MACRO FISCAL GENERAL DIRECTORATE

FISCAL STRATEGY PAPER

Medium Term Fiscal Framework

1396/2017

MINISTRY OF FINANCE
GOVERNMENT OF THE ISLAMIC REPUBLIC OF AFGHANISTAN

Fiscal Strategy Paper Contents

Key Acronyms

ADB	Asian Development Bank
ANDS	Afghan National Development Strategy
COFOG	Classification of Functions of Government
CPI	Consumer Price Index
FDI	Foreign Direct Investment
FPD	Fiscal Policy Directorate
FPF	Financial Programming Framework
FSI	Financial Sustainability Indicators
FSP	Fiscal Strategy Paper
GDP	Gross Domestic Product
GIROA	Government of the Islamic Republic of Afghanistan
IDA	International Development Association
IMF	International Monetary Fund
IsDB	Islamic Development Bank
MFD	Macro Fiscal Directorate General
MFM	Macro Framework Model
MOF	Ministry of Finance
MTBF	Medium Term Budget Framework
MTEF	Medium Term Expenditure Framework
MTFF	Medium Term Fiscal Framework
NPP	National Priority Plan
PEFM	Public Expenditure and Financial Management Law
SOE	State Owned Enterprise

Introduction

This fiscal strategy paper (**FSP**) will set out the Government's medium term macro-fiscal framework, and provide guidance for the circumstances under which the 1396 budget will be set. It contains:

- The Afghanistan Macro Forecast for 1396, and outer years and the international context
- The policy framework under which the budget will operate, including rules the Government will adhere to, setting out the Macroeconomic, Fiscal and Spending Policy areas.
- The medium term outlook for revenues, and broad categories of non-discretionary and discretionary expenditure, including aid forecasts and scenarios
- An overview of past performance in Government spending, and aid execution
- A discussion of the risks presented for the next fiscal year, including estimations of their impact
- A debt sustainability and fiscal sustainability analysis
- Initial Forward Estimates for the Line Ministries, based on past expenditures (as a cost of continuing current policy)

Risks are compiled in order to determine scenarios for the macro-fiscal framework, some of these are set out in the ***Risks to the Macro-Fiscal Framework*** section, under Impacts; others are set out in the Scenarios portion of the ***Medium Term Fiscal Framework*** section. An overview of the macroeconomic and fiscal risks is set out in a Risk Matrix on page 32.

The Government produces the macro-fiscal forecasts using a macro-framework model built around EViews, and uses multiple sources of information in order to inform these forecasts. The assumptions behind the macro forecasts are set out on page 13; the policy assumptions behind the fiscal forecasts are set out in the ***Fiscal Policy*** section (detailing the broad fiscal policy framework). These forecasts, and accompanying analysis, are produced by the Macro Fiscal General Directorate (**MFD**), of the Ministry of Finance.

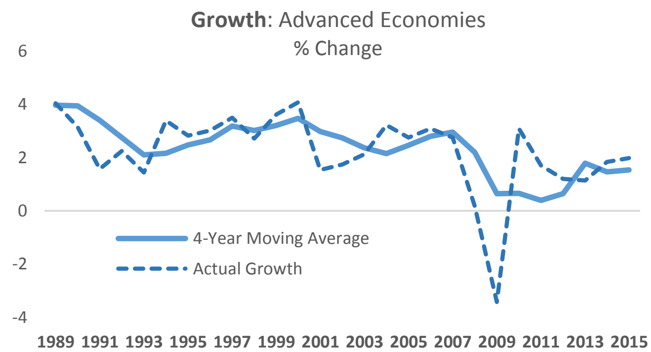
The macro-fiscal data set out in this document are the initial estimates for 1396 and onwards[1], these figures are indicative and may be adjusted during budget preparation as more information becomes available on the base year performance (1395) and on overall macro-fiscal conditions.

[1] Estimates have been generated for 1395 as a base year, as the final data is not available for this year at the time of production.

International Economic Outlook

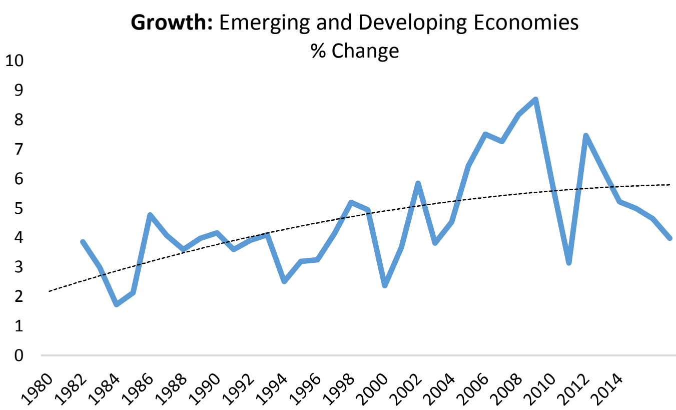
Overview of Economic Conditions

Growth has been subdued in 2015, with the IMF estimating world-wide growth of around 3.1%, with growth particularly reduced in emerging and developing economies. The latter still accounts for considerable amounts of overall economic growth, and as a result a downturn offset much of the improvement in conditions in advanced economies. The growth in advanced economies, while it has seen some improvement, still lags behind the performance prior to the financial crisis.



Source: IMF World Economic Outlook, October 2015

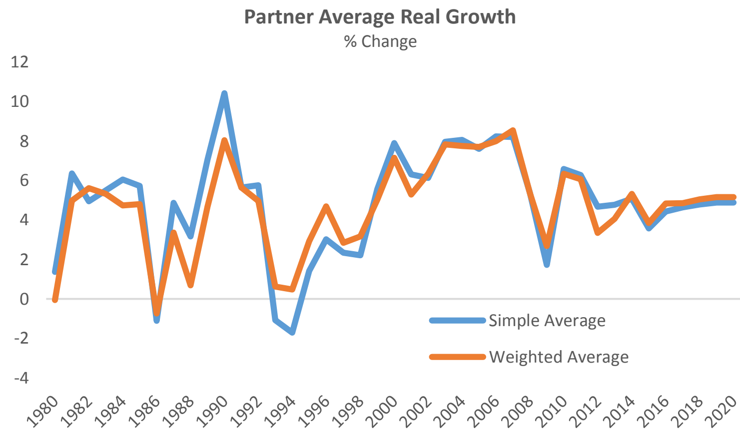
Recent activity has been hurt by the slowdown in growth in China, and the subsequent slowdown in commodity prices impacting commodity exporting economies. While this has helped growth, and household incomes, in commodity importers it has slowed growth in the exporting economies – which are typically developing and emerging markets.



Source: IMF World Economic Outlook, October 2015

Over time we have seen improvements in the growth performance of emerging and developing economies, and while growth has fallen post-2008 it remains high.

World Economic Outlook for 1395 and 1396



The IMF is projecting a slow pickup in global growth, from an estimated 3.1% in 2015, increasing gradually to 3.4% in 2016, and 3.6% in 2017; a slight revision downwards on the previous speed of growth acceleration. The uptick in growth is expected to be driven by resilient growth in the United States, and some strengthening in Japan, as well as some pickup in the Middle East despite lower oil prices. Growth will remain weak in Latin America, in part because of a recession in Brazil, and growth in Russia is expected to lag as a result of sanctions and lower oil prices.

Large drops in, particularly fuel, prices are not expected to see significant increase again in the next couple of years, with futures prices projecting relatively stable prices over time, with some small increase.

% Change	2014	2015	2016	2017	2018	2019	2020
China	7.3	6.8	6.3	6.0	6.1	6.3	6.3
India	7.3	7.3	7.5	7.5	7.6	7.7	7.7
Islamic Republic of Iran	4.3	0.8	4.4	4.0	4.2	4.4	4.4
Japan	-0.1	0.6	1.0	0.4	0.7	0.9	0.7
Kazakhstan	4.3	1.5	2.4	3.8	4.0	4.2	4.5
Pakistan	4.0	4.2	4.5	4.5	5.2	5.2	5.2
Russia	0.6	-3.8	-0.6	1.0	1.5	1.5	1.5
Turkmenistan	10.3	8.5	8.9	9.2	8.6	8.4	8.2
United Arab Emirates	4.6	3.0	3.1	3.3	3.5	3.6	3.8
Uzbekistan	8.1	6.8	7.0	6.7	6.5	6.5	6.5

Source: IMF World Economic Outlook, October 2015

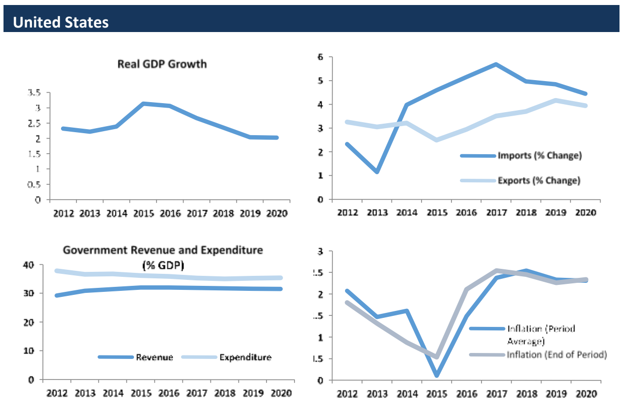
World

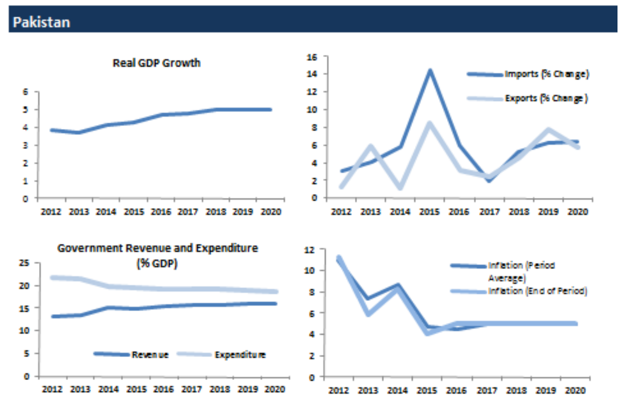
2016 will see an election in the United States, a vote on the UK's membership in the European Union, a further slowing of growth in China and the continued lifting of sanctions on Iran. The IMF projects that global output gaps in advanced economies will narrow further, with improved activity in emerging economies like Brazil and Russia.

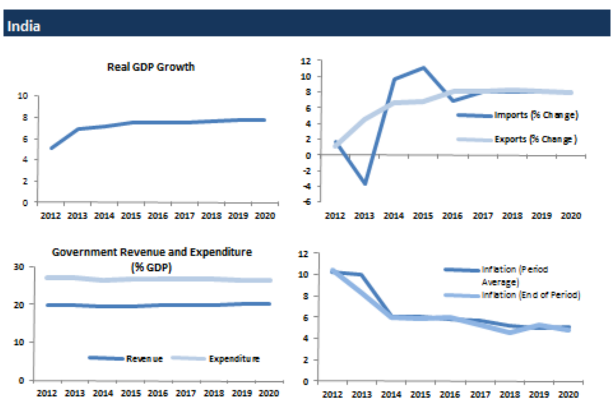
The US saw the first move away from extraordinary monetary conditions in 2015 with a small rise in the interest rate; and a further unwinding is likely to happen at a slow rate over the medium term.

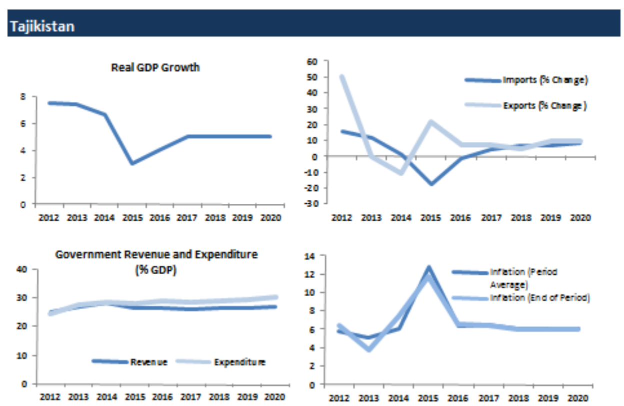
Regional

The performance by partners, detailed in the charts below, shows a general narrowing of fiscal gaps (with the exception of Tajikistan), and an expected moderation of inflation (although the rate is expected to pick up again in the United States after extremely low inflation in 2015).





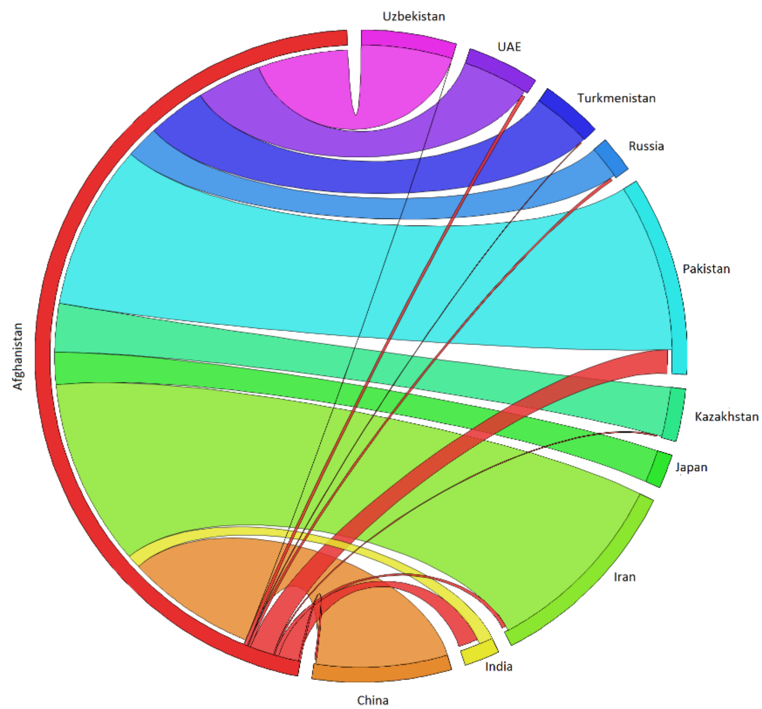




Trade flows within the region have remained relatively steady, with the key training partners for imports (shown in multiple colours) continuing to be Pakistan, Iran, China and other close regional neighbours.

The exports of Afghanistan (shown in red) are primarily towards Pakistan and India, in line with historic performance.

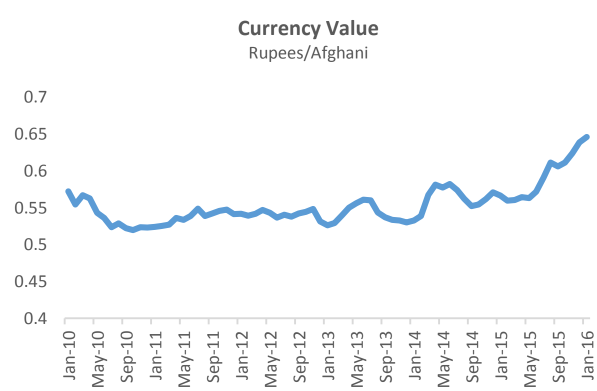
The chart on the right shows the flows to the 10 large trading partners (by exports plus imports).



Source: *INTRACEN, 2014 Trade Flows. MFD Staff Calculations*

Iran: Iran has seen large falls in economic activity in a few key sectors (including construction and manufacturing) in recent times; with the slowdown in part the result of delays in investment decisions while sanctions are lifted and falls in commodity prices internationally hurting a key export. Growth is however likely to be significantly improved as sanctions are lifted, with greater access to financing options, financial services, international trade and investment.

Pakistan: lower oil prices are likely to boost Pakistan's growth prospects, however a number of sectors have seen some reduction in activity, including in export sectors. However, in general prospects are likely to be positive given planned investment in energy and regional trade expansion. The rupee saw significant falls in value, in line with the Afghani, meaning there have been smaller falls against the rupee than other currencies.



India: India is expected to see a continued strengthening of growth following on from improved business confidence and general economic conditions. Inflation has seen a moderation, but risks still remain from volatility in global markets.

China: China's growth is expected to slow in the coming years, with subsequent effects on world commodity demand. Afghanistan is not too reliant on China at the moment for exports, however a continued slowdown is will reduce the likelihood of any startup in extractive industry within Afghanistan.

Box 1: Economic Changes in China and Lessons for Afghanistan

China's economy is emerging now as the leading world economy and has experienced a remarkable transformation and rapid growth over the last 25 years. One of the key aspect for this economic change has been the role of private sector in achieving its high rate of growth. The economic growth has averaged 9.5% over the past two decades. Many industries have become integrated into the world supply chain which made China the largest exporter in the World. Changes in the government economic policies to give greater rein to market forces have driven this extraordinary economic performance.

Initially, this transformation began in the agriculture sector, and gradually extended to industry and a large portion of the services industry. In addition, the government's introduction of a company law permitting private individuals to own limited liability corporations, and rigorous enforcement of competition laws sharpened the business environment and increased the FDI in the country. Even the momentum towards a freer economy has increased this decade after China got the WTO membership.

To speed up the growth, the government in 2005, abolished the regulations that prevented privately-owned companies from entering a number of sectors, such as infrastructure, public utilities and financial services. Overall, these changes have permitted the emergence of a powerful, robust private sector in the economy.

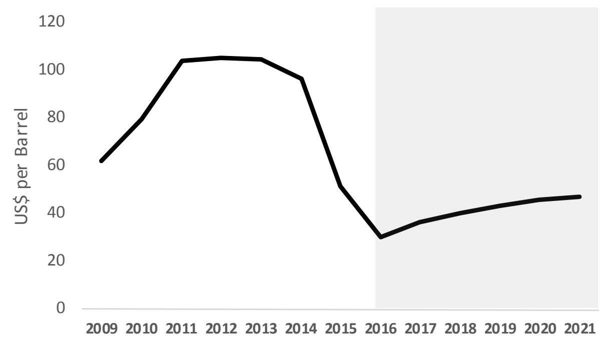
This is not all, the government has also introduced a number of reforms into the state-owned sector that dominated the economy in the early 1990s. Those reforms included changing the state-owned enterprises into corporations. As a result, the number of state-controlled industrial enterprises fell by over one half. These and the other reforms helped improve opportunities for investment utilizing the funds generated by one of the highest rates of savings in the world – the gross saving rate approaches half of GDP. This led to a particularly rapid increase in the capital stock. Investment has also led to an increasingly urban society–a movement that has gone in step with a flow of people from the land into the service and manufacturing sectors of the economy.

Moreover, the government has adopted a policy of raising the educational qualifications of young people. A program was launched to give all children nine years' education, to ensure that all rural areas achieve this goal by 2006. All the above reforms, new laws, and facilities provided by the government led to rapid growth during this period.

Commodity Performance and Forecasts

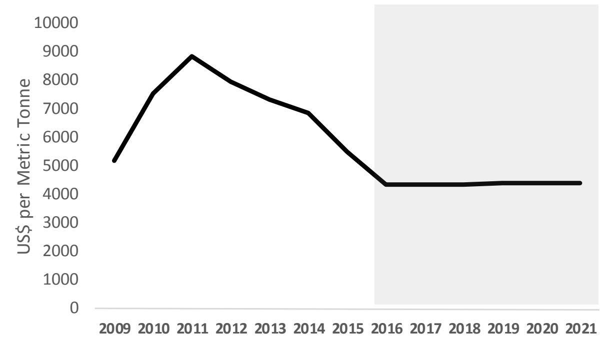
Crude Oil Prices Forecast	**Copper Prices Forecast**

Crude Oil Prices Forecast



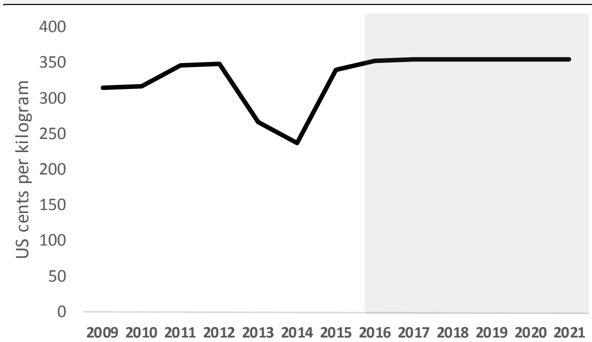
Afghanistan relies on imports of imported fuel, and fuel prices locally tend to move in line with international prices. Prices dropped considerably in late 2014/early 2015, pushing down local prices. They are expected to recover slightly heading towards 1395, however futures prices indicate that prices are expected to remain lower for some time.

Copper Prices Forecast



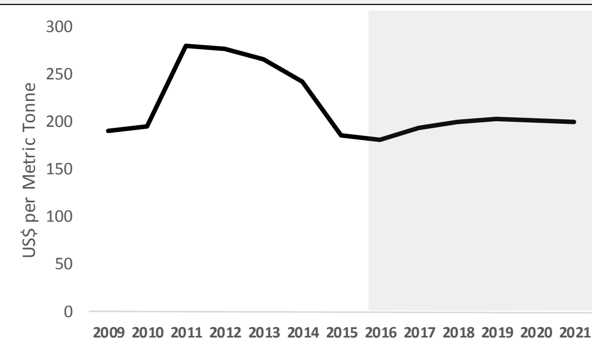
Copper prices have declined dramatically from a peak in 2011, unfortunately this has made copper a less attractive investment around the world, including in Afghanistan. Prices are expected to stabilise over the medium term, meaning we cannot rely on an increase in copper prices to make mining investments more appealing here.

Tea Prices Forecast



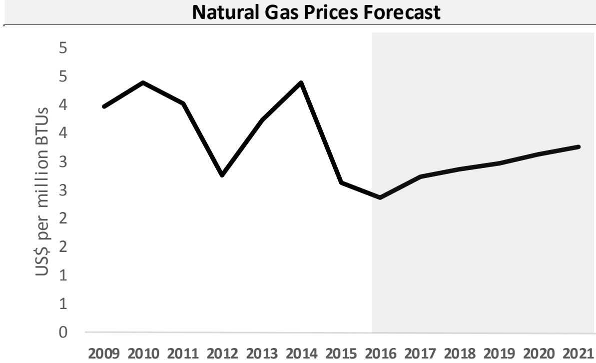
Tea prices are expected to stabilise, having recovered from a drop in line with the general commodities drop.

Wheat Prices Forecast



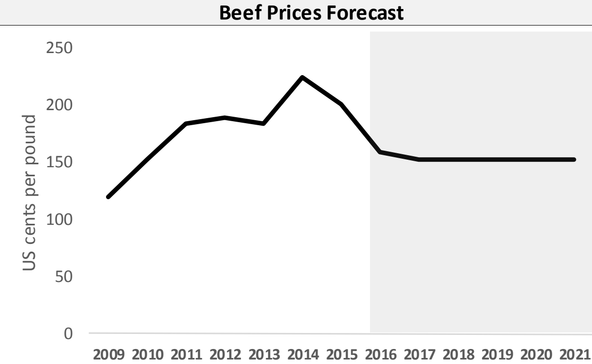
Wheat prices are expected to remain fairly stable, with limited recovered from the falls. As a result this shouldn't create additional pressure on households.

Natural Gas Prices Forecast



Natural gas prices are expected to see some increase, remaining in line with historic trends

Beef Prices Forecast



Are expected to remain flat, again reducing the pressure on household budgets.

Source: IMF WEO, and MFD Staff

Box 2: Commodity Prices

The options and futures prices for commodities give an indication of the market expectations for the future movements of prices. The volume and costs of sales at a given strike price indicate either that the buyers expect prices to exceed or fall below the strike price (depending on whether the option is a call or a put).

We look at the sales of options for crude oil; the volume of the outstanding contracts at each strike price for Mary 2016 is shown below:

Volumes of put options we would therefore expect to fall below the likely future price, giving people a hedge against falls that are too significant. Whereas call options we would expect to rise above future expected prices, as people hedge against too significant a price rise.

Futures prices give the price people are willing to pay now for the future delivery of a commodity, as a result again give an indication of the movement of market expectations.

Both of these measures indicate a slow, slight increase in commodity prices over the course of the year and the medium term. Large jumps in the prices will be dependent on decisions made by the major oil producers, but in general a slowdown in investment and a slowdown in expansion of supply should lead to an upward pressure on prices in the immediate future.

ODA Outlook

A number of factors impact the levels of ODA support countries provide, including factors that (1) affect which country they elect to provide resources to, and (2) the overall level of resources provided for ODA. The former would, for example, be impacted by geo-political considerations, as well as the level of wealth in the recipient country. The latter could be affected by factors like the level of GDP growth in the donor country, their fiscal deficit, or overall spending etc.

In this section below we overview some of the factors impacting ODA provision, as a method of giving an idea of the outlook for ODA support to Afghanistan.

Decisions to give ODA:

Countries make their decisions on how much ODA to give overall based on:

- Their own levels of GDP growth, which would be expected to be especially pronounced in those countries which have a percentage of GDP target for ODA (e.g. the 0.7% of GDP target)
- Their historic levels of ODA support, implying that policies do not change dramatically, and once a decision is made on a level of ODA support it tends to remain relatively sticky.

Decision on who to give ODA to:

Countries make a decision on who receives ODA based on:

- The level of GDP, there is a negative relationship between GDP level and ODA. A ten percent increase in the level of GDP is estimated to permanently push down aid by 2%.
- The level of institution quality, in the short term, pushes up aid support to a country
- The level of need, using a proxy of infant mortality. This component most influences the size of the aid flows in those looked at.

As a result, we expect a gradual diminishing of aid resources, offset slightly by the size of the need at the moment including security needs, as well as the reforms the Government is putting in place to encourage donor support.

Risks in the World Economy

The major risks in the World economy include:

- The slowdown in growth in China provides risks for the region and the broader world, especially through the likely impact it will have on commodity prices and Chinese investment decisions
- An overall slowdown in emerging market economies, or a stall in the recovery in those economies
- Over-tightening of monetary policy in the developed world
- Uncertainty in the European Union reduces investments and growth

Regional Risks:

- Continued low commodity prices put pressure on fiscal and economic situation for countries in the region and delay further investment
- Insufficient improvements in job growth, and growth not feeding through to improved household incomes and living conditions
- Regional conflicts extend or worsen, causing growth and trade to deteriorate and hurting regional connection efforts

Macroeconomic Performance and Outlook

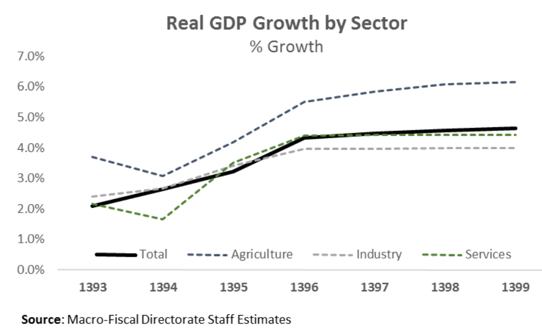
Historic Performance

Economic Performance in 1394

The Afghan economy has been growing and recovering slowly after having experienced a sizable economic downturn and fiscal crisis in 2014. The growth rose to almost 2.6 percent in 2015 from 1.5 percent in 2014. The outlook for the economic recovery and growth is looking positive, as it is evidenced by strong revenue collection by the government in 2015.

Economic growth

For 2016, the growth is estimated to be 3.2 percent, driven by the contribution of the recovering services, agriculture, and construction sectors particularly.



- 1394 is estimated to have been a reasonable year for agriculture, with growth in wheat production, livestock expected to remain stable. Next year we expect moderate growth in agriculture, with no reason to expect a downturn.
- Construction we expect to see continued growth in, particularly in line with a commitment to expand the execution of large development projects.
- Government services likely to continue to grow, reflecting new resources, and new donor support likely to come through the budget.
- Reduced activity in restaurants, hotels and retail likely – as demand in those areas corrects

Inflation

At the beginning of the year, there was a sizeable drop in international prices which filtered through to deflation in the local market. The increase in prices at the end of the year was driven by the changes in local taxes, particularly on sales (the BRT increase) and on imports.

Exchange and Trade

The rate is likely to continue to depreciate, although at a slower rate, since the fundamentals are likely to change with decreasing donor flows over time. Imports are likely to reduce as firms correct to lower market requirements for imported goods.

The removal of sanctions on Iran is likely to create new trading opportunities, and potentially hold down import costs for groups operating in Afghanistan who previously could not use Iranian imports.

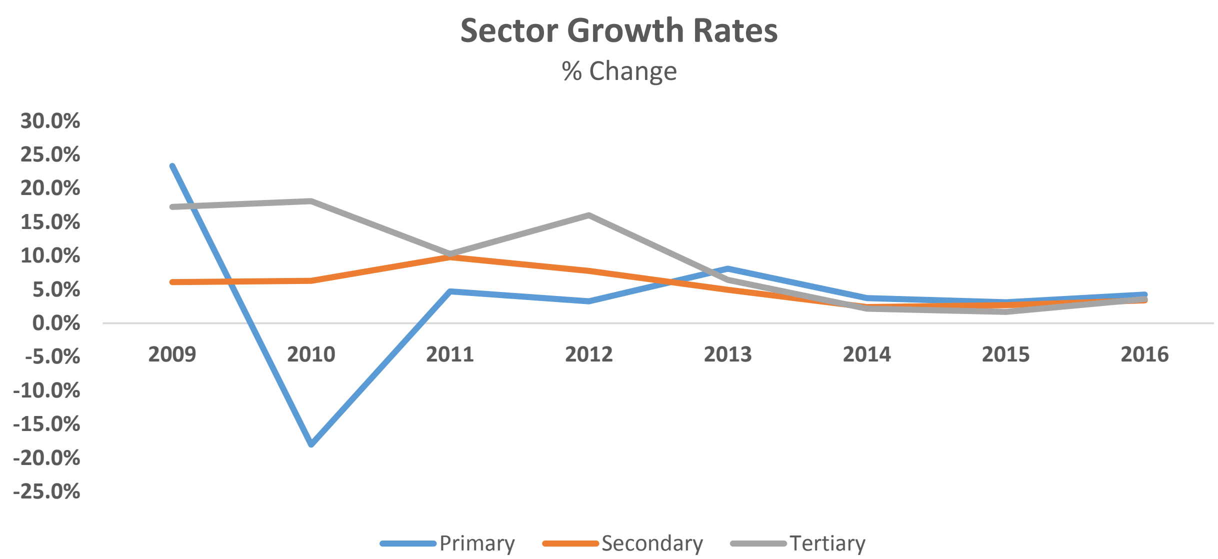
Monetary Sector

Private sector credit dropped in 1395, exacerbating problems for businesses in Afghanistan. In part this may have been caused by (1) the economic uncertainty and (2) the falling currency prompting banks to make more dollar investments abroad to maintain investment value. We expect some improvement in credit this year with a stabilizing currency, and in the medium term Government efforts to build a debt market through Government bills is expected to deepen the financial sector.

% Change	Historic							
Unless otherwise noted	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Real GDP Growth - Factor Price	**16.3%**	**3.0%**	**8.6%**	**10.6%**	**6.4%**	**2.6%**	**2.2%**	**3.7%**
Growth by Sector								
Primary	23.3%	-18.0%	4.7%	3.3%	8.1%	3.7%	3.1%	4.2%
Secondary	6.1%	6.3%	9.8%	7.8%	4.9%	2.4%	2.7%	3.4%
Tertiary	17.2%	18.1%	10.3%	16.0%	6.4%	2.2%	1.7%	3.6%

Source: Macro-Fiscal Directorate Staff Estimates — Figures include opium

Source: Central Statistics Office, and FPD Staff Estimates



Outlook

Growth is expected to pick up in 2016 after a period of slow growth, and continue to improve through 201. Improving activity in the agriculture sector, and efforts like the Government's Jobs for Peace program are expected to see reductions in unemployment and push growth slightly higher.

Inflation is expected to remain moderate, with some pick up in 2017 in line with the historic acceleration in prices after a slowdown. The inflation in 2016 is largely driven by the low rates in 2015, leading to a higher percentage price rise being apparent in 2016. In the medium term inflation is expected to moderate to around 4 percent.

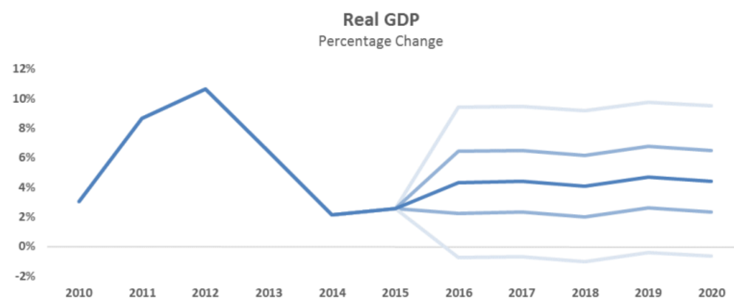
In percentage change	Historic	Current	Budget		Outer Years		
Unless otherwise noted	2015	2016	2017	2018	2019	2020	2021
Real GDP Growth - Factor Price	**2.2%**	**3.7%**	**4.1%**	**4.2%**	**4.8%**	**4.5%**	**4.4%**
Real GDP Growth - Market Price	2.6%	4.3%	4.4%	4.1%	4.7%	4.4%	4.4%
Nominal GDP Level (Afs bn**)**	1219.3	1319.3	1426.8	1526.7	1632.8	1736.2	1843.1
NGDP by Sector (Afs bn**)**							
Primary	280.5	319.5	357.6	395.8	440.9	484.4	530.1
Secondary	253.0	301.9	322.8	341.0	358.5	374.1	389.6
Tertiary	655.7	641.9	682.3	723.0	762.8	803.6	845.7
GDP Deflator	-0.4%	2.5%	3.6%	2.8%	2.2%	1.8%	1.7%
CPI Inflation							
EOP	0.1%	4.9%	8.0%	4.9%	4.1%	3.8%	3.6%
Average	-1.5%	6.5%	5.7%	5.9%	4.7%	3.9%	3.7%

Source: Macro-Fiscal Directorate Staff Estimates — Figures include opium

We have assumed that:

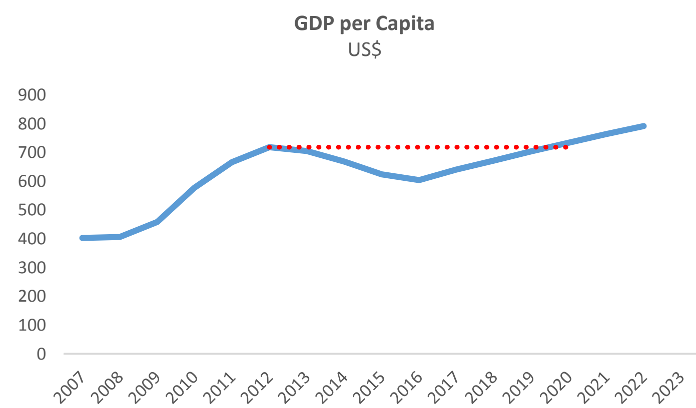
- Weather conditions remain favorable, and there are no adverse shocks to rain fed farming
- Security conditions remain relatively stable, and donor activity does not reduce too significantly in the medium term
- Government services continue to see increases pushing up services activity

GDP is being led by growth in the agriculture sector, with expansion expected in the growth of wheat and fruits. Livestock growth is expected to remain relatively slow, in line with historic performance. This is expected to mean that, over the medium term, agriculture becomes a large proportion of economic activity, and services diminish (in line with falling donor activity, and less reliance on the Government as a major source of activity). The chart on the right shows the stochastic projection for growth: with 50% confidence we expect growth to be between 2% and 6% over time, and with 90% confidence we expect it to fall between 0% and 10% over time. The wide range of uncertainty reflects the large shocks that have been seen historically in growth.



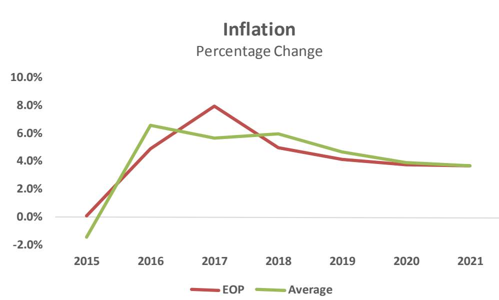
GDP Per Capita: GDP per capita is expected to start rising after slight falls in 2014 and 2015, reflecting the slowing activity in the country. The GDP per capita is expected to recover to 2013 values in 2016.

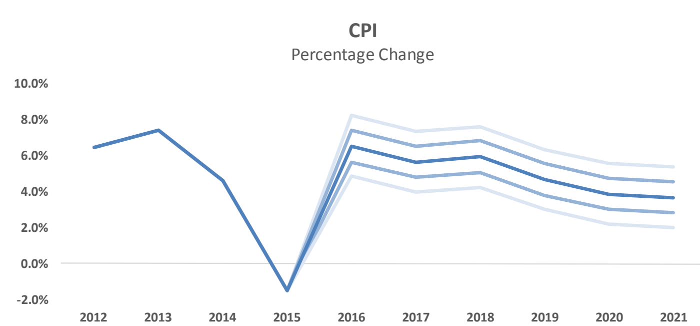
GDP Per Capita	2015	2016	2017	2018	2019	2020	2021
in Afs	37797	40099	42515	44593	46751	48730	50712
in USD (at 2016 exchange rate)	569	603	640	671	703	733	763



In US dollar terms the value is expected to take slightly longer to recover, recovering back to the previous peak by 2019. This is in part the result of the large falls in the currency value. In PPP (Purchasing Power Parity) terms this is likely much higher, given the low cost of living in Afghanistan.

Inflation: International prices are likely to remain subdued; both options contracts and futures prices reflect an expectation of continued low prices. The inflation is expected to remain moderate, but will pick up to 4.9% in 2016. Inflation is likely to pick up back to trend as a result of: (1) the continued effect of new measures; (2) the depreciation of the currency; (3) construction and jobs projects are likely to push prices up. There is also likely to be some pressure from international prices increases local prices.





Imports: imports are expected to remain fairly consistent, there will be some slowdown in the long term as the aid slows down, however we do not expect a significant drop-off in the medium term.

Exports: Exports are expected to remain fairly consistent, there has been limited expansion in secondary processing of materials (for example, marble, food etc) and as a result limited scope for immediate, significant export growth. Exports will likely expand once extractive industries start operation, however this is likely to be delayed while prices remain low.

Exchange Rate: The Government does not produce a medium term exchange rate forecast explicitly given the uncertain in forecasting exchange rates. However, in general we expect to see a stabilization of the currency, improving the situation in 2015. ***See Annex for Exchange Rate Assessment.***

This forecast is based on internally developed econometric models linking exchange rate expectations (i.e. historic exchange rates) and historic inflation rates to movements in the exchange rate over time.

The table below sets out the Afghanistan's estimated and forecast balance of payments:

Balance of Payments	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Current Account	**252**	**440**	**584**	**826**	**989**	**1256**	**1543**
Goods Balance	-472	-454	-499	-472	-534	-532	-567
Imports	513	589	557	577	603	625	643
Exports	41	135	58	105	70	93	76
Services Balance	41	36	58	66	73	81	91
Payments	125	143	136	140	147	152	156
Receipts	166	179	193	206	220	233	247
Net Income and Transfers	683	858	1025	1232	1449	1706	2018
Capital Account	**23**	**41**	**47**	**25**	**21**	**32**	**29**
Capital Transfers	2	19	34	8	7	15	14
Foreign Direct Investment	21	22	12	18	14	16	14
Other	0	0	0	0	0	0	1
Errors and Omissions	-15	-12	6	-11	-3	-8	-5
Changes in Reserves	**260.0**	**469.2**	**636.1**	**840.7**	**1006.1**	**1279.3**	**1567.0**
Reserve	**691.0**	**1160.3**	**1796.3**	**2637.1**	**3643.1**	**4922.4**	**6489.3**

Source: MFD Staff Estimates

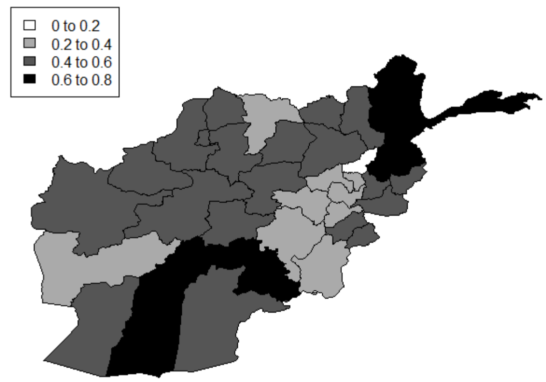
Population Forecast:

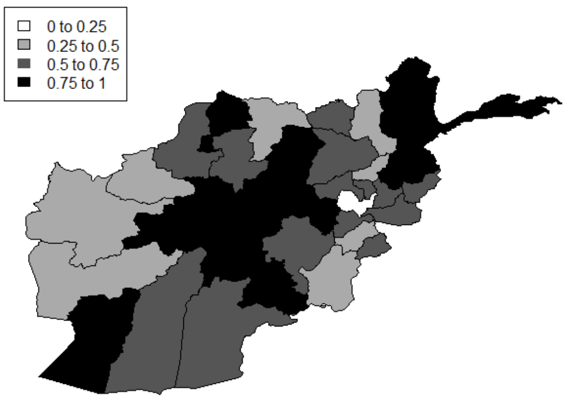
The population is expected to grow at around 2 percent per year, in line with estimates from the UN.

Social Indicators of Afghanistan

All data is take from the National Risk and Vulnerability Assessment (NRVA).

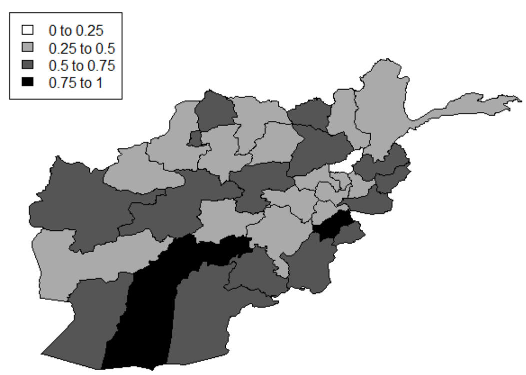
The map on the right shows the multi-dimensional poverty index (MPI) measure; 0 as the lowest poverty, 1 as the highest. While strides have been made in improving incomes and living standards; continuing this improvement will remain a government priority, and ensuring equity between provinces.





The map on the left shows the access to water (as a percentage of the population in the province). Again, significant strides have been made in attempts to ensure access to basic facilities over time.

The map on the right shows the access to electricity (as a percentage of the overall population in the province).



Fiscal Performance

Last Year's Performance (1394)

Ministry of Finance of the Islamic Republic of Afghanistan

Summary Fiscal Outturn - End of Year, 1394

Domestic Revenue including mining: The Government collected Afs 121.8 bn of a budget of Afs 125.5bn

Total Spending: The total spending of the Government was planned to be Afs 438.7 bn, of which Afs 320.9 bn was spent

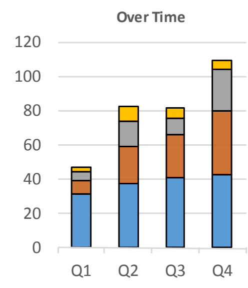
Donor Support: Donors committed Afs 302.9 bn towards the budget, Afs 179.3 bn was actually spent

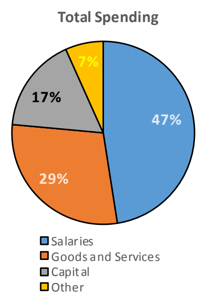
Total Deficit/Surplus: The total needed from other resources this year was Afs -19.8 bn.

Mining Revenue: The total revenue from the extractive industry was Afs 0.61 billion.

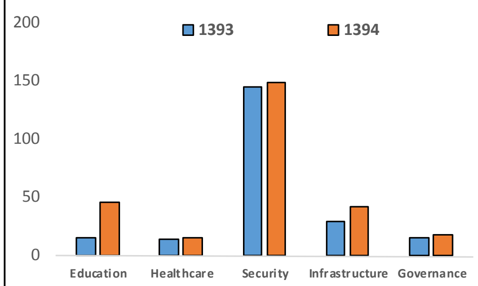
All figures are in billions of Afghanis

Spending on Inputs

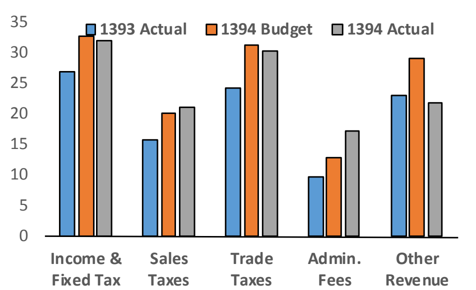




Spending on Sectors



Domestic Revenue from Sources



Meanings

Donor Support

This is the total amount of aid Government has received

Domestic Revenue

This is the total amount Government raised themselves

Total Spending

This is the total amount the Government has spent.

Total Deficit

This is the difference between total revenue and spending

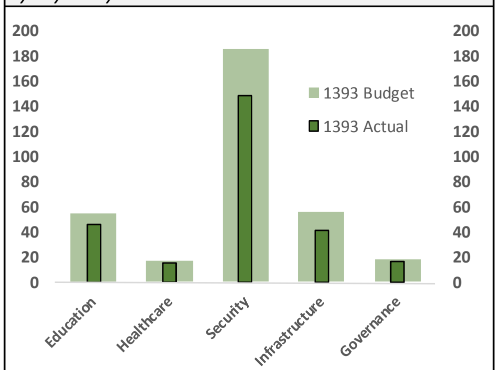
Total Revenue = Domestic Revenue + Donor Support

Budget: the Government passes a budget at the start of the year, which plans out how much each area will get to spend.

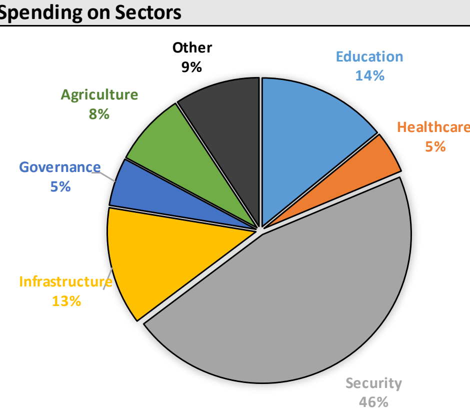
Expenditure: the expenditure is the amount each project/Ministry/Sector actually spends of their budget.

Portion of Budget Spent:

By Key Policy Area



Spending on Sectors



Source: AFMIS, Jan-16

Historic Debt:

Afghanistan went through the Heavily Indebted Poor Countries Initiative (**HIPC**) debt write down, which significant reduced the debt between Decision Point and Completion Point. Since that point debt has been largely concentrated in remaining debt from the Russian Federation, and debt to the multilateral organisations (our only source of borrowed funds at the moment). Debt has slightly increased as a proportion of GDP over the last year, as a result of small increases in the size of multilateral and bilateral debt, particularly from the IFIs. There was a slight increase in the Russian debt, largely as a result of valuation changes due to the falling currency.

	2014	2015
Total	**161.4**	**171.6**
% GDP	13.3%	14.1%
Multilateral	**71.6**	**77.6**
IDA	23.4	24.2
Asian Development Bank	39.2	43.9
IMF	6.5	6.4
IsDB	2.5	3.3
Bilateral	**58.9**	**63.0**
Russia	53.9	57.4
Bulgaria	0.5	0.5
Kuwait	1.3	1.4
Saudi Fund	2.6	3.1
Iran	0.6	0.6
Domestic	**31.0**	**31.0**
Central Bank	31.0	31.0

Source: Macro Fiscal Directorate Staff Calculations, World Bank, IMF and Debt Management Unit, Ministry of Finance

Expenditure Policy

The Government has set out a number of key priorities, including (1) ensuring that the Jobs for Peace effort is financed; (2) the creation of a Citizen's Charter setting out a level of service delivery across Government and (3) ensuring that policy development going forward occurs through the national councils.

The key policy priority areas for the Government in this budget are[2]:

- Job Creation schemes (Ministry of Agriculture, Ministry of Public Works, Ministry of Rural Rehabilitation and Development)
- [Cabinet/Minister/Khalid]

Going forward the Government will also expand focus on, in future years:

- Electricity projects: including hydropower dams
- Water management projects: irrigation projects etc.
- Private sector development projects

Macroeconomic Policy

Afghanistan has undergone a period of difficult adjustment with the withdrawal of international forces, and the reduction of international organisations. The reduced activity has worsened the economic situation, removing a significant number of jobs which were reliant on those forces, and impacting peripheral sectors like retail, restaurants and hotels, and transportation, as well as reducing rental prices in Kabul.

In reaction to this the Government has introduced a new strategy to improve economic prospects, particularly focused on jobs.

Key Goals:

1. Agriculture become self-reliant in next five years.
2. Making Afghanistan a transit hub.
3. Proper institution building and development of the regulatory framework for mining sector development.
4. Managing water resources and building hydro-power dams to generate electricity for exportation to the neighboring countries in need.

Policy:

The new policy fits around three strategic areas, these three pillars are:

- **First Pillar** (*Jobs and Productivity*): raise national productivity by rationalizing and focusing our investments in agriculture, mining, infrastructure, and regional connectivity in particular of course the human capital.

[2] These priority areas will determine the focus of new activities and projects for this budget.

- **Second Pillar** (*Business Friendly*): Afghanistan needs to build markets where firms can compete fairly, can create jobs, and where they can benefit from value chains that bring knowledge, capital and access to markets.
- **Third Pillar** (*Corporation and Transportation*): build partnerships with the private sector that enable growth and partnerships with our neighbors near and far to build regional cooperation for peace and prosperity and development.

First Pillar:

The newly introduced "Jobs for Peace" initiative, is intended to meet the aim of the first pillar – improving access to employment both long and short term, and boosting agriculture productivity. While ensuring that the effort leaves behind a permanent infrastructure that can help growth further. With this objective in mind, the Jobs for Peace effort will focus on:

1. ***Rehabilitating Agricultural Infrastructure***: much of the growth improvements in countries in Asia occurred post large investments in agriculture which helped to stabilize wages and improve poverty, paving a base for industry[3].
2. ***Labour intensive urban cleanup and repair***: ensuring that we fix the problems in our cities as a byproduct of employment
3. ***Fortifying Urban Peripheries***: ensuring we employ at-risk youth to help conserve and protect the areas around cities.
4. ***Micro-grants for female heads of households***: in order to promote small-scale works.
5. ***Housing finance***: producing a large stock of affordable housing
6. ***Cash transfers***: a program of cash transfers to help promote health in urban areas, in order to improve livelihood prospects.

Beyond the policy efforts set-out in the Jobs for Peace program, the government is also aiming to manage its water resources. To that aim, the government has plans to start construction of around 21 dams in the upcoming years. Water resource management will also play a key role in ensuring we can meet our goals in agriculture and electricity production.

Second Pillar:

Afghanistan's score in the World Bank's Doing Business Index is 177 out of 189, and running a business in the country remains a difficult task. One of the focus areas of the Government will be on improving the ease of operating a registered, legal business in the country – ensuring that businesses can have access to opportunities to expand work, and have a stable environment in which to operate. This will include:

1) The setting up of a one stop shop for business registration
2) The improved ease of business registration including eliminating the need for a tax clearance letter and extending the length of licenses
3) Special Economic Zones

[3] "Sources of developmental ambition in Southeast Asia" (2013), Henley, David

Third Pillar:

A number of regional co-operation efforts are underway including the TAPI project, CASA-1000 and multiple other agreements. The Government has set out the ambitious objective of restoring the Silk Road, with Afghanistan playing the role of a major connecting hub for the region. This effort falls into a number of key areas including: (1) the creation of transport connections; (2) the creation of trade agreements and (3) the creation of major resources agreements like TAPI. We will continue to work closely with CAREC on regional integration efforts.

Building Transit

The government has planned transit schemes for resources including gas transportation, and electricity. A number of the key schemes are:

- Turkmenistan – Afghanistan – Pakistan – and India (TAPI): this is a gas transportation pipeline, transporting gas from Turkmenistan to the region. It is expected to start in early 2020 and is estimated to generate around $ 450 million per year for the country.
- Turkmenistan-Uzbekistan-Tajikistan-Afghanistan - and Pakistan (TUTAP) power transmission project is sharing power across the region.
- Central Asia South Asia – 1000 is a power transmission project, transmitting a summer time power from Central Asia into South Asia.

Building Trade

- Regional Economic Cooperation Conference on Afghanistan (RECCA) is a regional cooperation body focused on projects that are passing Afghanistan. The sixth RECCA conference was held in September of 2015, and the Government emphasized the priority to turn Afghanistan into a regional hub revitalizing the "Silk Road" route.
- Afghan Pakistan Transit and Trade Agreement (APTTA) is a trade agreement that allows Afghanistan access to a number of sea and dry ports in Pakistan to trade Afghan goods with the rest of the world. It is a priority of the Government to ensure this agreement is fully implemented.

Building Transport

- Airports have been improved to ensure they can carry expanded export volumes (up to 600 tonnes per day); and this will be further increased.
- Plans are in place to construct the Chaman-Spink Boldak railway, and the Peshawar-Jalalabad railway and plans are in place for the development of the Peshawar-Kabul motorway.

Fiscal and Tax Policy

Fiscal Framework

The fiscal policy of the Government of Afghanistan helps set the framework for the medium term fiscal scenarios. The fiscal policy outlined in this section is the result of international agreements the Government has committed, as well as statements of the Government's fiscal objectives over the medium term. In general, the Government has adopted a contractionary fiscal policy, reducing the level of spending in order to meet resource availability. As Afghanistan does not borrow and has limited reserve funds, the fiscal policy is pro-cyclical, with falls in expenditure occurring alongside falls in economic activity.

Fiscal policy in Afghanistan is heavily influenced by both the 1393 cash crisis, and the large donor support to Government. 1393 saw a downturn in revenues, as a result of events surrounding the elections, and security transition. This downturn in revenues led to the use of the Government's funds held in the Treasury Single Account (**TSA**). As a result of these events, the fiscal policy over the medium term is tied to ensuring fiscal recovery from the downturn, and building the Government's domestic resources.

The Government proposes to slowly phase out donor support to key Government operations, bringing more on budget, and ensuring that the domestic revenues grow at a rate fast enough to cover operational expenditure in the long term. Over the medium term the Government proposes to increase the coverage of operational spending by domestic revenues. This is in line with the long run aim of covering the security expenditure fully by 2024.

The re-integration of government operations within the budget and government systems is a key aim of the government, in order to ensure that the Government controls more of the operational aspects of running the state – including on security, policy making, audit and oversight and budget preparation. In the medium term framework therefore, the Government's key fiscal policy aims can be stated as:-

- The reduction over the medium of the portion of the operational budget funded externally, and an improvement in the domestic revenue/operational spending ratio.
- The Government intends to ensure a build-up of cash reserves over the medium term in the Treasury Single Account, in order to provide a cushion of funds for future downturns. Given our commitment to avoid borrowing, we must ensure we are able to manage liquidity through a reserve of funds, and close management of cash.

Fiscal Policy from IMF Agreement:

Historically agreements under the IMF program have involved: -

- Ceiling on short term borrowing set to zero
- Ceiling on non-concessional[4] borrowing set to zero
- Ceiling on government guaranteed borrowing set to zero
- Ceiling on arrears set to zero

The Government has had a number of agreements with the IMF, including an Extended Credit Facility (**ECF**) program, and most recently a Staff Monitored Program (**SMP**). These have required the Government to adhere to a restricted borrowing plan, including no short term, or non-concessional borrowing. As a result, borrowing from local markets is unlikely to occur in the medium term, and borrowing is primarily sourced from the main concessional lenders (the World Bank IDA facility, the Asian Development Bank and the Islamic Development Bank). The ECF program came to an end in 1393 (2014), and was replaced with the 1-year SMP. A likely future 3-year program is in the process of being negotiated in line with the Government's commitment to ensure continued engagement with the Fund, and would most probably include a similar commitment to restrict borrowing. See chart below for an overview of fiscal conditions under historic IMF programs.

Terms and Conditions of Loans under Historic IMF Agreements

Term	Long Term	Short Term
Concessionality	Non-Concessional	Concessional
Borrower	Central Government	Guaranteed SOE

A long term, concessional loan to central Government would be uncapped under the agreement with the IMF; however, any other variant is subject to a zero cap (for example, a short term loan by the central government, regardless of conditions, would be not within the terms of the agreement).

As a result, in the MTFF resource envelope we have restricted borrowing to the identified concessional borrowing in the medium term. This includes borrowing from the ADB, IsDM and World Bank IDA (as well as the funds from the IMF agreement – see ***Debt and Fiscal Sustainability*** *Section*).

The next agreement with the IMF:

The aim in part of the new program is to ensure that the Government's reform agenda is given prominence, and that there is the generation of sufficient fiscal space to ensure development projects can go ahead. The Government will seek the IMF's support in ensuring this as well as more continued

[4] For the purposes of this rule, non-concessionality is defined as a grant element of less than 35 percent, typically we are aiming for a grant element of 60 percent.

engagement over policy and macroeconomic issues with the IMF. The new program will be a 3-year Extended Credit Facility (**ECF**) program[5].

Fiscal Policy from PFEM Law:

The Public Finances and Expenditure Management Law (**PFEM**) Law sets out the conditions under which guarantees may be given by the Central Government. In only two circumstances can the Government give a guarantee for a loan, these are:

- Where a law is in place authorizing the value of the guarantee
- Where the budget law includes appropriation for the value of the guarantee

As a result, we are not assuming that the framework contains any commitments to give guarantees throughout the year. Therefore the Government will not acquire new contingent liabilities throughout the medium term.

The PEFM sets out rules on the preparation of the budget, including timelines and reporting requirements after the fact, as part of this it sets out a rule on the appropriation for contingencies, which will guide the contingency appropriation in the MTFF.: "An appropriation not exceeding 3% of total program expenditures for contingencies".

Fiscal Policy from the Minerals Law:

At the moment all minerals revenue goes through the general Government budget and the Treasury Single Account (**TSA**), the Government does not operate a separate fund to save minerals revenue as either a revenue stabilization or wealth fund.

Fiscal Policy from Other Agreements:

- The Government has made a commitment to phase out external support to the security sector by 2024, starting with financing for meals for soldiers being brought on budget, and with increasing salary payments being made by the Government instead of through donor support. The Government committed to ensuring that operation and maintenance spending was slowly phased on to budget.
- Afs 500 million of domestic revenue is committed to security sector spending (ANSF - Ministry of Defense and Ministry of Interior – Chicago Conference Agreement) (NSC and NDS – the Government contributes more in previous years, because we have a wider definition of the security sector.)
- The Government earmarks around 10% of domestic revenue each year as a contribution to the development budget. The Government maintains discretion over how this money is spent within the development budget.

[5] An ECF is a 3-year program with access to Fund resources, made available to PRGF countries with long-term balance of payments deficits. As part of the program the IMF and the Government will agree a set of reform benchmarks, and quantitative criteria that determine success under the program.

Government Debt Strategy:

The Government set out, in 2005, a series of debt policies which determines the constraints on debt acquisition by the Government. These are in line with the policies agreed under the programs with the IMF, and are intended to elaborate further the Government's continued commitment to debt sustainability. Among these are:

- Debt is the total of Government borrowed funds, guarantees and contingent liabilities, and as a result fall under these constraints.
- The Government will only acquire debt from the International Financial Institutions (**IFIs**), and that debt should be at concessional rates: with repayment terms, service charges and other fees and charges below market.
- The Government sets an annual limit on borrowed funds and guarantees, set out in the Budget book, however there is no longer term limit set out.
- The Government will only issue domestic debt when circumstances support it, and policies, procedures and processes have been established.
- The Ministry of Finance, in consultation with the Budget Committee, will determine if a specific project should be financed through borrowing, dependent on the economic rationale of the project, the number of beneficiaries and any other criteria the Government deems to be important.

In line with the commitments under previous IMF programs, the Government will not borrow, other than concessionally.

Policy Objectives Affecting Aggregate Ceilings:

- The Government aims to ensure that operation and maintenance of new capital is accounted for the in the expenditure plans of Budgetary Units through the medium term, ensuring that the cost of capital expenditure projects are fully realized at the decision time.

Earmarked Operational Budget:

Portions of the operational budget are earmarked towards specific expenditures. The donor support to the operational budget cannot be used generally within the operational expenditures, and is instead focused on the security sector (within that sector there is some room for some small variety of uses within the codes agreed with donors). These areas of support are:-

- LOTFA: is earmarked to the security sector, it is to be used for salary payments.
- CSTC-A: is earmarked to the security sector, however there is discretion within that where the money may be spent (MoD and MoI)
- NATFO (National Army Trust Fund Office): is earmarked to the security sector, primarily training and development expenditure.

Revenue Policy Objectives

The Government aims to ensure that enough domestic resources are mobilized to allow for the development of new projects and activities in line with Government policy objectives each year. The tax policy decisions will be reactive to the needs of the national budget.

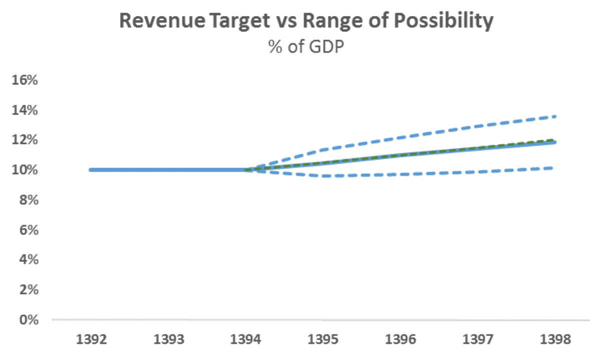
a. Fulfill the implementation of the 'my tax paid for…' program to educate citizens on why tax payment is important and how it impacts their lives.

b. Ensure the implementation of ASYCUDA WORLD across 6 major customs locations, to ensure accurate report on our largest streams of revenues.

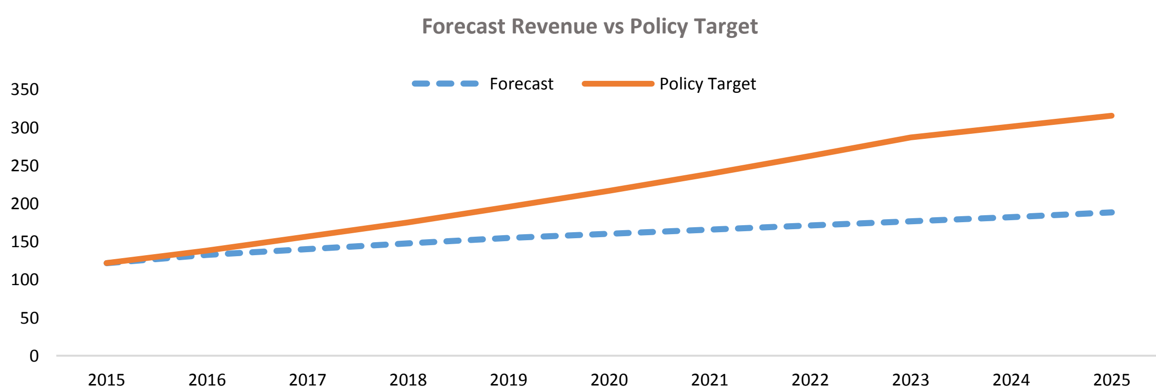
c. Strengthen the Customs enforcement unit to address leakages in the system.

d. Turn Afghanistan into a regional transit hub: with the CASA-1000, TAPI and TUTAP programs and our work in CAREC supporting power and energy transit.

The aim of the Government is to ensure growth of around 0.5% each year as a proportion of GDP. Collection in 1394 was 10%, meaning for 1395 and 1396 the aim is to collect 10.5 and 11% of GDP respectively.



The revenue collection target is ambitious, but feasible. The chart opposite shows, for the range of all countries since the 1980s that have achieved improvements in their collection, the scale of that improvement – mapped on to Afghanistan's target rates of collection to GDP. This shows that our aim is entirely in line with the degree of improvement that has been seen by other countries historically over a 5-year period.



Tax Policy Changes

In 1394 the Government introduced a number of new tax policy measures[6], these continued to 1395 through re-introduction in the national budget book and have influenced the baseline forecasts for revenue.

The new measures include:-

- An increase in the overflight fees charged to airlines, pending agreement on the increase with the International Air Transport Association (**IATA**).
- An increase in the rate of Business Rate Tax (**BRT**) charged on sales of goods
- An increase in certain tariff duties paid at the border
- An increase in the fee placed on the import of a liter of fuel.
- The introduction of taxes on the top-up credit for mobile phones

Tax Measure	**Change in Collection**	**Macroeconomic Impact**	**Policy Impact**	**Efficiency Impact**
Custom Duties	4.2	-0.9	1.1	4.0
BRT	4.2	1.23	3.0	0.0
Fuel Fee	0.5	0.04	0.8	-0.3
Telecoms	0.8	0.0	0.8	0.0
Overflight Fee	0.1	0.0	0.2	-0.1
LPG Fee	0.4	0.0	0.4	0.0
All Other	11.3	0.80	0.0	10.5
TOTAL	21.5	1.17	6.3	14.0

The table above shows estimates of the reasons for increases in the tax collection this year, highlighting the efficiency gains the Government has made in collection over the course of the year. The macroeconomic impact on the customs duties in decomposed into two components (1) a valuation effect – the falls in the value of the currency mean that the value in Afs of imports rises and (2) a demand effect – that the falls in the value of the currency reduce the purchasing power and the demand for goods from abroad after increasing their costs. We assume the latter outweighs the former.

The policy impacts are calculated based on the within year change in monthly collection as a result of the introduction of the policy (thus, assuming those effects are the same through the year, not incorporating macro and efficiency changes). The efficiency impact is the residual.

The gains made in efficiency reflect the collection of historic arrears, and the effort the Government has made, despite a difficult economic environment, to improve domestic collection. New policy measures have had a smaller impact than initially hoped, as a result of delays in implementation and high demand responses to some goods (see ***Box 3***).

[6] The new measures were primarily introduced later in the year, and collected only for a few months.

Box 3: Demand responses to new measures

The new measures introduced in the 1394 Budget were delayed in implementation, reducing slightly the expected collection from them. The below table estimates the size of the collection as a result of the policy change through the new measure, and estimates an annualized return:

New Measure	Collection	Annualised
BRT 2% to 4% (both domestic and imports)	Afs 3.0 billion	Afs 12.0 billion
Customs Duties increases	Afs 1.1 billion	Afs 4.4 billion
Overflight Fee increase	Afs 0.2 billion	Afs 0.4 billion
Fuel Fee (and LPG) fee increase	Afs 1.2 billion	Afs 3.6 billion
Mobile Fee introduction	Afs 0.8 billion	Afs 3.2 billion

Source: MFD Staff Estimates

The table below shows the implied elasticity, i.e. how responsive demand is to prices/taxes, from the new measures, the calculations are based on the collection additions calculated above:

Item	Elasticity
Overall Goods (from BRT)	-7.09
Imported Goods (from Customs)	-3.52
Overflight	-0.39
Fuel	0.00

Source: MFD Staff Estimates

The elasticities also provide a check on the calculations above – they should be in line with the same values from similar countries.

Tax Expenditures: tax expenditures are tax incentives that the Government provides for particular types of provision of services, or goods, or to encourage a particular activity in line with policy goals (they can be provided through deductions, exemptions or differential rates of taxation). These are so called because the policy goal could also be achieved through a direct expenditure rather than through revenue foregone. As part of the commitment to full policy transparency some of these are set out here, and the Government will develop a more comprehensive listing and costing over time:

- An exemption on BRT for the provision of non-profit health services
- An exemption on BRT for the provision of non-profit education services
- There are BRT exemptions for financial and insurance services (in line with Article 65 of the Income Tax Law)

- Income received from renting a residential property to a natural person for more than 6 months of the tax year is exempt from BRT.
- Each of: religious services, humanitarian aid, G+S to the Government for natural disaster reconstruction, and physical education and sports are all exempt from BRT providing they are non-profit entities.

Box 4. Background to the Value Added Tax (VAT)

VAT was planned to be implemented in FY 1394, however due to the complexity of the tax system, the ARD wasn't ready to roll out this tax in 1394. Hence, it is now planned to be implemented in a future year.

VAT is a tax on consumption levied whenever the value of goods and services increases as they change hands in the course of production, distribution, and final sale to the consumer. The VAT has two concepts in VAT – zero-rating and exemption of goods and services. The VAT law has provided special provisions in this regard for certain goods and services which are exempted and zero-rated.

With the VAT introduction, the entire 2% BRT levied in border will be exempted along with partial replacement of 2% BRT collected by LTO office. Hence, the introduction of VAT will not be a huge burden in the market and should not adversely affect the price level as well. The overall effect of price level would be an increase of around 1.4% to 2% only. Manufacturing and Equipment will be affected the most, however the price level of telecommunication will fall by around 1% or higher. Similarly the effect on food and beverages will be very minimum.

VAT has a major advantage over the BRT: VAT prevents tax on tax and further exempts and zero-rates tax on certain essential goods and services. However there are still caveats to it, such the intricacy of tax calculation and compliance.

Risks to the Macro-Fiscal Framework

This section sets out the risks to the macro-fiscal framework, including an assessment of the scale of the risk, the likely outcomes of the risk and potential mitigation strategies.

Risk Matrix

The below table sets out the key risks to the Government's macro-fiscal forecasts.

Risk	Likelihood	Impact	Details
Fiscal: domestic revenue collection is reduced once all arrears in tax payment have been collected.	MEDIUM	HIGH	High returns from domestic revenue collection were the result of collections in historic arrears and some one-off payments. As a result, future collection, which would not include these, could be less than expected.
Macroeconomic: continued security problems cause reduced economic activity in the provinces	HIGH	MEDIUM	Peace talks are underway with insurgents however risks remain to the security situation given the worsening casualty rates in recent years, and emerging new threats.
Fiscal: efforts to increase execution rates impact the cash available, and potentially cause liquidity concerns.	MEDIUM	MEDIUM	Efforts by the Government to continue regular high-level cash management meetings and monitor cash and expenditure throughout the year will help mitigate this.
Fiscal: efforts to improve the execution of development spending are impacted by security, and problems in new procurement processes.	MEDIUM	HIGH	The Government aims to execute 80% of the development budget in 1395. While reforms to the management processes in MoF and support from the Office of the President could help promote execution, there are still risks out of easy control.
Macroeconomic: continued high level of immigration reduces the value of the Afghani.	MEDIUM	MEDIUM	Large outflows of people in 1394 have reduced the value of the Afghani, as high levels of exchange occurred. Depending on the security situation and European policy this may continue this and next year.
Fiscal: new measures face political difficulties leading to reductions in rates in 1396.	LOW	HIGH	Difficulties were faced this year in continuing the new measures; there has been pressure in the past to reduce the rates for taxes.
Macroeconomic: large pickup in prices if international prices increase again.	MEDIUM	MEDIUM	Much of the fall in prices last year was the result of follow through to the local market of large falls in international commodities, particularly fuel. If this were to occur again prices may spike.
Macroeconomic: low rainfall or hail during the spring impact crop performance, reducing agriculture growth.	LOW	MEDIUM	Hail during the spring has historically reduced the production of fruits, particularly grapes.
Fiscal: Exchange rate depreciation causes cost increase for Government imports	MEDIUM	MEDIUM	The exchange rate has fallen dramatically in the past year, this could feed through into higher prices locally, putting pressure on Government expenditures.
Macroeconomic: trade barriers placed against the exports of fruits impacts livelihoods.	LOW	LOW	An imposition of trade barriers, or non-tariff barriers, would reduce activity.
Fiscal: Aid slowdown (commitments don't materialize)	MEDIUM	HIGH	Reduced aid support, either as a result of disbursements not made, or conditionality not met by the Government could drastically cut back expenditures.

Fiscal: Revenue slowdown as a result of continued import slowdown	MEDIUM	MEDIUM	Reduced import activity could affect multiple revenue lines.
Macroeconomic: continued uncertainty reduces FDI	MEDIUM	MEDIUM	FDI does not see much growth as a result of continued uncertainty.
Macroeconomic: lower donor activity will impact economic activity (and will potentially increase unemployment).	MEDIUM	HIGH	Feed through effects from donor reductions impact other sectors of activity.
Fiscal: the risk of reduced retail activity (leads to underperformance to target in BRT collection as well as reduced overall growth).	LOW	HIGH	Retail activity is particularly vulnerable to changes in donor presence, and changes in consumer confidence. Falls in confidence could lead to cut backs on consumables.
Macroeconomic: international commodity and food prices rise again after the slowdown this year.	MEDIUM	LOW	At the moment we do not predict a large increase in food or fuel prices, however a large upward pressure on prices would occur if international commodity prices started rising again.
Macroeconomic: inflation and reduction in the external dollar flow cause a depreciation in the value of the Afghani.	MEDIUM	LOW	The strength of the US dollar this year has caused a general depreciation against the dollar around the world. However, Afghanistan has the added pressure of difficulties from reducing dollar flow, and increased demand for foreign currency with emigration.
Fiscal: O&M costs are calculated as higher than anticipated	LOW	MEDIUM	The costs of particularly donor-determined projects create pressure for the budget in the medium term. This will be a particular issue once we come to assessing the baseline costs of providing services through rolling assessments of Ministries.
Fiscal: pension payments are exceeded by pension collections in the medium term	MEDIUM	LOW	The cost of the pension scheme will outweigh the collection made on employee contributions. It is likely to also outweigh the cost of the employee and employer contributions in the medium term.
Fiscal: Government cash reserves remain very low, and mismatches between revenue and expenditure could precipitate another cash shortage.	MEDIUM	HIGH	A key difficulty for the Government remains the low available cash; this has led to a fiscal crisis in previous years. Cash available remains low, and could lead to problems in ensure speedy payment.
Macroeconomic: depreciation of the Afghani causes increases in food prices, and the CPI going forward[7]	MEDIUM	MEDIUM	Similar to the difficulties it may present to the Government expenditures – increases in prices as a result of the currency fall could lead to pressure on household expenditures.
Macroeconomic: continued emigration creates a downward pressure on the Afghani	MEDIUM	HIGH	Continued high levels of emigration, for which people typically require US dollars, could create a continued pressure on the currency.

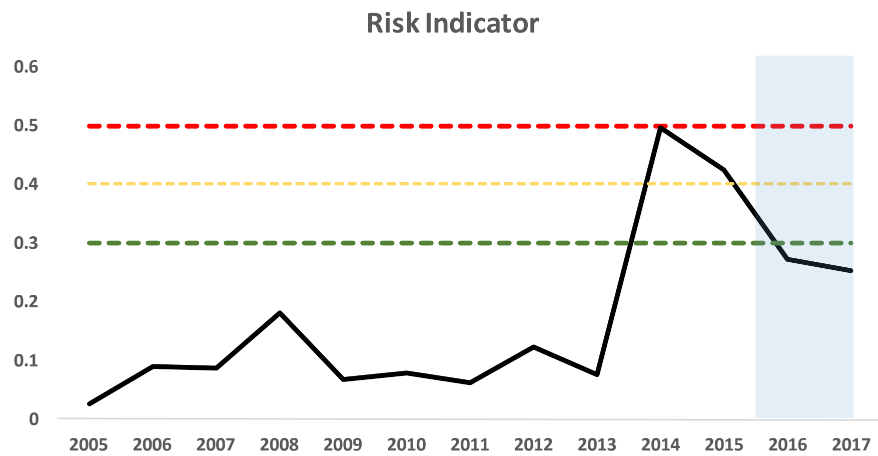
Source: Ministry of Finance and Macro Fiscal Directorate

[7] Low impact, as this will likely only offset some of the falls in prices.

Fiscal Risk Indicator

Indicator Value for 2017	26%

The reduction in the indicator for risk of a fiscal crisis since last year is the result of improved revenue and economic growth outlook, and a reduction in the likely structural and primary fiscal balances by the end of the year. Debt to GDP remains far below the threshold for risk, as do interest payments to revenue. The major risks to the fiscal situation in the indicator are the high fertility rate, presenting fiscal pressures in the future; non-performing loans creating pressures from the financial sector and the previous period's poor fiscal performance. **While the indicator has fallen there is still substantial risk from the TSA balance, which remains low.**



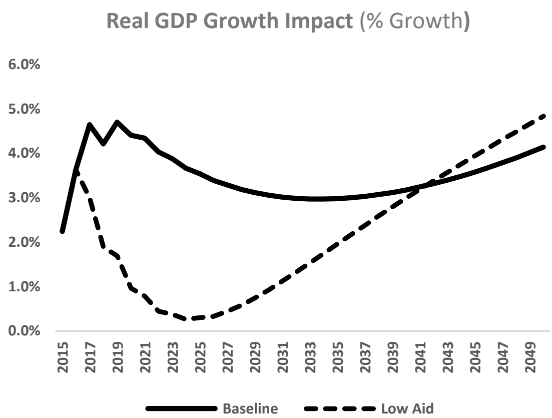
Impact of Risks

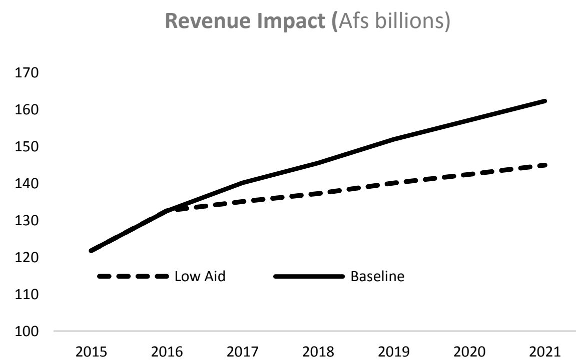
In order to judge the scale of the impact of these risks we run some simulations (set out below), to estimate the likely effect.

Aid Slowdown

Foreign aid has a significant impact on the Afghan economy, currently almost 60% to 70% of the core budget expenditures are funded through donor aid and assistance. If we assume that all donor's aid is reduced by 25% each year (starting from year 2016 onward), there expects to be sharp fall in the economic growth by 2024, with growth bottoming out at between 0 and 1%. However, it will be gradually recovering and moving upward from 2027 (the year aid is assumed to stop in the scenario), and reach the average growth of around 3.5% to the baseline in 2041.

A reduction in aid of 25% each year (as assumed in the below scenario) would have a dramatic impact on the collection of resources by the Government – given how closely donor support is tied to all areas of the economy – and similarly would reduce economic activity significantly in the near term.



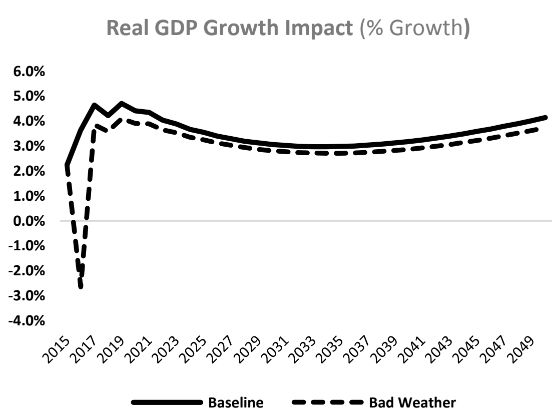


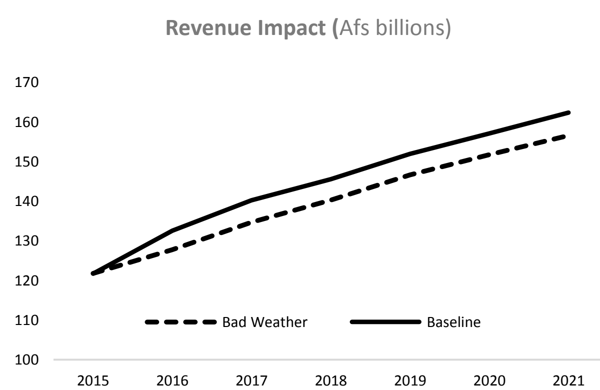
The results in the above show an immediate decline in growth, on a significant scale with lower growth through the medium term. Growth picks up again in the future as a result of the base effect – it is growing from a smaller base and so appears as a faster rate. The revenue impact is also significant, dramatically slowing collection as a result of how interlinked aid is with the rest of the formal economy.

Drought Year (2016)

Bad weather or drought is expected to have significant impact on the agriculture production, as large part of cultivation lands in Afghanistan are dependent on rain fall. If we assume bad weather or drought during 2016, there is estimated to be a large fall in growth (around -2.5 percent), however, there will be quick recovery through 2017. The economic growth will still be lower and below than the baseline growth.

Low precipitation has caused dramatic drops in sector performance in the past (with falls of 15-20% in the sector). While 2015 saw reasonable levels of precipitation and 2016 is likely to also, this scenario is included to give an idea of the potential scale of the impact if a drought were to occur in any given year in the future.



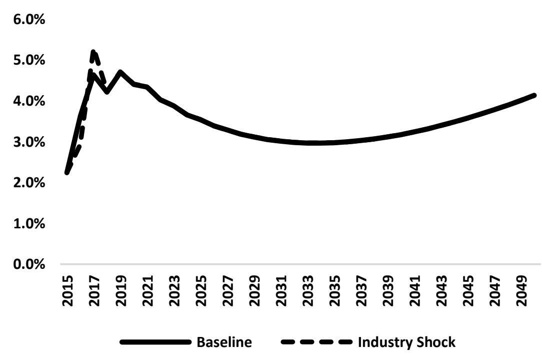


The immediate fall in activity in the year in which the drought occurs is followed by a recovery and some medium term slowdown in growth (as a result of reduced capital, and the likely impact a drought year would have on health and labour). Collection is not as impacting in the year in which the drought occurs, partially because so little is collected directly from the agriculture sector, however there is a medium term impact as growth all over is reduced. A drought in 2016 is estimated to reduce the revenue collection by almost Afs 5-6 billion lower than the baseline revenue estimates through to the year 2021.

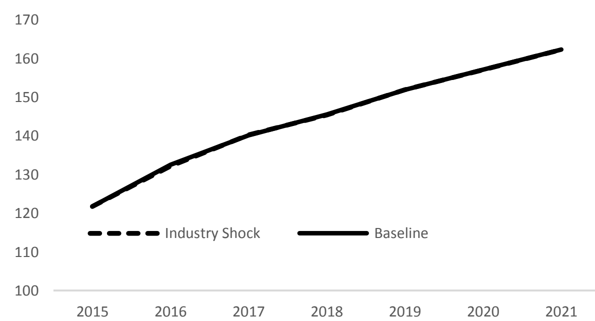
Industry Sector Falls

A slowdown in the industrial sector of -2.5 percent in 2016 is simulated here to give an impression (1) of the impact the industrial sector has on revenue and (2) of the degree to which there are significant interlinkages between areas of the economy.

Real GDP Growth Impact (% Growth**)**



Revenue Impact (Afs billions)



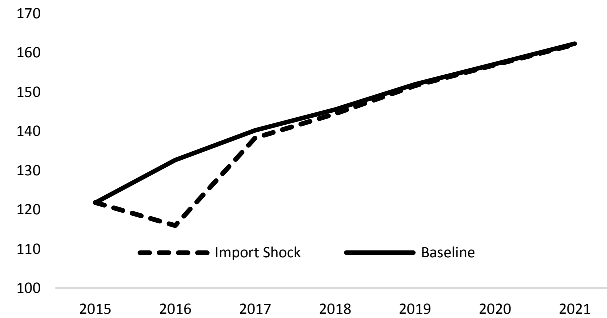
The scale of the impact is relatively subdued, and recovers the next year – implying that (1) an overestimation of the industrial sector growth should not significantly alter revenue projections, provided the overestimation is not too significant and (2) shocks to any individual sector, provided there is no damage to capital stock accumulation or the labour force, should recover the next year – implying falls in confidence during the election should eventually be fully recovered from.

Import Shock

Afghanistan is still a highly import dependent country. As shown in the graph, a fall in imports will significantly impact the growth. However, in 2017 the recovery will be quite fast, even exceeding the baseline growth, but will be around the same level till 2049.

An import shock of Afs 200 billion in 2016 would have a significant impact on revenue collection. This simulation is included in order to show the impact primarily of the change in revenue. Given the shock is an exogenous shock to imports it is difficult to determine exactly what the Real GDP impact would actually be, given it is likely a real GDP shock would be the cause of any change in imports, or at least correlated through another variable (e.g. donor slowdown).

Real GDP Growth Impact (% Growth**)** **Revenue Impact (**Afs billions)



This scenario assumes the imports recover back to the previous level, hence the bulk of the impact is in the year of the shock (with revenues falling significantly). There is some future revenue shock as a result of reduced activity in the future years, however this remains small. As a result, inaccurate estimation of the scale of import activity (or shocks to the activity) can have significant effects given the overreliance on import revenues. The import shock is expected to push down revenue collection by almost Afs 7-8 billion till 2016. However, there will be sharp recovery by 2017, and almost return to the baseline collection by 2019 and onward.

Pensions Scheme

[costs of the scheme, changes to the scheme, planned reforms to the scheme. Take sections of the pension review paper -HABIB]

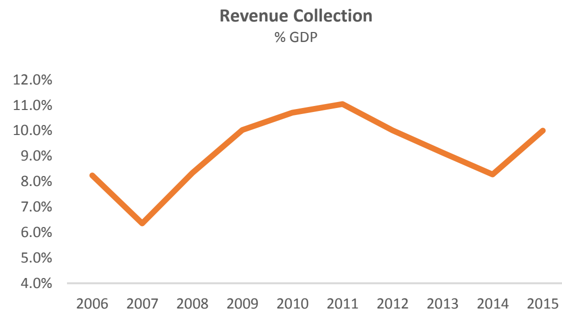
Mitigation Strategies

Risk	Mitigation Plan	Measurement
Domestic revenue collection is reduced once all arrears in tax payment have been collected.	The Government is working on the identification of all arrears that can be collected, and has in the past introduced new measures to offset low performance.	Domestic Revenue Collection to Target.
Aid materialization	The Government is putting in place efforts to monitor conditionality throughout the year, and ensure follow up.	Conditional aid collected, and proportion of conditionality met.
Cash management	The government will work on the introduction of new cash management methods, including possibly a treasury bill.	Levels of suppliers' arrears.

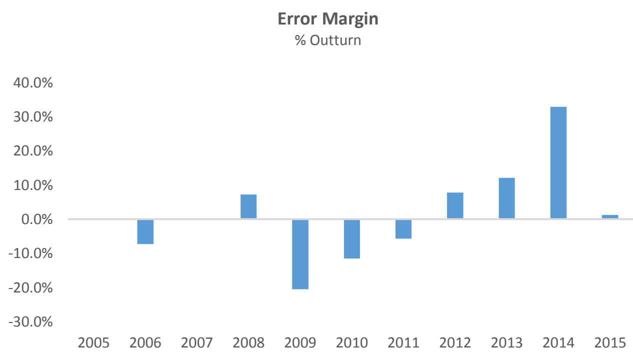
Indicators

Revenue to Target:

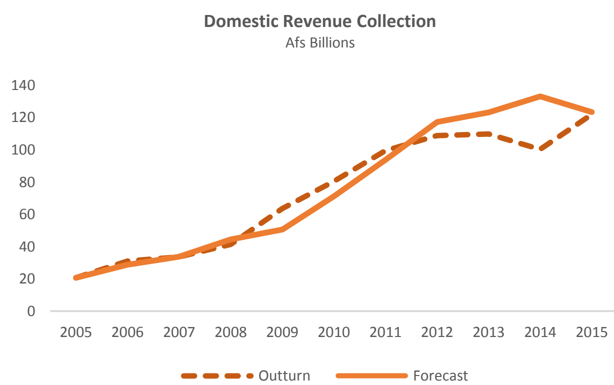
Revenue collection has remained around 9% of GDP, this fell slightly in recent years, falling to the lowest recent level in 2014 when collection fell to just 8.3%. In 2015 we saw a dramatic recovery back up to trend, and going forward expect collection to remain around the 9-10% mark (although we will target higher).



Forecasts have seen increasing errors over the period from 2008, initially under-, then over- forecasting the collection. However, 2015 saw a return to accurate performance of the revenue collection. The aim of the Government is to ensure conservative forecasts that may systematically slightly under-estimate revenue, in order to ensure budgets are prepared in line with realistic resources and do not have to be cut dramatically through the year.



The chart on the left shows the collection against the forecast, again showing an improvement in 2015 in the accuracy of the forecast.



Medium Term Framework

Revenue	Historic 2015	Current 2016	Budget 2017	Outer Years 2018	2019	2020	2021
Total Revenue	**325.3**	**430.0**	**412.4**	**390.2**	**338.4**	**312.8**	**301.1**
Total Domestic Revenue	**121.7**	**132.7**	**140.5**	**148.5**	**155.6**	**161.5**	**167.4**
Tax Revenue	**88.8**	**103.0**	**106.1**	**111.3**	**116.0**	**120.2**	**124.6**
Fixed Taxes	10.3	13.0	13.0	12.8	12.9	12.9	13.0
Taxes on Income and Profits	21.6	24.9	24.0	27.0	28.0	28.9	29.8
Taxes on Property	0.9	0.9	1.1	1.1	1.2	1.3	1.4
Taxes on Goods and Services	20.9	23.8	31.0	32.4	34.5	36.6	38.9
Taxes on International Trade	30.2	32.1	33.1	34.4	36.1	37.6	38.8
Other Taxes	5.0	8.2	4.0	3.6	3.2	3.0	2.7
Grants	**203.5**	**297.2**	**271.8**	**241.6**	**182.7**	**151.2**	**133.6**
Other Revenue	**32.9**	**29.7**	**34.4**	**37.2**	**39.7**	**41.3**	**42.8**
Property Income	4.2	1.9	1.9	2.1	2.0	2.1	2.2
Sales of Goods and Services	6.3	6.3	6.7	6.8	7.1	7.4	7.9
Fines & Penalties	17.0	15.3	18.8	21.0	22.8	23.5	24.0
Other	5.3	6.2	6.9	7.3	7.8	8.2	8.7
Sale of Non-Financial Assets	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
Medium Term Fiscal Framework	**319.9**	**445.9**	**411.0**	**387.4**	**334.1**	**308.2**	**295.4**
Discretionary	235.1	300.0	275.0	256.8	210.2	189.2	181.1
Non-Discretionary	84.8	145.8	136.0	130.6	124.0	119.0	114.3
o/w Interest	1.1	0.6	0.6	0.6	0.7	0.7	0.7
o/w Matching	0.0	0.0	0.0	0.0	0.0	0.0	0.0
o/w Pensions	19.9	18.8	21.4	23.4	23.4	23.4	23.4
o/w Earmarked Aid and Loans	63.8	126.4	113.9	106.6	99.9	94.9	90.2
Forward Estimates/Current Budget [1]							
Total Expenditure	**319.9**	**445.9**	**411.0**	**387.4**	**334.1**	**308.2**	**295.4**
Salaries	151.9	167.1	172.5	169.6	136.7	121.9	116.2
Goods and Services	55.6	67.9	62.9	61.8	49.8	44.4	42.3
Capital	7.8	6.2	8.8	8.6	7.0	6.2	5.9
Interest	1.1	1.1	0.6	0.6	0.7	0.7	0.7
Transfers [2]	19.9	35.1	21.4	23.4	23.4	23.4	23.4
Discretionary Development	18.0	48.1	18.0	16.7	16.7	16.7	16.7
Non-Discretionary Development	65.5	120.4	113.9	106.6	99.9	94.9	90.2
Remaining Resources			**12.8**	**0.0**	**0.0**	**0.0**	**0.0**
Primary Balance	**6.5**	**-15.2**	**2.0**	**3.5**	**5.0**	**5.3**	**6.4**
Overall Balance	**5.4**	**-15.8**	**1.4**	**2.8**	**4.3**	**4.6**	**5.7**
Financing	**1.1**	**15.8**	**-1.4**	**-2.8**	**-4.3**	**-4.6**	**-5.7**
Payments	1.8	4.7	4.6	4.2	4.3	4.6	5.7
Domestic	0.0	0.0	0.0	0.0	0.0	0.0	0.0
External	1.8	4.7	4.6	4.2	4.3	4.6	5.7
Receipts	2.9	20.5	3.2	1.4	0.0	0.0	0.0
Domestic	0.0	10.7	0.0	0.0	0.0	0.0	0.0
External	2.9	9.9	3.2	1.4	0.0	0.0	0.0

Source: Macro-Fiscal Directorate Staff Estimates, Aid Management Directorate, Debt Management Unit

1/ Forward estimates may represent a drop on the budget since they are based on the last outturn figure and may reflect required efficiencies

2/ In 2016 this includes all the contingency codes, actual expenditure on pensions is estimated at around Afs 21 billion

Key Assumptions

The framework has been built under the following key policy assumptions, among others, set out in the ***Fiscal Policy*** section:

- The Government will not borrow, except for on a concessional basis for specific projects
- The Government will finance increasing amounts of the security sector expenditure with the intention of providing full support by 2024.

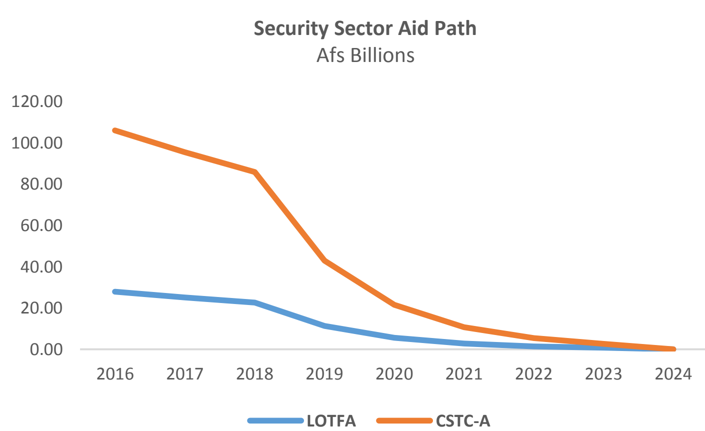
The macro-framework provides the basis for forecasting individual revenue lines (this is set out in detail in the Annex). In general, tax lines are forecast using regressions based on the macro-framework.

The other assumptions include:

- We have not incorporated revenues in the outer years from TAPI and other transit schemes yet, these will be incorporated when there is more certainty as to the start date.
- We have kept the outer years relatively conservative, in order to allow resources to be available for new policies in future years.
- This creates the apparent need to make savings in outer years to ensure current policy is affordable and new policy from this year is affordable in the outer years.
- The aid assumptions are kept conservative for the outer years
- We have assumed a specific amount of Government support to security (around US$ 560 million), which will increase over time. Reducing or increasing this amount (and either reducing/increasing security spending or increasing/reducing the LOTFA/CSTC-A contribution) will change the fiscal space.

Detailed Assumptions on Fiscal

The Government's pledge to reduce reliance on donor aid for the security sector requires a cutback in the use of LOTFA and CSTC-A funds with more resources coming from domestic sources. However, if the cost of the security sector remains around US$ 5 billion per year this would most likely be a difficult path of reduction to achieve, this is why the Government is committed to both (1) improving domestic revenue collection significantly, and (2) improving efficiencies in the security sector.



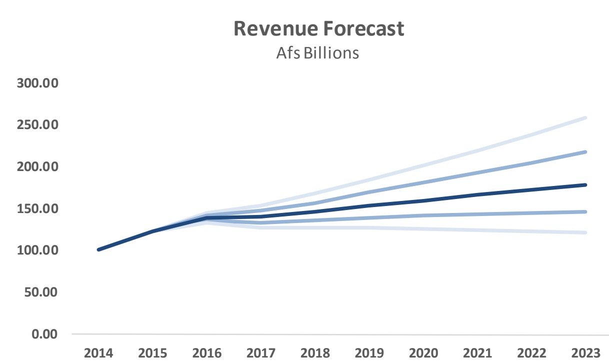
Figures for discretionary development aid are taken from initial AMD estimates derived from donor commitments, the figures for non-discretionary development are assumed to see reductions, in favour of funds moving to ARTF and other discretionary development options.

The figure for domestic borrowing in 1395 is assumed not to be paid back, since it is likely that execution will not be high enough on expenditure to require this financing.

Revenue Forecast

	Historic	Current	Budget			Outer Years		
Revenue	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Total Revenue	**295.3**	**325.3**	**430.0**	**412.4**	**390.2**	**338.4**	**312.8**	**301.1**
Total Domestic Revenue	**100.1**	**121.7**	**132.7**	**140.5**	**148.5**	**155.6**	**161.5**	**167.4**
Tax Revenue	**78.0**	**88.8**	**103.0**	**106.1**	**111.3**	**116.0**	**120.2**	**124.6**
Fixed Taxes	10.8	10.3	13.0	13.0	12.8	12.9	12.9	13.0
Taxes on Income and Profits	18.7	21.6	24.9	24.0	27.0	28.0	28.9	29.8
Taxes on Property	0.8	0.9	0.9	1.1	1.1	1.2	1.3	1.4
Taxes on Goods and Services	16.6	20.9	23.8	31.0	32.4	34.5	36.6	38.9
Taxes on International Trade	26.0	30.2	32.1	33.1	34.4	36.1	37.6	38.8
Other Taxes	5.1	5.0	8.2	4.0	3.6	3.2	3.0	2.7
Grants	**195.2**	**203.5**	**297.2**	**271.8**	**241.6**	**182.7**	**151.2**	**133.6**
Other Revenue	**22.0**	**32.9**	**29.7**	**34.4**	**37.2**	**39.7**	**41.3**	**42.8**
Property Income	2.3	4.2	1.9	1.9	2.1	2.0	2.1	2.2
Sales of Goods and Services	2.7	6.3	6.3	6.7	6.8	7.1	7.4	7.9
Fines & Penalties	12.0	17.0	15.3	18.8	21.0	22.8	23.5	24.0
Other	5.0	5.3	6.2	6.9	7.3	7.8	8.2	8.7
Sale of Non-Financial Assets	**0.0**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**

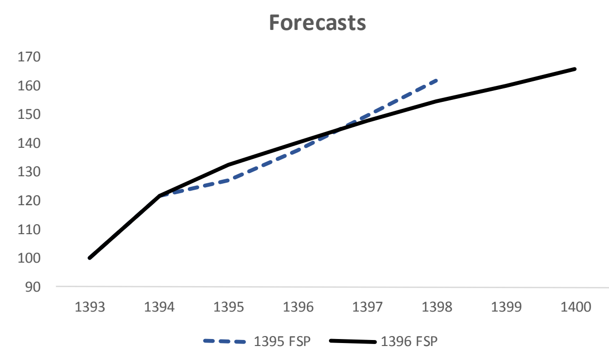
The revenue forecast is impacted by the uncertainty in the macro-forecast and uncertainty in how the macro-forecast impacts the revenue collection.



Changes to Forecasts

The forecast produced for the 1395 FSP incorporated estimates for the outer years, including 1396. The initial estimate for 1396 was Afs 137 billion, which has now been revised up to Afs 140 billion. Revisions have occurred as a result of:

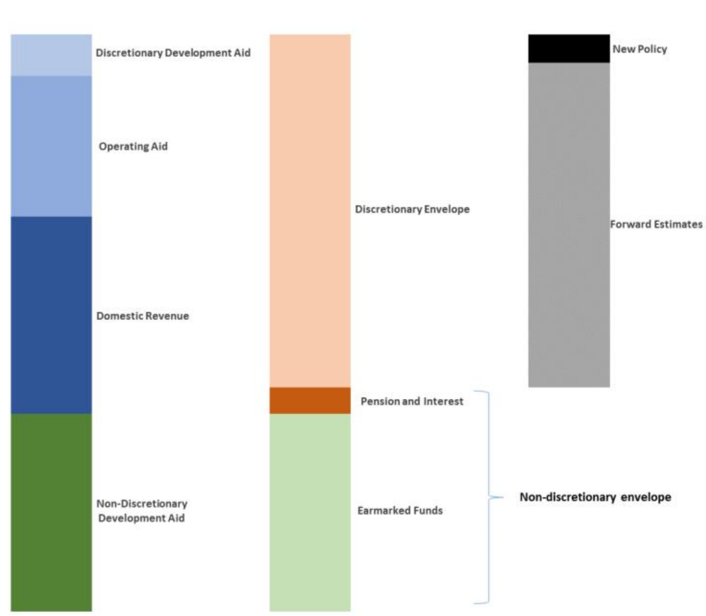
1) Changes to the base year estimates
2) Improved confidence over the new measures remaining in place
3) Revisions to the modelling to bring more in line with historic performance.



Medium Term Fiscal Framework

The MTFF sets out the resource envelope broken down into the resources which can be allocated in the budget process and those which cannot. The resources which cannot be adjusted in the budget process require other changes to legislation or donor agreements. The values are set out here to give an indication of the resources that could be freed up with changes to donor agreements.

The non-discretionary development aid is earmarked directly to projects determined outside of the budget process; other revenues (shown in blue) are in part used to finance pensions and interests (another component on non-discretionary expenditure). The remaining discretionary envelope is thus used to finance the forward estimates (the cost of continuing current policy) and the new policy initiatives.



Non-Discretionary Expenditure

Non-discretionary expenditure (**NDE**) includes pensions, interest and earmarked funds from non-discretionary development aid. This year we have dropped the policy determined expenditure (largely salaries) since this is incorporated in to the forward estimates.

Each of these expenditure lines is determined by agreements or policy, and is influenced in part by the macro environment, and changes to policy, and the assumptions built into the model:-

Pensions: Pensions are a legally required expenditure by the Government, set out in the Pensions' Laws and Regulations. As part of this law the Government makes payments to former civil servants who have historically contributed into the pension scheme. At the moment this is approximately 120,000 pensioners. We expect pension costs to grow significantly each year. (For more detail on the costs of pensions and the risks see the **_Risks to the Macro-Fiscal Framework_** Section). The pension figures in the main MTFF table shows the total pensions for retirees and martyrs. The latter is a non-contributory pension, and so is not included in the sustainability analysis, as it always presents a cost to the budget.

Earmarked Project Aid: donor support which is specifically set for particular projects, rather than whichever projects the Government chooses to allocate it to. That is, projects where the decision to not expend on the particular project would reduce the revenue by an equivalent amount.

Additional items that could be considered non-discretionary expenditures, but are not incorporated yet as a result of a lack of available information, are:

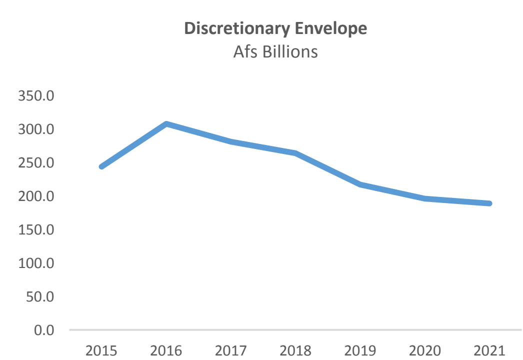
Matching Funds: no data on matching funds has been incorporated at the moment, however this could also be considered a non-discretionary expenditure, where the Government has agreed to provide these.

Membership Fees: the government has limited membership fees costs during the year, however these are considered to be legally required (as a result of international agreements) and thus non-discretionary.

Earmarked Other Codes: these are the contingency budgetary funds the Government sets aside in case of emergency need.

Discretionary Envelope

The discretionary envelope sets out the amount of funds the Government has allocative power over during the budget process. The total envelope, minus the non-discretionary (or already committed) funds above, and minus the policy determined spending gives the remaining discretionary envelope which can be allocated in the budget based on policy priorities, planned projects and past performance.



The discretionary envelope is expected to reduce over time, in line with reductions in certain donor resources (particularly LOTFA and CSTC-A). In order to offset the possible reduction, the Government will:

1) Conduct reforms to the pension scheme to ensure its sustainability
2) Push for greater donor resources to be provided on a discretionary basis
3) Expand domestic resources, through schemes like TAPI, and through an expansion of base revenue (see **_Revenue Policy Objectives_**).

Bank Accounts: the cash carry forward from 1394 is less than Afs 1 billion (estimated at Afs 0.6 billion). We assume the carry forward to 1396 will be zero.

Donor Support to the Budget

There is a lot of off-budget support to the security sector, incorporating spending on goods and services, and other areas. We have captured here the on-budget support through LOTFA, CSTC-A and others.

Funds from ARTF and DPG are discretionary development funds along with the government's contribution to the development funds (and we have incorporated a portion of donor support under discretionary funds in order to reflect this). DPG disburses upon the satisfactory performance of the government in certain predetermined areas.

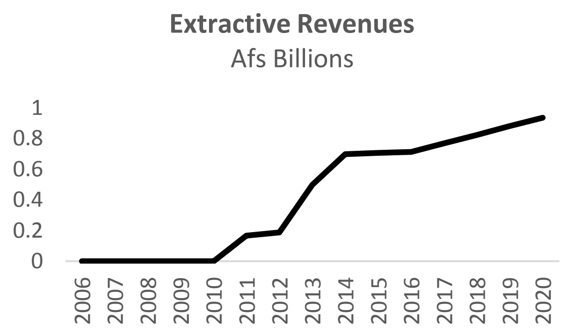
Figures for the donor support to the budget are given through a rules based estimate, and will be updated to reflect actual commitments once these are available. The operational donor support is based on the assumption that support will be phased out towards 2024.

Fund	Discretionary/Non-Discretionary
LOTFA	No discretion, must be used for largely salaries, in the security sector. All salaries captured under policy determined spending in the MTFF.
CSTC-A	Limited discretion, must be used for salaries and other expenditures including fuel, in the security sector. All salaries captured under policy determined spending in the MTFF.
ARTF O&M	Discretion over how it is used, providing it is used on O&M. Falls under the discretionary development budget. Estimated value included under discretionary envelope in MTFF (i.e. not all development grants are counted as earmarked).
ARTF Ad Hoc	Discretion over the use of this within the operational budget, however this is a one-off support and will not be extended in 1395.
NATFO	No discretion, must be used for largely for pre-determined training, in the security sector.
ARTF Incentive	Discretion over which projects it can be used for, however it must fall under development. Estimated value included under discretionary envelope in MTFF (i.e. not all development grants are counted as earmarked).
World Bank (DPG)	Discretion over which projects it can be used for, however it must fall under development. Estimated value included under discretionary envelope in MTFF (i.e. not all development grants are counted as earmarked).
ARTF (Operations)	Discretion, however must be used within the operation budget.
Donor Project Support	No discretion, support for specific development projects must be used on those project areas it has been agreed. This falls under earmarked codes in the MTFF.

Discretion within the MTFF is determined on an expenditure basis – expenditures are identified which are non-discretionary for the Government (i.e. agreed donor projects etc) and then resources are split among them. All the items with no-discretion are put as either non-discretionary earmarked expenditures in the MTFF, or linked to policy determined expenditures anyway.

Mining Revenue

The forecast assumptions for mining revenue remain conservative. The Government's policies and objectives around the management of the Mining sector are in the process of being revised with the new Government, as a result it is difficult to set a timeline for the beginning of operations of most projects.



There is therefore expected to be limited revenues collected from the extractive sector in the near future; once large projects begin these will be incorporated into future estimates.

Debt and Fiscal Sustainability

Debt Sustainability

The Public Financial and Expenditure Management (**PFEM**) Law sets out the rules under which the Government must operate borrowing. The Government is required to ensure that the borrowing undertaken through the fiscal year is used for developmental purposes. This includes building infrastructure, creating industrial parks and other alike activities which will help boost foreign investment in Afghanistan.

Currently Afghanistan is not in the dire situation of debt crisis like many other countries and debt can still be considered as a financing strategy to fund in investment projects in sectors of the economy. Below is a brief overview of the baseline debt, debt sustainability, shocks and scenarios, and what factors affect the debt sustainability of Afghanistan.

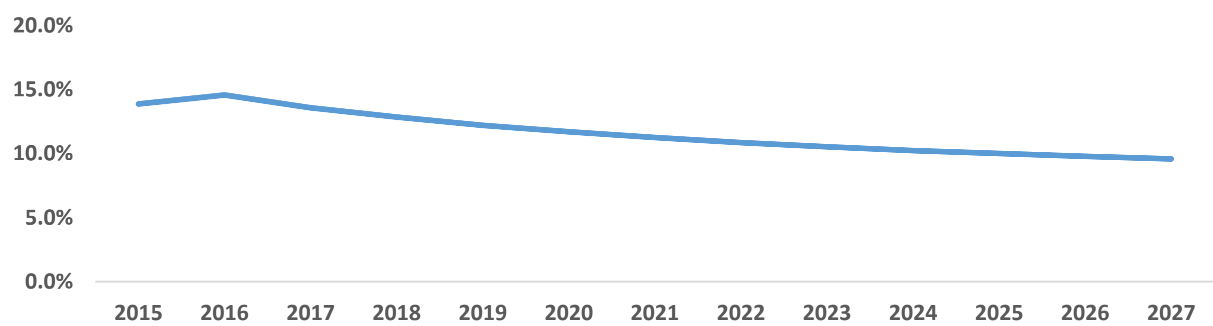
The Government's debt policy and framework is set out in the ***Fiscal Policy*** section.

DSA Table	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Baseline Debt/GDP	13.9%	14.6%	13.6%	12.8%	12.2%	11.7%	11.2%
Growth Shock Debt/GDP	13.9%	15.3%	14.2%	13.4%	12.7%	12.2%	11.6%
External Debt Service/Exports	5.3%	3.9%	8.9%	4.6%	7.1%	5.7%	8.4%
External Debt Service/Reserves	0.3%	0.5%	0.4%	0.3%	0.3%	0.3%	0.3%
Total Debt Service/Revenues exc rollover	1.8%	4.0%	3.7%	3.3%	3.2%	3.3%	3.8%

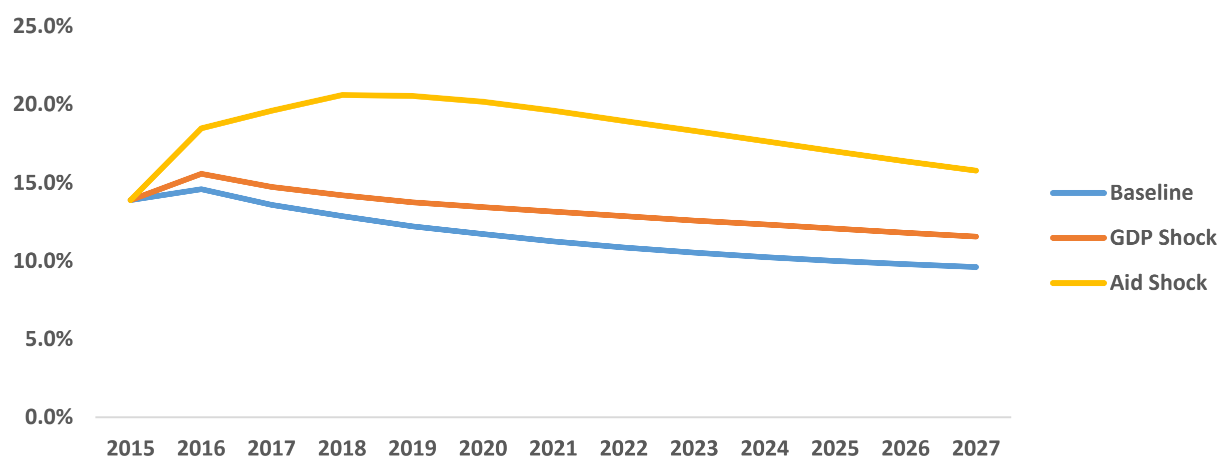
Since most of Afghanistan's current debt stock is on concessional basis, it remains well within the safe thresholds for most repayment indicators and will continue to do so in medium term (with the exception of some concern over debt service to exports – as a result of low exports). The debt stock will gradually diminish by 2027.

Shocks to the baseline, for example on, the exchange rate, an aid slowdown, and lower GDP growth, cause some concern for debt over time. A great portion of the debt is in foreign currency, hence a slight change in the exchange rate will have huge impact on debt profile (see chart DSA 3 – most of the accumulation of debt over time is under the assumption that the exchange rate further diminishes). Similarly, a slowdown of 30% of operating aid will have to be complemented with further borrowing which will certainly increase the debt stock from its current 14 percent of GDP to over 21 percent.

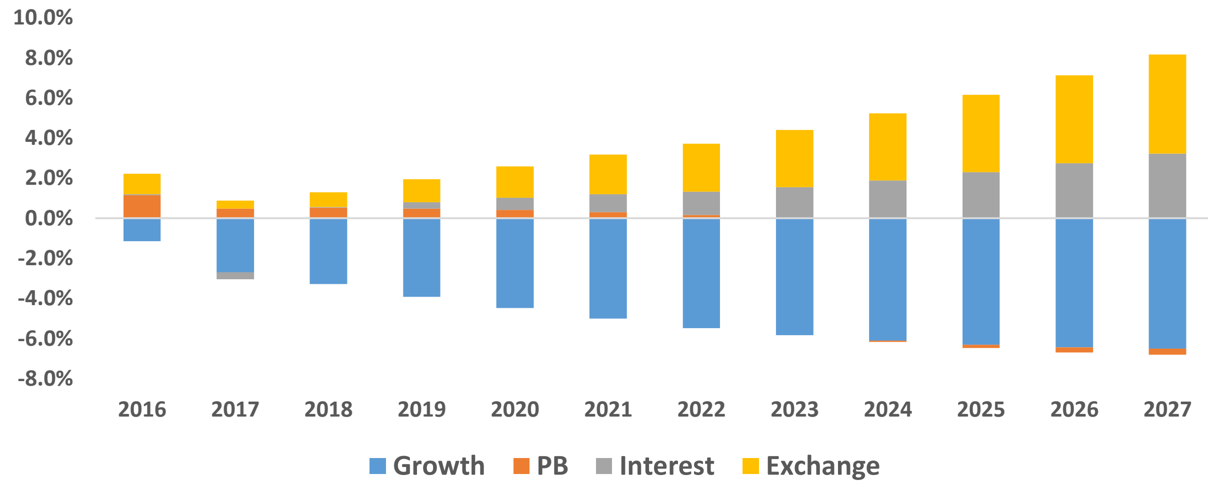
DSA 1. Debt Stock over time (% GDP)



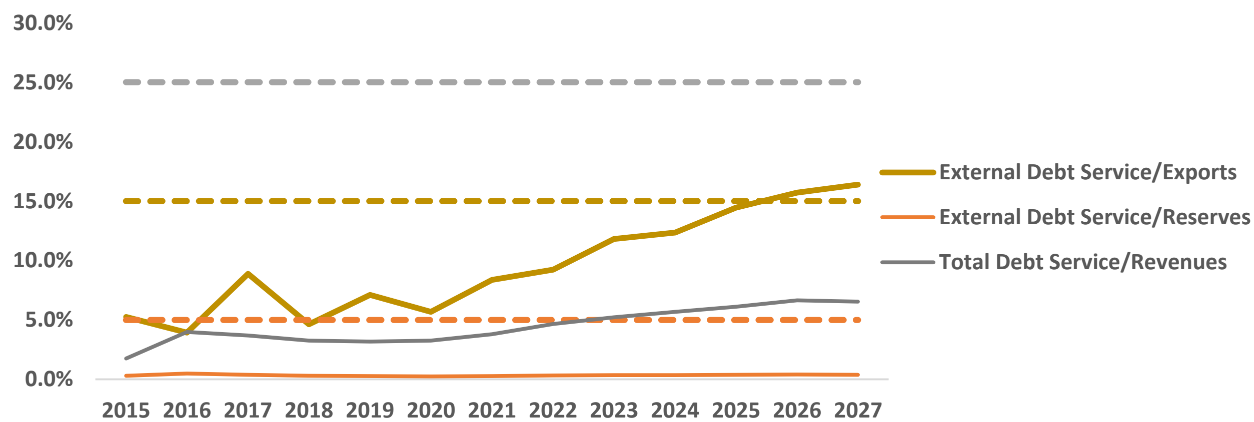
DSA 2. Debt Stock Shocks (% GDP)



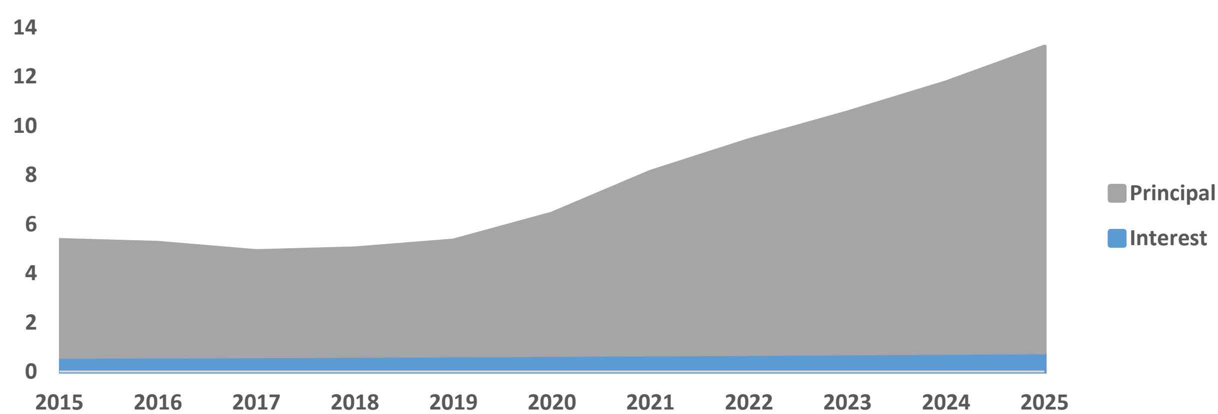
DSA 3. Contribution to Debt Stock (% GDP)



DSA 4. Debt Sustainability Thresholds (%)



DSA 5. Principal and Interest (Afs billions)



Fiscal Sustainability

The major fiscal sustainability indicator is the portion of the Budget covered by domestic revenue. The Government's medium term objective is to increase this proportion.

Fiscal Sustainability	2015	2016	2017	2018	2019	2020	2021
Domestic Revenue to GDP	10.0%	10.0%	9.8%	9.7%	9.5%	9.2%	9.0%
Grants to Total Revenue	62.6%	69.2%	66.0%	62.0%	54.1%	48.5%	44.6%
Non-Tax/Domestic Revenue	27.0%	22.2%	24.2%	24.7%	25.0%	25.0%	24.9%
Employee Compensation/Domestic Revenue	48.6%	50.9%	52.4%	53.8%	55.6%	57.6%	59.2%
Spending minus Development Grants/Domestic Revenue	171.8%	170.7%	178.5%	187.8%	195.6%	202.8%	210.0%

Ensuring fiscal sustainability has been a key main goal of the Ministry of Finance over the past a decade and more. However, due to huge expenditure pressures and lower revenue growth as a percent of GDP, there has been difficulty in achieving a self-sustaining level of expenditures. The Government has aimed to ensure that domestic revenue should cover operating expenditures and gradually takeover the development budget as well. For the fiscal year 1395, domestic revenue estimated to cover 30 percent of the core budget only and 48.2 percent of the operating budget.

Looking to the above table, we are showing that domestic revenue as a percent of GDP is expected to decline from 10 percent to 9 percent in the medium term, this is partially the result of conservative outer year forecasts, as well as ensuring that forecasts are in line with historic performance. Since the government has the commitment with donor agencies to have more contributions to the security sector, this will require more efforts to boost domestic revenue in the medium term to keep the current momentum of the sustainability, particularly to GDP ratio.

Forward Estimates

Methodology for Forward Estimates

The Forward Estimates are calculated based on a set of indexes which are used to estimate the "cost of continuing current policy" for each budgetary unit; at the moment the baseline does not reflect an accurate cost of operating services, however this will be improved over time through a process of rolling public expenditure reviews of Ministries. This then provides a guaranteed funding for Ministries, minus any efficiency savings. For the operating budget this is calculated through growing the codes 21, 22, and 25 by indexes including inflation, population etc. as appropriate. For the discretionary development budget, we calculate what the cost of the ongoing projects are in the budget and outer years; this is based on the multi-year costings provided by Ministries, where available, otherwise discretionary development funds are held constant. This should show a falling figure over time as projects slowly move to completion, generating additional space in the future for new policy.

Cost of Continuing Current Policy

This is produced pre-BC1, and provides the base for Ministries' budgets for operating and discretionary development. Non-discretionary development projects which are ongoing and new are just reported during the budget process (and should also be reported for the lifetime of the project).

This year this will be calculated through simple indexation; eventually moving over to more complicated methods including (1) formula based appropriation and (2) accounting for one-off expenditures. The cost of continuing current policy, in so far as projects are concerned, is just the cost of bringing the project to completion over multiple years.

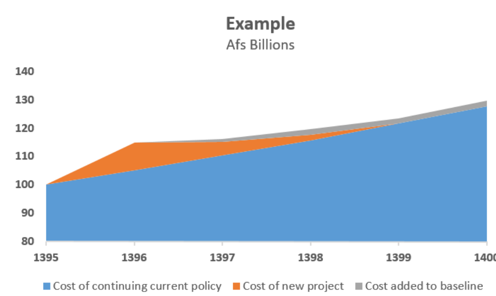
For example:

	Year 1	Year 2	Year 3	Year 4	Year 5
With multi-year costing	10	20	30	5	0
Without multi-year costing	10	10	10	10	0

The Ministry will be given the equivalent of last year's discretionary development budget, if it is not possible to gather information on when the timeline of projects ends. The Ministry is then guaranteed these funds (minus any efficiency savings etc) for the next year once the project is agreed to this year – it becomes part of their "cost of continuing current policy". See chart below.

Cost of New Policy

The forward estimates totaled together give the estimate for the total cost of operating the government next year at current levels. The resource envelope minus the total cost of the forward estimates gives the available resources for new policy; this is then allocated by Cabinet.



Ministries will submit a costing for new projects that include (1) multi-year costs of the project, and (2) the additional cost added to the baseline for the operation and maintenance of the completed project.

Components of the Forward Estimates:

Fiscal Space

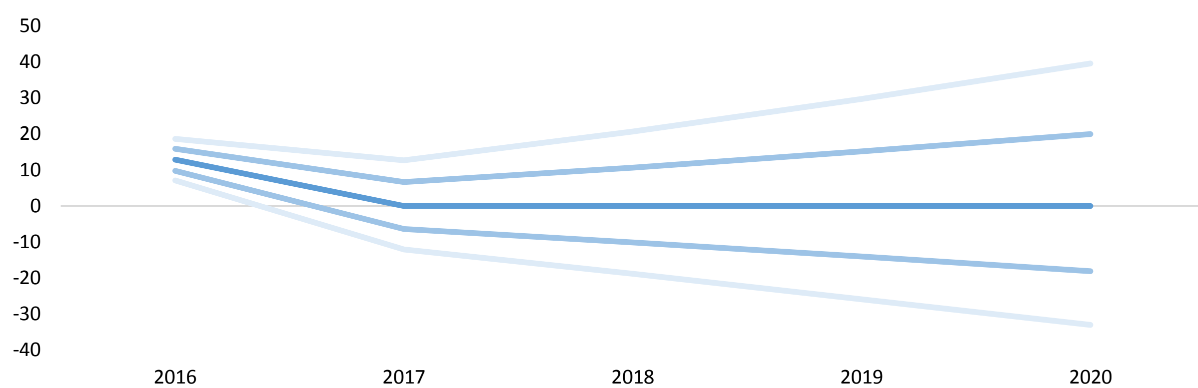
The fiscal space available after the forward estimates can be used to finance new projects and activities. This is sensitive to both policy decisions by the Government (including on tax rates, contributions to security etc) and on the macro-economic environment. The initial estimates for the fiscal space are Afs 13.5 billion. Fiscal space could be created through:

- A decision to reduce the size of the contribution to the security sector: *this is currently set at Afs 37.7 billion and is in line with the prior commitment to phase out by 2024 and contribute at least US$ 500 million.*
- A decision to raise new taxes or change tax rates.
- A decision to create an efficiency across all Ministries or on particular sectors: *for example, an enforced saving on all salary expenditures through reducing them across the board by 1% this year from the current forward estimate would free an additional Afs 1.7 billion.*

Scenario	Fiscal Space
Baseline	12.8
Exchange Rate Shock[1]	-4.8
Salary Efficiency of 1%	14.5
Overall Efficiency of 1%	15.6
Zero Agriculture Growth	10.3

1/ Currency value halves in 2016

Fiscal Space as result of revenue uncertainty
Afs Billions



Values of Forward Estimates

Forward Estimates	Historic	Current	Budget	Outer Years			
Codes 21, 22, 25 Operating	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Office of the President	2963	4489	4743	4664	3759	3352	3194
Upper House (Masharano Jarga)	518	490	518	509	410	366	349
Lower House (Walsi Jarga)	1339	1542	1630	1602	1291	1151	1097
Supreme Court	2975	3314	3502	3443	2775	2474	2358
President's Protective Services + NSO	1053	1179	1246	1225	987	881	839
National Radio & Television	386	511	540	531	428	382	364
National Security Office	260	418	441	434	350	312	297
Ministry of Finance	2793	3960	4184	4114	3315	2956	2817
Ministry of Parliamentary Affairs	90	79	83	82	66	59	56
Ministry of Defense	64438	69189	73101	71876	57926	51653	49227
Ministry of Foreign Affairs	3064	3879	4098	4029	3247	2896	2760
Ministry of Commerce	563	706	746	733	591	527	502
Ministry of Interior	57038	67199	70999	69809	56260	50167	47811
Ministry of Education	30476	33051	35618	35021	28224	25168	23986
Ministry of Higher Education	3812	5152	5552	5459	4400	3923	3739
Ministry of Refugees and Repatriation	200	241	254	250	201	180	171
Ministry of Mines	496	584	617	607	489	436	416
Ministry of Communication	435	524	553	544	438	391	373
Ministry of Economy	200	220	232	228	184	164	156
Ministry of Information, Culture and Youth	446	513	542	533	429	383	365
Ministry of Public Health	3747	3808	4104	4035	3252	2900	2764
Ministry of Women's Affairs	159	183	193	190	153	137	130
Ministry of Agriculture	1098	1144	1209	1189	958	854	814
Ministry of Water and Energy	537	585	618	608	490	437	417
Ministry of Public Works	3840	4011	4238	4167	3358	2994	2854
Ministry of Rural Rehabilitation and Development	504	526	556	546	440	393	374
Civil Aviation Administration	402	316	333	328	264	236	224
Ministry of Transport & Aviation	249	275	291	286	231	206	196
Ministry of Border and Tribal Affairs	362	403	426	419	338	301	287
Ministry of Labor, Social Affairs & Martyrs and Disabled	1321	1393	1472	1447	1166	1040	991
Ministry of Counter Narcotics	157	183	194	190	153	137	130
Ministry of Urban Development & Housing	234	285	301	296	238	213	203
Ministry of Justice	530	604	638	627	506	451	430
Attorney General's Office	1076	1168	1234	1213	978	872	831
ANSA	55	66	70	69	55	49	47
Independent Directorate of Local Governance	1990	2242	2369	2329	1877	1674	1595
Independent Directorate of Environment	178	198	209	205	165	147	141
Science Academy	168	207	219	216	174	155	148
IARCSC	323	352	372	366	295	263	251
National Olympics Committee	177	294	311	306	247	220	210
General Directorate of National Security	10827	12675	13392	13168	10612	9463	9018
Geodesy and Cartography Office	110	131	138	136	110	98	93
Control and Audit Office	130	137	145	142	115	102	98
The High Office of Oversight & Anti-Corruption	133	127	134	132	106	95	90
Office of Disaster Preparedness	76	97	102	101	81	72	69
Independant Election Commission Complaint Office	79	58	61	60	48	43	41
Election Commission	112	218	231	227	183	163	155
National Statistics Office	130	149	157	154	124	111	106
Afghanistan High Atomic Energy Commission	28	33	35	35	28	25	24
Directorate for Kuchis	47	61	65	64	51	46	44
Independent Commission for Oversight and Implementation of Constitution	59	47	50	49	40	35	34
Land Authority	175	221	234	230	185	165	157

Forward Estimates	Historic	Current	Budget	Outer Years			
Discretionary Development	2015	2016	2017	2018	2019	2020	2021
Office of the President	180	180	180	166	166	166	166
Upper House (Masharano Jarga)	46	46	46	42	42	42	42
Lower House (Walsi Jarga)	2	2	2	2	2	2	2
Supreme Court	16	16	16	14	14	14	14
President's Protective Services + NSO	27	27	27	25	25	25	25
National Radio & Television	61	61	61	57	57	57	57
National Security Office	0	0	0	0	0	0	0
Ministry of Finance	645	645	645	597	597	597	597
Ministry of Parliamentary Affairs	43	43	43	39	39	39	39
Ministry of Defense	0	0	0	0	0	0	0
Ministry of Foreign Affairs	112	112	112	104	104	104	104
Ministry of Commerce	37	37	37	34	34	34	34
Ministry of Interior	511	511	511	473	473	473	473
Ministry of Education	654	654	654	605	605	605	605
Ministry of Higher Education	2129	2129	2129	1970	1970	1970	1970
Ministry of Refugees and Repatriation	2	2	2	2	2	2	2
Ministry of Mines	246	246	246	227	227	227	227
Ministry of Communication	900	900	900	833	833	833	833
Ministry of Economy	86	86	86	79	79	79	79
Ministry of Information, Culture and Youth	109	109	109	101	101	101	101
Ministry of Public Health	2024	2024	2024	1873	1873	1873	1873
Ministry of Women's Affairs	39	39	39	36	36	36	36
Ministry of Agriculture	724	724	724	670	670	670	670
Ministry of Water and Energy	1978	1978	1978	1831	1831	1831	1831
Ministry of Public Works	3029	3029	3029	2804	2804	2804	2804
Ministry of Rural Rehabilitation and Development	585	585	585	541	541	541	541
Civil Aviation Administration	1042	1042	1042	964	964	964	964
Ministry of Transport & Aviation	28	28	28	26	26	26	26
Ministry of Border and Tribal Affairs	81	81	81	75	75	75	75
Ministry of Labor, Social Affairs & Martyrs and Disabled	88	88	88	82	82	82	82
Ministry of Counter Narcotics	18	18	18	17	17	17	17
Ministry of Urban Development & Housing	570	570	570	528	528	528	528
Ministry of Justice	140	140	140	129	129	129	129
Attorney General's Office	29	29	29	27	27	27	27
ANSA	49	49	49	45	45	45	45
Independent Directorate of Local Governance	403	403	403	373	373	373	373
Independent Directorate of Environment	19	19	19	18	18	18	18
Science Academy	6	6	6	5	5	5	5
IARCSC	56	56	56	52	52	52	52
National Olympics Committee	187	187	187	173	173	173	173
General Directorate of National Security	77	77	77	71	71	71	71
Geodesy and Cartography Office	16	16	16	15	15	15	15
Control and Audit Office	32	32	32	30	30	30	30
The High Office of Oversight & Anti-Corruption	94	94	94	87	87	87	87
Office of Disaster Preparedness	28	28	28	26	26	26	26
Independant Election Commission Complaint Office	0	0	0	0	0	0	0
Election Commission	0	0	0	0	0	0	0
National Statistics Office	0	0	0	0	0	0	0
Afghanistan High Atomic Energy Commission	0	0	0	0	0	0	0
Directorate for Kuchis	10	10	10	9	9	9	9
Independent Commission for Oversight and Implementation of Constitution	0	0	0	0	0	0	0
Land Authority	60	60	60	56	56	56	56
Human Rights Commission	34	34	34	31	31	31	31
Independent Board of New Kabul	100	100	100	93	93	93	93
Water Supply and Canalisation Corporation	382	382	382	353	353	353	353

Technical Annexes

Macro-econometric Framework Model

The Macro-economic model used by the Government for the preparation of this report is a macro-econometric framework model, built around set of identity equations and regressions. The revenue forecasts are determined by sets of regressions on the macroeconomic variables, and adjustors are used to include the impact of policy decisions.

CGE Simulations

The Government conducts some internal modelling using a computation general equilibrium model – to estimate the impact of tax policy changes, and changes to aid flows, and household and government investment. This is used to inform the forecasting in the macro-framework model, and for simulations under the risk section.

The CGE model is an Excel based model, using a few simple identities to balance three production markets (Agriculture, Manufacturing and Services), as well as the Labour market, and household spendings. The Government is included and must run a balanced budget in the model, matching taxation and spending; and decisions on household spending are made based on a utility function.

Stochastic Modelling

The fan charts in this paper are generated through the stochastic generation results. There are two forms of uncertainty in the forecasts: (1) the uncertainty over the value of the inputs impacting other factors (e.g. GDP impacting revenue etc) and (2) the uncertainty over the form and scale of the effect (e.g. how much does GDP impact revenue).

DSA

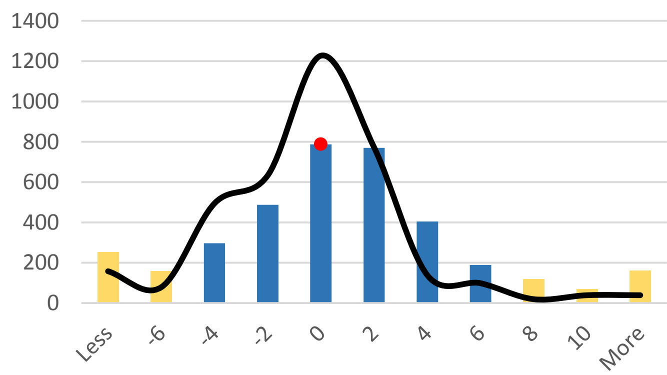
The DSA thresholds are:

External Debt Service/Exports: 15.0%
External Debt Service/Reserves: 5.0%
Total Debt Service/Revenues (*exc. rollover***)**: 25.0%
Concessionality: 60% grant element

Realism of Forecasts

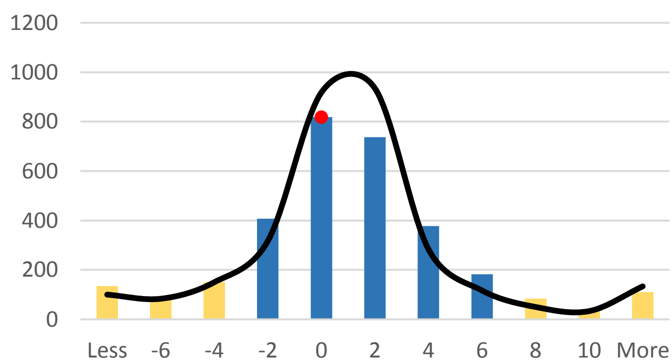
The distributions in the below reflect the changes that countries around the world have seen during a 3-year period. The figures are taken from the IMF WEO, for the time period between 1980 and 2014. The black line represents the scaled distribution for just the most recent year (in order to see if the change is realistic given the changes that other countries are seeing in the same period). The red dot represents Afghanistan, the shaded yellow areas are the unlikely areas.

Realism of the GDP Forecast:



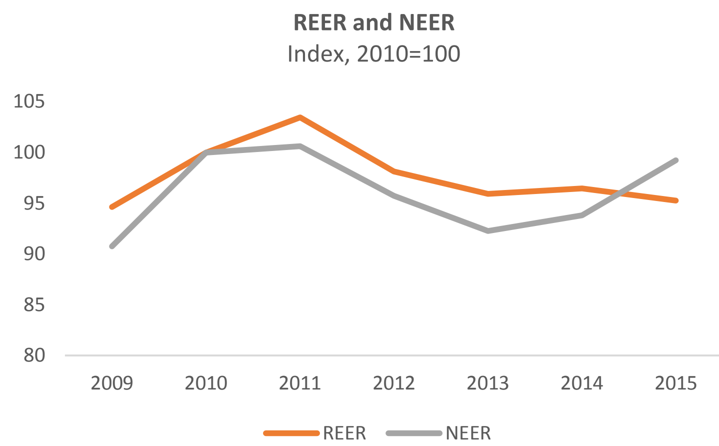
The GDP forecast is in line with the 3-year adjustments in GDP growth made by other countries historically. The chart at the side shows (in the bars) for all countries from 1980 onwards the scale of the three year adjustments in their growth rates. The black line shows similar but just for the recent year.

Realism of the Revenue Forecast:

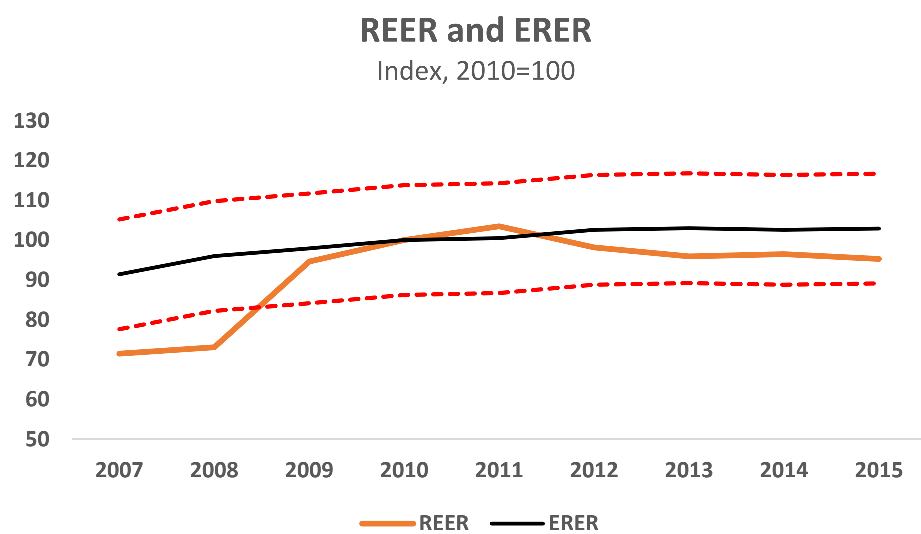


The revenue forecast is in line with the 3-year adjustments in revenue to GDP made by other countries historically. The chart at the side shows (in the bars) for all countries from 1980 onwards the scale of the three year adjustments in their revenue to GDP numbers. The black line shows similar but just for the recent year.

Real Effective Exchange Rate Analysis



The Real Effective Exchange Rate fell relative to the nominal this year as a result of falls in the exchange rate, and deflation in the economy. As a result, the effective competitiveness of Afghan goods has increased. Going forward we expect an increase in the REER, as our fundamentals (Terms of Trade etc), show us to be potentially undervalued.



Risk Indicator

Contents of the Indicator

The indicator is intended to give a signal of the likelihood of a fiscal crisis given the underlying performance of the fiscal situation, and the overall economy. The aim is to have a single measure that is easily usable as a trigger warning to senior management: if the indicator goes up, the situation is worsening, if it goes down the situation is improving. This will be prepared as part of the budget preparation using the budget figures for the indicators like GDP, fiscal balance etc. It will then be updated during the year as part of the risk report produced by FPD.

Development of the Indicator

The indicator was prepared using an "Event Study" approach, attempting to minimize the number of both false positive and false negative results from selecting a particular threshold level of an individual indicator. The set of countries with identified fiscal crisis are placed into a dataset, with a number of measurable criteria like GDP growth, fiscal balances, debt stock etc. For each one of these individual measures an example threshold value is set (for example, 2% GDP growth); any countries with below 2% GDP growth are therefore assumed to be in a crisis, and those above are assumed not to be. This naturally leads to a lot of false positives (where we attribute a crisis and there was not one) and some false negatives (where we miss a crisis that actually occurred). The aim therefore is to pick the threshold value that minimize both the false positive and the false negatives using this formula: $Overall\ Error = \frac{FP}{NC} + \frac{FN}{NNC}$, where NNC are Number of Non-Crisis events, NC are the number of crisis events (and FP and FN are false positives and false negatives).

The set of final thresholds are given in the table in the section below. For the overall indicator the individual indicators are given either a 1, if they breach their threshold, or a 0 if they do not. The 1s and 0s are then multiplied by the weighting to get the value of the overall indicator.

Weighting of the Indicator

The indicator weightings were developed using the size of the *Overall Error* term. The weighting is calculated from this signaling power: (1-*Overall Error*).

The final weighting for each individual indicator is then given as:

$$\frac{(1 - Overall\ Error)}{\sum_i (1 - Overall\ Error)}$$

The table to the right shows both the threshold values and the weightings that were generated (certain thresholds trigger if you are above, others if you are below).

	Weight	Threshold	Value
Structural Balance	1.24%	-1.4	0.70
Structural Balance t-1	1.06%	-1.9	-3.54
Structural Balance t-2	0.51%	-1.6	1.43
Debt Stock	0.38%	42.8	12.00
Debt Stock t-1	0.09%	7	10.55
Debt Stock t-2	0.95%	86	6.71
Revenue	1.25%	20	32.9
Primary Balance	2.57%	-2.1	-0.20
Fertility Rate	2.50%	2.3	5.40
Fertility Rate t-10	0.62%	2.7	6.93
ODA	9.01%	9	172.36
ODA t-1	9.70%	13	172.36
ODA t-2	10.85%	13	172.36
ODA t+1	9.72%	20	150.00
Interest (% Revenue)	9.87%	2	0.50
NPL	7.13%	4	6.12
Pop65	5.15%	9.5	2.00
Reserves	1.86%	4600000000	n/a
Reserves t-1	3.48%	3300000000	7288702809
Reserves t+1	2.19%	3900000000	n/a
Dependency Ratio	6.52%	15.5	96.00
GDP growth	13.36%	3	3.50