

CHAPTER 4. MOBILIZING DOMESTIC REVENUES

4.1 As seen in Chapter 3, sustained rapid growth of domestic revenue is a central element of Afghanistan's state-building and reconstruction agenda. International experience suggests that the larger the tax gap (the difference between the taxes actually paid and what should be paid according to existing laws and statutes), the more radical are the changes needed. With a tax gap on the order of 60%, Afghanistan needs to adopt a comprehensive strategy including revamping of the tax administration in order to obtain significant improvements in compliance. Based on the more detailed analysis in Volume III, Chapter 1, this chapter first briefly outlines the key features of Afghanistan's existing revenue base. It then reviews progress and summarizes key issues in improving revenue policy and strengthening tax administration. The last section presents some illustrative medium-term revenue projections.

A. Revenue Structure

4.2 While in industrialized countries the revenue to GDP ratio is typically around 45-55%, for the least developed countries it is closer to 20%. With revenue at 4.5% of GDP in 2004/05, Afghanistan is an outlier even in this group (Table 4.1). Tax revenues (3.4% of GDP) are only one-fourth the average for low-income countries.

Table 4. 1: Central Government Revenues (% of GDP)

Country/region	GDP per capita (USD) 1/	Total revenue	Total tax revenue
Afghanistan (FY2004/05 est.)	253	4.5	3.4
Sub-Saharan Africa	765	19.7	15.9
Asia and Pacific	1,447	16.6	13.2
Low-income countries	n/a	18.0	14.9
Low- middle income countries	n/a	21.8	15.8
Non-OECD average	n/a	n/a	15.2
Selected countries average	n/a	17.4	14.8
Pakistan	420	16.4	12.4
Iran	1,700	20.5	8.6
India	470	18.5	14.3
Kazakhstan	1,520	22.3	18.4
Kyrgyz Republic	290	19.1	15.0
Azerbaijan	710	20.5	19.4
Uganda	240	11.5	10.7
Rwanda	n/a	10.4	n/a

Sources: Government Finance Statistics (IMF); Keen (2004).

Notes: Figures refer to country averages between 1997-2001, where available.

For each revenue classification, only countries for which data are available are included.

1/ Country data refers to GNI per capita (World Bank)

4.3 Afghanistan's economy has many features commonly associated with a low tax base, including: (i) extremely low level of development; (ii) a large informal sector implying a narrow tax base; (iii) the dominance of agriculture which is hard to tax; and (iv) capacity constraints hindering the ability of the Government to collect taxes and of taxpayers to comply with tax regulations. Revenue mobilization is further complicated by the large opium economy that cannot be taxed directly, the need to consolidate Government control throughout the country, and heavy reliance on aid funds that are exempt from taxation. In addition, Afghanistan historically had very low domestic revenue mobilization — in the 1970s the tax to GDP ratio was around 7%, one of the lowest in the world. Afghanistan's medium-term revenue potential therefore is likely to be toward the lower end of the 11-14% of GDP range.

4.4 Domestic revenues have grown significantly over the last two years, starting from an extremely low base. In 2002/03, they reached \$129 million, equivalent to 3.2% of GDP. In 2003/04, revenues reached \$208 million (4.5% of GDP), and in 2004/05 they rose to an estimated \$269 million, also 4.5% of

GDP (Table 4.2). The 2005/06 budget projected a modest increase in revenues to \$333 million (4.7% of projected GDP).

Table 4. 2: Domestic Revenue Collection

	2002/03	2003/04	2004/05	2005/06
	Est.	Est.	Est.	Budget
Domestic Revenue (percentage GDP)	3.2	4.5	4.5	4.7
Domestic Revenue (Afs)	5,864	10,168	12,812	16,150
Domestic Revenue (\$)	129	208	269	333
Domestic Revenue (percentage shares)	..	100	100	..
<i>Tax Revenues</i>		62	75	
Taxes on income, profits and capital gains		4	8	
Domestic taxes on goods and services		3	9	
Taxes on international trade and transactions		53	57	
of which: Import duties		52	54	
<i>Non Tax Revenues</i>		38	25	
Admin. fees & charges, non-industrial sales		35	20	
Central Ministries (percentage shares)	..	29	21	..
Provinces	..	71	79	..
of which (in percent of total revenue),				
Herat		41	34	
Kandahar		7	11	
Nangarhar		7	12	
Kabul		5	5	
Balkh		3	9	

Source: MOF, Fund staff estimates.

4.5 **Revenue is concentrated in a small number of taxes** (Table 4.2). As in many less developed economies, import duties are the main source of revenue because they are relatively easy to monitor and collect, comprising over 50% of the total (Table A.5 in the Statistical Annex). Box 4.1 summarizes the major tax instruments currently being utilized in Afghanistan.

Box 4. 1: Summary of Major Tax Instruments in Afghanistan

Customs duties constitute the largest source of revenue in Afghanistan, as in many developing countries, largely because they are relatively simple to administer. While domestic taxes tend to grow in importance as countries develop, these are more difficult to administer and will be a long-term objective for Afghanistan. In the interim, the average import tariff should be kept relatively low, with a limited dispersion of rates to reduce arbitrary and excessive effective rates of protection as well as to minimize opportunities and incentives for corruption.

Export taxes should be avoided since they tend to cause an outflow of resources from the export sector to less efficient uses, compromising growth objectives. Recent tax reforms have lowered tax rates for exporters.

Income Taxes. Income taxes ideally should be levied on a global basis and include all forms of income. The corporate and top personal tax rates have been aligned at 20%, relatively low by international standards. Accompanying this move, new administrative provisions were added to the law, including introduction of self-assessment principles; provision for tax rulings so that investors have greater certainty about tax rules; and strict secrecy rules to heighten the accountability of the tax administration in dealing with sensitive business information. The planned restoration of the wage withholding tax and the simplification of personal tax rates, with only two nonzero personal rates, should help improve compliance. The level of exemption has been set to effectively remove most civil servants from taxation (which should ensure a progressive system).

Sales taxes. These taxes should be consolidated as a simple and broadly based tax on final consumption. However, Afghanistan currently has a complex and cascading system of Business Receipts Tax (BRT) based on turnover and numerous presumptive (fixed) taxes for smaller traders, which is far from ideal. While a single rate Value-added-tax (VAT), with crediting provisions and zero-rating of exports, is one of the most efficient taxes, it would be administratively too complex to implement at this time. However, over the medium term Afghanistan should expand the BRT toward a more broad-based consumption tax that broadens the tax base and avoids cascading.

Excise taxes. There are currently no excise taxes in Afghanistan.

4.6 **Over 93% of total revenue is collected either by Central Ministries (mainly in Kabul) or in just five of Afghanistan's 34 provinces:** Herat, Nangarhar, Kandahar, Balkh, and Kabul. Four ministries account for 88% of total revenue reported by central ministries: MoF, Ministry of Communications which derives revenue from the sale of telephone services, Ministry of Commerce from commissions on imported goods, and Ministry of Interior from motor vehicle registrations.

4.7 ***In addition, municipalities collect some revenues.*** These include, for example in the case of Kabul, taxes on real estate (a rental tax and a levy on property notionally intended to cover the cost of sanitation services); various duties for business licenses, contracts, property deeds, markets, etc.; fees for services (e.g. cleaning of septic tanks of residential properties); rents; and proceeds from sale of land etc. The revenue yields of these taxes and levies are low, however: in the case of Kabul, total municipal revenues in 2004/05 are roughly estimated at around \$6 million – in a center of economic activity with a population of around three million.

4.8 ***There are many small “nuisance” taxes.*** With around 90 active taxes – half of them generating less than Afs 1 million (\$21,000) during 2004/05 – the administrative costs of some taxes most likely outweigh the revenue gain. The income tax law provides for a variety of presumptive taxes on small businesses, usually referred to as fixed taxes, as well as the cascading turnover tax (BRT). The law also identifies 170 tax categories of business establishments. Removing many of these small “nuisance” taxes and simplifying the tax collection system will be cost-effective and helpful to the private sector.

4.9 ***There are also illicit taxes and instances of double taxation or ambiguities in tax laws.*** The business community has noted numerous cases where illicit taxes add to the cost of business. For example, additional “transport taxes” may be levied on the owner of the goods, and provincial or municipal authorities may charge other ill-defined taxes. Municipal taxes also need to be streamlined as noted above, and there are cases of double taxation, for example on rental property income as the central government introduced a new services tax on rental income in 2004 (in most countries, property income is taxed at the local level). Businesses have also complained that the legal code is often unclear; for example with respect to tax-deductible expenses, with varying interpretations. This can lead to disputes and corruption.

B. Improving Revenue Policy and Tax Administration

4.10 MoF is responsible for revenue policy and revenue collection, with functions divided between the Afghanistan Customs Department (ACD) and the General Presidency of Revenue (GPR). The ACD historically has been a much more distinct entity, with functions including collection of customs duties and management of a customs service. The GPR has traditionally been in charge of domestic taxation policy, with actual collection being handled by the Mustoufiats.

GENERAL APPROACH

4.11 ***The ideal tax system raises in a fair manner the required revenues while minimizing distortions.*** It should (i) minimize interference with individual consumption, saving, and investment decisions; (ii) be relatively simple, transparent, and rules-based to encourage compliance and discourage corruption; and (iii) be stable and predictable to reduce uncertainty.

4.12 ***The Government’s strategy should focus on improving compliance for taxes and locations with the highest revenue yields.*** This also implies getting rid of numerous low-yield “nuisance taxes” and curbing illicit levies as well as avoiding double-taxation and confusion. Some taxes may have good potential over the longer run, but large revenue yields in the short- to medium-term should not be expected. Mineral exploitation has good potential and is likely to generate tax and other revenues once the recently approved Minerals Law is implemented (see Volume IV, Chapter 4). Similar potentials may also exist in hydrocarbons, for which a Hydrocarbons Law is being prepared. However, these potential revenue sources will take time to develop.

4.13 Agricultural taxes have a long history as a religious tax (*zakat*). Subsequently taken over by the State and collected at the local level, agricultural tax was once a significant source of revenue. However, it has fallen into disuse over a long period of time, and any attempt to reinstate it is likely to be severely hampered by the security situation and prevalence of opium, as well as widespread poverty in rural areas. Nonetheless, given the importance of agriculture to the economy – and to avoid distortions that might

result from exempting an entire sector permanently from taxation – it may be advisable to revitalize agricultural and land taxes over time.

4.14 ***Tax policy and tax administration reform will be closely linked.*** Afghanistan’s strategy for revenue mobilization needs to take into account the very weak state of institutions and limited implementation capacity. Tax policy needs to provide a modern framework within which the tax administration can be built. International experience suggests the following guiding principles for tax administration reform: (i) ***reducing the complexity of the tax system*** by reducing the number of taxes, harmonizing rates, reducing exemptions, and eliminating illicit charges and double taxation; (ii) ***encouraging taxpayers’ voluntary compliance*** with simplified self-assessment procedures and better taxpayer education; (iii) ***differentiating the treatment of taxpayers by their revenue potential***, commonly through the creation of a Large taxpayer Office and risk management strategies; and (iv) ***ensuring effective management of tax reforms.***

4.15 ***A major improvement was the establishment in 2004 of the Treasury Single Account (TSA)***, which integrates Government accounts into an account or set of linked accounts through which the Government collects revenues and transacts payments. The apex of the system is a single account held by the Ministry of Finance (Treasury) at the Central Bank. The TSA is designed to ensure that all Government revenues, wherever collected, are transferred to the central Government.

4.16 ***Civil service reforms are required to develop a motivated and skilled cadre of revenue staff*** (Chapter 9). The customs and tax administrations face unique challenges in having to collect funds for the Government, which increases the risk of corruption. Therefore a key component of the customs and tax reform programs is the development of professional (dedicated) tax and customs services. This entails specialized training programs and institutions, a career development structure within the service, and as and when appropriate, a performance-based remuneration system. These reforms are currently being undertaken as part of MoF’s PRR program

CUSTOMS ADMINISTRATION REFORM

4.17 Customs administration reform will continue to be critical for success. During 2004, the ACD implemented important measures to: (i) simplify the tariff system (Box 4.2); (ii) introduce simplified customs clearance documentation and procedures; and (iii) establish an effective system of customs brokers to facilitate a speedier transit process. Ongoing reforms are extending ACD’s operations in the provinces and include: (i) a modern customs code; (ii) major improvements in the customs infrastructure throughout the country; (iii) gradual introduction of a computerized recording and management system (ASYCUDA, a standard international program for customs, Box 7.2); (iv) re-organizing and re-building of human capacity in the central and regional customs offices; and (v) legislation to establish effective enforcement mechanisms, combined with an effort to reduce illegal charges and consolidate and rationalize the number of charges.

4.18 The Customs administration faces many challenges, including the poor security environment, lack of experienced managers, poorly trained staff, inadequate facilities and equipment, and outdated and cumbersome operating policies and procedures. Customs regulations reportedly are not applied consistently throughout the country, and the lack of an automated system undoubtedly impacts negatively on revenue performance.

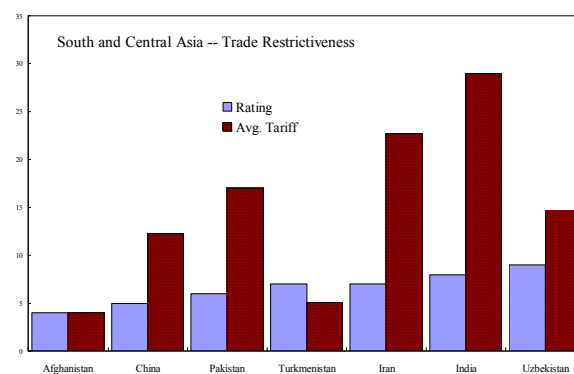
DOMESTIC TAX ADMINISTRATION REFORM

4.19 The domestic tax base is likely to remain relatively narrow for some time, and reforms being implemented will focus on large taxpayers. The current set of reforms includes: (i) the adoption of a tax reform package in June 2004; (ii) the creation of a Large Taxpayer Office (LTO) and restructuring of the headquarters and provincial revenue organizations; (iii) the nationwide roll-out of a new Taxpayer Identification Number (TIN); and (iv) the consolidation of tax legislation amendments to address the excessive use of tax holidays, exemptions, and “special agreements”.

Box 4. 2: Afghanistan's Trade Regime

Establishment of an open and transparent trade regime has been a consistent priority of the Government, which has made sweeping tariff and customs administration reforms, resulting in a significant improvement in transparency and simplicity, leaving Afghanistan as one of the most open economies in the region.

Under the previous trade regime there were 25 tariff bands, with rates ranging from 7-150%, and with a simple average of about 43%. However, a highly-appreciated artificial exchange rate was used in calculating payments of customs duties (made in domestic currency), which meant that actual payments were on the order of only 5-10% of nominal tariff levels. An overhaul of the tariff system brought the number of rates down to six (2.5, 4, 5, 8, 10, and 16%), with relatively low dispersion of rates, and shifted to use of the market exchange rate in calculating duties payable. By virtue of this rationalization, the average tariff declined to 4% (weighted by the number of items in each rate category). Even with the addition of a range of "fees", the estimated average applied tariff is only 5.3% – the lowest in the region. Afghanistan maintains import bans on only a few products (largely for religious purposes), and imposes no seasonal restrictions, quotas, or other non-tariff barriers. Furthermore, licensing requirements – reformed effective April 2004 – have been drastically simplified. The import license application process, which previously involved 42 steps, 58 signatures, and several weeks of processing, now involves only three steps, six signatures, and two days to process. As a result, Afghanistan's trade regime currently rates as a "4" in terms of the IMF's Trade Restrictiveness Index, same as the EU and United States.



4.20 *A focus on large taxpayers can enhance revenues.* In many countries a small number of taxpayers (perhaps 5%) account for 75% or more of total tax collections. In Afghanistan, the need to focus on large taxpayers is heightened by the low level of compliance and very limited administrative capacity. Afghanistan established an LTO in 2004 within the Revenue Directorate of MoF. In order to become fully effective, this newly-created organization needs to focus on selecting and then developing an appropriate relationship with the largest taxpayers, and should not get diverted to collect revenue from smaller clients. Appropriate criteria for large taxpayers have been developed by the Government. Within about two years, the LTO can be expected to be collecting at least 60% of total (non-customs) domestic tax revenue.

4.21 *Reform of provincial tax offices will require long-term capacity building efforts.* Although the LTO in due course should collect a considerable proportion of tax receipts, the provincial revenue offices, currently based in the Mustoufiats, will continue to collect substantial amounts, which will be important to ensure a relatively broad base of taxation. However, the GPR has never been the headquarters of the tax administration as the provincial Mustoufiats report to the Treasury. To develop a more professional service, the current PRR plan aims to build a new tax administration headquarters and operational tax offices in provinces reporting to it.

MOVING TOWARD A BROAD-BASED CONSUMPTION TAX

4.22 The current indirect tax system has serious deficiencies, including: (i) a narrow tax base leading to low revenue yield; (ii) serious potential cascading (albeit generally at a low rate); and (iii) disincentives to export. These problems could be addressed by moving toward a broad-based manufacturers sales tax in 3-5 years, which can generate a significant amount of revenue and will be necessary to ensure fiscal sustainability over the longer term. Value Added Tax (VAT) is the most common form of consumption tax imposed by central governments, used in more than 100 countries.⁹ However, introduction of a VAT

⁹ In a VAT system, all persons or businesses engaged in supply of taxable goods and services are required to register for VAT and charge VAT on all taxable sales. Their actual liability, however, is only the net of the VAT charged on their sales (output tax), reduced by the VAT paid or payable by them (input tax) for goods and services purchased for use in their taxable activities.

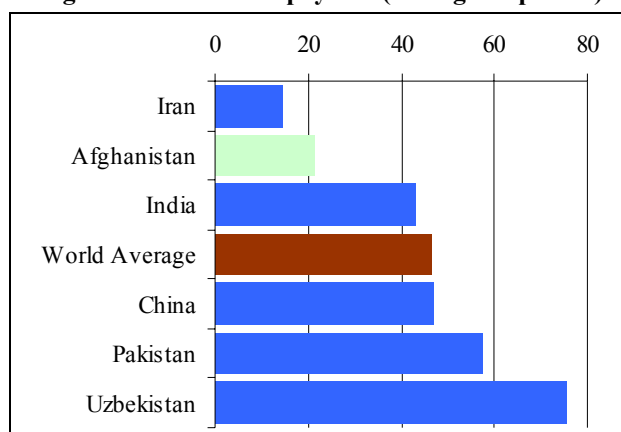
through to the retail level may represent a more radical reform of the tax system than the Government is prepared to introduce, or is needed.

4.23 ***A single-stage sales tax at manufacturing level may be the best option.*** Phased extension of the recently introduced taxes on selected services could pave the way for a broader-based consumption tax as development of administrative capacity permits. A manufacturing sales tax imposes the tax at the point where goods are first sold in the case of domestically produced goods, and at the point of customs clearance for imported goods. A single tax rate for all goods would be simpler to administer and would not distort relative prices. This kind of sales tax has been employed in many countries in the earlier stages of their tax development, and it can be expanded further to wholesale and eventually retail commerce with a minimum of disruption.

TAXATION AND INVESTMENT INCENTIVES

4.24 Overall, the tax regime in Afghanistan is rather competitive, with one of the lowest corporate income tax rates in the region. In 2004, the corporate income tax was reduced to a flat rate of 20% of net taxable income. Cross-country comparisons of tax rates are difficult, but in Pakistan corporate tax rates range from 35% to 50%, Iran charges a flat rate of 25%, in China the rate is 30%, in India the rate is 36.75% for domestic companies with a more complex schedule for foreign companies, and in Uzbekistan the corporate tax rate ranges from 20-35%. Figure 4.1 highlights Afghanistan's relative position by comparing the total tax burden (excluding tax on labor) that would face a typical firm in several countries.

Figure 4. 1: Total tax payable (% of gross profits)



Note: World Average covers 155 countries. Source: *Doing Business Indicators*, World Bank.

4.25 The first-best strategy for sustained investment promotion consists of providing a ***secure, stable, and transparent legal and regulatory framework***, as well as adequate supporting institutions, including a tax system in line with international norms. On the other hand, available evidence suggests that providing ***tax incentives for investment promotion*** is not cost-effective and that the revenue cost is potentially significant. As a general rule, indirect tax incentives should be avoided (as inefficient), and discretion in granting incentives should be minimized as this can encourage corruption.

4.26 More specifically, tax holidays, which are widespread in developing countries, have well-known shortcomings. They basically consist of applying a rate of corporate income tax lower than the regular rate – often zero – to companies in a certain sector or region for a pre-specified period. The main objective of tax holidays is to increase investment. They raise several issues:

- By exempting profits irrespective of their amount, tax holidays benefit an investor who expects a high rate of return and probably would have invested even without the incentive.
- Tax holidays provide strong incentives for tax avoidance, as taxed enterprises could enter into economic relationships with exempt ones to shift their profits to the latter through transfer pricing. The duration of tax holidays also is prone to abuse.

- Time-bound tax holidays, if they have any impact at all, tend to attract short-run projects, which typically are less beneficial for the economy. In Afghanistan, over 40% of tax holidays granted before mid-2004 were reportedly awarded to construction companies.
- The revenue cost is seldom transparent, unless enterprises are required to file proper tax returns and the aggregate fiscal “loss” is calculated. Conservative estimates by MoF put the revenue loss due to exemptions and concessions granted prior to July 2004 at \$30 million.
- Tax incentives could be of questionable value to a foreign investor because the benefits may be offset when profits are repatriated through an increased tax charge in the home country.

4.27 In 2004, tax holidays and exemptions were replaced by two tax incentives: accelerated depreciation and unlimited loss carry-forward. These have the least of the shortcomings associated with tax incentives. Since merely accelerating depreciation of an asset does not increase the total allowable depreciation beyond its original cost, little distortion in favor of short-lived assets is generated. Neither is there much incentive for an enterprise to engage in tax abuse. Accelerated depreciation also does not have the other negative elements associated with tax credits.

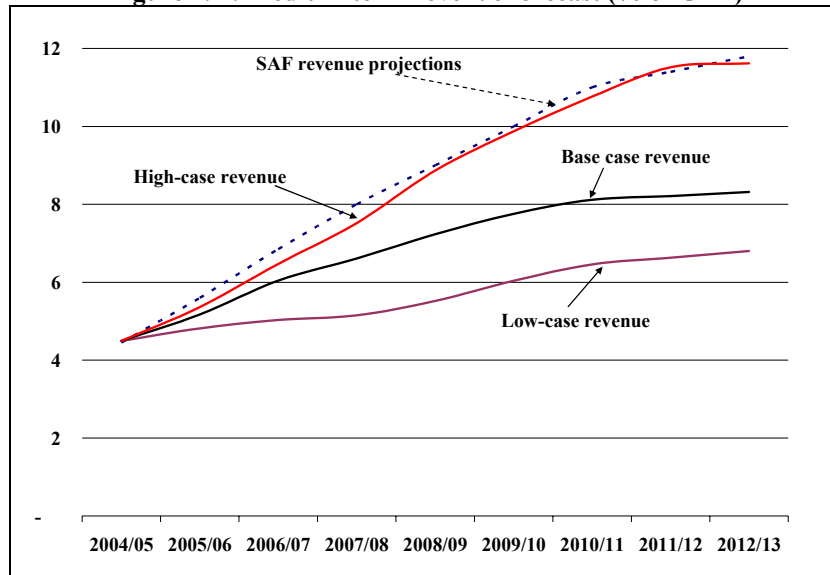
C. Medium-term Revenue Projections

4.28 Underlying the fiscal scenarios outlined in Chapter 3 are illustrative revenue projections driven by: (1) economic growth and inflation; (2) customs and tax policy reforms; (3) customs administration reforms; and (4) tax administration reforms. The macroeconomic assumptions are similar for each scenario, with real GDP growing at around 10% over the first four years and falling to around 7.5% thereafter. Inflation also falls from an initial rate of 10% per annum to 5%, while the nominal exchange rate remains stable. Several alternative scenarios illustrate the implications of different reform paths over a ten-year period:

- *Scenario 1 (baseline case) assumes gradual implementation of the five-year customs and tax administration reforms.* These include the wage withholding tax (raising a total of \$120 million in the first three years); selected service taxes including roll-out to other urban centers (\$36 million in the first five years); and the airport tax (\$2.7 million over three years). Improvements in compliance are 10-15% per annum during the first six years before falling to 5% per annum subsequently.
- *Scenario 2 (high-case) assumes accelerated implementation of the five-year customs and tax administration reforms combined with additional revenue measures.* Improvements in compliance rates are higher than in scenario 1, 20% p.a. in the first four years, then gradually falling to 5% annually, assuming stronger performance from Customs administration and the LTO. There is also a gradual move toward a consumption tax which broadens the tax base, and eventually royalties from the mineral sector gradually come on stream.
- *Scenario 3 (low case) assumes no further tax policy reforms.* Based on reforms so far, compliance rates improve by around 10% p.a. during the first six years before falling to 5% p.a. thereafter. No additional major policy reforms are implemented.

4.29 The revenue ratios for each scenario are shown as a percentage of GDP in Figure 4.2 (see also Statistical Appendix Table A.6). These ratios may provide useful benchmarks for assessing Afghanistan’s revenue path. As discussed in Chapter 3, in the low case scenario Afghanistan would fail to meet a number of its policy objectives. ***While the high-case scenario would require considerable efforts and thorough reform implementation, experience in other post-conflict countries suggests that it could be achieved.*** Although the revenue to GDP ratio rises by in excess of one percentage point per year in the first four years, some other post-conflict countries have achieved this level of revenue performance. For example, the creation of the revenue authority in Uganda helped to double the tax revenue/GDP ratio from 6% to around 12% in the 1990s (Figure 4.3b). In Rwanda the tax revenue/GDP ratio increased sharply from a low of 4% in 1994 to around 12% in late 2002 (Figure 4.3a).

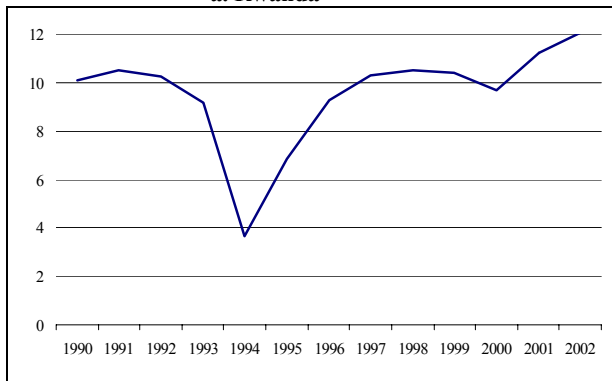
Figure 4. 2: Medium-term revenue forecast (% of GDP)



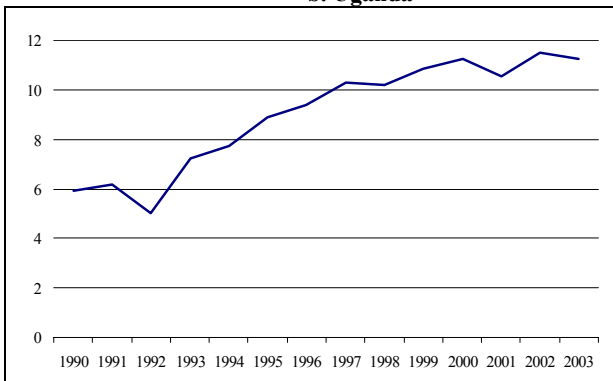
Source: *Securing Afghanistan's Future (SAF) and IMF estimates.*

Figure 4. 3: Comparative Growth in Revenue Collection (% of GDP)

a. Rwanda



b. Uganda



Source: *IMF, Government Financial Statistics and Staff reports.*

4.30 **However, Afghanistan's particular context and the inherent risks it faces should be kept in mind.** The country's GDP, for example, depends to a large degree on agriculture, which is volatile. The exchange rate, relatively stable since the introduction of the new Afghani (and assumed to remain so under all scenarios), may also be subject to bouts of instability in the face of shifts in demand, uneven aid inflows, or actions against the opium economy. Furthermore, institutional capacity is still weak, and the quality of policy-making (while strong thus far) is uncertain over the medium term. These factors suggest that there is a risk that revenues would turn out to be considerably lower than projected here.

4.31 **Nevertheless, fiscal sustainability considerations (Chapter 3) imply that increasing domestic revenue mobilization needs to be given very high priority.** This will reduce aid dependence over time, create fiscal space for development, and send a very strong signal of the Government's commitment to progressing toward fiscal sustainability – both to Afghanistan's own people and to the international community – thereby enhancing the latter's confidence to continue to provide financing for the country's operating budget until the gap between recurrent expenditures and revenues is bridged.