

RESEARCH ARTICLE

Inadequate Revenue Threatens Afghanistan's Stability

Steve Sternlieb*

If Afghanistan is to maintain some semblance of stability in 2014 and beyond it must prepare for a substantial donor funding reduction and seek to grow its domestic revenue. Funding for the Afghan government's operating expenses as well as further development projects is heavily dependent on donor support. Unfortunately for Afghanistan, its fiscal position is eroding as domestic revenues decline, expenses rise, and donor aid falls. Security gains as well as public services and economic development are at risk due to this mismatch. Afghanistan's challenge in the coming years will be how to deal with this mismatch without fueling instability. It cannot simply assume that donor funding will continue to cover its funding gap. This paper assesses Afghanistan's deteriorating fiscal situation and concludes with some observations on what the Afghan government and the donor community must do, preferably in concert, to address it. It assumes that Afghanistan and the United States will ultimately sign a bilateral security agreement allowing a continued coalition military presence, without which the country's fiscal situation could rapidly deteriorate.

Afghanistan's Fiscal Sustainability Crisis

Fiscal sustainability is defined as the ability of a government to meet its operating expenditures from domestic revenue, essentially being able to pay its bills without outside financial assistance. According to the World Bank, the Afghan government's revenues declined in 2013 as public spending increased. Budget expenditures are expected to continue rising, largely due to spending on security, service delivery, building essential infrastructure, and operations and maintenance (WB 2013a: 4 & 6). The World Bank is the preeminent organization tracking and reporting on Afghanistan's macroeconomic

situation. Both the Afghan and U.S. governments rely on the Bank's data.

In January 2014, according to the Special Inspector General for Afghanistan Reconstruction (SIGAR), the Afghan parliament approved the budget for 2014. It totaled US\$ 7.5 billion - a 10.3 percent increase over the previous year - and included US\$ 4.9 billion for the operating budget and US\$ 2.6 billion for the development budget. That is more than three times the government's projected domestic revenue of about US\$ 2.4 billion. Afghanistan's fiscal deficit is one of the worst in the world. Consequently, Afghanistan relies on international assistance to pay most of its civilian operating and development budgets as well as the bulk of its security costs. (SIGAR 2014: 11 & 147).

* Sternlieb Group, United States
sternliebs@yahoo.com

The shortfall is actually much greater because there are billions of dollars more in annual expenses that are not yet included in the Afghan budget. The international community funds these expenses outside the budget. This includes the bulk of Afghan security operating costs - estimated at US\$ 5 to 6 billion annually - as well as many public services. Rising operation and maintenance costs will place even greater pressure on the Afghan budget. The World Bank estimates future non-salary operation and maintenance requirements will skyrocket, from US\$ 335 million annually in 2010/11 to US\$ 4.8 billion by 2015–2016 as the Afghan government assumes full responsibility for the operation and maintenance of assets (WB 2012b: 111). In addition to reasonably quantifiable cost pressures, such as for operation and maintenance as well as social services like healthcare and education, other cost pressures that are not easily quantified may push the financing gap higher than current projections. These include the effect of bad harvests on food security, natural disasters like floods, the Afghan-youth demographic bulge's impact on services¹, and the return of refugees and internally displaced persons to their homes and the resulting increased demand for services.

The Afghan government, the World Bank, and the International Monetary Fund (IMF) expect the financing gap between domestic revenue and projected expenditures for combined operating expenses and development to remain high over the next decade. In their June 2012 joint analysis, the World Bank and the IMF reported that fiscal sustainability is becoming a more distant goal for Afghanistan, likely to be reached only after 2032 (WB/IMF 2012: 3). The IMF, in conjunction with the World Bank, projected the financing gap will total over US\$ 70 billion over the transformation decade of 2015 through 2024, and billions of dollars more after 2024 (IMF 2012a: 14–15 & 25).² In October 2013 the World Bank reaffirmed that the projected total financing gap, while

declining from about US\$ 7 billion in 2014, will remain high throughout the period 2013–2025, remaining at almost US\$ 4 billion in 2025 (WB 2013b: 4).³ The Bank did not indicate whether this financing gap assumed Afghanistan would be paying all its operating costs, including for security, by 2025. If not, the financing gap will be even larger. Thus, Afghanistan will remain dependent on massive prolonged foreign aid for continued development initiatives and operating expenses.

Although the international community pledged billions of dollars in July 2012 at the Tokyo conference on Afghanistan (MFAJ 2012), these funds only provide a short-term solution. Current funding and pledges do not address the mismatch between growing Afghan expenditures and the international expectations of significant but declining donor aid. In fact, U.S. funding reached a high water mark in 2010 and has been declining since. Between 2010 and 2013 SIGAR reported that U.S. funding declined 41 percent, from US\$ 16.7 to US\$ 9.8 billion (SIGAR 2013: 69). For fiscal year 2014 the U.S. Congress further reduced funding, providing 37 percent, or US\$ 3.2 billion, less than President Obama requested for Afghan security and 50 percent, or US\$ 1.1 billion, less than requested for reconstruction activities (SIGAR 2014: 66). Afghanistan's need for donor support has been recognized and reported on by the United States, the Afghan government, the World Bank, and the IMF, but the donor community has so far been unable or unwilling to find a solution.

The donor community has in fact contributed to the fiscal sustainability crisis. First, it has funded projects that reflect the priorities of individual donors rather than Afghan priorities. Many of these projects have not transitioned to Afghan government control and operation and it is unclear as to which projects will transition. This lack of coordination and communication between donors and the Afghan government has led to assets either being abandoned or used for other than

their intended purposes. Second, donors have funded development projects with little thought to whether the Afghan government could maintain them. Each development project has an operating cost that if not covered ultimately undermines the project. For example, in November 2013 the Washington Post reported that a clinic once deemed a model for Afghanistan, and funded by the United States, was closing because the Afghan government was unable to fund its operating costs (Sieff 2013). Furthermore, according to USAID, while by 2010 nearly US\$ 4 billion had been spent by the international community, including the United States, on building and repairing roads in Afghanistan, many of these roads were built without a clear source of funds for maintaining them (USAID 2010: 3). Underscoring this, in January 2014 the Washington Post reported that Western officials said the Afghan government is unable to maintain even a fraction of the roads and highways constructed since 2001 (Sieff 2014). Even if the Afghan government were to devote all its revenue to its operating budget, forgoing further development, it would still be fiscally unsustainable without donor assistance.

Security Will Be Affected as Much by Funding as by Security Conditions

Several factors - including threats to a country's interests, how it proposes to fight its enemies (in military speak called doctrine), and available budgets - guide a country's decisions on the size and shape of its military forces. In Afghanistan a worsening security situation coupled with a U.S. willingness to spend billions of dollars to build Afghan security forces led to substantial growth. According to the U.S. Department of Defense (DoD), this investment is leading to improved security (DoD 2013b: 1).

Whether the Afghan government can sustain the gains in security will depend as much on adequate funding as on conditions on the ground. The international community, led by the United States, has contributed more

than US\$ 60 billion through August 2013 for security, primarily to build, equip, train, and sustain the Afghan National Security Forces (ANSF) (SIGAR 2013: 81; CRS 2013: 30–31).⁴ Without adequate funding these Afghan security forces cannot be maintained, which directly affects the ability to provide security. Improved security can allow for a planned reduction in security forces and lower sustainment costs, while fostering the investor confidence necessary to drive the economic growth needed for a self-sustaining Afghan government, which in turn generates more revenue. Conversely, a deterioration in security prevents reducing security forces, raises sustainment costs, and inhibits economic growth, reducing revenue generation. Adequate funding is critical for sustaining the desired level of security forces but it may prove elusive. Given the uncertainty surrounding funding, in addition to being conditions-based, the future size of the ANSF will be funding-based.

Sustaining a smaller ANSF will be determined as much if not more by available funding as by security conditions

Under current plans, the ANSF are not fiscally sustainable. The ANSF's size has been incrementally increased over the past decade to its current target level of 352,000. The World Bank estimates that sustaining a 352,000 person ANSF would cost US\$ 5 billion annually (WB 2012a: 10). The U.S. Congressional Research Service (CRS) reports a higher cost, US\$ 6 billion (CRS 2012a: 32). Whether adequate funding will be available is uncertain at best.

To make the cost of sustaining the ANSF more affordable, at a May 2012 summit the North Atlantic Treaty Organization (NATO) called for reducing its size from the current target of 352,000 to 228,500 by 2017, security conditions permitting (NATO 2012: 2–3). The estimated cost of sustaining this smaller force is US\$ 4.1 billion annually. The pace and the size of the reduction will be decided by the government of Afghanistan

in consultation with the international community. The planned size will be reviewed regularly against the developing security environment. However, as of February 2013, NATO was already considering a proposal that would delay the reduction by continuing to fund an Afghan security force of 352,000 troops through 2018 as a way of convincing Afghanistan that its allies are not going to abandon it. At the May 2012 summit the NATO Declaration on Afghanistan confirmed the international commitment to supporting the ANSF and called on the international community to commit to long-term sustainment. Keeping a larger force in place longer will increase the size of the international commitment as discussed below.

NATO expects that the Afghan government - which had projected domestic revenues of US\$ 2.4 billion for 2014 - would pay at least US\$ 500 million annually for sustaining the ANSF beginning in 2015, with the aim that it assumes full financial responsibility for its own security forces by 2024. The international community, including the United States, would pay the difference between Afghan funding and the overall sustainment cost, but few details of such a deal have been made public.

While NATO expects the Afghan government to fully fund its security forces by 2024 at the reduced size of 228,500 personnel, there are significant differences among NATO, the Afghan government, World Bank, and IMF views on security funding. Only NATO believes the Afghan government can fully fund its security forces by 2024. Given the uncertainty surrounding funding, in addition to being conditions-based, the future size of the ANSF will be funding-based, i.e. dependent on the availability of adequate funds. As the U.S. Secretary of Defense said in 2012, 'The size of the future Afghan force will largely depend on the funds that are going to be put on the table.' (Trofimov 2012).

In December 2012 the U.S. DoD reported that given Afghanistan's current economic

and fiscal constraints, the international community pledged to contribute the remaining amount of the US\$ 4.1 billion NATO estimated for sustaining a smaller ANSF for the three years beginning in 2015 (DoD 2012c: 99). Subsequently, in November 2013, the DoD reported that international donors had committed to providing US\$ 1 billion per year for the three years beginning in 2015. The Afghan government will provide US\$ 500 million a year during the same period and will progressively increase its contribution over time. The U.S. pledged to seek US\$ 2.5 billion per year (DoD 2013b: 80). That still leaves an annual shortfall of US\$ 100 million for the smaller force and an even larger shortfall for the currently sized force.

In August 2013 the United States acknowledged that Afghan government revenue generation would not cover operating expenditures, including increased security spending, until sometime after 2025 (SIGAR 2013: 84-85).⁵ Consequently, sustaining Afghan security forces will require financial support from the international community for more than another decade.

It may be well after 2025 before the Afghan government can fully fund its security forces. In November 2011 the Afghan government stated its goals of funding a professional highly effective ANSF by 2030 and reducing dependence on donor assistance (GIRA 2011: 5). In July 2012 the Afghan government reported that by 2025 Afghanistan will have reduced its dependence on international assistance in non-security sectors to levels consistent with other least-developed nations (GIRA 2012: 3). It made no mention of when it could fully fund security. However, as of August 2012 the IMF reported that fiscal sustainability is becoming a more distant goal, likely to be reached only after 2032 (IMF 2012a: 3). In the United States alone this period encompasses five presidential elections and ten congressional elections. It is impossible to predict future financial commitments so far out.

NATO funding plan contains shortfalls

Further complicating matters, the NATO funding plan contains two major shortfalls. First, it does not include, or at least fully include, the cost of certain military capabilities called enablers, such as medical evacuation; intelligence, surveillance, and reconnaissance; airlift; and close air support. Second, it does not address how the Afghan government and the international community will sustain the currently sized ANSF.

In an April 2012 report to Congress, the DoD said that as a result of a deliberate decision made when the plan for expanding the ANSF was formulated, the initial focus for the ANSF was on building combat capability and leveraging International Security Assistance Force (ISAF) enablers to support the ANSF (DoD 2012a: 26). Subsequently, in July 2013 the DoD reported that by the end of ISAF's mission in 2014, U.S. and coalition enabler support to the ANSF would be withdrawn, creating gaps which, if not addressed, would reduce the Afghan government's ability to provide security for its populace and deter external threats (DoD 2013a: 69). As recently as November 2013, the DoD reported that Afghan capabilities are still limited and the ANSF continues to require ISAF intelligence, surveillance, and reconnaissance; airlift; resupply; medical; route clearance; and close air support assistance. The lack of these enablers prevents many ANSF units from reaching full operational capability (DoD 2013b: 3 & 33). The DoD says it is working to acquire enablers for the ANSF, but fielding has been slow.

As recently as September 2013 the UN Secretary-General reported that there remains a notable shortage of logistical, air support, medical evacuation, and counter improvised explosive device capabilities within the ANSF (UN 2013: 5). Afghan officials, including the Afghan Defense Minister, have said that the Afghan army badly needs the enablers that are currently provided by NATO. According to the Afghan Defense Minister, without them the Afghan army

Force size	228,500	352,000
Total cost	\$4.1	\$5.0
Afghan government contribution	\$0.5	\$0.5
Non-U.S. donors	\$1.0	\$1.0
Implied US contribution	\$2.6	\$3.5

Table 1: Potential U.S. Contribution to Sustaining the ANSF (dollars in billions). Source: Developed from NATO, DoD, World Bank, and CRS information

lacks the full capabilities of a modern army (DoD 2012b: 6).

The second problem is that the NATO plan does not provide a budget for the 352,000-strong ANSF. Even if security conditions permit a reduction in the ANSF, the force is going to be larger than the projected future 228,500 person force for several more years and hence have a higher sustainment cost through 2017, and now possibly through at least 2018. If security does not improve, Afghan security forces could remain larger than the planned 228,500, depending on funding. According to senior DoD officials, the drawdown was not set to begin until 2016 (HASC 2012: 29). If NATO does decide to keep the larger force in place through 2018, the drawdown would not begin until two years later. The DoD has yet to provide a public cost estimate for the sustainment of a larger force. As discussed earlier, cost estimates for sustaining the 352,000-sized ANSF once reached vary from US\$ 5 to US\$ 6 billion annually. As shown in **Table 1**, the annual funding shortfall between assumed Afghan and non-U.S. donor contributions and overall ANSF sustainment costs range from US\$ 2.6 to US\$ 3.5 billion. To be conservative, this author used the lower World Bank estimate. If the CRS estimate is used, the implied U.S. annual contribution to sustain a 352,000 person ANSF rises to US\$ 4.5 billion. This is almost twice as much as the implied U.S. contribution reported by the DoD.

The DoD reported in April 2012 that the United States, as well as the NATO Training Mission-Afghanistan, continues to work through diplomatic channels and international organizations to encourage allies and partners to provide greater assistance to sustain the ANSF (DoD 2012a: 45). While the United States will likely continue to provide the majority of the ANSF funding for the foreseeable future, the issue of international financial assistance will assume greater importance if U.S. funding continues to decrease over time. However, as illustrated above, there may be more rather than less need for donor funding if conditions do not permit a reduction in ANSF force size. The bulk of this funding would presumably have to come from the United States. If sufficient funding does not materialize, the ANSF force size would have to be adjusted to available budget regardless of security conditions.

Economic Growth and Revenue Generation are Too Weak to Allow the Afghan Government to Become Self-Sustaining

It is widely acknowledged that it will take years before the Afghan government is capable of generating sufficient revenue to fund its operating costs as well as future development. As noted earlier, the World Bank and the IMF reported that it would take almost 20 years, until 2032, for the Afghan government to become self-sufficient. CRS reports that Afghanistan will remain donor dependent indefinitely (CRS 2013: Summary). To become fiscally sustainable the Afghan government must undertake some combination of reducing spending, increasing economic growth, and increasing revenue. There are, however, many challenges to doing so.

Reducing spending

Reducing spending must be part of any Afghan plan to bring spending in line with likely revenues. The government must assume that donor contributions will decline more rapidly than revenue generation

increases. However, reducing spending carries risks. Security spending at 60 percent of the operating budget is the biggest driver of operating expenses and that is understated as discussed earlier because much security funding is off budget. It is also the most susceptible to change under different scenarios, either from increases or reductions in the size of the ANSF. Any reduction in security spending, however, puts the recent gains in security at risk as reduced spending would result in fewer security forces and less operational capability. Fewer security forces could in turn lead to more instability, which in turn could reduce economic activity and revenue generation, exacerbating fiscal sustainability. Some argue that in countries like Afghanistan political elites have a financial interest in the country being peaceable most of the time (WB 2007: Abstract). Nevertheless, history shows that sometimes these elites, as well as those seeking to seize power from elites, can and have acted against their economic self-interest. This was the case in Afghanistan in the 1990s when Kabul was largely destroyed by civil war and in Bosnia in the 1980s when the country was badly damaged during ethnic fighting.

Reduced spending on other aspects of the Afghan government - such as healthcare, education, and infrastructure - could also foster instability. Over the past few years Afghanistan has made considerable gains in all these areas. For example, in 2012 the Afghan government reported that access to primary healthcare had increased from 9 percent of the population to more than 57 percent; more than 8 million students are enrolled in school; and almost 5,000 miles of national highways, regional highways, and provincial roads have been built, cutting travel times between centers by 75 percent (GIRA 2012: 4). These gains have increased public expectations regarding government delivery of services. Reducing spending would erode these gains, causing popular resentment and correspondingly increasing instability. Afghanistan needs to find a strategy to adjust expectations regarding the level

of social services while finding ways to minimize the impact of reducing said services.

Economic growth is critical, but Afghanistan does not provide a conducive climate for private-sector investment

The Afghan government believes the private sector will be the main source of future economic growth, jobs, and revenues. However, the Afghan government, the World Bank, and non-governmental organizations (NGOs) have identified significant challenges – including corruption, an inhospitable business environment, and the lack of electricity – to private-sector development. The World Bank ranks Afghanistan as one of the worst countries in which to do business.

The Afghan government recognizes its challenges. In July 2012 it reported that despite some achievements, the overall business environment is still characterized by a weak regulatory and legal regime, institutional and structural deficiencies, poor infrastructure, and corruption. It identified corruption as the most important barrier to sustained economic growth. The Afghan government stated that corruption ‘damages the legitimacy of the government, affects the quality and quantity of services delivered to our citizens, and undermines the confidence of our people and development partners in the integrity of the state’ (GIRA 2012: 20). Corruption also reduces revenue that should be paid into the national treasury.

The World Bank’s reporting on *The Afghanistan Investment Climate in 2008*, the latest available, identified constraints to private-sector growth, including a lack of electricity (WB 2009: vii & ix). The Bank, in a September-November 2008 survey of private firms in urban areas, identified six key constraints to private-sector growth: (1) weak policy enforcement; (2) poor provision of electricity; (3) crime, theft, and disorder; (4) corruption; (5) access to land; and (6) access to finance. These constraints resembled those found in a 2005 World Bank survey, with a marked deterioration in policy

enforcement and security related to crime, theft, and disorder. Regarding electricity, the Bank reported that the lack of electric power is a hugely constraining factor - both on its own as a direct ‘tax’ on productivity - and combined with limited access to land as a fundamental barrier to entry. Firms report losing, on average, 9 percent of output because of power losses. Firms that have access to the grid are 49 percent more productive than those that do not. As recently as July 2013, the DoD reported that power is only available to one-third of the population and power imports, along with domestic generation, do not provide 24-hour supply to those connected (DoD 2013a: 164).

As mentioned above, the World Bank ranks Afghanistan as one of the worst countries in which to do business. Progress in improving Afghanistan’s business climate has been nonexistent. The Bank, in the latest iteration of its *Doing Business* annual report, published in October 2013, reported that Afghanistan ranked 164 out of 189 countries, virtually unchanged from its January 2013 position of 168 out of 185 countries (WB/IFC 2013b: 3; WB/IFC 2013a: 3).⁶ These are lower than the ranking that the Bank reported in its 2012 report, which ranked Afghanistan as 160 out of 183 countries (WB/IFC 2012: 6), which in turn was down six spots from its 2011 ranking of 154. In Transparency International’s 2012 and 2013 Annual Corruption Perception Indexes, Afghanistan ranked last, tied with North Korea and Somalia.⁷ In the 2010 Annual Corruption Perception Index it ranked 176 out of 178 countries. In November 2011, the Afghan government committed to improving its ranking in the corruption index by moving from a rank of 176 in 2010 to 150 within three years (GIRA 2011: 3). However, as noted above, its ranking has essentially been stagnant. In addition, it committed to improving by 15 positions in the World Bank’s *Doing Business* survey within three years, but its position has instead declined.

Expanding regional trade through the New Silk Road initiative will take many years

In July 2011, the U.S. Secretary of State announced the New Silk Road initiative, a long-term economic vision to transform Afghanistan into a hub of transport and trade (SCFR 2011: 9). It envisioned greater Afghan economic integration in the region and a role in a 'New Silk Road' trading system which would presumably accelerate Afghan private-sector growth and customs revenue receipts. The initiative is based on the idea that if Afghanistan is firmly embedded in the economic life of the region it will be better able to attract new investment, benefit from its resource potential, and provide economic opportunities for its people.

Achieving the benefits of the New Silk Road vision may never occur due to the challenges described below and if it does will take years and require private sector and regional cooperation. Obtaining regional cooperation will be difficult. CRS reported in September 2012 that persuading Afghanistan's neighbors to support Afghanistan's stability instead of their own particular interests has been a focus of U.S. policy since 2009, but with mixed success (CRS 2012b: Summary). A December 2011 Senate Foreign Relations Committee majority staff report describes challenges going back to 2006 (SCFR 2011: 9–10). The report noted that in 2006 the State Department advanced a vision to link Central Asia with Afghanistan, Pakistan, and India, while also expanding continental trade. The United States also signed a *Trade and Investment Framework Agreement* with the countries of Central Asia in 2004. These initiatives were promising, but the same obstacles that stymied progress then still existed in Central Asia at the end of 2011, including lack of regional cooperation, corruption, inhospitable business climates, regional rivalries, and the unfavorable cost differential between continental and maritime trade. More recently, in an August 2012 report,

the Center for Strategic and International Studies (CSIS) cast doubts on the efficacy of the New Silk Road initiative as a development strategy. The report concluded that most of Afghanistan's neighbors and regional powers have little interest in injecting massive investment in or integrating their economies with Afghanistan (CSIS 2012: 5–6).

Revenue growth will be slow

The Afghan government projects its annual revenue will quadruple between 2011 and 2025, from US\$ 2 billion to US\$ 8.4 billion (GIRA 2012: 24). However, most recently, Afghan government revenue, rather than rising as predicted by the Afghan government, has instead declined. The World Bank reported in October 2013 that after a decade of strong fiscal performance, revenue collection weakened in 2013, potentially delaying Afghanistan's path toward self-reliance. The Bank reported that revenues in the first six months of 2013 were down 11 percent (WB 2013b: 3). Furthermore, little is being done to fund infrastructure operating costs. For example, the DoD reported in July 2013 that donor-funded development efforts continue to improve Afghanistan's infrastructure, including roads and power. However, regulatory authorities and operations and maintenance mechanisms necessary for the long-term sustainability of this infrastructure are immature or have yet to be developed (DoD 2013a: 162).

The Afghan government expects that overall economic growth, development of the mining sector, and imposition of a value-added tax (VAT) will contribute to revenue growth (GIRA 2012: 6 & 24). In particular its estimates rely on the rapid development of the mining sector as the key driver of Afghanistan's future economy and domestic revenue generation. However, as outlined below, both the mining sector and VAT revenue are likely to grow more slowly than originally projected due to delays in enacting necessary legislation and, in the case of

mining, developing infrastructure and ensuring security.

Revenue from mining will take many years to develop and key legislation is yet to be enacted

The Afghan government hopes mining will become the main vehicle for revenue generation for the nation (GIRA 2012: 9). In October 2011, the DoD reported that the cultivation of Afghanistan's mineral resources had the potential to generate significant economic growth and government revenues in the medium- to long-term (DoD 2011: 99). The DoD further reported that the U.S. Geological Survey estimates the country has more than US\$ 900 billion in untapped mineral resources. However, the United States and other international donors have pointed out that mining will not be a quick fix to Afghanistan's revenue problems. The United States Embassy in Kabul and U.S. Forces Afghanistan said in the October 2012 *Civil-Military Strategic Framework* that it would likely take many years before the Afghan government sees any meaningful revenue flow from its mineral deposits (USEK/USFA 2012).

Several challenges must be overcome before mining can generate significant revenue. First, the Afghan government must implement legislation that accommodates private-sector investment (companies that win the right to conduct mineral exploration do not currently automatically receive the right to mine their discoveries), develop infrastructure such as railways to ferry minerals to markets, and ensure security for mining assets and personnel. This constitutes a tremendous amount of uncertainty for what the Afghan government considers a key driver of the country's future economy and domestic revenue generation.

Success in revising Afghanistan's mining law to make mining more attractive to foreign investors has been elusive. As mentioned above, under current law companies that win the right to conduct mineral exploration do not automatically receive the right to mine

their discoveries. If any mineral deposit is discovered, the exploitation (i.e. mining) rights are bid separately. Because exploration can cost hundreds of millions of dollars, companies are reluctant to invest in exploration if they cannot be assured of being able to mine any minerals they discover. Efforts to revise the mining law have been stalled for more than a year. In July 2012, the Afghan cabinet, which would submit proposed changes to the parliament, had rejected proposed changes to mining laws. The Afghan cabinet approved a draft mining law in February 2013 and sent it to the parliament in July 2013, but parliament had not acted on it as of January 2014 (CRS 2014: 65). The legislative changes would allow for exploration and exploitation to be bid together. The changes are seen as necessary by the mining sector to bring in investment by international mining companies. SIGAR reported in October 2013 that the DoD's Task Force on Business and Stability Operations warns that without legislative reform that links exploration and extraction rights, as well as institutes a formal and fixed royalty rate, many companies will not bid on new tenders and may not sign contracts on existing awards. According to the Task Force, the delay has significantly hindered private-sector investment (SIGAR 2013: 155).

Generating revenue from the exploitation of minerals also depends heavily upon developing the appropriate infrastructure, particularly rail. It is generally agreed that a railway system will take a minimum of five years to complete, and considering the difficult terrain, the tenuous security situation, and disagreements over who should build it, it may take considerably longer.

A secure environment is needed for building infrastructure and extracting resources, including site and route security. The Afghan government is responsible for securing mining sites and transportation routes. The Ministry of Mines established a Protection Unit of 1,500 personnel, established specifically to safeguard the country's mineral

deposits. However, according to the U.S. State Department, the protection unit has not developed as anticipated, so the Afghan National Police has taken over security for extractive industries. As recently as October 2013, the State Department reported that the Ministries of Interior and of Mines have failed to adequately address site security issues (SIGAR 2013: 143).

The Aynak copper mine illustrates the security- and infrastructure-related challenges (among others) in developing the mining sector. In October 2013, SIGAR reported that development of the mine remains delayed by the discovery of cultural relics in the area, difficulties in land acquisition, lack of primary infrastructure, and security concerns (SIGAR 2013: 158). Furthermore, rail access is necessary for copper to be mined at Aynak to its full potential. The Ministry of Mines believes that the China Metallurgical Group Corporation (MCC), which won the bid for the right to develop Aynak, is required to build the necessary rail. According to SIGAR, the Afghan media recently reported that the MCC intends to exercise its option to renegotiate the contract. The U.S. State Department said that MCC wanted to specifically renegotiate its commitments to build a railroad, a power plant, and a copper smelting plant. MCC has concluded that it will not be economically feasible for it or any other investor to build rail. It is more realistic to expect the Afghan government to build mainline railroads, with mining companies building spurs from the mainline to mining sites. Building rail is expensive and presumably would have to be funded by donors. These challenges have pushed back the planned timeline for extraction, which would slow growth in domestic revenues.

Value-Added Tax will take several years to come on line

After increased mining revenue, the Afghan government expects the implementation of a Value Added Tax (VAT) to be the next largest driver of increased domestic revenue. VAT

implementation is part of the IMF's Extended Credit Facility (ECF) for Afghanistan. The ECF timeline originally called for VAT legislation approval by parliament by December 2012 and implementation of the VAT in 2014 (IMF 2012b: 14).

The timing and projected collection amounts are questionable. As part of the ECF timeline, the Afghan government was supposed to submit the VAT legislation to parliament for approval by the end of December 2012. However, that goal apparently was not met according to a review of U.S. government reporting through January 2014. In February 2013, the IMF reported that the Afghan authorities will continue and intensify their preparations for the successful implementation of the VAT in 2014, initially through the timely submission of the draft VAT law to parliament together with measures for its implementation and outreach to familiarize and prepare the private sector (IMF 2013: 1). As with the mining legislation, passage through cabinet and parliament may prove contentious and could impose unexpected delays in the process. The Afghan government projects revenue from the proposed VAT to add around US\$ 700 million to government revenue beginning in 2015, with VAT revenue increasing as the GDP grows (GIRA 2012: 24). However, the IMF and World Bank project growth in VAT revenue to be slower, with the World Bank not expecting VAT revenues to be realized until 2016/2017 (WB 2012b: 53).

Although mining and the VAT have the greatest potential to increase Afghanistan's domestic revenue, there are other important potential revenue streams.

Revenue leakages reduce government receipts

The Afghan government is currently not collecting all the revenue it should be receiving. SIGAR reported in April 2012 that customs collections are very susceptible to fraud and corruption at all major entry points, and the Afghan government contin-

ued to make little progress counteracting the problem (SIGAR 2012: 108–109). Corruption issues range from small bribes paid to customs inspectors, to large-scale smuggling and fraud that are often tied to provincial governments and criminal patronage networks, according to the State Department. Customs collection has grown tremendously - from US\$ 50 million in 2004 to almost US\$ 1 billion in 2011. Nevertheless, the DoD reported in July 2013 that customs revenue has recently struggled due in large part to increasing corruption (DoD 2013a: 133). Much more progress is needed in countering fraud and corruption in customs collection at ports of entry. Staff members at inland customs depots have suggested that up to 70 percent of potential border revenue is lost to corruption.

Efforts to address customs corruption are stalled. On February 23, 2013, after 18 months of deliberation on how to address corruption at border posts, the Afghan Finance Minister signed the charter of the Afghan Presidential Executive Commission on Borders Airports and Customs Depots, a senior-level interagency body tasked with reducing corruption within the Afghan customs and border regimes. However, in June 2013, the Afghan Council of Ministers decided not to authorize the charter. The Ministry of Finance indicated that the issue of the Commission would not likely be raised again now that the Council of Ministers has withdrawn support (SIGAR 2013: 139).

As the mining industry develops, the Afghan government could also face leakages through underreporting of mine production. A current aspect of the mining sector that needs more attention is transparency and enforcement mechanisms for mining revenue to ensure the Afghan Treasury is receiving the full benefit of mining revenue once it starts to flow. Unless a robust system is put into place before mining revenues start increasing, the risk of corruption and revenue leakage could undermine revenue collection.

Conclusion and Courses of Action

Afghanistan faces a loss of revenue that could sweep away the gains of the past decade. This conclusion offers observations and courses of action that the Afghan government and the donor community - preferably in concert - should consider in responding to this loss of revenue.

The Afghan government can no longer count on full donor support to make up for its domestic revenue shortfall. Rather it must develop a three-prong strategy consisting of the following steps:

- Develop funding plans to cope with varying levels of income, ranging from depending on domestic revenue alone following a cessation of all donor funding to continuing to receive current levels of donor funding. If the Afghan government continues to receive some level of donor support it must prioritize what it will fund at varying support levels. It would be unrealistic to expect continued donor support at current levels, as those levels have declined over the past several years and can be expected to decline further. If Afghanistan has to depend solely on domestic revenue it will have to decide on how to balance funding security costs, social services, and infrastructure maintenance. Even if the government used 100 percent of domestic revenue to fund security, it would still have to make deep cuts. If it tries to maintain some level of social services there would have to be even greater cuts in security spending. Alternatively, funding some level of social services would help alleviate heightened instability and should be a high priority. Afghan access to healthcare as well as health outcomes have increased over the past decade. The number of children in school has grown exponentially as has the expectation of access to free education, which is in fact guaranteed by the Afghan constitution. Reducing those services would have a visible and imme-

diate impact on Afghan lives. Operation and maintenance, already a low priority for the Afghan government, would by necessity continue to be a low priority. This is regrettable as roads and buildings will deteriorate due to a lack of upkeep; however, if funding is unavailable, deferring maintenance, while undesirable, is unavoidable. Without robust donor support, Afghanistan would also have to stop all future development projects for some years to come - and would probably be forced to terminate those underway - until domestic revenue improves. To the extent there is some level of donor support it can 'buy back' some of these spending reductions.

Regarding security, a lack of funding to maintain necessary security forces poses the greatest risk to sustaining security gains. If donor funding is insufficient to cover security costs, the Afghan government will have to reduce the size of its security forces, find a way to operate less expensively, or some combination of the two. A smaller security force would make it difficult, if not impossible, to maintain the security gains of the past decade. It may however be possible to mitigate reductions in the security forces by reducing operating costs. The Afghan security forces are built on a Western model that is technology- and logistics-heavy, as well as on Western quality of life standards for its security forces. By reverting to a less sophisticated model that relies on less sophisticated equipment, operating costs could be reduced. Costs could also be reduced by adopting quality of life standards more in line with Afghan standards. Higher standards have a much greater logistical tail that drives costs higher. For example, providing air conditioning in the hot Afghan summer requires power generators, which in turn require fuel, which must be transported to bases around the country and which require convoy security to reach their destinations. The generators also require a skilled workforce to

operate and maintain them.

- At the same time the Afghan government should take steps to increase domestic revenue. It should start by enacting the mining and VAT legislation that have been awaiting action for more than a year. Mining offers the potential of generating substantial revenue over time but current legislation inhibits the foreign investment necessary to develop the country's mineral wealth. Afghanistan planned to institute a VAT beginning in 2014 but has yet to enact the necessary legislation. Additionally, Afghanistan should enact user fees such as a gasoline tax to fund operation and maintenance expenses. This would provide a steady stream of funding for development projects once they are complete. Finally, it must act to stop revenue leakage in customs collection. Unfortunately, the Afghan government has proven incapable to date of taking such steps. If it is unwilling to do so it is unrealistic to expect donors to continue making up its revenue shortfalls.
- The Afghan government must also adjust its people's expectations about the future level of public services. In doing so it must undertake a public education campaign explaining how much is spent on social services and the sources of revenue for such services; how a reduction in donor funding will affect those services; and what the government plans to do to maintain such services. As discussed above, reducing social services can fuel instability. The potential for instability is much greater once public expectations rise, as has happened in Afghanistan.

Without prolonged massive donor support, the international community's investment in Afghanistan is at risk. Yet it is impossible to predict donor support levels in the long term. The United States, for example, has an annual funding process. There are, however, steps the donor community can take. While it is impossible to predict with accuracy future funding

levels, one can examine the trend in funding, which is downward. One can also look at comparable support to other countries and to Afghanistan in earlier periods, which declined as military activity did. To address this, the donor community should acknowledge current realities and take the following steps:

- Afghan security forces face a funding crisis. The government of Afghanistan will be unable to meet NATO's call to fully fund the ANSF by 2024 and it is unrealistic to expect donors to maintain current funding levels. Although there is a conditions-dependent plan to reduce the size of the security forces to a more affordable level, any reduction would not begin before 2016 at best. There is no funding plan for this larger force, only an assumption that the donor community, led by the United States, would continue to provide the necessary funding. The international community must provide some indication of what funding to expect over the next few years and - recognizing that the currently sized and constituted ANSF is unaffordable - take immediate steps to help design a smaller, more affordable force. Such a force should be based on Afghan quality of life standards, take into account Afghan technical capabilities, and be less technology dependent.
- Continuing to fund development projects without a means to assure their continued operating costs is an exercise in futility. All future development spending needs to be undertaken with a clear understanding of how their operating costs will be paid. Given Afghanistan's limited revenue, to the extent that donors continue to fund new development projects they should be expected to provide operating funds along with the project until the Afghan government is able to fund it. Since the Afghan government is not likely to be in a position to fund new operating costs, much less existing operating costs, the donor community

should shift its focus to sustaining current gains by funding operating costs. At the same time donors should not give the Afghan government a blank check to indefinitely fund operating costs. Donors should incentivize the Afghan government to develop dedicated funding streams for future operating costs both by offering a dollar for dollar match of donor funds to new Afghan revenue up to whatever level the donor community is prepared to provide, and by setting a sunset date for donor funding. If the Afghan government is unwilling to take steps to fund its own programs, at some point those programs will have to fail.

2014 is a watershed year for Afghanistan for a variety of reasons, including the withdrawal of U.S. combat forces, the April 2014 presidential elections, and the uncertainty surrounding the signing of a U.S.-Afghan bilateral security agreement. While world attention is focused on these events it is critical to not ignore Afghanistan's fiscal sustainability crisis. If the Afghan government and the donor community fail to come to grips with this crisis the gains made over the past decade are at risk regardless of how other events evolve.

Author Information

Managing Director at the Sternlieb Group, offering monitoring and evaluation of program outcomes and research and analysis on policy issues, U.S.

Notes

- ¹ The Afghan-youth demographic bulge's impact on services should be quantifiable, but it is not clear that it has been included in budget projections.
- ² The report provided data as a percentage of GDP, which was converted to dollars by the author.
- ³ Dollar values calculated by the author based on World Bank data.
- ⁴ Total contributions calculated from SIGAR and CRS data.

⁵ SIGAR reported that in August 2013, the DoD and the State Department released the latest revision of the U.S. Civil-Military Strategic Framework for Afghanistan. The framework, which replaces a previous October 2012 version, provides strategic guidance for all American civilian and military personnel serving in Afghanistan and outlines U.S. priorities through what the framework calls the 'transformation decade' of 2015–2024. In developing the revised framework, U.S. planners made several assumptions, including that Afghan government revenue generation will not cover operating expenditures - including increased security spending - and development costs until sometime after 2025.

⁶ The World Bank and the International Finance Corporation's, *Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises* and *Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises* are the tenth and eleventh in a series of annual reports investigating the regulations that enhance or constrain business activity. *Doing Business* presents quantitative indicators on business regulation and the protection of property rights that can be compared across economies and over time.

⁷ The Corruption Perceptions Index ranks countries according to their perceived levels of public-sector corruption. The 2012 and 2013 indices draw on data sources from independent institutions specializing in governance and business climate analysis. The sources of information used for the 2012 and 2013 indices are based on data gathered in the previous 24 months. The index includes only sources that provide a score for a set of countries/territories and that measure perceptions of corruption in the public sector. Transparency International is an NGO that monitors and publicizes corporate and political corruption.

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