

AFGHANISTAN INCLUSIVE AND SUSTAINABLE GROWTH ASSESSMENT

I. INTRODUCTION

1. Afghanistan is one of the poorest countries in the world and Asia's poorest, and it also faces one of the most daunting sets of circumstances for inclusive and sustainable growth. Gross domestic product (GDP) per capita was estimated at \$565 in 2016. Afghanistan ranked 169th out of 188 countries in the Human Development Index 2016, Asia's lowest performer.¹ The path out of this low status of development will be difficult. Afghanistan has essentially been in a continuous state of war since the late 1970s, and the current insurgency is gaining momentum, with the Taliban now controlling more territory than at any time since being driven from power in 2001.

2. Progress has been made in a few areas since reconstruction began in 2001, mainly education and health. Also, some critical infrastructure has been built, providing transport connectivity and electricity to more people than ever before. Yet there is a long way to go for Afghanistan, and the challenges ahead will be difficult to surmount.

3. Afghanistan is currently in the "Transformation Decade" (2015–2024), with the aim of becoming self-reliant at the end of the period. A new national development strategy, the Afghanistan National Peace and Development Framework 2017–2021, has been prepared.² The framework is a plan for achieving self-reliance covering the country's development goals, key reforms, and investment priorities under the national priority programs.

4. This report assesses Afghanistan's current status, challenges, and prospects for inclusive and sustainable growth. It is intended to inform and help shape the country partnership strategy (CPS) between the country and the Asian Development Bank (ADB). The assessment examines several topics, including the conflict and its effect on development; economic performance and prospects; the status of poverty, gender, and social sectors; labor market and the business environment; environment and climate change; and key impediments to inclusive and sustainable growth. It concludes with some implications for ADB's engagement with Afghanistan during the next CPS period.

II. CONFLICT AND POLITICAL ECONOMY

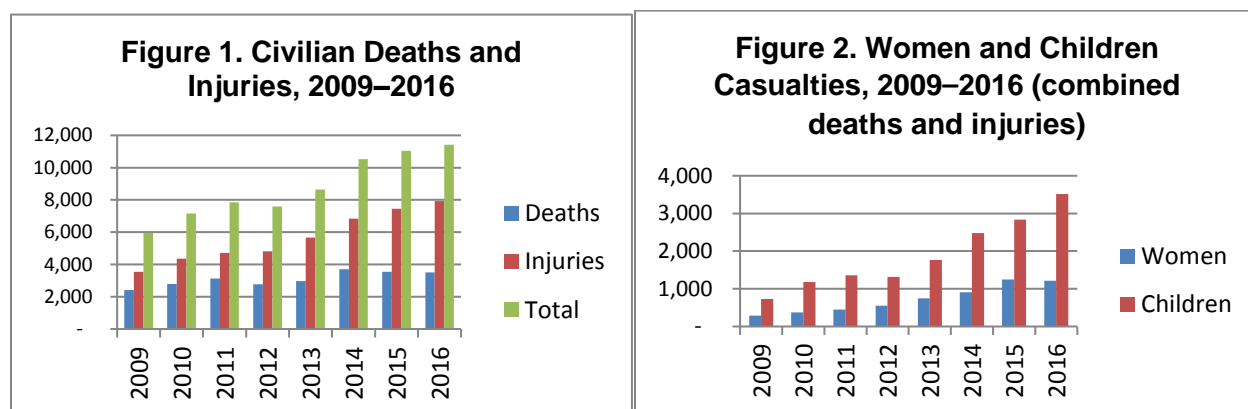
A. Conflict in Afghanistan

5. Afghanistan has been in a state of war for decades, starting with the Soviet Union's invasion of Afghanistan in 1979, the civil war following the departure of Soviet troops in 1989, and then during the rule of the Taliban regime from 1996 to 2001. The Taliban were driven from power by a United States-led intervention in late 2001, but eventually regrouped and started an insurgency in 2005, which has spread throughout much of the country and continues to this day.

¹ United Nations Development Programme. *Human Development Report 2016: Human Development for Everyone*. New York.

² Government of Afghanistan. 2016. Afghanistan National Peace and Development Framework (ANPDF), 2017 to 2021. Kabul

6. The conflict in Afghanistan has taken a heavy toll on the population. One estimate is that over 111,000 people have been killed and another 116,000 injured since 2001.³ Millions more people have fled as refugees or become internally displaced, and the civilian toll from the conflict is increasing as the insurgency continues to escalate. In 2016, there were 11,418 civilian casualties (3,498 deaths and 7,920 injured), which was a 3% increase in total civilian casualties over 2015 (Figure 1); almost one-third of these casualties were children (Figure 2). The actual figure for all casualties—children and adults—is likely higher, as the figures are considered underestimated because of the rigorous documentation required for inclusion in these statistics.



Source: United Nations Assistance Mission in Afghanistan. 2017. *Afghanistan: Protection of Civilians in Armed Conflict Annual Report 2016*. Kabul.

7. The fighting shows no sign of easing, and the various peace efforts between the previous and current administrations and the Taliban have been unsuccessful.⁴ The relatively recent presence of Daesh⁵ in eastern Afghanistan presents yet another front on which the Afghan National Army needs to engage. The conflict will continue to have a profound effect on the population, especially women and children, and poses an enormous obstacle to inclusive and sustainable growth.

B. Political Economy

8. Political economy issues present obstacles to inclusive and sustainable growth. Afghanistan has a complicated mix of politics, economic interests, and formal and informal institutions that is affecting the exercise of power and economic development in the country. The political economy stakes became much higher after 2001 as billions of dollars in donor aid and foreign military spending poured into Afghanistan for reconstruction and state building. Competition for the allocation of funds at the central level and contracts at the local level has led to corruption and instability in government, and has reinforced informal centers of power and wealth at the local level (warlordism).

9. Compounding the political economy issues is drug production and trafficking. Afghanistan is far and away the world's largest producer of opium and heroin, producing around 90% of the world's supply. Opium is a major source of income for the insurgents, criminal groups, and local

³ Neta C. Crawford. 2016. *Update on the Human Costs of War for Afghanistan and Pakistan, 2001 to mid-2016*. http://watson.brown.edu/costsofwar/files/cow/imce/papers/2016/War%20in%20Afghanistan%20and%20Pakistan%20UPDATE_FINAL_corrected%20date.pdf

⁴ The current government reached a peace agreement in September 2016 with Gulbuddin Hekmatyar's Hezb-e Islami militant group.

⁵ Daesh is used locally to refer to Islamic State militants in Afghanistan. It is an Arabic acronym.

militias, but production and trafficking are also a major source of corruption. Opium production is appealing to farmers because it is more profitable than legal cash crops.⁶ Additionally, opium is drought resistant and easy to transport and store, and is a huge employment generator for the rural landless poor.

III. RECENT GROWTH, POVERTY, INEQUALITY, AND ENVIRONMENTAL DYNAMICS

A. Economic Performance

10. Over half of the GDP consists of services, while agriculture accounts for 23% and industry 21%. The volatile performance of the agriculture sector greatly influences the country's annual growth rate. Afghanistan's economy features a limited export base. Exports, consisting primarily of carpets and rugs, agriculture and animal products, and internal sales to nonresidents (largely foreign troops) are equivalent to only 10% of imports. Afghanistan also has a large informal economy, mainly from opium production. Another important feature is that since the end of the Taliban regime, donor aid has underpinned the reconstruction and economic growth, and Afghanistan remains dependent on this aid. Donor grants in 2016 covered an estimated 63% of total government expenditures, 76% of development expenditures, and 58% of recurrent expenditures. GDP growth in Afghanistan averaged 8.7% annually during 2003–2013. However, growth has slowed greatly since 2014, averaging less than 1.4% annually during 2014–2016. The rapid decline in growth during 2014–2016 is mainly attributed to the deteriorating security conditions, the ongoing political instability that began with the 2014 presidential election and continues with the tenuous power sharing arrangement, and the impact of the withdrawal of most foreign troops from Afghanistan at the end of 2014.

11. Domestic revenue was less than 10% of GDP in 2013 and 2014 before rising to 10.2% in 2015 and 11.8% in 2016. Although these figures are low even for a least developing country, the government exceeded the International Monetary Fund (IMF) revenue collection targets in 2015 and 2016. Total domestic revenue collection in 2016 was 14.6% higher than the benchmark target agreed with the IMF under the ongoing IMF program—Extended Credit Facility. Nonetheless, a small tax base, along with critical weaknesses in tax and customs collection, have led to Afghanistan having one of the lowest ratios of domestic revenue to GDP in the world.

12. Over half of the government's expenditure goes toward security, leaving limited fiscal resources for development expenditures. The lack of funds for development is exacerbated by the weak performance in budget execution. The development budget, which covers spending on physical, economic, and social infrastructure, has had low execution rates, varying from 46% to 57% since 2013.

B. Poverty and Inequality

13. Despite occasional high growth rates since 2002, economic growth has not been pro-poor, as poverty (measured by consumption) remains high and over 50% of the population is deemed vulnerable to becoming poor.⁷ Poverty remained virtually unchanged between 2007–2008 and 2011–2012, but since then it is estimated to have increased from 36.5% in 2011–2012 to 39.1% in 2013–2014.⁸

⁶ It should be pointed out that poppy cultivation is also labor intensive and therefore a source of livelihood for hundreds of thousands of rural Afghans.

⁷ World Bank. 2014. *Islamic State of Afghanistan: Pathways to Inclusive Growth*. Washington, DC.

⁸ Central Statistics Organization. 2016. *Afghanistan Living Conditions Survey 2013–2014*. Kabul.

14. Several disparities are found with poverty in Afghanistan, and these include urban–rural, regional, and ethnic differences. Rural poverty is about 10 percentage points higher than urban poverty, but urban poverty is increasing because of rural–urban migration. Poverty varies across regions in Afghanistan, with the highest poverty headcounts in the northeast, west–central, and eastern parts of the country, with 40%–50% of these populations living in poverty. In terms of the number of poor, the greatest concentrations are in the central (including Kabul) and northeast regions, where 40% of poor people live.⁹ The nomadic Kuchi population has the highest poverty rate among the ethnic groups, with nearly 52% living in poverty.

15. Measures of inequality are worsening. Between 2011–2012 and 2013–2014, the poorer segments (bottom two quintiles) of the population had more per capita consumption decline than the richer segments (top two quintiles). Earlier, between 2008 and 2012, the poorest 20% had a 2% decline in real per capita consumption, while the bottom 40% had flat per capita consumption and the richest 20% had a 9% increase in consumption.¹⁰

16. Another dimension of poverty and inequality is unequal access to basic services. Access to improved drinking water improved overall from 27% in 2007–2008 to 65% in 2013–2014, but the rural population’s access is 58% compared to 91% in urban areas. Furthermore, there are vast disparities among provinces, with access to improved drinking water ranging from 10% to 94%. Access to improved sanitation was only 39% overall as of 2013–2014. Among the poor, access to improved sanitation is 29.5%, while for the nonpoor it is 46.5%. Once again, there are vast provincial disparities (with access ranging from 20.0% to 70.0%) and urban–rural inequality (with urban access at 76.5% compared to 29.0% for rural areas).

C. Education and Health

17. Afghanistan has made significant improvements in education since 2002. School enrollments are perhaps the greatest achievement in education. In 2001, only about 1 million children, mostly boys, were enrolled in school. By 2013, Afghanistan had approximately 8.6 million children enrolled in school, with 39% of these being girls. However, despite impressive gains in enrollment and a sharp reduction in gender disparity in education, Afghanistan still has some of the worst education indicators in the world. The net enrollment ratio for primary school in 2013 was 72% (61% for females and 82% for males), while the net attendance ratio for primary education was only 55%. Around four out of 10 children enrolled in grade 1 fail to reach grade 6. Enrollment in higher education is one of the lowest in the world, with only 8.7% of tertiary age youth enrolled in tertiary education as of 2013–2014, but this figure is up from just 5.4% in 2011–2012.

18. Similar to education, the health sector has seen improvements but still has a long way to go in terms of improved health outcomes and equitable access to services. Among the key health indicators are that the maternal mortality ratio has decreased to 327 deaths per 100,000 live births (as of 2014) from 1,600 deaths per 100,000 live births in 2002; the infant mortality rate has declined to 66 deaths per 1,000 live births (as of 2015) from 115 deaths per 1,000 live births in 2002; and the under-5 mortality rate has come down to 91 deaths per 1,000 live births (as of 2015) from 157 deaths per 1,000 live births. Moreover, Afghanistan has one of the highest levels of child malnutrition in the world, with about 55% of children under 5 years of age suffering from chronic malnutrition.

⁹ The central region has a lower poverty rate than the national average but a large percentage of the total population.

¹⁰ World Bank. 2016. *Afghanistan: Systematic Country Diagnostic*. Washington, DC.

19. For women, the major obstacles to health services are physical access to health facilities, the lack of female health care providers, and costs of health services (footnote 8). Gender inequality in decision making and women's restricted mobility (i.e., the need for women to be accompanied by male family members, which increases travel costs) hinder women's access to health services. Also, a lack of female health care workers forms a barrier to women's equal access to health care. Only 53% of the rural clinics in Afghanistan have a female physician, and less than 25% of doctors and nurses are women.

D. Labor Market Developments

20. Afghanistan's labor market is facing considerable challenges that will likely restrict economic growth over the medium term. The labor market is characterized by low skills and low literacy, high unemployment and underemployment, a large number of new entrants to the labor force each year, and high levels of child labor.

21. Afghanistan has a low-skilled workforce, with over 40% of total employment being in the agriculture sector. Adult literacy is only 34%, while youth literacy (15–24 year olds) is 52%. Poor literacy and low education levels hinder productivity and limit the scope for mobility into more productive sectors of the economy. The limited supply of skilled and professional workers also deters investment in sectors crucial for future economic growth and development.

22. The overall labor force participation rate is a low 55% (2013–2014), with men at 81% and women at only 29%. Women's labor force participation is low because of cultural factors, caring for family and the home, security risks, and a lack of job opportunities. Providing women with employment opportunities is one of the keys to reducing fertility rates and demographic pressures, and to ensuring inclusive growth. Women work mostly in the informal sector, with about two-thirds of employed women working in agriculture. However, about 70% of the manufacturing labor force is made up of women because of carpet weaving.

23. Unemployment in 2013–2014 was estimated at 22.6% (male 17.6%, female 36.8%), up from 14.0% in 2007–2008, and underemployment was 16.4% (male 17.4%, female 13.5%). Youth unemployment was 27% (male 22%, female 41%) in 2013–2014, and the situation could get worse with the estimated 400,000–500,000 new entrants to the labor market every year (mostly young people). While finding sustainable jobs for youth has important economic and social ramifications, such as for emigration, high youth unemployment also creates a larger pool of young people who are vulnerable to recruitment for the insurgency.¹¹

24. Afghanistan has one of the highest rates of child labor in the world. Depending on the definition used, the child labor rate is 26%–29% of 5–17 year olds, which means 2.7 million–3.0 million children. Child labor in rural areas is 30% of 5–17 year olds compared to 10% for urban areas. Gender differences also exist, with child labor among boys being nearly 33%, well above the rate of nearly 20% for girls. Child labor perpetuates the cycle of poverty because children are unable to acquire the necessary education and skills or stay healthy enough to get out of poverty.

E. Gender Equality

25. Afghanistan continues to face severe gender disparities. The Gender Inequality Index for 2016 ranked Afghanistan 154th out of 159 countries (footnote 1). However, improving gender equity is difficult because of the cultural and social restrictions placed on women and girls, such

¹¹ Money earned from participating in the insurgency is considered a major factor in why many youth join the fighting.

as attitudes about education for girls, seclusion of women, and limited movement outside of the home. Furthermore, women have little decision making authority within the household over matters such as how money is spent, including money earned by women in the household, and they have been marginalized in reconstruction and development since the early 2000s.

26. Gender inequality is evident in nearly all aspects of life. For employment, women are often not allowed to work outside the home, and those who are face significant challenges in finding work outside of agriculture. Women generally lack networks for nonagricultural employment, have limited mobility, are responsible for childcare and household duties, and lack social acceptance for employment outside of the home. Additionally, the high rate of illiteracy among women prevents many from entering the formal workforce or participating in community governance. The few women who do work outside of the home tend to receive less hours, get paid less than men, and are more likely to engage in vulnerable employment.

27. Education disparity remains a critical barrier to gender equality. Although educational attainment for girls and women has improved since 2001, there is still a wide gender gap in enrolment in all levels. The gender parity indices (the ratio of girls to boys) at all levels of education for 2014 were 67% for primary education, 39% for secondary education, and 54% for tertiary education. There are many reasons for the gender inequality in education, but the top three identified from a 2013–2014 household survey that included why girls are not in school were (i) family didn't allow (32.8%), (ii) studied as far as needed (12.2%), and (iii) early marriage (10.4%) (footnote 8). Other factors include a shortage of girls' schools and few female teachers, especially in rural areas; insecurity, including attacks on female students and girls' schools; and poverty.

28. Some of the inequalities and obstacles to women and girls accessing health care were noted (para. 19). The strong cultural, religious, and social norms which govern women's rights see many Afghan women unwilling or unable to see male physicians, and as a result their utilization of health care services is low. Afghan women's health indicators, specifically on sexual and reproductive health, are among the lowest globally. Additionally, women are highly vulnerable to food insecurity and malnutrition.

29. Additionally, gender-based violence is a pervasive problem, with devastating effects on women's physical, reproductive, and mental health. One study found that 87% of Afghan women face physical, sexual, or psychological violence, or are forced into marriage, and 62% experience multiple forms of violence.¹²

F. Progress Towards Achieving Millennium Development Goals

30. Afghanistan adopted the Millennium Development Goals (MDGs) in 2004. As a result of the late start, the MDGs were extended in Afghanistan from 2015 to 2020. Also, because of the conflict situation, Afghanistan added a ninth MDG, on enhanced security. As of 2017, the Sustainable Development Goals are still in the process of nationalization (of targets and indicators) and alignment in Afghanistan.

31. Assessing progress on the MDGs is problematic in Afghanistan. Data are missing for several indicators, while other indicators do not have recent data. Also, many of the MDG indicators in Afghanistan lack specific targets by which progress could be measured. Based on a review of MDG documents for Afghanistan from 2015, Afghanistan on the whole has a mixed

¹² Global Rights. 2008. *Living with Violence: A National Report on Domestic Abuse in Afghanistan*. Washington, DC.

record of progress towards the MDG targets.¹³ Two MDGs are making good progress (MDGs 4 and 5), two are not progressing well (MDGs 1 and 3), and another five showed mixed results (MDGs 2 and 6–9). Based on the latest progress report, among the indicators for which there is measurable progress, 17% of the indicators have been achieved, 30% are on track, 4% are achievable, 43% are off track, and another 4% appear to be difficult to achieve.¹⁴

G. Environment, Climate Change, and Natural Hazards

32. Afghanistan's environment is coming under greater pressures because of rapid population growth, poor management of water resources, overgrazing by livestock, encroachment on forest land, and climate change. Even the conflict is directly affecting the environment, as Afghanistan is one of the most heavily mined countries in the world and the ongoing conflict restricts forest conservation initiatives. The current environmental conditions have given Afghanistan a rank of 176th out of 180 countries in the 2016 Environmental Performance Index.¹⁵

33. **Urban air quality.** Urban air quality in major cities such as Kandahar, Herat, Mazar-e-Sharif, Jalalabad, and especially Kabul is poor. The main reasons for the poor air quality are the rapid growth of the urban vehicle fleet with a high share of old and/or poorly maintained vehicles; substandard fuel; roads with poor surfaces generating high quantities of dust; burning fuels, coal, and tires for cooking and heating (which affects women in particular); and widespread use of diesel generators.

34. **Water resources.** Afghanistan is a semi-arid, drought-prone country and poor management of water resources and water shortages are placing increased pressures on water resources. Much of the country has experienced a drop in the water table because of drought and overextraction of groundwater. The shortage of water, especially for irrigation purposes, affects the livelihoods of people reliant upon agriculture. Although most of the agriculture land is rain fed, around 98% of total water withdrawal in the country is used for irrigation purposes. The situation is exacerbated by the continually increasing amount of land under irrigation and deteriorating irrigation networks that contribute to water shortages and underutilized agricultural potential. The decades-long conflict has compounded the problems by damaging the irrigation systems or preventing regular maintenance and repair.

35. Water resources are further stressed by the fact that Afghanistan loses about two-thirds of its water from rainfall, snow, and glacial melt each year to its neighboring countries because of its low water storage capacity. Climate change is also contributing to the declining availability of water resources and causes drought. The implication is that more than 2.5 million people in Afghanistan are affected by drought or are vulnerable to the impacts of recurrent drought and water shortages.

36. **Rangelands, forestry, and biodiversity.** Rangelands are an important resource for the rural population and support more than 35 million livestock and wildlife. Rangelands are important to the Kuchi population's livelihood, most of whom rely on livestock rearing. Rangelands are presently in poor condition as they are under increasing pressure from livestock. Overgrazing in mountain areas causes soil erosion and forest depletion and, as a consequence, results in

¹³ Based on review of Government of Afghanistan. 2015. *A Decade of Opportunities: Afghanistan Millennium Development Goals Ten Years Report (2005–2015)*. Kabul; and United Nations Statistics Division. 2015. *MDG Country Progress Snapshot: Afghanistan*. <http://mdgs.un.org/unsd/mdg/Host.aspx?Content=Data/snapshots.htm>

¹⁴ Not 100% due to rounding; author's calculations based on Ministry of Economy. 2015. *A Decade of Opportunities: Afghanistan Millennium Development Goals 10 Years Report (2005–2015)*. Kabul.

¹⁵ Environmental Performance Index. Country Rankings. <http://epi.yale.edu/country-rankings>

landslides and mudflows. Forest areas are also stressed and diminishing. Only 2.0% of Afghanistan is covered by forest, down from 3.5%–4.5% in the 1970s. The destruction of natural habitats threatens biodiversity, with a number of species under threat of extinction. With more than 80% of the population relying on natural resources and the environment to meet their daily needs, stronger efforts are needed to protect the rural population and ensure their sustainable livelihoods.

37. **Climate change.** On global indices, Afghanistan is ranked among the countries most at risk to the adverse effects of climate change because of its vulnerability to expected impacts and its low adaptive capacity. Climate change is expected to pose significant risks to economic activity and quality of life of the population, with a likely disproportionate impact on the poor and marginalized groups. By compounding existing problems such as growing resource scarcity and inefficient production, climate change will likely create challenges for inclusive and sustainable growth, particularly in a context of low institutional capacity and heightened security risks.

38. Afghanistan's per capita greenhouse gas emissions of 1.0 ton of carbon dioxide equivalent are significantly below the global average of 6.2 tons because of relatively low levels of industrialization. However, emissions are expected to grow by approximately 2.7% per year between 2015 and 2030 under a business as usual scenario compared to global carbon dioxide emissions, which are expected to grow by 1.2% per annum in the same period.¹⁶ Under moderate future global emission scenarios, the recent trends of higher temperature and lower precipitation are expected to continue. Mean temperatures are expected to rise by 2.0°–3.5° Celsius (C) relative to 1995 levels by mid-century (up to 4.0° C in winter months), and precipitation is expected to further decline by up to 10%. The change is expected predominantly in the central and southern regions of the country.

39. The poor, and disproportionately women and children, particularly those in subsistence agriculture, are most vulnerable to the effects of climate change. In addition to the agriculture sector, infrastructure is also exposed to climate change effects. Transport infrastructure, including roads, bridges, and railways, is vulnerable to increased frequency and magnitude of hazards which may reduce their performance, availability, and lifetime. Flood events and precipitation-induced landslides may render transport networks impassable and increase maintenance requirements. Higher mean temperatures and more frequent temperature extremes may affect the performance of construction materials. In energy, hydro power generation, particularly small hydro power plants, is vulnerable to decreased water availability, while thermal power plants are also vulnerable to reduced water supplies as well as decreased efficiency from higher mean temperature and heat waves.

40. **Natural hazards.** Afghanistan is already prone to natural disasters, and the effects of climate change will worsen the situation. Numerous natural hazards such as earthquakes, floods, droughts, and landslides strike Afghanistan each year and take a toll on the population, particularly the poor. From 2002 to mid-2017, Afghanistan experienced 103 natural hazards with over 6,200 deaths and 5.1 million people affected.¹⁷ Moreover, poverty, population pressures, and uncertain land tenure lead more people to live in hazard-prone areas, thereby compounding the risks from climate change.

¹⁶ United Nations Framework Convention on Climate Change. 2015. Islamic Republic of Afghanistan: Intended Nationally Determined Contribution, Submission to the United Nations Framework Convention on Climate Change. http://www4.unfccc.int/ndcregistry/PublishedDocuments/Afghanistan%20First/INDC_AFG_20150927_FINAL.pdf

¹⁷ Université Catholique de Louvain. The Emergency Events Database. <http://www.emdat.be> (D. Guha-Sapir; accessed 5 July 2017).

H. Civil Society Participation

41. There are over 7,000 civil society organizations (CSOs) registered in Afghanistan, including over 1,700 registered domestic nongovernment organizations (NGOs), over 200 international NGOs, and over 5,700 associations (i.e., social organizations, foundations, and unions) as of 2015. Many more informal, traditional, and unregistered CSOs exist, including more than 20,000 community development councils established under the National Solidarity Program as well as *shuras* (councils) in most villages. Since the end of the Taliban regime, CSOs and NGOs have balanced their emergency response work with longer-term reconstruction and development initiatives. The establishment of an internationally recognized government has provided CSOs and NGOs with new opportunities to rearticulate the role of humanitarian actors, both as service contractors and as mission-driven CSOs. Most of their work is in health care, emergency relief, school reconstruction and educational programming, community development, capacity building programs, and agriculture.

42. Despite some success of the National Solidarity Program and its successor, the Citizens' Charter, the participation of communities and CSOs in development is constrained by several factors. First, elders and tribal leaders still maintain a great deal of decision-making authority at local levels. Second, most CSOs face financial constraints and limited administrative capacities, which affect their ability to implement projects. Many CSOs rely on foreign funding, which is gradually decreasing. Third, CSOs are often forced to shift activities and their focus in order to meet changing donor interests, as dictated by the foreign policy interests of different international stakeholders. Fourth, lack of security affects CSOs' ability to work, particularly in remote areas where insurgents are active.

I. Business Environment

43. The private sector has been neither the engine of growth nor a facilitator of social inclusion in Afghanistan. According to one recent report, the Afghan private sector contributes merely 10%–12% to GDP.¹⁸ This is the result of a poor business enabling environment and the distortions of the foreign aid dependence. Moreover, the economy is largely informal and contains a significant illicit component. The informal economy is estimated by some to be as high as 80%–90% of total economic activity (footnote 18).

44. In the World Bank's *Doing Business 2016*, Afghanistan ranked 177th out of 189 countries.¹⁹ Afghanistan ranked in the bottom 20% for seven indicators: protecting minority investors (189th), construction permits (185th), registering property (184th), trading across borders (174th), enforcing contracts (172nd), resolving insolvency (160th), and getting electricity (156th). The country fared better in starting a business (32nd), paying taxes (89th), and getting credit (97th).

45. The business environment and private sector development are greatly affected by the high levels of corruption. Afghanistan was ranked 169th out of 176 countries with a score of 15 out of 100 in the *Corruption Perceptions Index 2016*. Bribes are commonly paid by firms and constrain the growth of micro, small, and medium-sized enterprises. Moreover, corruption is a deterrent to investment and formalizing enterprises, and has implications for fueling the insurgency and the lack of popular support for the government.

¹⁸ R. Ghiasy, et al. 2015. *Afghanistan's Private Sector: Status and Ways Forward*. Stockholm.

¹⁹ World Bank. 2016. *Doing Business 2016: Measuring Regulatory Quality and Efficiency*. Washington, DC.

46. In addition to corruption, several obstacles hinder the growth of the private sector. Economic policies and the business legal and regulatory framework are inadequate. Legislation does not provide sufficient protection for investments, and its implementation is unpredictable at best. Formal government economic institutions are in their infancy and are not able to regulate the economy effectively. Some economic reforms have been launched by the current unity government, but they are incomplete and have yet to have much effect. One key recent accomplishment, however, is Afghanistan's accession to the World Trade Organization in 2016.

47. The ongoing insurgency is another major factor restricting private sector activity. Violence increases the costs of doing business and deters investment. Furthermore, the conflict has led to much capital flowing outside the country instead of being reinvested into Afghanistan. Even many of the wealthiest business people have moved away from the country because of the conflict.

48. Afghanistan's infrastructure is severely lacking, and much of the existing infrastructure has been damaged by the war and deferred maintenance. The deficient infrastructure negatively affects private sector growth and job creation. While over 75% of the population in large urban areas have access to grid-connected electricity, less than 10% of the rural population has access to grid-connected power. Overall, about 30% of the population receives grid-connected electricity. The limited road network is incomplete and mostly in bad shape, leading to much of the country being unconnected. Only 15% of the planned national highways have been built, while more than 85% of the roads are in poor condition, with large portions, particularly in rural areas, impassable.

49. Limited access to finance and a weak financial system also pose major constraints on the private sector. Domestic credit to the private sector was only 4.2% of GDP in 2014, whereas the regional average was 42.0%. According to the 2014 Enterprise Survey, merely 2% of firms use banks to finance their investment.²⁰ The limited access to finance is also reflected in the number of financial accounts. As of 2014, only 10% of adults, including only 4% of women, had an account at a financial institution. Women are less able than men to access funds for starting small and medium-sized enterprises or expanding a home-run business, which keeps them locked in vulnerable and informal employment and limits their economic empowerment.

J. Economic Growth Prospects

50. Afghanistan has been struggling to create a sustainable economy through a period of high insecurity and political uncertainty. Unfortunately, the economic situation is not likely to change significantly over the medium term, and this will have profound implications on poverty reduction and human development indicators. Economic growth needs to pick up significantly in order to reduce poverty and counter the high population growth rate. The security situation is not expected to improve rapidly and will remain a key constraint on the economy, and political uncertainty and gridlock could continue throughout the current administration. ADB forecasts GDP growth of 2.5% in 2017 and 3.0% in 2018. The medium-term outlook is also affected by the high expenditure needs, particularly for security, and weak revenue flows (footnote 10), but the mining industry is expected to eventually become a key driver of growth in the medium to long term and help offset declining donor aid.

²⁰ World Bank. 2014. *2014 Enterprise Survey*.
<http://www.enterprisesurveys.org/data/exploreeconomies/2014/afghanistan>

IV. KEY IMPEDIMENTS TO INCLUSIVE AND SUSTAINABLE GROWTH

51. This assessment has shown that Afghanistan remains one of the least developed countries in the world. Nearly all sectors or thematic areas in Afghanistan need vast improvements. None of the areas is expected to improve rapidly, and therefore all of these can be seen as significant impediments to inclusive and sustainable growth in the country. Hence, singling out a few critical impediments is difficult. Nevertheless, this section focuses on what could be considered the most likely key binding constraints on inclusive economic growth and sustainability in Afghanistan.

A. Insurgency

52. The ongoing insurgency poses the greatest threat to inclusive growth in Afghanistan. The conflict is impinging on every aspect of economic and social development in the country, and without a peace settlement Afghanistan will not be able to achieve its full growth potential. The conflict continues to destroy and limit infrastructure development, deters investment and other economic activities, causes capital outflows, restricts access to schools and health services, restrains women from venturing out of the home, displaces thousands of people, and diverts much public finance to security costs. Parts of the country affected the most by the insurgency will likely fall behind the relatively more peaceful areas. Hence, the cornerstone of Afghanistan's inclusive and sustainable growth is an end to the insurgency. However, a peace agreement will likely remain elusive, and with the insurgency escalating and the Taliban controlling more territory than ever since 2001, the conflict will continue to pose the biggest constraint on inclusive growth and economic development for the foreseeable future.

B. Infrastructure Deficit

53. Despite progress in infrastructure development since 2002, the transport network remains vastly incomplete and in poor condition. Afghanistan's road network, with a density of only 4 kilometers (km) per 1,000 square km, is far below the levels achieved by its neighbors. The percentage of households within 2 km of a road is 52% nationally, 95% in urban areas, and 38% in rural areas. The result is that much of the population lacks adequate access to transport infrastructure, thereby limiting mobility and access to markets and employment opportunities. From an economic perspective, the poor transport infrastructure inhibits trade, restricts the development of natural resources, hinders regional integration, and limits inclusive economic growth.

54. Similarly, inclusive economic growth is limited by power availability and reliability. Afghanistan ranks among the lowest 5% in per capita energy consumption globally and is a net energy importer. Insufficient energy supplies and the demand–supply imbalance constrain growth and income opportunities and create disparities in economic development.

55. The primary barrier to improved agriculture is a lack of proper infrastructure to channel water for agriculture purposes.²¹ This includes the lack of a proper water distribution system and water storage capacity and overall poor management of water resources. Most of the water loss in Afghanistan is due to the low efficiency of irrigation systems. The low efficiency partly stems from the fact that the vast majority of irrigation comprises informal irrigation systems. Afghanistan has only 10 formal irrigation systems covering around 10% of the irrigated land. With the proper

²¹ Civil-Military Fusion Centre. 2012. *Irrigation, Profits & Alternatives Crops*. http://reliefweb.int/sites/reliefweb.int/files/resources/Full_Report_4263.pdf

distribution of water, the amount of irrigated land in Afghanistan could double (footnote 21), thereby increasing opportunities for rural livelihoods.

56. The infrastructure deficit in Afghanistan also limits the potential benefits and economic opportunities that regional integration can offer. Regional infrastructure can increase trade and transit, increase cross-national commercial links, create jobs, and generate new business opportunities.

C. Adverse Population Dynamics

57. **Demographic pressures.** Afghanistan has one of the highest fertility rates in the world at 5.1% (as of 2011–2012). This high fertility rate leads to a rapid population growth rate, which is now 2.5%. The high population growth rate has two major implications. First, it means that recent slow economic growth rates will make poverty reduction very difficult, and therefore a cycle of high poverty and high population growth will persist. Second, it places even more pressures on labor market absorption capacity, which is already stressed and unable to provide enough jobs for the hundreds of thousands of new entrants to the labor market each year.

58. **Large population of internally displaced people and returning refugees.** Afghanistan has had a large population of internally displaced people and refugees for decades. In 2016, over 635,000 people were newly displaced, which was 66% higher than in 2015. Currently there are an estimated 1.3 million internally displaced people. As for refugees, over 4.8 million people have been repatriated back to Afghanistan by the United Nations High Commissioner for Refugees since 2002, and in 2016 alone over 1 million Afghan refugees returned from Pakistan and Iran, presenting an immediate crisis situation. As of 2017, an estimated 2.3 million Afghan refugees still live in neighboring countries.

59. **Emigration.** Unlike the main refugee exodus prior to 2002 and then the wave of returning refugees from 2002 until around 2012, the newest wave of population movement is migration abroad. Afghanistan has gone from net immigration to now net emigration, and it is mainly due to labor opportunity reasons. The significance of this is that many of the educated and skilled population, nearly all of whom are men aged 15–39 (93% of emigrants), are leaving the country. The resulting “brain drain” and capital flight could hurt economic growth, investment, and the country’s ability to move up the chain in value-added economic activities.

D. Capacity and Governance Effects on Growth, Equality, and Stability

60. Institutional capacities in government ministries and agencies are limited, thereby reducing the effectiveness of development assistance and the efficient use of it, and resulting in poor service delivery and weaknesses in performing basic functions. Developing the capacities of these ministries and agencies is part of the “state building” process that is necessary to overcome fragility in Afghanistan. There is a variety of reasons for the low capacities, including a poor education system, high staff turnover, donors bypassing government systems, capacity substitution, limited management skills, lack of funding, and fragmented responsibilities.

61. Corruption exists at all levels of government in Afghanistan and is one of the greatest challenges to rebuilding and stabilizing the country. Corruption takes a toll on economic growth but also on equality and political stability. There are many channels for corruption to negatively affect economic growth. It reduces investment from domestic and foreign sources and raises costs to businesses. Corruption can delay infrastructure development as contract rigging and illegal payments are arranged. It also reduces the amount of revenue that the government collects

in taxes and customs. Another effect of rampant corruption, and one particularly relevant to Afghanistan, is that it undermines government legitimacy. The current government has prioritized anticorruption and initiated some reforms, such as the Anti-Corruption Justice Center which is prosecuting significant corruption cases involving high-ranking government officials.

E. Exclusion of Women

62. The advancement of women in Afghanistan has made some progress since 2002, but gender inequality is still vast in all aspects of society. Essentially half of the Afghan population is not participating fully in the development of the country, with women and girls facing unequal access to economic opportunities, education, finance, health services, legal protection, property rights, and political participation.

63. There are many benefits from the inclusion of women and girls. Improved gender equality leads to higher economic growth, more rapid poverty reduction, and improved development outcomes for everyone. Gender equality also helps to alleviate demographic pressures as women stay in school longer and tend to have a lower fertility rate if employed. Benefits to the future generation occur because educated women are more likely to invest in the health and education of their children. However, these potential benefits are at risk given the level of exclusion of women and girls in all facets of life in Afghanistan.

F. Private Sector Environment

64. Afghanistan's private sector needs to become the driver of growth, but it is currently constrained by a weak operating environment (including the legal and regulatory environment and business-related government services such as registration and licensing), the poor security conditions, and limited managerial and technical skills. Only the private sector can absorb the hundreds of thousands of new entrants to the labor market each year and the large influx of returning refugees. Otherwise, achieving inclusive economic growth will be difficult.

V. IMPLICATIONS FOR ADB COUNTRY ENGAGEMENT

65. Economic growth in Afghanistan has not been inclusive. Even some years of high economic growth rates have not led to a reduction in poverty, and growing disparities are evident based on consumption data. Afghanistan and its development partners such as ADB need to find ways to make economic growth more inclusive and sustainable. The following implications and suggestions are made to increase the impact of ADB's operations in Afghanistan in the next CPS period. ADB needs to be selective in addressing the key impediments to growth, as ADB cannot directly affect some of them, such as the security environment and population dynamics.

A. More Inclusive Infrastructure

66. It is widely known that infrastructure promotes economic growth, provides access to services and economic opportunities, links markets, and fosters regional integration. Given Afghanistan's dearth of infrastructure throughout the country, particularly in rural areas, and the poor condition of existing infrastructure, maintaining a focus on infrastructure provision remains relevant for ADB.

67. However, ADB can make infrastructure more inclusive and sustainable. There are several possible ways this could be done. Exploring potential synergies among infrastructure sectors, particularly with other development partners, would help address the holistic needs of the

populations along project sites. For example, ADB could examine ways to integrate various combinations of energy, transport, irrigation, or communications infrastructure in particular localities.

68. Infrastructure can also become more inclusive by better integration of gender dimensions in all projects. Currently many projects in Afghanistan do not include gender components or provide specific benefits to women and girls. All project designs should consider how gender dimensions can be featured so that infrastructure becomes more inclusive for women and girls.

69. Additionally, ADB could explore ways to integrate lagging regions of the country with more economically well-off regions. Closing the gap in access to essential services and markets would create more equal opportunities for people in the poorer areas of the country.

B. Addressing Climate Change and the Environment in ADB Operations

70. Given Afghanistan's vulnerabilities to climate change, environmental degradation, and natural hazards, ADB could explore more ways to address these issues that are vital to the country's long-term sustainability. Much of this effort could take place through the existing priority sectors. Energy, transport, and ANR are among the sectors in Afghanistan that are (i) most at risk to the effects of climate change, (ii) for energy and transport, key contributors to annual greenhouse gas emissions, and (iii) prioritized under the country's adaptation and mitigation strategies and policies. Through the selection and design of appropriate investments, ADB's engagement in Afghanistan should help address the risks posed by climate change, environmental degradation, and natural hazards.

71. There are a few ways in which this could be accomplished. First, ADB could address crosscutting climate and environment issues by investing in clean and renewable energy. Second, incorporating climate risk mitigation and disaster risk reduction measures in roads, bridges, and railways could help address climate risks in rehabilitation and construction of the transport network. Third, ADB could support the mainstreaming of climate and disaster risk management and environmental sustainability in the governance of public resources, such as through capacity building in seasonal and climate change modeling, forecasting, and analysis; watershed monitoring and management; disaster and climate change risk assessment and management; "climate smart" project development; and strengthening environmental assessment and management capacity. And finally, ADB could improve water management and water productivity in Afghanistan's agriculture sector by increased water productivity in climate-proofed irrigation systems; promoting climate-resilient agriculture practices; improved transboundary monitoring and water management; improved surface and groundwater storage; and establishing water quality monitoring systems.

C. More Explicit Focus on Gender Equality

72. Gender inequality is a significant obstacle to inclusive economic growth in Afghanistan. ADB's contributions to gender were minimal during 2009–2015.²² In addition to gender mainstreaming, which has had limited impact in ADB's operations in Afghanistan, a gender-targeted approach could be pursued to ensure greater benefits accrue to women and girls. For infrastructure projects, ADB could identify in the initial project design stage specific initiatives or components for women and girls. Specific gender elements in infrastructure project designs would be intended to increase the use of services by women and girls, and increase their participation.

²² ADB. 2015. *Country Partnership Strategy Final Review: Afghanistan (2009 to mid-2015)*. Manila.

This could include sanitation facilities in road projects and targeting women as specific beneficiaries of agriculture or finance projects, or in energy, encourage inclusion of female employees in the electricity utility and invest in capacity building of women experts in the field.

D. Fragile and Conflict-Affected Situation Approach Fully Implemented

73. Afghanistan is classified by ADB as a fragile and conflict-affected situation (FCAS), and the current security and political conditions give rise to great uncertainty in the future. ADB should be more diligent in applying an FCAS approach because of the security conditions, weak institutions and governance, and other causes of fragility. In particular, ADB could (i) ensure that conflict sensitivity is used throughout the entire project cycle; (ii) require that thorough risk assessments and mitigation strategies are prepared for each project up front, including an examination of internal and external factors underlying fragility and the drivers of conflict; (iii) ensure that local conditions related to potential or actual conflict in a project area are clearly understood by ADB staff, government officials, and project management units; (iv) ensure close collaboration with civil society; and (v) apply appropriate flexibilities allowed under ADB's FCAS approaches to project appraisal requirements, project processing, procurement, and disbursement (footnote 23).²³

E. Government Capacity Building

74. Government capacities are limited and there are extensive needs for institutional development and reform, and human capacity building. ADB has worked on institutional and human capacity development in the three priority sectors of energy, transport, and ANR, and made progress in strengthening government capacities. ADB should continue with this approach and give high priority to capacity building in the new CPS.

F. Private Sector Development

75. The private sector enabling environment needs to improve to promote employment and economic growth opportunities. Clearly the security situation is a major drag on private sector development, but progress can still be made in improving the enabling environment so that the private sector can flourish when security conditions improve. In coordination with other development partners, ADB could explore suitable areas for private sector development, such as the legal and regulatory environment and conditions for future public-private partnerships.

²³ Efforts to implement an FCAS approach have commenced under ADB's capacity development technical assistance for Building Resilience to Fragility in ADB-Supported Projects. (ADB. 2015. *Building Resilience to Fragility in ADB-Supported Projects*. Manila).