UNITED STATES INSTITUTE OF PEACE
PEACEBRIEF 185
United States Institute of Peace • www.usip.org • Tel. 202.457.1700 • @usip
May 2015

William A. Byrd
E-mail: wbyrd@usip.org

Afghanistan's Continuing Fiscal Crisis
No End in Sight

Summary

- The fiscal crisis that has been building over several years in Afghanistan came to a head in 2014, with no abatement in recent months and limited potential for improvement in the current year.
- Political uncertainty, the weakening Afghan economy, corruption in tax collection, and stagnant government revenues, as well as increasing security and other expenditures, all contributed to the current fiscal crisis.
- Massive ongoing international assistance (especially for Afghan National Security Forces) and stopgap measures by the Afghan government have averted an outright fiscal collapse.
- The crisis is having deeply insidious effects, however: The apparent political gridlock in the National Unity Government is being paralleled by financial gridlock.
- A combination of bold, coordinated actions would be required to break out of the current fiscal impasse, but it seems doubtful whether the Afghan government and its international partners are prepared to do this.

"The outlook for the rest of this year includes continuing revenue shortfalls, an enduring expenditure squeeze, spending cutbacks, further possible accumulation of arrears, and perhaps another request for exceptional aid to the Afghan budget."

The Descent into Crisis

Enormous Structural Fiscal Gap. For some time it has been apparent that Afghanistan faces a huge structural fiscal gap between expenditures and resources—25–40 percent of the gross domestic product (GDP)—which will have to be bridged by international aid for the foreseeable future.1 This gap is attributable mostly to the large size and high cost of the Afghan National Security Forces (ANSF)—roughly $5 billion per year (equivalent to more than 20 percent of GDP). Scenarios prepared for the high-level international conferences on Afghanistan in Chicago and London in 2012 put the total security and civilian fiscal gap in the range of $7–8 billion annually.

2012–13: Deteriorating Trends. After peaking at 11.6 percent of GDP in 2011/12, Afghanistan's domestic revenue stagnated in nominal terms and declined precipitously as a share of GDP, to 9.7 percent in 2013.[2] While partly explained by the sharp slowdown in economic growth to 3.7 percent in 2013 (compared to over 9 percent per year on average earlier) and associated lower imports—which adversely affected customs and other tax receipts—the hemorrhage of government revenue also appears to reflect pervasive corruption in tax collection. Weak revenues along with increasing security expenditures (albeit funded largely by international assistance) squeezed civilian spending, especially nonwage expenditures. The domestically financed budget deficit, covered by drawing down the government's deposits at the central bank (Da Afghanistan Bank [DAB]), which had been built up as a result of fiscal surpluses in earlier years, reached 0.8 percent of GDP in 2013.

2014: A Fiscal "Perfect Storm." Deteriorating trends culminated in 2014, when a number of adverse factors combined to bring about a full-blown fiscal crisis. Buffeted by the long delay in signing the Bilateral Security Agreement, political uncertainty associated with the 2014 presidential election, and the slow formation of the National Unity Government (NUG), the economy weakened further, with growth declining to 2 percent—despite a third consecutive good agricultural harvest. This is lower than the rate of population growth, so average per capita income declined. Budget revenues fell by an unprecedented 8.5 percent in nominal terms, and the revenue-to-GDP ratio dropped further to 8.4 percent. Despite the lack of revenue, expenditures increased, reflecting higher security spending and a near doubling of social transfers due to a sharp increase in the rate of payment to martyrs and disabled and their families (legislated in 2013) and an increase in the number of beneficiaries.

Toward the end of the year the government was running out of cash and announced a fiscal shortfall of $537 million for 2014 as a whole (after existing security and civilian aid).[3] Exceptional financial assistance to cover this gap was requested, and donors provided some $190 million, $100 million of which came from the United States. The remaining shortfall was managed by drastically cutting nonwage operating expenditure (O&M) and stopping discretionary development projects;[4] continuing to draw down the government's DAB deposits, thereby running a domestically-financed budget deficit equivalent to 1.6 percent of GDP (double that of 2013); and incurring arrears—not paying outstanding bills for nonwage O&M and discretionary development projects—of around $200 million.[5] These extraordinary measures allowed the government to get through the year and maintain salary payments but left it with little cash and significant unpaid bills.

2015: Continuing Crisis, Little Improvement So Far. Adverse fiscal trends have continued in the current year, with total budget revenue in the first four months only slightly higher than in the same period in 2014. Economic growth in 2015 is projected at 2.5 percent—well below the 4 percent forecast a few months ago. The government has few discretionary resources, and remaining arrears constitute a prior claim on any funds that become available.

A nine-month International Monetary Fund (IMF) staff-monitored program was agreed to by the Afghan government and IMF staff on March 20.[6] While it does not include financial support, the program will provide the much needed IMF seal of approval for Afghanistan's macroeconomic management, an important enabling factor for on-budget assistance. But it remains to be seen whether the IMF program will play a positive role beyond that in helping Afghanistan to navigate the fiscal crisis.

Afghanistan's 2015 national budget does not respond to the fiscal situation's severity. Targeted revenue growth is over 25 percent; given the stagnation of revenue so far this year, the annual target is almost certainly unattainable. Total budgeted expenditure, though barely higher than last year's budgeted level, represents a considerable increase from actual expenditure in 2014. Thus, overly optimistic resource projections have once again resulted in an expenditure budget that does not incorporate hard decisions on cutbacks, other than protecting salaries at the expense of other spending.

Prognosis and Possible Ways Forward

The outlook for the rest of this year includes continuing revenue shortfalls, an enduring expenditure squeeze, spending cutbacks, further possible accumulation of arrears, and perhaps another request for exceptional aid to the Afghan budget. The government, stuck with virtually all of its limited resources precommitted (not least to pay salaries), low cash reserves, and unpaid bills, will be unable to engage in new spending initiatives to address Afghanistan's development challenges.

Much of what can be done in the short run will only slightly ameliorate the fiscal crisis, though the combined impact of the measures listed below, if all are implemented, would be greater.

- **Tightening up against corruption in revenue collection** can be expected to give revenue a modest boost in the short run.
- **Tax increases may help to some extent.** The IMF staff-monitored program includes revenue measures targeted to reap $170 million in 2015, but this is probably overly ambitious and, in any case, is well under half of the budgeted revenue increase and less than the amount of arrears outstanding at the end of 2014.
- **Expenditure controls** will continue to play a role, but absent hard decisions these will be limited and distortionary—exacerbating the squeeze on civilian O&M and discretionary development projects.
- **Recovery of Kabul Bank assets**, along with other asset sales and recoveries, would have a positive fiscal impact, but only over time.
- **Another round of exceptional aid to the budget** would help support short-run fiscal management, but there appears to be limited appetite among donors for more stopgap and temporary relief.
- **Continuing flexible fiscal policy** is an option but would need to be pursued with caution. In the past two years the government covered small fiscal deficits by drawing down its deposits at DAB, but these deposits have now been largely exhausted. Modest government borrowing from DAB, either by running an overdraft (negative deposit balance) or preferably through the sale of government bonds to DAB (some of which might also be purchased by the public), would be unlikely to increase inflation in the current recessionary economy.[7] Care would need to be taken, however, to avoid loss of fiscal discipline let alone large-scale monetization of deficits, which would be disastrous.

While the measures outlined above combined would facilitate more effective fiscal management and avoid the need for *in extremis* measures, such as further incurring arrears, much bolder actions would be needed to provide a way out of the current fiscal crisis and make a dent in the structural fiscal gap.

- **Serious expenditure prioritization,** including strategic rather than merely ad hoc cutbacks, would require hard decisions and a high level of political will in the administration and in the legislature, which seems unlikely in the current political situation.
- **Attracting Afghan capital back from other countries** and encouraging private investment would provide an economic boost and thereby increase revenues. This could only be enabled, *inter alia*, by much more positive business perceptions than at present of the effectiveness, political stability, and longevity of the current administration.
- **A substantial reduction in ANSF costs** is the only means of significantly narrowing the structural fiscal gap, but beyond some economization, which may be possible, this would depend on a durable reduction or cessation of fighting with the Taliban insurgency. Moreover, the benefits from savings would in the first place accrue to the United

States and other donors in the form of lower assistance for ANSF, and so would not alleviate the squeeze on Afghan revenues and civilian expenditures. This issue could be addressed by an agreement with donors that savings on ANSF costs would be shared between reductions in Afghan revenues allocated to security expenditures and lower security aid.

- **Major acceleration of on-budget aid**—by shifting large amounts of bilateral assistance already in the pipeline to the Afghanistan Reconstruction Trust Fund or direct budget support—would make a real difference and provide fiscal space for investments by the government in Afghanistan's development. However, donors most likely would be reluctant to engage in such front-loading and on-budgeting of aid, except perhaps if the government boldly moves forward with reforms and meaningful structural fiscal measures.

Conclusion

There is no end in sight for Afghanistan's fiscal crisis. Marginal improvements are possible but will not resolve the crisis. Major progress would only be possible if the Afghan government and international partners strongly prioritize bringing about a fiscal turnaround and the government engages in bold actions with proactive international support. Given the ongoing conflict, the internal politics of the NUG and its slow start, the ambitious political agenda in the NUG agreement, which is likely to pre-empt attention, and the considerable obstacles to taking bold initiatives on both sides, it seems doubtful whether the government and international partners would take the proactive, inevitably somewhat risky actions required. In that case, however, the fiscal outlook will be for more of the same.

Notes

1. The fiscal gap was projected over a ten-year period starting in 2011, in Richard Hogg, Claudia Nassif, Camilo Gomez Orsorio, William Byrd, and Andrew Beath, *Afghanistan in Transition: Looking beyond 2014* (World Bank, 2013).
2. Fiscal and economic data for recent years are drawn primarily from the World Bank's most recent *Afghanistan Economic Update* (World Bank, April 2015) available at www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2015/04/27/090224b082e136e3/1_0/Rendered/PDF/Afghanistan0economic0update.pdf. See also monthly and quarterly reports by the Afghan Ministry of Finance, available at www.budgetmof.gov.af.
3. While doubts were raised from some quarters about the size of this request, since the decline in the revenue-to-GDP ratio between 2011/12 and 2014 represented a revenue loss of more than $600 million in 2014, the rough order of magnitude may be reasonable.
4. This refers to projects funded by Afghan discretionary budget resources, not donor project grants.
5. World Bank, *Afghanistan Economic Update*, 13–14.
6. See IMF press release (www.imf.org/external/np/sec/pr/2015/pr15128.htm).
7. The macroeconomic impact of such borrowing would be the same as that of an equivalent drawdown of positive deposits at DAB, as occurred in the prior two years.

About This Brief

William A. Byrd is a senior expert at the U.S. Institute of Peace, who has been following fiscal and other developments in Afghanistan. He has published extensively on Afghanistan's economy and related topics. The views expressed do not necessarily reflect those of the U.S. Institute of Peace, which does not take policy positions.

United States Institute of Peace
2301 Constitution Ave., NW
Washington, D.C. 20037
www.usip.org

USIP provides the analysis, training, and tools that prevent and end conflicts, promotes stability, and professionalizes the field of peacebuilding.

For media inquiries, contact the office of Public Affairs and Communications, 202.429.4725