

# AFGHANISTAN DEVELOPMENT BRIEF



## Highlights of Afghanistan Fiscal Year 1398 Budget

December 2018

Topic: FY 1398 Budget

The budget for Fiscal Year 1398 was approved by parliament on 1<sup>st</sup> January 2019. It provides a consolidated medium-term fiscal outlook with lower fiscal deficits for budget year amid drastic decreases in aid and increasing government responsibility for security spending over the medium-term.

In this note we provide an assessment of the technical aspects of budget and discuss the implications of the medium-term fiscal framework. The budget document is technically sound and includes some significant improvements in compliance with international best practices. The medium-term fiscal implications of the budget are concerning, however, with declining aid leaving little fiscal space for development and O&M spending over the medium term as security expenditures rapidly increase.

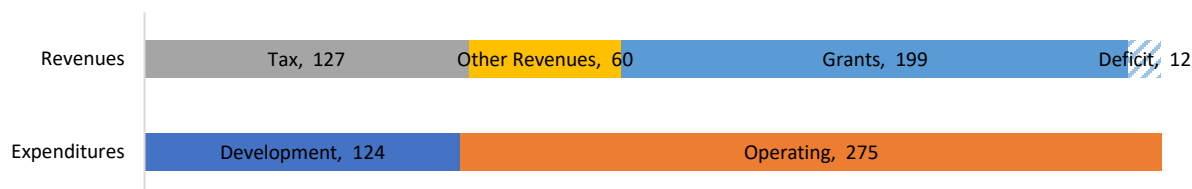
### Budget aggregates

**The 1398 fiscal deficit is reduced from previous budgeted deficits**

Overall revenues and expenditures are budgeted to decline by 3 percent for FY 1398 compared to previous year. Total expenditures are estimated at Afs<sup>1</sup> 399.4 billion (25.5 percent of GDP), of which 47 percent is financed from domestic revenues and about 50 percent is financed through aid. The total fiscal deficit is budgeted at Afs 12.4 billion compared to Afs 16.1 billion in the previous year, with financing sources not yet identified.

Domestic revenue collection is expected to increase by 8 percent, while grants are expected to decline by 11 percent in 2019 and much more over the medium term. The decrease in expenditures mainly comes from drastic reductions in pension and contingency funds as well as lower budgeting for development projects to reflect expected improvements in execution and the exclusion of poorly performing projects. Revenues by source and expenditures by type are shown in Figure 1.

**Figure 1: Fiscal Year 1398 Budget**  
(in billion Afs)



<sup>1</sup> Afs refers to the currency of Afghanistan named afghani.

## Several improvements have been made to presentation and content of the FY1398 budget

### The budget is anchored in reasonable forecasts for 2019

The presentation of the budget is better aligned with international norms and standards, contingent liabilities are identified, the contingency fund allocations have been reduced. Gender issues are given some visibility, and the budget is anchored within realistic macroeconomic forecasts for the budget year.

The forecast economic growth rate of 3 percent during 2019 appears to be slightly optimistic considering the upcoming elections and lower agriculture growth in 2018 due to severe drought. The government expects to collect 8 percent higher revenues in 2019, which represents a realistic target and a slowdown from recent expenditure growth rates. Overall budget expenditures are in line with total expenditure in FY 1397.

### Development projects have been reviewed

Development projects have been reviewed for execution performance. Projects with persistently low rates of execution have been removed from the budget, freeing up fiscal space for other needs. This can be expected to help with further improvements in budget execution throughout the fiscal year.

### Presentation of the budget is aligned with international standards

The budget is presented based on Classification of the Functions of Government (COFOG). Developed by OECD and adopted by UN Statistical Division, the COFOG classification of the budget brings important advantages, including: i) facilitating international comparisons; and ii) linking expenditures to specific policy goals.

### Contingent liabilities and fiscal risks are identified

The budget document also includes an assessment of contingent liabilities and risks facing the government in next fiscal year and over the medium term. The contingent liabilities include risks arising from deteriorating security situation, climate change, direct and indirect guarantees from PPP projects and SoEs, and social spending such as on pension and refugee repatriation. In future years, budget documentation could be improved by quantifying and including measures to mitigate these risks.

### Contingency allocations have been reduced from previous years

Contingency fund allocations are reduced from previous years. While inclusion of some contingency funding is consistent with international good practice, expenditures from this fund have previously been used for a variety of purposes inconsistent with the objectives of a contingency allocation. This has undermined overall budget realism. A reduced contingency allocation is an important step towards budget credibility, but it will also be important to ensure that budgeted contingency resources are used only for genuinely unforeseeable needs.

### The budget includes forward estimates

Building on the previous budget reforms, the budget includes medium-term estimates at a disaggregated level. This ensures that the budget documents provide a realistic assessment of medium-term expenditure needs and pressures, facilitating medium-term fiscal and policy planning.

**Budget formation was informed by gender considerations**

Throughout the budget process, budget hearings included discussion of the gender aspects of ministry budget initiatives. The budget document also discusses plans to further mainstream gender, including through protecting expenditures on projects and programs that benefit women and promoting equal access of men and women to government services.

**Medium-term implications of the 1398 budget**

While the budget document is technically strong, the medium-term framework it presents is worrisome. Within the medium-term fiscal framework presented in the budget document, increasing government responsibility for security spending squeezes out resources available for development spending and service delivery.

**Medium-term revenue estimates are optimistic.**

Medium-term revenue forecasts included in the budget are optimistic and predicated on optimistic growth projections. Over the medium term, domestic revenues are expected to increase at an average rate of 11 percent. This may be difficult to achieve given the expectation of political disruptions through the elections. Even under these optimistic revenue scenarios, the medium-term framework includes some problematic trends.

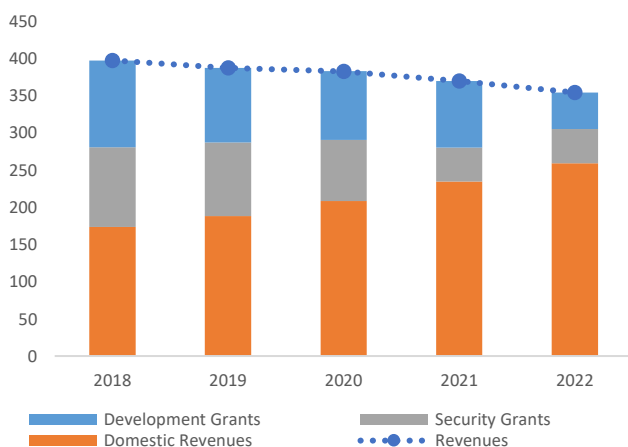
**The budget will be increasingly skewed towards the security sector...**

Firstly, security expenditures are expected to absorb an increasing share of available revenues. As security sector grants decline, government will have to finance security sector needs, including personnel costs from its own resources. As of 2018, only about 23 percent of domestic revenues are utilized to finance security spending. Over the medium-term, this ratio is expected to increase to 60 percent by 2021.

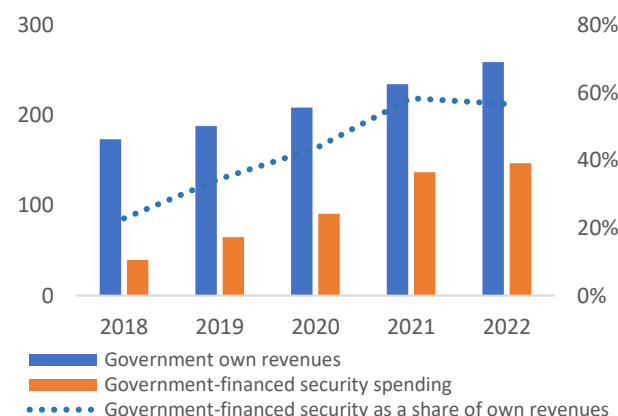
**..and security personnel costs will squeeze out development and O&M spending**

With security sector personnel costs, accounting for a larger share of the budget, resources available for development projects and O&M expenditures decline. The medium-term fiscal framework includes gradual declines in government spending on goods and services and development projects while wages and salaries are expected to increase at an average rate of 6 percent over the medium term.

**Figure 2: Medium term revenues**  
(in billion Afs)



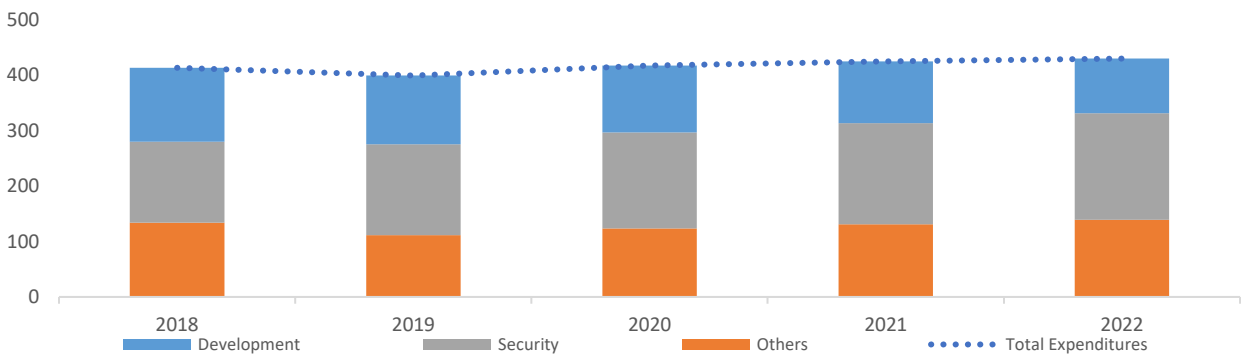
**Figure 3: Domestic revenues financing security**  
(in billion Afs)



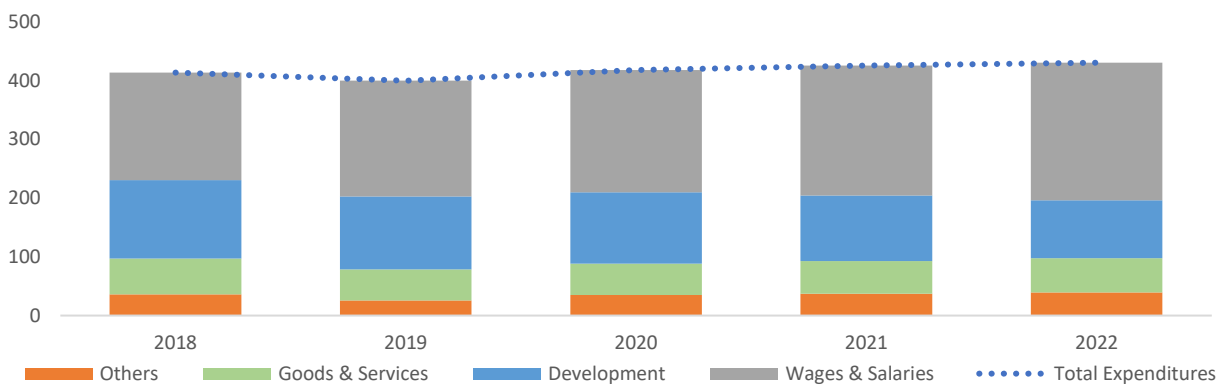
**Budgeted deficits are unsustainable over the medium-term.**

Finally, the medium-term fiscal framework suggests higher fiscal deficits following 2019. Deficits included in the budget framework reach an unsustainable level of 4 percent of GDP by 2022. It is not clear how these deficits could be financed, given limited access to either private or official debt financing, and government policies to avoid contracting of substantial non-concessional debt.

**Figure 4: Overall expenditures**  
(in billion Afs)



**Figure 5: Disaggregated expenditures**  
(in billion Afs)



## Conclusions

The 1398 budget is a technically strong document. It includes several important improvements over previous budget documents, which help to facilitate fiscal

transparency and support better links between public expenditure and policy priorities.

Despite technical improvements, the budget document also paints a daunting picture of the fiscal challenges currently facing Afghanistan. The medium-term fiscal framework included in the budget clearly shows that reductions of international grant support over coming years will: i) place pressure on development expenditures; ii) lead to a reorientation of revenue-financed expenditure towards security sector needs; and iii) generate a potentially significant gap between expenditure needs and available resources.

Government should continue recent progress with improving public financial management systems, including through the annual budget process, to ensure pressures associated with declining grant support are managed as best possible. Ultimately, however, without continued and extended grant support or a radical change in the current security situation, development and service delivery needs are likely to go increasingly unmet as government takes on greater responsibility for financing the security sector.

Table 1: FY 1397 budget execution performance

	FY 1397 Budget			Actual Expenditure	Execution against		
	Approved Budget	MYR	Reported in FY 1398 Budget		Approved Budget	MYR	Reported 1398 Budget
<b>Overall Budget</b>	377	407	413	388	103%	95%	94%
<b>Operating</b>	266	284	280	260	98%	92%	93%
<b>Development</b>	111	123	133	128	115%	104%	96%
<b>Discretionary</b>	52	58	58	53	103%	93%	93%
<b>Non-Discretionary</b>	59	65	75	74	126%	114%	99%

Note: in billion Afs unless otherwise stated

Source: Approved budget documents and budget execution report as of end December 2018

Table 2: FY 1397 budget execution performance by sectors

	Operating			Development			Overall Execution
	Budget	Expenditure	Execution	Budget	Expenditure	Execution	
Security	155,517	138,315	89%	3,251	2,913	90%	89%
Governance and Rule of Law	25,187	24,495	97%	10,054	9,323	93%	96%
Infrastructure	7,255	6,964	96%	57,118	55,564	97%	97%
Education	43,200	42,045	97%	6,672	5,775	87%	96%
Health	4,605	4,318	94%	18,352	17,150	93%	94%
Agriculture and Rural Development	3,111	2,954	95%	30,330	28,729	95%	95%
Social Protection	31,608	30,431	96%	1,403	1,274	91%	96%
Economic	11,130	10,958	98%	134,323	127,526	95%	95%

Note: in million Afs unless otherwise stated

Source: Budget execution report as of end December 2018