EADS Regional Trends Report on

Afghanistan and Pakistan

August 2014

Afghanistan and Pakistan are in a similar pattern of moderate economic growth and face similar development challenges. Pakistan has fewer costs and delays imposed on trade than does Afghanistan, as well as a higher rank on the *Ease of Doing* Business scores. However, Afghanistan improved its relative business climate notably during 2013, while Pakistan's standing slid. Based on the most recent indicators, Pakistan stands ahead of Afghanistan on political freedoms, but the first round of presidential voting in Afghanistan was widely seen as a positive step forward while democratic institutions in Pakistan remain stressed. Economic growth remains a vital tool for both countries to address many of their problems, but the development challenges of corruption, poor governance, and other problems themselves are hindering a rapid expansion of their economies.

This snapshot analyzes Afghanistan and Pakistan. Countries in USAID South Asia region include Bangladesh, Bhutan, India, Maldives, Sri Lanka, Pakistan, and Afghanistan. When comparisons with other regions are made, the focus is on the 121 countries that received at least $2 million in USAID assistance in fiscal year 2012, excluding high income countries based on World Bank GNI per capita data for 2012. Data presented in this snapshot come from a diverse set of sources listed in the 'Additional Information' section at the end of this snapshot.

Economic Growth

The International Monetary Fund (IMF) expects both Afghanistan and Pakistan to experience moderate GDP growth between 2014 and 2019. Growth in Afghanistan slowed in 2013 after a very strong performance in 2012 due to a jump in agricultural output. In Pakistan, according to the IMF, the manufacturing sector performed better than expected due to currency depreciation and an improvement in the electricity supply. This performance, however, was offset by weak cotton production. Growth in Pakistan was also hampered by fiscal consolidation as the government corrects macroeconomic imbalances, and low foreign domestic investment caused by energy shortages and security concerns.

Source: IMF, World Economic Outlook (April 2014)

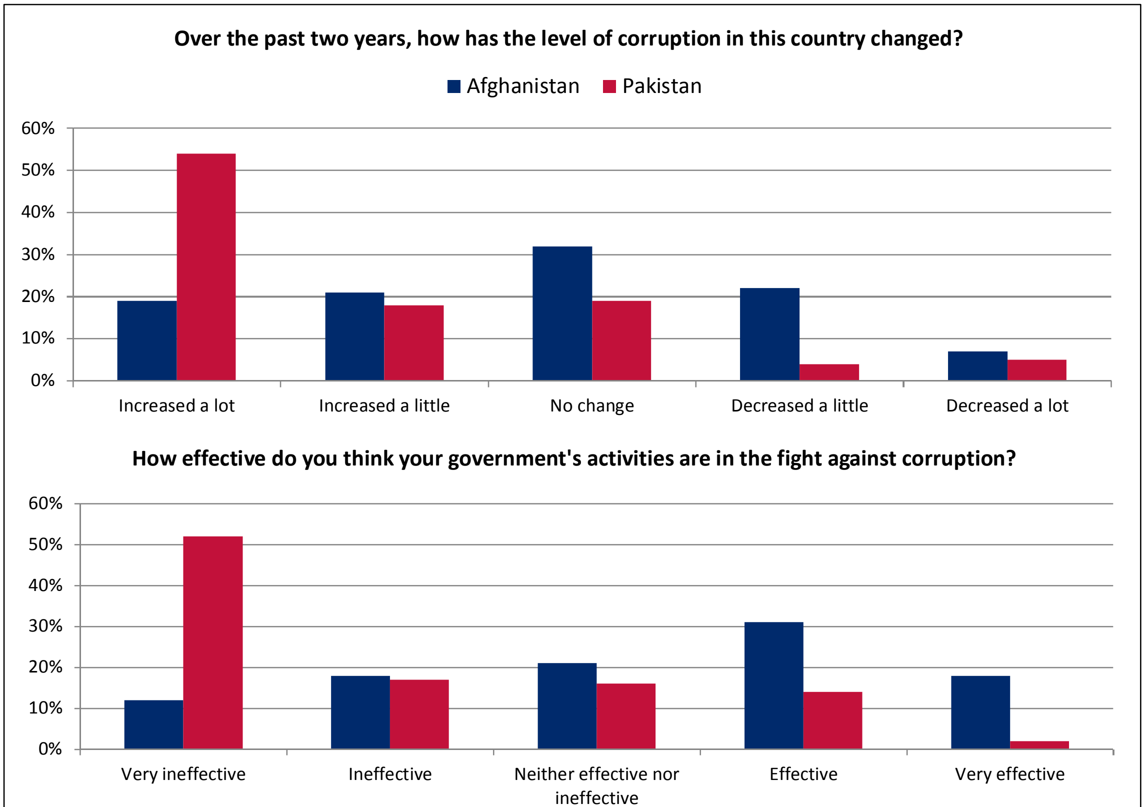
Looking forward, both Afghanistan and Pakistan are expected to grow less than 4 percent in 2014, with growth rates slowly climbing to just over 5 percent for both countries by 2019. GDP per capita will grow somewhat more slowly, forecast at 0.8 and 1.1 percent in 2014 in Afghanistan and Pakistan, respectively, rising to 3.4 and 3.1 percent by 2019. The slower growth in Afghanistan is expected due to the upcoming pullout of coalition troops, with a negative impact on economic growth, especially if a Bilateral Security Agreement to allow for continued involvement is not signed with the United States. Pakistan's efforts to improve their economic situation are hampered by problems with corruption and poor electricity supply, and agriculture is expected to weaken.

Corruption

Control of corruption is crucial for political stability, rule of law, increased democracy, and future economic success. In addition to a border, Afghanistan and Pakistan also share a common problem of rampant corruption. Afghanistan was ranked the world's most corrupt state, among 175 countries in the index, along with Somalia and North Korea in the *2013 Corruption Perceptions Index (CPI)* report by Transparency International. According to *A Survey of the Afghan People – Afghanistan in 2013* by The Asia Foundation, the top three major challenges for Afghanistan were insecurity (30 percent), corruption (26 percent), and unemployment (25 percent). In addition, survey results reveal that Afghans saw corruption as a major problem in all facets of life and at all levels of government. Based on another key source, the *Global Corruption Barometer* (GCB) by Transparency International, Afghanistan's legal system, judiciary, and NGOs were the entities most affected by corruption in 2013.

Corruption in Pakistan is perceived as widespread, systemic, and deeply entrenched at all levels of society and government. Pakistan ranked very low on the CPI (127th out of 175), below India (94th) and Nepal (116th), and slightly above Bangladesh (136th) in South Asia. In a 2011 *Gallup Poll*, 81 percent of Pakistanis saw their government as rife with corruption, up from 68 percent in 2005. Police and political parties are the most affected entities by corruption, according to GCB. Since 2007, Pakistan has been experiencing a downward trend on the *Global Governance Index* by the World Bank across the categories of government effectiveness, regulatory quality, and control of corruption.

The *GCB* for 2010/11 showed many challenges for both countries. In response to the question: "In the past three years, how has the level of corruption in this country changed?" 60 percent of Afghanis and 77 percent of Pakistanis answered that it had increased. The most recent *Global Corruption Barometer*, from 2013, offered more positive news for Afghanistan.



Source: Transparency International, *Global Corruption Barometer, 2013*

More than half of the population in Pakistan felt that the level of corruption had increased by a lot from 2011 to 2013, while more than 20 percent in Afghanistan felt that it had decreased a little over the same period. With respect to perceptions of how effective the government's anti-corruption efforts are in their country, Afghanis are far more trusting than Pakistanis. Nearly half of the population in Afghanistan sees the efforts as either effective or very effective, while more than half in Pakistan see the efforts as very ineffective.

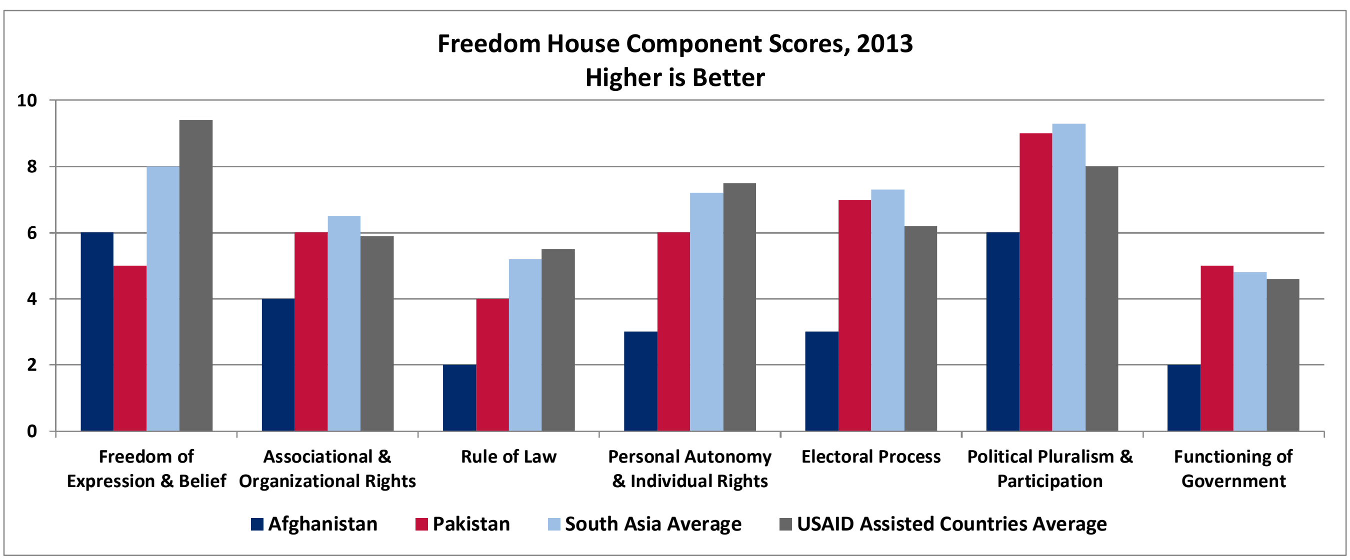
In both Afghanistan and Pakistan, reducing corruption would have the direct benefit of improving economic performance and governance. In addition, less corruption would give donors more trust in the country's institutions and lead to more effective utilization of foreign aid.

Political Freedom

In the *Freedom in the World 2014* report by Freedom House, Pakistan was scored **Partly Free** and Afghanistan **Not Free**. Pakistan scored the lowest in the South Asian region in freedom of expression and belief score (5), followed by Afghanistan (6). The low score is despite Article 19 of the constitution of Pakistan, which guarantees freedom of speech and expression and freedom of the press with certain restrictions, such as criminalizing blasphemy against Islam.

The *2014 World Press Freedom* report by Reporters Without Borders ranked Pakistan 158th out of 180 countries on the Press Freedom Index. The report emphasizes that the Pakistani government seems powerless against the Taliban, jihadist, other armed groups, and military apparatus. In addition, the report emphasizes that journalists are not freely able to speak out since they might be abducted, tortured, or even murdered. Afghanistan ranked (128th) on the Press Freedom Index.

Afghanistan scored poorly on the functioning of government score. The stability of Afghanistan is dependent on the capacity, transparency, and legitimacy of the Afghan government especially after the foreign forces transfer the security mission to the Afghan leadership. The government remains weak and corrupt. A Congressional Research Service report, *Afghanistan: Politics, Elections, and Government Performance*, cites concerns that in the wake of the Afghan election an informal coalition of faction leaders could rise to power. These leaders might recruit armed fighters and increase instability, corruption, and human rights abuses.

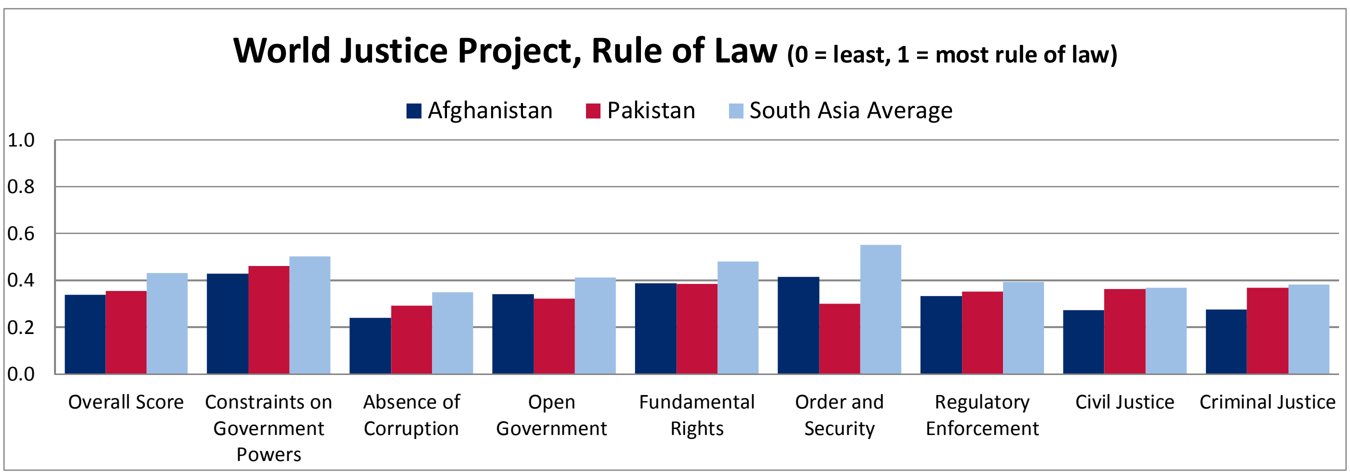


Rule of Law

Pakistan and Afghanistan ranked in the bottom on the rule of law index by the World Justice Project (WJP) *Rule of Law Index* for 2014.

Pakistan is weak in all dimensions of the index scoring (96th out of 99 countries) and ranked the worst on order and security (99th) because of civil conflict, terrorism, crime, and the use of violence to resolve personal grievances. In addition, Pakistan ranked badly in open government (95th) and regulatory enforcement (95th). However, Pakistan performed better in criminal justice (68th) and constraints on government powers (73rd), mainly because of the presence of an independent judiciary and comparatively effective oversight by the legislature and non-governmental checks. But due to high corruption and the dreadful condition of correctional facilities, the judicial system is slow and unproductive. Despite Pakistan's low rank in fundamental rights (92nd), it ranks better than its regional peers in freedoms of speech and assembly.

Afghanistan ranked as the second worst performer (98th) in the WJP Rule of Law Index. Afghanistan faces the difficult task of increasing the accountability of public officials and improving the functioning of its public institutions. Afghanistan showed some strengths based on limits of the legislature and non-government checks, but also weakness in the areas of judicial independence and effective auditing and review. The judicial system in Afghanistan faces many challenges including: high corruption, undue influence, inefficient enforcement, discrimination against women and religious minorities, and violations of due process. In terms of order and security, it ranks 97th because of the fragile security situation due to armed conflict, crime, and the use of violence for remedy. Lastly, Afghanistan's fundamental rights rank (91st) is negatively affected by the lack of labor rights, equality treatment protections, and freedom of religion.



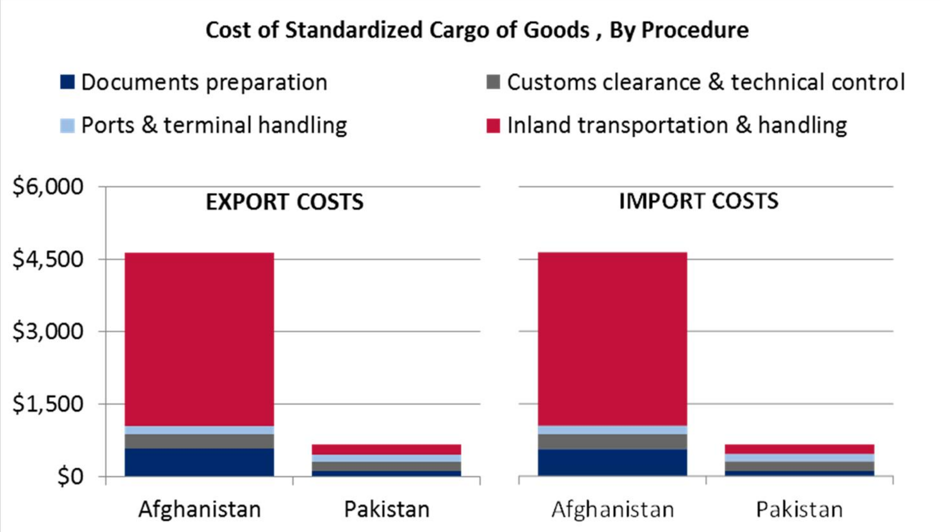
Trade and Infrastructure

In the past ten years, merchandise trade has increased over 300 percent in Afghanistan and 150 percent in Pakistan. Both countries are net importers, and have seen larger increases in imports than exports. However, the IMF's *World Economic Outlook* (WEO) forecasts that exports will increase faster than imports between 2014 and 2019, with Pakistan's exports forecast to increase 8.8 percent in 2014, but will then increase more slowly, dropping off to only 5.5 percent annually by 2019.

For Afghanistan, the IMF expects exports to decrease this year and in two of the next three years, but to grow 17.1 percent in 2019, while import growth is forecast to remain low. Many of Afghanistan's exports are agricultural, fruits and nuts made up 23 percent of exports in 2012. Nonetheless, manufactured woven rugs represented 17 percent of exports. Pakistan has a greater variety of exports, many of which are cotton, textiles, and apparel; combined these related categories accounted for over 35 percent of exports in 2013.

Pakistan makes it easier to trade than many South Asian and USAID-assisted countries, but Afghanistan makes it particularly difficult for firms wishing to trade. The time it takes to export a container from Afghanistan (81 days) is nearly three times the average for USAID-assisted countries (28 days), and has been increasing. Most of the time is spent on preparing documents. Although Afghanistan is landlocked, and security concerns and poor infrastructure make transit difficult, inland transportation, at 25 days, accounts for only 31 percent of the total time spent on export procedures (although this alone takes longer than the entire 21-day export process from Pakistan), with document preparation taking over half.

Looking at cost to export, inland transportation and handling accounts for 78 percent of the cost to export from Afghanistan. For Pakistan, document preparation also accounts for over half the time to export, although costs are more evenly divided. Customs clearance and technical control contribute the most costs, followed next by inland transportation and handling.



Source: World Bank, *Doing Business* 2013

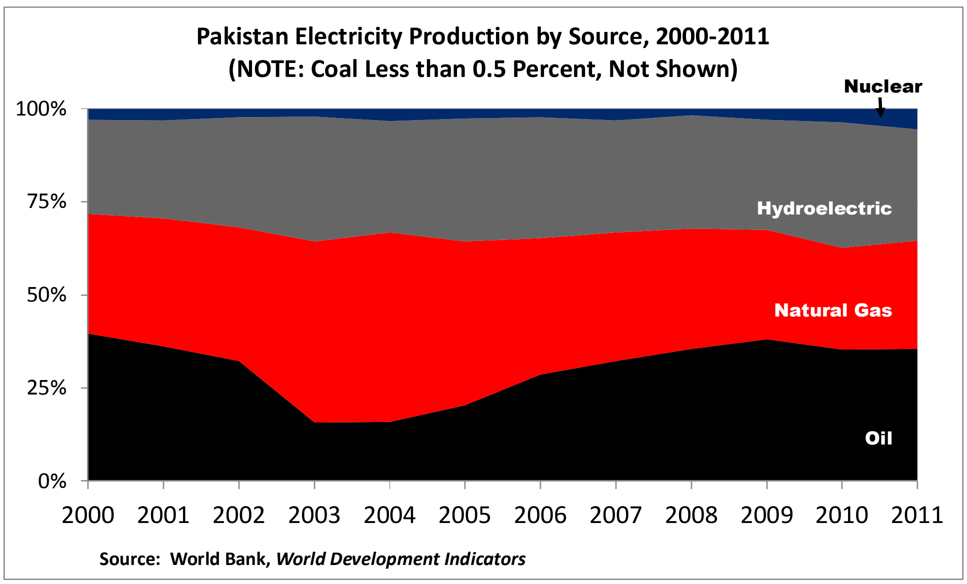
Afghanistan's high costs of trade reflect their landlocked status and a lack of necessary infrastructure; Pakistan also severely lacks adequate infrastructure. In its 2014 *Pakistan Infrastructure Report*, Business Monitor International (BMI) is pessimistic about Pakistan's infrastructure, projecting slower growth in the construction sector in 2014. Although it acknowledges that new projects are being planned; the demand for infrastructure is high; the Pakistani population is large and young; and the country is in a strategic location near fast-growing economies, BMI predicts that problems and risks in the Pakistani economy will dampen new construction projects. These include corruption, security risks, high interest rates and a weak currency that can increase costs, cause fiscal shortfalls that make funding uncertain, and worsen a poor business environment. Many of these problems also exist, often to a greater degree, in Afghanistan, which also lacks some of Pakistan's advantages, such as access to the sea and a large population.

Energy: Electricity

Mainly due to three decades of war and conflict, the Afghani energy infrastructure is undeveloped and mismanaged. Only 30 percent of its population has access to electricity, according to the latest *World Development Indicators* report. Also, according to the *World Bank Enterprise Surveys*, nearly two-thirds of surveyed firms in 2014 identified electricity as a major constraint and obstacle for investment.

Similarly, Pakistan has a poor transmission system that causes electricity line losses. Business Monitor International calculates that the average electric power distribution loss as percentage of output for 2004–2013 is 20 percent. Pakistan ranked 175th out of 189 countries in getting electricity in *Doing Business 2014* report. Causes of the energy crisis in Pakistan are poor management, lack of accountability, increased in consumption, and economic and political instability.

Another major problem that the Pakistani power sector is facing is circular debt. According to *The Causes and Impact of Power Sector Circular Debt in Pakistan,* a report by the Planning Commission of Pakistan, the country has a large and growing circular debt, which is the amount of cash shortfall within the central power purchasing agency that it cannot pay to power supply companies. This debt is mainly caused by poor governance, delays in tariff determination and notifications, fuel price adjustments, poor revenue collection, and the impact of high transmission and distribution losses.



To make matters worse, the mixture of resources for electricity generation in Pakistan is also imbalanced. Pakistan depends highly on only a few, very limited, and expensive energy sources for electricity production. Dependency on the price of crude oil destabilizes electricity generation expenditures in Pakistan. The country currently lacks the ability to shift energy production towards cheaper sources of energy such as coal, or renewable sources such as wind and solar energy.

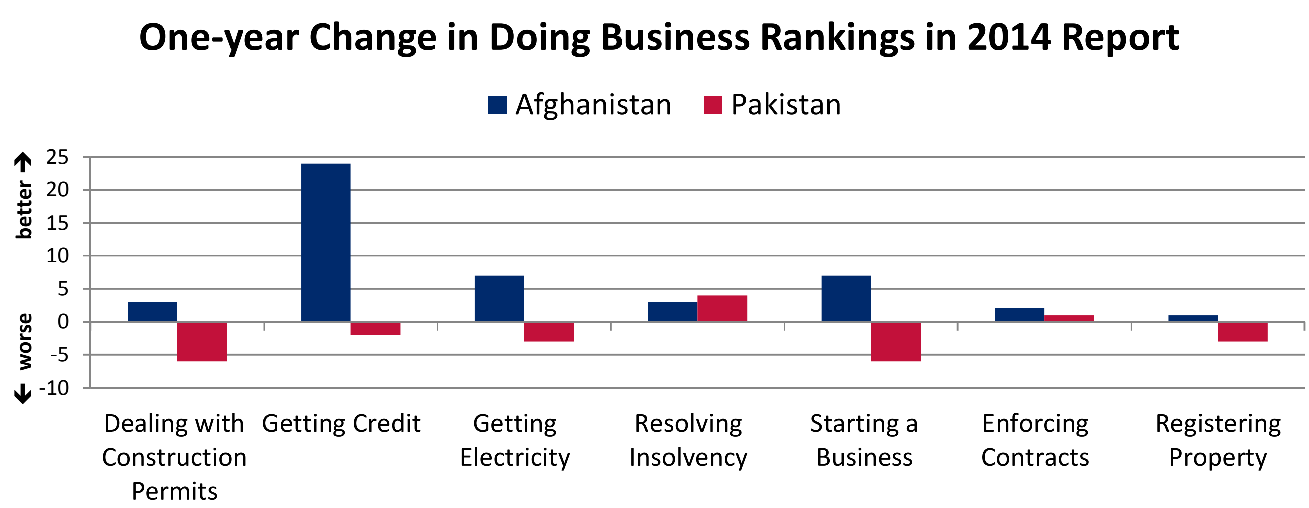
To address longstanding problems, the government and private sector utilities have moved aggressively to expand electricity production away from coal. As untapped coal fields have been discovered in southern Pakistan, the government has decided to use coal to ease dependence on costly imported oil. Projects currently underway will add more production capacity in phases over the next six years.

Business Climate

Both Afghanistan and Pakistan are poor environments for doing business, with Afghanistan in the bottom quartile of countries on the World Bank's *Ease of Doing Business 2014* index (which has 2013 data), and Pakistan in the second to last quartile. Afghanistan, however, advanced six spots in the rankings between 2012 and 2013, while Pakistan slid four spots, losing ground in seven out of ten sub-indicators.

Afghanistan improved in seven out of ten sub-indicators. It made starting a business easier by reducing the time and cost to obtain a business license and by eliminating the inspection of the premises of newly registered companies. It also strengthened its secured transactions system by implementing a unified collateral registry, causing it to jump 24 places in the sub-ranking for ease of obtaining credit. The World Bank reported no reforms to either improve or worsen the business environment in Pakistan.

The current direction of change is evident from a consideration of the seven Doing Business components where Afghanistan improved its ranking in the most recent report. Of those seven components, Pakistan's standing slid in five areas.



Source: World Bank, *Doing Business*, 2014

Fiscal Situation

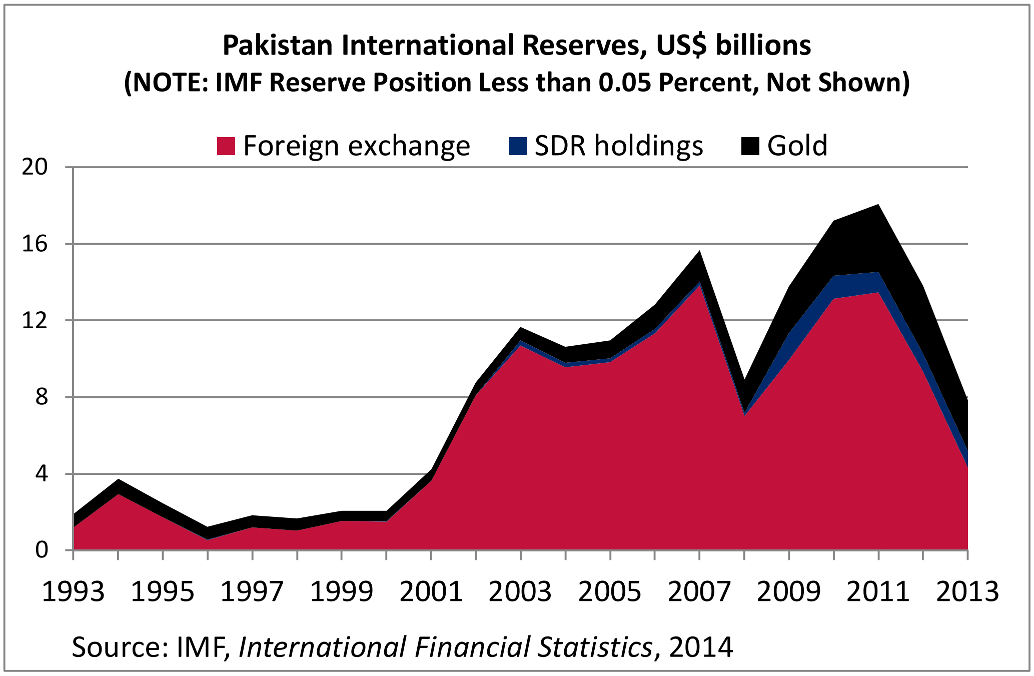
Afghanistan's fiscal deficits are smaller than those of Pakistan, though it is very dependent on donor funding. Afghanistan ran slight surpluses in 2010 and 2012, and slight deficits in 2011 and 2013; it is forecast to run more deficits than surpluses in the next five years, with the deficit reaching 1.5 percent of GDP in 2019.

Fiscal deficits have been a challenge for Pakistan due to expanding energy subsidies, loss-making state-owned enterprises, and rising security costs. Under its IMF Extended Fund Facility program, Pakistan is reducing energy subsidies, clearing its circular debt, and privatizing state-owned enterprises. However, chances of the circular debt growing again remain high. The IMF predicts that Pakistan's deficits will continue through 2019, but they will decline steadily as a share of GDP. The high mark for deficit as a percent of GDP (since 1993) was 8.4 percent in 2012. The ratio dropped to 5.3 percent by 2014 and the IMF projects that it will further narrow to 3.2 percent in 2019.

Foreign Reserves

Since the IMF began regularly reporting Afghanistan reserves data in 2008, foreign reserves have been steadily growing. They represented 7.2 months of imports in 2012.

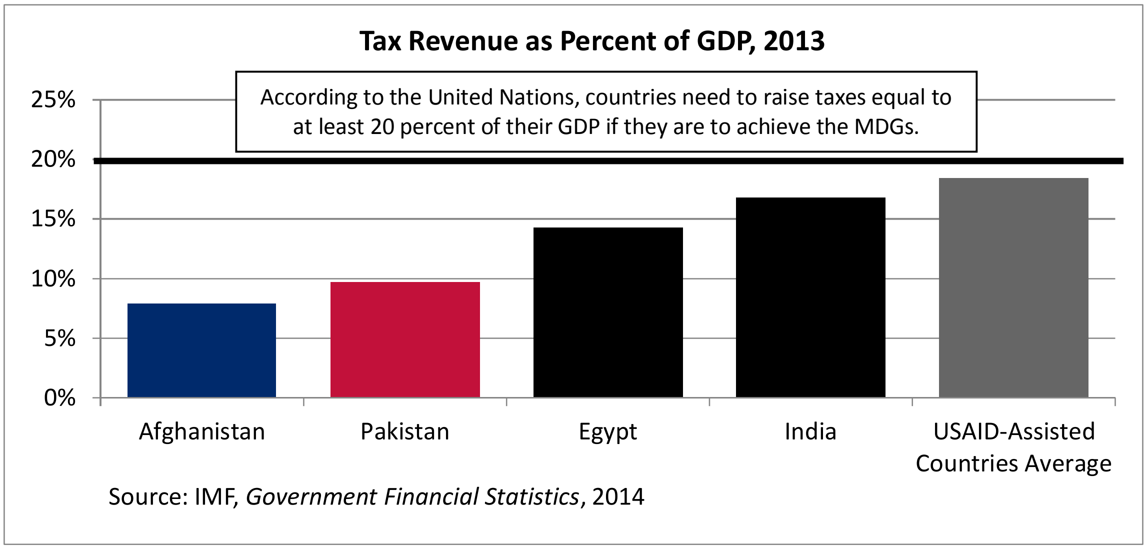
By contrast, Pakistan has experienced a sharp drop in international reserves since their high in 2011, particularly in foreign currency reserves. In 2012, reserves represented 3.1 months of imports. Reserves have recovered slightly in recent months thanks to the IMF loan, increased exports and remittances, and infusions of cash from other countries, but remain low compared to recent years.



Domestic Revenue Mobilization

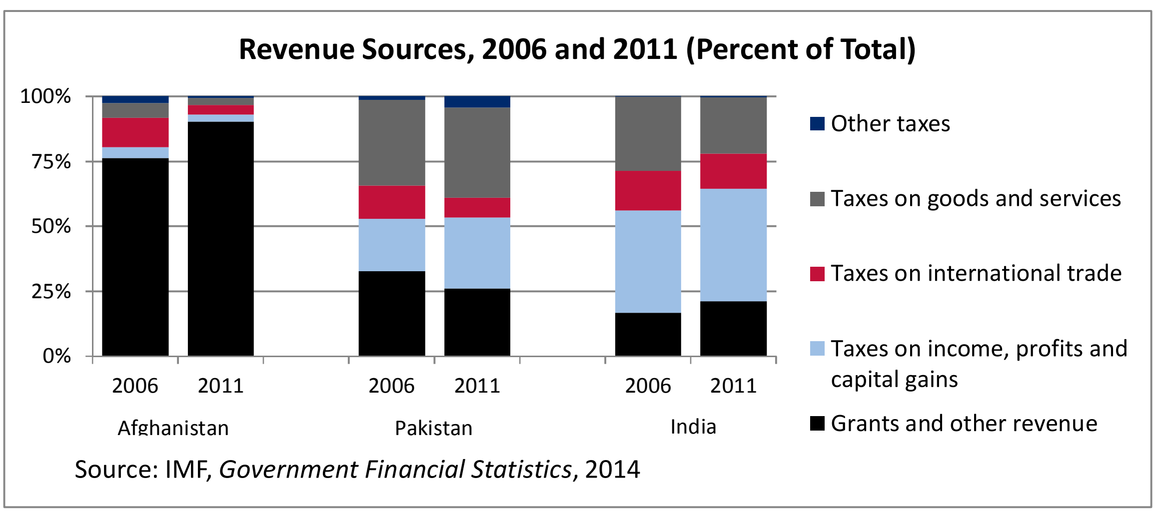
Domestic revenue plays an important role in developing countries, enabling them to decrease poverty, improve public services, and ultimately reduce the high dependency on foreign aid. According to the United Nations, countries need to raise at least 20 percent of their GDP through taxes to achieve the Millennium Development Goals (MDGs). (*What Will It Take to Achieve the Millennium Development Goals? – An International Assessment, UNDP*, June 2010)

Tax revenue as percentage of GDP in 2013 for Pakistan was 9.7 percent and in Afghanistan was 7.9 percent; both countries were well below the UN recommended minimum to achieve the MDGs and below the USAID assisted countries average (18.4 percent). Other countries such as Egypt and India are also below the USAID-assisted countries average, but still higher than either Pakistan or Afghanistan. According to *Afghanistan: Managing Public Finances for Development* main report by the World Bank, Afghanistan's low tax base is mainly caused by the presence of a large informal sector, the dominance of the agricultural sector, capacity constraints hindering the ability of the Government to collect taxes and the ability of taxpayers to comply with tax regulations, and the extremely low level of development.



Pakistan and Afghanistan lack diversity in revenue sources. For example, revenue in Afghanistan relies heavily on grants and other resources which are exempt from taxation. In 2013, revenue from grants and other revenue were 90.2 percent of total revenue, an increase from 76.2 percent in 2006. Taxes on income, profits and capital gains, as well as social contributions, account for smaller shares. According to the World Bank, customs and other import duties as a percentage of tax revenue in Afghanistan decreased to 40 percent in 2011 from 48 percent in 2006. Taxes from international trade as a percentage of revenue in Afghanistan decreased to 3.8 percent in 2011 from 11.2 percent in 2006.

Pakistani revenue from taxes on international trade tremendously decreased by almost a half (from 13.0 percent in 2006 to 7.6 percent in 2011) as a result of losses from customs revenue. In many developing countries, import duties are the main source of revenue since they are easy to monitor and collect, though corruption is a main challenge for tax and customs officers.



Additional Information

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For country-specific data and additional information about the countries covered in this report, please visit the ESDB Country Portal at http://esdb.eads.usaidallnet.gov/query/do?_program=/eads/esdb/countryPortal.

Sources used in compiling this report include the semi-annual *World Economic Outlook* from the International Monetary Fund (IMF), as well as the IMF *Government Financial Statistics* and *International Financial Statistics* databases; Transparency International's *2013 Corruption Perceptions Index* and *Global Corruption Barometer*; the Asia Foundation's *A Survey of the Afghan People- Afghanistan in 2013*; the World Bank's *Global Governance Index, Ease of Doing Business*, *World Development Indicators*, and *World Bank Enterprise Surveys*; Freedom House's *Freedom of the World 2014*; Reporters Without Borders' *2014 World Press Freedom*; *Afghanistan: Politics, Election, and Government Performance*, from the Congressional Research Service; *Rule of Law Index for 2014* from the World Justice Project; the *2014 Pakistan Infrastructure Report* from Business Monitor International; *The Causes and Impact of Power Sector Circular Debt in Pakistan* from the Planning Commission of Pakistan; the report *What Will It Take to Achieve the Millennium Development Goals? – An International Assessment* from the UNDP (June 2010); and other Internet news sources.