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Abstract

Tax evasion is the illegal evasion of taxes by individuals, corporations, and trusts. Tax evasion often entails taxpayers deliberately misrepresenting the true state of their affairs to the tax authorities to reduce their tax liability and includes dishonest tax reporting, such as declaring less income, profits or gains than the amounts actually earned, or overstating deductions. Afghanistan is cracking down on tax evasion to repair its finances as the country’s economy struggles with renewed violence and the withdrawal of the huge coalition presence that fed business for years. The departure of most foreign troops two years ago allowed the Taliban to take advantage of the security vacuum and escalate attacks on the government, hurting consumer and business confidence. Double-digit economic growth rates collapsed to almost zero a year after the withdrawal.

Key words: Deliberately, Misrepresenting, Cracking down, Tax evasion, Escalate, Vacuum, Double-digit, Collapse.

1.0 Introduction

Tax evasion is a general term often used in cases where an individual or a company evades taxes all together in violation of a country’s tax laws. Tax evasion can take many forms: individuals or businesses underreporting their income, or failing to report their income all together; companies and individuals also hide or evade obligatory tax withholding on rental income and rental payments, on business services, on dividends and on staff salary payments. Large-scale underreporting of profits in various sectors such as telecommunications, construction, trading and extractive industries, is also quite common.

Tax evasion is an activity widely practiced in Afghanistan by national and international companies, organizations and individuals. The willingness of a country’s citizens to pay taxes and the ability of a country’s government to collect taxes is a critical factor in improving the economic situation of a country, especially for third world countries such as Afghanistan which are suffering from terrorism, corruption and poor governance. Taxes also play a crucial role in maintaining the existence of the state. Small firms, large firms and international companies and organization are required to pay taxes and the role of any government should be to establish procedures for the collection of taxes in order to support its public service sectors. For example, public health care, government employees’ salaries, education, the work of the National Police and National Army, and the maintenance of public utilities which provide people and industries with energy and water – all such government expenditures rely, at least to some extent, on taxes. Based on the information provided by various sources (Afghan Zariza & AISA) there are 40,000 local and international companies registered with Afghanistan Investment Support Agency (AISA) and investigations shows that some of these companies, especially foreign companies owe billions Afghanis (AFN) as tax to the Afghan government and some of them function without the obligatory business license. Some of these foreign companies which are
working in Afghanistan has continuously failed to clear the dues, despite repeated reminders from the Afghan government’s Ministry of finance.

There are various reasons for the tax evasion problem in Afghanistan. The fundamental problems are manifold, but include the lack of a strong political will, an overly bureaucratic system, poor government standards, loopholes in the rules, weak enforcement mechanisms, and a lack of resources and expertise. Another reason relates to corruption, the payment of bribes and the use of political influence. Many Afghans who should be paying large tax bills, especially wealthy businessmen, are closely linked to senior officials and political figures. These “untouchables” do not always pay their full tax bill. In addition, customs revenues, which account for about half of Afghan government revenues, have been declining due to the theft of custom duties. (Rosenberg, 2013)

Tax evasion determinants have not been investigated in Afghanistan, nor have any published studies fully examined the factors influencing tax evasion. Thus far only a few media pieces have reported on occasional superficial cases of tax evasion with researchers referring to this issue in their studies or desk reviews. Research on tax evasion and tax avoidance is an urgent requirement to identify the actors involved and to highlight the revenue loss to the country. The proposed study will cover the matter comprehensively in two parts; 1) a literature review and some qualitative research will be conducted; 2) legal gap analysis research will be undertaken to find the gaps and to develop an accurate measure of tax evasion at the individual and corporation levels and identify the variables associated with tax evasion.

In this study various forms of tax evasion will be evaluated;

1. **Non Declaration of Income**: This is the most common form of tax evasion practiced by individuals and companies. Under this form of tax evasion, individuals and companies have not declared all their income to the tax officials or to the Ministry of Finance. In this case, some companies and individuals have more than one source of income or do not disclose all of their income or all of their sources of income to the government.

2. **Non Payment of Customs Duties**: Customs duties are often under paid or not paid at all in Afghanistan. Importers avoid paying customs duties by either under pricing the products that are imported into the country or by understating the quantity of such goods imported.

3. **Smuggling of Goods**: Some businessmen or people pay no customs duties on the products that are brought in or taken out of the country. Individuals pay bribes on the main transit routes or they use transit routes where there are no custom offices functioning. Alternatively, these individuals pay bribes to high government authorities who, in turn, let them take goods in or out in the country without the payment of legally required duties.

Beside these forms of tax evasion, most of the big companies working in Afghanistan evade rent withholding, business receipt tax, dividend taxes, and staff withholding taxes. In the latter case this arises because there is no proper system to track staff salaries paid by employers.

### 1.1 Background of the Study

Afghanistan’s taxation system is improving but remains one of the greatest impediments to economic growth and foreign direct investment. Despite sustained efforts of the AACC, the International Stability Operations Association (ISOA) and other trade groups and donor government representatives over the years the issue continues to haunt the National Unity Government (NUG). If problems with the current system could be
resolved concretely, this would immediately impact business growth and capital investment (especially in the short term). Taken together with other equally important market-oriented policy reforms this change could help improve national employment and private sector development for decades to come. Below the AACC has laid out the problems and challenges with the current Afghanistan taxation system and we close with specific recommendations on moving forward strategically to solve these issues.

First, it should be acknowledged that the Government of the Islamic Republic of Afghanistan (GIRoA) is under significant pressure from the World Bank, bilateral and multilateral donor institutions to ensure that its collected tax revenue system is growing to the point it becomes fully, financially self-sufficient and eventually sustainable. This difficult task is compounded by the reality that many of the foreign private firms operating in Afghanistan are considered “tax-exempt” under U.S. law since their services are provided by American foreign assistance (or those of other donor states) that support the GIRoA and people of Afghanistan. Under U.S. law, no U.S. assistance is taxable by the host government that receives this assistance through implementation by U.S. foreign policy/assistance implementing organizations like DynCorp or Chemonics or by international NGOs like Save the Children or Islamic Relief. Even today however, these programs are not exempt under Afghanistan law. Second, after the formation of the National Unity Government (NUG) GIRoA has focused on increasing its own “domestic resource mobilization or DMR” revenues by more aggressively pursuing tax cheats and individuals and organizations who try to shield or hide wealth from taxation inside Afghanistan. The result has been a significant improvement in the percent of DRM revenues collected and to a great extent they should be complemented on this undertaking. However, in the process of achieving these milestones the GIRoA, principally through the Ministry of Finance, has also determined that a number of foreign organizations (mostly for profit businesses) that were implementing U.S. foreign assistance and thus tax exempt under U.S. law, were also operating inside Afghanistan in certain non-foreign assistance projects and services and were using their U.S. Government support contracts to hide or avoid tax obligations to the GIRoA.

1.1.1 Problem Statement

The tax evasion has the following problems:

1. **Political:** Most revenue collection procedures depend on government policies, many which include exemptions for specific actors. For example: a great deal of revenue is lost due to exemptions stipulated by international agreements between donor countries and Afghanistan’s revenue departments (For example, international forces and their companies receive custom exercise and revenue tax exemptions, which are also used by some multinational companies not operating within that sector and resulting in a significant loss of government revenue. Recently, the Afghan government even entered into a dialogue to consider receiving less international aid in exchange for terminating the exemptions policy on international imports.

2. **Economic:** Changes in taxation, economic growth, interest rates and inflation can have a negative impact on the behavior of taxpayers. For instance the frequency of fluctuation in the Afghan currency (AFN), pegged to the U.S. dollar (USD) poses a challenge as most imports are in USD and changes in the exchange rate result in higher inflation of the AFN.

3. **Social:** It is difficult to introduce a tax collection system after a prolonged period of war, particularly when instability persists. In most villages the practice of paying taxes is linked to either unfamiliar or associated with informal illicit or illegal activity; without a legacy of lawful government taxation, a rigorous public awareness campaign is needed.

4. **Technological:** Revenue collection officers often use paper-based systems, which limit the capacity to perform their duties effectively and in a timely manner. At present, paying taxes incurs an additional logistical
and financial burden on citizens, particularly residents of the most rural communities, who must organize their work schedule and travel great distances to pay their taxes. In the rest of the world, the government enables citizens to pay taxes from their homes (online) or within their own communities (sending the final documents through the mail).

5. **Environmental:** The security situation and lack of functioning infrastructure limits the mobility of taxpayers and tax collectors; twenty-one of Afghanistan’s 34 provinces are currently in a state of conflict or partial conflict.

6. **Legal:** The discriminatory nature of certain government policies favors particular communities and political groups and negatively impacts the tax collection process (e.g., the parliament of Afghanistan voted against the new tariff rates on cigarettes to favor members of ruling groups who profit from their sale).

**1.1.2 Objectives of the study**

The broad objective of this study is to determine why people evade tax owed to the government of Afghanistan and to suggest ways of minimizing these practices in Afghanistan. The objectives will be further broken down to the following specific objectives:

1. The current state of tax evasion in Afghanistan
2. An assessment of the relationship between tax rates, tax evasion and existing legal gaps
3. An investigation as to why people evade taxes and in which sectors tax evasion is most common
4. An analysis of the effect of tax evasion on the revenues of the Ministry of Finance of Afghanistan
5. To propose solutions to the problem of tax evasion in Afghanistan

**1.1.3 Research questions**

1. What forms does tax evasion typically takes in Afghanistan?
2. Is the existence of loopholes in the Afghan tax law system an opportunity for tax evasion?
3. Is there any effect of tax evasion on the Afghan economy?
4. How can tax evasion and tax avoidance be minimized in Afghanistan?
5. In which sector tax evasion is common or not controlled?
6. How much money are we talking about?

While we will try to make an estimate of the total amount of revenue which is foregone by the government as a result of tax evasion. This is clearly a difficult task and will require separate research on each type of tax which is under collected.
2.0 Literature Review

The Ministry of Finance has threatened legal action against a number of small and medium security, communications, printing and airline companies that have evaded taxes "for several years."

The ministry did not disclose the offending companies, but it warned that they would be prosecuted and their names made public if they failed to pay all their taxes before the end of the Afghan fiscal year, coinciding with mid-January 2013. The ministry spokesman added that the number of tax-evading companies has decreased since last year, but he emphasized that more companies should pay their taxes in a timely manner. The government has recently taken a hard line against offending companies.

"Some local companies in the media, printing press, air, security, and telecom sectors that have not cleared their accounts for a few years now. Their licenses have been seized and their penalties are increasing," said Spokesman Waheed Tawhidi.

"They should resolve their problem with the government and pay their taxes. Their names will be made public if they don't pay their taxes," he added.

Tawhidi said the ministry is willing to work with companies to facilitate a gradual payment of their back taxes.

The government is largely dependent on foreign aid for the vast majority of its budget expenditures. With the so-called security and economic transition underway, Afghanistan is attempting to boost government revenues and reduce its aid-dependency.

Cracking down on tax-evading foreign and domestic corporations and boosting customs taxes have been the cornerstones of the government's policy.

The Ministry of Finance has reported improved revenues over the past couple of years, but the revenues are a fraction of government expenditure.

A new tax regime aimed at weaning Afghanistan off international aid has boosted government revenues but drawn complaints from some private businesses that it hits them unfairly, dampening hopes of economic recovery after decades of war. Afghanistan’s finance ministry says it expects to raise almost $2.5 billion in revenues in the year to March, 2017, $500 million above target, an important achievement as cash for aid and foreign armed forces begins to slow.

The increase in a country plagued by corruption and tax evasion is down to better tax collection rather than a stronger economy, though, and firms say they are being targeted by over-zealous officials whose demands on time and money are preventing them from investing in expansion for the future. With Islamist insurgents controlling large swathes of territory and appealing to young men to join their ranks, creating jobs is crucial to Afghanistan’s battle against militancy. “Their only concern is raising a certain amount of revenue. How it’s done is of no concern to them,” said Mustafa Sadiq, whose firm Omaid Bahar Fruit Processing usually employs around 200 staff and double that number at peak times. “They’re not increasing the volume of business, they’re just increasing taxes on whatever there is left.” Under rules introduced at the end of 2015, the main business receipts tax rate was doubled from two to four percent and companies must now pay four times a year.
Although absolute levels are not high by international standards, compliance imposes a heavy burden for a sector where many had been used to paying no tax at all. Businesses, many of which learned of the new rules months after they became law, complain of arbitrary and overbearing tax inspectors and say the system is slow, inefficient and open to abuse with some officials demanding bribes for quick clearance. Already struggling to compete with cheap imports from neighbors Iran and Pakistan, they say the tax drive is stifling the private sector, which saw a 30 percent decline in new business registrations during the first half of 2016. Bahar makes juices from apples, grapes and pomegranates, mainstays of the horticultural sector that the government sees as a top development priority. Instead of expanding, Sadiq says he spends much of his time wrangling with inspectors or doing paperwork. “I personally planned to start two or three small manufacturing businesses but I decided no,” he said. “I haven’t been as disappointed at any time in the past 30 years.”

2.1 Boosting Revenue

Economic development in Afghanistan rarely draws the headlines, which are dominated by the ongoing conflict. Much of the $20 billion economy, whose main products, aside from opium, are fruit and carpets, operates informally, paying no taxes. While the government needs revenues, it must try to avoid squashing private enterprise. “If the government is under pressure, then so is the private sector,” said Fawad Saafi, whose Mill factories group makes products ranging from PVC tubes to foam mattresses. His workforce has dropped from 700 to under 200 as economic growth stalls and business dries up.

Saafi’s problems point to a dilemma for the government in Kabul. International donors recently pledged $15.2 billion to 2020, but after that, the future is unclear and there is little appetite for open-ended support. The government has raised airline over flight fees and slapped a 10 percent levy on mobile phone top-ups, but mining riches are a distant dream and efforts to introduce VAT on consumption failed.

Meanwhile, growth is expected to come in at no more than 2 percent for 2016, well below the rate of population growth. Although companies complain, the finance ministry claims some success in increasing domestic revenue and beating targets set by donors. “Taxes are nobody’s favorite, especially those who have to pay and that’s why you see resentment,” said Khalid Payenda, director-general for macro fiscal policy at the ministry. He says the government is aware of the risk of overtaxing one section of the economy, and expresses some sympathy for the bureaucracy companies face. “But if you look at it from the perspective of the government, I think they did a very good job of bringing the fiscal picture back to normality.”

President Ashraf Ghani has taken Afghanistan into the World Trade Organization and launched infrastructure projects like energy and rail networks to strengthen regional links and trade. But after decades of war, Afghanistan is ranked 183 out of 190 countries in the World Bank’s Doing Business index and the tax drive has not made it easier. “Large formal companies complain that the more responsible and visible companies share disproportionate corporate burden of taxes,” the report noted. It is unclear whether revenues, boosted in 2015 by currency fluctuations and back taxes, will continue to rise. “The feeling amongst many business people is that if some bureaucrats drive past a successful business they’ find a way to extract money from it,” said Franz-Michael Mellbin, EU Special Representative to Afghanistan. “That makes for a really hostile business environment and it doesn’t need to be.” ($1 = 66.5500 afghanis) Additional reporting by Mirwais Harooni; Editing by Mike Collett-White Our Standards:The Thomson Reuters Trust Principles.

In the early 1980s, direct taxes accounted for about 15% of government revenues. The share provided by indirect taxes declined from 42% to 30%, as revenues from natural gas and state enterprises played an increasing role in government finance. Tax collection, never an effective source of revenue in rural areas, was
essentially disabled by the disruption caused by fighting and mass flight. Under the Taliban, arbitrary taxes, including those on humanitarian goods, were imposed.

In 2005 the government introduced an income (or wage) tax. Employers with two or more employees were required to pay 10% on annual income over about $3,500 and 20% on income over about $27,000.

3. Methodology

Aid for Afghanistan is reducing and Afghan government is expected by international community to generate internal revenue. Therefore, this research will attempt to identify priority areas where there is potential for the government to ameliorate leakages. Our research will require visits to different government and non-governmental organizations and to private companies to gather information and documents related to tax evasion. We will seek to gather accurate data and information about various contracts, the nature of the contracts and the tax declaration process. The study will require on-the-ground research and site visits, an in depth literature review, key informant interviews and focus group discussions with several categories of people from Government and non-governmental organizations as well as subject matter experts with experiences in different countries and with individuals having in depth knowledge of the tax situation in Afghanistan.

The study will be based on a literature review and interviews with individuals involved directly or indirectly in tax evasions and contracting. The study will be conducted through experienced researchers who have extensive knowledge of tax matters in Afghanistan. The Research Manager of IWA, who has background in a variety of different qualitative and quantitative research subjects, will lead the entire project beginning with data and information collection up to the final stage of the project. An expert researcher will draft the report.

IWA will build a team of researchers under the direct supervision of international experts to design the research methodology to effectively collect data, analyze the collected data and write up the analytical report. The outcome of this study will help to build on the existing knowledge base regarding tax evasion. It will also provide the tax authorities at the MoF with an insight into what measures they might take in reorganizing the overall operations of the tax office in the future. Furthermore, it is hoped that this research will assist the tax authorities and the National Procurement Authority to identify those individuals and companies/corporations currently evading taxes due to the Government of Afghanistan.

4.0 Findings

The negative result of tax violations that often leads to tax evasion and in different countries would enter irreparable strikes to the status of their national economy then can better understand the necessity of the existence penalties for those who violate the tax laws and we can realize its importance.

Afghan lawmakers are also considering the importance of the existence of legal measurement relating to tax crimes and offenses, and its role in prevention and reduction of such violations. The tenth chapter of Law on Administration of Taxation Affairs states some situations in which taxpayer is considered delinquent and deserve to be punished. The following briefly outlines some of these cases:

**In case of intentional avoid from submission income tax sheets:** The person who cannot provide its income tax sheets in accordance with the income tax law or until the expiration of the extended due date of the tax
office, individual person will sentence by the court of competent jurisdiction to pay the fine of five thousand Afghanis (5,000) and legal person the sum of twenty thousand Afghanis (20,000).

**In case of not withholding the taxes:** The person who will not pay the withholding tax in accordance with provisions of tax laws without any reasonable excuse; the individual person will be sentenced by the court of competent jurisdiction to the payment of an extra amount of ten percent of the withholding tax, imprisonment which not exceeding six months or both (fines and imprisonment).

**In case of not archiving and maintaining the records:** The person who does not arrange and maintain his/her records intentionally in accordance with provisions of tax laws; individual person will be sentenced by the court of competent jurisdiction to pay the fine of 25,000 Afghanis and legal person the sum of 100,000 Afghanis, or imprisonment not exceeding six months or both (fines and imprisonment).

**In case of non-cooperation with officials of revenue departments:** The person who does not provide necessary facilities to the officials or not cooperating in cases specified by law in accordance with provisions of tax laws; individual person will be sentenced by the court of competent jurisdiction to pay the fine of 10,000 Afghanis and legal person the sum of 40,000 Afghanis.

**In case of using false TIN intentionally:** The person who intentionally uses incorrect TIN in tax return sheets, or any document that have been predicted in the tax laws; the individual person will be sentenced by the court of competent jurisdiction to pay the fine of twenty-five thousand Afghanis (25,000) and legal person to one hundred thousand Afghanis (100,000). Or to imprisonment not less than three months and not more than six months, or to both (fines and imprisonment).

**Noncompliance with notifications and inquiries:** The tax office can ask the person in written to provide documents, records, information, or computerized information which is available in tax office within the period expressed in the notice, or presence in the time and place specified in the notice in order to assess it’s tax affairs; the person who doesn’t complied the written notice without any reasonable cause; individual person will be sentence by the court of competent jurisdiction to pay the fine of 5,000 Afghanis and legal person the sum of 20,000 Afghanis.

**In case of providing false or misleading statements:** The person who intentionally provides false or misleading statements or removes a certain part of it; the individual person will be sentenced by the court of competent jurisdiction to pay the fine of 40,000 Afghanis and legal person the sum of 160,000 Afghanis, or imprisonment not exceeding six months or both (fines and imprisonment).

**Intentionally creating obstacles to tax officials:** The person who intentionally hamper the implementation of employees tasks which is cited by the tax law, individual person will be sentenced by the court of competent jurisdiction to pay the fine of 40,000 Afghanis and legal person the sum of 160,000 Afghanis, or imprisonment not exceeding six months or both (fines and imprisonment).

Finally, it should be noted that the above issues relate to taxpayers and conditions which are related to tax officials, auditors, and other involved parties are is not mentioned.

**5. Conclusion**

Tax evasion is an illegal activity which aims to hide taxable income from the view of the tax authorities. It should be distinguished from tax *avoidance*, which consists in trying to reduce one's taxable income by exploiting the tax law while staying inside its boundaries. While the distinction between the two may
sometimes be unclear, there are at least a large number of cases that definitely belong in the evasion category; these are sometimes referred to as the hidden or black economy.

Tax evasion is a risky activity. By holding back information from the tax authorities, there is always a risk of being discovered, in which case one typically faces a penalty rate on the unreported income. The gain on a dollar of unreported income, i.e., the regular rate of income tax, must be balanced against the probable loss, which is the probability of detection times the penalty rate of tax. When the regular income tax rate goes up, the gain increases, and it thus tends to encourage evasion, e.g., in the form of working in the hidden economy. Theory seems to support the common concern that a high tax level encourages cheating and dishonesty. However, this should not lead us to expect that high-tax countries necessarily have more tax evasion than countries with lower tax levels. The extent of evasion depends not only on the level of income taxation, but also on a number of other social and economic factors, and these are likely to vary considerably among countries.

Theoretical hypotheses in this area are particularly hard to confront with empirical data; in the nature of things, there are no official statistics for the hidden economy, and survey research faces some special difficulties in making individuals answer questions truthfully. A number of the empirical studies that have been made use very indirect methods, such as deducing the size of the hidden economy from the public's holding of cash, and the reliability of this kind of approach is highly disputed (Cowell 1990).

More standard approaches tend to yield estimates which indicate that the hidden economy has a volume of 2–10 percent of the GNP of the official economy. Many studies also indicate that evasion is higher for self-employed than for salaried employees. This is in good accordance with the theory, for wages and salaries are usually reported directly by employers, so the probability of evasion being detected is much higher for employees than for the self-employed, implying that evasion is a less risky gamble for the latter.

It should be added that the emphasis on rational risk-taking behavior as an explanation of tax evasion does not imply that in the economist's view of the world all taxpayers are completely amoral, reporting their income only when a cost–benefit calculation has shown them that evasion does not pay. There are strong indications that many taxpayers report their true income even when under-reporting could easily go undetected. The chief aim of the theory is to explain the behavior of those who do evade taxes, and although they too may take moral considerations into account, they are also likely to consider the risk-taking aspects of their activities in a rational manner.

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