

# WEEKLY ANALYSIS

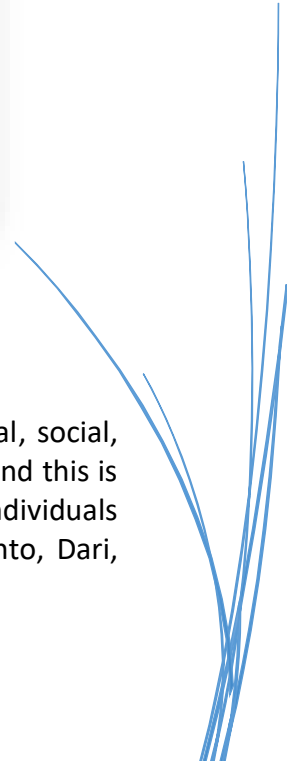
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## TAX EXEMPTION AND ITS IMPACT ON AFGHANISTAN'S ECONOMY

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Weekly Analysis is one of the CSRS publications analyzing significant weekly political, social, economic, and security events in Afghanistan and the region. The prime motive behind this is to provide strategic insights and policy solutions to decision-making institutions and individuals in order to help them design better policies. Weekly Analysis is published in Pashto, Dari, English and Arabic languages.



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Center for Strategic and Regional Studies (CSRS)



## TAX EXEMPTION AND ITS IMPACT ON AFGHANISTAN'S ECONOMY

### Introduction

Throughout history, taxation has been crucial for governance. Financial resources are essential for providing public services, investing in infrastructure, supporting social programs, and maintaining economic stability. Additionally, taxes play a significant role in the equal distribution of wealth, increasing transparency, ensuring government accountability, and reducing corruption. Without an effective and efficient taxation system, governments cannot advance their agendas, initiate development programs, or maintain order and stability in society.

In these circumstances, the Islamic Emirate of Afghanistan has implemented policies aimed at supporting businessmen and reducing financial pressure on them (as indicated by information provided by the Ministry of Finance, which registers 206 categories of businesses in the country). These measures include reducing taxes and granting tax exemptions to support entrepreneurs and small businesses. In its latest move, the Ministry of Finance has raised the minimum revenue threshold subject to taxation from 150,000 Afghanis to 2 million Afghanis for small enterprises.

These exemptions include raising the income threshold eligible for taxation and reducing tax rates. Recently, the Ministry of Finance of the Islamic Emirate increased the minimum income threshold for small businesses subject to tax from 150,000 Afghanis to 2 million Afghanis. The tax rate on income exceeding this threshold has been reduced from 0.5 percent to 0.3 percent. For instance, if a shopkeeper earns 3 million Afghanis, 2 million Afghanis of that income will be tax-exempt, and a 0.3 percent tax will be applied to the remaining 1 million Afghanis. It is worth noting that at the beginning of 1403, the government also exempted taxes on shop signs and waived overdue vehicle fines. Additionally, over the past three years, the government has provided and implemented various facilities and exemptions in different sectors. [1]

Reducing tax levels and implementing tax exemptions can have broad impacts on a country's economy. These impacts can be both positive and negative, depending on various factors such as the way these policies are implemented, the overall economic conditions, and the tax structure. In Afghanistan, given the fragile economy and the urgent need for economic development, it is crucial to thoroughly examine the effects of tax exemptions on the country's economy.

This analysis aims to explore the different effects of tax exemptions on Afghanistan's economy and to assess whether these exemptions can achieve the government's intended



objectives. By closely examining the positive and negative impacts of these policies, the analysis will attempt to provide recommendations for improving the effectiveness of tax exemptions and propose future policy suggestions.

## WHAT ARE TAX EXEMPTIONS?

According to the Income Tax Law enacted in 1387, which is still in effect, an exemption is "a portion of the taxpayer's income that is exempted from taxation according to the provisions of this law." This law specifies various exemptions in different sections. For instance, under Article 11, government revenue, except for state-owned enterprises, is not subject to taxation. Article 10 lists exemptions for institutions, Article 6 addresses exemptions for non-residents, and Article 14 specifies 13 categories of income that are not subject to tax. Other similar exemptions are also mentioned.

Additionally, the law outlines another method of exemption. Although income from an economic activity is taxable, a minimum threshold is set for it to be taxed. For example, under Article 4 of the personal income tax, income from salaries up to 5,000 Afghanis is exempt from tax, or rental income up to 10,000 Afghanis is exempt. Furthermore, according to Article 75, income less than 60,000 Afghanis from small businesses is not subject to tax and is exempt. Many similar cases can be found in Afghanistan's Income Tax Law. [2]

## WHY TAX EXEMPTIONS?

High-ranking government officials cited various reasons for the decision to implement tax exemptions during a public announcement. These reasons included listening to the people's voices, the compassion of the Islamic Emirate's leadership, providing ease for the people, especially traders, and fulfilling promises made by the government. [1] While each of these reasons can justify considering such exemptions, apart from political motives—which are always a significant factor in implementing tax exemptions—the important economic reasons that governments consider are as follows. As will be observed, although these exemptions have a positive impact on the general public and the economy, their direct and greater effect will be on professions and small businesses.

### 1. Reduction of Operational Costs

- **Increased Profitability:** By reducing or eliminating taxes, professions, and entrepreneurs can retain more profits. This increase in profitability allows them to have more financial resources available for the expansion of their businesses.



- **Allocation of More Resources to Business Development:** The financial resources saved through tax exemptions can be invested in improving the business, developing new products, and marketing. .[3]

## 2. Investment Encouragement

- **Increase in Business Investment:** Tax exemptions can instill a positive spirit in traders and entrepreneurs and motivate them to make new investments in their businesses. This may include purchasing new equipment, increasing production, and improving workflow processes.
- **Support for Small and Medium-sized Enterprises (SMEs):** The funds obtained from tax exemptions can be used in other aspects of SMEs' lives and to improve their living standards, such as healthcare, education, and recreation. [4]

## 3. Employment Creation

- **Increase in Job Opportunities:** Tax exemptions can help businesses to hire more workforce. Additionally, they may lead to the creation of new businesses, both of which can contribute to reducing unemployment rates and increasing household income.
- **Improvement of Working Conditions:** With improved financial conditions for businesses due to exemptions, traders can provide better working conditions for their employees. This improvement can lead to increased job satisfaction and productivity. [5]

## 4. Enhancement of Competitiveness

- **Price Reduction:** Tax exemptions can enable businesses to reduce the prices of their products and services. This can lead to increased demand in the market, improving their market share, and ultimately enhancing their revenues.
- **Increase in Quality and Innovation:** With preserved financial resources, businesses can invest in research and development, improve the quality of products and services, and innovate, thereby enhancing their competitiveness in domestic and international markets.[5]

## 5. Encouragement of Formalization



- **Reduction of Informal Economy:** Tax exemptions can incentivize informal businesses to register and formalize their operations. Formalizing businesses grants them access to financial facilities, government services, and larger markets, consequently contributing to economic growth.
- **Increase in Financial Transparency:** Formalization of businesses increases financial transparency, enabling better government oversight of economic activities.
- **Prevention of Tax Evasion:** High tax burdens often motivate tax evasion and reliance on the informal economy. Hence, these exemptions reduce the tax burden, discouraging tax evasion and informal economic activities. [4]

## 6. Boosting Consumption and Demand

- **Increase in Disposable Income:** Tax exemptions can increase the disposable income of businesses, entrepreneurs, and the community as a whole, leading to a rise in domestic demand for goods and services.
- **Driving Economic Activity:** Increased demand can stimulate production and sales across various sectors, thereby contributing to the overall economic growth of the country.

## POSITIVE EFFECTS OF TAX EXEMPTIONS ON AFGHANISTAN'S ECONOMY

### 1. Improvement in the Livelihood of Entrepreneurs

In Afghanistan, entrepreneurs do not have a decent standard of living, and since taxes represent a form of expense, any tax exemption that alleviates this burden contributes to improving the livelihood of these entrepreneurs. Typically, they start businesses out of necessity, using their limited capital accumulated over many years of overcoming various challenges or obtained through borrowing. With minimal income derived from these businesses, they manage their lives. For this category of entrepreneurs, tax exemptions mean reducing the burden of expenses, allowing them to allocate these resources to their small businesses or essential needs such as education, healthcare, and their families. In some cases, tax exemptions for businesses can be accompanied by price reductions, benefiting the general public. This is because entrepreneurs generally add taxes as a separate component to the retail price, resulting in higher overall prices.

### 2. Development and Improvement of Businesses Quantitatively and Qualitatively and Economic Growth



In situations where Afghanistan's economic conditions are not favorable and unemployment rates are high, tax incentives, including exemptions, can create a conducive environment for increasing and improving businesses both quantitatively and qualitatively. Reduced taxation encourages the establishment of new enterprises and fosters the motivation to start new businesses in the broader economy. However, this is not solely related to tax exemptions; other factors, such as the ease of transitioning for former government employees from public duties to small and medium enterprises (SMEs), also play a role. On the other hand, reduced expenditures due to tax exemptions lead to business expansion, process improvement, innovation, and the introduction of new goods and services, thus creating a more favorable environment for attracting more labor force and increasing employment levels. As job opportunities expand, societal income levels rise, consequently boosting consumption in the broader economy. This means that tax exemptions can simultaneously increase both supply and demand in the market. Increased supply and demand elevate the level of investment, fostering economic growth.

### 3. Prevention of Tax Evasion and Expansion of the Formal Economy

One of the reasons for tax evasion and reluctance to pay taxes in developing countries like Afghanistan is the imposition of heavy taxes on small and micro-enterprises. Over time, excessively high and unreasonable taxes either force small businesses to collapse or compel them to engage in tax evasion. Moreover, high tax rates encourage businesses to continue their operations informally without obtaining or renewing licenses. This situation leads to the expansion of the informal economy, which in itself poses a more serious problem and has irreversible effects on the economy. On one hand, it creates issues such as lack of access to banking services and limited access to markets and opportunities for businesses. On the other hand, for the government, monitoring these informal businesses becomes challenging and costly, resulting in reduced government revenues due to tax evasion. Tax exemptions and the establishment of reasonable taxes prevent tax evasion and encourage people to obtain licenses and establish legal businesses.

## **NEGATIVE EFFECTS AND CHALLENGES OF TAX EXEMPTIONS**

**Reduction in Government Revenues:** Taxes are perceived as income for both the payer, i.e., consumers, and the recipient, i.e., the government. Taxes, including tax revenues, constitute a significant and essential source of government income, accounting for about 12 percent of the total revenues of the Islamic Emirate, according to the World



Bank report. Tax exemptions announced reduce the level of government revenue. [6] In situations where the government's access to international aid is limited and Afghanistan's economy is in a precarious state, this can pose challenges for the government and increase budget deficits. This potentially affects government activities and services in various areas, including developmental projects, education, healthcare, and other vital sectors. Consequently, it may lead to increased public dissatisfaction and neutralize and negate the positive effects of the announced tax exemptions at the national level.

### **Tax Injustice**

The best tax exemption is one that benefits everyone. When only certain segments of the economy benefit from it, others may bear a disproportionate burden or may not share in the benefits of the exemption enjoyed by the first group. Otherwise, the exemption will conflict with the principle of justice, which is implemented by the government. Even if tax exemptions are granted to small businesses and traders in their business operations, if the government imposes additional costs on these businesses when obtaining permits, providing health and education services, or paying taxes due to complex tax systems and time-consuming processes, it will neutralize the effects of the exemptions. It becomes apparent to some that these exemptions are only granted to hide or normalize the increase in taxes and fees in other sectors by the government. In practice, it is observed that in various sectors such as obtaining school certificates, university diplomas, driver's licenses, marriage certificates, and approvals from the Ministry of Foreign Affairs, fees have seen a significant increase. This implies that the tax burden on businesses has been disproportionately higher than other segments of society, which in some cases are the poorest.

### **Long-Term Negative Effects**

While tax exemptions can be useful short-term tools to encourage economic growth and support small and medium-sized enterprises, inadequate long-term management can have serious negative effects on Afghanistan's economy. These effects include a reduction in government revenues (as explained in the above section). As a result of revenue reduction, government investments in vital sectors such as education, training, and transportation decrease, which can have significantly negative impacts on the ability to provide public services both quantitatively and qualitatively.

Poorly managed tax exemptions and the existence of discrimination in the tax system, influenced by lobbying from interest groups and government-affiliated entities, or the weakening of tax culture when large or medium-sized taxpayers feel that exemptions are





unfair and do not apply to them, or that these exemptions have imposed a greater tax burden on them, both directly and indirectly, lead to tax evasion, expansion of the informal economy, increased dissatisfaction, and injustice. All these hinder sustainable economic development in Afghanistan and add complexity to the tax system.

## CONCLUSION

Following the introduction of tax exemptions and facilitations, the Islamic Emirate of Afghanistan has raised the threshold of taxable revenues for businesses from 150,000 Afghanis to 2 million Afghanis and reduced the tax rate from 0.5% to 0.3% on amounts exceeding that threshold. This adjustment is set to take effect from the first day of Hamal 1403. These exemptions can have both positive and negative effects on the economy of Afghanistan. For example, they can improve the livelihoods of entrepreneurs and businessmen as the extra burden of consumption is lifted from their shoulders. Additionally, reduced consumption due to tax exemptions can lead to the development and improvement of businesses quantitatively and qualitatively, ultimately contributing to economic growth. Entrepreneurs can reinvest the exempted amounts into their businesses, leading to increased supply and employment in the economy, or they can spend it elsewhere, thus increasing demand. This simultaneous movement of supply and demand fosters economic growth.

Furthermore, tax exemptions can incentivize business owners to pay their taxes on time, obtain licenses, and engage with the formal economy. However, on the other hand, these exemptions can have negative effects on the economy and society. For instance, they may reduce government revenues and increase budget deficits, disrupting essential government activities and leading to budget shortages. Additionally, they can unfairly shift the burden of taxation onto certain groups while exempting others, leading to dissatisfaction and eroding trust in the government. Moreover, tax exemptions may have long-term negative effects on the economy, such as reducing government income, exacerbating inequality, and weakening the culture of taxation.

In conclusion, while tax exemptions can stimulate short-term economic growth and benefit certain sectors, their long-term implications must be carefully managed to avoid negative consequences on the economy and society.



## RECOMMENDATIONS

1. To prevent negative impacts, the government should carefully plan and manage tax exemptions and regularly evaluate their effects to avoid creating injustice and long-term problems.
2. The principle is for the government to generate its revenue from sources that impose the least pressure on the general public, especially the poor. If it intends to increase taxes, it should communicate the rationale clearly to the public, consult with income groups and stakeholders, and announce alternative sources to cover the revenue loss resulting from exemptions. This approach fosters transparency, consultation, satisfaction, oversight, and better policy alignment.
3. Although the contribution of small businesses and trades to overall government revenue may be low, it is still suggested that the government rely on non-tax revenues such as mining revenues to offset the revenue loss from this sector. The government should always avoid relying on revenues (both tax and non-tax) that put pressure on the general public, especially the poorer segments of society. [7]
4. The government should pay attention to adjusting the granted exemptions and ensure fair enforcement. It should take legal action against those who abuse exemptions and prevent tax evasion and the informal economy. Moreover, in adjustable cases, the impact of exemptions on prices should be observed to demonstrate that all citizens have benefited from them. [7]
5. The country's academic institutions (universities and research academies) should scientifically and empirically investigate the positive and negative effects of tax exemptions so that the findings can inform future policies.

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**Contact Us:**

Email: [info@csrskabul.com](mailto:info@csrskabul.com) - [csrskabul@gmail.com](mailto:csrskabul@gmail.com)

Website: [www.csrskabul.com](http://www.csrskabul.com) - [www.csrskabul.net](http://www.csrskabul.net)

Phone & WhatsApp: +93780618000

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