

AFGHANISTAN TO 2030

PRIORITIES FOR ECONOMIC DEVELOPMENT UNDER FRAGILITY



یک چادری از عفت و ناموس به سرکن وانگاه به مکتب برو تحصیل هنرکن در مکتبیت دایم تی تحصیل طلب باش در خانه مواظب به قوانین ادبیت



This document is a product of the staff of the International Bank for Reconstruction and Development/The World Bank. The findings, interpretations, and conclusions expressed in this paper do not necessarily reflect the views of the Executive Directors of The World Bank or the Governments they represent. The World Bank does not guarantee the accuracy of the data included in this work. The boundaries, colors, denominations, and other information shown on any map in this work do not imply any judgment on the part of The World Bank concerning the legal status of any territory or the endorsement or acceptance of such boundaries.



This report was prepared by a team led by Claudia Nassif and Tobias Haque and including Omar Joya, and Aman Farahi.

Rebekah Smith provided substantive inputs to the section on labor mobility. The report draws from background papers prepared by Andras Bordor, Silvia Raedelli, Christina Weiser, Nandini Krishnan, Michael Stanley, Yaw Nyarko, Carole Chartouni, Rebekah Smith, Daniel Sanchez, Fanny Missfeldt-Ringius, Jie Li, Ahmed Rostom, Subika Farazi, Rishabh Sinha, Leila Aghabarari, Matthew Morton, Nadia Rocha, Carmen Estrades, Robert Holzman, Nathalie Lahire, Patrick Asea, Joshua Blumenstock, Tarek Ghani, Sylvan Herskowitz, Ethan Kapstein, Thomas Scherer, and Ott Tommet.

Useful review comments were provided by Martin Rama, Vinaya Swaroop, Shantayanan Devarajan, Kevin Carey, Gladys Lopez-Acevedo, Nadia Piffaretti, and Wilfried Engelke. The report was prepared under the overall guidance of Shubham Chaudhuri, Robert Saum, and Manuela Francisco.

The authors are grateful for close cooperation and collaboration with officials of the Government of the Islamic Republic of Afghanistan during all stages of preparing this analysis. The report has benefited from comments and inputs from a wide range of experts from government, development partner agencies, and the World Bank. Background papers were subject to extensive consultation, including through a seminar series at the World Bank office in Kabul throughout 2016-17. Emerging conclusions from this work were presented at the Brussels Conference on Afghanistan in September, 2016.

All background papers and accompanying policy notes will be made available from: www.worldbank.org/afghanistan

THIS REPORT PRESENTS ECONOMIC DEVELOPMENT PRIORITIES FOR A FRAGILE AFGHANISTAN

Sixteen years after the fall of the Taliban regime Afghanistan is still characterized by conflict and insecurity.

Increasing violence and insecurity is deterring investment and imposing enormous human costs. Over half of the population lives in poverty. Unemployment rates are high. Population growth poses challenges to public service delivery capacity, while a youth bulge means that the number of young Afghans joining the labour force radically outstrips the number of available jobs.

A deep economic slowdown, triggered by the 2012 drawdown of international security forces, the decline in international aid, and political instability following the 2014 elections are now threatening to reverse past development gains.

While much progress has been made, Afghanistan's institutions remain incapable of mediating contestation over resources, protecting property rights, or providing security to citizens. International evidence – and Afghanistan's own experience – shows that strong institutions take many years to emerge and that such emergence is not inevitable even over the long-term.

Overall, the current combination of protracted conflict, weak institutions, and poor economic development creates a vicious circle that will be difficult to break.

This report identifies economic development options for Afghanistan in the context of likely ongoing fragility.

In the short-term, Afghanistan needs to escape the current slowdown despite a difficult fiscal and security situation. Public expenditure needs to be directed to the highest priorities in order to spur demand, and further reform progress is required to build confidence and increase investment. If the right choices are made, gains achieved now can lay the foundations for future growth.

Over the longer-term, Afghanistan urgently needs a broad-based growth model that not only produces growth and jobs, but also generates sufficient domestic revenue and foreign exchange to sustain government activities and macroeconomic stability. This model must reflect the reality that some level of fragility and institutional weaknesses will likely persist. Any growth strategy must be achievable in the context of tight constraints on fiscal resources and expected declines in aid.

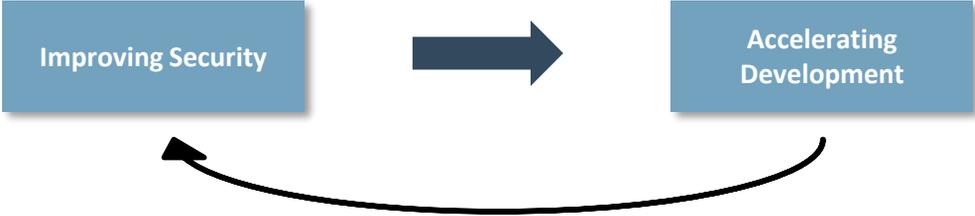
Taking continued fragility as the start-point, this report answers the following questions:

-  **How can Afghanistan escape the current slowdown?**
-  **How can Government, firms and households best manage the risks associated with fragility?**
-  **What growth model can achieve development needs under the context of ongoing fragility and resource constraints?**
-  **How can economic development priorities be financed?**

"We must plan to move our country beyond its history of war and poverty and begin the long journey to prosperity"

Afghanistan National Peace and Development Framework (ANPDF) 2017-2021

QUESTIONS OF SECURITY AND DEVELOPMENT ARE INEXTRICABLY LINKED



Improving security is vital for improved development outcomes:

HUMAN CAPITAL	Conflict imposes huge direct human costs. Conflict and insecurity is also a major constraint to service delivery, undermining the improvements in human capital that are required to drive economic growth.
INVESTMENT	Private investment is directly deterred by conflict, which increases business costs and undermines confidence. Major extractives projects have been delayed partly due to ongoing conflict and insecurity, while evidence shows that business activity is reduced in areas where security incidents are most common.
FISCAL SPACE	Security requirements are imposing large and unsustainable costs on the Government of Afghanistan. A large proportion of the budget is absorbed by security expenditures, squeezing out required investment in social services and infrastructure.

Though channels are complex and mediated by many factors, progress against development can help improve security:

INCOMES	Insurgents do not fight primarily to make money. But international evidence shows that participation in insurgent groups declines when opportunity costs increase – opportunity costs are higher when alternative income-generating opportunities exist or become more profitable.
OPPORTUNITIES	There is strong evidence that violence increases in the context of youth bulges and limited opportunities. Ensuring faster job creation is vital for managing the security risks associated with Afghanistan’s upcoming youth bulge.
INSTITUTIONS	There is strong evidence that perceptions of exclusion, victimization, and corruption spur violence. Stronger institutions are vital to address these underlying drivers of conflict, especially in relation to the justice sector and management of land and water rights.

KEY MESSAGES

1



To escape
slowdown:

Improve efficiency of public expenditure.

- Move expenditures towards activities that have the greatest economic impact
- Strengthen the budget process to free up fiscal space and reallocate resources towards growth priorities.

Support increased investor confidence.

- Continue to remove unnecessary regulatory constraints to investment
- Demonstrate commitment to policy reforms to build credibility.

2



To manage the
impacts of fragility:

Prioritize limited political capacity towards reforming the public sector institutions that matter most for growth.

Pursue policy measures that mitigate fragility-related risks facing households and firms.

- Introduce a broad cash-transfer scheme to help households mitigate the long-term costs of security and other shocks
- Reduce unnecessary regulatory constraints, improve access to financial services, and introduce new financial instruments to help firms better deal with insecurity.

3



To achieve inclusive
long-term growth:

Pursue a balanced growth strategy that addresses Afghanistan's multiple economic development challenges.

- Pursue extractives development to mobilize required revenues and foreign exchange receipts
- Invest in agriculture to reduce poverty, generate jobs, and improve livelihoods
- Increase investment in human capital so that future growth opportunities can be captured.

4



To finance growth
priorities:

Align all available resources around a coherent growth strategy.

- Align planning processes around a coherent growth strategy so that limited available resources have greatest possible impact
- Bring a greater share of aid on to the budget to ensure alignment with policy priorities and maximize the local economic impact
- Strengthen public investment management processes to ensure all expenditure is of high quality and aligned with policy priorities.

STRUCTURE OF THE REPORT

Part 1:
Afghanistan since
“Transition”
Page 8

- Despite substantial gains against many indicators, Afghanistan remains a poor, fragile country.
- Developments since “Transition” – the 2012-2014 drawdown of international security forces – have driven a deep, sustained slowdown.
- The strong government response to recent challenges is cause for cautious optimism.

Part 2:
Economic
Development
Challenges
Page 17

- In the short-term, Afghanistan faces a deep slowdown with very few policy levers available to drive growth.
- In the longer-term, Afghanistan requires a growth strategy that addresses multiple pressing economic development challenges, including the need for increased growth, jobs, foreign exchange receipts, and revenues.

Part 3:
Addressing Economic
Development
Challenges
Page 25

- Immediate improvements in public resource allocation and business environment reform can help escape slowdown.
- Policy measures are needed to shield households and firms from the impacts of fragility.
- A balanced long-term growth strategy can meet Afghanistan’s different economic development needs, including focus on agriculture, extractives, and human capital.

Part 4:
Financing Economic
Development
Priorities
Page 64

- Investment required for growth is affordable if resources are tightly prioritized.
- Increasing the share of aid on budget is vital for realizing growth potential.
- Afghanistan will continue to rely on elevated levels of international assistance.

1. AFGHANISTAN SINCE “TRANSITION”

- Despite substantial gains on many indicators, Afghanistan remains a poor, fragile country.
- Developments since “Transition” – the 2012-2014 drawdown of international security forces – have driven a deep, sustained slowdown.
- The strong government response to recent challenges is cause for cautious optimism.



DEVELOPMENT OUTCOMES HAVE IMPROVED SUBSTANTIALLY SINCE 2001



GDP PER CAPITA

from \$120 to \$580



REVENUE

from 3.3 percent to 11.9 percent of GDP



LIFE EXPECTANCY

from 44 to 61 years



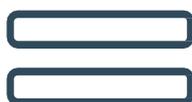
SCHOOL ENROLMENT

from 0.8 million to over 8 million



MATERNAL MORTALITY

from 1600 to 327 (per 100,000 births)



GENDER EQUITY

from 0 percent to 27 percent of seats in Parliament held by women



INFRASTRUCTURE

from almost none to over 18 million mobile phone subscriptions



PFM

stronger PFM system than other fragile states

BUT AFGHANISTAN REMAINS A POOR, FRAGILE COUNTRY

HUMAN DEVELOPMENT



Human Development Index Ranking

- More than half of the population lives below the poverty line.
- Limited access to services lead to poor living standards for the majority of the population.

AID DEPENDENCE



Grants as percent GDP

- Aid finances around 60 percent of the government budget.
- Aid inflows finance a trade deficit of 32 percent of GDP.

ECONOMIC STRUCTURE



Agriculture share of total employment

- Low levels of private investment.
- Aid inflows and public sector investment drive a large share of economic growth.
- Economic production is concentrated in agriculture and services.

INSTITUTIONS



Corruption Perceptions Index Ranking

- Years of conflict have eroded governance systems and fuelled corruption and patronage.
- Active conflict persists, with large areas of the country beyond the control of government.
- The rule of law is extremely weak, especially outside of main urban centres.

Sources: World Bank data, UNDP Human Development Index 2017, Transparency International Corruption Perceptions Index 2017.

DEVELOPMENT PROGRESS SLOWED FROM 2014, REFLECTING A SERIES OF NEGATIVE SHOCKS

The drawdown of international security forces coincided with Presidential elections.

Following the fall of the Taliban regime in 2001, Afghanistan received massive international development and security assistance. More than 100,000 NATO troops were stationed in Afghanistan until 2014, supporting operations against the on-going insurgency and assisting in building and training a national defence force.

Security and civilian aid amounted to an estimated 112 billion between 2002 – 2015, peaking in 2011 at approximately US\$15.7 billion, equivalent to 97 percent of GDP, making Afghanistan one of the most aid-dependent countries in the world.

In order to ensure a path toward self-reliance, the Government of Afghanistan and NATO partners agreed in 2010 on a gradual handover of security responsibilities to be completed by end-2014.

At the same time, the country prepared for a highly anticipated presidential election in 2014. Together with the drawdown of international troops, the elections were widely seen as an opportunity for a fresh start with an administration that could revitalize a peace process, act more independently, and move the economy away from heavy dependence on aid.

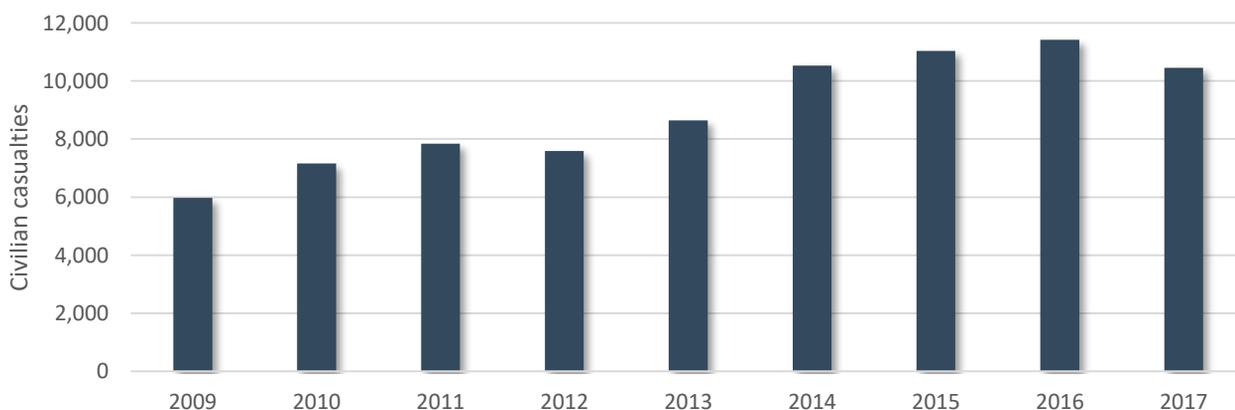
The outcome of the election led to much greater disruption for a much-longer period than was expected.

The outcome of the election was disputed, among allegations of electoral fraud. Conflicts and negotiation of formal and informal power-sharing arrangements between the two branches of the National Unity Government caused major delays in the appointment of ministers to key ministries.

Divisions within the new government also led to long delays in filling senior civil servant posts, with less suitable candidates often selected on the basis of acceptability to both parties. The existence of parallel bureaucracies under both leaders exacerbated co-ordination problems and led to contestation and bargaining over decisions made at every level.

Insurgent violence increased, driven by competition between rival anti-government factions. Civilian casualties increased to a post-2001 high of 11,418 in 2016, while an increasing proportion of Afghanistan's land area remains under the control of anti-government elements.

THERE HAS BEEN A SHARP INCREASE IN CIVILIAN CASUALTIES SINCE 2014



Source: UNAMA

“TRANSITION” AND POLITICAL UNCERTAINTY NEGATIVELY IMPACTED AID, GROWTH, AND REVENUES

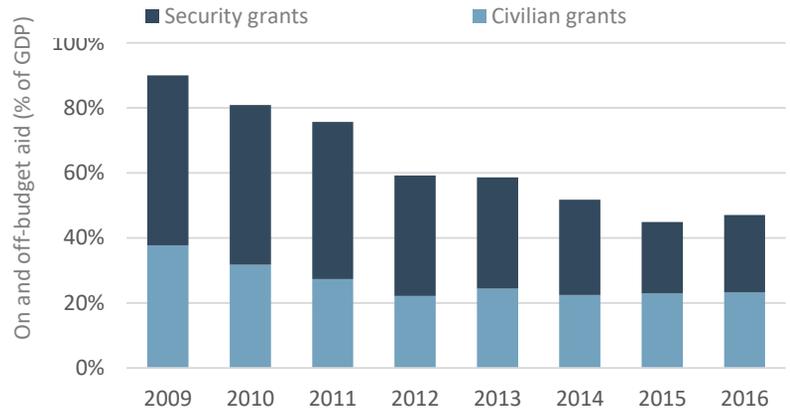
The drawdown of international troops was also associated with a significant decline in military and civilian aid.

The combination of political uncertainty, greater insecurity and the decline in international aid adversely affected consumer and investor confidence, leading to a sharp reduction in aggregate demand. Impacts were exacerbated by poor weather conditions and a decline in agricultural production.

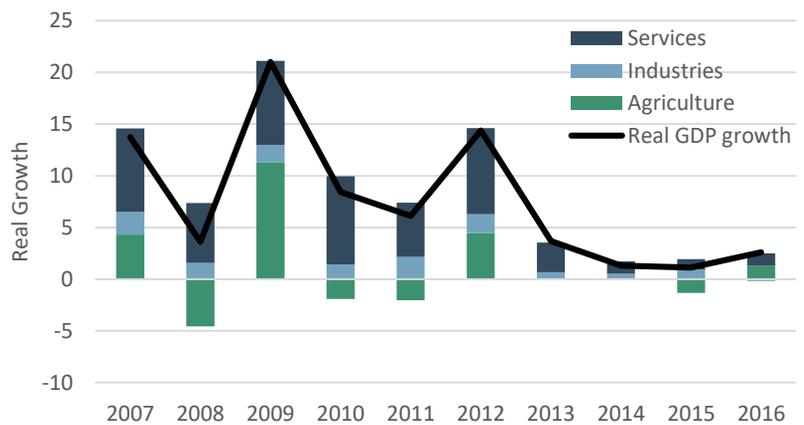
Domestic revenues fell amid political uncertainty and increasing corruption, while security spending increased in the face of increasing violence.

The ensuing fiscal crisis necessitated additional donor support and left treasury reserves depleted.

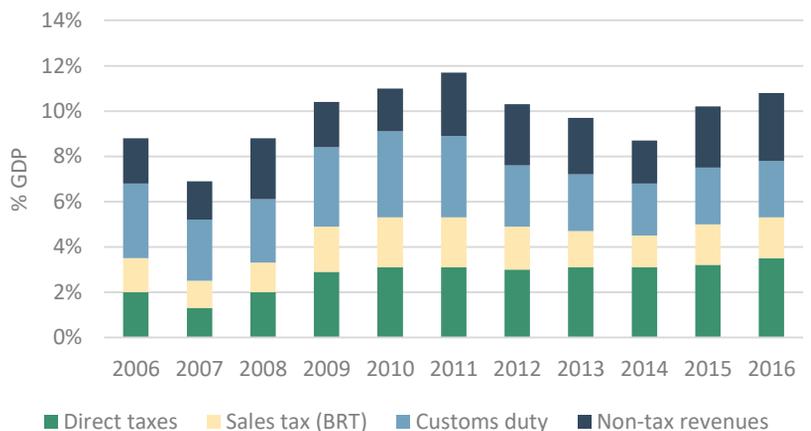
MILITARY AND CIVILIAN AID ALMOST HALVED OVER 2009-2014



GROWTH FELL TO THE LOWEST RATES SINCE 2001



AFTER A PERIOD OF STRONG GROWTH , REVENUES DECLINED



Source: World Bank data

PRIVATE SECTOR CONFIDENCE AND INVESTMENT DECLINED

New firm registrations

The number of new investment activities declined by more than half from 2012 to 2016.

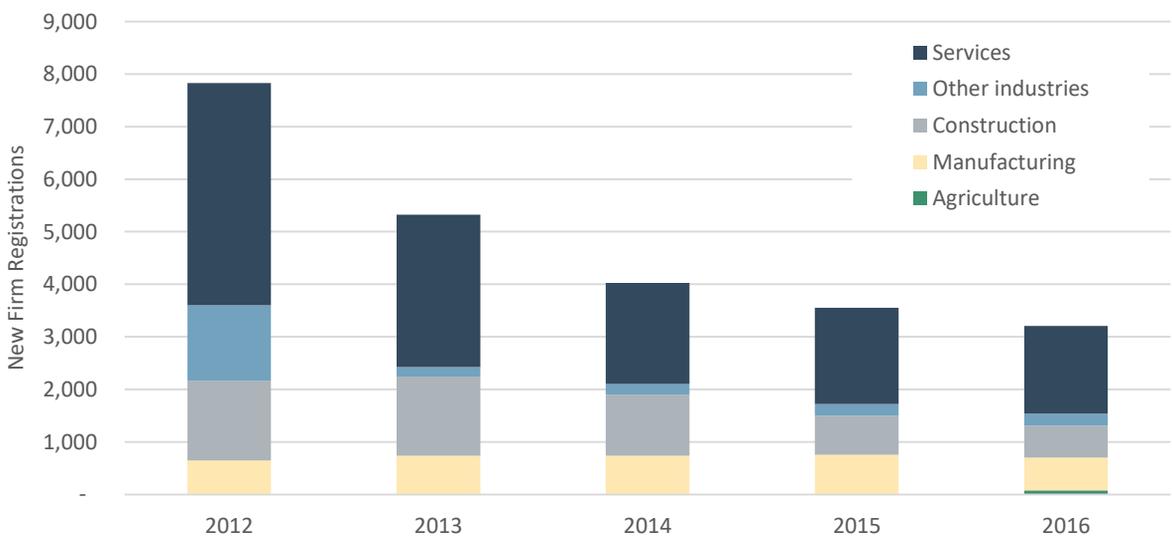
Commercial loans

The value of commercial loans to the private sector declined from 4.9 percent of GDP in 2011 to 3.4 percent of GDP in 2016 with bank liquidity increasing, reflecting weak demand for loans.

Mining Investment

Mining activities, which gained momentum in the pre-transition years, were suspended by government on the basis of perceived large governance risks.

NEW FIRM REGISTRATIONS DECLINED RAPIDLY ACROSS MOST SECTORS



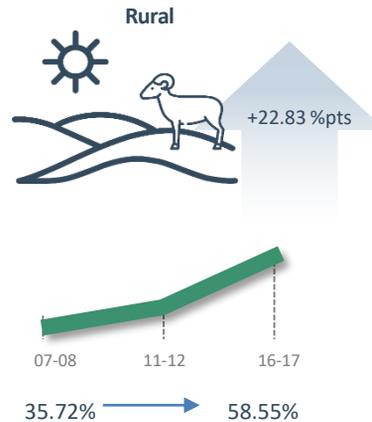
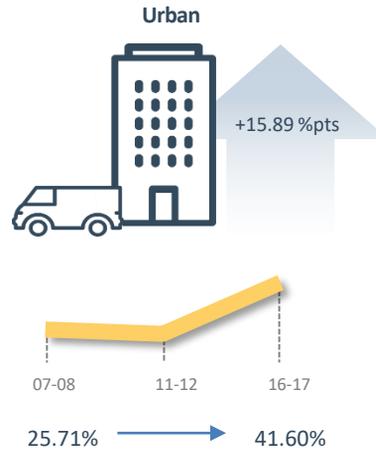
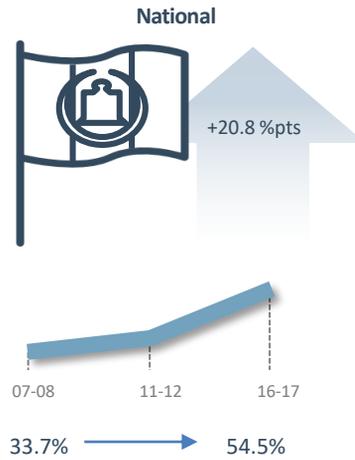
Source: Ministry of Commerce and Industry

POVERTY AND UNEMPLOYMENT INCREASED

Unemployment and underemployment have increased. The number of Afghan males aged 25-50 in full-time employment as a share of the population has declined from 76.3 percent in 2011/12 to 53.1 percent in 2013/14 to 67.6 percent in 2016/17.

National poverty increased from 38.3 percent in 2011-12 to 54.5 percent in 2016-17. Over 18 million Afghans now live in poverty and many more are at risk of falling into poverty.

Poverty is concentrated in rural areas but the difference is becoming less pronounced over time due to an upward trend in rural-urban migration. With the majority of Afghans living in or close to urban centres, it is likely that poverty will increasingly become an urban phenomenon.



Source: NRVA and ALCS data

RETURN MIGRATION AND DISPLACEMENT EXACERBATED HARDSHIP AND RISKS

Returnee flows have accelerated since 2014 and are now reaching unprecedented levels.

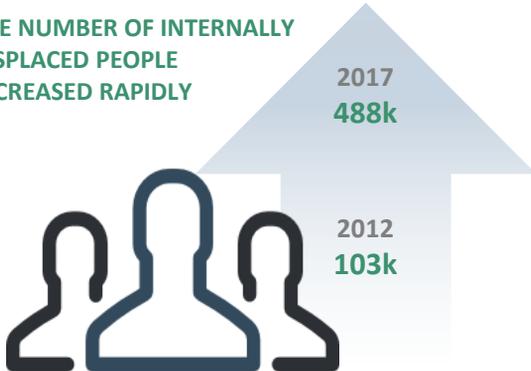
Nearly one million Afghans are thought to have returned to Afghanistan during 2016, mostly due to intensifying push factors in Pakistan. The total number of internally displaced is currently around 1.2 million.

With push factors now playing the dominant role, there are concerns that returnees will have limited human capital, few resources, and limited connections to help manage transition.

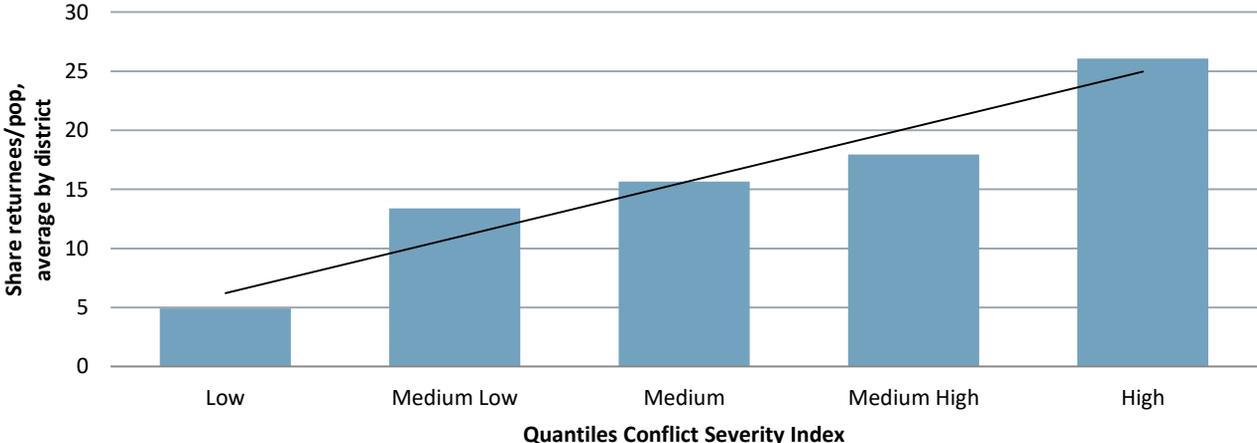
Districts that have – on average – received more returnees since 2002 are likely to experience higher levels of conflict. This may reflect pressure on land and other resources generating conflict in the context of large returnee populations.

Previous experience is cause for concern given emerging evidence of declining absorption and “reintegration” capacity. Recent survey evidence shows increasing incidence of repeated-displacement among returnee populations. This is likely to reflect both higher levels of conflict within Afghanistan and potentially exhaustion of resources available to accommodate returnees at the community level.

THE NUMBER OF INTERNALLY DISPLACED PEOPLE INCREASED RAPIDLY



DISTRICTS AFFECTED BY CONFLICT TEND TO HOST MORE RETURNEES



Source: ALCS data, World Bank analysis

GOVERNMENT REFORM EFFORTS HAVE SEEN A REBOUND IN CONFIDENCE

The National Unity Government (NUG) has pursued a number of key reforms to boost investment and strengthen institutions.

Measures have been introduced to:

- **Strengthen leadership and governance in the military.** Senior military leadership has been revamped and professionalized training introduced for officers. Civilian controls have been introduced over core support functions such as procurement, financial management, and audits.
- **Combat corruption.** An anti-corruption justice center has been established, and a new anti-corruption strategy has been introduced. Progress has been made in identifying and sanctioning corrupt behavior, including through new asset declaration requirements for civil servants.
- **Reduce regulatory constraints.** Business environment reforms have been progressed, including a one-stop shop for issuance of construction permits.
- **Strengthen public procurement.** A centralized procurement unit has been established to better control and safeguard expenditures.
- **Strengthen revenues.** A range of revenue policy and administration measures have seen revenues rebound from 8.7 percent of GDP in 2014 to over 11.9 percent of GDP in 2017.
- **Support regional integration.** Afghanistan is collaborating with every one of its immediate and near neighbors to achieve increased commerce, transit trade, and investment, including cooperation on major projects: TAPI, Chabahar Port; TAP500; CASA-1000; and a number of multi-national railways.
- **Support communities.** The “Citizens’ Charter” program will provide guaranteed minimum service standards to participating communities, through Community Development Councils.

Reforms are driving increased confidence.

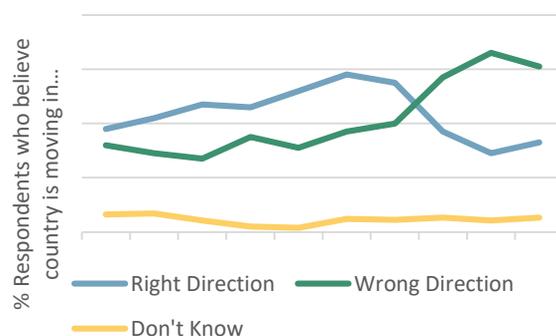
Business sentiments, as measured by a quarterly survey conducted by the Afghanistan Chamber of Commerce, have been improving since mid-2015. While business owners still appear less optimistic than in the decade prior to the transition, the results indicate a change in attitudes of domestic investors.

According to the Asia Foundation’s Survey of the Afghan People citizens are showing more optimism about the future of their country. The number of Afghans who say the country is moving in the right direction has increased from 29 percent to 32.8 percent, while the number who say the country is moving in the wrong direction has declined to 61.2 percent, down from a record high of 65.9 percent in 2016. The two most frequently cited reasons for optimism relate to rebuilding the country (51.0 percent) and, counterintuitively, improved security (50.6 percent).

BUSINESS SENTIMENT HAS IMPROVED



SURVEYS SHOW INCREASED OPTIMISM



Sources: Afghanistan Central Business Registry, Asia Foundation Survey of the Afghan People

2. ECONOMIC DEVELOPMENT CHALLENGES

- In the short-term, Afghanistan faces a deep slowdown with very few policy levers available to drive recovery.
- In the longer-term, Afghanistan requires a growth strategy that addresses multiple pressing economic development challenges.



THERE IS NO EASY WAY OUT OF THE CURRENT SLOWDOWN

OPTIONS TO STIMULATE GROWTH THROUGH FISCAL AND MONETARY POLICY ARE LIMITED



Financial systems in Afghanistan are underdeveloped and monetary transmission channels are weak. In the current situation, it is unlikely that increased money supply would lead to lower commercial interest rates or compensate for weak credit demand.



It would be difficult to finance increased expenditures without additional external on-budget aid. Increasing taxes on the existing tax base could be counterproductive, given that major taxpayers are already relatively highly taxed.



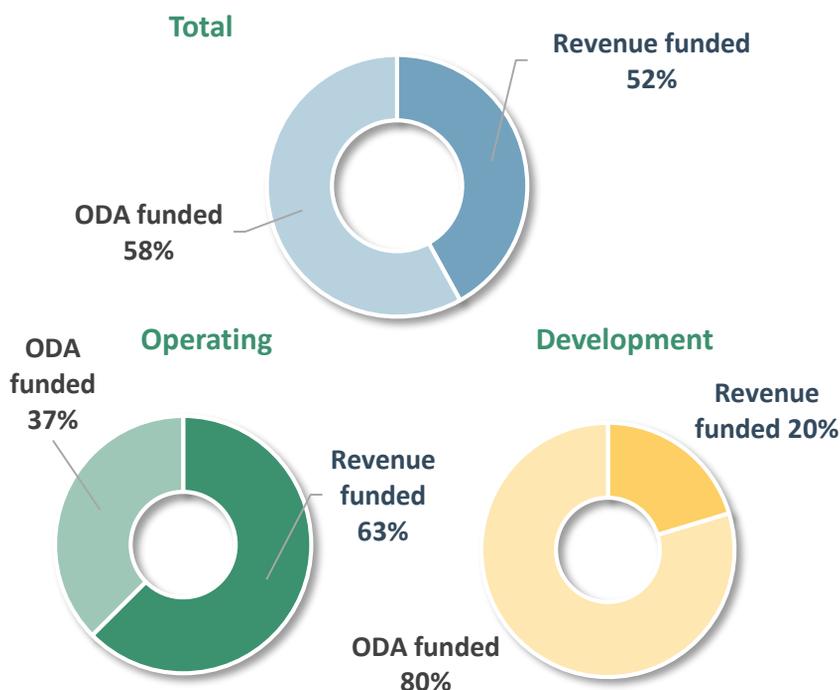
Reducing taxes or granting exemptions will unlikely override other binding constraints to investment such as insecurity – and may erode fiscal stability objectives or undermine much needed public investment.

Fiscal space is limited by imperatives for security spending and costs of providing basic services to a growing population.

Aid covers almost 60 percent of Afghanistan's on-budget civilian expenditures and 80 percent of on-budget development expenditures.

In the absence of new sources of revenue, more on-budget aid would be needed to finance an effective fiscal stimulus.

2013-2017 FUNDING FOR ON-BUDGET EXPENDITURES



SCOPE TO FURTHER INCREASE REVENUES IS LIMITED

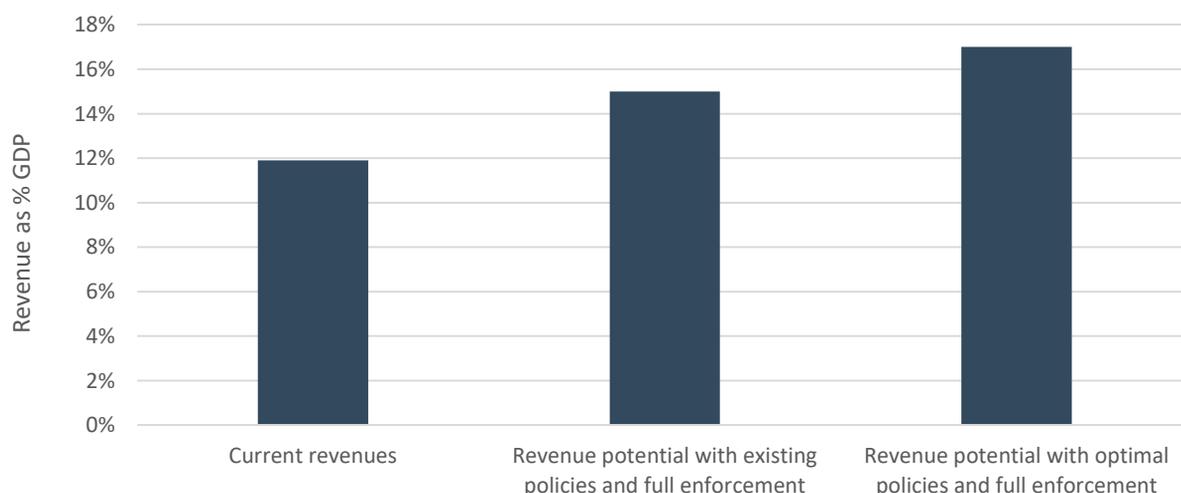
Taking account of Afghanistan's economic structure and population dynamics, Afghanistan's tax potential is estimated at up to 17 percent of GDP.

This estimate assumes optimal tax policy and administration. Revenues could be increased to around 15 percent of GDP by fully enforcing existing tax policy settings and eliminating leakages. With changes to Afghanistan's economic structure, such as through the mobilization of extractives, total revenue could expand beyond 17 percent of GDP.

The Government is working on further reforms to tax administration and plans to introduce a VAT in 2019. By 2020 these reforms could show tangible impact. Regulating illegal mining and improving collection of royalties from licensed mines could also help, but this would require much stronger enforcement capacity.

In the meantime, scope to quickly and significantly increase revenues is limited. Afghan firms in the formal sector are already relatively highly taxed. Further tax increases on the current narrow base of tax payers would exacerbate already-high costs of doing business, deter investment, and place much-needed economic growth and job-creation at risk.

EVEN WITH OPTIMAL TAX POLICY AND ADMINISTRATION, REVENUE POTENTIAL IS LIMITED



Source: World Bank analysis

THE VICIOUS CYCLE OF CONFLICT AND FRAGILITY IS HARD TO BREAK

Despite impressive progress in some areas, Afghanistan's institutions remain weak.

While a huge amount has been achieved in building state institutions from a very low base, government capacity and resources remain constrained in vital areas. State power is contested by different actors at multiple levels, and sometimes misused, increasing uncertainty for the private sector. Formal rules remain very unevenly enforced in key sectors, including mining, land, taxation, and justice.

Afghanistan is ranked among the most-corrupt countries in the world by Transparency International, while Afghanistan is among the lowest two percent of countries in terms of rule of law, as measured by the World Governance Indicators. Violence is a cause and consequence of weak institutions. Violent insurgency – fueled by the illicit economy and international actors – has placed a huge burden on government finances and capacity, slowing institutional strengthening efforts.

At the same time, poor perceptions of government are an important driver of conflict: consistent with international experiences, Afghan insurgents frequently cite corruption of the state, ethnic partisanship of state institutions, and direct or indirect exposure to unfair or disrespectful treatment or violence at the hands of security forces as primary reasons for joining opposition groups. International evidence shows that such factors are often as important as unemployment or limited access to economic opportunities in driving conflict.

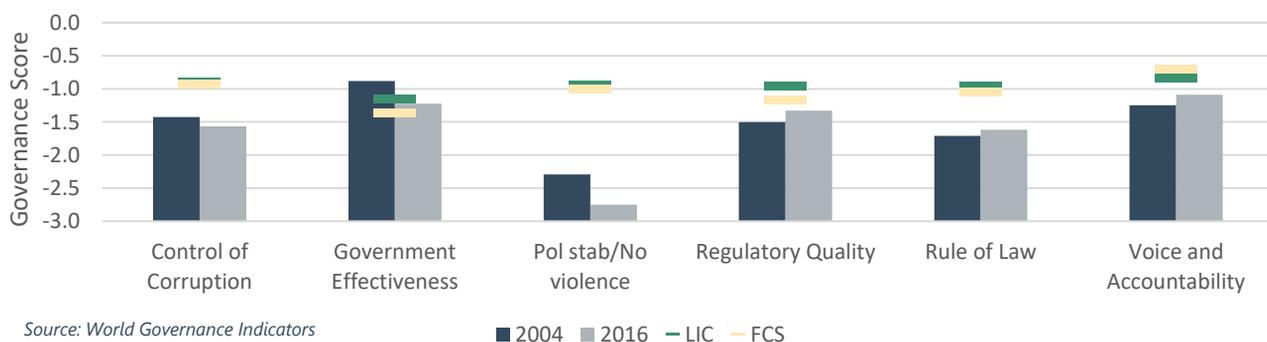
Fragility is likely to persist.

Global evidence has demonstrated that countries are more likely to experience conflict when exposed to many of the stressors that Afghanistan is currently trying to manage. These stressors include: i) external support for domestic insurgents; ii) illicit cross border flows; iii) high unemployment and low incomes; iv) severe corruption; v) ethnic rivalry; and vi) perceived discrimination on behalf of the state. While peace deals and other political advances may reduce violent conflict, it is likely that some level of violence will persist for as long as these stressors continue to exist.

Global evidence is also clear that strong formal institutions emerge only under particular political circumstances and over a period of decades. The 2011 World Development Report found that in the best case it takes fragile states 20 years to achieve the institutional quality that could be considered “good enough” to provide the minimal conditions for development.

Any growth strategy for Afghanistan therefore needs to be robust to ongoing institutional weaknesses and some level of violent conflict, rather than rely on any assumption that such weaknesses can be quickly or easily addressed.

AFGHANISTAN LAGS FRAGILE STATES AGAINST INSTITUTIONAL INDICATORS AND PROGRESS HAS BEEN UNEVEN



DEMOGRAPHICS EXACERBATE CHALLENGES

Afghanistan's high population growth rate creates challenges for service delivery and savings.

Afghanistan's fertility rate is among the highest in the world. On average, Afghan women have 5.3 children. The annual population growth rate is close to 3 percent which means that the population will double over the next 25 years.

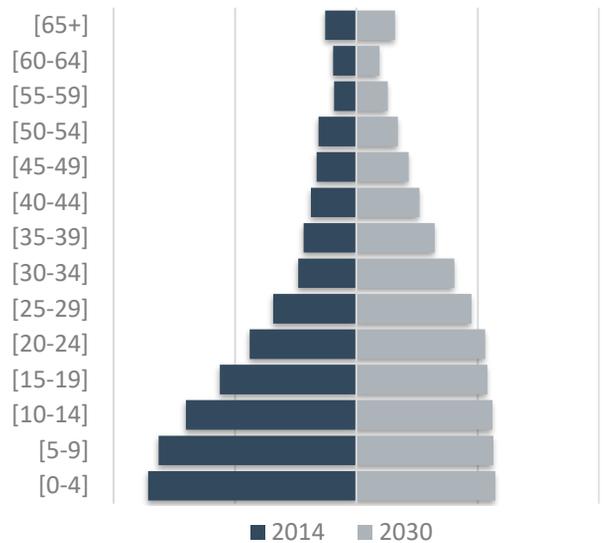
The population of Afghanistan is very young. By 2020, the number of school-age children will grow to 5.5 million— 2.5 million more than the education system can currently absorb. High dependency ratios undermine savings. 47.5 percent of the population is aged 15 or below and economically dependent. This means households use their incomes predominantly for consumption and reserve little for savings. Lower savings limit Afghanistan's capacity to grow, with fewer resources available to finance investment.

An approaching youth bulge presents employment and conflict challenges.

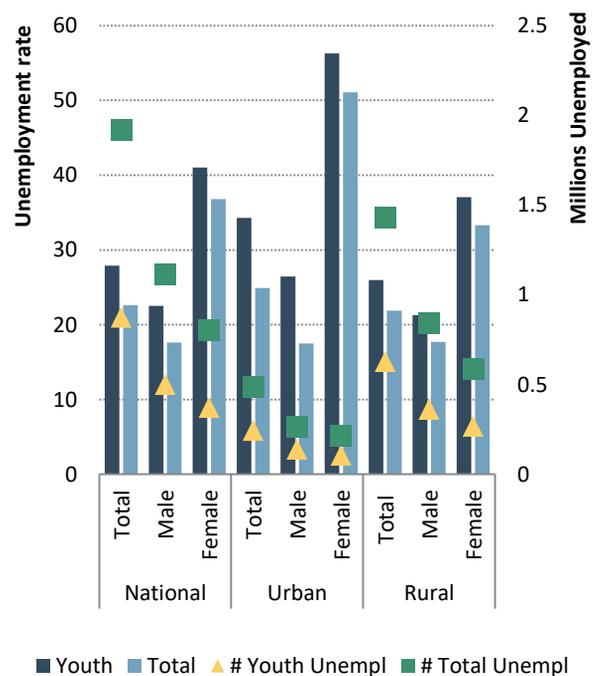
The labor force is expected to increase by 4 million by 2025. This means that every year between 480,000-600,000 new entrants will potentially seek jobs – many more than the economy can absorb. Around 500,000 young males are already unemployed, most of whom reside in rural areas (72 percent) and have either no (43 percent) or only primary education (26 percent). 71 percent of young people cite unemployment as the biggest problem they face.

Most empirical research finds a positive association between youth bulges and higher risks of conflict. Several researchers have suggested that a large supply of labor within a given age cohort can overwhelm available opportunities, leading to frustrated expectations and loss of status among – especially – young men, leading to increases in violence or the emergence of insurgencies. Youth bulges in the presence of slow growth and limited job opportunities can be particularly perilous, especially if migration channels are limited.

A YOUTH BULGE IS APPROACHING



YOUTH UNEMPLOYMENT IS ALREADY HIGH



Source: ALCS (2013/14 and 2016/17) data and World Bank analysis

THE CURRENT ECONOMIC STRUCTURE CONSTRAINS FUTURE OPTIONS

Afghanistan's economy remains undiversified.

The needs of the post-conflict reconstruction process, financed largely by foreign aid, shifted the economy away from agriculture towards services. However, services remain largely unsophisticated, dominated by wholesale, retail and transportation. At 12 percent of GDP, manufacturing accounts for only a small share of production and has contributed little to growth over the past 15 years. The recent decline of aid reduced the demand for services and construction, and magnified the relevance of agriculture.

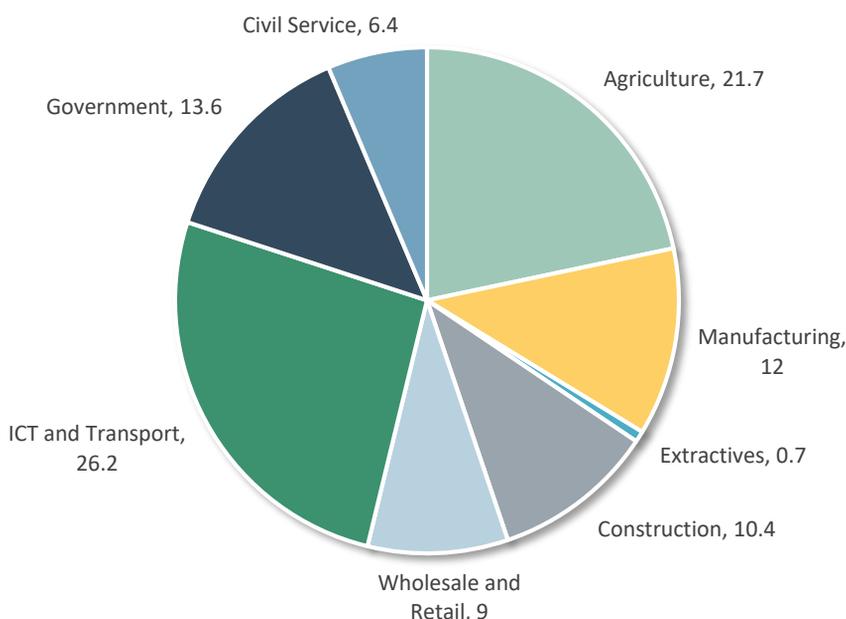
93.5 percent of manufacturing and most exports depend on agriculture. Private aggregate demand is highly correlated with agriculture output, as it constitutes a source of income for nearly half of the population. Nevertheless Afghanistan is not yet fully able to meet its food needs and depends on imports in most years.

Afghanistan is likely to remain reliant on agriculture and natural resources over the period of analysis.

Education levels and manufacturing capabilities are too low to expect rapid expansion of manufacturing and services. Prospects for manufacturing are further worsened by heavy reliance on imported inputs and the prohibitive cost of trade. As primary production expands, opportunities will emerge for construction, upstream and downstream industries, and – possibly – manufacturing.

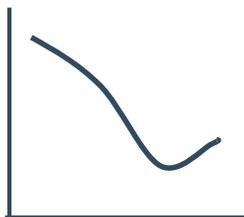
Transformation is also constrained by likely limited investment. On-going fragility and low savings rates will limit private sector investment over the next 15 years. At the same time aid is expected to further decline and the potential for borrowing will remain limited. Revenue potential, even under the best case scenario, is constrained, requiring tough choices in the allocation of public resources.

AFGHANISTAN'S ECONOMY REMAINS UNDIVERSIFIED AND RELIANT ON AGRICULTURE



Source: Central Statistics Office

AFGHANISTAN NEEDS A GROWTH STRATEGY THAT ACHIEVES MULTIPLE OBJECTIVES AND IS ROBUST TO FRAGILITY



Short-Term Impact

To escape the current slowdown, some short-term measures are required to build confidence and spur growth.



Job Creation

With 480,000-600,000 Afghans reaching working age each year, generation of substantial new employment opportunities is vital.



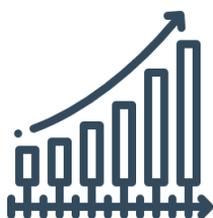
Revenue Generation

Aid currently finances 60 percent of the government budget – new sources of growth have to generate sufficient revenue to compensate for declining aid.



Foreign Exchange Generation

With aid relied upon to finance a trade deficit equal to around 40 percent of GDP, export growth is vital for sustainability.



Poverty Reduction

With persistently high rates of poverty and growing inequality, growth has to provide broad opportunities to the poor.

IN FOCUS:

AFGHANISTAN'S ECONOMIC GEOGRAPHY

Afghanistan's internal geography continues to shape development.

Aid-driven growth over the past decade has disproportionately benefited cities and exacerbated regional disparities. The poverty rate in urban areas is ten percentage points lower than in rural areas. The poorest areas in Afghanistan are often geographically isolated both from government services and markets.

Afghans are increasingly urban.

Consistent with the experience of other developing countries, Afghanistan is experiencing rapid urbanization as rural populations seek access to the perceived broader range of economic opportunities that cities provide. The relative growth of urban populations has accelerated with migration, with internally displaced and returnee populations seeking access to services and economic opportunities in and around cities – especially Kabul.

Cities are unlikely to drive growth.

Unlike in many developing countries, however, the economic benefits of urbanization may be limited. In the absence of a substantial manufacturing sector, it will be difficult for the economy to generate sufficient good quality jobs for urban arrivals. There is little reason to believe that population concentration would, itself, drive major growth of manufacturing given human capital, infrastructure, and security constraints.

The best opportunities for urban job creation are likely to be in the service sector.

Public sector employment and procurement opportunities will remain concentrated in urban areas and Afghans will continue to travel to cities to purchase goods and services. Larger urban populations offer service businesses larger markets and scope for specialization. Improving the business regulatory environment and addressing land and infrastructure constraints to the growth of service industries should be the highest priority for urban job creation.

Population concentration offers opportunities for improving access to services.

While scope for productivity benefits from urbanization may be limited, important gains might still be achieved in terms of improving access to services. Economies of scale mean that services and infrastructure can be provided at lower cost in urban centers, allowing improved quality and access. Such gains are not automatic, however, and require adequate urban planning and public investment. Reforms should immediately focus on ensuring that municipal authorities have the authority and capacity to raise and manage revenues to deliver vital urban infrastructure and services. Ensuring that urban arrivals can access land and establish secure land property rights is also vital for realizing potential economic and social benefits of an increasingly urban population.

3. ADDRESSING ECONOMIC DEVELOPMENT CHALLENGES

- Immediate improvements in public resource allocation and business environment reform can help escape slowdown.
- Policy measures are needed to shield households and firms from the impacts of fragility.
- A balanced long-term growth strategy can meet Afghanistan's different economic development needs.





IMMEDIATE IMPROVEMENTS
IN PUBLIC RESOURCE
ALLOCATION AND BUSINESS
ENVIRONMENT REFORM
CAN HELP ESCAPE THE
SLOWDOWN.

IMPROVING THE QUALITY OF PUBLIC EXPENDITURE CAN HELP SPUR SHORT-TERM RECOVERY

Afghanistan's economic situation is precarious. With limited public resources available for new demand-side measures, economic management should focus on increasing the impact of existing spending, containing negative impacts of insecurity, and safeguarding livelihoods.

Options include:

-  Reorienting budget expenditures towards labour-intensive and community-based programs that directly reach the population with the greatest needs and spur consumption, driving economy-wide benefits
-  Improving budget execution, including by scaling down large infrastructure project that have not yet reached implementation stage and re-allocate towards basic education health service delivery.
-  Continuing to improve quality of spending for basic service delivery
-  Working with business groups to identify possible measures to address binding business environment constraints, including cooperative arrangements for security
-  Implementing investment climate reforms to reduce the cost of doing business

BUSINESS REGULATORY CONSTRAINTS CAN BE SUBSTANTIALLY REDUCED

Mobilizing growth sectors will require private sector investment.

Agriculture and extractives development are heavily dependent on private investment decisions. Achieving growth will require active private sector engagement and adequate private sector confidence.

Generating broad opportunities from growth sectors will require a vibrant private sector.

The impact of agriculture and extractives on employment and broader growth depends on the capacity of firms to take advantage of new markets and consumer demand, including in service sectors and ancillary industries.

An improved business environment is vital to realize growth potential.

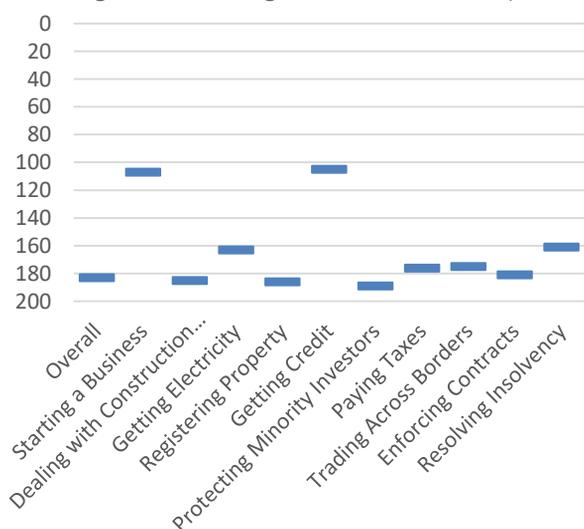
Developing growth sectors and ensuring that benefits are maximized depends on creating an environment as conducive as possible to new investment. Business surveys show that regulatory and administrative processes continue to constrain investment.

Simple measures could have a large impact on firms.

While some problems facing investors are tightly tied to broader issues of fragility, other constraints could be relatively easily addressed through removing red tape and reducing opportunities for corruption within administrative processes – especially business licensing and construction approvals.

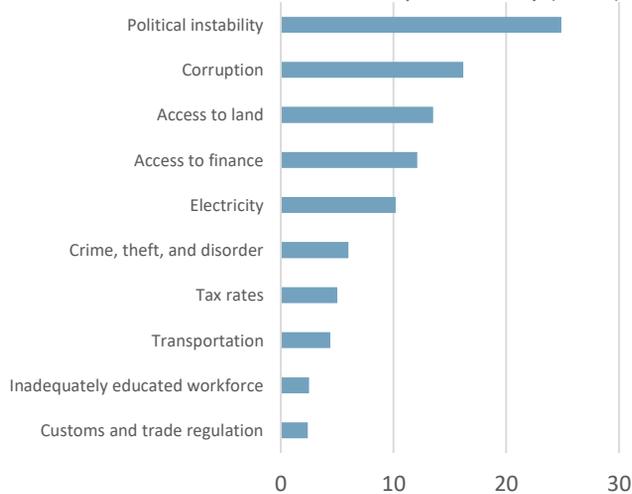
REGULATORY CONSTRAINTS ARE HEAVY

Ranking on 2017 Doing Business Indicators (of 190)



INVESTORS CITE A RANGE OF CONSTRAINTS

Main constraints cited in Enterprise Survey (2014)



IN FOCUS: PRIORITIES FOR PRIVATE SECTOR DEVELOPMENT

Government is currently in the process of developing a National Priority Program for Private Sector Development. While work on the document is ongoing, the following strategic priority areas and specific policy recommendations are currently being considered:

Strategic Priority 1: Restoring confidence and creating an enabling environment

- Short-term:
- Facilitate collective approaches to security and crime-prevention between businesses
 - Appoint an ombudsman to help firms facing corruption at government agencies
 - Streamline business start-up processes and reduce fees
- Medium-term:
- Implement online business registration
 - Introduce expedited construction permitting for low-risk structures
 - Automate systems for monitoring electricity outages and allow for online applications for electricity connection and services
 - Introduce e-payment for all taxpayers

Strategic Priority 2: Increasing access to key inputs for business

- Short-term:
- Finalize the Financial Inclusion Strategy
 - Identify Public-Private Partnership (PPP) opportunities and pilot different PPP models
 - Identify land under ownership of defunct SOEs which can be used for serviced industrial parks
- Medium-term:
- Remove legal and regulatory constraints to Islamic banking
 - Pilot Special Economic Zone (SEZ) development
 - Develop an infrastructure master plan for industrial parks, SEZs, and connective infrastructure.

Strategic Priority 3: Sharing risks and crowding in investment

- Short-term:
- Clarify organization responsibilities for investment promotion
 - Undertake a rapid review of state-owned enterprise performance using existing analysis
- Medium-term:
- Streamline the foreign investment approval process
 - Issue visas for skilled foreign staff as part of investment approval processes
 - Wind down moribund state-owned enterprises while improving governance and performance of those that are viable and serving a public purpose

Strategic Priority 4: Securing and facilitating trade and transit

- Short-term:
- Develop an action plan for coordinated implementation of existing trade-related strategies and policies
 - Review the Afghanistan Pakistan Transit Trade Agreement and consider expanding to other countries
 - Negotiate improved visa arrangements with UAE and other key partners
- Medium-term:
- Implement the Customs Reform program and Trade Facilitation Agreement
 - Expand the operations of the one-stop export shop to include air-freight exports



POLICY MEASURES ARE
NEEDED TO SHIELD
HOUSEHOLDS AND FIRMS
FROM THE IMPACTS OF
FRAGILITY.

POLICY MEASURES ARE REQUIRED TO MANAGE FRAGILITY RISKS FACING HOUSEHOLDS AND FIRMS

Given ongoing fragility, policies are needed to:

-  Mitigate the aspects of fragility that are imposing the greatest constraints on growth;
-  Support the private sector in managing the impacts fragility to allow continued investment.



STRENGTHEN INSTITUTIONS

Government lacks the capacity and resources to enforce compliance with all formal rules and institutions. A selective approach is therefore required, focusing on establishing “good enough” institutions in areas that matter most for development.



MITIGATE RISKS FOR HOUSEHOLDS

Households in Afghanistan are exposed to negative shocks to a unique extent, with insecurity constraining available responses. Social transfer systems could help households manage risk and avoid reliance on harmful coping strategies.



MITIGATE RISKS FOR FIRMS

Firms are negatively impacted by general insecurity, crime, and corruption. Establishing rule of law is a long-term challenge. In the short-term, regulatory reforms should reduce opportunities for corruption and financial instruments should be introduced to help firms manage fragility risks.



STRENGTHENING INSTITUTIONS IS VITAL FOR DEVELOPMENT

The impact of income on conflict is mediated by institutions

Low income countries are much more likely to experience conflict. There is little international evidence of a direct causal link between low incomes and violence, however, with most research instead pointing to institutional weaknesses as driving both insecurity and low incomes. Growth in the presence of weak institutions may do little to address fragility, while strengthening institutions can be expected to deliver both increased growth and reduced conflict.

The impact of unemployment on conflict is mediated by institutions

Recent international evidence suggests that insurgents are seldom motivated solely by a lack of economic opportunities. Some evidence suggests that broader economic opportunities can reduce participation in insurgent groups by raising opportunity costs. But economic motivations are generally secondary to broader factors in driving people to join insurgent groups, including ideological motivations, perceived ethnic partisanship of state institutions and direct or indirect exposure to unfair or disrespectful treatment or violence at the hands of international or domestic security forces.

Expanding economic opportunities may play a positive role in reducing conflict, by increasing the opportunity cost of insurgency and building support for the state. But jobs – on their own – are unlikely to completely address conflict pressures, especially if such opportunities are unevenly distributed and exacerbate real or perceived inequities.

The impact of services on conflict is mediated by institutions

There is no clear evidence that improvements in service delivery either address conflict, or increase the legitimacy of the state. Some evidence suggests that the introducing services in heavily underserved areas can exacerbate conflict pressures through contestation over new resources. Recent research suggests that equitable access and the perceived legitimacy of allocation decisions matters more than the quality or coverage of services in determining whether service provision will moderate or exacerbate conflict pressures.

"I did not join the Taliban because I was poor. I joined because I was angry."

- 18 year old Taliban recruit



REFORM EFFORTS MUST BE PRIORITIZED IN A DIFFICULT POLITICAL ENVIRONMENT

There have been substantial improvements in formal rules, regulations, laws, and processes across most sectors. But there are continued large and unpredictable divergences between formal rules and actual practices in areas key to growth and development (mining, land, public service delivery, taxation and justice).

Institutions and property rights are constantly contested by powerful actors who have little interest in abiding by or enforcing formal rules. No actor wields sufficient power to enforce a single set of rules over all others. Contestation leads to uneven and unpredictable enforcement of rules, undermining state legitimacy and investor confidence.

1. Acknowledge that a gap between formal rules and actual practices is likely to remain, at least in some areas.

All developing countries exhibit a gap between formal rules and actual practices. International experience shows that the existence of this gap does not seem to prevent countries from reaching much higher incomes and better development outcomes than Afghanistan.

Afghanistan is constrained not so much by formal rules not being followed as by instability, unpredictability, and conflict arising from rules being constantly contested. Uncertainty creates incentives for short-term predation at unsustainable levels.

2. Ensure realistic expectations regarding the impact of adopting “good practice” institutions.

Better quality formal rules will not necessarily lead to stronger institutions or better development outcomes if those rules are not enforced. The political drivers of weak institutions need to be acknowledged.

3. Prioritize scarce government capacity and political capital to address the institutional weaknesses that matter most.

Natural resources are a vital part of Afghanistan’s economic future. Weaknesses in the justice system and policing are contributing to conflict pressures. Given that government cannot enforce all rules all the time, it may be necessary to focus scarce capacity, resources, and political will on those institutions that matter most for development.

4. Compensate losers when necessary.

In some instances, necessary institutional reforms harm the interests of powerful actors, potentially undermining enforcement and limiting the impact and credibility of reforms. Compensating losers – when necessary – can build coalitions for required change.



RISKS TO POOR HOUSEHOLDS ARE PRONOUNCED

Households in Afghanistan are uniquely exposed to shocks.

88 percent of households in Afghanistan experienced at least one shock in 2013/14. The proportion of households experiencing shocks is among the highest in the world. The most common shocks are those related to prices, water, and natural disasters.

Poorer households are more likely to experience shocks and adopt harmful coping mechanisms.

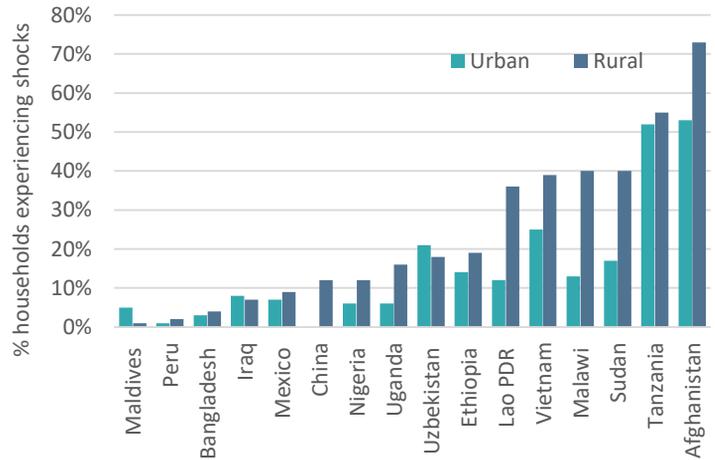
The median household in the wealthiest 20 percent of households experienced 2.6 shocks during 2013/14, compared to 4.3 shocks experienced by the median household in the poorest quintile.

Poor households are more likely to have to adopt coping strategies when impacted by shocks. A third of all households in the highest wealth quintile reported that they did not need to adopt coping mechanisms when impacted by a negative shock. By contrast, nearly 85 percent of households in the lowest income quintile needed to adopt coping strategies when impacted by shocks.

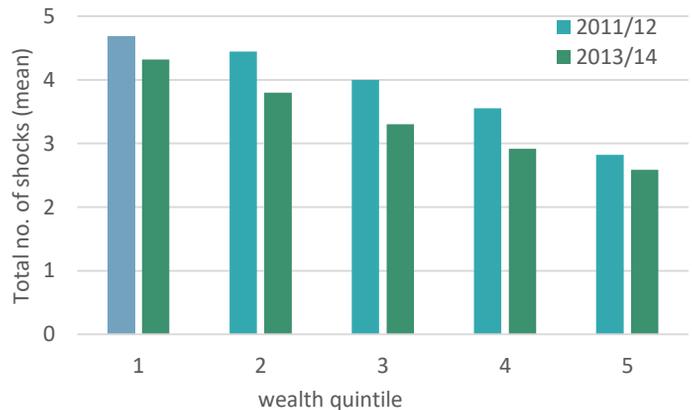
Poorer households are also more likely to rely on harmful coping mechanisms. Across all households, the most common strategies for dealing with shocks are to reduce expenditures and take on loans. Reflecting that poorer households are exposed to more frequent shocks and have fewer resources available to manage them, harmful coping mechanisms are more frequently employed. Such mechanisms include: decreasing food intake and quality, buying food on credit, and taking on loans. More than a third of all households, and about half of households in the lowest wealth quintile households used harmful coping strategies.

Source: ALCS, World Bank analysis

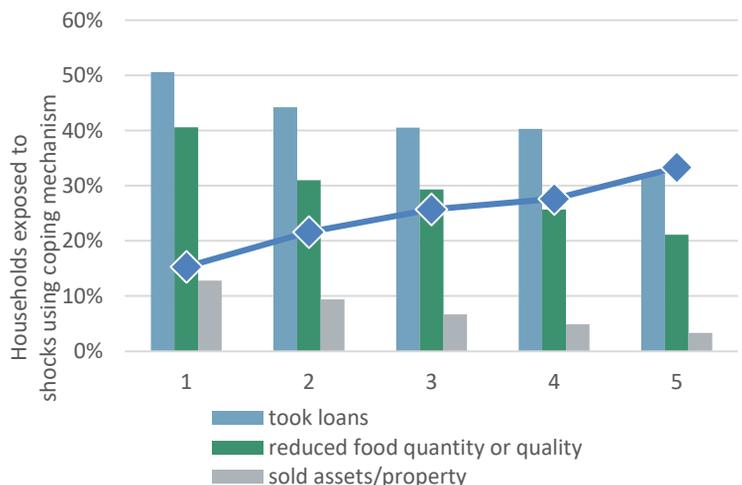
HOUSEHOLDS ARE UNIQUELY EXPOSED TO SHOCKS



POORER HOUSEHOLDS EXPERIENCE MORE SHOCKS



POORER HOUSEHOLDS USE HARMFUL COPING MECHANISMS





RISKS ARE EXACERBATED BY INSECURITY AND LACK OF ACCESS TO CREDIT

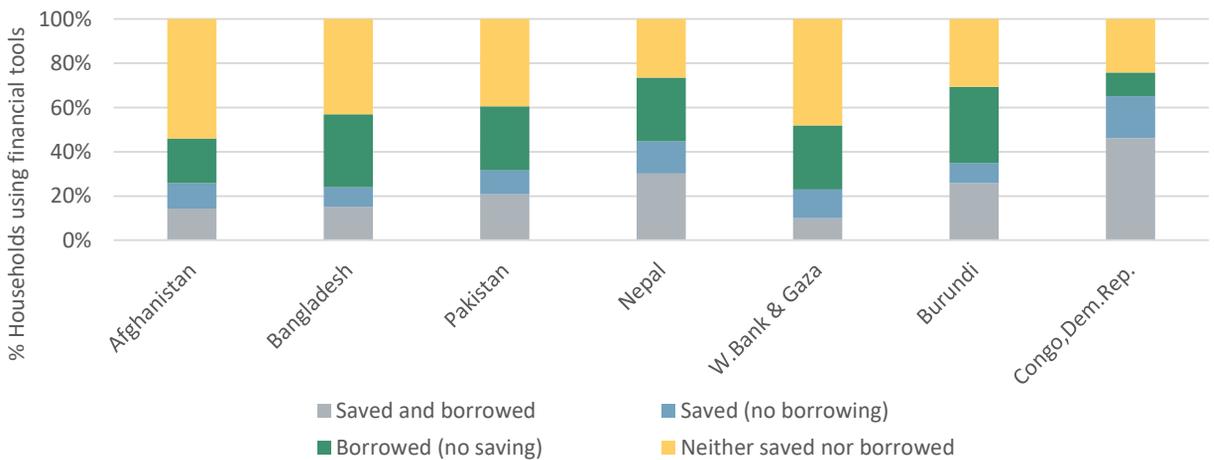
Households in insecure districts are significantly more likely to draw on harmful coping mechanisms across all wealth quintiles.

Poor households in areas self-assessed as insecure were much more likely than those in secure areas to resort to taking on loans, purchasing food on credit, reducing expenditures, and reducing the quantity or quality of food purchased. While 44 percent of households in the lowest quintile resorted to harmful coping strategies in secure areas, the equivalent figure was 56 percent in insecure areas.

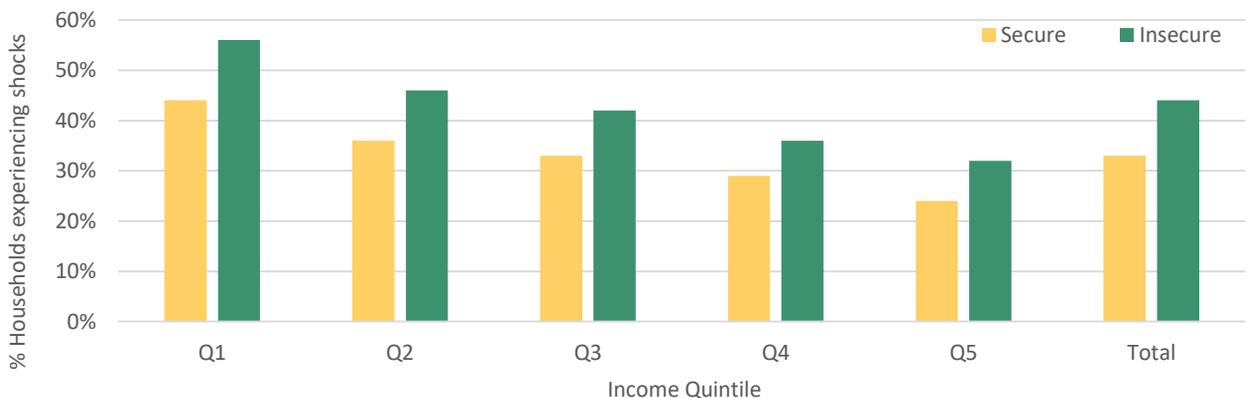
Reliance on harmful coping mechanisms may be exacerbated by very low access to savings and credit.

Accessing savings and credit can be an important means of avoiding reliance on harmful coping strategies. But households capacity to borrow and save appears heavily constrained. More than half the Afghan adults had neither saved nor borrowed in the past 12 months, well below the FCS average. While 27 percent of adults in other FCS economies saved as well as borrowed, only 14 percent of Afghan adults did so. Only 10 percent of Afghan adults currently have access to a bank account.

HOUSEHOLDS LACK ACCESS TO FINANCIAL TOOLS TO MANAGE SHOCKS



HOUSEHOLDS IN INSECURE AREAS ARE MORE EXPOSED TO SHOCKS



Source: ALCS, World Bank analysis



A SOCIAL PROTECTION SCHEME COULD HELP MITIGATE RISKS FACING HOUSEHOLDS

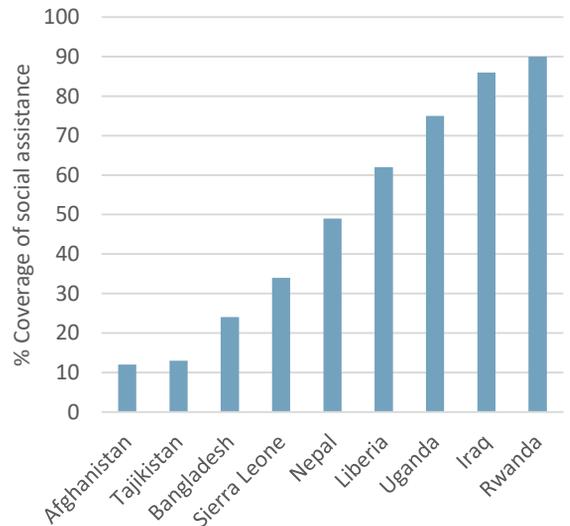
Afghanistan would benefit from a comprehensive social protection scheme.

Efforts to protect the poor and vulnerable in Afghanistan face a number of challenges, including fragmentation, extreme reliance on off-budget programming and tight fiscal resources. A review of social protection in Afghanistan found that most of the initiatives trying to address poverty and vulnerability consist of short-term, small, and fragmented schemes. With few exceptions, safety net interventions are financed and implemented off-budget by humanitarian partners who struggle with decreasing resources and coordination challenges.

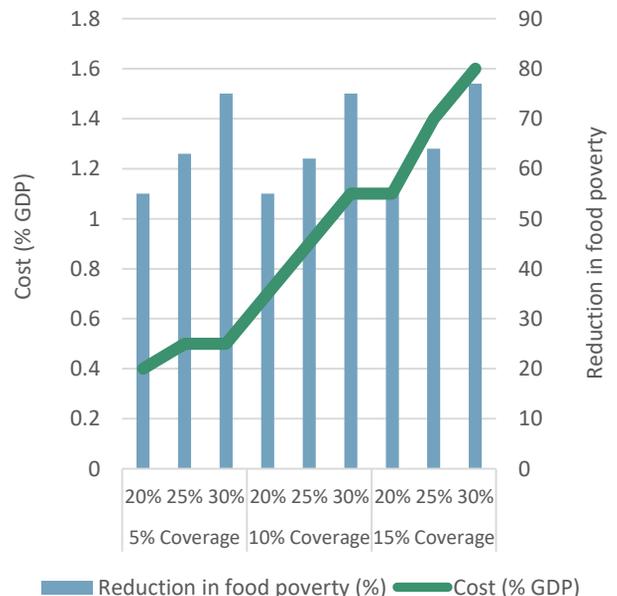
The Government channels almost all of its social assistance resources to the Martyrs and Disabled program (1.1 percent of GDP), with no resources allocated to safety net schemes targeted to the poor. As a result, social assistance spending and coverage in Afghanistan are among the lowest when compared with similar countries. International comparisons show that many fragile and conflict-affected countries tend to rely more heavily on social safety nets than other countries to help their populations cope with heightened social and economic stress associated with such contexts. Investing in a regular and predictable poverty targeted cash transfer that would provide 20 percent of the basic food basket value to 10 percent of the Afghan population (about 350,000 households). The annual cost of such a scheme is estimated at about 0.7 percent of GDP, without administrative costs. With the current targeting system of the cash transfer pilot, it is estimated that close to 70 percent of the funds would reach the poor, and the poverty rate could be halved.

The introduction of such a scheme would likely also bring long-term reductions in vulnerability through human investment channels. If average effects from other developing countries hold, basic cash transfers (i.e., without conditions) could increase children’s odds of school enrolment by over 20 percent. In response to improved food security and smoothing of consumption, households would be expected to increase investment in human capital formation and productive assets.

SOCIAL ASSISTANCE COVERAGE IS VERY NARROW



A HIGH IMPACT, LOW COST SCHEME IS POSSIBLE



IN FOCUS:

COMMUNITY DEVELOPMENT IN AFGHANISTAN

THE NATIONAL SOLIDARITY PROGRAM

The National Solidarity Program has been operational in some 35,000 communities across Afghanistan over the past 14 years. Under the program, grants are provided to communities to undertake development projects with use of grant resources governed by Community Development Committee, elected by community members. Half of all CDC seats are allocated to women, giving them the opportunity to participate in decision-making at the village level and a forum to voice their opinions. The program provided:

- 81,000 small-scale reconstruction and development activities, providing over 13 million Afghans with access to improved water supply and sanitation, rural roads, irrigation, power supply, health, and education services.
- 47.8 million days of work for skilled and unskilled workers, injecting much needed short-term wage transfers into poor rural communities throughout Afghanistan.

Program evaluations have illustrated positive development impacts but ambiguous impacts on governance. The program had a positive effect on access to drinking water and electricity, acceptance of democratic processes, perceptions of economic wellbeing, and attitudes toward women. Effects on perceptions of local and national government performance and material economic outcomes were, however, more limited or short-lived. While perceptions of government entities immediately improved in communities where the program was active, the impacts faded following project completion. There is no evidence the program improved perceptions of central state legitimacy or increased satisfaction with local leaders.

THE CITIZENS' CHARTER

The Citizen's Charter supports the Government's long-term goals of reducing poverty and deepening the relationship between citizens and the state. The program replaces the NSP and will achieve its objectives in two ways.

- First, by providing development services and grants through CDCs, the government will increase trust that government can provide valued local benefits, deepening the social contract and improving perceptions of government. The Charter will help connect government, especially local government and municipalities, with its citizens.
- Second, by using community oversight over service provision through a high profile government program, the program will strengthen bottom-up accountability for service delivery and provide information to political leaders regarding service delivery successes and constraints.

The program is structured around minimum service standards. The program will build public confidence in government by guaranteeing access to a basic package of services and infrastructure. 11,500 communities in rural and urban areas will receive the stated minimum service standards under the program. Through building broad community-level knowledge of service standards, accountability for delivery through both CDC-administered projects and line-agency programs will be established.



FIRMS ARE HEAVILY IMPACTED BY CONFLICT AND INSECURITY

Conflict and insecurity has a pronounced impact on firms.

New analysis utilizing cell-phone data confirms that fewer firms are active in areas that experience greater conflict. But – in general – firms are most effected by general lawlessness and crime. 15.5 percent of firms experience crime-related business losses – higher than SAR comparators – and three-quarters of firms consider crime an obstacle to doing business. Weak rule of law reduces incentives for firms to grow. Medium-sized firms face the greatest negative impacts from insecurity, and are more likely to experience crime-related losses than either small or large firms. Medium-sized firms represent worthwhile targets for predation, while lacking the resources to protect themselves. Five out of six firms with 20-99 employees reported crime as an obstacle to doing business.

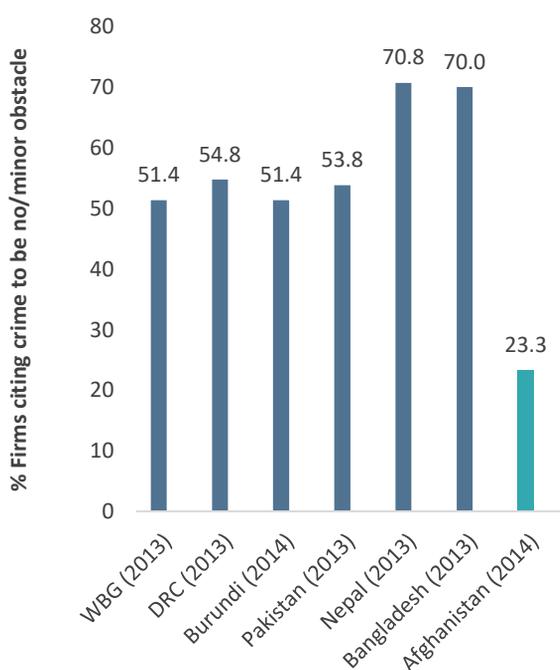
Insecurity reduces incentives for firms to invest.

Firms that invest are much more likely to experience crime, especially in Kabul and Kandahar. Informal firms that invest are three times more likely to experience crime than informal firms that do not invest. Investment may be perceived as signaling an opportunity for predation.

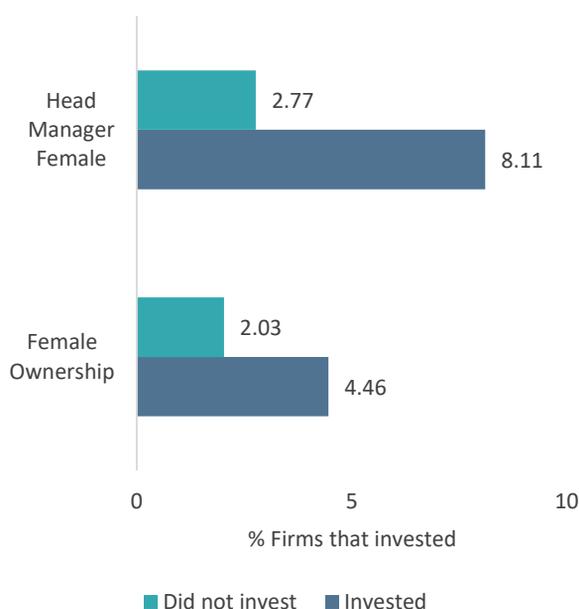
Female management and ownership is concentrated in firms that invest. Women are three times more likely to be a head manager and twice as likely to have an ownership stake in an investing firm relative to a non-investing firm.

This could signal a stronger risk-appetite among women, or overrepresentation of women in firms that are more likely to invest for other reasons. Firms lack access to credit, and many lack access even to bank accounts.

CRIME IS CITED AS A CONSTRAINT BY FIRMS



FEMALE-HEADED FIRMS ARE MORE LIKELY TO INVEST



Source: Business enterprise survey

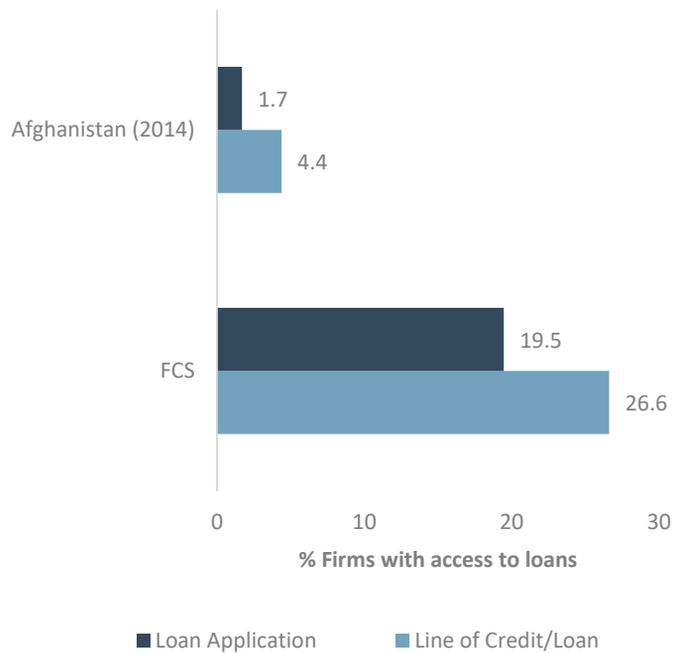


FIRMS LACK EVEN BASIC MECHANISMS FOR MANAGING RISKS

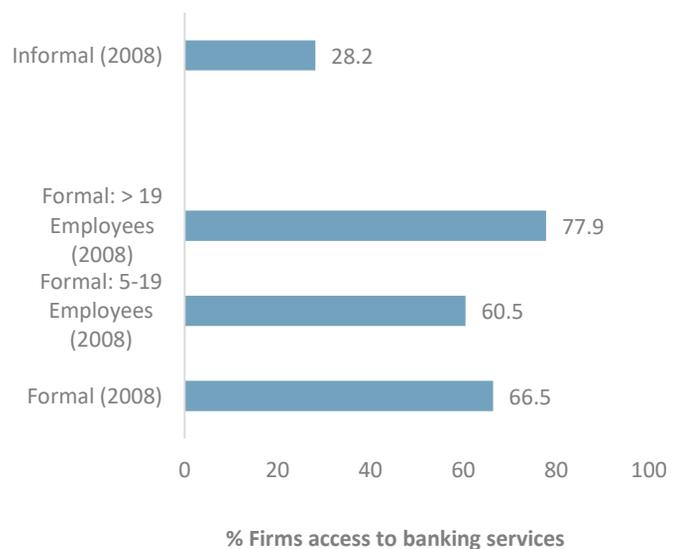
Firms lack access to credit, and many lack access even to bank accounts. Lacking access to credit both reduces the capacity of firms to manage risks arising from insecurity and presents a constraint to investment in itself. More than 80 percent of firms that invest use internal funds to finance their entire purchases. Only 3 percent of firms use bank loans to finance their investment, compared to 18 percent across FCS countries.

Less than 1 in 20 firms in Afghanistan has a line of credit or a loan from a financial institution and less than 2 percent of firms reported having applied for a loan in the previous year. Such low levels of external financing are consistent with Afghanistan's very-low credit to GDP ratio (4.0 percent as of end-December 2015, compared with 21.1 in FCS economies on average). Two thirds of informal firms and one-third of formal firms do not hold a bank account.

FIRMS LACK ACCESS TO LOANS



FIRMS LACK ACCESS TO BANKING SERVICES



Source: Business enterprise survey



REGULATORY REFORMS AND FINANCIAL TOOLS CAN HELP FIRMS MANAGE RISKS

Addressing insecurity and reducing opportunities for predation are vital in the longer-term. In the meantime, specific actions can be taken to help firms mitigate risks.

- 1. Regulatory reforms to reduce unnecessary risks**

Reforms to the business regulatory environment present opportunities to reduce risks faced by firms, even in the context of ongoing insecurity. The difficult security environment is deterring investment, but additional constraints are unnecessarily created by burdensome regulatory processes that create opportunities for corruption.
- 2. Financial sector development**

Over the medium-term, deeper and better functioning financial markets are required to help firms manage risks. This will require development of a well-regulated insurance industry and an increase in savings rates through expanding financial inclusion, including trust-building through strengthened deposit insurance. Financial sector development and expansion of the banking sector would also help with the development of social protection mechanisms.
- 3. Credit guarantees/ risk sharing facilities**

Risks of crime and insecurity are to some extent idiosyncratic and can therefore be shared. Internationally, risk sharing facilities have helped promote investment by sharing risks across investors.
- 4. Political risk guarantees**

Development agencies offer products by which firms can ensure themselves against political risks. Greater use could be made of such facilities, providing protection to a larger number of smaller firms. Constraints will need to be considered and carefully addressed, given current high pricing of Afghanistan's sovereign risk.

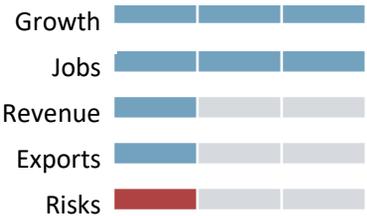


A BALANCED LONG-TERM
GROWTH STRATEGY CAN
MEET AFGHANISTAN'S
DIFFERENT ECONOMIC
DEVELOPMENT NEEDS.

GROWTH FROM DIFFERENT SOURCES IS REQUIRED TO MEET DIFFERENT DEVELOPMENT NEEDS



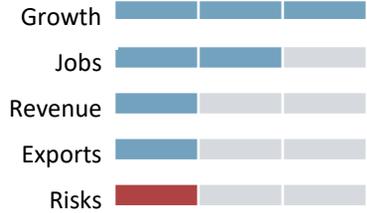
Agriculture
For broad-based growth and jobs.



Agriculture remains the foundation of Afghanistan’s economy and could provide substantial gains to growth and livelihoods.



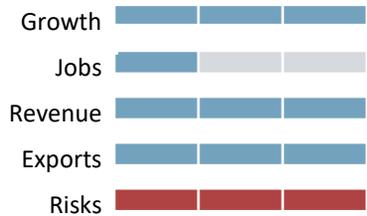
Human capital
A foundation for any growth strategy.



Human capital investment to address existing deficits is required for any feasible growth strategy. Investing in managed labor mobility can provide growth, income, and stability benefits.



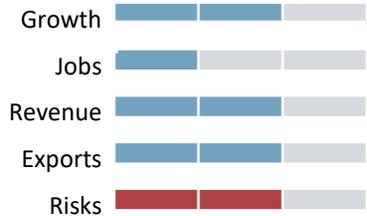
Extractives
For required exports and revenues.



While there are important risks to be managed, only extractives are likely to provide sufficient exports and revenues to substitute declining aid.



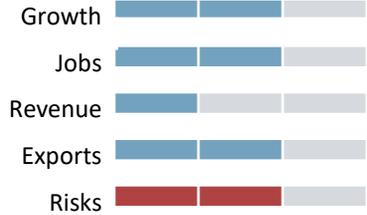
Trade
To enable agriculture and extractives.



Trade and regional integration offer important potential if infrastructure investments are targeted towards enabling agriculture and extractive exports. Infrastructure investment specifically targeting commodity transit trade is costly and high risk.



Labor Mobility
To provide additional opportunities.



With a continued oversupply of labor even under best-case scenarios, investing in managed labor mobility can provide growth, income, and stability benefits.



AGRICULTURE IS THE BACKBONE OF AFGHANISTAN’S ECONOMY

Afghanistan’s economy is largely agrarian.

Agriculture is one of the main contributors to economic growth accounting for one-third of GDP growth over the past decade. Most agriculture is rain-fed, which makes agricultural output and GDP growth highly volatile and dependent on weather.

Agriculture has very strong links to the rest of the economy. Private aggregate demand is highly correlated with agriculture output, with agriculture providing a source of income for nearly half of the population. Agriculture employs about 40 percent of the total workforce. Moreover, nearly 90 percent of exports and 95 percent of manufacturing relies on agriculture.

Wheat is the dominant food crop. Only about 8 million ha of land in Afghanistan is arable (12 percent of total). Currently only about 2 million ha is irrigated while the remainder is either under rain-fed cultivation or left fallow. Wheat accounts for two-third of the cultivated area. Yet the country is not self-sufficient in cereal production and imports an average of 1.2 million mt/year. There is a long tradition of horticulture and livestock production. Both sub-sectors suffered from the impacts of war

and displacement prior to 2001, and remain vulnerable to drought and poor disease control. Horticulture and livestock products account for a smaller share of output than wheat, but make up a large share of Afghanistan’s exports (fresh and dried fruits, nuts, skins, wool, and cashmere) and provide almost an equally large proportion of jobs.

Opium will be difficult to displace.

Afghanistan is globally a near monopoly producer of illicit opium. Opium is Afghanistan’s single most important cash crop, occupies about 10 percent of irrigated land, and provides a source of income for many poor and landless farmers. It accounts for 4.5 percent of GDP in 2016, with total production at farm-gate values of US\$900 million. With its large negative impact on governance and state-building, long-term dependence on poppy cultivation is not in the country’s interest. However, displacing opium production is very difficult due to the crop’s relative robustness to weather conditions, easy marketability, and high profitability. Efforts to eradicate or displace opium have so far proven to be generally unsuccessful, with opium production reverting to high levels of production in recent years.

Jobs

Agriculture employs about 44 percent of the total workforce.

70 percent of the population is rural and mostly dependent on agriculture.

Livelihoods

61 percent of all households derive income from agriculture – for 28 percent of all households it is the main source of income.

Poverty

The poor disproportionately depend on agriculture. The poverty rate in rural areas is 58.6 percent, about 17 percentage points above urban areas.

Gender

An estimated 54 percent of Afghanistan’s agricultural workforce is female, and women are especially prominent in horticulture and animal husbandry.



AGRICULTURE HAS GREAT POTENTIAL FOR GROWTH AND JOB CREATION

Potential:

- Low-risk sector that could contribute 1.6 percentage points to GDP growth annually.
- 1.2 million additional jobs over the next 10 years reflecting strong linkages with the rest of the economy.
- Relatively low revenue potential as agricultural activity is often informal and incomes will likely remain below the taxation threshold.
- Good export potential for horticulture and livestock products but will require relatively complex supply chains.

Main constraints:

- Insufficient irrigation infrastructure and water conveyance systems.
- Poor on-farm water management.
- Insecure land tenure and inefficient land markets.
- Farmers have limited access to new knowledge and improved technologies.
- Few trained female extension workers.

What needs to be done:

- Rehabilitate and expand irrigation structures.
- Improve water management.
- 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 HAS IMPROVED DRAMATICALLY, BUT PROGRESS IS SLOWING

Afghanistan has dramatically increased investment in human capital since 2001.

The number of primary-school students has increased from 770,000 in 2001 to more than 6 million today. Expansion in access to healthcare services has led to impressive reductions in infant mortality (from 93 to 66 per 1,000 live births) and increases in life expectancy (44 to 60 years).

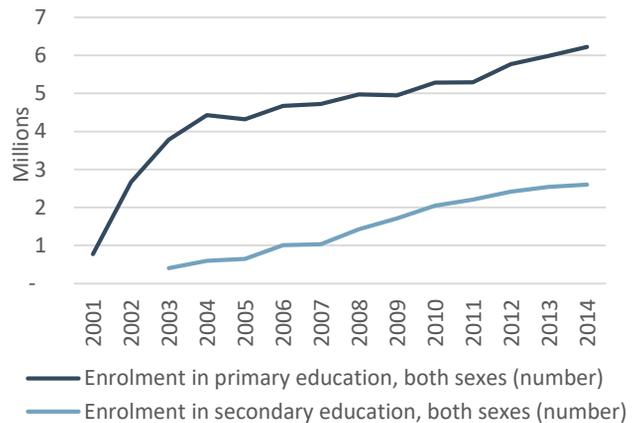
Much still needs to be achieved.

Life expectancy remains 11 years short of the global average, and slightly below the low-income country average. Only around half of children attend secondary school, and literacy rates are among the lowest in the world. There are important concerns regarding education quality and perceived mismatches between investment in skills and labor market demands. The pace of progress against some indicators is slowing. Largely reflecting the deteriorating security situation, primary attendance rates for girls and in rural areas have declined since 2011/12. The pace of improvement in access to maternal care and education outcomes has slowed. Reduced access to health and education services has been especially pronounced in conflict-affected areas.

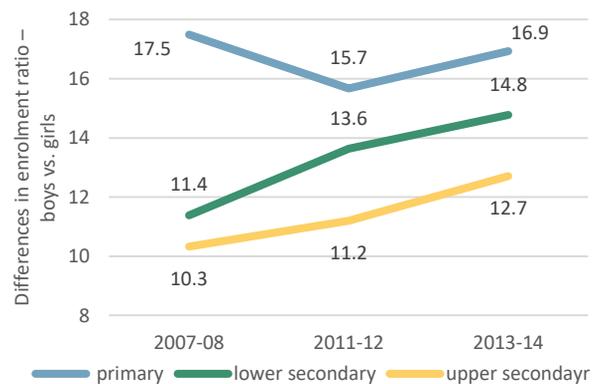
Resources are scarce.

Per capita on-budget government spending on health and education has declined over recent years. Health remains overwhelmingly privately financed (75 percent), and government spends only around US\$7 per capita on healthcare. 18 percent of households in Afghanistan borrow to pay for healthcare, while only 5 percent borrow for education. Under constitutional provisions guaranteeing free education, the majority of education expenditure is by government and donors. With a growing population it will be difficult to maintain current service coverage and standards, let alone improve quality and increase access.

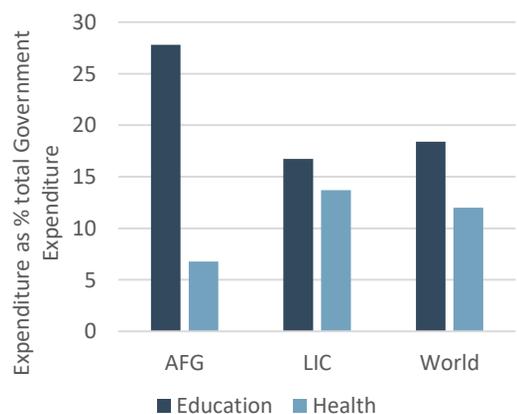
ACCESS TO EDUCATION HAS RAPIDLY IMPROVED



GENDER GAPS ARE NOW GROWING



THERE IS LITTLE PUBLIC INVESTMENT IN HEALTH



Source: ALCS, World Development Indicators, Ministry of Finance data



BASIC PROBLEMS IN THE EDUCATION SYSTEM NEED TO BE ADDRESSED

ATTENDANCE AND ATTAINMENT GAP

- Half the children and youth who are enrolled in a school do not attend. Gender, income, parental education and location play a significant role in school attendance decisions. Girls stay out of school because of family pressures. Boys, because of work. Security concerns affect all.
- Literacy rates among the 5-15 year-olds have declined between 2012 and 2014. Learning assessments at the 6th grade level show many children are behind.
- Build boundary walls to improve security.
- Mobilize community involvement to encourage attendance.
- Actively recruit female teachers.

RESOURCE MISALLOCATION

- Teacher training, deployment, and pay need significant improvements. Most teachers are underqualified.
- No funds are set aside for early childhood education, while adult training and literacy programs are too limited in their outreach, and are not geared towards developing life-skills.
- Staffing costs are too high, crowding out other necessary recurrent expenditures (such as school supplies).
- Seek budget allocations and donor support for early childhood education.
- Include traditional apprenticeships in skills training programs to reach the large number of youth.
- Introduce electronic systems for managing and ensuring validity of education sector payroll.

INSUFFICIENT AND FRAGMENTED RESOURCING

- Overall resources are declining – the share of education spending in the budget is 13 percent in 2018, down from 25 percent in 2010.
- Funding from the international community—nearly half of all spending—remains off budget and flows directly to projects.
- Increase overall resource allocation to education.
- Prepare a medium-term needs plan, paying attention to regional disparities in inputs and outcomes, with special consideration given to the maintenance needs for new schools.
- Align on- and off-budget expenditures around the needs plan.



ADULT EDUCATION COULD BRING BENEFITS, BUT INVESTMENT IS NEEDED

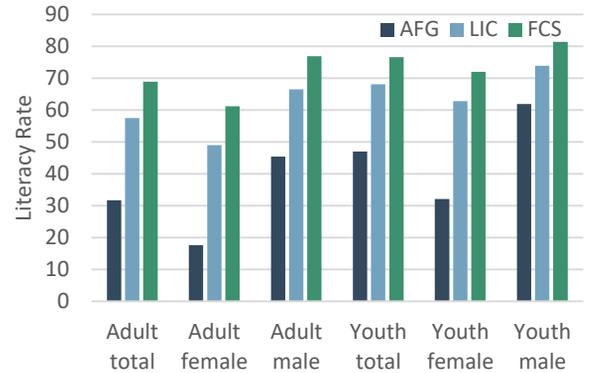
There is great need for adult education.

Nearly 70 percent of the working-age population is illiterate, impeding productivity, communication, and political/social engagement. More than 80 percent of women are illiterate, with international literature showing a strong relationship between higher women's education and lower fertility rates. The poor are least likely to be literate, have fewer years of schooling, and larger household sizes.

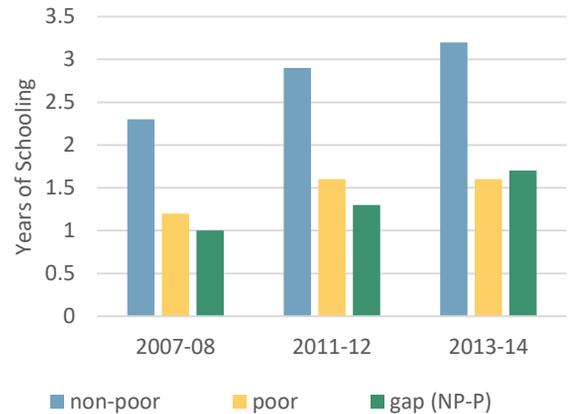
Improving education for adults will require greater investment.

International experience with adult education programs is mixed, but some evidence suggests well-designed adult programs can address illiteracy within short timeframes and at relatively low cost. Current investment in adult education, however, is very limited. On-budget spending on adult education was around US\$20 million in 2015. Adult education programs accounted for around 1 percent of total expenditure, and 4 percent of education expenditure. Off-budget donor spending on TVET was around US\$12.6 million in 2015, while investment in adult literacy was around US\$3.2 million. Adult education comprised 19 percent of off-budget education expenditures in 2015. Total investment in adult education was around 4 percent of total investment in education in 2015, and around 0.6 percent of GDP. While education expenditure has remained a fairly stable share of civilian expenditure, expenditure on adult education has been volatile and has declined over time.

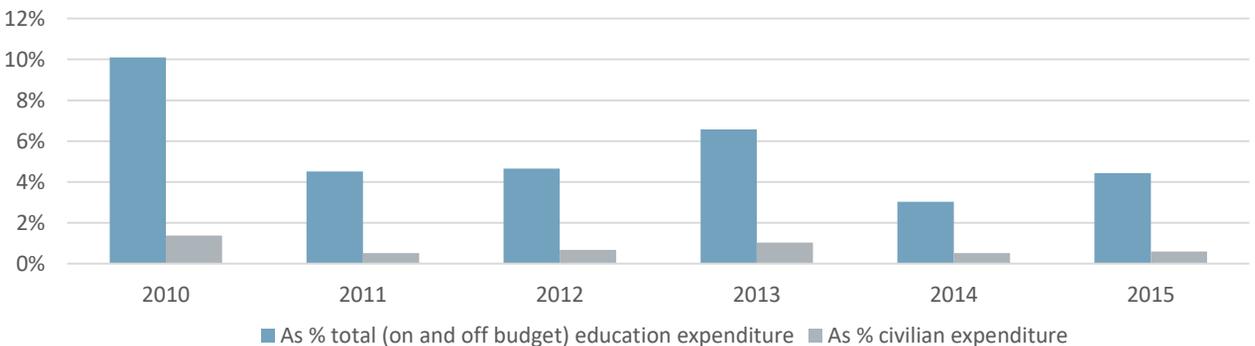
LITERACY RATES ARE EXTREMELY LOW



THE POOR LACK EDUCATION



THERE IS LITTLE INVESTMENT IN ADULT EDUCATION





AFGHANISTAN MUST INVEST MORE IN HUMAN CAPITAL

Potential:

- Improved human capital is a vital input for any potential growth strategy. Every year of schooling raises earnings by 10 percent. This rate of return is higher than alternative investments, including bonds, stocks, deposits, and housing.
- Investment in human capital represents low risk, given potential contribution to growth from different sectors.
- Modelled scenarios suggest increases in human capital investment could yield substantial benefits to employment and incomes.
- Labor productivity increases will fuel increased output while reduced fertility associated with improved education outcomes drives higher incomes.

Main constraints:

- Low absolute public spending levels of education and (especially) health constrain development outcomes.
- Inequities in access between the rich and the poor and urban and rural areas may be contributing to fragility and urbanization pressures.

What needs to be done:

- Increase spending on education and health spending from 33 percent to 50 percent of civilian spending to ensure increased access and improvements in quality.
- Expand primary healthcare services, prioritizing rural areas.
- Invest in early childhood education, skills and literacy programs.
- Reform skills training programs to include traditional apprenticeships for unskilled and semi-skilled youth.
- Strengthen focus on female education to close the gender gap and reduce fertility.



EXTRACTIVES ARE A VITAL COMPLEMENT TO AGRICULTURE AND RISKS CAN BE MANAGED

Afghanistan's extractive resource base is large and uniquely undeveloped.

The country is endowed with a wide range of minerals, from well-known assets in copper, coal, iron ore, gold and oil and gas to more speculative deposits in those minerals, as well as lithium and gemstones. Sector output could meet demand on international markets but would also serve domestic needs for construction material.

Extractive developments in Afghanistan have experienced setbacks in recent years. Recent experience with small-scale gem mining and medium-scale coal and gold mining has highlighted that mining development, when poorly managed, can fuel conflict and corruption while delivering few benefits to citizens. Reflecting this experience, concerns regarding governance capacity have led policy-makers to virtually halt investment and development progress in the sector. Global commodity price developments have rendered some projects less attractive to private investors, but interest remains high for the majority of opportunities.

Over the next 15 years, extractives is the only sector that has the potential to produce exports and revenues at scale. Extractives in Afghanistan will only reach maturity over time, but important impacts may be felt early. If properly leveraged through reforms and public investment, extractives offer opportunities to accelerate growth and support improved livelihoods.

Extractives development brings risks.

There is ample country specific and empirical evidence showing that – under certain circumstances – extractives development can be detrimental to development prospects, especially in fragile and conflict contexts. The phenomenon of countries endowed with natural resource wealth experiencing poorer development outcomes is known as the

'resource curse'. Of predominant concerns for Afghanistan is the danger that extractives development can: i) erode gains achieved in governance; ii) spur conflict through real or perceived inequity in distribution of rents; iii) threaten the environment and cultural assets; iv) trigger disputes over rights to control resources; and v) provide financing to insurgent groups. These are all very legitimate concerns.

The pitfalls of the resource curse can be avoided.

Many low-income countries have managed to harness their resource wealth to improve human development. Countries that were able to succeed in natural resource development with initially-weak institutions include Botswana, Colombia, Ghana and Trinidad & Tobago. These successes suggest the emergence of an international policy learning curve with many good practice examples that can be modified and adopted for the Afghan context.

Afghanistan cannot forgo the potential of extractives development.

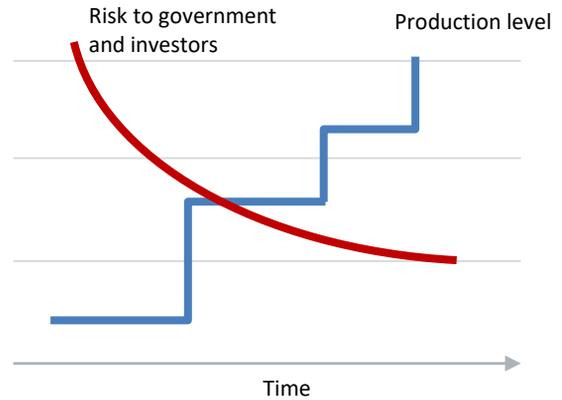
Given Afghanistan's daunting governance risks and conflict vulnerabilities, and weak capacity in the Ministry of Mines and Petroleum, the challenges to develop natural resources into a productive growth sector are overwhelming. Yet, extractives is the only sector that could provide sufficient fiscal revenue and export earnings to offset expected declines in aid. Extractives also have important potential to spur growth in other sectors through creating demand for services or providing inputs into the production process. New, successful investment in extractives would provide a positive signal to the broader private sector regarding the direction of policy and economic prospects, helping to build confidence.



A DIVERSIFIED AND INCREMENTAL APPROACH CAN HELP MANAGE RISKS

An iterative, proof of concept approach can bring substantial benefits.

- Lowers risks to government and investors through learning
- Opportunity to anchor capacity building activities and allows to build institutions over time
- Stress-tests legal and regulatory framework
- Provides signals to both, domestic and international investor community over viability of investments
- Provides opportunity to experiment with benefit sharing mechanisms.



The diversity of Afghanistan’s resources can also be leveraged to reduce risks.

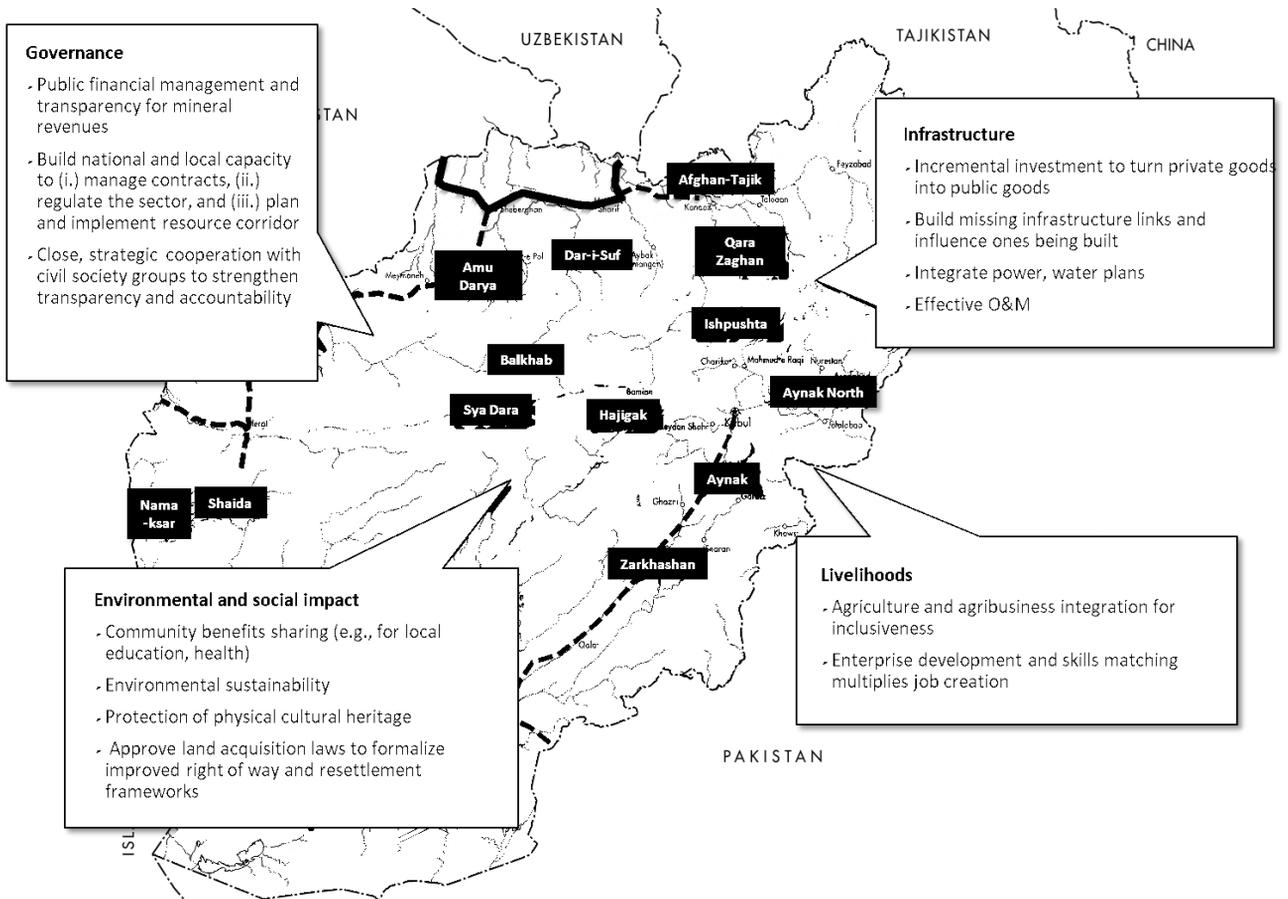
- The availability of a range of natural resources reduces exposure to price shocks
- Development of different industry types facilitates iterative development, moving progressively towards high risk/high return operations with deep linkages across the economy.

	Metallic minerals	Hydrocarbons	Industrial minerals (small/medium scale)	Artisanal mining
Exploration	<ul style="list-style-type: none"> • High risk / high reward • High probability of losses 	<ul style="list-style-type: none"> • High risk / high reward • High probability of losses 	<ul style="list-style-type: none"> • Lower exploration risk • Probability of losses tied to end-use markets 	<ul style="list-style-type: none"> • Risks limited with appropriate licensing
Production	<ul style="list-style-type: none"> • Capital Intensive (\$50m to \$1b) • Global Investors 	<ul style="list-style-type: none"> • Capital Intensive • Global Investors 	<ul style="list-style-type: none"> • Lower capital requirements (\$1m to \$50m) • Greater emphasis on domestic investors 	<ul style="list-style-type: none"> • Modest capital requirements • Domestic investors
Economic links	<ul style="list-style-type: none"> • Lateral linkages • Local content • PPP infrastructure opportunities • Formal benefits sharing 	<ul style="list-style-type: none"> • Some lateral linkages • PPP infrastructure opportunities • Formal benefits sharing 	<ul style="list-style-type: none"> • Modest lateral linkages • Formal benefits sharing 	<ul style="list-style-type: none"> • Few linkages



THE RESOURCE CORRIDOR APPROACH REMAINS VIABLE AND RELEVANT

The resource corridor program was launched in 2013 as a national priority program but has lost momentum in recent years. The program sought to use extractive sector development as an anchor for infrastructure deployment and policy actions that would equally support growth in agriculture and services sectors and regional connectivity. Synergies between private and public investment in the extractives sector can reduce cost of infrastructure deployment. Benefit sharing mechanisms and skill development programs can leverage enterprise and community development. While a resource corridor is not a panacea it can be a powerful instrument to generate inclusive growth from a sector that otherwise might provide benefits only to a small number of workers in isolated geographical areas.





THE POTENTIAL OF EXTRACTIVES MUST BE HARNESSSED

Potential:

- High risk sector that could see Afghanistan achieve 5 percent annual GDP growth assuming accelerated investment in 2017 - 2020.
- Modest job impact: 100,000 – 125,000 jobs additional jobs over the next 10 years through resource corridor approach.
- High Revenue potential: 3 percent of GDP annually through 2030 (excl. energy transit).
- Exports could grow by 10 percent annually and gradually substitute for the decline in aid.
- Large potential to leverage public investment in infrastructure through PPPs.

Main constraints:

- Underinvestment in exploration and production due to legal and regulatory uncertainty.
- Weak capacity at Ministry of Mines and Petroleum.

What needs to be done:

- Identify opportunities for scalable proof of concept investments.
- Restore interest in exploration activities by disseminating geodata and improving outreach activities to private sector.
- Invest in and concentrate required capacity in MoMP. Meanwhile pull in international service providers to oversee and manage licenses.
- Reenergize resource corridor program.



AFGHANISTAN'S EXPORT PERFORMANCE IS WEAK, BUT TRADE OFFERS OPPORTUNITIES

Afghanistan runs large and longstanding trade deficits.

Afghanistan's official merchandise exports were US\$694 million in 2015 – just 8 percent of exports (US\$8,724 million). Due to its narrow production and manufacturing base, Afghanistan depends heavily on imports of fuels, food staples, processed materials, and manufactured goods. Imports consistently increased over the 2000s reflecting the large import needs for reconstruction, but have been declining in recent years as a result of the withdrawal of international troops, the decline in aid resources and associated public spending, and due to the weakening currency.

Exports, though low in overall volume, have grown in recent years. Merchandise exports have grown by 6 percent per year on average since 2013. Export growth in recent years is largely attributed to an uptake in the production of horticultural products. The largest exported categories of goods include fruits and dried nuts, metals (consisting almost exclusively of scrap iron), mineral products, cotton, and carpets.

Afghanistan's trade is heavily concentrated, making it susceptible to external shocks.

The top ten export products account for more than 70 percent of total exports, compared with 13 percent for South Asia. The top-five destinations – Pakistan and India, Iran, Turkmenistan and Germany – account for almost 90 percent of exports compared to 38 percent for South-Asia. Similarly top-20 imports and top-ten import partners account for 50 percent and 80 percent of all imports respectively. Pakistan and India are Afghanistan's most important trade partners by a wide margin.

The low share of exporting firms suggests low export capabilities and high barriers to trade.

Enterprise surveys indicate that only 6.7 percent of Afghan firms export. This share is low compared with averages for the South Asia region (13 percent) and the developed world (36 percent). Low export performance is consistent with very low foreign investment, which can provide an important conduit for acquiring knowledge and technology. FDI flows in Afghanistan – mostly originated from the UAE and China – were less than 1 percent of GDP in recent years.

AFGHANISTAN HAS SUBSTANTIAL TRADE POTENTIAL



Commodity export

Countries typically broaden exports within the existing production base and product mix or by moving production up the value chain. In Afghanistan, agriculture and – to a much larger extent mining – stand out as the sectors with the largest potential to drive exports in the future. Improved agriculture production and productivity will likely drive import substitution more than increased agricultural exports over the next ten years.



Energy transit

Building regional connectivity for energy transit trade can: (i) deliver benefits from Afghanistan's role as a 'bridge' linking the energy reserves of Central Asia with the growing demand of South Asia; and (ii) provide Afghanistan with electricity to meet its own acute domestic shortages. Major regional energy projects are already underway and will help build regional connectivity in this area.



Internet backbone

Afghanistan also has a potentially important role to play in improving the regional connectivity of high capacity, domestic fibre-optic networks. While Afghanistan's ICT market and infrastructure is still nascent, the Government is working hard to promote private investment in fibre-optic networks including through participation in regional initiatives.



AFGHANISTAN FACES TRADE CONSTRAINTS BEHIND AND AT THE BORDER

GEOGRAPHY AND CONFLICT

- Complex topography, underdeveloped road infrastructure and high transportation risks mean that cost of trade are very high.
- Around 50 percent of firms in Afghanistan consider transportation a major or severe constraint.
- It cost \$5,045 to ship a container from Afghanistan compared to \$1,922 from the average South Asian country.

TRADE POLICY

- Implementation of APTTA remains challenging and causes congestion at border crossing points with Pakistan.
- Tariff barriers are on average fairly low in Afghanistan and Central Asia, but tariff peaks in some Central Asian economies exist on several products that are of export interest for Afghanistan.

CROSS-BORDER INSTITUTIONS

- Afghan exporters spend 86 days on average to ship their goods. This compares with 33 days on average in South-Asia.
- Around 85 percent of total time spent to export is related to documentary compliance and 15 percent is due to border compliance .

PRODUCTION CONSTRAINTS

- Exports are only weakly correlated with movements of the currency exchange rate but strongly with agriculture output. This implies binding constraints in production.



COMMODITY TRANSIT IS A LONG-TERM OPPORTUNITY

Gains from commodity transit trade may be modest and slow to materialize.

Roughly estimated, improved transport connectivity between Afghanistan and the rest of Central Asia could boost regional trade by \$5.2 billion and increase Afghanistan’s revenues by \$260 million per year (1.3 percent of GDP).

However, Afghanistan’s transportation (road and railroads) network is currently underdeveloped. Globally and within the region, Afghanistan shows the weakest performance in logistics and transportation (ranked 158 out of 160 countries).

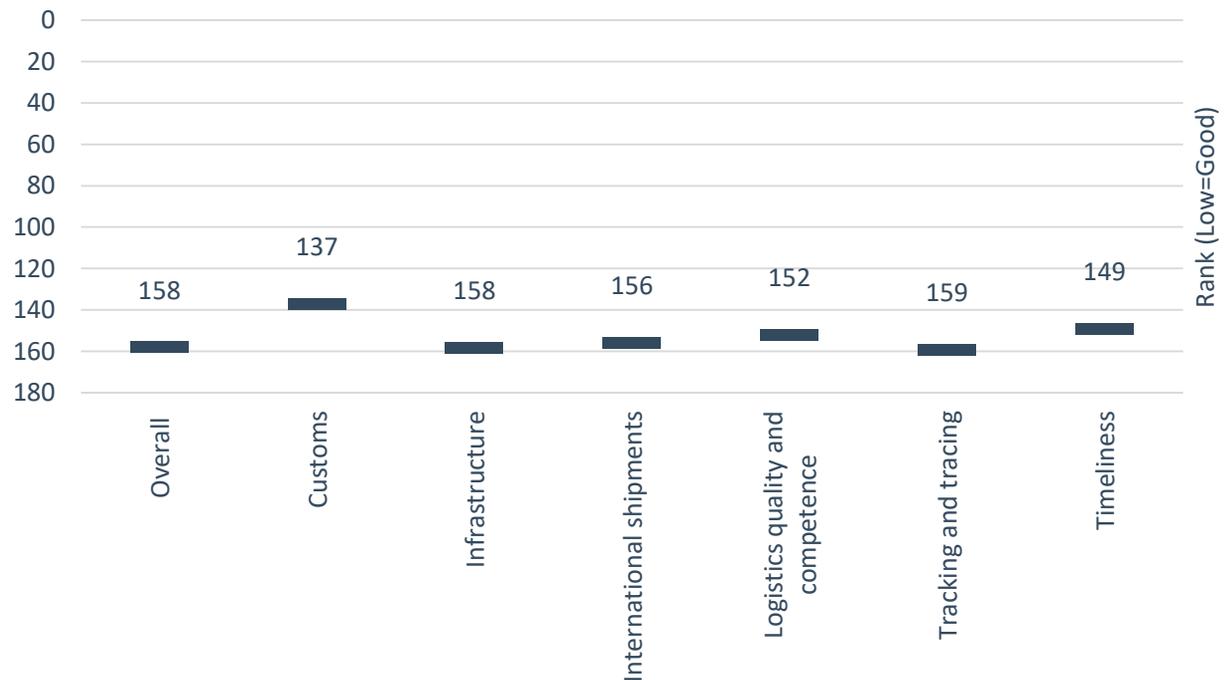
Achieving a competitive edge in transportation and logistics will require large investment in transportation and border infrastructure which will compete with infrastructure demands in productive sectors. Moreover, regional trade potential is shaped by sensitive political and geopolitical considerations which are not entirely under Afghanistan’s control.

Overreliance on commodity transit therefore represents a risky development option.

Of all modalities of trade, commodity transit is also the most vulnerable to the ongoing context of insecurity, providing opportunities for predation and extortion along transport routes.

A sensible approach to transit trade development would be based on careful prioritization of infrastructure investment: i) to resolve existing congestion at important trade points; ii) to meet emerging needs in productive sectors (agriculture and mining); and iii) in partnership with the private sector.

AFGHANISTAN’S LOGISTICS PERFORMANCE RANKINGS ARE POOR



Source: Logistics Performance Index



TRADE DEVELOPMENT SHOULD FOCUS ON AGRICULTURE AND EXTRACTIVES

Potential:

- Development of agriculture and extractives show combined the largest potential and can boost exports by 14 percent.
- Energy transit trade could add 3.1 percent to export growth annually and contribute substantially to revenue growth through 2030.
- Reducing export times to 25 days could increase existing exports by 20percent, which corresponds to USD152 million per year if production constraints are eased.
- By and large, employment impacts will be maximized through the development of agriculture exports.

Main constraints:

- Export development is reliant on expanding production capacity in agriculture and extractives.
- High transportation cost and risk due to underdeveloped road infrastructure and insecurity.
- Customs and border inefficiencies lead to long delays.
- Congestion at border crossing points with Pakistan impose substantial costs.

What needs to be done:

- Improve efficiency in documentation requirements and processes, including establishing a single window and information portal for trade.
- Improve cross-border institutions to reduce wait times at strategic border points by offering 24/7 customs services, reducing traffic congestion, and expanding border capacity.
- Improve road infrastructure and quality in response to demand from domestic exporters.
- Continue discussions with Pakistan on resolving APTTA implementation constraints.
- Deepen and expand existing trade agreements with regional partners.

Note: Estimates of trade potential and impacts are based on analysis of 2014 data.

IN FOCUS: ENERGY EXPORT AS A DEVELOPMENT STRATEGY

Other countries in the region have been able to leverage economic benefits from extensive natural endowments through electricity exports to neighboring economies.

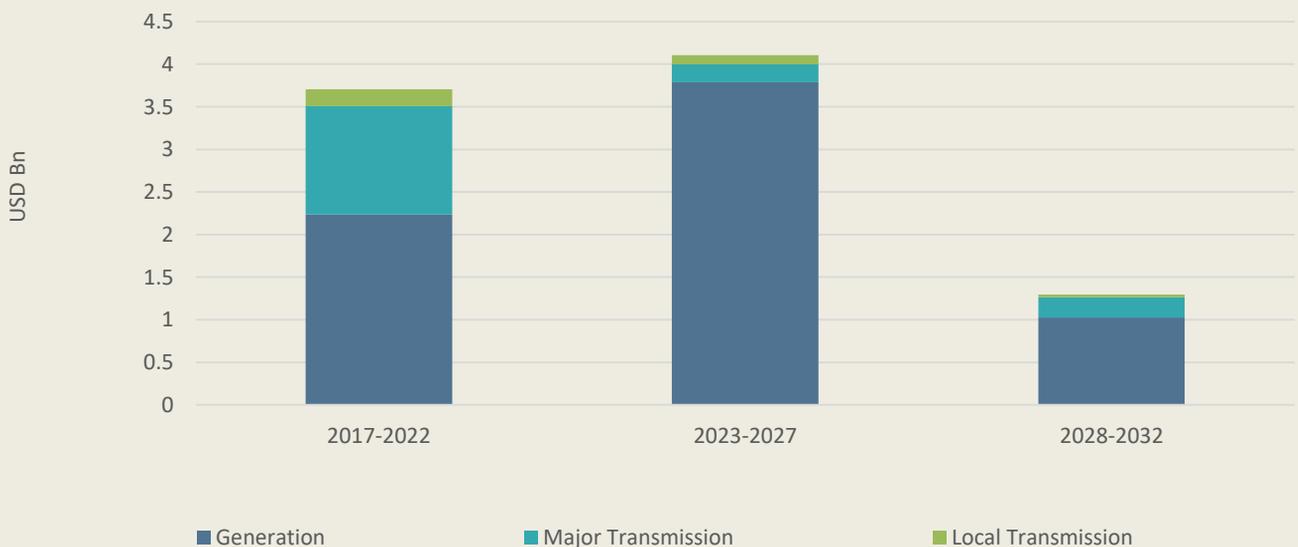
Modeling undertaken for this analysis shows that, by prioritizing investment in hydro generation and major transmission infrastructure, including large scale projects such as Kunar A (Shal), Afghanistan could generate in excess of 5 TWh of electricity for export beginning in 2026, although at a cost in terms of slower growth in connecting domestic customers to the grid.

While technically feasible, pursuing such a strategy would involve considerable costs and risks.

- It is likely to be difficult to attract private investment for large-scale development of generation plants given long lead-times, insecurity, and political uncertainty.
- If publicly financed, large-scale projects would squeeze out alternative, higher- impact public investments (investment space under most plausible aid scenarios).
- Domestic economic impacts of hydropower projects would be limited given likely reliance on external skilled labour during construction and very limited labour requirements during ongoing operations.
- Export potential would remain contingent on energy policy decisions in market countries, which could be influenced by unpredictable political developments.
- Large-scale hydro development may expose Afghanistan to similar fragility pressures as mining, including contestation over the natural resource and distribution of benefits, and potential security vulnerabilities at generation and transmission facilities.

INVESTMENT COSTS FOR ENERGY EXPORT ARE EXTREMELY HIGH

Investment costs for development of potential exports



IN FOCUS: EXPANDING ACCESS TO ENERGY IN AFGHANISTAN

Distributed generation, including stand-alone and mini-grid systems, offer attractive options for extending electricity supply to the local population within the current context of uncertainty.

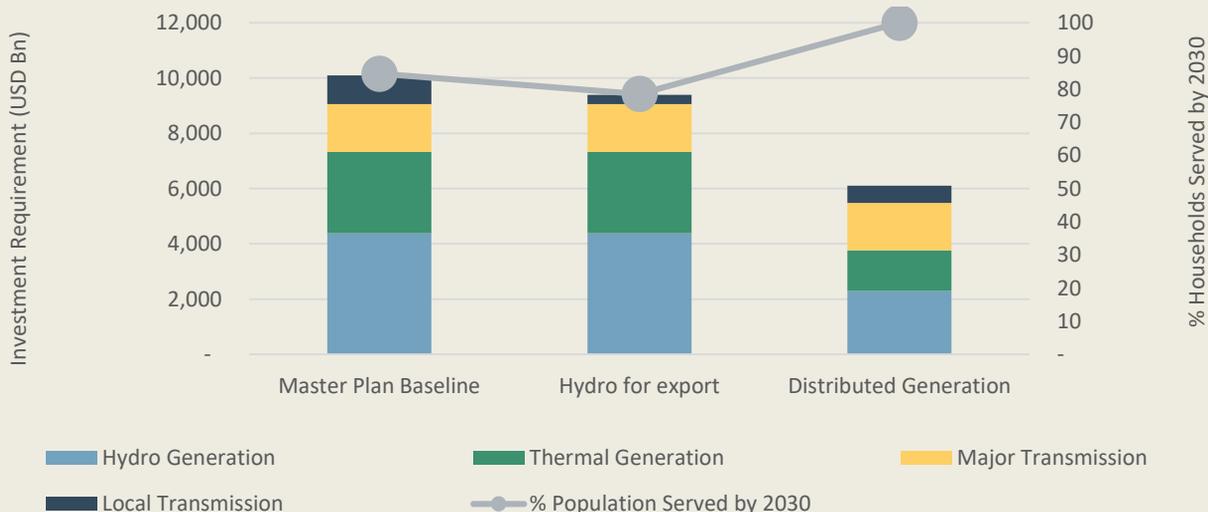
This approach would reduce the need for risky and high-cost investments in large-scale grid-connected generation and transmission projects while accelerating supply of electricity to a large portion of the currently unserved population - especially in areas remote from the grid. Expanded and improved access to electricity would both improve living standards and help to fill an infrastructure gap in support of economic growth. Reliance on distributed generation would allow the utility to defer dealing with the problems of asynchronous operations of different sections of the grid, and to match the investment in supply specifically to demand in a particular areas. Small scale renewable technologies, such as Solar Home System (SHS), would be ideally suited to distributed generation. Mini-grids are well suited to either micro-hydro, solar arrays, or a combination of either solar or wind supplemented by diesel. Small-scale investments would be robust to fragility, and could be delivered through the Citizens Charter or other community-level programs, potentially improving perceptions of the state.

With public investment to support distributed distribution, export would remain a long-term option.

While Afghanistan would address domestic electricity demand through a combination of small-scale isolated generation, moderately sized grid-connected generation and imports over the medium-term, opportunities for developing export potential could still be pursued. Under a distributed generation scenario, generation investments would include mid-sized hydro and thermal investments connected to the grid, as well as smaller isolated projects in areas where grid connection would be costly and/or technically challenging. Imports would continue to be needed to meet grid-based energy demand, although energy imports would decline from around 50 percent of total demand to 19 percent by 2030. Even as a distributed generation was being pursued, government could continue to solicit private investment in large-scale projects with potential for export. Public investment in large-scale export-oriented projects could also be pursued in the future once immediate public investments in agriculture and human capital begin to deliver growth and revenue returns, generating additional fiscal space.

DISTRIBUTED GENERATION IS THE MOST COST-EFFECTIVE OPTION TO EXPAND ACCESS

Investment costs for expanding access

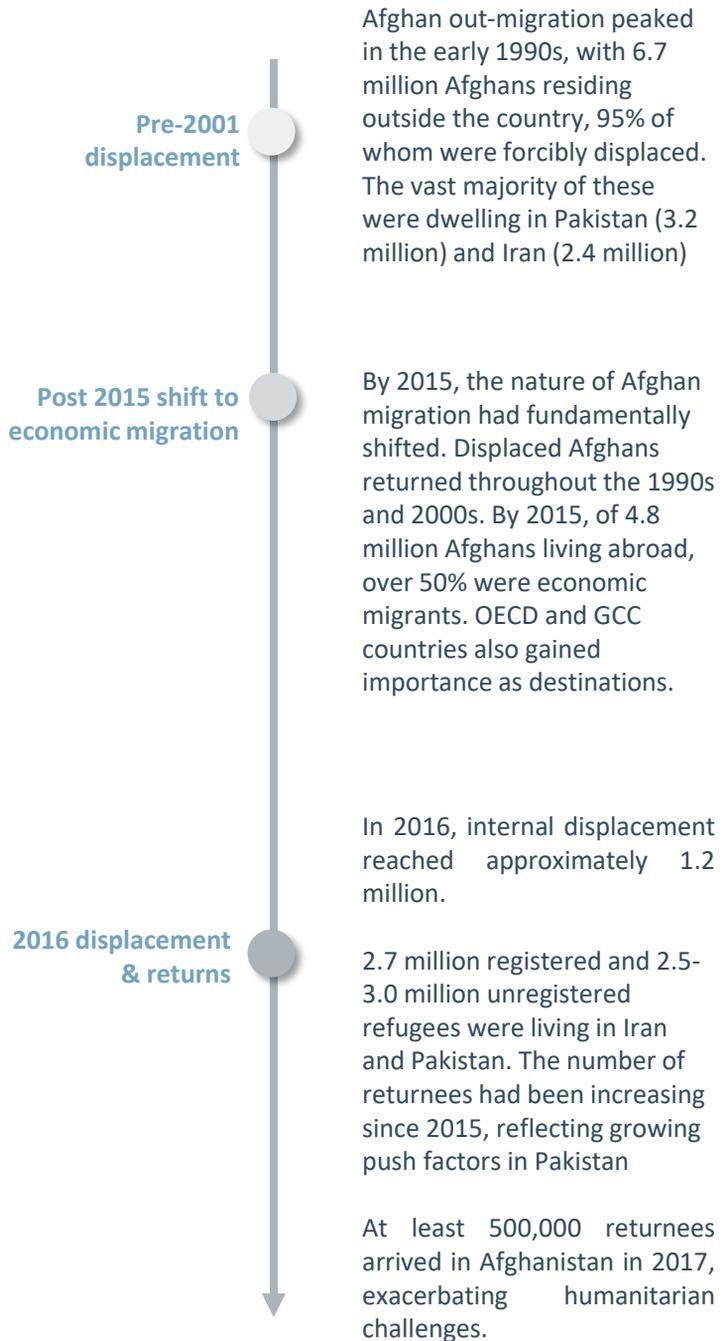




AFGHANISTAN HAS A LONG HISTORY OF LABOR MOBILITY

Afghanistan has experienced throughout its recent history major migration outflows and inflows, driven by economic opportunities, changing conflict dynamics, and natural disasters. Since 2015, economic migration has outstripped displacement as the primary component of Afghanistan's outflows.

Of the total 3.8 million households in Afghanistan in 2013/2014, 16 percent have members who are international migrants. 9.3 percent of households have members who were refugees and returned to their home country. 11.2 percent of households include economic migrants. The difference (about 4.5 percent of households) have family members who are both forcibly-displaced and economic migrants.





ECONOMIC MIGRATION HAS IMPORTANT IMPACTS ON EMPLOYMENT AND POVERTY

Labor mobility represents an important opportunity for Afghanistan.

In Afghanistan, as in many low-income countries, labor migration presents a critical opportunity to alleviate labor market pressures, increase wages, and reduce poverty, and through remittances contribute to increasing domestic income, consumption, and bolstering foreign exchange receipts.

At an individual level, labor mobility is critical to expanding employment opportunities.

Our analysis shows in all growth scenarios, job growth would not be sufficient to keep pace with the growing labor supply, leaving a considerable number of people un- or underemployed. This means migration pressures will remain high, with an estimated 150,000 – 250,000 people per year searching for income opportunities abroad to maintain the current unemployment rate. Employment abroad also offers increased wages, with Afghans working in Iran receiving four times, and in the United States eight times, the comparable wages in Afghanistan.

A number of factors influence individual economic migration in Afghanistan:

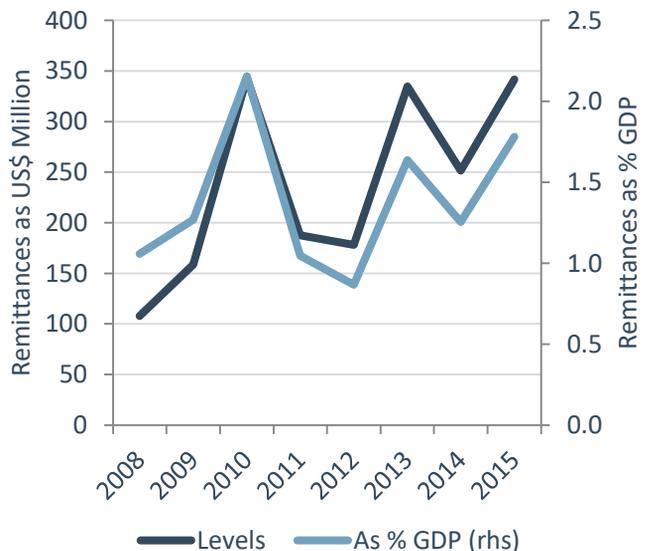
-  Pull factors: improved employment outcomes, wage differentials ranging from four to eight times wages in Afghanistan, and risk mitigation from economic shocks
-  Push factors: Insecurity and conflict, natural disasters, economic shocks and unemployment
-  Affordability: Migration is costly and requires a set of resources (assets, networks, education). Richer households are more likely to have individual members migrating because they have the resources to facilitate the migration.

At the household level, remittances are an important source of livelihoods.

Remittances resulting from migration are significant and likely higher than officially reported. Official statistics put remittance inflows in 2015 at \$340 million (1.7 percent of GDP) and outflows at \$150 million (0.7 percent of GDP). Using a range of data sources our analysis suggests that remittances inflows are more likely between 3 – 7 percent of GDP.

The ALCS 2013/14 indicates that around 6 percent of Afghan households rely on remittances as one of their three main sources of income (70 percent of labor income on average). Remittances are highly relevant for those beneficiaries, though, averaging US\$1680 annually (more than half of their income). Further, remittances to Afghanistan are negatively correlated with GDP growth, implying a risk-diversifying strategy to mitigate the impacts of economic downturns for Afghan families.

REMITTANCE FLOWS ARE SIGNIFICANT AND UNDERSTATED IN OFFICIAL DATA





MANAGED MIGRATION PRESENTS IMPORTANT OPPORTUNITIES

Lack of legal channels and high costs have resulted in largely irregular Afghan migrant flows.

Migration in Afghanistan is currently largely unmanaged, in part because Afghanistan does not have any functioning agreements through which Afghans may regularly migrate to work abroad. Irregular migration accounts for 91.1 percent of Afghans in Iran, 50 percent of Afghans in Pakistan, and almost all Afghans in the GCC.

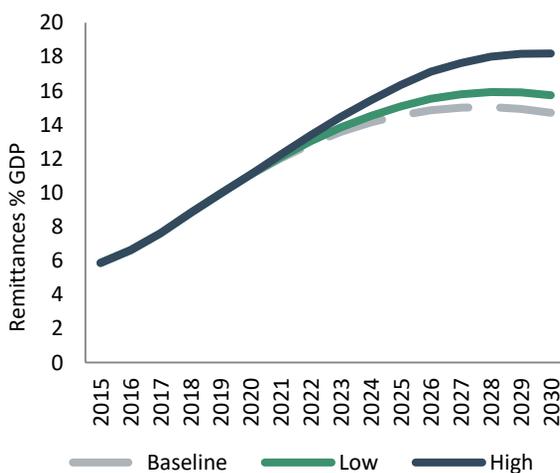
Unmanaged migration in Afghanistan limits opportunities for growth and employment.

Irregular migration poses a number of risks to migrants, such as high costs paid to smugglers and the lack of legal protections against abuse and exploitation. Further, it leads to inferior employment outcomes, as constrained legal access to the labor market in the destination country, resulting in lower wages and uncertainty around employment.

Managed migration can maximize benefits for Afghanistan and potential host-countries.

Managed migration flows, based on bilateral labor migration agreements, promise improved regularity of migration patterns, access to higher-wage countries,

MANAGED MIGRATION INCREASES REMITTANCES



Source: World Bank analysis

and more and sustained remittances. They also offer the possibility to maximize benefits from increased incentives for human capital acquisition and better access to diaspora resources.

Our migration simulations show that official remittances could grow from 14 percent of GDP by 2030 in a scenario of unmanaged migration to 18.5 percent of GDP in a plausible scenario of managed migration. This is roughly the level of civilian aid estimated for 2017 – 2020.

Labor demand in advanced economies presents opportunities for managed migration.

Demand for managed migration growing in many countries due to an aging working population and decline in fertility rates that limits growth in labor supply. Origin countries such as Afghanistan can identify promising markets by assessing their labor market need, political receptiveness, and cultural/language affinities of work forces. Using this method, Turkey and the GCC countries have been identified as potential partners for Afghan managed migration.

PROSPECTS VARY BY LABOR MARKET

	Labor Market Need	Political Receptiveness	Cultural / Language Affinities	Overall
Pakistan	M	L	H	M
Iran	M	L	H	M
GCC	H	M	M	M
Malaysia	M	M	M	M
Europe	H	L	L	L
Australia	M	M	L	M
Turkey	M	H	H	H
Central Asia	L	L	M	L



AFGHANISTAN MUST MOVE FROM UNMANAGED TO MANAGED MIGRATION

Potential:

- Double current levels of economic migrants and offer additional job opportunities for 10,000 to 50,000 people annually, reducing fragility risks through the employment channel.
- Immediate wage increases of 300 to 800 percent for workers placed abroad.
- Increase remittances to 18.5 percent of GDP by 2030 in a plausible scenario of managed migration.
- Increase incentives for human capital investment.

Main constraints:

- Absence of legal channels for labor migration from Afghanistan.
- Insufficient governance framework and lack of institutional mechanisms to facilitate, support and protect migrants.
- Exceedingly high time and cost burden associated with regular migration, resulting from overly burdensome exit requirements and poorly functioning systems.

What needs to be done:

- Identify potential host countries and negotiate labor market access for Afghan workers.
- Create an inter-governmental coordination mechanism and streamline visa and exit clearance processes.
- Strengthen labor intermediation for Afghans going abroad by establishing systems for recruitment and skills certifications and verification.
- Balance mobility with protection by strengthening embassy services in host countries, offering pre-departure training, and conducting information campaigns.

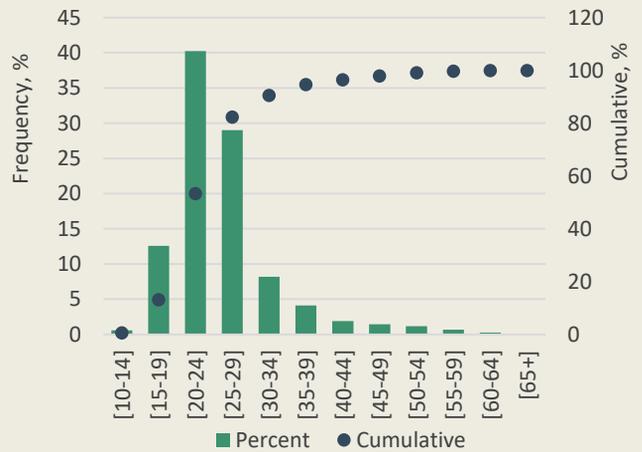
IN FOCUS: AFGHANISTAN'S ECONOMIC MIGRANTS

Economic migration is predominantly a male, youth and rural phenomenon

- 53.3 percent of economic migrants are below the age of 24 and 83 percent are less than 30 years of age.
- 75 percent migrate from rural areas – reflecting the deteriorating security and economic situation in rural areas.
- The fact that economic migrants typically have low skill levels suggests that migration decisions are dominated by “push factors” and/or existing migration networks for low skill occupations – there is no evidence that the highly skilled are better able to access migration opportunities.

ECONOMIC MIGRANTS ARE MOSTLY YOUNG

Age profile of economic migrants



Iran and Saudi Arabia are the largest host countries of Afghan economic migrants

- By country of destination, Iran hosted 1.4 million labor migrants in 2015, nearly two-thirds of the total workers who migrated from Afghanistan in search of better economic opportunities.
- Other important destinations for economic migrants are GCC countries (380,000 workers, mostly in Saudi Arabia) and OECD countries (350,000 workers).

ECONOMIC MIGRANTS ARE MOSTLY IN IRAN AND THE GULF

Stock of economic migrants by destination



IN FOCUS:

ECONOMIC DEVELOPMENT AND CONFLICT RISKS

A successful growth strategy for Afghanistan must include both extractives and agriculture. But activities in these sectors present important conflict and governance risks.

Illegal mining is wide-spread, and transactions around licensed mining activities have often been subject to corruption, leading to substantial revenue loss. Contestation over illegal and informal mining activities has driven violent conflict, and financial proceeds from extractive activities have been used to support insurgent groups. Until recently, Government has been reluctant to pursue further extractives development given the negative experiences to date and obvious risks.

In agriculture, opium remains Afghanistan's largest export (estimated at US\$2 billion, compared to total formal exports of just US\$720 million). Poppy production almost doubled to 9000 tons in 2017 and the area under poppy cultivation increased to 328 thousand hectares – the highest ever recorded. The opium economy has proven difficult to displace and is driven by weak rule of law, easy access to key trade routes, and absence of alternative livelihood generating activities.

The financial flows associated with both extractives and opium erode governance, undermine confidence in government, generate conflict, and fuel corruption.

Extractives can be developed in a way that allows risks to be managed.

Extractive-related risks could be mitigated through the following measures:

- Pursuing the resource-corridor approach to ensure that extractive activities are fully integrated into the broader economy, and benefits are relatively equitably shared.
- Ensuring that an appropriate fiscal framework is in place to smooth utilization of mining revenues and support long-term sustainable gains from extractives-financed programs and investments.

- Utilizing an incremental, proof-of-concept approach to build a diversified portfolio of investments. This approach allows required capacities to be built up over time, while mitigating price shocks and risks associated with reliance on a single project or commodity.
- Establishing clear institutional responsibilities and building required capacities in the Ministry of Mines and Petroleum and other involved government agencies, and accessing sustained international support for technically-demanding tasks.

Agricultural development should lead to substitution away from opium production.

Existing research on opium production in Afghanistan suggests that improvements in agricultural production and productivity should contribute to reducing opium cultivation.

- Farmers are often driven to opium production by the loss of assets, displacement, or other negative shocks. Improved agricultural productivity and implementation of an improved social protection system could protect against such shocks.
- Increasing returns to licit agriculture is the most effective approach to dis-incentivizing opium farming, leading to substitution towards licit production.
- Most opium farming takes place on unirrigated land and there is no evidence that irrigation expansion has previously led to increased opium cultivation.

4. FINANCING ECONOMIC DEVELOPMENT PRIORITIES

- Investment required for growth is affordable if resources are tightly prioritized.
- Increasing the share of aid on budget is vital for realizing growth potential.
- Afghanistan will continue to rely on elevated levels of international assistance.



GROWTH POTENTIAL IS HIGH, BUT WILL DEPEND ON INVESTMENT

Economic modeling results show substantial growth potential, especially from agriculture and mining.

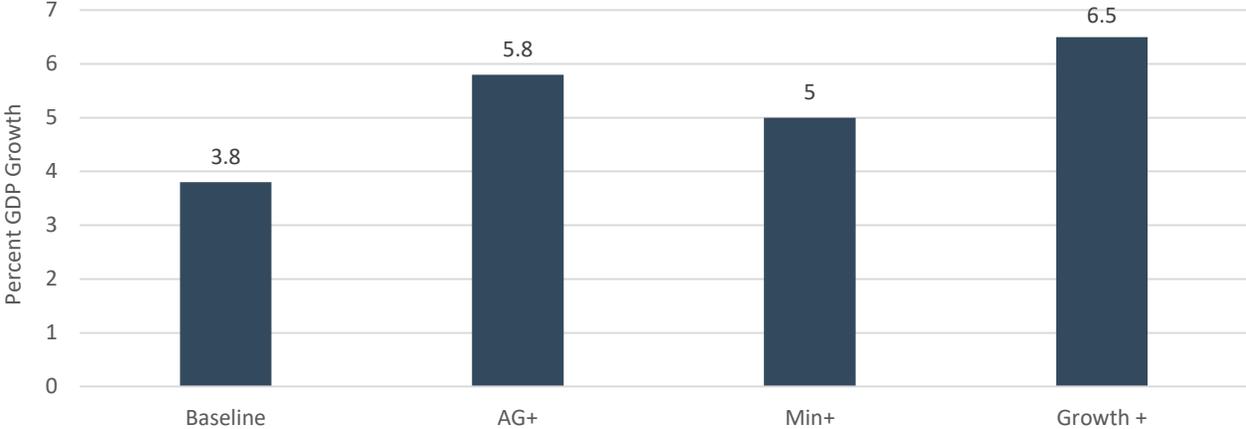
Public investment requirements for the Growth+ scenario are substantial.

- Both mining and agriculture scenarios deliver significant increases to growth.
- The Growth+ scenario shows that mobilizing growth from agriculture and extractives, while increasing investment in human capital could deliver average annual GDP growth of 6.5 percent over 2016-2030.

- Public investments are costed for all scenarios.
- Results show that mobilizing new growth sources requires public investment of around US\$1 bn per year over the next four years.

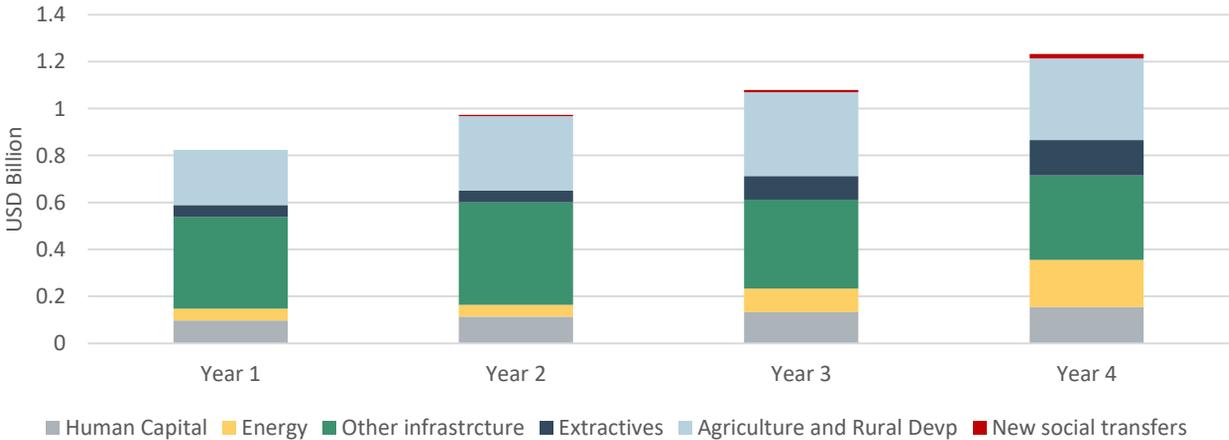
A BALANCED STRATEGY COULD DELIVER RAPID GROWTH

Growth model outcomes to 2030 – Average annual GDP growth at factor prices



INVESTMENT NEEDS TO MOBILIZE ALL SECTORS ARE SUBSTANTIAL

Public investment requirements for the Growth+ Scenario



Source: World Bank analysis

REFORMS WILL NEED TO BE INTRODUCED IN A DIFFICULT ENVIRONMENT AND UNDER TIGHT FISCAL CONSTRAINTS

Action is required to spur growth.

Under the baseline, growth would average just 3.8 percent over the period and provide little employment growth. With population growth of around 3 percent 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.

Short-term impacts are limited.

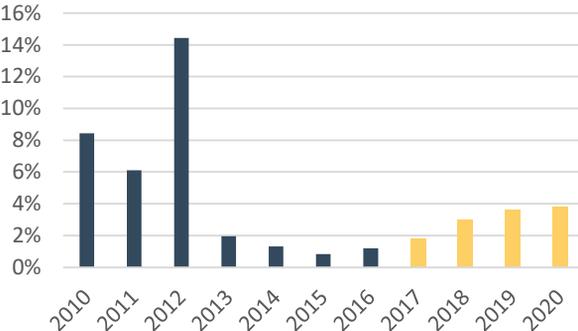
Mobilizing new growth sources will only have an impact after several years, due to lead-times for implementation and investment. Growth will likely remain slow over coming years (around 2.2 percent for 2018, increasing gradually to 3.8 percent by 2020), reflecting weak demand and an increasing output gap.

Fiscal resources are limited by cost pressures.

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, with three million children out of school.

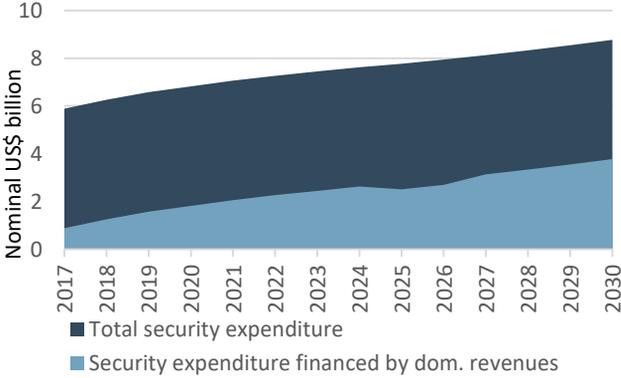
GROWTH WILL REMAIN SLOW WITHOUT REFORM

Real GDP Growth – Baseline Projections



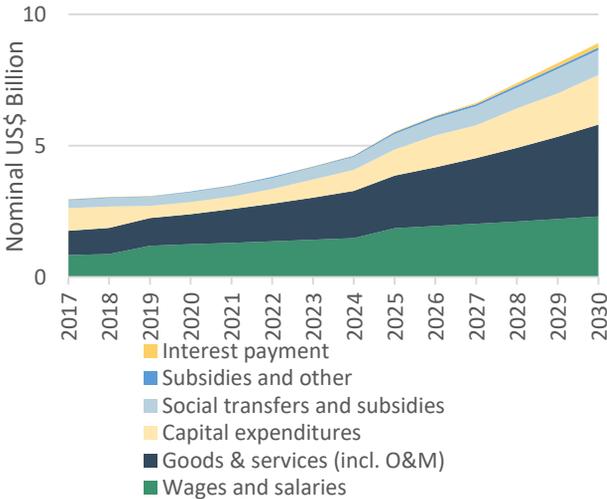
SECURITY EXPENDITURES WILL GROW

Total security expenditure projections



PUBLIC EXPENDITURE GROWTH IS REQUIRED TO MAINTAIN CURRENT SERVICES

Total security expenditure projections



Source: World Bank analysis

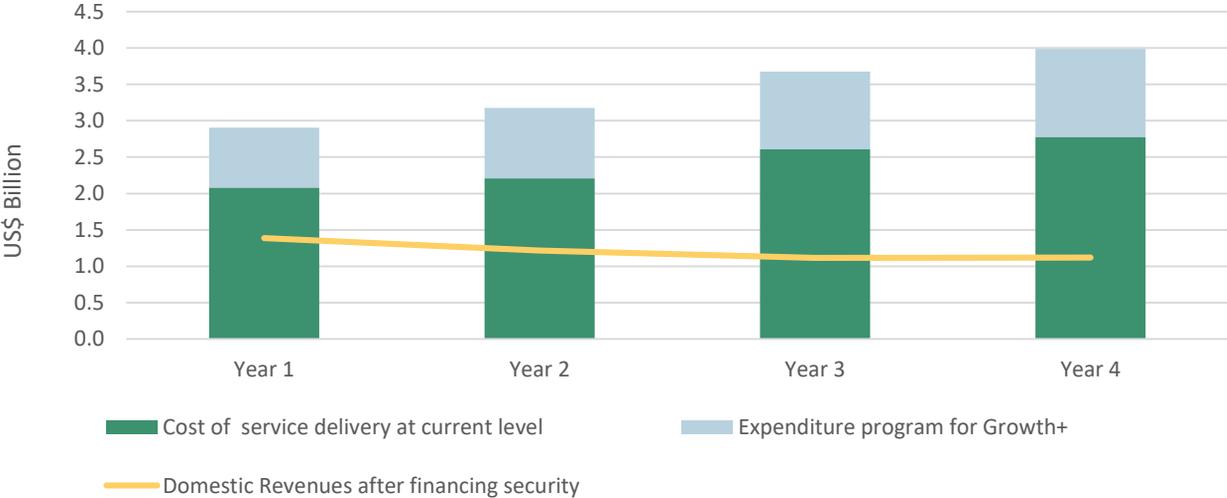
REQUIRED PUBLIC INVESTMENTS ARE POSSIBLE WITH CURRENT AID COMMITMENTS

US\$2.2 billion of on-budget civilian aid will be required per year for investment to realize the balanced growth scenario. This is affordable if:

- Aid is maintained at the level of Brussels commitments
- The proportion of aid either delivered on-budget or precisely aligned with the required investment program increases to 60 percent of total aid.

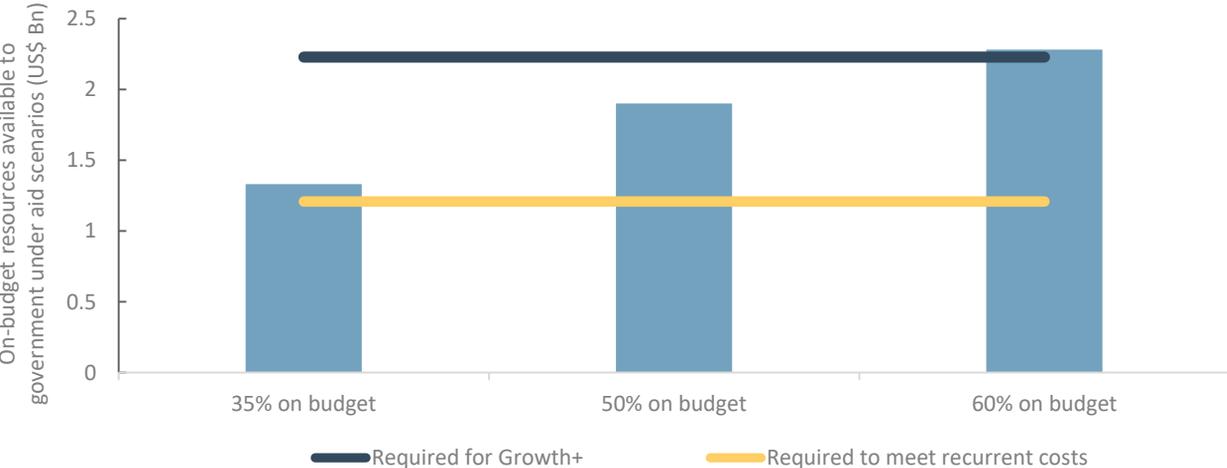
EXPENDITURE NEEDS EXCEED AVAILABLE REVENUES

Government budget – revenues and civilian expenditure needs



EXPENDITURE NEEDS COULD BE FINANCED BY BRINGING MORE AID ON BUDGET

Available resources at different levels of on-budget financing



Source: World Bank analysis

MORE ON-BUDGET AID IS VITAL FOR GROWTH

On-budget aid will be more effective in mobilizing growth strategies for several reasons.

Firstly, delivering through budget systems supports alignment and coordination of projects and program. It can sometimes be difficult to ensure that off-budget aid is used for projects that fully align with government strategies and priorities, given limited government oversight and restricted involvement in planning processes.

Secondly, there is overwhelming evidence from Afghanistan and internationally that on-budget expenditures are more cost-effective than off-budget expenditures, reducing reliance on expensive imported skills and materials. Finally, international and local evidence shows that spending through government systems has a greater positive impact on the local economy (including in terms of the creation of employment and private sector opportunities)

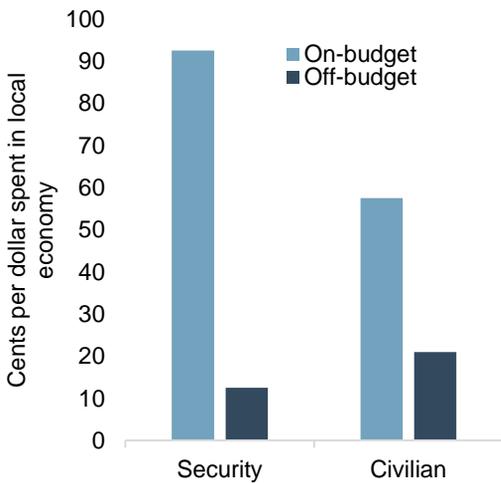
Government can encourage greater on-budget support.

Donors may require changes or improvements to public financial management systems, including procurement and payroll systems or the implementation of anti-corruption measures before increasing on-budget support. These requirements could usefully be communicated immediately to Government, with technical assistance provided to implement required reforms.

Discussions regarding the need for increased on-budget aid should reflect the facts that that: i) Afghanistan’s public financial management systems are relatively advanced compared to other fragile or low-income countries; and ii) opportunities for corruption also occur with off-budget expenditure.

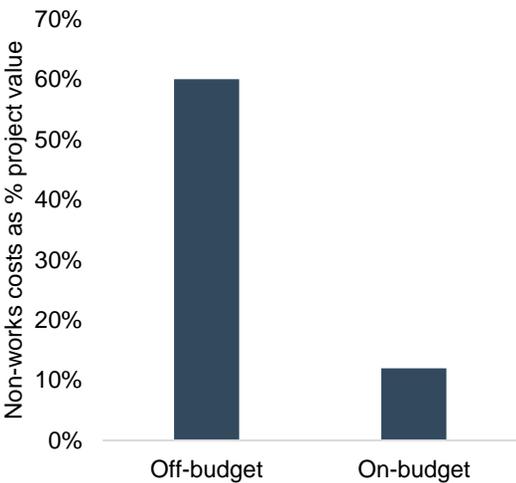
ON-BUDGET AID - GREATER ECONOMIC IMPACT

Cents per dollar spent within the Afghanistan economy by modality



ON-BUDGET AID - GREATER EFFICIENCY

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



Source: World Bank analysis

PUBLIC INVESTMENT NEEDS TO BE CAREFULLY PRIORITIZED

If development partners are to make greater use of government systems, the effectiveness of the budget as a planning tool must be strengthened. Given scarce resources it will be important to prioritize investments carefully to enable growth drivers.

Ensure investment decisions are informed by consistent and realistic economic planning

- Develop costed and coherent sector investment plans linked to the ANPDF
- Develop and apply project selection criteria that reflect priorities within these plans

Build and concentrate capacity for investment management within a small group of growth-relevant ministries

- Assess the adequacy of the existing public investment management systems
- Provide training and “train the trainer” programs on project selections, assessment, management, and monitoring to those agencies with key roles to play in managing public investments

Continue to strengthen and modernize core government public financial management systems

- Maintain progress with improving the budget process, strengthening procurement, building audit capacities, and reviewing alignment between public spending and policy priorities
- Strengthen public investment management processes from project selection to monitoring and evaluation

PROTECTING SOCIAL SECTOR EXPENDITURES IS A LOW-RISK STRATEGY

Common distinctions between ‘economic’ and ‘social’ spending make little sense in Afghanistan.

A skilled and healthy workforce is a vital input to all forms of economic activity. Improving health and education is likely to be just as important as hard infrastructure for economic growth. While there is limited international evidence regarding the optimal composition of expenditures between social services and infrastructure, returns on social investment are likely to be high in Afghanistan. This is due to current extremely low levels of human capital resulting from years of underinvestment.

Investment in human capital is robust to risk.

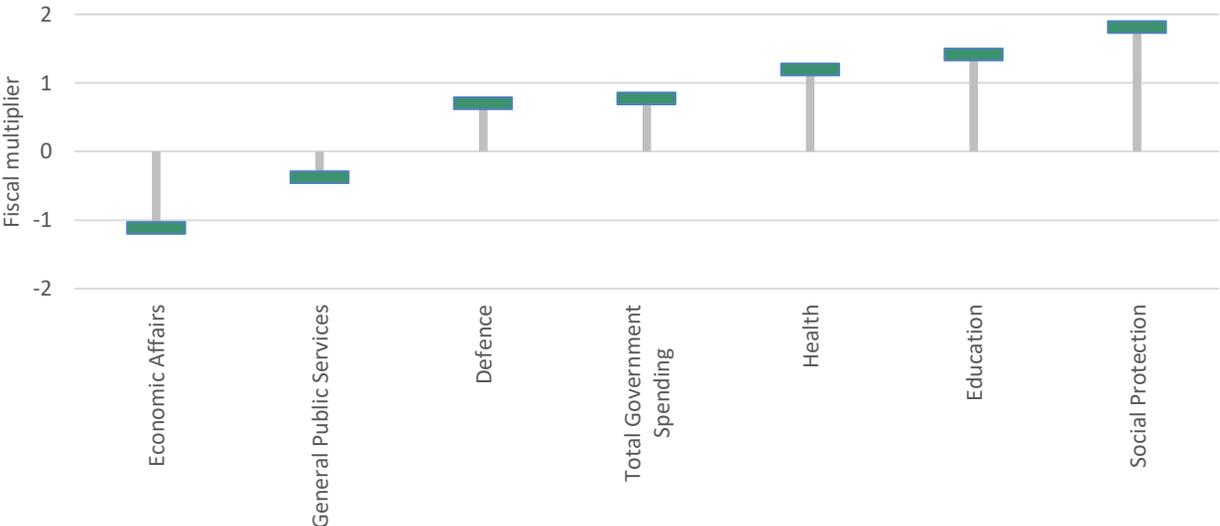
Investment in physical infrastructure can be subject to a range of risks. The viability of mining investments can depend on global commodity prices. The returns on connective infrastructure can depend on policy actions taken in neighboring countries, security conditions, and global market developments. In this context, investments in health and education are relatively low risk, with Afghans able to apply their labor in a range of different sectors or geographical areas in response to changing economic conditions and opportunities.

Expenditure on social sectors delivers higher fiscal stimulus.

An additional benefit of social sector expenditure is the relatively high direct economic impact. Because a large proportion of expenditure on health and education goes into salaries and locally-procured goods and services, the impact on the local economy is direct and substantial. This contrasts with infrastructure sectors, which tend to depend heavily on imported skills, equipment, and materials. Recent research has highlighted the large fiscal multipliers from social sector spending in Afghanistan. Multipliers express the ratio by which an additional dollar of public spending grows the economy. Large multipliers for social transfers, health, and education reflect that these type of investments have large direct impacts on domestic demand while also expanding the productive capacity of the economy.

RECENT EMPIRICAL WORK SHOWS HIGH MULTIPLIERS FROM SOCIAL SPENDING

Estimated conditional functional multipliers by sector



Source: Asea (2017), commissioned analysis for World Bank

FISCAL SPACE COULD BE INCREASED, BUT AFGHANISTAN WILL REMAIN RELIANT ON AID FOR THE MEDIUM-TERM

There are options available to free up additional fiscal space.

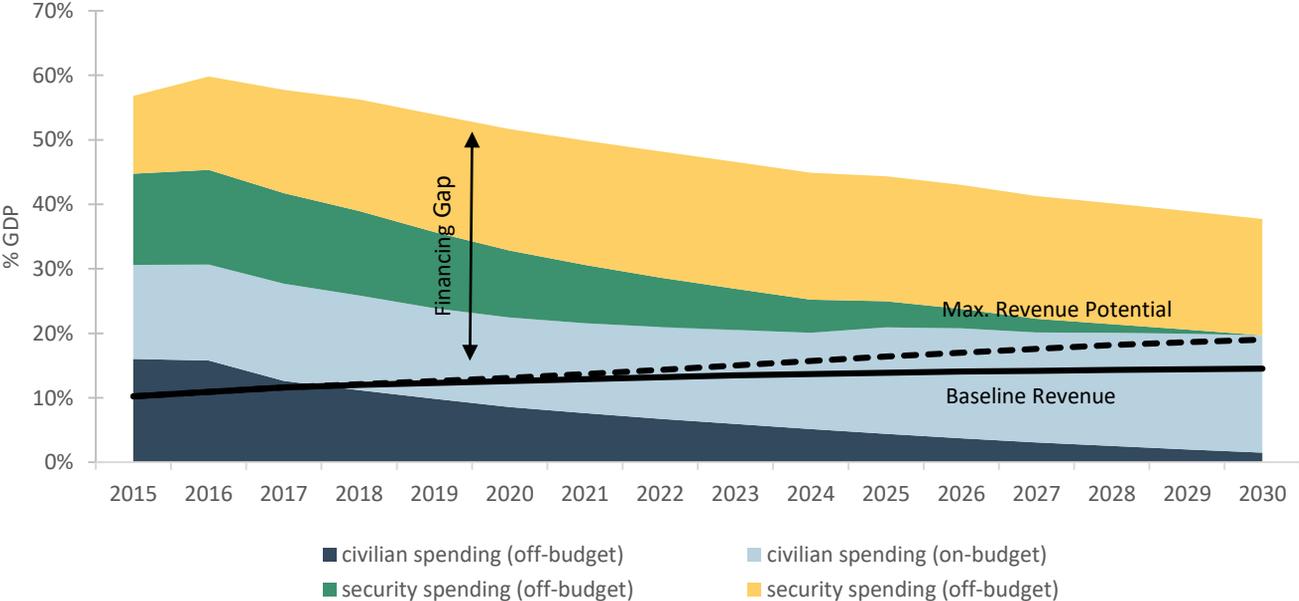
- Revenue mobilization.** Continued efforts to improve revenue compliance and policy could help increase revenues over time. Administrative improvements, including the roll-out of electronic systems, should be prioritized. But under Afghanistan’s current economic structure, revenue potential is limited to around 17 percent of GDP even under ideal tax administration and policy settings. Further increasing revenue would require the mobilization of new sources of growth, including extractives.
- Managing security costs.** The current trajectory of security expenditures is unsustainable. Security expenditures are increasingly squeezing out development spending. This may prove counter-productive, given evidence that insecurity can be mitigated through improving access to economic opportunities, generating employment, and strengthening institutions. Reforming security sector expenditures is a long-term challenge, however, and scope for immediate savings is limited.
- Pension reforms.** The current pension scheme is unsustainable. Civil service pension expenditures will outweigh contributions and become a net cost by 2024. Reforms now can free up 0.7 percent of GDP in fiscal space for poverty-oriented spending (e.g. transfers) over the medium-term.

Under any scenario, however, Afghanistan will remain highly reliant on aid.

The annual financing gap – the external resources that Afghanistan will require to finance all on and off-budget civilian and security expenditures – will be equal to 34.5 percent of GDP through 2030 under the baseline. Under a high-growth scenario, this gap declines, but remains significant at around 30 percent of GDP.

EVEN UNDER THE BEST CASE, DOMESTIC REVENUES ARE INSUFFICIENT TO FINANCE EXPENDITURES

Public spending and domestic revenues under different scenarios



ANNEXES

 The MAMS Model

 Modeled Growth Scenarios



THE MAMS MODEL

MAMS is an economy-wide simulation model designed to analyse development strategies and their impact on economic growth.

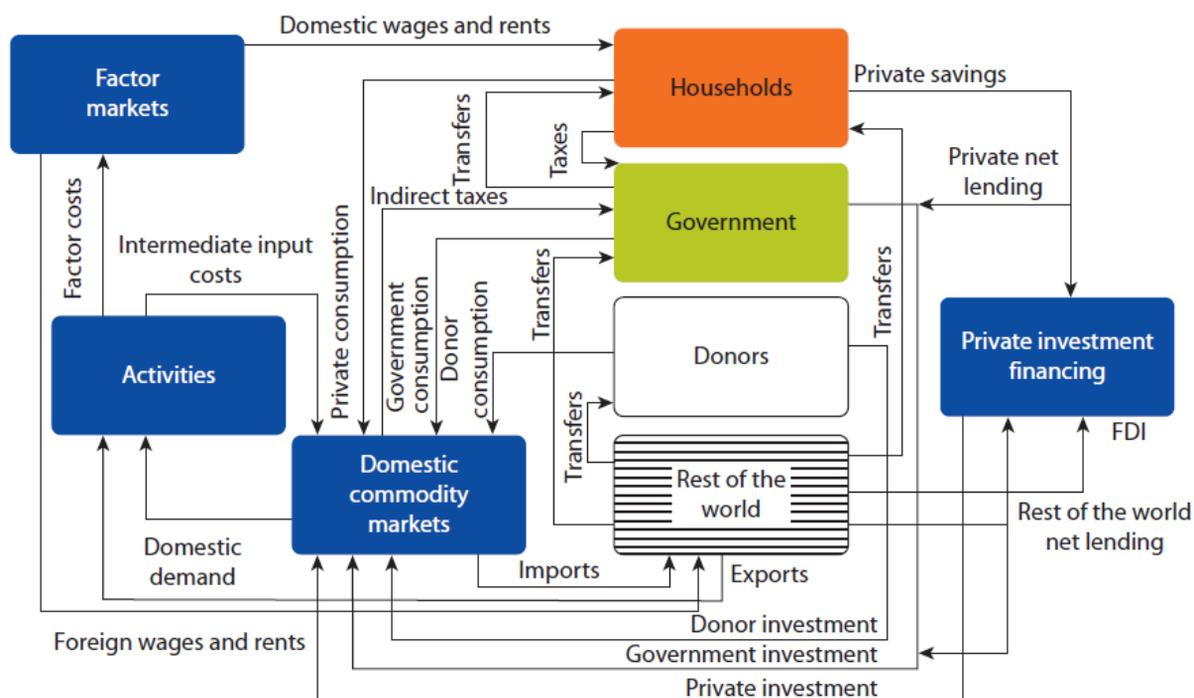
The model provides a simplified representation of the Afghanistan economy. The model includes government, donors, and the private sector. It is a general equilibrium model, capturing how shocks flow through the economy as relative prices change.

The Afghanistan MAMS model parameters are defined using country data. Country data is used to replicate the structure of the economy and certain behavioral parameters, such as elasticities for substitutability in production.

The model has been developed using a fiscal framework that is consistent with World Bank and IMF projections. Fiscal expenditures are driven by projected costs while revenue assumptions reflect current revenue policy settings and planned policy reforms.

Minor transactions included in the model are not depicted in the graphic below, including: pension payments from households to government; debt service on domestic debt from government to households; and debt service on external debt from government to the rest of world. More information regarding the MAMS model can be found here: <http://go.worldbank.org/XSQT186EN0>

AGGREGATE PAYMENT FLOWS IN MAMS



MODELED SCENARIOS

Baseline

Current policy settings. \$4 bn of civilian aid per year through 2020, and then declining to low-income country average (10 percent GDP).

- No structural change due to limited public investment.
- Insecurity continues to limit FDI and domestic investment.
- Slow mining development - only Amu Darya.
- TAPI and CASA-1000 proceed.

Agriculture+

Agriculture growth driven by irrigation investment and extension services. Assumptions informed by agriculture sector studies.

- Wheat productivity increases by around 50 percent by 2030.
- Livestock productivity doubles by 2030.
- Land under irrigation increases by 50,000 hectares per annum.

Mining+

Mining development proceeds with required public investments and efforts to attract private investment.

- Development of Amu Darya as per baseline.
- Additional hydrocarbon development (Afghan-Tajik oil basin).
- Additional mining investments (Aynak copper, Hajigak iron ore, medium-scale coal, marble, chromite, gold, lithium).

Growth+

Program of growth-enhancing measures implemented through policy reforms and public investments.

- Agriculture and mining scenarios realized.
- Human capital investment increases to 50 percent of civilian expenditures, boosting labour productivity and reducing fertility rates.
- Managed labour mobility scheme introduced.
- Targeted social transfer system introduced.

