Afghanistan: Transition Economics Update

November 27, 2014

The World Bank
Outline

- Development Progress and Challenges
- Key Messages from Tokyo and Transition Economics Report
- Recent Economic and Fiscal Developments
- Priority Agenda going forward:
  - Restoring Fiscal Stability
  - Restoring Confidence and Creating Private Sector Jobs
  - Strengthening Social Cohesion and Service Delivery
Decade before transition (2003-12): Significant progress from very low base

• **Economic Progress:**
  – GDP growth averaged 9.4 percent during 2003-12
  – GDP per-capita from $186 in 2002 to $688 in 2012
  – Domestic revenues up from 3% of GDP in 2002 to 11.6% of GDP in 2011
  – Public financial management improvements enabled increases in on-budget expenditures from $346 million in 2002 to $4.9 billion in 2012

• **Social Progress:**
  – School enrollment up from 1 million (few girls) in 2001 to 9.2 million (3.6 million girls) in 2013
  – Access to improved water source up from 22 percent to 50 percent of population
  – Life expectancy up significantly over the same period
  – Maternal mortality more than halved
Formidable development challenges

**Poverty and Demography**
- Poverty high and persistent (36% of population in 2012)
- About 400,000 new entrants into labor force each year
- Low human development, despite decade of progress

**Aid Dependence**
- Economic activity, service delivery, security highly reliant on aid

**Security and Fragility**
- Undermine progress toward job creation and self-reliance
- Continued progress on service delivery critical for social cohesion

**Corruption and Governance**
- Progress in fighting corruption and building institutions critical
Tokyo Conference and Transition Economics

• **Persistent financing gap:**
  Aid will decline as share of GDP, but a persistent financing gap will remain through 2025 (with considerable needs for security, O&M, and improving low levels of development)

• **Economic Growth:**
  Projected at 5 percent per year given smooth political and security transition

• **International community:**
  Recognized need for more on-budget assistance to mitigate impact of declining aid

• **Government:**
  Recognized need to improve revenues, prioritize spending, and strengthen absorptive capacity and PFM systems
Sharp slowdown in economic growth in 2013-14, driven by uncertainty and a confidence crisis

- Uncertainty since 2013 over the political and security transition, compounded by the protracted elections impasse in 2014, has led to a slump in investor confidence
- Growth, down sharply to 3.7% in 2013, has fallen further to 1.5% (proj.) in 2014, from average of 9.4 percent per year during 2003-12
Fiscal crisis underway, with declining revenues leading to an unfinanced fiscal gap, depleted cash, and arrears in 2014

- Revenues projected at 8.7% of GDP in 2014, down from 11.6% in 2011 (due to the economic slowdown plus weaknesses in enforcement)
- In first 10 months of 2014, a large unfinanced fiscal gap led to depleted cash balances and accumulating arrears
- Expenditures were higher due to security and mandated social spending

![Graph of Domestic Revenues 2003-2014](chart-image)

![Bar chart of Components of Discretionary Civilian and Security Spending (US$ millions)](chart-image)

<table>
<thead>
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<th>Component</th>
<th>Discretionary Development</th>
<th>Civilian Recurrent</th>
<th>Security</th>
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* Excludes security spending financed by grants
Arrears and depleted cash reserves from 2014 will require identifying additional fiscal space in 2015

- Even with urgent donor financing, the unfinanced fiscal gap in 2014 is expected to leave residual arrears and depleted cash reserves

- The draft 2015 budget combines an ambitious increase in revenues with certain expenditure restraints to close the unfinanced fiscal gap
  - Repaying arrears and rebuilding cash reserves will require identifying additional fiscal space
  - It will be important to ensure that revenue projections are credible and backed by adequate measures
  - Expenditure restraints should be prioritized to avoid stifling economic recovery and compromising development outcomes
Priority Agenda: Emerging Issues for Attention

Restore fiscal stability by creating fiscal space

- Improve revenues, secure additional on-budget assistance, prioritize expenditures to safeguard progress on development outcomes
- Fiscal space even more important with revenues lower than previously projected
- Security spending pressures may require rethinking financing options

Restore confidence and create private sector jobs

- Investor confidence down; jobs needed for 400,000 new workers per year; poverty high and persistent at 36% and 50% considered vulnerable

Strengthen social cohesion and service delivery

- Fragility and conflict remain pervasive; women’s labor force participation, literacy, infant mortality remain lacking despite improvements of the past decade

Corruption and Governance

- Fighting corruption and strengthening governance critical across the board
Restoring fiscal stability: Revenues need to rise significantly, but will require bold reforms

• The centerpiece of restoring fiscal stability is improving revenues
  – Without a significant increase in revenues, Afghanistan cannot restore fiscal stability, given its considerable expenditure needs

• Immediate, credible, and bold measures are needed, including for example:
  – expediting custom action plan implementation, including HR measures, enforcement powers for ACD, improving inspection and post-clearance audit procedures, and countrywide rollout of ASYCUDA valuation module
  – expediting VAT implementation with 10% rate and approving Tax Admin Law
  – conducting effective and risk-based audits to improve taxpayer compliance

• In the medium term, extractive industries can be a source of considerable revenues, but will require progress on the regulatory and legislative framework
Restoring fiscal stability: Secure adequate on-budget assistance and prioritize spending

- Even with improved performance, revenues may only rise to 12.8% of GDP in 2018 (lower than prior projection of 14% of GDP for 2018)

- Increasing on-budget assistance even more important, but will require improving the government’s absorptive capacity

- Expenditure prioritization even more important to avoid compromising progress on development outcomes
Rethinking security sector financing could help safeguard critical civilian operating and developing expenditures

- Risks from security expenditure pressures exacerbated by a number of factors:
  - Uncertain revenue prospects and rising revenue contribution to security
  - Rising non-ANSF security spending, which need to be fully financed by revenues
  - Potential mismatch between security needs and Chicago financing scenarios (e.g. troop levels), with residual financing needs falling on revenues
Restoring Confidence and Creating Private Sector Jobs

- **Smooth political and security transition** paramount in reducing uncertainty

- Addressing weaknesses in **financial sector, investment climate, and land tenure system** can help to restore investor confidence

- **Agriculture, mining, and services** expected to serve as the key growth drivers in the post-transition period once confidence is restored

- **Reforms** to stimulate higher agricultural productivity and expansion of mining could raise average growth to 7% during 2015-2025.
Strengthening Social Cohesion and Service Delivery

Service delivery plays a dual role in Afghanistan:

- Build social cohesion and trust in public institutions in an environment of fragility and conflict where economic prospects are compromised
- Lay foundation for jobs and growth, through education, health, and infrastructure

Key priorities include:

- Promoting social inclusion for women and other excluded groups
- Supporting targeted rural and urban development programs
- Prioritizing regional integration to meet energy and water needs, explore opportunities for labor migration, and expand trade and transit
- Improving efficiency of service delivery
Going forward:
Restore Confidence and Support Development

- Restore fiscal stability through improved revenues, securing adequate on-budget grant assistance, and prioritizing spending

- Restore investor confidence and create private sector jobs by addressing financial sector, land, and business climate impediments and by unlocking the potential of agriculture, services, and extractive industries

- Strengthen social cohesion and service delivery by promoting social inclusion, targeted rural and urban programs, and improving efficiency of service delivery
  - Prioritize regional integration to establish Afghanistan’s role as a regional economic partner in trade and transit, energy and water, and labor migration

- High level commitment to tackle corruption, strengthen governance, and safeguard public financial management is critical across the board