FINANCING PEACE

Fiscal Challenges and Implications for a Post-Settlement Afghanistan

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Acknowledgements

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Executive Summary

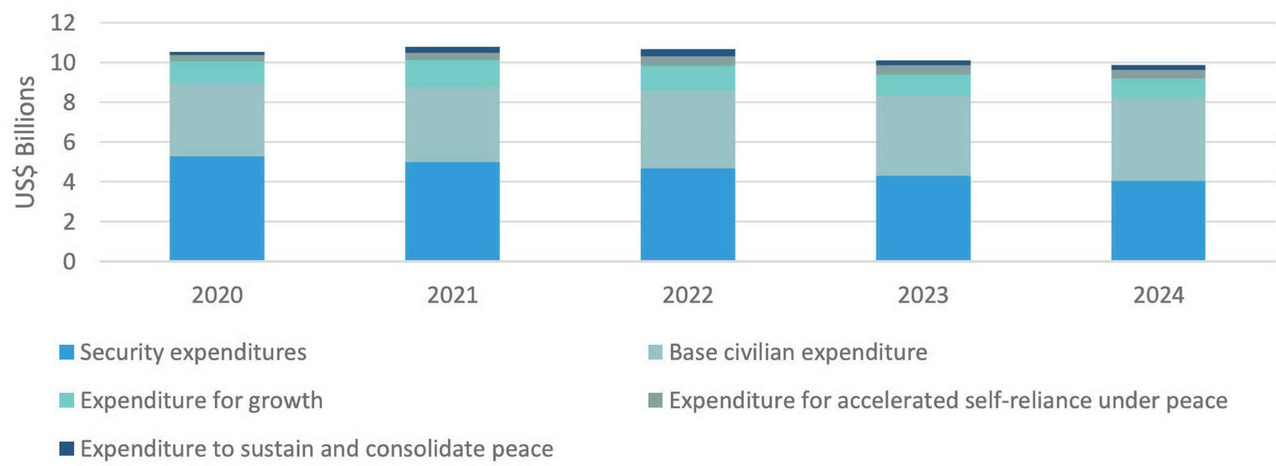
The international community is currently planning for a potential political settlement in Afghanistan. Negotiations may bring opportunities for significant reductions in violence. Government and development partners are considering how to support, consolidate, and sustain any reduction in violence following a potential political settlement, through humanitarian, development, and reintegration programming. This note provides an analysis of overall medium-term financing needs and identifies implications for ongoing grant support and post-settlement programming.

Public expenditure in Afghanistan is already at high and unsustainable levels. Total public expenditure is equal to around 58 percent of GDP, much higher than average for a low-income country. Revenues have grown rapidly over recent years, but still fall far short of what would be required to support expenditure at current levels. Total revenues are currently equal to only around US$2.5 billion dollars per year, while total expenditures are equal to around US$11 billion per year.

Total financing needs are likely to remain at close to current levels. Aggregate future financing needs are driven by expenditures on: i) security; ii) core government services and infrastructure; iii) new public investments required to support accelerated economic growth; and iv) post-settlement programming initiatives to consolidate and sustain a political settlement, such as community development and job creation schemes. Aggregate financing needs are expected to remain close to current levels. Declines in security sector expenditure will be offset by the need for increased civilian spending to support a rapidly-growing population and facilitate faster economic growth.

Figure: Total financing needs remain roughly constant over the projection period

Total projected financing needs



Total grant needs will depend on the pace of economic growth and revenue generation over coming years. Grant needs for different expenditure categories and under different economic growth scenarios are presented in the table below. While grant needs remain substantial over the medium-term, they could be accommodated easily under most scenarios even if grants decline gradually from current levels of around US$8.5 billion per year. These grant needs exclude any potential costs of targeted disarmament, demobilization, and reintegration programming.

Table: Grant needs remain substantial under all likely scenarios
Annual grant needs by scenario and expenditure category

	Growth and revenue scenario			
	Downside	**Baseline**	**Mid-case**	**Rapid growth**
	Average annual grant needs 2020-2024 (US$ billions)			
Base expenditures (security and civilian)	6.4	5.8	5.3	4.6
Base expenditures + Expenditures for accelerated growth	7.5	7.0	6.4	5.6
Base expenditures + Expenditures for accelerated growth + Expenditures to consolidate and sustain peace	8.2	7.6	7.0	6.3

Under a baseline scenario of continued slow economic growth and moderate improvement in revenues, grant needs would range between US$5.8 billion and US$7.6 billion per year. US$5.8 billion per year would be sufficient to finance maintenance of existing services and gradual expansion of infrastructure in line with population growth. US$7 billion per year would be sufficient to finance current services and infrastructure with additional investments to support more-rapid growth (including human capital and infrastructure improvements). US$7.6 billion per year would be sufficient to meet current infrastructure and service costs, finance growth-enhancing investments, and provide resources for additional programs to sustain and consolidate peace, including through expanded community development and job creation programs.

A precipitous decline in grant resources, however, would force very difficult trade-offs between important policy objectives. A precipitous reduction in either security or civilian grants would force a choice between: i) sustaining security spending; ii) maintaining the delivery of basic government functions (such as social services and infrastructure); iii) undertaking required public investments to support faster economic growth and poverty reduction; and iv) delivering short-term benefits to Afghans following a political settlement to help to sustain and consolidate peace. Benefits of short-term post-settlement programming are likely to be short-lived if they come at the cost of continued investment in the basic functions of government and the core service delivery mechanisms that have been built up since 2001.

Expectations should be realistic regarding the capacity of new grant-financed programs to deliver a substantial peace dividend. Resources available for delivering a post-settlement dividend are likely to remain limited under any scenario, relative to the extent of grant support already being provided. The most significant benefits of a political settlement are likely to be realized if such a settlement leads to improvements in security, political stability, and freedom of movement. Increased private sector investment, job creation, and access to services resulting from such improvements is likely to deliver much more significant and sustainable benefits than grant-financed interventions. This is especially the case given the current context of already-unsustainably high public expenditure and likely declines in grant support over the medium-term.

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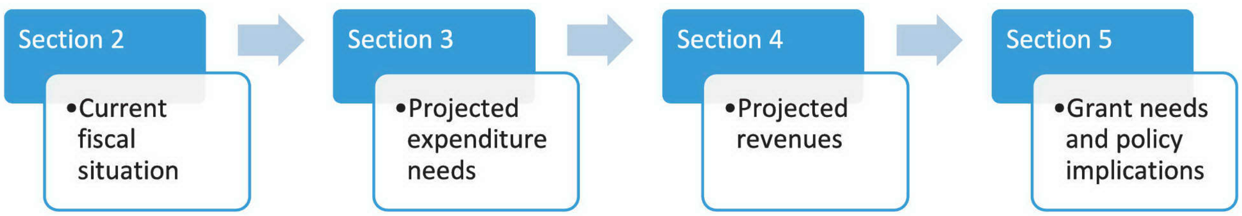
1. Introduction

The international community is currently planning for a potential political settlement in Afghanistan. Ongoing negotiations between various parties may bring opportunities for significant reductions in violence. Government and development partners are considering how to support, consolidate, and sustain any reduction in violence following a potential political settlement, through humanitarian, development, and reintegration programming.

Post-settlement programming is likely to occur in the context of tight resource constraints. Grant support to Afghanistan remains at extremely high levels. The future level of grant support is subject to substantial uncertainty, with current pledges extending only through 2020. Declines in grant support are expected over the medium-term.

This note provides an analysis of Afghanistan's likely financing needs following a political settlement. Section two provides a high-level summary of Afghanistan's current fiscal situation and levels of aid dependence. Section three identifies approximate overall medium-term financing needs across security and civilian expenditures. Section four outlines Afghanistan's medium-term revenue potential based on several economic growth scenarios. Based on a comparison between projected financing needs and revenues, section five presents potential grant needs under a range of expenditure and economic growth scenarios and discusses implications for policy and programming.

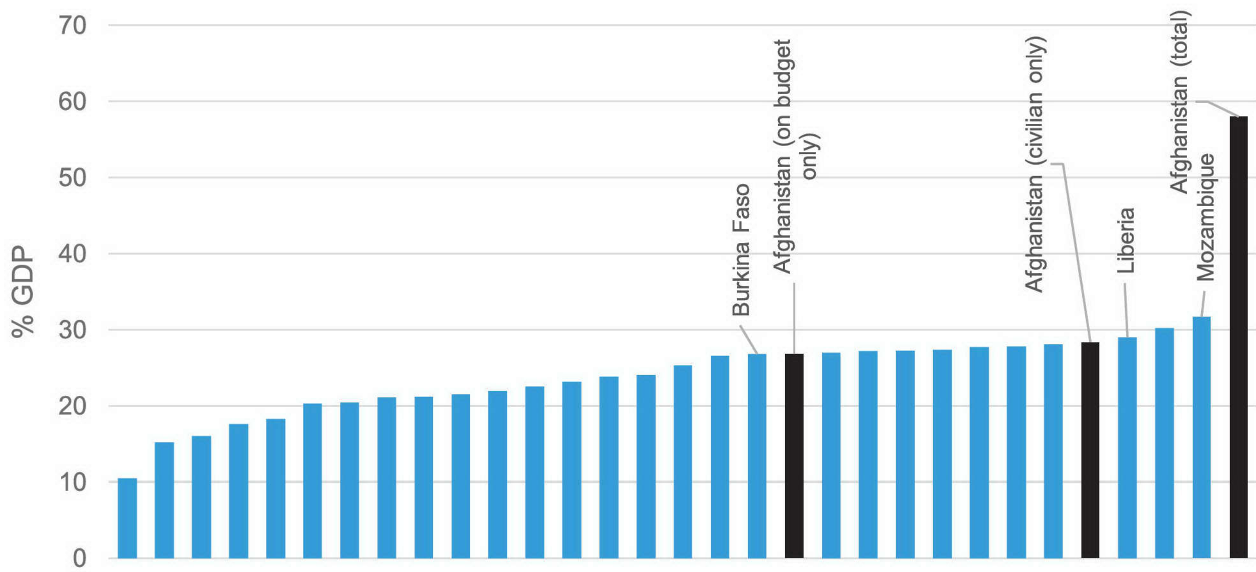
Figure 1: Structure of this note



2. Fiscal context

Public expenditure in Afghanistan is at high and unsustainable levels. Total public expenditure is equal to around 58 percent of GDP, much higher than average for a low-income country. High total expenditure is driven by very substantial security sector expenditures. Security spending accounts for just over half of total expenditures. Security spending is equal to around 30 percent of GDP, compared to just three percent for the average low-income country.

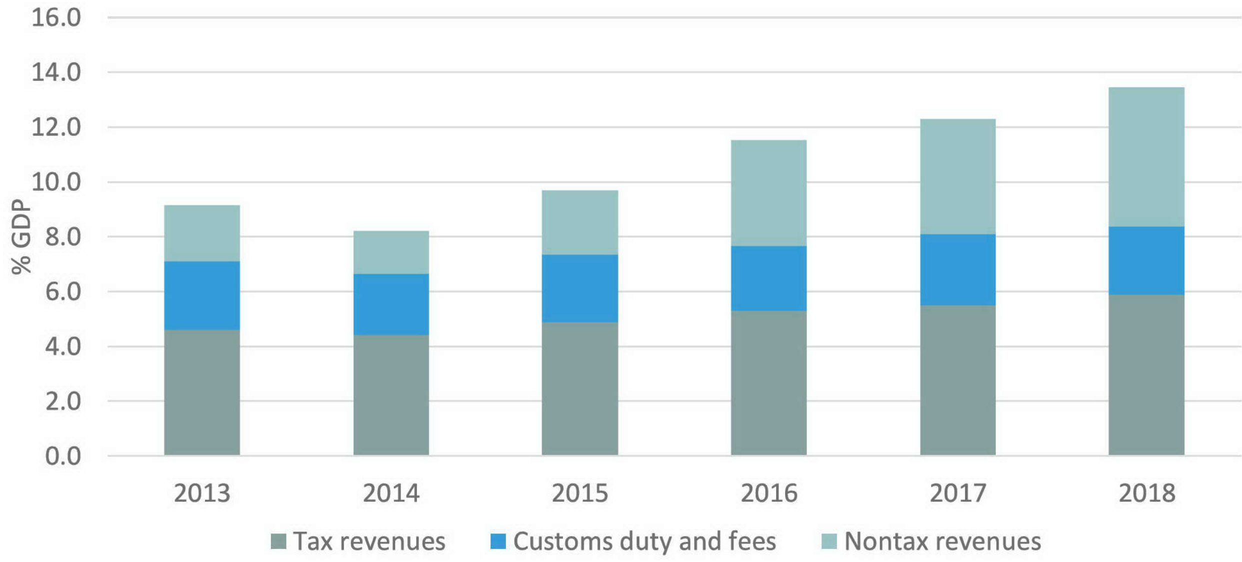
Figure 2: Afghanistan's total public expenditure is extremely high
Total public expenditure as a share of GDP (Afghanistan and low-income countries)



Note: On-budget includes all on-budget expenditure, including civilian and security. Civilian includes all non-security expenditure, including on- and off-budget non-security expenditure.

While revenue performance has improved significantly over recent years, total revenues fall far short of expenditures. Afghanistan has achieved remarkable progress in increasing revenues over recent years, with total government revenues increasing from around 8 percent of GDP in 2014 to around 13.5 percent today. Government revenues are currently comparable to those of other South Asian countries. However, total revenues are currently equal to only around US$2.5 billion dollars per year, while total on- and off-budget expenditures are equal to around US$11 billion per year.

Figure 3: Revenues have grown rapidly
Revenues by source as % GDP



Afghanistan therefore remains heavily reliant on grants. Reflecting the wide gap between revenues and expenditures, Afghanistan continues to rely on grants to finance 75 percent of total public expenditures. Total grants are equal to around US$8.5 billion per year. This is equal to around 45 percent of GDP, compared to an average of around 10 percent for low income countries.

Figure 4: Afghanistan is highly reliant on grants to finance expenditure
Total public expenditure and financing sources

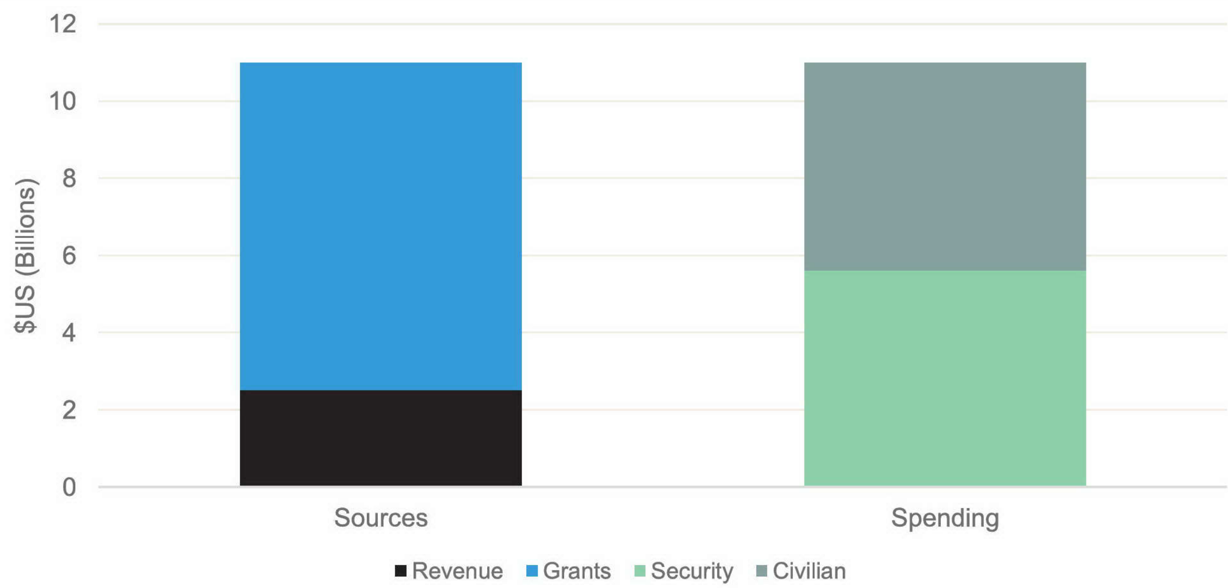
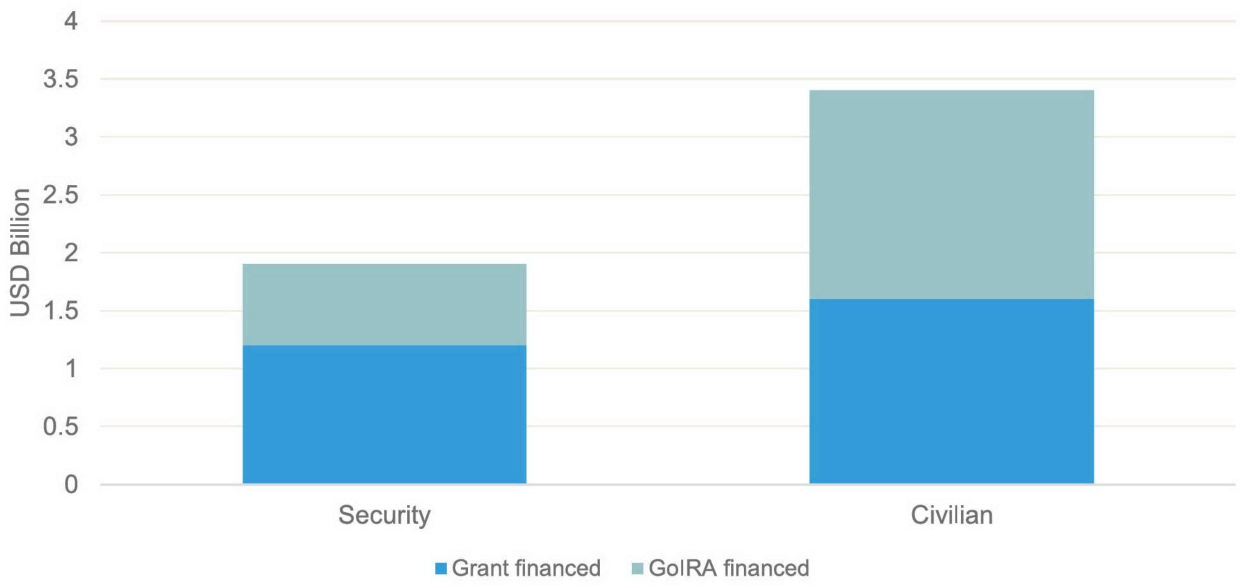


Figure 5: Grants support a large share of both civilian and security on-budget expenditure
Expenditure and financing sources – on-budget security and civilian



Box 1: Grant financing sources

Grant financing to both the civilian and security sectors is channeled through trust fund and bilateral mechanisms. The largest single source of on-budget civilian support to Afghanistan is through the Afghanistan Reconstruction Trust Fund (ARTF), administered by the World Bank. The ARTF provides around US$800 million of on-budget grant support per year, complemented by around US$400 million of World Bank International Development Association (IDA) resources. Additional on-budget support is provided through the Asian Development Bank-administered Afghanistan Infrastructure Trust Fund (AITF).

The largest source of on-budget security support is the Combined Security Transition Command – Afghanistan (CSTC-A), which currently provides around US$900 million per year to the Ministry of Defense and Ministry of Interior. The UNDP-administered Law and Order Trust Fund for Afghanistan (LOTFA) provides an additional US$300 million per year of on-budget support.

Figure: Grant support by source

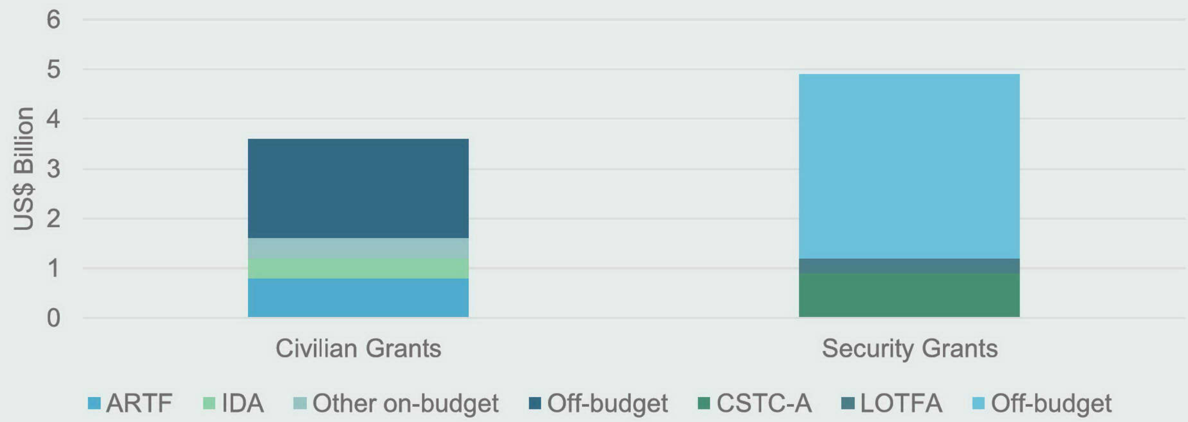
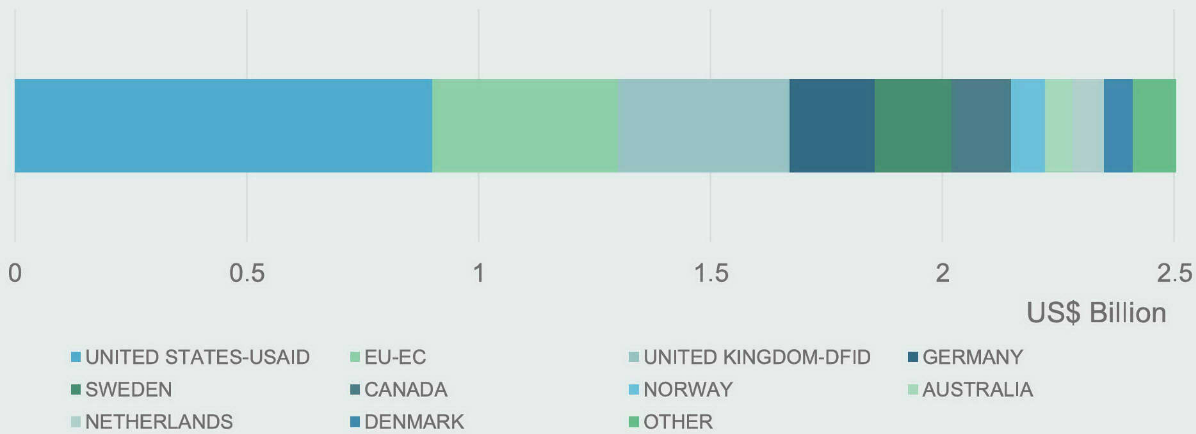


Figure: ARTF pledges 2018-2020

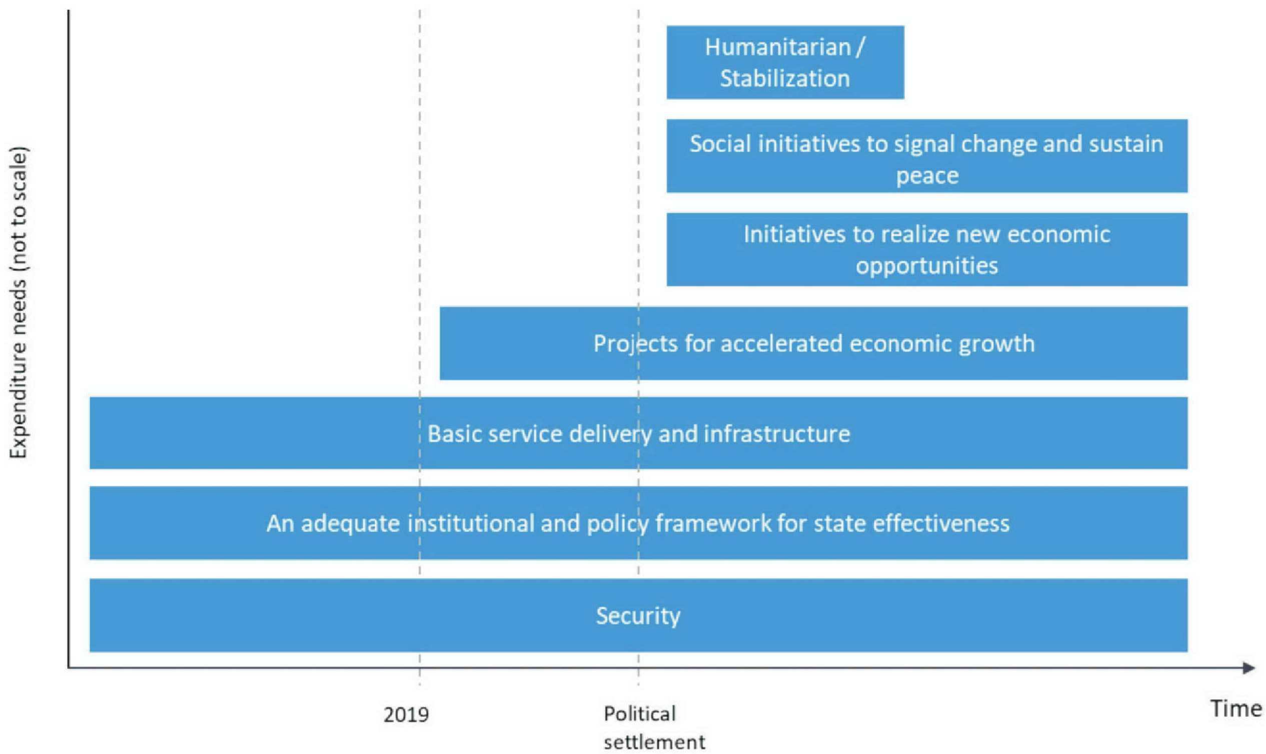


3. Financing needs

1.1. A framework for financing needs

Afghanistan's upcoming financing needs fall within several clear categories. These expenditure categories are depicted in the figure below. Existing 'base' expenditures (depicted as the lower layers in the figure) will persist over the medium term. Base expenditures include adequate financing of the security sector and basic social services and infrastructure. In addition, new financing needs will emerge following a potential political settlement. In the sections that follow, we quantify expenditure needs in each category to develop an estimate of over medium-term aggregate financing needs.

Figure 6: Grants support a large share of both civilian and security expenditure
Expenditure and financing sources – security and civilian



1.2. Security expenditure needs

Current security sector expenditure in Afghanistan is approximately US$5.6 billion. Security expenditures are financed overwhelmingly through grants, with security grants equal to around US$4.9 billion per year.

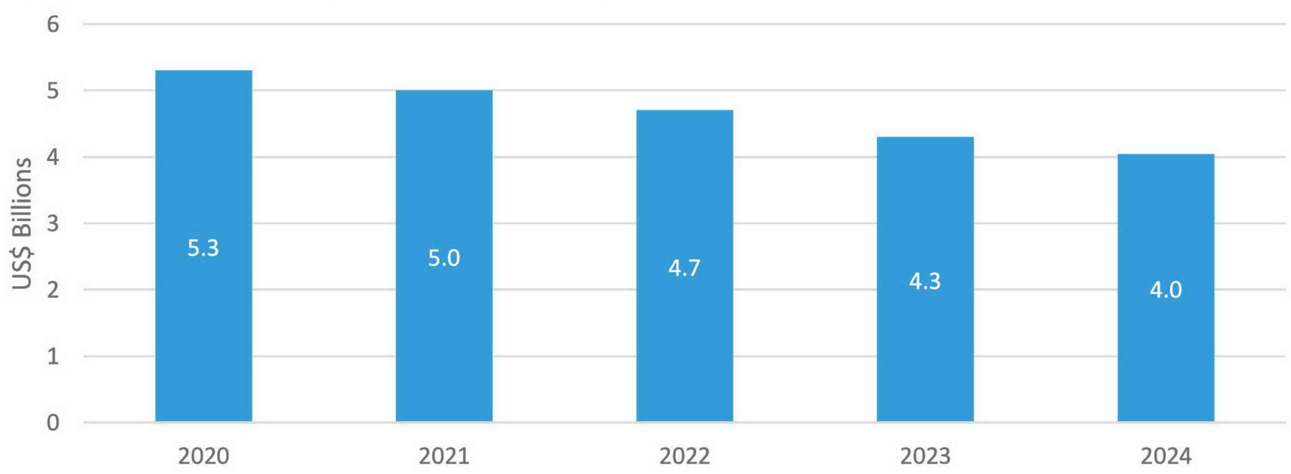
Peace may bring opportunities to consolidate security sector expenditure. A political settlement and subsequent reduction in violence may allow for substantial reductions in security sector expenditures over time. Changes to force size, structure, equipment, and mission may have important implications for the cost of the security sector. However, international experience shows that security spending does not typically decline rapidly in low-income settings following a peace agreement, with the formal security sector often expanding to integrate former combatants.

The GoIRA is currently working towards achieving significant savings in the security sector. A range of potential savings measures have been identified by GoIRA that might have the potential to reduce security sector costs by up to US$1 billion. Realizing these savings goals, however, would require important changes to policies, procedures, and systems, including bringing important off-budget expenditure items on-budget.

Under the assumption of an improvement in security conditions and realization of potential savings, security expenditures are projected to decline to around US$4 billion by 2024. This represents a US$1.6 billion reduction from current levels arising from both efficiency improvements and any potential change in force size and composition.

Savings in the security sector are unlikely to result in increased resources being available for civilian expenditure needs. With the security sector overwhelmingly financed by grants, any cost savings are likely to accrue to international partners rather than to the GoIRA, which is expected to meet an increased share of the costs of the security sector over time. International partners generally provide security and civilian grants through different budget lines and agencies, with limited scope for fungibility. This suggests that any reduction in the costs of the security sector will be accompanied by commensurate reductions in grant support, representing progress towards self-reliance but without freeing up additional resources for development needs.

Figure 7: Security expenditure needs may decline gradually over time
Projected security sector expenditures with savings



1.3. Base civilian expenditure needs

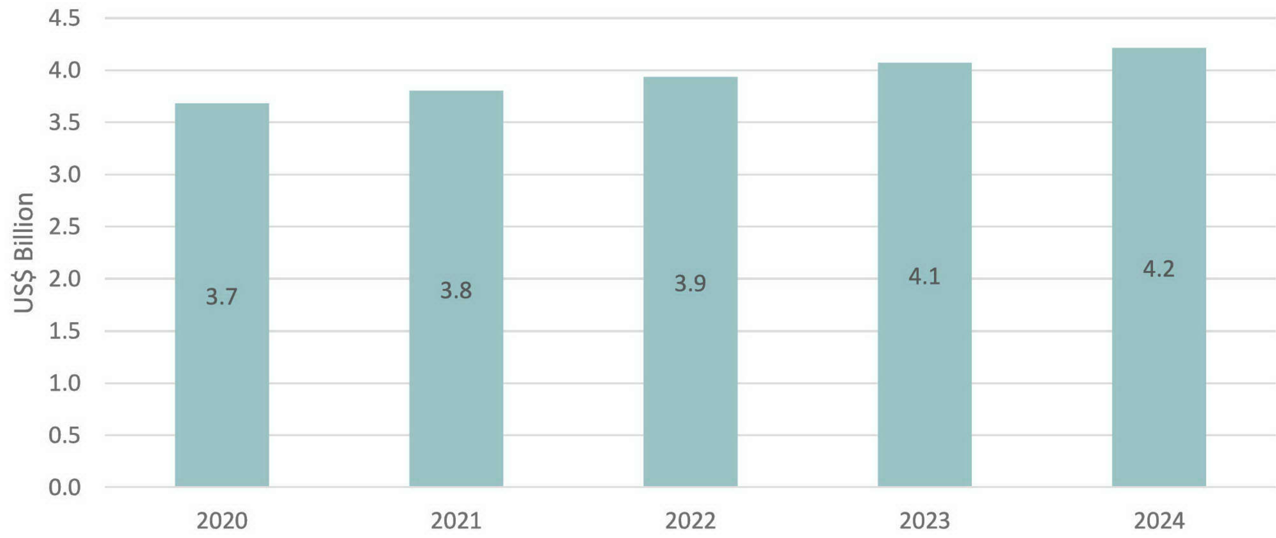
Base civilian expenditure needs include the provision of basic services and infrastructure. Total on-budget base civilian expenditure is currently around US$3.6 billion per year. Of this amount, around US$1 billion is spent on salaries and wages, with the majority of salary expenditure allocated to social sectors. Other operating costs are equal to around US$1 billion per year. Around US$1.2 billion a year is spent on capital acquisition, almost entirely through the development budget. These expenditures represent the core functions of government, including the delivery of health and education and key investments in roads, energy, and irrigation.

Base on-budget civilian expenditure needs are expected to grow over time. Base civilian expenditure needs are expected to grow over time for two primary reasons. Firstly, Afghanistan's population is growing rapidly (at around 2.3 percent per year). Some level of expenditure growth is required simply to sustain the current level of services to an expanding population. Secondly, Afghanistan is currently significantly underinvesting in operations and maintenance (O&M) expenditures. GoIRA is taking on responsibility for operating and maintaining assets provided by donors. Previous analysis has shown that Afghanistan must increase investment in O&M expenditure to around seven percent of GDP to effectively sustain the current asset base and avoid a deterioration in services and infrastructure.

Based on conservative assumptions, base on-budget civilian expenditure needs are expected to increase to around US$4.2 billion by 2024. This represents an increase of around US$500 million per annum over current levels. This assumes: i) constant per capita on-budget expenditure on services and infrastructure (taking no account of potential expansion of services to new areas following a political settlement); and ii) Gradual increases in O&M expenditure to the equivalent of seven percent of GDP by 2024 (from a current level of around five percent of GDP).

Figure 8: Base civilian expenditure needs will continue to increase

Projected base expenditure needs to sustain services and infrastructure



1.4. Expenditures for accelerated growth

Economic growth in Afghanistan is currently too slow to reduce poverty and increase living standards. The economy is currently growing by around two percent per year, while the population is growing at around 2.3 percent per year. This equates to declining per capita incomes. Poverty rates are rapidly increasing, with the number of Afghans living below the basic needs poverty line (of around US$1 per day) increasing from around 39 percent in 2012 to around 55 percent today. The number of jobs available to Afghans is currently declining, while 300,000 young people enter the labor force every year. While a reduction in violence may facilitate improvements in growth, employment, and living standards, substantial public investments to improve services and expand infrastructure are likely to be needed to mobilize new growth sources that could drive a step-change in economic growth.

Public investment needs for accelerated growth are reflected in the GoIRA's Growth Agenda for Transformative Change and Self-Reliance ('the Growth Agenda') presented at the Geneva Ministerial Conference on Afghanistan in late 2018. The Growth Agenda proposes a substantial program of reforms and public investments that could lead to growth rates of up to eight percent per annum, assuming significant improvements in security conditions. Key sectors for investment include: i) agriculture, including major expansions in irrigation; ii) human capital, focusing on expanded access to and quality of health and education; iii) energy, including complete financing of DABS's energy investment plan; and iv) regional integration, including major connectivity projects. Financing growth agenda investments would require around US$1 billion per annum over the next five years.

Figure 9: Public investment requirements under the GoIRA Growth Agenda
Required expenditure by sector (US$ millions)

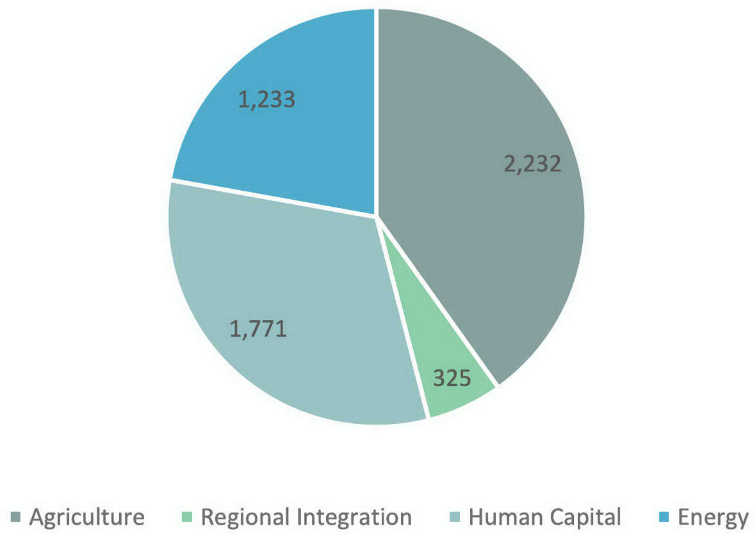
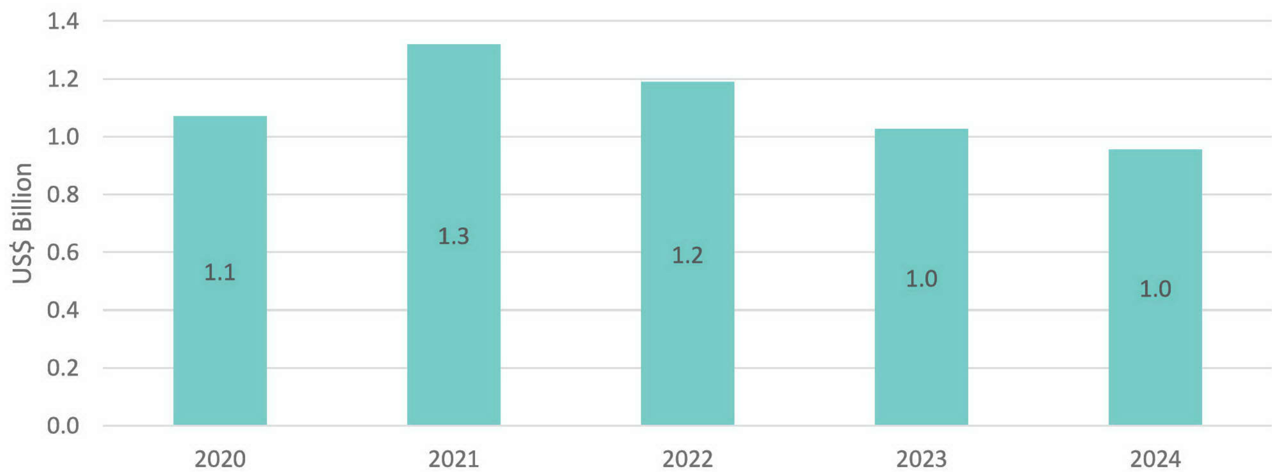


Figure 10: Substantial investment would be required to support faster growth
Projected expenditure on public investments for accelerated growth



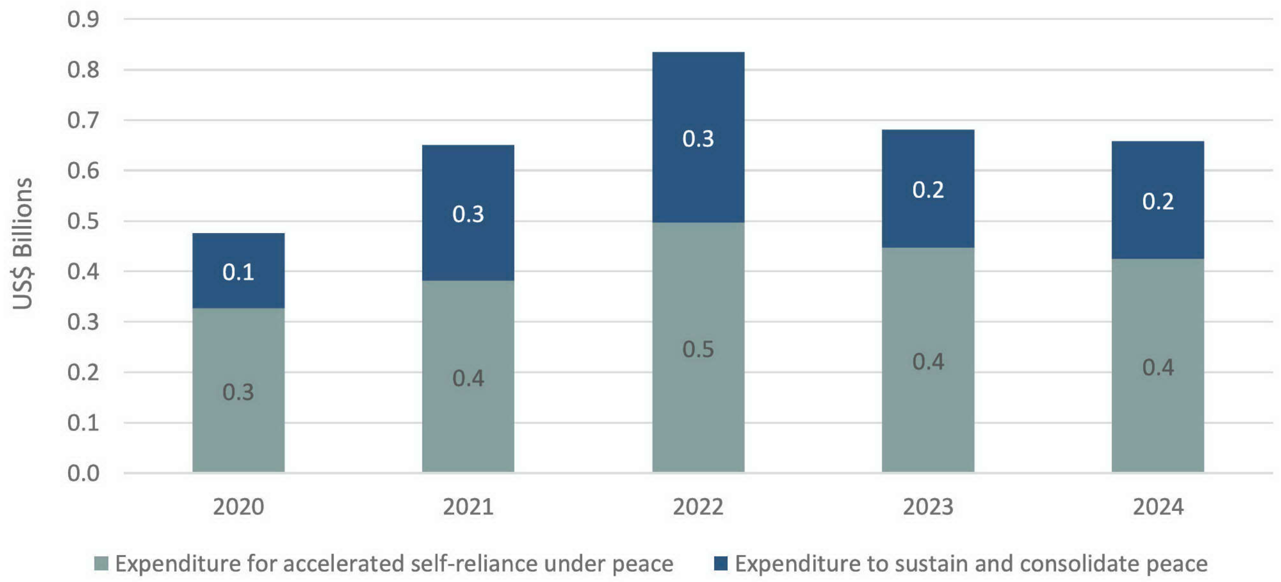
1.5. Expenditures to consolidate and sustain peace

Afghanistan is likely to face additional financing needs following a political settlement. The international community has been working to identify potential economic projects and programs that could be pursued following a political settlement to both: i) help consolidate and sustain peace by delivering immediate post-settlement gains to Afghans; and ii) take advantage of potential new opportunities for economic growth following an improvement in security conditions. These programs and projects are presented in the

Post-Settlement Economic Initiatives Report (PEIR) prepared by the World Bank and the Peace Working Group (which comprises major international donors and the Ministry of Finance).

Some proposed post-settlement programs overlap with activities included in the Growth Agenda. Both the PEIR and Growth Agenda proposals include substantial investments in human capital, agri-business infrastructure, and expansion of irrigation networks. Excluding initiatives already included under the Growth Agenda, the total cost of proposed post-settlement programming is around US$3.3 billion over five years.[1] Programs to sustain and consolidate peace – including rapid roll-out of social programs, community development, and job creation schemes – are expected to cost around US$1.2 billion to 2024. Programs to take advantage of new opportunities for economic development under improved security – including intensified support to policy and regulatory reform, attraction of international investment, and roll-out of Phase II of the Citizen's Charter program – are expected to cost around US$2.1 billion over the period.

Figure 11: Additional significant expenditures would be required to consolidate and sustain peace
Projected expenditures for post-settlement economic initiatives



[1] The PEIR document presents a six-year investment plan (2019-2024). Given current expected timelines for a political settlement, we assume here that initial investments would take place in 2020. The final year of the PEIR investment plan therefore falls beyond the next pledging period and costing are not included here.

Box 2: How do projected expenditures link to other planning documents?

Projected expenditures include all investments included in the Post-Settlement Economic Initiatives Report (PEIR) prepared by the 5+4+3 Donor Peace Working Group.

Projected expenditures also include all public investments included in the Government's Geneva Growth Agenda plan. There is substantial overlap between the investment needs identified in the PEIR and in the Geneva Growth Agenda. The largest expenditure items included in both documents are expansion of irrigation systems and increased investments in health and education.

Projected expenditures include some investments that are also specified under the Government's Afghanistan Self-Reliance Accelerator Package (ASAP), including in energy network improvements and irrigation network expansions. Housing-related investments under the PEIR also somewhat overlap with housing-related investments in the ASAP. Additional investments included in the ASAP are not included in projected investment needs because: i) government is planning to mobilize private financing for many of the ASAP projects; ii) ASAP projects require further economic analysis before full implementation; and iii) many ASAP investments would occur beyond the timeframe of the next pledging period.

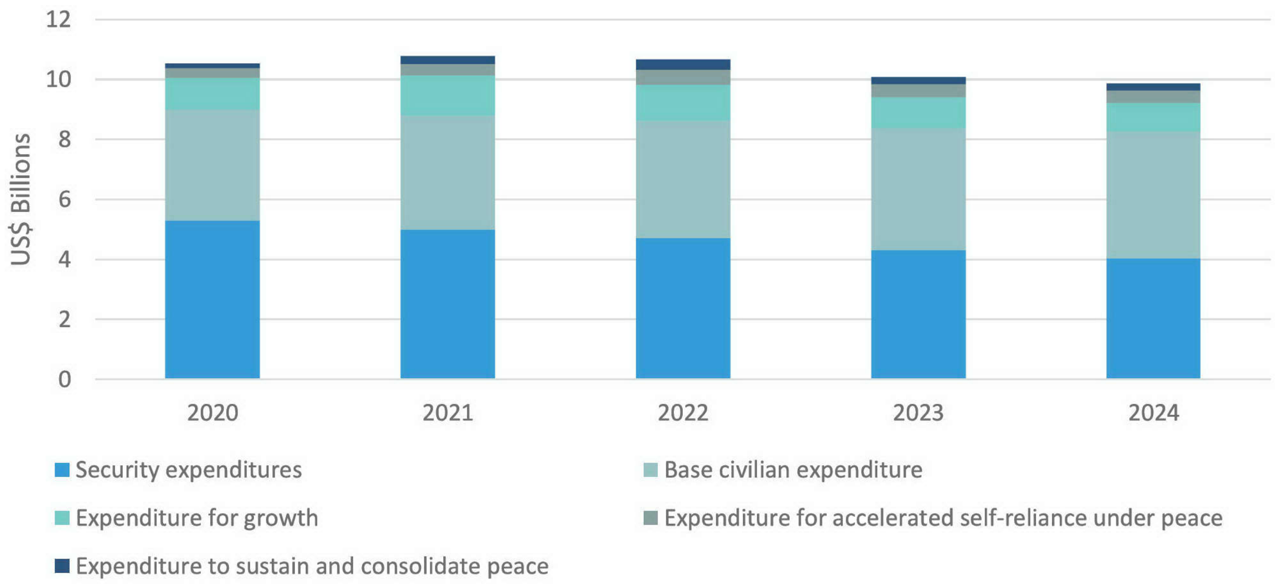
1.6. Total financing needs

Aggregate financing needs for various expenditure categories are projected to remain roughly constant over time. Simple aggregation of the expenditure categories discussed above shows total expenditure needs declining very slightly from around US$10.5 billion in 2020 to around US$9.9 billion by 2024. The decline is driven mostly by expected consolidation in the security sector, which offsets expanding civilian expenditure needs.

Afghanistan may face additional expenditure needs not currently included in this analysis. These projections include all development programming for service delivery, infrastructure, and institutional strengthening support. However, following a political settlement, there may be substantial additional expenditure needs for the roll-out of humanitarian assistance or Disarmament, Demobilization, and Reintegration (DDR) programming. Any costs associated with humanitarian and DDR programming would be additional to the financing needs presented here.

Figure 12: Total financing needs remain roughly constant over the projection period

Total projected financing needs



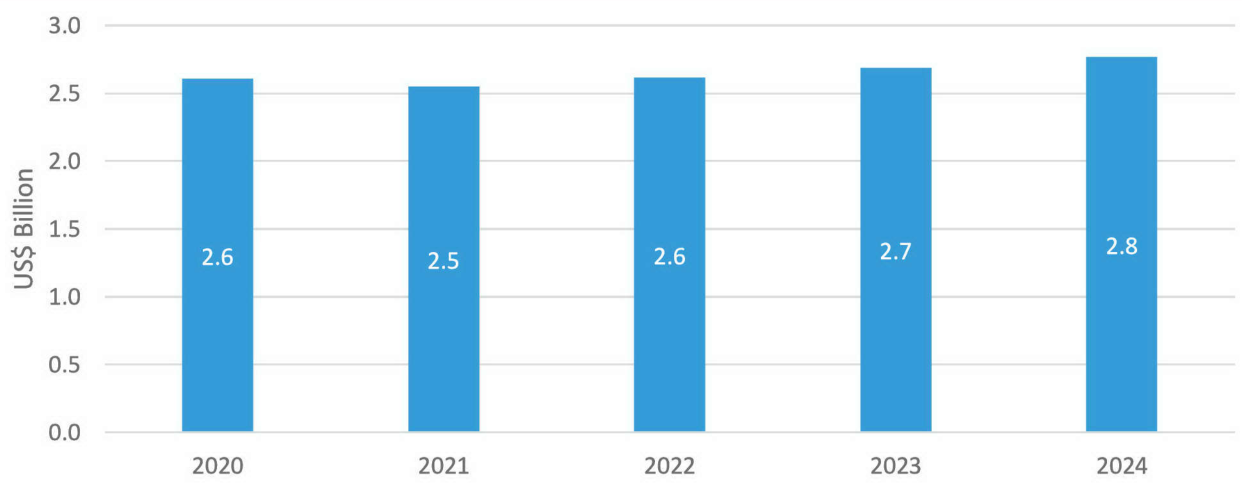
4. Growth and revenue scenarios

Government's capacity to meet financing needs will depend heavily on additional revenue mobilization. While there may be some scope to raise revenue from additional policy and administrative measures, substantial increases in revenues are likely to depend on accelerated economic growth and mobilization of major revenue-generating projects in connective infrastructure and extractive sectors. In this section we present three potential scenarios for economic growth and revenue generation.

1.7. Baseline scenario

Under a baseline scenario, revenue growth would be minimal. Under a baseline scenario, conflict continues at current levels. Limited progress is made with policy and institutional reforms. No major new revenue-generating projects are realized. Economic growth accelerates only slightly to around three percent per annum over the period. Under this scenario, revenues increase only slightly from around US$2.5 billion in 2019 to around US$2.8 billion by 2024.

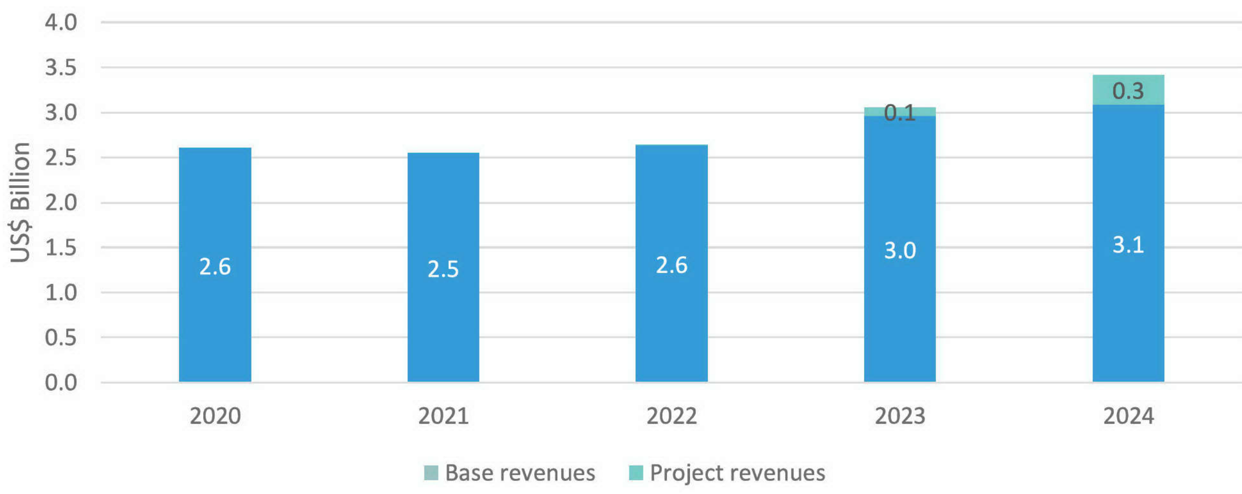
Figure 13: Under a baseline scenario, revenue growth would be modest
Projected revenues under a baseline scenario



1.8. Mid-case scenario

Under a medium-case scenario, revenue growth would be significant. Conflict continues at close to current levels. Significant progress is achieved, however, with policy and institutional reforms, including the introduction of a Value-Added Tax (VAT). Mobilization of transit infrastructure projects generate revenues of around US$300 million per year by 2024.[2] Economic growth accelerates to around 4.5 percent per annum over the period, but output remains constrained by conflict. The combination of accelerated economic growth and improved tax performance through implementation of VAT leads to growth of core tax revenues to around US$3.1 billion over the period. Total revenues increase from around US$2.5 billion in 2019 to around US$3.4 billion by 2024.

Figure 14: Under a mid-case scenario, revenues could increase to around US$4 billion by 2024
Projected revenues under a mid-case scenario



1.9. Rapid growth scenario

Under a rapid growth scenario, revenue growth would be rapid. With a significant reduction in violence, economic growth and tax administration improve substantially. Significant progress is achieved with policy and institutional reforms, including the introduction of a Value-Added Tax (VAT). Mobilization of extractives and transit infrastructure projects generate revenues of around US$600 million per year by 2024.[3] Economic growth accelerates to around six percent per annum over the period. The combination of accelerated economic growth and improved tax performance through implementation of VAT leads to growth of core tax revenues to around US$3.4 billion over the period. Total revenues increase from around US$2.5 billion in 2019 to around US$4.2 billion by 2024.

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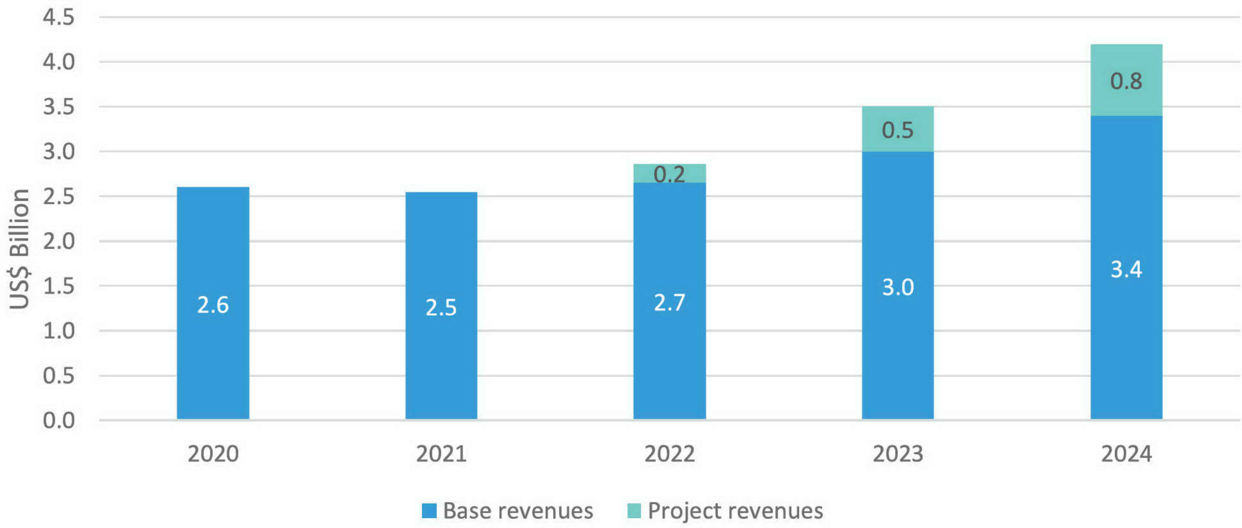
[2] Major connectivity projects are completed and begin to generate revenues by the end of the period, including CASA-1000, TAPI, and TAP-500.

[3] Mining projects are mobilized towards the end of the projection period, including Aynak, Hajigak, Shaida, and Badakshan. Current informal mining is formalized and cement, marble, and coal production increase. Major connectivity projects are completed and begin to generate revenues by the end of the period, including CASA-1000, TAPI, and TAP-500.

Figure 15: Under a rapid growth scenario, revenues could reach US$5 billion by 2024

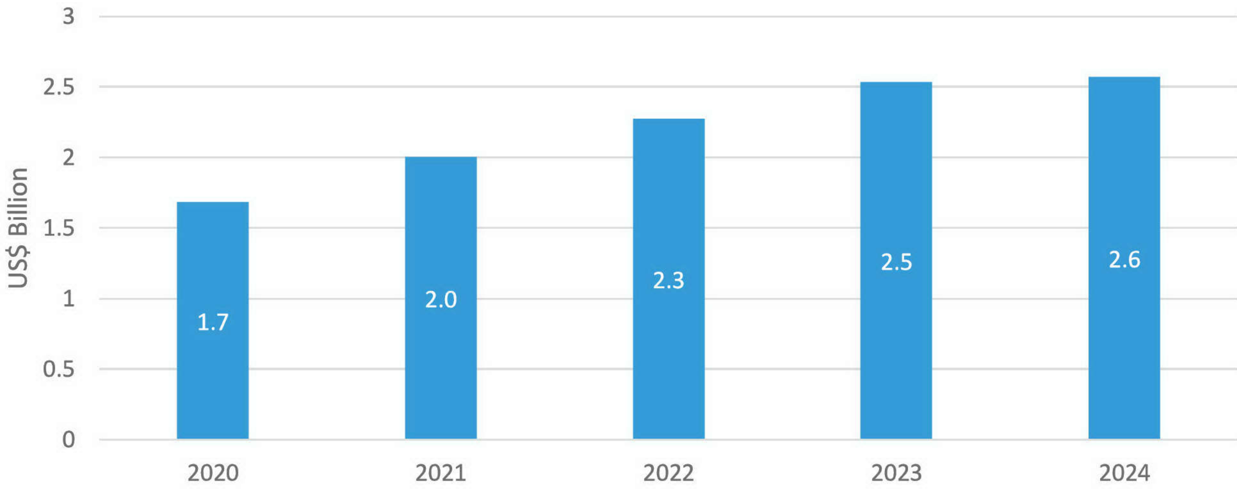
Expenditure and financing sources – security and civilian



A downside scenario could see revenues collapsing. Under a downside scenario, conflict intensifies, and governance and institutions are weakened. No progress is made with policy and institutional reforms. No major new revenue-generating projects are realized. Economic growth remains stagnant at around 1.5 percent per annum. Revenue performance weakens to a similar extent observed over the 2014 election period (revenue as a percentage of GDP collapses to around 8.5 percent in 2020 before recovering gradually to current levels by the end of the period). Under this scenario, revenues fall quickly from around US$2.5 billion in 2019 to just US$1.7 billion in 2020, before recovering to around current levels by 2024.

Figure 16: A downside scenario could see collapsing revenues

Projected revenues under a downside scenario

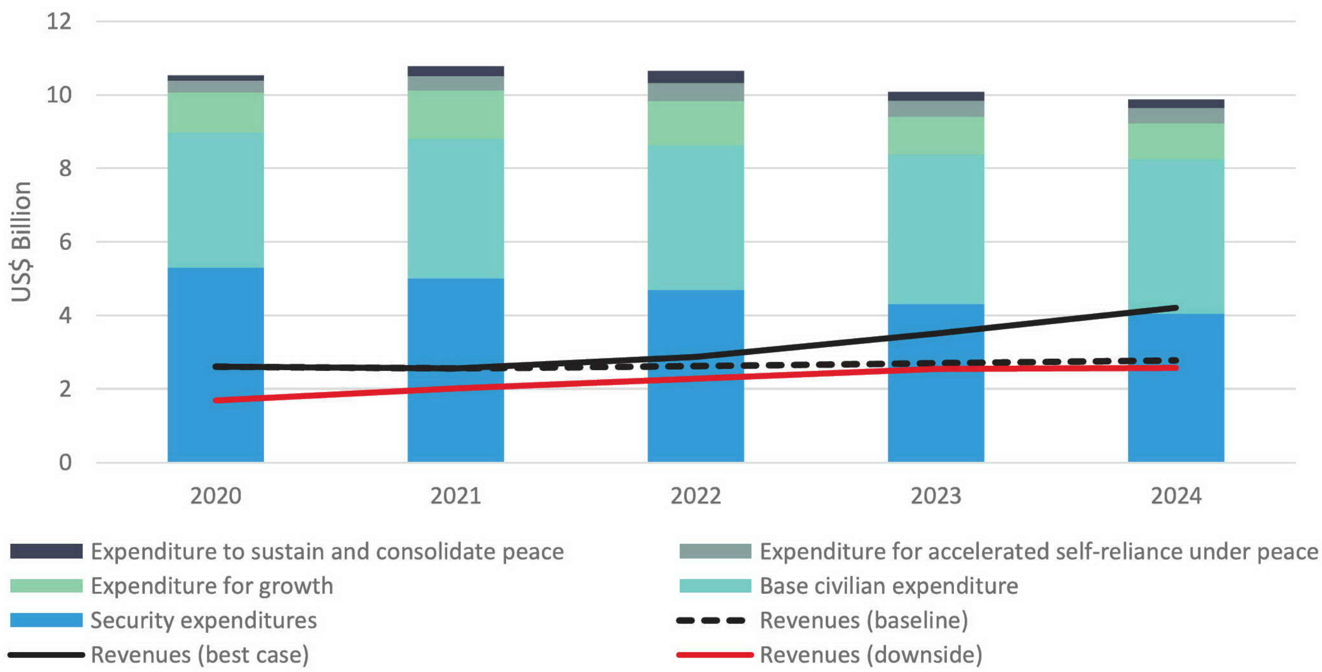


5. Implications for financing and policy

5.1. Grant needs

Grant needs have been estimated based on the difference between financing needs and government revenues under different scenarios. As shown in Figure 17, the gap between financing needs and revenues remains substantial, even under a rapid growth scenario. Even under a scenario of strong economic growth and mobilization of revenue-generating projects, revenues would only be equivalent to around 40 percent of total expenditure needs by 2024.

Figure 17: Afghanistan will remain reliant on grants to finance planned expenditures
Financing needs and revenues to 2024



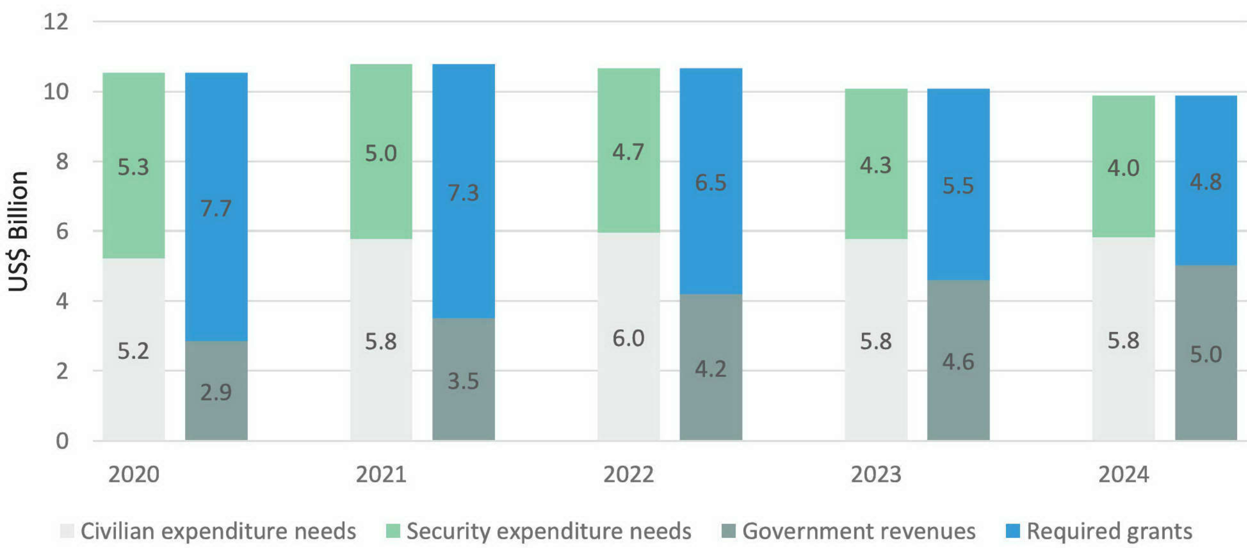
The table below summarizes annual grant requirements to meet expenditure needs under different categories. Donor grants of between US$5.3 billion and US$6.4 billion per year are required simply to finance expected security expenditures and maintain service delivery and infrastructure at current levels (it is very unlikely that growth would reach 'best case' levels unless public expenditures to support growth were adequately financed). If expenditure programs are to be mobilized to support faster economic growth and sustain and consolidate a political settlement, total grant needs will reach between US$6.3 billion and US$8.2 billion per year, depending on economic growth and revenue generation.

Table 1: Grant needs remain substantial under all likely scenarios
Annual grant needs by scenario and expenditure category

	Growth and revenue scenario			
	Downside	Baseline	Mid-case	Rapid growth
	Average annual grant needs 2020-2024 (US$ billions)			
Base expenditures (security and civilian)	6.4	5.8	5.3	4.6
Base expenditures + Expenditures for accelerated growth	7.5	7.0	6.4	5.6
Base expenditures + Expenditures for accelerated growth + Expenditures to consolidate and sustain peace	8.2	7.6	7.0	6.3

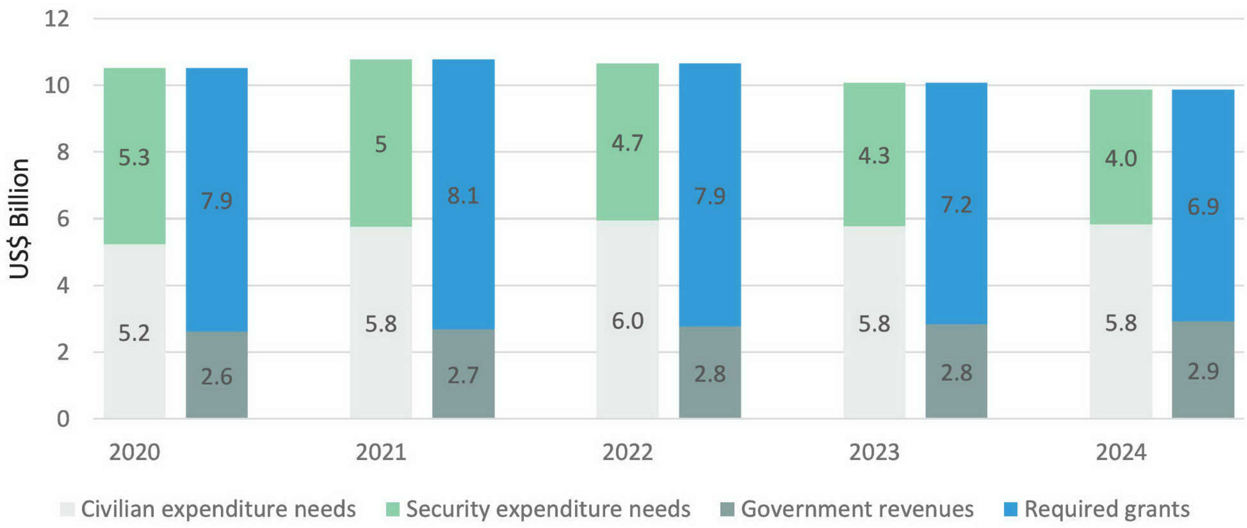
Under an optimistic scenario including substantial reductions in violence, grant needs decline to around US$5 billion per year by 2024. During initial years, grants remain at elevated levels and are sufficient to finance investments to support accelerated economic growth and sustain a political settlement (as described in the sections above). With improvements in security and substantial public investment, the economy grows rapidly, reaching real GDP growth of around six percent per annum. Mobilization of revenues resulting from strong growth, tax administration improvements under improved security, and new revenue-generating projects progressively substitutes grant financing.

Figure 18: Under a rapid growth scenario, grant needs could decline to US$5 billion per year
Expenditure and financing sources to 2024 under rapid growth scenario



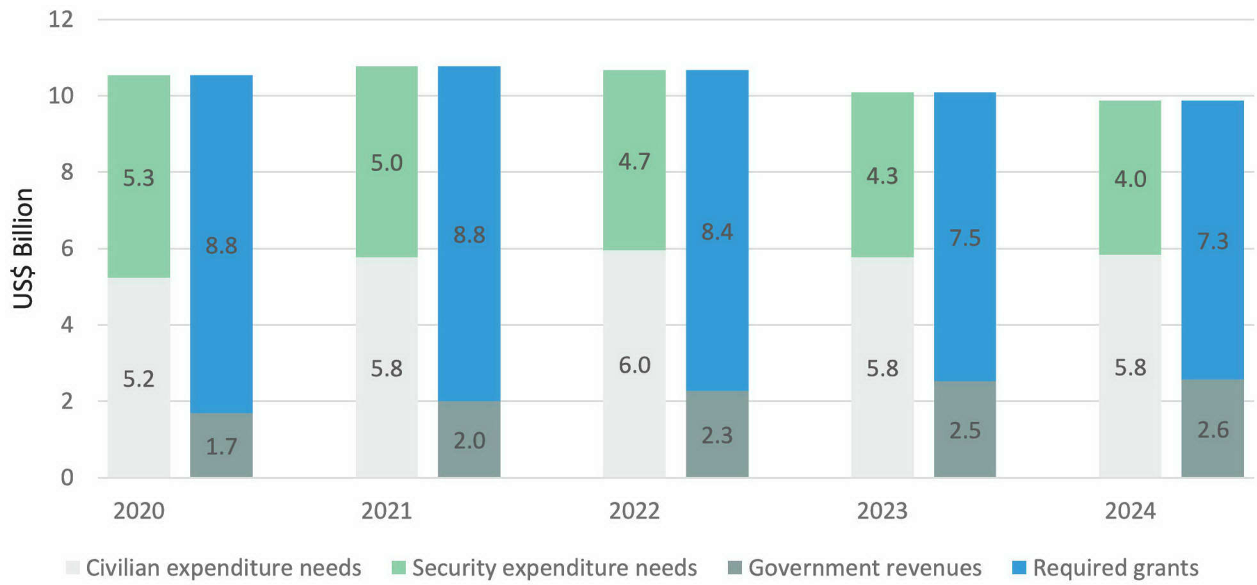
Under a scenario of continued violence, grant needs decline only slightly over the period. Grants are sufficient to finance investments to support accelerated economic growth and sustain a political settlement (as described in the sections above). With continuing violence and insecurity, however, economic growth remains sluggish, remaining at around three percent per annum. With slow revenue growth, Afghanistan remains reliant on grants to finance service delivery and infrastructure.

Figure 19: Under a baseline scenario, grant needs will only gradually decline
Expenditure and financing sources to 2024 under baseline scenario



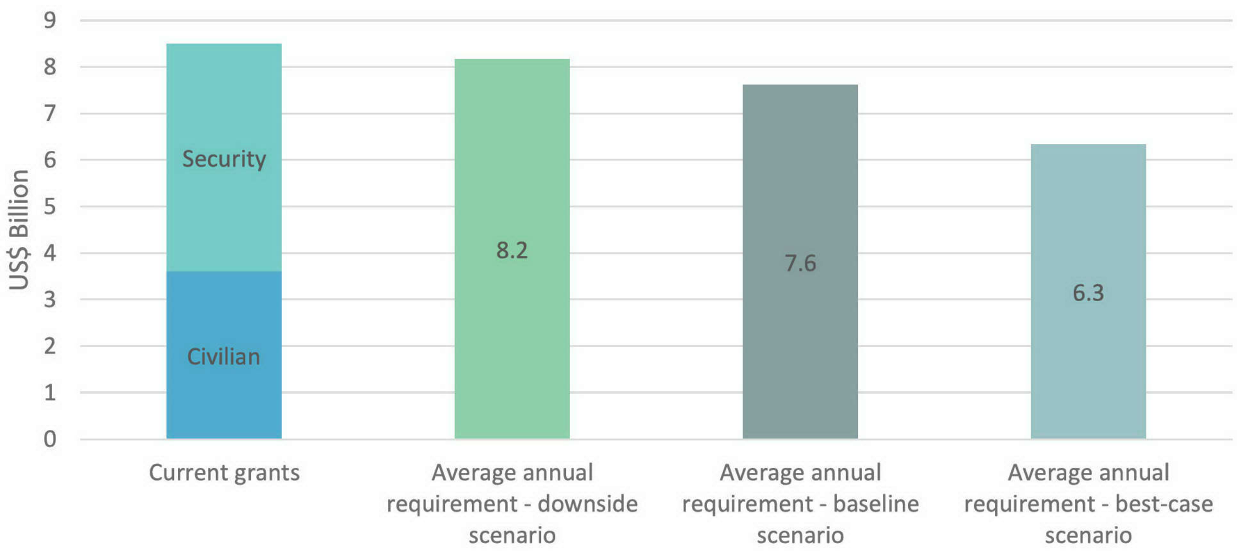
Under a downside scenario of intensified violence and deteriorations in governance and institutions over the election period, grant needs increase in the short-term. Slight increases in grants from current levels are required to support investments for accelerated economic growth and post-settlement initiatives. As revenue recovers over the medium-term, grant needs gradually decline. With continuing violence and insecurity, the economy stagnates, growing at around 1.5 percent per annum.

Figure 20: Under a downside scenario, grant needs increase in the short-term before declining gradually
Expenditure and financing sources to 2024 under downside scenario



All financing needs could be met if grants remain close to current levels. Total grants to Afghanistan are currently around US$8.5 billion (around US$4.9 billion in security grants and around US$3.6 billion in civilian grants). This compares with total estimated annual financing needs of between US$6.3 billion and US$8.2 billion under different scenarios.

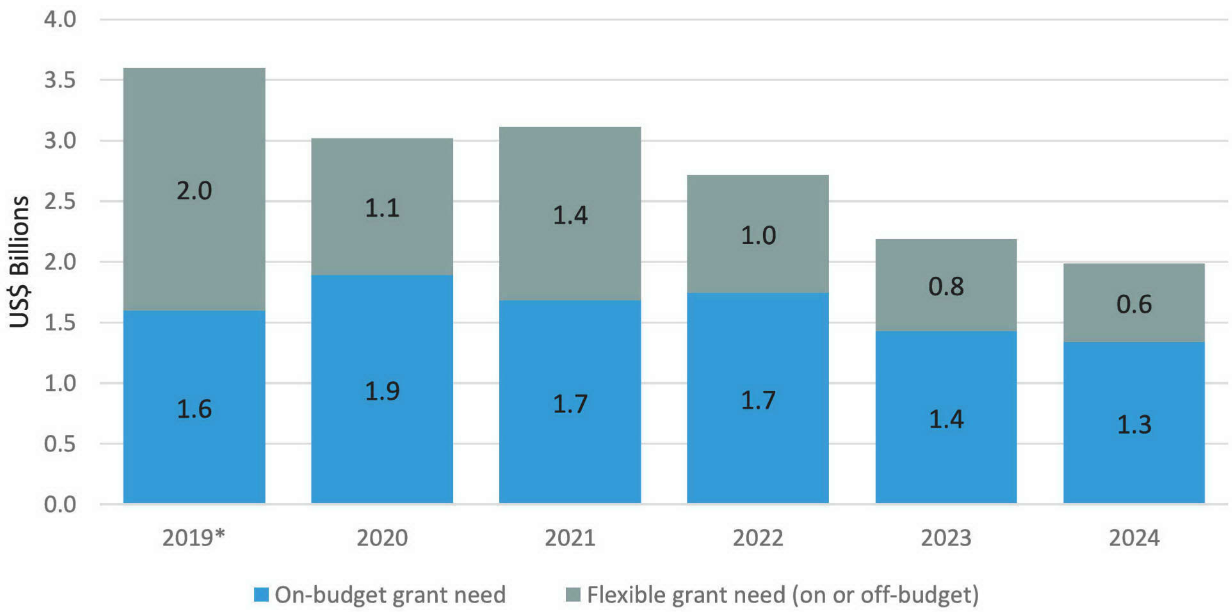
Figure 21: All financing needs could be met if grants remain close to current levels
Current grants and average annual future grant requirements by scenario (2020-2024)



On-budget grant needs will remain substantial. A substantial proportion of total grant needs would need to be delivered on-budget. On-budget expenditure needs include: i) base security and civilian spending to meet increased costs under existing government programs; ii) increased spending on education and health services under the Growth Agenda to improve human capital and accelerate growth; and iii) post-settlement economic initiatives included in the PEIR that would be delivered through core government systems, including health, education, and community development initiatives.

Under a rapid growth scenario, the proportion of civilian grants delivered on-budget would need to increase over time. Under a rapid growth scenario, civilian grant needs can be met even with significant reductions in total grants and civilian grants. In dollar terms, on-budget financing needs would remain roughly constant at around US$1.5 billion per year, while off-budget spending could decline. However, this implies an increase in the proportion of civilian grants delivered on budget from around 45 percent in 2019 to around 70 percent by 2024.

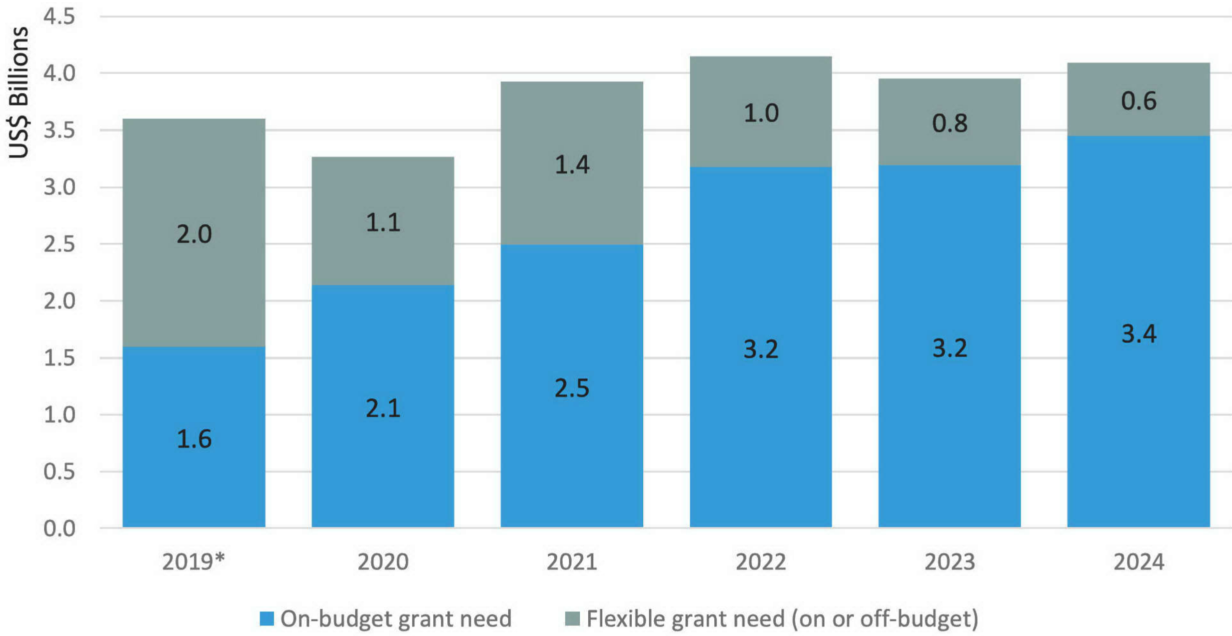
Figure 22: Under a rapid growth scenario, on budget grant support would need to be maintained
On-budget and flexible civilian grant requirement under rapid growth scenario (2020-2024)



Under a baseline scenario, civilian grant needs would increase slightly (even as overall grant needs declined) and the proportion of civilian grants delivered on-budget would need to increase rapidly. Under a baseline scenario, civilian grant needs would increase slightly to around US$4 billion per year. In dollar terms, on-budget grant needs would increase from around US$1.5 billion to more than US$3 billion by 2024. This implies a rapid increase in the proportion of civilian grants delivered on budget from around 45 percent in 2019 to around 85 percent by 2024.

Figure 23: Under a baseline scenario, on-budget grant needs would increase

On-budget and flexible civilian grant requirement under baseline scenario (2020-2024)



Box 3: Can Afghanistan meet financing needs through borrowing?

Many countries meet financing needs for investment projects through accumulation of public debt. Debt financing can provide a useful option for financing projects with high rates of economic return that would otherwise be unaffordable with available fiscal resources. Financing investment projects through public borrowing is unlikely to be a viable medium-term strategy in Afghanistan, however, for several reasons.

- **Limited sources of concessional finance.** Multilateral development banks are typically a major source of concessional debt for most low-income countries. Afghanistan, however, is receiving its full allocations from the World Bank and Asian Development Bank in the form of grants. This is because Afghanistan is classified at 'high risk' of debt distress under the World Bank/IMF Debt Sustainability Framework. An improvement in Afghanistan's debt distress risk rating would not lead to additional concessional debt being available from multilateral development banks, but rather a transition from grant support to concessional loan support (i.e. concessional loans would substitute, rather than be additional to, grant support reducing rather than expanding fiscal space for investment).

- **IMF and World Bank policy constraints on non-concessional borrowing.** Many developing countries borrow from external commercial lenders at non-concessional terms. However, under the current IMF Extended Credit Facility Program, Afghanistan faces a zero-limit on non-concessional debt (with the possibility of project-by-project exemptions). This zero-limit reflects Afghanistan's heavy level of reliance on international grants and risks that Afghanistan would be unable to sustainably service debt if grant support declined. A breach of debt limits included in an IMF program could substantially impact allocations and terms of support from the World Bank and other donors.

- **Absence of willing external private sector creditors.** International commercial lenders are typically reluctant to lend to countries with weak institutions and without established track-records of successfully managing public debt. According to international metrics, Afghanistan has weak institutions and very weak debt management capacity. This means that commercial debt may be difficult to secure and very expensive, involving high interest costs to compensate for perceived risk.

- **Underdeveloped domestic debt market.** Many developing countries borrow at commercial terms from domestic financial sector institutions. In Afghanistan, there may be substantial scope for government borrowing from the highly-liquid banking sector. At present, however, the policy, regulatory, and commercial framework for domestic borrowing has not been established. Further, capacity and institutions for debt management remain weak within the Ministry of Finance.

- **Sustainability constraints and risks.** International experience illustrates large risks involved with rapid debt accumulation, especially of commercial debt. Debt crises can occur when expected returns from public investments are not realized or the economy faces other shocks. The costs of debt service can only be met through further borrowing, leading to explosive and unsustainable increases in debt levels and debt-service costs. Debt crises can delay development progress by decades through diverting resources towards debt servicing and away from services and infrastructure and undermining macroeconomic stability.

In Afghanistan, a cautious and phased approach to accessing debt financing is appropriate. This would begin with: i) building debt management capacity within the Ministry of Finance; ii) pursuing regulatory and policy reforms to establish a domestic debt market, including broader progress with financial sector development; and iii) establishing a clear debt management strategy informed by risk and debt sustainability analysis. Over the medium-term, Afghanistan could access modest levels of debt financing from a domestic debt market. Accessing substantial international commercial debt to finance public infrastructure projects should remain a longer-term challenge.

Policy implications

The above analysis has the following implications for policy:

- **Sustaining grants at close to current levels would help to facilitate growth and sustain and consolidate a political settlement.** It is possible to finance all expenditure needs even with grants on a gradually declining trajectory. If grants are kept at close to current levels in the near-term, economic growth and a potential reduction in violence would allow significant improvements in growth and development outcomes, substantially reducing future grant needs. All current financing needs could be met even while reducing average annual grants over 2020-2024 by up to US$2.2 billion from current levels.

- **Rapid and significant reductions in grants would force very difficult trade-offs between important policy objectives.** A precipitous reduction in either security or civilian grants would force a choice between: i) sustaining security spending; ii) maintaining the delivery of basic government functions (such as social services and infrastructure); iii) undertaking required public investments to support faster economic growth and poverty reduction; and iv) delivering short-term benefits to Afghans following a political settlement to help to sustain and consolidate peace.

  Reallocation of existing grant resources away from the core functions in order to support short-term gains following a political-settlement would raise important questions of sustainability. Benefits of short-term post-settlement programming are likely to be short-lived if they come at the cost of continued investment in the basic functions of government and the core service delivery mechanisms that have been built up since 2001. Continued investment in health, education, and core infrastructure – heavily dependent on donor support – must continue if human capital is to improve and sustainable growth is to be achieved.

- **Substantial civilian on-budget grant needs will remain.** Even under a rapid growth scenario, on-budget grant needs will remain close to the current level of on-budget grant support. If core expenditure needs are to be met, on-budget grant support will need to be sustained with savings arising mostly from reductions in off-budget programming.

- **Expectations regarding the capacity to deliver a peace dividend through grant programming must be realistic.** Resources available for delivering a post-settlement dividend are likely to remain limited under any scenario, relative to the extent of grant support already being provided. The most significant benefits of a political settlement are likely to be realized if such a settlement leads to improvements in security, political stability, and freedom of movement. Increased private sector investment and job creation resulting from such improvements is likely to deliver much more significant and sustainable benefits than grant-financed interventions. This is especially the case given the current context of already-unsustainably high public expenditure and likely declines in grant support over the medium-term.