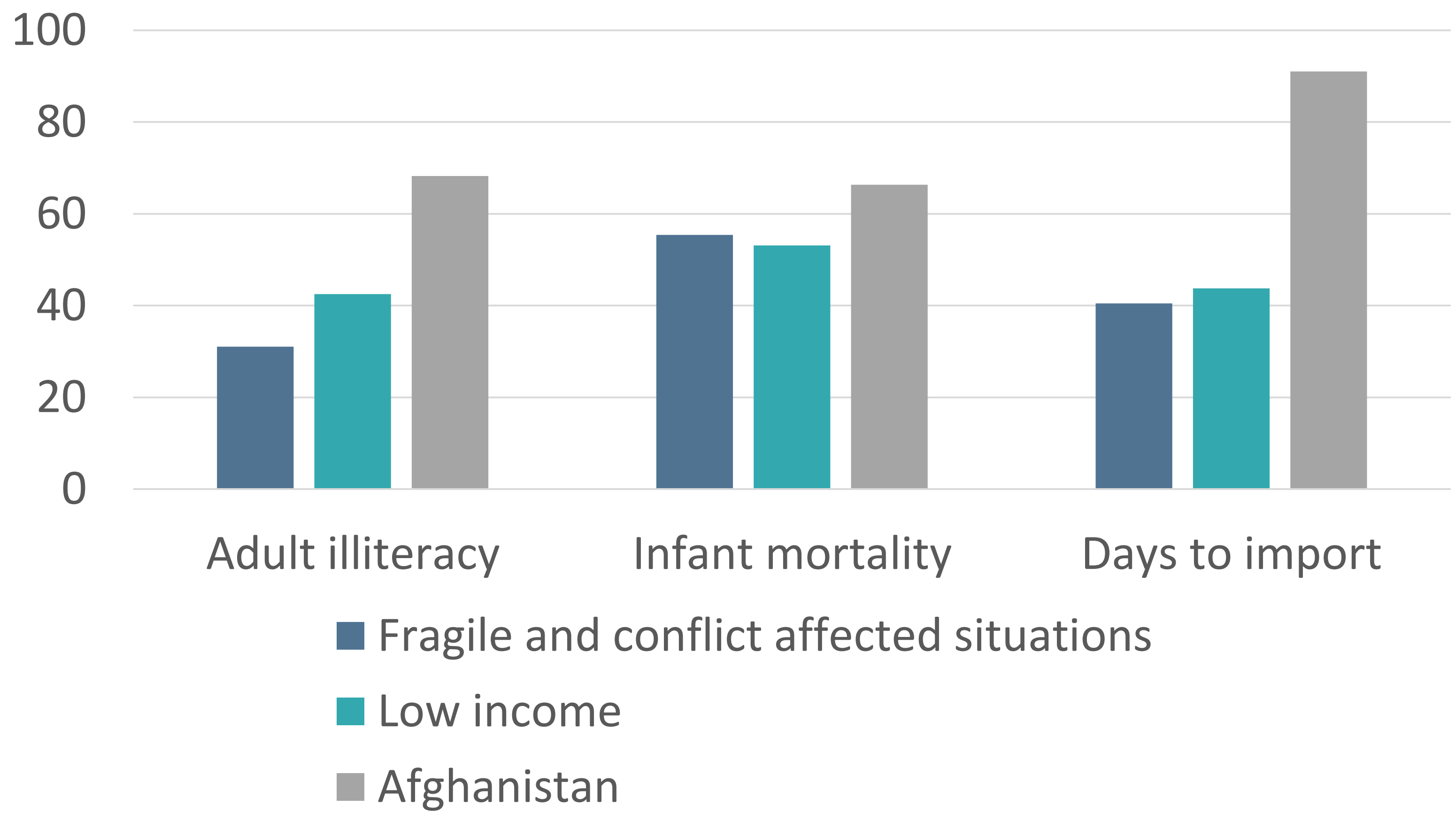
Population pyramids, 2014 & 2030



Limited human and physical capital limit options for structural change and leapfrogging.

- Low literacy and numeracy and a lack of physical infrastructure will constrain transformation to services or manufacturing.
- Natural resources will therefore continue to play a key role in Afghanistan's economy.
- New production will be geographically concentrated around natural resources rather than in cities.

Human and physical capital indicators



Analytical approach

What is Afghanistan's growth potential?

What are the implications for the budget?

What will drive growth?

What can be done to reduce and manage fragility?

15 year time horizon

Assumption of ongoing fragility

Achievable within resource constraints

Analysis shows potential for faster growth through agriculture and mining

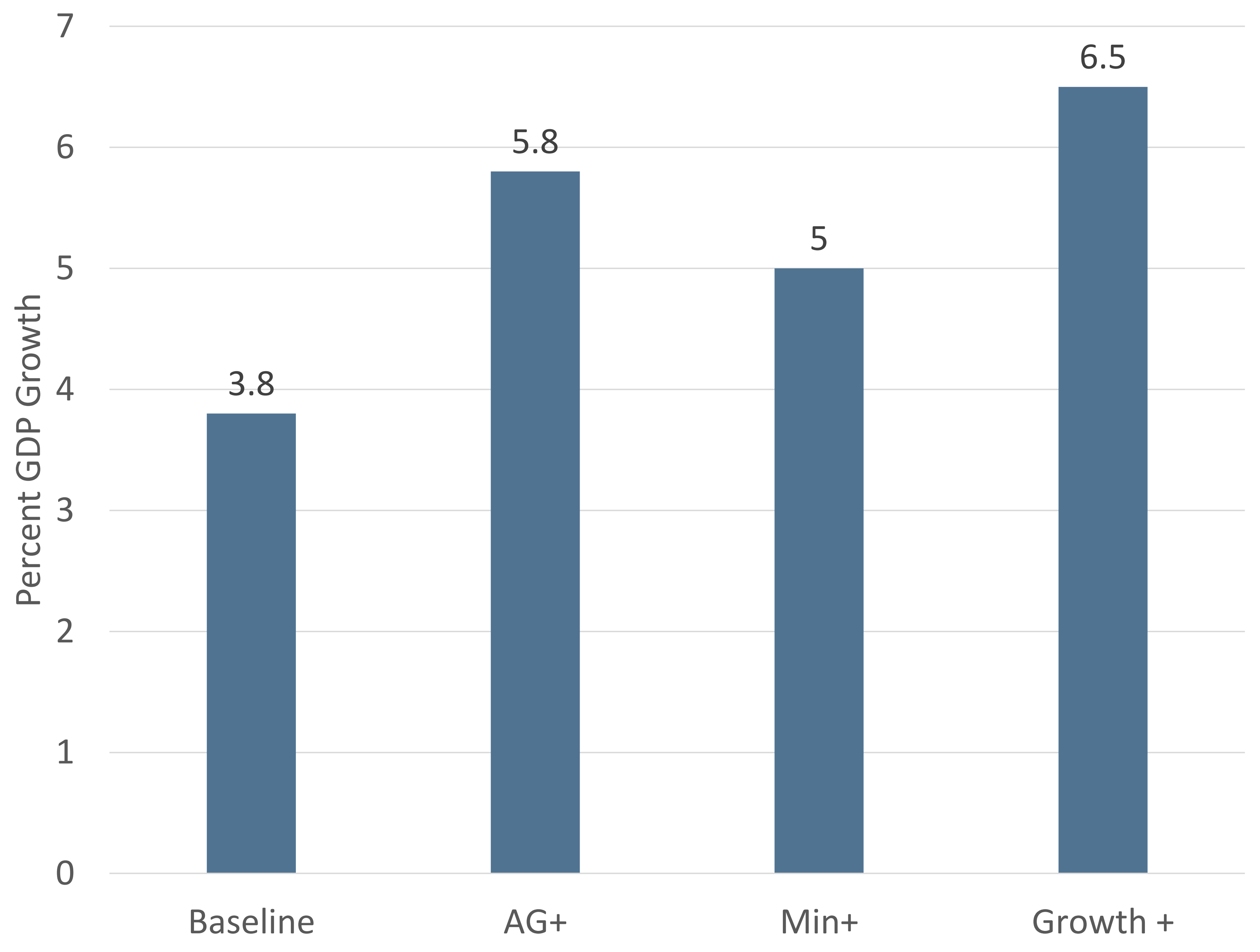
Baseline

- $4 bn of civilian aid per year through 2020, and then declining to low-income country average (10% GDP).
- No structural change due to limited public investment.
- Insecurity continues to limit FDI and domestic investment.
- Slow mining development: Amu Darya, TAPI and CASA.

Growth Plus

- Higher levels of aid in the short-term, but declining more rapidly as domestic revenues improve.
- Strong reform and expenditure program support accelerated agriculture (AG+) and mining development (Min+).
- Human capital investment increases from 35% to 50% of civilian expenditure.
- Managed migration schemes are introduced.

Growth Model Outcomes 2017- 2030
(GDP growth at factor price, average annual)



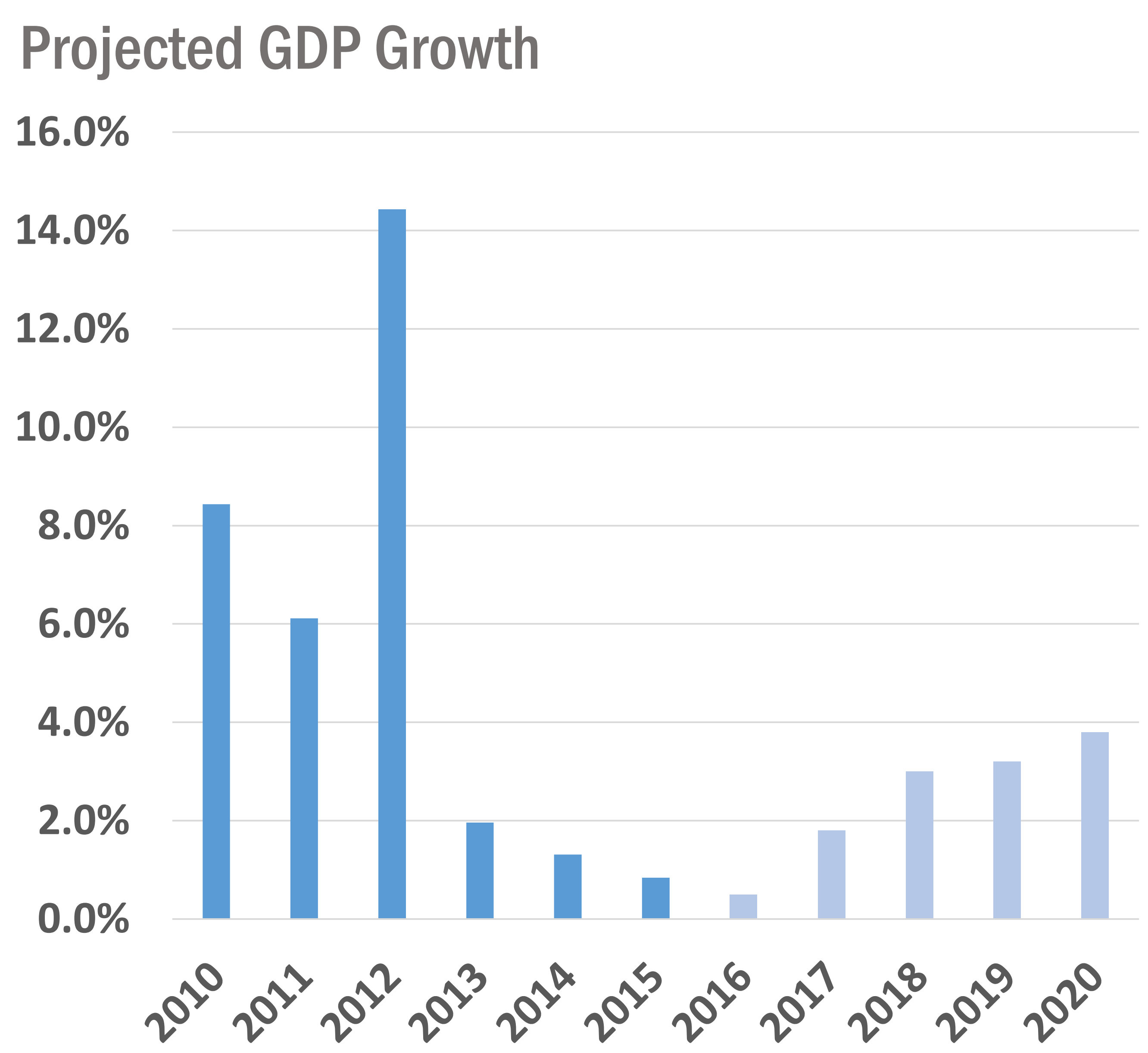
Development must be progressed in a challenging economic context

Action is required now...

- Under the baseline, growth would average just 3.8% over the period and provide little employment growth.
- With population growth of around 3% per year, there would be negligible improvements in incomes and living standards.
- The baseline scenario represents high risk given potential negative security and other shocks, and possible fragility pressures arising from low growth and increasing unemployment.

...but will have limited short-term impact.

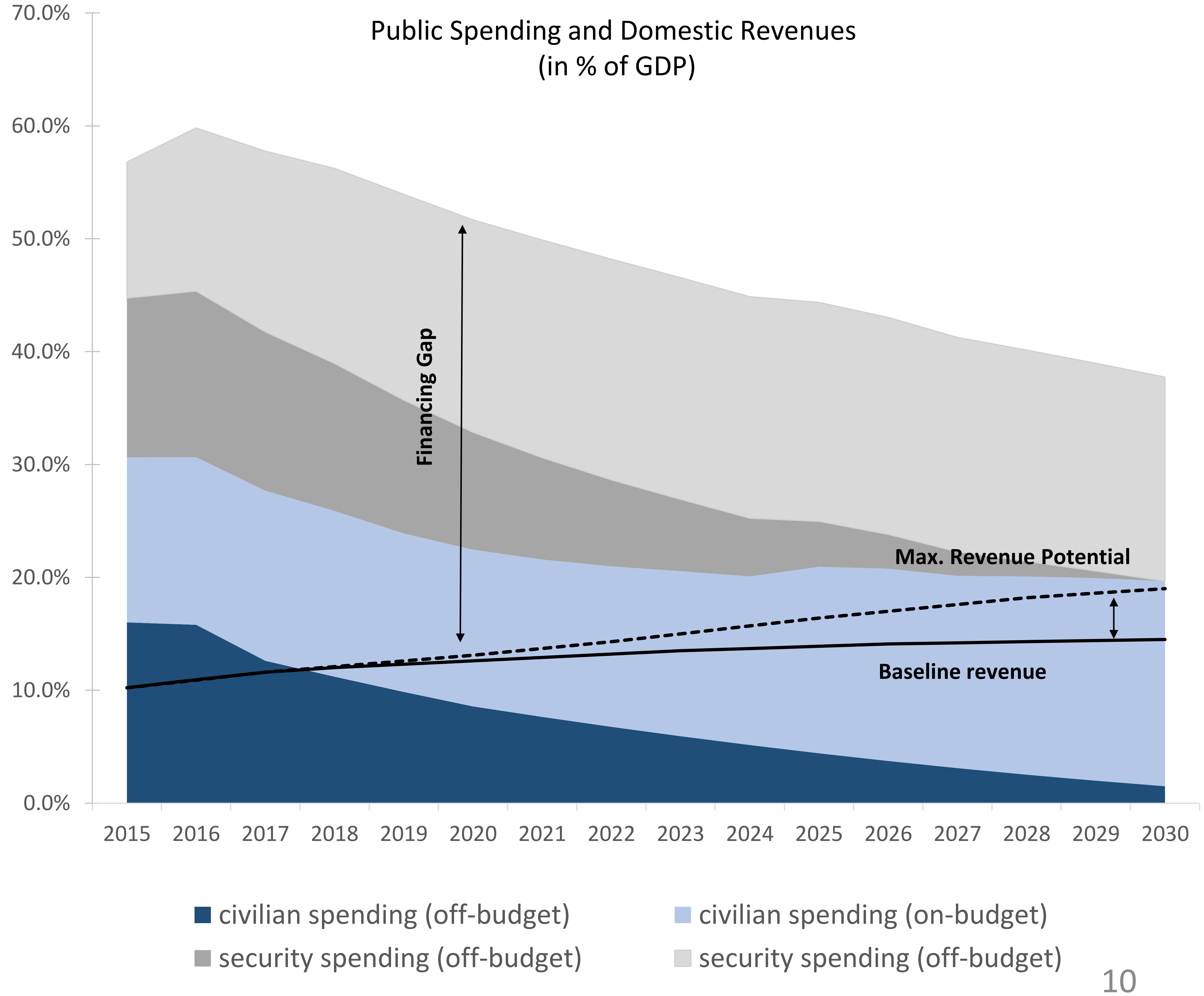
- Mobilizing new growth sources will only have an impact after several years, due to lead-times for implementation and investment.
- Growth will likely remain slow over coming years (around 0.5% for 2016, increasing gradually to 3.8% by 2019), reflecting weak demand and an increasing output gap.
- Government does not have sufficient fiscal space for stimulus (e.g. increased social transfers) to boost short-term growth.



Afghanistan will continue to require extraordinary levels of aid

- Public spending will continue to be critical for development, even if private sector investment picks up.
- High costs of security will limit resources available to meet the needs of a growing population.
- Revenue potential remains limited - revenues are expected to increase from 10.2% of GDP in 2015 to 14.5% of GDP by 2030. Achieving revenue of up to 19% of GDP by 2030 will only be possible with mining development.
- The annual financing gap – the external resources that Afghanistan will require to finance all on and off-budget civilian and security expenditures – will average 34.5% of GDP through 2030 under the baseline.

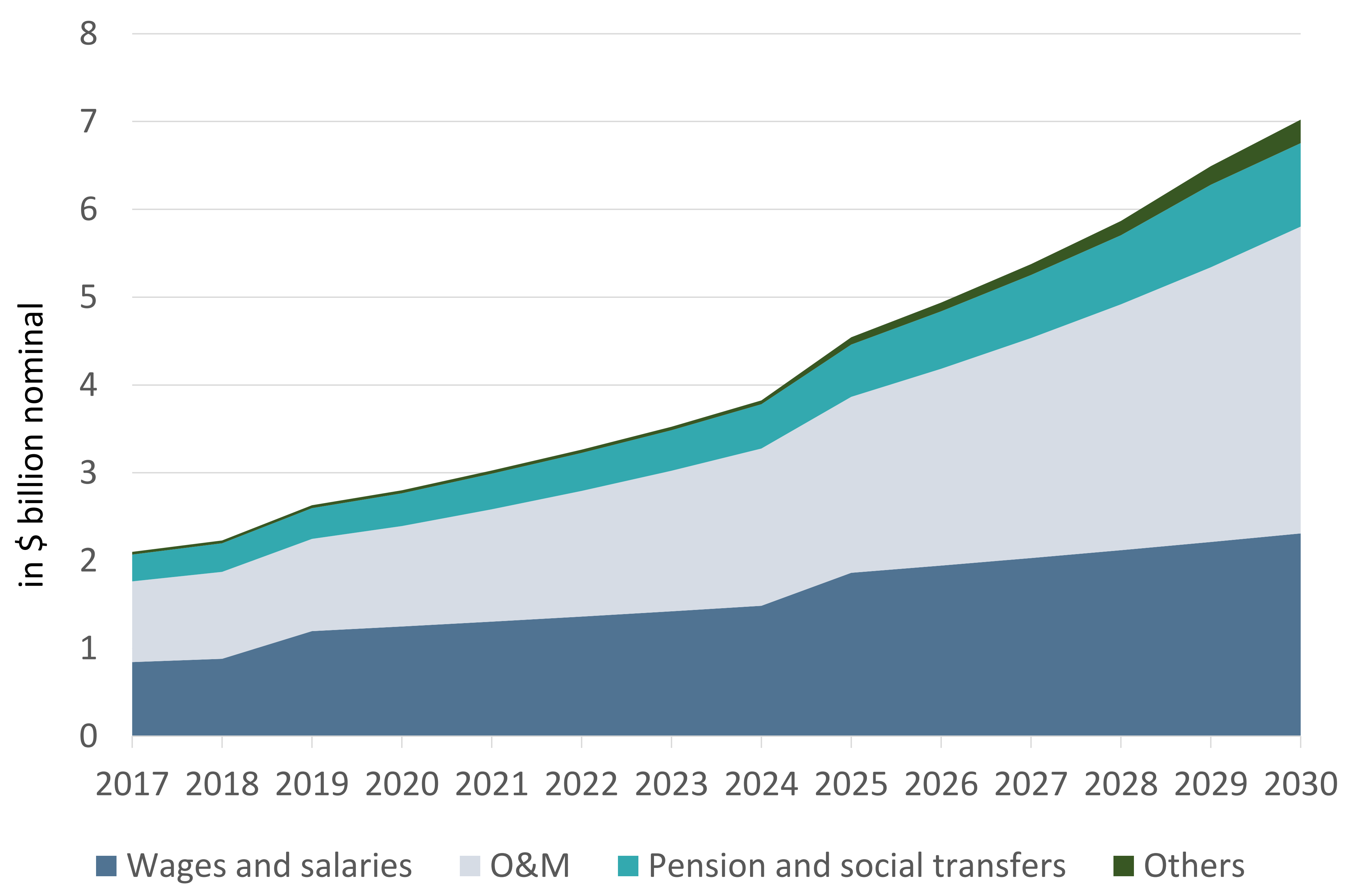
Even in the best case, domestic revenues will not suffice to finance basic development needs



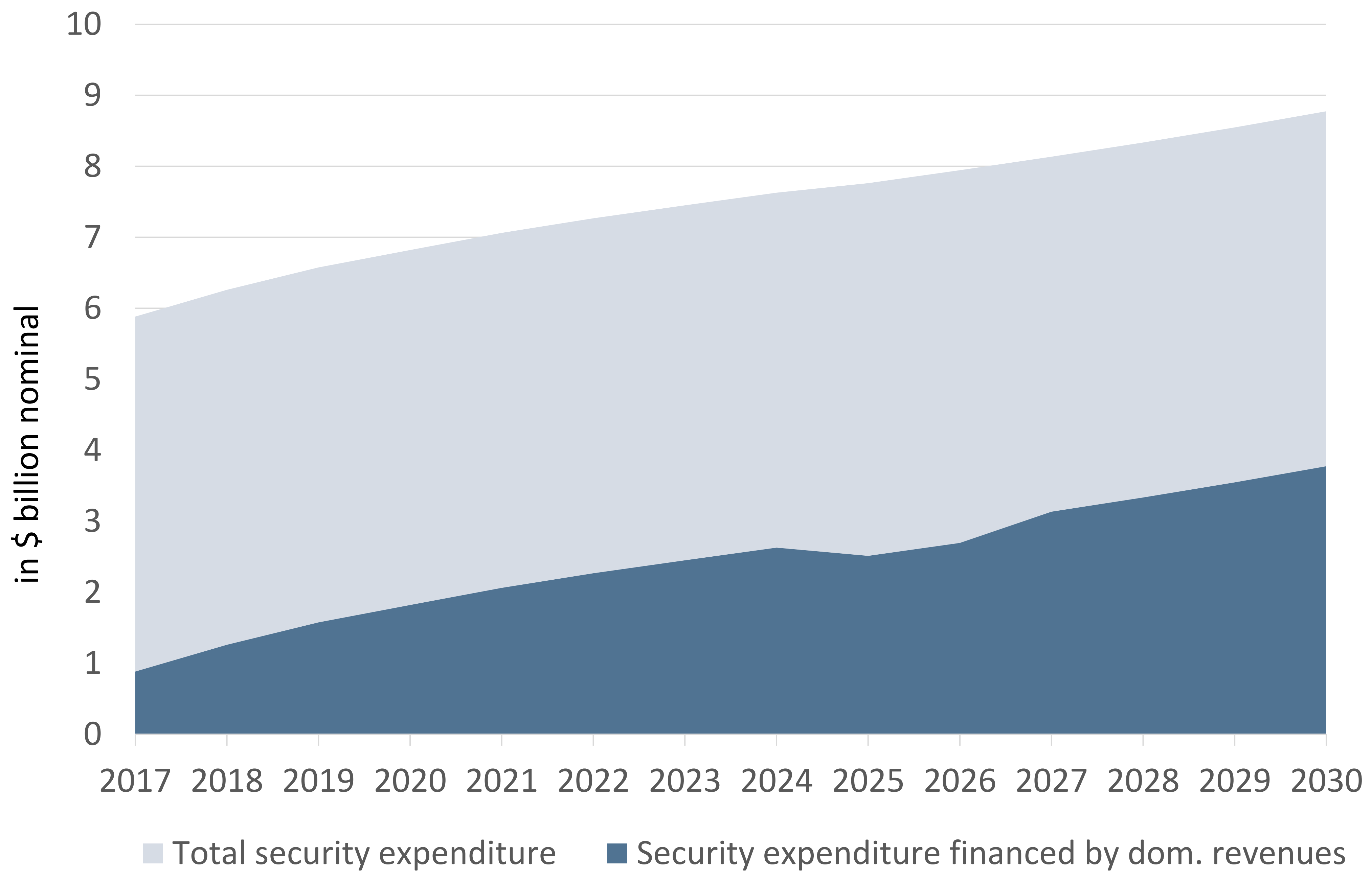
Security and basic service delivery needs will drive public spending

- Security expenditures will expand rapidly with government security commitments consuming a growing share of revenues.
- Civilian spending will need to grow rapidly just to sustain current service levels, driven by population growth, O&M requirements on existing assets, and changing civil service salary structure. This level of spending will still leave a large population underserved i.e. 3 million children out of school.

Public spending needs to maintain current level of service delivery



Projected evolution of security expenditures

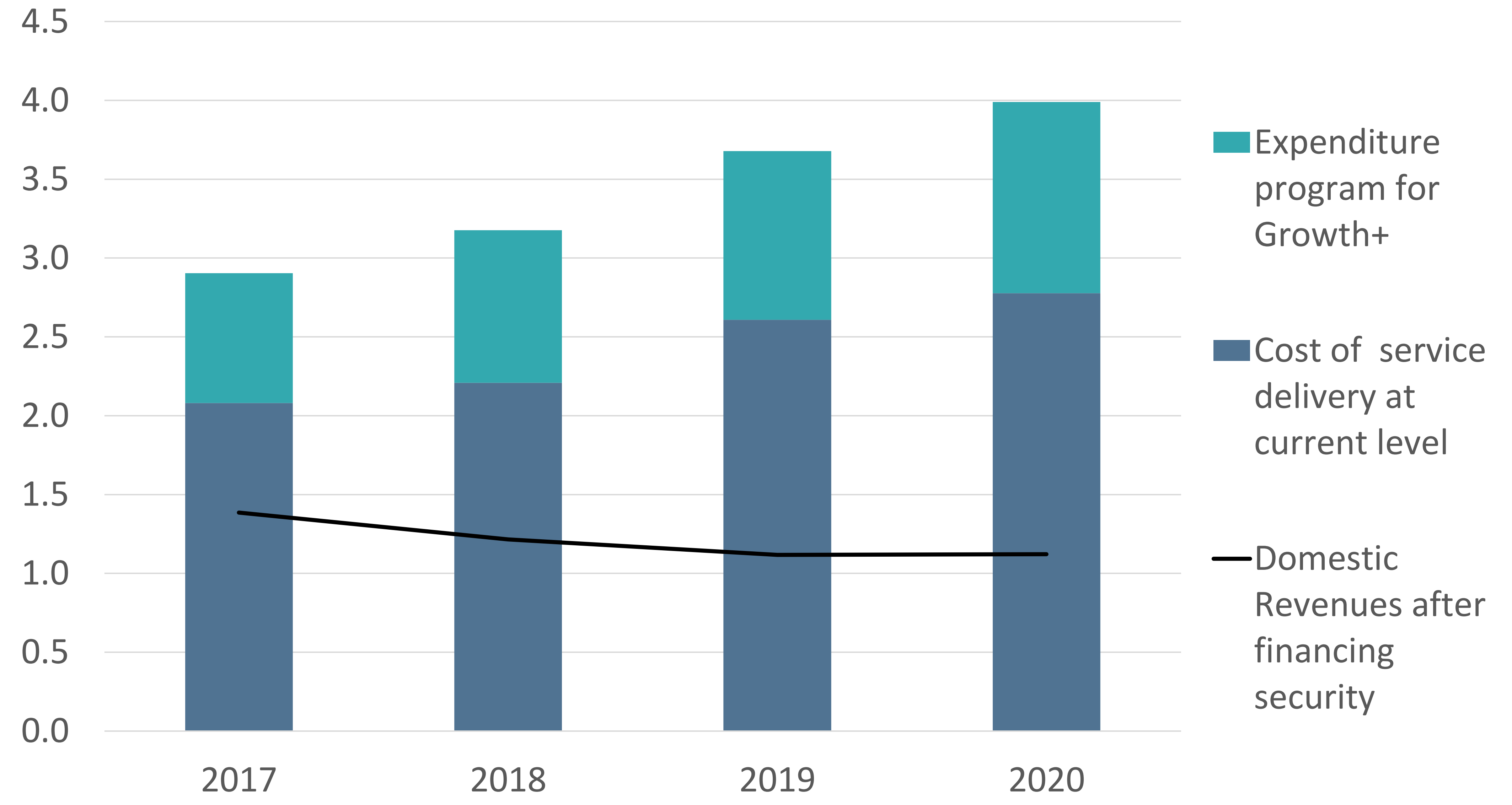


Better outcomes will require higher levels of aid

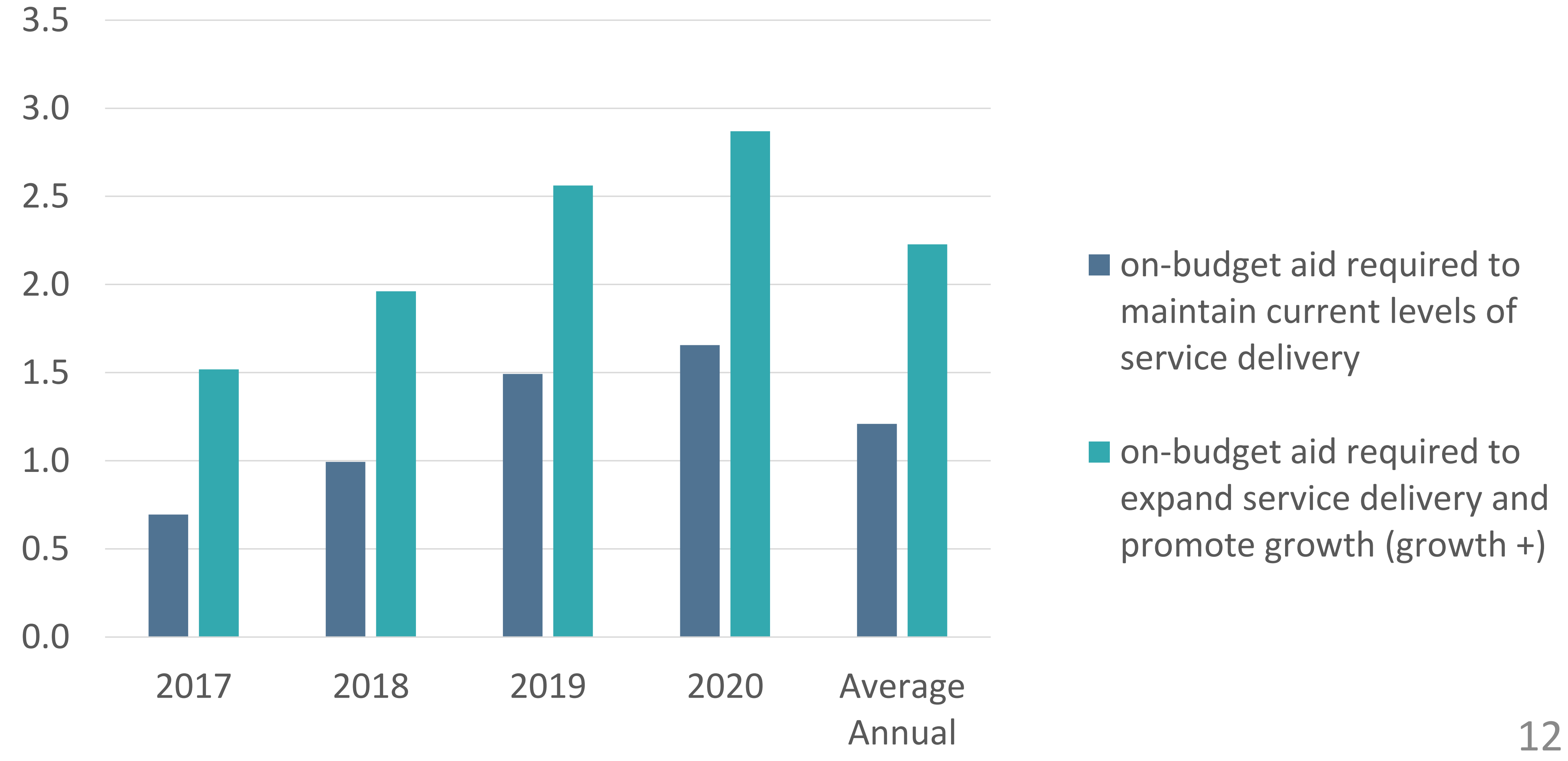
Substantial on-budget civilian aid is required over the next four years to improve development outcomes.

- Security commitments will absorb more than half of revenue over 2017-2020.
- Remaining domestic revenues will be insufficient to meet basic operational costs of Government.
- US$1.2 billion of on-budget civilian aid will be required per year just to cover recurrent expenditure pressures.
- US$2.2 billion of on-budget civilian aid will be required per year for investment to support growth and development progress (Growth+).

Government Budget: Revenues and civilian expenditure needs ($ billion)

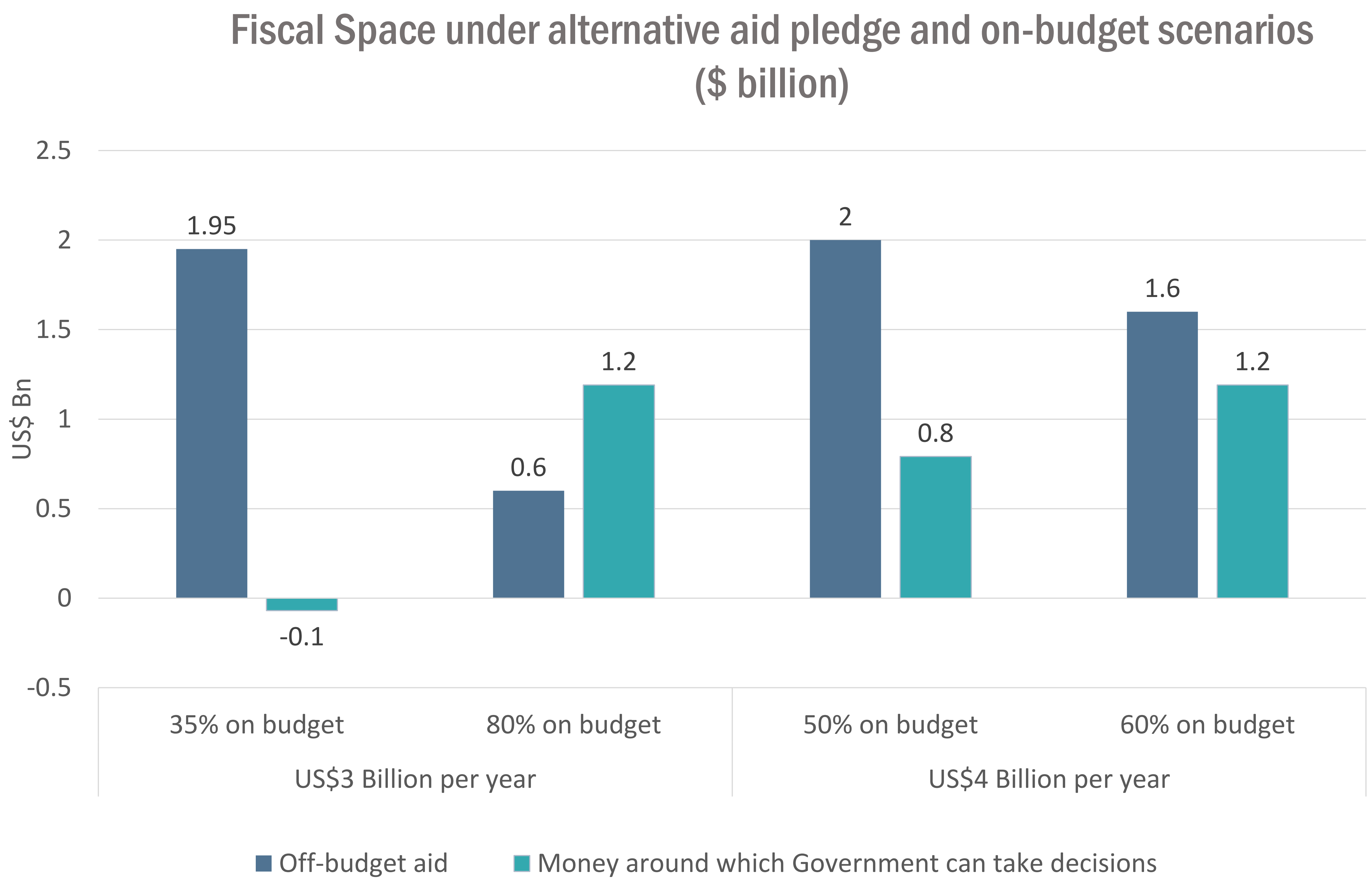


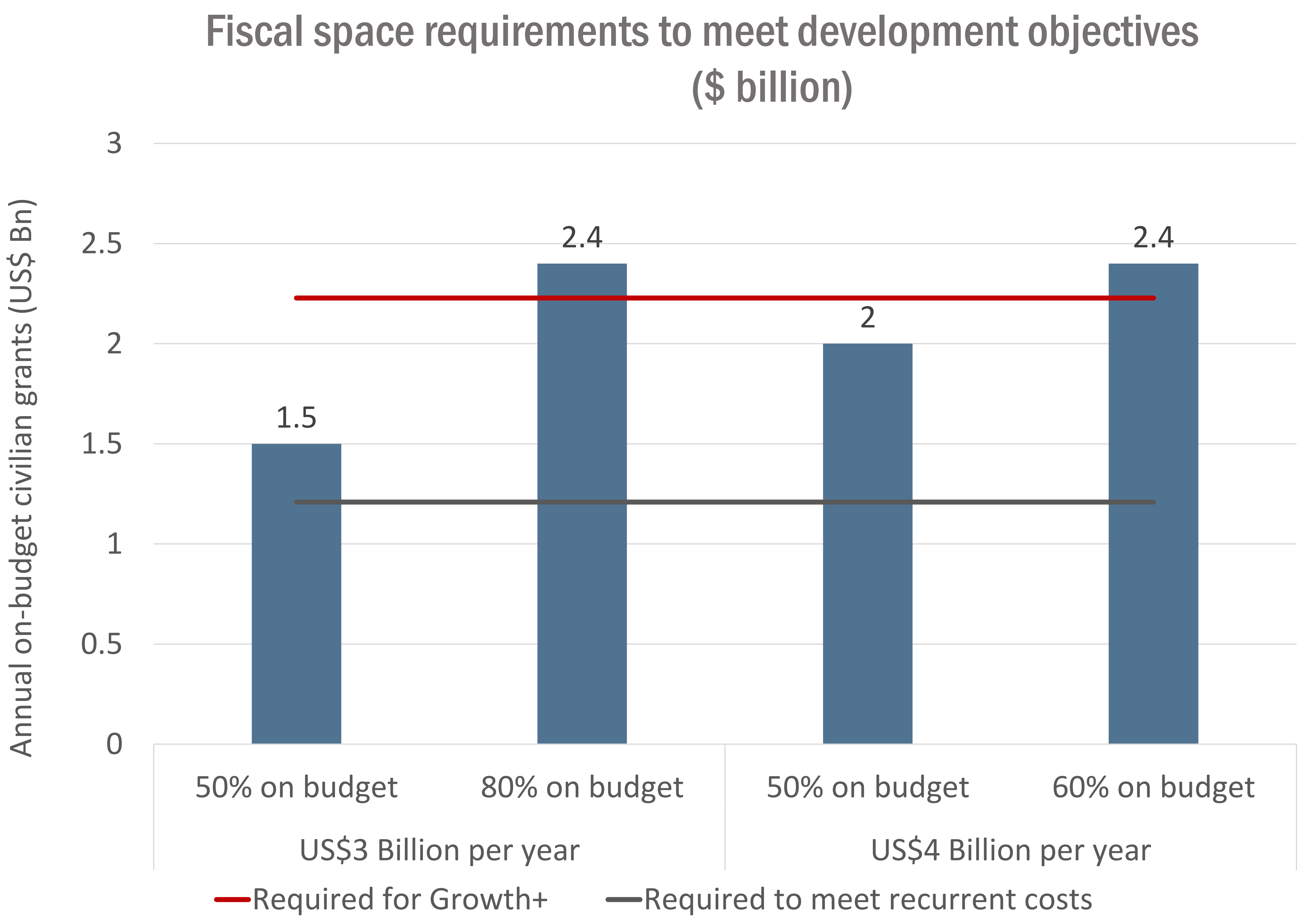
Government Budget: Aid financing ($ billion)



… and moving more aid on budget

- In 2015 disbursement of civilian aid amounted to $ 4.5 billion. Less than 50% of this amount was channeled through the Government's treasury.
- Government's ability to use the budget as an instrument for development planning hinges on the proportion of aid on-budget.
- Even if current levels of aid are maintained, more aid needs to move on budget to expand coverage of country systems and provide Government with fiscal space to implement development plans.

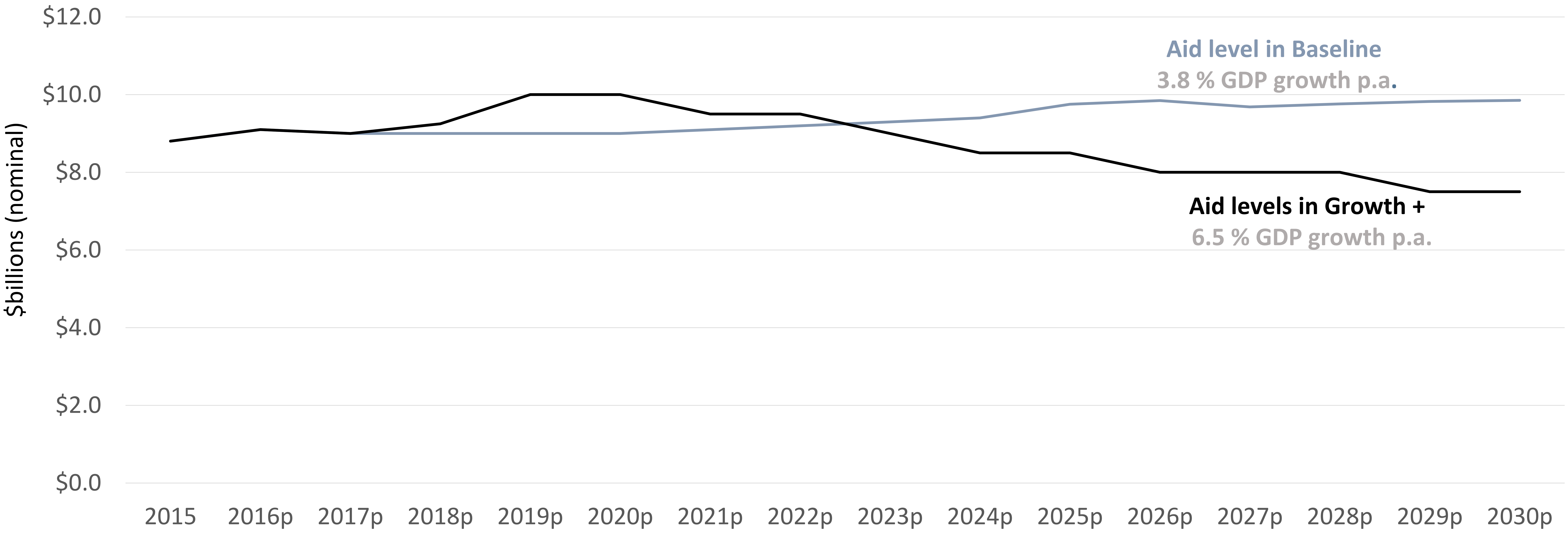




Increased aid over the next four years can reduce long-term aid needs

The Growth+ scenario relies upon additional aid to finance investments that generate growth, increase revenues, and reduce the financing need over time. Financing those investments now would reduce aid requirements in the future

Projected levels of total security and civilian aid across different growth scenarios



There are four additional ways to create fiscal space

Revenue Mobilization

- Continue strengthening compliance including through e-payments
- Streamline processes and procedures for tax payments
- Support private sector confidence and investment, including in the mining sector

Public Spending Efficiency

- Ensure investment decisions are informed by consistent and realistic economic planning
- Build and concentrate capacity for investment management within a small group of growth-relevant ministries
- Continue to strengthen and modernize government systems

Security Costs

- Security expenditures are increasingly crowding out fiscal space for development
- Identify upcoming decision-points that change the trajectory of security spending

Pension Reforms

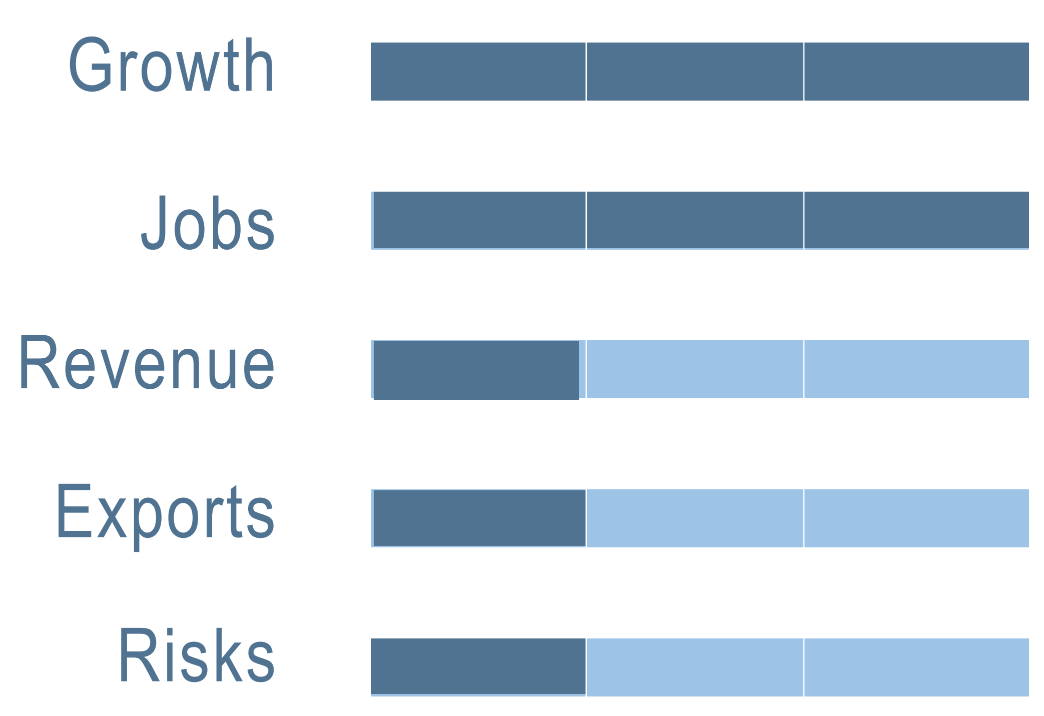
- Civil service pension expenditures will outweigh contributions and become a net cost by 2024
- Reforming the pension scheme now can free up 0.7 % of fiscal space for poverty-oriented spending (e.g. transfers)

Agriculture and human capital will be central to growth and job creation

Agriculture

Agriculture can be a major driver of growth, supporting incomes and reducing poverty.

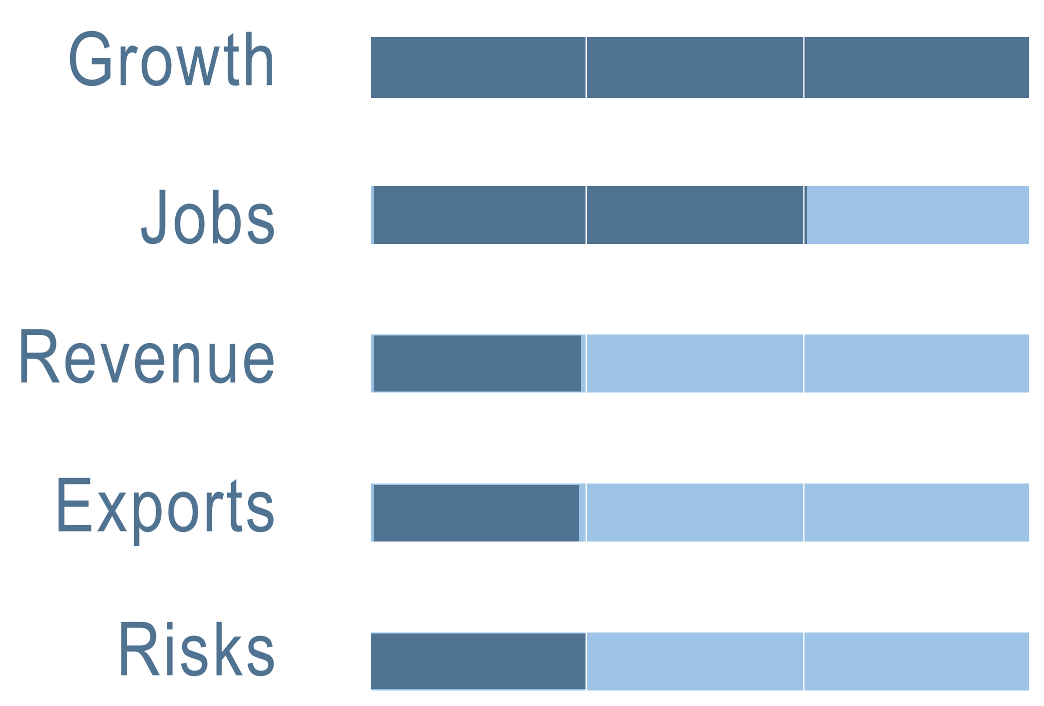
- Rehabilitate and expand irrigation structures.
- Approve pending land legislation and invest in land management systems and capacity.
- Improve availability and quality of knowledge extension services.
- Provide literacy programs for rural populations to improve productivity and to support rural community mobilization.



Human capital investment

Human capital investment is required to improve productivity and incomes under any growth scenario.

- Increase education and health spending from 33% to 50% of civilian spending to ensure increased access and improvements in quality.
- Expand second chance, vocational training, and adult education programs to improve labor productivity. Strengthen focus on female education to close the gender gap and reduce fertility.
- Expand primary healthcare services, prioritizing rural areas.

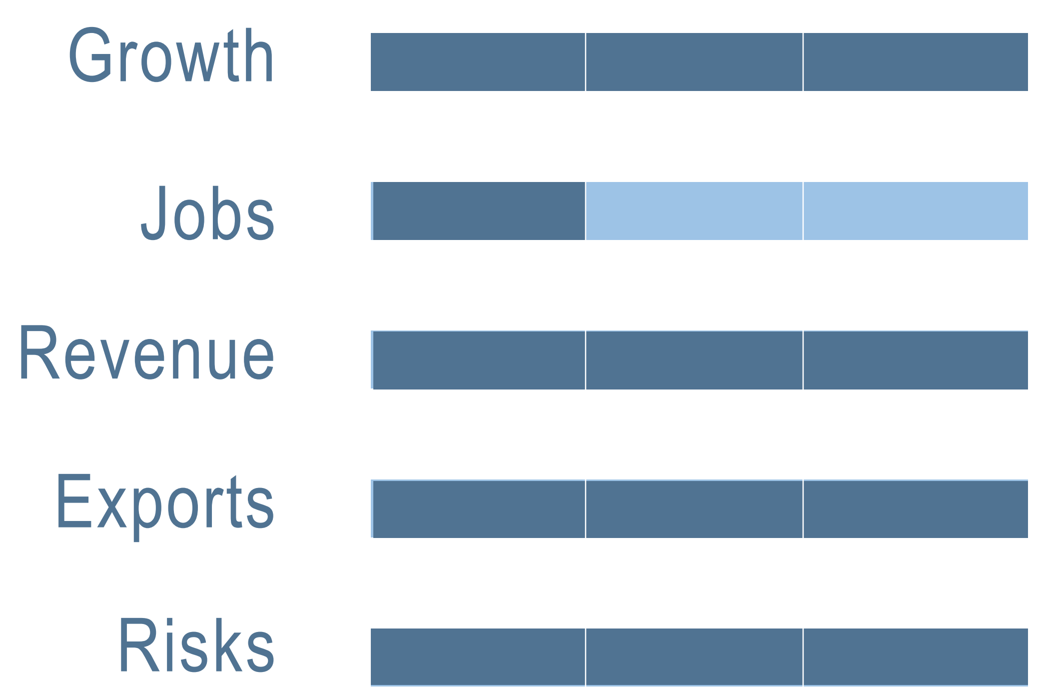


New sources of exports and revenues are needed

Extractives

Extractives have potential to generate substantial exports and revenues, but risks need to be carefully managed.

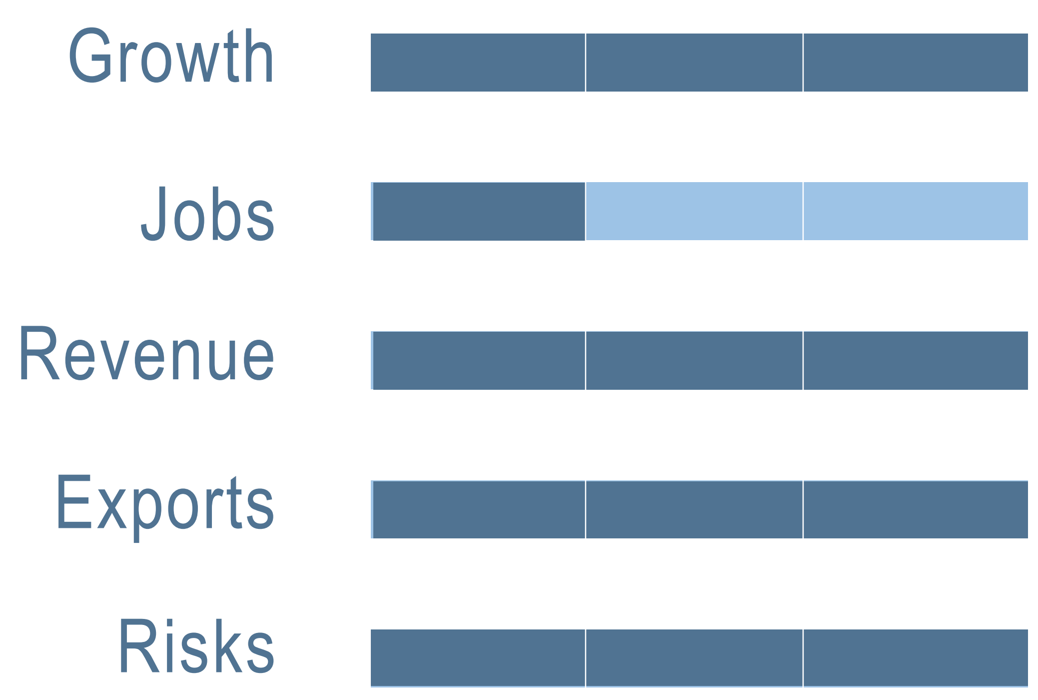
- Modeling suggests substantial contributions to exports and revenues if governance and fiscal risks can be managed.
- Identify opportunities for scaleable proof of concept investment that can pursued while the institutional and regulatory environment is progressively strengthened.



Hydropower

Energy exports are a potential alternative to extractives, but will be slower to take-off, carry similar risks and higher fiscal costs.

- Large-scale development of generation plants will be difficult to finance given insecurity and budget constraints.
- Export potential is contingent on energy policy decisions in market countries.
- Large-scale hydro development may expose Afghanistan to similar fragility pressures as extractives.
- Small-scale, off-grid solutions could offer domestic coverage at lower cost.

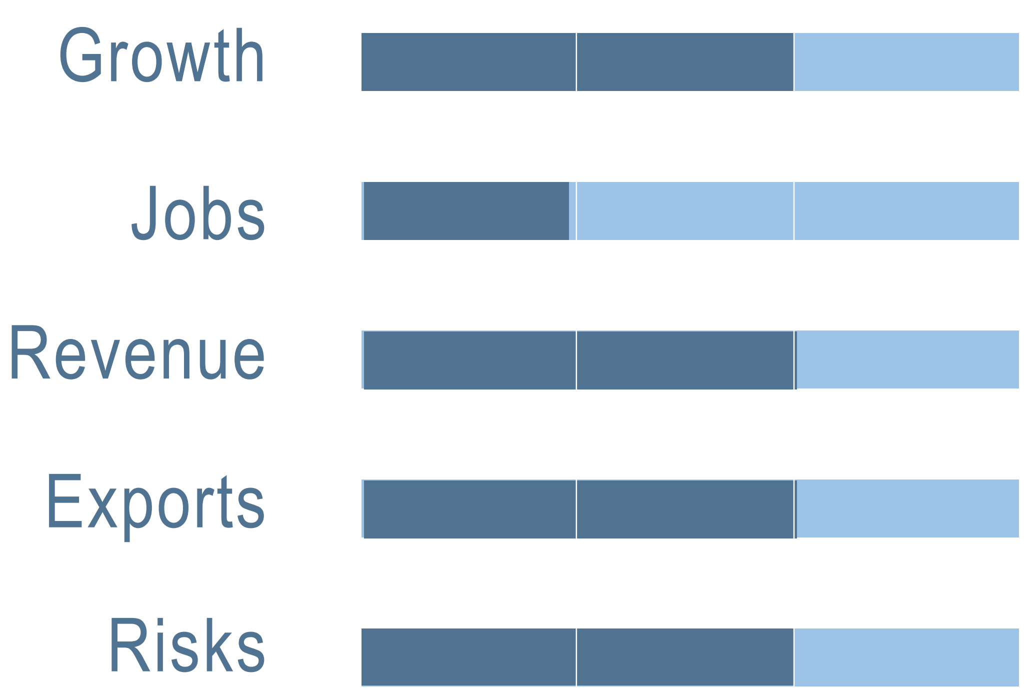


International flows can support sustainable growth

Regional Integration

Expansion of trade infrastructure would yield greater returns if supporting agriculture or extractives development. Regional energy transit trade and IT connectivity show potential for revenue generation independently of extractives. Commodity transit is not competitive in the current risk environment

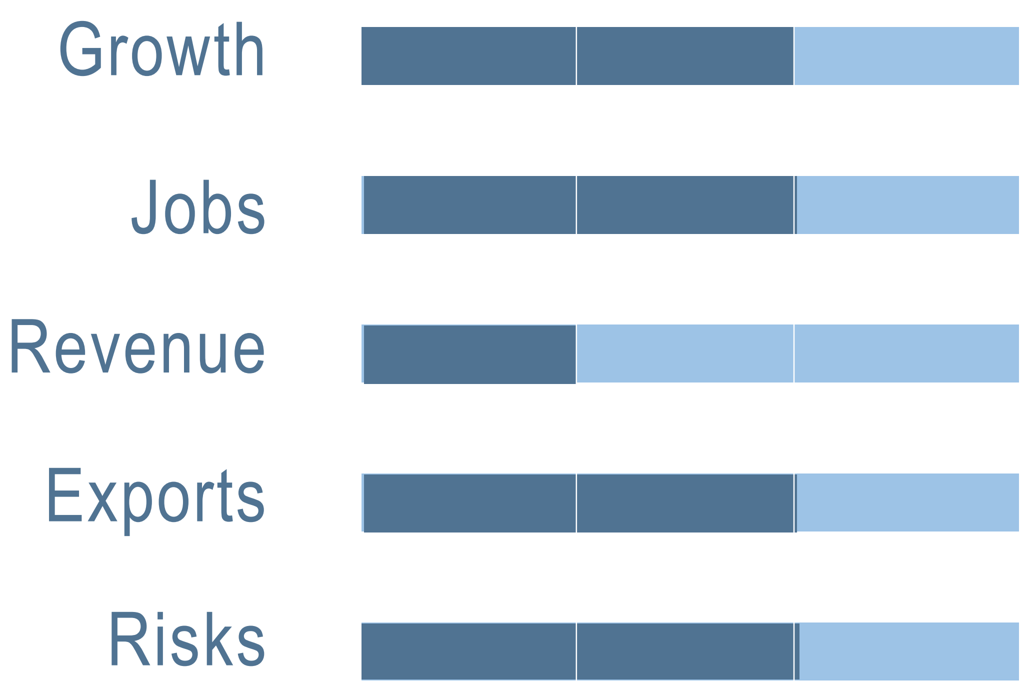
- Carefully assess economic rationale for transportation infrastructure.
- Ensure swift implementation of regional energy connectivity projects.
- Establish a single window and trade information portal, improve border. management, coordination and trade facilitation at border crossings with Pakistan to reduce delays.



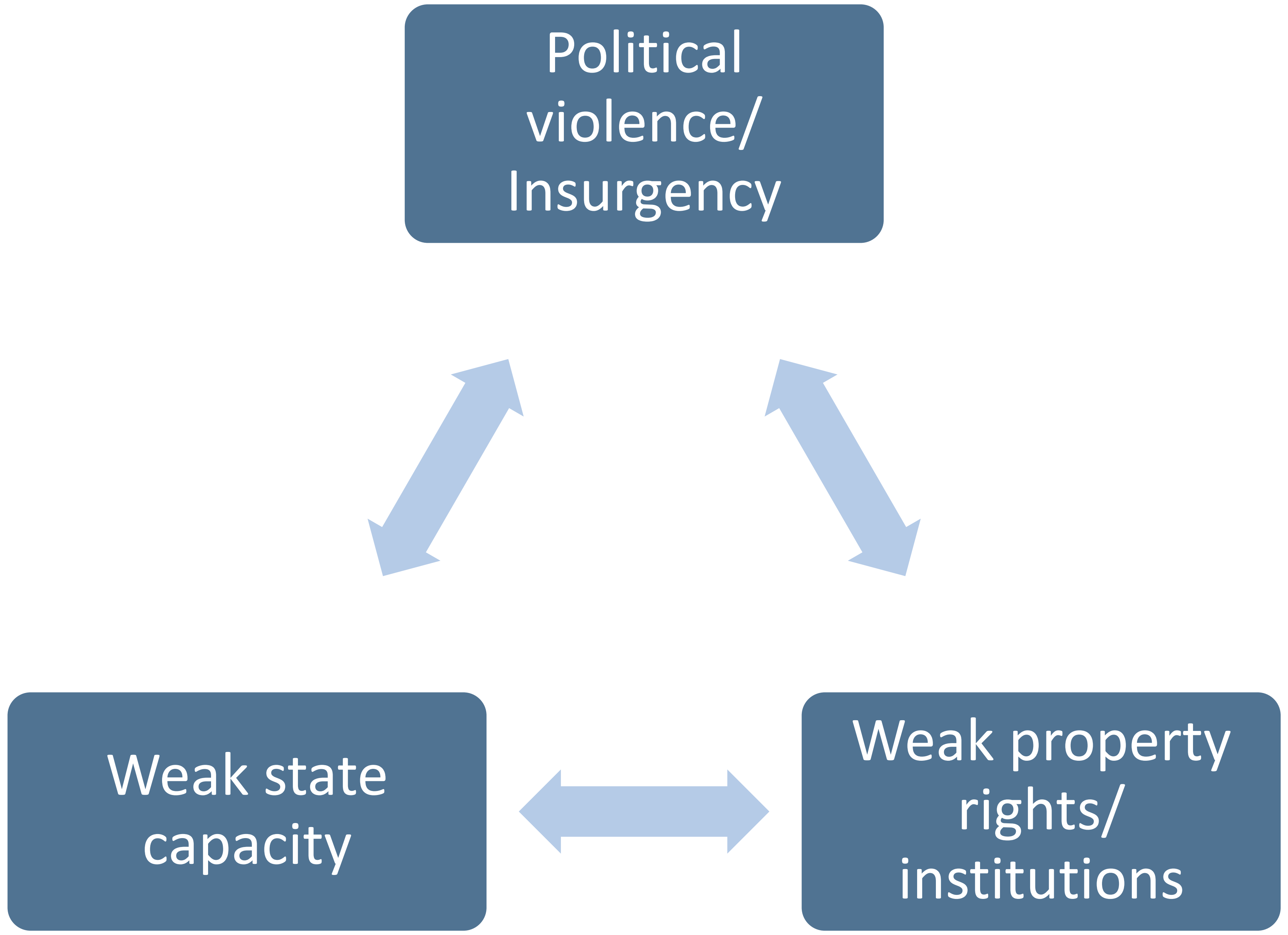
Labor Migration

Managed labor migration can reduce population pressures while increasing human capital and incomes.

- Identify potential host countries and negotiate bilateral labor agreements.
- Establish a functioning governance structure for migration which formalizes international labor flows and effectively supports Afghan workers going abroad (intermediation and protection).
- Access technical assistance to build institutions and capacity to support managed migration.



Fragility will persist, but more stable institutions could moderate risks



Fragility has several overlapping dimensions

- Private sector opportunities are profoundly impacted by insecurity and violence.
- Institutional weaknesses make it more difficult for the private sector to deal with conflict risks.
- Strengthening institutions can support investment, by helping the private sector manage risks in the context of continued political violence.

Formal rules will remain contested and unevenly enforced

- Contestation over property rights and risks of expropriation create uncertainty and deter investment.
- Some powerful actors have limited interest in abiding by or enforcing written rules.
- Given weak state capacity, it is unrealistic to expect that formal institutions can be universally enforced.

Institutional strengthening efforts should focus on key agencies and functions

Reduce institutional instability and predation in areas that matter most for growth and stability.

- Prioritize reducing predation and providing predictability in areas vital for development - the mining sector, land, justice, and taxation.
- If necessary, compensate powerful actors when enforcement of formal institutions required for growth presents a major threat (for example, offer leases to those illegally occupying government land).
- Insulate key institutional decision-making responsibilities (on a project, geographical, or functional basis) from political pressures through allocation to (or development of) 'islands of effectiveness'.
- Build bottom-up accountability for government performance, including through the Citizens' Charter Initiative.

Provide firms and households with tools to manage fragility.

- Introduce specific policy instruments to help firms and households manage risks arising from long-term institutional weaknesses.

Households in Afghanistan are uniquely exposed to a variety of risks

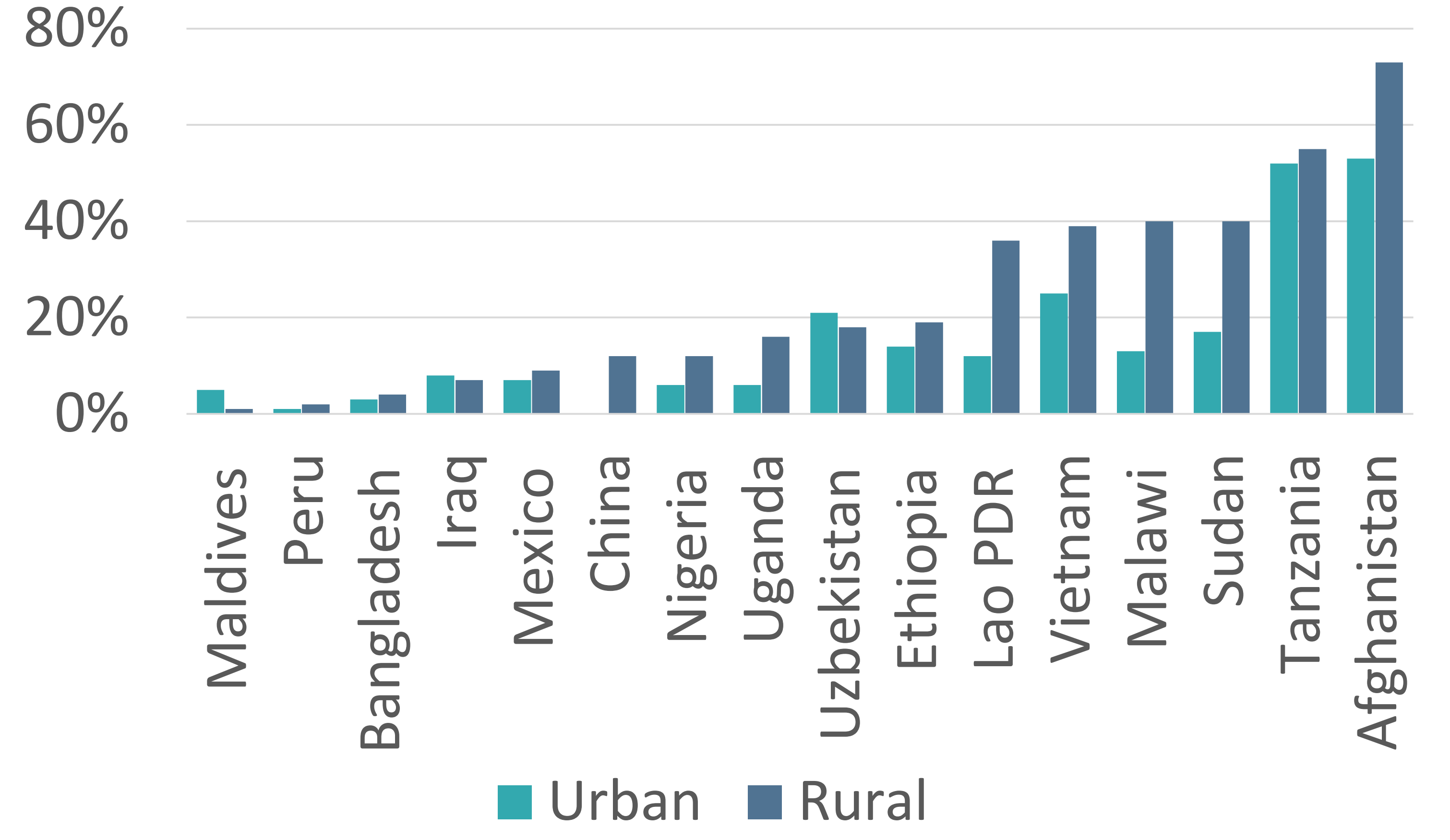
The number of households experiencing shocks in Afghanistan is among the highest in the world.

- 88 % of households experienced at least one shock in 2014.
- Climate and natural hazard related shocks are more common than security shocks. But households facing insecurity are more likely than others to resort to harmful coping strategies.
- Responses to shocks are creating long-term poverty traps — including reducing human capital investment and reducing food consumption.

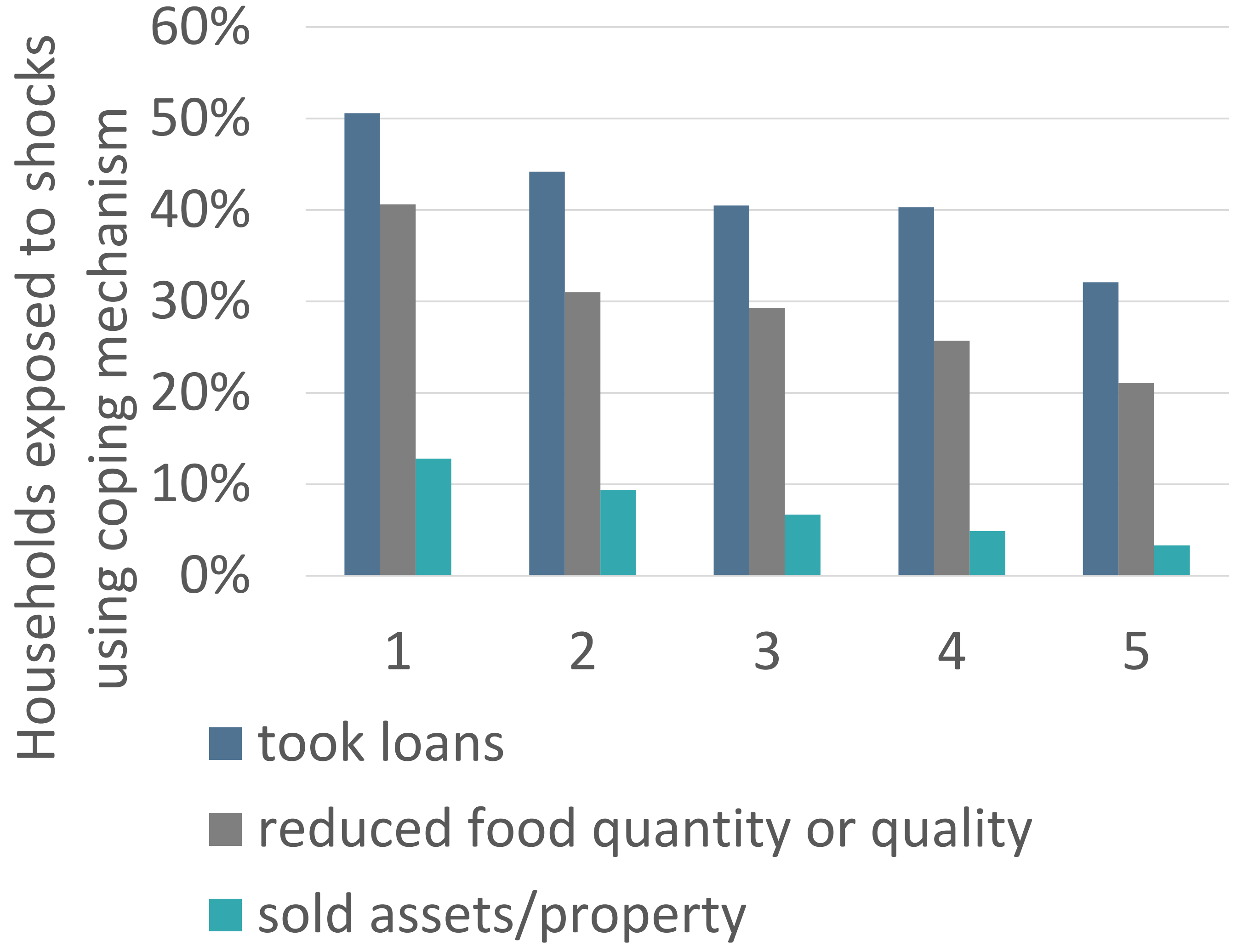
A broad-based social transfer system could help negative coping mechanisms.

- A transfer program costing around US$210 million per annum could cover 5% of the population, halve food poverty, and substantially reduce need for negative coping mechanisms.

Proportion households experiencing multiple shocks



Coping mechanism by quintile of households exposed to shock



Firms are heavily impacted by crime and insecurity

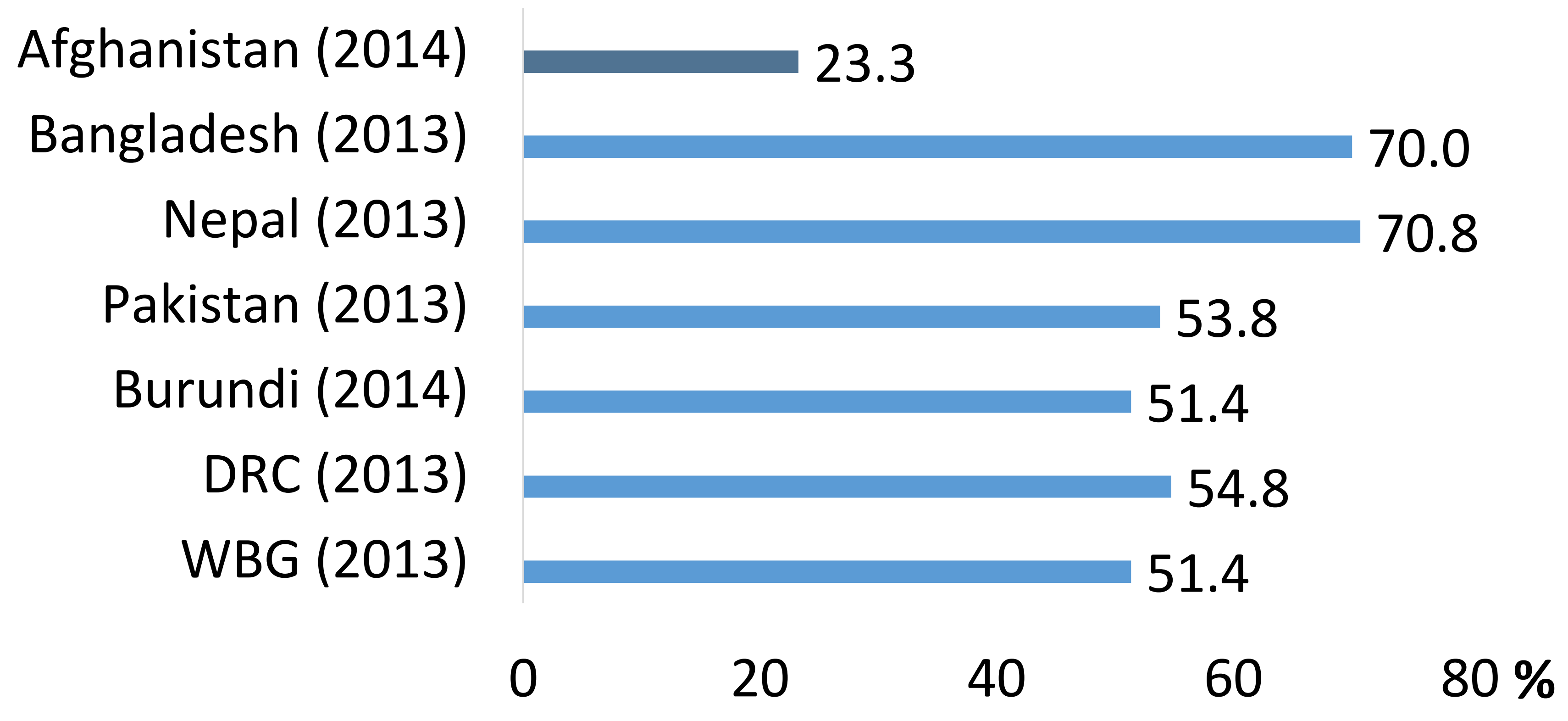
Investment is heavily constrained by insecurity and lawlessness.

- Medium-sized and investing firms are much more likely to be a target for criminal predation. Large firms are better able to protect themselves against crime-related risks.
- Predation of medium-sized firms discourages firms from growing to the point where they could generate substantial employment and investment.
- Firms owned by women are more likely to invest, despite pervasive insecurity.

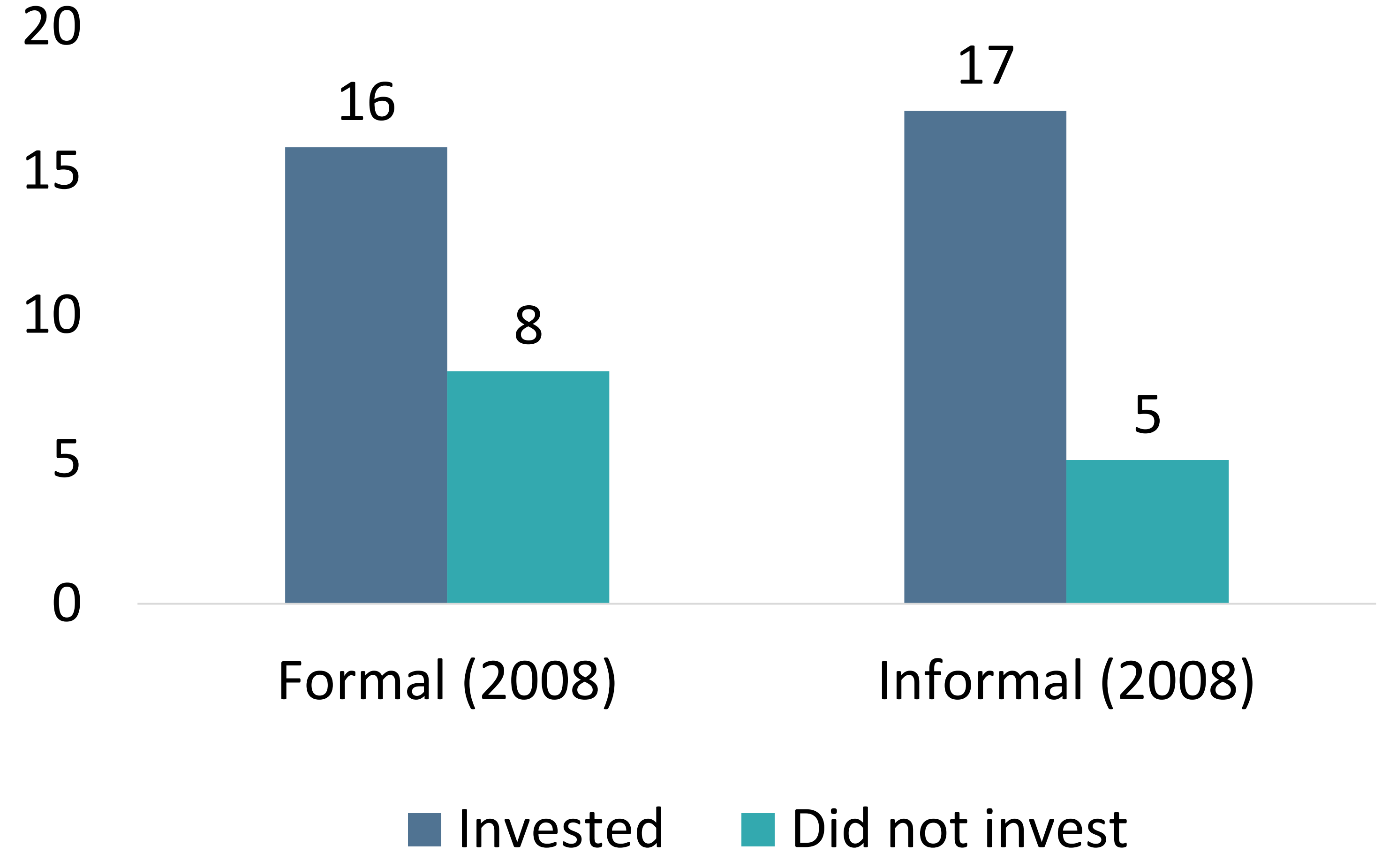
As progress is made towards strengthening rule of law, partial risk/credit guarantee schemes could help firms share risks.

- Prioritize financial sector development, including institutions and corporate governance.
- Implement a credit/risk sharing facility to promote investment in crucial sectors.
- Improvements in financial sector inclusion could support substantial increases in private investment over the period.

Firms citing risk of crime to be no/minor obstacle (%)



Firms reporting crime-related losses (%)



In focus: Poverty and Spatial Inequity

Poverty is widespread and concentrated in rural areas.

- Poverty increased from 36% in 2012 to 39% in 2014.
- The urban poverty rate is 28%, compared to 38% in rural areas.
- Poverty is concentrated in mountainous and relatively isolated areas, including the Northeast, East, and West regions.

Urban conditions are a growing concern as returnees and the internally displaced move to cities.

- The return of 5.8 million refugees and the influx of internally displaced people has driven very rapid urban population growth.
- The vast majority of the urban population does not have formal tenure and urban services are being overwhelmed.

Land and municipal finance reform should accompany agricultural development and increased human capital investment.

- Agricultural development and expanded rural services can both reduce rural poverty and moderate the pace of urbanization by improving rural living conditions.
- But urbanization is likely to continue given the concentration of public expenditure and service sectors in urban areas.
- Urban land reform is required to provide secure tenure to urbanizing populations.
- Reforms to municipal financial administration can ensure cities can raise revenues to pay for required infrastructure and service improvements.

Implications

Government

1. Create fiscal space by reviewing security spending, strengthening revenue compliance, and reforming pensions.

2. Allocate scarce resources to sectors, agencies, and functions that matter most for development
   a. Prioritize resource sectors – development of these sectors can create revenues with which to pursue other development goals over time
   b. Invest in human capital, which will underpin all growth strategies
   c. Focus institutional strengthening efforts on the agencies and functions that matter most – natural resource regulation, justice, public investment management, and key economic and social ministries.

3. Help the private sector manage enduring fragility risks by introducing a social transfer system for households and a credit/risk sharing facility for firms.

Development partners

1. Ensure that constituencies understand the sensitivity of Afghanistan's economic prospects to changes in aid.

2. Provide a greater proportion of aid through the budget to increase fiscal space.

3. Moderate expectations regarding the achievable pace of institutional reform, recognize the need for political accommodations, and target governance and institutional strengthening efforts to sectors and agencies that matter most for development.

Annex

Aid – better on budget?

More aid on budget helps deliver government priorities

The Paris Declaration on aid effectiveness commits donors to increased alignment and use of country systems in aid delivery.

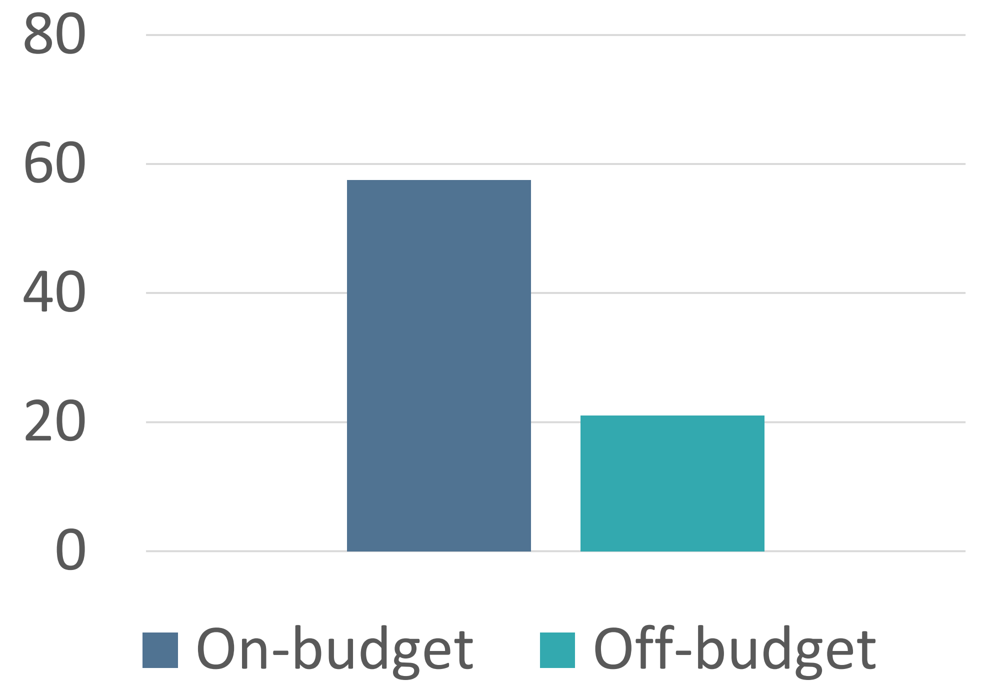
Delivering aid through country systems ensures:

- Sustainability – delivering aid flows through country systems supports the strengthening of those systems
- Cost effectiveness – using local labor and procurement can reduce costs and significantly improve value-for-money
- Alignment – on-budget aid supports government programs, ensuring consistency with government priorities.

More aid on budget supports economic development

- Aid spent "on" Afghanistan is not necessarily spent "in" Afghanistan - the proportion of aid spent on local relative to imported goods and services varies significantly depending on donor modalities
- The local economic impact of expenditures delivered through budget systems is much higher than aid delivered off-budget, due to local employment and domestic procurement
- Moving more aid on budget can create jobs and support the domestic private sector, increasing the benefits from every dollar of aid spent.

Cents per dollar spent within the Afghanistan economy by modality (Civilian spending)



Estimated non-works costs as % project value (selected Afghanistan road projects)