

CHALLENGES PRESENTED BY THE LEGAL AND REGULATORY FRAMEWORK GOVERNING PRIVATE FOR-PROFIT ACTIVITY

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I. FRAMEWORK

According to the World Bank's *2005 Investment Climate in Afghanistan*, "in addition to insecurity, poor land tenure and corruption, the high level of uncertainty and risk facing investors in Afghanistan comes from the absence of a clear legal framework."¹

Three overlapping systems constitute the legal framework in Afghanistan: the *Sharia* (Islamic Law), the *Shura* (traditional systems of informal justice) and the formal system based on the constitution², sometimes overlapping layers of legislation from pre-war times, the communist era and the Taliban. Therefore, few corporate managers are clear about which laws actually apply to them. As *The Investment Climate* puts it, "given the arbitrary enforcement and lack of effective court, [business people consequently] do not spend much time worrying about it. Only 10 percent of the survey³ sample mentioned the legal system as a major or severe constraint. However, establishing a strong legal framework would lower risk and encourage investors." Indeed, the Initial Afghanistan National Development Strategy (I-ANDS) document claims that "the Government is committed to improving the legal and regulatory environment, with a particular focus on enforcement, to strengthen implementation mechanisms in order to lower transaction costs for

businesses and to improve the climate for Foreign Direct Investment."⁴

This background paper aims to present the main challenges Afghan businesses face in dealing with the current legal, administrative, regulatory and fiscal environment governing business activity, and to propose recommendations for the improvement of this environment. Five case studies have been conducted in Kabul and Herat with trading, construction, telecommunications and manufacturing companies. Based on these case studies and other research on private sector development in Afghanistan, key issues currently hampering business development are analysed (cross-cutting and institution-specific issues related to the Commercial Court, Ministry of Commerce and Industries, AISA and Ministry of Finance), along with the responses currently being provided to tackle them. These identified issues then serve as the basis for an initial set of recommendations.

II. CASE STUDIES

Case Study 1: Informal house building company in Kabul

The “Engineer” is an informal contractor or *Tekadar* who was educated and trained in Pakistan, worked six years in Tajikistan and returned to Afghanistan four years ago. He has undertaken private house building projects in Kabul, as well as in Jalalabad and Laghman.

The Engineer is currently building a very large house in Kabul for a senior government official. The value of the contract is approximately US\$ 120,000 and the Engineer estimates that he will take about US\$ 15,000 (12.5 percent) in profit at the end of four months. Despite the scale of the project, the Engineer has little fixed capital invested in his firm. Aside from a computer and a small generator, his company has no assets. He merely circulates capital from the client and takes the margin as personal income.

Though he is currently in violation of the Afghan law because he does not pay any taxes on his income, the very limited enforcement capacity of the Ministry of Finance is what protects him the most: despite the high visibility of his house building activities, he has never been approached by anyone from the Government demanding taxes or even bribes.

In 1383 (2004), he tried to establish a company and register with the Ministry of Commerce, then responsible for issuing business licences for construction companies, but he reports that he was asked to pay a high cost of bribes (according to him, a commission agent approached him for US\$ 600), so he lost confidence in the government and decided not to register as a legal entity.

The Engineer is not legally compelled to get an AISA licence for his activities; he is technically free to engage in economic activity as a natural person and is under no obligation to form a legal entity such as a corporation. If he were to form a company, registration as a with AISA would cost US\$ 750.

However, there seems to be only few marginal benefits for him to get an AISA Investment Licence and thus have to pay taxes. With such a licence, he could win small projects with international donors, but it is not clear if these would represent a higher value than his current house building activity. Having a licence would not ensure him a higher legal protection, as he believes that the Commercial Court of Kabul province is barely operational.

Issues

- ◆ Negative experience with the Ministry of Commerce affects the overall perception of Government
- ◆ Lack of enforcement capacity of the Ministry of Finance reduces the incentive to pay taxes
- ◆ Lack of direct benefits of acquiring an AISA licence (limited access to lucrative markets and no additional legal protection as the Commercial Court is perceived to be inefficient)

Case Study 2: Informal manufacturer in Herat

Ghulam rents a shop in the heart of Herat that doubles as a factory, housing several looms as well as a storefront for his silk wares. In total, he employs 10 loom operators who work on a commission basis. Some of them work in the rear part of the storefront, while others work on looms in their own homes. About half of the home-based labourers are women. The shawls, a mixture of silk and synthetic fabric, are sold out of the storefront. The enterprise has about US\$ 2,500 in fixed capital (the majority being invested in looms) and limited working capital.

Ghulam expresses interest in expanding. He believes that if he could secure 125,000 Afs (US\$ 2,500), he could first expand his production by purchasing 10 additional looms (thereby directly funding 20 to 40 percent of the loan) and by using the rest as working capital in order to import the raw materials himself. He believes that with the expanded capacity, he could reduce his prices significantly and command a larger market share.

Ghulam, and the other silk makers in the area, are registered with the municipality and make annual tax payments. However, because they do not keep accurate records, their tax burden is assessed through the “Fixed Taxes”⁵ system; in this case, at only a fraction of what a formal company would pay. In fact, he and the other informal manufacturers in the cluster do not understand how the Fixed Taxes are currently assessed, and Ghulam is not aware of any alternative to the current taxes he pays. He has no information about AISA and the costs or benefits of its Investment Licence. He also considers his firm to be too small to adopt formal business practices such as using a bank account or accurate record-keeping. Regarding formal financing opportunities, he has no experience of it and, due to a lack of information, overestimates the cost of finance.

Ghulam's main need is access to credit, but an official licence is a prerequisite to obtaining a loan from commercial banks. Even though US\$ 2,500 would be sufficient to buy an additional 10 looms and double his output, without any titled land or property he is unable to secure even a microcredit loan. Even if Ghulam formalised his factory, he would probably face difficulties in obtaining financing. Private banks remain reluctant to offer loans without significant collateral (which Ghulam lacks) due to poor legal protection and the absence of key financial infrastructure such as insurance.

Issues

- ◆ Entrepreneurs lack information on how Fixed Taxes are calculated and what the costs and benefits of the AISA licence are
- ◆ Difficult to obtain titled land and property
- ◆ Financial gap experienced by SMEs which limits their ability to expand

Case Study 3: Informal vehicle trader in Herat

TR is a small vehicle trading company in Herat which imports cars from Germany. While most car importers in Herat import vehicles via Dubai, from where they are then shipped to Bandar-e-Abbas and driven overland to Islam Qala (at the border next to Herat), some importers also buy vehicles in Europe (mostly in Germany) and then transport them overland – a route made popular in the 1970s. Taking advantage of the dramatic growth of vehicle use since 2002, TR's owner established his company in 1384 (2005), and registered at the Ministry of Commerce the same year.

Owning a business licence allows TR's owner to pay less customs taxes: two percent of the costs of goods (including duties) as an advance payment, versus the three percent that non-licensed traders pay. TR's owner believes that his licence from the Ministry of Commerce allows him to receive legal protection from the Commercial Courts:

“If these things happen [other businesses break contracts or steal my names and ideas], the Commercial Courts will help me.”

TR's owner describes all government institutions he has dealt with as heavily corrupt. TR paid US\$ 349 in extra costs for the Trading Licence when it should normally only have cost him US\$ 57. He is very negative about the customs process which he also describes as corrupt:

“At customs, money is the law [...] There is a lot of bribery going on there. It has slowed our business and we are tired of it. The high tax abated our business.”

However, bribes can also help him in his business, as they allow him to easily alleviate the customs duties he should face:

“If we give bribes, customs officials will underestimate the value of the goods, and we will pay less tax. If we don't pay bribes, our goods will be delayed in customs.”

Lack of enforcement of the law is apparent in the taxes TR's owner pays. A trader is requested to pay the balance between the Business Receipts Tax (BRT) and his annual Corporate Income Tax payment on one side, and the advance payments made at the border on the other side. However, there is no clear system of enforcement of this balance payment. In fact, TR's owner does not pay it and has not been asked for it.

Issues

- ◆ Discount on advance payment for licensed traders is enforced at customs
- ◆ Reported corruption at the Ministry of Commerce and Customs Departments
- ◆ Lack of enforcement capacity of the Ministry of Finance reduces the incentive to pay the balance taxes at the end of the year

Case Study 4: Partially formal trading company in Kabul

STI, a trading company and retailer which sells a variety of cables, bulbs and other electric devices imported from Iran, was established in 2002. It currently employs 20 people and is present in Kabul, Mazar-e-Sharif and Herat. STI's owner registered his company at the Ministry of Commerce in 2002 and obtained an AISA licence in 2005.

Attitudes of STI's owner seem to have played an important role in his interactions with government institutions. He is convinced that there is strong enforcement of governmental regulations, and that it is impossible to operate without a Trading Licence or avoid paying taxes.

The owner of STI registered at AISA, even though it was not compulsory for him as a trader, because he wanted to diversify his activity by opening a factory. He therefore expected an AISA licence to

provide him with some direct benefits, particularly a parcel of land in one of its Industrial Parks. However, he said that he neither received any land, information, training nor assistance from AISA. STI's manager claims to be a victim of corruption and illegal taxes. He resents the registration process at the Ministry of Commerce, as it is lengthy and requires bearing unofficial costs in bribes. He is similarly very negative about the process at customs:

“The process at customs is the same as it is at the Ministry of Commerce. Here also, if you give money or have connections with government officials, your work will be finished in one day. If not, it will take a long time to finish your work there.”

STI's owner also suffers, though willingly, from illegal taxation. The Kabul Municipality appears to be collecting a “Customs Tax”. Although this tax does not have any legal basis, he perceives it as normal:

“When our goods enter Kabul city, the Municipality takes a two percent tax on the value of the goods. And we comply with this regulation because it is the rule of the Government and it is applicable to every business.”

Issues

- ◆ Reported corruption at the Ministry of Commerce and Customs Departments
- ◆ Reported illegal taxation from the Kabul Municipality
- ◆ Apart from licensing, limited additional services provided by AISA (limited access to land, training)

Case Study 5: Formal scratch dealer, Kabul

P Tel is an example of the Foreign Direct Investment brought to Afghanistan by returnees. The company was created in 2003 by an Afghan-American returnee (Western-educated), who had left the country with his family before the war. This company is a scratch card dealer: the company buys scratch cards from a mobile phone operator and sells them through a nationwide network of outbound sales staff. P Tel's manager is proud of the formal business practices he implements, both concerning his direct employees (the company has contracts with its employees as well as with the outbound sales team) and the modern accounting tools he uses.

For P Tel's manager, registering was compulsory for almost moral reasons. Asked if he thought that registration was an obligation for his type of company, he answered:

“Yes! Of course. I didn't come back to Afghanistan to start an illegal company.”

However, the primary benefit of being formal for P Tel is that the company is able to keep its main supplier, the telecom operator, and to interact with other actors:

“Whenever we work with mobile phone companies or with NGOs, the Ministry of Finance, etc., they are asking us for our business licence.”

The manager of P Tel is extremely positive about the registration process at AISA:

“AISA has an excellent system, implemented in a proper way. It gives me hope that this kind of modern system is working here in Afghanistan, and I believe that tomorrow I could start several businesses. There are still problems and shortcomings, of course, but compared to the old system of registration at the Ministry of Commerce, AISA's operations are impressive.”

However, P Tel's manager reports corruption cases at the Ministry of Finance. According to him, this corruption reduces the enforcement level and will last until fundamental structural changes are made.

“The infrastructure of the Ministry of Finance remains very weak. It just takes one bribe and the clerks will take a zero off of your revenues and reduce your tax burden. As long as there is no good system in place and the civil servants have low salaries, there will be no progress on this front.”

One of the main characteristics of the sector of activity in which P Tel operates is the very low after-tax profit margin of companies. According to P Tel's manager, it is often one percent or sometimes close to zero percent when the market is tough. Regarding taxes, the BRT tax seems to him unfair and inappropriate, and he does not plan to pay it next year:

“The BRT tax is very unfair and we probably will not pay it, because as we have such a high turnover and low profit margin, it would obliterate any possible profits.”

Issues

- ◆ Owning an AISA licence ensures credibility with suppliers

- ◆ AISA licensing process is reported to be efficient and corruption-free
- ◆ Reported corruption during tax collection processes at the Ministry of Finance

III. ANALYSIS: BEST PRACTICES AND GAPS IN THE LEGAL, ADMINISTRATIVE, REGULATORY AND FISCAL FRAMEWORK

The aim of this section is to identify the main best practices and issues mentioned in both the Case Studies previously listed and by entrepreneurs interviewed in the context of other research led on private sector development in Afghanistan. First, the main cross-cutting issues are analysed, and then issues specific to the Commercial Court, the Ministry of Commerce and Industries, AISA and the Ministry of Finance are developed.

Cross-cutting Issues

Lack of Commercial Laws

Apart from the Private Investment Law, very few commercial laws exist. The risk of doing business in Afghanistan is therefore considerably increased.

The Ministry of Commerce and Industries is the lead government ministry for the implementation of the Private Sector Development (PSD) strategy, determined in the ANDS.⁶ In this context, the “Commercial Law Working Group Project”, funded by USAID and hosted at the Ministry of Commerce and Industries, has drafted the following laws for submission to the Ministry of Justice which are currently going through the parliamentary process: Partnership Law, Corporate Law, Contracts Law, Commercial Arbitration Law, Commercial Conciliation Law, Anti-Trust and Unfair Business Practices Law, Labour Law, Secured Transaction and Mortgage Law, and Law on Foreign and Domestic Private Investment. An Insurance Law and a Bankruptcy Law have also been drafted. These laws, some of which existed before, are being made WTO-compliant as Afghanistan is already taking steps to enter the World Trade Organization.

However, it is a slow process. For instance, the Partnership Law, the Corporations Law and the Contracts Law were all drafted by the American Bar Association (ABA) and were submitted by the Ministry of Commerce and Industries to the Ministry of Justice in early 2005. They were

reviewed and returned to the Ministry of Commerce and Industries in November 2005, and are still in a draft status.

Complexity of the Licensing System

Fifty-six licences have been identified by the Investor Roadmap project conducted by the Ministry of Commerce and Industries.

“Investors in 22 sectors have to not only be registered with the Commercial Court to be a legal entity and obtain an AISA licence; they also have to obtain sectoral licences. [...] While licences in some of these sectors have the potential for creating economic value, in many others there would not seem to be any economic rationale for mandating them.”⁷

The multiplicity of licences creates an important administrative burden to private sector development without necessarily correcting any market failure.

Property Rights Issues

Many businesses cite access to land as one of the biggest impediments to investment in Afghanistan. The lack of reliable property rights⁸ is an important component of this broader issue, and constitutes a major challenge for business people, as it considerably increases the risk of owning land.

The Land Titling and Economic Restructuring of Afghanistan project (LTERA), funded by USAID and implemented by Emerging Markets Group, handles the land titling problems. One of its main objectives is to build trust between investors and the Government. The LTERA project combines an extensive mapping of the land, with the restoration of almost five million legal documents – including approximately 500,000 title deeds stored in the Registration Courts (*Makhzan*) which are dependent on the Supreme Court. The LTERA project also aims to improve land tenure, with pilots in two districts of Kabul. It is involved in the drafting of the Anti-eviction Law and the Informal Property Formalisation Law.

Lack of Access to Formal Financing

Access to credit has been identified as another of the main obstacles to investment in Afghanistan.⁹ Most banks are located in Kabul and provide service primarily to international donors and businesses, foreign Non-Governmental Organisations (NGOs) and foreign government agencies. Because the financial system is not structured enough, Afghan firms rely almost entirely upon internal funds and loans from friends

and family to fund operations, or on loans provided by *hawaladars*.

Lack of legislation has been identified by the CEO of a major Afghan Bank as one of the main impediments to formal financing. Large commercial banks are reluctant to grant loans to business people because they do not receive any protection from the legal system or institutions. The absence of well-defined “company laws” (corporate or partnership laws) is a major issue. The lack of a Secure Transaction Law and poor property registries make it extremely difficult for borrowers to provide the necessary collateral to banks. As there is not any Mortgage Law, people who want to borrow from formal banks generally have to sell an asset to the bank, with the clause that they will get it back after having reimbursed their loan. Another issue is the absence of a Bankruptcy Law, which does not allow a secure creditor, such as a bank, to be reimbursed in priority in case of bankruptcy. As there is a separate background paper dealing specifically with finance issues, there is no further discussion of the problems associated with a lack of access to finance in this paper.

Absence of Legitimate and Efficient Chambers of Commerce and Business Associations

Two groups of chambers currently exist in Afghanistan: the Afghan Chamber of Commerce and Industry¹⁰ (ACCI), established 75 years ago; and the Afghan International Chamber of Commerce (AICC), founded in 2004 on the initiative of Afghan businessmen. A very limited number of business associations are also active, among which, for instance, is the Afghan Builders’ Association (ABA).

ACCI and AICC vie¹¹ for official recognition: ACCI is supported and currently being reformed by the German Agency for Technical Cooperation (GTZ), whereas AICC is funded by USAID and supported by CIPE. This conflicting situation adds uncertainty to the business environment and does not allow businessmen to turn to a legitimate Chamber of Commerce or business association to represent their interests with the Government. Considering the current lack of legal protection for companies, Chambers of Commerce have a major responsibility in helping and promoting Afghan businesses. However, there is no current response provided to ensure that legitimate Chambers of Commerce or credible business associations providing resources, capacity building and governmental support to its members will arise.

Commercial Court (Ministry of Justice)

Context

The Commercial Court has three main objectives: registering companies as legal entities¹², validating the transfer of property rights and ensuring legal protection for entrepreneurs (essentially by solving disputes between merchants).

Issues

Lack of rigour of the process: Currently all registrations with the Commercial Court are processed by the Ministry of Commerce or AISA; most business people are therefore unaware that they have been registered with the Commercial Court. The Property Rights transfer procedure has been described by a specialist in land titling issues as not being rigorous. Two witnesses and reportedly some bribe giving have been sufficient, in certain cases, to allow an individual to become the legal owner of land.

Little protection provided to businessmen:

Above all, the Commercial Court seems to provide little protection to business people as the absence of commercial laws is a significant impediment to the arbitration of commercial matters. The Primary Commercial Court in Kabul hears only about 10 cases per month: it reportedly suffers from transparency issues, long delays and lacks qualified legal professionals. According to one of the judges, the enforcement capacity of the Court is very limited. Most interviewees in the Informal Sector Survey (ISS) conducted in May/September 2006 by Altai Consulting¹³ were indeed pessimistic about recovering debt, enforcing contracts or protecting trademarks through the Commercial Court.

A dispute resolution system that few

businessmen use: As a consequence, a large majority of businessmen seem to prefer informal arbitration mechanisms such as the *Shura* system¹⁴ or rely, when they can, on other institutions such as the Chambers of Commerce, AISA or the Ministry of Commerce.

Current responses

According to the I-ANDS document, by the end of 2010 “the Government will continue its efforts to strengthen the judicial sector [...], improve the commercial courts system, property rights and enforcement mechanisms.¹⁵ [...] A merit and performance-based system will hold officials accountable.”¹⁶ At present, the “Rule of Law Program” at the Ministry of Justice funded by USAID, among others, has notably started the training of judges of the whole judicial system and

disseminated copies of Afghanistan's basic laws throughout the country.

Ministry of Commerce and Industries (MoCI)

Context: Focus on the Trading Licence

The process of obtaining a Trading Licence at the MoCI has been considerably simplified.¹⁷ The country was 16th in the 2005 Doing Business rankings for starting a business¹⁸: a major achievement.

Issues

Lack of legitimacy of the Trading Licence: The licence is a vestige of a time when Afghanistan had a controlled trading system. At present, the policy is designed to foster the development of an open, liberalised, market-based trade regime; therefore traders contest its use. However, the greatest benefit of the licence is the decreased tax burden paid by business people at customs: two percent¹⁹ of the costs of goods versus the three percent that non-licensed traders pay.²⁰

Lack of transparency in licensing process: Official fees are not posted in all Departments throughout the country; officials interviewed during the fieldwork phase of the ISS produced only conflicting information about the costs and requirements of the licence. In spite of the reforms conducted, survey respondents of the ISS who registered in the last 12 months reported numerous delays and high unofficial costs (as illustrated in Case Study 3).

The difficulties faced by traders to obtain a Trading Licence have, among other factors, generated very negative attitudes toward the Government in general and some procedures specifically.

Current Responses

The Priority Reform and Restructuring²¹, a key component of the Public Administration Reform, is currently underway in the MoCI. Some of its main objectives are to build a more efficient and service-oriented public administration and to reduce costs for business people.

Afghan Investment Support Agency (AISA)

Context

AISA was established in September 2003 as a "one-stop shop" for investors, and charged with the responsibilities of registering, licensing and promoting all new investments in Afghanistan. It has dramatically streamlined the registration and licensing process, since only one step – at AISA – is required from investors who are provided with an "Investment Licence".²² AISA also helps business people in their interactions with governmental institutions; manages industrial parks; and organises road shows throughout other continents to attract potential investors and clients. AISA serves as a reference point for business people in terms of its efficient licensing process.²³ According to ISS survey respondents, AISA is the state of the art institution in terms of transparency and they praise it overall as a model of efficiency.

Issues

Legitimacy of the Investment Licence: Some analysts criticise the legitimacy of the "Investment Licence" According to them, though registering as a legal entity at the Ministry of Justice is the norm in most countries, and adds significant value by correcting for market failure,²⁴ the Investment Licence only imposes additional costs on investors: "Essentially, the AISA licence serves as a fund-raising device for AISA."²⁵ Moreover, these additional costs are high: Fees associated with the licence (from US\$ 240 to US\$ 1,290) are very high compared to Afghanistan's per capita GDP (US\$ 300 in 2005), that is, 80 to 430 percent of GDP per capita. As a comparison, the average cost of registration in the OECD countries is 6.8 percent of GDP per capita.²⁶

Limited land available in Industrial Parks: Acquiring land is by far the most costly, time-consuming and risky process which investors face in Afghanistan.²⁷ AISA can provide options with five Industrial Parks²⁸ already built or projected. AISA claims that its Industrial Parks²⁹ are "modern, strategically located, well-managed, regulated and attractive".³⁰ However, some analysts consider that an Investment Promotion Agency (IPA) should not manage Industrial Parks: "The international best practice is to have an independent economic/industrial zone authority developing and managing industrial parks."³¹

Ministry of Finance – *Mustufiats* / Customs

Context

A major reform of the tax system took place in 2005 with the adoption of the Income Tax Law, which established or confirmed several taxes: the Business Receipts Tax, the Corporate Income Tax, the Wage Withholding Tax and a set of Fixed Taxes for businesses without reliable documents.

Issues

Unrealistic taxation?: Though the tax burden in Afghanistan remains one of the lowest in the world,³² most managers interviewed in the ISS viewed taxes and customs duties as too high and inappropriate³³ in the current economic situation – Afghanistan being a society in which taxes have never been raised to the extent of the Income Tax Law. Many respondents also had the feeling that the money collected was not being used for the common good of the people. The main taxes of the Income Tax Law were regarded as unrealistic. Even though the BRT³⁴ is deductible from the Corporate Income Tax, it is particularly unpopular amongst some managers who describe it as being too high³⁵: a two percent³⁶ tax on sales imposes a heavy burden on companies in a country where most businesses have a very low profit margin. One of the major drawbacks of the BRT is also that it is a cascading tax paid at each transaction, thus inflating by two percent, five percent or 10 percent the product prices at each step of the value chain. Very few ISS survey respondents had paid the 20 percent Corporate Income Tax (tax on profit) because of the lack of enforcement, but also because only large companies which operate with formal business practices actually have the capacity to calculate it.

Lack of transparency of tax collection: The *Mustufiats* are often pointed out as imposing an array of *sukooks*³⁷ and “nuisance taxes” on a legal³⁸ or pseudo-legal basis. The tax and duties collecting system was also reported by ISS survey respondents to break down because of a lack of transparency: Some revenue collectors have been reported to collect bribes.³⁹ Managers often seem willing to pay bribes, not only when strictly required, in order to receive preferential treatment or to reduce the costs of registration or tax payment below official rates.⁴⁰ More generally, the opacity of procedures at the *Mustufiats* and customs is pointed out. Businessmen often complain that the calculation of the amount of taxes they pay is unclear to them.⁴¹

For example, the implementation of fixed taxes seems to be largely arbitrary, as unregistered businesses without reliable records face highly unpredictable tax assessments.⁴²

Unpredictability of the application of the law by the Government: The perceived unpredictability of the Government about taxation issues has created insecurity among investors. In 2003, the transitional Government granted four to seven year tax holidays for new investors, but since then, new investors have been informed not only that they were going to lose these tax holidays, but that they had to pay taxes for the previous years.⁴³

Lack of communication: No communication efforts through the mass media currently exist concerning taxes and their use by the Government. The lack of communication appears to be one of the major issues for the Ministry of Finance. An advisor to the Revenue Department of the Ministry of Finance regrets that there is no funding available for advertising how funds that are collected are being used for the public good. Unrealistic taxation, perceived corruption and opacity of procedures, unpredictability of the Government and lack of communication efforts from the Ministry of Finance have generated, among other factors, widespread mistrust in the business community toward that institution.

Current Responses

Provincial Revenue Offices have been created in order to replace *Mustufiats* in seven provinces⁴⁴ before being extended to the rest of the country. A competitive hiring process⁴⁵ has enabled the Ministry of Finance to recruit motivated and reliable civil officers. These Provincial Revenue Offices will play a role very different from that of the *Mustufiats*, as they will not directly collect taxes. Thanks to the “Self-Assessment Program”, which suppresses all interactions between business people and *Mustufiat* employees concerning the payment of taxes, tax payers will have to file a Tax Return Form and bring it directly to the Da Afghanistan Bank where payments will be made. Taxes should be self-assessed in Kabul for the 1385 (2006 – 2007) fiscal year.

According to customs officials, customs are far from collecting what they should. Some experts estimate that revenue collection is less than half of what it should be. To increase revenues, a “five-year reform program” (2003-2007) is currently being undertaken, and tax collection is sharply increasing. A new Customs Tariff⁴⁶ has also been implemented along with a comprehensive Customs Code.

As a first step to address overly complex and bureaucratic importation procedures and corruption, a Single Administrative Document,⁴⁷ based on the European Union format, was implemented in July 2003 in Kabul and since then in Herat, Kandahar, Mazar-e-Sharif and Nangarhar.

Concerning the *sukooks* and nuisance taxes, drafts of legislation are currently going through the parliamentary process, in order to amend the Income Tax Law and be clear about which taxes are legal or not. These legislative drafts aim particularly to suppress taxes not coming from the Income Tax Law, such as taxes imposed by state-owned enterprises or Municipalities, and taxes which were imposed by Presidential decrees. They also aim to simplify and make more efficient the “Fixed Taxes”. According to an advisor of the Revenue Department of the Ministry of Finance, the BRT could be replaced in three to five years by a VAT system.

IV. RECOMMENDATIONS

Enhance the implementation of the Civil Service Reform

A major Civil Service Reform should complement initiatives currently being conducted, drawing, for instance, on the “best practices” of AISA or on the implementation of the new Provincial Revenue Offices at the Ministry of Finance.

These “best practices” include re-hiring of civil servants through a strict selection process, constant training of civil servants, higher salaries and a “one-strike policy” for asking or accepting any bribe. Feedback from users having interacted with these government officials should also be systematically collected by an independent organisation.

To combat corruption, another major emphasis should be made to guarantee transparency of administrative requirements: Fee amounts and procedures should be posted in government offices, booklets should be made available to business people etc. Solutions such as the “Self-Assessment Policy”, which suppresses all interactions between business people and civil service officers concerning the payment of taxes, could also constitute a “best practice” to combat corruption.

Foster the adoption of Commercial Laws by Parliament

Afghanistan is in need of new legislation, particularly of Commercial Laws. Partnership Law, Corporate Law, Contracts Law, Commercial Arbitration Law, Commercial Conciliation Law, Anti-Trust and Unfair Business Practices Law, Bankruptcy Law, Labour Law, Secured Transaction and Mortgage Law, Law on Foreign and Domestic Private Investment, Land Titling and Property Registration Law, Insurance Law, Land Ownership Law etc. have been drafted and are currently undergoing the adoption process by Parliament. Intense lobbying of the Parliament and relevant actors should be encouraged to accelerate the process. Once these laws have been enacted, a major communications effort on the existence and content of these laws should be implemented targeting the business community.

Ensure a consistent application of the law

An independent commission should be in charge of a permanent assessment of all Ministries, to make sure laws are applied consistently. Systematic assessment of civil servants’ knowledge of the laws should be conducted and cross-checked with feedback collected from business people dealing with these civil servants. Training sessions on legislative and regulatory requirements should be conducted routinely in Ministries and be made compulsory for civil servants.

Redefine AISA’s mandate: Toward a unique “Business Licence”, managed by AISA

The complexity of the current licensing system in Afghanistan (56 different licences), and the success of the AISA “Investment Licence”, suggest that AISA should take charge in the licensing process for all businesses in Afghanistan by providing a unique “Business Licence”.

AISA would then become a “one-stop shop” for all businesses willing to get a licence, and would take care of all the required formalities⁴⁸ to register a business in Afghanistan. This “Business Licence” would exist in three formats: one for investors; one for traders (its delivery would then require approval from an official of the Ministry of Commerce detached at AISA); and one for industries formerly requiring a specific licence (its delivery would also require approval from an expert of the relevant Ministry). Involvement of officials from the Ministry of Commerce and from other Ministries

should ease the transfer of responsibilities. The cost of this AISA “Business Licence” should be much lower than that of the AISA “Investment Licence” so that all types of businesses could afford it. Non-relevant industry-specific licences should be abolished. This reform would introduce a major change for AISA, which should transfer its investment promotion activities to another organisation such as the Chamber of Commerce. The management of industrial parks should remain under AISA’s responsibilities, as it can constitute a powerful incentive for businesses to get the new “Business Licence”. These industrial parks should become much more numerous and the Government could consider transferring the industrial parks currently owned by the Ministry of Mines and Industries to AISA to be rehabilitated.

A major communications effort directed toward the business community should also be conducted to make sure the new registration requirements are clear to all.

Help the Ministry of Finance to conduct a major communications effort

The reforms currently underway at the Ministry of Finance, particularly regarding tax collection (implementation of Provincial Revenue Offices, Self-Assessment policies), should be advertised.

A particular communications effort (TV spots, radio spots, billboards) should be made on the usage of the public money collected by the Ministry of Finance (building of roads, hospitals etc.), as there seems to be a widespread feeling in the country that this money is not being used for the common good.

Foster the solving of land titling issues and access to land

As access to land remains one of the major challenges Afghan business people face, more aid resources should be devoted to solving this issue. The development of industrial parks should also be fostered.

Most of these recommendations are in line with the Government of Afghanistan’s ongoing reforms at the national, provincial and local level, and the efforts of these institutions should be encouraged. Moreover, Afghanistan’s leadership should create an enabling environment through the provision of sustained political support for such a broad endeavour.

¹ World Bank, *The Investment Climate in Afghanistan: Exploiting Opportunities in an Uncertain Environment*, 2005, p.24.

² This formal system remains limited as a relatively small number of laws have been enacted since 2001.

³ Survey conducted by the World Bank for the report.

⁴ I-ANDS, p.165.

⁵ The Income Tax Law has provisions for assessing taxes on the income of individuals and companies which do not keep sufficiently accurate records to pay taxes based on profit and loss statements. These so-called “Fixed Taxes” are imposed in lieu of the formal taxes, such as the Business Receipts Tax or the Corporate Income Tax.

⁶ Among the “Strategic Benchmarks” set in the I-ANDS document by the Afghan Government, one statement says that by the end of 2010, “the legal framework required under the Constitution, including [...] commercial law, will be put in place, distributed to all judicial and legislative institutions, and made available to the public.”

⁷ MoCI, Investor Roadmap, p.3-4

⁸ During the 20 years of conflict endured by Afghanistan, many land titles were lost or damaged, and many others forged – while the population of the country and of its major cities, particularly Kabul, dramatically increased. In Kabul, for instance, according to a USAID official, 70 to 80 percent of people live in informal settlements. The last Master Plan for the city was designed in 1978 for 500,000 inhabitants.

⁹ In the World Bank’s 2005 “Doing Business Report”, Afghanistan ranks 153 out of 155 countries for getting credit, a measure of credit information sharing and legal rights of borrowers and lenders.

¹⁰ ACCI was reported by interviewees to have limited activity. According to one of its Commercial Deputies, the Kabul ACCI deals with a reduced amount of issues brought to them by entrepreneurs: less than 15 per month.

¹¹ To solve the conflict between ACCI and AICC, ACCI was at the origin of a survey among businessmen and of several conferences which took place between June and August 2006. The whole process concluded the supremacy of ACCI, but the results are contested: a key advisor to AICC described the survey as “totally illegitimate”. A law on the Chamber of Commerce is reportedly being drafted; if ACCI comes out as the only legal Chamber of Commerce, AICC will then become only an association of businessmen.

¹² This process is comprised of three steps: obtaining police clearance; obtaining a Tax Identification Number (TIN); advertising in the official gazette giving the basic information of the proposed firm: name, business, ownership.

¹³ Informal Sector Survey, conducted by Altai Consulting for the Ministry of Commerce and Industries/Adam Smith International, May-August 2006.

¹⁴ World Bank, *The Investment Climate in Afghanistan*, 2005, p.26; I-ANDS, p.122.

¹⁵ I-ANDS, p.165.

¹⁶ I-ANDS, p.122.

¹⁷ Reforms were conducted under a Bearing Point/TSG Investor Roadmap project in 2004. The number of signatures needed to obtain a Business Licence has been reduced from 53 to five and the time to obtain a licence from six/eight weeks to five/seven days (MoCI, Investor Roadmap, p.4).

¹⁸ This ranking takes also into account the Investment Licence at AISA, which requires only one step. A

problematic barriers for investors worldwide (investment registration and licensing) has thus been successfully addressed in Afghanistan.

¹⁹ Including Duties.

²⁰ The rationale behind the discounted rate is that licensed traders are registered with the Government and can be held accountable for the balance (2 percent on the subsequent sale price and 20 percent of annual profit) at the end of the year.

²¹ Adopted by the Government of Afghanistan in 2003 by Presidential Decree, the PRR is the responsibility of the Independent Administrative Reform & Civil Service Commission (IARCSC).

²² AISA takes care of all other formalities: acquisition of a Tax Identification Number, handling the investor's obligations of reporting to the Central Statistics Office, and ultimately registering their investment at the Commercial Court.

²³ As P Tel's manager states in Case Study 5: "It gives me hope that this kind of modern system [AISA] is working here in Afghanistan."

²⁴ For instance, the registration procedure is necessary so that the investment project becomes a juridical entity that can enter contracts, sue or be sued, etc. (MoCI, Investor Roadmap, p.3).

²⁵ MoCI, Investor Roadmap, p.23.

²⁶ World Bank, Doing Business Database, 2005.

²⁷ Many companies interviewed during the fieldwork cited lack of land as a major challenge they face.

²⁸ The first phase includes Industrial Parks in Kabul (Bagrami), Kandahar, and Mazar-e-Sharif; the second phase includes Industrial Parks in Kabul (Kamari) and Jalalabad, and are USAID-funded.

²⁹ Industrial Parks owned by the Ministry of Mines and Industries seem to provide fewer facilities. The owner of a manufacturing company interviewed during the fieldwork of the survey, who did not manage to get a land from AISA but got one from the Ministry of Mines and Industry in the Industrial Park of Pul-e-Charki, complained about the absence of a canalisation system in his industrial park: He himself had to dump used water in the desert; he also mentioned that he spent a lot of money to keep running a generator for his plant as the industrial park did not provide for any electricity.

³⁰ Companies can buy land in AISA's industrial parks at US\$ 25 per square meter.

³¹ MoCI, Investor Roadmap, p. 30.

³² The World Bank's Doing Business Database finds that a "typical" company pays 21.4 percent of its gross profits in taxes in Afghanistan, compared to 35.3 percent on average in South Asia and 57.4 percent in Pakistan. Only Iran, which benefits from oil revenues, has lower taxes. The average import duty in Afghanistan is only 4 percent of the cost of the goods imported, the lowest rate in the region.

³³ Customs duties on raw materials are particularly criticised. Many respondents claim they should be lifted to support Afghan businesses.

³⁴ The BRT is a first step toward a Value Added Tax (VAT). At the moment, according to an advisor to the Ministry of Finance interviewed, there is not the capacity in the *Mustufiats* to collect the VAT.

³⁵ P Tel's manager in Case Study 5 resents the BRT: His profit margin is so low (1 percent or lower on average) that it would obliterate any possible profit.

³⁶ The BRT amounts to 10 percent of income from services used by high-income consumers, such as hotel receipts, restaurants, telecommunication services and airlines; to five percent of passive income, such as interests, dividends, rents, and royalties; to two percent for all other goods and services.

³⁷ Which amount to additional fees charged to cover the expense of tax collection.

³⁸ Generally Presidential Decrees.

³⁹ As illustrated in Case Study 5.

⁴⁰ The owner of a construction company interviewed in the survey thus explains that he escapes paying taxes by giving bribes and having his company recorded as not functional during the previous year.

⁴¹ Lack of information about taxes and calculations procedures is illustrated in Case Study 2.

⁴² As explained before, the Income Tax Law has provisions for assessing taxes on the income of individuals and informal companies which do not keep sufficiently accurate records to pay taxes based on profit and loss statements. These so-called "Fixed Taxes" are imposed in lieu of the formal taxes, such as the BRT or the Corporate Income Tax.

⁴³ According to the Government, only firms that did not complete the formalities to receive the tax holidays in a timely manner or were promised them by unauthorised persons are loosing them. However, many firms were not aware of what the exact process was when they made their investment.

⁴⁴ Kabul, Kandahar, Nangarhar, Parwan, Balkh, Herat and Kunduz.

⁴⁵ Two hundred people have been recruited out of 1,200 applicants through a series of exams.

⁴⁶ The Tariff structure has been simplified: The range of tariffs has been reduced from a maximum of 150 percent to a range of 2.5 to 16 percent of the costs of goods.

⁴⁷ ASYCUDA (the Customs Automation system promoted by UNCTAD Geneva) will implement and computerise the final version of the Single Administrative Document.

⁴⁸ Acquisition of a TIN at the Ministry of Finance, handling of the investor's obligations of reporting to the Central Statistics Office, registration of the company at the Commercial Court.

