MACRO FISCAL POLICY DIRECTORATE GENERAL

FISCAL STRATEGY PAPER

Medium Term Fiscal Framework

2019/1398

MINISTRY OF FINANCE
GOVERNMENT OF THE ISLAMIC REPUBLIC OF AFGHANISTAN

Preface

The Fiscal Strategy Paper (FSP), which is published once a year, outlines the country's fiscal policies and medium-term macro-fiscal framework in the context of prevailing macroeconomic policies and outlook of the Afghan economy. It covers recent economic developments, outlook of macroeconomic performance and fiscal stance, and the medium-term fiscal framework and forward estimates of Afghanistan.

The Fiscal Strategy Paper is intended for a wide audience, including policy makers, the donor community, the private sector, and the community of analysts and professionals engaged in Afghanistan's economy.

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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

Chapter1: Introduction

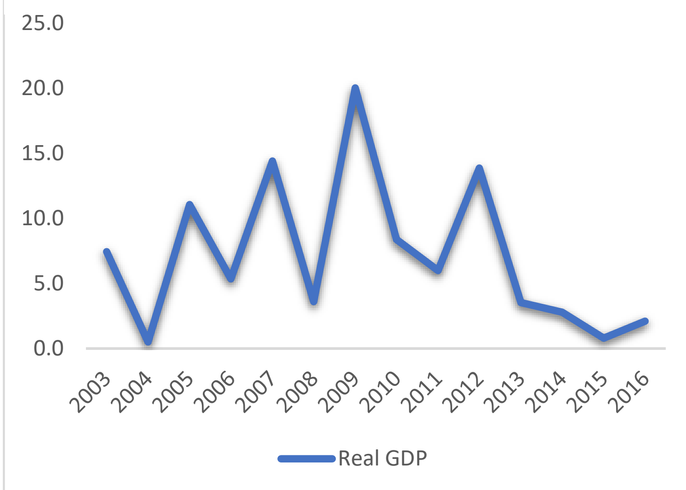
The fiscal strategy paper (FSP) outlines the country's fiscal policies and medium-term macro-fiscal framework in the context of prevailing macroeconomic policies and outlook while articulating the country's strategic priorities and policies for the fiscal year 1398. The main contents are as below:

- Overview of recent economic development, and the issues of key social indicators
- The outlook of macroeconomic performance and its fiscal stance
- Medium-term fiscal outlook and forward estimates
- Economic growth options and the four key sectors for growth stimulation

1.1 Overview of recent economic development

The Afghan economy has been slowly recovering and growing after the withdrawal of international security forces, which triggered a severe economic downturn and fiscal crisis in 2014. The economic growth rebounded with the rate increased from 1.1 percent in 2015 to 2.2 percent in 2016 and continued in 2017, primarily due to strong growth in the agriculture sector. Continued political uncertainty, low level of investors' confidence and a decline in aid contribute to low level of economic growth in the past few years.

Figure 1: Real GDP growth 2003 - 2016



Source: MFM report, MoF 2018

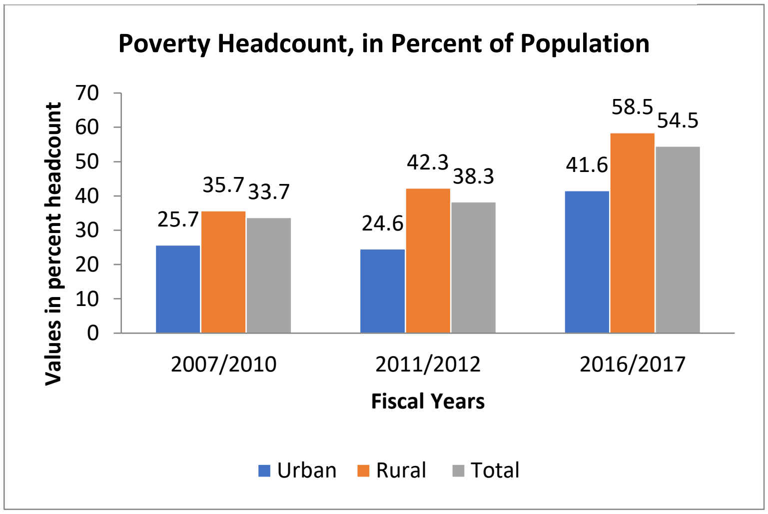
Amid this transitional period, the government recently takes a number of on-going initiatives which are potentially capable of improving investment prospects, and ultimately economic growth. For instance, Afghanistan was formally admitted to the World Trade Organization (WTO) on July 2016. This helps in facilitating transit, resolving disputes with trade partners, and gain access to international markets. Chabahar seaport is another cost-efficient transit route for Afghan trade. The expansion of the air corridor program marks the significant importance for Afghanistan's economic development. The implementation of the first air freight initiative between Afghanistan and India in 2017 has given major impetus to increase its footprint to other countries namely; Saudi Arabia, Turkey and United Arab Emirate. Air corridors are indispensable and pertinent factor for the country's growth as these initiatives will positively impact the trade balance of Afghanistan.

Similarly, TAPI project is a vital initiative for economic growth as it will provide gas for Afghanistan, Pakistan, and India through Turkmenistan, and will create thousands of job opportunities for Afghans. Khan steel is the newest industrial company, established in 2015. This new venture has created numerous jobs for the local community, reduced the costs of construction, and contributed to development.

These initiatives could improve the prospects for investment and economic growth given there is conducive environment.

1.2 Poverty rate, unemployment and other socioeconomic problems in Afghanistan

Figure 2: Increase in poverty in urban/rural areas



Socioeconomic context of the country has been negatively affected as a result of lower economic growth, and deteriorating security situation. It is lower than the last ten years, more and more people are going below the poverty line. For instance, poverty rate was 34 percent in 2007/08, while in 2016/17 the rate became almost double, as more than half of the population are below the poverty line. The nature of poverty is quite acute especially in rural areas, where people cannot afford the basic needs. Based on recent household survey (ALCS 2016/17), the unemployment rate stands at 24 percent with the female unemployment rate is two and a half times higher than the male unemployment rate. The continued demographic pressure and sluggish economic growth have worsened the country's unemployment situation. Low skilled labor and illiterate workers are particularly prone to these demographic episodes As the annual population is growing by 3 percent and around 400,000 Afghan people are entering the labor market each year, and the number of refugees returning from Pakistan and Iran is growing; therefore more job opportunities and economic activities are required to employ the workforce and improve per capita income of the people.

Chapter 2: Economic Outlook and Macroeconomic Performance

2.1 Outlook of Domestic Economy

Large infusion of international financial assistance has driven the economic growth in Afghanistan in the last 16 years. Between 2003 and 2014, Afghanistan received a large chunk of donor assistance, as a result of which the average growth rate during these years reached almost 9.5 percent. However, economic growth slumped to 2.1 percent between 2014 and 2016 as a result of the rapid decline in donor assistance.

In the medium term, donor aid is anticipated to reduce further, and the budget will tighten. Government while resources from aid are falling, domestic revenue is projected to rise steadily in line with the goals set out in the National Peace and Development Framework. Afghan Government is committed to implement fiscal reforms to set a path for more efficient and credible national budget.

Based on the baseline scenario, the outlook for economic growth in the medium term looks stable at 3.5 percent in 1398 (2019), which is expected to rise to 4.5 percent by 1400 (2021). However, with a reshuffle of sector reallocation, the Macro and Fiscal Policy Directorate assumes that the growth scenario might change. According to an analysis by Macro and Fiscal Policy Directorate's estimations, if the government allocates relatively more funds in the upcoming budget to those sectors with a higher growth multiplier, it will positively impact the growth outlook. For instance, Agriculture and Rural Development Sector, Education Sector, Health Sector, Social Protection Sector (only for short-term) and Infrastructure sector are identified as higher growth positive multiplier. On the other hand, the analysis shows that the Infrastructure Sector has a negative multiplier. To counter its effects; the government needs to finance the additional funding of the Infrastructure Sector through the private capital investment – the Public-Private Partnerships.

2.2 Macroeconomic Performance and Outlook:

This section sets out the economic parameters that underpin the national budget for 2019 and provides economic guidance to the medium-term outlook. It also briefly defines the international and regional economic outlooks that have an impact on the Afghan Economy.

2.2.1 Gross Domestic Product (GDP)

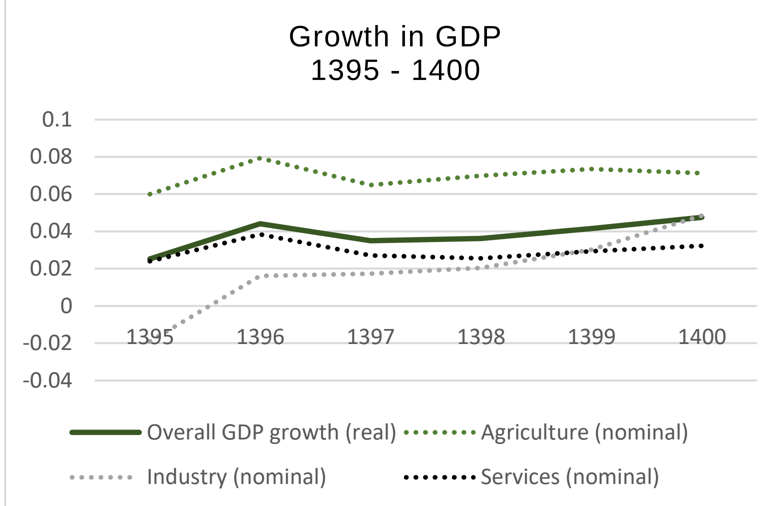
Gross Domestic Product growth increased from 1.3 percent in 2015 to 2.6 percent in 2017. In the forward estimates, real GDP growth is expected to remain at 3.5 percent for 2019 and 4.5 percent for 2020. Assuming the security situation does not deteriorate, and agriculture does not experience major weather-related shocks, economic conditions are likely to improve, in which agriculture, construction, and industrial sectors are likely to be the main contributors to national output. Furthermore, these projections assume peaceful and smooth parliamentary and district council elections in 2018 as well as the Presidential election in 2019.

Traditionally, the agriculture sector (mainly fruits and cereals) had important contribution in economic growth in Afghanistan Rain is an important determinant of agriculture sector performance. The vulnerability of the agricultural sector to increased temperatures and changes in rainfall patterns negatively impact the production of rain-fed farmland. Couple with some effective agricultural interventions, the government should reduce bring the rain-fed farmlands to conventional streams to minimize the possibility of volatility of the production in this sector.

Followings are the key assumptions for economic growth over the medium term:

- Directing investment to areas which can stimulate Government economic growth in the short and medium term, and contribute to the wellbeing of the people. The government needs to invest in projects that can have a direct impact on household level, or can reduce poverty at the bottom. In addition, the government needs to reprioritize investment in such areas as agriculture, infrastructure (by crowding in private sector capital through PPP), health and education. Weather conditions are assumed favorable to rain-fed farming. This would assumingly realize around 7 percent average growth in agriculture sector over the next four years.

Figure 3



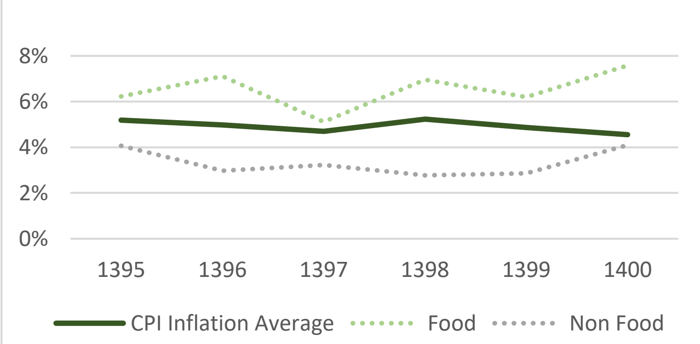
- Recovery in construction will be steady, but slow in line with government commitments to expand execution of large development projects.

2.2.2 Inflation

Afghanistan is mostly reliant on imports of commodities, so change in the prices of imported goods is reflected in the basket of commodities used to calculate local inflation rates. In the medium-term, inflation is projected to remain stable at 4.7 percent with only a small fall to 4.6 percent in 2022.

Due to some exogenous factors and the imported nature of inflation, the Central Bank (DAB) does not have full autonomy to adjust the inflation rate. However, the efforts of Da Afghanistan Bank should be to maintain the stability of the inflation at moderate level to prevent its corrosive impact on the purchasing power of poor, and on the national budget. The anticipated reduction in the donor grants will depreciate the Afghani particularly the US dollar. This would result in increase in domestic prices and the price of imports will also increase. An increase in domestic prices will have negative impact on the poor segments of the society Increase in prices will also have negative impact on the national budget as it reduces the real value of money to purchase the same quantity of goods and services

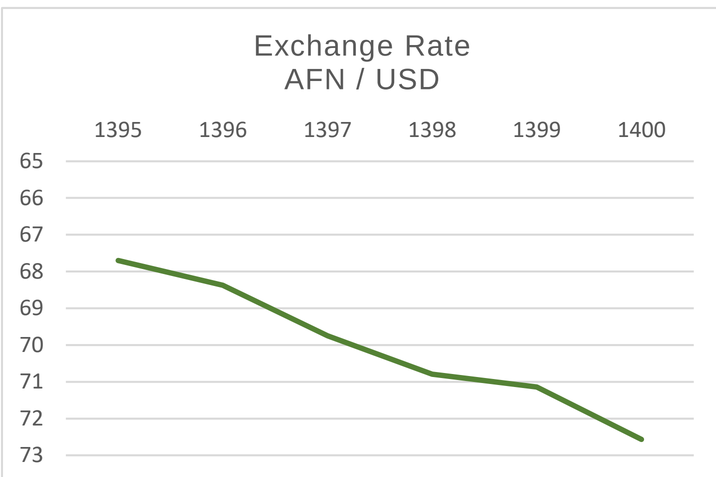
Figure 4



2.2.3 Exchange Rate

Afghani against the US dollar depreciated from 66.3 AFN/USD to 68.9 AFN/USD in 2016. In the medium term, the value of Afghani will remain at around 70.7 against the UDS. The exchange rate plays insignificant role to balance the BOP because the export sector is characterized by supply deficiencies elasticity pessimism. Due to declining foreign aid, we assume that the exchange rate will depreciate by 1.5 percent in the medium term annually. To counter the adverse effects of the exchange rate volatility, we suggest that the Central Bank of Afghanistan should play its conventional role of stabilizing the currency through injecting USD to the market.

Figure 5



2.2.4 Balance of Payments

On the external sector, Afghanistan operationalized the air corridors, which increased exports from USD 571 million in 2015 to USD 831 million in 2017. Similarly, imports have slightly increased from USD 7.72 billion in 2015 to USD 7.79 billion by the end of 2017. Government Exports are likely to increase as output from extractive industries increases.

The trade balance for goods records a large deficit. Currently, Imports are 6.5 times more than exports. However, the balance of services shows a surplus, partly because of remittances from family members outside of Afghanistan. Overall, large deficit in current account balance is a key macroeconomic risk as it will further depreciate the Afghani against the US dollar, which will increase domestic prices and reduce the demand for imports; this will, in turn, put more pressure on the currency. Foreign direct investment is one of the alternatives to play its role in narrowing down the difference between exports and imports. This might happen in the extractives sector, but it will require stable security situation, and a regulatory environment that provides conducive environment for foreign direct investment.

2.3 International Economy

Average economic growth for Afghanistan’s major trading partners was 4 percent in 1395 (2016) and it is projected to fall to 3.7 percent in (2018). Among Afghanistan’s trading partners, for 1395 (2016), China and India, with 9.5 percent and 7 percent respectively, had the highest levels of growth largely because of massive physical capital stock and exceptionally robust service sector respectively. While Canada and Japan, with 1.9 percent and 1.2 percent respectively had the lowest rates of growth mainly because of low inflation and interest rates. Weak consumer spending and crumbling social security system are quite peculiar to lower growth in Japanese economy. Unknowns of US corporate tax cuts and NAFTA’s renegotiation triggered some business fears, which decreased lower economic growth rate in Canada. 2.3.1 Economic Outlook for the United States and Afghanistan’s neighbors:

The United States of America: Afghanistan is mainly reliant on donor aid to finance its national budget. The donor grants finance at around 60 percent of the Afghan budget, US is the major donor among others. Thus, the US foreign policy that guides aid to its allied countries has its direct impact on Afghan economy. In addition, certain US policies government, such as measures to adopt protectionist trade policies, could negatively affect global trade flows, especially with emerging economies like China and India. Furthermore, the US has begun to move away from the extraordinary monetary conditions that have prevailed since the global financial crisis with a small rise in the US Federal Reserve’s benchmark interest rate.

India: India has emerged an important trade partner of Afghanistan. The recent establishment of air corridor between Afghanistan and India has created an opportunity for Afghanistan to export to India. The cargo service aims to improve landlocked Afghanistan's links to markets abroad and boost the growth prospects of its agricultural and carpet industries. The recent improvements in Afghanistan’s trade balance are attributed mainly to the opening up of this air corridor.

China: Chinese economy is undergoing a major structural change. Activity continues to shift to consumption, while investment growth rate remains well below those in recent years. Chinese economy has introduced significant cuts in overcapacity sectors. In the first quarter of 2018, China recorded its first current account deficit since 2001. China’s growth is expected to slow in the coming years, with subsequent effects on world commodity demand. However, downside risks to the outlook stem from financial sector vulnerabilities and an intensification of trade tensions amid increased protectionism in key trading partners. Afghanistan is not too reliant on China for exports; however, a continued slowdown may reduce the likelihood of future investment from China in Afghanistan’s extractive industry.

Iran: Iran has seen large falls in economic activity in 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 the economy. Growth is, however, likely to be significantly reduced if sanctions remained intact, with lesser access to financing options, financial services, international trade, and investment. The United States' renewal of sanctions on Iran is having an unintended knock-on effect on Afghanistan. The Afghani is taking a hit as dollar smugglers capitalize on the shortage of foreign exchange in neighboring Iran, mainly because of the US sanctions. The imposition of sanctions on Iran by the USA caused the fall in Toman value against other currencies. Thus, Afghani will continue to take the beat as dollar smugglers rush to provide much-needed foreign exchange to the neighboring Iranian economy.

Pakistan: In Pakistan, including export sectors, several other sectors suffered from economic slowdown. In general, prospects are likely to be positive given planned investment in energy and regional trade expansion. The Pakistani Rupee saw significant falls in value, in line with similar falls in Afghani; meaning there have been smaller impacts for Afghanistan against the rupee than other currencies. Historically, Afghanistan was reliant on Pakistan for import commodities; however, with the recent opening-up of trade routes with neighboring countries like Turkmenistan, Kazakhstan, Uzbekistan and Iran (Chabahar), the trade reliance on Pakistan has decreased. Against the initial projects, the forecast for GDP growth is at 3% in the next two years, down from 5.8% in 2018. Since the start of 2016, imports of construction materials related to large-scale Chinese infrastructure investments led to the current-account deficit to soar, while its weakening currency along with economic growth pushed inflation higher.

East-Northeast Asian Economies:

Growth in the region is projected to moderate to 6.3 percent in 2018, and to 6.1 percent on average in 2019-20. The structural slowdown in China will offset a further pickup in the rest of the ASEAN region. Momentum in the global activity could lead to stronger-than-expected regional growth with solid exports and strong domestic demand. Overall, conditions are mostly favorable for the region in 2018, including robust global trade, moderate borrowing costs and sustained capital inflows. However, the possibility of an abrupt tightening of global financing conditions and intensified trade tensions between the two global economies could have negative impact of the health of the ASEAN economies. Countries with rapidly rising fiscal deficits are vulnerable to disruptions in financial activities. Geopolitical risks and tensions remain elevated on the Korean Peninsula. Domestically, monetary conditions have tightened somewhat and tighter prudential policies have kept credit growth in check in these economies. Several major economies have renewed their fiscal consolidation efforts in 2018 (e.g., China, Indonesia, Malaysia, and Vietnam)

2.4 International Trade

South Asia and Central Asia are important trading partners of Afghanistan. The share of total intra-regional trade in South Asia was 5.28 per cent in 1394 (2015). Central Asia with an Intra-Regional trade share of 8.97 percent was better than South Asia. 71 per cent of Afghanistan’s export in 2015 went to South Asia Association for Regional Cooperation (SAARC) member countries and 47.8 per cent of total imports were supplied by those countries. 15 percent of Afghanistan’s total imports in 2015 were supplied by Central Asia, but they received only 7.7 percent of Afghanistan’s total exports.

The recent dynamics in globalization created some potential risks directed to international trade. The adverse outcomes of the NAFTA renegotiations could hold back growth in Mexico. The trade-restricting policies by China and the US could have on the region through confidence, trade, financial and commodity market channels, and may encourage policy support for trade protectionism. Protectionism in the form of increases in actual tariffs to bound tariffs would reduce exports in advanced economies. However, for some specific agricultural products, such as soybeans, and maize, tariff increases by China on U.S. exports could raise demand for LAC exports. However, Brexit is expected to trigger new trade agreements, with significant consequences for the European Union.

Chapter 3: Afghanistan Fiscal Policy

3.1 Current Fiscal Policy Stance:

Afghan government uses fiscal policy as a means to adjust its spending levels and tax collection to monitor and influence the economy. It uses different combinations of these two sides to achieve medium term economic goals. In a new bid to live within the means, the government adopted contractionary fiscal policy through reducing spending level. For more than a decade, Afghanistan enjoyed expansionary fiscal policy, which was largely held together by injecting donor assistance to the economy. However, the withdrawal of International Security Assistance Forces from Afghanistan in 2014, foreign aid declined; which financially constrained the overall economy. In addition, security situation worsened which resulted in the overall revenue. Due to downturn in revenue, the government used funds from Treasury Single Account (TSA), and as a result of this, the fiscal policy over the medium term is tied to ensuring fiscal recovery from the downturn, which is possible through stimulating domestic resources for revenue mobilization.

The Afghan government aims to phase out from donor support for operating expenditure, and strengthen domestic revenue mobilization at a better rate to ensure covering operating expenditure in the long term. Fully financing security sector expenditure by 2024 is the one of the most important commitments of the Afghan government with the International Community. The 1397 budget manifest a significant shift of approach to fiscal planning. The government for the first time presents a consolidated budget over the medium term. The government is committed to formulating fiscal policy in a way that can ensure catering for the fiscal gap, which is emerging as a result of donor assistance. The government will adopt a more structured fiscal strategy approach with the long-term goal to support economic growth and development. The approach includes three policy principles as highlighted in the ANPDF document.

1. To encourage more investment and growth and protect it from shocks, the government will adopt fiscal policy as key tools.
2. To improve revenue performance to cover operational expenditure and to gradually cover development needs in the long-term because donor support will continue to decline.
3. To balance the budget in the long-term without borrowing provided that borrowings are conditional based on agreement with IMF.

The medium term fiscal strategy aims to achieve some aspirational goals set the government of Afghanistan. This will help decision maker at the top to attract investment to the right areas of the economy. The medium term aim of the government of Afghanistan set in the Afghanistan National Peace and Development Framework (ANPDF)are as follows; government

1. Deliver average growth of 5 percent per year until 2020;
2. Increase development budget expenditure by 15 percent each year as we expand delivery of education and health services in the medium-term;
3. Annually stimulate domestic revenue by up to 12 percent, with the overarching goal of having domestic revenues account for 14 percent of GDP by 2020;

3.2 Factors overshadowing the efficiency of fiscal policy and the way to tackle them to

Some factors have created the challenges for the government to implement its fiscal policy and achieve its socioeconomic goals. These factors also challenge the government in bringing the necessary reforms in the budgetary process, and for the realization of more fiscal space. Such factors are; government

- High degree of budget fragmentation that has characterized the national budget for more than a decade. For this factor, a consolidated national budget is required to eliminate fragmentation. Currently, both operating and development budgets are broken down by economic classification, administrative, function, fund, program and geographical location.
- Too many projects across too broad a scope, leaves the government with little fiscal flexibility to move funds to where they can be spent for better outcomes. The implementation of a credible medium-term expenditure framework for this factor is done that sets out the consolidated budget for the budget year 1397 and three forward years.
- Over budgeting, led to low budget execution and undermined the credibility of the budget.
- Poor practices in programs and projects planning, designing and structure that do not allow money to be redirected from lower priority activities to higher priority activities. For this factor, the annual budget process is revised from the next year to better align budget outcomes with high national priorities.
- Security situation and uncertainty is also constraining the domestic resources, mainly in revenue generation, and as a result of low budget execution rate, lower level of economic development.
- Corruption in government institutions put the public and donor money in danger of waste or embezzlement. This undermines the confidence of the donor agencies and more crucially of the investors. As a result, the level of economic activities declines. To reduce corruption, the government has started some initiatives; for instance, change management and the introduction of latest technology to the day to day business.

Chapter 4: 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.

4.1 Risk Matrix

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

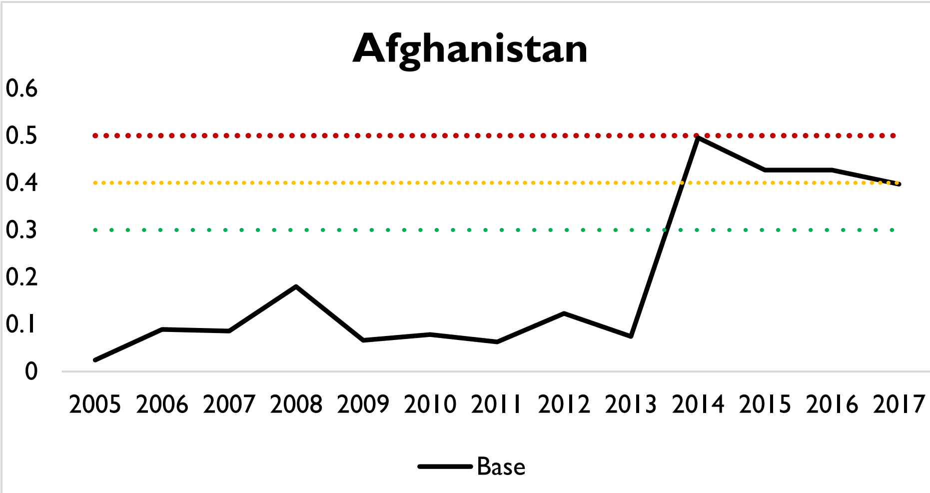
Risk	Likelihood	Impact
Rating Maintained		
Macroeconomic: Depreciation of the Afghani causes increases in food prices, and the CPI	LOW	MEDIUM
Fiscal: Exchange rate depreciation causes cost increase for Government imports	LOW	MEDIUM
Fiscal: Interest rate increase creates additional debt costs	LOW	LOW
Fiscal: Aid slow down (commitments don't materialize)	MEDIUM	HIGH
Fiscal: Revenue decreased due to WTO tariff decrease regulations	HIGH	HIGH
Fiscal: The risk of reduced retail activity (leads to underperformance to target in BRT collection as well as reduced overall growth).	LOW	HIGH
Fiscal: O&M costs are calculated as higher than anticipated	LOW	MEDIUM
Fiscal: Pension payments are exceeded by pension collections in the medium term	MEDIUM	LOW
Fiscal: Government cash reserves remain low, and mismatches between revenue and expenditure could precipitate another cash shortage.	MEDIUM	HIGH
Macroeconomic: Inflation and reduction in the external dollar flow cause a depreciation in the value of the Afghani.	MEDIUM	LOW
Macroeconomic: Continued uncertainty reduces FDI and Investment in general	MEDIUM	HIGH
Macroeconomic: Lower execution in the development budget will decrease economic activity (and will potentially increase unemployment).	MEDIUM	HIGH
Macroeconomic: International commodity and food prices rise again after the slowdown this year.	MEDIUM	LOW

Rating Changed/Newly Added			
Macroeconomic: Weak growth may result in an increase in poverty and stagnant high unemployment rate	**MEDIUM**	**HIGH**	
Macroeconomic: Increased and Continued security problems cause reduced economic activity in the provinces	**MEDIUM**	**HIGH**	
Macroeconomic: Continued border closure with Pakistan will have inflationary effects	**MEDIUM**	**HIGH**	
Fiscal: Internally displaced and returnees create fiscal pressure on the government in the short, medium and long-term	**MEDIUM**	**MEDIUM**	
Fiscal: Continued border closure will result in loss of government revenue	**LOW**	**MEDIUM**	

Risk of Fiscal Crisis Since Last Year	**Volatile**

Indicator Value	39.7%
Change on the Previous Forecast	4.9%
Change on Previous Year	0.54%

The reduction in other indicators for risk of a fiscal crisis since last year is the result of improved revenue and economic growth outlook, and a reduction in the likely structural and primary fiscal balances by the end of the year. Debt to GDP remains far below the threshold for risk, as for making interest payments to revenue. **The major risks to the fiscal situation in the indicator are the high fertility rate, presenting fiscal pressures, and further pension pressure in the future; the previous period's poor fiscal performance and low GDP growth rate.**



Red Line – Indicates Severe Risk of Crisis

Yellow Line – Indicates Increased Risk of Crisis

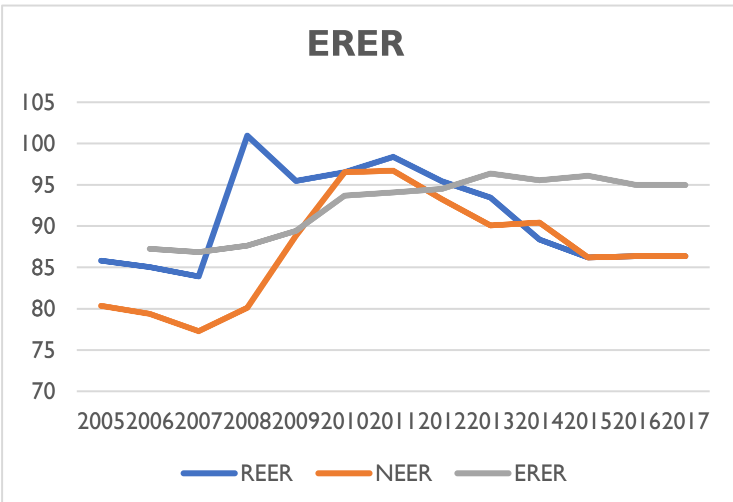
Green Line – Indicates

4.2 Risk Indicator Values

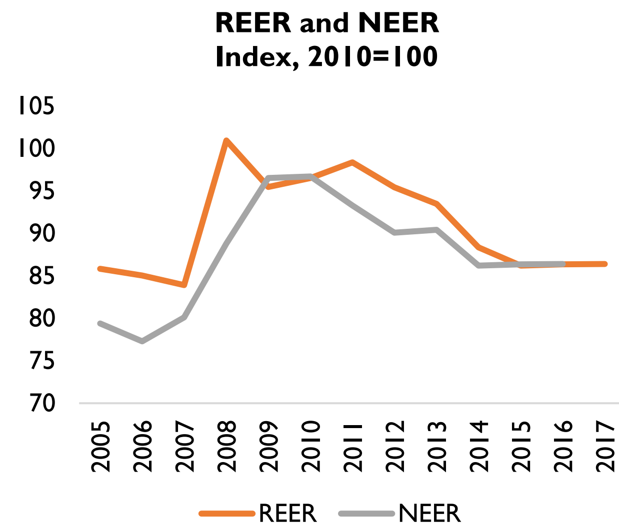
	Weight	Threshold	Values
Structural Balance	1.24%	-1.4	-50
Structural Balance t-1	1.06%	-1.9	-18.27
Structural Balance t-2	0.51%	-1.6	-0.9
Debt Stock	0.38%	42.8	14.6
Debt Stock t-1	0.09%	7	11
Debt Stock t-2	0.95%	86	10.54665172
Revenue	1.25%	20	33.8
Primary Balance	2.57%	-2.1	-3.7
Fertility Rate	2.50%	2.3	6
Fertility Rate t-10	0.62%	2.7	8
ODA	9.01%	9	
ODA t-1	9.70%	13	172.3620774
ODA t-2	10.85%	13	172.3620774
ODA t+1	9.72%	20	172.3620774
Interest (% Revenue)	9.87%	2	0.2
NPL	7.13%	4	8
Pop65	5.15%	9.5	n/a
Reserves	1.86%	4600000000	7288702809
Reserves t-1	3.48%	3300000000	7288702809
Reserves t+1	2.19%	3900000000	7288702809
Dependency Ratio	6.52%	15.5	5
GDP growth	13.36%	3	0.035

4.3 Real Exchange Rate Analysis

The forecast for 1398 is that the exchange rate continues to remain to the year average rate of 75.4. This is based on the fact that the exchange rate seems to be over-valued against fundamentals, and the continued reliance on grants and foreign transfers, which are likely to pick up again.



The equilibrium real exchange rate approach implies that the currency is not in line with fundamentals at the moment, due to high depreciation.



The forecast for the REER shows no change in the equilibrium of the currency exchange

4.4 Mitigation of Risks

Below some of the most pressing risks, as well as mitigation methods, are highlighted:

Risk	Mitigation Method
Continued depreciation of the exchange rate	The introduction of the Sukuk will promote the maintenance of reserves in Afghani. Awareness campaign to promote the use of Afghani. One way to do is to ban the use of Pakistani Rupees/Iranian Currency in the border provinces will increase Afghani value.

	Providing jobs and improving socioeconomic conditions to stop Afghans leaving the country.
Prices continue to rise leading to inflation	Introduction of price stabilizations mechanism or procedures. Increase in the central bank cash reserves to decrease Afghani depreciation. Working on further alternative import routes other than Turkham and Spinboldak to reduce the dependency of Afghan markets on Pakistani products.
Risk of increased pension payments creating fiscal pressure on the government.	The government should approve the new pension policy. Find other means of financing pension payments.
Internally displaced and returnees create fiscal pressure on the government in the short, medium and long-term	A joint effort should be initiated with international NGOs active in the area to address their needs. They should be prioritized in the government job creation projects and relief efforts. Discussions should be initiated with European countries, Iran and Pakistan to stop sending back the refugees.

4.5 Medium Term and Long Term Risks

Key Medium Term Risks

- Lower public budget execution yields negative impact on economic growth performance and social development.
- The **low levels of reserves in the TSA** present a risk for multiple years, given the length of time, it will take to rebuild cash.
- Increasing **salary costs** in the medium term will create pressures for the Government, particularly as more project-financed salaries are pushed on to the Government budget.
- The WTO tariff rules present a risk of decreased revenue after revision of revenue lines for decreased tariff rate based on the membership agreement.

Key Long-Term Risks

- The increased **cost of pensions** is likely to become unsustainable in around 2020, with contributions surpassed by expenditures.
- Continued multiple currency budgeting and contract awards that are likely to depreciate Afghani.
- High dependency on imported goods and weak local production in the local markets, and deteriorating current account balances represent a severe risk over the course of next multiple years.
- Limited monetary instruments for stabilization of currency exchange rate poses a significant risk of increasing the likelihood of further depreciating Afghani.
- Increase in the numbers of internally displaced people and returnees is likely to create fiscal pressures and puts them at higher risk of poverty and makes long-run reintegration and security efforts even more challenging.

Measures to Address

- The Government could work on addressing the **pension costs** by setting up a separate pension fund, or in the short-term setting aside the surpluses from the contributions instead of using them as general revenue. In the longer-term, a review of the scheme with recommendations on parametric reforms will be conducted by MFPD.
- To examine **revenue loss,** the MFPD in collaboration with the Revenue Department will conduct a review of individual revenue lines to identify those that slow down/decreases the revenue after revised tariff and come up with new possible tax measures to improve collection. The MFPD will also conduct a review of the likely sustainable tax collection i.e. how much revenue we should be expecting to raise from other lines to offset revenue loss in the medium term.
- The Government shall achieve the target of Afs 10 billion in the account over the course of the year, even if this means expenditure cuts this year. The funds in the TSA should not be used to finance the budget deficit (i.e. the budget should be set not taking into account this funds) since they are for liquidity management, not financing.

Chapter 5: Medium Term Framework

The Medium Term Fiscal Framework sets out the estimated resources (domestic revenue plus total grants) for current budget 2018 and the planned budget of 2019 and next three years. The framework is built based on a number of key policy assumptions for domestic revenue, donor support, expenditure, and borrowing, as given in below table:

Table 1. MTFF

	2017	2018	2019	2020	2021	2022
Medium Term Fiscal Framework Afs Millions	**Historic**	**Current Budget**	**Proposed Budget**		**Outer years**	
Preliminary	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
TOTAL REVENUE AND GRANTS	**348,535.6**	**399,035.2**	**378,135.3**	**373,175.8**	**338,268.0**	**360,592.4**
Domestic Revenue	**161,892.4**	**173,500.0**	**188,139.4**	**206,176.3**	**226,229.7**	**248,554.1**
Tax Revenue	**111,514.8**	**119,346.2**	**129,269.0**	**141,478.1**	**154,935.6**	**169,776.0**
Taxes on Income and Profits	39,267.2	41,285.2	43,893.1	47,151.6	50,683.1	54,513.1
Taxes on Property	450.1	464.6	484.3	510.0	537.0	565.6
Taxes on Goods and Services	33,071.3	35,677.2	38,950.9	42,963.8	47,413.6	52,349.7
Taxes on Trade	35,897.1	38,988.1	42,873.8	47,612.4	52,878.3	58,730.4
Other Taxes	2,829.2	2,931.1	3,066.8	3,240.3	3,423.6	3,617.2
Non-Tax Revenue	**50,377.6**	**54,180.2**	**58,870.4**	**64,698.2**	**71,294.1**	**78,778.1**
o/w Social Contribution	*5,095.6*	*5,199.0*	*5,304.6*	*5,412.3*	*5,522.1*	*5,634.2*
Grants	**186,643.2**	**225,535.2**	**189,995.9**	**166,999.5**	**112,038.3**	**112,038.3**
Operational	118,392.9	118,714.2	98,600.0	82,063.5	45,590.9	45,590.9
Development	68,250.3	106,821.0	91,395.9	84,935.9	66,447.4	66,447.4
TOTAL EXPENDITURE	**356,453.4**	**415,158.8**	**405,178.6**	**396,522.7**	**402,499.5**	**410,014.4**
Operating	**253,591.9**	**292,214.2**	**287,928.6**	**291,541.1**	**305,488.2**	**320,518.4**
Compensation of Employees	174,187.9	176,705.7	183,562.2	194,576.0	206,250.5	218,625.6
Use of Goods and Services	47,878.2	47,743.8	46,017.0	47,857.3	49,772.3	51,763.2
Interest	23,787.3	1,802.9	1,802.9	1,802.9	1,802.9	1,802.9
Social Transfers	2,471.4	-	61.6	65.9	70.6	75.5
Gross Acquisition of Nonfinancial Assets	5,267.0	12,871.1	8,226.3	8,802.1	9,418.3	10,077.6
Contingencies	-	53,090.7	48,258.6	38,436.9	38,173.7	38,173.7
Development	**102,861.5**	**122,944.6**	**117,250.0**	**104,981.6**	**97,011.3**	**89,496.0**
Discretionary	41,950.0	57,708.0	55,614.2	50,125.7	46,543.9	43,066.0
Non-Discretionary	60,911.5	65,236.6	61,635.9	54,855.9	50,467.4	46,430.0
Deficit	**(7,917.9)**	**(16,123.6)**	**(27,043.4)**	**(23,346.9)**	**(64,231.5)**	**(49,422.0)**
Cash Reserve		10,000.00				
Deficit after cash reserve	**(7,917.88)**	**(6,123.65)**	**(27,043.38)**	**(23,346.93)**	**(64,231.49)**	**(49,422.01)**

Source: MFPD Staff Forecasts

Key Assumptions

- There is zero ceiling on non-concessional borrowing and guarantees. The government will not borrow or grantee any loans, except for on a concessional basis for specific pro-growth development projects. Any non-concessional borrowing for development project should be consulted with IMF.
- The government would need to maintain the overall budget deficit (including grants) close to zero, and reducing operating budget deficit (excluding grants) over the medium term as a

fiscal policy anchor. To do this, it should mobilize more domestic resources to move towards fiscal sustainability.

- The government will finance increasing amounts of security sector expenditure with the intention of fully financing security expenditure by 2024.

The other assumptions include:

- We have kept the outer years relatively conservative, having a watch on the existing donor commitments and availability of resources in future years.
- We need to make savings in expenditure so that cover the deficit arising from aid reduction in outer years. This is needed 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, and assumed to decline by around half of the current level, as the Brussels commitments will be only till 2020.
- We 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 deducing/increasing security spending or increasing/decreasing the LOTFA/CSTC-A contribution) will affect the fiscal space.

Revenue forecast assumptions:

- The revenue forecast for the budget and outer years is based on each individual revenue line, grown by specific macroeconomic assumptions such as growth in GDP, GDP deflator, GDP by sub-sectors, inflation, World inflation, growth in imports, efficiency, and revenue measures, etc.
- Revenue estimates from TAPI and other transitory revenues were not incorporated in the outer year revenue forecast; these will be incorporated when there is more certainty on its coming to effect.
- We did not incorporate the estimated revenue from the VAT into our forecast, as the implementation of the VAT will be started 2021.

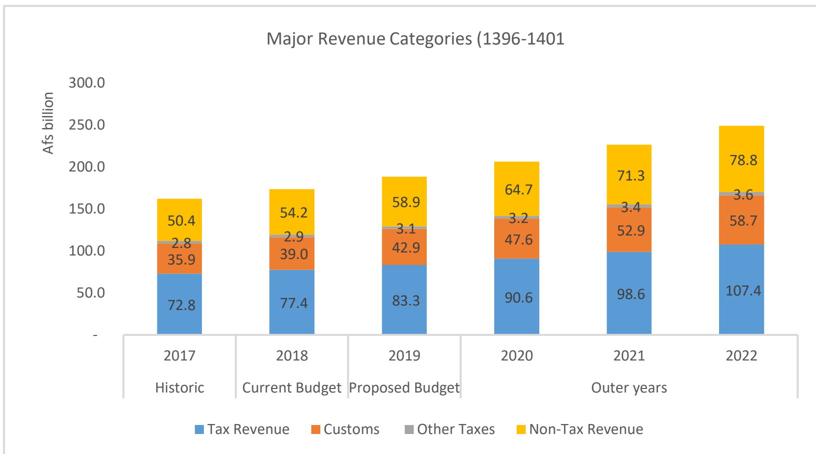
5.1 Revenue projection (1396 – 1401)

Over the past three years, the strong performance of revenue was one of the remarkable achievements of the government. Government maintaining revenue collection at such pace will help the government to come closer towards its main goal of self-reliance in terms of financing public expenditures from domestic resources. The revenue to GDP ratio significantly increased over this period. This indicator largely rose up from the lowest of 8.6 percent in 1393 to 11.6 percent in 1395 and 11.9 percent in 1396 respectively. In FY 1396, the total domestic revenue collected was Afs 169.1 billion, which surpassed the target of Afs 153 billion by 11 percent. Compared to FY 1395 (Afs 141.8 billion), the change was around 19 percent.

5.2 Revenue Outlook (1396 – 1401)

The period 1396 – 1401 demonstrate steady and strong revenue growth outlook. The forecast shows domestic revenues are expected to increase from actual Afs 165.1 billion (without one-off) in 1396 to budgeted target of Afs 173.5 billion in 1397, Afs 188.1 billion, Afs 206.3 billion, and Afs 226.2 billion in 1398, 1399, and 1400 respectively. The main revenue categories include tax revenue, non-taxes, and custom duties, which are grown by their respective macroeconomic assumptions (i.e. GDP, inflation, GDP deflator, import growth, efficiency, and so on).

The above revenue figures includes the social contribution from the employees, which is expected to transfer to the pension separate account if the amendments in the pension law is approve from the cabinet and parliament. The revenue target will be lowed to Afs 182.8 billion for the FY-1398.

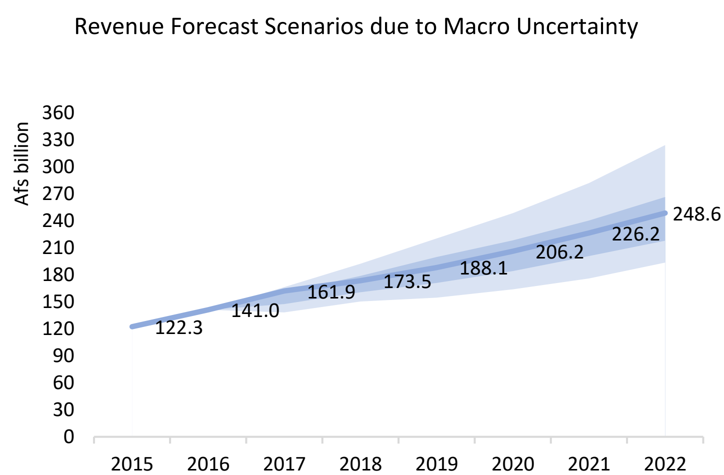


The tax revenues are the largest contributor to overall domestic revenue, and are projected to be around Afs 83.3 billion in FY 1398. An increase of up to Afs 107.4 billion (or 39 percent increase) over the end of 1397-1401 is expected in it. The non-tax collection will be around Afs 58.9 billion in FY 1398, and a change of Afs 78.8 billion (or 45 percent increase) will be realized till the end of the period 1397-1401. The collection from the customs duties is projected to be Afs 42.9 billion in FY 1398, and expected to rise up to Afs 58.7 billion (or 51 percent increase) by the end of FY 1401. Reforms and improvement in tax administration by the government were the major causes of the improved revenue collection. The government is committed to upholding its revenue-enhancing measures and reforms over the following years.

5.3 Revenue Forecast Sensitivity Analysis

Revenue forecast over this period is contingent upon risks and changes in the macro assumptions (like GDP, exports and inflation). The sensitivity of revenue forecasts to changes in economic parameters is set out in Figure 5 below.

Figure 8



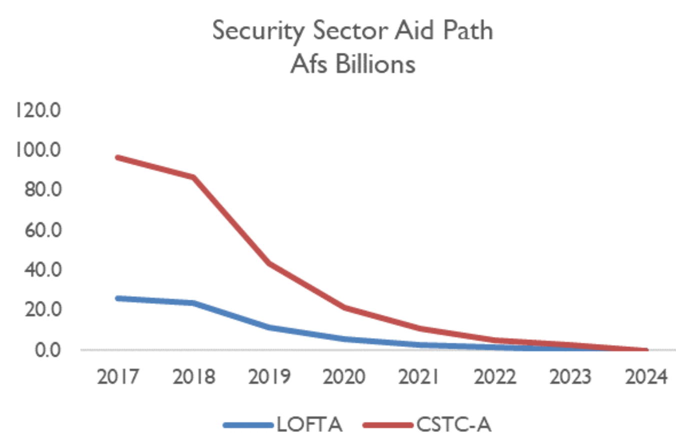
5.4 Value-Added Tax (VAT) Forecast

The government is committed to mobilizing more domestic sources through either policy changes or improvement in the tax administration. The government is in consultation with International Monetary Fund (IMF), and is currently working on a detailed strategic plan for the implementation of VAT, which is going to come into effect in 2021. Based on the initial estimations of the government and IMF, a VAT with a rate of 10 percent is expected to yield additional revenue of 2 percent to GDP.

5.5 Government Security sector costs

Governments per its agreement with international partners is intended to gradually reduce its reliance on donor aid for security sector and meet the security costs through domestic revenue. This goal will be achieved by 2024 according to the commitment. However, if the cost of the security sector does not change and remain US$ 5 billion per year, the achievement of this goal will be difficult and might put significant pressure on the national budget and the government ability to do both (1) significantly improve domestic revenue collection, and (2) improve efficiency in security sectors.

Figure 9



5.6 Donor Support (1395 – 1401)

The aid estimates for the budget and outer years are based on current commitments, which were made in Warsaw and Brussels. We assumed aid would decline by around half of the current level beyond 1399 (2020). For new commitments, the government may go for discussions with donor countries after the existing commitments end in 1399.

The non-discretionary development grants are based on existing commitments and expenditures, which are assumed to reduce in favor of funds moving to ARTF and other discretionary development options. The outer years' estimates assume a 'matching grant' for estimated expenditure, which will be either paid through cash or in-kind by third parties.

Figure 10

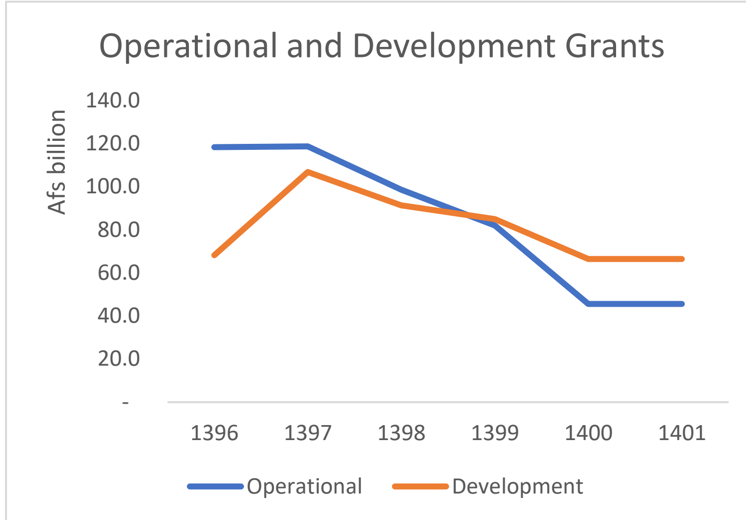


Table 2. Discretionary grants

figures are in Afs million	1396	1397			1398	1399	1400	1401
	Actual	budget	Changes in MYR	Revised	Outer Years			
Grants	**158,988.9**	**141,129.6**	**19,169.0**	**160,298.6**	**116,407.4**	**112,143.5**	**61,570.9**	**61,570.9**
Operating Grants	**118,392.9**	**113,330.9**	**5,383.3**	**118,714.2**	**86,647.4**	**82,063.5**	**45,590.9**	**45,590.9**
ARTF				-				
ARTF IP		5,000.0	-	5,000.0				
ARTF IP +		-	3,483.3	3,483.3				
LOTFA		29,387.6	-	29,387.6	26,899.9	25,484.1	14,157.9	14,157.9
CSTC-A		71,685.4	-	71,685.4	59,722.7	56,579.4	31,433.0	31,433.0
CSTC-A MoD		55,328.2	-	55,328.2	44,923.7	42,559.3	23,644.1	23,644.1
CSTC-A MoI		16,357.2	-	16,357.2	14,799.0	14,020.1	7,788.9	7,788.9
NATO		88.6	-	88.6	24.8			
SPAD				-				
NDP		5,000.0	1,900.0	6,900.0				
EU - State Building Contract		2,169.3	-	2,169.3				
Administrative Profit of DAB	-			-				
Development Grants - Discretionary	**40,596.0**	**27,798.7**	**13,785.7**	**41,584.4**	**29,760.0**	**30,080.0**	**15,980.0**	**15,980.0**
ARTF IP		17,200.0	(4,432.0)	12,768.0				
ARTF IP +			18,795.5	18,795.5	22,320.0	22,560.0	15,980.0	15,980.0
World Bank			-	-	-	-	-	-
NDP		5,934.0	(5,934.0)	-				
SMAF			3,417.0	3,417.0				
EU - (Immigration and Refugee Fund)			1,119.1	1,119.1				
EU - State Building Contract	-	4,664.7	820.1	5,484.8	7,440.0	7,520.0	-	-

5.7 Donor support (types)

The budget for security sector is receiving large off-budget support that come through the Resolute Support Mission and covers spending on goods and services in addition to the on-budget support through LOFTA, CSTC-A and others.

The funds from ARTF, USAID, NDP, and State Building Contract (SBC EU) are used to support operating spending in 1397 budget. On the other hand, the funds from ARTF IP Plus, SBC EU and DPG WB, NDP USAID and the government contribution are discretionary development funds.

State Building Contract (SBC) is a contract between the government and European Union, under which the Union releases funds for the Afghan government based upon the satisfaction achievements by the Afghan government. This EU's on-budget support program will be extended for the next two years from 2018.

Development Policy Grants (DPG) is disbursed upon the satisfactory performance of the government in predetermined areas.

Fund	Discretionary/Non-Discretionary
LOTFA	No discretion, must be used for large salaries in the security sector. All salaries captured under this policy are predetermined to be spent in MTFF.
CSTC-A	Limited discretion must be used for salaries and other expenditures including fuel in the security sector. All salaries captured under this policy are predetermined to spent in 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. This is a one-off support and will not be extended beyond 1395.
NATO	No discretion, must be used largely for pre-determined training in 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).
EU (SBC)	Discretion over how it is used, it is on-budget support subject to fulfillment of performance criteria, including fixed and variable components.
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

Chapter 6: Forward Estimates

Methodology for Forward Estimates:

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

Ministries, where available, otherwise discretionary development funds are held constant. This should show a falling figure over time as projects slowly move to completion, generating additional space in the future for new policy.

Cost of Continuing Current Policy:

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

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

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

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

Cost of New Policy:

The forward estimates totaled together give the estimate for the total cost of operating the government next year at current levels. The resource envelope minus the total cost of the forward estimates gives the available resources for new policy; this is then allocated by Cabinet. Ministries will submit a costing for new projects that include (1) multi-year costs of the project, and (2) the additional cost added to the baseline for the operation and maintenance of the completed project.
Components of the Forward Estimates:

Fiscal Space:

The fiscal space available after the forward estimates can be used to finance new projects and activities. This is sensitive to both policy decisions by the Government (including on tax rates, contributions to security etc.) and on the macro-economic environment. The initial estimates shows deficit and there is no fiscal space available.

Fiscal space could be created through:

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

Forward Estimates - Operating Expenditures

Code	Ministry Name	1396	1397	1398	1399	1400	1401
		Acual	Budget MYR	Proposed Budget	Outer Years		
10	Office of the Chief of staff to the president	-	3,679.3	3,704.3	3,910.1	4,127.7	4,357.7
11	Meshrano Jirga	512.8	528.6	535.9	566.0	597.8	631.4
12	Wolesi Jirga	1,643.1	1,657.2	1,690.0	1,786.2	1,888.0	1,995.6
13	Administrative Office of the President	5,248.9	2,199.7	2,236.0	2,359.0	2,488.9	2,626.1
14	Supreme Court	3,382.7	3,573.7	3,689.7	3,907.4	4,137.9	4,382.1
15	Presidential Protective Service	1,555.6	1,801.0	1,813.5	1,918.2	2,029.1	2,146.4
16	Radio and television of Afghanistan	536.5	462.8	464.2	489.0	515.3	543.0
17	National Security Council	981.2	488.9	486.5	511.9	538.6	566.8
20	Ministry of Finance	14,672.2	2,140.3	2,158.6	2,274.0	2,395.8	2,524.3
21	Ministry of State & Paliamentary Affiars	147.1	181.6	177.5	187.5	198.1	209.3
22	Ministry of Defence	58,689.8	70,389.7	69,653.6	73,544.9	77,659.2	82,009.6
23	Ministry of Foreign Affairs	4,939.7	5,213.2	5,291.0	5,569.8	5,863.7	6,173.8
24	Ministry of Haj & Relagious Affairs	1,150.9	1,254.6	1,277.3	1,349.2	1,425.1	1,505.5
25	Ministry of Commerece and Industry	452.2	517.4	513.5	540.7	569.4	599.7
26	Ministry of Interior Affairs	57,538.3	61,401.2	60,940.2	64,444.8	68,154.8	72,082.4
27	Ministry of Education	32,988.3	35,777.3	36,880.2	39,034.7	41,316.3	43,732.2
28	Ministry of Higher Education	5,145.3	5,619.2	5,680.3	5,987.6	6,312.1	6,654.6
29	Ministry of Refugee &Returnes	287.8	326.3	326.1	344.1	363.1	383.3
32	Ministry of Mines and petrolum	539.3	616.5	624.3	658.5	694.6	732.8
34	Ministry of Communication and Information Technology	565.9	597.8	596.6	629.1	663.6	699.9
35	Ministry of Economy	241.6	289.3	288.2	303.9	320.6	338.1
36	Ministry of Information and culture	615.8	593.9	599.1	632.0	666.8	703.5
37	Ministry of Public Health	4,204.1	3,713.9	3,754.5	3,958.0	4,172.9	4,399.8
38	Ministry of women affairs	223.4	226.4	222.6	234.9	248.0	261.9
39	Ministry of Agriculture, Irrigation & Livestock	1,329.2	1,364.2	1,394.0	1,473.3	1,557.2	1,645.9
41	Ministry of Energy and Water	895.1	683.6	689.9	727.7	767.6	809.7
42	Ministry of Public Works	3,136.3	567.9	579.8	612.5	647.0	683.5
43	Ministry of Rural Rehabilitation and Development	724.8	526.3	524.6	553.0	583.1	614.8
44	Civil Aviation Authority	317.2	378.3	379.2	399.2	420.4	442.7
45	Ministry. of Trasport	289.5	285.3	285.1	300.6	316.9	334.2
46	Ministry of Frontiers and Tribal Affairs	446.3	511.5	503.1	528.0	554.1	581.6
47	Ministry of Labor Social Affairs Martyrs and Disabled	23,278.5	1,440.6	1,446.8	1,524.7	1,607.0	1,693.8
48	Ministry of counter narcotics	211.9	244.2	241.2	254.0	267.4	281.5
49	Ministry of Urban development and Housing	444.6	388.1	388.3	409.1	431.1	454.3
50	Ministrt of Justice	688.3	778.9	777.1	820.3	865.9	914.1
51	Attorney General Office	2,077.6	2,347.0	2,379.7	2,517.2	2,662.8	2,816.9
58	Afghanistan National Standard Authority	78.2	91.1	91.6	96.6	101.9	107.4
59	Independent Directorate of Local Governance	3,537.5	4,126.8	3,957.3	4,158.2	4,369.9	4,592.8
60	National Environmental Protection Agency	219.0	234.9	233.1	246.0	259.7	274.1
61	Afghanistan Academy of Sciences	223.1	236.9	242.3	256.2	271.0	286.6
62	Indepdendant Administrative Reforms and Civil Service	416.0	506.3	503.5	531.0	560.0	590.7
63	General Directorate of Sports and Fitness	331.7	287.6	278.1	291.0	304.6	318.7
64	General Directorate of National Security	15,102.6	16,034.6	16,373.7	17,305.6	18,291.5	19,334.5
66	supreme and Audit office	151.7	167.9	169.0	178.2	187.8	198.0
67	High Office of Anti Corruption	136.9	169.9	171.2	180.9	191.1	201.9
68	Afghanistan National Disaster Management Authority	768.3	147.6	146.2	153.9	161.9	170.4
71	Independent Electoral Complaints Commission	139.7	332.9	308.2	325.7	344.2	363.9
72	Independent Election Commission	361.0	336.0	337.3	354.9	373.5	393.0
73	Central Statistics organization	146.5	181.1	183.9	194.2	205.1	216.6
75	Afghanistan Atomic Energy Comission	45.7	55.8	55.2	58.4	61.7	65.2
76	Directorate of Kochis	134.9	156.7	151.1	159.1	167.6	176.5
79	Kabul Municipality	-	-	-	-	-	-
81	Micro Finance Investment Support Facility for Afghanistan	-	-	-	-	-	-
82	Urban Water Supply and Canalization Corporation	-	-	-	-	-	-
83	Da Afghanistan Brishna Shirkat	-	-	-	-	-	-
84	Capital Region Independent Development Authority	45.8	122.5	117.7	123.6	129.7	136.2
85	Independent Commission for Overseeing the Implementation of Constitution	65.8	76.8	77.7	81.9	86.3	90.9
86	Afghanistan Independent Human Rights Commission	30.2	41.2	39.3	40.9	42.5	44.2
87	Afghanistan Independent Land Authority	470.9	654.6	663.2	700.0	739.0	780.2
88	Executive Directorate and Secretariat of Ministers Council	1,084.2	555.1	538.0	565.3	594.0	624.2
89	Afghanistan Railway Authority	-	38.6	36.9	38.8	40.9	43.0
	Contingencies	-	53,090.7	48,258.6	38,436.9	38,173.7	38,173.7

Forward Estimates - Development Expenditures

Code	Ministry Name	1396	1397	1398	1399	1400	1401
		Acual	Budget MYR	Proposed Budget	Outer Years		
10	Office of the Chief of staff to the president	-	133.3	130.4	116.1	106.8	98.2
11	Meshrano Jirga	15.4	9.8	9.6	8.6	7.9	7.2
12	Wolesi Jirga	28.3	27.3	26.7	23.8	21.9	20.1
13	Administrative Office of the President	540.2	1,009.9	988.2	879.5	809.1	744.4
14	Supreme Court	103.4	102.0	99.8	88.8	81.7	75.2
15	Presidential Protective Service	104.9	136.7	133.7	119.0	109.5	100.7
16	Radio and television of Afghanistan	97.5	119.6	117.0	104.2	95.8	88.2
17	National Security Council	-	-	-	-	-	-
20	Ministry of Finance	4,556.2	3,015.2	2,950.4	2,625.9	2,415.8	2,222.5
21	Ministry of State & Paliamentary Affiars	12.5	20.0	19.6	17.4	-	-
22	Ministry of Defence	108.3	68.3	66.9	59.5	54.8	50.4
23	Ministry of Foreign Affairs	692.1	1,093.4	1,069.9	952.2	876.1	806.0
24	Ministry of Haj & Relagious Affairs	417.4	637.9	624.2	555.5	511.1	470.2
25	Ministry of Commerece and Industry	219.0	308.2	301.6	268.4	246.9	227.2
26	Ministry of Interior Affairs	718.2	1,686.5	1,650.2	1,468.7	1,351.2	1,243.1
27	Ministry of Education	4,393.7	5,108.0	4,900.3	4,361.3	4,012.4	3,691.4
28	Ministry of Higher Education	2,083.1	2,213.3	2,165.7	1,927.5	1,773.3	1,631.4
29	Ministry of Refugee &Returnes	223.8	99.7	97.6	86.9	79.9	73.5
32	Ministry of Mines and petrolum	781.4	1,056.1	1,033.4	919.7	846.2	778.5
34	Ministry of Communication and Information Technology	1,239.3	1,648.5	1,613.1	1,435.6	1,320.8	1,215.1
35	Ministry of Economy	290.0	417.4	408.5	363.5	334.5	307.7
36	Ministry of Information and culture	371.6	297.4	315.5	280.8	258.3	237.6
37	Ministry of Public Health	14,377.6	12,310.0	12,045.4	10,720.4	9,862.8	9,073.7
38	Ministry of women affairs	29.6	45.0	44.1	39.2	36.1	33.2
39	Ministry of Agriculture, Irrigation & Livestock	9,249.8	9,452.0	9,248.8	8,231.4	7,572.9	6,967.1
41	Ministry of Energy and Water	4,914.3	4,035.2	3,948.4	3,514.1	3,233.0	2,974.3
42	Ministry of Public Works	15,430.7	15,218.6	14,891.4	13,253.3	12,193.0	11,217.6
43	Ministry of Rural Rehabilitation and Development	14,416.7	19,282.8	18,868.2	16,792.7	15,449.3	14,213.3
44	Civil Aviation Authority	2,942.8	3,618.9	3,541.0	3,151.5	2,899.4	2,667.5
45	Ministry. of Trasport	14.7	90.5	88.6	78.8	72.5	66.7
46	Ministry of Frontiers and Tribal Affairs	109.2	99.1	97.0	86.3	79.4	73.0
47	Ministry of Labor Social Affairs Martyrs and Disabled	737.6	815.8	773.1	688.1	633.0	582.4
48	Ministry of counter narcotics	793.9	567.0	554.8	493.8	454.3	417.9
49	Ministry of Urban development and Housing	3,737.2	5,263.1	5,150.0	4,583.5	4,216.8	3,879.4
50	Ministrt of Justice	300.7	276.8	270.8	241.1	221.8	204.0
51	Attorney General Office	167.2	155.9	152.5	135.7	124.9	114.9
58	Afghanistan National Standard Authority	30.8	36.9	36.1	32.1	29.5	27.2
59	Independent Directorate of Local Governance	1,148.1	2,883.9	2,821.9	2,511.5	2,310.6	2,125.8
60	National Environmental Protection Agency	40.9	80.4	78.7	70.0	64.4	59.3
61	Afghanistan Academy of Sciences	11.3	16.8	16.4	14.6	13.4	12.4
62	Indepdendant Administrative Reforms and Civil Service	669.3	890.2	871.0	775.2	713.2	656.1
63	General Directorate of Sports and Fitness	50.2	147.5	144.4	128.5	118.2	108.8
64	General Directorate of National Security	117.5	102.5	100.3	89.3	82.1	75.6
66	supreme and Audit office	163.6	321.9	315.0	280.3	257.9	237.3
67	High Office of Anti Corruption	6.2	-	-	-	-	-
68	Afghanistan National Disaster Management Authority	-	-	-	-	-	-
71	Independent Electoral Complaints Commission	-	-	-	-	-	-
72	Independent Election Commission	-	-	-	-	-	-
73	Central Statistics organization	8.3	83.0	81.2	72.3	66.5	61.2
75	Afghanistan Atomic Energy Comission	-	-	-	-	-	-
76	Directorate of Kochis	84.0	149.6	146.3	130.2	119.8	110.2
79	Kabul Municipality	3,192.4	2,180.9	2,134.0	1,899.3	1,747.3	1,607.6
81	Micro Finance Investment Support Facility for Afghanistan	774.0	215.9	211.3	188.0	173.0	159.1
82	Urban Water Supply and Canalization Corporation	150.4	597.4	584.5	520.2	478.6	440.3
83	Da Afghanistan Brishna Shirkat	10,564.3	13,167.4	12,884.3	11,467.0	10,549.7	9,705.7
84	Capital Region Independent Development Authority	1,036.4	1,442.5	1,411.5	1,256.2	1,155.7	1,063.3
85	Independent Commission for Overseeing the Implementation of Constitution	-	-	-	-	-	-
86	Afghanistan Independent Human Rights Commission	17.2	27.3	26.7	23.8	21.9	20.1
87	Afghanistan Independent Land Authority	313.7	657.8	643.7	572.9	527.1	484.9
88	Executive Directorate and Secretariat of Ministers Council	264.5	274.4	268.5	239.0	219.8	202.3
89	Afghanistan Railway Authority	-	820.1	802.4	714.2	657.0	604.5
	Contingencies	-	8,408.9	5,275.4	5,324.2	5,342.5	5,160.7

Chapter 7: Government Spending Options to Stimulate Growth:

Government spending options to stimulate growth in the short, medium and longer term:

Key Summary:

1. The historical allocation of budget to the development projects were not growth enhancing. According to the analysis of the Macro and Fiscal Policy department, out of 95 development programs, 20 programs were spending more than 85 percent of the development expenditures, the remaining programs spent less than 15 percent of the budget. This means that expenditures in development budget were skewed towards only few large programs, other programs were either redundant (i.e. not executing) or of less importance.
2. To overcome this issue, the government of Afghanistan brought fundamental changes and reforms in the national budget of 2018., in which, the ministry of finance took the following key steps:
   - The poor practice of carrying forward previous years' projects was not a good practice. In 2018 budget, the Ministry of Finance closed all the non-performing projects and programs and allocated their funds to well-performing projects/programs.
   - The government replaced the systematic overestimation of program and project expenditures with more accurate and credible forward estimates.
   - The government also accounted for a relatively equal distribution of funds by province and districts levels.
   - In addition, the government aligned its expenditures with the available resources, making it a credible budget.
3. What to do? The way forward – In order to make the government spending more growth enhancing, the Macro and Fiscal Policy Department has done an analysis that helps further stimulate the economic growth. The key summary of this analysis is that the government needs to allocate relatively more funds in its upcoming budget to those sectors with a higher growth multiplier. The sectors identified with a higher growth multiplier are Agriculture and Rural Development Sector, Education Sector, Health Sector and Extractives. The paper finds that the Infrastructure Sector has a negative multiplier. To counter its effects; the government needs to finance the additional funding of the Infrastructure Sector through the private capital investment – through the Public Private Partnerships.
4. According to the World Bank poverty estimates of 2016-17, the national poverty is recorded at 55 percent. It has been worsened compared to 38 percent in 2011-12. The more inequality, the slower the growth—a conclusion now endorsed even by the IMF. To improve this condition, in the short-term, the government needs to channel more funds into the household level by doing X and Y to improve the aggregate demand.

Given the new reforms brought in 2018 budget, we expect that the execution rate of the development budget will be more than 85 percent for this year. The government expenditures are aligned with the availability of existing resources. 2018 is a consolidated budget; the development and operating budgets are added together, presented in the same currency and the same classification - object, location, program, project, fund, and function.

These set of reforms are expected to help improve the quality of the budgeting process, and the execution rate of the development budget - the execution rate will further improve the economic growth.

Macro and Fiscal Policy Department has done an analysis that helps further stimulate the economic growth. The key summary of this analysis is;

- In the short term: The government needs to channel more funds to household level to reduce poverty and generate economic growth in the bottom level – through citizen charter, cash for work and small construction programs. In addition, the government should make more efforts to address the concerns of business community to ease the activities of the private sector and small entrepreneurs.
- In the medium to longer term: We suggest a reshuffle of funds into the existing budget. The idea is that the government allocates relatively more funds in its upcoming budget to those sectors with a relatively higher growth multiplier. The sectors that the Macro and Fiscal Policy department has identified are Agriculture and Rural Development Sector, Education Sector, Health Sector and Extractives. The paper finds that the Infrastructure Sector has a negative multiplier, but its role in the economic growth in the long-term is crucial. To counter the negative effects of the government spending in Infrastructure sector; we suggest that the government needs to finance the additional funding of the Infrastructure Sector through the private capital investment – through the Public Private Partnerships. That will help the government to save money to invest in other areas of growth while the private sector to actively participate in the Infrastructure Sector of the country.

The two options of growth and their implications are discussed below in more detail:

7.1 Short-term Options:

In the short term, we suggest that the government should spend on those areas that have high household impacts. The purpose of these spending is to reduce poverty and increase employment opportunities in the bottom level. The following are the areas of investment for the government of Afghanistan to stimulate growth in the short-term and improve the living conditions of the bottom level pyramid.

7.1.1 Government spending options to channel funds to household level: The CSO and World Bank Poverty Estimates of 2016-17, indicate the national poverty line at 54.5 percent. It has worsened compared to 38.3 percent in 2011-12. The analysis of the ALCS data also suggests that Afghanistan's labor market is under considerable stress. Almost one quarter – 24 percent – of the country's labor force is unemployed.

To reduce the gap of inequality and increase the job opportunities for the less well-off people, the government needs to do spending in those programs that channel funds to household level. These programs include, *Cash transfer program like greeneries, Citizen Charter and Jobs for Peace Programs, Agriculture subsidies to small farmers and their access to market, government service deliveries in Health sector, spending on women empowerment programs through government NPP, spending in small construction programs and increased expenditures in social security services.*

By doing this, the government will reduce the gap of inequality or in other words will reduce the increased poverty due to low income at the bottom level. Because the less wealthy consume a greater share of their income than do the rich, they expand demand when they have more income. When demand is expanded, jobs are created6.1.2 Improve budget execution: Low execution is amongst the main reasons for the low growth rate. The conventional way of carrying forward non-executing projects to the next year was one of the primary reasons for the low execution of development budget in the line ministries for many years. Fortunately, the Ministry of Finance has attempted to resolve this issue as part of the 2018 budget reforms. It has worked on a different approach for the carry forward projects. It penalized the low performing projects and transferred their unspent amount to projects which performed well. In part, this would also mean working with donors to reallocate their projects as well; including identifying projects, which are not performing, and shifting resources to projects, which can be expanded easily to generate quicker results. To this end, the execution rate will increase, which ultimately have a positive impact on growth.

International experience suggests that most problems in budget execution are due to bad project planning and preparation. Thus, the focus needs to be on improving upstream planning and budgeting processes, and insist on full technical, economic and financial appraisal before allocating budget resources.

Even for donor-financed projects, we suggest that the Ministry should review costing and disbursement schedules with the relevant implementing ministry and determine if it is feasible and realistic or if donors should be encouraged to place funds elsewhere.

Execution plays an important role in job creation and growth. Based on our analysis, an additional spending of Afs 140,600 creates an additional one job. The propensity of expenditure of Afs 3 will contribute to Afs 1 to GDP (A Capital Output ratio of 3: 1).

In 1395, 54% of development budget was executed. Based on the above analysis:

- If 60% (Afs 105.4 billion) of the development budget had been executed, an additional 74,800 jobs would have been created and this would have led to additional GDP growth of 0.25 percent point.
- If the 70% (Afs 122.9 billion) of the development budget had been executed, an additional 199,700 jobs would have been created and this would have led to additional GDP growth of 0.68 percent point.
- If the 80% (Afs 140.5 billion) of the development budget had been executed, an additional 324,600 jobs would have been created and this would have led to additional GDP growth of 1.11 percent point.

7.1.3 Address immediate concerns of business community: The private sector plays an important role in economic development of a country. Doing business in Afghanistan is more difficult than in other countries in the region. In the World Bank's 2017 Doing Business Index, Afghanistan ranks 183 out of 189 economies in the ease of doing business. Private sector intervention may re-energize the economic activities, thus the private investment part of the GDP may increase, and as a result the private consumption.

To encourage the expansion of private investment in Afghanistan, we recommend implementing the following reforms, which have limited direct investment cost to the government and merely requires policy reforms;

- Provision of micro-credit facilities to ease access of credit for the small entrepreneurs and farmers. In Afghanistan, the commercial banks are less willing to give loans to private investors unless they provide loan collateral several times higher than actual loans. Thus, the mobilization of funds from commercial banks to investors becomes a challenging task, which eventually slows down economic activity and growth.
- Provide investment tax credits instead of planned tax exemptions (Income Tax Law).
- Improve inter-ministerial coordination of PPP Processes.
- Avoid entering MoU's or other contractual commitments with the private sector until all due diligence is completed.
- Conduct regulatory audits in key sectors and remove regulatory redundancies.
- Offer and encourage risk sharing facilities and political risk guarantees (for both, domestic and international investors).
- Forcefully implement critical reforms to ease government processes and finalize e-governance laws for full deployment of e-payment processes to reduce corruption.
- Land reforms and registration of informal settlement;
- Continue improving governance of financial sector, upgrading risk management guidelines within financial institutions;
- Support development of insurance services.

7.2 Medium and longer-term growth options:

The government options to stimulate growth in the short-term are of high importance to decrease poverty and boost aggregate demand by channeling funds to household level. However, in the medium to longer term, we suggest that the government should invest in Agriculture, Human Capital (Health & Education), Extractives and Infrastructure Sectors (by crowding in private sector capital through PPP partnerships). These sectors have an estimated higher impact on growth relative to other sectors, given their higher growth multiplier. A transfer of the development funds by allocating relatively more funds to sectors with higher fiscal multipliers would therefore support greater growth.

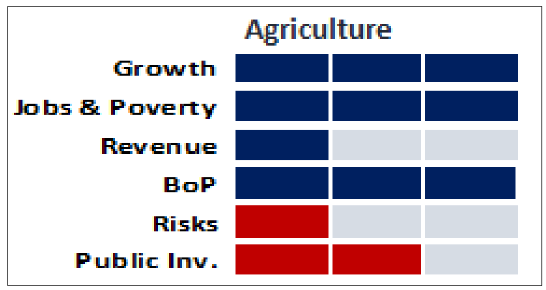
A fiscal multiplier quantifies how strongly economic output increases when public expenditures increases. A World Bank study estimated the size of fiscal multiplier for different functional categories of public spending in Afghanistan. Multipliers for different functional categories of spending vary considerably, from -1.1 for Infrastructure Sector to 1.82 for Social Protection Sector, with the multiplier for overall spending being 0.78.

The following are the investment options:

7.2.1 Investment in Agriculture Sector:

Afghanistan is an agricultural country; with about 80 percent of its population depend on this sector for their livelihood. However, the irrigated land is less than 11 percent. Efforts in the agriculture sector should be towards increasing the share of the irrigated land, and stabilize growth in this sector by reducing volatility in incomes in the sector to support poverty alleviation, increase private investment in the sector and stabilize food prices within the country. Investing in agriculture has low risk and under our simulated scenarios could contribute about 1.4 percent points annually to growth and could contribute to 1.2 million jobs creation over the next 10 years.

Investing in Agriculture is a good import substitute and increases the export potential and thus enhances the BOP position. However, the income to the government from this sector is relatively low, given that the agricultural products in general are tax exempt. However, gearing it to an agribusiness, by dealing in agriculture products and services that have a commercial value, like processed food and dairy products could contribute to higher revenue to the government.



The following are some of the main areas for the government to invest in the agriculture sector:

- Irrigation: Investment on irrigation have been found positive on the economic growth (Fan, Hazell and Thorat (2000)), and may reduce the volatility of agriculture returns (reducing the reliance on rain fed farming); improving the predictability of the sector and thus investment.
- Research & Development: Supporting larger scale farming and agribusiness to bring new technologies, and supporting R&D has seen some of the largest returns to investment (Fan, Hazell and Thorat (2000) and Fan, Zhang and Zhang (2002))
- Supporting infrastructure and transport: This covers two areas, both the roads to connect farm areas, and the transport (buses, trucks etc.) that allow the movement of goods to market. While the latter could be provided through private means, the former is less likely to be so. (Fan (2004), World Bank report on Infrastructure and Pro Poor Growth).
- Current relevant budget projects: Construction and extension of cold storage; Provision and Distribution of Improved Seeds and Fertilizer; Canal Trencher; Construction of co-operative cold storage.

How to channel government spending in the agriculture sector:

- Reallocating public spending from subsidizing private inputs (fertilizer, seeds, and grants to farmers and farmers' groups) towards providing agriculture and irrigation public goods and services.

- Reorienting government support to help small farmers and farmers' groups to gain access to global value chains and to meet the domestic demand for higher value-added products.
- Continuing the government's income support to small and poor farmers, but also providing incentives for them to pursue productive investments. Conditional cash transfers, providing incentives to put these cash transfers to productive use, may result in increased investment and productivity in the agricultural sector. Indonesia has extensive experience in cash transfers, and that has proved to be useful in increasing their economic growth.
- Putting in place a comprehensive M&E system that allows the government to evaluate the impact of its transfer programs. Such a system would be instrumental to prevent/correct mistakes in program design and maximize effectiveness in bringing about the necessary increases in agriculture productivity, as well as alleviating poverty in rural areas.

A case study: Agriculture Reforms in Pakistan (1958-68) and how it helped in their economic growth:

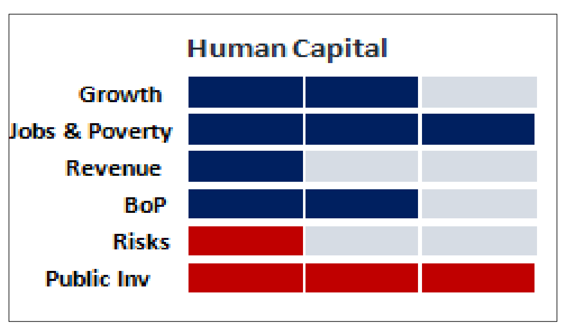
In Pakistan, the first land and agriculture reforms were implemented during the Ayub Khan presidency (1958-1968). These reforms led to Agriculture or Green Revolution in Pakistan with an economic growth of nearly 7 percent per annum. These reforms improved income levels in rural areas with sufficient availability of grain foods. The major policy changes included investments in irrigation, water and tubewell development, fertilizer supply, distribution and price support.

Around 50 percent of farmland in Pakistan is irrigated (World Bank, 2011); this level of significant irrigation has been in place for a long period of time (as far back as 2001, around 48% of agriculture land was irrigated, World Bank). This was the result of significant investment in the irrigation system; including in the 1960s and 1970s with the completion of the Mangla Reservoir and the Indus Basin Works and is reflected in the higher yields in the sector.

7.2.2 Investment in Human Development (Health & Education):

Too much of the poverty at the bottom of the income spectrum is due to economic discrimination and the failure to provide adequate education and health care facilities to them "Joseph Staglitz". He further writes that, if we provided more opportunity to the poor, including better education and an economic system that ensured access to jobs with decent pay, then perhaps we would not spend so much on prisons. The poor instead would be better able to seize new employment opportunities, in turn making our economy more productive.

The development of human capital ranges from spending on school education and literacy programs to vocational trainings and better provision of health services. Spending on human capital has low risk and relatively robust to insecurity. Even though it is little difficult to quantify its contribution to growth, but



empirical results suggest that private returns are very high. Investment in adult literacy could significantly improve productivity in agriculture.

While investing in Education, the government needs to consider the areas of high performance and weak performance in Afghanistan (e.g. pre-school enrolment is high, but number of teacher training support programs is low). Thus, there is no point in investing in building new pre-schools, it would be much better to support teacher training etc. to improve the quality.

Empirical studies: They suggest a positive relationship between investing in human capital and economic growth:

Many research papers have shown a positive relationship between investing in human capital and economic growth. Becker (1964) and Mincer (1974) conducted an empirical study on the relationship of investment on human capital and social rate of return. In their study, they highlighted a strong linkage between education, productivity and output levels, with a social rate of return in the range of 6 to 12 percent.

Developed countries and investment on Human Capital: Table 4 indicates the total expenditures on education as a percentage of GNP in the developed countries. We can see from the above table that developed countries spend a significant portion of their revenue on education and education quality has been shown to be linked strongly to growth and welfare (e.g. Hanushek, 2013). Noteworthy to say that education changes not only the livelihood of a nation but also their mindset, rationality and the way they think. It changes both economic and their social perspectives.

Table 4: **Total expenditure on education as percentage of GNP**

Country	1970	1975	1980	1985	1990	1995	1998*
Belgium	6.0	6.2	6.0	6.0	5.0	5.0	4.7
Denmark	6.7	7.6	6.7	7.0	7.1	7.7	7.4
Germany						4.8	5.0
Greece	1.7	1.7	1.8	2.4	2.5	2.9	3.0
Spain	2.0	1.8	2.6	3.3	4.4	4.9	4.8
France	4.8	5.2	5.0	5.8	5.4	6.1	6.0
Ireland	4.8	5.8	6.3	6.4	5.6	6.0	5.8
Italy	3.7	4.1	4.4	5.0	5.2	4.7	4.3
Luxembourg	3.6	4.7	5.7	3.8	3.6	4.1	4.3
Netherlands	7.2	8.1	7.6	6.4	6.0	5.2	5.0
Austria	4.5	5.6	5.5	5.8	5.4	5.6	5.5
Portugal	1.5	3.5	3.8	4.0	4.2	5.3	5.7
Finland	5.9	6.4	5.3	5.4	5.7	7.5	7.9
Sweden	7.6	7.0	9.0	7.7	7.7	8.1	8.5
United Kingdom	5.3	6.6	5.6	4.9	4.9	5.3	5.3
EU-15 (average %)	**4.7**	**5.3**	**5.4**	**5.3**	**5.2**	**5.5**	**5.5**

NB: * Estimated percentage based on OECD *Education at a glance*, 2001
Source: Unesco statistical yearbooks

7.2.3 Investment in Health Sector: Health investment is another important human capital development indicator. For the more recent historical period, health improvements have served to increase income (Bleakley 2007). The channel is generally through improvements in health for the young that enable children to attend school for more days and to learn more. Health improvements also allow adults to work more days and years over their lifetime and to labor more intensively (Almond 2006).

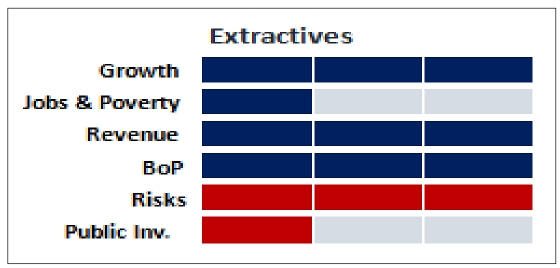
Afghanistan and investment on Human Capital (Education and Health): Expenditure on education and health in Afghanistan, relative to countries in the region, is lower as a portion of GDP. The average is calculated on the basis of all countries from 2000-2012.

	Afghanistan	Pakistan	Tajikistan	India	Average
Military	37.9	23.5	15.4	17.6	8.9
Health	6.5	4.2	5.8	7.0	11.5
Education	4.8	11.3	14.3	11.5	14.8

Taken over years 2000-2012, WB-WDI

7.2.4 Investment in Extractives:

Afghanistan is endowed with natural resources. It has an estimated total value of mineral deposits ranges between one to three trillion USD. According to a WB analysis, even a modest development in extractives could contribute 1.6 percentage points to GDP growth annually through 2030. If functional, it could generate about 100,000 to 125,000 jobs and could catalyze more.



Additionally, extractives have a high revenue potential and could contribute to 3 percent of GDP annually through 2030, exports could grow by 10 percent and gradually substitute for the decline in aid.

However, extractives shall be dealt with care, as underdeveloped countries usually have problems of underdeveloped institutional capacity, the rule of law and governance. These factors could potentially give room for corruption and misuse of mineral resources. The government of Afghanistan should make sure, that the extractions are not exploited, and they are in the safe hands.

7.2.5 Natural resource extractions and the Dutch Disease problem:

In economics, the term “Dutch disease” is the relationship between the increase in the economic development of a specific sector for example natural resources and a decline in other sectors like manufacturing sector or agriculture. The mechanism of this decline is that with the increase in exports of natural resources, the nation's currency becomes stronger (appreciates) compared to currencies of other nations. As a result, the export of this country in other commodities becomes more expensive making it less competitive in other areas.

<u>Case 1: The Dutch Disease problem in the Netherlands:</u> The term Dutch disease takes its origin from here when in the Netherlands a vast natural gas deposit in the North Sea was discovered in 1959. The newfound wealth and massive exports of oil caused the Dutch guilder (Netherland currency) to rise sharply, making exports of all nonoil products less competitive on the world market. Unemployment rose from 1.1% to 5.1%, and capital investment in the country dropped. Afterward, the Dutch disease became widely used in economics to describe the paradoxical situation where seemingly good news, such as the discovery of large oil reserves, turns out to have a negative impact on a country's broader economy.

<u>Case 2: The Dutch disease problem in Great Britain:</u> In the 1970s, Great Britain also faced the same economic condition. The country was rich in oil, and they had large reservoirs of oil in the cost of Scotland. The price of oil quadrupled, and it became economically viable to drill for more reservoirs in the North Sea. By the late 1970s, Britain had become a net exporter, and they relied mainly on the export of oil. The pound appreciated in value, but the country fell into recession when British workers demanded higher wages and exports became uncompetitive.

<u>Case 3: Dutch disease in Canada and Russia:</u> In 2014, economists in Canada reported that the increased influx of foreign capital related to the exploitation of the country's oil sands may have led to an overvalued currency and a decreased competitiveness in the manufacturing sector. At the same time, in Russia, the ruble had greatly appreciated for similar reasons.

7.2.6 Is the Dutch Disease applicable to Afghan economic context?

In Afghanistan, the effect of Dutch disease in the next 10 to 15 years seems implausible. In theory, an appreciated currency discourages the export potential of a country, however in Afghanistan; the export is constraint to supply deficiencies, and exchange rate plays insignificant role in the BOP position. Second, the magnitude of the natural resources at the beginning of the extractions will not be much significant to distort the exchange rate equilibriums. However, in the long-run when Afghanistan reaches to its competitiveness in industrial and export markets, the effects of Dutch disease could become evident.

7.2.7 How to tackle the Dutch disease problem?

The famous economist, Joseph Staglitz, has proposed a solution to the problem of Dutch disease by keeping the foreign exchange earned from extractives out of the country. Invest the money elsewhere. Bring it in only gradually. Some countries, notably Nigeria, are trying to implement these lessons. It has proposed creating stabilization funds and, in future, it will sell its natural resources in transparent, competitive bidding processes.

7.3 Investment in Physical Infrastructure:

In general, investment in infrastructure is positively correlated with growth. Two recent literature reviews by Romp & de Haan (2007) conclude that there is more consensus than in the past that public investment on infrastructure positively affects economic growth. Bom & Lighthart (2009) also confirms the results and found that on average spending in infrastructure increases growth by around 0.08—i.e. a 1 percent increase in the stock of public capital would lead to a 0.08 percent increase in GDP.

7.3.1 Afghanistan & investment in Physical Infrastructure:

In Afghanistan, the results contradict the above literature. According to a World Bank study, investing in Infrastructure is negatively correlated with growth. A World Bank recent multiplier analysis has concluded that investment on Infrastructure Sector in Afghanistan has a negative multiplier effect, of -1.1 percent. It is seemingly due to the fact, that Afghanistan imports most of its construction raw materials from abroad, and this increases the import volume of the country, which in effect reduces the GDP growth.

7.3.2 Crowding in Private investment to support Infrastructure Sector in Afghanistan:

As discussed above, investment in Infrastructure in Afghanistan is indirectly correlated with growth. If the government of Afghanistan invests in the Infrastructure Sector exclusively through the government resources, the economic growth will shrink. To resolve this, we propose crowding in private investment to make partnerships with the private sectors in the Infrastructure Sector. These partnerships will ensure a longer-term sustained growth for Afghanistan.

The following are some of the main areas for the government to support partnership with the private sector.

- Investment in interconnected infrastructure: Estache and Wren-Lewis (2011) note that higher returns are developed from large-scale interconnected infrastructure projects (like the completion of the US interstate highways system); and that higher returns are seen once the system is completed. In Afghanistan's case, this would imply that completion of the countrywide road system (where possible, and in line with security concerns) would yield higher returns on completion of the system than the components have created during. Municipal roads alone show limited impact (Pereira and Pereira (2017)).
- Water and sanitary: Binswanger et al. (1992) have found limited returns from canal infrastructure, in India. However, water infrastructure has been found to be more beneficial in parts of sub-Saharan Africa (Estache et al. (2005)). Given the importance of agriculture, and the vulnerability to snow and rainfall levels, in Afghanistan, the impact of this could be substantial.
- Energy investment: in country-specific studies this has typically been shown to be one of the more productive sub-sectors, and generate private investment (Estache and Garsous (2012)); however it is worth two caveats (1) investment in this area in Afghanistan has already been substantial and thus there may be limited additional returns on a rapid basis compared to other areas and (2) reliance on country-specific studies obviously depends significantly on country-specific factors influencing returns. Studies (Barnes et al. (2002)) have found however that there is a complimentarily between education investment and electricity investment. Given the high levels of energy investment already in place this creates a potential significant gain

from further education investment (especially in for example, secondary, where outcomes are currently weaker), which would also generate additional returns to private investment in the longer term.

- Telecoms: there is a strong relationship between telecoms infrastructure and growth that has been established in multiple country studies (Chakraborty and Nandi (2011). This in part may be because telecoms infrastructure (a) reduces the coordination costs of business and search costs of work but also (b) increases options for other payment etc. mechanisms and money supply (e.g. mobile money).
- Transport: within city transport, bus services etc., can support private sector investment and job mobility.

7.4 Growth Scenarios:

Status quo: Under the status quo, the real GDP growth rate will be at 3.1 percent in 2018 and 4.3 percent in 2020. To this end, we are proposing the alternative growth scenarios, by changing the sector allocations and assigning more of the budget to those sectors with a higher fiscal multiplier.

Scenario1: Under Scenario1, more funds are allocated to sectors with a *higher growth multiplier*. These sectors include *Agriculture and Rural Development, Education, Health and Social Protection, while keeping allocation to Infrastructure Sector constant*. With the given allocation shown below, the growth rate increases to 5.5 percent in 2020 from 4.3 percent in the baseline scenario, on average 1.2 percentage points higher each year compared to the baseline allocation in the next four years.

Scenario 1:
(Increase allocations to sectors of growth)

	Actual				Projected			
	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP	3.7%	1.3%	1.1%	2.4%	3.1%	4.2%	4.9%	5.5%
Development (Million Afs)	**80,089.48**	**72,648.88**	**82,908.92**	**93,891.61**	**100,170.49**	**112,391.29**	**126,103.01**	**141,487.58**
Security	11.33%	5.35%	1.0%	1.35%	1.2%	1.0%	0.8%	0.6%
Governance and Rule of Law	2.30%	1.34%	1.9%	1.41%	1.3%	1.1%	1.0%	0.8%
Infrastructure	35.03%	30.07%	40.9%	43.29%	43.29%	43.29%	43.29%	43.29%
Energy	11%	10%	19%	19%	19%	19%	19%	19%
ICT & Urban Development	5%	4%	5%	6%	6%	6%	6%	6%
Transportation	19%	16%	17%	18%	18%	18%	18%	18%
Education	**9.40%**	**11.56%**	**10.2%**	**9.12%**	**9.6%**	**10.1%**	**10.6%**	**11.1%**
Health	**8.95%**	**12.49%**	**13.5%**	**13.17%**	**13.4%**	**13.6%**	**13.8%**	**14.0%**
Agriculture and Rural Development	**27.85%**	**34.36%**	**27.4%**	**25.11%**	**26.1%**	**27.0%**	**28.0%**	**28.9%**
Social Protection	**0.94%**	**0.48%**	**0.5%**	**1.05%**	**1.0%**	**1.0%**	**0.9%**	**0.9%**
Economic Governance	4.20%	4.34%	4.5%	5.50%	4.2%	3.0%	1.7%	0.4%

Scenario 2: In Scenario 2, we have increased the allocation to the Infrastructure Sector while allocation to other sectors remains in line with the baseline scenario. Given that Infrastructure has a negative multiplier in the short to medium terms, an increase to this sector decreases growth relative to Scenario 1.

Note: Scenario 2 is not the desired growth option. It has undermined allocation to the sectors of growth (Agriculture, Education, and Health & Social Protection) with relatively higher fiscal multipliers.

Scenario 2:
(Increase allocations to sectors of growth)

	Actual				Projected			
	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP	3.7%	1.3%	1.1%	2.4%	3.1%	3.7%	4.4%	4.9%
Development (Million Afs)	**80,089.48**	**72,648.88**	**82,908.92**	**93,891.61**	**100,170.49**	**112,391.29**	**126,103.01**	**141,487.58**
Security	11.33%	5.35%	1.0%	1.35%	1.12%	0.88%	0.64%	0.41%
Governance and Rule of Law	2.30%	1.34%	1.9%	1.41%	1.21%	1.00%	0.79%	0.59%
Infrastructure	**35.03%**	**30.07%**	**40.9%**	**43.29%**	**45.09%**	**46.90%**	**48.70%**	**50.50%**
Energy	**11%**	**10%**	**19%**	**19%**	**19.63%**	**19.94%**	**20.25%**	**20.56%**
ICT & Urban Development	**5%**	**4%**	**5%**	**6%**	**5.79%**	**5.80%**	**5.81%**	**5.81%**
Transportation	**19%**	**16%**	**17%**	**18%**	**18.41%**	**18.63%**	**18.86%**	**19.08%**
Education	9.40%	11.56%	10.2%	9.12%	9.25%	9.39%	9.53%	9.66%
Health	8.95%	12.49%	13.5%	13.17%	13.21%	13.25%	13.29%	13.33%
Agriculture and Rural Development	27.85%	34.36%	27.4%	25.11%	25.40%	25.69%	25.98%	26.28%
Social Protection	0.94%	0.48%	0.5%	1.05%	1.06%	1.08%	1.09%	1.10%
Economic Governance	4.20%	4.34%	4.5%	5.50%	3.66%	1.81%	-0.03%	-1.87%

Scenario 3: Scenario 3 is our desired growth option. Under this scenario, we have increased the development budget allocation to the Infrastructure Sector, by financing the additional through the private capital investment (we have assumed our additional spending, as well as reforms to promote private sector investment, crowds in and promotes more private investment to the Infrastructure Sector) while allocation to other sectors of growth increases proportionally to the first scenario to sustain growth and to cancel out the effects of negative multipliers of the Infrastructure Sector.

Scenario 3: crowding-in-private investment (Increase allocations to sectors of growth)

	Actual				Projected			
	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP	3.7%	1.3%	1.1%	2.4%	3.1%	4.5%	5.3%	5.9%
Development (Million Afs)	80,089.48	72,648.88	82,908.92	94,069.98	100,137.87	112,244.90	125,733.44	140,750.42
Additional Private Investment (Million Afs)	-	-	-	-	1,840.21	4,202.64	7,196.23	10,949.85
Security	11.33%	5.35%	1.0%	1.35%	1.2%	1.0%	0.8%	0.6%
Governance and Rule of Law	2.30%	1.34%	1.9%	1.41%	1.3%	1.1%	1.0%	0.8%
Infrastructure	**35.03%**	**30.07%**	**40.9%**	**43.29%**	**45.09%**	**46.90%**	**48.70%**	**50.50%**
o/w Private sector				**0.01%**	**1.80%**	**3.61%**	**5.41%**	**7.22%**
Energy	11%	10%	19%	19%	20%	20%	20%	21%
ICT & Urban Development	5%	4%	5%	6%	6%	6%	6%	6%
Transportation	19%	16%	17%	18%	18%	19%	19%	19%
Education	**9.40%**	**11.56%**	**10.2%**	**9.12%**	**9.6%**	**10.1%**	**10.6%**	**11.1%**
Health	**8.95%**	**12.49%**	**13.5%**	**13.17%**	**13.4%**	**13.6%**	**13.8%**	**14.0%**
Agricluture and Rural Development	**27.85%**	**34.36%**	**27.4%**	**25.11%**	**26.1%**	**27.0%**	**28.0%**	**28.9%**
Social Protection	**0.94%**	**0.48%**	**0.5%**	**1.05%**	**1.0%**	**1.0%**	**0.9%**	**0.9%**
Economic Governance	4.20%	4.34%	4.5%	5.50%	4.2%	3.0%	1.7%	0.4%

7.5 Suggestions and concluding remarks:

7.5.1 Short term / 2019 Budget

- In the short term, the government needs to channel more funds to household level to reduce poverty and generate economic growth in the bottom level. Address concerns of the business community, and undertake pro-business reforms.
- Continue on the reform programs of 2018 budget by freeing up resources locked in non-performing programs and projects and reallocate the resources to better spending programs.6.5.2 Medium to Long term / beyond 2019 Budget
- Agreement on implementing Scenario 3 to re-allocate resources to the sectors that generate relatively higher growth.
- Crowding in private sector capital in infrastructure sector through PPPs to attract investments. One of the significant sectors for private investment is energy. It is worth keeping in mind that PPPs present significant risks and difficulties themselves – and we need to ensure we have a good team of lawyers and negotiators for the initial set up. A lot of PPAs (power purchase agreements) have government's pay for a significant amount of generation capacity – without

the immediate need for it. While demand may grow, if it does not grow as quickly as needed, there is a large contingent liability risk to the government having to pay for generated power it cannot sell. So, in utilizing this approach it would be necessary to (a) get in some good international lawyers and negotiators to help negotiate with the firms; and (b) get in a good modeler to develop financial models of the contracts.

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