

# Afghanistan: Transition Economics Update

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November 27, 2014



The World Bank

# Outline

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- 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

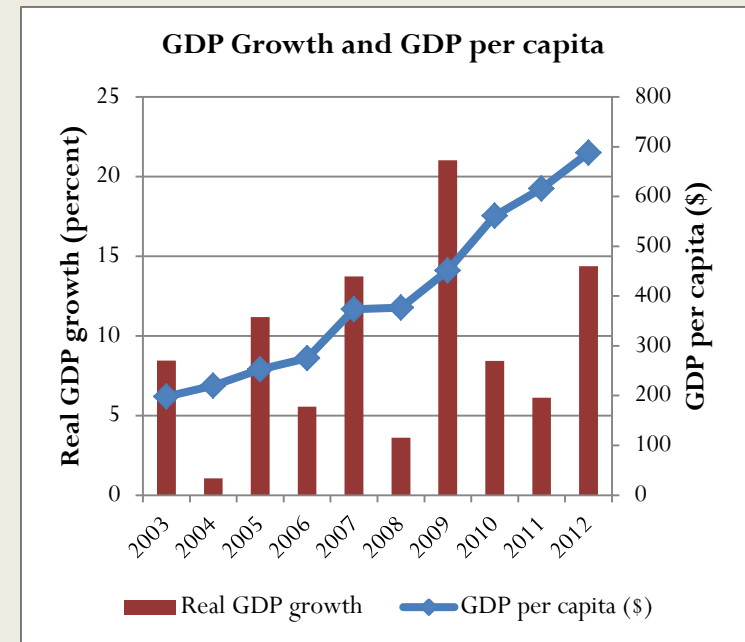
## Decade before transition (2003-12): Significant progress from very low base

### • 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

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### 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

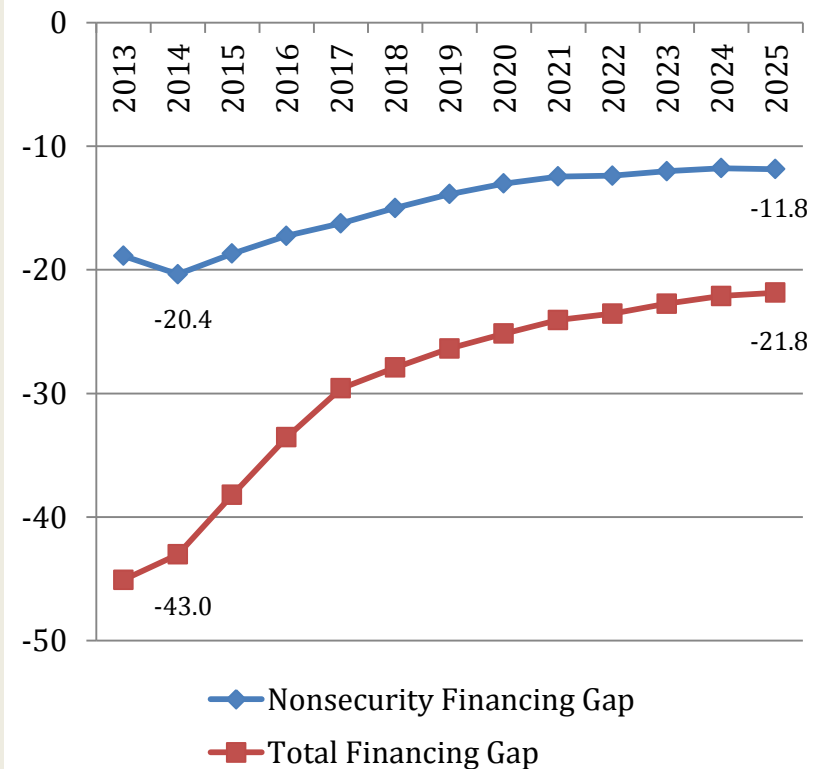
- **International community:**

Recognized need for more on-budget assistance to mitigate impact of declining aid

- **Government:**

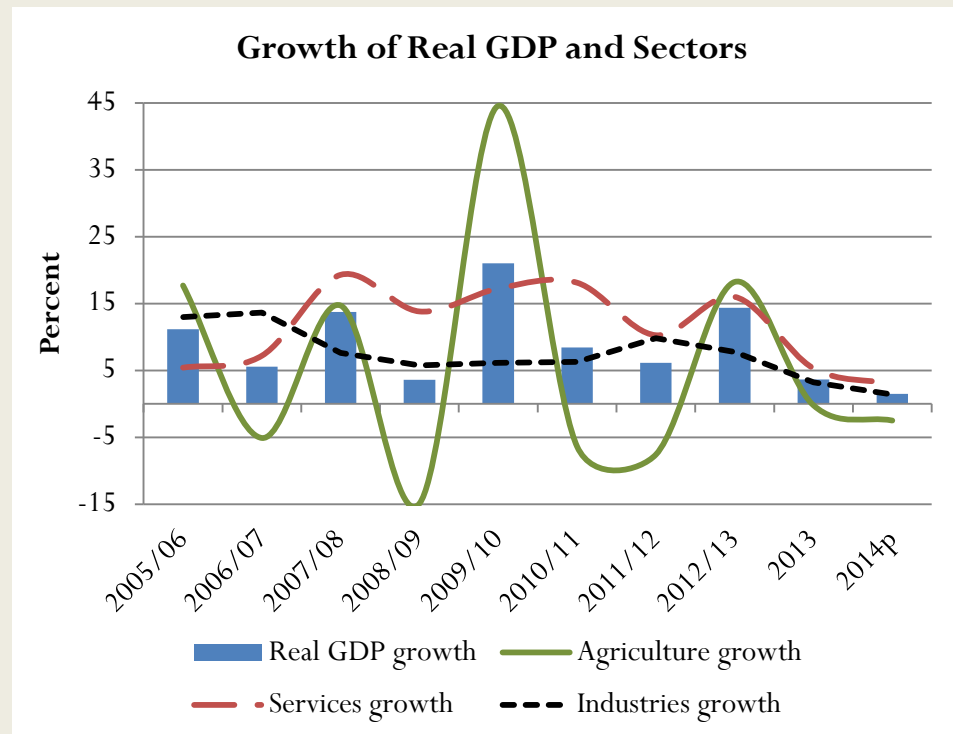
Recognized need to improve revenues, prioritize spending, and strengthen absorptive capacity and PFM systems

**Estimated Financing Gap, 2013-2025**  
(% of GDP, On-budget plus Off-Budget)



## Sharp slowdown in economic growth in 2013-14, driven by uncertainty and a confidence crisis

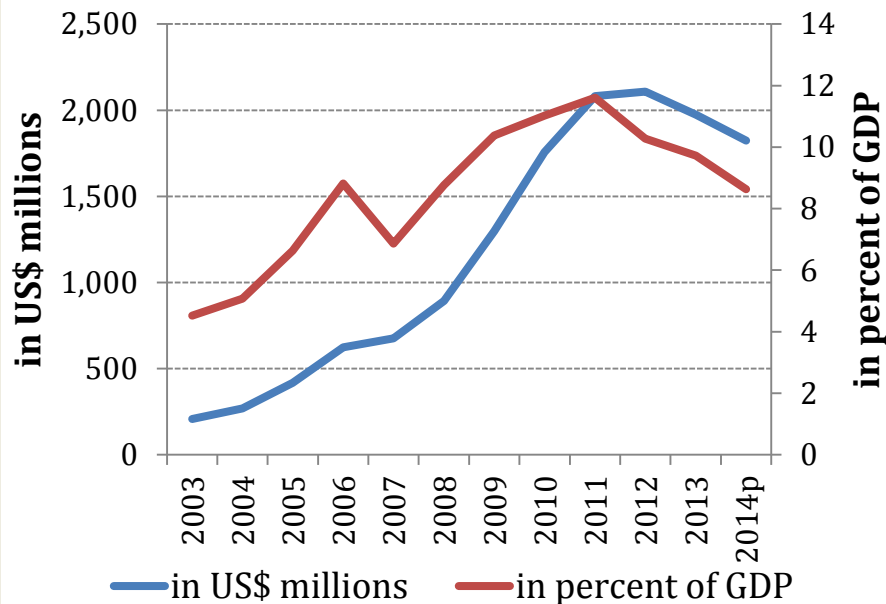
- Uncertainty since 2013 over the political and security transition, compounded by the protracted elections impasse in 2014, has led to a slump in investor confidence
- Growth, down sharply to 3.7% in 2013, has fallen further to 1.5% (proj.) in 2014, from average of 9.4 percent per year during 2003-12



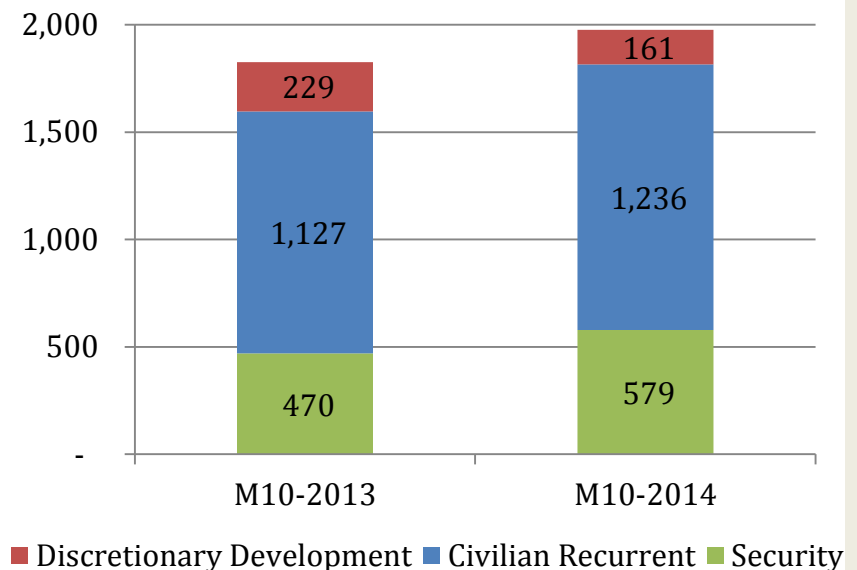
## Fiscal crisis underway, with declining revenues leading to an unfinanced fiscal gap, depleted cash, and arrears in 2014

- 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

### Domestic Revenues 2003-2014



### Components of Discretionary Civilian and Security Spending (US\$ millions)



\* Excludes security spending financed by grants

## Arrears and depleted cash reserves from 2014 will require identifying additional fiscal space in 2015

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- 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

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### 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

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- **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

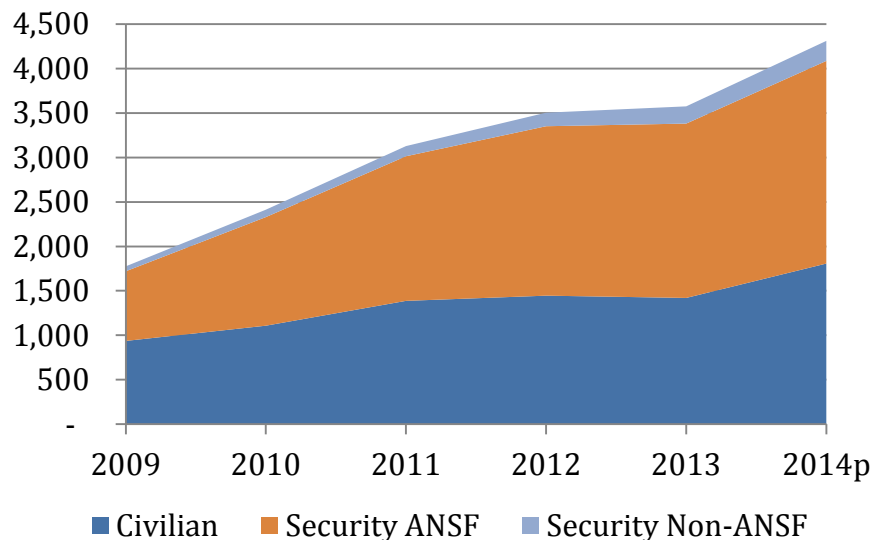
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- Even with improved performance, revenues may only rise to 12.8% of GDP in 2018 (lower than prior projection of 14% of GDP for 2018)
- Increasing on-budget assistance even more important, but will require improving the government's absorptive capacity
- Expenditure prioritization even more important to avoid compromising progress on development outcomes

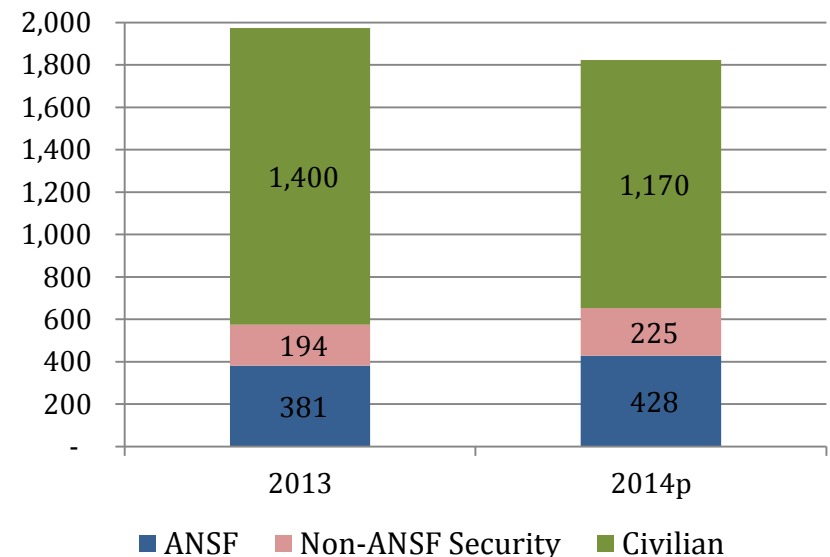
## Rethinking security sector financing could help safeguard critical civilian operating and developing expenditures

- 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

**On-budget security and civilian operating expenditures (in US\$ millions)**



**Revenue contribution to civilian and security purposes (in US\$ millions)**



## Restoring Confidence and Creating Private Sector Jobs

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- **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

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- 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