

# **AFGHANISTAN**

## **SYSTEMATIC COUNTRY DIAGNOSTIC**

February 1, 2016



**WORLD BANK GROUP**

## **CURRENCY EQUIVALENTS**

Exchange Rate Effective January 6, 2016

Currency Unit – Afghan Afghani (AFS)

US\$1.00 = AFS 68.4855

**Fiscal Year:** December 21 – December 20

## **ABBREVIATIONS AND ACRONYMS**

|         |  |
|---------|--|
| ACD     | Afghanistan Customs Department                         |
| AISA    | Afghanistan Investment Support Agency                  |
| AML/CFT | Anti-Money Laundering / Counter Financing of Terrorism |
| ANSF    | Afghanistan National Security Forces                   |
| ARAZI   | Afghan Land Authority                                  |
| ARTF    | Afghanistan Reconstruction Trust Fund                  |
| ASYCUDA | Automated System for Customs Data                      |
| CGE     | Computable General Equilibrium                         |
| CSO     | Central Statistics Organization                        |
| DAB     | Da Afghanistan Bank                                    |
| EITI    | Extractive Industries Transparency Initiative          |
| GDP     | Gross Domestic Product                                 |
| ICT     | Information and Communication Technologies             |
| IDA     | International Development Association                  |
| IDPs    | Internally Displaced People                            |
| IFC     | International Finance Corporation                      |
| IMF     | International Monetary Fund                            |
| MAIL    | Ministry of Agriculture, Irrigation, and Livestock     |
| MoCI    | Ministry of Commerce and Industry                      |
| MoF     | Ministry of Finance                                    |
| MTEF    | Medium Term Expenditure Framework                      |
| NRVA    | National Risk and Vulnerability Assessment             |
| NSP     | National Solidarity Program                            |
| O&M     | Operations and Maintenance                             |
| PFM     | Public Financial Management                            |
| SCD     | Systematic Country Diagnostic                          |
| TMAF    | Tokyo Mutual Accountability Framework                  |
| UNHCR   | United Nations High Commission for Refugees            |
| UNODC   | United Nations Office on Drug and Crime                |
| VAT     | Value Added Tax  |
| WB      | World Bank   |
| WDR     | World Development Report                               |

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## Executive Summary

1. **Afghanistan is a deeply fragile and conflict affected state.** It has been in almost constant conflict for over 35 years since the Soviet invasion of 1979. This has had a destabilizing effect on the social cohesion of the country, exacerbating ethnic divisions and weakening government institutions and rule of law. No meaningful, durable political settlement has been in place in Afghanistan for nearly 4 decades. In the absence of a political settlement—and buffeted by protracted conflict, severe human losses and displacement, and physical and institutional destruction over the past half-century—Afghan politics has involved short-run, intra-elite bargaining among shifting groups with control over their own armed forces, where violence and the threat of violence are an integral part of the process. Administrative positions in government, as well as privileged access to economic resources—public procurement contracts, revenue sources, land, mining contracts, and proceeds from illicit economic activities, among others—are the “spoils” over which this elite bargaining has taken place.

2. **Today the country is at a crossroads in its development with economic growth down sharply and poverty incidence stubbornly high.** Significant economic and social progress was achieved from a very low base between 2003 and 2012. Economic growth averaged 9.4 percent per year and key social and infrastructure indicators including school enrollment, life expectancy, and access to water improved markedly. However, poverty incidence nationwide remained stagnant at about 36 percent between 2007 and 2012. Furthermore, an unprecedented political, security, and economic transition since 2012 has led to a marked decline in economic performance and threatens the foundations of stability and progress in Afghanistan. Economic growth fell sharply to 1.5-2 percent in 2014 and 2015 as private sector confidence slumped and a fiscal crisis unfolded as declining revenues led to depleted cash reserves and accumulating arrears.

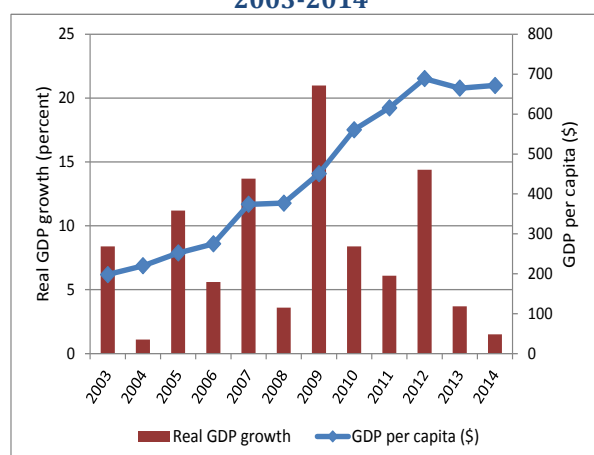
3. **Afghanistan faces tremendous development challenges.** GDP per-capita is among the lowest in the world, poverty is deep and widespread, and social indicators are still at very low levels. The authorities face an overriding need to prioritize interventions within tight budget constraints. The new government has declared its commitment to address Afghanistan’s development challenges, through its paper “Realizing Self Reliance: Commitments to Reforms and Renewed Partnership” presented at the London Conference in December 2014. The purpose of this *Systematic Country Diagnostic* (SCD) is to provide an evidence-based diagnostic within an objective framework to help in the identification of development priorities. The diagnostic is not meant to be rigid or overly prescriptive. Indeed, countries in conflict often face rapidly evolving circumstances and flexibility to adjust quickly is a necessity. The SCD is thus intended to set forth a broad and flexible framework for thinking about choices, prioritization and sequencing.

### *Who and Where are the Poor*

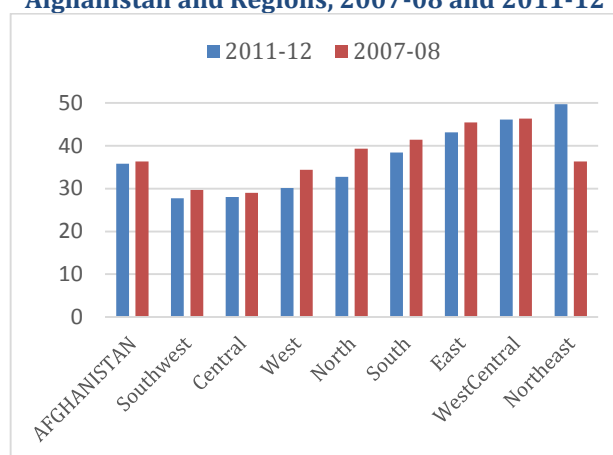
4. **A look at the trends and profile of poverty is a good place to start in identifying development priorities.** Paradoxically, despite strong growth and improved social indicators,

poverty has remained stubbornly high at about 36 percent of the population between 2007 and 2011. A number of factors are responsible for this pattern. First, regional disparities have been considerable: from 2007 to 2011, poverty increased sharply in the Northeast region and remained stuck at high levels in the East and West Central regions. This suggests that addressing regional disparities will be important in reducing poverty going forward. Second, the poor in Afghanistan tend to live in rural areas, derive their livelihood from agriculture, and are more prone to being underemployed or employed in casual and vulnerable jobs. This suggests that reducing poverty will not only require strong employment generation, but also more stable and less vulnerable types of employment, with special attention to rural areas and agriculture in particular. Third, the poor are considerably less educated, have lower access to services, and are more vulnerable to shocks. This suggests that reducing poverty will require more targeted provision of services and efforts to mitigate shocks.

**Figure 1: GDP Growth and GDP per capita  
2003-2014**



**Figure 2: Poverty Incidence  
Afghanistan and Regions, 2007-08 and 2011-12**



Source: Afghan authorities, staff estimates, and World Development Indicators

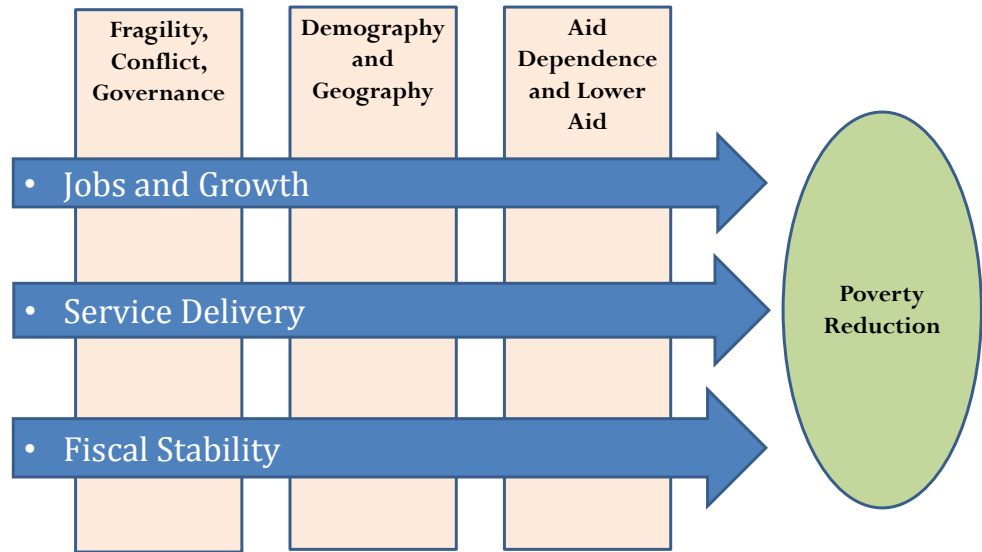
### ***The Three “Constraints”***

*This diagnostic argues that Afghanistan will need to confront three major underlying “constraints” in its efforts to reduce poverty.*

5. **The first and most important constraint is fragility and conflict.** Afghanistan’s fragility, defined both in terms of weak state institutions and dysfunctional societal relations leading at one extreme to violent conflict between groups, is all pervasive and affects almost every aspect of development. First, the government is in violent conflict with a determined and well-resourced insurgency which increasingly threatens the foundations of the state. Levels of violence are high and there are growing numbers of civilian casualties. The insurgency is bolstered both by external forces as well as internally by poor governance and lack of an inclusive political settlement. Second, government capacity is weak, with pervasive corruption and considerable influence of historically entrenched groups. The weak state and political institutions have been a breeding ground for elite capture and corruption which in turn undermines state legitimacy. Third, social and ethnic divisions

have been exacerbated by conflict and weak institutions. These aspects of fragility and conflict undermine investor confidence, restrict the range of sectors that can feasibly drive jobs and growth, impede efforts to bolster service delivery, and undermine revenue mobilization. Furthermore, corruption and weak governance undermine all aspects of reform progress in Afghanistan, which amounts to a mutually reinforcing cycle of fragility and underdevelopment.

**Figure 1: Three Constraints and Three Pathways to Reducing Poverty in Afghanistan**



6. **The second constraint is the demographic and geographic landscape.** Afghanistan faces high population growth and a youth bulge, with 400,000 entrants into the labor force each year. The proportion of the population aged 15 or below is a remarkable 51.3 percent, making Afghanistan one of the youngest countries in Asia. These demographic pressures are exacerbated by significant numbers of returning internally displaced persons (IDPs) or refugees. All this will require strong and sustained job creation and growth, without which large numbers of working age Afghans will become unemployed or underemployed, thus exacerbating poverty. In addition, significant demographic and geographic disparities exist in employment generation and access to services. The widespread exclusion of women from economic participation represents large economic costs and deserves special attention. Addressing these disparities is critical to ensuring that growth is more inclusive going forward. Finally, the rapid rate of urbanization and Afghanistan’s mountainous terrain with remote communities suggests that improving the provision of urban services and enhancing connectivity will be important going forward.

7. **The third constraint is declining aid.** Afghanistan is unique worldwide in its extraordinary dependence on foreign aid, which amounted to 45 percent of GDP in 2013 and is critical to financing growth, service delivery, and security. Furthermore, security expenditures are remarkably high (with on budget and off budget security spending about 25 percent of GDP in 2014), thus reducing fiscal space for much needed civilian operating and development spending. While aid is already down from peak levels, it is projected to be drawn down further in the medium term. This has several

implications. First, it means that new sources of growth driven increasingly by the private sector will be important for jobs and growth in the post-transition period. Second, it means that the expansion of service delivery going forward will need to pay increasing attention to targeting and effectiveness. Third, it means that fiscal stability and development progress will require significant efforts to mobilize revenues and prioritize spending going forward.

### ***Three Pathways***

*This SCD argues that the major constraint to development progress is the prevailing insurgency and civil conflict.* Without peace or at least a significant reduction in levels of violence, technical or policy based measures to reduce poverty will have marginal impact at best. The three pathways set out below are therefore necessary but insufficient without an end to the current levels of violence and insecurity.

8. **Strong and Inclusive Growth and Job Creation:** A preponderance of international experience has shown that strong growth is necessary, although often not sufficient, to reduce poverty. In Afghanistan, the need for strong growth takes on a new urgency in an environment of *fragility and uncertainty* where private sector confidence and growth have collapsed since 2013 and in an environment of *declining aid* where new sources of growth will be required in the post-transition period. Unless strong growth is restored and sustained, poverty is very likely to rise. This is particularly true in Afghanistan in light of the *demographic pressures* of high population growth and large numbers of new entrants into the labor force. At the same time, Afghanistan's experience between 2007 and 2011 shows that growth will also need to be more inclusive going forward. This means ensuring that growth is accompanied by strong and stable job creation across all *geographic regions* of Afghanistan.

9. **Expansion of Prioritized Service Delivery:** Inadequate access to social and infrastructure services can constrain prospects for job creation and growth, extend exclusion and inequality, and exacerbate *fragility*. In the case of Afghanistan, therefore, continued progress in expanding service delivery is a key instrument to improve employment and growth prospects, enhance the inclusiveness of growth, and to address Afghanistan's fragility. However, the expansion of service delivery needs to take place in an environment of *declining international assistance*, significant *regional inequality*, and *persistent insecurity*. This calls for more effective and targeted service delivery going forward. A key focus of the SCD is, therefore, on identifying opportunities for improving the targeting and effectiveness of service delivery going forward.

10. **Fiscal Stability:** Afghanistan remains highly reliant on *international assistance* for job creation, service delivery, and security. With international assistance declining gradually and domestic revenue mobilization falling short, the fiscal outlook currently threatens the foundations of Afghanistan's development progress. Significant action will be needed in the areas of revenue mobilization, securing adequate donor assistance, and expenditure prioritization to not only restore fiscal stability, but also address the medium term challenge of reducing dependence on external



assistance. Efforts to increase revenues will need to pay particular attention to the environment of *fragility and weak governance*, while efforts to prioritize expenditures will need to pay attention to *demographic and geographic disparities* across Afghanistan.

### ***Interventions and Selectivity***

**11. In the face of a growing insurgency and heightened uncertainty, development interventions alone will have limited impact, but will nevertheless need to be tailored to the circumstances.** The principal constraint facing Afghanistan's development prospects is the conflict itself and its wider ramifications on the economy and society. Development becomes more difficult as access to large swathes of territory becomes more contested. While bringing about a significant reduction of the conflict is in large part a political issue requiring a political solution, some development interventions may have greater impact on the prospects for poverty reduction than others and provide the best opportunity for progress in a fragile environment. Some interventions may also help mitigate fragility and uncertainty to some extent or at least avoid exacerbating the situation. As such, carefully selecting and tailoring development interventions to the fragile circumstances is a critical imperative for Afghanistan.

**12. The selectivity and sequencing of development interventions described in this report will need to be driven by a number of criteria.** First, interventions with the *greatest impact on the three constraints* to poverty reduction should be prioritized. In this context, interventions with an impact on multiple constraints would be particularly valuable. Second, the degree of *uncertainty and conflict* will be important in prioritizing interventions. If uncertainty, conflict, and weak reforms continue, resources will be insufficient to expand infrastructure and services. The emphasis will then need to be on preserving basic services and maintaining fiscal stability, while strengthening select institutions to restore confidence and provide a path out of crisis. Finally, within a fragile context, the *"how"* is just as important as the *"what"* of interventions. In order to increase chances of successful implementation, the design of interventions will need to overcome weak capacity, entrenched interests, considerable uncertainty, and to take into account the needs and voice of local citizens and communities.

*Within each of the three priority areas identified in this report, a number of interventions will be important based on the criteria for selectivity and sequencing.*

**13. Jobs and Growth.** Strengthening *agriculture* is a top priority, not just because it is home to most casual and vulnerable jobs associated with high levels of poverty, but also because agriculture needs to drive growth and jobs in the face of fragility and declining aid. More stable and less vulnerable jobs will need to come from improving commercial value chains, with additional interventions to support those who rely on subsistence farming. In light of Afghanistan's tremendous potential, *extractive industries* can serve as an important source of confidence and growth, as well as provide government revenue to bridge the fiscal gap in the medium term. However, good governance, transparency in resources and contracts, and community involvement are critical,

particularly in a fragile and conflict environment with weak institutions. Finally, with *private sector confidence* badly shaken, addressing cross-cutting investment bottlenecks can provide a strong signal and help bolster confidence. This includes addressing the weak financial sector, poorly functioning land markets, and fragmented licensing and registration regimes.<sup>1</sup>

14. Expanding service delivery. The challenge for Afghanistan is to continue to expand services within tight budget constraints by improving targeting to those most in need, including women and lagging regions. Overall, governance, systems and client feedback for services, including clarifying subnational delivery and accountability arrangements, will be as important as the services themselves. In *education*, the interventions will need to further expand access while enhancing equity, quality, and relevance. In *health*, lagging programs (including family planning, nutrition, and immunization) will need to be prioritized and government stewardship will need to be strengthened. Special attention is needed to enhance access to services and employment *opportunities for women*. Weak coordination and targeting of *social protection programs* need to be addressed. *Infrastructure investments* need to be prioritized through targeted rural and urban development programs, adequate resources for maintenance and rehabilitation, pursuing sector-specific measures to enhance efficiency, and leveraging regional integration. The potential to expand private sector participation in service delivery and infrastructure development, including through public-private partnerships where appropriate, should also be explored. Improving

15. Fiscal stability. *Improving revenues* is central to restoring fiscal stability and in large part involves fighting corruption and addressing chronic weaknesses in governance. Implementation of technical solutions needs to be proactively backed by a broad spectrum of relevant actors in the context of Afghanistan's weak institutions and fragmented political order. Even under optimistic assumptions of revenue mobilization, Afghanistan will continue to need *substantial donor grant aid* for the next decade. A predictable flow of civilian and security donor assistance, with an increasing share on budget to enhance effectiveness and impact, will thus be important. Under a deteriorating scenario of uncertainty and conflict, it may be necessary to mobilize urgent donor aid, which would contribute to the global public good of stabilizing Afghanistan. *Prioritizing expenditures* will require developing a realistic and flexible multi-year, medium term expenditure framework (MTEF) to continually update and revise expenditure priorities within a given budget envelope. Expenditure prioritization efforts will also need to pay particular attention to current and potential demographic and geographic disparities in expenditures.

#### *Scenarios of uncertainty and conflict*

16. **Political factors outside the realm of development policies are a primary driver of the degree of uncertainty and conflict in Afghanistan going forward.** A key unknown is the extent to which current efforts to start negotiations with the Taliban insurgency will bear fruit. The government has taken bold actions to initiate dialogue and negotiations, including engagement with neighboring countries. In the longer term, there is widespread understanding that peace would yield

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<sup>1</sup> Lack of reliable infrastructure and low levels of human capital and skills (discussed in the next section on service delivery) are also serious impediments to private sector led job creation and growth.

enormous economic and social benefits for Afghanistan and the wider region. However, the path toward peace is unclear. One of the risks is political fallout within Afghanistan between its various factions or with regional and international partners, depending on what trade-offs become necessary to reach an agreement. Another key unknown is the extent to which expectations about the ambitious political reform agenda can be met and the nature of any resulting fallout.

17. **While the full array of interventions are important for sustained poverty reduction in Afghanistan, the best hope under a deteriorating scenario of uncertainty and conflict may be to preserve the gains and mitigate increases in poverty.** The degree of uncertainty and conflict will thus be a critical consideration in prioritizing interventions. If uncertainty, conflict, and weak reforms continue, Afghanistan will face an uphill battle in reducing poverty. Economic activity will likely stagnate, poverty and social cohesion will suffer, and resources will be insufficient to expand infrastructure and services. Under such a *deteriorating scenario*, the emphasis will need to be on preserving basic services and maintaining fiscal stability, while strengthening select institutions to restore confidence and provide a path out of crisis. On the other hand, reduced uncertainty and conflict can usher in a scenario of improving prospects. Under such a *stabilizing scenario*, improved confidence and increased resources to expand infrastructure and social services can accelerate job creation and poverty reduction. This would provide space for broader institution building and further enhancing the inclusiveness of growth. The table below provides further detail on how interventions can be prioritized under alternative scenarios of uncertainty and conflict.

**Table 1: Selectivity of Interventions under Alternative Scenarios**

| Priority Areas            | Deteriorating Scenario  | Stabilizing Scenario  |
|---------------------------|---|---|
| Growth and Jobs           | Focus on core agriculture and other more resilient sectors; shore up confidence of financial sector; continue to rely on public sector for jobs.  | Diversify to higher value added agriculture; pursue good governance and investments to leverage extractive industries; reinforce private sector confidence.   |
| Service Delivery          | Preserve basic services; pursue labor-intensive infrastructure investments, including through community platform; explore direct household transfers; target interventions to contain insurgency and most vulnerable. | Further expand infrastructure and social services, with targeting to lagging regions and excluded groups to enhance poverty impact; enhance quality and relevance in education; explore private participation in infrastructure and service delivery. |
| Fiscal Stability          | Pursue confidence building measures to support governance and revenues; mobilize urgent donor aid; prioritize expenditures to finance essential services, social assistance, and investment.                          | Improve tax revenues and strengthen customs; mobilize predictable flow of grant aid; put in place a systematic MTEF to manage security expenditure obligations, finance adequate O&M, and consolidate social protection programs.                     |
| <b>Strategic Priority</b> | Preserve gains; mitigate increases in poverty   | Reduce poverty gradually over time  |

18. **Some development interventions can help mitigate uncertainty and fragility.** While some fragility drivers are outside the development realm, many of the specific development interventions discussed in this report are intended to either mitigate uncertainty or provide the best opportunity for progress in a fragile environment. Strengthening agriculture is particularly important because of its relative resilience to conflict, while improving the functioning of land markets can help bolster both private sector confidence and state legitimacy in an environment of fragility. Providing safe passage for girls and women to education and health facilities is particularly important in a conflict environment, while leverage regional integration for energy and water needs can help mitigate regional drivers of conflict. Revenue mobilization efforts need to focus on those technical solutions which have the greatest impact on mitigating endemic corruption and weak governance, while expenditure prioritization efforts will need to pay attention to geographic disparities in aid flows related to security considerations.

19. **Poverty and development outcomes will depend very much on the degree of uncertainty and conflict, and development interventions under a deteriorating scenario will be insufficient to reduce poverty.** Under a deteriorating scenario, encouraging broad-based private investment will be difficult, so that job creation will need to continue to rely on agriculture and the public sector. Safeguarding the integrity of the banking sector will be important to avoid a downward spiral of investor confidence. In the area of service delivery, increasingly tight resources will limit new investments in infrastructure and require a focus on a core set of basic services and labor-intensive investments to support jobs. Opportunities for social safety net interventions will increasingly need to be explored to cushion the impact on the poor. Such a protracted low case scenario will also require a slower drawdown of aid and be associated with lower development outcomes. On the other hand, if levels of insurgency and uncertainty begin to abate and if the new government's strong reform vision can be translated into concrete actions, Afghanistan could well launch itself on a challenging but more optimistic decade of transformation with a gradual reduction of high levels of poverty.

*Focusing on the “how” in addition to the “what”*

**Within a fragile context, the “how” is just as important as the “what” of development interventions.** Making progress on the interventions identified in the three priority areas is often an uphill task in Afghanistan's increasingly fragile and conflict environment. In this context, careful thought needs to be put into the design of the interventions to overcome weak capacity, entrenched interests, and considerable uncertainty, and to take into account the needs and voice of local citizens and communities. These aspects of design should help improve the odds of successful implementation and lead to a stronger possibility of interventions becoming sustainable in the face of fragility. In addition, it will be important for Afghanistan to pursue a number of complementary initiatives to gradually address the fundamental sources of fragility. These include initiatives to strengthen the legitimacy and accountability of public institutions, reduce corruption, and improve capacity of the public administration.

**The design of development interventions will need to carefully overcome weak capacity and entrenched interests and take into account the needs of local communities.** Agriculture

infrastructure or rural roads need to be provided in a way that does not further entrench existing elite landowners but rather, provides hope and opportunity to ordinary Afghan citizens. Efforts to develop extractive industries need to first improve transparency and accountability, with careful selection of partners and beneficiaries to avoid elite capture of resources. Extractives should also be integrated with wider development efforts, so that services provided to mining operations (power, water, and roads) are coordinated with the needs of local communities. Improving banking sector confidence needs to recover Kabul Bank assets and hold perpetrators accountable to demonstrate stronger accountability.

**Initiatives to strengthen the legitimacy, accountability, and capacity of the public sector will be important.** Despite noticeable improvements in some areas such as public financial management, progress in other areas such as rule of law and public administration reforms has lagged. The capacity of core civil service is inadequate and reliance on parallel civil service is high. Corruption is rife, with a culture of impunity for entrenched elites. At the sub-national level, overlapping institutional mandates and unclear roles of provincial officials leads to a complex governance environment with multiple stakeholders and informal relationships. A number of initiatives can help in these areas. Developing a sustainable core civil service and reducing reliance on parallel capacity will require phasing out ad-hoc pay mechanisms, ensuring compliance with harmonized consultant pay scales, prioritizing establishment of critical civil service cadres, and strengthening the appointment processes. Anticorruption efforts can include further strengthening internal and external audit and procurement, as well as developing an anticorruption strategy with independently monitored targets and milestones. Finally, the subnational governance framework can be clarified by resolving ambiguity in the sub-national policy regarding dual responsibility of line ministries and provincial governors over provincial line departments.

**Trade-offs between short run stability gains and longer run development opportunities can influence the selection of interventions.** Activities to promote short-run stability, however well-intentioned, can often be at the expense of worsened longer-term development opportunities. Conversely, some actions which have the potential to mitigate fragility over the medium- to longer-term could be disruptive and possibly even de-stabilizing in the short run. These tensions result in dilemmas for policymakers and international partners, which must be factored into decisions on policies, programs, and investments.

**One major time-horizon tension relates to anti-corruption efforts.** Firing incompetent or corrupt officials and striving for merit-based senior appointments can clash with political bargaining and the political culture of dividing the “spoils”. Moving towards greater transparency and accountability is necessary in the long run to gain greater legitimacy for Afghanistan’s institutions, but may increase tensions in the short run. Similarly, efforts to move service delivery towards the province level needs to be considered carefully in light of transparency at this level as well as provincial capacity to deliver. There is no easy answer and each activity will need to be carefully thought through both in terms of time horizons and real and perceived benefits.

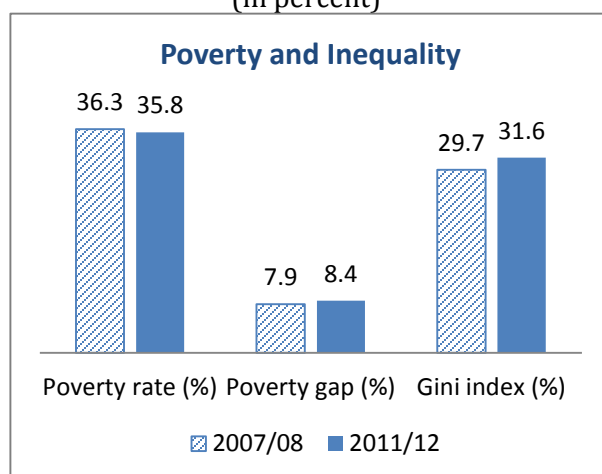
## Chapter 1. Who and Where are the Poor?

1. **Afghanistan has made limited progress in reducing poverty nationwide because of a number of factors.** Despite strong growth and improved social indicators between 2007 and 2011, poverty incidence remained stagnant nationwide at about 36 percent of the population. Poverty increased sharply in the Northeast region and remained stuck at high levels in the lagging East and West Central Regions, but declined significantly in other parts of Afghanistan, including the North and West. Lagging regions appear to have fallen behind because of remoteness, climatic shocks, lower aid, and fragility. The poor in Afghanistan also tend to live in rural areas, derive their livelihood from agriculture, are more prone to being underemployed, and have lower access to services.

### Poverty levels and trends

2. **About 36 percent of the population is poor and this percentage has not declined nationwide between 2007/08 and 2011/12.** According to the national poverty headcount - the share of the population with consumption below the poverty line - 36 percent of all Afghans remained impoverished in 2012. Likewise, the national poverty gap has remained at about 8 percent.<sup>2</sup> About 9 million Afghans in 2012 had consumption levels below the minimum expenditure deemed necessary to satisfy basic food and non-food needs. This is about 600,000 more Afghans living in poverty in 2012 than in 2008. Consequently, Afghanistan's poverty deficit - which is defined as the amount of resources it would take, if perfectly targeted, to lift all families out of poverty - increased from \$575 million (28.6 billion Afs) in 2008 to \$993 million (47.4 billion Afs) in 2012.

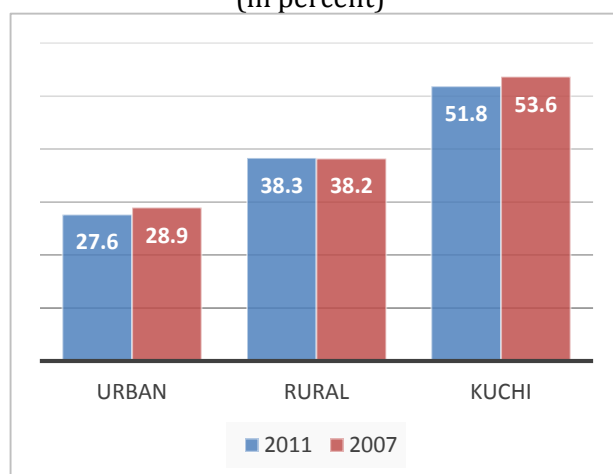
**Figure 1.1: Poverty and Inequality**  
(in percent)



Notes: Rural category includes Kuchi

Source: Staff calculations using NRVA 2007-08 and 2011-12

**Figure 1.2: Poverty Incidence by area**  
(in percent)

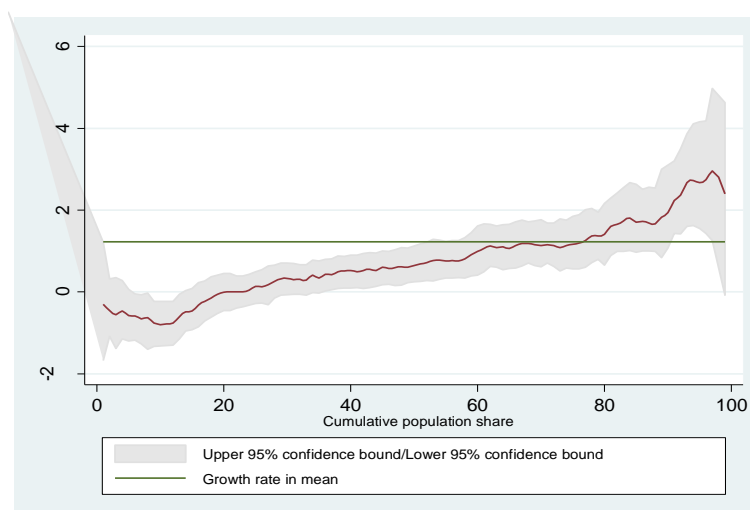


3. **Poverty remained higher in rural areas and the highest among the Kuchi nomadic population.** The poverty rate in rural areas was 38.3 percent in 2011-12, about 10 percentage points

<sup>2</sup> The poverty gap index is the average percent shortfall in income for the poor from the poverty line.

higher than in urban areas. The nomadic Kuchi population is the most vulnerable to the risk of poverty: in 2011-12, the poverty headcount of the Kuchi was 51.8 percent. With rural areas (including the Kuchi population) accounting for a majority of the population (76 percent), a majority of the poor (82 percent in 2011-12) are also found in rural areas. The urban-rural poverty gap has remained stable over time, although migration towards urban areas has led to an increase in the number of poor living in urban areas (by about 240,000 individuals from 2007-08 to 2011-12). Consequently, the trend in stagnant poverty nationwide is not due to a widening rural urban divide. In fact, per capita consumption in rural areas is actually increasing faster than in urban areas - by 1 percent annually compared to only 0.3 percent annually, respectively.

**Figure 1.3: Growth Incidence Curve**



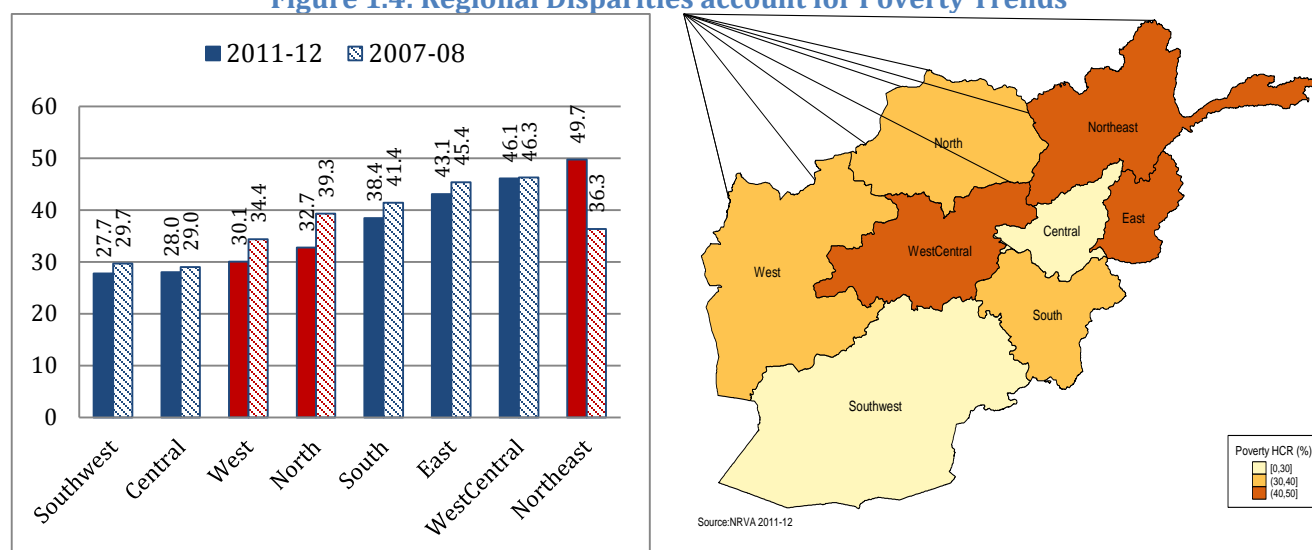
4. **Growth has not been equally distributed and inequality has increased.** The growth in per capita consumption for those at the top of the distribution was substantially higher than for those at the bottom (figure 1.3). In fact, the growth in per capita consumption of the poor was actually negative (-0.17 percent), meaning the poor have been falling further behind the non-poor as the economy grows. Likewise, while the poorest 20 percent of the population saw a 2 percent decline in real per capita consumption and the bottom 40 percent experienced flat per capita consumption, the richest 20 percent experienced a 9 percent increase. Consequently, the Gini index<sup>3</sup> increased from 29.7 in 2008 to 31.6 in 2012, providing further demonstration of widening inequality during this period. A simple simulation shows that had the country's economic growth been distributed evenly across the population, poverty would have declined by 4.4 percentage points.

<sup>3</sup> The Gini index measures the degree of inequality in the consumption expenditure of families, with zero meaning every family consumes the same amount and a rate of 100 meaning one family consumes everything.

## Geography and Lagging Regions

5. **A key factor responsible for stagnant poverty nationwide is regional disparity, with the highest poverty in the lagging Northeast, West Central, and East regions.** According to the 2011-12 NRVA, poverty ranged from 27.7 percent in the Southwest to 49.7 percent in the Northeast. The variation in poverty across administrative provinces was even more striking, ranging from as low as 3.6 percent in Farah province to as high as 65.4 percent in Takhar province. Generally, poverty rates were the highest and the levels of wellbeing the lowest in the Northeast, West-Central, and Eastern regions in 2011-12, while lower levels of poverty were found in the Southwest, Central, West, and North, with an intermediate level of poverty in the South.<sup>4</sup>

**Figure 1.4: Regional Disparities account for Poverty Trends**



Source: Staff calculations using NRVA 2007-08 and 2011-12

6. **Poverty declined or remained flat across all regions of Afghanistan except the Northeast where it increased sharply between 2007 and 2011.** The Northeast region is a clear standout in terms of the poverty trend during this period. Poverty either remained flat or declined in all other regions (e.g. declining by 6.5 percentage points in the North and by 4.3 percentage points in the West). In contrast, poverty increased sharply by 13.4 percentage points in the Northeast. The extraordinary increase in poverty in the Northeast played a large part in accounting for stagnant poverty countrywide between 2007 and 2011. Had the Northeast's exhibited patterns of consumption growth and poverty as in the rest of the country, nationwide poverty incidence would have fallen by 3 percentage points.

<sup>4</sup> Classification of provinces by regions is as follows: **Southwest:** Nimroz, (Helmand), Kandahar, Zabul, Urozgan; **Central:** Kabul, Kapisa, Parwan, Wardak, Logar, Panjsher; **West:** Badghis, Herat, Farah; **North:** Samangan, Balkh, Jawzjan, Sar-e-Pul, Faryab; **South:** Ghazni, Paktika, Paktya, (Khost); **East:** Nangarhar, Kunarha, Laghman, Nooristan; **West-central:** Ghor, Bamyan, Daykundi; **Northeast:** Badakhshan, Takhar, Baghlan, Kunduz. Provinces of Helmand in the SouthWest and Khost (South) have been excluded from the analysis due to lack of poverty data.



7. **A number of factors explain why poverty increased in the Northeast and remained persistently high in the other lagging regions.** First, the Northeast and other lagging regions made less progress in reducing the share of underemployment and vulnerable employment (day labor, self-employed, and unpaid family workers) which are associated with higher incidence of poverty. Second, the lagging regions experienced a higher incidence of shocks during this period, which is likely to have itself impacted the lack of progress in reducing vulnerable employment. This suggests that reducing poverty will not only require strong employment generation, but also more stable and less vulnerable types of employment, with special attention to rural areas and agriculture in particular. Third, exploring the poverty profile also helps shed light on the reasons behind persistently high poverty in Afghanistan and in the lagging regions in particular. The poor are considerably less educated, have lower access to services, and are more vulnerable to shocks. This suggests that reducing poverty will require more targeted provision of services and efforts to mitigate shocks.

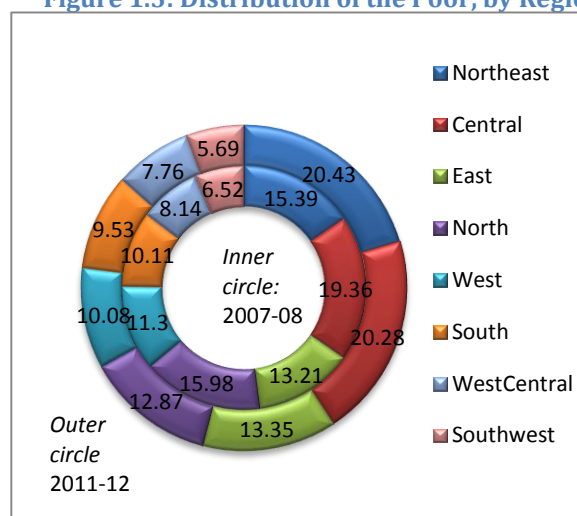
### Poverty Profile: Who are the Poor?

8. **The poor in Afghanistan are part of younger and larger households, derive livelihood from agriculture, and are more prone to being underemployed.** The poor are younger on average and live in larger households. Specifically, the poor are 21 percent more likely than the nonpoor to live in a household with 8 or more members, while 48 percent of the poor are aged 12 and younger, compared to 41 percent of the non-poor. About 83 percent of the poor live in rural areas, compared to 73 percent of the non-poor, and 63 percent work in agriculture (and other primary sectors), compared to 55 percent of the non-poor. Furthermore, the poor are more likely to be engaged in casual and informal types of employment compared to the nonpoor.

**Table 2: Poverty Profile:  
Characteristics of Poor and Nonpoor  
Populations (in percent)**

|                             | Nonpoor | Poor |
|-----------------------------|---------|------|
| Age 12 or Younger           | 41      | 48   |
| Household Size 8 or more    | 56      | 68   |
| Rural population            | 73      | 82   |
| Unemployment Rate           | 7       | 9    |
| Underemployment Rate        | 38      | 41   |
| Primary Sector (% Ttl Empl) | 36      | 43   |
| Literacy (age 15+)          | 37      | 24   |
| Secondary Enrollment        | 39      | 30   |
| Electricity Access (% pop)  | 75      | 64   |
| Drinking Water (% pop)      | 50      | 40   |
| Natural Disaster Shocks (%) | 34      | 41   |

**Figure 1.5: Distribution of the Poor, by Region**

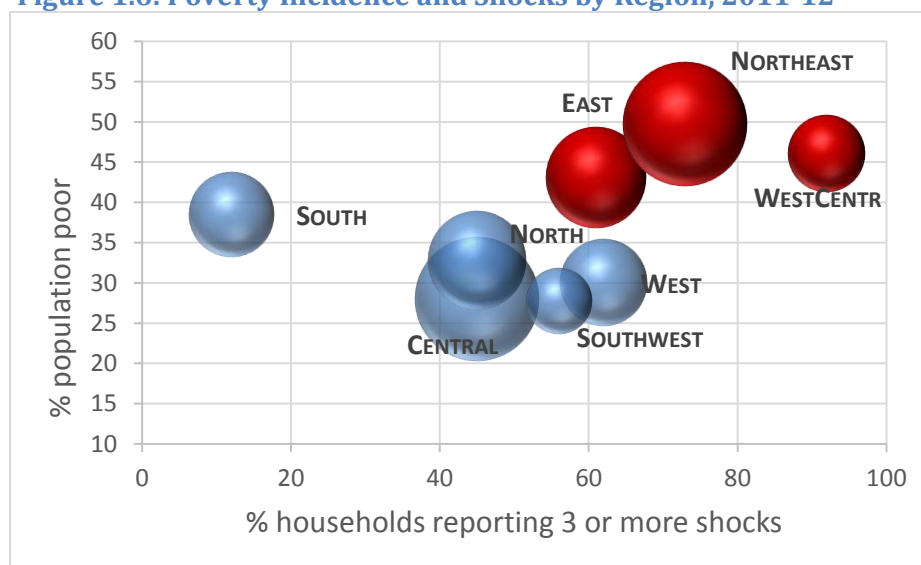


Source: Authors' calculation using NRVA 2007-08 and 2011-12

9. **The poor are considerably less educated, have lower access to services, and are more vulnerable to shocks.** The poor are considerably less educated than the non-poor in Afghanistan. The poor are 20% more likely to be illiterate and 15% less likely to have completed primary education past the age of 15. The poor also have less access to infrastructure services than the non-poor. About 64% of the poor have access to electricity, versus 75% of the non-poor, and 40% of the poor have access to safe drinking water, versus 50% of the non-poor. The poor are significantly more likely to have experienced some negative shocks. 52% of the poor have experienced water shortage shocks versus 46% of the non-poor, 41 percent have suffered with natural disasters, versus 34% of the non-poor, and 16% of them have been affected by an epidemic versus 10% of the non-poor.

10. **The poor also disproportionately live in the Northeast Region.** As shown in figure 1.5, two fifths of the poor reside in two regions of the country—Northeast (20 percent) and Central (20 percent). The large contribution of the Central region to the poor population is a direct consequence of its large share of the total population (26 percent), since its poverty rate is lower than the national average. But in the case of the Northeast region, its large contribution is mainly caused by the high poverty rates observed there (50 percent), since it only contributes to 15 percent of the total population. After the Northeast and the Central regions, the East and the North each account for 13 percent of the poor, and the remaining regions account for one third of the poor.

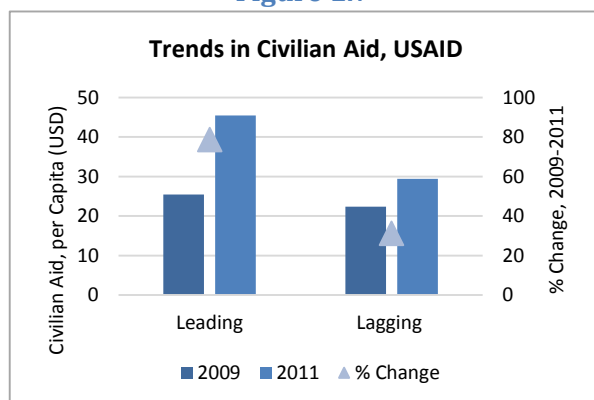
**Figure 1.6: Poverty Incidence and Shocks by Region, 2011-12**



11. **The spatial concentration of poverty appears to be related to disparities in topography, climatic shocks, aid, and other dimensions of fragility.** The evidence indicates that the Northeast, East, and West Central Regions, where poverty incidence is higher, are more remote measured by their geographic elevation and rugged topography which make it difficult to reach markets and provide social services. These areas also more frequently experienced climatic shocks such as flooding and frost, with the incidence of such shocks also rising between 2007 and 2011 (figure 1.6). Finally, these areas exhibit a much lower presence of foreign and national troops as well as lower flows of aid which suggest lower integration with the large part of the Afghan economy that

relies heavily on aid. Another important dimension of fragility, opium cultivation, also likely affects poverty incidence through several channels. While opium provides income to households involved in this activity, a strong opium sector also reinforces corruption and fuels the insurgency.

**Figure 1.7**



**Figure 1.8**



12. **Reducing poverty and improving shared prosperity in Afghanistan will require improved spatial inclusion, enhanced focus on agriculture, more targeted provision of services, and mitigation of shocks.** We have learned that increasing inequality across regions is a significant inhibitor of poverty reduction despite strong economic growth. The poverty profile has also pointed us to important factors such as agriculture, targeted provision of services, and mitigation of shocks that can contribute to more effective poverty reduction efforts. The analysis in this SCD explores in greater detail some of the explanations for certain regions lagging behind others. What role has foreign aid played in poverty trends and regional disparities? How do geographic, topographic or structural differences between regions contribute to regional disparities? How does the isolation or connectedness of certain regions contribute to poverty reduction? Answering these questions will also involve a look at the patterns and drivers of growth and service delivery across Afghanistan.

## Chapter 2. Three Critical Constraints

1. **This chapter provides an analysis of three critical constraints to poverty reduction in Afghanistan: fragility and conflict; demography and geography; and declining aid.** Of the three constraints, fragility and conflict is the most important. Afghanistan has been in conflict now for over 30 years with increasingly high levels of violence and large numbers of civilian casualties. Conflict is increasingly eroding the fabric of society and undermining social cohesion. Government capacity is weak, with pervasive corruption and considerable influence of historically entrenched groups. At the same time Afghanistan faces high population growth, with 400,000 entrants into the labor force each year and low female labor force participation, and considerable variation across regions in topography, climatic shocks, security, and services. Finally, Afghanistan is extraordinarily dependent on foreign aid for the financing of jobs, services, and security, while aid is declining significantly over time. A thorough understanding of these three constraints is critical in identifying and diagnosing Afghanistan's development options.

### Fragility, Violent Conflict, and Weak Governance

2. **Violent conflict is an extreme form of fragility. Afghanistan has been caught up in violent conflict over many decades. The WDR 2011 on Conflict, Security, and Development provides a framework for understanding and addressing development challenges in countries facing multiple stresses and conflict.** It indicates that countries endowed with weak institutions tend to experience repeated cycles of violence (see Figure 2.1). Such countries are predisposed to becoming stuck in conflict traps, where any respite from civil war and other forms of organized violent conflict may be only temporary.<sup>5</sup> Breaking out of repeated cycles of violence and moving to a path of stability and sustained development is far from easy. Conventional policy solutions and reforms often do not work, and building legitimacy and institutions can take a very long time—measured in decades and longer. In the short run, it is critical to begin to develop trust among the population. Achieving early results is crucial, such as through restoring basic services or through public-works employment programs or other initiatives that deliver visible results quickly to the population. In the medium to longer-term, strengthening and gaining citizen trust in institutions providing security, justice, and jobs should be prioritized, to move on a sustained path away from repeated cycles of violence.

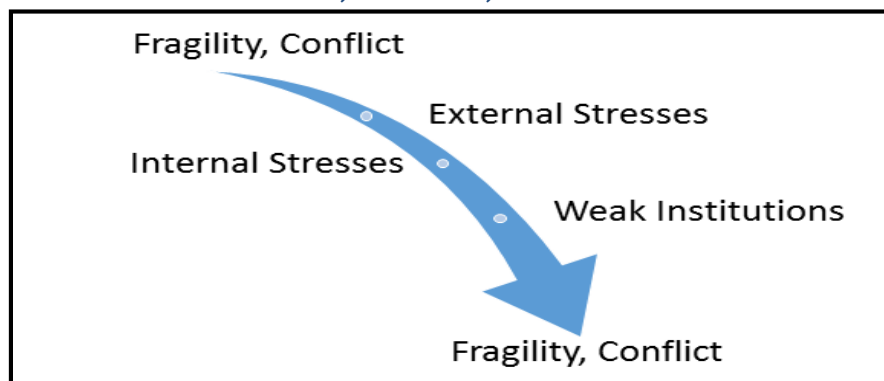
3. **Afghanistan has been unable to break out of the cycle of violence.** In late 2001 and for several years thereafter, Afghanistan was widely seen as a post-conflict country following the surprisingly quick defeat of the Taliban regime by the US and international military intervention. During this early period, the heavy dependence on the former Mujahedeen to oust the Taliban led to a compromised political settlement that entrenched the old power elite. Within 4-5 years, the Taliban rebounded, aided by their ability to seek sanctuary in neighboring countries and by predation and

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<sup>5</sup> Once a country has been in a civil war, the probability that it will revert to violent conflict becomes significantly higher than for countries that have not experienced such conflict within the past decade / generation.

poor governance on the part of the Government. From 2005, a growing insurgency established itself, initially in the south but expanding geographically over time. Military actions often led to short term “stabilization” approaches rather than sustainable long term development interventions.

**Figure 2.1: WEAK INSTITUTIONS, STRESSES, AND REPEATED CYCLES OF VIOLENCE**



4. **In order to break the cycle of violence, it is important to identify, understand and attempt to address the particular sources of fragility in Afghanistan.** Drivers of fragility in Afghanistan fall into three broad groups. First, weak state and political institutions, with unclear authorities and dependent on external assistance, leads to decisions often being driven more by intra-elite bargaining processes than by an effective use of resources and accountability to the local population. This is exacerbated by privileged access by the elite to economic resources—public procurement contracts, revenue sources, land, mining contracts, and proceeds from illicit economic activities. Second, the persistent Taliban insurgency is bolstered both by external forces as well as internally by poor governance. The interconnection between the insurgency and the illicit economy and criminal activities also makes it difficult to bring reconciliation. Third, ethnic divisions have been exacerbated during the past several decades of conflict, including most recently ethnic mobilization during the election process. Mitigation is often sought through distribution of government positions and access to resources through ethnic networks but this again exacerbates governance issues.

**TABLE 2.1: AFGHANISTAN FRAGILITY DRIVERS, POSSIBLE SOURCES OF STABILITY / RESILIENCE**

|   | <b>Drivers of fragility</b>   | <b>Possible anchors of stability</b>   |
|---|---|--|
| <b>Weak State, Political Institutions, and Governance</b> | Incipient political institutions; Intra-elite bargaining; Weak state; competition over fewer resources (land); Patronage and corruption; poor local governance and second civil service   | Government capacity exists and can be strengthened and roles clarified; Patronage, corruption may resolve elite and ethnic tensions in short run, but objective regulatory improvements are needed for longer term stability; less aid and more internally generated resources may help move away from rentier state, reduce corruption over time. |
| <b>Conflict, Insecurity, and External</b>                 | Taliban, local conflicts, and external support; Geopolitical involvement by outside countries and proxy conflicts; Landlocked, mountainous terrain with illicit regional activities; High ANSF cost and casualties and ethnic tilt; | Neighbors accept need for Afghan stability, Taliban dialogue, and territorial integrity; ANSF effective militarily and can protect core areas in short run; international security support and funding committed for 3   |

|                               |   |  |
|-------------------------------|---|--|
|                               | uncertain role of international forces in the medium term   | years; Regional geopolitical progress would yield multiple benefits. No significant separatist movements.  |
| <b>Social and Demographic</b> | Ethnic fragmentation worsened by conflict; Gender issues, risk of backlash; Refugees return may increase tensions; High population and labor force growth; Rapid urbanization | Local “bonding” social capital; War-weariness; Entrepreneurial, mobile population; Generational change; More national identity, global connectivity; higher social indicators, narrower gender gap |

5. **Afghanistan can pursue a number of initiatives to gradually address these fundamental sources of fragility.** The different sources of fragility are not isolated from one another but rather mutually reinforcing, which make them particularly difficult to address. Still a number of initiatives can help. First, it will be important to make progress on an inclusive platform for negotiations that engages all key stakeholders, including the Taliban. Second, it will be important to support reforms that strengthen the capacity and institutions of government and reduce opportunities for corruption, with feedback from local citizens, though this may be resisted by some vested interests. Third, it will be necessary to give all ethnic and demographic groups a stronger sense of ownership and belonging to the national effort. In pursuing each, it will be important to ensure realism, prioritization (“picking one’s battles”), and patience, with staying power in implementation over time more critical than “quick fixes” that may meet heavy resistance on ethnic or cultural grounds (even though such actions may have a role at the beginning to send a strong signal about the seriousness of the government’s intent).

6. **The Government is moving forward on the peace process with the Taliban but progress is slow.** The current conflict with the Taliban, in addition to being an outcome of the breakdown of fragility into violent conflict, is a major driver of continuing fragility in Afghanistan and the main obstacle to growth and poverty reduction. While not strong enough militarily to win major victories on the battlefield, nor to hold district centers for any significant periods of time, the Taliban have taken some territory in more remote areas. Indeed, Taliban influence is growing in many parts of the country in ways that observers consider to be unsustainable, with estimated ANSF casualties close to 400 deaths per month. There is therefore widespread recognition of the importance of reconciliation, although the terms of any reconciliation could also fuel tensions itself.

7. **Strengthening and improving the legitimacy/accountability of institutions is central.** Since 2001, there have been noticeable improvements in some areas, particularly in the management of public finances. Yet, in other areas, such as rule of law and the establishment of a more functional public administration service, progress has been far slower. Reliance on externally contracted civil service capacity remains substantial and core government functions are vulnerable to fluctuations in donor funding. Overall, there is still a widespread culture of impunity for the elite and corruption is rife (Transparency rates Afghanistan as second from bottom out of 174 countries). At the sub-national level the overall structure of government is characterized by significant systemic contradictions. Historically, direct formal functional and budget authority for the delivery of most key services in the provinces is held by highly centralized line ministries which work largely on their own with little local coordination between them. Cutting across this system is the system of

provincial governors, who have little formal responsibility for service delivery but wield enormous local authority and power. For many Afghans, citizens lack information and feedback venues, the state is remote, petty corruption is endemic and most Afghans perceive they have to pay bribes in order to obtain public services.

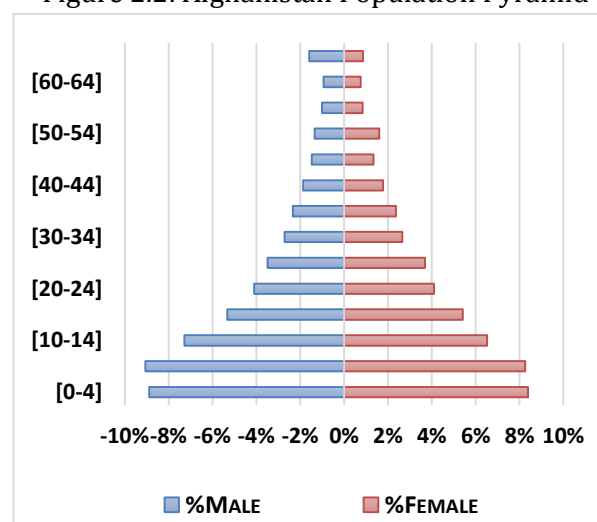
8. **A focus on increasing transparency and accountability in the private sector will also be important to restoring growth.** Private sector confidence has slumped due to the uncertainty associated with fragility and lack of security. Since firms make investment decisions based on risk-return considerations, measures to encourage private investment need to reduce perceived risk or increase anticipated returns. An improvement in confidence will depend on both reduced political and security uncertainty, as well as addressing key private sector constraints. The weak financial sector, poor investment climate, and insecure land tenure and registration are a serious drag on investor sentiment in Afghanistan. Inadequate infrastructure and low levels of human capital and skills are also impediments to growth of the private sector. According to the 2014 Enterprise Survey for Afghanistan, the largest obstacles reported by firms include political instability, corruption, and access to land, finance, and electricity.

9. **Finally, social and ethnic drivers of fragility need to be recognized and addressed, especially over the longer term.** Afghans have strong ethnic and other group identities— while Afghanistan has never suffered from a significant separatist movement, ethnic divides have increased over many years of conflict. Most recently, ethnic mobilization during the second round of the 2014 presidential election demonstrated the continuing importance of ethnic cleavages. The understandable tendency to distribute government positions and access to resources through ethnic networks remains well-entrenched. Gender inequality and low female social indicators along with very low female participation in the labor market constitute another large impediment to development that requires attention. From a fragility perspective, however, gender is an extremely sensitive issue as possible backlash on gender issues could contribute to greater fragility or even a rolling back on gains made to-date.

## Demography and Geography

10. **Afghanistan faces a demographic bulge that will require strong and sustained job creation.** Population growth is rapid at about 2.5 percent and the proportion of the population aged 15 or below is 51.3 percent, making Afghanistan one of the youngest countries in Asia. The population pyramid is, therefore, characterized by a wide base which means that a large number of new workers will enter the labor force over the next decade. On average, the labor force is expected to expand by about 400,000 workers per year over the next decade.

Figure 2.2: Afghanistan Population Pyramid



11. **The demographic bulge is exacerbated by returning internally displaced persons (IDPs) and refugees.** According to UNHCR statistics, 2.6 million Afghans continue to live as refugees overseas, with 1.6 million in Pakistan. However, re-integration of both IDPs and refugees is extremely difficult not only because of limited resources to meet basic shelter and food needs, but also because of limited land and livelihoods in their original home communities. A further return of refugees would place additional pressure on an extraordinarily challenging jobs outlook going forward. Without a planned approach, a chaotic return is likely to further raise tensions and increase fragility.

12. **In addition to the demographic bulge, the widespread exclusion of women from labor participation is an added economic burden.** According to the 2011-12 NRVA, female labor force participation in Afghanistan is only 19 percent. As a result, only 3.9 million out of 27 million Afghans are employed, which places a tremendous burden on the economy. One of the most critical inputs needed for growth and poverty reduction is a healthy and better equipped workforce. Improving the status of women is central not only to improving economic well-being but also to reducing fragility and conflict. Women have a central role to play, not only as workers themselves, increasingly in paid employment, but also in raising and influencing the next generation of workers, and in improving the quality of public services.

13. **Rapid urbanization is another factor that needs careful consideration in the development diagnostic.** Although the majority of people (and the poor) still reside in rural areas, cities are growing at a very rapid rate and often in a chaotic manner. Some estimates put the population of Kabul at more than 5 million, up from 1.8 million in 2000. Unless rapid urbanization is managed properly, the lack of basic planning and services will lead not only to unrealized economic benefits but also potentially give birth to hotspots for tension and conflict.



**14. The geography of Afghanistan has a pervasive impact on its development prospects.**

Afghanistan is a landlocked country with one of the highest mountain ranges – the Hindu Kush – running through its central spine and dividing the nation into separate areas, including peaks and valleys, plains, and deserts to the south. It is unsurprising, therefore, that there exists considerable disparity across regions in poverty, access to services, conflict, and fragility. Under such circumstances, enhancing connectivity is important in improving development prospects. Many Afghans live in cities or remote fertile valleys between mountains (with only 20 percent of the land used as fields) and this has implications for service delivery. Economic activity and livelihoods are intimately linked to Afghanistan's geography, but also subject to significant risks in terms of earthquakes, floods, droughts and landslides. Snowmelt feeds most agriculture and Afghanistan has considerable minerals and other natural resources that could provide the potential for growth.

**15. Afghanistan's location at the crossroads of South and Central Asia is an important opportunity.**

For much of its history, this central location has caused it to be caught between geopolitical forces beyond its control, and external players have fed the conflict. At the same time, this location has also historically been at the heart of the Silk Road, and offers the potential for Afghanistan to become a transit hub for trade and energy between markets in Asia and Europe. This means that international connectivity must play an important role in its development going forward. Building trade and energy links with neighboring countries can also have a positive impact on reducing the drivers of conflict by giving them a stake in Afghanistan's prosperity.

## **Declining Aid**

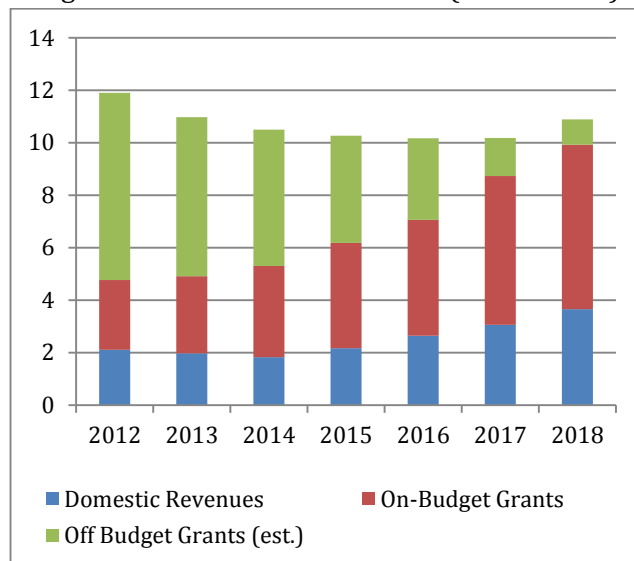
**16. Aid has dominated the Afghan economy for the past decade.** In 2013, total security and development aid was estimated at about \$9 billion, roughly 45 percent of GDP. This was down from about 60 percent of GDP in 2009. At present, aid finances a large part of security costs, except for about \$500 million per year contributed by the government from domestic revenues. Aid also finances large parts of essential services including education, health, infrastructure investment, and the government administration. The extraordinary level of aid also means that it finances large parts of economic activity and employment in Afghanistan. At the same time, such high aid flows have encouraged waste and corruption, aid dependence, and use of parallel systems to circumvent limited government absorptive capacity.

17. **International donors have agreed to maintain aid flows to Afghanistan going forward, although at gradually declining levels.**

At the 2012 Tokyo Conference, the international community committed to providing \$16 billion in development assistance to Afghanistan over four years (2012-2015) and to continue significant but declining aid through the next decade. The 2012 Chicago Conference estimated Afghan National Security Force (ANSF) costs of about \$4.1 billion per year, with the amount coming from domestic revenues initially \$500 million and rising over time. As a result, total security and development aid is expected to

gradually decline as a share of GDP over the medium term, from about 45 percent of GDP in 2013 to about 25 percent by 2018. Sustainability is a serious risk. Internal revenue mobilization has weakened rather than increased since 2012, and aid fatigue is clearly evidenced in donor budget discussions. It will be critical therefore that more aid be channeled through the budget so it can be coordinated and prioritized together, and more goods and services can be procured within Afghanistan to boost the economy.

Figure 2.3: Revenues and Grants (US\$ Billions)



18. **As aid volumes are scaled down as a share of GDP in the medium term, new sources of growth will be needed in the post-transition period.** Agriculture, extractive industries, and services are likely to be among the significant sectors driving growth going forward. Afghanistan will also need to leverage its strategic geographic location to tap the potential of regional integration. Even if the protracted uncertainty is addressed, new sources of growth are realized, and international aid is maintained at moderate levels, growth will likely decline to 5-6 percent per annum during 2015-25, down from the average growth of 9.4 percent during 2003-12.

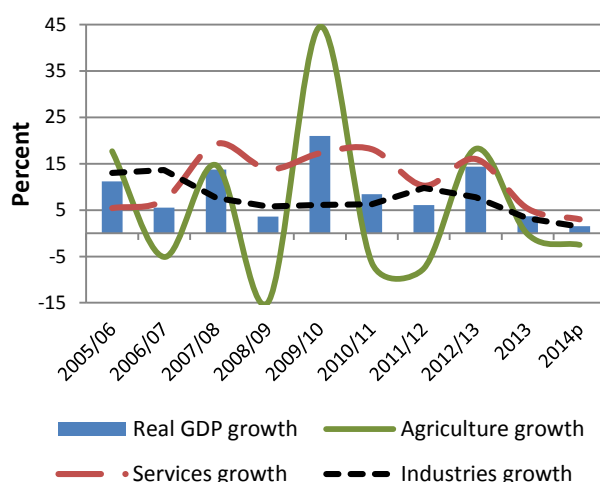
19. **A tighter aid environment also has implications for prioritization of services.** Afghanistan faces tremendous needs in the areas of security, social, and infrastructure services. As aid is drawn down going forward, meeting these needs will require greater targeting and effectiveness in the delivery of services. Exploring alternative delivery models including a greater role for NGOs and the private sector will be important. Even with these measures, Afghanistan will need to mobilize greater domestic revenues in order to meet its needs.

## Chapter 3. Jobs and Growth

### Sources of Growth

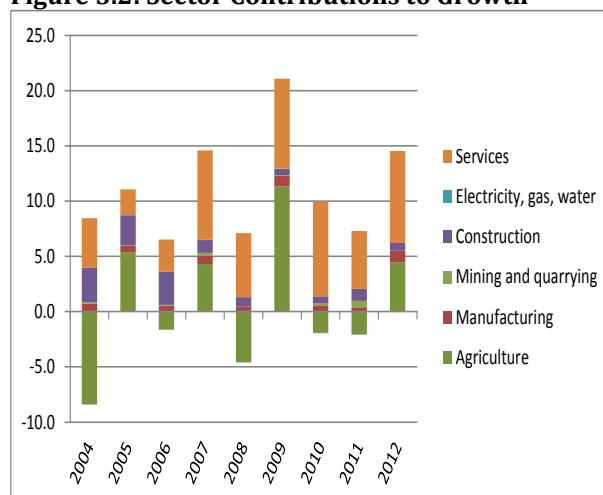
1. **Strong growth in Afghanistan during 2003-12 was fueled in large part by extraordinary levels of aid and was thus unsustainable.** Economic growth averaged 9.4 percent per year between 2003 and 2012, driven by investment in reconstruction, expansion of services fueled by aid, and periodic surges in agricultural production. Part of this exceptional growth performance was a result of the high level of aid Afghanistan received over the past decade. International security and development assistance grew sharply to a peak of more than 70 percent of GDP during 2008-10. These aid flows fueled growth of the Afghanistan National Security Forces security sector as well as development of civilian infrastructure and services, such as education, health, electricity, and roads. The heavy reliance on aid indicates that the growth patterns during the 2003-12 were not sustainable, with total security and development assistance declining to 45 percent of GDP in 2013 and projected to decline further to about 25 percent by 2018.

Figure 3.1: Growth of Real GDP and Sectors



Source: CSO and Bank Staff estimates

Figure 3.2: Sector Contributions to Growth



2. **Agriculture was also one of the largest contributors to economic growth during 2003-12, thus accounting for its volatility.** In 2009, for instance, when growth was a remarkably high 21 percent, agriculture directly accounted for 11.3 percent, thanks to favorable weather conditions and a rich harvest. Moreover, other parts of the economy are also indirectly linked to agriculture, with food processing accounting for 96 percent of the manufacturing sector. The reliance on agriculture also explains the considerable volatility of growth: around one-third of Afghanistan's agriculture is rain-fed, which makes agricultural output and thus GDP growth heavily dependent on the weather.

3. **Afghanistan's official export base is very narrow, although unrecorded export of opium is large.** Official exports – mostly dried fruits and nuts, other derivatives of agricultural production,

and carpets – amounted to only 5.5 percent of GDP in 2012/13. There is also the large, unrecorded export of opium (estimated at 7-8 percent of GDP). But even factoring in illicit exports, Afghanistan underperforms on exports. Countries at similar income levels tend to have an export-to-GDP ratio closer to 30 percent. This suggests that the large volumes of aid fueled non-tradables at the expense of tradables, thus further compromising the sustainability of growth.

4. **Economic growth fell sharply in 2013-14 as uncertainty over the political and security transition led to a considerable slowdown.** Growth fell sharply from 14.4 percent in 2012 to 3.7 percent in 2013 and 1.5 percent (estimated) in 2014. With uncertainty leading to a slump in investor and consumer confidence, growth weakened significantly across the board in the non-agricultural sectors, including manufacturing, construction and services. New firm registrations fell sharply in 2013 and 2014, pointing to a sharp slowdown in private investor activity. Meanwhile, agriculture production in 2013-14 has been flat since the bumper harvest of 2012, which did not help to counterbalance the overall slowdown in GDP growth in 2013 and 2014.

## Patterns of Job Creation

5. **Afghanistan's labor market is characterized by high economic dependency and low levels of participation among women.** According to data from the 2011-12 NRVA, only 3.9 million out of 27 million Afghans are fully employed. Such high levels of economic dependency are a result of a large population under working age, low levels of female labor force participation, and high rates of underemployment. Fewer than 50 percent of Afghans of working age (16 years old and over) are actively employed, in large part because of very low female labor force participation (19 percent according to the 2011-12 NRVA and even lower in urban areas). Even among the employed, almost 40 percent are considered under-employed (i.e. working fewer than 40 hours per week). The challenge of poverty reduction is, therefore, intertwined with improving the quality of existing jobs and creating more opportunities for individuals, particularly women, to join the labor force.

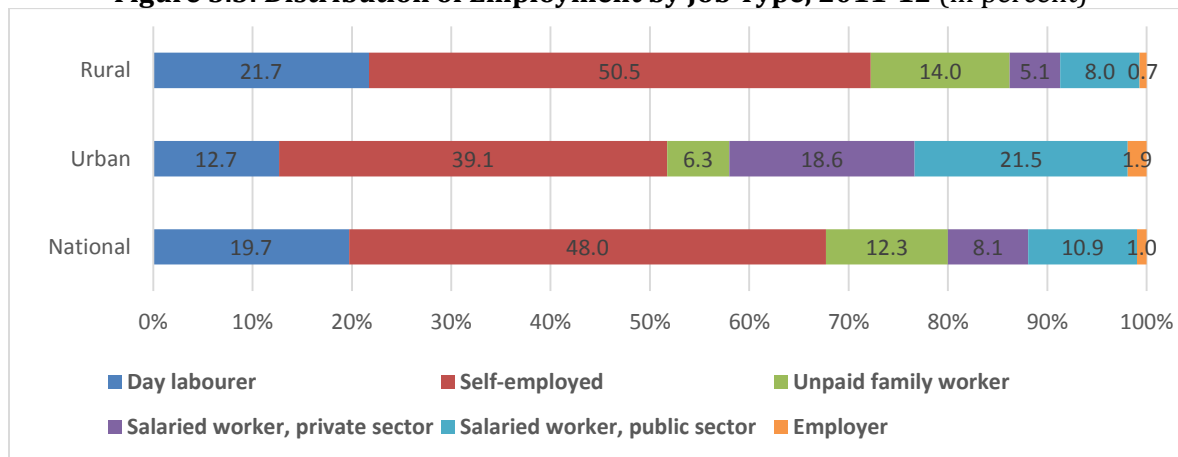
**Table 3.1: Labor Market Indicators 2011-12 (in percent)**

|                 | Participation | Under-Employment | Unemployment |
|-----------------|---------------|------------------|--------------|
| <b>Urban</b>    | <b>45.5</b>   | <b>23.4</b>      | <b>9.1</b>   |
| Male            | 77.1          | 18.4             | 7.8          |
| Female          | 12.8          | 58.4             | 16.9         |
| <b>Rural</b>    | <b>53.8</b>   | <b>42.4</b>      | <b>7.2</b>   |
| Male            | 85.3          | 36.2             | 5.3          |
| Female          | 21.2          | 71.0             | 15.3         |
| <b>National</b> | <b>51.7</b>   | <b>38.2</b>      | <b>7.7</b>   |
| Male            | 83.2          | 32.1             | 5.9          |
| Female          | 19.1          | 68.8             | 15.6         |

Source: Staff calculations based on NRVA 2011-12

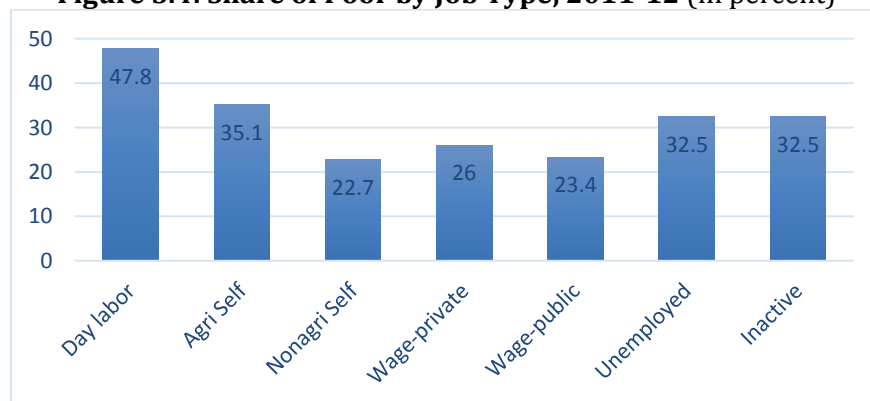
6. **Vulnerable jobs and labor underutilization are prevalent across Afghanistan, and particularly in rural areas.** Vulnerable employment (which includes casual/day labor, self-employment, and unpaid family workers) represents the vast majority—80 percent—of jobs across Afghanistan. This pattern is even more acute in rural areas where vulnerable employment represents 86 percent of jobs, compared to 58 percent in urban areas. Furthermore, approximately 46 percent of the labor force in rural areas is either unemployed or underemployed, compared to 30 percent in urban areas. Interestingly, unemployment is higher in urban than rural areas, while underemployment is higher in rural areas. This likely reflects higher living standards and thus higher reservation wages in urban areas, where 45 percent (63 thousand) of the 140 thousand unemployed individuals is represented by relatively more educated youth in the 16 to 25 age group. In fact, 65 percent of unemployed youth have completed primary education and 49 percent have completed lower secondary education.

**Figure 3.3: Distribution of Employment by Job Type, 2011-12 (in percent)**



Source: Staff calculations based on NRVA 2011-12

**Figure 3.4: Share of Poor by Job Type, 2011-12 (in percent)**



Source: Staff calculations based on NRVA 2011-12

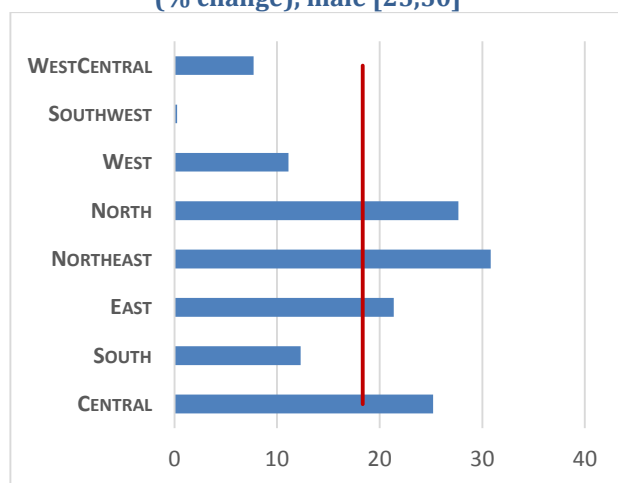
7. **Vulnerable jobs are associated with higher levels of poverty.** The share of workers that are poor varies considerably across employment type, with day laborers and agricultural self-employed workers exhibiting particularly high levels of poverty. According to the 2011-12 NRVA, 47.8 percent of day laborers and 37.4 percent of agricultural self-employed workers were poor. On the other hand, only 22.7 percent of non-agricultural self-employed workers, 26 percent of private salaried workers, and 23.4 percent of public salaried workers were poor. Finally, unemployed and inactive workers also exhibited higher levels of poverty at 32.5 percent. These figures suggest that in order to reduce poverty more stable and non-vulnerable employment opportunities will need to be generated, as well as improving the productivity and earnings potential of day laborers and agricultural self-employed workers.

**Table 3.2: Trends in Labor Market Indicators by Region, Male age [25,50] (in percent)**

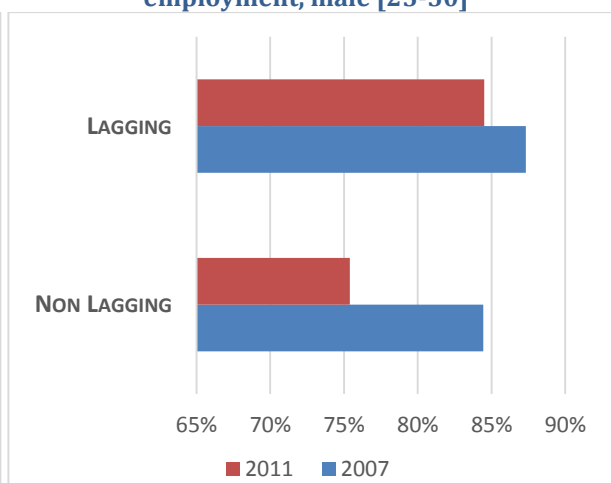
|                    | Employment / WAP |         | Underemployment |         | Unemployment |         |
|--------------------|------------------|---------|-----------------|---------|--------------|---------|
|                    | 2007-08          | 2011-12 | 2007-08         | 2011-12 | 2007-08      | 2011-12 |
| <b>Central</b>     | 88.79            | 91.17   | 27.45           | 22.14   | 8.53         | 5.62    |
| <b>South</b>       | 82.03            | 90.68   | 52.77           | 35.83   | 16.36        | 7.11    |
| <b>East</b>        | 92.73            | 95.72   | 55.12           | 30.28   | 4.88         | 1.99    |
| <b>Northeast</b>   | 84.90            | 95.22   | 51.72           | 54.83   | 12.91        | 2.57    |
| <b>North</b>       | 84.32            | 93.15   | 38.98           | 24.10   | 13.92        | 3.16    |
| <b>West</b>        | 90.72            | 94.53   | 59.99           | 36.57   | 7.56         | 2.94    |
| <b>Southwest</b>   | 93.31            | 97.15   | 48.86           | 20.82   | 4.06         | 2.04    |
| <b>WestCentral</b> | 89.74            | 90.13   | 29.38           | 23.71   | 9.56         | 6.83    |

Source: Staff calculations based on NRVA 2007-08 and NRVA 2011-12

**Figure 3.5: Employment generation by region (% change), male [25,50]**



**Figure 3.6: Trends in the share of vulnerable employment, male [25-50]**



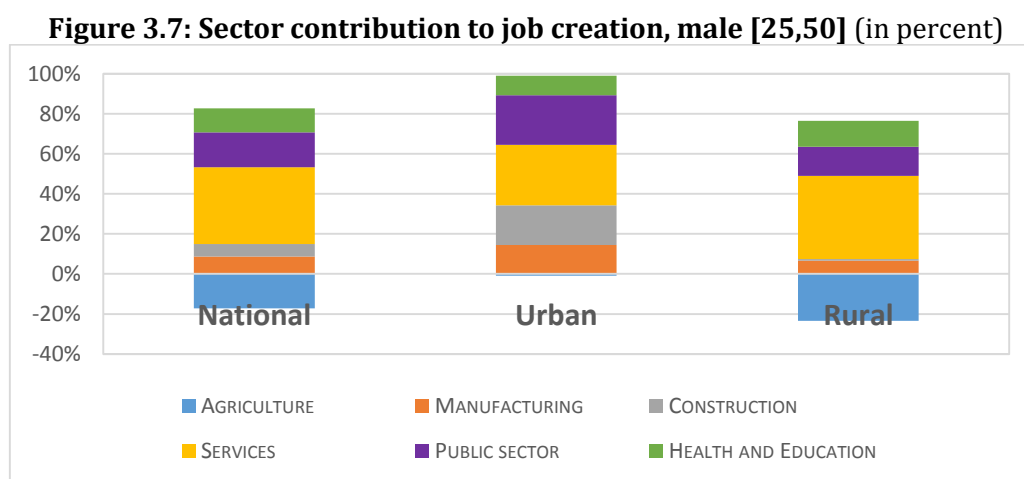
Source: Staff calculations based on NRVA 2007-08 and NRVA 2011-12

8. **The Northeast region where poverty increased sharply made the least progress in reducing underemployment and vulnerable employment.** The sharp increase in poverty in the Northeast appears to be related to employment trends. In particular, while the Northeast experienced strong employment growth from 2007 to 2011, it was also the only region where

underemployment increased (from 52 percent in 2007 to 55 percent in 2011) for prime age males, with all other regions experiencing significant reductions in underemployment.<sup>6</sup> Furthermore, the lagging regions (Northeast, East, and West Central) also made the least progress in reducing the share of vulnerable employment (day labor, self-employment, and unpaid family workers) where the incidence of poverty is high.

9. **The lack of progress in reducing underemployment and vulnerable employment in lagging regions appears to be related to a high incidence of shocks.** According to the 2011-12 NRVA, the Northeast and other lagging regions experienced a significantly higher incidence of shocks. This suggests that the lack of progress in reducing underemployment and vulnerable employment in the lagging regions was in part because of greater shocks to the main sector of employment (i.e. agriculture) induced the creation of less durable and more vulnerable types of employment. The poorer quality of employment opportunities did not help in smoothing consumption through the crisis, thus resulting in higher levels of poverty over time.

10. **The decline in underemployment and vulnerable employment in most other regions appears to have come from a shift in employment from agriculture to services and the public sector.** Development aid and military spending facilitated growth of the services sector, which generated 60 percent of the new jobs for prime aged men between 2007 and 2011. On the other hand, jobs in agriculture actually declined during this period. As a result of the overall employment shift from agriculture to services and the public sector, vulnerable employment declined nationally among prime aged men. Nationally, increases in salaried jobs led to a decline in vulnerable employment for prime aged males from 85 percent to 78 percent.



Source: Staff calculations based on NRVA 2007-08 and NRVA 2011-12

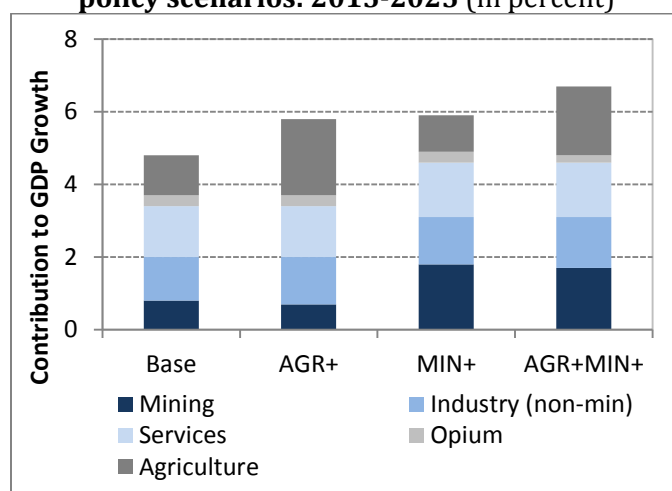
<sup>6</sup> As a result of changes in the NRVA between 2007 and 2011, employment indicators across the two surveys are only comparable for prime aged men (age 25-50), but not for women, the youth, and the elderly.

## Jobs and Growth Priorities for Poverty Reduction

11. **The analysis in this chapter suggests that in order to generate adequate jobs and growth for poverty reduction, Afghanistan will need to address a number of important challenges.** The first is to restore private sector confidence that has slumped sharply from the fragility and uncertainty of the transition and resulted in a collapse in growth during 2013-15. The second is to support new sources of job creation and growth in the post-transition period in the face of declining aid. The third is to ensure that the quality and distribution of jobs created across Afghanistan enable workers to transition out of poverty. As the analysis in this section will show, these objectives can be advanced through a set of mutually reinforcing priorities.

12. **Reducing poverty will require strong growth and job creation from new sources in the post-transition period.** Restoring growth in Afghanistan will require mitigating uncertainty and bolstering investor confidence. However, simulations suggest that even without protracted uncertainty, the aid drawdown will lead to lower growth of about 5 percent per year in the 2015-18 post-transition period, less than the average growth of 9.4 percent per year during 2003-12. As aid volumes are scaled down as a share of GDP in the medium term, new sources of growth will be needed in the post-transition period. Agriculture, extractive industries, and services are likely to be among the significant sectors driving growth going forward. Afghanistan will also need to leverage its strategic geographic location to tap the potential of regional integration. The post-transition growth outlook is contingent on a relatively stable security environment. At the same time, specific policies will need to be implemented to stimulate economic activity in the key sectors identified.

**Figure 3.8: Growth Simulations with Aid Drawdown under alternative policy scenarios: 2015-2025 (in percent)**



Source: Staff calculations based on CGE Model

13. **Reducing poverty will also require creating more stable and less vulnerable jobs in agriculture and other sectors across Afghanistan.** The lack of progress in reducing vulnerable employment in the Northeast (where poverty increased significantly from 2007 to 2011) appears to be related to sectoral shifts in employment generation. Specifically, the lagging Northeast and West



Central Regions were the only two regions where employment in agriculture actually increased. This explains the limited progress in reducing vulnerable employment in the lagging regions, compared to non-lagging regions where the decline in vulnerable employment was associated with lower employment in agriculture. Going forward, however, job creation will need to come from both agriculture and non-agriculture sectors. This suggests that in order to reduce poverty, in addition to strong overall employment generation, the focus will also need to be on generating more stable and less vulnerable employment in agriculture. The agriculture sector strategy will need to pay particular attention to this dimension of job creation.

## Agriculture

14. **Revitalizing agriculture will be central to sustaining growth and creating jobs going forward.** Agriculture accounts for a quarter of GDP and is also closely linked to other parts of the economy, including manufacturing (food and beverages) and services (transport and retail). Agriculture is also highly relevant to poverty mitigation and job creation, with more than 50 percent of the labor force tied to the sector. Raising agricultural earnings and providing employment opportunities to the burgeoning labor force and those displaced from jobs in construction and services is a priority for both social and security reasons. According to the recently completed *Agriculture Sector Review*, developing agriculture calls for a two pronged strategy: (1) commercial development of value chains with greatest potential to scale up (wheat, horticulture, livestock); and (2) improving productivity of rain-fed farming and small scale livestock which provide subsistence for many of the near poor.

15. **Driving development of the priority value chains will require addressing a number of key policy and investment priorities:**

- **Water:** Inadequate and inefficient irrigation systems and poor on-farm water management are critical constraints facing the wheat, horticulture, and livestock fodder sectors. Rehabilitation of existing irrigation schemes and better on-farm water management are the highest priorities, given significantly lower costs than investing in new irrigation infrastructure.
- **Extension services:** The extension system of the Ministry of Agriculture, Irrigation, and Livestock (MAIL) reaches a small fraction of farmers and is unrealistically ambitious and outdated. Revising and updating the extension services delivery model, by opening up to the private sector and NGOs, with MAIL focusing on an enabling and regulatory role instead of direct provision, is a critical priority.
- **Regulation of inputs:** While significant resources are spent by farmers on agricultural inputs (fertilizers, seeds, pesticides, livestock breeding materials, etc.), many of these are of poor quality. Improved certification, regulation, and enforcement of agricultural phytosanitary measures are important priorities.
- **Security of land tenure:** The limited and outdated land registration system leads to widespread disputes and undermines incentives for long-term investments in orchards and

agro-industry. Immediate needs are to secure the rights of private owners, especially in irrigated and peri-urban areas, improve land-leasing arrangements, and facilitate the development of efficient land markets.

- **Access to credit:** Credit is a constraint for intensive livestock and horticultural production. While the financial sector remains nascent and fragile, options include supporting sustainable development of the First Microfinance Bank and the Agriculture Development Fund, as well as agro-financing structures such as leasing and value chain financing.
- **Agroindustry and MSMEs:** Significant need and potential exists for upstream and downstream agroindustry and micro and small and medium enterprises (MSMEs) in trucking, cold storage, canning, drying, and other activities. In addition to the factors already discussed, fostering private investment in these activities will also require enhancing entrepreneurial skills and capacity and improved farm to market connectivity through rural and regional roads.

16. **Additional interventions will be needed for those in remote rain-fed farming areas and nomadic livestock systems.** Interventions to raise the productivity of rain-fed crops and extensive livestock systems are needed to help the poor and nomads. Interventions that would offer widespread gains at relatively low cost include disseminating drought-tolerant crop varieties, controlling animal diseases, and reforms in property rights and the management of open pasture. Without intervention, it will also be difficult to raise returns to the level where they can compete with opium poppy in the livelihood strategies of many poor farm households. Coordinated activities would be important with community development programs, education and skills training, and targeted livestock programs for nomadic people.

## Extractive Industries

17. **Although extractive industries currently account for a very small share of GDP, they have significant potential.** Mineral deposits – including oil, natural gas, copper, coal, and iron ore – provide the nation with a diversity of development opportunities. The sector represents a potential driver of economic growth and revenue generation that is less reliant on public investment given the role of the private sector to pool capital. Extractives themselves may not produce large numbers of jobs, but leveraging the resources and building linkages can stimulate job creation in upstream and downstream sectors (for example, by utilizing natural gas in the power sector). Moreover, extractives have the potential to contribute substantially to government coffers.

18. **Good governance is critical, particularly in a fragile and conflict country with weak institutions, to leverage Afghanistan's resource wealth towards broader development objectives.** Extractive industries can be a blessing, but also a curse in countries with weak institutions where the sector has fueled rent-seeking activity and exacerbated corruption. Improving transparency and accountability in the sector (to avoid elite capture of resources and promote productive investment of proceeds) is thus critical to the development of extractives. In Afghanistan, the government has been working to modernize policy and regulatory instruments and provide

strong transparent, non-discretionary administration for more than a decade. Key challenges relate to strengthening governance in the following key thematic areas: (a) ensuring non-discretionary and transparent award of contracts and licenses; (b) building core capacities, skills and administrative systems to ensure regulatory compliance and improved sector performance; (c) building capacities for collection of taxes and royalties; (d) ensuring sound financial management; and (e) implementing sustainable policies for inclusive growth, strong benefit sharing, and catalyzing broader economic growth and diversification.

19. **Leveraging extractives for development also requires commitment to a long-term strategy and a strong vision on how the sector will contribute to growth, diversification, and nation building.** Resource opportunities require time to complete exploration, feasibility studies, regulatory approval and construction. Smaller incremental investments can progressively build into larger commercial operations over long periods of time. Such a long-term strategy requires stability of policies backed by adherence to a vision regarding the roles and responsibility of the government and investor to grow the sector and deliver benefits to all Afghans. Uncertainty in fiscal policy, non-transparent or discretionary decision-making processes, or a lack of clarity regarding roles and responsibilities (obligations between government, community, and investor) can have devastating impact on a long term growth strategy. The Government of Afghanistan has decided to implement a 'Resource Corridors' strategy to leverage extractive industry investments by combining actions in four areas: physical infrastructure, livelihoods, environment and social impact, and governance.

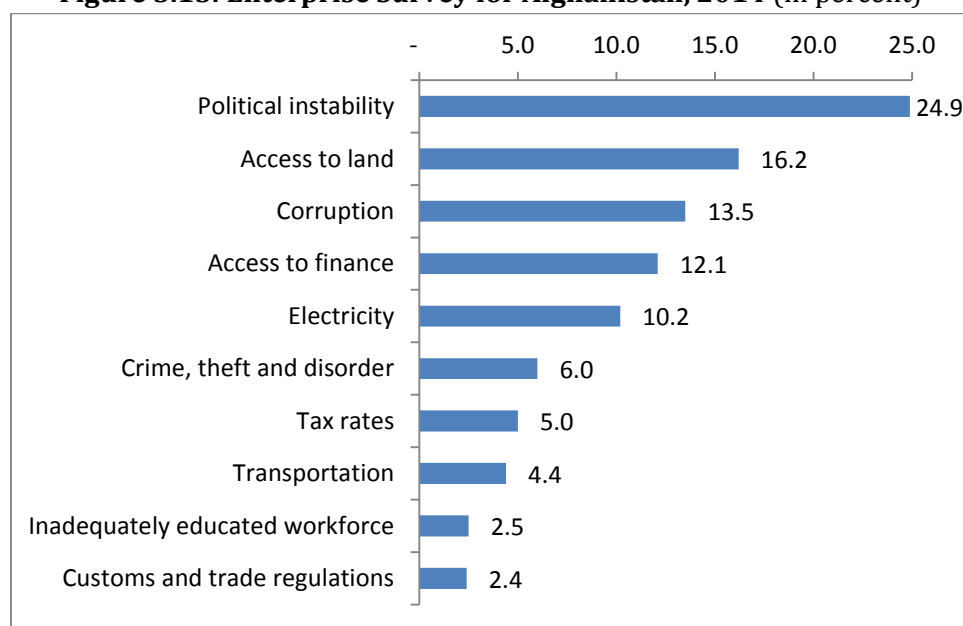
20. **Unlocking the potential of extractives will require progress on the legislative and regulatory framework as well as securing financing for the necessary infrastructure.** These include:

- **Address regulatory gaps and promulgate mining regulations relating to licensing and contracts; financial management; health and safety; and explosives.** The new mining law, ratified by parliament in 2014, represents a significant step forward towards aligning laws and regulations in Afghanistan's mineral sector to international good practice. However, concerns remain with respect to security of tenure in which the investor has the right to move from an exploration to exploitation license subject to regulatory compliance (Article 54), transfer of licenses (Article 29), and the unstated need for full contract transparency and beneficial ownership of investing companies. In order to provide assurances to investors, these weaknesses will need to be addressed either through regulation or through further revision to the legislation.
- **Foster strong revenue transparency and ensure benefit sharing.** Afghanistan endorsed the principles of the EITI in 2010 and is currently in the process of validation of compliance with EITI standards. It will be critical to vigorously follow-up on the EITI process and achieve full compliance to ensure that all revenues are traceable, published, and framed contextually, including public disclosure of key mining agreements and terms. The government will also need to ensure that the benefits of extractives development are shared both through the budget and more directly.

- **Continue to build core capacity and institutions.** Continued capacity building of regulatory institutions (MoMP, NEPA) is a long term activity – with a focus on contract compliance monitoring, including environment and social aspects.
- **Sequence investments to establish “proof of concept” through the ‘Resource Corridor’ strategy.** This would mean moving forward with implementing scalable investments around (a) immediate oil & gas opportunities; and (b) Hajigak iron ore and Aynak copper, including identifying potential incremental public investments (in roads, rail, power and water) to leverage the infrastructure investments of extractive industry investors. Furthermore, encouraging private investment in power generation can provide an efficient use for locally extracted natural gas and result in a knock-on impact for the wider economy, in terms of economic activity and job creation. Once these efforts demonstrate that regulatory oversight is transparent and extractive projects are yielding benefits, they can be scaled up and expanded to other areas.

## Restoring Private Sector Confidence

**Figure 3.15: Enterprise Survey for Afghanistan, 2014 (in percent)**



Source: 2014 Enterprise Survey for Afghanistan

21. **Restoring private sector confidence is critical to improving growth prospects.** According to the 2014 Enterprise Survey for Afghanistan, the largest obstacles reported by firms include political instability, corruption, and access to land, finance, and electricity. In addition, Afghanistan ranks at the 183rd position (out of 189 economies) in the 2015 Doing Business report, with particularly low rankings on protecting minority investors, dealing with construction permits, trading across borders, enforcing contracts, and registering property. The 2014 Enterprise Survey reports that 47 percent of firms experienced at least one bribery payment request (“bribery

incidence”), compared to 37 percent in 2008 and 21 percent for other landlocked developing countries. Insecure land tenure and lack of reliable power are also major constraints. Because of unreliable power, 48 percent of firms own a generator.

**22. Strengthening confidence in the financial sector and improving access to finance should be a key priority moving forward.** The 2014 Enterprise Survey reports only 2 percent of firms are using banks to finance investments. Domestic credit to the private sector was 4.2 percent of GDP in 2014, compared to 16 percent for Pakistan, 18 percent for Tajikistan, and far below the region’s average of 42 percent. The banking sector also suffered from the 2010 Kabul Bank crisis, which exposed major issues of fraud and money laundering in financial sector governance in Afghanistan. Privatization of New Kabul Bank (NKB) has not been completed to date, with the authorities indicating that they are carefully assessing various options. The Kabul Bank crisis also raised concerns about the Central Bank’s capacity to adequately supervise the banking sector. The microfinance sector had started to emerge with 373,080 active borrowers reported by March 2008, but then suffered a delinquency crisis. It subsequently began to recover, but has recently stalled due to the economic slowdown. Increasing access to financial services for low income households, micro, small and medium enterprises as well as for the agriculture sector will be critical to allow for private sector led job creation. Specific priorities include:

- **Demonstrate accountability and stronger governance of the banking sector.** Pursuing recovery of Kabul Bank assets and holding perpetrators accountable is a critical priority. This would signal a shift in governance and accountability of the banking sector. Furthermore, a decision on the various options under consideration regarding privatization or restructuring of New Kabul Bank should be completed as soon as possible in order to strengthen banking sector stability.
- **Strengthen regulatory and supervisory capacity of Da Afghanistan Bank (DAB).** DAB needs to exercise effective regulatory and prudential oversight of all financial institutions, with a focus on enforcement. Early detection of weak banks would help avoid serious financial crises (and a repeat of the Kabul Bank crisis). The approval of the new Banking Law, and accompanying regulations, is therefore a priority. DAB also needs to exercise effective Anti-Money Laundering / Counter Financing of Terrorism (AML/CFT) supervision of all financial institutions through effective enforcement of recently enacted AML/CFT legislation and approval and enforcement of necessary accompanying regulations.
- **The Government can play an enabling role to increase access to financial services, but should avoid being a direct provider.** International experience shows that the Government should avoid being a *direct* provider of financial services, particularly in weak governance environments with fiscal constraints. The Government should instead focus on *indirectly* supporting increased access. The Microfinance Investment Support Facility for Afghanistan (MISFA) provides an interesting example of such indirect support. The Government should ensure that the Agricultural Development Fund (ADF) becomes a sustainable financial institution with strong governance and efficient financial resources management. The efforts

of DAB to strengthen the financial sector infrastructure (public credit registry, movable collateral registry, modernization of payment system, and digital finance framework) should also be continued. Firm-level interventions to improve financial literacy, enterprise management, and corporate governance can also enhance bank's appetite for MSME risk and thus increase access to financial services for MSMEs.

**23. Improving the business environment through streamlining business registration and operating rules is also essential.** In the last few years, business entry to Afghanistan has been simplified by taking company registration out of the commercial courts and by establishing an Afghan Central Business Registry. While this is a leap forward, all firms must also separately obtain and periodically renew a trade or investment license, in addition to sector specific licenses from respective ministries. All of this often proves too onerous for many firms, creates opportunities for rent seeking, and encourages informal sector activity. The following should be instituted:

- **Streamline and unify the license and registration systems and clarify institutional roles.** Delivering aggressively on the investment climate reforms that have been initiated would send a strong signal to the private sector. A key priority in this area is to issue and implement a roadmap to unify the systems of trade and investment licenses and to integrate with the business registration system. In this context, it will be important to clarify the overlapping responsibilities between the Afghanistan Investment Support Agency (AISA) and the Ministry of Commerce and Industry (MoCI).
- **Foster an enabling business environment, while avoiding discriminatory investment incentives.** In July 2013, the Cabinet approved a series of investment incentives including tax holidays, subsidized land and public loans. International experience with such policies has been that they mostly generate adverse incentives, encourage rent-seeking, and involve considerable fiscal costs, particularly in countries with weak investment climate. Afghanistan would thus do well to avoid such incentives and focus more on strengthening the overall investment climate.

**24. Poorly functioning land markets is another identified priority.** Legal and regulatory impediments to the sale and purchase of land, combined with a lack of transparent land records and an efficient land administration system, prevent the development of an efficient land market. Outdated systems, overlapping responsibilities, and lack of capacity at local levels have compounded problems. Decades of conflict and widespread displacement have resulted in competing claims to land and conflicts between individuals, communities, and citizens and the state. Finally, the process by which the state may acquire private lands for public purposes, including for resettlement and compensation, lacks the legal and procedural guidance necessary for efficiency and fairness. In order to address these shortcomings, the following priorities will be important:

- **Amend the laws for land management and land acquisition.** The laws, currently under review by the Ministry of Justice, are expected to improve security of tenure for various categories of land users including women, recognize customary tenure and collective

usufruct rights (e.g. to pastureland). More accessible and transparent procedures for land registration are proposed by moving from the current court-based toward administrative registration. Most legal disputes relate to land, and increased opportunities for formalizing out-of-court dispute settlement are needed. Current land acquisition law needs resettlement and livelihood restoration as part of compensation, regularized land and asset valuation, and comprehensive consultations and appeal options for affected persons. Measures of transparency and good governance in land administration and management combined with comprehensive public awareness campaigns and outreach would enhance consensus building in favor of reform prior to parliamentary ratification.

- **Initiate and operationalize an allocation policy for state lands with a clear focus on the demand for land by the poor and underprivileged groups in society** that builds on the objective of equitable access to land as formulated in the National Land Policy. The current Land Allocation Schemes need a revision to address prevailing weaknesses and incorporate good global practices. Further, it is recommended that state-owned land be leased out to smallholders since long-term leases that are secure can be a substitute for individual ownership. It is also recommended to look into possibilities of market based land purchase system schemes to facilitate land access across different size of farmers.
- **Strengthen tenure security and usufruct rights, including recognition of communal land as envisaged in the National Land Policy and Land Management Law.** This will have significant positive impact on the majority of the country's smallholders and pastoralists.
- **Improve the governance structure for ARAZI and enhance its capacity.** As ARAZI assumes increasing responsibilities as an independent authority, it needs to ensure transparency and accountability mechanisms. Community based natural resource management and formalizing community participation in all land governance matters would help counteract social exclusion, malfeasance and corruption in land and property matters. Transparency in governance is required to protect the interests and rights of the majority and more vulnerable sections of society. ARAZI will require more financial and technical resources to augment its current institutional capacity, which is vital for effective implementation of its expanded mandate and responsibilities.
- **Formal recognition of community-based land dispute settlement.** Multiple studies and surveys reflect a general preference for informal justice sector settlements. Significant experiences have been gained and documented with community-based, out-of-court dispute settlement of land disputes. Incorporating established and successful procedures into the legal framework, adding judicial validation to de-facto processes, could reduce the burden of legal cases in the court system and provide a better level of protection to the poor.

25. **Afghanistan's ability to achieve growth through agriculture and mining will also be impacted by climate change and disasters.** Afghanistan faces significant impacts of climate change

and disasters which will impact growth prospects. The most obvious is the impact of floods and droughts on agriculture productivity. In addition, mining operations need to be supported within an environmental and social framework that is sustainable. It is also worth highlighting that the impact of these issues will have a disproportionate effect on the poor, especially since the poorest regions are most likely to be impacted by them, and it will be important to develop mechanisms to mitigate the shocks for the poor. These and other aspects of climate change and disaster management will need to be assessed.

### **Durable Jobs versus Immediate Jobs**

26. **The priority interventions discussed in this chapter are intended to restore economic growth and support a pattern of more durable job creation.** Restoring economic growth is important because growth has slumped sharply during 2013-15. More durable job creation is important because the high incidence of casual and vulnerable employment in the Northeast and lagging regions was one of the reasons for lack of progress in reducing poverty despite strong growth between 2007-08 and 2011-12. However, not all of the interventions necessary to achieve these objectives may be possible under a deteriorating scenario of uncertainty and conflict in Afghanistan. Under such a scenario, encouraging broad-based private investment will be difficult, so that job creation will need to continue to rely on agriculture and the public sector. Safeguarding the integrity of the banking sector will be important to avoid a downward spiral of investor confidence. Furthermore, Afghanistan may need to explore opportunities for targeted labor-intensive infrastructure investments, including through the community development platform. Such interventions, along with direct cash and other social assistance measures, are discussed in the next chapter.



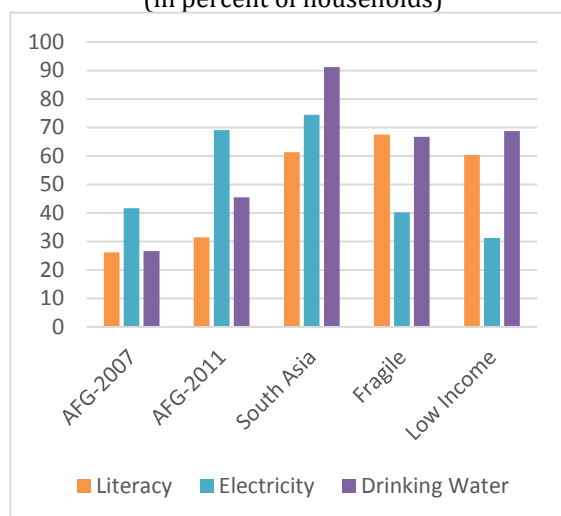
## Chapter 4. Expanding Service Delivery

*Afghanistan will need to continue to expand services, with greater attention to regional inclusion, mitigating shocks, and enhancing effectiveness*

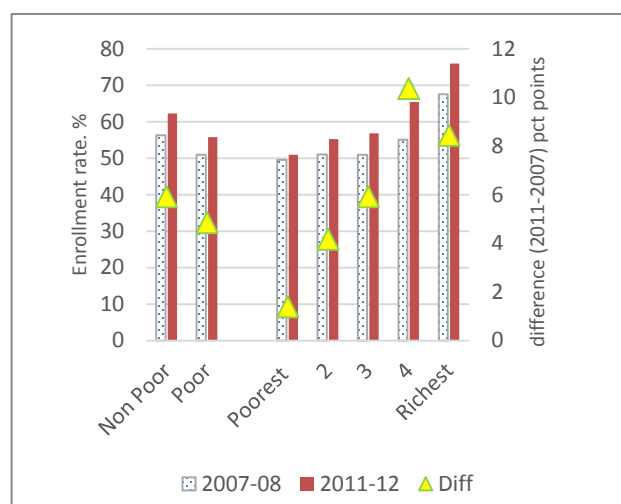
### Trends in Access to Services

1. **An unprecedented expansion in education and health services has taken place in Afghanistan.** School enrollment has increased considerably and gender disparities have narrowed. Enrollment increased from 1 million (including only a few girls) in 2001 to 9.2 million (including 3.6 million girls) in 2011. In the health sector, primary health care coverage has expanded enormously and infant and maternal mortality rates have declined considerably. By 2008, 68 percent of Afghans had access to basic healthcare facilities within an hour's walk compared to only 8 percent in 2001.

**Figure 4.1: Trends in Access to Services and International Benchmarks**  
(in percent of households)



**Figure 4.2: Percent of children age [7,12] in school**



Source: Staff calculation using NRVA 2007-08 and 2011-12; various sources including WDI for international benchmarks

2. **Extensive infrastructure has also been built since 2001, leading to gains in access to water, sanitation, electricity, and road connectivity.** Afghanistan's road network has been extensively rehabilitated, with reductions in travel time between major cities. Electricity production has more than doubled, particularly following investments in recent years. At the community level, programs such as the NSP have delivered basic infrastructure including irrigation facilities, water supply and local power generation. From 2007-08 to 2011-12, the share of population with access to safe drinking water increased from 26.6 to 45.5 percent; the population with access to electricity increased from 41.7 to 69 percent and that with access to improved sanitation from 4.9 to 8.2 percent.

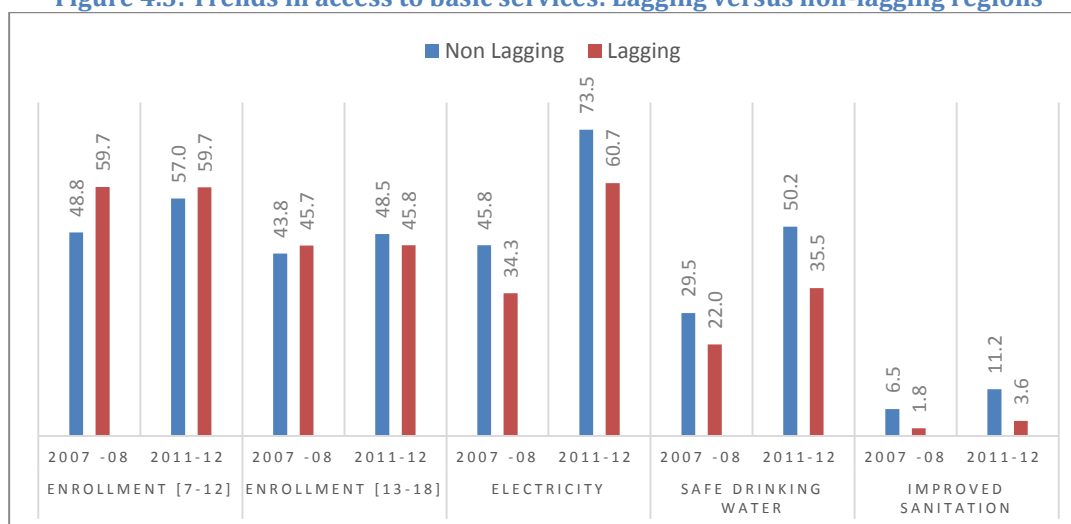
3. **Despite considerable progress, Afghanistan is still a long way from closing its human capital and infrastructure gap with other South Asian, low income, and fragile countries.** The magnitude of the challenge is particularly striking when considering how long it will take to catch up with its comparators. If the current pace of progress continues, for example, it will take Afghanistan 20 years to catch up with low income countries in education and nearly 4 years to catch up on access to drinking water.

## Inequality in Access to Services

4. **Gaps in access to services between the poor and non-poor are sizeable and in some cases, widening.** Children in households whose per capita consumption falls below the poverty line have significantly lower enrollment rates than their counterparts in non-poor families. In 2011, differences in enrollment between the poorest and richest quintile were as wide as 25 percentage points for children aged 7-12 and 31 percentage points for children aged 13-18. Of particular concern, the improvement in school enrollment over time has been stronger for the richest segments of the population, contributing to widening the education gap of the poor. Similarly, in 2011, the gap in the share of the poor and non-poor with access to skilled birth attendance was 15 percentage points (up from 11 percentage points in 2007). For electricity and safe drinking water, the gap was 11 and 9 percentage points respectively in 2011.

5. **Education outcomes in lagging regions have stagnated, while the gap in access to basic services has increased over time.** While lagging regions actually had higher education enrollment in 2007, their advantage dissipated by 2011, mostly due to a drop in enrollment rates in the North East. Furthermore, in other services (access to safe drinking water, sanitation, and electricity), the gap between lagging and non-lagging regions increased from 2007 to 2011 (by 7.2, 3, and 1.3 percentage points, respectively).

**Figure 4.3: Trends in access to basic services: Lagging versus non-lagging regions**

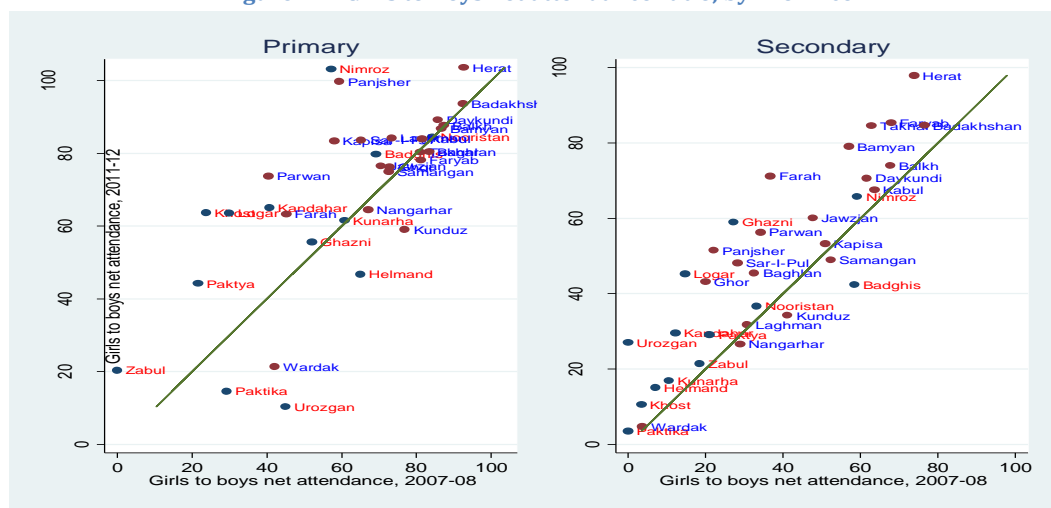


Source: Authors' calculation using NRVA 2007-08 and 2011-12

6. **Outcomes at the province level exhibit a very high degree of heterogeneity.** The stark differences in outcomes across Afghanistan's regions are likely exacerbated by a lack of transparency in the allocation of resources at the subnational level. The lack of need-based criteria for allocation between provinces as well as donors' tendency to channel aid resources to more insecure areas in the south and south-east in order to meet stabilization objectives has likely reinforced spatial inequalities. Provinces with nearly full access to services coexist with others in which there is none, and provinces experiencing an improvement in outcomes coexist with others in which outcomes have deteriorated over time. As an example, in 2011, the gap between the province with the lowest (Urozgan) and the highest (Panjsher) net primary enrollment rate was 88 percentage points. The province with the greatest improvement over time (Panjsher) started from a similar level in 2007 as the two provinces experiencing the greatest decline (Wardak and Kunduz).

7. **Educational attainment for women has improved, but the gender gap in enrollment is far from being closed.** Illiteracy and poor education are key factors behind the socioeconomic exclusion of Afghan women. Investments in the education sector have led to higher literacy among women, particularly among younger cohorts. However, the difference in enrollment rates between boys and girls remains sizeable. The enrollment gap is the highest in rural areas and increases with age. Between 2007-08 and 2011-12, the gender gap in enrollment remained largely constant for the 7-9 and 16-18 age groups; narrowed for the 10-12 age group and increased for the 13-15 age group, due to the lack of improvement over time in rural girls' enrollment.<sup>7</sup> Insecurity, together with poverty and early marriage, is a top obstacle to the improvement of women's education outcomes. Specifically, the ratio of girls' to boys' net attendance rates tend to be lower in high conflict provinces at both the primary and the secondary level.

Figure 4.4: Girls to Boys net attendance ratio, by Province



Notes: High conflict provinces indicated in red

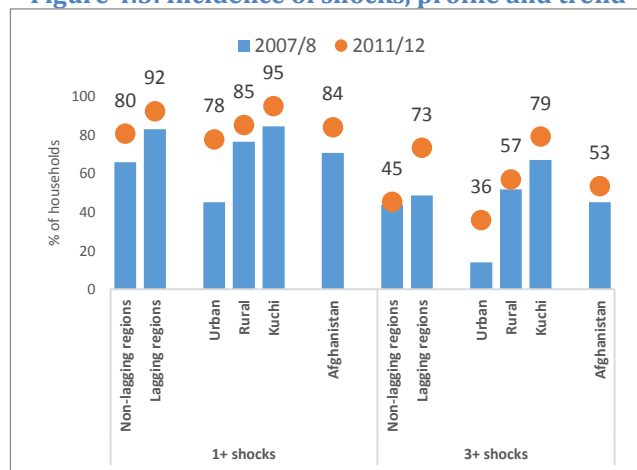
Source: Authors' calculation using NRVA 2007-08 and 2011-12.

<sup>7</sup> For the 10-12 age group, the improvement in girls' enrollment outpaces that of boys in both rural and urban areas. On the other hand, for the 13-15 age group, enrollment of girls in rural areas did not change over time, against a 6.4 percentage point improvement of boys' enrollment.

## Shocks and Vulnerability

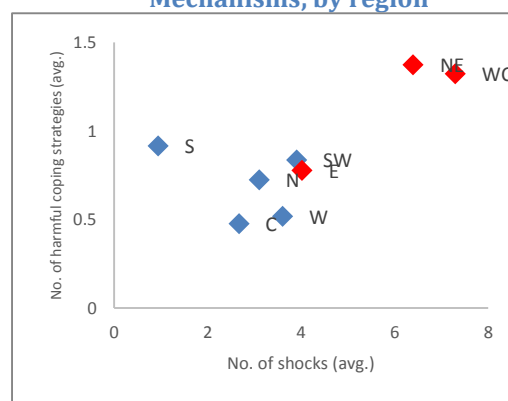
8. **Vulnerability to shocks is one of Afghanistan's most defining social and economic challenges and an important dimension of its fragility.** Exposure to shocks is pervasive and increasing, with approximately 84 percent of households experiencing at least one shock per year in 2011, up from 71 percent in 2007. Fifty-three percent of households reported three or more shocks, up from 45 percent. While methods and instruments are not fully comparable, the incidence of shocks in Afghanistan far exceeds that in other developing countries, such as India, Lao PDR, Malawi, Pakistan, Peru and Uganda<sup>8</sup>. Afghanistan's extreme geography and climate, heavy reliance on subsistence agriculture, conflict and political instability, and absence of formal safety nets are all important factors shaping vulnerability to shocks. With 36 percent of the population below the poverty line and 50 percent below twice the poverty line, high exposure to risk and limited coping mechanisms can have a detrimental impact on welfare and human capital accumulation.

**Figure 4.5: Incidence of shocks, profile and trend**



Source: Authors' calculation using NRVA 2007-08 and 2011-12

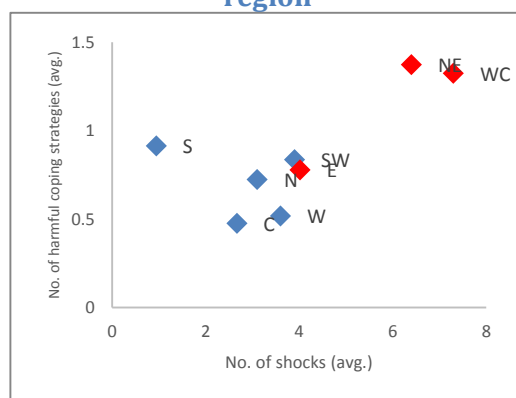
**Figure 4.6: Shocks and Harmful Coping Mechanisms, by region**



9. **Households living in lagging regions experienced more shocks and used more harmful coping mechanisms.** Natural hazards played a significant role in higher vulnerability of these regions. Households living in lagging regions (particularly the Northeast and West Central regions) suffered from a significantly higher average number of shocks and were more likely to rely on harmful coping strategies. Natural hazards play a major role in determining the higher vulnerability of households living in lagging regions. The difference in shock incidence between lagging and non-lagging regions is the strongest in case of natural hazards. In particular, within the natural hazards category, lagging regions – North East and West Central regions in particular – are particularly prone to suffer from shocks related to the interplay between geography/terrain and extreme weather conditions, such as late damaging frosts, heavy rains/flooding, severe winter conditions and landslides/avalanches.

<sup>8</sup> See, for example, the World Development Report 2014 on Managing Risk for Development.

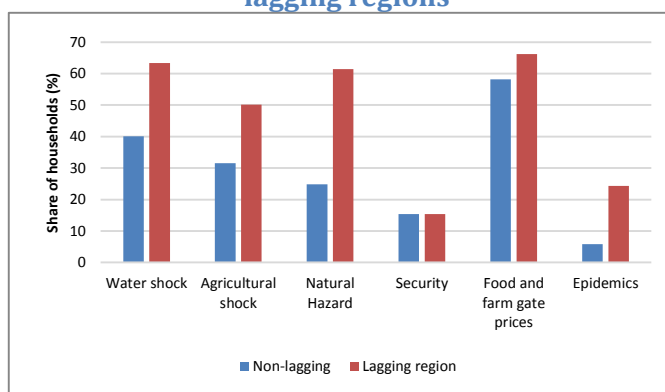
**Figure 10: Vulnerability to shocks, by region**



Note: Lagging regions indicated by red marker

Source: Authors' calculation using NRVA 2011-12

**Figure 11: Shocks Incidence, lagging vs non-lagging regions**



Source: Authors' calculation using NRVA 2011-12

## Enhancing Education, Health, and Social Protection Services

10. **The challenge for Afghanistan will be to continue to expand access to basic services, within a tight budget and in a way that enhances inclusion and social cohesion.** Service delivery plays a dual role in Afghanistan: promoting social cohesion and trust in public institutions, while laying the foundation for inclusive job creation and growth. With levels of education and health among the lowest in the world, Afghanistan will need to continue expanding basic services. However, given the tight budget and the foregoing analysis on inequality in access and prevalence of shocks, services will need to be targeted in a way that enhances impact on inclusion, social cohesion, and poverty. Alternative delivery mechanisms will also need to be explored, including where appropriate through the private sector.

11. The following priorities can be highlighted for education and health:

- **Further enhance access and equity in education:** Specific measures include securing adequate financing for education; diversifying service delivery modalities by increasing the engagement of communities, private sector and NGOs; decentralization of education services to the provincial and district levels; strengthening demand-side interventions, particularly for girls and vulnerable populations (e.g. separate latrines, boundary walls, more female teachers, reduced distance to school, targeted scholarships).
- **Improve quality and relevance in education** by systematizing the ongoing national learning assessment and using the results to improve teaching and learning; implementing transparent and merit-based processes to recruit, deploy and manage teachers; strengthen data systems for better monitoring and reporting on outcomes and evaluation; providing gradual fiscal and institutional autonomy to tertiary institutions, and developing Quality Assurance and Accreditation systems; and partnerships with the private sector to enhance relevance of skills training.

- **Secure adequate financing in health, prioritize lagging programs, and strengthen government stewardship of health systems.** Adequate financing is needed to sustain the gains and further enhance access particularly to remote communities. Prioritizing lagging programs involves prioritizing provision of family planning services; scaling up nutrition support programs; and strengthening immunization.
- **Improving the management of hospitals and the efficient use of resources is key to meet the increasing demand for hospital services.** Hospitals now receive budgets without clear accountability mechanisms in place for proper monitoring of expenditures and services provided. In addition to the problem of the lack of autonomy and clear accountability (internal and external), there is also a problem of the lack of human resources (especially nursing personnel at least in public hospitals) and of poor and non-standardized quality of care.

12. **Special attention is needed to enhance access to services and employment opportunities for women.** Women are underrepresented in the provision of education, health services and the public sector, which has negative implications on women's access to education and health services, or public services in general. Women's labor force participation is very low at under 20 percent. While no simple solutions are available in countries like Afghanistan where gender gaps are deeply rooted in norms, cultural and social practices, the 2013 Afghanistan Gender Stocktaking recommends the following measures:

- Develop policies to encourage female higher education to enhance participation in education, health, and civil service; targeted vocational training; targeted transportation and childcare services; supporting microfinance programs; and supporting agricultural value chains that allow for greater participation of women.

13. **Social protection faces a number of challenges including limited budgets and weak coordination and targeting.** The recent increase in the Martyrs and Disabled pension spending puts the program's fiscal sustainability at risk, and leaves little room for social assistance interventions targeted to the poor. A review of social protection in Afghanistan (World Bank, 2012) found that most of the initiatives trying to address poverty and vulnerability consist of small and fragmented schemes financed and implemented off-budget. At the same time, paying attention to only the people currently below the poverty line would neglect the large number of households at risk of falling below the poverty line when exposed to shocks. The Government should enhance its role in coordinating and harmonizing the various social assistance programs implemented on and off budget, and prioritize the use of scarce resources to improve the resilience of the poorest and most vulnerable. Priority should be given to building targeting and safety net delivery systems to identify and reach the poor and vulnerable.

14. **Multi-sectoral policy actions are important in medium- and long-term risk reduction.** There are several entry points for such actions. An improvement in Afghanistan's security situation would reduce the plight of millions of people, enable more children (especially girls) to attend schools, increase private investment and improve access to services. Public health interventions could reduce the risk of health shocks. Within a tight budget, a coordinated approach to health and

education services could be considered. Cultural and gender issues may also lend themselves to thinking about services in a coordinated way.

## Enhancing Access to Infrastructure

15. **Afghanistan needs to prioritize its infrastructure investments.** Given the sheer size of the funding requirements and financing limitations, Afghanistan will need to be very strategic in planning and building new infrastructure by prioritizing and sequencing infrastructure investments to get the largest impact from every dollar invested. Criteria used to prioritize infrastructure investment needs play a major role in mitigating the infrastructure gap. Ideally, the Government should develop a methodological framework to determine funding decisions. Typically such frameworks consist of three main steps: (i) identifying factors that affect infrastructure investment decisions, (ii) quantifying identified factors, and (iii) ranking the infrastructure projects based on their locational impacts to enhance agglomeration benefits in the strategic resource corridors. Where appropriate, opportunities for public-private partnerships need to be seized.

16. **One way to prioritize infrastructure at the local level is through targeted rural and urban development programs.** Such programs can help enhance local participation, strengthen communities, and take advantage of agglomeration effects, although a number of challenges will need to be addressed. The National Solidarity Program (NSP) has provided a participatory platform for service delivery throughout 33,000 villages in rural Afghanistan. At the other end of the spatial spectrum, vast unplanned developments have been built in and around Afghanistan's six largest cities often stretching beyond existing municipal boundaries, with severe unmet demand for water, sanitation, roads, public transport and waste disposal. The following specific measures will be important:

- Continue to support the National Solidarity Program (NSP) and explore options to adapt and strengthen the program by addressing issues related to fiscal sustainability, O&M, and institutional arrangements. This includes formalizing community development councils (CDCs) as the principal platform for service delivery and maintenance at the village level.
- Ensure that the new municipal governance framework clearly defines roles and responsibilities of the municipal government in relation to all other subnational bodies, and clarifies municipal revenue source. Prioritize municipal development by advancing revenue improvement plans in the six largest municipalities and establishing a municipal development fund that targets unplanned areas for delivery of basic municipal services.

17. **Before investing in new infrastructure, options for rehabilitating and maintaining infrastructure assets need to be prioritized to ensure gains made are not lost.** Without regular maintenance, physical infrastructure can rapidly fall into disrepair during its design life, requiring expensive reconstruction to bring it back to adequate standards. For example, the cost of full reconstruction of roads that have been poorly maintained is, on average, at least three times the cost

of maintenance. Lack of adequate maintenance triggers a progressive deterioration of the quality of the infrastructure services, which hurts users and development outcomes. Realistic estimates of operation and maintenance needs should be an integral part of well-specified multi-year medium term expenditure framework.

**18. Measures to increase operational efficiency and expand service provision are necessary to achieve full return on investment.** Naturally such measures are very sector-specific. The below indicate a number of priority actions across different investment categories.

| Sector           | Priority Actions   |
|------------------|--|
| <b>Energy</b>    | <ul style="list-style-type: none"> <li>Take advantage of regional infrastructure initiatives, which can help Afghanistan increase energy production and access. These include the CASA-1000 project intended to carry Central Asian power to Pakistan, the Turkmenistan-Afghanistan-Pakistan-India (TAPI) pipeline intended to carry Central Asian gas to Pakistan and India, and the TUTAP power transmission project involving Turkmenistan, Uzbekistan, Tajikistan, Afghanistan, and Pakistan. Next to new investments, these arrangements also require strengthening trade agreements and resolving issues related to interconnectivity.</li> </ul>  |
| <b>Water</b>     | <ul style="list-style-type: none"> <li>Increase capacity and strengthen the basic Water Resources Management (WRM) function at the Ministry of Energy and Water (MEW).</li> <li>Update the river basin investment plan.</li> <li>Develop Water Storage Facilities.</li> <li>Initiate a disaster risk management strategy including: (a) collecting hydromet data and start developing capacity for forecasting and early warning; (b) establish an inter-ministerial committee to address disaster risk management in a comprehensive manner; (c) initiate actions on community-based disaster risk management.</li> <li>Initiate discussions with other riparian users and negotiate the utilization of the water resources, including construction of new storage facilities.</li> </ul> |
| <b>ICT</b>       | <ul style="list-style-type: none"> <li>Position ATRA as an independent agency, outside direct control of the Government</li> <li>Increase the capacity of the regulator to manage the sector going forward, be responsive to innovation, and to create an enabling environment for private investment</li> <li>Review universal service fund policies and close it down if disbursements do not match collections.</li> <li>Supporting infrastructure sharing capacity and private sector involvement on ICT.</li> </ul>   |
| <b>Transport</b> | <ul style="list-style-type: none"> <li>Scale up the National Rural Access Program by giving it priority to maintain existing roads and emphasizing connectivity to and within the major trunk road network. and</li> <li>Provide affordable transport service for urban citizens and emphasize technical assistance to municipalities, traffic police and national public transport providers for managing and sustaining public transport service.</li> </ul>   |



- Rehabilitate and improve the capacity of trunk road bottlenecks e.g. Salang tunnel, Baghlan (Dushi) – Bamyan highway, Kabul Ring Road etc., to provide all year connectivity between major economic growth corridors
- Consolidate all fragmented transport functions into a new Ministry of Transport, establishing Road Authority and Road Fund.
- Develop capacity in the Afghanistan Railway Authority: strengthen capacity to manage private operators safely and leverage private sector mining interests to invest in railway lines.
- Develop capacity in the National Transport Institute and National Construction Laboratory, Civil Aviation Authority and urban transport related agencies.

**19. Afghanistan’s location at the crossroads of South, Central, and West Asia offers the opportunity to leverage investments in infrastructure.** Afghanistan will need to engage proactively to establish its role as a transit route linking energy-rich Central Asian countries with energy hungry South Asian countries. With four out of its five river basins part of international waterways, Afghanistan will need to engage actively with downstream riparian countries to secure necessary water resources. Finally, with domestic job creation expected to fall short of the growing labor force, Afghanistan should explore opportunities for labor migration to Gulf countries. These efforts can establish Afghanistan’s role as an important economic partner and help to therefore mitigate regional stress factors driving fragility. The following specific measures are suggested:

- Tap the potential of regional integration to enhance access to electricity, including proactively engaging on key power projects (CASA-1000, TAPI, and TUTAP)
- Issue a policy directive on a government-wide approach to consulting downstream riparian countries on projects on international waterways
- Negotiate circular migration agreements bilaterally with “friendly” countries to provide access to working visas for large numbers of Afghans.

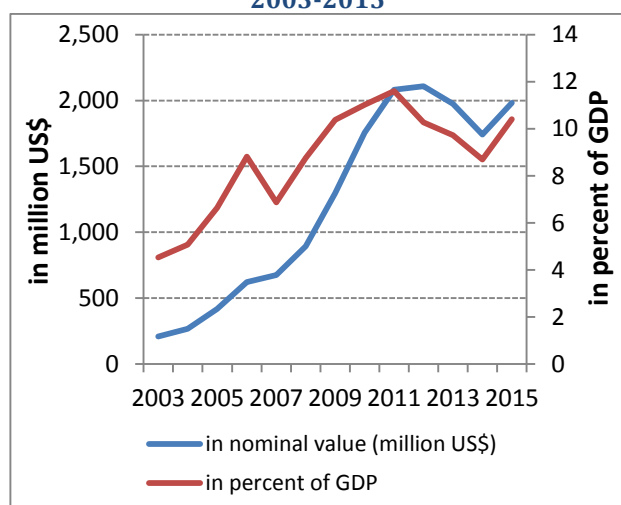
**20. The role of private sector in providing infrastructure services should be explored further.** Where appropriate, opportunities for public-private partnerships (PPPs) should be explored. The private sector is already a successful provider of telecom services, with the number of mobile telephone subscriptions increasing to over 20 million, compared to less than 60,000 few years ago; and 50 percent of rural households now having access to telecom services. Another potential area for private sector engagement in infrastructure is in power generation, distribution and transmission. Experience suggests that relatively light PPP structures will be suitable in the context of Afghanistan as a starting point to build experience. These include projects where the government and/or donors finance capital and even operating expenses or where multilaterals provide guarantees against payment risk to enhance private sector confidence to invest. The private sector is engaged with the objectives of benefiting from efficiencies, knowledge and management. Increasing public sector capacity to manage PPPs is also important.



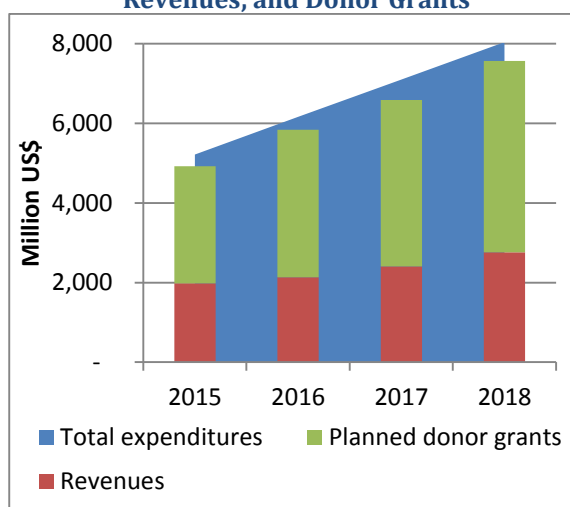
## Chapter 5. Urgency of Fiscal Stability

1. **Afghanistan faces a serious fiscal outlook.** After a decade of strong revenue performance, domestic revenues fell from a peak of 11.6 percent in 2011 to 8.7 percent in 2014, before rebounding to 10.4 percent in 2015. The decline in revenue collection was driven by the economic slowdown and weaknesses in enforcement and compliance. Despite a number of austerity measures put in place in 2014 to contain the crisis, the government faced an unfinanced fiscal gap of about \$350 million in 2014, which led to accumulated arrears of around \$200 million and depleted cash reserves. The authorities put in place a number of new revenue measures in 2015 and exercised expenditure restraint which, along with an increase in discretionary budget aid, helped improve the cash position at end-2015. Despite the improvements in 2015, the 2014 fiscal crisis significantly weakened the overall fiscal outlook, with financing constraints expected to remain considerable in the medium term. Expenditure pressures are growing and the potential for further improving revenues remains unclear.

**Figure 5.1: Domestic Revenues, 2003-2015**



**Figure 5.2: Projected On Budget Expenditures, Revenues, and Donor Grants**

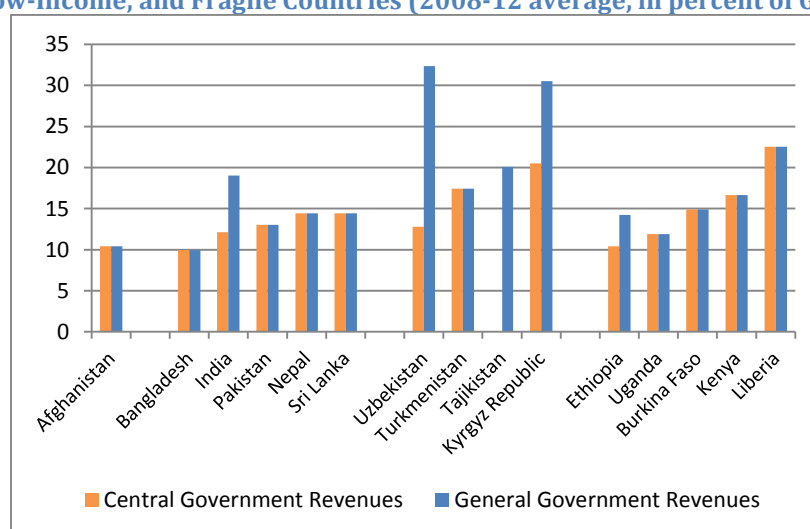


2. **The medium term fiscal outlook is daunting due to extraordinary expenditure needs, weak revenues, and a drawdown in donor aid.** Afghanistan faces extraordinary expenditure needs in the areas of security, service delivery, infrastructure development, and operations and maintenance (O&M). As off-budget expenditures gradually shift onto the budget over the next several years, on-budget expenditures are projected to increase from 26 percent of GDP in 2014 to 35.1 percent of GDP by 2018. The medium term fiscal framework for Afghanistan is based on improving revenues gradually replacing international aid. However, as revenues deteriorated rapidly during 2012-14, the medium term revenue trajectory that can be expected for 2016-18 is also considerably lower, while expenditure needs remain high. As such, unless revenue performance improves considerably, a sizable fiscal deficit will likely persist over the medium-term. This will lead to difficulty in meeting critical civilian operating and development expenditures, which would adversely affect social stability and development progress.

## Revenue Mobilization

3. **Revenues in Afghanistan are low when compared to other countries in South and Central Asia, as well as other fragile, low-income countries.** While revenues in South Asia are generally low, that of Afghanistan is among the lowest in the region. Afghanistan's revenues are also among the lowest for any low-income, fragile state.<sup>9</sup> Preliminary analysis by Bank staff suggests that Afghanistan is collecting significantly less than its revenue potential. Even with the existing tax policy and legal framework, potential revenue could be 3-5 percentage points of GDP higher than the actual levels collected, pointing toward considerable weaknesses in tax administration and compliance.

**Figure 5.3: Revenues in Afghanistan and select South Asian, Central Asian, Low-Income, and Fragile Countries (2008-12 average, in percent of GDP)**



Source: World Development Indicators, Bank staff data reports (LDB), IMF's Government Finance Statistics database, and IMF staff country reports

4. **The recent decline in revenue collection can be attributed to both the economic slowdown and weak enforcement in customs and tax administration.** Customs duties, tax revenues, and nontax revenues have all declined as share of GDP since 2011. The decline in customs duties from 3.6 percent of GDP in 2011 to 2.2 percent in 2014 is particularly marked. With the economic slowdown, the structure of imports has shifted, with a decline in fuel, vehicles, and other luxury and higher tariff items. However, leakages and weaknesses in enforcement are a large part of the problem, particularly given that the decline in collections began in 2012 when economic growth was very strong. Increased uncertainty from the political and security transition has encouraged greater rent seeking and tax evasion. Improving revenue collection going forward is one of the most important economic policy priorities facing Afghanistan today.

<sup>9</sup> "Domestic Revenue Mobilization in Fragile States." 2014. OECD

5. **Improving revenue mobilization in large part involves fighting corruption and addressing chronic weaknesses in governance.** Strengthening enforcement and fighting corruption in customs includes a number of technical solutions such as improving HR management, introducing additional randomized post-inspections, mobilizing post clearance audit in major custom houses, establishing additional border crossing points to reduce border leakages, further rolling out ASYCUDA, and strengthening the enforcement powers of the customs authority. However, the implementation of these technical solutions needs to be proactively backed by broad spectrum of relevant actors in the context of Afghanistan's fragmented political system and high-level political support. Failing this, the technical solutions are likely to produce limited or no result, in the face of entrenched vested interests from local and national elites.

6. **Improving revenues will also require bolstering growth and improving the investment climate in parallel.** The decline in revenue collection has taken place at a time when growth has fallen in an environment of increased political instability and high fragility. Strengthening revenue mobilization will thus require parallel efforts to bolster economic growth and improve the investment climate. The mining sector, in particular, has the potential to contribute significantly to Afghanistan's long-term financing needs. However, in order to develop the mining sector and attract private investment, the legislative and regulatory framework needs to be strengthened, while also improving the business climate to attract the necessary investment.

7. In order to improve revenue mobilization, the following priorities will be important:

- **Implement rigorously the newly approved HR management strategy within the tax and customs administration.** Weaknesses and deficiencies in HR management have been identified as one of the most important enablers of corruption within the revenue administration. Both the revenue and the customs administration are in the process of implementing new HR management systems. The new HR strategy and system comprise: (i) a strategic review of the current staff; (ii) competitive recruitment processes that minimize lateral entry possibilities; (iii) a merit based appointment, placement, and career progression; (iv) an attractive and competitive salary scale and incentives; (v) the establishment of a performance management system; and (vi) in combination with previous measures, the establishment of a zero-tolerance policy for cases of corruption and conflict of interests.
- **Improve organization and structuring of the Revenue Department.** Improvements in the organizational structure of the ARD are critical for strengthening tax administration and enforcement. A number of priority reforms in this regard includes: (i) providing the ARD with more autonomy in administration and decision-making; (ii) reducing fragmentation of functions across the ARD headquarter and provincial tax offices; and (iii) improving the reporting lines within the ARD.
- **Conduct effective and risk-based taxpayer audits as part of strengthening and streamlining the tax clearance process for firms.** The tax clearance process for firms remains cumbersome for business and ineffective in mobilizing revenue. Extending risk-based taxpayer audits can help to improve compliance and focus the resources of the revenue department on higher risk firms. It is estimated that extending risk-based audits to high risk

firms in the Large Taxpayer Office (LTO) and the Medium Taxpayer Office (MTO) can generate an additional Afs 6-7 billion over the next year.

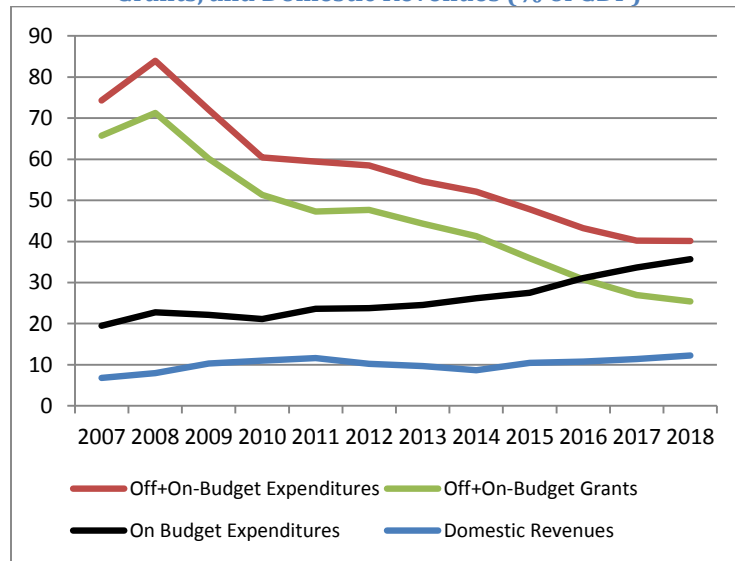
- **Roll out a natural resources revenue regime.** As investments and activities in the Extractives Industries (EI) sector pick up in the medium term, these can serve as an important new revenue source. Success in this area will require rolling out a revenue regime for EI which maximizes economic rents for Afghanistan while preserving investment incentives, ensures full transparency in line with the Extractives Industries Transparency Initiative (EITI), and sharing of revenues with local communities.
- **Eliminate tax exemptions, and introduce instead transparent, clearly-defined incentives in the tax code.** Tax exemptions and tax holidays have been granted over time to both domestic and foreign companies by various committees and entities in the government. Such inconsistent exemptions create distortions in the market and lead to increased rent-seeking. A better practice is to eliminate all exemptions and instead introduce transparent and clearly-defined incentive mechanism in the tax code. This will reduce economic loss and increase effectiveness of such instruments by directing them towards the activities and sectors where they would have the largest impact.

## Securing Adequate Donor Financing

8. **Even under optimistic scenarios of revenue mobilization, Afghanistan will continue to need substantial donor grant aid for the next decade.** Total estimated on and off budget spending in 2013 was 55 percent of GDP, with donor grants financing about 45 percent of GDP. Going forward, even assuming some consolidation of security expenditures and an optimistic scenario for revenue mobilization, Afghanistan will continue to need grant aid of about 25 percent of GDP or \$7 billion in 2018. Any sharper drawdown in aid flows during 2015-18 will have a serious negative impact on economic growth and social outcomes. In fact, if a consolidation of security spending does not materialize and improvements in revenue mobilization are only modest, the grant aid needed in 2018 could be significantly larger. As such, it will be critically important to:

- Secure adequate civilian and security donor assistance to finance the large fiscal gap (expected to last through 2025) and work with development partners to maintain a predictable flow of financing. Under a deteriorating scenario of uncertainty and conflict, it may be necessary to mobilize urgent donor aid, which would contribute to the global public good of stabilizing Afghanistan.

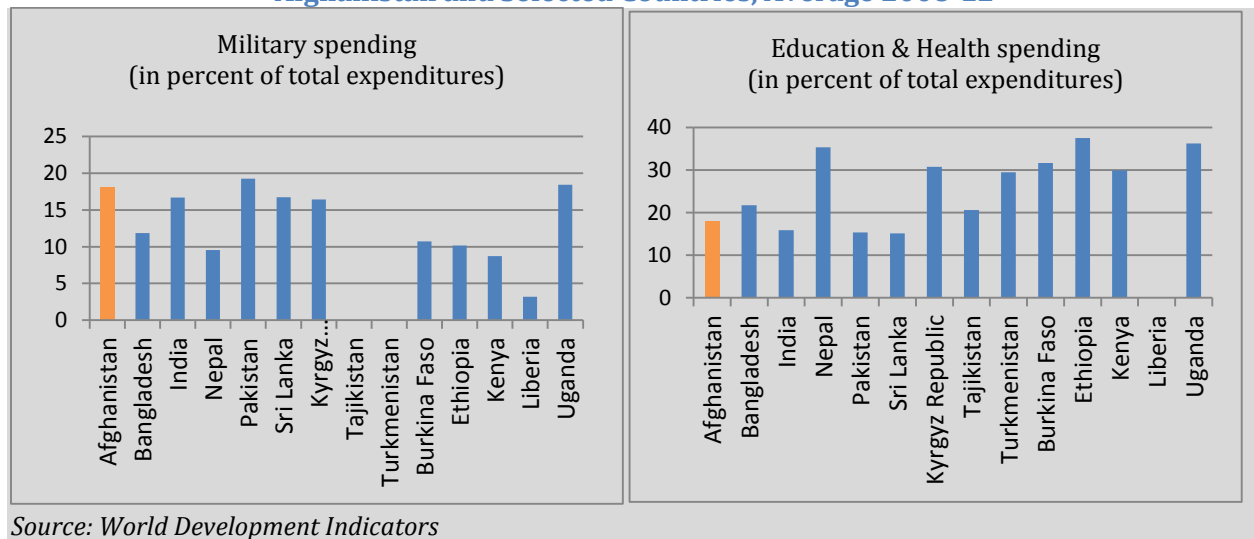
**Figure 5.4: Total Off and On Budget Expenditures, Grants, and Domestic Revenues (% of GDP)**



## Enhancing Expenditure Prioritization and Efficiency

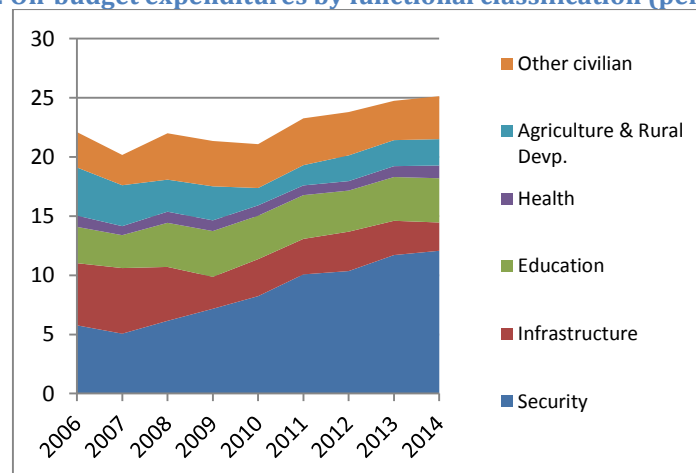
9. **Compared with other fragile, low-income countries, Afghanistan has higher levels of public expenditure, but spends less on human development and more on the security sector.** Security sector expenditures are high in Afghanistan because the country is still in conflict. On-budget security spending increased from 26 percent of total expenditures (incl. recurrent and total development) in 2006 to 48 percent in 2014. At the same time, Afghanistan's public spending on health and education is lower than some other low-income, fragile states. This indicates that the ongoing conflict could be undermining development progress in Afghanistan. While higher security spending in the country is understandable in the circumstances, the government needs to safeguard critical civilian expenditures and ensure that core public services are delivered efficiently and effectively.

**Figure 5.5: Composition of Expenditures, Functional Classification, Afghanistan and Selected Countries, Average 2008-12**



10. **Large security expenditure obligations are a major challenge for fiscal stability and risk crowding out critical civilian operational and development spending.** On-budget security spending increased from 26 percent of total expenditures (incl. recurrent and total development) in 2006 to 48 percent in 2014. At the same time, civilian expenditures not only declined as a share of total spending, but also dropped from 16 percent of GDP in 2006 to 13 percent in 2014. The rise in security spending comes as a result of an increase in the size of Afghan National Security Forces (ANSF), increases in security operation needs, and a gradual shift of security costs that were previously financed off budget by donors onto the budget. However, a large portion of security spending still remains off budget and is projected to come on budget only over time. In this context, rapidly rising security spending and constrained resources risk crowding out critical civilian operating and development spending, as illustrated by the “perfect storm” in 2014.

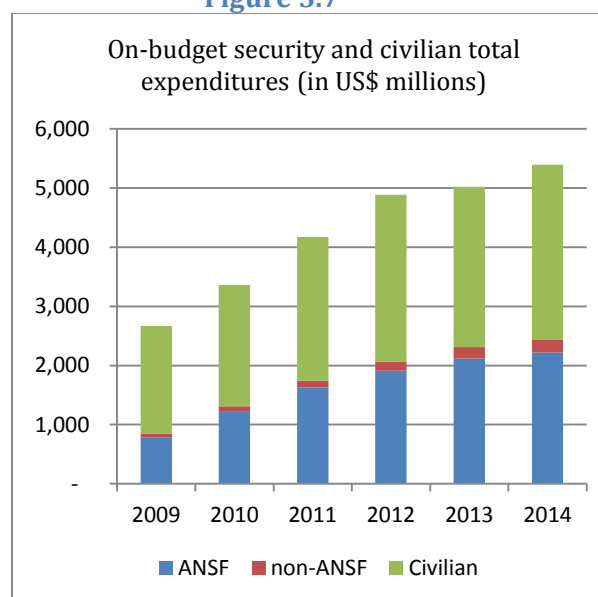
**Figure 5.6: On-budget expenditures by functional classification (percent of GDP)**



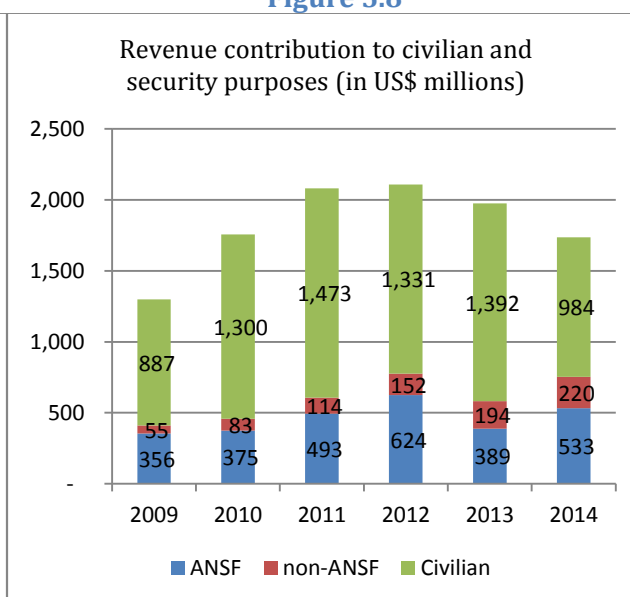


11. **As revenues have declined, domestic financing of security has been sustained at the cost of squeezing domestic financing of critical civilian spending.** Although revenues declined from \$2 billion in 2013 to \$1.7 billion in 2014, the contribution to security increased from \$583 million to \$754 million. This has come at the cost of reducing the government's ability to meet its civilian financing needs. Revenue contribution to civilian spending dropped from \$1.4 billion in 2013 to slightly below \$1 billion in 2014. While the Afghan National Security Forces (including Army and Police) are financed in large part by foreign grants (with a domestic contribution component), non-ANSF security costs are fully financed by revenues. In fact, non-ANSF security costs have increased four-fold over the past five years, from only \$55 million in 2009 to \$220 million in 2014, which were entirely met by domestic revenues. This means that the government's total security contribution from revenues can easily exceed the Chicago Conference commitment of \$500 million.

**Figure 5.7**



**Figure 5.8**



12. **Given its extraordinary spending needs and uncertain financing, Afghanistan will need to prioritize, safeguard, and enhance the efficiency of civilian spending.** While donors have committed roughly \$8 billion per year (divided between security and civilian assistance) for 2013-16, this is contingent on the government meeting TMAF commitments and is, in any case, more uncertain for outer years. Total aid is projected to decline as a share of GDP, which will require consolidation of total off and on budget spending as a share of GDP going forward. If ambitious revenue targets do not materialize, the pressures to curtail spending will be even greater. In this context, in order to avoid damage to growth prospects and social outcomes, a number of priority areas and measures to enhance expenditure efficiency will be important:

- Develop a realistic and well-specified multi-year medium term expenditure framework (MTEF) to safeguard and prioritize spending in the areas of expanding targeted service delivery, improved targeting of social assistance, infrastructure development, and adequate O&M. The MTEF should bring together the following objectives:

- Manage risks arising from growing security expenditure needs that could crowd out critical civilian spending;
- Prioritize civilian spending by focusing on a core set of basic public services.
- Provide adequate funding for operations and maintenance of civilian assets and key infrastructure;
- Ensure social protection programs are well targeted to enhance effectiveness and limit costs.

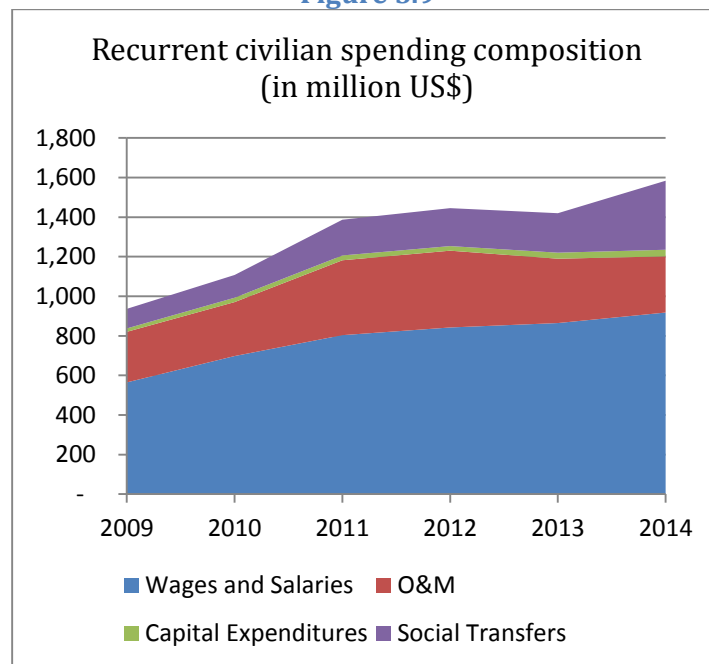
**13. Prioritizing civilian spending will require focusing on a core set of public services and operations and maintenance of essential infrastructure.** Sector-specific strategies will be required to identify the most efficient and effective way of delivering basic public services. This will involve thinking of different modalities of service delivery in different sectors. For instance, in health, public services are contracted out to NGOs, and this has facilitated effective service delivery without necessitating capacity development of sub-national staff or intervention of sub-national entities. Furthermore, it will be important to improve sub-national institutions, strengthen the regulatory framework for sub-national service delivery, clarify roles and responsibilities of different entities, develop subnational PFM systems, and improve accountability and transparency at sub-national levels.

**14. Operations and maintenance costs are severely under-funded in Afghanistan.** Over the past decade and a half, most infrastructure assets built off-budget by donors were gradually transferred to the government. However, sufficient funding has not been allocated through the budget to maintain these assets over time. In 2011 for instance, the cost of maintaining civilian assets in 5 core sectors (education, health, rural development, transport and energy) was estimated at \$710 million, and was projected to increase to \$1.1 billion by 2014.<sup>10</sup> However, budget allocated for O&M in those five sectors in 2011 amounted to only \$132 million. Total civilian recurrent spending for O&M has actually declined in nominal terms from around \$380 million in 2011 to \$285 million in 2014. As a percent of GDP, while civilian wages & salaries have remained constant at around 4.5 percent over the past five years, O&M (in the recurrent budget) has shrunk from 2 percent of GDP in 2009 to 1.4 percent in 2014. Such trends demonstrate that safeguarding civilian O&M in light of recent expenditure pressures arising from security sector and declining foreign aid is critical.

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<sup>10</sup> "Afghanistan in Transition: Looking beyond 2014." 2012. The World Bank. Based on Altai Consulting (2011) "Assessing O&M of Key Assets in Afghan Provinces"

Figure 5.9

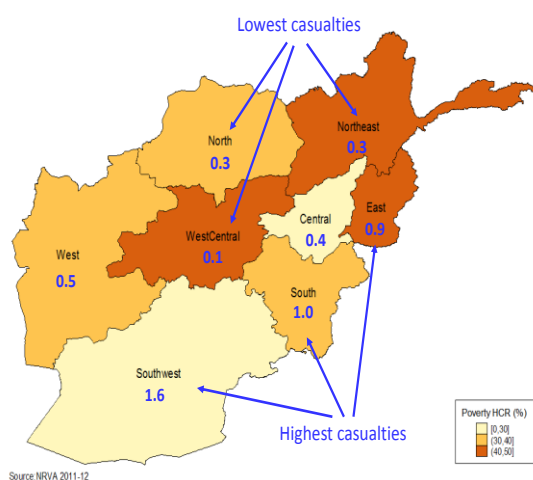


15. **Social protection needs to be better targeted at the poor to increase efficiency and reduce the risk of undermining fiscal sustainability.** Social protection spending almost doubled between 2012 and 2014, a period when revenue collection weakened. While Afghanistan still compares well with similar countries with respect to social protection spending (about 2 percent of GDP, combining on and off-budget), the Government provides essentially all its social protection resources to public sector retirees, and martyrs and disabled and their survivors, leaving little room for social assistance schemes targeted to the poor. The existing safety net reaches less than 25 percent of the poor, while about six million Afghans living in poverty are not covered by any formal social protection program. A number of measures would help improve the targeting of social assistance, including: (a) setting up coherent safety nets, including labor intensive public works program focused on shock prone areas and poverty targeted cash transfers for the poorest; (b) enhance the Government's role in coordinating and harmonizing the various social assistance programs implemented on and off budget; and (c) contain the cost of the public pension and the Martyrs and Disabled (M&D) programs.

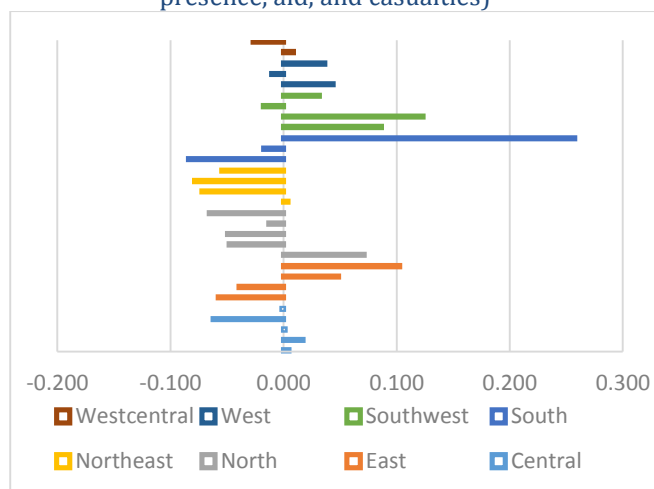
16. **Expenditure prioritization efforts will need to pay particular attention to current geographic and demographic disparities in expenditures.** One particularly powerful example is the disparity across regions in the presence of Afghan National Army (ANA) and international security forces, which has a significant impact in increasing per capita consumption and reducing poverty. As can be expected, the presence of troops is much lower in provinces with low casualties, which ironically are also the higher poverty regions, including in particular the Northeast and West Central Regions. Estimates of the cumulative impact of troop presence, aid, and casualties show that insecure regions in the South, Southwest, and East received significantly higher welfare benefits from the high levels of troops in these regions. The presence of troops has a positive impact on welfare, which more than offsets the negative impact of casualties. Furthermore, the presence of Afghan

troops has a much stronger positive impact on household welfare than international troops, probably an indication that Afghan troops contribute more to the local economy via higher domestic spending. As Afghanistan prioritizes expenditures going forward, it will be important to take note of such significant disparities in welfare incidence of expenditures across geographic areas and demographic groups.

**Figure 5.10: Poverty Rates are higher in “safe regions” with lower casualties**  
(Casualties per 1000 inhabitants)



**Figure 5.11: Unsafe Regions received significant welfare benefits from hosting major military units**  
(Impact on consumption per capita from troop presence, aid, and casualties)



17. **Off-budget expenditures lead to a number of inefficiencies.** At present, off-budget spending is estimated to be as large as on-budget expenditures, and this contributes to a number of inefficiencies. Donor funded projects are often implemented in a fragmented manner and not aligned with the development strategy of Afghanistan. Off-budget spending can also result in inadequate programming for future operations and maintenance, which leads to poor sustainability of the infrastructure that is developed. An important priority moving forward therefore will be to:

- Develop a roadmap to ensure that most off-budget expenditures come under the purview of the budget by 2018. This will require prudent planning and phasing of activities, and enhancing the PFM systems within the government that would support additional expenditures being executed through the public system.

18. **A multi-year capital budgeting system would help Afghanistan better prioritize its overall development spending.** Given Afghanistan’s large infrastructure development and O&M needs, it will be critical to develop a multi-year public investment program and improve its capital budgeting processes. This is even more important given that a large portion of infrastructure development at present takes place off budget and without coordination within a coherent public investment program well integrated with the annual budget cycle. It will be important therefore to :

- Develop a multi-year public investment plan and capital budgeting process to prioritize new capital expenditures and O&M needs, well integrated with the annual budget cycle.

19. **The capital budget is essentially a medium-term public investment plan, consistent with but more detailed than capital expenditures in the annual budget.** As most investment projects are implemented over several years, capital budgeting can help better plan and manage investment projects and monitor their efficiency. An effective capital budgeting system is intimately linked to the project cycle and includes five main components: (i) strategic planning, (ii) project planning and screening; (iii) capital budget formulation and project selection, (iv) capital budget implementation and monitoring, and (v) evaluation and audit of completed projects.

## Chapter 6. Conclusions: Way Ahead and Prioritization

1. **In the face of a growing insurgency and heightened uncertainty, development interventions alone will have limited impact, but will nevertheless need to be tailored to the circumstances.** The principal constraint facing Afghanistan's development prospects is the conflict itself and its wider ramifications on the economy and society. Development becomes more difficult as access to large swathes of territory becomes more contested. While bringing about a significant reduction of the conflict is in large part a political issue requiring a political solution, some development interventions may have greater impact on the prospects for poverty reduction than others and provide the best opportunity for progress in a fragile environment. Some interventions may also help mitigate fragility and uncertainty to some extent or at least avoid exacerbating the situation. As such, carefully selecting and tailoring development interventions to the fragile circumstances is a critical imperative for Afghanistan.

2. **The selectivity and sequencing of development interventions described in this report will need to be driven by a number of criteria.** First, interventions with the *greatest impact on the three constraints* to poverty reduction should be prioritized. In this context, interventions with an impact on multiple constraints would be particularly valuable. Second, the degree of *uncertainty and conflict* will be important in prioritizing interventions. If uncertainty, conflict, and weak reforms continue, resources will be insufficient to expand infrastructure and services. The emphasis will then need to be on preserving basic services and maintaining fiscal stability, while strengthening select institutions to restore confidence and provide a path out of crisis. Finally, within a fragile context, the *"how"* is just as important as the *"what"* of interventions. In order to increase chances of successful implementation, the design of interventions will need to overcome weak capacity, entrenched interests, considerable uncertainty, and to take into account the needs and voice of local citizens and communities.

*Within each of the three priority areas identified in this report, a number of interventions will be important based on the criteria for selectivity and sequencing.*

3. **Jobs and Growth.** The interventions in this priority area will need to address a number of objectives. This includes restoring confidence, growth, and job creation in the face of fragility and uncertainty; generating sustained growth and jobs from new sources in the face of declining aid; and creating more stable and less vulnerable jobs across all geographic regions.

- Strengthening *agriculture* is a top priority, not just because it is labor intensive and because most of the poor live in rural areas, but also because agriculture needs to be a leading driver of growth and jobs in the face of fragility and declining aid. Furthermore, since agriculture is the home of most casual and vulnerable jobs associated with high poverty in lagging regions, interventions in agriculture will also need to create more stable and less vulnerable jobs. Improvement in commercial value chains will need to come from policy and investment interventions in the areas of irrigation, extension services, regulation of inputs, security of

land tenure, and access to credit. Additional interventions will be needed to support those who rely on subsistence farming.

- In light of Afghanistan's tremendous potential, *extractive industries* can serve as an important source of confidence and growth, as well as provide government revenue to bridge the fiscal gap in the medium term. However, good governance, transparency in resources and contracts, and community involvement are critical, particularly in a fragile and conflict environment with weak institutions. Progress on the legislative and regulatory framework will need to go hand in hand with financing for necessary infrastructure and investments.
- While *private sector confidence* has been badly shaken by fragility and uncertainty, addressing cross-cutting investment bottlenecks can provide a strong signal and help bolster confidence. This includes addressing the weak financial sector, poorly functioning land markets, and fragmented licensing and registration regimes. Confidence in the financial sector and access to finance would benefit from demonstrating accountability and stronger governance in the banking sector, strengthening regulatory and supervisory capacity of DAB, and playing an enabling role in enhancing access without becoming a direct provider. Improving shortcomings in land markets will require amending laws for land management and acquisition and improving the governance structure and enhancing capacity of ARAZI.

4. **Expanding service delivery.** The interventions in this priority area will need to continue to expand services, with greater attention to regional (across provinces) inclusion, mitigating shocks, and enhancing effectiveness. The challenge for Afghanistan is to continue to expand services within tight budget constraints by improving targeting to those most in need, including women and lagging regions. Overall, governance, systems and client feedback for services, including clarifying subnational delivery and accountability arrangements, will be as important as the services themselves.

- In *education*, the interventions will need to further expand access while enhancing equity, quality, and relevance. This will require securing adequate financing, diversifying service delivery modalities through engagement of local communities, the private sector, and NGOs, decentralization to provincial and district levels, and demand side interventions.
- In *health*, poor performing programs (including family planning, nutrition, and immunization) will need to be prioritized and government stewardship will need to be strengthened.
- Special attention is needed to enhance access to services and employment *opportunities for women* by developing an explicit incentive framework to encourage women's participation in provision of education, health, social services, and the civil service more generally, while addressing mobility constraints in access to services.
- Weak coordination and targeting of *social protection programs* need to be addressed.

- *Infrastructure investments* need to be prioritized through targeted rural and urban development programs, adequate resources for maintenance and rehabilitation, pursuing sector-specific measures to enhance efficiency, and leveraging regional integration. The National Solidarity Program (NSP) should be supported, while addressing issues relating to sustainability, adequate O&M, and formalizing CDCs as the principal platform for service delivery and maintenance of infrastructure at the village level. Revenue improvement plans in the six largest municipalities need to be advanced while establishing a municipal development fund to target unplanned areas for delivery of basic municipal services. Finally, Afghanistan can tap the potential of regional integration to leverage investments in electricity and water.
- Private sector participation in service delivery and infrastructure development should be explored and enabled, including where appropriate through PPPs.

5. **Fiscal stability.** In order to address the immediate fiscal crisis and the challenging medium term fiscal outlook, Afghanistan needs to pursue a three pronged strategy including improving revenue mobilization, securing adequate donor assistance, and prioritizing expenditures.

- *Improving revenues* in large part involves fighting corruption and addressing chronic weaknesses in governance. The specific technical solutions include expediting implementation of reforms in customs and revenue administration, conducting effective and risk-based taxpayer audits, rolling out the natural resources revenue regime, and replacing tax exemptions with transparent incentives. Implementation of these technical solutions needs to be proactively backed by a broad spectrum of relevant actors in the context of Afghanistan's weak institutions and fragmented political order.
- Even under optimistic assumptions of revenue mobilization, Afghanistan will continue to need *substantial donor grant aid* for the next decade. A predictable flow of civilian and security donor assistance, with an increasing share on budget to enhance effectiveness and impact, will thus be important. Under a deteriorating scenario of uncertainty and conflict, it may be necessary to mobilize urgent donor aid, which would contribute to the global public good of stabilizing Afghanistan.
- *Prioritizing expenditures* will require developing a realistic and flexible multi-year, medium term expenditure framework (MTEF) to continually update and revise expenditure priorities within a given budget envelope. This would seek to accomplish a number of key objectives including managing risks from growing security expenditures, prioritize civilian spending by focusing on a core set of basic public services, provide adequate financing for operations and maintenance (O&M), and ensure social protection programs are well targeted. Expenditure prioritization efforts will also need to pay particular attention to current and potential demographic and geographic disparities in expenditures.



6. **While the full array of interventions are important for sustained poverty reduction in Afghanistan, the best hope under a deteriorating scenario of uncertainty and conflict may be to preserve the gains and mitigate increases in poverty.** The degree of uncertainty and conflict will thus be a critical consideration in prioritizing interventions. If uncertainty, conflict, and weak reforms continue, Afghanistan will face an uphill battle in reducing poverty. Economic activity will likely stagnate, poverty and social cohesion will suffer, and resources will be insufficient to expand infrastructure and services. Under such a *deteriorating scenario*, the emphasis will need to be on preserving basic services and maintaining fiscal stability, while strengthening select institutions to restore confidence and provide a path out of crisis. On the other hand, reduced uncertainty and conflict can usher in a scenario of improving prospects. Under such a *stabilizing scenario*, improved confidence and increased resources to expand infrastructure and social services can accelerate job creation and poverty reduction. This would provide space for broader institution building and further enhancing the inclusiveness of growth. The table below provides further detail on how interventions can be prioritized under alternative scenarios of uncertainty and conflict.

**Table 6.1: Selectivity of Interventions under Alternative Scenarios**

| Priority Areas            | Deteriorating Scenario  | Stabilizing Scenario  |
|---------------------------|---|---|
| Growth and Jobs           | Focus on core agriculture and other more resilient sectors; shore up confidence of financial sector; continue to rely on public sector for jobs.  | Diversify to higher value added agriculture; pursue good governance and investments to leverage extractive industries; reinforce private sector confidence.   |
| Service Delivery          | Preserve basic services; pursue labor-intensive infrastructure investments, including through community platform; explore direct household transfers; target interventions to contain insurgency and most vulnerable. | Further expand infrastructure and social services, with targeting to lagging regions and excluded groups to enhance poverty impact; enhance quality and relevance in education; explore private participation in infrastructure and service delivery. |
| Fiscal Stability          | Pursue confidence building measures to support governance and revenues; mobilize urgent donor aid; prioritize expenditures to finance essential services, social assistance, and investment.                          | Improve tax revenues and strengthen customs; mobilize predictable flow of grant aid; put in place a systematic MTEF to manage security expenditure obligations, finance adequate O&M, and consolidate social protection programs.                     |
| <b>Strategic Priority</b> | Preserve gains; mitigate increases in poverty   | Reduce poverty gradually over time  |

7. **Political factors outside the realm of development policies are a primary driver of the degree of uncertainty and conflict in Afghanistan going forward.** A key unknown is the extent to

which current efforts to start negotiations with the Taliban insurgency will bear fruit. The government has taken bold actions to initiate dialogue and negotiations, including engagement with neighboring countries. In the longer term, there is widespread understanding that peace would yield enormous economic and social benefits for Afghanistan and the wider region. However, the path toward peace is unclear. One of the risks is political fallout within Afghanistan between its various factions or with regional and international partners, depending on what trade-offs become necessary to reach an agreement. Another key unknown is the extent to which expectations about the ambitious political reform agenda can be met and the nature of any resulting fallout.

8. **Some development interventions can help mitigate uncertainty and fragility.** While some fragility drivers are outside the development realm, many of the specific development interventions discussed in this report are intended to either mitigate uncertainty or provide the best opportunity for progress in a fragile environment. Strengthening agriculture is particularly important because of its relative resilience to conflict, while improving the functioning of land markets can help bolster both private sector confidence and state legitimacy in an environment of fragility. Providing safe passage for girls and women to education and health facilities is particularly important in a conflict environment, while leverage regional integration for energy and water needs can help mitigate regional drivers of conflict. Revenue mobilization efforts need to focus on those technical solutions which have the greatest impact on mitigating endemic corruption and weak governance, while expenditure prioritization efforts will need to pay attention to geographic disparities in aid flows related to security considerations.

9. **Poverty and development outcomes will depend very much on the degree of uncertainty and conflict, and development interventions under a deteriorating scenario will be insufficient to reduce poverty.** Under a deteriorating scenario, encouraging broad-based private investment will be difficult, so that job creation will need to continue to rely on agriculture and the public sector. Safeguarding the integrity of the banking sector will be important to avoid a downward spiral of investor confidence. In the area of service delivery, increasingly tight resources will limit new investments in infrastructure and require a focus on a core set of basic services and labor-intensive investments to support jobs. Opportunities for social safety net interventions will increasingly need to be explored to cushion the impact on the poor. Such a protracted low case scenario will also require a slower drawdown of aid and be associated with lower development outcomes. On the other hand, if levels of insurgency and uncertainty begin to abate and if the new government's strong reform vision can be translated into concrete actions, Afghanistan could well launch itself on a challenging but more optimistic decade of transformation with a gradual reduction of high levels of poverty.

*Focusing on the "how" in addition to the "what"*

10. **Within a fragile context, the "how" is just as important as the "what" of development interventions.** Making progress on the interventions identified in the three priority areas is often an uphill task in Afghanistan's increasingly fragile and conflict environment. In this context, careful thought needs to be put into the design of the interventions to overcome weak capacity, entrenched

interests, and considerable uncertainty, and to take into account the needs and voice of local citizens and communities. These aspects of design should help improve the odds of successful implementation and lead to a stronger possibility of interventions becoming sustainable in the face of fragility. In addition, it will be important for Afghanistan to pursue a number of complementary initiatives to gradually address the fundamental sources of fragility. These include initiatives to strengthen the legitimacy and accountability of public institutions, reduce corruption, and improve capacity of the public administration.

**11. Trade-offs between short run stability gains and longer run development opportunities can influence the selection of interventions.** Activities to promote short-run stability, however well-intentioned, can often be at the expense of worsened longer-term development opportunities. Conversely, some actions which have the potential to mitigate fragility over the medium- to longer-term could be disruptive and possibly even de-stabilizing in the short run. These tensions result in dilemmas for policymakers and international partners, which must be factored into decisions on policies, programs, and investments.

**12. One major time-horizon tension relates to anti-corruption efforts.** Firing incompetent or corrupt officials and striving for merit-based senior appointments can clash with political bargaining and the political culture of dividing the “spoils”. Moving towards greater transparency and accountability is necessary in the long run to gain greater legitimacy for Afghanistan’s institutions, but may increase tensions in the short run. Similarly, efforts to move service delivery towards the province level needs to be considered carefully in light of transparency at this level as well as provincial capacity to deliver. There is no easy answer and each activity will need to be carefully thought through both in terms of time horizons and real and perceived benefits.

## Appendix A: Consultations and Team Composition

### Internal Consultations

1. **The SCD has benefited from a highly inclusive internal consultation process that began with the Policy Notes exercise in 2014 and has continued into the SCD exercise in 2015.** In light of the tight timeline for the SCD, the approach that has been used has intended to avoid replicating the year-long prioritization exercise conducted as part of the Policy Notes based on inputs and participation of all GPs and IFC. The Policy Notes included three rounds of internal consultations:

#### *Internal Consultations for Policy Notes*

|                      |   |
|----------------------|---|
| February-March 2014: | First round of detailed presentations by all GPs on challenges, analytical work, and priorities in their respective areas |
| March 2014           | Policy Notes Workshop in Dubai to synthesize the storyline within and across three thematic areas.                        |
| April-June 2014      | Focused discussions with specific GPs to refine the storyline and policy priorities in their respective areas             |

2. **As part of the SCD process itself, several rounds of consultations across GPs, CCSAs, IFC, and MIGA** have taken place to brainstorm on the approach and timeline, identify areas for further analysis, discuss initial findings, and brainstorm on implications of the findings for priorities to reduce poverty. In addition to extensive focused discussions, the following team-wide consultations were held including GPs, CCSAs, IFC, and MIGA:

#### *Internal Consultations for SCD*

|                |  |
|----------------|--|
| November 2014  | Pre-concept brainstorming on timeline, approach, team composition, structure of management supervision, and outline of concept<br><br>Launch Email from CD to all GPs, IFC, and MIGA including PPT on the “What, When, Who” of the Afghanistan SCD, requesting a focal point from each GP, and requesting any relevant analytical inputs |
| January 2015   | Pre-concept brainstorming on fragility framework for SCD and draft outline of concept note   |
| February 2015  | Pre-concept team discussion on draft concept note and outline of fragility note  |
| March 2015     | Concept Review Meeting   |
| May 2015       | Brainstorming on PPT on Draft Outline of SCD and Draft Fragility Note  |
| August 2015    | Extended SCD Team brainstorming on Draft SCD   |
| September 2015 | Full Country Team Meeting on Draft SCD   |

### External Consultations

3. **The SCD comes at an important time in the World Bank Group’s engagement and dialogue with the new government.** Through the Afghanistan Policy Notes and a number of specific quick response notes, the WBG has proactively supported the new government since October 2014 in assessing its development challenges and appropriate responses. The new government declared its commitment and vision to addressing these challenges through its paper “Realizing Self Reliance: Commitments to Reforms and Renewed Partnership” presented at the London Conference on Afghanistan in December 2014. The SCD is expected to continue this proactive engagement and dialogue with the government, development partners, and civil society.

4. **The team has undertaken a set of external consultations with counterparts in Afghanistan.** This has taken the form of moderated workshops with the government, civil society, the private sector, and development partners. The workshops have involved a presentation by the team of the findings and priorities identified by the SCD followed by an interactive discussion with counterparts to encourage a two way exchange of ideas.

*External Consultations for SCD*

|  |   |
|--|---|
| Time:                                  | September 13-16   |
| Audience:<br>(Four Separate Workshops) | (1) Government<br>(2) Civil Society<br>(3) Private Sector<br>(4) Development Partners   |
| Format:                                | Powerpoint Presentation:<br>What is the SCD?<br>What are findings of the SCD?<br>Questions for Discussion<br>Interactive Discussion with audience |

External consultations with the Afghan authorities and development partners have also taken place in the context of the work on the Programmatic Poverty Assessment and the policy dialogue related to the ARTF Incentive Program.

### **Team Composition**

5. This SCD has been prepared by a core team comprising Faruk Khan (TTL, MFM), Silvia Redaelli, Pedro Olinto (Poverty), Tony Cholst (CMU), Gladys Lopez-Acevedo (SARCE), and Guillemette Jaffrin (T&C and F&M). IFC inputs were coordinated by Serena Cavicchi, Wagma Karokhail, Meagan Andrews, Rapti Goonesekere, and Patricia Wycoco, while MIGA inputs were coordinated by Paul Barbour. The SCD has had an informal Advisory Committee comprising Robert Saum (Country Director), Martin Rama (SAR Chief Economist), Stephen Ndegwa (Operations Manager), Shubham Chaudhuri (MFM Practice Manager), Benu Bidani (Poverty Practice Manager), Nadeem Siddiqui (IFC Country Manager), Richard Hogg (Program Leader), Suhail JmeAn (Program Leader), and the core team members. In response to the country director’s SCD launch announcement in November, all GPs provided a focal point to lead their contributions to the SCD as

listed below. Based on the incremental gap-filling work and report structure identified in the concept note, additional team members have been asked to contribute as needed.

| Global Practice/Cross-Cutting Support Area | Focal Points  |
|--|---|
| Agriculture                                | William B. Magrath, Ladisy Chengula, IFC Team                 |
| Climate Change                             | Daniel Mira-Salama  |
| Education                                  | Nathalie Lahire   |
| Energy & Extractives                       | Richard Spencer, Michael Stanley, IFC Team                    |
| Environment & Natural Resources            | James Monday  |
| Finance & Markets                          | Guillemette Jaffrin, Ahmed Rostom, IFC Team                   |
| Fragility                                  | Alexandre Marc, Radhika Srinivasan, Richard Hogg, Asta Olesen |
| Gender                                     | Asta Olesen, Aphichoke Kotikula                               |
| Governance                                 | Richard Hogg, Paul Sisk, Paul Welton                          |
| Health, Nutrition & Population             | Tekabe Belay, Ghulam Sayed, Inaam Huq                         |
| Jobs                                       | Samantha Watson   |
| Macroeconomics & Fiscal Mgmt.              | Omar Joya, Claudia Nassif, Faruk Khan                         |
| PPP  | TBC   |
| Poverty                                    | Pedro Olinto, Silvia Redaelli                                 |
| Social Protection and Labor                | Lucian Bucur Pop  |
| Social, Urban, Rural & Resilience          | Asta Olesen, Deepali Tewari, Ladisy Chengula, Naila Ahmed     |
| Trade & Competitiveness                    | Guillemette Jaffrin, Khaleda Atta, IFC Team                   |
| Transport & ICT                            | Luquan Tian, Siddhartha Raja                                  |
| Water                                      | Toru Konishi  |

The team gratefully acknowledges the excellent and enthusiastic research support received from Vincent Floreani (SARCE) and Maya Sherpa (Poverty).

6. The analysis in the SCD primarily relies on an array of existing analytical work and strategy documents. The SCD has been closely coordinated with the *Poverty Status Update* led by Silvia Redaelli. Other analytical and strategy documents include the World Bank's *Afghanistan Policy Notes* (2014), the *Pathways to Inclusive Growth* (2014) report, the *Agriculture Sector Review* (2014) report, the periodic Poverty Update notes, the *PEFA* (2013) report, the flagship publication *Afghanistan in Transition: Looking Beyond 2014*, the *Afghanistan National Development Strategy*, the *National Priority Programs*. A list of reference documents is contained in Appendix B. Incremental gap-filling analytical work that was needed during the course of the SCD was limited to select issues that required further attention.

### Data Limitations

Data limitations, including both availability and quality, are a serious constraint to important economic and social analyses in Afghanistan. This is, of course, also an issue in other fragile and conflict countries. A number of limitations have proved particularly acute for the analyses on Afghanistan.

Macroeconomic data on national accounts, public finances, trade, and balance of payments are generally available, but lacking on a number of fronts. First, import and export data reported by the Central Statistics Office (CSO) and the Customs Department vary widely and both are known to fall short of actual figures on

imports and exports. Second, national accounts data is not disaggregated by regions or by quarters, which makes it difficult to track economic activity across the different regions of Afghanistan and on a high frequency basis. Third, a large portion of public finance data is off-budget and reliable, consolidated figures are not available on a regular basis.

The household survey data is also lacking on a number of fronts. First, the last survey dates from 2011/12 and it is likely that living conditions have changed significantly since then, particularly in light of the difficult transition. Second, the quality of the data in specific provinces is highly suspect, thus requiring difficult adjustments and exclusions. Third, the absence of a quality 2005 PPP for Afghanistan prevents computation of a \$1.25 2005 PPP international poverty line for Afghanistan.

Finally, an important data limitation relates to undertaking systematic analyses of important dimensions of fragility and conflict. These include limitations associated with the data on natural resources, ethnic fragmentation, presence of troops, aid flows, corruption, and absence of data incorporating sufficient spatial variation.

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Afghanistan Policy Notes Synthesis

Afghanistan Policy Notes (2 pagers and 10 pagers by Specific Topic):

- Fiscal Stability
- Finance and Investment Climate
- Land, policy notes
- Agriculture
- Extractive industries
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