THE WORLD BANK

Transition in Afghanistan: Looking Beyond 2014

Executive Summary

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TRANSITION IN AFGHANISTAN: LOOKING BEYOND 2014

Transition—the full assumption of Afghan responsibility for security by end-2014, the drawdown of most international military forces and the likely reduction in overall assistance—will have a profound impact on Afghanistan's economic and political landscape, extending well beyond 2014. *This study assesses the medium to longer term impacts of declining aid and military spending on economic growth, poverty, fiscal management, service delivery and government capacity. It suggests options to Government of Afghanistan (GoA) and the international donor community to manage and mitigate the adverse impacts of transition while exploiting the opportunities to improve aid effectiveness and encourage inclusive growth. This is the beginning of the process – additional analysis from the World Bank will develop these themes further over the coming months.*

------ EXECUTIVE SUMMMARY ------

Political uncertainty and insecurity could undermine Afghanistan's transition and development prospects. International experience (summarized in the World Bank's 2011 *World Development Report*) demonstrates that violence and especially protracted internal insurgency are extremely damaging to development, and that political stability and consolidation are key ingredients of transitions to peaceful development. If there is worsening insecurity and increasing uncertainty about longer-term stability, Afghanistan's development prospects will be harmed.

The extremely high level of current annual aid (estimated at $15.7 billion in 2010) is roughly the same dollar amount as Afghanistan's GDP and cannot be sustained. Aid has funded the delivery of essential services including education and health, infrastructure investments as well as government administration. There have been substantial improvements in the lives of Afghans over the last 10 years as a result of this effort. But these inflows, most outside the Afghan budget, have been so high that inevitable waste and corruption, aid dependency and use of parallel systems to circumvent limited Government absorptive capacity have impeded aid delivery and the building of a more effective Afghan state. The level of public spending -- both on and off budget -- that has been financed by such high aid flows will be fiscally unsustainable for Afghanistan once donor funds decline. Lesser amounts, matched by more effective aid delivery could, in the end, lead to some more positive outcomes. The key issue is how to manage this change and mitigate the adverse impacts and put aid and spending on a more sustainable path for the longer-term. International experience and Afghanistan's history after the Soviet military withdrawal in 1989 demonstrate that violent fluctuations in aid, especially abrupt aid cutoffs, are extremely damaging and destabilizing.

Large financial inflows outside the Afghan budget and fragmented aid in a situation of weak governance have been major sources of rents, patronage, and political power. This has inadvertently exacerbated grievances and conflicts as the relative strength of elite groups in Afghan society shifted. As aid declines, reliance on the opium economy and other illicit activities could increase. Ensuring that increasingly constrained public funds are well-used reinforces the need to maintain and improve upon the significant progress made by the Finance Ministry in establishing public financial management systems and a robust Afghan budget process.

The impact of declining aid on economic growth will be less than might be expected. Why? Because most international spending "on" Afghanistan is not spent "in" Afghanistan, and much of what is spent in Afghanistan leaves the economy through imports, expatriated profits and outward remittances. Nevertheless, projections suggest that, under even favorable assumptions, real GDP growth may fall from 9% a year over the past decade to 5-6% during 2011–18. Given Afghanistan's annual population growth of 2.8%, this would mean only limited improvement in average per capita income, continuing high rates of underemployment and little progress in reducing poverty. Only growth at the very maximum of the range of plausible scenarios would enable Afghanistan to achieve meaningful reductions in poverty and higher average per capita incomes. For example, with real GDP growth of 6% a year, average per capita income – currently one of the world's lowest at $528 dollars -- would take 22 years or about a generation to double.

Economic growth is much slower under less favorable scenarios. The growth projections are based on a set of assumptions (scenarios) related mainly to security, sources of growth, aid levels, and changes in investment climate. If the assumptions in the less favorable scenarios come to pass —for example, if agriculture performance is poor, if major mining investments (Aynak for copper and Hajigak for iron ore) do not materialize, or if aid declines precipitously over the period – then growth could drop to 3-4%. Deteriorating security and governance would lead to further economic decline. The underdeveloped financial sector and low rates of financial intermediation leave little scope for helping Afghan businesses adjust to slowing growth. Conversely, the decline could be partly mitigated by reducing aid in a gradual, planned manner and by increasing the amount of aid that is actually spent within Afghanistan which would result if more aid is channeled through the Afghan budget.

Underemployment will increase because the activities affected by declining financial inflows (services, construction) are relatively labor-intensive. Unemployment and especially underemployment in Afghanistan—respectively estimated at 8% and 48%—are already high, even with today's rapid economic growth. Roughly 6–10% of the working population has benefited from aid-financed job opportunities, most of these in short-term employment. Declining aid, therefore, can be expected to exacerbate underemployment levels (with fewer casual labor opportunities and lower pay for skilled employees).

The impact of the decline will affect some groups more than others. Aid has not been evenly spread across the country. Because of the choices made by donors, and the predominant role of stabilization and military spending, the conflict-affected provinces have had significantly higher per capita aid than the more peaceful (and often poorer) provinces. As a result, the slowdown in aid will be felt more acutely in the conflict-affected areas and in urban centers. If aid declines gradually so that it can be partly offset by growth of the security, mining, and civilian public sectors, the impact could be softened and spread over time. This would allow labor markets more time to adjust.

The direct poverty impact of declining international spending might be limited if aid becomes more equally distributed across provinces and the composition shifts toward development programs rather than short-run stabilization activities. Aid disproportionately devoted to the more conflict-affected provinces has had only a modest impact on poverty. Households in the conflict-affected provinces were less poor on average to begin with, so this concentration of aid inadvertently increased inequality amongst provinces and between groups. National programs delivered through Government, such as NSP, have benefitted Afghans more equitably.

The worst impact of transition will be on the fiscal situation with a projected financing gap of 25% of GDP by 2021/22. Even assuming ambitious targets for robust growth in domestic revenue are met (with a projected rise from 10% of GDP to more than 17% of GDP a decade from now) there will be an unmanageable fiscal gap. This gap arises primarily as a result of operations and maintenance (O&M) spending and the wage bill for security which together will be 17.5% of GDP by 2021. The civilian wage bill will increase to 9%, the non-security operation and maintenance (O&M) expenditure to 4%, other operating spending to 2.5%, and the core development budget to 10% of GDP.

To close this enormous fiscal gap, Afghanistan must rely on continuing international funding to pay for most security costs (salary and non-salary) if the size of the security sector (ANA and ANP) remains at currently agreed levels. In addition, civilian aid will need to be spent more selectively for development and O&M. Various combinations of aid and domestic resources for different spending categories are possible. But a reasonable approach could be for domestic revenues to cover the full civilian operating budget and a portion of the security costs (at the current level of 3% of GDP). Donors would finance the remaining bulk of security costs plus a more highly prioritized core development budget. Other low-income countries receive, on average, around 9% of Gross National Income in non-security development assistance. Afghanistan would require close to three times this level in total aid. If these levels of foreign assistance for security and civilian expenditures are not forthcoming, then GoA will need to make extremely difficult and possibly destabilizing tradeoffs – either grossly underfunding or significantly shrinking Afghan security forces or crowding out essential civilian spending, or both.

Public resources will need to be focused on ensuring regular delivery of key basic services and essential infrastructure. Investments almost entirely funded by donors over the past decade have significantly increased access to basic services and infrastructure including in basic health and education, rural access, power and irrigation. Nevertheless, Afghanistan's development indicators still remain among the worst in the world. Afghanistan's public finances will not be able to absorb both the cost of operating and maintaining all of the infrastructure assets created in an often fragmented manner over the past 10 years and delivering the range of social and other services to the Afghan people currently financed through donor-funded programs. This will require difficult decisions requiring cutting or shrinking some programs, not maintaining all assets, and managing expectations accordingly. Better outcomes would result if sustainable institutions for maintaining key infrastructure are developed and operate transparently. Strict priorities among the many demands for O&M and services will also be necessary to provide fiscal space for public investments that will be critical to maintain and increase growth.

Increasing on-budget aid and managing O&M through government systems would greatly improve aid effectiveness. But the government will need to overcome serious absorptive capacity constraints if it is to be in a position to receive additional donor money on budget. After core development spending more than doubled in absolute terms between 2005/06 and 2007/08, disbursement levels have stalled at just under $1 billion annually over the past four years. This is a result mainly of unrealistic budget formulation, large budget carryovers from previous years, budget rigidity resulting from earmarked donor funding and limited government capacity to implement projects on time. The execution of the operational budget has been historically high (96% in 2010/11), but this has been almost entirely wage spending. In the future, managing O&M—expected to increase from only $335 million now to $4.8 billion by 2015/16 (of which$1.3 billion is for civilian O&M) -- will be a major challenge.

Improving the capacity of the core civil service, with an emphasis on strengthening budget execution and service delivery, will be critical for government functioning and service delivery. Today's extremely heavy reliance on a "second civil service" of externally funded Afghan staff needs to be transformed into core government capacity. Transition provides an opportunity to rationalize the terms and conditions of externally funded staff, bring them into a coherent framework of government capacity development, and over the longer term integrate them with the regular civil service. This will put government functioning and service delivery on an affordable and sustainable path. Even then, GoA will not have sufficient resources of its own to absorb the costs of these externally funded staff. Moreover, some level of foreign-provided technical assistance will need to remain. Therefore, donor financing for externally funded staff and TA will be required, but in a way that better aligns with the government's own planned rationalization and that will increasingly strengthen its ability to deliver on its own.

At the same time, ensuring the delivery of services to the Afghan people requires delegating much more responsibility in this regard to the provincial level. To date only a tiny fraction of the total O&M budget goes outside the line ministries in Kabul. Enhancing the capacity of provincial offices to participate in budget formulation and of key spending ministries to execute their budgets at the sub-national level will need to be an important focus of the transition period moving forward. Without this, it could be difficult for GoA to absorb a greater proportion of aid on budget and deliver results to the Afghan people.

Transition will require the concerted and sustained efforts of both the Afghan government and the international community to overcome difficulties and sustain development progress. Factionalized politics, patronage and corruption make it harder for GoA to pursue a more cohesive longer term national agenda. Likewise, if the international community views transition from a narrow perspective of a hand-over of security rather than an opportunity to enhance the coherence and effectiveness of international assistance, it will be difficult for the Government to achieve more sustained development objectives over a longer time horizon. And even with the best efforts of GoA and donors, successfully managing transition will also require a level of political and security stability sufficient to encourage private investment.

Transition outcomes can be improved through the actions and policies of both the Afghan government and the international community. Drawing from the analysis, a number of suggestions are given below.

For Government of Afghanistan, these could include:

- ***To make hard choices in a highly constrained resource environment*** is not easy for any government, but especially difficult in the current political and security situation. Nevertheless, it will be essential that ***GoA, working closely with donors, ensures that the core civilian/development budget does not become a casualty of high security expenditures and inadequate aid***.

- ***Continue to strengthen public financial management systems and the budget process, and reduce rent-seeking opportunities and leaks in revenue collection.*** This will underpin donor confidence and commitment to shift more aid onto the budget and offset political economy pressures on the budget.

- ***Pursue more aggressively and effectively public administration reforms, rationalizing the second civil service and enhancing capacity, particularly at the sub-national level.*** This will be crucial for the longer term sustainability of the Afghan state.

- ***Foster a better environment for the private sector to encourage investment, entrepreneurship and innovation.*** A successful transition will require replacing economic growth driven largely by aid-based public investment and consumption to one that is inclusive and sustainable. This will require not only security, but concerted efforts in policy reform, good governance and reduction in rent-seeking. Infrastructure investments are needed to support gains in agriculture, natural resource development and enterprise development as engines for growth and job creation.

- ***Manage the allocation of resources to provinces to ensure greater equity and participation.***

__**For the international community, these could include**__:

- ***Ensure that reductions in international assistance are gradual, predictable, and orderly.*** This will reduce uncertainty, short-termism, and sharp fluctuations in aid. The alternative runs a high risk of destabilizing fragile gains in development outcomes, social cohesion and Government legitimacy built up over the past 10 years.

- ***Any chance for fiscal viability will require a continuation of funding for most wage and non-wage costs of Afghanistan's security sector over the medium term,*** unless its size and cost become much lower. In the face of large demands for security spending, Government will also need support in protecting the civilian budget, including public investment and O&M.

- ***Channel a much larger proportion of aid flows through the Afghan government budget***. Assuming GoA does it part to increase its absorptive capacity, this will help mitigate the adverse economic impacts of declining aid since the local economic impact of on-budget aid is much higher.

- ***Rationalize the deployment and wages of the "second civil service" and develop an orderly plan for its integration into the regular civil service.*** That will maintain adequate capacity at feasible cost to support the government's functioning and service delivery in the medium-term.

- ***Connect Afghanistan with regional and global markets*** by removing restrictions on trade and transit and helping support the infrastructure investments necessary to realize the potential of the country's mineral wealth and to support inclusive growth along resource corridors.