

**Working Paper 1**  
**for**  
**Afghanistan Public Expenditure Review 2010**  
Second Generation of Public Expenditure Reforms

**Country Overview and Role of Public  
Expenditure**



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# Country Overview and Role of Public Expenditure<sup>1</sup>

## A. The Economic Setting

1. **Afghanistan's recent economic growth has been impressive.** Real annual GDP growth averaged 11.2 percent (Table 1) in the seven years between 2002/03 and 2008/09, one of the highest growth rates in the world. Much of this growth was due to the expansion of trade and services and industrial activities from the depressed levels experienced during the Taliban regime. Fluctuations in weather-dependent agricultural output accounted for most of the undulations in overall GDP growth seen during this period.

**Table 1 Economic Growth Rates and Per Capita GDP**  
(Comparison between Afghanistan and Selected South Asian Countries)

	2007	2008	Ave 02-08	Per capita GDP 1/
<b>Afghanistan</b>	<b>16.2%</b>	<b>2.3%</b>	<b>11.2%</b>	<b>426</b>
Bangladesh	6.4%	6.2%	6.1%	494
Bhutan	14.0%	13.8%	9.4%	1,979
India	9.1%	7.1%	8.6%	1,068
Iran	7.8%	5.6%	6.0%	5,352
Maldives	7.3%	5.8%	7.2%	4,059
Nepal	3.3%	5.3%	4.0%	441
Pakistan	6.0%	6.0%	6.3%	1,013
Sri Lanka	6.8%	6.0%	6.3%	2,020

1/ In current US\$ in 2008

Source: World Bank Online Database (Sep 2009), Central Statistics Organization (CSO)

2. **Macroeconomic performance also seems satisfactory.** Key macroeconomic balances were well within tolerable limits (Table 2). For example, the core budget deficit (after grants) ranged between 0 percent and 3 percent of GDP annually, and the

**Table 2 Afghanistan: Selected Economic Indicators**

	2005/06 (SY1384)	2006/07 (SY1385)	2007/08 (SY1386)	2008/09 (SY1387)	2009/10 (SY1388)
	Actual	Actual	Actual	Actual	Pre. Actual / Estimate
<b>1. Output and Prices</b>					
Real GDP Growth Rates (%) 1/	14.5	11.2	16.2	2.3	n.a.
Nominal GDP (in millions US\$) 1/	6,852	8,186	10,170	10,662	n.a.
Real GDP Growth Rates 2/	16.1	8.2	12.1	3.4	15.1
Nominal GDP (in millions US\$) 2/	6,489	7,723	9,659	11,700	n.a.
Consumer Price Index (% , period average)	12.3	5.1	13.0	26.8	n.a.
<b>2. Public Finances (% GDP)</b>					
Domestic Revenues	6.4	7.5	7.0	6.9	9.4
Total Expenditures (Core Budget)	16.8	20.3	20.7	19.2	20.2
Operating Expenditures	9.9	11.2	10.6	11.6	13.1
Core Development Spending	6.9	9.1	10.1	7.6	7.1
Operating Budget Balance (excl. grants)	-3.5	-3.7	-3.6	-4.6	-3.7
Operating Budget Balance (incl. grants)	1.4	1.2	1.3	0.2	n.a.
Core Budget Balance (incl. grants)	-0.9	0.0	-1.8	-3.7	n.a.
<b>3. External Sector (% GDP)</b>					
Current Account (excl. official transfers)	-75.2	-70.0	-62.0	-54.5	n.a.
Current Account (incl. official transfers)	-2.8	-4.9	0.9	-1.6	n.a.
<b>4. Memorandum Items</b>					
External Budget (in millions US\$)	5,361	4,590	10,992	4,101	n.a.
Exchange rates (period average)	48	49	50	51	52 3/

1/ Partially including the drug economy in agriculture, 2/ excluding the drug economy, 3/ Budget assumption  
Source: IMF, Central statistics organization (CSO), Ministry of Finance (MoF)

<sup>1</sup> This working paper was produced by Yoichiro Ishihara (World Bank, SASEP) for Afghanistan Public Expenditure Review based on information available as of March 31, 2010.

current account deficit (including grants), between 1 percent and 5 percent of GDP annually, mainly due to large inflows of external assistance. These inflows also helped to maintain the nominal exchange rate to around 48-50 local currency units to the US Dollar.

## B. Afghanistan's Development Challenges

### 3. These seemingly impressive achievements mask serious underlying problems and challenges.

Despite rapid economic growth since 2001, Afghanistan remains one of the most developmentally challenged countries in the world:

- GDP per capita was only US\$426 in 2008, ranked 165<sup>th</sup> out of 174 countries.
- Poverty remains widespread. In 2007/08, 36 percent of the population lived below the poverty line, and a further 25 percent are located just above the poverty line<sup>2</sup>. Any small additional shock (such as higher prices) could push a large number of people below the income poverty line.
- Afghanistan's social development indicators like primary education, gender equality, child and maternal mortality etc. lag well behind those of other low-income countries and its peers in South Asia (Table 3).
- According to the UNDP's Human Development Index, Afghanistan ranked 181<sup>th</sup> out of 182 countries in 2010 (projection). There are also wide gender-based disparities: access of women (and girls) to education, healthcare, employment opportunities for example are much more limited than for men.

**Table 3 Selected MDGs Indicators in 2007**

	Afghanistan	Low income	South Asia
<b>Goal 1: Eradicate extreme poverty and hunger</b>			
Employment to population ratio, 15+, total (%)	58	66	57
Employment to population ratio, ages 15-24, total (%)	45	53	43
<b>Goal 2: Achieve universal primary education</b>			
Primary completion rate, total (% of relevant age group)	38	65	80
<b>Goal 3: Promote gender equality and empower women</b>			
Proportion of seats held by women in national parliament (%)	27	17	14
Ratio of female to male primary enrollment	59	89	94
Ratio of female to male secondary enrollment	33	85	84
<b>Goal 4: Reduce child mortality</b>			
Immunization, measles (% of children ages 12-23 months)	68	76	65
<b>Goal 5: Improve maternal health</b>			
Maternal mortality ratio (per 100,000 live births)	1,800	780	500
<b>Goal 6: Combat HIV/AIDS, malaria, and other diseases</b>			
Incidence of tuberculosis (per 100,000 people)	161	266	174
Tuberculosis cases detected under DOTS (%)	66	49	63
<b>Goal 7: Ensure environmental sustainability</b>			
Forest area (% of land area)	1	25	17
Improved sanitation facilities (% of population with access)	30	39	33
Improved water source (% of population with access)	22	68	87
<b>Goal 8: Develop a global partnership for development</b>			
Internet users (per 100 people)	2.1	5.2	14.5
Mobile phone subscribers (per 100 people)	17.2	23.2	24.1

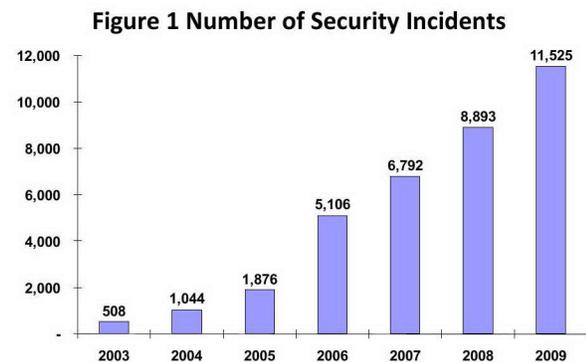
*Based on data availability for Afghanistan*

*Source: World Bank Online Database as of September 2008.*

<sup>2</sup> Defined as the number of people between the poverty line and 30 percent above the poverty line.

4. **Though the economy has grown rapidly, the sustainability of high growth that is critical for poverty reduction and development is a major concern.**<sup>3</sup> The economy suffers from major structural weaknesses. Agriculture, for example, is heavily dependent on the weather so the prolonged drought reduced crop production (and overall GDP) in 2008/09. Moreover, agriculture is dominated by opium cultivation. Afghanistan produced 93 percent of the world's total opium production in 2008, accounting for more than one-third of the overall economy<sup>4</sup>. High opium prices are a major factor discouraging the cultivation of traditional food crops and part of the reasons why Afghanistan is so reliant on food imports. Afghanistan's operating and development expenditures are heavily dependent on external aid (see Annex 2)<sup>5</sup> which has been a mixed blessing.
5. Prospects for sustained growth, poverty reduction and human development are also threatened by the deteriorating security situation, poor governance and increased corruption.

- **Security.** Security continued to deteriorate through 2006 and 2009. The Taliban insurgency has spread within, and outwards from, its original core areas in the southern provinces, (particularly Kandahar, Helmand, and Uruzgan where the security situation is most acute), to areas near Kabul like Wardak province, and the capitol itself. Civilians and aid workers appear to be increasingly targeted by the insurgency while mounting



Source: UNDSS

civilian casualties from air strikes by international forces have become a growing source of anger. The number of security incidents countrywide has sharply increased from 1,900 in 2005 to 11,500 in 2009 (Figure 1). Discussions have begun to increase the size of the army and police in response to the rapid deterioration in the security situation<sup>6</sup>.

<sup>3</sup> In post-conflict economies, high rates of economic growth in the early years are quite common; but, unless appropriate policies, programs and economic reforms are implemented to address structural weaknesses, growth quickly begins to taper off.

<sup>4</sup> United Nations Office on Drugs and Crime (2008) Afghanistan Opium Survey 2008

<sup>5</sup> In 2006, Afghanistan ranked sixth out of 135 countries in terms of foreign assistance as a share of GDP.

<sup>6</sup> More discussions on the security sector are in Annex 5.

- Governance and anti-corruption.** By all accounts corruption is widespread in Afghanistan. It threatens government capacity and effectiveness, encouraging a culture of patronage and illegal activities, and damaging the credibility of the state in the eyes of the public and its development partners. Afghanistan is now seen as the second worst in the world. Its ranking in the Transparency International's Corruption Perceptions Index has deteriorated sharply from 117 out of 159 countries in 2005 to 179 out of 180 countries in 2009 (Table 4). Weak governance and the lack of rule of law are major problems at the provincial and district levels also.

**Table 4 Corruption Perception Index**

	2005		2009	
	Score	Rank	Score	Rank
<b>South Asian Countries</b>				
<b>Afghanistan</b>	<b>2.5</b>	<b>117</b>	<b>1.3</b>	<b>179</b>
Bhutan	n.a	n.a	5.0	49
Bangladesh	1.7	158	2.4	139
India	2.9	88	3.4	84
Maldives	n.a	n.a	2.5	130
Nepal	2.5	117	2.3	143
Pakistan	2.1	144	2.4	139
Sri Lanka	3.2	78	3.1	97
<b>Neighboring Countries</b>				
China	3.2	78	3.6	79
Iran	2.9	88	1.8	168
Tajikistan	2.1	144	2.0	158
Turkmenistan	1.8	155	1.8	168
Uzbekistan	2.2	137	1.7	174
<b>Total Countries</b>		<b>159</b>	<b>-</b>	<b>180</b>

*Source: Transparency International, World Bank*

To address these concerns, the government recently established the Independent Directorate of Local Governance (IDLG) as a separate department for local administrations, disseminated a new anti-corruption law in the summer of 2008, and set up a High Office for Monitoring Implementation of the Anti-Corruption Strategy. Afghanistan also ratified the United Nations Convention against Corruption (UNCAC) and is working with the United Nations Organization on Drugs and Crime (UNODC) to make the country's laws consistent with UNCAC over time. The impact of these positive developments will depend on how effectively they are implemented.

### C. Afghanistan National Development Strategy (ANDS)

- The government formulated the ANDS in April 2008 in recognition of the magnitude of the development challenges it faces. The ANDS, which serves as Afghanistan's Poverty Reduction Strategy Paper (PRSP), follows and builds on a series of earlier government strategy documents.<sup>7</sup> It involved extensive consultations with domestic and external development partners over two years.
- The ANDS provides a very comprehensive development strategy, linked to a longer-term development vision of the country. It rests on three key pillars: security; good governance, the rule of law and human rights, and economic and social development. The strategy focuses on 17 sectors and includes substantive discussions on a number of issues of critical importance to development management, including the participatory process, poverty profile, the macro-economic framework, aid effectiveness and coordination, the implementation framework and monitoring arrangements. It also integrates six important cross-cutting issues<sup>8</sup>. The government has recently established a Government Coordinating Committee (GCC), consisting of key ministers and senior officials, to oversee the progress of ANDS implementation. The Ministry of Finance (MoF) takes the lead in coordinating aid and the

<sup>7</sup> Including the *National Development Framework* of April 2002, *Securing Afghanistan's Future* Report of January 2004, and the *Interim Afghanistan national Development Strategy (I-ANDS)* of January 2006. ANDS also builds on the commitments made by the Government in the context of the 2006 Afghanistan compact.

<sup>8</sup> Six cross-cutting issues are counter-narcotics, anti-corruption, capacity development, gender equality, environment, and regional cooperation

work of implementing line ministries, while the Ministry of Economy (MoEc) is responsible for monitoring and evaluation.

8. The ANDS was generally well prepared and is of good quality. Nevertheless, from an operational perspective, there are several weaknesses relating to fiscal policy/public expenditures<sup>9</sup>.
  - The macroeconomic framework is ambitious, both in relation to resources (domestic and external) that are unlikely to be available, and the country's technical and implementation capacity to effectively manage and efficiently utilize such resources.
  - Given the current low domestic revenue/GDP ratio, the ANDS relies heavily on external aid (see Annex 2). Effective management of the government's core- and external budgets is critical to achieving ANDS' goals and objectives.
  - Although considerable progress has been made recently, the institutional capacity for auditing and monitoring is still weak. The government is setting up a detailed monitoring framework with some 250 indicators. Such a system is likely to be beyond the country's current capacity and needs to be simplified and streamlined.
  - Finally, the links between the ANDS, the MTF and the annual budget are weak. Effectively designed and employed, the latter two can be powerful instruments for prioritizing the ANDS and for managing public resources to achieve its goals. This is in part due to the split between the core and external budgets noted earlier, which in turn contributes to considerable opaqueness in public expenditures, a lack of coordination between the two budgets, and inadequate prioritization.
9. The government of Afghanistan produced the first annual progress report in September 2009. The report describes the progress of the government in bringing the ANDS to its implementation stage. The lack of prioritization in many sectors remains the main obstacle for an effective ANDS implementation.

#### **D. Role of Public Expenditure and Key Fiscal Challenges**

10. It is abundantly clear that fiscal policy/public expenditure will need to play a critical role if the ANDS is to be implemented successfully. Better public resource management is essential to ensure that limited resources are optimally allocated to support ANDS priorities. Existing institutional arrangements and procedures must be properly harnessed, rationalized and strengthened to ensure that allocated funds are made available to priority activities, and used efficiently.
11. Public expenditure in Afghanistan, especially on key service delivery sectors such as education, has been insufficient and/or ineffective in achieving the objectives outlined in the ANDS. The following challenges all negatively affect the level- and efficiency of public expenditures:
  - (1) **Lack of fiscal sustainability.** Unlike other countries, full coverage of operating expenditures by domestic revenues is a reasonable indicator of fiscal sustainability in Afghanistan because it is not a steady state in terms of fiscal aggregate, and financing costs are negligible since the bulk of the fiscal deficit is grant-financed. The fiscal sustainability indicator improved from 38 percent in 2002/03 to 67 percent in 2006/07. However, the indicator deteriorated to 60 percent in 2008/09 mainly due to higher than expected operating budget expenditures before it improved to 72 percent in 2009/10.

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<sup>9</sup> For a more detailed discussion, see the Joint IDA-IMF Staff Advisory Note (JSAN) on the Poverty Reduction Strategy Paper, May 2008.

Also, prospects for achieving fiscal sustainability significantly deteriorated over the past year. Although ANDS' macroeconomic framework plans to achieve 100 percent coverage in 2012/13, the latest Medium-Term Fiscal Framework (MTFF) in July 2009 assumes only 70 percent.

- (2) **Low domestic revenues.** The large size of the opium economy, low GDP and widespread corruption all negatively affect domestic revenues, which remain very low compared to other low-income countries. Domestic revenues as a share of GDP fell to 6.9 percent in 2008/09 before it went up to 9.4 percent in 2009/10. Moreover, the level is much lower than the average (between 11 percent and 12 percent of GDP) of other developing countries. Low domestic revenues affect the fiscal space for public expenditure and pose a major impediment to achieving fiscal sustainability.
- (3) **Pressure on operating budget expenditures.** Operating budget expenditures doubled between 2006/07 and 2009/10. The main reasons for the increase are the growth in security sector operating expenditures, Afghan National Army (ANA) and Afghan National Police (ANP) salaries and the planned implementation of Pay and Grading (P&G) reforms. Pressure on operating expenditures amplifies the challenge of achieving fiscal sustainability and the availability of financial resources for public service delivery such as health and education.
- (4) **Large security sector share.** Accounting for more than 40 percent of government employees, the security sector is the largest sector in the national budget, and a reflection of the security situation in Afghanistan. Nevertheless, PFM in the security sector has not been fully integrated into the government-wide system. Fiscal sustainability analysis suggests that ANA and ANP are not fiscally sustainable from domestic revenues alone. The large commitment to security also means that the government is unable to allocate enough financial resources to public services.
- (5) **Low core development budget execution rates.** Core development budget expenditures are essential for infrastructure investment as well as service delivery. However, core development budget expenditures equivalent to 9 percent of GDP remain undisbursed each year. The execution rates fell from 54 percent in 2007/08 to 40 percent in 2009/10. The low rates reflect (i) low absorption capacity of line ministries; (ii) poor budget formulation process by both MoF and line ministries, and (iii) budget formulation capacity of donors. The low execution rates negatively affect not only the level of public expenditure on infrastructure and service delivery, but also state-building and GDP growth.
- (6) **Weak policy guidance for public expenditure policy.** The ANDS does not provide clear priorities to guide public expenditure policy, and the MTFF in its current form is a reactive projection of expenditures rather than a source of proactive policy direction. As a result, public expenditure policy is formulated without clear policy guidance, suggesting expenditures have not necessarily been allocated to ANDS priorities.
- (7) **Large size of the external budget.** Even excluding security sector assistance, Afghanistan's aid dependency ratio (net official aid/gross national income) is one of the highest in the world. Foreign assistance accounts for 85 percent of the national budget. In 2002/03-2008/09, three quarters of total public expenditures were through the external budget. The presence of the large external budget especially makes the alignment of national objectives with the national budget particularly challenging.