MACRO FISCAL GENERAL DIRECTORATE

# FISCAL STRATEGY PAPER

## Medium Term Fiscal Framework

# 1397/2018

MINISTRY OF FINANCE
GOVERNMENT OF THE ISLAMIC REPUBLIC OF
AFGHANISTAN

## 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 |
| 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 |
| MFPD | Macro Fiscal Performance 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 |

# 1. Introduction

The fiscal strategy paper (FSP) sets out the government's medium-term macro-fiscal framework and provides guidance for the circumstances under which 2018 (1397) budget will be set. It contains:

i. The Macro Forecast for 2018 (1397), and outer years and the international context;
ii. 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;
iii. The medium-term outlook for revenues, and broad categories of non-discretionary and discretionary expenditure, including aid forecasts and scenarios;
iv. An overview of past performance in government spending, and aid execution;
v. A discussion of the risks presented for the next fiscal year, including estimations of their impact;
vi. A debt sustainability and fiscal sustainability analysis;
vii. Initial Forward Estimates for the Line Ministries, based on past expenditures (as a cost of continuing current policy).

The 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 26.

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 11; 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 (MFPD), of the Ministry of Finance.

The macro-fiscal data set out in this document are the initial estimates for 2018 (1397) and onwards[1], these figures are indicative and may be adjusted during the budget preparation as more information becomes available on the base year performance (2016/1395) and on overall macro-fiscal conditions.

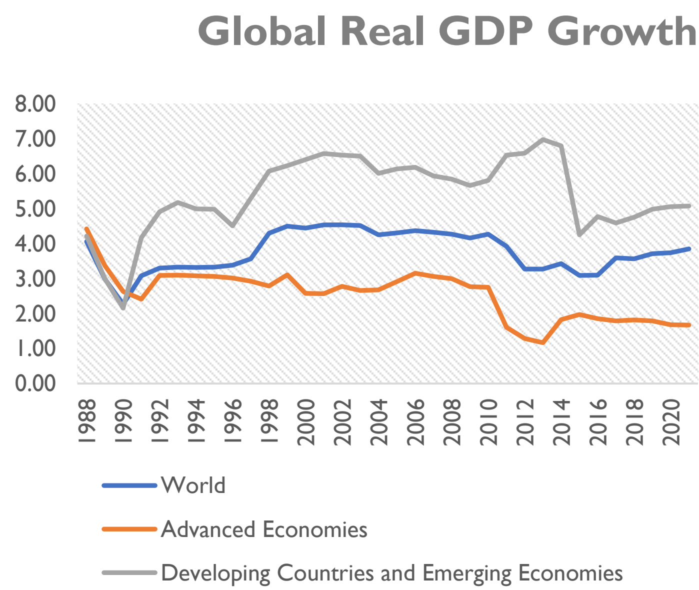
[1] Estimates have been generated for 1396 (2017) as a base year, as the final data is not available for this at the time of production.

# 2. International Economic Outlook

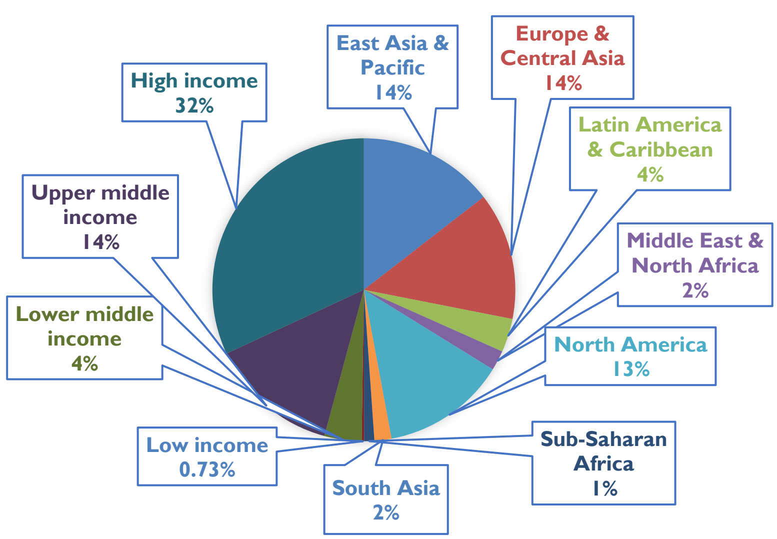
## 2.1 Overview of Economic Conditions

The total world output was USD 73.891 trillion in 2016 (1395), and shows a substantial increase on last year as the World continues to recover from the financial crisis and developing countries adapt to lower commodity prices. Advanced economies having produced 32 percent of total world output, had the highest share of global GDP. Upper middle-income countries and East Asia and Pacific each produced 14 percent of world output. South Asia and Sub-Saharan Africa, the poorest regions of the world produced 2 percent and 1 percent of total world output respectively.

World output growth was 3.1 percent in 2016 and as per IMF projections, it is expected to slightly increase to 3.6 percent in 2017 (1396). While the average growth of advanced economies is expected to fall from 1.98 percent to 1.86 percent, it is expected to increase for the emerging and developing economies from 4.26 percent to 4.78 percent.




**Source**: IMF World Economic Outlook, October 2016




Source: World Bank,

SHARE OF REGIONS IN WORLD GDP

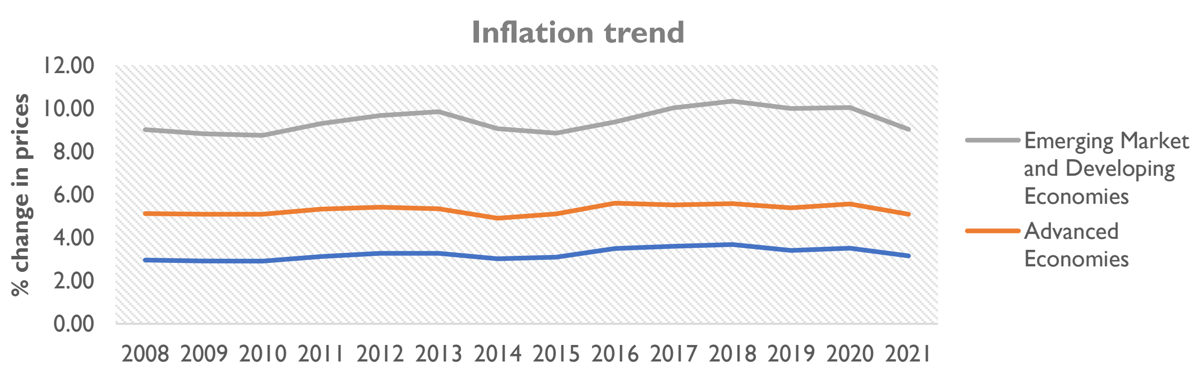
Average economic growth of major trade partners of Afghanistan was 4 percent in 2016 and it is projected to fall to 3.8 percent and 3.7 percent growth in 2017 and 2018 respectively. Among trading partners of Afghanistan China and India with a growth rate of 9.5 percent and 7 percent respectively, had the highest growth rate, Canada, and Japan with 1.9 percent and 1.2 percent growth rate had the lowest growth rate in 2016. China's growth rate is projected to fall to 8.5 percent in 2017, while India will perform at the same rate. The table below presents growth performance of major importers from Afghanistan. This fall represents some risk to the external environment for Afghanistan, and could create pressure on exports and foreign currency.

| Partners/Year | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1389 | 1390 | 1391 | 1392 | 1393 | 1394 | 1395 | 1396 | 1397 | 1398 | 1399 | 1400 |
| Canada | 2.8 | 2.9 | 2.8 | 2.6 | 2.5 | 2.1 | 1.9 | 2.2 | 2.2 | 2.0 | 1.9 | 2.0 |
| Japan | 1.2 | 1.7 | 1.7 | 1.7 | 2.5 | 1.7 | 1.2 | 1.1 | 1.1 | 1.1 | 0.7 | 0.7 |
| Turkey | 5.0 | 5.0 | 5.0 | 5.0 | 3.5 | 4.0 | 4.0 | 4.6 | 4.5 | 3.5 | 3.5 | 3.5 |
| Iran | 5.4 | 4.7 | 4.0 | 4.7 | 2.2 | 3.2 | 4.3 | 2.0 | 2.4 | 2.4 | 2.1 | 4.1 |
| Qatar | 8.4 | 9.2 | 2.2 | 7.9 | 3.3 | 4.9 | 4.3 | 7.0 | 6.5 | 6.4 | 3.9 | 1.7 |
| Saudi Arabia | 3.7 | 5.3 | 4.3 | 5.8 | 5.1 | 4.6 | 4.9 | 4.2 | 4.3 | 4.3 | 3.3 | 2.1 |
| United Arab Emirates | 4.0 | 5.3 | 6.2 | 7.7 | 5.1 | 4.8 | 4.2 | 3.7 | 3.7 | 4.2 | 4.1 | 3.4 |
| India | 7.0 | 7.0 | 6.7 | 6.7 | 6.0 | 7.0 | 7.0 | 7.0 | 6.5 | 6.0 | 6.0 | 6.0 |
| Malaysia | 6.5 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Pakistan | 6.2 | 6.0 | 7.0 | 7.2 | 7.0 | 6.0 | 6.0 | 3.5 | 3.0 | 5.0 | 5.0 | 5.0 |
| Thailand | 6.0 | 5.5 | 5.5 | 6.0 | 6.0 | 5.0 | 5.0 | 5.0 | 5.0 | 4.5 | 3.8 | 3.0 |
| Kazakhstan | 6.5 | 6.1 | 7.5 | 8.0 | 8.0 | 6.5 | 6.4 | 6.4 | 6.2 | 5.4 | 4.2 | 4.9 |
| Kyrgyz Republic | 4.6 | 4.5 | 2.5 | 4.5 | 5.6 | 3.4 | 5.0 | 5.0 | 5.0 | 5.2 | 5.3 | 4.5 |
| Russia | 5.0 | 5.5 | 5.2 | 5.6 | 5.0 | 5.0 | 4.0 | 3.8 | 3.6 | 2.5 | 1.5 | 1.5 |
| Tajikistan | 6.0 | 6.0 | 8.0 | 7.0 | 7.0 | 5.0 | 5.0 | 6.0 | 6.0 | 5.8 | 5.0 | 4.5 |
| China | 7.5 | 8.0 | 8.5 | 10.0 | 10.0 | 9.5 | 9.5 | 8.5 | 8.5 | 6.5 | 6.3 | 6.0 |
| Turkmenistan | 5.0 | 5.0 | 9.0 | 9.1 | 8.4 | 6.9 | 6.9 | 6.1 | 7.2 | 8.3 | 6.9 | 6.2 |

**Source**: IMF World Economic Outlook, October 2016

## 2.2 Prices

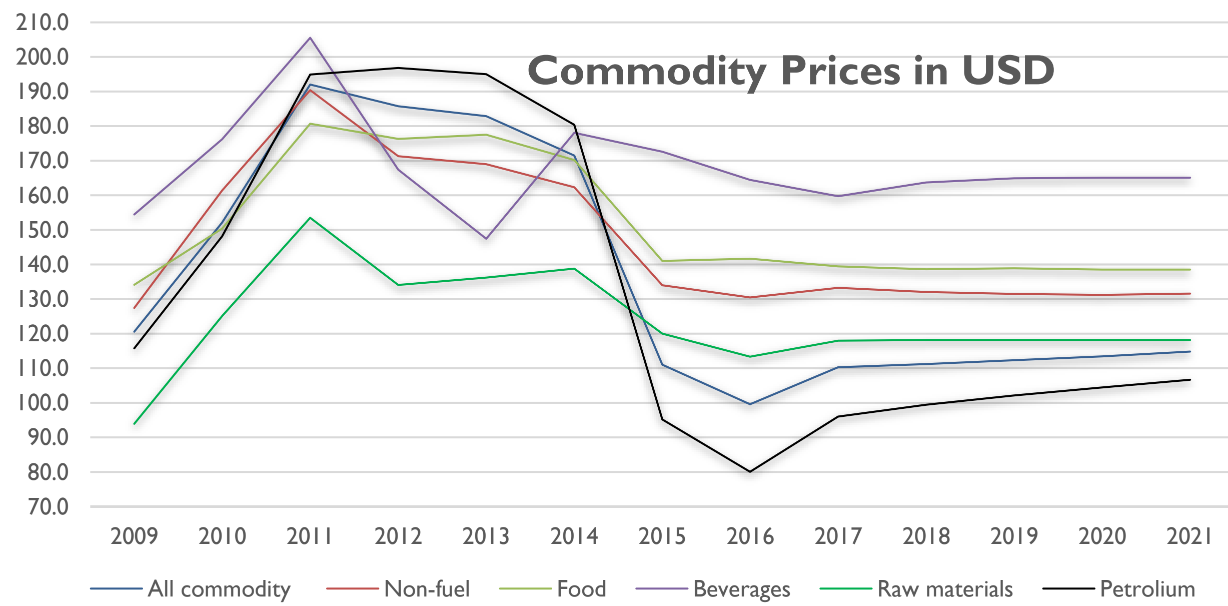
Changes in World general prices have been smooth since 2014 (1393). On average prices increased by 3.1 percent in 2015 and 3.5 percent in 2016. Prices in advanced economies and emerging economies had




Source: World Bank & IMF

the same smooth trend as the world average, reflecting a lack of dramatic system price shocks. For advanced economies, it was 2 percent in 2015 and 2.1 percent in 2016. Similarly, in the emerging economies prices increased by 3.76 percent and 3.77 percent in 2015 and 2016 respectively. It is estimated that on average world prices will increase by 3.6 percent in 2017.

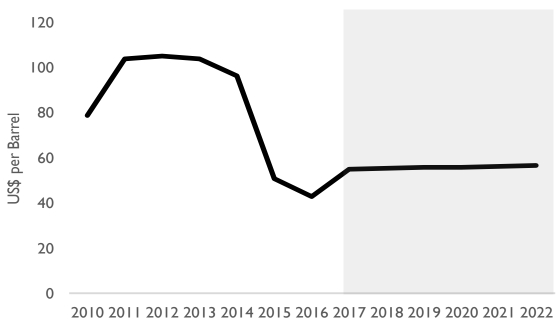
The consumer price index for all commodities fell by 10 percent in 2015 - 2016 (1394 - 1395). Except for the food prices which increased by 0.4 percent between 2015 and 2016, the price of all other consumer commodities fell. Energy price in general reduced by 16 percent. It is projected that the consumer prices will increase by 10 percent in 2017 (1396). Projections show 19 percent increase in energy prices, 18 percent in petroleum and 4 percent increase in the price of metals. Contrary to 2015 - 2016, in 2017 price of food and beverages is projected to reduce by 1.6 percent and 2.8 percent, respectively.




The increase in prices of energy and metals will affect the prices of manufactured commodities. This will have negative pressure on general prices for small, importing countries like Afghanistan. This might lead to increase in prices more than national projections.

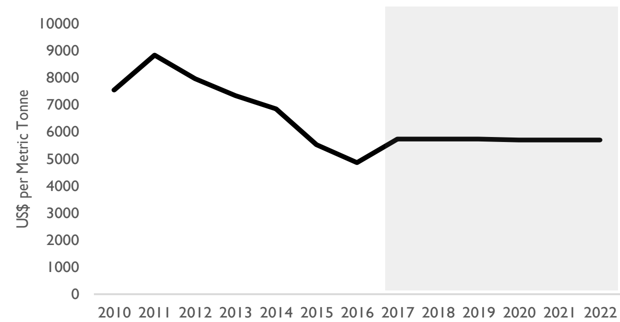
## 2.3 Commodity Performance and Forecasts

**Crude Oil Prices Forecast**



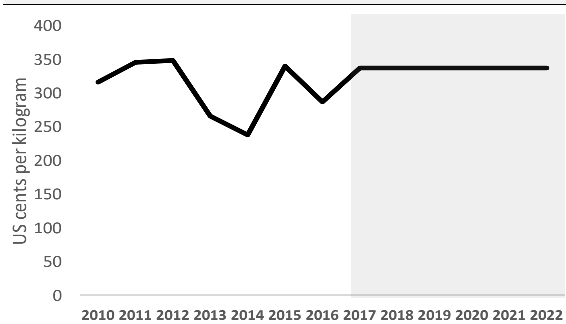

Afghanistan relies on imports of imported fuel, and fuel prices locally tend to move in line with international prices. Prices dropped considerably in late 2014 and early 2015 pushing down local prices. The prices have increased slightly and are expected to remain stable in 2017 and 2018.

**Copper Prices Forecast**



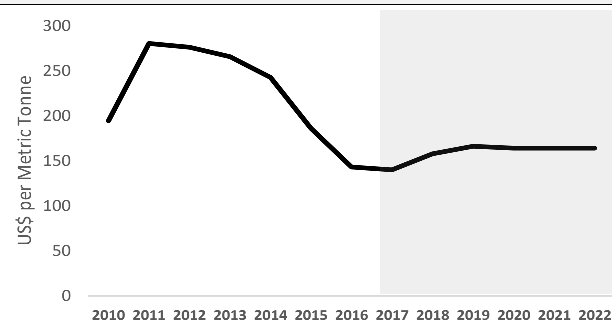

Copper prices declined dramatically from the peak in 2011, this fall has made the investment in copper less attractive in the world, including in Afghanistan. The copper prices decreased in 2015 and picked up slightly towards the end of 2016. The copper prices are not expected to increase in the near future. This means that mining investment in Afghanistan will not be appealing in the near future.

**Tea Prices Forecast**



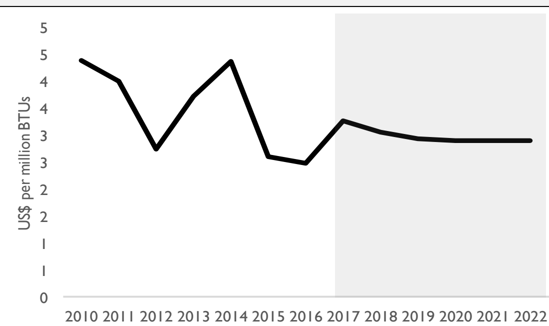

The tea prices dropped in 2016 after a brief rise in the year of 2014 and 2015. It is projected that the prices will remain stable that's in line with the general commodities drop

**Wheat Prices Forecast**



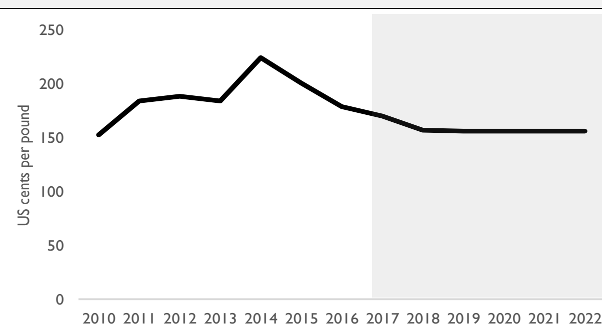

Wheat prices declined gradually and are projected to remain fairly stable, with limited recovery from the falls. As a result, this should not create additional pressure on households.

**Natural Gas Prices Forecast**




The natural gas price picked up in 2016, and the outer years' forecast shows a stability in the price of natural gas.

**Beef Prices Forecast**




In line with the stable prices of other commodities, Beef price shows a flat movement in the next years. This level of price reduces the pressure on the household's income.

**Source:** IMF WEO, and MFPD Staff

## 2.4 International Trade

Total world trade flow was USD 33.4 trillion in 2015. China, USA, Germany and Japan were among the top traders. China with 14 percent share in total global export was the biggest exporter, and with 10 percent share in total global imports, it was the second largest importer. In 2015 total world trade flows fell by 11.13 percent as compared to 2014.

South Asia and Central Asia are important trading partners for Afghanistan. Total intra-regional trade share in South Asia was 5.28 percent in 2015 which increased slightly over the previous year. Central Asia with Intra-Regional trade share of 8.97 percent was better than the South Asia. 71 percent of Afghanistan's export in 2015 went to SAARC member countries and 47.8 percent of total imports were supplied by those countries. 15 percent of Afghanistan's total imports in 2015 was supplied by Central Asia, but they received only 7.7 percent of Afghanistan's total exports.

## 2.5 US and Neighbors' Economic Outlook

***The United States of America:*** Certain policies of the new government in the US, including potential cut backs in support for international programs (through USAID, the UN and World Bank) and measures which may seek to reduce levels of imports to the US, would affect the world global trade flows and financial flows, especially with the emerging economies like China and India. A move to reduce immigration to the US from Afghanistan would limited the size of growth in remittance flows in the future. Furthermore, 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.

***India*****:** India started a demonetization measure to curb black money and fight corruption. In the short run, this can have a significant impact on the retail business. Afghanistan exports 32.8 percent of its domestic goods to India. The demonetization may affect Indian consumer demand for Afghanistan's exports.

***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 now for exports. In September 2016, the first train from China arrived at Hairatan Afghanistan for trade. The direct trade relation in the future may increase Afghan exports to China, whereas at the moment balance of trade with China remains negative. The size of the trade is small and will bear less impact on the trade between Afghanistan and China. However, a continued slowdown will reduce the likelihood of any startup of China in the extractive industry within Afghanistan.

***Iran***: Iran has seen large falls in economic activity in a few key sectors (including construction and manufacturing) in recent times; delays in investment decisions while sanctions are lifted, and falls in commodity prices internationally have slowed down the economy. Growth is, however, likely to be significantly improved as sanctions are lifted, with greater access to financing options, financial services, international trade, and investment. There does however remain some risk from any re-establishment of sanctions. The Chahbar port project will increase prospects for Afghan trade with the rest of the world and decrease its reliance on Pakistan.

***Pakistan***: Lower oil prices are likely to boost Pakistan's growth prospects; however, several 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

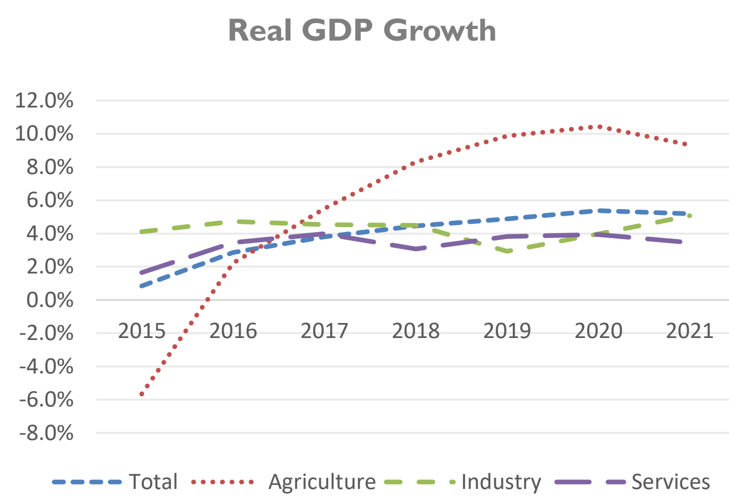
(Pakistani Currency) saw significant falls in value, in line with the Afghani, meaning there have been smaller falls against the rupee than other currencies; however, this does not change our nominal price competitiveness with Pakistan. Afghanistan is now connected to Central Asian countries, China, Chahbahar will increase access to the rest of the world for trade. Reliance of trade on Pakistan is on decrease, although Afghanistan has a bilateral trade agreement with Pakistan called APTTA to boost trade ties between the two countries.

# 3. Macroeconomic Performance and Outlook

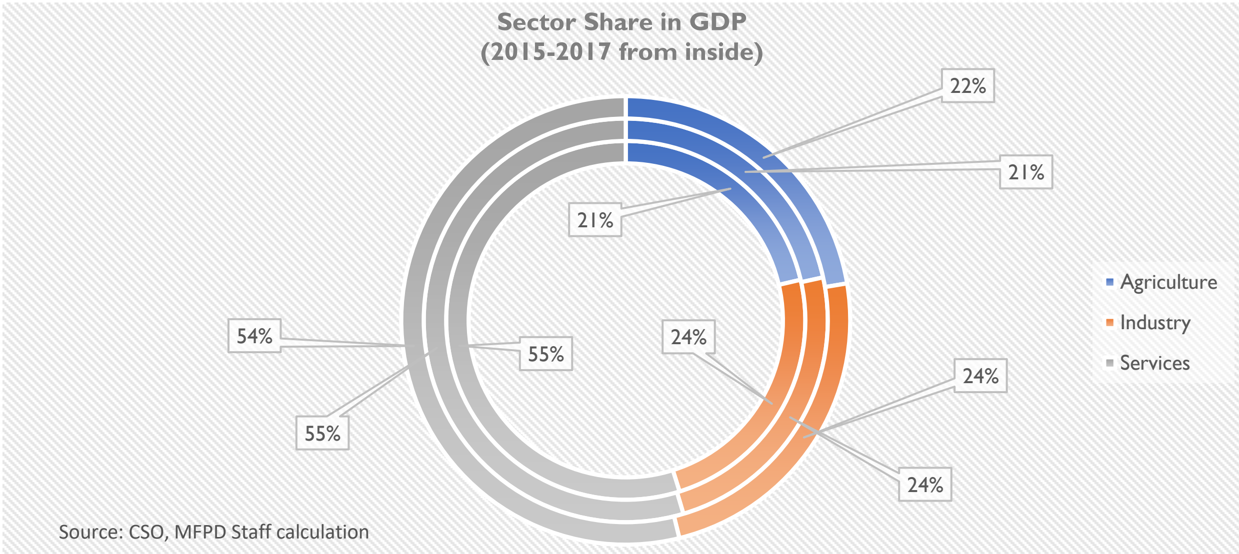
## 3.1 Historic Performance

### Economic Performance in 2016 (1395)

After the 2014 (1393) downturn, the economy started to grow smoothly. In 2016 (1395) Real GDP was Afs 1,245 billion which grew by an estimated 2.9 percent in real terms. This growth rate is significantly higher than the 2015 (1394) real growth rate of 0.8 percent. All sectors in this year had a positive contribution to overall growth. Agriculture recovered remarkably from -5.7 percent growths in 2015 to 2.2 percent in 2016. The cereal production (including wheat), significant driver of agricultural growth declined by almost 14 percent largely due to weather conditions in the year of 2015. Agricultural in Afghanistan is mostly reliant on weather conditions. Similarly, industry and services grew by 4.7 percent and 3.4 percent respectively, which is 0.6 percent and 1.8 percent more than that of 2015 growth rate respectively. While agriculture's contribution to overall output growth is significant, its share remains very small. It contributed 21 percent to GDP as its share. The share of services and industry to GDP was 55 percent and 24 percent respectively. It is projected that in the coming year agriculture's contribution will increase to 22 percent, industry will remain the same and services will reduce to 54 percent. However, given the amount of snowfall as compared to last year, agriculture output may increase even further.



Source: CSO, MFPD Staff calculation



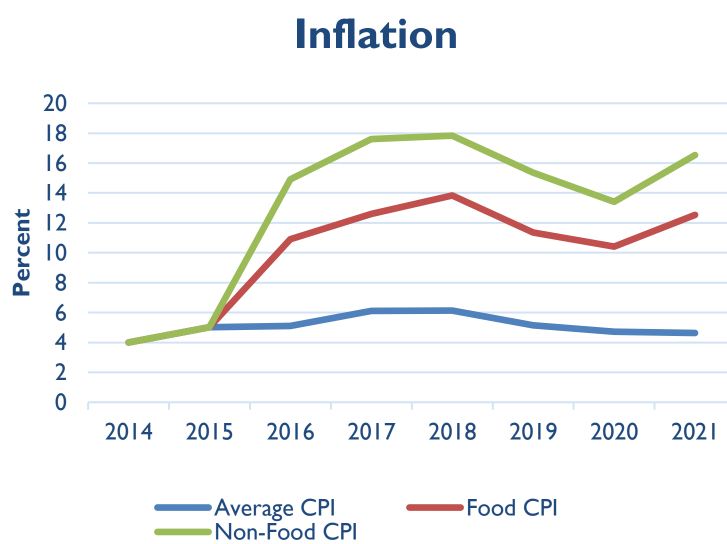

### Economic Growth

The GDP growth for the year of 2017 is projected to be 3.8 percent, driven by the contribution of recovery in agriculture, services, and construction sectors in particular:

- In the year of 2016 the agriculture sector recovered from negative growth rate to positive. In the year of 2017, we expect moderate growth in Agriculture, with no reasons to expect a downturn. Despite a very dry wet-season the latter half of the season saw sufficient rainfall and snowfall not to present significant risk.
- We expect to see continued growth in construction in line with a commitment to expand execution of large development projects.
- The execution of national priority projects is anticipated to boost overall economic activity in the country; improving the employment of high-consuming individuals.
- Government services are likely to grow, reflecting new resources, and new donor commitments in the Brussels conference.

### 3.2 Inflation

Average consumer prices in 2016 slightly increased as compared to 2015. Although prices increased over the 2015 average in the first quarter, because of increased oil prices and continued depreciation of Afghani (3.5 percent in the first two quarters), the yearly average increased due to increase in global oil prices and depreciation of Afghani against USD in the last two quarters of 1395/2016 (2 percent in the last two quarters). It is estimated that in line with the increase in oil prices in the world markets, the average consumer prices will also increase by

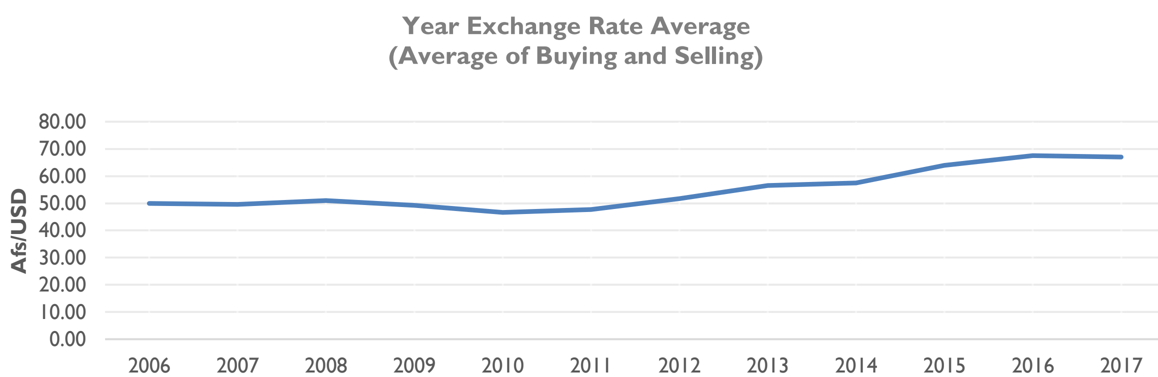



Source: CSO, MFPD staff calculation

approximately 2 percent in 2017. Projections show an increase in both food and non-food prices in 2017. However, food prices, particularly the price of cereals depends on domestic agriculture production, which largely depends on snowfall in winter and rainfall in the spring season.

### 3.3 Exchange Rate

In 2015 due to the large scale of migration to Europe, the Afghani depreciated drastically against US dollar. This trend continued till the second quarter of 2016. Till this period, the Afghani depreciated by 3.5 percent. The exchange rate fell in the third and fourth quarter of 2016 due in part to a reduction in the number of migrants. The exchange rate has stabilized to Afs 67/USD and the same is expected to continue in 2017. Private sector credit dropped in 2016, exacerbating problems for businesses in Afghanistan. This may have been caused by the economic uncertainty and falling currency, prompting banks to make more dollar investments abroad to maintain investment value. It is expected that in 2017 and 2018 with a stabilizing currency there will be some improvements in credit, and in the medium-term Government efforts to build a debt market through Government bills is expected to deepen the financial sector.




Source: Da Afghanistan Bank

### 3.4 Balance of Payments

The volume of exports has increased slightly over the past years and it is expected that going forward it will remain fairly stable, as there has been limited expansion in secondary processing of materials (for example, marble, food etc.) and thus limited scope for export of significant increases in the quantities of manufactured goods. Exports will likely expand once extractive industries start operations. It is expected that imports will increase by 14 percent in 2017 as compared to 2016 and decrease in the outer years. The reason for the reduced imports could be shifting demand to domestic goods. However, in the medium-term a significant drop in imports would not be expected.

The goods balance shows a deficit due to the high need for imported produce. However, the services balance shows a surplus, as a result of the provision of services to foreign organizations in Afghanistan. The income and transfers account is positive partly because of remittances from family members outside of Afghanistan.

Overall, the current account balance is positive due to direct transfers (aid).

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

| **Balance of Payments (in million Afs)** | **2016** | **2017** | **2018** | **2019** | **2020** | **2021** |
|---|---|---|---|---|---|---|
| **Current Account** | **129208** | **85546** | **13381** | **39682** | **-111593** | **-145249** |
| Goods Balance | -453882 | -509802 | -567960 | -533131 | -607047 | -603182 |
| *Imports* | -589280 | -676731 | -639997 | -662729 | -693023 | -717710 |
| *Exports* | 135397 | 166929 | 72037 | 129598 | 85976 | 114529 |
| Services Balance | 47502 | 54552 | 51591 | 53423 | 55865 | 57855 |
| *Payments* | -143120 | -164360 | -155438 | -160959 | -168317 | -174313 |
| *Receipts* | 190623 | 218912 | 207029 | 214382 | 224182 | 232168 |
| Net Income and Transfers | 535588 | 540795 | 529750 | 519390 | 439589 | 400077 |
| **Capital Account** | **6345** | **-377** | **4530** | **2725** | **3006** | **1725** |
| Capital Transfers | 67 | 314 | 487 | 1131 | 213 | 326 |
| Foreign Direct Investment | 12242 | 6800 | 9974 | 7530 | 9125 | 7821 |
| Other | -5964 | -7492 | -5931 | -5937 | -6331 | -6423 |
| **Changes in Reserves** | **135553** | **85168** | **17911** | **42407** | **-108587** | **-143524** |
| **Reserves (US$ m)** | 13124 | 13611 | 13674 | 14298 | 12701 | 10591 |

### 3.5 Economic Outlook

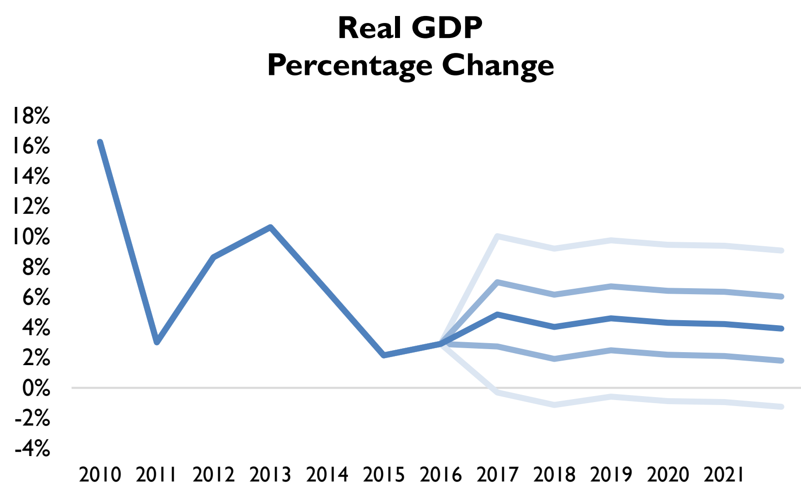
After a slow recovery in the year of 2016, the expected growth rate picked in 2016 to an estimated 2.9 percent, and we expect this improvement in the growth rate will continue to improve through 2021. Improving activity in the agriculture sector, government plans in investing in infrastructure projects such as energy and regional connectivity will stimulate the economy. Inflation will increase moderately in 2018 in line with the historic slow increase in the year of 2016 and expected increase in the same levels in 2017. In the medium-term inflation is expected to moderate to around 6 percent.

| In percentage change | **Historic** | **Current** | **Budget** | | **Outer Years** | |
|---|---|---|---|---|---|---|
| Unless otherwise noted | **2016** | **2017** | **2018** | **2019** | **2020** | **2021** |
| **Real GDP Growth - Factor Price** | 2.9% | 3.8% | 3.8% | 4.5% | 4.9% | 5.4% |
| **Nominal GDP Level (**Afs bn**)** | 1245.0 | 1422.2 | 1525.2 | 1609.9 | 1734.7 | 1859.8 |
| **NGDP by Sector (**Afs bn**)** | | | | | | |
| Primary | 260.2 | 291.4 | 309.7 | 330.2 | 364.0 | 402.1 |
| Secondary | 288.4 | 335.5 | 355.9 | 374.6 | 395.3 | 414.1 |
| Tertiary | 663.6 | 757.1 | 822.8 | 866.6 | 935.1 | 1001.9 |
| **GDP Deflator** | 0.0% | 10.0% | 3.4% | 1.0% | 2.7% | 1.8% |
| **CPI Inflation** | 4.5% | 6.2% | 6.1% | 4.5% | 4.7% | 4.5% |

**Source:** MFPD Staff Estimates                Figures include opium

We have assumed that

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

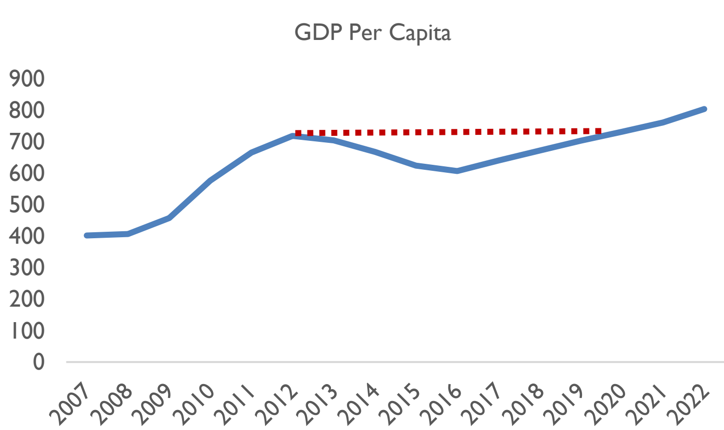



MFPD Staff Estimates

The growth level of GDP is led by improved performance in the agriculture sector with expected expansion in the growth of wheat and fruits. Livestock growth will 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 interval, we expect growth to be between 3 percent and 6 percent over time, and with 90 percent confidence interval we expect it to fall between 0 percent and 10 percent over time. The wide range of uncertainty reflects the large shocks that have been seen historically in growth.

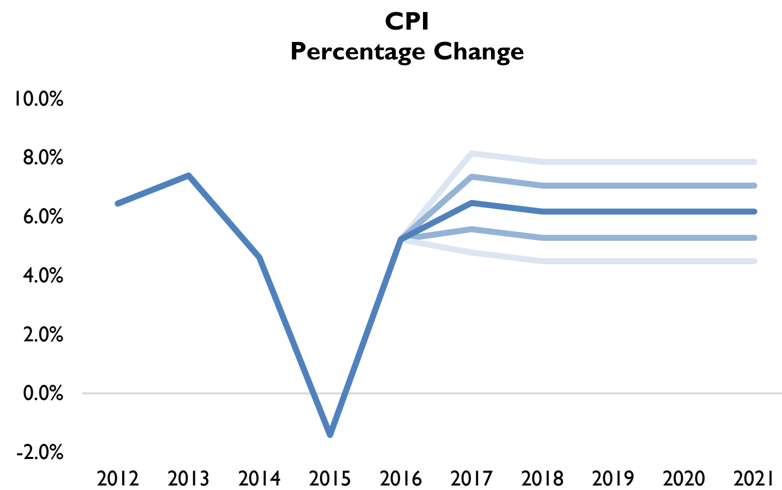
GDP per capita is expected to start rising after slight falls in 2014 and 2015, reflecting the slowing activity in the country. The GDP per capita is expected to recover to 2013 values in 2018.  High population growth, and a young population, obviously weakens rapid growth in this measure.

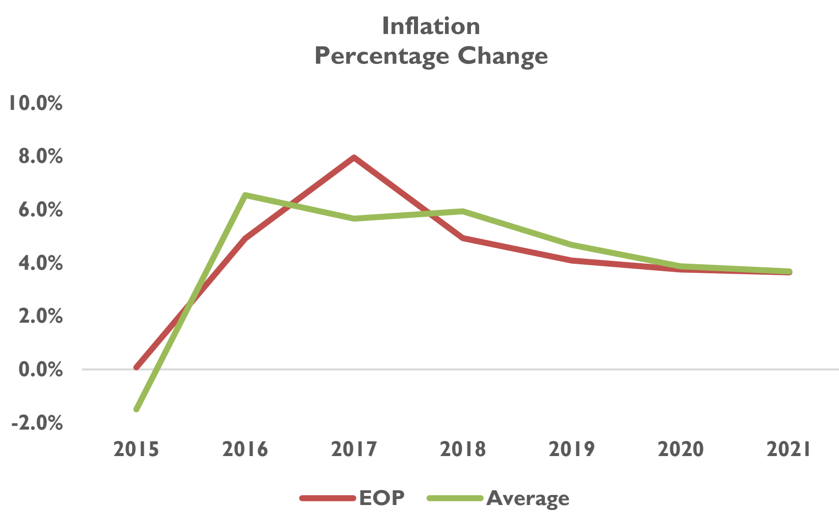
| **GDP Per Capita** | **2016** | **2017** | **2018** | **2019** | **2020** | **2021** | **2022** |
|---|---|---|---|---|---|---|---|
| in Afs | 40305 | 42569 | 44619 | 46737 | 48658 | 50576 | 53425 |
| in USD (at 2016 exchange rate) | 606 | 640 | 671 | 703 | 732 | 761 | 804 |




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 have picked up slightly; both options contracts and future prices reflect an expectation of a moderate increase. The inflation is expected to be 6 percent in 2017. There are: (1) no new measures that will likely increase the inflation; (2) currency exchange rate remains stable, any unforeseen depreciation will pressurize consumer price index. Any increase in international prices will likely increase local prices.



# 4. Fiscal Performance

## 4.1 Last Fiscal Year's Performance (1395) – Summary

### Summary Fiscal Outturn – End of Fiscal Year, 1395

**Domestic Revenue including mining:** The government collected Afs 143.27 in billions of a budget of Afs 132.7 in billions

**Total Spending:** The total spending of the government was planned to be Afs 463.44 in billions, of which Afs 354.22 in billions was spent

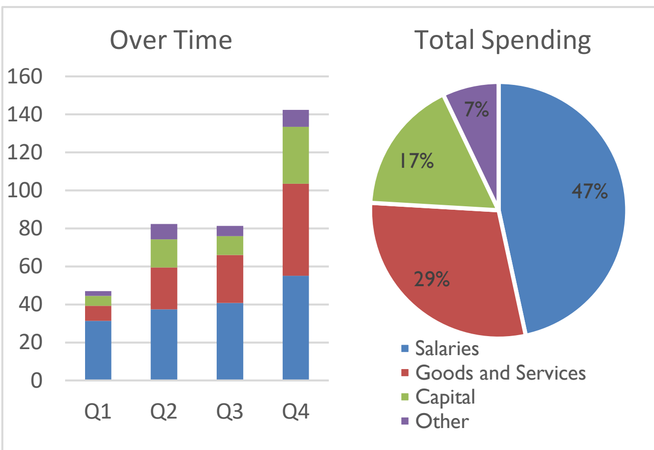
**Donor Support:** Donors committed Afs 297.23 in billions towards the budget, Afs 201.29 in billions was actually spent

**Total Deficit/Surplus:** The total needed from other resources this year is Afs 7.66 in billions

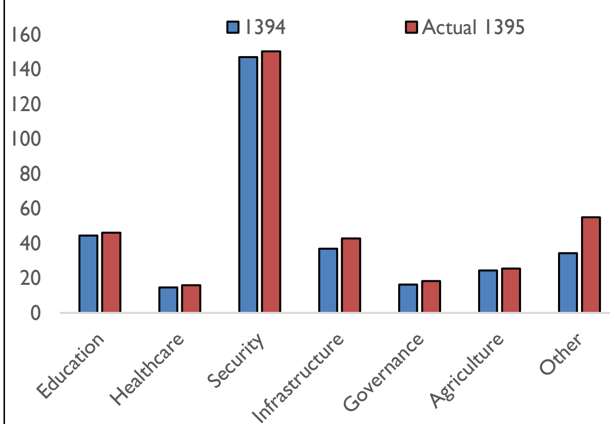
**Mining Revenue:** The total revenue from the extractive industry was Afs 1.04 in billions

*The following figures are all in billions of Afghanis*

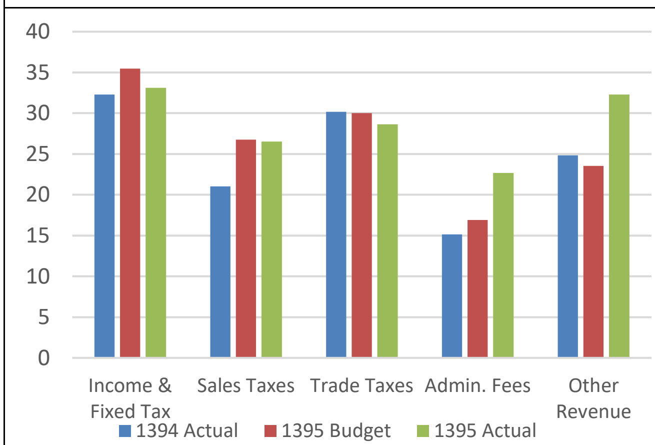
**Spending on Inputs**




**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

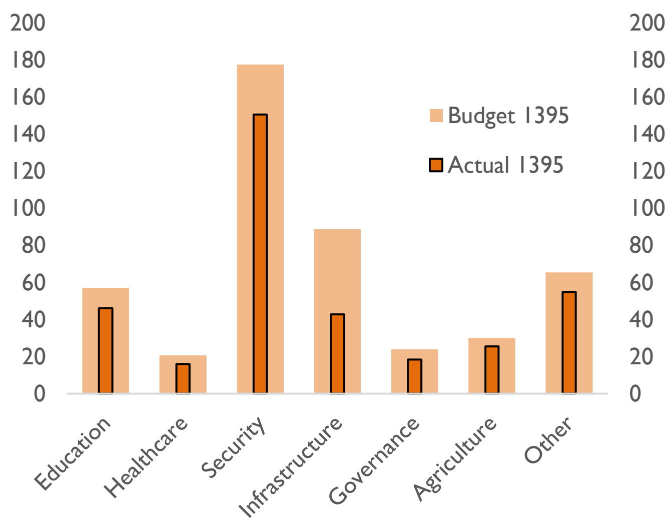
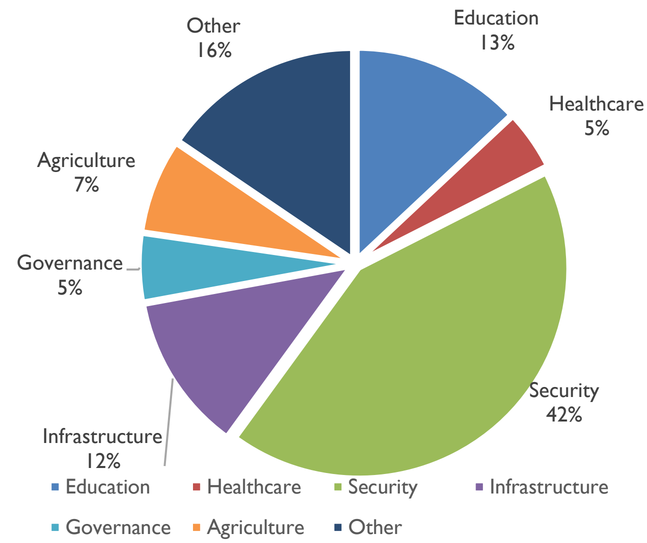
**Total Spending**

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 area will get to spend<br>**Expenditure:** The expenditure is the amount each project/Ministry/Sector actually spends of their budget | |
|---|---|
| **A portion of Budget Spent:** | **Spending on Sectors** |
| *By Key Policy Area*<br> |  |





Source: AFMIS, Jan – 16, 2017 Macro-Fiscal Performance General Directorate

## 5. Macroeconomic Policy

The Afghanistan National Peace and Development Framework (**ANPDF**) focuses on a long-term strategic plan to achieve self-reliance and commitment towards peace. This strategic plan provides medium-term economic growth objectives centered on maximizing the long-term welfare of the people in an equitable and sustainable way (these are set out below). The investments towards economic growth are intended to ensure stable growth in the real incomes of the population that will increase aggregate demand after a sharp drop in the last three years.

The economic policies are aimed at more utilization of the resources that will lead to future prosperity. The ANPDF medium run stabilization policy is expected to have long-term effects. The stability, output and real economy will improve and lead to greater long-run investment in capital, more incentives for firms to invest and increased growth levels. The national priority programs' execution is expected to increase growth levels to an average of 3.5% in the year of 2017 and beyond in the next 4 years. The long-term macroeconomic policy is to have labor driven growth in order to ensure jobs for the people and decrease the infrastructure and human capital deficit.

The key objectives of the Government's macroeconomic policy are:

(1) to ensure moderate, positive inflation;
(2) improve the external balance, and;
(3) decrease the level of unemployment and poverty.

Inflation beyond the threshold will likely harm the growth levels of the country. Consumers and business will acquire more foreign currency (US Dollars) as security if they are concerned the currency (Afghani) they hold today will buy less in the near future. Dollarization will create further pressure on prices and further inflation through the exchange rate channel.[2] This will also make the existing exports expensive to the destined countries; as a result, targeting this area and building currency credibility is a key goal of the government.

The external balance has seen minor improvement as imports fell in the last three years due to cut back on consumption by consumers. However, the country is still running a negative current account balance. Once the aggregate demand revives, the current account balance deterioration will likely increase, as the domestic real sectors are not well developed, creating an excess of demand for foreign goods. Debt repayments remain small as donor grants are filling the financing gap of public expenditure. As a result, a key goal of the government is to start to substitute many of the things we import with locally produced goods – supporting businesses here in Afghanistan to produce what we consume.

Unemployment levels remain high, particularly among the youth, and poverty increased post military and political transition. Short-term programs such as Jobs for Peace Program are designed to cushion the effects of the downturn of the economic cycle on households and create employment in the rural and urban areas. Unskilled labor suffers more while there are shortages of jobs in the market, and with a small buffer of savings low-skilled labor are vulnerable to quickly fall below poverty line. The growth policies will be targeted to decrease unemployment and reduce poverty in the medium and long term; supporting education, small-scale public works and ensuring new business investment is labor intensive.

[2] "How to De-Dollarize Financial Systems in the Caucus and Central Asia?". Naceur, Hosny, Hadjian. IMF Working Paper WP/15/203. p- 7.

## 5.1 Afghanistan National Peace and Development Framework

The framework lays out economic, political and security context for the economic development of the country. The economic performance is envisaged in improvements in agriculture, extractive industries, and trade. The context of ANPDF orients a fiscal strategy to guide budgetary allocation to support policy goals and ensure the sustainable management of public investment.

### Increasing National Productivity

National Priority Programs (NPPs) in design should reflect a job-rich government development programs. NPPs are the investment proposals devised based on the outcomes of the Cabinet discussions. ANPDF identifies major sectors for intervention to boost growth and generate employment.[3] The sectors identified follows as:

1. **Comprehensive Agriculture Development Program**

Agriculture is an underdeveloped sector and still provides employment opportunity to 40% of the population. The sector suffers from weak water resource development, poor quality inputs such as seeds and fertilizers, natural resource degradation and weak infrastructure for domestic and exporting markets. The public investment in the agriculture sector will be channeled to areas that yields growth, employment and provides food security to smallholders.

2. **Private Sector Development**

The private sector can turn into growth engine of the economy where Small and Medium Size enterprises (SMEs) can become the backbone of the economy. SMEs can create millions of jobs and can meet the local demand and fill the gap of import substitution. The policies will enable the environment to scale up the private sector through bringing regulatory reforms and in the future launch financial inclusion programs.

3. **Mineral and Resource Development Program**

Afghanistan is a resource rich country and extractive industries exploitation can generate a notable revenue for the government. The government will bring reforms in contracts, establish full government control over mining areas, build new freight rail links to regional networks in Turkmenistan and Iran, and expand oil and gas exploration.

4. **Energy and Infrastructure Development**

Public investment in Energy and Infrastructure is vital to creating vibrant markets. Despite the progress, there is a shortage of energy and infrastructure building. The government will reduce transportation costs to expand rural-urban trade, complete 500Kv national grid, increase domestic generation to 2,300 MW and gain revenue from energy arbitrage between Central and South Asia.

5. **Advancing Regional Integration**

[3] For more information see, "Economic Growth and Job Creation" and "Poverty Reduction and Social Inclusion", ANPDF, 2016. p18 – p 27.

The geographic location as an advantage is transit hub between East, South, Central and West Asia that can be a major economic resource. Initial investments in cross-border energy transmission and dry ports to promote trade and WTO accession will facilitate more cross-border commerce for regional connectivity. Afghanistan will join regional projects such as One Belt, One Road (OBOR), encourage Public Private Partnership, enhance engagement with regional organizations, and strengthen our embassies and trade missions.

### 6. Increasing Labor Productivity and Investing in Human Capital

The country has the skill and job disparity in the market. To meet the skill demands of the job markets, the government will invest in vocational education, engineering, managerial skills, the service industry and reforms to make our labor more flexible and responsive.

### 7. Urban Development Program

The cities have grown in size and in number, and now it needs to become drivers of growth. The government will work to build municipal and metropolitan management capacities while the urbanization is in effect. The government will create a network of dynamic, safe, livable urban centers, turn urban centers into economic growth hubs, cultural centers, social inclusion, decentralize urban planning and establish participatory urban governance mechanisms.

## Poverty Reduction and Social Inclusion

Afghanistan has lacked development policies targeting poor and strategies to improve the livelihoods of the vulnerable population. The government approach is to improve growth and productivity through programs concentrated on building skills and providing access to opportunities. ARAZI, a national priority program on land administration is one of our core pillar of poverty alleviation.

### 1. The Citizen’s Charter Program

The Citizen’s Charter program will improve mechanisms for service delivery in education, health, basic rural infrastructure, and agriculture services. The Citizen’s Charter program is designed to reduce poverty and break the cycle of fragility and violence, using Community Development Councils (CDCs) as the entry point for both governance and development activities.

### 2. Women’s Empowerment

The ANPDF economic policy focuses on the social and economic participation of Afghan women, the government is also committed to women participation in the political context of the country. The government will invest as much as USD 250 million over the next fifteen years in programs empowering women, as part of our poverty reduction commitment. The government’s gender policy rests on five pillars;

1. Implementing the government’s global commitments on human rights, security, and freedom from domestic violence for Afghan women;
2. Ensuring full access to education and health services, including higher education;
3. Launching the Women’s Economic Empowerment National Priority Program;
4. Securing the constitutional rights for women through the full execution of our laws; and
5. Advancing women in government and business.

### 3. Social Protection

Afghanistan cannot yet afford large-scale national safety nets or tax-based transfer programs. But pro-poor spending can be significantly increased and made more efficient. We will reduce poverty primarily by helping the poor increase their skills, productivity, and access labor intensive paid employment through the Jobs for Peace program. The Program was launched in 2016 and has already provided over two million paid days of work to repair and maintain village infrastructure.

## 6. Fiscal Policy

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 2014 cash crisis, and the large donor support to the government. 2014 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, as well as ensuring sufficient fiscal space for expenditures on new policy objectives of the National Unity Government.

The Government proposes to slowly phase out donor support to key Government operations in line with international commitments, bringing more on a 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:

a. The reduction over the medium of the portion of the operational budget funded externally, and an improvement in the domestic revenue/operational spending ratio.
b. 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.

### 6.1 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 to borrow 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, a Staff Monitored Program (**SMP**), and most recently a newly agreed ECF program agreed with the IMF in July, 2016. 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. After completion of SMP, a 3-year program has been agreed with the Government's commitment to ensuring continued engagement with the Fund and includes similar commitment to restrict borrowing. See chart below for an overview of fiscal conditions under historic and current IMF program.

**Terms and Conditions of Loans under IMF Agreements**

| **Term** | **Long Term** | **Short Term** |
|---|---|---|
| **Concessional Terms** | **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, Islamic Development Bank and World Bank-IDA (as well as the funds from the IMF agreement – see ***Debt and Fiscal Sustainability*** *Section*).

### 6.2 Fiscal Policy from PFEM Law

The Public Finances and Expenditure Management Law (**PFEM**) 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".

### 6.3 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.

### 6.4 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.

### 6.5 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 on a concessionary basis.

### 6.6 Policy Objectives Affecting Aggregate Ceilings

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

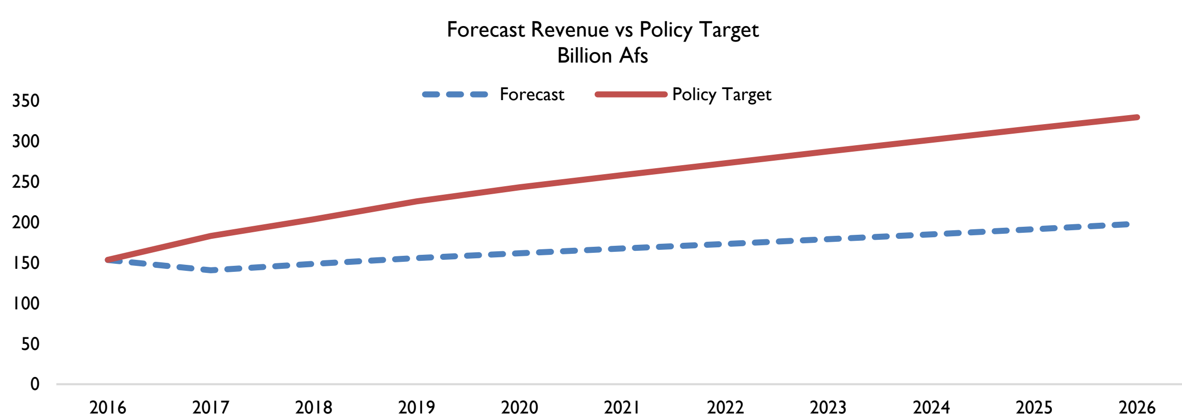
**Revenue Policy Objectives**

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. The policy objectives below will aim to ensure we can meet our policy target for revenue improvement. These have not been included in to the baseline as the exact scale of the impact is not definite:

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

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

C. 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 the 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.

# 7 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.

### 7.1 Risk Matrix

| Risks | Likelihood | Impact | Details |
|---|---|---|---|
| | | | |
| Macroeconomic: Lower development budget execution rate undermines the economic recovery | High | High | Development projects are key to improving the economic recovery and improving the welfare of the citizens. Lower execution rate will slow down development across the country and further make the poor vulnerable to severe poverty. |
| Fiscal: Efforts to improve the execution of development spending are impacted by security, and problems in procurement processes | Medium | High | The government failed to achieve 80% execution rate previously and it should look into further reforms to achieve a higher percentage of execution rate. The 5-year rolling plan coverage expansion, MoF reforms, and support from the Office of the President could help promote execution rate. |
| Macroeconomic: Continued security problems cause reduced economic activity in the provinces | High | Medium | Political and Military efforts are underway to pacify the war-affected provinces and contain the spread of violence. There is a surge in civilian and military causality, and internally displaced population due to war has almost doubled up. |
| Fiscal: Internally displaced and returnees create fiscal pressure on the government in the short, medium and long-term | High | Medium | In the immediate term, the government has to arrange for basic shelter and food for the internally displaced and 1.2 million returnees to the country. In the medium run, the government has to provide basic services such as health, education, security, water, electricity, and sanitation among other services. The inflow of returnees for better opportunities into major cities builds pressure on the already poor infrastructure in the urban areas. |

| Risks | Likelihood | Impact | Details |
|---|---|---|---|
| Fiscal: The risk of reduced retail activity leads to underperformance to target 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 cutbacks on consumables. |
| Macroeconomic: Slow economic recovery and shortage of energy supply further harms the economy | Medium | High | The jobs lost post military and political transition will bear negative consequences on the economy. The consumption has decreased, households are affected by job loss, demand for energy has increased while alternative energy sources make it expensive for businesses and households to sustain the costs. |
| Fiscal: The budget favors less development projects that are job rich and alleviate poverty | High | High | Development projects should be taken into the budget that promotes growth levels and creates jobs for the urban and rural population. Poverty levels have increased close to 40%, unemployment was 24% in 2012. Unemployment is expected to be at higher levels now and the number mounts. |
| Fiscal: Domestic revenue is weak to finance full budget; the deficit would expand significantly with a fall in donor aid | Medium | High | The government should mobilize resources to increase the domestic revenue to finance more development projects. |
| Fiscal: Government sees reduced fiscal space to finance national priority projects if revenue fails to perform to increase economic growth levels | Medium | High | MoF should create fiscal space to allow the government to fund priority projects and design fiscal stimulus to boost the economic growth recovery. |
| Fiscal: Weak Public Investment Management could result in poor targeting of projects and loss of funds, or weaker economic outcomes. | High | Medium | Public Investment Management increases the efficiency and the impact of implementing development projects. The current management is at poor state, and reforms will also help in increasing development budget execution rate. |
| Macroeconomic: Domestic prices are susceptible to changes in international prices | Medium | Medium | Prices increased last year as prices in the international market started picking up. Further increase in international prices will pull up domestic prices. |
| Macroeconomic: WTO accession could result in loss of revenue due to decreased tariff rates | High | Medium | WTO tariff rates are now applied and it will likely result in loss of revenue in the Customs Directorate. |
| Fiscal: Customs Directorate should increase efficiency, and find alternative tariff sources to minimize the loss due to WTO accession | Low | Medium | With fall in aggregate demand and lower tariff rates, it is unlikely that the revenue loss can be recovered in the current macroeconomy. Increased efficiency, strengthened reforms and minimized leakages in customs will make up for the losses of the revenue. |

| Risks | Likelihood | Impact | Details |
|---|---|---|---|
| Fiscal: Demonetization in India and weak economic growth in trade partner economies will result in decline of exports of Afghanistan | Medium | Low | India remains a large importer of Afghan fruits and dry fruits, other economies import limited products from Afghanistan. The demonetization of India that has already disrupted Indian consumer demand will decrease demand for foreign (Afghan) produces. |
| Macroeconomic: Lower donor activity will impact economic activity | Medium | High | New aid commitments may not materialize, either as a result of disbursements not made, or conditionality not met by the government could drastically cut back expenditures. |
| Macroeconomic; Continued uncertainty reduces Foreign Direct Investment | Medium | Medium | Foreign Direct Investment does not see much growth as a result of continued uncertainty. |
| Macroeconomic: Inflation and reduction in the external dollar flow cause a depreciation in the value of the Afghani | Medium | Low | US Dollar appreciated in the year of 2015-2016 as demand for foreign currency increased with migration. The exchange rate gains of Da Afghanistan Bank can maintain the current level exchange rate. The US Dollar dominance in the economy may build pressure on Inflation through the exchange rate. |
| Fiscal: Government cash reserves remain low, and mismatches between revenue and expenditure could precipitate another cash shortage | Medium | High | A key challenge 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 speedy repayment. |
| Fiscal: Operation and Maintenance costs are calculated as higher than anticipated | Low | Medium | The costs of projects pressure for the budget in the medium term. This will be a particular issue once assessing the baseline costs of providing services through rolling assessments of Ministries. |
| Macroeconomic: Lower growth levels results in a decline in domestic revenue and a higher fiscal deficit | Medium | High | The increase in economic activity will restore consumer and investors' confidence, and decrease exchange rate volatility. Exchange rate volatility will lead to further dollarization, capital flight, and inflationary pressure. |

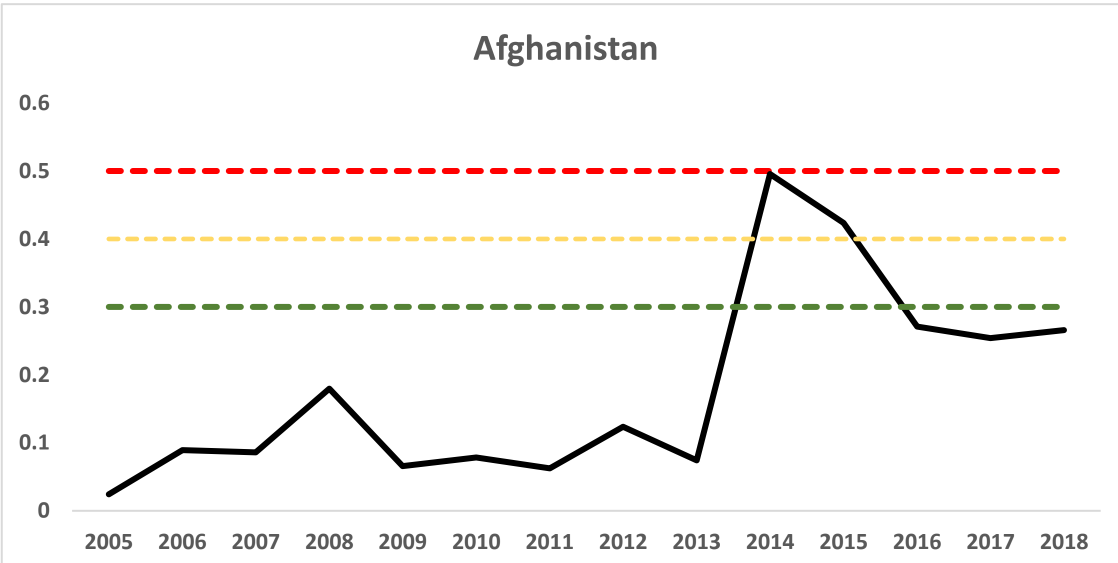
### 7.2 Fiscal Risk Indicator

| | |
|---|---|
| Indicator Value for 2018 | 27% |

Red Line – **Indicates Severe Risk of Crisis**

Yellow Line – **Indicates Increased Risk of Crisis**

Green Line – **Represents Limited Risk of Crisis**



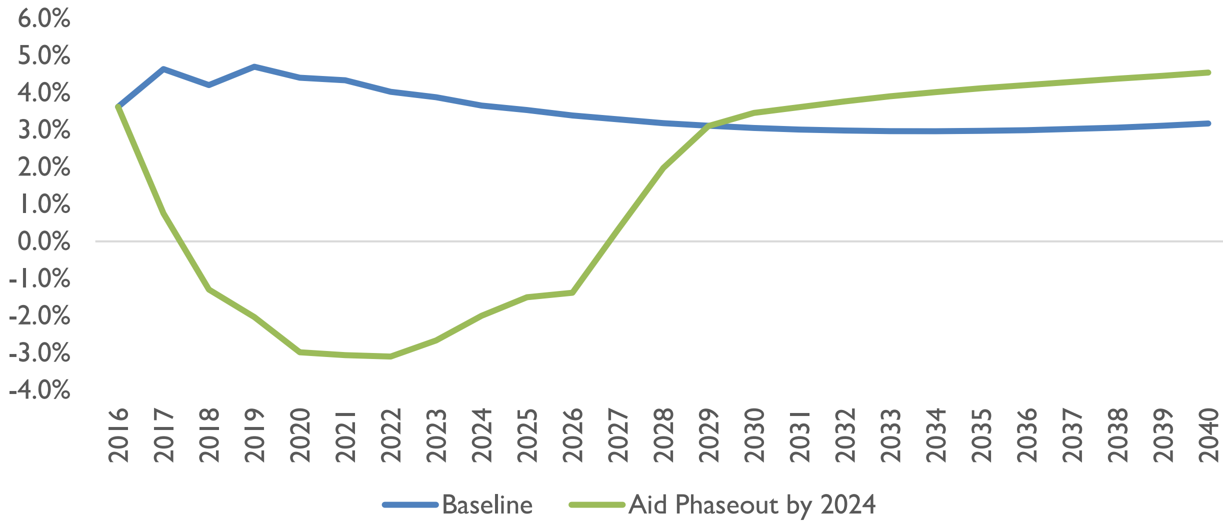

There is a slight increase of one percent in the risk indicator since last year that is almost negligible. The risk value of fiscal crises indicates limited risk of crisis as a result of improved revenue and economic growth outlook, and a reduction in the likely structural and primary fiscal balances by the end of the year. Debt to GDP ratio 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. This represents a significant recovery from the difficulties of 2014.

### 7.3 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 - 70 percent of the core budget expenditures are funded through donor aid and assistance. If we assume that all donor's aid is reduced by 25 percent each year (starting from the year 2017 onward), there expects to be sharp fall in the economic growth by 2024, with growth bottoming out at between 0 and 1 percent. However, it will be gradually recovering and moving upward from 2027 (2021 is the year aid is assumed to stop in the scenario), and reach the average growth of around 3.5 percent to the baseline in 204.

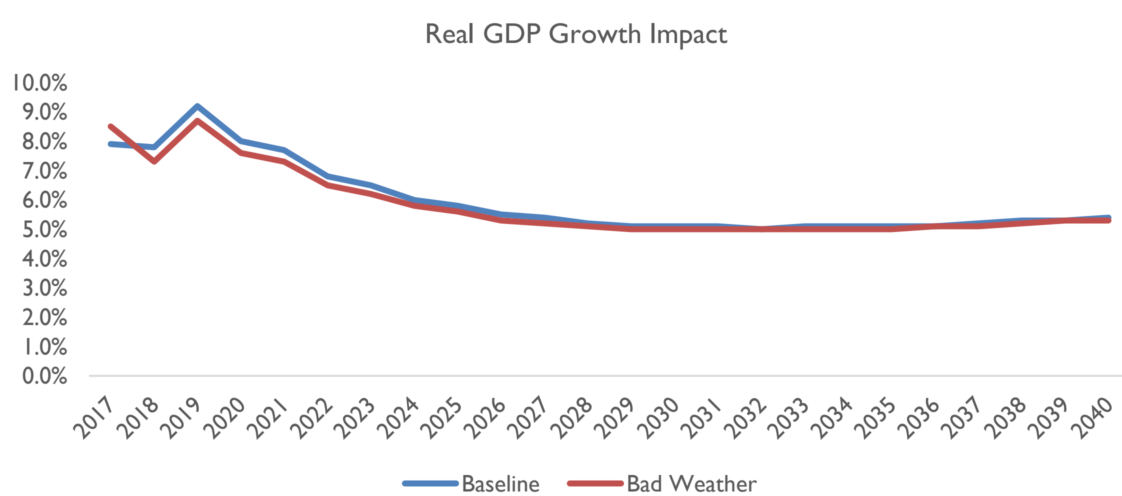



A reduction in aid of 25 percent each year (as assumed in the below scenario) would have a dramatic impact on the collection of resources by the government – given how closely donor support is tied to all areas of the economy – and similarly would reduce economic activity significantly in the near term.

The results in the above graph 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 at 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 (2017)**

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 rainfall. If we assume bad weather or drought during 2018, there is estimated to be a decrease in growth (around 1 percent), however, there will be



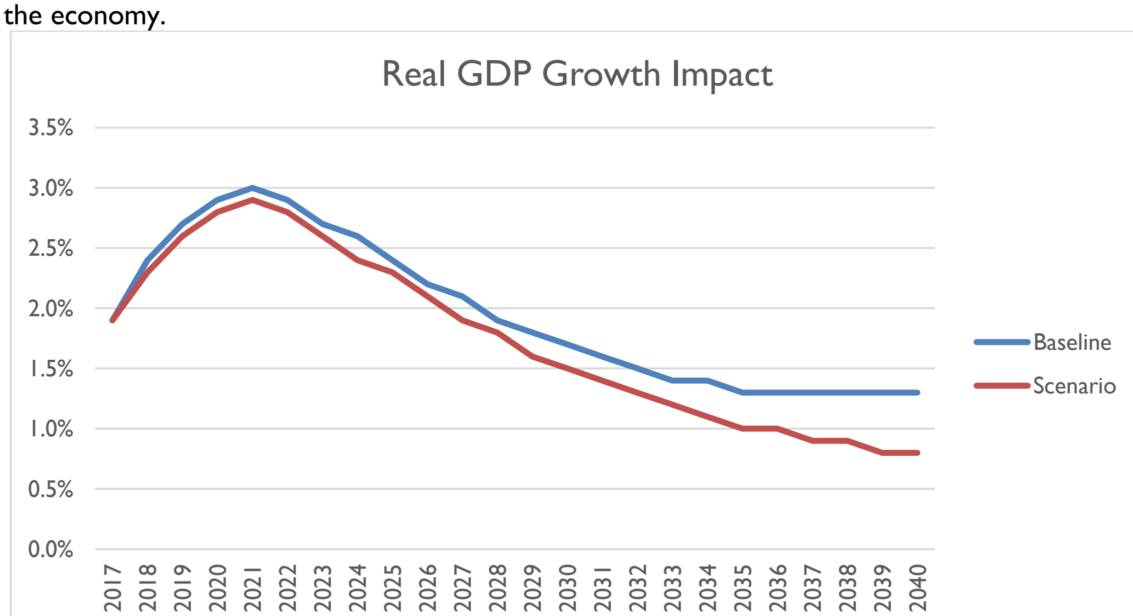
quick recovery through 2019. The economic growth will still be lower and below than the baseline growth, and GDP would remain lower as a result of the shock to human and physical capital and livelihoods.

Low precipitation has caused dramatic drops in sector performance in the past (with falls of 15 - 20 percent in the sector). While 2016 saw reasonable levels of precipitation and 2017 is likely to also (snow has been good across the country in 2017), 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 labor). The collection of revenue is not as impacted 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 on revenue since growth all over is reduced. A drought in 2017 is estimated to reduce the revenue collection by almost Afs 5-6 billion lower than the baseline revenue estimates through to the year 2022.

**Services Sector Falls**

A slowdown in the services sector of negative 2.5 percent in 2017 is simulated here to give an impression of the impact of the services sector has on GDP and the interlinkages between the areas of the economy.

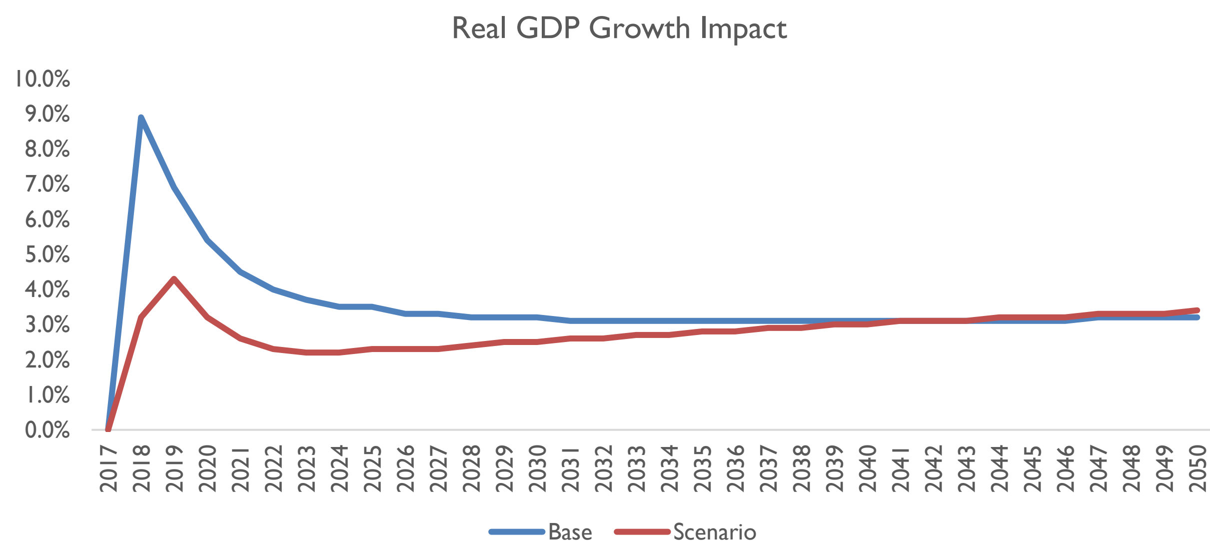



The scale of the impact is relatively small in the initial few years and the gap widens further after 2029. This implies that an overestimation of the services sector in the medium term should not significantly alter the GDP projections; provided the overestimation is not too significant except for the outer years. The shock to the sector will take longer given it bears impacts on capital stock accumulation or the labor force.

**Import Shock**

Afghanistan is still a highly import dependent country. As shown in the graph, a fall in imports will significantly impact the growth. The recovery will be very slow to match the baseline growth, and it will pick in 2039 and will be around the same level till 2049.

An import shock of Afs 200 billion in 2017 would have a significant impact on the GDP growth levels. This scenario assumes the imports recovers back to the previous levels in the long run. The bulk of the impact is in the initial few years and slowly the gaps narrow down until it goes slightly above the baseline. As a result, inaccurate estimation of the scale of import activity (or shocks to the activity) can have significant effects given the overreliance on imports. It is worth noting that the scale and form of the




shock will depend upon the reasons impacting imports; an import slowdown predicated by a donor would likely have substantial growth impact.

### 7.4 Mitigation Strategies

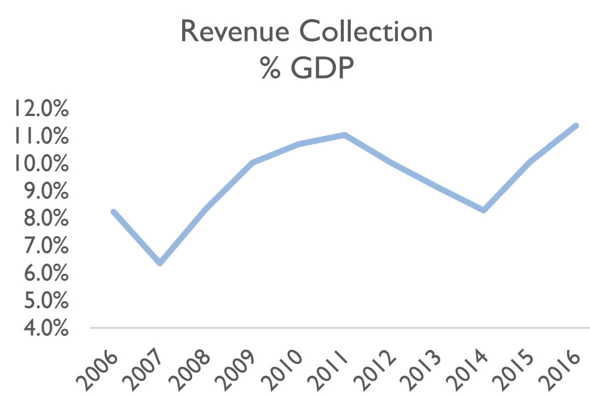
The following matrix represents the mitigation strategy for the major risks outlined in the risk matrix. The mitigation plans for the major risks are directly linked to reducing risks at other areas of the economy.

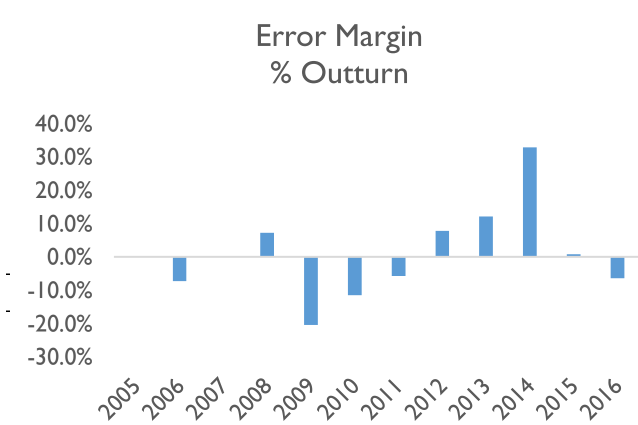
| Risk | Mitigation Plan | Measurement |
| --- | --- | --- |
| The decaying effects of the measures introduced in 2015 to increase domestic revenue. | No new policies have been placed to strengthen the tax base for this year; however, the government will enforce the reforms to minimize revenue leakages. | Domestic Revenue to target. |
| The budget favors fewer development projects that are job rich, and development execution rate is low. | Strengthen public investment management, and build the capacity of budget staff to identify projects through cost | The increase in the development budget execution rate, and selection of pro-poor and job-rich development |

| | | |
|---|---|---|
| | benefit and effective analysis. | projects. |
| No fiscal space to implement NPPs to boost economic growth. | Partial or complete money should be freed up from stalled or slow implemented projects. The money should be reallocated to new priority programs designed to create jobs, alleviate poverty and address returnees' crisis. | Creation of fiscal space. |
| 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. | The level of suppliers' arrears. |

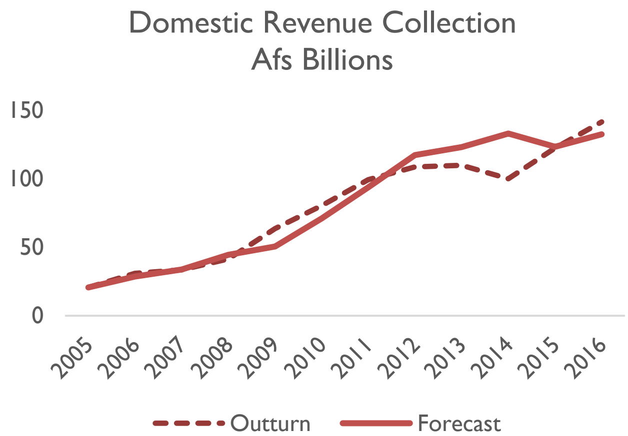
### 7.5 Revenue to Target Indicator

Revenue collection, as a percent of GDP, has significantly increased to 11.4 % in 2016 from the lowest level at 8.3% in 2014, showing a sharp recovery (around 3.1 percentage point) over the past two years, and reflecting substantial successes in improving revenue performance. While compared to 2015, it shows an increase of 1.4%, mainly attributed to continued improvement in performance by the collecting agencies. Going forward we expect revenue collection to further increase by around the 12% mark (although all depend on the collection momentum to carried out in next years as well).




Between years 2008 and 2014, there have been some forecasting errors - initially under-forecasting then over-forecasting resulting from limited actual historical data. However, 2015 saw a return to the accurate performance of the revenue collection, while 2016 experienced a slight under-forecasting error. The over-forecasting in 2014 and its preceding years has led the government to be prudent and make more conservative forecasts. This way, it will ensure the budget is prepared in line with realistic resources and do not have to be cut dramatically throughout the year.




The chart on the left shows the collection against the forecast, in which saw an improvement in the accuracy of the forecasts in 2015 and 2016 respectively.

## 8. **Medium Term Framework**

| **Revenue** | Historic **2016** | Current **2017** | Budget **2018** | Outer Years **2019** | **2020** | **2021** | **2022** |
|---|---|---|---|---|---|---|---|
| **Total Revenue** | **346.0** | **411.3** | **397.7** | **377.2** | **325.3** | **302.3** | **306.8** |
| **Total Domestic Revenue** | **143.3** | **152.5** | **145.9** | **154.8** | **161.9** | **170.1** | **191.8** |
| **Tax Revenue** | **94.0** | **105.0** | **106.6** | **112.1** | **116.4** | **121.0** | **126.1** |
| Fixed Taxes | 9.9 | 13.0 | 12.5 | 12.6 | 12.8 | 12.9 | 13.0 |
| Taxes on Income and Profits | 23.2 | 22.6 | 25.4 | 28.3 | 29.4 | 30.4 | 31.5 |
| Taxes on Property | 0.4 | 0.4 | 0.4 | 0.5 | 0.5 | 0.6 | 0.7 |
| Taxes on Goods and Services | 26.5 | 28.8 | 33.8 | 35.4 | 37.5 | 39.7 | 42.4 |
| Taxes on International Trade | 28.6 | 33.8 | 31.9 | 32.9 | 34.2 | 35.6 | 36.9 |
| Other Taxes | 5.3 | 6.3 | 2.6 | 2.3 | 2.0 | 1.8 | 1.5 |
| **Grants** | **192.1** | **258.8** | **251.7** | **222.3** | **163.2** | **132.1** | **114.9** |
| **Other Revenue** | **49.3** | **47.5** | **39.3** | **42.8** | **45.5** | **49.1** | **65.7** |
| Property Income | 1.8 | 3.0 | 1.0 | 1.2 | 1.2 | 1.5 | 1.6 |
| Sales of Goods and Services | 5.4 | 10.2 | 5.2 | 5.3 | 5.6 | 5.9 | 6.4 |
| Fines & Penalties | 25.2 | 33.2 | 22.8 | 25.3 | 27.1 | 29.2 | 44.4 |
| Other | 6.3 | 1.1 | 10.4 | 11.0 | 11.7 | 12.5 | 13.4 |
| **Sale of Non-Financial Assets** | **10.6** | **0.0** | **0.1** | **0.1** | **0.1** | **0.1** | **0.1** |
| **Medium Term Fiscal Framework** | **353.0** | **404.7** | **396.4** | **374.3** | **320.8** | **297.4** | **301.4** |
| Discretionary | 264.6 | 287.4 | 280.7 | 262.9 | 215.1 | 195.8 | 203.7 |
| Non-Discretionary | 88.3 | 117.3 | 115.7 | 111.4 | 105.7 | 101.6 | 97.8 |
| *o/w Interest* | 0.8 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 |
| *o/w Matching* | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| *o/w Pensions* | 24.4 | 18.8 | 21.4 | 23.4 | 23.4 | 23.4 | 23.4 |
| *o/w Earmarked Aid and Loans* | 63.1 | 97.9 | 93.7 | 87.4 | 81.7 | 77.6 | 73.7 |
| **Forward Estimates/Current Budget** [1] | | | | | | | |
| **Total Expenditure** | **353.1** | **406.5** | **396.4** | **374.3** | **320.8** | **297.4** | **301.4** |
| Salaries | 166.2 | 173.3 | 188.6 | 199.1 | 208.3 | 216.9 | 225.5 |
| Goods and Services | 63.5 | 36.9 | 71.9 | 75.7 | 79.0 | 82.1 | 85.1 |
| Capital | 4.8 | 7.3 | 5.5 | 5.7 | 6.0 | 6.2 | 6.4 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Interest | 0.8 | 0.5 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 |
| Transfers[2] | 24.4 | 27.6 | 18.8 | 21.4 | 23.4 | 23.4 | 23.4 |
| Discretionary Development | 93.3 | 63.0 | 80.5 | 80.5 | 80.5 | 80.5 | 80.5 |
| Non-Discretionary Development | | 97.9 | 93.7 | 87.4 | 81.7 | 77.6 | 73.7 |
| **Remaining Resources** | | | **-63.1** | **-96.1** | **-158.7** | **-189.8** | **-193.8** |
| | | | | | | | |
| **Primary Balance** | **-6.1** | **7.1** | **1.9** | **3.5** | **5.1** | **5.5** | **6.0** |
| **Overall Balance** | **-6.9** | **6.6** | **1.4** | **2.9** | **4.5** | **4.8** | **5.3** |
| | | | | | | | |
| **Financing** | **1.1** | **11.6** | **-1.4** | **-2.9** | **-4.5** | **-4.8** | **-5.3** |
| **Payments** | 1.8 | 1.7 | 4.6 | 4.3 | 4.5 | 4.8 | 5.3 |
| Domestic | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| External | 1.8 | 1.9 | 4.6 | 4.3 | 4.5 | 4.8 | 5.3 |
| **Receipts** | 2.9 | 13.3 | 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 | 2.7 | 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.

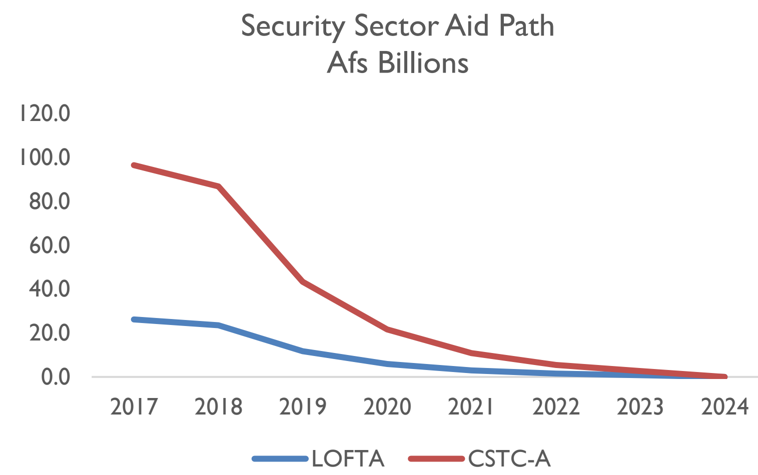
The other assumptions include:

- 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 the 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 Policy

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 favor of funds moving to ARTF and other discretionary development options.

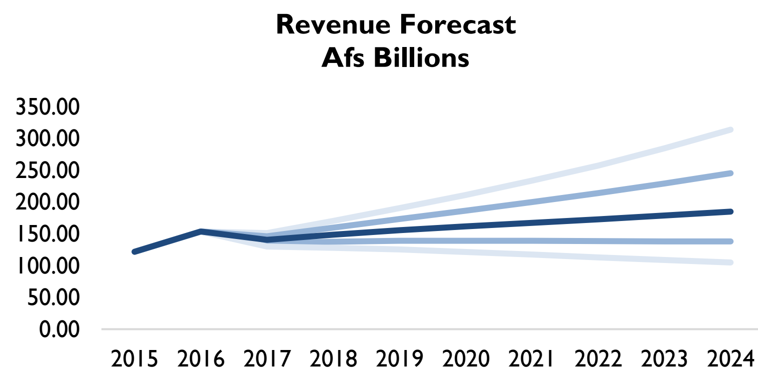
The figure for domestic borrowing in 1396 is assumed not to be paid back since it is likely that the execution will not be high enough on expenditure to require this financing.

### 8.1 Revenue Forecast

| | Historic | Current | Budget | Outer Years | | | |
|---|---|---|---|---|---|---|---|
| **Revenue** | **2015** | **2016** | **2017** | **2018** | **2019** | **2020** | **2021** |
| **Total Revenue** | **325.3** | **423.7** | **414.6** | **392.1** | **339.4** | **313.3** | **301.3** |
| **Total Domestic Revenue** | **121.7** | **153.5** | **140.5** | **148.5** | **155.6** | **161.5** | **167.4** |
| **Tax Revenue** | **88.8** | **100.8** | **106.2** | **111.3** | **115.9** | **120.2** | **124.6** |
| Fixed Taxes | 10.3 | 11.0 | 12.9 | 12.8 | 12.9 | 12.9 | 13.0 |
| Taxes on Income and Profits | 21.6 | 24.1 | 24.0 | 27.0 | 28.0 | 28.9 | 29.8 |
| Taxes on Property | 0.9 | 0.4 | 1.1 | 1.1 | 1.2 | 1.3 | 1.4 |
| Taxes on Goods and Services | 20.9 | 28.6 | 31.1 | 32.4 | 34.5 | 36.6 | 38.9 |
| Taxes on International Trade | 30.2 | 31.3 | 33.1 | 34.4 | 36.1 | 37.6 | 38.8 |
| Other Taxes | 5.0 | 5.3 | 4.0 | 3.6 | 3.2 | 3.0 | 2.7 |

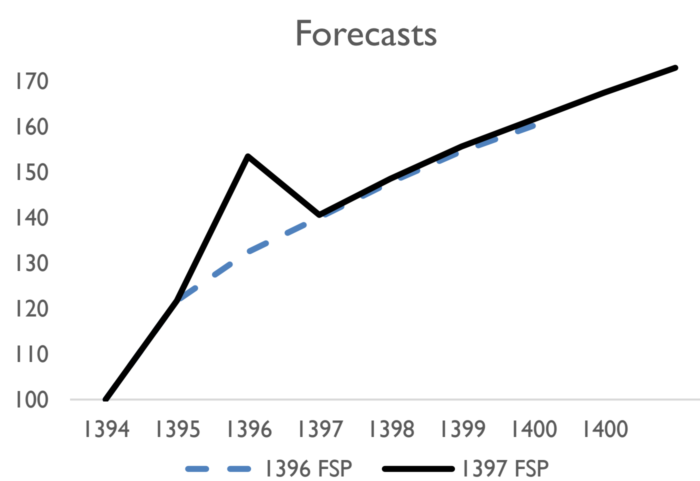
| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Grants** | **203.5** | **258.8** | **274.0** | **243.6** | **183.7** | **151.7** | **133.8** |
| | | | | | | | |
| **Other Revenue** | **32.9** | **52.7** | **34.4** | **37.1** | **39.7** | **41.3** | **42.8** |
| Property Income | 4.2 | 1.9 | 1.9 | 2.1 | 2.0 | 2.1 | 2.2 |
| Sales of Goods and Services | 6.3 | 5.7 | 6.7 | 6.8 | 7.1 | 7.4 | 7.9 |
| Fines & Penalties | 17.0 | 27.0 | 18.8 | 21.0 | 22.8 | 23.5 | 24.0 |
| Other | 5.3 | 6.7 | 6.9 | 7.3 | 7.8 | 8.2 | 8.7 |
| | | | | | | | |
| **Sale of Non-Financial Assets** | **0.1** | **11.4** | **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.



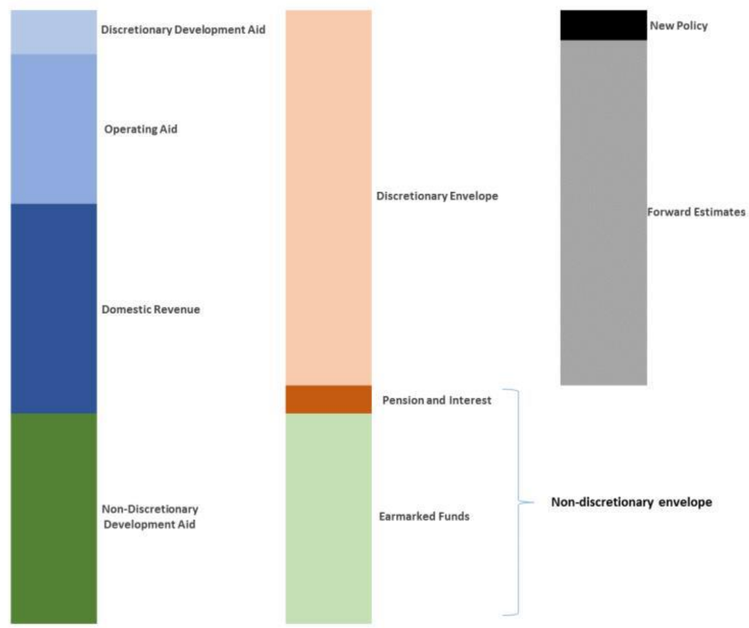

### Change to forecasts

The forecasts produced for the 1396 FSP incorporated estimates for the outer years, including 1397. The initial estimate for 1397 was Afs 140 billion, which has now been revised up to Afs 141 billion. There has been small adjustment in the forecast.



## 8.2 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 of 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 into 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. 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:***

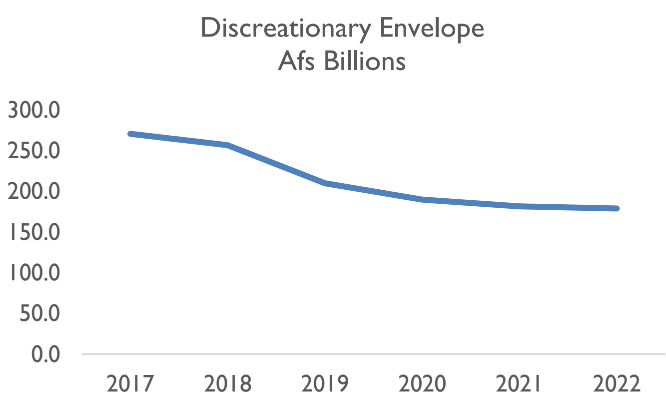
***Matching Funds:*** No data on matching funds has been incorporated at the moment, however, this could also be considered a non-discretionary expenditure, where the Government has agreed to provide these.

***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 a number 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 LOFTA 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.

**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 LOFTA, 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). Development Policy Grants (DPG) disburses upon the satisfactory performance of the government in certain predetermined areas.

Figures for the donor support to the budget are given through rules based estimate and will be updated to reflect actual commitments once there 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 large salaries, in the security sector. All salaries captured under policy determined to spend 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 to spend 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.

# 9. Forward Estimates

## 9.1 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 the new policy.

### Cost of Continuing Current Policy

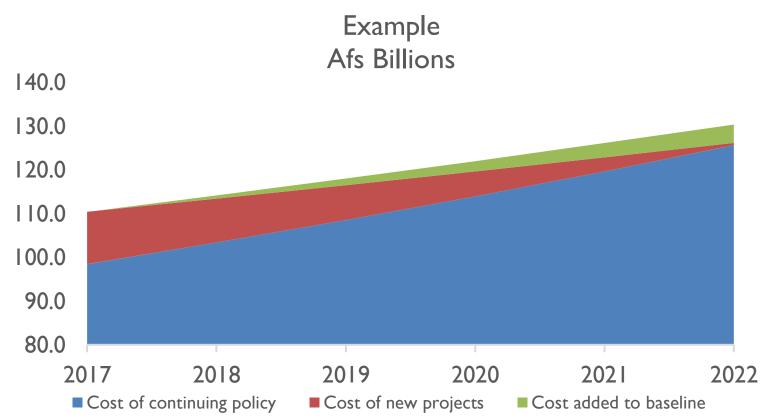
This is produced pre-BC1 (budget circular 1) and provides the base for Ministries' budgets for operating and discretionary development. Non-discretionary development projects which are ongoing and new are just reported during the budget process (and should also be reported for the lifetime of the project).

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 to the right.




**Cost of New Policy**

The forward estimates totaled together to 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.

The 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.

**9.2 Values of Forward Estimates**

| **Forward Estimates** | Historic | Current | Budget | | Outer Years | | |
|---|---|---|---|---|---|---|---|
| Codes 21, 22, 25 Operating | **2016** | **2017** | **2018** | **2019** | **2020** | **2021** | **2022** |
| Office of the President | 5054 | 5245 | 5404 | 5304 | 4274 | 3859 | 4029 |
| Upper House (Masharano Jarga) | 485 | 504 | 519 | 509 | 410 | 371 | 387 |
| Lower House (Walsi Jarga) | 1518 | 1575 | 1623 | 1593 | 1283 | 1159 | 1210 |
| Supreme Court | 3413 | 3542 | 3650 | 3582 | 2886 | 2606 | 2721 |
| President's Protective Services + NSO | 1346 | 1396 | 1439 | 1412 | 1138 | 1027 | 1073 |
| National Radio & Television | 548 | 569 | 586 | 575 | 463 | 418 | 437 |
| National Security Office | 729 | 756 | 779 | 765 | 616 | 556 | 581 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Ministry of Finance | 14694 | 15248 | 15711 | 15422 | 12426 | 11219 | 11713 |
| Ministry of Parliamentary Affairs | 143 | 149 | 153 | 151 | 121 | 110 | 114 |
| Ministry of Defense | 82482 | 73264 | 75490 | 74098 | 59704 | 53903 | 56276 |
| Ministry of Foreign Affairs | 4484 | 3074 | 3168 | 3109 | 2505 | 2262 | 2361 |
| Ministry of Commerce | 917 | 952 | 981 | 963 | 776 | 700 | 731 |
| Ministry of Interior | 60068 | 62333 | 64227 | 63042 | 50796 | 45860 | 47880 |
| Ministry of Education | 31531 | 32720 | 33715 | 33093 | 26664 | 24073 | 25133 |
| Ministry of Higher Education | 4912 | 5097 | 5252 | 5156 | 4154 | 3750 | 3916 |
| Ministry of Refugees and Repatriation | 265 | 275 | 284 | 278 | 224 | 203 | 211 |
| Ministry of Mines | 505 | 525 | 540 | 531 | 427 | 386 | 403 |
| Ministry of Communication | 538 | 558 | 575 | 564 | 455 | 411 | 429 |
| Ministry of Economy | 232 | 241 | 248 | 244 | 196 | 177 | 185 |
| Ministry of Information, Culture and Youth | 518 | 537 | 554 | 543 | 438 | 395 | 413 |
| Ministry of Public Health | 3530 | 3664 | 3775 | 3705 | 2986 | 2695 | 2814 |
| Ministry of Women's Affairs | 185 | 192 | 198 | 194 | 156 | 141 | 147 |
| Ministry of Agriculture | 1207 | 1252 | 1290 | 1266 | 1020 | 921 | 962 |
| Ministry of Water and Energy | 625 | 649 | 669 | 656 | 529 | 477 | 498 |
| Ministry of Public Works | 3308 | 3433 | 3537 | 3472 | 2797 | 2526 | 2637 |
| Ministry of Rural Rehabilitation and Development | 509 | 528 | 545 | 534 | 431 | 389 | 406 |
| Civil Aviation Administration | 321 | 333 | 343 | 336 | 271 | 245 | 256 |
| Ministry of Transport & Aviation | 266 | 276 | 284 | 279 | 225 | 203 | 212 |
| Ministry of Border and Tribal Affairs | 411 | 426 | 439 | 431 | 347 | 313 | 327 |
| Ministry of Labor, Social Affairs & Martyrs and Disabled | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Ministry of  Counter Narcotics | 224 | 232 | 239 | 235 | 189 | 171 | 178 |
| Ministry of Urban Development & Housing | 286 | 297 | 306 | 300 | 242 | 218 | 228 |
| Ministry of Justice | 620 | 643 | 663 | 650 | 524 | 473 | 494 |
| Attorney General's Office | 1238 | 1285 | 1324 | 1300 | 1047 | 946 | 987 |
| ANSA | 68 | 70 | 72 | 71 | 57 | 52 | 54 |
| Independent Directorate of Local Governance | 3300 | 3425 | 3529 | 3464 | 2791 | 2520 | 2631 |
| Independent Directorate of Environment | 190 | 197 | 203 | 199 | 161 | 145 | 151 |
| Science Academy | 201 | 208 | 215 | 211 | 170 | 153 | 160 |
| IARCSC | 340 | 353 | 364 | 357 | 288 | 260 | 271 |
| National Olympics Committee | 254 | 264 | 272 | 267 | 215 | 194 | 203 |
| General Directorate of National Security | 12724 | 13203 | 13605 | 13354 | 10760 | 9714 | 10142 |
| Geodesy and Cartography Office | 131 | 136 | 140 | 137 | 111 | 100 | 104 |
| Control and Audit Office | 135 | 140 | 145 | 142 | 114 | 103 | 108 |
| The High Office of Oversight & Anti-Corruption | 113 | 118 | 121 | 119 | 96 | 86 | 90 |
| Office of Disaster Preparedness | 756 | 785 | 808 | 793 | 639 | 577 | 603 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Independant Election Commission Complaint Office | 84 | 88 | 90 | 89 | 71 | 64 | 67 |
| Election Commission | 207 | 215 | 222 | 217 | 175 | 158 | 165 |
| National Statistics Office | 139 | 145 | 149 | 146 | 118 | 106 | 111 |
| Afghanistan High Atomic Energy Commission | 35 | 36 | 38 | 37 | 30 | 27 | 28 |
| Directorate for Kuchis | 75 | 78 | 80 | 79 | 63 | 57 | 60 |
| Independent Commission for Oversight and Implementation of Constitution | 66 | 69 | 71 | 70 | 56 | 51 | 53 |
| Land Authority | 263 | 273 | 281 | 276 | 222 | 201 | 210 |

| **Forward Estimates** | Historic | Current | Budget | Outer Years | | | |
|---|---|---|---|---|---|---|---|
| Discretionary Development | **2016** | **2017** | **2018** | **2019** | **2020** | **2021** | **2022** |
| Office of the President | 359 | 169 | 133 | 74 | 74 | 74 | 74 |
| Upper House (Masharano Jarga) | 6 | 3 | 2 | 1 | 1 | 1 | 1 |
| Lower House (Walsi Jarga) | 7 | 3 | 3 | 1 | 1 | 1 | 1 |
| Supreme Court | 122 | 58 | 45 | 25 | 25 | 25 | 25 |
| President's Protective Services + NSO | 117 | 55 | 43 | 24 | 24 | 24 | 24 |
| National Radio & Television | 117 | 55 | 43 | 24 | 24 | 24 | 24 |
| National Security Office | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Ministry of Finance | 3790 | 1789 | 1401 | 784 | 784 | 784 | 784 |
| Ministry of Parliamentary Affairs | 17 | 8 | 6 | 4 | 4 | 4 | 4 |
| Ministry of Defense | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Ministry of Foreign Affairs | 708 | 334 | 262 | 147 | 147 | 147 | 147 |
| Ministry of Commerce | 186 | 88 | 69 | 38 | 38 | 38 | 38 |
| Ministry of Interior | 331 | 156 | 122 | 69 | 69 | 69 | 69 |
| Ministry of Education | 5634 | 2659 | 2082 | 1165 | 1165 | 1165 | 1165 |
| Ministry of Higher Education | 2548 | 1202 | 942 | 527 | 527 | 527 | 527 |
| Ministry of Refugees and Repatriation | 208 | 98 | 77 | 43 | 43 | 43 | 43 |
| Ministry of Mines | 1414 | 667 | 523 | 292 | 292 | 292 | 292 |
| Ministry of Communication | 532 | 251 | 197 | 110 | 110 | 110 | 110 |
| Ministry of Economy | 216 | 102 | 80 | 45 | 45 | 45 | 45 |
| Ministry of Information, Culture and Youth | 177 | 83 | 65 | 37 | 37 | 37 | 37 |
| Ministry of Public Health | 12369 | 5837 | 4572 | 2558 | 2558 | 2558 | 2558 |
| Ministry of Women's Affairs | 37 | 17 | 14 | 8 | 8 | 8 | 8 |
| Ministry of Agriculture | 7170 | 3383 | 2650 | 1483 | 1483 | 1483 | 1483 |
| Ministry of Water and Energy | 4065 | 1918 | 1503 | 841 | 841 | 841 | 841 |
| Ministry of Public Works | 13662 | 6447 | 5050 | 2826 | 2826 | 2826 | 2826 |
| Ministry of Rural Rehabilitation and Development | 15399 | 7267 | 5692 | 3185 | 3185 | 3185 | 3185 |
| Civil Aviation Administration | 3359 | 1585 | 1241 | 695 | 695 | 695 | 695 |
| Ministry of Transport & Aviation | 54 | 26 | 20 | 11 | 11 | 11 | 11 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Ministry of Border and Tribal Affairs | 66 | 31 | 24 | 14 | 14 | 14 | 14 |
| Ministry of Labor, Social Affairs & Martyrs and Disabled | 645 | 305 | 239 | 133 | 133 | 133 | 133 |
| Ministry of Counter Narcotics | 805 | 380 | 297 | 166 | 166 | 166 | 166 |
| Ministry of Urban Development & Housing | 2748 | 1297 | 1016 | 568 | 568 | 568 | 568 |
| Ministry of Justice | 265 | 125 | 98 | 55 | 55 | 55 | 55 |
| Attorney General's Office | 115 | 54 | 43 | 24 | 24 | 24 | 24 |
| ANSA | 53 | 25 | 20 | 11 | 11 | 11 | 11 |
| Independent Directorate of Local Governance | 22 | 10 | 8 | 4 | 4 | 4 | 4 |
| Independent Directorate of Environment | 31 | 14 | 11 | 6 | 6 | 6 | 6 |
| Science Academy | 4 | 2 | 1 | 1 | 1 | 1 | 1 |
| IARCSC | 71 | 33 | 26 | 15 | 15 | 15 | 15 |
| National Olympics Committee | 81 | 38 | 30 | 17 | 17 | 17 | 17 |
| General Directorate of National Security | 115 | 54 | 43 | 24 | 24 | 24 | 24 |
| Geodesy and Cartography Office | 23 | 11 | 9 | 5 | 5 | 5 | 5 |
| Control and Audit Office | 297 | 140 | 110 | 61 | 61 | 61 | 61 |
| The High Office of Oversight & Anti-Corruption | 55 | 26 | 20 | 11 | 11 | 11 | 11 |
| Office of Disaster Preparedness | 5 | 2 | 2 | 1 | 1 | 1 | 1 |
| Independant Election Commission Complaint Office | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Election Commission | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| National Statistics Office | 26 | 12 | 10 | 5 | 5 | 5 | 5 |
| Afghanistan High Atomic Energy Commission | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Directorate for Kuchis | 25 | 12 | 9 | 5 | 5 | 5 | 5 |
| Independent Commission for Oversight and Implementation of Constitution | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Land Authority | 202 | 95 | 75 | 42 | 42 | 42 | 42 |
| Human Rights Commission | 45 | 21 | 17 | 9 | 9 | 9 | 9 |
| Independent Board of New Kabul | 118 | 56 | 44 | 24 | 24 | 24 | 24 |
| Water Supply and Canalisation Corporation | 72 | 34 | 27 | 15 | 15 | 15 | 15 |

# 10. 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 specifically used for developmental purposes. This includes building the infrastructural projects which will lead to high economic and social returns.

Afghanistan is not in the debt distress or debt crisis situation like many other countries, however still susceptible to more shocks if there is either a sudden large reduction in the donor assistance or significant fall in the economic growth. With assumed current level of donor financing, the government can still borrow under highly concessional terms so to finance the key sector development projects. Below is a brief overview of the baseline debt, debt sustainability, shocks and scenarios, and what factors affect the debt sustainability of Afghanistan.

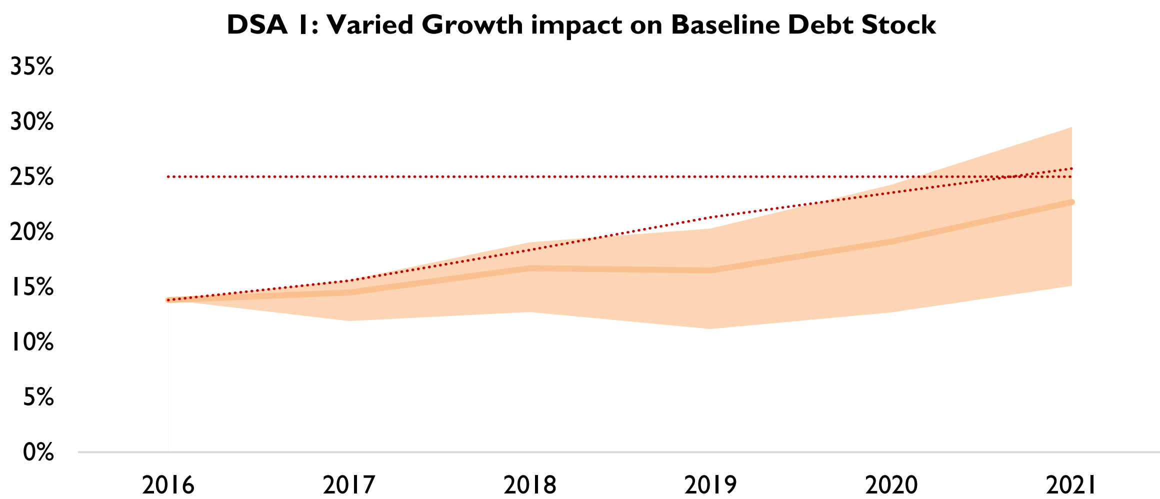
| **DSA Table** | **2015** | **2016** | **2017** | **2018** | **2019** |
|---|---|---|---|---|---|
| Baseline Debt/GDP | 13.8% | 14.5% | 16.7% | 16.5% | 19.1% |
| Growth Shock Debt/GDP | 13.8% | 15.6% | 19.1% | 20.3% | 24.3% |
| Portion Loans below Min. Grant Element [1] | 91.0% | 96.5% | 99.3% | 0.0% | 0.0% |
| External Debt Service/Exports | 0.5% | 1.4% | 1.9% | 1.5% | 2.0% |
| External Debt Service/Reserves | 0.2% | 0.6% | 0.6% | 0.5% | 0.7% |
| Total Debt Service/Revenues exc rollover | 1.1% | 3.4% | 3.3% | 2.8% | 3.3% |

1/ Threshold for the minimum Grant element is 60 percent

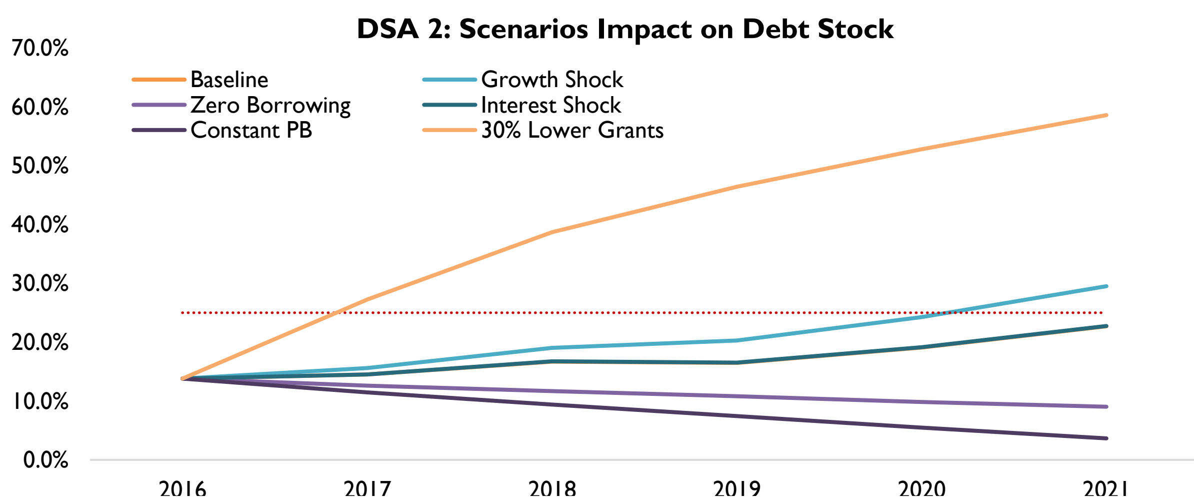
Given the international standard and debt thresholds[4] for similar income countries, most of the debt indicators are far below and well within acceptable bounds. The Debt to GDP ratio is currently 14.5 percent, which shows that it has slightly risen because of lower economic growth over the past few years. Over the medium term, this ratio is expected to gradually rise as a result of new borrowing but will remain stable if economic performance is more than expected. However, a small shock of around 7 percent fall in nominal GDP growth will adversely impact the outlook and debt stability, as the debt to GDP ratio will increase to 24 percent in 2018. Overall, the debt sustainability will not be affected too much, as the resulted indicators have not breached the international thresholds, including 30 percent of debt to GDP.

The other indicators like debt service-to-exports ratio currently stand at 1.4 percent and are expected to increase to 2 percent in 2018. Based on HIPC initiative, this should not exceed 15 percent. Similarly, the indicators such as debt service to reserves and debt service to revenues ratio also remain low. For instance, the debt service-to-revenue ratio remains well below at 3.4 percent compared to the threshold of 25 percent as per the HIPC initiative.

[4] PV of debt to GDP 30%, Export 100%, and Revenue 200%



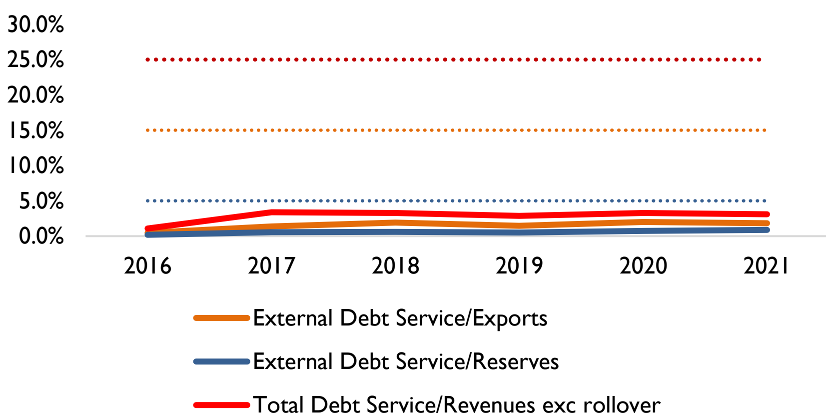

The debt in the medium term fiscal framework remains low, and within the bound for sustainability (the red lines reflect an upper boundary of 25%, and a boundary given through a 4% of GDP deficit each year, the green shaded area is the result of GDP uncertainty); however, it shows that debt level is expected to rise while moving to longer term. The Government has adopted neither a balance rule nor a rule on the debt ceiling, as a result, these are just shown for illustrative purposes.




The fiscal framework set out in the MTFF operates under the Government's rules about borrowing (i.e. only concessional, long-term debt to the Government can be undertaken). This DSA sets out the impact, in the medium term, of any debt planned through agreements with the International Financial Institutions (IFIs) or similar, on concessional terms. The government is restricted from excessive borrowing, but only for a specific development project with highly economic and social returns.

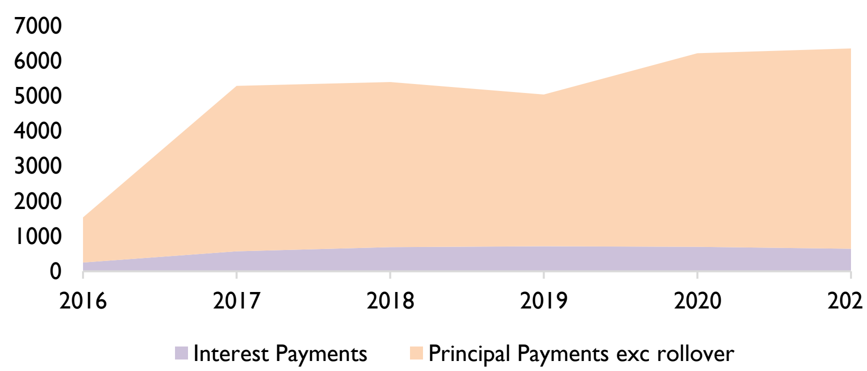
Apart from other factors, the high dependency on foreign aid is the primary risk to debt sustainability. Any reduction in aid support (particularly through operational aid) would lead to either increase in budget deficit after grants, or a sudden and unsustainable increase in debt burden, as shown in the graph.

**DSA 3: Sustainability Thresholds**



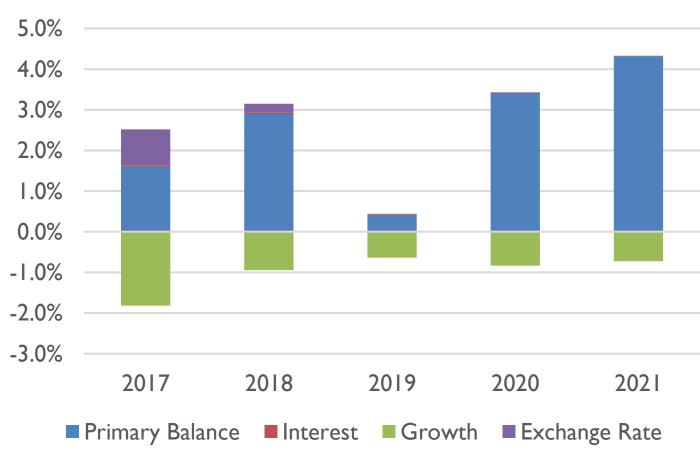

Most of the outstanding debts have higher grace periods, which mean that principal amounts will be paid farther than the future years. The principal payments increase as a result of the forecast depreciation over time of the Afghani, which in turn increase the cost of debt payment in local currency, even though the cost of payments in the contracted currency does not increase. To reduce the impact of exchange rate risks in the long term, the government will need to adopt a debt strategy that could include domestic borrowing too in the public debt profile.

**DSA 4. Interest and Principal Payments**




Due to successful fulfillment of HIPC completion point, a large amount of accumulated debt was forgiven while for the remaining outstanding loans, mostly concessional, their interest rates were reduced. This means that Afghanistan does not have any likely fiscal risks from debt service payments. However, there is still the risk of currency depreciation, as most of the external debt profile is denominated in foreign currency. In the medium term, the government can only borrow on highly concessional terms, which most likely means a service fee below 1 percent - further ensuring costs remain low.

**DSA 5. Impact of Factors on Debt/GDP**




The debt stock as a percent of GDP is expected to reduce over time as a result of economic growth. With expected economic growth, any government plans to borrow concessional, would have a smaller impact than growth, despite an increase in the debt stock in absolute terms. However, it is essential that the borrowing will be disbursed specifically on pro-growth development projects. Since our debt stock is denominated in foreign currencies, the depreciation of the Afghani will increase debt stock. The increase in interest payment will increase the debt stock, while deficit increase in primary balance would lead to further borrowing to finance the deficit. This is currently not the case as the government has sufficient and surplus cash amount (buffers) in the TSA account.

**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.

Ensuring fiscal sustainability has been a key main goal of the Ministry of Finance over the past 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 take over 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.

| Fiscal Sustainability | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|
| Domestic Revenue to GDP | 11.4% | 11.0% | 11% | 11.0% | 11.0% | 11.1% |
| Grants to Total Revenue | 64.6% | 62.9% | 60.6% | 57.9% | 49.0% | 42.4% |
| Non-Tax/Domestic Revenue | 33.4% | 30.3% | 31.0% | 31.1% | 31.3% | 31.6% |
| Employee Compensation/Domestic Revenue | 115.9% | 119.8% | 117.6% | 116.4% | 113.4% | 109.9% |
| Spending minus Development Grants/Domestic Revenue | 88.7% | 114.3% | 127.0% | 105.5% | 133.1% | 142.8% |

Looking to the above table, we are showing that domestic revenue as a percent of GDP is expected to decline from 11.4 percent to 11 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.

# 11. Technical Annexes

### Macro-Econometric Framework Model

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

### Multiplier Effects

The government undertakes usage of some internal models to estimate the impact of government fiscal policy. The multiplier effects model answers the question of autonomous expenditure increase for some exogenous reasons impact on the total real income in the equilibrium.

The impacts measured by multipliers depend on the source of the demand for example investment, government expenditure and exports. The initial stimulus can lead to results of different total impacts and different distributional effects. The Multiplier effects is an indication of the flexibility, which can support policy guidance across all sectors of the economy.

### Stochastic Modelling

The fan charts in this document 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).

### 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 MFPD.

### 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 is 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: $Overall\ \square rror = FPNC + FNNNC$, 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 is 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:

$(1-OverallError)$ divided by

$\Sigma_i(1-Overall\ Error)$

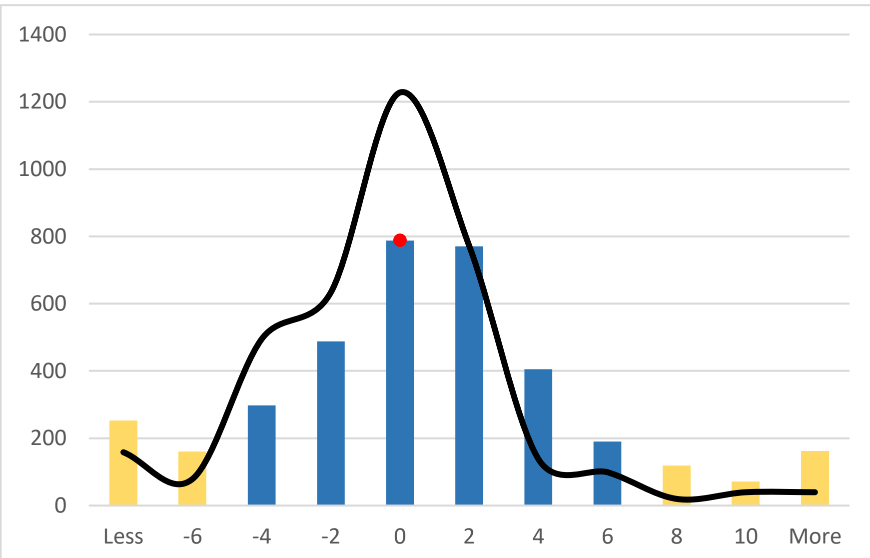
The table to the right shows both the threshold values and the weightings that were generated (certain thresholds trigger if you are above, others if you are below).

| | Weight | Threshold | Value |
|---|---|---|---|
| Structural Balance | 1.24% | -1.4 | -18.27 |
| Structural Balance t-1 | 1.06% | -1.9 | 0.70 |
| Structural Balance t-2 | 0.51% | -1.6 | -3.54 |
| Debt Stock | 0.38% | 42.8 | 12.00 |
| Debt Stock t-1 | 0.09% | 7 | 12.00 |
| Debt Stock t-2 | 0.95% | 86 | 10.55 |
| Revenue | 1.25% | 20 | 38.00 |
| Primary Balance | 2.57% | -2.1 | -0.13 |
| Fertility Rate | 2.50% | 2.3 | 5.40 |
| Fertility Rate t-10 | 0.62% | 2.7 | 6.93 |
| ODA | 9.01% | 9 | 60.00 |
| ODA t-1 | 9.70% | 13 | 172.36 |
| ODA t-2 | 10.85% | 13 | 172.36 |
| ODA t+1 | 9.72% | 20 | 50.00 |
| Interest (% Revenue) | 9.87% | 2 | 0.00 |
| NPL | 7.13% | 4 | 6.12 |
| Pop65 | 5.15% | 9.5 | 2.00 |
| Reserves | 1.86% | 4600000000 | 1,646,060,000 |
| Reserves t-1 | 3.48% | 3300000000 | 6,801,559,367 |
| Reserves t+1 | 2.19% | 3900000000 | 6,693,645,209 |
| Dependency Ratio | 6.52% | 15.5 | 65.00 |
| GDP growth | 13.36% | 3 | 3.80 |

### Realism of the Forecasts

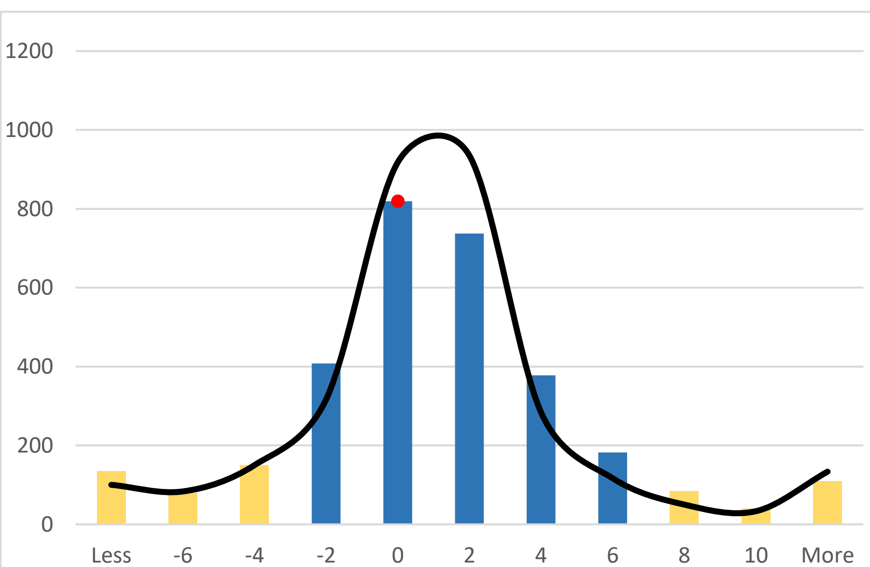
The distribution in the below reflect the changes that countries around the world have seen during a 3-year period. The figures are taken from the IMF WEO, for the time period between 1980 and 2015. The black line represents the scaled distribution for just the most recent year (in order to see if the change is realistic given the changes that other countries are seeing in the same period). The red dot represents Afghanistan, the shed yellow area are the unlikely areas.

#### Realism of the GDP Forecast



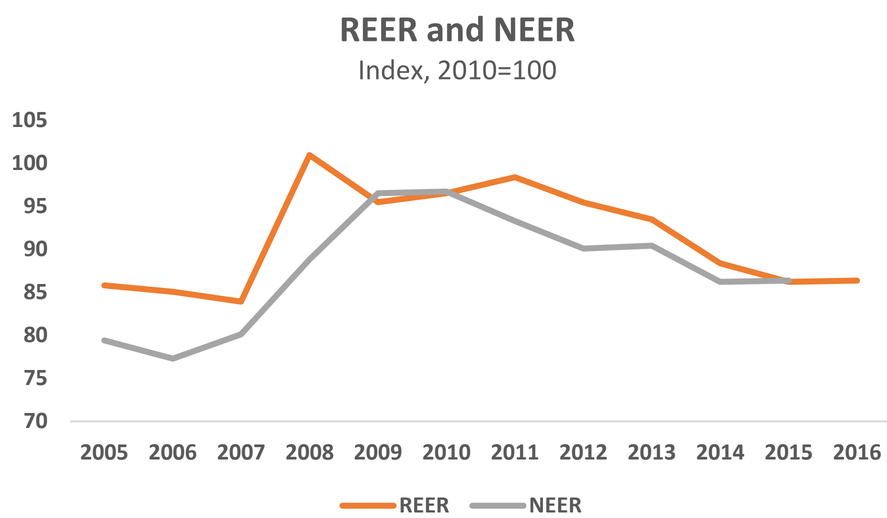

**The GDP forecast is in line with the 3-year adjustments in GDP growth made by other countries historically.** The chart at the side shows (in the bars) for all countries from 1980 onwards the scale of the three-year adjustments in their growth rates. The black line shows similar but just for the recent 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 (REER) became same to the Nominal Exchange Rate (NEER) this year as a result of increase in exchange rate this year and slow increase in inflation in the economy. As previously expected in the FSP, the REER has increased and we expect an increase in REER, as our fundamentals (terms of trade etc), show us to be potentially undervalued.