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William A. Byrd
Email: wbyrd@usip.org

M. Khalid Payenda
Email: khalid.payenda@gmail.com

Afghanistan's Revenue Turnaround in 2015

Summary

- After stagnation and decline in 2013–14, Afghanistan's total budgetary revenue increased by nearly 22 percent in 2015—an extraordinary turnaround of 30 percent as compared to the 8 percent drop in 2014.
- Only one-fifth of this revenue growth reflected currency depreciation and other macroeconomic trends; a little less than a quarter of the increase was the result of new and increased taxes, and more than half was due to stronger tax collection efforts, including better control of corruption.
- Some of the key success factors for the revenue growth in 2015 included strong, consistent leadership; high-level political backing; firing corrupt managers; solid processes and competent human capital in the Ministry of Finance; tight monitoring of customs and tax units; and political outreach to justify tax increases and manage political blowback.
- The revenue performance shows that targeted progress is possible amidst Afghanistan's current difficulties; political management and engagement with the legislature can be effective; existing inefficiencies and unexploited potential provide space to improve performance, at least in the short run; and institutional and capacity development can pay off.
- The outlook for revenue in 2016 is fairly good, but squeezing more revenue from the existing system will run into diminishing returns. The long-term challenge will be to grow the economy and develop new, buoyant revenue sources, which will not be easy given poor prospects for mineral revenues and for additional revenues from the proposed Value Added Tax.
- Afghanistan's impressive revenue performance in 2015 has been very beneficial at the margin and helps avoid short-run fiscal crises such as the one in late 2014, but it will not diminish the country's massive overall fiscal gap or its large aid requirements for the foreseeable future.

> "Afghanistan's impressive revenue turnaround in 2015 was genuine and predominantly reflected better collection efforts as well as new tax measures…"

The 2015 Revenue Turnaround[1]

After growing rapidly post-2001 and peaking at 11.6 percent of Afghanistan's gross domestic product (GDP) in 2011/12, total budgetary revenue stagnated and declined, falling to 9.7 percent of GDP in 2013 and 8.7 percent in 2014, when it dropped by 8.3 percent in absolute terms. These developments precipitated a fiscal crisis toward the end of 2014, with a large estimated year-end budgetary shortfall, accumulation of arrears, and "emergency" requests for aid.[2] Sharply lower GDP growth—which fell from near double-digit levels in the decade before 2012 to 3.7 percent in 2013 and 1.3 percent in 2014—constrained revenue potential. However, revenue mobilization efforts weakened as well, reflecting most notably the lack of high-level government focus on, and prioritization of, revenue collection. The long, drawn-out election process was a distraction and may have led to revenue leakages to fund political activities. The short time horizons for government officials may have also played a significant role—thinking they might be replaced after the election, many may have tried to maximize their incomes through corrupt activities. Further, existing mechanisms for monitoring and enforcement in the Ministry of Finance (MoF) may have been weakened.

The recovery of revenue from the 2014 nadir started slowly but built momentum during 2015. For the year as a whole, revenue reached Afs 121.8 billion, an increase of Afs 21.7 billion (close to 22 percent)—impressive in itself and a turnaround of around 30 percent compared to the previous year's decline. As a ratio to GDP, revenue strongly recovered to 10.3 percent in 2015, in part reflecting low GDP growth (projected at 1.3 percent—no higher than in 2014) and negligible inflation in 2015.

Most of this increase in revenue was not due to currency depreciation or economic growth and inflation. Rough estimates suggest that only Afs 3.3 billion of increased revenue (15.2 percent of the total increase) was attributable to nominal growth of imports (which was 7.4 percent in 2015, reflecting currency depreciation plus any change in the volume of imports), and Afs 1.1 billion (5.1 percent) to the nominal increase in GDP (real economic growth plus inflation).[3]

New tax measures introduced in 2015 had an estimated positive impact on revenue of Afs 5.1 billion (23.5 percent of the total increase in revenue). These measures included doubling the Business Receipts Tax (BRT) from 2 to 4 percent, increased levies on imported fuel and gas, a 10 percent tax on mobile phone top-ups, and an increase in the overflight fee for commercial airliners. Some of these measures were not popular, and political will and outreach on the part of the government were required to get them passed by Parliament.

More than half (56.2 percent) of the total revenue increase in 2015 reflected a stronger revenue mobilization effort and more efficient tax collection.[4] Collection of arrears and one-off payments amounted to Afs 8.8 billion (40.6 percent of the total increase in revenue). The remaining Afs 3.4 billion comprised other increased revenue collection, most of which (Afs 2.8 billion) occurred in the Customs Department.[5]

These calculations demonstrate that Afghanistan's impressive revenue turnaround in 2015 was genuine and predominantly reflected better collection efforts as well as new tax measures rather than revenue inflation attributable to currency depreciation or other macroeconomic trends.

Success Factors and Lessons

Interestingly, the 2015 revenue turnaround was engineered by the MoF, a relatively well-established agency in the Afghanistan context with low staff turnover and considerable capacity built up over time. In this largely stable institutional context, the most salient factors behind the substantial progress achieved in 2015 included the following:

- Strong leadership, focused attention, and follow-up from the top level of government and in the MoF itself were key. For example, provincial governors and other subnational officials were ordered to support revenue collection, and the Minister of Finance personally followed revenue developments closely.
- The unprecedented firing of forty corrupt or inefficient senior staff, including some ten customs and revenue directors and thirty managers, sent a powerful signal to improve tax collection efforts and discouraged bad behavior among other staff.[6]

- Tight monitoring of revenue collection by MoF leadership created pressure to improve performance. The decision to transfer the customs police from the Ministry of Interior to the MoF (a long delayed reform finally initiated in 2015) also should be helpful in this regard.
- The changing political context was important as well; the end of uncertainty over the election and the formation of the National Unity Government, however protracted and imperfect, put an end to some major sources of distraction and politicization.
- Adroit political outreach to the legislature and other stakeholders enabled significant new revenue measures to be enacted by Parliament, albeit with some delay;[7] consistent engagement with Parliament also helped minimize political blowback from the large-scale firing of MoF senior staff.[8]
- Finally, building upon a sound base, the MoF's technical systems and processes continued to be reformed and improved, and its human capital remained relatively strong among Afghan ministries.[9]

This experience demonstrates that targeted progress can be achieved, even in Afghanistan's challenging political and security environment. Focused leadership and prioritization make a major difference when complemented by solid implementation capacity and processes. The pursuit of institutional strengthening and capacity development in the MoF for well over a decade paid off when combined with the other elements required to address revenue issues. Political management and outreach clearly are important as well and, based on the revenue experience, are not impossible even in the current fractured political context. And for revenue as well as probably in other areas, existing inefficiencies and unexploited potential provide space to improve performance, at least in the short run.

Current Issues and Prospects

The outlook for revenue in 2016 is reasonably good, not least since the full-year impact of tax increases initiated in late 2015 should more than offset the negative effect of no longer having such large arrears to collect. The net positive impact is roughly estimated at Afs 4.5 billion, equivalent to 3.7 percent of the 2015 revenue.[10] However, revenue growth may not approach 2015's 20 percent-plus pace, especially given the continuing weakness of the economy.

Moreover, squeezing more revenue from the existing system will run into diminishing returns as available tax potential increasingly gets exploited. The tiny group of large taxpayers in Afghanistan is already taxed at high rates, and imports also are subject to fairly high total taxation (customs duties, BRT collected on imports, fixed taxes, and other levies). While there is scope for additional tax measures, further over-taxation of the small part of the Afghan economy that can be taxed relatively easily should be avoided.

The long-term challenge will be to grow the economy and develop new, buoyant revenue sources. This will not be easy because envisaged mining revenues will not materialize anytime soon,[11] and the proposed Value Added Tax (VAT) would not bring in much more revenue compared to BRT (which VAT would replace) in the initial years of implementation.

In conclusion, Afghanistan's impressive revenue performance in 2015 reflected a combination of effective, consistent leadership which prioritized revenue collection; adroit political management and outreach; strong administrative sanctions (firings); legislative changes (tax increases); and continuing technical and process improvements. The revenue turnaround has been very beneficial at the margin and helps avoid short-run fiscal crises, such as the one in late 2014, but it will be difficult to maintain high revenue growth in coming years, unless the economy improves. Moreover, the progress achieved in 2015 and which can reasonably be expected over the next several years will not diminish the massive overall fiscal gap or the country's large aid requirements for the foreseeable future.

Notes

1. Numbers in this Brief, based on MoF preliminary data for 2015, are the authors' own estimates, subject to revision. Final reconciliation of revenue data may result in adjustments. Financial figures are in Afghan currency; the exchange rate was 57.4 Afs per U.S. dollar on average in 2014 and 60.8 in 2015. The Afghan fiscal year runs approximately from December 21 to December 20; calendar years in this brief refer to the corresponding Afghan fiscal year.
2. For a discussion of the 2014 fiscal "perfect storm," see William A. Byrd, "Afghanistan's Continuing Fiscal Crisis: No End in Sight," Peace Brief no. 185 (Washington, DC: U.S. Institute of Peace, May 2015), www.usip.org/publications/2015/05/15/afghanistans-continuing-fiscal-crisis-no-end-in-sight. See also Omar Joya, *Afghanistan Economic Update, April 2015* (World Bank), www.openknowledge.worldbank.org/handle/10986/21894, which provides details on the crisis and the government's response.
3. This is the amount by which revenue other than that collected by the Customs Department would have increased if the ratio of revenue to nominal GDP had remained unchanged in 2015. The estimated nominal GDP growth used for this calculation is 2 percent, but it probably was even lower, with real GDP growth projected at only 1.3 percent and inflation in the consumer price index estimated at virtually zero in 2015 (based on year-end levels), or at -1.5 percent (based on average levels during the year).
4. This amount has been calculated as the residual after the impact of currency depreciation and economic growth and inflation is subtracted from total revenue growth.
5. Total revenue collected by the Customs Department (customs duties, BRT levied at point of import, fixed taxes, and other levies) increased by Afs 10.1 billion in 2015, of which Afs 3.3 billion is attributable to the nominal growth of import value, Afs 4.0 billion to new tax measures, and the remaining Afs 2.8 billion to stronger revenue mobilization efforts.
6. In the past, corrupt or inefficient managers in government agencies typically were not fired but instead were transferred to other positions, representing a much weaker form of administrative sanction which left open the possibility that these persons might be restored to their previous position later, or moved to another lucrative appointment.
7. For example, MoF leadership emphasized to the National Assembly that the tax increases were essential to fund projects in the discretionary development budget, thereby getting approval in the end. There was also outreach to businesses and traders affected by the tax increases, so that even though they were opposed to the changes, they were not surprised.
8. Another example of effective outreach to Parliament by the MoF is the 2016 budget process; the budget was approved by the legislature in a timely manner and without drastic or problematic changes. During the run-up to the submission of the budget, the MoF's budget team had almost daily meetings with the Parliament's finance and budget committee, and the Minister interacted socially with many Parliamentary representatives.
9. Numerous "technical" process improvements and reforms were implemented in 2015. In Customs these included upgrading the ASYCUDA software and its implementation in 90 percent of customs units; implementation of valuation, risk management, and border management modules; commencement of E-payment in two customs houses; and initiation of auto-messaging to customers. In the Afghanistan Revenue Department (ARD), a number of policy and technical measures were implemented (ARD, *Achievements Report FY1394*, December 2015).
10. The full-year impact of new tax measures instituted during 2015 is estimated at Afs 15.8 billion, which implies a net increase in 2016, as compared to 2015, of around Afs 10.6 billion. According

to MoF estimates, an additional Afs 1.7 billion of arrears could be collected in 2016; thus, the net decrease in revenue on this account would be Afs 6.1 billion.

11. Exploitation of large "mega-resources" such as the Aynak copper and Hajigak iron mines will be long delayed, while smaller resources are being wantonly extracted by politically-connected power-holders with negligible revenues accruing to the government. See Javed Noorani, "Afghanistan's Emerging Mining Oligarchy," Special Report no. 358 (Washington, DC: U.S. Institute of Peace, 2015), www.usip.org/publications/afghanistan-s-emerging-mining-oligarchy.

About This Brief

William A. Byrd is a senior expert at the U.S. Institute of Peace, and M. Khalid Payenda is senior adviser to Afghanistan's Minister of Finance and leads the Macro-Fiscal Performance Department in the Ministry of Finance. Both authors are economists and have been following the Afghan economy and fiscal and revenue developments for a number of years. The views expressed in this brief are those of the authors and should not be attributed to the Government of the Islamic Republic of Afghanistan or the Ministry of Finance, or to the U.S. Institute of Peace, which does not take policy positions.

United States Institute of Peace
2301 Constitution Ave., NW
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