Public Disclosure Authorized

Public Disclosure Authorized

70851 v1

THE WORLD BANK

Afghanistan in Transition: Looking Beyond 2014

Volume 1: Overview

May 2012

Contents

Contents ..... **i**
Preface ..... **ii**
Acknowledgments ..... **iii**
Overview ..... **iv**
Aid and the challenge of transition iv
International experience and Afghanistan's history vi
Assessing and managing the economic impacts of transition vii
Analyzing the employment and poverty impacts of transition x
Responding to the fiscal impact of declining aid x
Boosting government capacity xv
Delivering services and maintaining infrastructure xvii
Key conclusions and recommendations xix

Figures

Figure 1 Aid trends in Afghanistan (US$ billion and percent) v
Figure 2 External and core budgets, 2010/11 ($ million and percentage of total) v
Figure 3 Real and agricultural GDP growth since 2003/04 (percent) vii
Figure 4 Decomposition of GDP at factor cost by activity and scenario, 2010/11–2018/19 (percent) viii
Figure 5 Core budget projections to 2021/22 (percentage of GDP) xi
Figure 6 Projected expenditure by 2021/22 (percentage of GDP) xii
Figure 7 Operating and total core financing gap (percentage of GDP) xiii
Figure 8 Core operating and development budget execution, 2005/06–2010/11 (percent and US$ million) xv
Figure 9 Share of externally funded staff in eight ministries and one agency, 2011 (percent) xvi

Tables

Table 1 Real macro indicators by simulation, 2010/11–2018/19 (percentage annual growth) ix
Table 2 Budget, donor funding, and O&M needs for five core sectors, 2011/12 ($ million) xviii

Preface

It has been said many times that Afghanistan is at a crossroads. This has never been truer than now. The withdrawal of most international troops by 2014 will have a profound and lasting impact on the country's economic and development fabric. This study explores some of these ramifications.

This report provides the analytical and quantitative underpinnings to the earlier executive summary and PowerPoint presentation on Transition disseminated by the World Bank in November, 2011 prior to the International Conference on Afghanistan in Bonn in December, 2011, and marks the culmination of the first of a set of studies examining different aspects of Transition in Afghanistan. Other studies under preparation for presentation at the Tokyo conference on Afghanistan in July 2012 will look in greater detail at what different levels of aid can buy in terms of development outcomes; From "Transition to Transformation —a more in-depth analysis of Afghanistan's development financing needs through to 2025; and a Resource Corridors strategy, which aims at leveraging the forthcoming mining sector investments to ensure they benefit the broader economy.

This first report is intended to be comprehensive, so it also discusses the broader historical and political economy context of development in the country, and how Afghanistan compares with other countries that have undergone their own transitions over the past 30 years. While many features of the Afghan story and the current challenges that Afghanistan faces are unique, other countries share different elements of that story—and may offer lessons on how to move away from violence and establish an enduring and stable transition to a better future.

Finally, it is well known that collecting reliable data on Afghanistan is extremely difficult. Moreover, much of the information that is available is subject to large margins of uncertainty, as well as often problems of incompleteness, incomparability, etc. Data are frequently changed and updated. Collecting and triangulating data on issues such as jobs, aid inflows, and security costs has posed a major challenge for the team. This report is based on data collected from various sources in 2011, and its analysis and findings therefore comprise the team's considered assessment using the best available information available by the end of that year. In addition, projections of future trends in Afghanistan inevitably are subject to uncertainty and reflect any weaknesses in the underlying data. Thus the report's projections should be seen as subject to further adjustments and improvements as better and more recent information become available. For example, a lower targeted level for the Afghan National Security Forces (ANSF) is currently being discussed by NATO and may be announced at the NATO Security Conference in Chicago in May 2012, but this should not change one of the main conclusions of this report that they will still need to be mostly covered by international funding for many years. The subsequent reports for Tokyo will update some of the data based on more recently collected information in 2012, and some of the projections may be refined accordingly. Whenever we use data, we have been careful to specify its source.

This report is presented in two volumes. Volume I is a stand-alone Overview which highlights the main findings, projections, and recommendations of the study. Volume II consists of five chapters presenting the detailed empirical background, analytical findings, projections, and recommendations of the study, along with a concluding chapter and three technical Appendices.

Acknowledgments

The report forms part of a broader examination by the World Bank of transition in Afghanistan. The team wishes to thank the Government of Afghanistan for its support to this analytical work. Partial funding for this study was provided by the U.K. Department for International Development and Australian Agency for International Development, whose contributions are gratefully acknowledged. The report was edited by Communications Development.

The study is the product of the combined efforts of a core team led by Richard Hogg (Governance adviser) and including Claudia Nassif (senior country economist), Camilo Gomez Osorio (economist), and Andrew Beath (economist) in Kabul, and William Byrd (consultant) in Washington, DC. Valuable contributions were made by: Dean Mitchell Jolliffe, Silvia Redaelli, Susanna Gable, Hans Lofgren, Richard Bontjer, Richard Scarth, Dallas Newby, Sakuntala Akmeemana, Kenneth Anye, Fotini Christia, Kinga Krisko, Gary Milante, Dhanie Nugroho, Khaled Payenda, Maha Ahmed ,Satyendra Prasad, Samina Bhatia, Gretchen Biery, Alice Burt and Astri Suhrke. The team benefited from comments by Brian Pinto, Aart Kraay, Shanta Devarajan, Hugh Riddell, Alexandre Marc, Graham Teskey and Nick Manning, who carefully reviewed the work at several stages during the preparation.

The team has benefited from the support of the Afghanistan Country Management Unit in Kabul, Nicholas Krafft (former Country Director), Josephine Bassinette (acting Country Director), and the guidance provided by the South Asia Region PREM Management team, consisting of Ernesto May, Joel Hellman, Tony Verheijen and Vinaya Swaroop. The work was refined over many presentations to the government and donors in 2011. To this end we would like to thank the Minister of Finance, Dr. Omar Zakhilwal and the head of the Afghanistan Transition Office, Dr. Ashraf Ghani. A PowerPoint and short executive summary on the findings of the study were formally presented at the International Conference on Afghanistan in Bonn in December 2011.

Authors of the individual chapters include William Byrd: chapter 1 “Lessons from History—Afghanistan and Elsewhere”; Claudia Nassif: chapter 2 “The Economic Impacts of Transition”; Camilo Gomez Osorio: chapter 3 “Managing the Fiscal Challenge”; Richard Hogg: chapter 4 “Building Government Capacity”; Andrew Beath and William Byrd: chapter 5 “Delivering Services and Maintaining Infrastructure.” Finally, the team would like to thank the international donor community in Kabul and ISAF as well as sector colleagues in the Kabul World Bank office for providing useful comments and valuable data at various stages.

Overview

Aid and the challenge of transition

Afghanistan will experience a major security and development transition over the next three years. At the Kabul and Lisbon Conferences in 2010, NATO and the Afghan government agreed that full responsibility for security would be handed over to the Afghan National Security Forces (ANSF) by the end of 2014. The country now faces the prospects of a drawdown of most international military forces over the coming several years—and an expected accompanying decline in civilian aid as international attention shifts elsewhere and aid budgets in many Organization for Economic Co-operation and Development (OECD) countries come under increasing fiscal pressure. The decline in external assistance will have widespread ramifications for Afghanistan's political and economic landscape well beyond 2014.

Development progress since 2001 has been mixed. Some major achievements have been recorded, such as rapid economic growth (with large fluctuations), relatively low inflation (after hyperinflation in the 1990s), better public financial management, and gains in basic health and education. Key social indicators, including life expectancy and maternal mortality, have improved markedly (admittedly from an extremely low base), and women are participating more in the economy. Yet in other respects, particularly governance and institution building, the country has fared less well, and many indicators have worsened in recent years. Afghanistan remains one of the world's least developed countries, with a per capita gross domestic product (GDP) of only $528 in 2010/11. More than a third of the population live below the poverty line, more than half are vulnerable and at serious risk of falling into poverty, and three-quarters are illiterate.

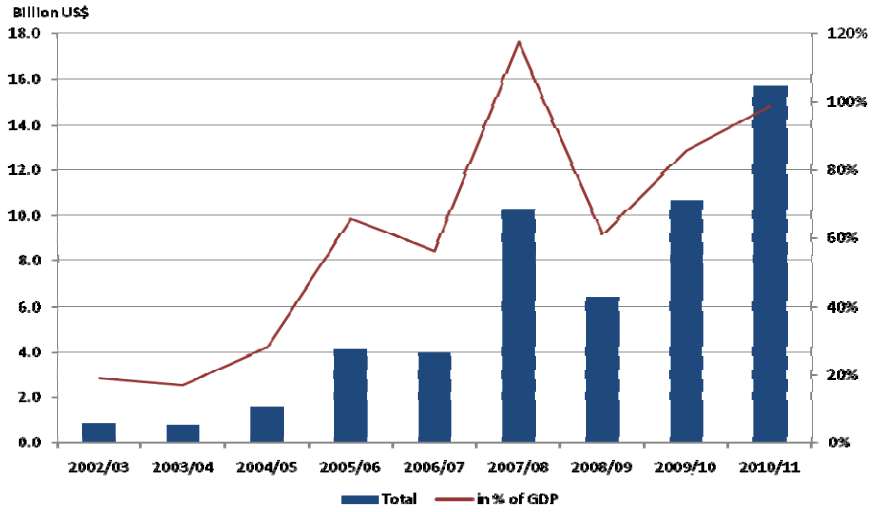
The large aid inflows that have benefited Afghanistan have also brought problems. Aid has underpinned much of the progress since 2001—including that in key services, infrastructure, and government administration—but it has also been linked to corruption, fragmented and parallel delivery systems, poor aid effectiveness, and weakened governance. Reflecting steep increases after 2005, civilian aid and spending on the ANSF in 2010/11 (together, "aid"), came to an estimated $15.7 billion—about the same as GDP (figure 1). While the bulk was security spending, civilian aid is estimated at more than $6 billion a year, or nearly 40 percent of GDP. Such aid dependency is almost unique (only a few smaller entities, such as Liberia and the West Bank and Gaza, have on occasion received more aid per capita).

Most aid is directly delivered by donors outside the government budget. In 2010/11, $13.8 billion (88 percent) was executed by donors and their implementing partners through the "external budget," and only $1.9 billion (12 percent) was on budget, through the "core budget" (figure 2). The external budget is financed from sources ranging from bilateral development agencies to military contracts. The core budget is split between the operating and development budgets. The operating budget consists largely of the government wage bill plus nonwage operation and maintenance (O&M) costs, funded by domestic revenue, multi-donor trust funds, and donors' budget support. The development budget consists of donor-financed projects and programs executed by the government, plus a small portion funded by budget support and domestic revenue.[1] Substantial recurrent costs are included in the development budget, under national programs such as the Basic Package of Health Services. Negligible

[1] In 2010/11 only 15 percent of the core development budget was domestically financed.

10 years ago, the core development budget now executes some $1 billion of development activities yearly.

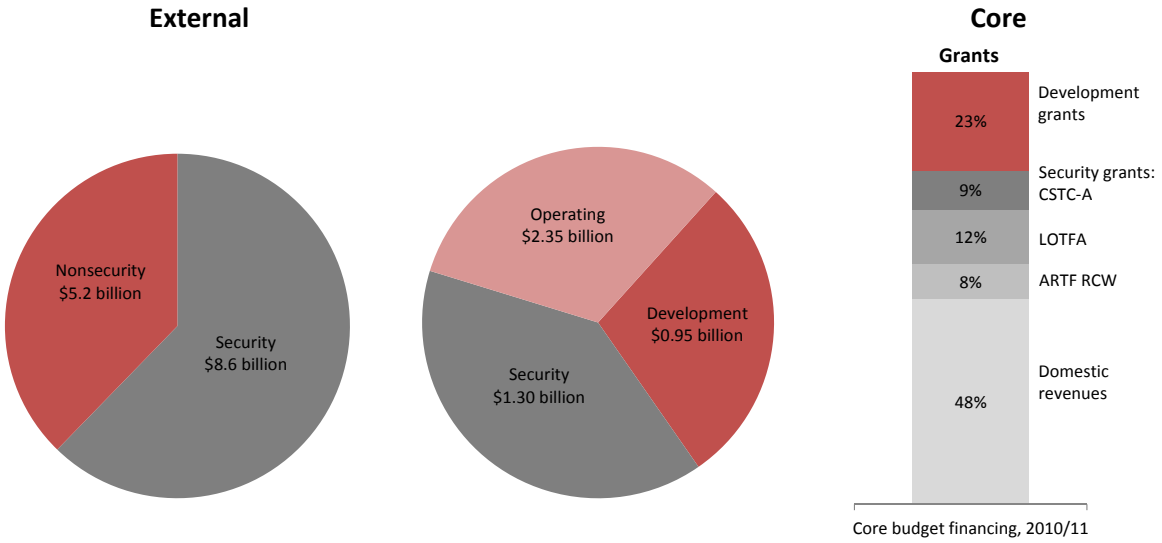
Figure 1 Aid trends in Afghanistan (US$ billion and percent)



Source: World Bank staff calculations.

Note: This figure excludes spending on international military forces. For example, U.S. spending for its Afghanistan mission was estimated at $118.6 billion in U.S. fiscal year 2010/11 alone, with a cumulative figure possibly as high as $444 billion.

Figure 2 External and core budgets, 2010/11 (US$ million and percentage of total)



Source: World Bank staff calculations.

Despite the large volume of aid, most international spending "on" Afghanistan is not spent "in" Afghanistan, as it leaves the economy through imports, expatriated profits of contractors, and outward remittances. The local content of external budget aid is estimated at only 10–25 percent, compared with around 70–95 percent for on-budget aid. With the bulk of aid (88 percent) going through the external budget, its local economic impact is limited.

Other countries' experience shows that the impact of large aid reductions on economic growth may be less than expected. Falling aid flows in Afghanistan will have the most impact on public spending—through both the core and the external budgets—because maintaining present levels of expenditure will be fiscally unsustainable for Afghanistan once donor funds decline. But if delivered more effectively, lower aid could lead to positive outcomes over the longer term. The main issue is how to manage this change, mitigate impacts, and put aid and spending on a more sustainable path. International experience and Afghanistan's history after the Soviet military withdrawal in 1989 demonstrate that violent fluctuations in aid—especially cutoffs—can be damaging and destabilizing.

This study suggests options for the government and the international donor community to manage and mitigate the adverse impacts of transition—not only declining aid—while exploiting the opportunities to improve aid effectiveness.

International experience and Afghanistan's history

Themes from international experience as well as Afghanistan's history illuminate transition issues. Born in the mid-18th century, Afghanistan has a longer history as a distinct political entity than most of its neighbors, and has always been a unitary state, but with traditional and informal local governance. It has also frequently relied on foreign financing to run the state and make public investments. Strikingly, there has never been a serious separatist movement in the country. Afghanistan enjoyed relative peace and stability from the 1930s to the 1970s, but after a Communist coup in 1978 and the Soviet occupation at the end of 1979, it suffered a quarter-century of conflict.

Afghanistan faces its transition with strengths and weaknesses. Strengths include rapid economic growth, low inflation, robust public financial management, and several effective national programs. The priority now is, at a minimum, to protect gains and if possible make further progress. After conflict, higher economic growth in a country is associated with a successful transition, and so a key question is whether Afghanistan can maintain adequate growth—that generates jobs—in a declining aid environment, and quite possibly amid continuing conflict and insecurity in some areas.

Weaknesses include the fact that Afghanistan is likely to continue trailing behind comparable countries in social indicators for decades. According to indicators such as political stability and consolidation, rule of law, and government effectiveness, Afghanistan's recent performance has been on a downward trend.

Worldwide, political consolidation and political stability are critical for a successful transition. In five countries that transitioned from conflict to stability and development—Cambodia, Mozambique, Rwanda, South Africa, and Vietnam—a dominant party emerged and reinvented itself as inclusive and resilient. In Afghanistan, effective political leadership, too, will be crucial: it has been critical in successful post-conflict transitions elsewhere, outweighing the role of international interventions. But Afghanistan has a low and declining rating for political stability on the Worldwide Governance Indicators, and faces clear challenges before the next election cycle in 2014/15.

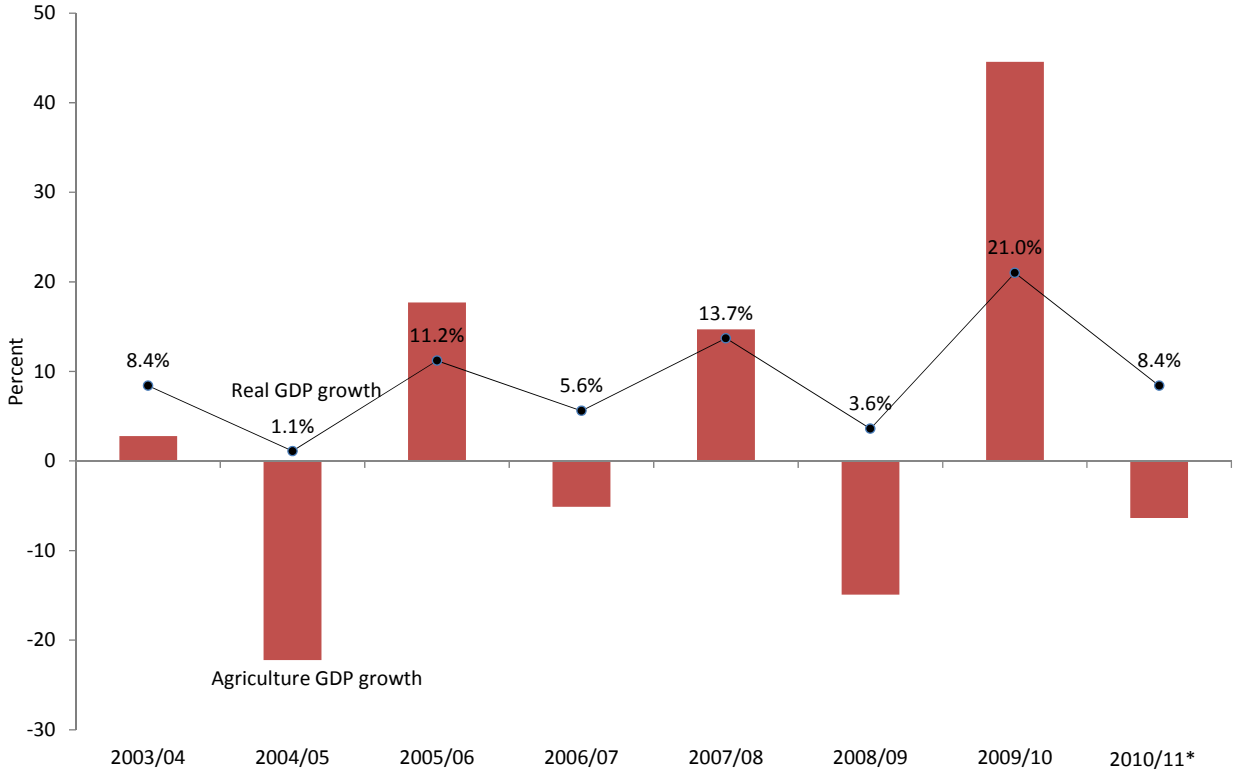
Aid inflows—in particular those focused on stabilization in more insecure and conflict-affected provinces—have become a source of rents, patronage, and political power, sometimes inadvertently exacerbating conflicts and grievances among different groups. So a decline in aid and international military spending—thus fewer resources to contest—may benefit the longer term political economy. But in the short term, the dislocations and adaptations of different interest groups could be disruptive.

Sudden sharp drops in external assistance can be particularly destabilizing by changing perceptions of the government's strength and encouraging political actors and armed groups to challenge the state's authority. Finally, as aid resources decline, there is a risk that reliance on the opium economy and other illicit activities may increase. Pressures are therefore likely to grow on (currently less vulnerable) public funds, such as domestic revenue and budget spending, reinforcing the need to maintain and strengthen public financial management systems and controls—and generally to support a robust Afghan budget process, including more on-budget and less fragmented aid.

Assessing and managing the economic impacts of transition

Afghanistan's economy has grown rapidly since 2001: real GDP has increased at 9 percent a year, though with wide year-to-year fluctuations largely due to agriculture's volatility (figure 3). Recovery from more than two decades of conflict and destruction, which left Afghanistan one of the poorest countries in the world, as well as a severe drought in the late 1990s, was a dominant factor in the initial post-2001 years. Growth has remained high in subsequent years—higher than in virtually any other low-income post-conflict country.

Figure 3 Real and agricultural GDP growth since 2003/04 (percent)



Source: World Bank staff calculations.

Note: Excluding opium production.

Services have contributed most strongly—and steadily—to growth, driven largely by consumption fueled by extraordinarily high aid in recent years. For services, communications and transport, followed by government services, have been the most important sources of growth, and for industry,

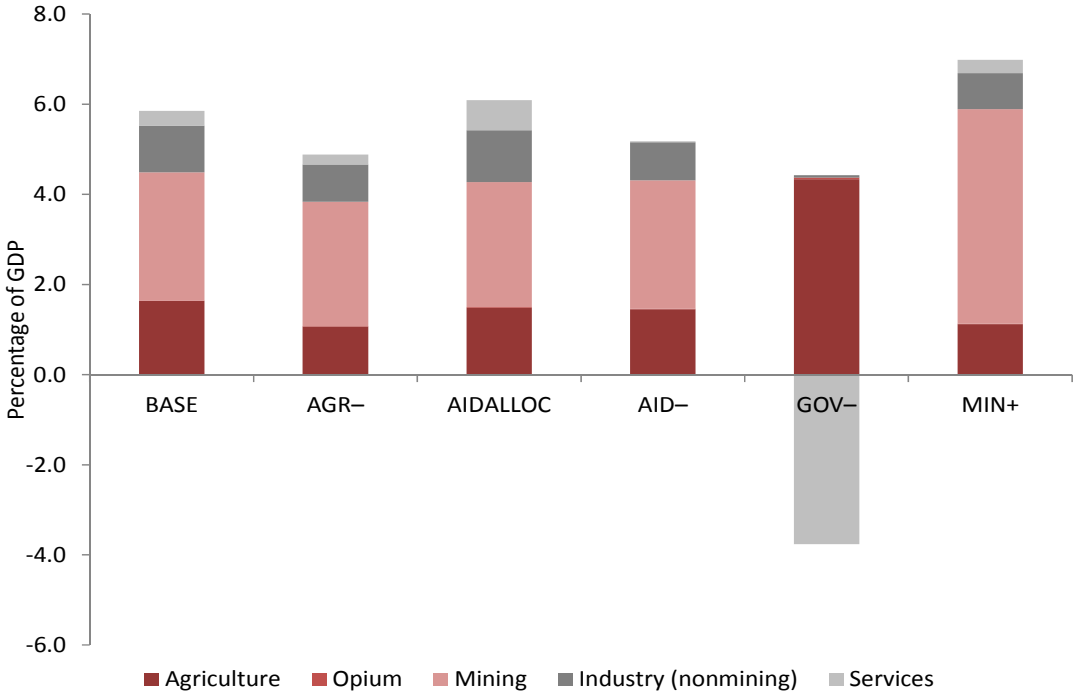
construction has been the main source. Mining's contribution has been marginal, but it has good potential. Agriculture remains important for its continued large share in the economy and for its provision of livelihoods to the majority of the rural population. Private consumption has contributed to the growth of aggregate demand in every year since 2005/06, with private investment playing a relatively small role.

Through 2025 growth is expected to be much slower, according to simulations of the transition's impact with a general equilibrium model (for more on the model visit *www.worldbank.org/mams*). The model uses projections based on different assumptions including security, aid volumes and modalities, sources of growth, and the investment climate (Appendix 1). Based on the model, six scenarios are projected (shown in summary in figure 4 and table 1).

The most optimistic scenario assumes the ambitious development of 11 mines in addition to the two being started at Aynak (copper) and Hajigak (iron) and further improvements in the investment climate and infrastructure development. In this scenario (MIN+ in figure 4 and table 1) average annual growth is 7 percent in 2011–18.

Much more likely, however, is the baseline projection in the BASE scenario, which has real GDP growth falling to around 6 percent a year during 2011–18 and further to 5 percent a year over the longer term. This projection assumes that the Aynak and Hajigak mines produce as expected, the investment climate improves moderately, agricultural productivity increases, and aid declines only gradually, to 23 percent of GDP by 2018 and 10 percent by 2025. Supporting this relatively favorable outlook, analysis of the financial sector and real estate market indicate that any further financial sector effects (following the Kabul Bank crisis of 2010), as well as expected declines in real estate prices during transition, are unlikely to have a major adverse impact on the economy.

Figure 4 Decomposition of growth in GDP at factor cost by activity and scenario, 2010/11–2018/19 (percent)



Source: World Bank staff calculations

Even these two more optimistic scenarios point to slower gains in average per capita incomes than in the last decade, continued high rates of underemployment (see next section), and limited progress in reducing poverty. Given rapid population growth (estimated at 2.8 percent a year), only economic growth somewhere around these two scenarios would enable the country to substantially reduce poverty and increase average per capita incomes in a generation. For example, with real GDP growth of 6 percent a year (the BASE scenario through 2018 but below that beyond 2018), average per capita incomes would double in 22 years. This underlines the importance of sustaining robust economic growth over the long run—a difficult challenge.

Rapidly falling aid would further reduce growth. The AID- scenario, reflecting lower consumption and investment as a result of a rapid decline in aid to 14 percent by 2018 and 10 percent by 2025, would reduce growth to 5.2 percent a year during 2011–18 (table 1). By contrast, putting 50 percent of total aid on budget (which raises its economic impact) and fully executing it immediately, (the AIDALLOC scenario), could lead to a rapid growth spurt as the local content of aid rises. But in reality, absorptive capacity constraints would most likely dampen the projected growth spurt greatly.

Table 1 Real macro indicators by simulation, 2010/11–2018/19 (percentage annual growth)

	BASE	AGR–	AIDALLOC	AID–	GOV–	MIN+
GDP at factor cost	**5.9**	**4.9**	**6.1**	**5.2**	**0.7**	**7.0**
Consumption						
Private	5.7	4.6	6.0	5.0	1.8	5.9
Donors	–14.1	–13.9	–21.3	–23.5	–56.7	–14.1
Government	1.6	2.0	7.4	1.6	–4.9	2.6
Fixed investment						
Private	3.5	2.4	4.3	2.8	–14.7	10.3
Donors	–10.2	–10.1	–17.7	–16.0	–63.3	–10.2
Government	1.3	1.2	9.8	1.0	–7.9	2.6
Exports	10.1	8.9	9.2	9.6	4.3	12.5
Imports	–2.2	–2.9	–2.8	–4.3	–10.7	–1.2
Absorption	**0.1**	**–0.7**	**0.3**	**–1.4**	**–6.4**	**0.7**
Real exchange rate (index)	**2.8**	**3.4**	**2.3**	**2.9**	**1.8**	**2.8**

Source: World Bank staff calculations.

Growth could turn negative if security and governance worsen significantly. Failure of the two major mining investments to materialize would result in 2 percentage points slower annual GDP growth. Applying historical rather than more optimistic projected growth rates for agriculture (the AGR- scenario) would reduce overall growth by 1–2 percentage points a year. Combining these changes with rapidly declining aid, zero total factor productivity growth, and faster depreciation of capital—as might be expected with deteriorating security and governance—would cause economic contraction of about 2 percent a year (the GOV-scenario), implying heavily declining average per capita GDP and incomes. In a worst-case scenario of worsening violence or outbreak of civil war (as in Afghanistan in the 1990s), the resulting economic contraction would be even more severe.

Thus transition presents serious threats to growth and economic stability, but these do not directly stem from declining aid itself. Key economic vulnerabilities are to risks of drought (which would adversely affect volatile agricultural production) and of falling business confidence as a result of worsening insecurity, corruption, governance, and uncertainty over Afghanistan's political future.

Donors can mitigate the adverse economic impacts of transition. They can program gradual reductions in aid and international military spending rather than an abrupt decline in asssistance. They can also increase the domestic economic impact of aid by channeling a larger proportion of aid through the Afghan government budget and by increasing domestic contracting. These would all help maintain

growth. The government can encourage such trends by further strengthening and improving public financial management and the budget process, enforcing sound procurement procedures (using existing legislation), and making stronger efforts to control corruption. Both sides can work together to foster mining development and resource corridors, and develop agriculture to help stabilize its output.

Analyzing the employment and poverty impacts of transition

Transition is likely to worsen the employment picture, not least because activities heavily affected by declining financial inflows (services and construction) are relatively labor intensive, whereas one of the expected new growth drivers (mining) is much less so. Based on limited available data unemployment and underemployment are estimated at 8 percent and 48 percent respectively, even with current rapid economic growth. Weakening labor markets during the transition could worsen the jobs outlook, affecting household incomes and possibly other aspects of the transition.

The direct employment impact of aid, while significant, does not seem to be excessively large. An estimated 6–10 percent of the working population has benefited from aid-financed job opportunities; most of them short term (less than six months). A $500 million decline in aid delivered outside Afghanistan's budget could directly affect 11,000–18,000 six-month jobs. It may also worsen underemployment and reduce household incomes (because of fewer casual labor opportunities and lower pay for skilled employees) rather than lead to much higher open unemployment. The impact will be greater in conflict-affected provinces (which have received much more aid per capita) and in urban centers. A gradual decline in aid would mute the employment impact, allowing labor markets to adjust and the security, mining, and civilian public sectors to grow and partly offset aid-related job losses.

Slower economic growth and the associated employment effects are expected to increase poverty, but it appears that aid reductions would not markedly affect it. This is mainly because higher donor spending—particularly the massive stabilization-oriented expenditures in some of the more insecure and conflict-affected provinces—appears to have had only a modest impact on poverty. This impact was identified through a comparison of three groups of provinces, grouped by the sum of per capita government and donor spending in 2007/08: low (< $100), medium ($100–$200), and high (> $200). Comparing changes between 2005 and 2008 (the only years with comparable household survey data) in the medium- and high-spending provinces with changes in the low-spending provinces showed that the high-spending group registered a very modest gain in monthly per capita food consumption: Af 110, equivalent to about $2.20 only.

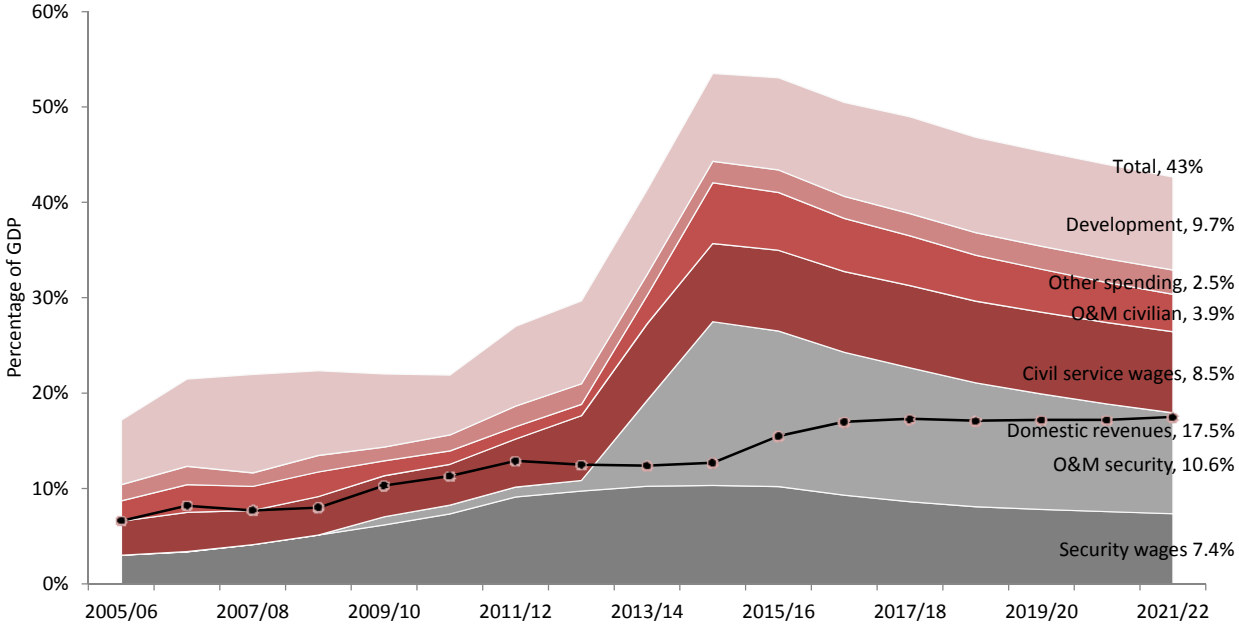
Responding to the fiscal impact of declining aid

The fiscal impact of the transition will be very large, requiring priority attention by both the Afghan government and the international community. Afghanistan's fiscal and budgetary performance over the past decade has been encouraging, laying a foundation for future progress. Revenue grew by 20 percent a year in the four years to 2010/11 and reached 11 percent of GDP, up from 3 percent in 2002/03. Sound public financial management systems have been introduced and strengthened, and fiscal discipline has been maintained, including for the civilian wage bill and staffing.

In the future, Afghanistan will need to continue to mobilize domestic revenue and further increase the revenue-to-GDP ratio—projected to reach 17.5 percent of GDP in 2021/22. This outlook assumes that the Aynak copper mine and the Hajigak iron mine start to produce in 2016/17 as expected under current plans (and under a BASE scenario of gradually declining aid). In an international perspective, this projected revenue growth—rising by more than half a percentage point of GDP a year over an extended period—would be impressive and above that of most other countries.

The main emerging fiscal management issues are on the expenditure side, with total government spending projected to reach 43 percent of GDP 10 years from now and even higher during many of the intervening years (figure 5). The fiscal situation will be rendered unsustainable largely by rising security spending for O&M and wages for the army and police. Non-security spending also will increase as additional O&M liabilities associated with the handover of donor-built assets are taken on, and with a rising government payroll, as the civil service pay and grading (P&G) reform is completed and some additional expenditure is incurred to develop a senior civil service cadre at higher wages. Security spending is projected at more than 17.5 percent of GDP in 2021/22 (about equal to the total projected domestic revenue in that year), the civilian wage bill at 9 percent, the civilian nonwage O&M bill at 4 percent, the core development budget at 10 percent, and other spending at 2.5 percent (figure 6).

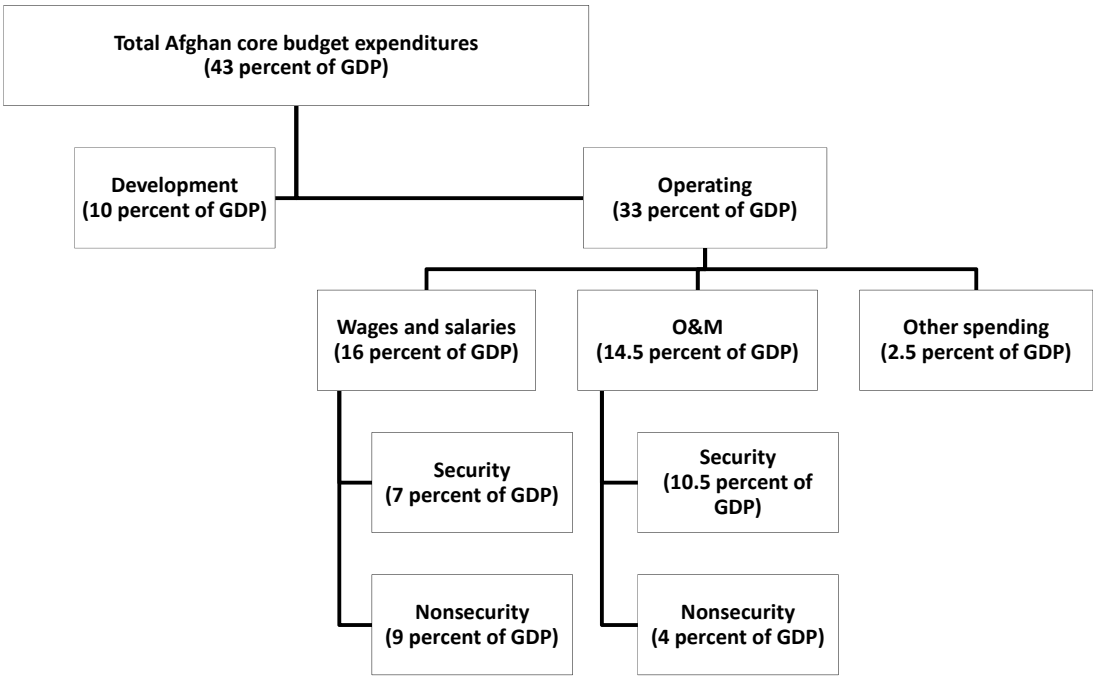
Figure 5 Core budget projections to 2021/22 (percentage of GDP)



Source: Ministry of Finance and World Bank staff calculations.

Note: Other spending includes pensions, transfers, interest payments, and liabilities associated with Kabul Bank.

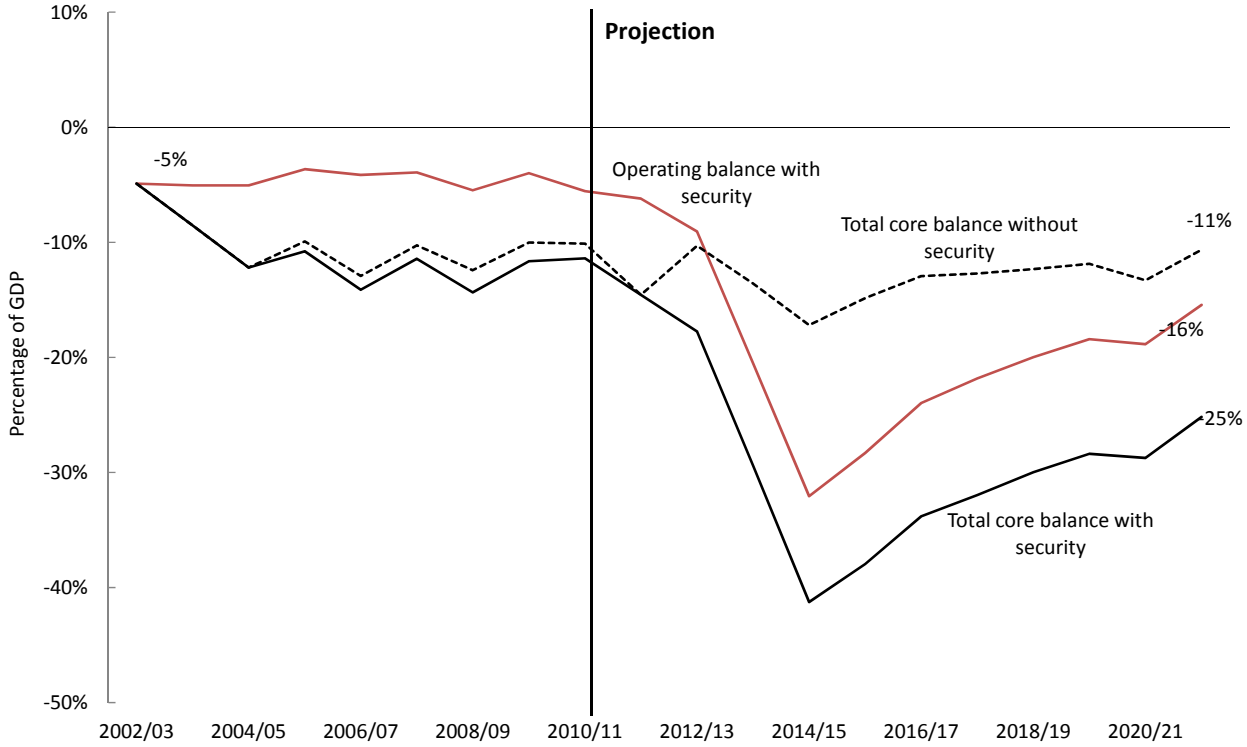
Figure 6 Projected expenditure by 2021/22 (percentage of GDP)



Source: World Bank staff calculations.
Note: Other spending includes pensions, transfers, interest payments, and liabilities associated with Kabul Bank.

The overall financing gap (before donor grants) is projected to increase sharply in the next several years and then stay very high for the rest of the decade. After peaking at more than 40 percent of GDP in 2014/15, the financing gap is projected to gradually decline when expected mining revenues materialize, reaching around 25 percent of GDP in 2021/22 (figure 7). This represents $7.3 billion in 2011 prices by 2021/22 and roughly $7.8 billion annually on average from 2014/15 to 2021/22. If domestic funding for security remains at 3 percent of GDP, the sector would account for somewhat more than half the overall financing gap (equivalent to 14.5 percent of GDP) and the civilian budget the rest (11 percent of GDP). While such large fiscal gaps will not materialize as actual fiscal deficits since they would be impossible for Afghanistan to finance, the projections demonstrate the seriousness of the country's fiscal dilemma, and the need for continuing very sizable aid inflows.

Figure 7 Operating and total core financing gap (percentage of GDP)



Source: Ministry of Finance and World Bank staff calculations.

Note: Projections assume that domestic revenue equivalent to 3 percent of GDP is devoted to security costs, and the rest to civilian expenditure.

Strong measures will be needed to close this enormous gap, and even then Afghanistan's fiscal situation will remain fragile and vulnerable to shock. Several factors loom large. First, if the size and cost of Afghan security forces remain at or close to recently targeted levels (352,000 for the police and army at an estimated sustainment cost of $5 billion a year for wages and O&M of equipment), Afghanistan will have to rely on continuing international funding to pay most security costs (salary and non-salary). Second, the share of aid channeled through the government budget will need to rise sharply. All aid projected in 2021/22 (equivalent to 25 percent of GDP, or $7.3 billion in 2011 prices under the BASE scenario) would need to be on budget or to pay for security expenditure (if some of the latter expenditures remain off-budget), and even then total aid under the gradual declining aid scenario would be too small to fully cover the gap.

Finally, strict priorities will be required to contain non-security budget spending within a fiscally manageable resource envelope—civilian aid, for example, will need to be spent much more selectively for development and O&M. Various combinations of aid and domestic resources for different spending categories are possible. But a reasonable approach could be for domestic revenue to cover the civilian operating budget and part of security costs at the current 3 percent of GDP. Donors would finance the remaining bulk of security costs plus a more highly prioritized core development budget. Low-income countries receive, on average, around 9 percent of gross national income in non-security development assistance—Afghanistan would require close to three times this level for combined civilian and security assistance in 2021/22.

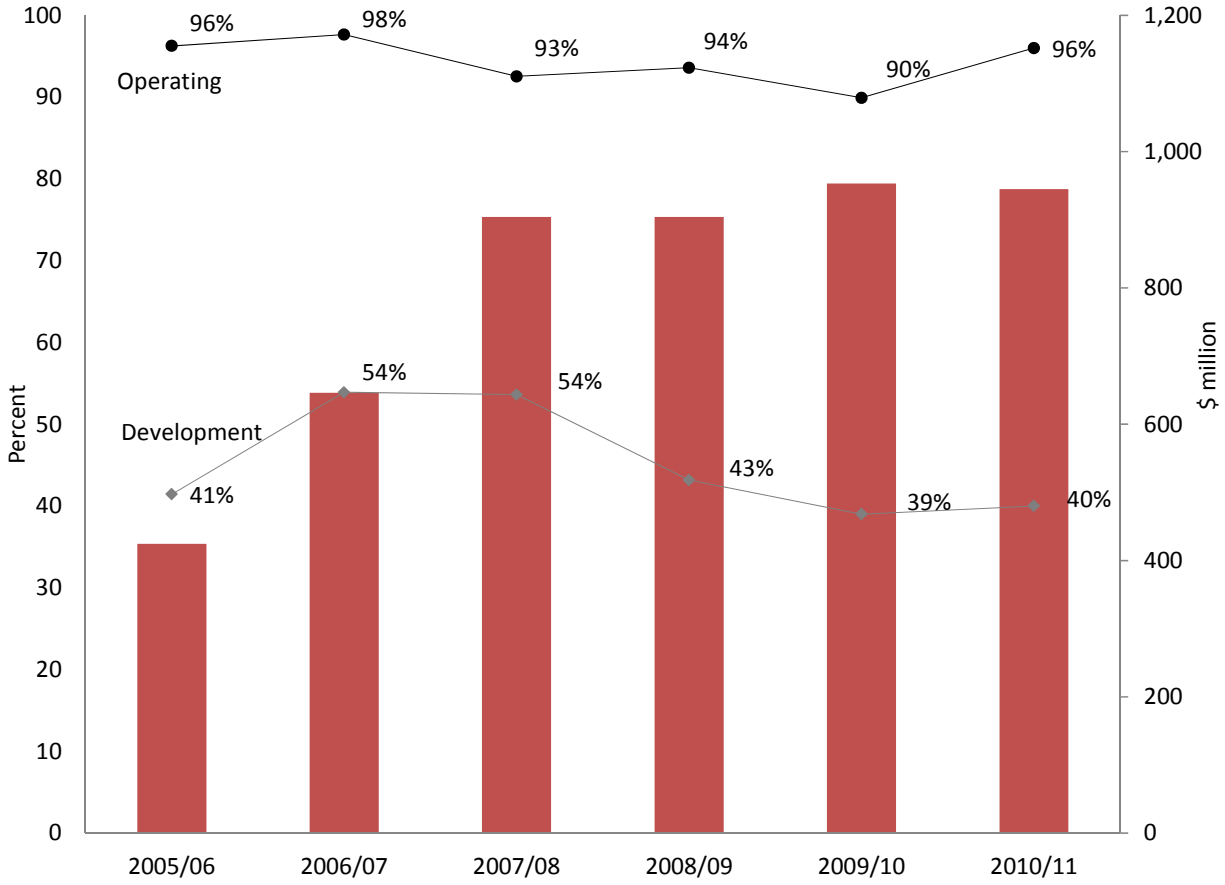
Less aid than envisaged under the BASE scenario would force the government to make even more difficult trade-offs between security and civilian spending. For example, if aid is 10 percent of GDP lower

than under the gradual decline scenario—roughly along the lines of the rapidly declining aid scenario—and security is protected at the currently targeted size and cost, there would be no room at all for development spending, and civilian O&M would most likely be squeezed as well. But if the civilian budget is protected, security could only be funded at less than half the currently targeted level. If aid cuts are even deeper the trade-offs would become all the more stark and damaging. It will be extremely important for the government, working closely with donors, to ensure that the core civilian budget does not become a casualty of high security costs and inadequate aid.

Increasing on-budget aid and managing O&M through government systems would greatly improve aid effectiveness, but the government will need to overcome serious absorptive capacity constraints. Core development spending, after more than doubling in absolute terms between 2005/06 and 2007/08, has since flattened out at around $1 billion in annual disbursements, with execution rates declining to the 40 percent range (figure 8). This is mainly due to unrealistically ambitious budget formulation, large budget carryovers from previous years, and rigidities resulting from earmarked donor funding, but also to deteriorating security in parts of the country and limited government capacity to implement projects on time.

While execution of the operating budget has been historically high (most recently 96 percent), Afghanistan does not have the capacity to handle very large O&M expenditure. O&M accounts for only about $335 million, or 10 percent of total core expenditure. But future requirements are expected to rise to $1.3 billion annually for civilian O&M alone and $4.8 billion in total, including security O&M. This will require developing an O&M policy and guidelines to line ministries on how to budget and allocate O&M. Because problems remain with efficiently allocating funds from the center to the provinces and building government capacity at these levels, investing in line ministry capacity for budget management is a priority.

Figure 8 Core operating and development budget execution, 2005/06–2010/11 (percent and US$ million)



Source: Ministry of Finance.

Note: Budget execution relates to the amount of the approved budget that is actually disbursed.

Boosting government capacity

Conflict during 1978–2001 had a highly destructive impact on the civil service and human capacity. Donors, needing to make an immediate impact through investments and service delivery, launched a range of schemes to provide technical assistance and expand capacity. But those schemes have largely substituted for—rather than built—regular civil service capacity, relying on foreign expertise and, increasingly, on Afghan externally funded staff (EFS), who receive higher salaries than regular civil servants, or top-ups through various government or donor-funded initiatives. Most of these capacity-substituting schemes involve funding channeled outside the budget, fragmenting efforts and reducing transparency about the real cost of running the government and delivering services.

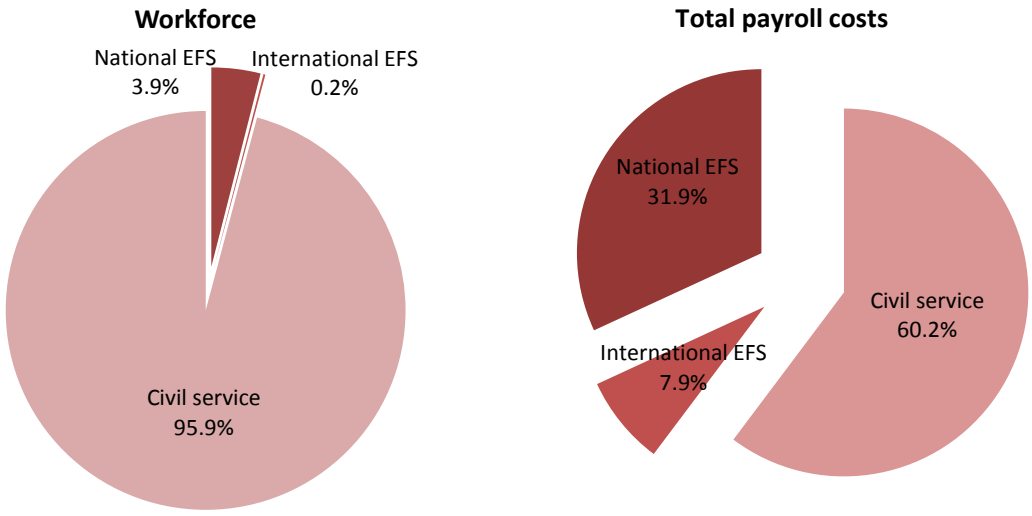
Growth of the civil service over the past decade has been modest. With teachers accounting for much of the increase, the service grew from 327,000 in 2004 to 355,000 in 2011, which is comparatively small by international and regional standards. Early attempts at institutional development achieved modest but uneven progress. And the ad hoc and ministry-by-ministry process left civil servants in a variety of

remuneration schemes and accomplished little institutional restructuring or core capacity development in the regular civil service.

Since 2008, civil service P&G reform has been the centerpiece of public administration reforms. The aim is to bring more coherence to ministries' organizational and staffing structures and their processes in order to improve effectiveness, decompress the old pay scales where all civil servants were paid a flat amount dominated by allowances, and shift from a closed, career-based civil service to an open, merit-based service where all posts are subject to open competition. More than 160,000 civil servants, including teachers, have completed P&G reform; it is planned that all civil servants will receive P&G salaries by 2014. But these reforms have not addressed the challenge posed by much higher salaries in the externally funded "second civil service," so the government has been unable to transfer such skills into the regular civil service.

A decade on from 2001, donors continue to fund large numbers of expensive technical assistance personnel, or international EFS. Estimates of the annual donor price tag in the past decade range from $250 million to well over $1 billion. Much of the cost is for international expertise deployed outside the government. The cost of EFS working in government (nearly all Afghans) is much more modest, though still well beyond the government's ability to pay from its own budget. The Ministry of Finance has estimated that as of 2010 about 7,000 Afghan consultants work in non-security ministries and agencies. A 2011 World Bank survey of eight key ministries and one agency found just under 5,000 EFS working in these entities, all but 200 of them Afghans, estimated to cost $125 million a year (figure 9). National EFS are remunerated at widely varying, often ad hoc rates.

Figure 9 Share of externally funded staff in eight ministries and one agency, 2011 (percent)



Source: World Bank staff calculations.

Afghan EFS perform crucial functions of public administration and service delivery. They are recruited by line ministries to work on donor-funded projects. Others are put in civil servant positions at senior grades, for example through the Management Capacity Program supported by the Afghanistan Reconstruction Trust Fund. Others work in line ministries as technical advisers. Reliance on EFS varies greatly among ministries, related to differing modes of service delivery and program management.

Transition is expected to reduce the donor funding available for EFS, but it also offers an opportunity for the government to review and change its dependency on technical assistance staff. Afghanistan is an

example of heavy reliance on outside capacity to deliver services. Core capacity development is limited, reflecting the large share of donor assistance delivered outside the budget. Even assistance delivered through the budget has often taken the form of ring-fenced projects managed by project implementation units outside the formal civil service structure.

The government needs to use the opportunity of the transition over the next three years to accelerate the transfer of capacity into the core civil service, develop delivery, policy, and management capacity in government institutions, and align that capacity with its more limited resources. These steps require a series of interlinked government interventions: confirming policy choices on delivery modalities that take account of even more constrained resources and possibly heightened insecurity; providing reasonable medium-term financing to front-line ministries to improve ministry efficiency and performance; and developing an incentive and governance environment that makes the civil service attractive as long-term employment for Afghans who have acquired high skills in donor programs.

Worsening insecurity—and the associated risk of more highly skilled members of the second civil service leaving the country—would pose a danger to service delivery. The government needs to work to ensure the confidence of these skilled Afghans to stay.

Delivering services and maintaining infrastructure

As fiscal pressures intensify, the government, with support of the international community, should prioritize core service delivery and infrastructure maintenance to protect development gains. Improvements in service delivery over the last decade have raised citizen expectations, and it will be important not to dash them and risk undermining citizen faith in government. A recent World Bank study of service delivery in three districts (Balkh, Bamiyan, and Laghman provinces)[2] revealed encouraging levels of satisfaction with health and education services provided there, though they were differentiated by proximity to services and the level of services available. These findings indicate that citizens are becoming more sophisticated about the level and quality of services they expect from the government.

As aid declines and if, as expected, more money is shifted on budget, the government will have to assume greater responsibility for maintaining key infrastructure through increased O&M (currently funded largely through the development and external budgets). The cost of delivering a core set of public services and operating and maintaining key infrastructure (basic education, primary health care, rural livelihoods, roads, and electricity networks) should be fiscally affordable, provided that the overall financing gap is closed.

Table 2 shows 2011/12 budget allocations for these five core sectors, broken down between salaries, nonwage O&M, and development, along with donor project spending and estimated requirements for O&M. Current O&M funding for sectors such as education and roads falls well below needs, while all sectors, to different degrees, are dependent on donors' project funding. Ensuring the continued provision of these services beyond transition will require some tough choices on assets and services that the government can no longer afford to maintain or deliver.

[2] *Strengthening District Level Accountability and Service Delivery in Afghanistan: Mapping of Fund Flows in three Pilot Districts* (prepared for the World Bank by Altai Consulting, 2011).

Table 2 Budget, donor funding, and O&M needs for five core sectors, 2011/12 ($ million)

	Education	Health	Rural	Transport	Energy
Core budget	**636**	**201**	**432**	**345**	**182**
Salaries	428	37	27	10	21
O&M	38	19	8	28	39
Development	168	144	397	306	121
Donor projects	**153**	**124**	**358**	**253**	**89**
Required O&M	**170**	**45**	**11**	**290**	**194**

Source: World Bank staff calculations.

Development spending represents only 26 percent of the education budget, which is largely taken up by teachers' payroll costs financed through the operating budget, leaving nonwage O&M grossly underfunded. This under provision makes it hard to sustain investments in infrastructure and maintain student enrollments, given deferred maintenance of school buildings and shortages of basic supplies. Required O&M in 2010/11 is estimated at $170 million against a budget allocation of only $38 million (see table 2). By 2014 this requirement is expected to increase to $235 million. Budgetary and administrative reforms in the Ministry of Education will be required to ensure that any additional O&M allocation is made available to schools.

Health service delivery depends much more on the development than the operating budget. Unlike education, primary health services are delivered mainly by nongovernmental organizations (NGOs), which are contracted by the Ministry of Public Health and funded by a few donors through the development and external budgets. Some 72 percent of the core budget is financed through the development budget. Any significant drop in external funding of the development budget would therefore pose a serious threat to health services.

Funding for agriculture and rural livelihoods activities is largely through the development budget. As in health, interventions in this sector are primarily implemented by NGOs and financed through the development and external budgets. Apart from NSP, most projects are small and funded by a single donor, though their great number translates into a large overall budget. NSP gets about half the sector's funding. It provides block grants ($33,500 on average) to rural communities to fund small, local infrastructure projects. NSP has set up locally elected community development councils to manage these investments.

Roads have been extensively rehabilitated and greatly expanded in the past 10 years thanks to large donor investments, but donors have, with few exceptions, preferred to build and rehabilitate roads rather than carry out O&M. In the 2011/12 core budget, for example, only $28 million was allocated to O&M for roads, compared with an estimated need of $290 million (projected to rise to $394 million in 2014). The severe underfunding of O&M has gravely undermined the effectiveness of investments in the sector. Looking forward, developing sustainable funding sources for O&M will be a challenge. One encouraging potential model is performance contracting of different sections of the network under a USAID-supported project.

The electricity sector is on a path toward financial self-sufficiency, but achieving it will require continued improvements in cost recovery and development of cost-effective generation options. The sustainability of investments has in the past been hamstrung by revenue losses due to illegal connections and collection leakages. The national power utility (DABS) has been corporatized, helping the sector to modernize technical and managerial capacity and recover costs. The sector may, possibly, cover its operating costs and some investment requirements in the next few years, but this will require DABS to

develop solutions to further curtail revenue losses, enhance human resource capacity, and ensure cost-effective growth of domestic generation capacity.

Budgetary and administrative reforms are needed for effective O&M delivery. No government ministry in any of the five sectors has the mechanisms, institutional capacity, or asset registers to budget for O&M on a unit-cost basis or to ensure that allocations are deployed as intended. Often, even the limited funds allocated to O&M are retained in Kabul as a contingency or, at best, disbursed irregularly. Before new facilities are built, their future O&M requirements need to be considered and funding identified. Otherwise, further development investments will offer only short-term impacts and will not realize hoped-for rates of return.

Key conclusions and recommendations

Political uncertainty and insecurity could undermine Afghanistan's transition and development prospects. International experience (summarized in *World Development Report 2011: Conflict, Security, and Development*) demonstrates that violence and especially protracted internal insurgency are extremely damaging to development, and that political stability and consolidation are key ingredients of transitions to peaceful development. This underlines ongoing efforts to reach a peaceful solution to the Taliban insurgency, and the urgent need for better political consolidation, particularly in the run-up to the next election cycle. (The presidential election is to be held in 2014, and parliamentary elections in 2015.) But if there is worsening insecurity and increasing uncertainty about longer term stability, Afghanistan's development prospects will be harmed.

The extremely high level of annual aid—roughly US$ 15.7 billion in 2010, about the same as Afghanistan's gross domestic product (GDP)—cannot be sustained. Aid has funded essential public services under government auspices (implemented directly or through government-contracted NGOs), including education, health, infrastructure investments, and government administration. And there have been substantial improvements in the lives of Afghans over the last 10 years. But these inflows, most outside the Afghan budget, are so high that waste, corruption, aid dependency, and parallel systems to circumvent the government's limited absorptive capacity have impeded aid delivery and building a more effective Afghan state. The public spending that these aid flows have financed—both on and off budget—will be fiscally unsustainable once donor funds decline. Less aid with more effective aid delivery could, in the end, lead to more positive outcomes. The key is how to manage declining aid, mitigate the adverse impacts, and put aid and spending on a more sustainable long-term path. International experience and Afghanistan's history after the Soviet military withdrawal in 1989 demonstrate that violent fluctuations in aid, especially abrupt cutoffs, are damaging and destabilizing.

The impact of declining aid on economic growth will be less than expected. Why? Because most international spending "on" Afghanistan is not spent "in" Afghanistan, and much of what is spent in Afghanistan leaves the economy through imports, expatriated profits, and outward remittances. Even so, projections suggest that, under reasonably favorable baseline projections, real GDP growth may fall from 9 percent a year in 2000–10 to 5–6 percent over 2011–18. Given Afghanistan's annual population growth of 2.8 percent, there would be limited increases in average per capita incomes, continuing high underemployment, and little progress in reducing poverty. Only growth at the upper range of plausible scenarios would enable Afghanistan to significantly reduce poverty and increase average per capita incomes. For example, with real GDP growth of 6 percent a year, average per capita income—currently among the lowest in the world at US$ 528—would take 22 years to double, about a generation.

Economic growth would be even lower under less favorable scenarios. Growth projections are based on assumptions (scenarios) related mainly to security, sources of growth, aid levels, and changes in the investment climate. If the assumptions in the less favorable scenarios come to pass—for example, if agriculture performance is poor, major mining investments (Aynak for copper and Hajigak for iron ore) do not materialize, or aid declines precipitously over the period—then growth could drop to 3–4 percent a year. Deteriorating security and governance would lead to even lower or possibly negative economic growth. While the Kabul Bank crisis has had a negligible macroeconomic impact, and banking sector problems are not expected to adversely affect future growth, the underdeveloped financial sector and low financial intermediation leave little scope to help Afghan businesses adjust to slowing growth. The decline could be partly mitigated by reducing aid in a gradual, planned manner and by increasing the amount of aid actually spent in Afghanistan—for example by channeling more aid through the Afghan budget (on-budget aid has a much higher impact on the Afghan economy than off-budget assistance does).

Underemployment will rise because the activities affected by declining financial inflows (services, construction) are relatively labor-intensive. Roughly 6–10 percent of the working population has benefited from aid-financed jobs, though most are short term. So declining aid can be expected to heighten underemployment (with fewer casual labor opportunities and lower pay for skilled employees), even if unemployment is not greatly affected. The adverse impact of lower economic growth on employment is likely to be much larger than the direct employment impact of declining aid, making this a concern during transition.

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

The most severe adverse impact of transition will be on the fiscal situation—Afghanistan will face a projected financing gap of 25 percent of GDP by 2021/22, even higher in some of the intervening years. The fiscal gap will be enormous despite hoped-for robust growth in domestic revenue (projected to rise from 10 percent of GDP to more than 17 percent a decade from now). This gap arises primarily due to high wage and nonwage security costs (projected at around 17.5 percent of GDP in 2021/22), along with funding the government and sustaining service delivery on the civilian side. The civilian wage bill is projected to increase to 9 percent of GDP, the non-security operation and maintenance (O&M) expenditure to 4 percent, other operating spending to 2.5 percent, and the core development budget to 10 percent.

To close this financing gap, Afghanistan must rely on continuing international funding to pay for most security costs, as long as the size of the security sector (Afghanistan National Army and Afghanistan National Police) remains at or close to recently agreed targets (352,000 personnel with an estimated sustaining cost of US$ 5 billion a year). And civilian aid will need to be spent more selectively for development and O&M. Various foreign aid and domestic resources are possible for different spending categories. But a reasonable approach could be for domestic revenues to pay for the full civilian operating budget and part of the security costs (at the current level of 3 percent of GDP). Donors would finance the remaining bulk of security costs plus a more highly prioritized core development budget. Comparable low-income countries receive around 9 percent of gross national income in non-security development assistance, whereas Afghanistan would require close to three times that. If these levels of

foreign assistance for security and civilian expenditures are not available, then the government will need to make extremely difficult and likely destabilizing tradeoffs—either grossly underfunding or significantly shrinking Afghan security forces or crowding out essential civilian spending, or both.

Public resources will need to be focused on ensuring regular delivery of basic services and essential infrastructure. Investments in national programs over the past decade, almost entirely funded by donors, have increased access to basic health and education, rural access, power, and irrigation. Even so, Afghanistan's development indicators remain poor. The country's public finances will not be able to absorb the costs of operating and maintaining the infrastructure assets created in an often fragmented manner over the past 10 years and delivering the social and other services financed through donor-funded programs. The Afghan government will only be able to afford a modest package of basic social and infrastructure services. Even this will require difficult decisions: cutting programs, not maintaining all assets, and managing expectations accordingly. Better outcomes would result if sustainable institutions for maintaining key infrastructure are developed and operated transparently. Strict priorities among the many demands for O&M and services will also be needed to provide fiscal space for critical public investments required to sustain growth.

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

Enhancing the core civil service, with an emphasis on strengthening budget execution and service delivery, will be crucial for government functioning and providing essential services. The heavy reliance on a "second civil service" of externally funded Afghan staff needs to be transformed into a reliance on core government capacity—not to directly deliver all services but to oversee service delivery. Transition provides an opportunity to rationalize the terms and conditions of externally funded staff, bring them into a coherent framework of government capacity, and integrate them with the regular civil service over the longer term—all putting government functioning and service delivery on an affordable, sustainable path. Even then, the government will not have enough resources to absorb the costs of these externally funded staff. And some foreign-provided technical assistance will need to remain. Thus donor financing for externally funded staff and technical assistance will need to continue, but in a way that better aligns with the government's planned rationalization and strengthens its core capacity.

Ensuring the delivery of services to the Afghan people requires delegating more responsibilities to the provincial level. Only a tiny fraction of the O&M budget gets outside the line ministries in Kabul. An important priority moving forward will be enhancing the capacity of provincial offices to participate in budget formulation and key spending ministries to execute their budgets subnationally. Without this, it could be difficult for the government to absorb a greater proportion of aid on budget and deliver results to its people.