



William A. Byrd

E-mail: wbyrd@usip.org

Afghanistan's Looming Fiscal Crisis What Can Be Done?

Summary

- Afghanistan faces a fiscal crisis that reflects worsening domestic revenue shortfalls since 2011, which could reach \$1 billion in 2014 compared with the 2011 outlook. The massive theft and fraud at Kabul Bank, failure of mining activities to pay taxes and royalties, and mislabeling of some commercial imports as duty-free are among other contributing factors.
- Turning the fiscal crisis around will take time, but a legitimate, credible new Afghan government coming into office is essential. Quality leadership and management teams in the Ministry of Finance and the Central Bank will be crucial for success.
- Urgent measures are needed to turn around poor revenue performance, including strong signals from the top, possible exploitation of limited new revenue sources, and cooperation among different agencies to reduce smuggling and contain revenue leakages.
- Accelerated recovery of stolen and lost Kabul Bank assets should be a priority, which could provide over \$100 million per year of extra fiscal space for the budget.
- Reforms of the revenue system need to be initiated, including introduction of a value-added tax, and possibly reform of the revenue and customs services.
- Expenditures will need to be cut. This requires the elimination of unnecessary and wasteful expenditures as well as the meaningful prioritization of programs within a tight resource envelope.
- Additional international fiscal support will be needed to help stabilize the budget in the short run. Linking aid for the Afghan discretionary budget to increases in domestic revenues and Kabul Bank recoveries would make sense.

“Political compromises that may need to be made in forming a government of “national unity” cannot become an obstacle to action; the new government will have to effectively take on a small number of urgent policy priorities requiring difficult decisions, and addressing the looming fiscal crisis certainly is one of them.”

Worsening Revenue Situation, Kabul Bank, and Other Fiscal Losses

As Afghanistan's political transition drags on with the delay in finalizing the outcome of the presidential election, the country faces severe budgetary problems that risk becoming a full-blown fiscal crisis. There has been a hemorrhage of domestic revenue, which peaked at 11.6 percent of gross domestic product (GDP) in the 2011–12 fiscal year following impressive growth over the previous decade, but fell to 9.5 percent in 2013. In the first six months of 2014 revenues further shrank by 1.5 percent in nominal terms, falling 21.5 percent short of the half-year budget target.¹ Declining

customs revenue has been the most important factor, reflecting lower imports² partly explained by slower economic growth, but also by diversion of more imports into smuggling and leakages of customs revenue due to corruption. Uncertainties over the political and security transitions—leading to short-termism, stopping business investments, and putting off purchases of imported durable and luxury goods—undoubtedly have contributed further to lower customs receipts. These uncertainties have been exacerbated by Afghanistan's failure to sign the Bilateral Security Agreement with the United States and by the recent White House announcement that residual US troops will be withdrawn from the country by the end of 2016.

In 2011 Afghanistan's domestic revenue was projected to subsequently rise as a share of GDP,³ not fall. A conservative estimate of the loss of revenue compared to the 2011 outlook is around US\$800 million this year. If revenue shortfalls continue through the rest of 2014, the annual loss could reach \$1 billion,⁴ and the cumulative loss since 2011 will be much more than that.⁵ Furthermore, the 2012 commitments of international civilian and security aid, made in Tokyo and Chicago respectively, were based on the relatively optimistic fiscal outlook coming out of 2011, with associated expectations of further robust revenue growth, which unfortunately has not materialized.

The massive fraud and theft at Kabul Bank⁶ has had serious fiscal consequences, as the Afghan government had to step in and guarantee the bank's deposits. The estimated potentially recoverable lost and stolen assets amounted to just over \$1 billion in 2010; after some recoveries and write-downs, the remaining potentially recoverable assets as of early 2014 were estimated at about \$680 million.⁷ The very slow asset recovery, along with the minor punishments meted out to some of those principally responsible for the fraud, have sent a negative signal about the Afghan government's commitment to good governance and sound fiscal management.

Another source of fiscal losses is the ongoing exploitation of mineral resources without paying royalties and taxes. This does not refer to mega-resources such as the Aynak copper and Hajigak iron mines, which are expected eventually to deliver large revenues for the Afghan budget but have been long delayed and will not get fully underway for years. Under government-awarded contracts, companies are currently exploiting valuable smaller resources, such as gold deposits. Abuses are occurring and contracts are not being observed, or are being changed in favor of the companies concerned after being awarded. Some companies apparently have extracted resources under the guise of exploration, without paying royalties and taxes.⁸ The associated fiscal losses cannot be quantified precisely, but could amount to tens of millions of dollars per year. Other examples of revenue losses include illicit logging and timber smuggling, gemstone exploitation, and labeling fuel imports for tax-free international military use but ultimately selling them on the commercial market.

The late U.S. senator Everett Dirksen once famously quipped, "a billion here, a billion there, and pretty soon you're talking about real money." In Afghanistan, however, \$1 billion is real money, and losing it carries grave consequences. It is equivalent to about 5 percent of the country's GDP, close to half of existing budget revenue, and well over half of development budget spending. Afghanistan cannot afford such losses, especially as past massive international assistance is declining. The Afghan government's fiscal underperformance also sends a negative signal to donors, discouraging them from maintaining aid, let alone increasing it.

Responding to and Coping with the Fiscal Crisis

What can be done? The budget situation has been worsening for the past three years, and turning it around will take time. Some immediate actions, however, can make a difference, along with policy measures that can improve Afghanistan's fiscal position over the medium term.

First, a legitimate, credible new Afghan government coming into office is essential. The outgoing Karzai administration's ability to take meaningful fiscal action is quite limited. A timely and positive conclusion to the presidential election will provide much-needed political stability and a potential time horizon of five years for the new administration. This, in turn, will stabilize expectations for individuals and businesses, encouraging purchases, imports, and business investments and perhaps reversing the ongoing massive capital flight from Afghanistan—all of which will have positive implications for revenue.

Second, the quality of leadership and management in key government institutions—especially the Ministry of Finance and the Central Bank—has been and will continue to be critical for success.⁹ The Minister of Finance and Central Bank governor and their management teams will need to be up to the task of navigating a very challenging fiscal and economic situation, and empowered to do so.

Third, urgent measures are needed to turn around poor revenue performance. The short-termism and apparently growing corruption that have crept in during the transition must be reversed. If, as expected, there is some recovery of demand, imports, and private investment after the new administration is inaugurated and the Bilateral Security Agreement with the United States is signed, the government will have to capture commensurate revenues from this revival of economic activity. Cooperation among different agencies, such as customs and border police, to reduce smuggling and contain revenue leakages will be essential, requiring strong signals from the top about the importance of revenue collection. There may also be some limited options to exploit new revenue sources, such as excise taxes on selected luxury goods or those with adverse health effects.

Fourth, accelerated recovery of remaining stolen and lost Kabul Bank assets should be made a priority. If half of them can be brought into the government's coffers during the next several years, this would amount to over \$100 million per year of extra fiscal space for the budget.

Fifth, reforms of the revenue system need to begin so they can start having positive results in coming years. The long-planned introduction of a value-added tax will improve the tax system and increase revenue yields over time. Reform of the revenue and customs services, perhaps including separating them from the regular Afghan civil service and providing appropriate remuneration and incentives, may be another option worth considering.

Sixth, expenditures will need to be cut. Adverse revenue trends can be reversed, but the lost revenues since 2011, even if partly offset by some additional aid (see below), will not be made up anytime soon. It will be painful for a new government to come into office and have to engage in austerity from the start, but identifying and cutting unnecessary and wasteful expenditure, and meaningfully prioritizing programs within a tight resource envelope, will be essential.

Seventh, additional international fiscal support will be required to help stabilize the Afghan budget in the short run. Shifting more aid resources onto the budget is a good option and would not necessarily require increasing total aid. Linking higher resources from donor partners for the Afghan discretionary budget to increases in domestic revenues and accelerated Kabul Bank recoveries would make sense.¹⁰

Finally, political compromises that may need to be made in forming a government of “national unity” cannot become an obstacle to action; the new government will have to effectively take on a small number of urgent policy priorities requiring difficult decisions, and addressing the looming fiscal crisis certainly is one of them.

Notes

1. For revenue shares in GDP, see World Bank, “Afghanistan Economic Update,” Washington, DC, April 2014, available at www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB

ABOUT THIS BRIEF

William A. Byrd is a senior expert at the U.S. Institute of Peace. He is a development economist with long experience working on Afghanistan and has published extensively on Afghanistan's economy and other topics. This Peace Brief comprises part of his ongoing work on Afghanistan's economic transition. The views expressed do not necessarily reflect those of the U.S. Institute of Peace, which does not take policy positions.

/2014/04/23/000456286_20140423092911/Rendered/PDF/875740WP0AfgHa00Box382171B00PUBLIC0.pdf (accessed August 17, 2014); for first half of 2014, see Ministry of Finance, "Monthly Fiscal Bulletin, Month 6, 1393," Kabul, August 2014, available at www.budgetmof.gov.af/images/stories/DGB/Reports_publication/FiscalBulletin/1393/1393%20Monthly%20Fiscal%20Bulletin%20Month%206%20English.pdf (accessed August 17, 2014).

2. Afghanistan's imports in the first half of 2014 reportedly fell by 26 percent. See Mirwais Harooni, "Afghan Trade to Rebound Sharply Once Election Deadlock Over, Officials Say," Reuters, August 11, 2014.
3. The World Bank's transition study, prepared in 2011, projected that Afghanistan's domestic revenue could increase from 11.6 percent of GDP in 2011–12 to 17.5 percent in 2021–22, i.e., by about 0.6 percentage points of GDP per year. See Richard Hogg, Claudia Nassif, Camilo Gomez Osorio, William Byrd, and Andrew Beath, *Afghanistan in Transition: Looking Beyond 2014* (Washington, DC: World Bank, 2013), available at www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2013/03/08/000333037_20130308111833/Rendered/PDF/758480PUB0EPI0001300PUBDATE02028013.pdf (accessed August 17, 2014).
4. Domestic revenue in 2013 was 2.1 percent of GDP lower than in 2011–12. Consistent with the World Bank transition study projections, revenues would have risen by 0.6 percent of GDP per year in 2013 and 2014 by a smaller amount—roughly estimated at 0.3 percent of GDP—in the nine-month fiscal year in 2012. (Afghanistan shifted from a fiscal year based on its solar calendar to one much closer to the calendar year, resulting in a shortened fiscal year in 2012.) Assuming no further decline in the revenue-to-GDP ratio, the estimated shortfall in 2014 would be 3.6 percent of GDP, or \$781 million, based on the International Monetary Fund (IMF) GDP projection of \$21.7 billion; see IMF, "Islamic Republic of Afghanistan: 2014 Article IV Consultation—Staff Report; Press Release; and Statement by the Executive Director for the Islamic Republic of Afghanistan," Country Report no. 14/128, Washington, DC, available at www.imf.org/external/pubs/ft/scr/2014/cr14128.pdf (accessed August 17, 2014). However, data for the first half of this year indicate that domestic revenue will decline further as a share of GDP in 2014, which would increase the revenue loss for the year as a whole by as much as another \$200 million or more.
5. Based on the same method of calculation as for 2014, the revenue loss in 2013 is estimated at \$621 million, and there would also have been a smaller revenue loss in 2012.
6. Independent Joint Anti-Corruption Monitoring and Evaluation Committee, "Report of the Public Inquiry into the Kabul Bank Crisis," Kabul, November 15, 2012, available at www.mec.af/files/knpir-final.pdf (accessed August 17, 2014).
7. IMF, "Islamic Republic of Afghanistan," box 5, 29–30.
8. Integrity Watch Afghanistan, "Afghan Krystal Company Has Illegally Extracted Gold in Exploration Stage after Three Years of Extraction, Residents Around the Mining Area Remain Impoverished," Kabul, July 27, 2014, available at www.iwaweb.org/_news/news0013_afghan_krystal_company.html# (accessed August 17, 2014).
9. William A. Byrd, "Afghanistan: Nurturing Political Space for Development," briefing, Chatham House, May 1, 2014, available at www.chathamhouse.org/publications/papers/view/199287 (accessed August 17, 2014).
10. Such an approach can build on the incentive program of the Afghanistan Reconstruction Trust Fund, which already includes a component linking recurrent budget financing to performance in mobilizing domestic revenue. See Afghanistan Reconstruction Trust Fund, available at <http://www.artf.af/policy-reform-program> (accessed August 20, 2014).



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INSTITUTE OF PEACE

2301 Constitution Ave., NW
Washington, D.C. 20037
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