UNITED STATES INSTITUTE OF PEACE www.usip.org

SPECIAL REPORT

2301 Constitution Ave., NW • Washington, DC 20037 • 202.457.1700 • fax 202.429.6063

William A. Byrd and Shah Zaman Farahi

Improving Afghanistan's Public Finances in 2017–2019

Raising Revenue and Reforming the Budget

About the Report

The third in a series of publications on Afghanistan's public finances, reflecting continuing collaboration between staff of Afghanistan's Ministry of Finance and the US Institute of Peace (USIP), this report, in addition to updating on revenue performance in 2017, assesses the new budgetary reforms, how the draft budget fared in Parliament, the outcome, and next steps and prospects for the reforms.

About the Author

William A. Byrd is a senior expert at USIP and Shah Zaman Farahi is an economist in the Ministry of Finance, Government of Afghanistan. The authors have been closely engaged in work on budgetary and public finance management issues for a number of years. Comments from M. Khalid Payenda, Zahid Hamdard, Asmar Amir, Sayed Ahmad Naseer, Shahmahmood Miakhel, and Belquis Ahmadi are gratefully acknowledged. The views expressed in this report are the authors' and should not be attributed to the Ministry of Finance, Government of Afghanistan, or to USIP.

Special Report 424 **April 2018**

Contents

Summary

- Following strong recovery and rapid growth in 2015 and 2016, Afghanistan's government revenue continued to increase robustly in 2017—by nearly 14 percent on a comparable basis.
- Although this rapid growth has more than offset the hemorrhage of revenue that occurred in 2013 and 2014 around the last presidential election and its problematic aftermath, receipts still fall far short of Afghanistan's enormous expenditures, especially for the country's large and expensive security forces. Afghanistan will thus remain highly aid dependent for the foreseeable future.
- Since late 2017, the Ministry of Finance's focus has shifted to expenditures; the recently approved national budget for the Afghan fiscal year 1397 (2018) embodies significant and promising reforms.
- The bargaining and delays in finalizing and gaining parliamentary approval for the 2018 budget resulted in only limited watering down of its realism, about $200 million (Afs 13.6 billion) in projects being added to ministries' budgets and to satisfy demands from parliamentarians. The degree of realism remains far greater than in earlier years, and the reforms in budget processes introduced have been retained.
- However, the budget represents just the beginning of a two-year reform process. In particular, the 2018 midyear budget review is envisaged as a major milestone where prioritization and accountability for spending (and for inability to spend) will be enforced. The 2019 budget would fully implement the budgetary reforms initiated in 2018. This timetable will be especially challenging given that reforms are to be implemented in the shadow of upcoming elec-

tions, including parliamentary elections (whether held in 2018, as currently scheduled, or in 2019) and especially the next presidential election.

Afghanistan's Intractable Fiscal Problems

Afghanistan over the past decade has consistently been one of the most aid-dependent countries in the world, its international security and civilian assistance (not including costs of foreign military forces deployed in the country) equivalent to around 100 percent of gross domestic product (GDP) at its peak during the 2009 to 2011 surge period. Even though the bulk of aid until recently has been executed outside the national budget, this high aid dependency has been mirrored in a large structural fiscal gap between expenditures and revenues, financed by donor grants.

In 2017 (Afghan fiscal year 1396), donor grants amounted to $3,863 million, covering 62 percent of total budgetary expenditures; domestic revenues funded only 38 percent.[1] This pattern of a large fiscal gap covered by external aid goes back to 2002 and is also a feature of future projections by the World Bank and others. The majority of the gap is accounted for by Afghanistan's extraordinarily high security expenditures, which amounted to more than one-third of total on-budget expenditures in 2017 (more than 10 percent of GDP).[2] Overall, donor grants to the Afghan budget were estimated at 18 percent of GDP in 2017.[3]

The sheer arithmetic of the fiscal gap means that neither the robust growth of government revenues since 2001 nor achievable revenue growth in coming years would make much of a difference in reducing the gap. Thus, for the foreseeable future, and barring a breakthrough in reconciliation and an end to or at least a substantial reduction in the level of conflict, Afghanistan will remain highly aid dependent. By the same token, any sudden sharp decline in aid would have disastrous consequences and precipitate a fiscal collapse—most likely accompanied by severe, unmanageable political, security, and economic problems.

Potentially serious incentive problems lurk behind the country's persistent high aid dependency. As long as on-budget assistance is financing Afghanistan's large fiscal gap, the government's incentives to raise more revenue might weaken. Another possible risk is that incentives to economize on expenditures, and to make hard decisions and spend limited available resources wisely and in a prioritized manner, are dampened by large aid inflows.

On the revenue side, treating government revenue as a key metric, trying to ensure that robust (double-digit) revenue growth is consistently maintained, and instituting various forms of conditionality associated with revenue performance represent a credible effort to offset any adverse incentive effect of aid inflows on revenue mobilization. Generally, this approach has been successful in achieving robust rapid revenue growth and increases in the revenue-to-GDP ratio over time. The notable exception was from 2012 to 2014, when economic problems associated with the international troop drawdown, and especially the political crisis around the 2014 presidential election and its messy aftermath, precipitated a hemorrhage of revenue. However, concerns are increasingly serious that striving to collect more and more revenue from a narrow tax base (mainly imports and a few larger and medium-sized businesses) in a weak economy will have an adverse impact on private-sector incentives and investment. Thus the emphasis is shifting away from the sheer amount of revenue targeted for collection, though it will be important to maintain solid revenue growth through the next election cycle, and to avoid anything like a repeat of the 2014 fiscal crisis.

On the expenditure side, control over total government budgetary spending has been reasonably well maintained, but pressures to economize on spending and prioritize to maximize cost-effectiveness and impact appear to have been weak. Chronic shortfalls in development budget execution are a sign of poor fiscal discipline on the expenditure side and a lack of prioritization. Continuing growth of government employment and the wage bill is perhaps another sign of weak fiscal discipline and continuing expansion of the establishment size. Pensions are a growing burden and a worrisome future fiscal liability.[4] The growth of security-sector spending, though understandable in light of continuing conflict and deteriorating security, may suggest similar problems that may be even more difficult to address.

The challenges of underlying weak incentives to economize on and prioritize budgetary expenditures have been compounded by the political economy dynamics with Parliament, one of whose roles under Afghanistan's Constitution is to approve the national budget. The approval process appears to have become a vehicle for members of parliament (MPs) to pressure the Ministry of Finance (MoF) and other ministries to include projects in their provinces that may not be of high economic or developmental priority in the national budget. Even more problematic, pressures may arise to contract businesses and hire individuals associated with MPs. Whether projects have decent rationales or are phantom projects (will not be implemented), the result is inflation of budgeted development expenditures and, in turn, chronic shortfalls in budget execution and related lack of realism of budget targets.

More generally, concerns about corruption in the budget process were a major motivating factor behind the reforms. The need to obtain parliamentary approval for budgets, backed up by MPs being able to threaten to oust government ministers (through interpellation vote), creates opportunities for corruption, as do bureaucratic interactions between various parts of the MoF and other ministries and agencies. Points of greatest vulnerability to corruption include machinations around pre-budget hearings, allocations and new projects approved during budget formulation, approval of the budget by Parliament, and allotments approved and contracts entered into during budget implementation.[5] One example of possible deal-making is that last year (2017), the budget was initially rejected by 136 of 140 MPs. At that point, according to a recent Integrity Watch Afghanistan report, the bargaining began: "The Ministry of Finance and Wolesi Jirga…agreed to allow each MP to have their projects of choice in the National Budget 1396. As a result, 350 projects worth of USD 70 million was forced into the National Budget. The National Budget 1396 was approved by 139 out of 140 MPs."[6] Such bargaining is likely also to result in a tendency to inflate budget expenditure targets and allocations, building in shortfalls in actual spending in relation to targets. It can lead to misallocation of resources and mismanagement.

Concerns about corruption in the budget process were a major motivating factor behind the reforms.

The amount of money lost through bargaining between government officials and MPs (in ways that personally benefit both sides) is not known or easy to assess, and it may well be less than corruption in some other spheres of activity in Afghanistan, such as government appointments, bribe-taking and extortion by security forces, regulations (paying for a driving license or a business permit) or services (paying for an education certificate or for health services), and the corruption linked to off-budget aid (not covered in the budget), mining, or the opium economy. More important than the outright financial losses, however, is the resulting distortions, inefficiencies, delays, and waste associated with corruption in public expenditures, which Afghanistan can ill afford.

Revenue Mobilization: Impressive Performance but Not a Game-Changer

As documented in various publications, the Ministry of Finance achieved an impressive turnaround of government revenue collection after the fiscal crisis in 2014 (which had been precipitated by serious revenue shortfalls), total revenue increasing at double-digit rates in both 2015 and 2016.[7] Strong growth continued in 2017, with total revenue increasing by nearly 14 percent over 2016 (on a comparable basis).[8] Because inflation remained low in 2017, and depreciation of the Afghani was negligible (at least against the US dollar), these factors were not major contributing factors behind revenue growth. Nor were any new tax measures or rate increases introduced during the year.[9]

Specifically, the Afghani depreciated by an estimated 0.5 percent against the dollar in 2017 over 2016 based on monthly average exchange rates in each year as reported by Da Afghanistan Bank (Afghanistan's central bank).[10] Inflation according to the consumer price index (CPI) was somewhat higher, at just under 5 percent.[11] Deflating collections that are denominated and collected in Afghanis (Afs 101.7 billion in 2017) by the CPI, and those calculated on the basis of foreign exchange value (Afs 59.8 billion) by the depreciation of the exchange rate, the estimated revenue collection due to CPI inflation in 2017 was Afs 4.8 billion (24.6 percent of the total underlying revenue increase), and that attributable to exchange rate depreciation only Afs 0.3 billion (a minuscule 1.5 percent of the total). Finally, the real growth of the economy, estimated at 2.4 percent in 2017, can be deemed to have contributed Afs 4.1 billion (21.0 percent of the total). These estimates, though crude, suggest that some 47 percent of total revenue can be explained by inflation, exchange rate depreciation, and real growth of the economy. Correspondingly, the residual 53 percent may be attributable to greater revenue mobilization efforts. In other words, better revenue collection and reduction in leakages contributed an estimated 7.3 percent revenue growth in 2017.

Afghanistan's revenue performance in recent years is all the more impressive in light of a recent International Monetary Fund study suggesting that the worsening conflict cost the country around $1 billion in lost revenues in 2016—equivalent to some 40 percent of total revenues actually collected that year.[12]

Budgetary Reforms: Better Late Than Never

The significant reforms introduced with the 2018 budget, under the leadership of the Minister of Finance, are impressive and commendable. They are, however, coming quite late in the five-year term of the current Afghan presidential administration. Indeed, implementation of the 2019 budget, envisaged as a fully reformed budget, will stretch beyond the current administration's term. Even more important, the entire two-year budgetary reform process will be occurring in the run-up to, during the conduct of, and immediately after parliamentary and district council elections (currently scheduled to be held in 2018) and the presidential and provincial council elections in 2019.

It would have been far better to initiate these reforms early in the presidential term, giving them time to be fully implemented and to start demonstrating benefits. That this did not happen was, at least in part, yet another adverse effect of the messy aftermath of the 2014 presidential election and the slow start of the current administration due to the complexities of the National Unity Government agreement and the political jockeying and policy gridlock that took up much of the National Unity Government's first few years in office.[13]

The design of the budgetary reforms is based on four goals:

- Disrupt the networks of politically connected interests that have profited from what some call auction-based budgeting.[14]
- Replace the existing system with one that places policy and people first.
- Pull together data, systems, and people to transform the process.
- Pursue a two-phase approach in preparing for and carrying out the budget process.

This year (2018) is about setting the foundations for a policy-based budget and in particular to get the structure of the budget papers right. This involves an unprecedented level of disclosures (including historical), full consolidation of the development budget (both discretionary and nondiscretionary) and operating budget, multidimensional budgeting (by economic category, administrative code, province, funding, projects, programs, and so on), parameter-driven rolling forward estimates (that is, a medium-term expenditure framework) for three years beyond the budget year, and a statement of compliance with international standards (currently Government Finance Statistics—GFS—standards on a cash basis).

The second phase, in year two (2019), will focus on fully getting the budget process right. A notable feature will be rolling forward estimates to create fiscal space by asking for savings against baselines. This will also make it more difficult to auction off the whole budget, by limiting debate to the creation of fiscal space and how to fill it. Fiscal discipline will start from the top: everything needs to go through the budget process. The MoF will need to be the gatekeepers to deter, prevent, and stop irregularities in the budget process. The second phase will also include full costing of new policies and projects; nothing will get through unless it has independently verified fiscal impact assessments and economic evaluations.

The overall strategy of the 2018 budget is summarized as "disclose, constrain, and fix":

- Disclose detailed data to disrupt the networks currently benefiting on a personal or group basis from the budget process, and to promote evidence-based resource allocation.
- Constrain behaviors by promulgating and maintaining a tight budget: in this regard projecting a so-called fiscal cliff in the outer year or years concentrates attention on the need to economize and prioritize.
- Fix the systems so that the MoF and, over time, other Afghan government institutions can effectively manage and implement budgets—independent of individuals.

The overall strategy of the 2018 budget is summarized as "disclose, constrain, and fix."

This strategy was helpful particularly in regard to gaining cabinet approval. The full disclosure helped the MoF find and communicate the loopholes that make the budget ineffective and inefficient. These gaps were constrained and fixed to the maximum extent possible this year, tightening the grip on accountability and transparency in the budget document.

The specific changes embodied in the 2018 budget can be divided into several categories, though many of the reforms affect more than one of them.[15]

Greater overall transparency. This budget marks a significant advance in presenting a fully consolidated picture of Afghanistan's public finances, what the document calls a cleaned-up budget, "more realistic and credible." Total resources for the budget—from government tax and nontax revenues, donor grants, and other sources—are comprehensively presented. On the expenditure side, the consolidated budget presentation includes the operating budget (salaries and operations and maintenance), the so-called discretionary development budget, which consists of projects and programs paid for by the government through its own resources (government revenues plus available non–project budget support from international partners), and the so-called nondiscretionary development budget—on-budget projects funded by donors with resources earmarked for particular projects and programs. It excludes off-budget donor funding, much though not all of which goes to the security sector but which also funds development projects executed by donors and their contractors. In the past, the quite different financing, decision-making processes, and implementation mechanisms for these categories resulted in a tendency to view them in isolation from one another, detracting from the budget's ability to provide an overall consolidated picture of the country's public finances. Recognizing that these differences will remain significant from a policy and operational standpoint, the new budget nevertheless does provide a consolidated picture, both overall and broken down by categories and agencies. Thus, for the first time, the budget is fully transparent.

More conservative, realistic budget projections. In addition to a refreshingly sober assessment of the current situation, future economic and fiscal prospects, and risks in its introductory text, the 2018 budget includes significantly more conservative projections than its predecessors:

- Projected real GDP growth from 2018 to 2020 (1397 to 1399)—at 3.4 percent per year—is on average more than one percentage point lower than in 2017.[16]
- Revenue projections also are lower, reducing the scope for inflated expenditures given the essentially balanced budget approach. For the three years following the annual budget year (2019, 2020, and 2021), this budget projects revenue increasing on average by more than two percentage points less per year than the 2017 budget did for its three outer years.[17]
- On-budget aid projections are much more conservative in the 2018 budget. Grant receipts in 2017 were lower than budgeted for that year, resulting in an estimated shortfall of Afs 40 billion (close to $600 million). This budget projects grants dropping by a further Afs 27 billion (approaching $400 million) in 2018, another Afs 23 billion ($341 million) in 2019, and a further Afs 13 billion ($200 million) in 2020. As a result, donor grants in the latter year are projected to drop around Afs 67 billion (more than $900 million) and to be 29 percent less than in 2017.
- Most starkly, the 2018 budget projects what it calls a fiscal cliff for the final year of its forward estimates—2021 (1400), in which donor grants are projected to be Afs 87 billion (more than $1 billion) lower than in 2020, a precipitous decline of 43 percent in that year alone. Cumulatively, this means a projected reduction of Afs 150 billion (crossing $2 billion) or 72 percent from 2017.[18]
- A final measure worth noting is the shift away from using the previous year's budget targets for budgeting. Instead, the 2018 budget uses the previous year's estimated actual expenditures. Because the development budget, in particular, invariably has fallen short of budget targets, this change also has the effect of making the expenditure targets in the 2018 budget more conservative.

The aim is to ease constraints and make the best possible use of the limited fiscal space available for spending.

Overall, this more conservative approach is intended to strengthen fiscal discipline and to focus attention on efficiency improvements and reprioritization of expenditures. The aim is to ease constraints and make the best possible use of the limited fiscal space available for spending.

Better development programming. The 2018 budget introduces multiyear projections for individual projects and programs. This three-year time horizon beyond the budget year not only provides visibility on the medium-term costs of programs and projects, but also forces consistency between projections of budgetary aggregates and the individual components of the budget. The budget strives to largely eliminate the pervasive phenomenon of carryovers, whereby funds budgeted for spending on a given project or program in a certain fiscal year were simply carried over to the next fiscal year if unspent. Greater discipline should come from this change to a use-it-or-lose-it approach. Carrying funds over also contributed greatly to the chronic shortfalls in development budget execution, given that funds and allocations that had little prospect of being fully spent were repeatedly rolled over into the following year's budget. The budget makes a strong distinction between expenditures on ongoing activities already approved on a multiyear basis and new initiatives, focusing on the latter and on whether they are in line with national development priorities. Moreover, the

2018 budget establishes a principle that ministries and agencies proposing new spending initiatives should find savings from other activities to offset the additional expenditures. This is intended to encourage micro-level fiscal discipline and curb the tendency to submit large numbers of new project proposals without prioritizing among them. The process will be targeted at removing poor performing or low-priority programs from the budget over the next few years.

Reducing the scope for corruption. The 2018 budget is striving to reduce the scope for corruption during the budget process in various ways. The consolidation and greater transparency of budget allocations and multiyear projections will be helpful from an integrity perspective as well. However, corruption risks are associated with unallocated contingency budget categories—which amounted to nearly Afs 57 billion (more than $800 million) in the 2017 budget. Unspent contingency funds can be and are shifted to other uses during budget implementation with less transparency and greater risk of corruption. Drastically reducing contingency allocations would not only be good for transparency and budgeting, it would also reduce the space for bribery and other irregularities to occur as contingency funds are spent during the fiscal year. A small start has been made with the 2018 budget in reducing the magnitude of existing contingencies by about 5 percent, but all of this modest reduction has been offset by new contingencies, mainly for funding of power plants. The 2018 budget, in its budget execution rules, sets forth provisions setting parameters for entering into government contracts and limits on discretion in this regard, which may be an attempt to limit the scope for corruption in the contracting process. On the other hand, budget allotments (authority to spend) will be provided, based on the approved budget and financial plans of ministries and agencies submitted to the MoF twice a year covering six months each. This could help make the process of allotting funding during budget implementation, a point of vulnerability to corruption, more automatic and less subject to the discretion of MoF officials approving allotments.

How the Budget Fared in Parliament: A Rockier Process Than Usual

Perhaps not surprisingly given its significant departures from past budgets, the 2018 budget faced a rockier road than usual in Parliament. The Wolesi Jirga's initial rejection on November 25 was in line with past patterns: this is an almost costless action (for the legislature) to set the stage for bargaining over the final budget. But this year, the rejection was not just a default reaction. When the budget was first submitted, Parliament found it confusing and complex. This year's budget was made compliant with GFS—which meant that the organization and presentation of the budget were new. To compound the confusion further, MPs saw a shrinking budget.

Parliament provided a list of twelve reasons for rejecting the draft, ranging from its complexity and different format from past budgets, to a significant reduction in expenditures relative to the 2017 budget targets, compensation to the Central Bank to offset losses of New Kabul Bank, and a number of more technical questions and objections. Many of the points raised had some validity, and the MoF strove to incorporate all of Parliament's comments in the revision of the budget.

Negotiations after Parliament rejected the initial proposal were intense. A tough MoF reform stance on budget credibility was met with strong pressure by Parliament, which was used to having bargaining leverage during the approval process. The budget and its implementation period coincided with the run-up to parliamentary elections and perhaps was seen by MPs as an opportunity to implement quick projects to gain public acceptance and votes. The ministry, however, was determined to rein in such practices in favor of enforcing fiscal discipline, strategic prioritization, and instituting broader reforms in public investments. With the reforms it was embodying, the new budget somehow came as a disappointment to MPs. For example, abandoning of automatic carry-forwards, implementing full disclosure, and enforcing fiscal discipline were unexpected.

This year, the MoF has emphasized budget credibility, realism, and economic justifications in the light of prospects for reductions in donor aid, whereas most MPs remained focused on annexed projects (also known as MPs' projects).[19] For some parliamentarians, geographical balance was the priority, for others a perceived fair share. Most of the discussions, however, revolved around the fate of the annexed projects, which often consist of projects that are parachuted in at the last minute without going through the appraisal process and often without a defined budget allocation.

The MoF has emphasized budget credibility, realism, and economic justifications in the light of prospects for reductions in donor aid.

The agreement in the approved budget for 2018 was to continue only with those annexed projects of the previous year that were already contracted or for which procurement was under way. To ensure equity within a constrained fiscal envelope, the MoF also removed large infrastructure projects in favor of small community-based projects such as water, sanitation, and the construction of schools, mosques, and clinics throughout all provinces. The experience with the budget approval process this year showed considerable progress by both executive and legislative branches of the Afghan state to discuss as well as institute tough reforms.

The Outcome: Survived Intact with Only Limited Watering Down

On January 17, the 2018 budget was approved by the Wolesi Jirga by an overwhelming margin, 122 votes to 30.[20] Although this approval was delayed beyond the start of the fiscal year, achieving it less than a month into the year was significant in view of the intensive and protracted negotiations. Even more important, the changes and reforms initiated survived without much watering down, although concessions were made to Parliament in the form of additional projects. It is not a perfect budget, but it paves a concrete way forward for future budget formulation to be more responsive to the socioeconomic conditions of the country while transparency and accountability are enforced.

During the process of revision, the development budget was increased by Afs 17.3 billion, from Afs 93.7 billion to Afs 111.1 billion, and the operating budget was reduced by Afs 1 billion (table 1). Of the total development budget increase, Afs 13.6 billion is in the discretionary development budget and Afs 3.7 billion in the nondiscretionary development budget. The reduction in the operating budget came from lowering the increase in the number of civil service positions by 1,043. The increase in the development budget came from additional funding of ministries (approved by the budget committee) and a small increase in annexed projects.

The increase in the development budget deficit (shown in table 1) will require the MoF to further strengthen efforts at revenue collection to help cover the financing gap. In any case, based on greater realism and especially budgeting based on the previous year's actual expenditure (as opposed to the past practice of budgeting on the basis of the previous year's—unrealistic—budget targets), the development budget execution rate is anticipated to rise significantly in 2018. Additional financing of the approved budget has not affected major fiscal discipline measures introduced:

- Discretionary funding is zero for new projects in the National Rural Access Program, which was a big source of redundant road projects and misuse of funds.

- Many annexed projects were already either in the procurement process or awarded and were inherited from the previous few years. The new annexed projects included are relatively smaller in size than those already awarded or in the procurement phase.
- The compromises made did not undermine the realism of the 2018 budget; the numbers remain accurate and realistic, and no excessive allocations that would be difficult or impossible to finance are included.
- Automatic carry-forwards of unspent project funds remain at zero.
- Project allocations are based on available resources and the forward estimates capturing the trend of previous years' budget execution.

Table 1. Draft and Approved 2018 National Budget Summary and Financing, Afs Billions

Description	Draft	Approved	Difference
Domestic resources	161.6	161.6	-
External assistance (grants and loans)	187.8	191.3	3.5
Total resources	349.4	352.9	3.5
Operating budget	267.2	266.1	(1.0)
Development budget	93.7	111.1	17.3
Total budget	360.9	377.2	16.3
Deficit / surplus	(11.5)	(24.3)	(12.8)
Operating budget			
Domestic revenue	161.6	161.6	-
Donor grants in operating budget	134.1	104.5	(29.6)
Total operating budget	295.7	266.1	(29.6)
Deficit / surplus	28.6	-	(28.6)
Discretionary development budget	38.5	52.1	13.6
Nondiscretionary development budget	55.2	59.0	3.7
Total development budget	93.7	111.1	17.3
Discretionary grants (NDP, EU, WB)	28.6	27.8	27.8
Nondiscretionary grants	53.7	58.1	4.4
Development resourcing	82.3	85.9	85.9
Deficit / surplus	(11.5)	(25.2)	(13.7)
Loans	1.5	0.9	(0.6)
Treasury cash reserves	9.9	10.0	0.1
Deficit / surplus (unfunded: savings, borrowing, new revenue)	0.0	(14.3)	(14.3)

Source: Ministry of Finance.
Note: Deficits are shown in parentheses.

Table 2 provides details of the 2017 and 2018 budgets. First looking at the 2017 budget, the budgeted finances and the executed budget differed significantly. The development budget execution rate stood at 67 percent and the operating budget execution rate at 95 percent, aggregating to 85 percent execution of the budget as a whole. Development budget execution rose from 54 percent in 2016 to 67 percent in 2017. The increase came about as a result of political pressure on ministers to improve budget execution. In November 2016, Parliament voted to remove seven ministers who had failed to "spend more than 70 percent of their ministries' development budget."[21] This political pressure did not necessarily translate into improvements in the efficiency of budget execution, however.

Table 2. 2017–2021 National Budget Summary and Financing, Afs Billions

	2017			2018		2019	2020	2021
Description	**Budget**	**%**	**Final**	**Budget**	**%**	**Projections**		
Total resources	419.4			352.9		337.0	333.3	276.4
Domestic resources	160.6	38		161.6	46	168.9	178.9	189.1
External assistance (grants and loans)	258.8	62		191.3	54	168.0	154.4	87.2
Total budget	429.4		356.7	377.2		376.5	367.1	350.5
Operating budget	268.4	63	254.1	266.1	71	273.5	280.7	287.2
Development budget	161.0	37	102.6	111.1	29	103.0	86.4	63.3
Deficit / surplus	(10.0)			(24.3)		(39.5)	(33.8)	(74.9)
Operating budget 1397								
Total operating budget	268.4			266.1		273.5	280.7	287.2
Domestic revenue	147.9	55	167	161.6	61	168.9	178.9	189.0
Donor grants in operating budget	120.6	45	87.1	104.5	39	86.6	82.1	45.6
Total financing for operating budget	268.4		254.1	266.1		255.6	260.9	234.7
Deficit / surplus	(0.0)		(0.0)	(0.0)		(17.9)	(19.7)	(52.5)
Development budget								
Total development budget	161.0		102.6	111.1		103.0	86.4	63.3
Discretionary development budget	63.1	39	42.4	52.1	47	62.3	52.7	43.0
Nondiscretionary development budget	97.9	61	60.2	58.97	53	40.7	33.7	20.3
Development resourcing	148.3			85.9		81.4	72.3	41.7
Domestic resources	12.7	9						
Discretionary grants (NDP, EU, WB)	40.3	27		27.8	32	40.7	38.6	21.4
Nondiscretionary grants	95.3	64		58.1	68	40.7	33.8	20.3
Deficit / surplus	(12.7)			(25.2)		(21.6)	(14.1)	(21.6)
Loans	2.7	21		0.9	4			
Treasury cash reserves				10.0	40	10.0	10.0	10.0
Deficit / surplus (unfunded: savings, borrowing, new revenues)	(10.0)			(14.3)		(29.5)	(23.8)	(64.1)

Source: Ministry of Finance, budget documents.

Note: The actuals of 2017 may differ from the official budget document. The first draft and second draft of the budget were submitted before the end of the fiscal year (December 21/22). The figures reported in the Final column are the end of the year figures; deficits are shown in parentheses.

The planned budget (at the start of the year) had a deficit of Afs 10 billion and budgeted external assistance of Afs 258 billion, which dropped to Afs 198 billion by the end of fiscal year 2017, revealing a large shortfall in donor aid, suggesting that donor aid has become more unpredictable. The difference between the planned budget and execution levels provides an indication of poor public expenditure planning, weak public investment management, and execution.[22] The carry-forwards (not reported in the table) in the 2017 budget were Afs 16.8 billion for the discretionary development budget and Afs 62 billion for the nondiscretionary development budget.

Two interrelated issues constraining fiscal space in previous budgets were low budget execution and over- or under-allocation of funds. The most significant reasons for low execution have been poor project planning and capacity issues in the line ministries. In addition, over-allocations were provided to certain functions and under-allocations to others, which, combined with the poor practice of not reallocating funds from underperforming projects to high performing and priority projects, tended to lower the budget execution rate. The practice of automatic carryovers further exacerbated these problems. Such practices undermined the effectiveness of the fiscal policy. The midyear review of 2018 will feature reallocations from poorly performing to high performing priority projects.

Setting the 2018 budget targets in relation to the actuals and execution of the 2017 budget provides more realistic and credible financial planning for the government. Consequently, external resources actually decreased by 26 percent between the budgeted levels of 2017 and 2018. The shrinking resource envelope means a higher level of deficit in the national budget for outer years. The projected trends of the recurrent and development budgets are on contrasting trajectories. The operating costs of the budget in the outer years will progressively squeeze more resources, leaving less and less space for the development budget as donor grants further decline.

Implementation of Budgetary Reforms and Unfinished Business

As noted earlier, the approval of the 2018 budget is only the next stage (after its preparation and submission to Parliament) in what is envisaged as a two-year process, leading to the implementation of a fully reformed national budget in 2019. Much work will be required to transform the budget into a fully effective and efficient national budget.

The MoF is already making further changes in the process of budget formulation and execution to be implemented during 2018, which include a revised cycle (identifying priorities rather than the bottom-up approach of previous years), more structured hearings (in preparation of the 2019 budget), synchronization of the Afghanistan Financial Management Information System and the budget system, simplifying the allotment procedures, and better planning from the line ministries in project formulation. Detailed project start and end dates will further enhance the forward estimates and calculate the fiscal space.

The next milestone will be the much heavier-than-normal load that will be carried by the midyear review of the 2018 budget, which will involve further acceleration of reforms resulting in a new supplementary budget—far more substantial than the fine-tuning that occurs in the typical midyear review. The review will generate cost savings by reviewing and analyzing public expenditures and weeding out poorly performing projects in the development budget. Then the 2019 (1398) budget is expected to fully embed the reforms initiated in the 2018 budget just as the new Parliament gets under way (if elections are held on schedule in 2018) or the existing Parliament is finishing up (if elections are delayed into 2019).

The next milestone will be the much heavier-than-normal load that will be carried by the midyear review of the 2018 budget.

A significant piece of unfinished business is sharply reducing the size of contingency and reserves funds in the budget from the current level of Afs 57 billion. This category includes some major expenditure items that are amenable to budgeting and hence should be taken out of contingencies and instead included in regular budget heads. Notable examples include interest payments on government debt, transfers to the central bank (for recapitalization), and pensions (civil, military, and martyrs and disabled), which together account for more than half of the total contingencies and reserves.

The MoF's vision is to move toward policy-based budgeting for the 2019 budget. Part of this effort also includes creating the fiscal space to cover the cost of new policy initiatives and the funding requirements of existing policies. To improve project identification, the

MoF is also strengthening the public investment management function. Where necessary, new projects should provide pre-feasibility and feasibility studies. At the moment, nondiscretionary and off-budget development projects have relatively stronger project selection criteria. Improvements in this regard for the discretionary budget will eliminate white elephant projects, improve planning and budget execution, and enable better evaluation.

Conclusions

The 2018 national budget marks the initiation of a credible reform process to achieve greater fiscal realism, provide a comprehensive picture of the public accounts, effectively prioritize expenditures, increase their efficiency, and reduce the scope for corruption. A good start has been made, and the budget survived the parliamentary approval process with only a modest degree of watering down. Major challenges lie ahead, however, including the 2018 midyear budget review and especially the 2019 budget. Maintaining momentum and forward progress will be especially difficult during what is likely to be a contentious and risky election season.

The budgetary reforms are promising, but they are just getting under way and may be fragile and at risk of being reversed.

The budgetary reforms are promising, but they are just getting under way and may be fragile and at risk of being reversed. Continuity and predictability to embed and advance the reforms will be critical, and consistent and proactive support for them on the part of Afghanistan's international partners would help enhance their prospects and reduce risks.

Continuing robust revenue growth also is a priority, though progressively squeezing the small existing tax base (mainly imports and a few larger enterprises) is running into decreasing returns, and could risk dampening private-sector incentives.[23] It will nevertheless be critical to maintain decent revenue growth and avoid a repeat of the large revenue shortfalls and resulting fiscal crisis that occurred around the time of the 2014 presidential election.

Finally, it must be recognized that even the best-designed and most successful budgetary reforms, and continuing robust revenue growth, would no more than marginally reduce Afghanistan's enormous structural fiscal gap, and therefore that the country will remain highly aid dependent. The reforms nevertheless are very important because they show commendable efforts to make improvements, enhance the transparency of the budget, enable better prioritization and cost-effectiveness of public spending, and over time reduce corruption. Thus, overall, these reforms—if their implementation continues and is at least moderately successful—enhance the credibility of the Afghan government's requests for high levels of on-budget aid, which will be needed for the foreseeable future.

Notes

1. The Afghan fiscal year runs approximately from December 21 to December 20. Given the very small gap of only ten days, calendar years mentioned throughout this paper refer to the corresponding Afghan fiscal year, as follows: 2016=1395, 2017=1396, 2018=1397, and so on.
2. The figures for security expenditures include only on-budget spending, not off-budget aid provided in money or in-kind, nor do they include the much higher expenditures of international military forces in Afghanistan.
3. Including foreign loans, total external financing of the budget amounted to 18.3 percent of GDP.
4. The government's wage bill grew by 8 percent annually from 2011 to 2016; subsidies, grants, and social benefits (including pensions) grew by 21 percent per year.
5. See Institute for State Effectiveness, "The Blight of Auction-Based Budgeting," September 2017, 3–4, http://effectivestates.org/wp-content/uploads/2017/09/Auction-Based-Budgeting-WEB.pdf.
6. Integrity Watch Afghanistan, "The Game of Numbers," December 2017, https://iwaweb.org/wp-content/uploads/2017/12/IWA__National-Budget__English_6.pdf.
7. See William A. Byrd and M. Khalid Payenda, "Afghanistan's Revenue Turnaround in 2015," Peace Brief no. 201, US Institute of Peace, February 2016, www.usip.org/sites/default/files/PB201-Afghanistans_Revenue_Turnaround_In_2015.pdf); "Revenue Growth in Afghanistan Continues Strong but Future Uncertain," Peace Brief no. 219, US Institute of Peace, February 2017, www.usip.org/sites/default/files/2017-02/PB219-Revenue-Growth-in-Afghanistan-Continues-Strong-but-Future-Uncertain.pdf); "Afghan Government Revenue Continues to Grow: A Bright Spot in a Weak Economy," Afghanistan Analysts Network, September 27, 2017, www.afghanistan-analysts.org/afghan-government-revenue-continues-to-grow-a-bright-spot-in-a-weak-economy/.
8. This growth rate is calculated after subtracting one-time inflows from the total revenue figures in both years. Because such one-offs were higher in 2016 than in 2017, including them results in a lower revenue growth figure (around 10 percent) but understates the underlying revenue growth and mobilization effort.
9. The same is true of 2016, so 2017 shows no full-year effect of earlier revenue measures.
10. Because foreign exchange revenue is collected throughout the year, the average of monthly average exchange rates at least crudely captures the impact of exchange rate depreciation on revenue calculated in foreign exchange. It is much better than simply comparing the 2016 and 2017 year-end point exchange rates (which show a depreciation of 4.0 percent between the two dates). One other possible issue is that the US dollar itself depreciated against other major currencies, such as the euro, during the latter part of 2017. However, the Afghani held up well against the currencies of neighboring countries such as Pakistan and Iran. So calculating depreciation based on average US dollar exchange rate in 2017 relative to 2016 was deemed the most appropriate approach (for the DAB exchange rate data, see http://dab.gov.af/en/DAB/currency).
11. Based on average of monthly national CPI data as reported by Afghanistan's Central Statistics Organization (http://cso.gov.af/en/page/ict/5555/5353).
12. See International Monetary Fund, "Islamic Republic of Afghanistan: Selected Issues," November 21, 2017, 3–12, www.imf.org/en/Publications/CR/Issues/2017/12/14/Islamic-Republic-of-Afghanistan-Selected-Issues-45474.
13. See William A. Byrd, "Understanding Afghanistan's 2014 Presidential Election: The Limits to Democracy in a Limited Access Order," Special Report no. 370, US Institute of Peace, April 2015, www.usip.org/sites/default/files/SR370-Understanding-Afghanistan%E2%80%99s-2014-Presidential-Election.pdf.
14. See Institute for State Effectiveness, "The Blight of Auction-Based Budgeting," 3–4.
15. The following discussion is based on Bill Byrd and Kate Clark, "The 2018 Afghan National Budget: Confronting hard realities by accelerating reforms," Afghanistan Analysts Network, December 5, 2017, www.afghanistan-analysts.org/the-2018-afghan-national-budget-confronting-hard-realities-by-accelerating-reforms.
16. The difference is slightly less if comparing the moving average of three-year forward estimates between the two budgets (2018–2020 for the 2017 budget and 2019–2021 for the 2018 budget), because the latter average is 3.7 percent per year versus 4.5 percent per year in the 2017 budget.
17. Revenue growth projections in the 2017 budget are 8.1 percent in 2018, 7.2 percent in 2019, and 8.0 percent in 2020, whereas the 2018 budget projects revenue growth at 4.6 percent in 2019, 5.9 percent in 2020, and 5.7 percent in 2021.
18. These conservative "baseline" projections exclude possible positive impacts from further reforms, or, particularly for 2021, possible donor decisions to make the decline in aid after completion of the Brussels and Warsaw commitments more gradual. Nevertheless, as a starting point for budgeting, the government is including only what it thinks it can safely rely on, not what it might hope for.
19. Projects under different programs previously not included in the main approved budget document appeared as an annex of annexed projects. The list was significantly influenced by MPs, and over the years the majority of the projects in this list have come from MPs.
20. See TOLO News, "MPs Approve New Fiscal Year's Budget," January 17, 2018, www.tolonews.com/business/mps-approve-new-fiscal-year%E2%80%99s-budget.
21. Thomas Ruttig, "Parliament Kicks out Ministers again: A multi-dimensional power struggle," Afghanistan Analysts Network, November 19, 2017, www.afghanistan-analysts.org/parliament-kicks-out-ministers-again-a-multi-dimensional-power-struggle.
22. The comparison of the budget outcome is against the approved budget at start of the fiscal year. The midyear budget of 2017 increased to Afs 469 billion. The 2018 budget also may be increased based on developments during the year.
23. See Byrd and Payenda, "Afghan Government Revenue Continues to Grow."

ISBN: 978-1-60127-714-5

An online edition of this and related reports can be found on our website (www.usip.org), together with additional information on the subject.

Of Related Interest

- *Leveraging US-China Cooperation to Build a Regional Consensus on Afghanistan* by David Rank (Special Report, March 2018)
- *USAID in Afghanistan: Challenges and Successes* by William Hammink (Special Report, December 2017)
- *Rule of Law, Governance, and Human Rights in Afghansitan* by Erin Houlihan and William Spencer (Peaceworks, August 2017)
- *Afghan Views of Government and Elections: Legitimacy Pending* by Anna Larson and Noah Coburn (Special Report, July 2017)
- *Political Stability in Afghanistan: A 2020 Vision and Roadmap* by Alex Thier and Scott Worden (Special Report, July 2017)

United States Institute of Peace
Making Peace Possible
2301 Constitution Ave., NW
Washington, DC 20037
www.usip.org
@usip