

Reforming Afghanistan's Fiscal Systems/Procedures

I. Introduction

1. To avoid prolonged poverty and aid dependency Afghanistan should adopt the fiscal goals and mechanisms that successful countries like Malaysia, Thailand, Singapore, Taiwan, Mauritius and Dubai have adopted. All involved reforming tax systems (like Afghanistan's) that suppressed growth in private investment and employment through unwise taxation of businesses, and widespread corruption. These other countries adopted a two-stage approach to tax reform. Their second stage or long run goal for tax reform was to make the public sector dependent for revenue on growth in private investment and employment rather than on donor aid and the taxation of businesses. This entails low tax rates on consumption expenditures, income and property and massive reform of the tax administrative and collection systems to spread the tax system countrywide and get rid of corruption. The target dates for achievement of this second stage were set at seven to ten years.

2. These countries also adopted, as a first stage, temporary policies for the seven to ten year **transition period**, prior to the achievement of an ideal business tax climate. The aim of these transitional policies was to relieve private investors of some of the costs and inadequacies of the existing tax system, thereby stimulating the employment and income growth that would constitute the tax base for the second stage. These temporary policies consisted mainly of offsetting actions such as exemptions, rebates, tax holidays, etc. However, in some cases, in some geographical areas or sub-sectors they also consisted of direct, aid-financed cash or in-kind subsidies to purchase tradable capital assets (i.e., collateral) which would enable start-up businesses to become creditworthy for commercial bank credits.

II. Sketch of What's Wrong With Afghanistan's Tax System

3. Afghanistan's current tax system collects some budget revenue (about 5% of GDP) but unfavorably lowers incentives to invest, produce and employ labor, thus reducing prospective future growth in budget revenues. Even worse, there is a negative relationship between tax collections and income growth under this tax structure: the greater are tax collections, the worse the impact on future consumption expenditures, employment and income. The only way to change this inverse relationship is to alter the tax system so that producer incentives improve, thus allowing revenue to grow because of enlargement of the tax base. Altering the tax system essentially involves switching from the current taxes to more investment and job friendly ones (altering the tax structure by removing taxes on business and applying them to consumption and income), and improving the tax collection and administration system to broaden the application of the new tax structure and to reduce/remove corruption from the system.

4. There is an alternative way to look at the problems with the present tax system. There are a large number of "nuisance" taxes that provide very little revenue but allow public servants to harass traders and producers, thus discouraging investment and employment growth. In addition, the Government currently relies on high taxes on total

revenue (not net income) and on capital and imported inputs that seriously depress business investment. The current tax collection and administrative apparatus is rife with petty corruption and too narrowly focused on bigger businesses, thus discouraging growth in size and efficiency. Finally, locally imposed, spotty, price controls act as a tax on all businesses, lowering taxes directly, by reducing revenue, and indirectly, by discouraging investment.

III. Summary of A Reform Effort

5. I set out below several maxims of tax reform that apply to Afghanistan. The Government should aim over a seven to ten year period to become dependent on growth in the private sector tax base, rather than aid, for revenue. It is also important to recognize that changing the tax structure and particularly reforming and expanding the coverage of tax administration and collection is expensive and deserving of the allocation of fairly large amounts of aid “investments”. Assuming there is agreement on a well-funded, 7 to 10 year revenue neutral tax reform program, the first step will involve **undoing** or getting rid of a large number of **nuisance taxes and price controls** and retraining (as part of the system reform process) those who have collected them to perform other tax collection/administration functions. Since the revenue actually transferred to the budget from these taxes is small, the revenue impact on the budget is of little concern.

6. Although reforming and expanding the administrative and collection systems is the most expensive and time consuming element in reforming the tax system, the most politically contentious and fiscally risky part is reforming the tax structure in a revenue neutral way. As indicated below, this entails replacing the revenue now earned through (anti-business) taxes on total revenue, imported inputs and capital (including FDI) with much more employment friendly, **flat, modest but widely applied** taxes on consumption expenditures and income.

Rough Estimates of Tax Rate Magnitudes For a Reform Effort

This note proposes that the main reform effort apply to expanding tax collection coverage to larger percentages of two tax bases, and altering the tax structure by replacing (too high) taxes on total revenue, imported inputs and capital expenditures with modest taxes on consumption expenditures (a GST) and on household income and the net income of businesses. Let's see what might happen if the GST and flat income tax rates are established at 10% each for the reform effort.

It is roughly the case in many developing countries with relatively “small” governments that private consumption expenditures (one tax base) are about 65% of GDP and that personal and net business income (the other tax base) is also about 65% of GDP. These numbers define the maximum size of the tax bases. If we assume that administrative reforms expand collection coverage to 100% of each tax base (unlikely, but these are assumptions), these percentages suggest that the combined revenue collections from both taxes would be 13% of GDP (as compared to 5% today). Of course tax collection rates today are nowhere near 100%, but the 13% figure indicates an achievable, deficit-free public sector expenditure/GDP ratio. If it is desirable to have public sector expenditures be, say, 16% of GDP, raising the GST to 15% would achieve this without deficits. Attaining current revenue neutrality (i.e., 5% of GDP) with both new tax rates set at 10% would involve achieving tax base collection coverage of about 40% (5% is approximately 40% of 13%). However, if the government were to introduce 10% GST and flat income taxes right now, it probably wouldn't begin collecting revenue of 5% of GDP immediately because collection coverage rates wouldn't immediately become 40% of the tax bases. Be that as it may, collection coverage rates will rise faster, the more resources that are devoted to reforming tax administration and collection efforts. This is why it is important that the Government “invest” significant amounts of aid in removing corruption and reforming tax administration and collection.

Property and inheritance taxes can also help the lower GST and flat income tax rates, and both are consistent with greater jobs creation. These taxes take from the rich more than from the poor, since the poor will not much on the way of property. This simply makes the tax system fairer.

In theory, the percentage value of these two new taxes should be calculated to exactly replace the revenue lost by discontinuing the incentive-destroying taxes. In practice, aid-financed expansion of the breadth of tax collection will allow revenue replacement, even if these new (consumption and income) taxes are set at flat, low levels of about 10% to 13% each – a sort of international consensus norm.

IV. Depend on private sector (tax base) growth for Public Finance

7. The alternative to more aid for Afghanistan is to initially curtail public sector expenditures and deficits (the “reach” of the public sector) while allocating more aid-financed expenditures to developing investment-friendly domestic tax and borrowing administrative systems. The resulting systems should emphasize fair, non-corrupt collection of broad-based but modest taxes, primarily on domestic consumption expenditures but also on income, rather than on capital, investment or imports of raw materials, machinery and equipment.¹ There should be very broad participation in payment of taxes and local purchasing of public sector bonds.² This will stimulate a growing public sector domestic tax base, thus allowing future scope for more social and infrastructural expenditures, while reducing future aid and import requirements.

V. Spend More Aid Now on Improving Taxes & Administration

8. Afghan businesses are currently subject to interventions by significant numbers of officials, each empowered by the present tax laws and precedents to collect modest fees. Despite the breadth of these interventions, the present tax system gathers only modest revenue for the Government. Instead, 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.

9. A major element of whole scale tax reform is **discontinuing** many taxes and **reducing** and **retraining** tax administration staff so that they receive better pay and become less prone to asking for gratuities. Price controls must also be discontinued. And, tax collection must be more widespread.

10. Spreading tax collection to all households and retail businesses will require a major public sector investment and aid financing averaging perhaps \$50 million per year for five to seven years. The government should “invest” considerable amounts of aid resources for extensively reforming the tax system and its administration. If other public sector initiatives must be delayed to finance these administrative reforms, they can later be financed by greater local tax collections and borrowing. If the Government makes and publicizes such a whole scale reform decision, donors, such as the IMF (through its Fiscal

¹ 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

² 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>

Affairs Department), can design and find financing for the reform program. The long-term incentive and political benefits of appropriate taxation, fairly collected, will outweigh the (mainly short-term) gains from profligate aid-financed expenditures.

VI. Taxation for Growth & Greater Economic Participation

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. 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 here³. This is a strategy that stresses taxing at the same rate the increased wage earner and net business income (the result of greater employment and private investment) and greater consumption expenditures. Taxes on employment generating capital and investment are kept at a minimum. An example of a particularly ruinous tax is the 20% tax (sometimes assessed as two 10% taxes) on total business revenue in Afghanistan. Much less harmful would be a 20% tax on net business income – that is, total revenue net of depreciation, other taxes and business expenses.

12. **Significantly Tax Consumption Expenditures** A key fiscal element for enabling more “open” and rapid, private sector development⁴ is to design a tax on consumption expenditures [a VAT (Value Added Tax) or GST (General Sales Tax)] that provides most of the revenue needed to finance the targeted amount of public expenditures. It is probable that IMF modeling exercises would show that a GST tax rate of about 10%-13%, broadly applied, would replace a considerable portion of the revenue collected from the myriad of existing (import and nuisance) taxes. The tax system will be relatively kind to private sector investment and production if a VAT, or GST at the retail level, provides significant amounts of the revenue required to finance public sector expenditures.

13. 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. Truly poor households can be given vouchers to pay the taxes on 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.

14. **Taxation of Income and Wealth** Corporate and household income taxes⁵ should provide another significant portion of total government revenue. Such taxes also play an important role in broadening and strengthening the overall tax base. A main reason for income taxes, in a setting of significant taxation of consumption expenditures, is to provide tax revenue while significantly expanding tax coverage and redistributing income

³ UAE policies are discussed by the IMF at: <http://imf.org/external/pubs/ft/survey/2002/102102.pdf>

⁴ The Dubai-Singapore-Hong Kong-Mauritius approach downplays any significance between foreign and domestic investment/investors, focusing more on stimulating employment through greater private as opposed to public sector investment. This approach assigns a relatively small role for public sector investment and the related concept of public sector “development expenditures.” This downplays the theory that tax revenue should be used to finance recurrent expenditures and borrowing used to finance capital expenditures: Borrowing is to cover any and all deficits and should be undertaken domestically.

⁵ Social security taxes are considered perfunctorily in a separate section below.

downwards in incentive-neutral ways. The goal, initially quite expensive, 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/GST.

15. Current best practices are that there is one (flat) tax rate of 10% to 13% on the incomes of households and businesses above a poverty threshold. 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 be different for households and businesses. For defining taxable business income (profits) it is best to use another open economy's accounting and depreciation rules, such as those in Ireland or UAE (Dubai) where an international business climate prevails.

16. **A Cautionary Note on Taxation of Rent (Oil, Gas & Minerals)** These taxes raise lots of revenue, supposedly without affecting private sector producer incentives. But in the end the taxes are derived from monopolies that prevent normally achievable growth in employment and GDP. Despite their supposedly glorious essence, virtually all countries that rely heavily on taxation of rents and royalties are in quite serious developmental trouble. For valid reasons (the subject of a voluminous literature) heavy reliance on taxation of rent and royalties (oil, gas, minerals) discourages general private sector expansion. The main reason for the trouble is that, taxes on the net income of mineral companies aside, royalties are derived mainly from monopolies that prevent aspiring new investors from increasing production and competing down prices by expanding output (and coincidentally, employment).

17. Royalties also fluctuate wildly and tend to ratchet up public sector consumption expenditures, causing waste, and deficits during downturns. Since they are derived from monopolies and fluctuate widely, economists (rarely listened to) suggest special treatment of royalties: They should be "sterilized" (smoothed) and a significant portion returned via the income tax system to citizens' households. The US state of Alaska is the best example of both.

18. **Wealth Taxes** 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.

19. A final consideration concerns **taxes for social security**. The overriding issue 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 is too good to be true). 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 private investment. It also allows over-collections of Social security taxes to finance excessive public sector expenditures in the initial years.

VII. Target Public Sector Expenditures & Deficits as Percentages of GDP

20. Part of the reform program would be agreement to limit **TOTAL** public sector expenditures to a relatively low percentage of GDP. This will allow more rapid private sector growth and development of a more democratic, less corrupt, more effective public sector. A low target of 10% to 13% (the latest IMF report on Afghanistan puts this figure at 10.5% for 2004⁶) would apply at least for the initial eight to ten years.

21. The Government should also 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.⁷ 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.

VIII. Finance Deficits With Local Currency Bond Sales, NOT Foreign Borrowing

22. 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 one⁸. 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 increase the ease of investor entry and exit and the liquidity of savings and investment.

⁶ 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>

⁷ William Easterly and Klaus Schmidt-Hebbel, The macroeconomics of public sector deficits: a synthesis:
The World Bank, 1991, Washington, DC.

⁸ Alexander Hamilton advocated this.

Tax Collectors Run Amok⁹

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. In addition, the two largest private investors in the country – AWCC and Roshan – are subject to numerous taxes and fees pursuant to their licenses, including 12.5% tax on their net revenues, in addition to all of the other taxes and fees listed above.

A2. With this many different taxes, there are too many tax collection points and officials empowered to collect them. Frequently a share of the taxes 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 tax base grow more rapidly.

⁹ The Ministry of Finance is to be commended for recent efforts to consolidate tax collection efforts.