

## **IMF & World Bank Country Fiscal Advice Stifles Private Sector Growth and Perpetuates Aid Dependency in Afghanistan**

### **Introduction**

1. The current private business climate in Afghanistan is abysmal, especially given the investment risks that private investors must take there. A significant reason for this is poor donor-directed economic policies: Importantly, the tax policy and administration discourage private enterprise and investment. To rectify this, the Afghan-American Chamber of Commerce and the Afghan International Chamber of Commerce (AACC/AICC) have on several occasions presented private-sector-friendly, state-of-the-art tax and tax administration reform recommendations to Afghanistan's Minister of Finance. The Minister and his Deputy have expressed sympathy, but have repeatedly maintained that they are "...simply doing what the IMF and World Bank requires us to do."

2. The Minister is in effect telling those interested in improving the tax climate for private enterprise that the IMF and Bank are the problem: That we must change the IMF and World Bank to improve things. Unfortunately, the IMF and Bank "country" staff working directly on Afghanistan, those on the ground, are arrogantly implacable. They seem to favor excessive, incentive-depressing taxation of existing businesses in the short run, presumably so Afghanistan can develop a larger, stronger, more capable central government that will efficiently and effectively administer an improved tax system and a larger private sector in the future. Their advice is wrong: It's dooming Afghanistan to a prolonged period of corruption, tepid, monopolistic private sector growth and stagnation in tax revenue collections. There will be little if any growth in the true tax base, that is, in employment, wages and household income of Afghan residents. This lack of growth in the true tax base will give rise to severe aid dependency.

3. That the IMF and World Bank would be giving advice on taxes and tax administration that is harmful to private sector growth in the sort run seems counterintuitive, given these institutions' penchant for privatization and private enterprise. In fact, both institutions will spend considerable amounts of money vehemently denying that their short-term fiscal advice stifles growth in a competitive, private sector tax base. And, in a sense they'd be correct: Other parts of the IMF and Bank, so-called central or operational support units, are proffering fiscal advice to hasten private sector growth much more like that which AACC/AICC is suggesting. Indeed, our advice is primarily based on the experience and recommendations of those support units in the IMF and Bank.

4. This note is occasioned by these apparent conflicts. IMF and Bank country staff on the ground, motivated primarily by insuring economic stabilization, are making fiscal recommendations that stunt private sector (tax base) growth and perpetuate aid dependency. At the same time other staff in central or support units in the IMF and Bank, e.g., in the Fiscal Affairs Department (FAD) in the IMF and the Public Resource

Management Unit in the Bank are making differently nuanced recommendations, consistent with more rapid growth in the private sector tax base in the short run.

5. This note assumes familiarity with state-of-the-art fiscal reform recommendations such as those espoused by IMF and Bank research/support units and contained in the AACC/AICC note entitled, “**Reforming Afghanistan’s Fiscal Systems/Procedures**” dated August 14, 2005 and available on the web<sup>1</sup>. This note suggests a strategy for implementing the more private-sector-friendly fiscal advice contained, e.g., in the AACC/AICC note. The strategy primarily involves formulating one, or likely more than one projects for improving tax administration and implementing fiscal reforms, and then **reallocating** some of Afghanistan’s projected annual aid receipts toward financing these projects. Implied is the sanctioning of reductions (delays) in some projected aid to be allocated for financing other public sector expenditures, those that will in the future be financed with tax revenues.

6. This note, a companion piece to the previously mentioned AACC/AICC note, is organized around several statements (“maxims”) about Afghanistan’s tax system. A statement is proffered and then elaborated on. The intention is to convince readers of two main things. First, that the Government of Afghanistan (GOA) will have to spend more (allocate more aid) on improving the tax system and its administration. Stated as only an economist would, this note assumes that there is a **positive relationship** between greater (sensible) expenditures for tax reform/collection and growth in Afghanistan’s tax receipts, in both the short and long runs. In the short run greater (sensibly crafted) MOF expenditures on tax collections increase revenues by expanding the **breadth** of tax collections. In the longer term greater expenditures on reforms **hasten growth in a broadened tax base**. This greater expenditure/tax revenue relationship explains our recommendation that aid for tax and tax administrative reforms are funneled through new, well-defined and funded **tax reform projects**.

7. The second point is that GOA, or really some of its ministerial staff, should look past IMF and Bank country staff and deal more directly with IMF/Bank central or support staff on tax reform matters. This can be done primarily in the context of the donor-financed tax and tax administration reform projects that we are recommending. This approach was effectively done by China fifteen years ago, and is now being undertaken by Malaysia and Thailand.

**Statement 1: Afghanistan’s current tax and tax administration system  
is worse (less private investment friendly) than the  
IMF and World Bank country staffs think it is.**

8. A private-sector-friendly tax system is one that extracts modest amounts of taxes, widely, from the consumption expenditures, income and property of households, whose employment and income are growing. This growth will mainly occur because of expansion of private, mainly SME investment, particularly in services. None of this exists in the present Afghanistan where existing businesses, not households pay taxes and

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<sup>1</sup> <http://users.erols.com/rmyers1/ReformAfghanTaxes11-30-05.pdf>

investment is a very risky proposition. Given this risk, investors need to see the prospect of significant profits. Instead, although only about 5% of estimated non-drug GDP is collected through domestic taxes, these taxes are paid by a few, very visible, successful but unlucky businesses.

9. An important result of this over-taxation of big, visible businesses is excessively lowering legally earned and retained profits. This significantly suppresses private investment incentives. Other problems of this “tax big businesses” approach are excessive consumption expenditures (lower saving) by households and rapid growth in small, technically inefficient informal business activities that are outside the tax base.

10. It is misleading, if not wrong in the present investment circumstances for GOA and IMF/Bank officials to claim that things are fine because the tax system is better now than it was before (in the 1960s!) in Afghanistan and on a par with certain comparator countries. Afghanistan’s earlier tax regime was so awful, viewed from the perspective of private investment incentives, that it is an inappropriate comparison. And, for the most part other “comparator” countries currently have much less risky investment environments than Afghanistan. In addition, these comparisons ignore the direction of global tax reforms.

11. Comparing the present tax regime and administration to best practices is much more appropriate than comparing the present tax regime to the past or to comparator countries. AACC/AICC has argued that currently evolving best practice examples are Dubai, Malaysia and Thailand. A notable past success is China, which looked past IMF and Bank country staffs to the central support units in these institutions for help in fashioning aid-financed projects for reform or its tax and tax administration systems.

12. IMF and Bank country staffs are suggesting to GOA that the current aid-flows to the public sector will allow the current, flawed tax system/administration to squeak by. That is, that they are in many important ways compatible with longer-term growth in private enterprise. This is doubtful. Their reasoning seems to be that current resource flows to the public sector, some garnered through capricious taxation of businesses, will lead to improvements in governance and publicly provided infrastructure, thus attracting more private investment. This sequencing (improve the public sector first and private sector development will follow) has not proved successful elsewhere. Increased corruption and overseas bank balances are more the norm with this sequencing.

13. Furthermore, there are now cogent analyses, based on endogenous growth theories that suggest that the reverse sequencing is more likely to be the case.<sup>2</sup> That is, prior private sector growth generates better public sector governance.<sup>3</sup> AACC/AICC feels that GOA should give more credence to this newer private-sector-first approach. It has had a startling positive impact in Vietnam.<sup>4</sup>

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<sup>2</sup> Dani Rodrik,

<sup>3</sup> I’ve never been sure what “good” governance is, but the causal relationship suggested here **does not** imply that authoritarian regimes bring better GDP growth and therefore must precede democracies.

<sup>4</sup> See (references).

**Statement 2: Properly collected domestic taxes are better sources of public sector revenue than donor aid.**

14. The general donor belief is that aid, whether grants or soft loans is a perfect substitute for properly collected tax revenue. This is by no means true. However, the attractiveness of getting something for free, or at a huge discount, causes developing countries to be mesmerized by aid and attracted to it like moths are to open flame. Despite this attractiveness, it is frequently the case that aid is economically harmful and therefore not at all “free.”

15. Aid is at best an inferior replacement for properly collected tax revenue. At worst, aid alters economic incentives in anti-development ways. And, this “at worst” scenario is all too frequent. One significant negative dimension of aid is that it gives rise to something called the “Dutch disease.” This disease unfavorably alters domestic market, producer incentives (prices and profits) vis-à-vis imports, thus lowering the attractiveness of domestic investments relative to investing abroad. Another is that aid stimulates feelings of entitlement that reduce producer/worker incentives and increase shirking. This leads to a downward spiral, with increasing aid chasing falling production and productivity down.

16. Against these negative effects of aid are the positive impacts of financing public sector expenditures with appropriate domestic resource mobilization - properly collecting taxes and engaging in domestic borrowing. Of course the tax collections must be appropriately sized – as size is measured by the public sector to GDP ratio.<sup>5</sup> Given that modest taxes are a fact of life, they do not negatively affect work incentives, if fairly and properly collected. They are thus “free” resources in an opportunity cost sense, providing they are modest and properly collected. Indeed, for target income workers, taxes can actually increase production and productivity.

17. In addition, there is mounting evidence that widely and fairly collected taxes hasten the development of Democracy and improved governance – again, “for free” (i.e., without donor aid or budgetary allocations for these).<sup>6</sup> This positive relationship emerges from the basic notion that widely and fairly taxed residents will be more involved in and demanding of their government. As long as residents think taxes apply equally to all, they will be less likely to engage in evasion, bribing and other activities that negatively affect the quality of governance. But they will demand that their tax payments be properly and efficiently spent. These are basic notions regarding domestic resource mobilization. They are based on Alexander Hamilton’s notions as set out in the Federalist Papers.

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<sup>5</sup> In fact, an additional benefit of using domestically collected tax revenue rather than aid is to obtain a notion of what constitutes the appropriate “size” of the public sector.

<sup>6</sup> Footnote this.

18. The donor community reasons that aid is needed in developing countries because the residents of poor countries can't/don't save. This is generally not true. Most developing country resident households, including most Afghans, actually do save (really, "invest") primarily as insurance against the onset of "lean" years. However, given a general lack of accessible and credible domestic saving/investment opportunities, many poorer households invest in informal (sometimes illegal) economic activities. It is this household saving/investing proclivity that gives rise to AACC/AICC calls for significant improvements in Afghanistan's investment climate and for making investment opportunities easily and cheaply accessible to all. In fact, it may be the case that the donor position is reversed: Aid flows that finance consumption, directly or indirectly, may actually **reduce** or "crowd out" domestic saving/investing activity, especially if the aid flows appear to be permanent, which is reasonable (see below).

19. The fact that large numbers of Afghan households will save and invest as insurance against negative shocks has significant implications for domestic resource mobilization. First, it provides a huge rationale for favoring taxes (a GST or Vat) on consumption expenditures. Such taxes garner revenue from all sectors, including informal and illegal (dope) activity, while allowing/encouraging greater amounts of household saving/investing activity. The argument against immediately beginning to implement consumption taxes is that they are expensive and technically difficult to initiate. But this ignores two points. First, they bring huge and continuing benefits – hence the use of the term "investment" when referring to spending for initiating them. Second, there is still-tepid but increasing willingness amongst donors to finance this "investment" with free aid. It is these points that lie behind the call by AACC/AICC for the use of aid to finance tax reform projects or "investments".

20. Second, this household saving/investing proclivity, although ignored by donors, has important implications for government borrowing to finance public sector deficits. At present donors offer free or cheap financing for domestic public sector deficits based on the premise that domestic saving is nil. Indeed, the essence of IMF Standby programs is to regulate aggregate demand by insuring that public sector deficits are financed in a non-inflationary way – essentially by approximately balancing monetary inflows of aid with outflows for imports.

21. AACC/AICC has called for an alternative to these IMF programs, involving financing (reasonable) public sector deficits with domestic, public sector bond sales. This would control inflation and provide domestic households with accessible, hopefully credible and legal investment opportunities for their savings. These bond sales would, as with properly collected taxes, also, to paraphrase Alexander Hamilton, "give residents a stake in their government and give the government a stake in its residents".<sup>7</sup> As with tax and tax administration reform, there is an "investment" aspect to initiating credible domestic public sector bond sales that represents a potentially excellent, productive use of aid money.

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<sup>7</sup> Footnote this.

22. An issue on sequencing provides a quite different explanation for why developing countries that follow IMF/Bank country-staff fiscal advice have low private sector savings and investment growth. IMF/Bank country staff advise/favor use of maximum amounts of “free” donor aid and expertise to improve the fiscal/governance situation, supposedly then stimulating private sector-generated growth in employment, total factor productivity (TFP) and household income (i.e., the tax base). This “exogenous” approach, which at it’s most defined might be identified as the “Washington Consensus,”<sup>8</sup> is losing theoretical and empirical respectability, not least because public sectors suck savings from the private sector to finance consumption. However, this “government first” sequencing is strongly favored by donors: It gives aid and aid workers an apparently respectable humanitarian function. Successes clearly attributable to this approach and sequencing are difficult to identify however.

23. A reverse sequencing approach, less favored by donors, seems to work better. This involves first stimulating or allowing development of competitive private enterprise that leads to growth in employment, TFP and household income (the tax base) and through this, garnering improvements in fiscal/governance situations. This sequencing is consistent with the now more fashionable “endogenous” reform and growth theories. These theories are increasingly believed because the opposite, donor favored sequencing doesn’t seem to work and because endogenous change seems to be a plausible explanation for several success stories, including the Asian miracle. In particular, this private-sector-first approach was successfully adopted in the 1980s by Hong Kong, Singapore, Taiwan and Mauritius, in the 1990s by China, and now in Malaysia and Indonesia, following its success in China.

24. The success of this private-sector-first approach is attributable among other things to its more favorable impact on domestic savings and investment. Prior growth in private competitive business activities (but not private sector monopolies – see below) leads to more effective, endogenous rather than donor, financing and oversight of public sector activity. This discourages corruption. Such endogenous oversight more effectively motivates improvements in public sector efficiency and responsibility. In short, growth in competitive private enterprise provides more effective management of the public sector than the reverse situation, involving donors and public servants trying to foster and oversee in efficient private enterprise. Again, the most closely watched, apparently succeeding example of this private-sector-first approach is Vietnam.

**Statement 3: Under-funded tax administration encourages development-destroying monopolies.**

25. Monopolies are pure evil from a developmental perspective, both economically and politically. They are the antithesis of economic development and democracy. They prohibit growth in the employment, wages, income (i.e., the tax bases) and skew the income distribution, financing tyranny of the few over the many. Monopolies increase prices and revenues by restricting growth in output (GDP), employment, wages and the number of investors/businessmen. Monopoly-related ill-gotten gains are used to make

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<sup>8</sup> Footnote this.

corruption payments (to buy public servants and politicians) and to finance luxurious lifestyles for the few at the expense of the impoverishment of the many. It was his exposure of the evils of monopolies, not of private enterprise, that stimulated Karl Marx to propound his theories.<sup>9</sup>

26. Despite their evils, monopolies are public servants' and donors' dreams. They're easily and cheaply manageable and taxable. Public servants and donors can deal with and control a small group of businessmen rather than perhaps twenty times as many squabbling, competing entrepreneurs, all heading in different directions. Monopolized private sectors are so easy to collect taxes and gratuities from and to "reform" that they are sanctioned, even welcomed despite huge social costs. And, monopolies rationalize increased public sector interventions and regulations, again pandering to public servant proclivities.

27. In truth, most developing country governments that under-invest in tax administration/collection are stuck between a rock and a hard place. Aid dependency takes over because donor grants and loans are easier to attract and spend<sup>10</sup> than expanding tax collections. Monopoly-related super-normal revenues are easy to tax, even though monopolies and therefore monopolized tax bases don't grow. Governments must pander to donors to insure continued aid and lending flows, frequently equal to 50% of expenditures. And they must allow/grant monopoly privileges that doom growth prospects, instead providing a relatively stagnant but easily and cheaply collectable amount of revenue.

28. Such economies nearly always have rapidly growing, untaxed informal business sectors and myriads of untaxed traders who, of course do not charge or collect taxes on consumption expenditures. The result of this dependency on aid and monopoly garnered tax revenue is slow growth in formal sector employment, income, investment and savings, but rapid growth in informal (non-taxed) economic activity.

29. IMF, Bank and other donor country staff dislike monopolies in a knee-jerk way but find their existence very comforting when engaging in stabilization and policy adjustment initiatives.<sup>11</sup> The easiest situation for donors is an aid-dependent, compliant government and a small number of influential businessmen who must look to the government and donors to maintain monopoly privileges. Aid dependent governments do what donors tell them to do. And these governments will continually be dependent on aid if the domestic taxes are collected mainly from (aid financed) imports and monopolies, neither of which grows robustly. In addition, a monopolized formal sector more quickly accedes to reform proposals than a fragmented bunch of squabbling, narrowly self-interested businessmen do.

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<sup>9</sup> But Marx got it horribly wrong. He saw monopolies as inevitable and advocated owning/regulating them rather than preventing their emergence and/or breaking them up. Given the importance of competition to growth, this "regulated monopolies can be good" thesis haunts the development field.

<sup>10</sup> Taxpayers pay more attention to how public sector money is spent.

<sup>11</sup> Egypt and Uganda are archetypical country examples for this section on aid and monopolies.

30. Unfortunately, monopolists extract policy reform “exemptions” as the price for their tax payments. The most developmentally deadly favor they’re given is nay-say power over new, competing investments by “upstart” investors.<sup>12</sup> Monopolists’ point to existence of excess capacity in arguing against issuing competitor licenses, without confessing that such excess productive capacity, a major consequence of their monopoly status, would disappear quickly if per unit prices were lowered.

31. Empirical practitioners see these aid dependency/monopoly problems as being serious: much more so than donor staffs do. To the (scant) extent that the problems are recognized and thought about by donor staff<sup>13</sup>, they would most probably be viewed as a second order sequencing problem related to the one discussed in paragraphs 22-24 above. Donors might argue, conceptually, that the emergence of monopolies is initially welcome: first because they allow easy and cheap tax collections - to finance strengthening of governance and growth-enhancing public sector initiatives – and second because they enable achievement of economies of scale. Key to this sequencing logic is the timely appearance of appropriate regulation, rather than competition. It is argued that these monopolies will provide the revenue and GDP growth that subsequently finances enhancements and improvements to their own regulation<sup>14</sup> -- regulation that will force them to act in socially beneficial ways.

32. Belief in this “monopoly-first-regulation-later” sequencing reached a nadir in the late 1960s and still has devotees, especially among control-oriented people who might be called “administrative Socialists”. However, most empirically oriented professional economists see it as being pure balderdash. Such sequencing doesn’t work in practice, for several reasons. One is that monopolists won’t let public servants (who are essentially getting paid by taxes on monopolies) regulate monopolies in socially beneficial ways. Another is that there is a dearth of knowledge regarding how to regulate monopolies in developmentally helpful ways. For this and other reasons, donors look the other way when it comes to monopolies: They offer a lot of aid, but don’t allocate much of it to reduce aid-dependency and/or to regulate/break up monopolies.

33. But the main reason this “monopolies-first” sequencing doesn’t cause positive development is that it can’t. True, some exogenous growth people believe that anything’s possible. However, the endogenous growth people argue effectively and empirically that monopolies are fundamentally incompatible with longer-term development. Monopolies don’t innovate and grow. In fact, the absence of growth inducing innovation in regulated monopolies is precisely why regulation isn’t a substitute for competition or “creative destruction”.<sup>15</sup> Regulating monopolies so as to make them innovate and grow is as

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<sup>12</sup> Footnote my 10 vs. 100 businessmen note.

<sup>13</sup> In truth, donor staffs don’t often consider this problem. I’m intuiting an explanation for their thinking that they themselves probably wouldn’t admit to. However, their behavior is consistent with my explanation.

<sup>14</sup> The acceptability of this sequencing is suggested in the book, REALITY CHECK: The Distributional Impact of Privatization in Developing Countries: John Nellis and Nancy Birdsall (ed). Center for Global Development, Washington, DC, October, 2005. See p. 28 for a summary of this point.

<sup>15</sup> Schumpeter

impossible as trying to “push a rope” or move a heavy box by pushing on an attached rope, meant to pull it.

34. We are left then with the argument that if private sector competition and growth in employment, investment and incomes are to flourish, Afghanistan must “invest” early and relatively heavily in designing modest taxes on consumption and income and broadening tax collection to cover most households. Relying on inexpensive, inappropriate ways of collecting taxes from businesses is bad for two reasons: It directly depresses private investment incentives because taxes on businesses (rather than on e.g., consumption expenditures) discourage private investors. In addition, there is indirect suppression because administering tax administration on the cheap breeds corruption and monopolies that, by their nature, prevent competing private investment and growth in the tax base.

**Statement 4: Aid flows are essentially perpetual but alter budgetary processes in developmentally unfavorable ways.**

35. There is a tendency for aid-receiving governments and donor advisors to think that any and all aid should be accepted when and in the form it’s offered. The reasoning behind this is a belief that aid offers will dry up after five years or so. A companion belief is that all aid offers should be accepted because they are always good for development. Neither of these is true. In fact, the gross amounts of aid flows to public sector budgets are virtually perpetual. However, they introduce artificial elements to the budgetary process that are developmentally harmful.

36. The evils of aid dependency dealt with above concern the fact that the relative certainty of generous aid disbursements, frequently equal to about 50% of public sector expenditures, reduces incentives to improve the tax system and tax collection apparatus. That is, relatively certain gross aid in-flows reduce incentives to make the fiscal system self-sustaining. Of greater concern in this subsection is that such aid and loan flows intermittently alter the pattern of public sector expenditures, introducing fiscal uncertainties that are developmentally harmful. That is the changing composition of these relatively constant aid flows forces adjustments in budgeting practices and public sector expenditure patterns that are developmentally unsettling.

37. Much of this uncertainty comes about because of different meanings of the term “sustainability.” IMF country staff view the term from a Macro-stabilization perspective – aid flows must equal but not exceed targets established in a financing framework. But other IMF/Bank staff see a “micro” aid dependency problem involving the productivity of aid receipts. This occurs because donors, mindful of macro sustainability issues want to maintain overall aid flow volumes, but must alter the composition of their aid pledges to do so. A donor can maintain a \$50 million annual aid flow to Afghanistan only if the focus of the aid keeps shifting (e.g., from agriculture, to health, to...) to create perceptions of sustainable successes.

38. In effect, an IMF country staff, stabilization-related concern for achieving targeted aid-flow volumes each year overrides other IMF/Bank staff concerns about the composition and purpose of aid. Suppose the IMF's financing framework shows that an GOA must fill, but not overfill an aid gap of \$20 million.<sup>16</sup> IMF country staff will be motivated to value certainty of receipt more than the productivity of aid pledges. A quite certain pledged aid disbursement of \$20 million to be used for consumption imports will be given pride of place in the fiscal and BOP budgets over more slowly disbursing aid pledges for investments. And worse, once the \$20 million is accepted in year one, it'll have to re-occur in order to make the IMF financial framework balance in years two and three, etc.

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<sup>16</sup> This would be aid that finances \$20 of local currency budgetary expenses **and** imports requiring about \$20 million of foreign exchange.