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Structural Reforms: Revitalizing Fiscal Institutions

Thierry Kalfon

The implementation of the fiscal strategy described in Chapter 3 was underpinned by a comprehensive technical assistance program, which aimed at restoring essential financial capacity in the Ministry of Finance (MoF) and line-ministries through the design of detailed reform projects, hands-on implementation of these reforms, and training of MoF staff. Specific assistance has also been provided in the areas of civil service reform and private sector development, which are key to maintaining fiscal sustainability.

A large number of international organizations and donors were involved in these efforts. In particular, following early diagnostic missions in 2002, the IMF outlined specific action plans to establish financial management capacity in the MoF and improve revenue mobilization. The government endorsed these proposals, which were subsequently carried out on the ground by the World Bank, the Asian Development Bank (AsDB), the European Union, the United States Agency for International Development (USAID), the United Kingdom's Department for International Development (DfID), Germany's Gesellschaft für Technische Zusammenarbeit (GTZ), and the U.S. Treasury. The IMF also assisted the authorities with monitoring progress in the reforms and suggesting further improvements, while hands-on implementation was being undertaken by other international organizations and bilateral donors. In the area of civil service reform, the World Bank played a leading role in both establishing the civil service commission and reviewing the civil service aspects of the overall fiscal strategy. Private sector development is an area where there is still considerable scope for further progress and support, especially in relation to the much-needed transformation of the large public enterprise sector.

Structural fiscal reforms have relied as much as possible on the existing systems, whenever they were found to be sound and reasonably well operated, in order to facilitate ownership of the reforms and yield immediate results. In the areas where revamping the existing system was required, technical assistance efforts primarily focused not only on getting the basic elements of the financial system right but also on preparing the ground for gradually introducing best international practice over the medium to long term. Similarly, particular emphasis has been put on building capacity in the MoF through intensive training and close partnership between the MoF departments and implementing agencies.

Improving Public Expenditure Management

From the outset, Afghanistan's interim and transitional authorities committed themselves to full transparency in managing public resources. This theme was articulated in President Karzai's speech during the Tokyo conference in January 2002 and has repeatedly been reaffirmed as a pillar of the reconstruction strategy since then.

Public expenditure management, as performed when the Afghan Interim Administration (AIA) took office, was far from meeting these objectives. Most of the financial management procedures in place before the war and still documented in the financial regulations had broken down: (1) reporting and recording of government expenditure was nonoperational because of the absence of any office automation and communication with the provinces; (2) budget internal controls and external audit had ceased functioning; (3) banking arrangements for government operations had collapsed; and (4) cash management and bank reconciliation were no longer performed. The fiscal functions that had survived, such as budget execution, some aspects of budget formulation, and management of budget appropriations and payroll, were mostly slow, cumbersome, and subject to both errors and abuse. Apart from the disruptions caused by the conflict, these weaknesses were also the legacy of years of deficit monetization, which removed the discipline of a budget constraint and hence precluded the development of effective financial management procedures. Against this background, a comprehensive program of technical assistance was designed to restore basic financial functions in the MoF.

Budget Execution and Financial Management

Immediate emphasis had to be put on urgently upgrading budget execution and financial management in the MoF in order to provide donors with the fiduciary assurances that they requested for realizing their pledges.

At the request of the AIA, in June 2002, the World Bank provided grant support for an Emergency Public Administration Project to fund the hiring of qualified international contractors in the areas of financial management, government procurement, and audit, with the tasks of (1) assisting the authorities in performing these functions and (2) building local capacities in order to hand over these functions to the authorities as soon as possible.

The financial management contractor, hired by the government under the World Bank project, developed for the treasury a computerized system for expenditure recording, payment processing, and financial reporting for budget spending—Afghanistan's Financial Management Information System (AFMIS). In order to deliver results immediately, AFMIS did not change the procedures and functions specified in the Afghan regulations but only computerized the existing manual system using a simple software package. Since October 2002, AFMIS has provided timely and reliable information on expenditures paid at the center, broken down by the source of funding (domestic revenues or grants), spending units, and economic and functional classification; and it has also significantly accelerated the expenditure payments through the automation of the printing of checks. In the initial period, however, this system suffered from important limitations: (1) its coverage was limited to central government expenditures only, excluding revenues and nonwage provincial expenditures;[1] (2) budget management facilities, such as appropriations, allotments, and transfers, were not available; (3) expenditure commitments were not recorded; and (4) the system did not perform reconciliation between treasury information and central bank statements. To address these issues, the system's functionalities were significantly expanded at the beginning of 2003/04 to include revenue information, provincial expenditures, and budget management functions. Although further improvements were still needed—especially with regard to recording financing sources for the operating budget, bank reconciliation, and monitoring the development budget—the introduction of AFMIS in a very short period of time critically improved expenditure management in the treasury and gave a concrete illustration of the authorities' commitment to fiscal transparency. One of this project's major achievements has been the progressive transfer of AFMIS operations from the contractor to Afghan staff following intensive training and capacity building.

In addition to the support provided to the MoF under the World Bank Emergency Public Administration project, the authorities have taken important steps to improve budget execution and reporting in the provinces. This task, which has received priority attention since the beginning of 2003/04, aimed at moving away from the existing impasse where (1) provinces did not report their nonwage expenditures to the center and (2) the center, in the absence of provincial expenditure reports, refused to

[1]Although the system had the technical capacity to record and account for nonwage provincial expenditures, no reliable information was received at the center on this category of expenditures in 2002/03.

transfer resources to the provinces. In this context, 40 Afghan fiscal advisors were trained in the MoF under USAID funding and sent to all provinces to assist them with financial reporting on both their revenues and expenditures. Six of them were assigned to the six provinces collecting the bulk of domestic revenues to coordinate the activity of the other provincial advisors.[2] Similarly, satellite communication facilities were set up on a pilot basis in the largest of these provinces to facilitate exchange of information between the MoF and its regional offices (Mustufiats). The rolling out of AFMIS to the provinces started in mid-2003. These initiatives yielded important and tangible results: in particular, whereas the Mustufiats did not report on their nonwage expenditures in 2002/03 (see Chapter 3), they started doing so in 2003/04. However, fiscal reporting still requires improvement, especially on revenues, as there are indications that major provinces report less revenue than they collect and most provinces send their reports to the center with significant delays. The progressive consolidation of the provinces' accounts into the accounts of the central government will help to address these issues (see next section).

Cash Management and Banking Arrangements

Cash management is a critical element of public resource management, especially in environments characterized by high demands on scarce public revenues. Government banking arrangements exert a strong influence on the ability of the treasury to effectively discharge its cash management responsibilities. Learning from international experience, most governments have opted for concentrating all government cash resources in a single bank account (the Treasury Single Account, or TSA) to strengthen treasury control over cash flows, reduce the cost of borrowing operations, and minimize idle cash balances.

While, in theory, Afghanistan was supposed to operate with a TSA, there had been, in practice, a proliferation of accounts in recent years that interfered with proper consolidation of cash resources, hindered prompt information on the government's fiscal situation, and led to fragmentation of the budget revenues. The IMF submitted to the authorities a progressive plan to consolidate the government's accounts in the center and the provinces and eliminate the accounts of line-ministries that do not serve the public interest. In line with these recommendations, the authorities streamlined the number of the MoF's bank accounts operated at the center for domestic revenue and expenditures.[3] Most importantly, in 2003 they undertook a complete overhaul of the government's banking arrangements in the provinces to improve revenue centralization. In August 2003, the treasury instructed the central bank to close all the provinces' accounts and transfer their balances into two new accounts, one for expenditures and one for revenues, the latter being operated on a "deposit basis" only, meaning that provinces will no longer be authorized to draw on their revenue account to spend without explicit authorization from the MoF. The next step will involve ensuring regular consolidation of these accounts into the central government's accounts and making timely transfers to the provincial accounts to allow provinces to make their expenditures according to their budget allotments.

The treasury does not currently undertake cash or financial planning. As a result, the MoF cannot inform the central bank of its in-year cash requirements, nor can it request donors to adjust their disbursement schedule according to government cash projections. This results in a lack of predictability in the resources made available to line-ministries, leading to delays and inefficiencies in budget execution. To address this issue, in 2003 the treasury established a cash-management unit charged with the responsibility of estimating revenue inflows, forecasting future disbursements, and developing an in-year cash plan. However, developing a full-fledged cash planning regime can only be envisaged in the medium term because this is a highly technical task, which will first require full introduction of a TSA and will need to be supported by extensive dedicated technical assistance.

Budget Formulation

Significant support was offered to the MoF and line-ministries for the preparation of the 2002/03 and 2003/04 budgets. The budget preparation for

[2]These provinces are Herat, Nangarhar, Kabul, Kunduz, Mazar-i-Sharif, and Kandahar.

[3]The number of these accounts was reduced from 26 to 2, excluding the specific accounts opened to track donor-funded expenditures.

2003/04 marked a vast improvement over the procedures followed in 2002/03 reflecting major efforts by the cabinet, MoF, and line-ministries toward information compilation, strategy formulation, prioritization, and coordination. However, further progress is needed in terms of better integration between the ordinary and development budgets, quality of budget submissions by the line-ministries, revenue projection, construction of the macrofiscal framework to underpin the initial budget estimates, introduction of hard budget constraints at the beginning of budget preparation, and development of a medium-term fiscal framework.

Various donors assigned a number of resident budget preparation experts to the MoF. Their tasks—in addition to hands-on support during the budget preparation process—focused on training, capacity building, and restructuring of the MoF Budget Department. This assistance, which initially dealt mainly with the ordinary budget, was expanded in 2003 to include the development budget, with the establishment of a development budget unit in the treasury supported by a budget resident advisor. Similarly, chief financial officers funded by the World Bank were to be appointed to key line-ministries to enhance their budget formulation and execution capacities.

Coordination of External Assistance

In a context where budget financing comes mainly from external sources and where a large number of multilateral and bilateral donors are involved in the reconstruction efforts, coordination of donor resources is of critical importance. The main instrument used by the authorities to avoid duplication of efforts and overlapping of donor projects is the National Development Budget (NDB), through which most of the donor assistance has been channeled (see Chapter 3). In addition, in April 2002, the authorities established the Afghan Aid Coordination Agency (AACA) as a public body within the government, to track the disbursement of foreign aid. The AACA's primary activities include (1) coordinating development efforts from bilateral and multilateral donors; (2) reviewing and endorsing projects and programs carried out by multilateral/bilateral agencies and nongovernmental organizations; (3) developing a comprehensive information system for tracking foreign assistance and monitoring development investments and programs; and (4) serving as secretariat for the Consultative Groups set up within the NDB. Since its creation the AACA's main achievement has been the development of a comprehensive donor information database recording the pledges, commitments, and disbursements from all donors.[4]

In addition, in December 2002, the MoF established, with the support of the World Bank, a Grant Management Unit (GMU) within the treasury that is responsible for assuring that donor contributions are utilized as specified in the grant agreements and reported accordingly. The GMU is intended to serve as the repository and custodian of all grant agreements, authorize offshore payments when government spending will not be channeled through the budget, maintain payment records, and report to donors and the MoF. The functions of the GMU and AACA may be merged into a new department to be established in the MoF.

Reforming Revenue Policy and Administration

Improving revenue mobilization will be a key factor in attaining fiscal sustainability. Afghanistan's operating expenses cannot be expected to be funded by donors' grants indefinitely. Over time external assistance will be increasingly allocated to development expenditures. The authorities' medium-term objective is therefore to fully finance the ordinary budget through domestic revenues. Meeting this ambitious objective would not be possible without a major overhaul of the tax and customs legislation and a large-scale reform of tax and customs administration. At the request of the AIA, the IMF helped the authorities in June 2002 to design a reform program in these areas, which is being progressively implemented with the assistance of international and bilateral donors.

Customs Policy and Administration

As customs duties account for more than half of total domestic revenue collection, improving customs policy and administration has been one of the authorities' top priorities. The 1974 customs law specified the import duties, fees, and charges levied on international trade and transactions. The cus-

[4]This database is publicly available and can be accessed at the following website: http://www.af/dad.

toms tariff included 25 tariff bands with rates ranging from 7 percent to 150 percent allocated across 888 tariff headings (for an unweighted average tariff rate of 43 percent).[5] Duty was calculated on the c.i.f. Afghan value of imported goods, using artificially low exchange rates of Af 2 per U.S. dollar to Af 4.5 per U.S. dollar—compared with a market rate of about Af 48 per U.S. dollar. In addition to the customs duties, there were a number of fees levied on imports, especially a 2.5 percent fee collected by the Chamber of Commerce for the valuation of imported goods (customs valuation was not performed by the customs administration but by the Chamber of Commerce). Although there is no excise tax, customs tariffs achieve the same result by imposing higher tariffs on certain goods, such as automobiles and tobacco products, which are not produced domestically and would normally be excised. Imports of petroleum, diesel, and kerosene for transportation purposes were exempt from duty.[6]

In early 2004, a customs reform package was enacted that included (1) the use of the market exchange rate of the Afghani in customs valuation; (2) the reduction of the number of tariff bands from 25 to 4;[7] and (3) a lowering of the tariff rates from the previous range of 0 to 150 percent to rates ranging from 0 to 20 percent. The streamlining and reduction of the tariff rates partly offset the effect of the adoption of the market exchange rate on the average level of customs duties.

These customs policy reforms, which are key to enhancing revenue collection, would not be successful unless enforced by a capable and effective customs administration. However, customs administration has been weakened by a lack of experienced managers, poorly trained staff, inadequate facilities and equipment, and outdated and cumbersome policies and procedures, all of which have created avenues for potential corruption and abuse. In particular, customs regulations have not been applied consistently throughout the country and, in some cases, customs duties are "negotiated" between taxpayers and customs officers. In July 2003, the authorities adopted a decree to simplify customs procedures. The provisions of this decree included the (1) adoption of the internationally recognized "single administrative document" for customs clearance; (2) improved monitoring of exemptions; (3) progressive introduction of the harmonized tariff codification for commercial goods; (4) development of a comprehensive computerized database for customs valuation; (5) establishment of a simplified customs regime for travelers; (6) licensing by the MoF of "customs brokers" to assist traders with the clearance of commercial goods; (7) the assignment of a taxpayer identification number (TIN) for each taxpayer; and (8) gradual phasing out of the Chamber of Commerce involvement in customs valuation.[8] In addition, the authorities designed a comprehensive five-year plan to strengthen the administration of customs. This strategic document calls for a complete revamping of the customs department and its regional offices, training of customs officials, reform of customs procedures (including investigation, enforcement, and controls), centralization of customs revenues collected by the provinces, and progressive rehabilitation of customs infrastructure, equipment, and communications. This plan covers the years 2003–07 and has an indicative cost of around US$100 million, of which two-thirds would be allocated to technical assistance. The opening in May 2003 of a model customs house, featuring a renovated warehouse and training facilities at Kabul airport, was a first step toward the implementation of this strategy.

Tax Policy and Administration

Around half of the domestic revenues collected in 2002/03 were noncustoms tax revenues. Therefore, improving revenue mobilization will require—in addition to reforming customs—the establishment of a fair, transparent, and easy to administer tax system.

The existing tax regime was defined in the 1965 income tax law, which provides for a progressive personal income tax (PIT) with rates varying from 4 percent to 60 percent, a flat 20 percent corporate income tax (CIT), a 2 percent business receipts tax (a form of sales tax on corporate entities' turnover), withholding taxes on imports and exports, and various fixed (presumptive) taxes (Appendix 4.1). It is difficult to ascertain all the details of the 1965 tax law and its application, since the law was amended by 18 separate decrees and not all amendments were

[5]The lack of data (historic import data sorted according to tariff codes are currently not available) makes it very difficult to assess the tariff structure, the extent of exemptions, and their impact on revenues.

[6]However, there appears to be a "monopoly tax" on petroleum products equal to 20 percent of the import value.

[7]Zero, 5, 10, and 20 percent.

[8]As well as full transfer of this function to the customs administration.

included in a comprehensive consolidated version. In addition, tax administrators in the MoF and its financial regional offices (Mustufiats) had different views about the applicable tax provisions, which were not applied consistently throughout the country. In particular, a Taliban decree of May 1999 reformed the personal income tax by introducing three rates of taxation (1, 8, and 20 percent) together with a series of exemptions. But it is unclear if these provisions were ever enforced.

The tax law included a number of serious deficiencies:

- The rule imposing taxation of worldwide income on Afghan citizens wherever they live meant that expatriate Afghans intending to return to Afghanistan would be met by a potentially crippling legal tax liability on all the income they earned abroad. This tax provision created disincentives for these individuals to return to Afghanistan and participate in the country's reconstruction.
- The top marginal rate for PIT (60 percent) was high even compared with international standards and cuts in at a relatively modest annual earnings level (less than half of the average annual salary). This hampered voluntary tax compliance and likely led to tax fraud. In addition, the existing tax rate structure, consisting of 32 different rates, was complex and difficult to administer.
- The coverage of the business receipts tax did not include certain services provided to expatriates and other high-income earners, resulting in revenue losses for the government.
- Limitations of the loss carryover period and depreciation allowances for the payment of the CIT discouraged investment.

In view of these deficiencies, the authorities prepared, with the assistance of resident tax advisors, an important set of tax policy reforms to improve the efficiency and the equity of the tax system. These measures, which conformed with the IMF's recommendations, were enacted by presidential decree on March 18, 2004, and included the following provisions.

The income tax regime was improved through (1) aligning the corporate and top personal tax rate (at 20 percent); (2) allowing a significant personal exemption to replace the previous complex individual and dependent deductions; (3) restoring a final wage withholding tax on higher-income employees; and (4) shifting the nexus of taxation from citizenship to residence. Similarly, the business receipts tax rate was increased to 10 percent on a limited range of services consumed by high-income earners (hotels, restaurants, international airline services, and telecommunications services) and new taxes were introduced including a tax on rental incomes, a snuff tax, and an airport departure fee. The system of fixed and presumptive taxes was also streamlined to simplify tax administration and reduce distortions between similar businesses. These policy measures were accompanied by specific administrative provisions including introduction of self-assessment principles, provisions for tax ruling, and new collection enforcement powers and penalty provisions.

These tax policy reforms were closely linked to a program to strengthen the capacity of the revenue department in the MoF and improve tax operations in the Mustufiats. This plan included the establishment of a large taxpayer unit (LTU) in Kabul in 2004. The LTU will be responsible for administering the personal income tax,[9] the business receipt tax, and the rent tax. The Kabul LTU will then be complemented by model tax offices for medium-income taxpayers, in which new operational procedures and concepts would be piloted.

Revitalizing the Civil Service

The underlying arrangements for government employment stem from the 1970 law on the "Status and Condition of Government Employees" as amended by the 1977 decree on the civil service, which provides for a system of centralized recruitment, job classification, grading, and pay. Although this legislation included a number of sound provisions, in reality Afghanistan's civil service emerged from the Taliban era in a state of profound crisis. Its situation could be characterized as follows:

- *Large uncertainties about the size of the public service*. It was very difficult to ascertain the number of staff employed by the government because of the absence of a nominal roll of employees and large variations in the number of staff paid each month. These difficulties were compounded by the failure of payroll data to in-

[9]As prescribed in the May 1999 Taliban decree until the tax law is amended.

dicate the specific ministry in which the provincial staff worked or to distinguish between staff working in ministries and those working in government enterprises. As a result, 2003 estimates for total civilian employment ranged widely from 240,000 to 331,000, excluding military personnel (about 100,000) and government enterprises (about 35,000). In addition, little was known about the status, competence, and efficiency of the civil service.

- *A serious lack of professional capacity*. Although the size of the civil service did not appear large relative to the population (1.4 percent of the population excluding state-owned enterprises and military), numbers were still out of proportion to the minimal services actually delivered. The low level of service reflected the very weak capacities in the ministries, with overrepresentation of unskilled workers in the government's workforce and the absence of qualified senior staff, most of whom emigrated during the war.
- *Pervasive patronage*. The AIA inherited a situation where a large number of civil servants had been hired on the basis of their ethnic origin and loyalty to the successive factions that ruled the country, rather than their proven professional qualifications.
- *Inappropriate pay arrangements*. The pay and grading system was inadequate to attract, retain, and motivate skilled civil servants:
  - The average monthly pay in 2003 for civil servants was approximately Af 1,800 (about $36), which was probably higher than market rates for unskilled staff but clearly well below what would be needed to retain or recruit qualified senior civil servants. Low salaries for public servants increase their vulnerability to corruption, especially among those dealing with the private sector (e.g., customs).
  - The wage structure was extremely compressed because food allowances comprised the bulk of total pay. The vast majority of government staff was paid approximately the same monthly salary of Af 1,800. The salary compression was recently exacerbated by the introduction of an additional flat rate food allowance in May 2002.
  - The government's ability to manage its workforce was hampered by the extensive practice by some donors and nongovernmental organizations to pay large "salary top-ups" to Afghan civil servants working on externally supported projects. This distorted the public and private sector pay market and created resentment from staff not benefiting from these arrangements.
- *Fragmented and duplicated government structures*. A number of public institutions were remnants of the old centrally planned economic model and their existence was no longer justified in a market-based economy. Similarly, in the past, the rationale for creating a number of government bodies was based on the need to grant official positions to powerful individuals and factions rather than to provide specific public services to the population. This resulted in the fragmentation of government structures and the unnecessary overlapping of many public functions.

In view of all these problems, reform of public administration and civil service is critical for Afghanistan's development and has therefore been made a priority in the reform agenda by both the authorities and donors. The World Bank has provided the authorities with significant technical assistance in this area.

An important step in the modernization of the civil service was the establishment, in June 2002, of the Administrative Reform and Civil Service Commission (ARCSC), the creation of which was an obligation of the government under the Bonn agreement. The commission's main responsibilities were set out in a presidential decree in June 2003. These responsibilities include designing and implementing the civil service management policies and procedures; coordinating the public administration reform program; recruiting government senior staff on the basis of a fair, transparent, and open process; and overseeing lower level appointments in the civil service. However, at the time of writing the specific delineation of responsibilities between the ARCSC, the MoF, the Ministry of Labor and Social Affairs, and the Office of Administrative Affairs was not fully clarified. In particular, it was unclear whether the ARCSC responsibilities would cover all—or only part of—the tasks usually assigned to a civil service management agency, including the establishment of a register of government-sanctioned positions; oversight of personnel records; development and maintenance of a human resource database; workforce planning; job classification and grading; and pay policy.

The authorities presented in the 2003/04 NDB a detailed short-term strategy for public administration and civil service reform, aiming at creating a lean, capable, and motivated civil service dedicated to supporting the country's national interests. This strategy focuses on the following elements: (1) drafting a new civil service law and subsidiary regulations governing civil service employment; (2) revising the pay and grading arrangements on a pilot basis; (3) developing a nominal roll for civil servants; (4) introducing a comprehensive government payroll system in the treasury; (5) reviewing ministerial staff and structures; (6) starting preparatory work for future retrenchment arrangements; and (7) individualizing salary payments.[10] The government also committed to improving the timeliness of provincial salary payments and implementing effective arrangements for enforcing civil service headcount ceilings mandated in the annual budget.

Although the authorities are fully aware of the central role of the civil service reform in the reconstruction process, they have emphasized that this reform is faced with considerable difficulties. It will take time and will need to be carried out with caution because of its potentially large economic and social implications. In particular, any across-the-board pay reform will need to remain compatible with medium-term fiscal sustainability. Moreover, detailed proposals for salary decompression remain contingent on a reliable classification of individual positions in the government, which is a lengthy and resource-demanding process that has not yet started. The implementation of a retrenchment program would be a highly sensitive political issue because civil service employment continues to serve as a social safety net for a large part of the urban population; also, this program cannot be implemented without prior development of a nominal payroll and effective establishment controls to avoid the dangers of staff leaving and then reentering the civil service.

Under these constraints, progress in the civil service reform has been slow.[11] However, important initiatives have been taken, including the approval by the cabinet in July 2003 of a presidential decree—Priority Restructuring and Reform Decree—introducing an interim additional salary allowance for specific positions in ministerial departments that are considered critical for reform (e.g., customs, tax) and are undergoing a large-scale restructuring of their functions. A number of departments have already submitted applications to the ARCSC to benefit from the provisions of the new decree, including customs and treasury in the MoF. A second decree was adopted in late 2003 to regulate and limit the salary top-ups granted by donor agencies.

Developing the Private Sector: Building a Market-Led Economy

Afghanistan has a long tradition of entrepreneurship and a vibrant private sector, which has actively engaged in agricultural production, trading activities, and small-scale industrial activity for centuries. In the 1980s, the development of the private sector was hampered by the preference given to an economic model based on state intervention and was further undermined by subsequent war, devastation, and neglect. The first condition to restoring Afghanistan's business vitality is to consolidate security and political stability throughout the country. Equally important is the establishment of a strong judicial system able to effectively enforce laws and regulations. Energizing the private sector also requires the building of a legal framework that would provide for fair, transparent, and simple rules for the operations of corporate entities, especially with regard to the banking system, tax and customs, competition protection, property registration, and foreign investment.

Important steps have been taken by the authorities in this direction, including enactment of new, modern banking and central banking laws (see Chapter 6), successful implementation of the currency conversion (see Chapter 5), large-scale customs reform, and enactment of a new domestic and foreign investment law.

In August 2002, the ATA replaced the 1987 law on domestic and private investment with a new law dropping the provisions of the previous system, which had negatively affected foreign direct investment, including joint venture requirements, minimum Afghan capital requirements, and limitations on repatriation of profits. The new law also provided three- to seven-year tax holidays to eligible companies, according to the type of investments, as well as

[10]Currently, salary checks are not cashed by the individuals: the manager of a spending unit cashes a check issued by the treasury, accounting for the salaries of his subordinates, and distributes the cash to his staff.

[11]Apart from the decrees establishing the civil service commission and its functions.

a four-year exemption from export tariffs and duties. Under the law, a High Commission on Investment, chaired by the Minister of Commerce,[12] became responsible for all policy decisions regarding domestic and foreign investment, and an Office of Private Investment (OPI), established within the Ministry of Commerce would determine which investments qualify for tax holidays. The authorities' decision to scrap the obsolete 1987 law was a critical step toward the development of foreign private investment in Afghanistan. However, the use of tax holidays as a tool for encouraging capital inflows was questionable. International experience has shown that such exemptions reduce the transparency of the tax system, hamper the efficiency of tax administration, and significantly erode the tax base, all of which may have a detrimental impact on revenue collection in the medium term. The IMF generally counsels against the use of tax holidays and recommends instead more transparent mechanisms for encouraging investment, such as low corporate tax rates, accelerated depreciation regimes, and liberal loss carryforward rules. Following these recommendations and those from other donors, the August 2002 law was redrafted in 2004, and a revised law is to be enacted.

The government has taken steps to attract investment in major areas, including the sale of a telecommunications license in October 2002 and the signing of public contracts with international developers to renovate two major hotels in Kabul.

In addition to stimulating foreign investment, the transformation—through partial/total privatization or closing down—of the extensive SOE network is a critical element of Afghanistan's transition to a market economy. Such a reform would eliminate the burden placed on the ordinary budget to support these enterprises,[13] restore a level playing field between these enterprises and potential private sector competitors, and reduce the scope for corruption. As of 2003, preliminary data suggest that, of the 174 public enterprises that operated under the communist regime (and accounted for more than one-third of the revenues of the ordinary budget), only 80 had survived (or 161, including their provincial branches), accounting for a total of more than 35,000 employees. Only a small number of SOEs seem to have been viable; none was self-sufficient—let alone profitable—and most of their employee salaries were fully paid out of the government's ordinary budget. The main SOEs in 2003 were the public utility companies, such as electricity and gas production and distribution, some of which have had partial success in collecting utility fees, but only in major urban centers.[14] Other important SOEs include fabric-making companies and small-scale cement industries.

The authorities have indicated that that they do not intend to revitalize nonfunctioning public enterprises and plan to close them down or divest them to the private sector whenever possible. A Commission for the Evaluation of the State-Owned Enterprises was established in June 2002 and started operating in January 2003. Its main activities include assessing SOE operations and assets, preparing recommendations for privatization, and drafting transparent privatization procedures. Its activities so far have been primarily limited to a census of the existing SOEs. Notwithstanding their commitment to an ambitious overhaul of the public sector, the authorities have acted cautiously in this area for the following reasons: (1) most records of SOE assets have disappeared, making it extremely difficult to design any privatization strategy; (2) there has been reluctance on the part of the government to rush into a privatization process that, without appropriate assurances and safeguards, could create considerable opportunities for corruption; (3) line-ministries have been reluctant to delegate the transformation of the enterprises operating in their sector to the newly created Commission for the Evaluation of SOEs; and (4) this is a highly technical area in which major technical assistance is required and no such assistance has materialized yet. Significant progress in this area is unlikely without strong support from the international community.

Appendix 4.1. Pay Structure for Government Staff and Tax Summary

As of August 2003, there were two pay scales for government staff in Afghanistan—one for perma-

[12]The commission comprises the ministers of finance, justice, foreign affairs, and planning and reconstruction, as well as two representatives of the private sector.

[13]About $52 million has been appropriated in the 2003/04 budget to fund SOEs.

[14]Ariana Airlines, the Afghan national airline, does not have the status of a public enterprise.

Box A4.1. Civil Servant Salaries

Base pay	Payable to all staff.
Food allowance	Payable to all staff.
Second food allowance	Introduced in May 5, 2002. Not payable to teachers.
Transport allowance	Payable only to public employees in Kabul.
Professional allowance	The amount of this allowance varies according to the level of education: • Af 8 for those who have completed high school; • Af 15 for a university degree; • Af 17.5 for an additional year beyond university; • Af 20 for a master's degree; • Af 25 for a doctorate.
Additional professional allowance	Only payable to permanent staff at the highest level of the pay scale.
Scientific allowances	Only payable to permanent staff at the highest level of the pay scale.

nent staff (*karmand*) and one for contract (*agir*) staff. *Karmand* were regular, permanent public employees, whereas *agir* were hired on fixed-term contracts. The base pay scales were very similar. The same monetary allowances applied to both, but teachers, whether *karmand* or *agir*, did not receive the second food allowance introduced on May 5, 2002. The different elements of the civil servants' salaries are outlined in Box A4.1.

The tax summary is presented in Table A4.1.

TABLE A4.1
Tax Summary
(As of August 2003)

Tax	Rate	Taxable Base	Remarks
Corporate income tax (CIT)	Flat rate of 20 percent.	Net profits of corporations and limited liability companies.[1]	• Most expenses incurred to derive gross income are deductible. • Firms are allowed to deduct losses incurred in previous years. • The CIT is mostly collected in the form of withholding taxes on imports and exports creditable against the income tax (see below).
Personal income tax (PIT)	Progressive schedule comprising 21 brackets, with rates varying from 4 to 60 percent.	Income of employees (salaries and wages) and profits of non-corporate entities.	• The basis for taxation is Afghan citizenship. The tax is imposed on the worldwide income of Afghan citizens wherever they live. • The wage PIT that used to be collected on government and private sector employees (wage withholding tax) seems to have disappeared at the beginning of the 1990s. Most of the PIT is now collected in the form of fixed presumptive taxes levied on individuals (see below).
Business receipts tax (BRT)	Two rates: • 2 percent: gross receipts of legal persons engaged in domestic business. • 2½ percent: receipts of legal persons engaged in import and/or export operations.	Gross receipts (before any deductions) of corporations and limited liability companies.	• The BRT comes in addition to the CIT on taxable profits. • The BRT must be paid within six months of the end of the fiscal year, irrespective of whether the business makes a profit or a loss. • Imports are not taxed under the BRT but exports are. • The BRT raises greater revenue than the CIT.
Fixed withholding taxes on imports and exports (creditable against the income tax)	• Imports: 4 percent for licensed importers and 3 percent for unlicensed importers.[2] • Exports: 4 percent for licensed exporters and 2 percent for unlicensed exporters.[3]	• Unincorporated exporters or importers.[4] • The tax is based on the duty-paid cost of imports/exports.	
Presumptive taxes in lieu of the income tax	• Retailers: Based on a 170 category classification of businesses. Taxation depends on the types of goods sold and the size and location of businesses. • Limited list of specific businesses (e.g., cinemas, theaters, mills): 10 percent on estimated turnover. • Transportation businesses (e.g., taxis, buses): Lump sum depending on the type, size, and characteristics of the vehicles used. • Government contractors: From 1 to 8 percent of the price of the goods and services purchased by the government.	Estimated gross receipts of corporations and limited liability companies (except importers and exporters).	The major reasons for using presumptive taxation in lieu of income tax are simplification, reducing compliance costs for the taxpayer and the tax administration, and combating tax evasion.[5]

TABLE A4.1 *(concluded)*

Tax	Rate	Taxable Base	Remarks
Import duties	25 tariff bands with rates ranging from 7 percent to 150 percent allocated across 888 tariff headings.	C.i.f. in Afghani value, using an exchange rate of Af 4.5 per U.S. dollar.	• Customs tariffs currently in use were introduced in 2000. • Imports of petroleum, diesel, and kerosene for transportation purposes are exempt from duty. • The exchange rate used for valuation is well below the open market rate (approximately Af 38–40 per U.S. dollar).
Fees and charges	• Chamber of Commerce license and valuation of imports/exports: 2.5 percent. • Red Crescent fee: 2.5 percent. • Ministry of Commerce's permit fees (e.g., cars $200 to $400, cigarettes $2.5 per case).	For the Chamber of Commerce and the Red Crescent: c.i.f. invoice value of exports or imports.	In addition to customs duties, there are numerous fees, and other taxes levied on imports and exports that add significantly to the cost of international trade.

Source: Afghanistan's Ministry of Finance.
[1]A type of partnership.
[2]For unlicensed importers, this tax is not creditable against the income tax.
[3]For unlicensed exporters, this tax is not creditable against the income tax.
[4]If they are incorporated, they only pay the CIT.
[5]In a presumptive tax, the concept of income tax base is replaced by indicators that are more easily measured.