Moving Away from Foreign Aid: A Case Study of Afghanistan

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Abstract

After the United States invasion of 2001 that toppled the Taliban's Islamic Emirate, a Republic Government was established in Afghanistan. The newly formed Government could not raise adequate public revenue to meet the growing public expenditure, which resulted in a large fiscal deficit. As the Afghan government could not afford debt-financing, it relied on foreign aid grants to fill the fiscal deficit. Since 2002, foreign aid grants influx helped the Afghan Government (and the economy) in many ways. However, a continued and massive reliance on foreign aid grants had several counterproductive consequences for the country, too. To understand the sources and implications of aid-dependency, as well as explore the potential solutions for overcoming aid-dependency, the author conducted this research. This research study uses a mixed research method, and the analysis is based on primary and secondary data.

This research's findings indicate that the small size of the economy, informality, high unemployment, lack of technical and institutional capacity, high level of corruption, and enormous military spending are some of the main reasons impeding the enhancement of domestic public resource mobilization (DPRM) in Afghanistan. To overcome these challenges, the author recommended short-term, medium-term, and long-term policy recommendations that could have a reasonable chance of success to enhance DPRM in Afghanistan. These recommendations are based on the analysis of the situation in Afghanistan and the lessons learned from other countries.

Acknowledgments

As the MIDE program is officially coming to an end with the submission of this thesis, I would like to extend my gratitude to Prof. Dr. Ulrich Wurzel and Prof. Dr. Dimitrios Zikos for their continued support and strategic guidance that helped me to complete this research study. I also remain indebted to other lecturers at the HTW-Berlin, from whom I learned a lot during the past year and a half. It is also imperative to mention that without the DAAD's generous funding and Ms. Cindy Gottstein's logistical support, this journey would not have been as convenient as it was, despite all the ups and downs.

On a personal note, I would like to extend my gratitude to my parents, especially my mother "Nazo Karimi," whose moral support is endless and irreplaceable in my life. Undoubtedly, my friends' and colleagues' support was also paramount in completing this research. Last but not least, I would distinctly appreciate Melissa Sánchez for her tireless support and reminder that "there will be light at the end of the tunnel one day," which pushed me forward.

Chapter One
Introduction

After nearly two decades of war (1979-1995) and following the collapse of the Taliban regime (1996-2001), civil conflict and political crisis affected the physical, institutional, social, and economic structures of Afghanistan severely (Joya, 2011). To rebuild new institutions, invest in public infrastructure, and expand the public services delivery, there was a pressing need for large public expenditure. Besides, fighting against a global network of terrorism inside the country was also demanding an additional large sum of military spending. To meet these growing public expenditures, the Afghan Government could not raise adequate public revenues from domestic sources (tax and non-tax income), as shown in figure 1.1. A prolonged civil conflict undoubtedly deteriorated Afghanistan's economy and the Government's institutional capacity for raising public revenue. However, from an economic standpoint, the main reasons for low public revenue collection are noticeably two. First, a large share of the Afghan economy (80-90 percent) remained subsistence-based and informal that cannot be taxed (Manthri, 2008; Ghiasy, Zhou, and Hallgren, 2015). Second, over the past two decades, the unemployment rate (24 percent of the total labor force as of 2017) and underemployment rate[1] (15.6 percent of the total labor force as of 2017) remained considerably high (CSO, 2018). Besides, the lack of technical capacity, high level of corruption, and enormous military spending were the other reasons impeding the enhancement of domestic public resource mobilization (DPRM)[2].

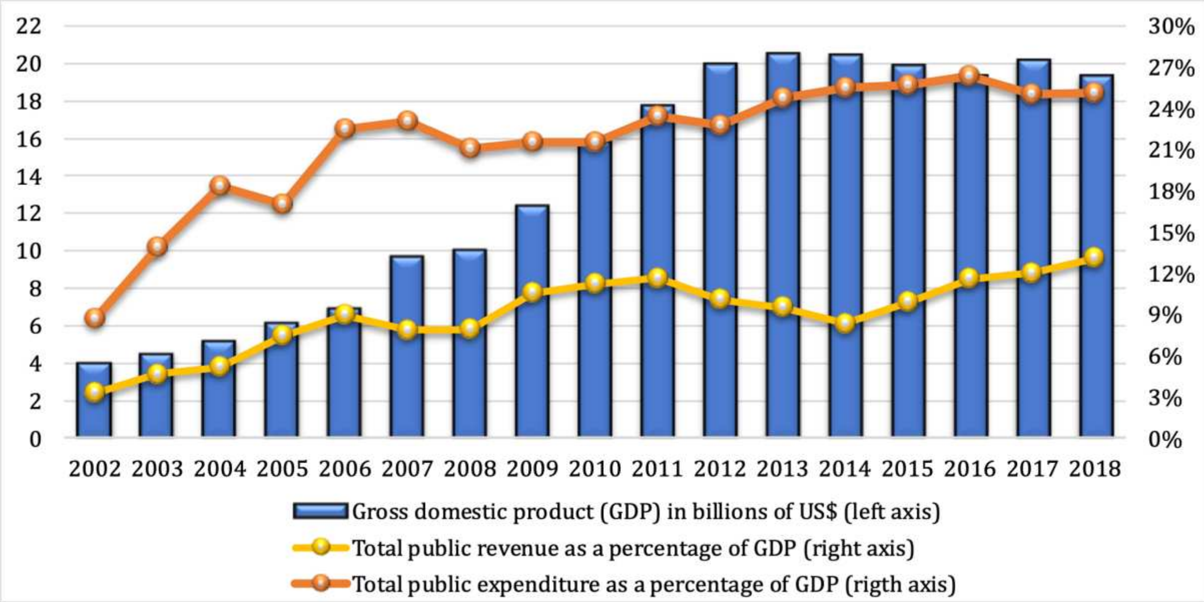
Given the circumstances, over the past two decades, Afghanistan's fiscal deficit stood around 58 percent of the total public expenditure, as depicted in figure 1.1. Due to the Afghan Government's weak financial position (inability to repay a large sum of loans supplemented by a growing interest), debt financing (both domestically and internationally, concessional or non-concessional) was impossible. Therefore, foreign aid

[1] "All persons aged 14 and over who, during the reference period of one week, were: i) working less than 40 hours, ii) available to work additional hours, and, ii) willing to work additional hours" (CSO, 2018, p. 56).

[2] DPRM can be described as the ability of a government in raising and productively spending the resources derived from taxes (direct and indirect) and non-taxes (resource rent or royalties, state-owned enterprises profit, government administrative fees, and other) income (Culpeper, 2008; UNCTAD, 2017; Gill, Bharali, and Glenday, 2019).

grants[3] filled the fiscal deficit gap and continuously financed a large share of the Afghan Government's public expenditure—both military and civilian (see figure 3.3).

Figure 1.1: Total public revenue and expenditure (2002-2018)



Source: Author's elaboration based on the data from ICTD/UNU-WIDER (2020) and IMF (2020)

Since 2002, foreign aid grants inflow has assisted a devastated Afghanistan in many ways: from establishing democratic institutions to the freedom of speech, improvement of public services delivery, and formation of the national security forces (Waldman, 2008). However, a continued and massive budgetary reliance on foreign aid grants (on-budget aid) transformed the Afghan Government into an aid-dependent rentier state (Rubin, 2002; Goodhand, 2002; Nixon, 2007; Bizhan, 2018; Isar, 2020). In turn, such dependency compelled the Government to remain accountable for donors—while making the minimum efforts in relation to its citizens to enhance DRPM. According to Bizhan (2018), an aid-dependent rentier state is described as the one which derives its revenue from foreign governments and related institutions with little political and organizational efforts in relation to its citizens.

Beyond undermining the state-society relationship, the massive flow of foreign aid grants in the absence of strong local institutions also promoted a culture of rent-seeking, politics

[3] By analyzing foreign aid in Afghanistan, this study mainly focuses on grants component of the foreign aid not the concessional loans because a large share of aid inflow to Afghanistan was in the form of grants. It is also imperative to mention that foreign aid grants includes both official development assistant (i.e., civilian aid) and military aid. See chapter two and three for more discussion on this topic.

of patronage, and corruption (Connor, 2012; Zürcher, 2012; Strand, Borchgrevink, and Harpviken, 2017; Bizhan, 2018). When donors decided to spend a large percentage of foreign aid grants outside the Afghan Government's budget (off-budget) due to the weak administrative capacity of the Government—such funding mechanism led to the establishment of parallel institutions governed by donors—which undermined the maturity process and centrality of public institutions (Bizhan, 2018). By and large, foreign aid grants funding (on or off-budget) had its distinct counterproductive consequences for Afghanistan that are discussed in detail under chapter three.

According to Bizhan (2018), off-budget foreign aid grants is the portion of the fund that is spent outside the recipient government fiscal budget with donors' utter discretion. These funds are typically channeled to different projects and programs that are designed and managed directly by aid providers, United Nations (UN) agencies, non-government organizations (NGOs), and private contractors. In contrast, on-budget aid is the portion of the fund that is channeled through a fiscal budget and directly spent by the recipient government. However, on-budget funding is usually stringent to aid-providers conditionality.

1.1 Research Questions

To systematically analyze Afghanistan's foreign aid dependency's economic and institutional hazards and provide appropriate solutions for strengthening the DPRM, the author constructed the following research question and sub-questions.

1) How to achieve financial self-reliance to move away from foreign aid dependency in Afghanistan?
   1.1) Through which sources Afghanistan became an aid-dependent country, and what were the implications of this dependency?
   1.2) What factors impede domestic public resource mobilization in Afghanistan, and how can it (DPRM) be improved based on the analysis of the domestic condition and lessons learned from other countries?

1.2 Research Methodology

This research study has followed an analytical research approach to find both causes and consequences of the discussed topics. Moreover, a cross-method (qualitative and quantitative) triangulation approach was used to ensure the reliability and validity of the data and results, as recommended by Olsen (2004) and Fusch, Fusch, and Ness (2018). According to Olsen (2004, p. 3), "in social science, triangulation is defined as the mixing of data or method so that diverse viewpoints or standpoints cast light upon a topic." He further adds that "the mixed-use of survey data with interviews is a more profound form of methodological triangulation" (Olsen, 2004, p. 3). In this study, instead of survey data, the author relied on online databases data because it was relevant, reliable, and sufficient.

1.1.2 Data Sources and Data Analysis

This study's primary data was collected through semi-structured interviews conducted with four individuals in Afghanistan representing the Afghan Government, the donor community, and civil society. The main interview questions were developed in line with the research questions (annex 7). For privacy and security reasons, the author would not disclose the interviewee names; instead, refer to them with a number. That being the case, interviewee one refers to the civil society representative, who was interviewed in person on March 3rd, 2020, between 5:10 to 5:48 p.m. at the Integrity Watch Afghanistan office in Kabul. Interviewee two refers to the donor community representative, who was interviewed in person on March 4th, 2020, between 3:00 to 3:40 p.m. at the Denmark Embassy in Kabul. Interviewee three refers to the Afghanistan Revenue Department's employee, who was interviewed in person on March 8th, 2020, between 11:15 to 11:50 p.m. at the Afghanistan Revenue Department in Kabul. Interviewee four refers to the Afghan Ministry of Finance's spokesperson, who was interviewed on the March 8th, 2020, between 2:05 to 2:30 p.m. at the Afghan Ministry of Finance in Kabul.

The secondary data was collected from multiple academic journals, Afghan Government institutional reports, think-thank organizations publications, and international development institutions policy papers. For the quantitative data analysis part, the author did not conduct any statistical tests. Instead, the author relied on the trends depicted in figures and tables that were constructed based on secondary data from several online databases referenced in this study.

1.3 Limitations of the Study

To the best of the author's knowledge, this research study had two main limitations. First, this study did not evaluate the Afghan Government's public expenditures in detail within each subcategory because it was out of this study's scope. Second, this study ignored the discussion about Afghanistan's taxation system (taxation regime) and its potential implications on public revenue generation. Therefore, the author strongly recommends these two areas for further exploration in future studies addressing DPRM. Besides, the author believes that most of the medium and long-term policy recommendations are discussed at the abstract level and that they have the potential of becoming research topics of their own

1.4 Significance of the Study

Given Afghanistan’s massive aid-dependency that had several counterproductive consequences for the country, this study is aimed to provide relevant policy recommendations for improving domestic public resource mobilization in Afghanistan to reduce reliance on foreign aid grants. In addition, this study’s findings and policy recommendations would be beneficial for the initial draft of the “Afghanistan National Peace and Development Framework II” (ANPDF-II) that discusses the development agenda of Afghanistan for the coming five years (2021-2025).

Chapter Two
Literature Review

In this chapter, the author focuses on two main issues. First, a critical analysis of foreign aid from an economic and institutional standpoint. Second, the lessons learned from a broad literature in overcoming aid-dependency through a mix of financial and non-financial self-reliance policies and measures.

2.1 An Overview of Foreign Aid

Todaro and Smith (2014, p. 747) broadly defined foreign aid as "the international transfer of public funds in the form of concessional loans or grants either directly from one government to another (bilateral assistance) or indirectly through the vehicle of a multilateral assistance agency such as the World Bank and alike." From a theoretical standpoint, Pankaj (2005) argued that development economics does not recognize foreign aid theory's independent existence because its economic legitimacy since post-World-War II primarily comes from the "Harrod-Domar" Keynesian growth model. According to the "Harrod-Domar" growth model, physical capital is the single crucial factor for long-term economic growth. In light of that, the provision of foreign aid is justified with "two-gap" and "three-gap" models (Todaro and Smith, 2014; Pankaj, 2005). The basic argument of the two-gap model is that "most developing countries face either a shortage of domestic savings to match investment opportunities or a shortage of foreign exchange to finance needed imports of capital and intermediate goods. Hence, the influx of foreign aid can fill that shortage" (Todaro and Smith, 2014, p. 751-752). The three-gap model complements its predecessor with a rationale for filling the shortage of public expenditure (mainly public investment) on top of domestic saving and foreign exchange[4] (Bacha, 1990; Todaro and Smith, 2014).

According to Lancaster (2007), foreign aid historically flew to developing countries for four primary purposes: i) developmental; ii) military; iii) humanitarian relief; iv) commercial. Furthermore, he explained that foreign aid could be in the form of cash

[4] With regards to three-gap model, Todaro and Smith, (2014, p. 753) highlighted that "without adequate complementary public investments in roads and other forms of infrastructure, including human capital; domestic savings availability for investment and foreign exchange availability for capital goods imports may have little impact on private-sector investment and growth."

(grants or concessional loan[5]), in kind of food aid, or debt relief[6]. He added that "these transfers could fund a diverse set of activities, including, but not limited to i) budgetary and balance of payments needs in the recipient countries; ii) investment projects and research activities; iii) economic or political reform programs; iv) technical advice and training; v) and humanitarian relief" (Lancaster, 2007, p. 11).

As discussed above, some economic models justify and analyze foreign aid's endowment. However, this research is not using any of the models mentioned above. Instead, this study aims to critically review foreign aid—from an empirical standpoint—to understand its implications beyond merely filling the capital shortage.

2.2 A Critical Analysis of Foreign Aid

Although foreign aid remains an essential source of capital flow for developing countries, its concept is controversial in the development economics literature. According to Dollar and Pritchett (1998), since its inception (post-World War II), foreign aid had dualistic objectives that were potentially in conflict. The first objective was to promote long-term growth and reduce poverty in developing countries that, in turn, would benefit developed countries from trading with developing countries as they grow. The second objective was to promote donor countries' short-term political and strategic interests[7].

Pankaj (2005) argued that foreign aid undeniably removes the three significant deficiencies of—physical capital, foreign exchange reserve, and technical knowledge—in underdeveloped and developing countries in the short-run. However, low capital formation is not the only problem in these countries, as their problems go beyond the constraints of saving and foreign exchange[8]. For instance, "socio-cultural impediments to growth and development, structural rigidities, the low level of technology, poor banking, and financial institutions, wrong government policies, and an overloaded primary sector are other deterrents of growth and development, which cannot be removed just by

[5] The main distinction between grants and concessional loan is that the former does not carry any obligation of repayment, while the latter carries the obligation of repayment along with a small percentage of interest.
[6] For a critical analysis of foreign aid in twenty first century, see Kharas (2009).
[7] For more detail, see Dollar and Pritchett (1998); Bandyopadhyay and Vermann (2013).
[8] Dollar and Pritchett (1998, p. 33) also concluded that "poor countries have been held back not by a financing gap, but by an institution gap and a policy gap. If they can overcome them, they can begin to grow successfully. Botswana and Thailand are examples of good management-Tanzania and Zambia of poor."

pumping extra capital from outside" (Pankaj, 2005, p. 112). Besides, he argued that there are severe political and economic hazards of a long-term dependence on foreign aid.

In his analysis, Pankaj (2005) said that one of the main economic hazards of reliance on foreign aid is that it kills the process of learning. He elaborated that "when the resources are produced indigenously, the concerned country has the opportunity to learn and develop the process of production, new skills, and technology. But when the resources are merely imported from outside, as happens with foreign aid, then the process of acquiring knowledge and skill is also lost" (Pankaj, 2005, p. 114). He also argued that reliance on foreign aid tends to promote export lethargy that can respectively cause indiscipline in the balance of payments. He elaborated that most developing countries choose the easy option and rely on foreign aid's endowment instead of restoring export promotion efforts to meet the foreign exchange shortage. Similarly, when a government relies on the endowment of foreign aid to finance its public expenditure, aid[9] could reduce the pressure on the recipient government to enhance the mobilization of public revenue from domestic sources (Gupta, Clemens, Pivovarsky, and Tiongson, 2003; Moss and Subramanian, 2005; Pankaj, 2005; Moyo, 2009; Combes, Ouedraogo, and Tapsoba, 2016; Gill et al., 2019).

Several scholars (Knack, 2001; Moss and Subramanian, 2005; Ghani and Lockhart, 2009; Moyo, 2009; Bizhan, 2018) argued that dependency on foreign aid distorts state-society relationship and accountability mechanisms (checks and balances) in the recipient country. In order words, dependency on foreign aid compels the recipient government (including civil society when aid is also channeled off-budget[10]) to remain accountable for donors rather than its citizens. In that context, Moss and Subramanian (2005, p. 8) added that "the effect of foreign aid may be most acute when it is given outside of the normal budget process (off-budget) and supports a fragmented parallel administration that typically poaches the most capable staff, cherry-picks certain donor-selected sectors, and generally undermines the incentives for building state institutional capacity." Moreover,

[9] Based on statistical data analysis, Gupta, Clemens, Pivovarsky, and Tiongson (2003) found that the provision of foreign aid in the form of grants is generally associated with low domestic public revenue mobilization, while aid in the form of concessional loans have the opposite effect.

[10] Off-budget foreign aid is described as the portion of fund that is spent outside the recipient government fiscal budget with the utter discretion of donors. These funds are typically channeled to different projects and programs that are designed and managed directly by aid providers, UN agencies, NGOs, and private contractors . While on-budget aid is described as the portion of fund that is channeled through fiscal budget and spent by government, however, stringent to aid-providers conditionality (Bizhan, 2018).

Knack (2001) and Moyo (2009) argued that by thwarting accountability mechanisms between state and society, on the one hand, foreign aid encourages rent-seeking behaviors, politics of patronage, and corruption. On the other hand, it weakens the social capital in the recipient country, that is—trust. Moyo (2009, p. 58) explained that "social capital, by which is meant the invisible glue of relationships that holds business, economy, and political life together, is at the core of any country's development." Beyond the distortion of the state-society relationship, Pankaj (2005) highlighted that foreign aid promotes a culture of "pauperization." By quoting from Ward and Bauer (1968, p. 50), Pankaj (2005, p. 115) explained that "pauperization promotes the idea that unearned doles are the main ingredient in livelihood."

Another controversy about foreign aid endowment is regarding its economic efficiency and sustainability. In this regard, Moss and Subramanian (2005) highlighted that aid-funded recurrent and capital fiscal expenditure in the recipient country might face potential problems in the long run because aid is highly volatile and dependent on the political decision of the donor countries[11].

2.3 Moving Away from Foreign Aid: A Pathway to Financial Self-Reliance

Reynolds, Anderson, O'Brien-Carelli, Wang, Madsen, Morton, Favreau, Fletcher, Lunchick-Seymour, and Biscaye (2017) explained that in the economics literature, the term "self-reliance" is used to describe the transition away from foreign aid dependency. Reynolds et al. (2017) added that although the realization of self-reliance depends on a wide range of financial and non-financial policies and measures, most papers focus on self-reliance's financial component (i.e., the ability to self-finance). Therefore, the authors recommend that, among several other policies, aid-dependent countries should consider the following two central policy options to self-finance their development.

The first key policy option is to access alternative external financial resources through foreign direct investment (FDI), trade, and remittances, including sovereign bond debt management (Reynolds et al., 2017). The authors emphasized that sovereign bond issuance can attract a sizeable amount of foreign capital, which can be used by a

[11] Several scholars (Alesina and Dollar, 2000; Moyo, 2009; Bandyopadhyay and Vermann, 2013; Todaro and Smith, 2014) argued that apart from economic consideration, foreign aid is mostly granted based on several political and military consideration.

government to finance infrastructural projects that are indispensable for long-term growth. Besides, the foreign capital inflow would also fill the shortage of foreign exchange for any deficit in the balance of payments. Based on Grigorian (2003) and Presbitero, Ghura, Adedeji, and Njie (2016) empirical findings, the attraction of foreign capital through sovereign bond is subject to numerous internal and external factors such as better fiscal position, less public debt, lower inflation, a larger economy, robust economic growth, high sovereign credit rating, competitive interest rate, and strong governance institutions. The other debt financing method to access foreign capital is to borrow from the IMF, World Bank, and regional development banks under concessional terms (through structural adjustment programs). Nevertheless, as fiscal borrowing implies the need for repayment, Heller (2005) highlighted that a government should ensure the debt-financed public expenditures will enhance public revenue to finance repayment of the borrowing.

The second key policy option is to increase tax revenues by expanding the tax base[12] through sustained economic growth (Reynolds et al., 2017)[13]. In other words, a government should adopt policies that can increase local households' and firms' income and wealth because they are the major contributors to tax revenue. While domestic public revenue sources are diverse (i.e., taxes, resource rent, state-owned enterprises profit, administrative fees, and others), Di John (2010) stressed that taxation remains central for several reasons. First, taxation builds nexus between state officials and interested groups of producers, labor unions, and consumers. Second, taxation bestows legitimacy to a state for establishing accountable and competent institutions that can, in turn, uphold the ownership of national policies and development strategies. Third, tax revenue allows a government to invest in social programs that contribute to economic growth and development. Fourth, taxation in the form of property tax and customs tax can increase the territorial reach of a state and its engagement with different sectors and countries.

According to Gill et al. (2019), a government's ability to raise domestic public revenue through taxation (direct and indirect taxes[14]) depends on three factors. First, "the

[12] Tax base is the total amount of income and asset that can be taxed (directly or indirectly) by a government.
[13] Cottarelli (2011) and Fjeldstad, Bøås, Bjørkheim, and Kvamme (2018) also emphasized on this particular policy option.
[14] Todaro and Smith (2014) defined direct taxes as those which are levied directly on individuals or businesses (like income tax) and they bear the tax burden themselves. While indirect taxes, which include customs duties (tariffs), excise taxes, sales taxes, value-added taxes (VATs), and export duties, they are levied on goods and services at different stage of production and supply chain. In the case of indirect taxation, the end-users will typically bear the tax burden.

structural characteristics of an economy," which means an economy that trades more and is less agrarian, makes it easier for a government to tax effectively. While an economy that is subsistence-based, mostly agrarian, and informal, it is hard for a government to tax effectively. In simple words, although difficult to conclude in few sentences, a government should focus on policies that can reinforce the structural transformation and reallocation of economic activities across the broad sectors of agriculture, manufacturing, and services. Second, "the administrative capacity of a government," which means that tax collection can be at its highest potential with effective tax enforcement and assessment, underpinned by taxpayers' compliance. In this regard, Georgia offers a remarkable example of better compliance and strict enforcement by introducing measures such as the implementation of an electronic tax filing and tax management system, simplification of the tax system, enhancement of audit and verification processes, the establishment of large taxpayer offices, and a gradual replacement of old tax and customs officers with new personnel as part of its anti-corruption reform (Akitoby, 2018). Moreover, Akitoby (2018) explained that a high-level political commitment with a clear mandate, buy-in from all stakeholders, and social dialogue contributed substantially to Georgia's successful tax revenue reform. Third, "the policy choices for taxation," which means maintaining reasonable tax rates (at marginal levels) across different taxpayers (tax categories) and also not allowing the deliberate exemption or under-taxation of some economic activities for political sakes, can boost the tax revenue.

In an IMF policy paper, Heller (2005, p. 6-7) recommended that as a rule of thumb, "for low-income countries (LICs)[15] raising the taxes share to at least 15 percent of GDP should be seen as a minimum objective." Although this goal's achievement depends on several factors discussed above, a country's taxation system (progressive, regressive, or proportional) that duly corresponds to that country's socioeconomic and demographic context remains central. It is important to mention that this study's scope does not include a discussion on the taxation systems.

Besides increasing domestic public revenue through taxation, Fjeldstad, Bøås, Bjørkheim, and Kvamme (2018) recommended that effective management of natural resource wealth

[15] According to the World Bank, LICs are those countries having a GNI per capita of US$ 1,035 or less as of 2019.

can generate a large share of non-tax domestic public revenue[16] (i.e., royalties) for LICs that are resource-abundant and characterized as fragile states[17]. Fjeldstad et al. (2018) suggest that the adoption of IMF's Managing Natural Resource Wealth Thematic Fund (MNRW-TF) models and fulfillment of the Extractive Industries Transparency Initiative (EITI) standards can help these countries for exploration and exploitation of natural resources. The MNRW-TF program includes five modules: "i) tax policy; ii) tax administration; iii) financial management; iv) management of revenue produced by the resources; v) statistics systems to monitor natural resources (e.g., tax revenue and national accounting system)" (Fjeldstad et al., 2018, p. 36). Notwithstanding, the broad literature underlines that countries should be aware of the complexities of natural resource extraction (depending on the type of resource) and careful of the hazards of long-term dependency on resource rent (the natural resource curses of political and economic volatility and "Dutch Disease")[18]. As Cottarelli (2011, p. 66) highlighted, "the features of the natural resource sector pose particular challenges for tax design—and mistakes can be very costly. Investments commonly involve high sunk costs, perhaps billions of dollars for a project that can last decades; rents are potentially substantial; output prices are highly variable; revenue is often the major benefit for the home country; investors are commonly multinationals capable of sophisticated tax planning; and—for hydrocarbons and minerals—the resource itself is exhaustible."

In addition to the public revenue mobilization policies discussed above, Heller (2005) described that public expenditure reprioritization is another crucial policy option that helps creating fiscal space for developmental programs underpinning economic growth. The author emphasized that reducing unproductive expenditures—mainly those of a recurrent nature such as government subsidies, military spending, embassies spending, including the problem of overstaffing—should be reassessed. He added that after reassessment, public resources could be allocated towards meritorious programs and key sectors such as health and education, which have the prospect of high national return in the long-run.

[16] Tax revenue is the income gained by the government through taxation (direct or indirect). While non-tax revenue is the income that is typically gained from natural resource rents and public services (administrative) fees.
[17] Fjeldstad et al. (2018, p. 10) explained that the characteristics of "lacking control of borders, monopoly on violence, procedures for taxation and dispute settlement, and a legitimate design for transfer of power from one ruler or regime to another" associated with fragility typically limit the taxation capacity of fragile states.
[18] For detailed analysis about the prospects of dependency on resource rent, see Bizhan (2018).

According to Cottarelli (2011) and Reynolds et al. (2017), some non-financial factors (including broader economic factors) are also essential in the pursuit of self-financing. These factors are including, but not limited to: i) the quality of governance (political and legal institutions); ii) deep financial sector; iii) lower inflation; iv) high GDP per capita; v) high levels of gross national investment; vi) export-led growth policies.

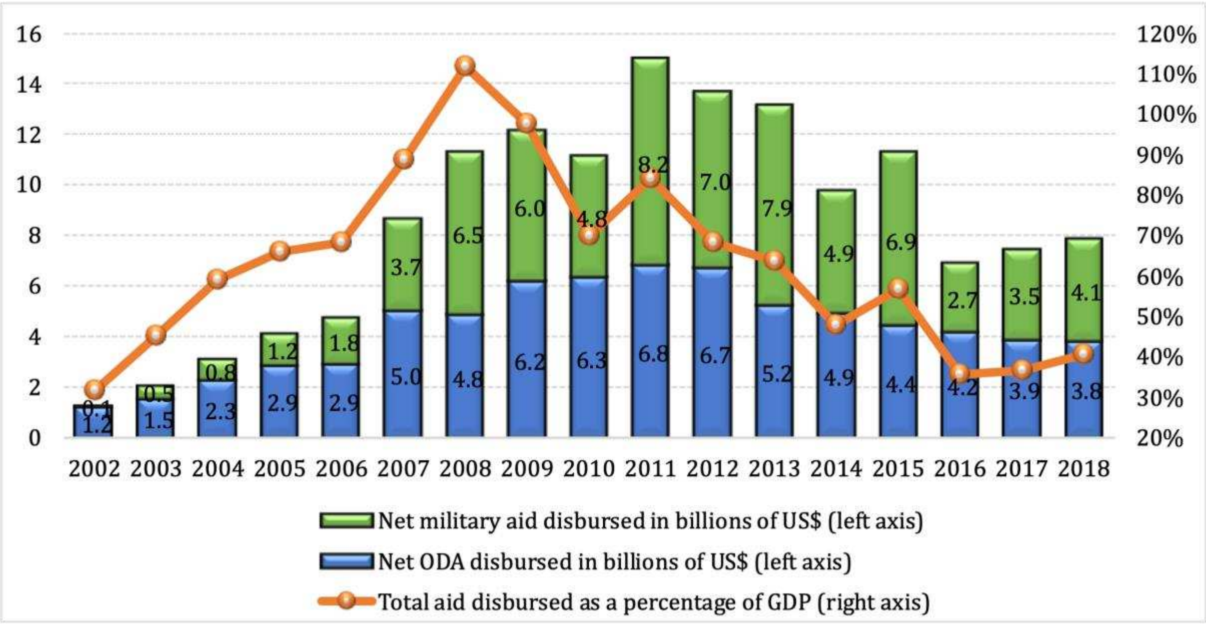
Chapter Three
Afghanistan Foreign Aid Dependency

Following the critical analysis of foreign aid in chapter two, Afghanistan's foreign aid path dependency remains controversial and paradoxical. Mainly because, on the one hand, foreign aid underpinned the economic growth and sustenance of the Afghan Government. On the other hand, on-budget and off-budget foreign aid funding had several counterproductive implications. To better understand the dualistic impact of foreign aid in Afghanistan, this chapter would initially explain how much foreign aid flew into Afghanistan, for what purposes (civilian and military), in what modality (on-budget and off-budget), and then discuss the implication of aid-dependency in detail.

3.1 Foreign Aid Inflow to Afghanistan

Between 2002-2018, international donors disbursed 73 billion US$ as official development assistance (ODA)[19] or civilian aid to support Afghanistan's reconstruction and 70 billion US$ as military aid to strengthen the Afghan army in the fight against terrorism, as shown in figure 3.1.

Figure 3.1: Total foreign aid disbursement to Afghanistan (2002-2018, Current Value)



Source: Author's elaboration based on the data from OECD (2020) and USAID (2020)

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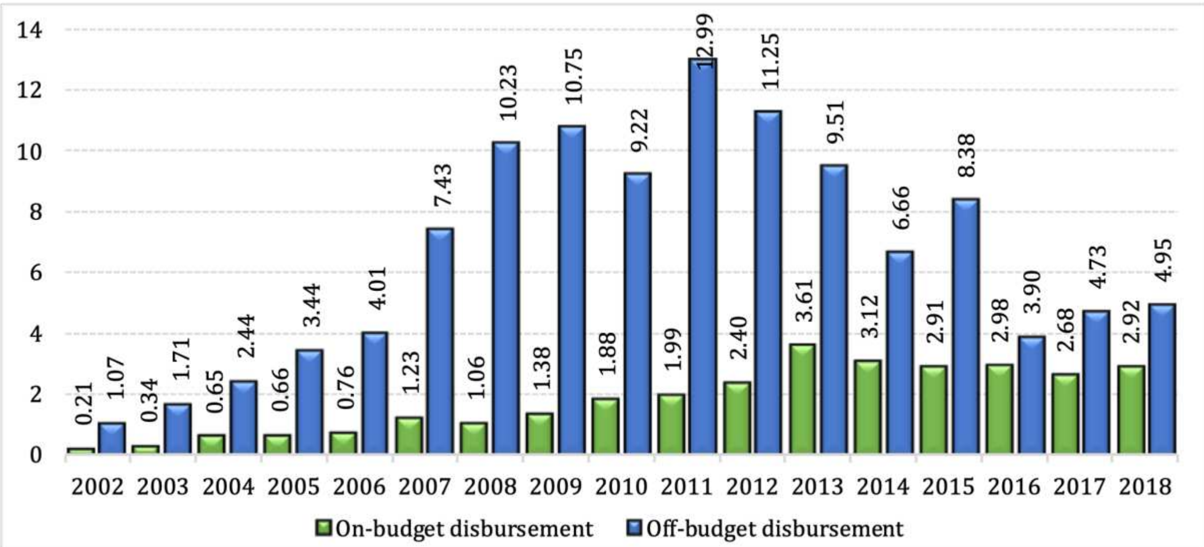
[19] OECD describe ODA as i) government aid, ii) that promotes and specifically targets the economic development and welfare of developing countries, iii) and typically possess a grant element of at least 25%. In the case of Afghanistan more than 95 percent of the ODA came in the form of grants, which carry no obligation of repayment.

While ODA (civilian aid) was disbursed by several donor countries (see annex 1 for a detailed list), the military aid was disbursed mainly by the United States of America, and it consisted of i) Afghanistan Security Forces Fund (ASFF); ii) Train & Equip (DOD); iii) Afghanistan Freedom Support Act (AFSA); iv) International Military Education and Training (IMET); v) Drug Interdiction & Counter-Drug Activities (DOD-CN).

During 2002-2018, donor countries historically disbursed foreign aid grants in two ways: on-budget and off-budget. Of the total foreign aid (both civilian and military) disbursed under Afghanistan's name, donors historically spent 79 percent (113 billion US$) themselves through the off-budget funding mechanisms. In comparison, the Afghan Government merely received 21 percent (31 billion US$) through an on-budget funding mechanism based on several bilateral and multilateral agreements, as shown in figure 3.2 and annex 1.

Figure 3.2: On and off-budget aid disbursement in billions of US$ (2002-2018)



Source: Author's elaboration based on the data from ICTD/UNU-WIDER (2020); OECD (2020); and USAID (2020)

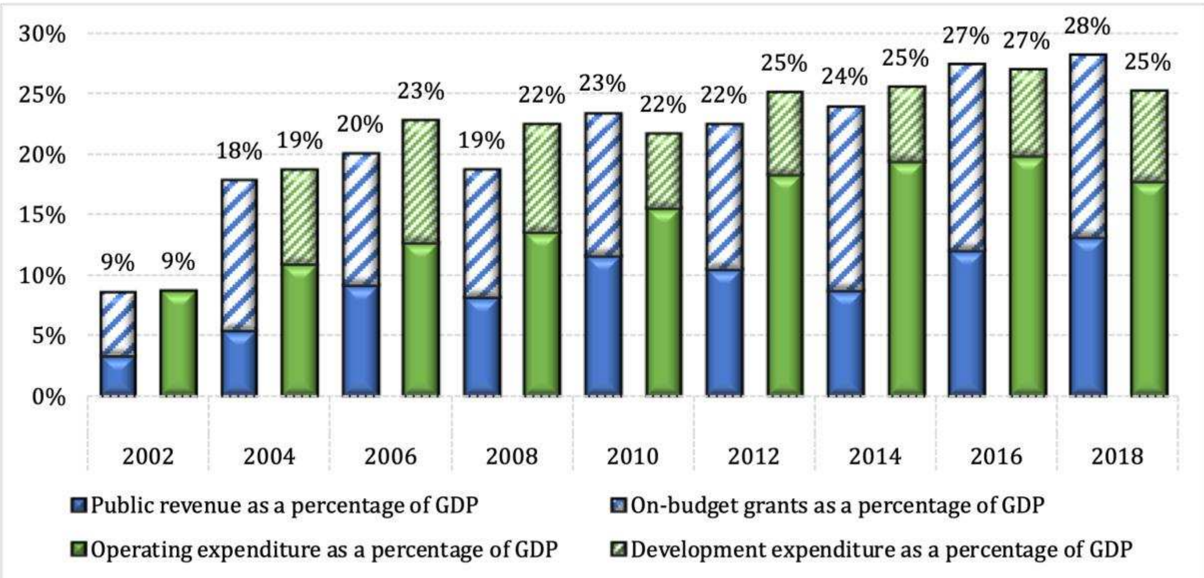
The main reasons behind foreign aid modality (off and on-budget structuring) were noticeably two. The first reason was the Afghan Government's weak public financial management (PFM) system. According to the World Bank (2011) report, weak PFM refers to both structural and capacity issues (including corruption-related concerns), as well as unrealistic budget formulation mechanisms (the inability to execute projected budget). The second reason was donors' strategic interest in particular projects and programs (typically separate from the Government's agenda) that can generate rapid results to "win the hearts and minds" of Afghans. Accordingly, several scholars (Nixon, 2007; Waldman, 2008; Bizhan, 2018) argued that foreign aid in Afghanistan has been historically prescriptive (donor-driven) and cling to the short term strategic and political interests of aid providers, rather than based on the endogenous needs and long-term strategic goals of Afghanistan.

Although foreign aid's modality was relevant to Afghanistan's context for the given reasons, on-budget and off-budget funding mechanisms had several distinct counterproductive consequences for Afghanistan that are discussed under section 3.4.

3.2 Fiscal Review of Afghanistan's Foreign Aid Dependency

As depicted in figure 3.3, between 2002-2018, on average, 58 percent of the total core budget (operating and development)[20] was historically financed through on-budget foreign aid grants (civilian and military). With the additional off-budget military aid under "ASFF,"[21] the overall weight of foreign aid grants (both civilian and military, on and off-budget) on the core budget will increase to an estimated 75 percent of the total public expenditure (World Bank, 2020a).

Figure 3.3: Core budget vis-à-vis public revenue and on-budget grants (2002-2018)



Source: Author's elaboration based on the data from IMF (2020); ICTD/UNU-WIDER (2020); and DGB (n.d.)

[20] Operating budget finances the recurrent expenditure of a government, while developing budget finances the developmental activities that yield an overall social welfare.

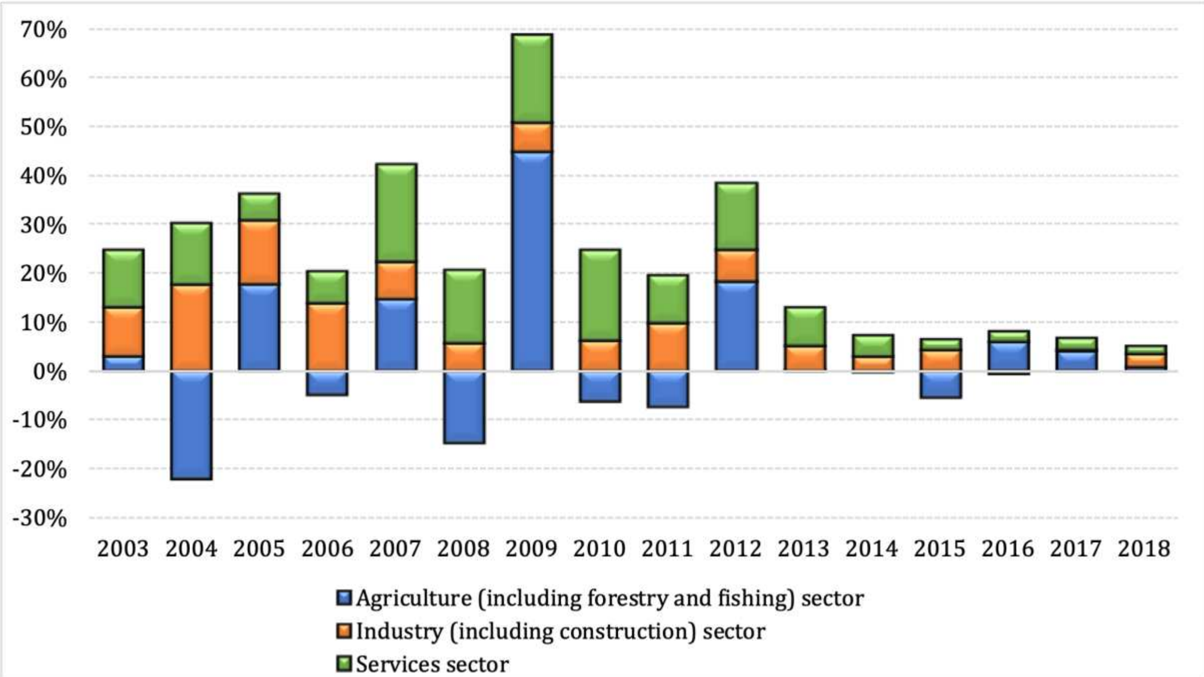
[21] Afghanistan Security Forces Fund (ASFF) is largely spent off-budget on equipment, supplies, and services for the Afghan security forces through the U.S. Department of Defense contracts (SIGAR, 2020a, p. 111).

Over the past two decades, foreign aid grants on-budget funding undoubtedly played a vital role in expanding public services delivery and fighting against a global network of terrorism inside the country. However, foreign aid grants continued availability, at a large scale, has inadvertently incentivized the Afghan Government to make the minimum efforts to enhance DPRM (Bizhan, 2018). This implication of aid-dependency (DPRM lethargy) in Afghanistan corresponds to the findings and critics of Gupta et al. (2003), Moss and Subramanian (2005), Pankaj (2005), Moyo (2009), Combes et al. (2016), and Gill et al. (2019).

3.3 Macroeconomic Review of Afghanistan's Foreign Aid Dependency

Between 2003-2018, Afghanistan experienced an exponential, yet volatile, economic growth of seven percent on average, as shown in figure 3.4 and annex 5.

Figure 3.4: Afghanistan GDP (sector-wise) annual growth rate (2003–2018)

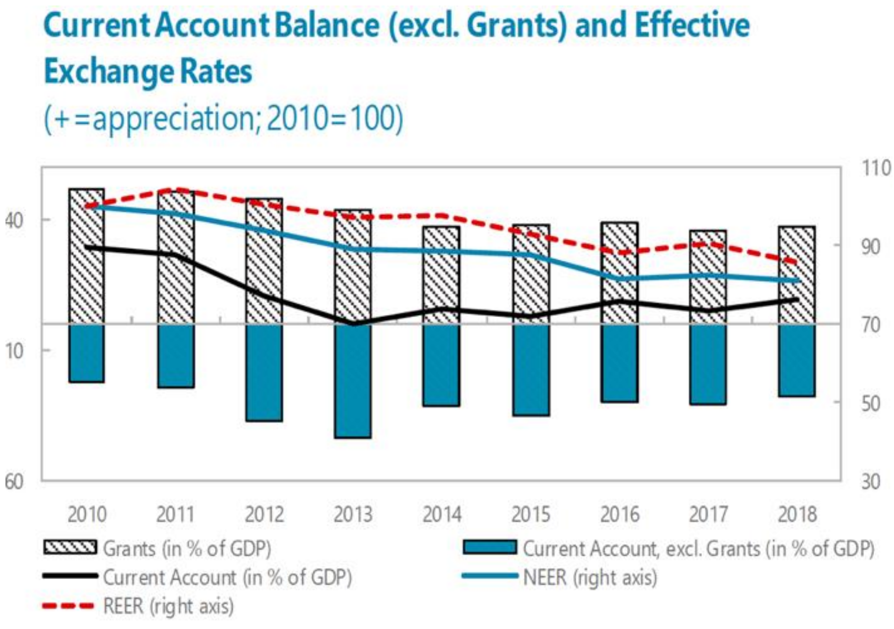


Source: Author's elaboration based on the data from World Bank (2020b)

According to Joya (2011), an increase in the agriculture sector's output during 2003-2011 was the main economic growth driver, as depicted in figure 3.4. However, some authors (Sud and Rankin, 2013; Hogg, Nassif, Osorio, Byrd, and Beath, 2013; Aslam, Berkes, Fukac, Menkulasi, and Schimmelpfennig, 2014) argued that much of the growth during the same period was also due to the infusion of donor funds that stimulated domestic consumption and public investment, which increased the services and industry sectors output[22] (figure 3.4). According to the World Bank (2011, p. 2) report, "growth in the security economy (largely funded by military aid) underpinned the demand for goods and services, equipment and operations, and maintenance of the national army." While Hogg et al. (2013, p. 62) highlighted that "a large non-military spending by donors (typically through off-budget channels) led to the employment of roughly 6.5-10 percent of the total Afghan labor force that stimulated the private consumption." As Afghanistan's industry sector was unable to meet the domestic consumers' needs, stimulation of the domestic consumption through foreign aid grants boosted the national appetite for imported goods. As a result, Afghanistan became a net importer with a sizeable deficit in the current account, as shown in figure 3.5.

Over the past two decades, Afghanistan's current account deficit has been historically high (on average, 25 percent of the GDP) due to a high share of imports (on average, 7 billion US$ annually) over exports (on average, close to a billion US$ annually). Afghanistan's historical dependency on imports (both consumer and capital goods) and extraction of foreign exchange through foreign aid grants (to pay for imports) correspond to the implication of aid-dependency that Pankaj (2005) referred to as "export lethargy."

Figure 3.5: Current account with and without grants (2010-2018)



Source: IMF (2019)

[22] Based on statistical analysis, Aslam et al. (2014, p. 17) found that "an additional dollar of donor aid to the domestic government yields about US$ 1.4 of additional real GDP."

The macroeconomic situation of Afghanistan indicates that the Afghan economy is highly dependent on foreign aid grants in one way or another. Therefore, any fluctuation in foreign aid inflow (given the fact that aid is subject to donors' strategic interest as highlighted in the literature review chapter) could have potential macroeconomic consequences[23].

3.4 The Implications of Foreign Aid Dependency

Several scholars (Rubin, 2002; Goodhand, 2002; Nixon, 2007; Bizhan, 2018; Clark, 2020) argued that a continued and massive reliance on foreign aid transformed Afghanistan into a weak and aid-dependent rentier state that, in turn, had several counterproductive consequences for the country. Based on the empirical literature focused on Afghanistan, some of the major implications of aid-dependency are discussed below.

3.4.1 State Fragmentation and Upward Accountability to Donors

Rubin (2002) argued that Afghanistan's historic aid-dependency has led to the fragmentation of the state into a rural economy that lives up to the subsistence (from agriculture) and an urban economy that lives up to the external finances. Accordingly, Bizhan (2018) highlighted that Afghanistan's fragmentation caused a lack of interactions between the state and society (households, enterprises, and civil society actors), which impeded a cohesive state-building process and accountability mechanisms in the country. He further elaborated that lack of engagement between the Afghan Government and rural citizens (where more than 70 percent of the total population lives) strengthened the legitimacy of local rebellions such as the Taliban to challenge the central Government from time to time. Whereas, at the urban level, the availability of on-budget foreign aid for the Afghan Government and off-budget funds for other societal actors (including civil society) created a competition among different stakeholders[24], which, in turn, compelled them to remain accountable for donors instead of each other (Nixon, 2007, Bizhan, 2018). In his concluding remarks, Bizhan (2018, p. 167) stated that "the process of upward accountability to donors unintentionally diverted the political and administrative focus of

[23] For more detail on potential economic impact of reduction in foreign aid inflow, see the empirical study by Nasery (2014).

[24] For more detail on how massive aid inflow led to a competition among different stakeholders in Afghanistan, see Willner-Reid (2017).

the Afghan government from pursuing a balanced strategy for building institutions and effectively investing in long-term development."

The narrative that "aid-dependency resulted in fragmentation of the Afghan state" is in line with the critics from the literature that i) aid-dependency distorts the state-society relationship and accountability mechanisms (checks and balances) in the recipient country (Knack, 2001; Moss and Subramanian, 2005; Ghani and Lockhart, 2009); ii) aid-dependency destroy the social capital of trust among stakeholders (Moyo, 2009); iii) aid-dependency promotes a culture of pauperization (Pankaj, 2005).

3.4.2 Formation of a Parallel Public Sector

As shown in figure 3.2, donor countries historically spent four-fifth of the total foreign aid outside the Afghan Government's budget supporting the country's development agenda and public services delivery in different areas such as education, health, good governance, security, social protection, and several other. However, massive off-budget spending led to the creation of a parallel public sector in Afghanistan that was administered by donors, which, in turn, undermined the legitimacy of the Afghan Government in carrying out its core responsibilities[25]. The Parallel public sector refers to the establishment of parallel structures and mechanisms developed by donors' outside the state's system (Bizhan, 2018). Besides, massive off-budget spending by donors brought in plenty of international NGOs to Afghanistan who distorted the domestic market of wages and housing rent with access to large funds (Langenkamp, 2002). Therefore, aid agencies rushing to Afghanistan (attracted by off-budget funding) became part of the problem in some ways.

3.4.3 Encouraging Rent-Seeking and Corruption

Strand et al. (2017) argued that the massive flow of aid (more than the country's GDP as depicted in figure 3.1) since 2001 less likely helped in poverty alleviation; instead, it fueled corruption and contributed to the development of a war-aid economy in Afghanistan. Connor (2012, p. 188) added that one of the main reasons why the massive flow of aid inadvertently fueled corruption and supported the sustenance of patron networks in Afghanistan was because of "too much aid spent too quickly and with less

[25] For more details, see Langenkamp (2002); Waldman (2008); and Bizhan (2018).

oversight[26].” Similarly, Zürcher (2012) argued that since the social fabric and real power constellations in Afghanistan, particularly during President Karzai’s regime, were based on patronage networks and clientelism, donor funding prolonged such apparatus. Bizhan (2018, p. 168) also highlighted that “some off-budget transactions remained hidden from public view while being fully spent on patronage. Some politicians, such as those in President Karzai’s office and strong-men, received hidden funds from the U.S. and Iran. These funds were given to individuals using off-budget channels rather than institutions, and details remained secret.” In a recent report, SIGAR (2020b, p. 2) highlighted that “of the total 134 billion US$ appropriated to Afghanistan’s reconstruction by the United States between 2002-2019, SIGAR reviewed approximately $63 billion and concluded that a total of approximately $19 billion or 30 percent of the reviewed amount was lost to waste, fraud, and abuse.” Such findings indicate that foreign aid spent in Afghanistan (both on-budget and off-budget) was prone to misuse, misallocation, and fraud for many reasons and in many ways[27], that, in turn, promoted (directly or indirectly) the politics of patronage and culture of rent-seeking and corruption. These implications of aid-dependency from Afghanistan are in line with the ones discussed by Knack (2001) and Moyo (2009).

3.4.4 The Hazards of Fiscal Instability

In addition to the counterproductive institutional implications, fiscal dependency on foreign aid has the hazard of severe fiscal instability because aid is highly volatile and dependent on the political decision of the donor countries, as highlighted in the literature review chapter by Alesina and Dollar (2000), Moss and Subramanian (2005), Moyo (2009), Bandyopadhyay and Vermann (2013), Todaro and Smith (2014). Similarly, in a World Bank report on Afghanistan, Hogg et al. (2013, p. 144) stressed that “the public spending financed by aid inflow—both on and off-budget—would be fiscally unsustainable once donor funds decline.” That being the case, any sharp decline in on-budget foreign aid grants could create severe fiscal instability in Afghanistan because the Afghan Government cannot afford to seek largescale loans (concessional or non-

[26] Connor (2012, p. 188) also argued that massive flow of aid spent with less oversight led to the “creation of destabilizing winner/loser dynamics in ethnically and tribally divided societies; supporting a lucrative war/aid economy that benefits insurgents, government officials and powerbrokers; and creating perverse incentives among key actors to maintain the status quo of insecurity and bad governance.”

[27] For more details on waste of aid funds through lavish salaries and corporate profit, sub-contracting and corruption in the procurement process, and donors ineffective fund monitoring mechanisms, see Waldman (2008); Connor (2012); Zürcher (2012); Strand et al. (2017); Harmer, Haver, and Wardak (2017); and SIGAR (2020a).

concessional) in foreign currency due to its weak fiscal and particularly monetary situation. Debt financing in the domestic currency could be possible through issuing sovereign bonds (also known as *Sukuk* in Afghanistan). However, at the moment, there is no such mechanism available in the country that allows the exchange of sovereign bonds at a largescale, except between the banks (Aslam et al., 2014)[28].

3.4.5 The Hazards of Macroeconomic Instability

As discussed under section 3.3, the massive inflow of foreign aid (both on and off-budget) historically contributed (directly or indirectly) towards the economic growth, employment, and retainment of a balanced current account. Nevertheless, given the exogenous and volatile nature of foreign aid[29], any sharp decline in aid inflow could create severe macroeconomic instability that would put pressure on the exchange rate, the balance of payment, and debt stock of the country (Joya, 2011; Nasery, 2014; IMF, 2019).

[28] Afghanistan currently does not have any stock exchange market.
[29] For more discussion, see Kharas (2008) and Nasery (2014).

Chapter Four
Domestic Public Resource Mobilization in Afghanistan

Chapter four examines the domestic public resource mobilization in Afghanistan, including the assessment of both public revenue and public expenditure, along with their subcategories' performance. In addition, a large part of this chapter is allocated towards the identification of barriers ahead of DPRM.

4.1 Assessment of Public Revenue Performance

Over the past two decades, Afghanistan's total public revenue (broadly comprised of tax and non-tax revenue) dramatically increased from 4 percent of the GDP in 2003 to 13 percent of the GDP by 2018 (see figure 1.1). Of the total public revenue, between 2003-2017, on average, 76 percent came from tax revenue, while the remaining 24 percent were from no-tax revenue, as shown in Table 4.1.

Table 4.1: Afghanistan public revenue decomposition (2003-2017)

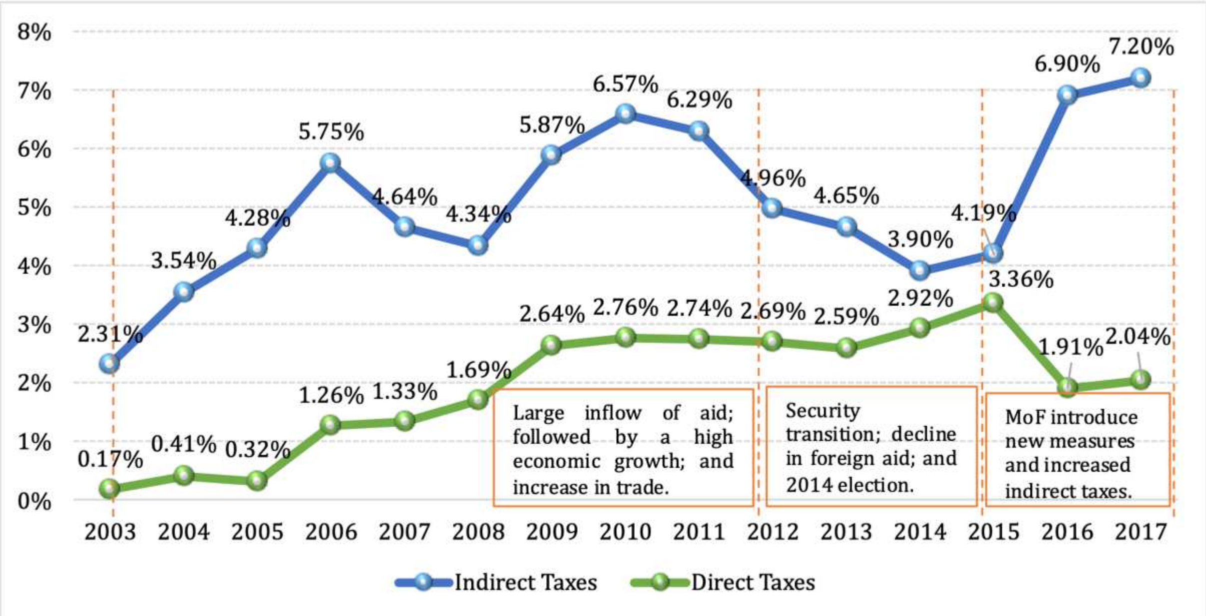
Afghanistan Public Revenue Decomposition	As a percentage of GDP *(2003-2017)* *Mean*	In millions of US$ *(2003-2017)* *Mean*
Total Public Revenue	**9.13%**	**1,274.67**
Tax Revenue	**6.95%**	**969.98**
Direct Taxes	1.92%	268.30
Taxes on income, profits, & capital gains	1.85%	258.90
Corporate income tax	0.95%	133.00
Personal income tax	0.74%	103.28
Capital income tax	0.16%	22.71
Taxes on property	0.07%	9.32
Indirect Taxes	5.03%	701.59
Taxes on imports & exports	3.02%	421.38
Import taxes	2.95%	411.35
Export taxes	0.07%	9.79
Taxes on goods & services	1.81%	253.13
Other taxes n.e.c.	0.19%	26.71
Non-Tax Revenue	**2.18%**	**304.78**
Other Revenue	1.97%	275.65
Revenue from sales of goods & services	1.57%	218.69
Property income revenue	0.19%	27.17
Revenue from other transfers	0.14%	19.92
Revenue from fines, penalties & forfeits	0.07%	10.33
Social Security Contributions	0.21%	29.13

Source: Author's elaboration based on the data from IMF (2020) and ICTD/UNU-WIDER (2020)

From a broader lens, Afghanistan's public revenue composition looks ideal because tax revenue, which is considered more effective and sustainable (as highlighted in the literature review), supersedes the not-tax revenue, which has the hazard of political conflict and distortion of public service delivery. However, the tax revenue (measured by the tax to GDP ratio) of Afghanistan remained considerably smaller (9.24 percent as of 2017) compared to the minimum threshold of 15 percent recommended by Heller (2005) in an IMF policy paper.

Besides a low tax to GDP ratio, Afghanistan's tax revenue composition also depicts that direct taxes vis-à-vis indirect taxes remain considerably smaller. As shown in figure 4.1, a large share of the Afghan Government's tax revenue (on average, 76 percent) comes from indirect taxes levied on goods and services (mainly business receipt tax and mobile phone top-up tax) and imports and exports (fixed tariffs or customs duty). Since Afghanistan is a net importer, much of the indirect tax comes from taxes levied on imported goods and services. High reliance on indirect taxation in Afghanistan indicates that the end-users of goods and services (consumers) carry the state's tax revenue's maximum burden.

Figure 4.1: Tax revenue composition in the percentage of GDP (2003-2017)



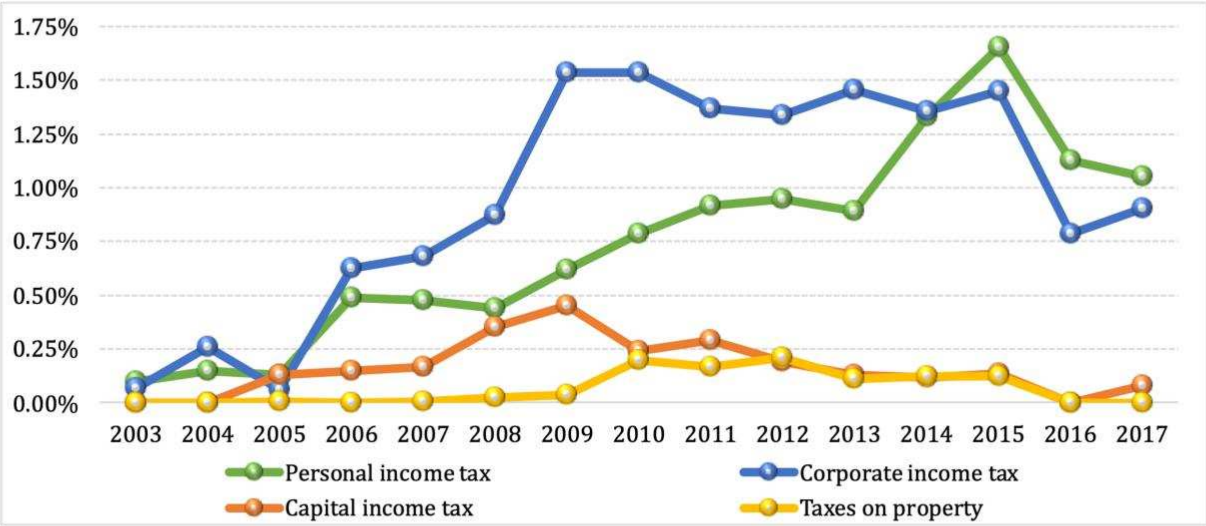
Source: Author's elaboration based on the data from IMF (2020) and ICTD/UNU-WIDER (2020)

Although direct and indirect taxes are discussed below in detail, some of the main reasons why direct taxes vis-à-vis indirect taxes remain significantly lower in Afghanistan are seemingly due to three main reasons: i) high unemployment (24 percent of the total labor force as of 2017) and underemployment (15.6 percent of the total labor force as of 2017) (CSO, 2018); ii) small size of the taxable economy that is mostly informal (80-90 percent) and subsistence-based (Manthri, 2008; Ghiasy et al., 2015); iii) lack of technical and administrative capacity (including corruption-related issues) at the Afghan Ministry of Finance (MEC, 2020).

4.1.1 Direct Tax Revenue Performance

The direct tax comprises corporate income tax, personal income tax, capital income tax, and property tax. As depicted in figure 4.2, a large share of the direct tax (on average, 91 percent) historically came from corporate and personal income taxes, which experienced a dramatic rise between 2003-2015 with the increase in private and public sectors capital investment—underpinned by a massive influx of foreign aid. However, the tax revenue from corporate and personal income sharply plummeted after 2015.

Figure 4.2: Direct taxes composition in the percentage of GDP (2003-2017)



Source: Author's elaboration based on the data from IMF (2020) and ICTD/UNU-WIDER (2020)

Apart from the reasons broadly mentioned under section 4.1, some of the leading causes were seemingly: i) an increase in the Business Receipt Tax (BRT) rate from 2 percent to 4 percent in late 2015, which inversely affected the direct and indirect corporate tax ratio because of the tradeoff among the two[30] (figure 4.1); ii) a considerable reduction in the

[30] According to the Afghan income tax law, after paying BRT on gross sales of imported of locally produced goods (i.e., indirect tax), a business will receive an equivalent of BRT as a tax credit (deductible expense) against its annual corporate tax payment (i.e., direct tax).

industry and services sectors growth rate (figure 3.4) from where a majority of the income and profit taxes are collected due to their larger share in the GDP (annex 2); iii) a considerable reduction in the foreign aid inflow (figure 3.1), which seemingly affected the household and enterprises income as explained under the section 3.3; iv) introduction of the National Technical Assistance (NTA)[31] salary scheme, which reduced the high paid salaries in foreign currency across the donor-funded projects (both in and outside the Afghan Government); v) political uncertainty that prevailed after the 2014 controversial presidential election, which resulted in the establishment of a National Unity Government (NUG)[32].

Regarding direct tax revenues from property and capital income tax subcategories, it is evident from figure 4.2 that the Afghan Government could not collect adequate revenues. The main reason for lower capital income tax is the lack of a stock exchange market (lack of trade in stocks and bonds) in Afghanistan, except for the exchange of bonds and other securities only between commercial banks and Afghanistan's central bank. The main reason for lower property tax is that the vast majority of taxable properties (especially the real estates) are unregistered in Afghanistan. Based on Gaston and Dang (2015) reporting, only 20 percent of Afghanistan's land is accurately titled.

4.1.2 Indirect Tax Revenue Performance

Indirect tax comprises import and export tax (also known as customs duty), goods and services tax (mainly from business receipt tax and mobile phone top-up tax), and other trade-related taxes (not elsewhere classified). As depicted in figure 4.4, import taxes (import duties) alone are the largest indirect tax revenue source—contributing, on average, 58.6 percent towards the total indirect tax revenues. However, MEC (2020) report indicate that due to the Afghan Ministry of Finance's weak administrative capacity (including a high level of corruption) and illegal interventions of external stakeholders (including local warlords and parliamentarians) in the customs department affairs[33], the share of import taxes remains considerably smaller than its optimal level. During the

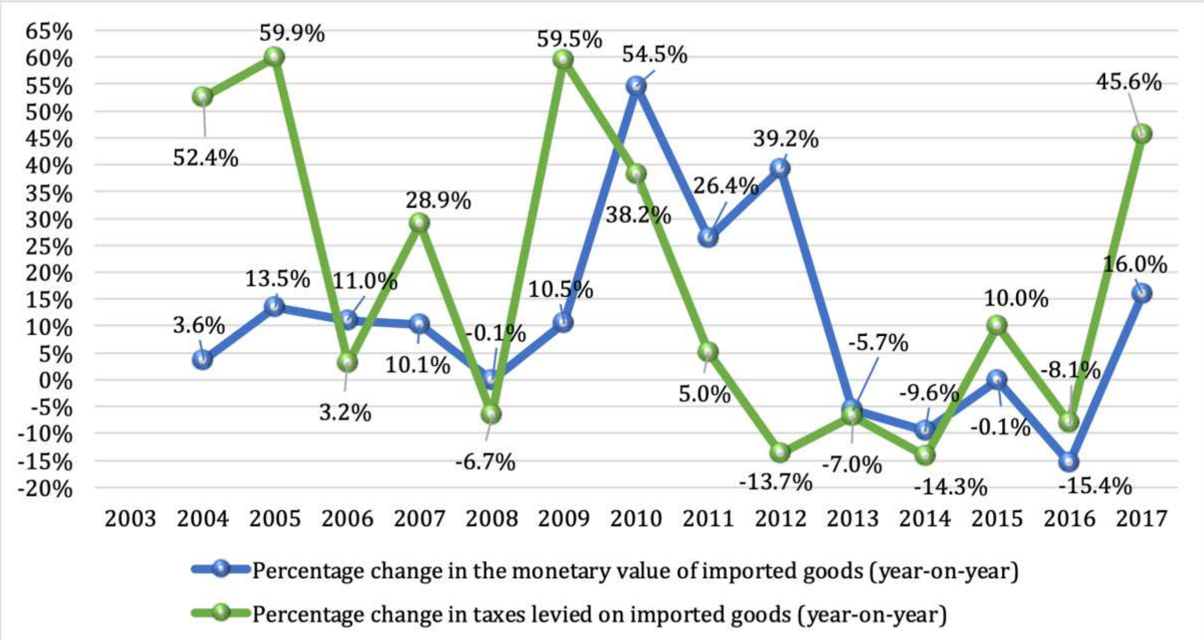
[31] NTA salary scheme was introduced to harmonize salaries across the donor funded projects and public sector for attracting skilled labor force into the public sector. As Langenkamp (2002) highlighted that aid agencies rushing to Afghanistan increased wages that took the competent labor force away from the public sector.

[32] The creation of the NUG has led to the partition of government (50-50) between the selected President and his top rival in the capacity of Chief Executive Officer (CEO). During the 4 years of the NUG, disputes were always high inside the government, which created plenty of uncertainties that adversely affected consumers and investors' confidence.

[33] For more detail, see MEC (2020) report on the Afghan Ministry of Finance (Customs and Revenue Department).

author's interview with the Afghan Ministry of Finance's spokesperson, he recognized that there are plenty of tax leakages at the customs offices that lead to revenue losses (Interviewee four, personal communication, March 8th, 2020). Similarly, figure 4.3 depicts that between 2003-2015, the percentage change in the monetary value of imports vis-à-vis tax revenue from imports experienced unparalleled fluctuation (without any considerable changes in the tariff rates, except for some tariff exemptions). Only after late 2015, with the rise of fixed tariffs on fuel, vehicle, aviation, and some other items, the tax revenue from imports spiked (Fazli, 2016; Byrd and Farahi, 2018).

Figure 4.3: Percentage change in the imports vis-à-vis taxes on imports (2003-2018)



Source: Author's elaboration based on the data from IMF (2020) and ICTD/UNU-WIDER (2020)

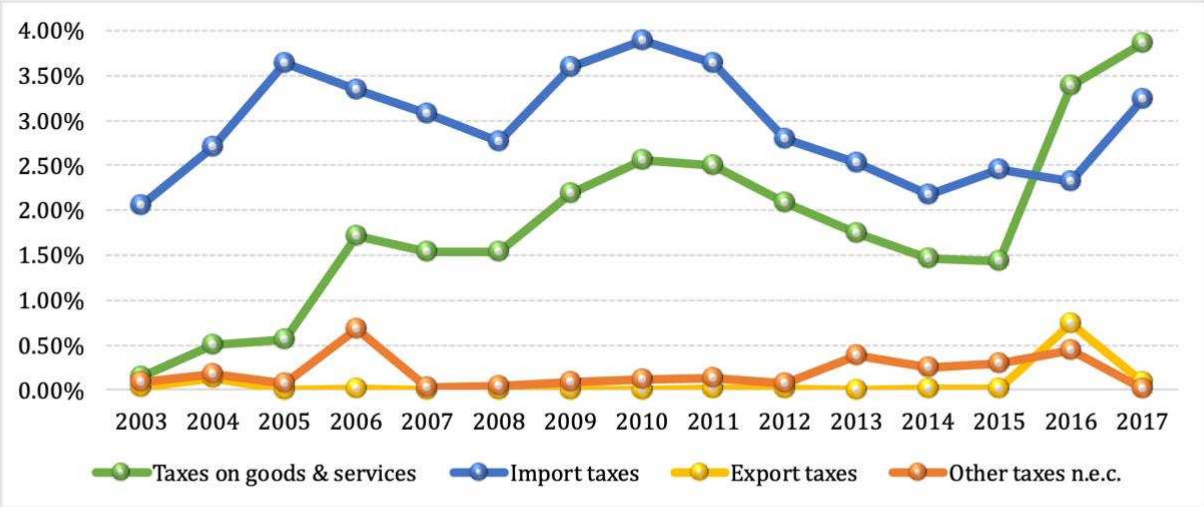
After import taxes (import duties), goods and services taxes are the second-largest indirect tax revenue source—contributing, on average, 36 percent towards the total indirect tax revenues, as depicted in figure 4.4. Between 2003-2015, a high share of the goods and services taxes were coming from BRT[34] levied at different rates from two to ten percent (enterprises bearing the cost of taxation) on the total cost (sales) of goods and services. These goods and services included both imported and domestically produced ones[35]. However, after late 2015, the Afghan Ministry of Finance increased the minimum

[34] BRT (Business Receipt Tax) is levied at different rates of 4% (previously 2%), 5%, and 10%, depending on the type of business, as specified in the income tax law of Afghanistan.

[35] Given the large size of imports (on average, 7 billion US$ annually) vis-à-vis domestically produced goods, much of the BRT during 2003-2017 was collected from imported goods.

BRT from two to four percent on applicable goods and services. In addition, the Afghan Ministry of Finance introduced a new form of ten percent tax levied on mobile phone top-up (consumers bearing the full cost of taxation)[36]. The newly imposed indirect taxation on mobile phone top-up that falls under the goods and services tax category has remarkably increased the overall public revenue since 2016 (Fazli, 2016), as also shown in figure 4.4.

Figure 4.4: Indirect taxes composition in the percentage of GDP (2003-2017)



Source: Author's elaboration based on the data from IMF (2020) and ICTD/UNU-WIDER (2020)

Contrary to mobile phone top-up tax (an extra indirect tax paid by consumers), BRT is, in principle, an advance direct tax payment (although treated as indirect tax[37]) by business companies and does not generate additional public revenue for the Afghan Government. Hence, the Afghan Ministry of Finance plans to apply a flat ten percent value-added tax (VAT)[38] by early 2021, which will replace BRT. According to the preliminary assumptions, the implementation of VAT is expected to generate an additional indirect tax revenue equivalent to 1.8 percent of the GDP by 2021 (World Bank, 2020a).

4.1.3 Non-Tax Revenue Performance

Non-tax revenue comprises revenue from sales of public goods and services (administrative fees), property income revenue (dividend from state-owned enterprises

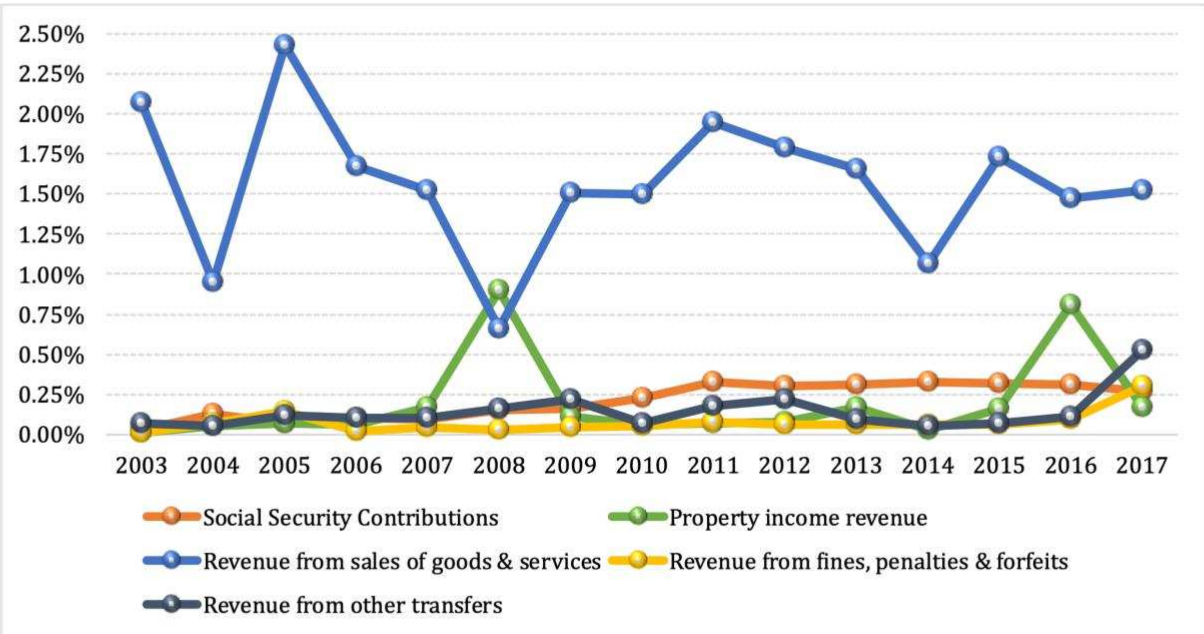
[36] Mobile phone to-up tax is an indirect tax imposed at 10 percent on the total amount of money a consumer credit to his or her balance.

[37] According to the Afghan income tax law, after paying BRT on gross sales (indirect tax), a business will receive an equivalent of BRT as tax credit (deductible expense) against its annual corporate income tax payment (direct tax).

[38] Value-added tax (VAT) is an indirect tax that is levied incrementally at different stages of production, distribution or sale to the end consumer. VAT can also be imposed on imports and exports.

and natural resources rent or also known as royalties), social security contributions (public servants' pension only), revenue from fines, penalties, and other miscellaneous sources. As depicted in figure 4.5, during 2003-2017, a large share of the non-tax revenue (on average, 72 percent)[39] historically came from the sales of public goods and services (administrative fees). In contrast, the non-tax revenue from public property (which has higher potentials for revenue generation from natural resources rent) remained considerably lower (on average, constituted 8.7 percent of the total non-tax revenue)[40]. As discussed under section 2.3, Fjeldstad et al. (2018) emphasized that effective management of natural resource wealth (through the adoption of IMF's MNRW-TF models and EITI standards) can generate a large share of non-tax domestic public revenue (i.e., royalties) for LICs that are resource-abundant and characterized as fragile states.

Figure 4.5: Non-tax revenue composition in the percentage of GDP (2003-2017)



Source: Author's elaboration based on the data from IMF (2020) and ICTD/UNU-WIDER (2020)

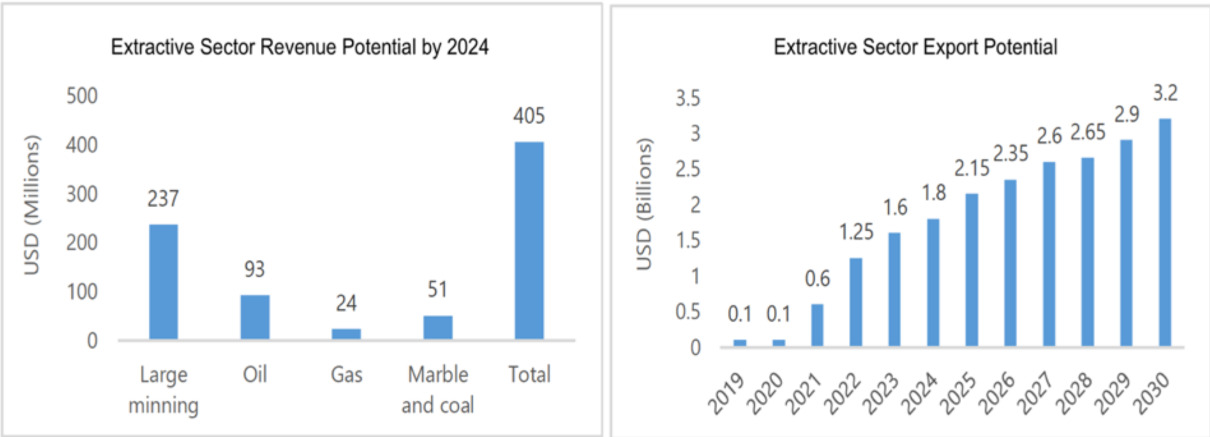
Several studies findings (Noorani, 2015; Samuel Hall, 2016; SIGAR, 2016; Afzali and Timory, 2017; MEC, 2018) highlighted that the main reasons for lower non-tax revenue from the natural resources rent are: i) insecurity in the mining areas, ii) illegal extraction of mines, iii) lack of domestic technical expertise, iv) and lack of administrative capacity (weak procurement, oversight, and revenue collection mechanisms) at the Afghan

[39] For more detail about improvements in non-tax revenue collection after 2015, see USAID (2017) report.

[40] Based on some estimates, Afghanistan has between one to three trillion US$ worth of natural resources (Ministry of Finance, 2020).

Ministry of Mines and Petroleum (MoMP)[41]. The Ministry of Finance (2020) report indicates that if the Afghan Government can resolve the obstacles (as mentioned above and under section 4.3) ahead of the extractive sector, by 2024, this sector has the potential of generating 400 million US$ annually in public revenue, 100,000 direct and indirect jobs, and 1.5 billion US$ increases in exports (see figure 4.6). However, all of these can be achieved conditional to an increase in the FDI and implementation of the broader development strategy (infrastructure deployment that supports the delivery of bulky mines and regional connectivity) under a peace scenario that is highlighted in the Afghanistan National Peace and Development Frameworks (ANPDF I).

Figure 4.6: Extractive sector revenue and export potential scenario



Source: Afghanistan Growth Agenda via the Ministry of Finance (2020) report

After non-tax revenue from resources rent, social security contributions (currently only comprised of public servants' pension) are considered the third largest non-tax revenue source. As depicted in figure 4.5, between 2003-2017, its contribution was 0.21 percent of the GDP on average (9.6 percent of the total non-tax revenue). However, it is imperative to highlight that the non-tax revenue from social security contributions possesses the liability of repayment in the future. Hence, it should be utilized (invested) efficiently. According to the Ministry of Finance (2020) report, during 2019, the public pension scheme's cost outweighed the collections made on public servants' contribution because there was no proper pension fund management system in place at the Afghan Ministry of Finance. To address this problem, in 2019, the Afghan Ministerial Cabinet approved the

[41] For a detailed discussion on MoMP's weak administrative capacity and its vulnerabilities to corruption, see MEC (2018) report of "Ministry of Mines and Petroleum Ministry-wide Vulnerability to Corruption Assessment."

creation of a "National Public Pension Fund" at the Pension Directorate of the Ministry of Finance.

Since 2016, the Afghan Government has also received a considerable amount of its non-tax revenue from the one-off domestic transfers (currency exchange gains) that are technically recorded under the revenue from other transfers. According to a SIGAR (2020a, p. 133) report, "the one-off domestic revenues are nonrecurring revenues arising from onetime transfers of funds, such as central bank profits from foreign exchange, to the Afghan government." The report further highlights that although one-off revenues derived from foreign exchange profit are not illegitimate government revenue sources, they are not considered a sustainable public revenue source. As a result, the Afghan Government should not continuously depend on unsustainable public revenue sources because they carry the hazard of fiscal instability.

4.2 Assessment of the Public Expenditure Performance

As depicted in Table 4.2, Between 2003-2017, on average, 38 percent of the total public expenditures (equivalent to 8.5 percent of the GDP)[42] were spent respectively on defense, public order, and safety[43]. The remaining 62 percent (equivalent to 13.6 percent of the GDP) were spent respectively on economic affairs, education, general public services, health, and other areas.

Table 4.2: Afghanistan public expenditure decomposition (2003-2017)

Afghanistan Public Expenditure Decomposition	As a percentage of GDP	As a percentage of total public expenditure
	(2003-2017) Mean	*(2003-2017) Mean*
Total Public Expenditure	**22.19%**	**100%**
Expenditure on defense	4.41%	19.38%
Expenditure on public order and safety	4.13%	18.44%
Expenditure on economic affairs	6.06%	27.75%
Expenditure on education	3.18%	14.35%

[42] These figures include only on-budget military spending and exclude the off-budget military funding from "ASFF".

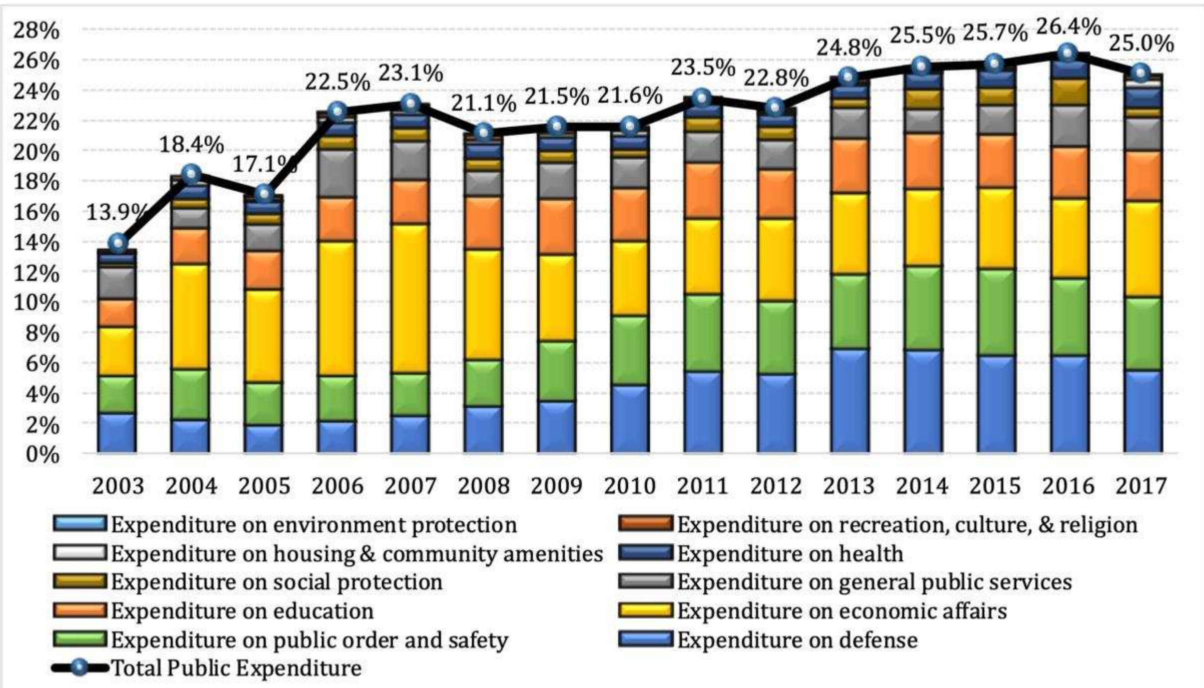
[43] Public order and safety expenditures are typically comprised of four categories: i) police force; ii) fire service; iii) law courts; iv) and prison service.

Expenditure on general public services	2.11%	9.69%
Expenditure on health	0.95%	4.27%
Expenditure on social protection	0.83%	3.65%
Expenditure on recreation, culture, & religion	0.25%	1.16%
Expenditure on housing & community amenities	0.23%	1.05%
Expenditure on environment protection	0.03%	0.12%

Source: Author's elaboration based on the data from IMF (2020)

By looking into the historical trends, public spending on security and non-security segments dramatically swapped during 2004-2008 and 2009-2017, as depicted in figure 4.7. During 2004-2008, as a massive amount of foreign aid and private capital flew into the country, and in the meanwhile, there was a growing need and utmost attention towards reconstruction and development—hence, a large share of the public expenditures was historically allocated towards the non-security sectors. However, during 2009-2017 (when domestic war intensified and military responsibilities were gradually transferred to the Afghan army), the security-related public expenditures dramatically increased vis-à-vis non-security expenditures, which altered the previous fiscal spending order[44].

Figure 4.7: Public expenditure composition in the percentage of GDP (2003-2017)



Source: Author's elaboration based on the data from IMF (2020)

44 For more detail, see World Bank (2019) report of "Afghanistan: Public expenditure report."

In an IMF working paper, Aslam et al. (2014) emphasized that allocating a high share of the fiscal budget towards the security sector (including defense, public order, and safety expenditures) for a fragile and underdeveloped country like Afghanistan is unprecedented and undesired. Accordingly, the World Bank (2016) report highlighted that Afghanistan's current military expenditure trajectory is unsustainable and squeezing the limited fiscal budget's space for developmental expenditures, which needs reassessment[45]. The World Bank remarks on Afghanistan's military spending are similar to Heller (2005), who emphasized that to create fiscal space, unproductive expenditures—mainly those of a recurrent nature such as government subsidies, military spending, embassies spending, including the problem of overstaffing—should be reassessed. Nevertheless, in the case of Afghanistan, due to an ongoing war against a global network of terrorism and domestic insurgency, the Afghan Government cannot dramatically reduce its security spending unless peace prevails.

Apart from the criticism regarding high budgetary spending on the security segment vis-à-vis non-security, public expenditures are also highly criticized for misuse and misallocation, including high operating budgetary spending (on average, 69 percent of the total public expenditure, as depicted in figure 3.3). A high operating budgetary spending implies that the public funds, which could have been spent on developmental purposes, are usually lost for overstaffing and subsidization at the cost of a large fiscal deficit that is historically funded through on-budget foreign aid grants. With regards to misuse and misallocation, Afzali and Timory (2017) and IWA (2020) reports highlighted several issues. For example, the IWA (2020) report indicated that some of the classified and contingency budget codes (such as code 91, which is a policy reserve fund) under the direct control of the Afghan President's office are usually overestimated or overused. In addition, the IWA (2020) report highlights that the national budget deviates by as much as 60 percent after approval from Parliament, which creates concern about fund utility.

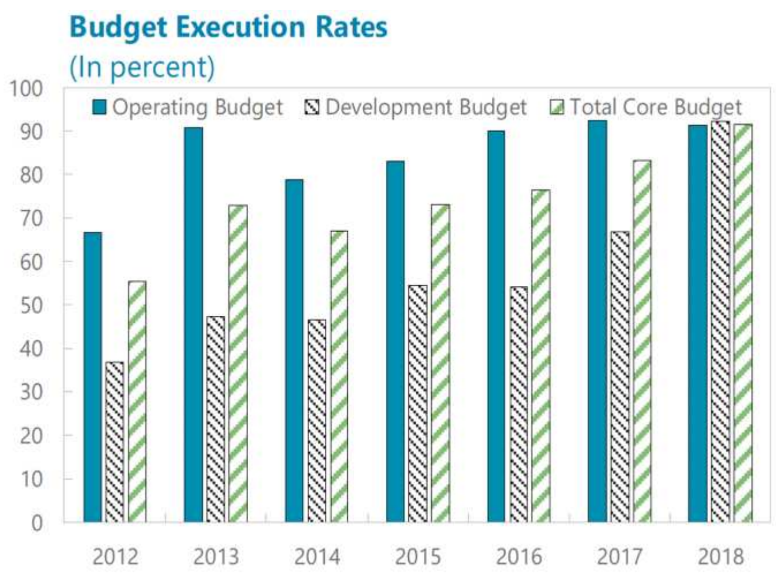
4.2.1 Total Core Budget Execution Rate Performance

A higher total core budget (operating and development) execution rate is essential for two main reasons. First, optimal utilization of the total core budget funds reinforces domestic consumption and public infrastructure that would, in turn, underpin economic growth

[45] For more detail on security expenditure reassessment mechanisms in Afghanistan, see Manthri (2008).

and domestic public resource mobilization, respectively. Second, given the Afghan Government's massive budgetary aid-dependency, a higher total core budget execution rate shows that the Afghan Government has a high absorptive capacity to effectively manage and spend the on-budget foreign aid grants. In other words, if the Afghan Government executes the total core budget optimally, donors would channel a large share of foreign aid grants through on-budget mechanisms (see section 3.1 and 3.4.2 for more discussion on why on-budget funding is essential vis-à-vis off-budget). However, as depicted in figure 4.8, before 2018, the total core budget execution rate was significantly lower. The World Bank (2011) report indicates that during 2008-2011 only 40 percent of the development budget was executed, which was mainly financed through foreign aid grants. The report further adds that the development budget lower execution rate's main reasons were structural and capacity issues (including corruption-related concerns) and unrealistic budget formulation mechanisms (the inability to execute the projected budget).

Figure 4.8: Total core budget execution rate (2012-2018)



Source: IMF (2019)

4.3 Barriers Ahead of Domestic Public Resource Mobilization

Under this section, the author discusses the most relevant barriers ahead of DPRM from five broader lenses: i) Administrative Barriers; ii) Legal and Institutional Barriers; iii) Social Barriers; iv) Political Barriers; v) Economic Barriers. These barriers are discussed based on the author's interview findings, data-driven analysis, and relevant policy papers on Afghanistan.

4.3.1 Administrative Barriers

i) Lack of Skilled Human Resource: Lack of transparency in the recruitment process and low salary scale (see annex 4) are often quoted as the main reasons for the inability to attract the skilled labor force. In the MEC (2020) report, the committee reviewed a sample of 100 personnel files at the Afghan Ministry of Finance and found that the recruitment procedures at the Ministry were not in line with the Independent Administrative Reform and Civil Service Commission's (IARCSC) standards in most of the cases. For instance, the committee report (MEC, 2020) found that several employees were assigned to technical positions at the Ministry of Finance either with irrelevant previous experiences or irrelevant credentials (i.e., agriculture, Islamic studies, or literature). Furthermore, MEC (2020) report also highlighted that lack of technical training, absence of a succession plan, and internal rotation were the other factors depriving the Ministry's existing personnel to obtain the necessary skills for carrying out the technical work effectively.

ii) Weak and Limited Technological Infrastructure: The Afghan Ministry of Finance uses the Automated System for Customs Data (ASYCUDA)[46] software for customs revenue management and Standard Integrated Government Tax Administration System (SIGTAS)[47] for tax revenue management. According to UNCTAD (2019) report, out of 40 customs offices across Afghanistan, only 24 are computerized (equipped with the latest version of ASYCUDA-World), and 19 are still paper-based. Based on MEC (2020) report, there are substantial operational gaps at the customs offices, which hampers the optimal operation of the ASYCUDA software. For instance, the report (MEC, 2020) indicates that: i) not all models of the ASYCUDA are used across the customs offices at the provincial level; ii) in most of the customs offices, the digital weighing scale, scanner, and security camera system are dysfunctional; iii) lack of interconnectivity

[46] ASYCUDA is an open-source computerized software developed by the United Nations Conference on Trade and Development. It is an integrated customs management system for international trade and transport operations. The latest version of the software in use is "ASYCUDA-World", which has several advantages over the rest.

[47] SIGTAS is created by SOGEMA Technologies, a Canada-based private tech firm that works as a client for the World Bank, Asian Development Bank, Inter-American Development Bank, and other developing agencies.

between different facilities at the customs offices; iv) lengthy procedures followed by limited checks and balances at different stages of the customs clearance[48].

With regards to SIGTAS software, it is operational in Afghanistan across 32 provinces out of 34 (MEC, 2020). However, across these 32 provinces, SIGTAS functionality is currently limited to at least group one level. According to MEC (2020, p. 134) report, "group one includes the three basic registration and tax identification number (TIN) issuance modules; group two includes documents, assessment, cashing, letters and reminders, and withholdings; and group three includes audit, enforcement, and objections" (see annex 6 for full functions of the SIGTAS software). Besides the operability limitations, the MEC (2020) report also highlighted that according to a World Bank assessment, Afghanistan Revenue Department's data center (servers) was never upgraded after its establishment back in 2008. As a matter of fact, it is vital to upgrade the servers to maintain the data safe and up to date. During the author's interview, the Afghan Ministry of Finance's spokesperson confirmed that 95 percent of the SIGTAS server's capacity is full, and only 5 percent is available for storing new data (interviewee four, personal communication, March 8th, 2020). With such a low server capacity, there are high chances of losing the newly entered data. The Ministry's spokesperson said that the senior management is aware of this problem, and talks are underway with the World Bank and service provider company to resolve this issue.

iii) Lack of Functional Electronic Tax Filing System: To eliminate red tapes and automate the tax filing processes, in 2017, the Afghan Ministry of Finance started a pilot project of electronic tax filing at the Large Taxpayer Office (LTO). After the successful trial at the LTO, in 2020, the trial version of the electronic tax filing system was also extended to the Small Taxpayer Office (STO) and Medium Taxpayer Office (MTO). However, fewer improvements have been made since then to make the e-filing system fully operational for the STO and MTO clients. Besides, the absence of electronic payment (e-payment) and electronic signature (e-signature) laws[49] brings up several concerns about the dispute settlement mechanisms of e-payment and e- tax filing.

[48] For further detail on these two laws, see MEC (2020, p. 60-94) report of "Ministry-wide Vulnerability to Corruption Assessment of the Ministry of Finance."

[49] These laws are already drafted, although officially not endorsed by the National Assembly.

4.3.2 Legal and Institutional Barriers

i) Limitations and Complexities in the Customs and Income Tax Laws: The Afghan Ministry of Finance has two separate laws for regulating customs and income-related taxation affairs. The principal law for governing customs affairs is the 2016 Customs Law supplemented by 54 procedures and three policies, which define and describe the arrangements, conditions, and responsibilities of the Customs Department that operate under the Afghan Ministry of Finance[50]. According to the MEC (2020) report findings, Afghanistan's Customs Law is broadly fit for customs affairs. Nevertheless, there are several inconsistencies and flaws in the Customs Law that were not appropriately addressed during the initial drafting. The report (MEC, 2020) highlights that the drafted law did not consider the private sector's consultation and concerns before enacting it; therefore, it is not compatible with the local customs affairs. The report further adds that instead of drafting the law per the local circumstances, they used the "cut and paste" approach. The most staggering flaw of the current law is that it lacks 18 procedures that are necessary to be adopted under the membership of Afghanistan into the World Trade Organization and the World Customs Organization. Furthermore, MEC (2020) also found that some of the Customs Law articles are either overlapping or confusing[51].

The principal law governing income-related taxation affairs is the 2009 Income Tax Law of Afghanistan that is supplemented by several assortments of other laws, manuals, and public rulings (MEC, 2020). For instance, the 2015 Tax Administration Law, 2015 Value-Added Tax Law, Arrears Law, Land Tax Law, and several other regulations and manuals comprised of Public Rulings, Council of Ministers' orders, Legislative Decrees, and ad-hoc decisions issued by the tax administration. MEC (2020) report indicates that although Afghanistan's 2009 Income Tax Law is one of the most effective and useful legislation examples of the post-Taliban regime, its assortment of several documents makes it difficult for taxpayers to follow the tax

[50] According to MEC (2020) findings, this law is not yet ratified by the National Assembly of Afghanistan. However, under the exceptional and emergency circumstance scenario, it is tentatively enacted through a presidential decree to carry on the customs affairs.

[51] For instance, MEC (2020, p. 28) found that "Article 195 states that administrative violations will be dealt with by a committee established for the purpose, although the Customs Violation Prevention Unit has been given responsibility in this area; moreover, in relation to dealing with those caught in the act of smuggling: Article 187 indicates that any vehicles, goods or equipment found will be confiscated, while Article 188 states that a fine will be imposed without seizure. Article 178 makes reference to paragraph five in Article 48 that does not exist (regarding administrative violations)."

guidelines. For more details, see Grut (2017) report of "How much do I need to pay? Changes to Afghanistan's Tax Law cause chaos and confusion."

ii) Lack of Value-Added Tax (VAT) and Excise Duty: Currently, no VAT[52] or excise duty[53] is levied on goods and services produced inside the country or imported from abroad due to the lack of technical capacity to manage the lengthy and complex processes of taxation. Although VAT's adoption would bring in additional public revenue, excessive reliance on VAT is an unsustainable approach. Any shock to the global trade or local consumer consumption pattern would deteriorate the public revenue stream from VAT. Moreover, excessive reliance on VAT also puts the maximum pressure mainly on poor-strata of the society (low and lower-middle-income consumers) that undermines the social protection principle of public financial management. As for the unavailability of excise duty (in addition to the lack of technical capacity), the main reason is the fear that by levying excise duty, certain goods' (Tobacco) smuggling might increase to evade taxes.

iii) High Level of Corruption and Revenue Leakages: Corruption (both grand and petty, institutional, and individual) has been identified as a major bottleneck ahead of reforms to enhancement DPRM in Afghanistan (MEC, 2020). According to Transparency International (2020) report, Afghanistan has been identified as the world's eighth most corrupt country. Based on a modest estimate, widespread petty and grand corruption costs Afghanistan an economic loss (both revenue loss and bribe) of five billion US$ per annum (Afzali and Timory, 2017). With regards to public revenue loss due to corruption (mainly from the customs revenue), Walsh (2014) reported that Afghanistan is losing around 500 million US$ annually based on most conservative estimates. In the MEC (2020, p. 65) report, the committee found that "One reported estimate of the scale of corruption in one Province is that only 10 percent of tariff income is sent to the Government, with 40 percent distributed among local Customs and other Government and elected Officials and 50 percent remaining with the traders." During the author's interview, when the Afghan Ministry of Finance's

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52 The Afghan Ministry of Finance initially planned to implement VAT in 2011, but it was constantly postponed. According to the latest information, by 2021 the VAT is planned to be implemented (World Bank, 2020a).

53 Excise duty is an indirect tax levied on the sale or use of certain products such as tobacco, alcohol, and gambling activities. The main purpose of excise duty is to discourage consumption of particular goods that are harmful for health and environment.

spokesperson was asked about the extent of tax revenue losses due to corruption, he abstained from mentioning any specific amount or percentage of the total public revenue. However, he recognized that a substantial percentage of the public revenue is lost every year due to corruption and tax leakages (interviewee four, personal communication, March 8th, 2020). Byrd and Payenda (2017, p. 3) also highlighted that "leakages are widely considered substantial, though impossible to quantify."

iv) Lack of a Stock Exchange Market: Afghanistan currently does not have any stock exchange market. The absence of a stock exchange market, on the one hand, deprive the economy of domestic private capital mobilization (including foreign capital inflow). On the other hand, it causes a loss in tax revenue from potential capital income (profit) for the Afghan Government. In addition, the lack of a stock exchange market also creates challenges for the issuance of sovereign bonds (also known as *Sukuk* in Afghanistan) to debt-finance the fiscal deficit.

4.3.3 Social Barriers

i) Lack of Awareness: Fazli (2016) argued that persistent instability impeded the Afghan Government's inclusive reach to every corner of the country. As a result, in most of the villages where the Government has no reachability, people either remained unaware of any tax obligation or engaged in illegal activities (such as poppy cultivation and illegal mining of precious stones), which cannot be taxed.

ii) Mistrust and Non-Compliance: Based on his survey findings, Bizhan (2019) argued that when appointments in tax administration and other government departments are based on nepotism and bribery, civil servants will use their role to make money for personal gains rather than serving the nation. As a result, citizens lose their trust in the system and react accordingly either by not complying with the tax obligations (evading the taxes through underreporting or not reporting at all) or negotiating with the tax collectors (bribing them) to pay the lowest possible tax amount.

4.3.4 Political Barriers

i) Persistent Civil Conflict: Four decades of war not only destroyed the private and public infrastructure in Afghanistan but also deprived the country from potential investment opportunities and socioeconomic development. According to the Institute for

Economics and Peace (2018) report, the economic impact of violence (which includes the direct and indirect costs of violence as well as an economic multiplier applied to the direct costs) as of 2017 in Afghanistan is estimated at around 67.8 billion US$ in purchasing power parity (63 percent of the GDP). Based on statistical analysis by Barrett (2018), between 2005-2016, the civil war caused the Afghan government a revenue loss of roughly 3 billion US$ that arose from the reduction in the revenue share of local activities. The author further argued that the potential public revenue gain from peace could be roughly six percent of the GDP per year. In addition to the public revenue loss, the domestic conflict also placed a heavy budgetary burden on the Government. As depicted in figure 4.7, since 2009, the security expenditure has considerably increased at the cost of depriving other central non-security sectors and a massive foreign aid dependency.

4.3.5 Economic Barriers

i) Small Size of the Taxable Economy and Tax-Base: Despite a high economic growth over the past two decades (see figure 3.4 and annex 5), the Afghan economy's size in terms of GDP did not increase above 20 billion US$ annually (see figure 1.1). Moreover, Ghiasy et al. (2015) reported that based on a World Bank estimate, 80-90 percent of Afghanistan's economic activities are still informal[54]. However, less is known regarding Afghanistan's informal sector[55]. With such a small economy that is massively informal and dysfunctional (subsistence-based) from the aggregate output point of view, less taxable capital remains in the formal economy that can generate adequate tax revenue for the growing public expenditure (Manthri, 2008). In other words, the tax base in Afghanistan remains considerably smaller due to the small size of the formal (taxable) economy.

[54] See Hakimi (2015) for more detail about illicit financial flows in Afghanistan.

[55] From an employment lens, Ghiasy et al. (2015, p. 11) reported that "formal jobs represent only around 9 percent of the total share of employment in Afghanistan, 20 percent of which are in the public sector."

Chapter Five
Policy Recommendations

In this chapter, the author recommends short-term, medium-term, and long-term policy recommendations that could have a reasonable chance of success to enhance DPRM in Afghanistan. These recommendations are based on the analysis of the situation in Afghanistan and the lessons learned from other countries. It is imperative to mention that the author acknowledges the ongoing civil conflict and its potential impact on these policy recommendations' feasibility. The short-term policy recommendations focus on the administrative barriers because they are mostly under the Afghan Ministry of Finance's and donor community's direct control and can be resolved quicker than the rest. The medium-term policy recommendations focus on legal, institutional, social, and political barriers because each one requires the engagement and cooperation of different stakeholders at different levels for an extended period. Lastly, the long-term policy recommendations focus on economic barriers (the need for regional integration and a structural transformation) that would typically require decades of planning and execution.

Before discussing the policy recommendations, it is imperative to mention that proposed policies' success is subject to a continued and high-level political commitment with a clear mandate, buy-in from all stakeholders, and social dialogue, as highlighted by Akitoby (2018) from Georgia's successful tax revenue reform.

5.1 Short-Term Policy Recommendations

i) <u>Increase On-Budget Funding:</u> Given the Afghan Government's massive budgetary aid dependency and inability to debt-finance in the short-run[56], the donor community should increase the on-budget funding conditional to ANPDF goals and enhancement of DPRM to counter the incentives for DPRM lethargy. This recommendation is backed by the fact that the Afghan Government's overall budget execution rate performance has considerably improved since 2015 (see figure 4.8), which allows the Government to manage the large sum of funds directly. Besides, the donor community should

[56] According to the World Bank (2018, p. 72) report, the Afghan Government's budget will be dependent on foreign aid at least until 2030.

refrain from massive off-budget spending due to its counterproductive consequences of promoting a parallel system and deterioration of the public institution's maturity process and centrality.

ii) Improve Recruitment Processes: To increase working efficiency and accountability, the Afghan Government in general, and the Ministry of Finance in particular, should recruit public servants through a merit-based process in-line with the IARCSC standards (interviewee two, personal communication, March 4th, 2020). Besides, the Afghan Ministry of Finance can also work on a personnel reform plan to replace old tax and customs officers (who got their jobs through nepotism or bribery) with new personnel to be hired transparently. The personnel reform strategy was central to Georgia's successful tax revenue reform, as Akitoby (2018) highlighted in an IMF policy paper.

iii) Adjustment of Salary Scales According to the Market Standards: The existing salary-scale at the Afghan Ministry of Finance is considerably below market standards, which needs to be adjusted to attract qualified human resources. Moreover, a salary increase would also reduce the incitement for embezzlement.

iv) Expansion of Electronic Tax Management Systems: As highlighted by Akitoby (2018), better compliance and strict enforcement were achieved in Georgia through implementing electronic tax filing and tax management systems. Given that, the Afghan Ministry of Finance should immediately expand and extend the ASYCUDA and SIGTAS software systems (as well as resolving the problem with the data center) to enhance tax revenue collection (both from income-related and customs) and eliminate the tax leakages resulting from manual procedures. According to the World Bank (2018, p. 19) report, "public revenues could be increased to around 15 percent of GDP by fully enforcing existing tax policy settings and eliminating leakages."

v) Enactment of Electronic Signature and Electronic Payment Laws: In collaboration with the National Assembly and the Ministry of Communications and Information Technology, the Ministry of Finance should finalize (enact) the long-waited e-payment and e-signature laws. These laws are a precondition for swift implementation of the e-filing system to foster revenue collection, including auditing procedures, enforcement, and compliance.

5.2 Medium-Term Policy Recommendations

i) Fight Against Corruption: The omnipresent corruption in the country not only deprives the Afghan Government of a potential share of public revenue but also discourages the taxpayers from trusting in, and complying with, the tax obligations. Lack of citizens' trust and compliance with the tax obligations eventually deteriorates the state-society relationship and accountability mechanisms between the two. That being the case, fighting against corruption is extremely vital at the national level—particularly at the Customs Offices of the Afghan Ministry of Finance that are the major sources of public revenue—to increase public revenue and buy-in from citizens (stakeholders) to comply with the tax obligations. The MEC (2020) "Ministry-wide Vulnerability to Corruption Assessment of the Ministry of Finance" provides detailed recommendations on overcoming corruption-related issues at the Afghan Ministry of Finance from all fronts—both at policy and administrative levels.

ii) Reassessment of the Income Tax and Customs Laws: The Afghan Ministry of Finance should revise the 2016 Customs Law for the errors and limitations described above. Furthermore, the Ministry should simplify and consolidate the assortment of different tax laws, manuals, public rulings, and legislative decrees into a single Income Tax Law. As Akitoby (2018) highlighted, a simpler tax system with a limited number of rates is essential for fragile states to foster taxpayer compliance and administration of taxation affairs with fewer challenges.

iii) Implementation of VAT and Excise Duties: Although the Afghan Ministry of Finance plans to implement VAT by 2021, an interviewee at the Afghanistan Revenue Department told the author that in the short-term, implementation of VAT is not feasible for several technical (including lack of administrative capacity) reasons (interviewee three, personal communication, March 8th, 2020). Therefore, the author would consider its feasibility of full implementation in some extended period. Based on preliminary assumptions, the successful implementation of VAT is expected to generate an additional indirect tax revenue equivalent to 1.8 percent of the GDP by 2021 (World Bank, 2020a). Besides the implementation of VAT, the Ministry should also consider implementing excise duties in the medium-term.

iv) Natural Resources Extraction: In the medium-term, the Afghan Ministry of Finance and Ministry of Mines and Petroleum should initially plan to extract small and medium scale mines (coal, cement, and alike) because they typically require simple technology, lesser time for extraction, and basic infrastructure (asphalted roads) for delivery (interviewee one, personal communication, March 3rd, 2020). The interviewee added that long-term planning is required for large-scale mines (copper, rare-earth elements, and alike) because their exploitation typically requires effective governance, appropriate skills (administrative and technical), extensive investment, extended time, sophisticated machinery, and infrastructure like a railway[57]. Fjeldstad et al. (2018) recommended that adoption of the IMF's MNRW-TF models and fulfillment of the EITI standards would help a country like Afghanistan to increase its non-tax public revenue from resource rent. Nevertheless, the Afghan Government should be mindful of the political and economic hazards of long-term dependency on resource rent.

v) Public Expenditure Reprioritization: Although the cost of security-related public expenditure is hefty on the fiscal budget, less can be done to reduce the security spending amid an ongoing civil conflict and war against the global network of terrorism. However, if the ongoing peace talks can lead to a permanent ceasefire, the Afghan Ministry of Finance can reconsider the security expenditures accordingly. As Heller (2005) recommended, reducing unproductive public expenditure—those of a recurrent nature such as government subsidies, military spending, embassies spending, including the problem of overstaffing—would create considerable fiscal space (or to say, reduce the fiscal deficit) for developmental programs.

vi) Debt-Financing: To gradually reduce fiscal aid dependency, the Afghan Government should finance developmental budgetary spending through debt. For debt-financing, the Afghan Government has two main options. First, debt-financing through issuing a sovereign bond (also known as *Sukuk* in Afghanistan). However, given the overall security, financial infrastructure, and macroeconomic situation in Afghanistan, it is currently not feasible to issue a sovereign bond[58]. Second, the Afghan Government can seek concessional loans under "structural adjustment programs" from institutions like the World Bank, IMF, Asian Development Bank, and others[59]. Nevertheless, debt-

[57] Afghanistan currently lacks an extended network of railways.

[58] See Presbitero et al. (2016) for more detail about the pre-requisites of issuing sovereign bond successfully.

[59] These types of debt-financing are often subject to strict conditionalities (i.e., austerity measures) that might have counterproductive consequences for the economy.

financing under concessional terms has strict conditionalities and even some unfavorable implications that the Afghan Government should be mindful of beforehand[60]. By and large, it is imperative to mention that as fiscal borrowing (in any form) requires repayment, the Afghan Government should ensure that the debt-financed public expenditures will enhance public revenue to finance repayment of the borrowing, as recommended by Heller (2005).

vii) Creation of a Stock Exchange Market: As highlighted above, the lack of a stock exchange market deprives the Afghan economy of private capital mobilization (including foreign capital inflow) and the Afghan Government of potential capital income tax revenue. Moreover, it impedes the issuance of sovereign bonds for debt-financing the fiscal deficit when necessary. To that end, establishing a stock exchange market is crucial for achieving all those goals.

5.3 Long-Term Policy Recommendations

i) Expand Taxable Economy (Tax-Base): As recommended by Cottarelli (2011), Reynolds et al. (2017), and Fjeldstad et al. (2018), a central policy to increase public revenue is by expanding the tax-base through sustained economic growth policies (including, but not limited to employment generation and promotion of export). Given that, the Afghan Government should adopt such long-term policies (having short-term and medium-term goals) that would increase local households' and firms' income and wealth because they are the main contributors to tax revenue (directly and indirectly). In simple words, although difficult to conclude in fewer sentences, the Afghan government should focus on policies that can reinforce the structural transformation and reallocation of economic activities across the broad sectors of agriculture, manufacturing, and services.

ii) Regional Integration: Regional integration is vital for Afghanistan in the long-run. On the one hand, regional integration will underpin Afghanistan's economic growth through the trade of goods and extension of the electricity grid and gas pipeline from resource-rich Central Asia to resource-scarce South Asia. On the other hand, it will allow Afghanistan to improve its fiber-optic and railway networks with the

[60] The author strongly recommends this topic to be further explored for extracting lessons learned for Afghanistan.

neighboring countries in the region and beyond. For a landlocked country like Afghanistan, an extended railway network is a cheaper and efficient means of transportation.

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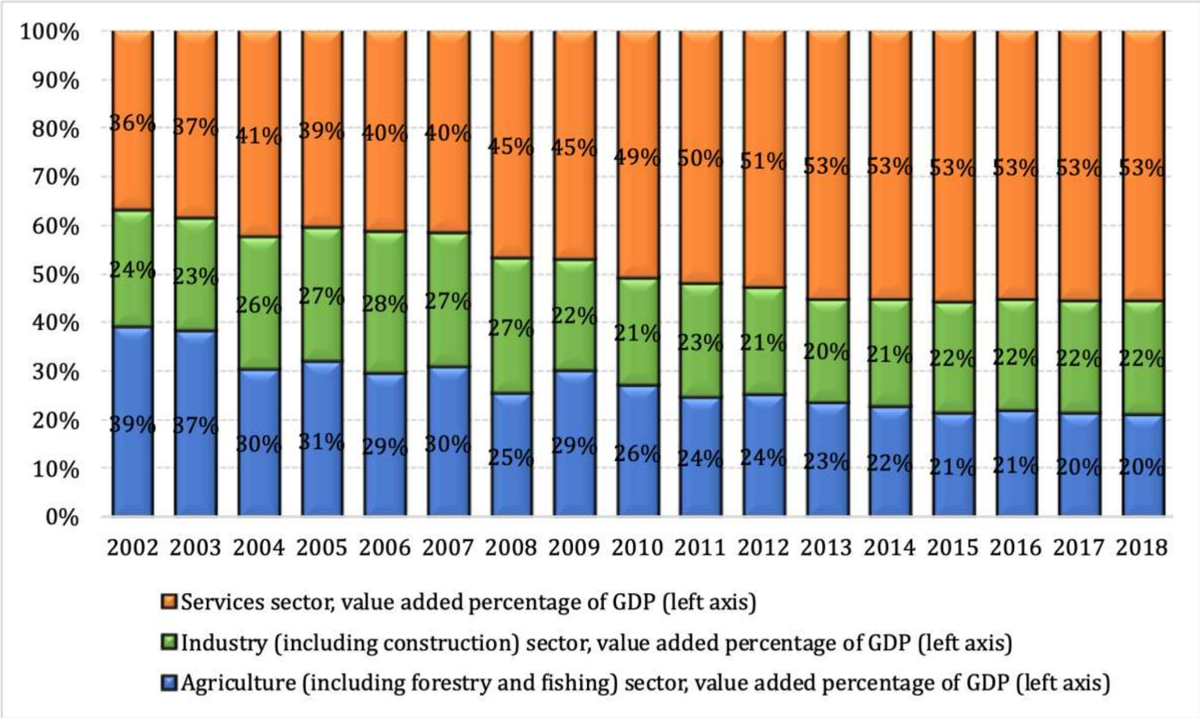
Annexes:

Annex 1: Afghanistan top 30 donors aid funding in millions of US$ (2002-2010)

		2002–2013	2002–2011		2002–2010		2002–2010	
Rank	*Donor*	*Pledge*	*Commitment*	*Total disbursement*	*On-budget disbursement*	*Off-budget disbursement*	*On-budget disbursement (as percentage)*	*Off-budget disbursement (as percentage)*
1	United States of America	56,100	44,356	37,118	2,455	34,663	7	93
2	Japan	7,200	3,152	3,152	900	2,252	29	71
3	Germany	5,029	2,130	762	287	475	38	62
4	European Union/European Commission	3,068	2,883	2,594	774	1,820	30	70
5	United Kingdom	2,897	2,222	2,222	861	1,361	39	61
6	World Bank	2,800	2,137	1,700	1,700	0	100	0
7	Asian Development Bank	2,200	2,269	1,005	955	50	95	5
8	Canada	1,769	1,256	1,256	491	765	39	61
9	India	1,200	1,516	759	0	759	0	100
10	Norway	938	775	636	232	404	36	64
11	Netherlands	864	1,015	1,015	426	589	42	58
12	Italy	753	645	540	212	328	39	61
13	Iran	673	399	377	0	377	0	100
14	Denmark	533	438	438	252	186	58	42
15	Sweden	515	635	635	171	464	27	73
16	Australia	369	744	656	112	544	17	83
17	Spain	308	220	194	84	110	43	57
18	United Nations	305	446	182	2	180	1	99
19	Pakistan	289	5	0	0	0	0	0
20	Saudi Arabia	268	140	103	25	78	24	76
21	China	252	139	58	0	58	0	100
22	Russian Federation	239	151	147	4	143	3	97
23	Switzerland	197	118	102	7	95	7	93
24	Agha Khan Development Network	190	140	140	0	140	0	100
25	Finland	152	160	160	48	112	30	70
26	Turkey	143	213	180	0	180	0	100
27	France	134	323	174	62	112	36	64
28	United Arab Emirates	97	134	117	0.4	117	0	100
29	Islamic Development Bank	87	70	17	17	0	100	0
30	South Korea	85	116	83	6	77	7	93
31	Others	327	305	283	59	224	21	79
	Total	**89,981**	**69,252**	**56,805**	**10,142**	**46,663**	**18**	**82**

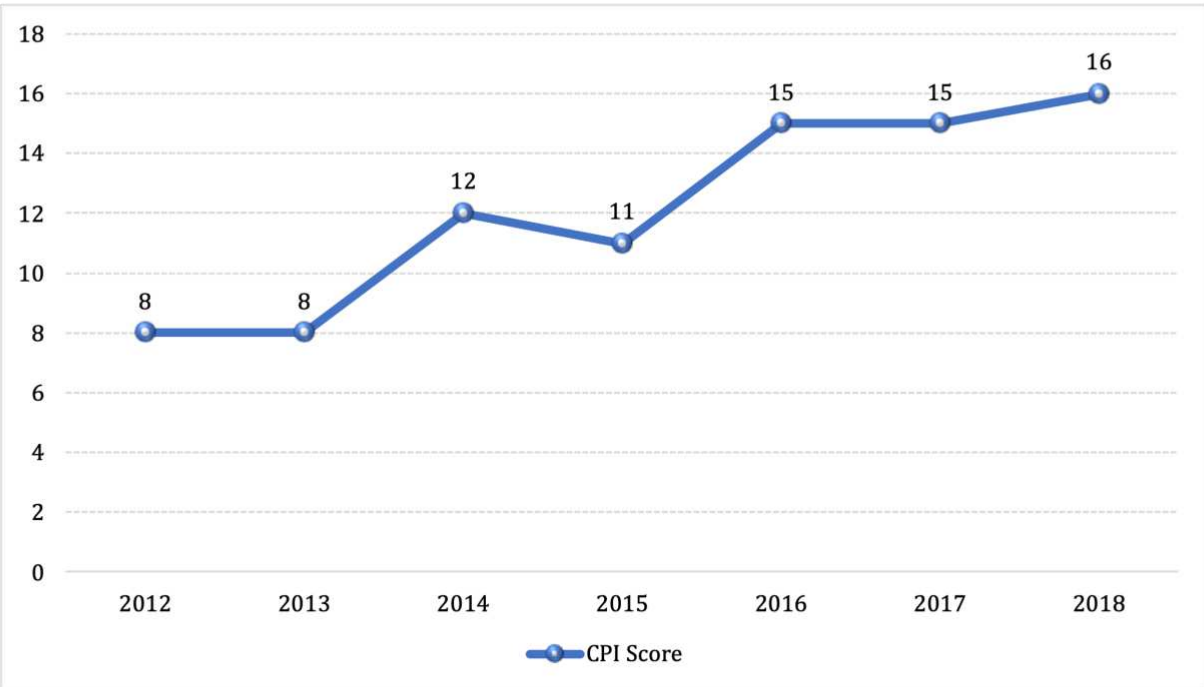
Source: Bizhan (2018)

Annex 2: Afghanistan sector-wise GDP Contribution (2002-2018)



Source: Author's elaboration based on the data from World Bank (2020b)

Annex 3: Afghanistan Corruption Perception Index (2012-2019)



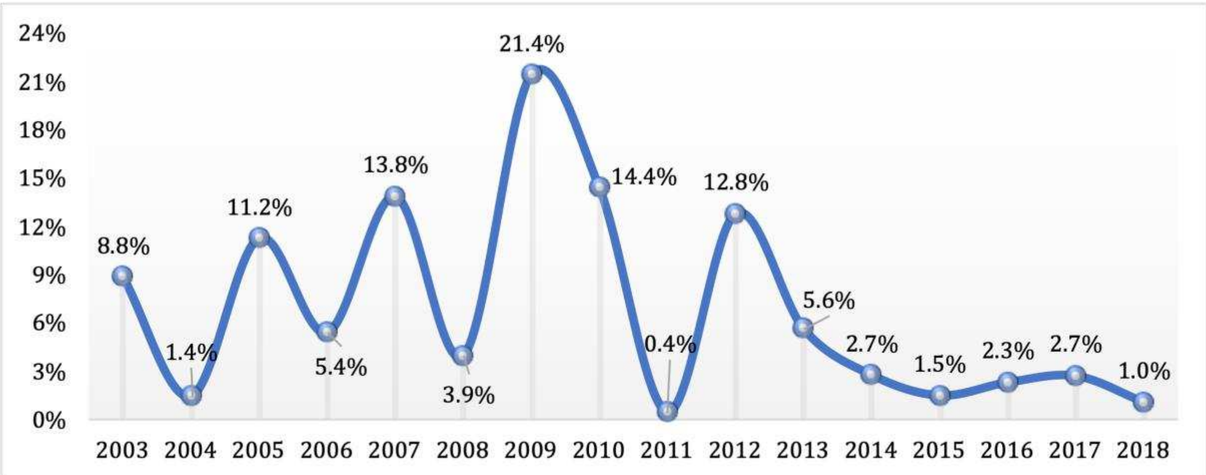
Source: Author's elaboration based on the data from Transparency International (2020)

Annex 4: Government salary scale based on the 2008 Civil Servants Law in US$

		Step 1	Step 2	Step 3	Step 4	Step 5
Line B	(Grade 1)	346	363	380	396	414
	(Grade 2)	234	247	260	273	285
Line C	(Grade 3)	166	175	185	194	204
	(Grade 4)	126	132	139	145	152
Line D	(Grade 5)	102	106	110	113	117
	(Grade 6)	83	86	89	92	96
Line E	(Grade 7)	71	73	75	77	79
	(Grade 8)	64	65	66	68	69

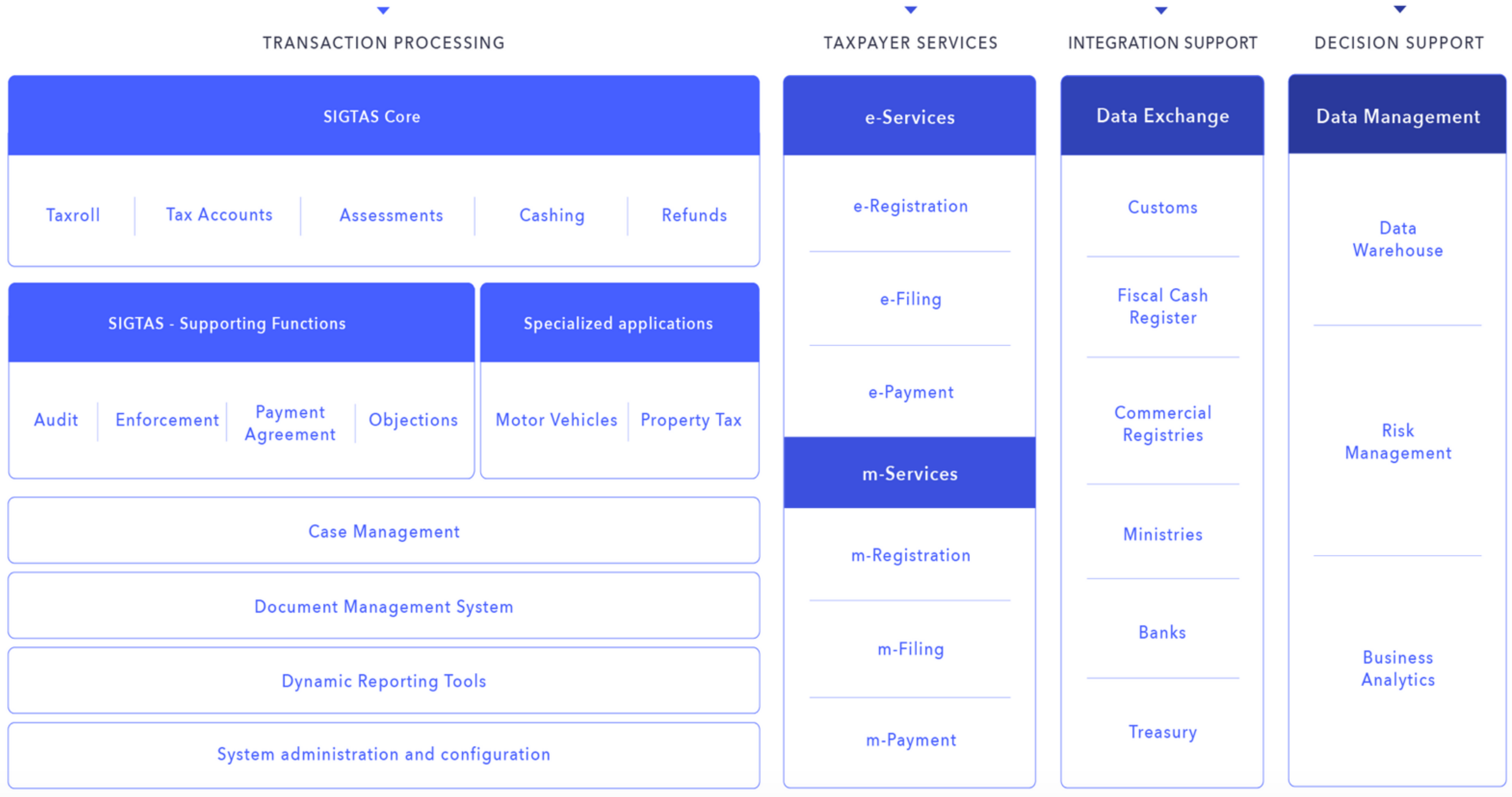
Source: MEC (2020)

Annex 5: Afghanistan's GDP annual percentage growth rate (2003–2018)



Data Source: Author's elaboration based on the data from World Bank (2020b)

Annex 6: SIGTAS software features



Source: SOGEMA Technologies (2018)