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Thoughts On Reforming Afghanistan's Tax and Public Sector Resource Mobilization Systems/Procedures

Introduction

1. AACC/AICC should be concerned that discussions of tax reform in Afghanistan will focus too much on what kinds of new taxes are needed, without first addressing the current system's bias against private enterprise. If the private sector, the Government's tax base, is to thrive in Afghanistan, there is a need to dismantle diverse elements of the present tax system and to disenfranchise many of an excessive number of public officials empowered to collect fees and taxes. A first step in tax reform might be to reduce the number of taxes and to consolidate tax and fee collection into the hands of a significantly smaller, more transparently identified number of personnel. In short, tax reform in Afghanistan could initially be viewed more as starting over, rather than trying to improve or add on to the present tax system. This starting over process, involving reducing the number of taxes and empowered tax collection officials is discussed as Item 1 below

2. In starting over, AACC/AICC might encourage the Government to adopt new fiscal policies and precedents that allow/encourage early expansion of the private sector, the Government's tax base, as a means of subsequently providing financing for increased public sector expenditures. Two alternative approaches should be rejected. The Government should not use public sector foreign borrowing to supplement domestic taxes in order to allow larger-than-otherwise public sector expenditures. The foreign-debt-inflated growth of public sector activities and the ensuing debt overhang prevents vibrant, efficient private sector growth. The Government should also rely on growth in the tax base to garner more revenue and avoid adopting excessively onerous or distortionary taxes that stifle private sector activity and/or drive it into the informal economy. Doing so will compromise future growth in GDP, the tax base, and the Government's future tax collections.

3. In the past, AACC/AICC has advocated that there be a "one-stop" investment agency, and that the only major initial requirement for prospective investors be that they register with the tax authorities and file annual tax returns. Following the discussion in item regarding starting over four more private sector-friendly issues are advocated under three more sub headings -- items 2, 3, and 4. **Item 2** advocates that overall public sector fiscal expenditures should be controlled so that they do not exceed 15% of GDP and deficits targeted to not exceed (say, 3%) of GDP. **Item 3** advocates that normal (i.e., not exceptional, shock-related) public sector deficits should be financed through public sector bonds, denominated in domestic currency and sold (and re-sold) in domestic asset markets. **Item 4** concerns the fact that taxes for revenue[1] should fall on consumption expenditures, not on savings, investment and production[2].

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[1] This note focuses on taxation to collect revenue rather than excise taxes, e.g., on cigarettes and environmental destruction that "correct" for anti-social behavior.
[2] This is based on the detailed tax reform manual published in 1991 by the World Bank entitled, LESSONS OF TAX REFORM, authored by Dr. Zmarak Shalizi and available on line at: www-wds.worldbank.org/servlet/WDS_IBank_Servlet?pcont=details&eid=000178830_98101910594254

4. If these principles are rigorously and successfully followed Afghanistan's public sector will become dependent on and accountable to a vibrant, expanding competitive private sector. Afghan households and producers will feel a sense of ownership of, rather than alienation from, their government. Private enterprise growth will aid in the development of an effective, non-corrupt public sector. The alternative sequencing, involving borrowing significant amounts of policy-conditional foreign financing to strengthen the public sector should be avoided, or at least sparingly resorted to. Such foreign borrowing has been a noticeably less effective in other countries that have accumulated large external debt overhangs and developed slowly. In these latter circumstances, private sector growth has been slow, if not nil, particularly compared to public sector growth. Private enterprises have become increasingly beholden to politicians and public servants for revenue, rather than on selling efficiently produced output[3].

I. Retrench the Present Tax System, Adopt Fewer Taxes, and Enfranchise a Limited Number of Tax Collectors

5. The current tax system and collection precedents make it difficult for private businesses to operate successfully in Afghanistan. Businesses are subject to interventions by significant numbers of officials, each empowered by the present tax laws and precedents to collect modest fees. Despite the breath of these interventions, the present tax system garners only modest revenue for the Government. Instead, most revenue collections from private businesses go astray rather than helping finance public sector expenditures. **Appendix 1** at the end of this note, entitled, "Tax Collectors Run Amok" contains two paragraphs chronicling the tax treatment that each private businessman and citizen in Afghanistan faces. Experience in other developing countries suggests that such an extensive, diverse, confusing and intrusive tax system poses significant barriers for growth in efficient private enterprise. Among other things, it encourages many private savers and investors will operate "outside" the formal economic system.

6. The present public sector resource mobilization system is a legacy of ad hoc taxes from several past regimes. Each regime added taxes and tax collection precedents rather than revamping the whole tax system. This has led to the need for a total revamping of the system. The existing multiplicity of taxes and collection points benefits to those in the tax system but makes it difficult for private investors to operate profitability. Indeed, many taxes can be viewed as providing civil servant salary supplements rather than as providing revenue to government budgets. There is also a bias against new, potentially competing investors. Existing businessmen cultivate friendships with tax collectors and then ask them to discriminate against potential competitor investors.

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[3] The theme, that public sector performance improves along with its dependency on domestic, private sector financing, particularly for deficit financing, is presented in a book entitled A Free Nation Deep in Debt: The Financial Roots of Democracy by James Macdonald: Farrar, Straus & Giroux, New York, 2003, 564 pp. For a review see: http://users.erols.com/rmyers1/MacdonaldBook.htm

II. Targeting Public Sector Expenditures & Deficits as Percentages of GDP

7. A primary reason to limit **TOTAL** public sector expenditures to a relatively low (i.e., under 15%) percentage of GDP in the initial years of the new government is to allow more rapid private sector growth and, in turn, development of a more democratic, less corrupt, more effective public sector. A low target of 10% to 15% (the latest IMF report on Afghanistan puts this figure at 10.5% for 2004[4]) would apply in the initial say, eight years. Donors tend to favor larger public sector expenditure/GDP ratios (more like 25-30%) in the early years on two questionable grounds. First, they argue that greater amounts of recurrent public sector expenditures will finance better, more socially oriented governments that will stimulate faster private sector growth. The facts don't support this theory: Successes following this "government first" approach have been few. More usual, when recurrent budgets are relatively large, is the emergence of predatory, authoritarian governments that thwart development of efficient private sectors.

8. A second reason Donors favor larger expenditure/GDP ratios in initial years is to add a "Development Expenditure" component to the budget. Such expenditures are supposed to have a positive social rate of return, but usually don't. These "development expenditures" are frequently subject to less strict expenditure controls and usually generate negative, not positive **ex post** social rates of return, not least because positive rates of return are dependent on private sector growth that doesn't occur.

9. The Government should choose to limit the size of overall public sector deficits, defined to include debt service payments on foreign borrowing. Limiting the deficit to 3% or less per year is a companion target to an expenditure/GDP target and will effectively prevent crowding out of private sector activity. A figure of "about 3%" is suggested as being appropriate by William Easterly in his 1991 study of deficits.[5] Excessive deficits inflate the public sector expenditure/GDP ratio and lead to subsequent calls for onerously high tax rates. In addition, larger deficits are inflationary, unless accompanied by foreign borrowing and similarly sized BOP (import minus export) deficits. The foreign borrowing and the BOP deficits cause currency over-valuations and reduce the attractiveness of private investments in production of domestically consumed, tradable output.

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[4] Islamic State of Afghanistan: First Review Under the Staff-Monitored Program: November 2004 IMF Country Report No. 04/364 p. 6. Available on the web in .pdf format at: http://www.imf.org/external/pubs/ft/scr/2004/cr04364.pdf

[5] William Easterly and Klaus Schmidt-Hebbel, The macroeconomics of public sector deficits: a synthesis: The World Bank, 1991, Washington, DC.

III Governments Should Finance Deficits With Local Currency Bond Sales, NOT Foreign Borrowing

10. There are significant developmental positives from financing (modest) public sector deficits through sales of local currency bonds, and significant negatives from financing such deficits with foreign borrowing. The thesis that there are significant positives of domestic currency bond sales is an old one[6]. Such sales spawn development of asset markets and provide less risky savings alternatives that increase the volumes of domestic saving over and above what they would be with public sector foreign borrowing. Government bond sales are significant prerequisites to the creation of domestic asset markets, which themselves increases the ease of investor entry and exit and the liquidity of savings and investment.

IV Taxes for Revenue Should Fall Mainly on Consumption Expenditures

11. Several AACC/AICC members have referred to Dubai's (UAE's) approach to taxation as being sensible for Afghanistan. And they are quite right to do so. The UAU is following a taxation and openness strategy, previously adopted by Hong Kong, Singapore and Mauritius, involving creating a vibrantly growing domestic tax/employment base by instilling an international business atmosphere in the domestic economy. Of course UAE has oil. But by adopting good fiscal and monetary policies and investing heavily in public sector capacity/institution building, UAE is avoiding the curse experienced by most other oil exporting countries: that oil revenues excessively expand the public sector, making it inefficient and corrupt, but also independent of private sector activity. Although landlocked, Afghanistan's position astride the trade corridor between South Asia and the Middle East and Europe suggests that a UAE-Dubai-like tax and development strategy could do very well there[7].

12. **Significantly Tax Consumption Expenditures** A key fiscal element for enabling more "open" and rapid, private sector development[8] is to design a tax on consumption expenditures (a VAT or Value Added Tax) that provides most of the revenue needed to finance the targeted amount of public expenditures. Initially targeting public sector expenditures at a low (i.e., 15% or below) percentage of GDP is part of the strategy. It's axiomatic that the tax system will be relatively kind to private sector investment and production **if** a VAT, at the retail level, provides, say, 11 percentage points of the 15% of GDP required to finance of public sector expenditures.

[6]Alexander Hamilton advocated this.
[7] The latest UAE policies are discussed by the IMF at:
http://imf.org/external/pubs/ft/survey/2002/102102.pdf
[8] It is important to note that the Dubai-Singapore-Hong Kong-Mauritius approach downplays any significance between foreign and domestic investment/investors, focusing more on stimulating private as opposed to public sector investment. As a result, this approach tends to assign a relatively insignificant role for public sector investment and the related concept of public sector "development expenditures." This denies significance to the theory that tax revenue should be sued to finance recurrent expenditures and borrowing used to finance capital expenditures. In this schema, borrowing is to cover deficits and should be undertaken domestically.

13. Afghanistan must move toward completely and fairly applying a VAT. Otherwise, it may "cascade" and be worse than some alternatives. There is a "razor's edge" issue with a VAT: Such sales taxes are good if they fall on retail sales, but they can be worse than offsetting income/profits taxes, at least for private sector growth, if they fall instead on sales at the wholesale level. As onerous as it seems, it makes sense to choose to invest first in constructing the institutions and administrative apparatus to collect a well-designed VAT **at the retail level**. The initial cost per unit of revenue raised will be high, but it will fall quickly with rapid growth in private production and employment.

14. It is crucial that expenditure taxes be applied broadly, to all domestic consumption expenditures, regardless of the status of the household and enterprise spending units. No spending units or consumption expenditures should be exempt, although VAT rates should be graduated at three levels, low for basic needs, medium (25%) for consumer durables and high (100%) for luxuries. Truly poor households would also be given vouchers to pay the taxes on these basic goods and services. Adopting such a VAT obviates the need for revenue building tariffs on imports, since capital and intermediate imports will be tax-exempt, and consumption imports will be taxed at their normal VAT rate, upon their purchase by final users.

15. One **conclusion** to this discussion on taxation of consumption expenditures is that the Government adopts the principle that a VAT provide the bulk (maybe 70% to 80%) of the (initially modest) ratio of public expenditures as a percent of GDP. **Another conclusion** is that the government and policymakers agree to a public sector investment sequencing involving initially investing in public sector capacity/institution building that enables complete and fair collection of consumption expenditure taxes **at the retail level.**

16. **Taxation of Income and Wealth** Although (corporate and household) income taxes[9] should provide a relatively small portion of total government revenue, they play a very important role in broadening and strengthening the tax base. The main reason for income taxes, in a setting of significant taxation of consumption expenditures, is to provide modest amounts of tax revenue while significantly redistributing income downwards in incentive-neutral ways. The goal should be to get every household and business to file an annual consolidated tax return. To accomplish this, the filing process must convey potential benefits to all tax filers. For most, this benefit will be to net out of income the double taxation implied by the VAT.

17. For businesses, additional benefits will be to get credit for expenses such as depreciation, reimbursable VAT, and any taxes paid on presumptive income. This latter applies particularly to providers of consumer services who will be particularly hard to draw into the tax system without such presumptive taxes. The poor can be attracted into the system by making them eligible for certain benefits (e.g., VAT vouchers) only if they file a consolidated tax return.

18. Tax rates on the income of households and businesses should be the similar and relatively modest, reflecting the fact that income taxes are not the major provider of tax revenue. There has been a movement away from several graduated rates and toward a

[9] Social security taxes are considered perfunctorily in a separate section below.

uniform rate in recent years. Since some income redistribution is the goal, the tax-free minimum should not be onerously low. There should be virtually no asymmetric or special interest exemptions/concessions and special attention must be paid to identifying and disseminating the accounting conventions to be used to define taxable income. These will, of course be different for households and businesses. For defining taxable business income (profits) it is probably best to use another open economy's accounting and depreciation rules, such as those in UAE (Dubai) where an international business climate prevails.

19. **A Cautionary Note on Taxation of Rent (Minerals)** Taxation of rent is everyone's favorite way to raise fiscal resources: Such taxes are theoretically supposed to be completely "free". They raise lots of revenue, supposedly without affecting private sector producer incentives. Mineral taxes, particularly on oil sold internationally, are the most widespread and voluminous. Despite their supposedly glorious essence, virtually all countries that rely heavily on taxation of "rents" are in quite serious developmental trouble. For some reasons (the subject of a voluminous literature) heavy reliance on taxation of "rent" (minerals) discourages general private sector expansion.

20. True rent is defined as profits derived from **NATURALLY in-elastically supplied output:** output that's provided under conditions of natural (not artificial) constraints on increases in supply. Unfortunately, it is extremely difficult to identify output that's naturally limited in an economic context. The supplies of almost every traded good expand or contract with changes in profitability, except when there are monopolies or artificial barriers to expansion/contraction. Economists used to think that payments for land use are the perfect example of rent but this is now passé: the supply of, e.g., urban land does indeed expand quite rapidly with increases in rent payments, unless there are artificial, land-use constraints on its growth[10]. In truth, **most limitations on the expansion of supply are artificial, not natural, and primarily due to monopolization of supply.**

21. The reality is that most "rent" taxation is actually taxes levied on excess profits (ill-gotten gains) from monopolization of the supply processes. Afghanistan must avoid this. Government tax collectors love monopolies: Taxing them is easy and cheap and garners revenues that are initially a higher percentage of GDP. But such revenues don't grow over time. Monopolies restrict private sector growth by preventing investment by competing investors. Given AACC's desire to see growth in both the **number** and the wealth of its members, it strongly advocates that the **Government vigorously pursue anti-trust actions rather than allow monopolies to flourish that might ease tax collection efforts** in the short run.

22. One **conclusion** to this discussion of taxation of rent is that **toleration/regulation of monopolies** for any reason, but particularly for easing tax collection**,** is ruinous to growth in the private sector and in the government's tax base. A s**econd conclusion is** that heavy public sector reliance on taxing rents, even if not monopoly generated, can cause serious development problems by reducing the government's dependency on

[10] If the government allows ownership and sale of urban but not agricultural or tribal land, it is giving urban landowners a monopoly that will earn them HUGE gains. Of course they'll willingly pay taxes (and bribes) the government and its officials to keep the monopoly.

private sector (and tax base) growth and by worsening private sector investment and production incentives. The higher the percentage of total revenue generated by taxes on rent (minerals), the more likely that the rest of private sector growth will be depressed.

23. As a rule, the broad issue regarding taxation of wealth concerns whether and to what extent there should be **estate or inheritance taxes**. On the face of it, estate taxes should redistribute wealth downwards. To most, this seems like a “fairness” issue. Economists see it as an incentive problem. They reason that it’s best to take wealth from exceedingly rich, unmotivated and unproductive children (the “Latafundia” in Latin America) and give it to others who are motivated to use it more productively. Unfortunately, estate tax issues are similar to those arising from taxation of rent: it is frustratingly hard to determine how estate taxes will affect future private sector investment and production. For one thing, the children of the rich may in fact be excellent users of inherited resources. Three rules apply however. **First**, estate taxes should not impoverish households. **Second,** governments that use resources in more growth and private sector sympathetic ways can have higher estate taxes than those that use resources poorly. **Third**, the more that productive capital is held by estate tax-exempt businesses, the less socially disruptive will be an estate tax on wealthy households.

24. A final consideration concerns **PAYE taxes for social security**. The overriding issue is here is the credibility of the government (citizens must believe that the government will deliver on its promises) and of the retirement program itself (if it looks too good to be true, it’s too good to happen). Countries with young populations with rapid GDP growth are in the best shape. Countries with aging populations where GDP isn’t growing are in worse shape. The tendency of most developing governments with relatively large public sector work forces is to over-promise on retirement as a way to underpay public servants on a current basis. This is akin to excessive public sector borrowing and will have a seriously depressing effect on longer-term private sector investment. It also allows over-collections of PAYE to finance excessive public sector expenditures in the initial years of PAYE collections.

25. It is suspect to believe that social security programs will earn average **financial** rates of return, for all participants taken together that are higher than those obtainable on domestic public sector borrowing. In fact, since social security programs are for large numbers of people, over long periods of time, it is unlikely that any financial and/or monetary gimmicks will rescue a program that can’t be shown to be financed and sustained with taxes. This should be the key to the Government's approach. If the promised annual retirement stipend, times the projected (growing) number of retirees, excessively raises the future public expenditure to GDP ratio, then the promises are not realistic and must be lowered.

Appendix 1

Tax Collectors Run Amok

A1. Investigation shows that the following taxes, tariffs, fees and commissions are being collected from the business and citizens of Afghanistan by the government: A border fee; a fee at the entrance to the cities; a tariff at customs; a 2.50% mandatory membership fee by the Afghanistan Chamber of Commerce and Industry on every transaction at customs; a 2% tax by the Ministry of Finance and 6% tax by the courts on the sales of real properties; a *5%* tax for the registration of motor vehicles by the courts; a *2.5%* tax by the Ministry of Finance on the value of all invoices on the bases of annual report; a monopoly tax; a consumption tax; a service tax. Then there is a 2% tax by the Ministry of Agriculture at customs for inspection services which are not provided yet. There is also a *2.50%* tax (Zakkat a religious tax) on net income by mosques and 10% tax on all agriculture products (Usher a religious tax). A 10% municipality tax on all goods transported through the city. There is an 11% tax on the value of the contracts that is mistakenly called progressive taxation. The tax on contracts is levied prior to any profit being made! Out of 12 months, one-month's rent is taken as tax on property by the Kabul municipality. A 60% tax is placed on annual income from real estate. In addition there is a tax for the municipality on real estate for services such as cleaning and garbage removal. A $137 fee is collected for every car registered with its steering on the right side. There is even a tax for the department of traffic. Also we have identified a 2% transportation tax and a 3% commission on transportation of goods and passengers. $100 to $200 in fees are collected by non-government groups on each truck passing through the border into Afghanistan that are passed on to the trader and subsequently to the consumers. Finally, $150 is collected from each truck coming into Afghanistan at customs and $100 is collected in the name of a "reconstruction tax" on all trucks entering into Afghanistan.

A2. As can be imagined, with this many different taxes, there are a myriad of tax collection points and officials empowered to collect them. Each collects all or some of the tax, but both parties acknowledge that some of the money collected remains with the official, rather than going back to the Government. In effect, Afghanistan has the worst of all fiscal worlds: The multitude of taxes and collectors imparts an anti-business bias that depresses growth in the tax base. At the same time, only scant amounts of the taxes collected get back to the Government to fund important social expenditures, including those that might make the private sector grow more rapidly.