

Introduction

Efficient administration of extractive industry (EI) revenues is a critical task for all resource-rich countries, especially those with weak administrative capacities. Since an integrated accounting, reporting and auditing system can encounter obstacles, even though it is a priority, it requires technical assistance to develop and implement.

Due to the unique nature of EI operations, a variety of fiscal instruments are applied to revenue collection since, in addition to having a large tax base, the sector usually involves large non-tax rents such as royalties, surface fees, premiums, penalties, etc. Factors such as the high potential of rent generation, non-renewability of resources, asymmetry of information, high upfront costs and investment, the intensive nature of extraction operations in an uncertain market and challenging accounting and audit environment for fiscal control further complicate EI revenue management.¹

Therefore, internationally accepted accounting and reporting standards have been developed to deal with key EI financial issues so that resource-rich countries could use them in sector policies, contracts, and licenses.²

Afghanistan is endowed with natural resources that could provide an alternative source of revenue to the current aid-dependent economy. The EI sector received significant attention and support during the period 2010-2013; however, the sector has since then weakened significantly due to falling iron ore and copper prices in international markets and due to political transition. The EI revenue collecting, reporting and auditing system in Afghanistan has also seen limited improvement and reform; further capacity support will be a critical investment in the long term.

Against this background, Afghan and German partners jointly selected mining governance as one of six key research topics for the Governance Forum Afghanistan (Govern4Afg) for 2016-2017. The research assessed the existing EI revenue collection and management system in order to meet international standards and best practices. It focused on all mining revenue-related accounting, auditing and reporting systems currently in place at the three relevant Afghan ministries: the provincial and national Ministry of Finance Revenue Departments, the Cadaster, and the Ministry of Mines and Petroleum Revenue Departments.

Methodology

The researchers conducted in-depth qualitative interviews with senior officials of both the above-mentioned ministries in Kabul, Kandahar, Herat and Nangarhar. A separate set of questions was posed to the mining companies in Kabul to assess the system from the client's (taxpayer's) perspective as well. The researchers collected a first round of information, most of which was then cross-checked and reconfirmed.

Key Findings

- **International Best Standards**

Because there is no globally agreed-upon, one-size-fits-all standard that details how governments should set up the process that transforms potential natural resource wealth into actual sustained economic development, governments have come up with a variety of processes and fiscal tools that work better in some cases and less well in others. There are, however, a number of widely recognized standards and guidelines that together form a set of international best practices. The key documents in this regard are the Extractive Industries Transparency Initiative (EITI) Standard 2016,³ the International Monetary Fund (IMF) Guide on Resource Revenue Transparency,⁴ and the

1 Natural Resources Governance Institute. Natural Resources Charter. http://www.resourcegovernance.org/sites/default/files/NRCJ1193_natural_resource_charter_19.6.14.pdf

2 The World Bank (2009). Extractive Industries Value Chain. Washington DC: http://siteresources.worldbank.org/INTOGMC/Resources/ei_for_development_3.pdf

3 Extractive Industries Transparency Initiative (2016). EITI Standard 2016. Oslo: Extractive Industries Transparency Initiative https://eiti.org/sites/default/files/documents/english-eiti-standard_0.pdf

4 International Monetary Fund (2007). Guide on Resource Revenue Transparency. Washington, D.C.: International Monetary Fund <https://www.imf.org/external/np/pp/2007/eng/101907g.pdf>

Natural Resource Charter Benchmarking Framework by the Natural Resource Governance Institute (NRGI).⁵

- **Extractive Industries Transparency Initiative**

The Extractive Industries Transparency Initiative (EITI) is a global coalition of governments, companies and civil society working together to improve open and accountable management of revenues from natural resources. EITI was first launched in September 2002 at the World Bank Summit on Sustainable Development in Johannesburg, and is governed by a not-for-profit member's association under Norwegian law. Stakeholders are the governments of implementing and supporting countries, companies and investors, and civil society organizations. EITI maintains the EITI Standard, a guideline for promoting transparency, accountability and better governance in countries that are rich in oil, gas and mineral resources. The latest version of the EITI Standard was published on 23 February 2016.

- **Need for Review of the System**

According to the 5th EITI report released in 2017, sufficient production- and payment-related data on mining companies does not exist in the Ministry of Mines and Petroleum. There are also many discrepancies between what the government and the mining companies report.⁶ Having reliable data on each contract with necessary production and sales information is critical.

The OECD 'Corruption in the Extractive Value Chain' toolkit identifies corruption in the value chain of extractives as a major hurdle to development in developing countries. The report identifies key corruption risks in mining revenue collection and management as follows:

- Inadequate legislative and regulatory framework for revenue collection
- Weak technical, financial and human capacity in revenue administration
- Lack of revenue-collection-related data transparency and access
- Opacity of commodity trading transactions
- Opacity over ownership and governance structures of key actors involved in the commodity trading
- Lack of transparency on commodity-trading-related data
- Lack of insufficient corporate due diligence

Afghanistan faces all of the above risks, with inadequate legislative and regulatory frameworks for revenue collection and lack of revenue-related data posing particular risks.⁷ Afghanistan has been an EITI candidate country since 2010, which is a step toward improving accountability and transparency. After a difficult start, the first reconciliation report was produced in 2012 and the fifth reconciliation report was published in April 2017; nevertheless, validation has yet to be granted by the International Secretariat in Oslo. Having the EITI framework and baselines now in place provides a good starting point. The EI sector can benefit from stronger capacity to monitor revenues to ensure sustainable and transparent governance and management.

The newly appointed acting Minister has the political support, with the earlier steps she has taken showing signs of resolve for reform. However, she would have to start from a low base since the Ministry of Mines and Petroleum has lost most of the capacity it had acquired during the last 10 years. While the government has not made any significant progress in developing the sector in the last couple of years, challenges posed to the sector have in the meantime increased. The sector has increasingly become attractive to political heavyweights and insurgents, leading to a spike in illegal mining, conflict over control of resources and the risk of some resources falling to the hands of insurgents. This coupled with the need for alternative sources of revenue for Afghanistan necessitates reforms in a number of areas, including amending the Mining Law, strengthening MoMP oversight and contract management capacity, improving transparency in contracting as well as modernizing the revenue collecting, reporting and auditing system. The focus of this policy paper is primarily on the latter.

⁵ Natural Resource Governance Institute (2016). Natural Resource Charter Benchmarking Framework. New York: Natural Resource Governance Institute https://eiti.org/sites/default/files/documents/english-eiti-standard_0.pdf

⁶ Hart Group. EITI Reconciliation Report. Kabul: EITI Secretariat, 2017. Web. 8 May 2017. 5Th EITI Afghanistan Reconciliation Report.

⁷ OECD Development Policy Tools. Corruption in the Extractive Value Chain. <http://www.oecd.org/publications/corruption-in-the-extractive-value-chain-9789264256569-en.htm>

- **Implication of the Existing System**

The existing revenue collection system for the EI sector is extremely weak, and strongly marked by corruption and lack of line department coordination.⁸ It has serious implications for the state, government and society in total. Critical functional units within the Ministry of Mines and Petroleum need reform and capacity development to be able to undertake the task of revenue collecting, reporting and auditing and function as a well-coordinated system.

Data management systems at the ministry are manual, without strong cross-checking mechanisms. This leaves the system vulnerable to corruption and misuse and cannot provide adequate contract status information to ensure state oversight over the mining operations and dues collection.

- **Inspection Directorate**

The Inspection Directorate, which plays a critical role in defining the taxation base and other forms of revenue, requires capacity development. Due to the nature of its work, it can be vulnerable to corruption, and there are reports strongly indicating corruption throughout the hierarchy. An independent third-party monitoring mechanism can also be used to improve transparency and accountability, and will avoid feeding the patronage-based networks that are taking shape around the mining sector. Company officials using their own political networks protect this network externally. Weaknesses in inspection, which is the first point of contact with companies, create data gaps and erode the real basis for taxation. Personal enrichment can drive corruption in the sector where mineral products, which are state assets, may be underreported.

- **Cadaster Directorate**

Cadaster is another critical department within the EI revenue system that assesses revenue based on the Inspection Directorate's production data and can fall vulnerable to corruption due to institutional weaknesses within the Ministry. Absence of adequate or legitimate data is a loophole in the system that can easily be exploited by individuals in the Cadaster Directorate. The opportunity to go for the provided data without going for verification, in return for a bribe, may allow companies to underreport and evade royalty payments. Therefore, Cadaster is an important piece in the system that both collects non-tax revenue and forms the basis for tax revenue. Improvements in data keeping and management by digitizing systems and connecting it with other units of the Ministry is highly important.

- **Customs Directorate**

In case of commodities that are exported, the Customs Directorate and its units can play a critical role in collecting export revenue. However, due to lack of integrated contract management among the Ministry of Finance and Ministry of Mines & Petroleum, there is room for corruption. There are reports that officials of the Customs Directorate have allowed underreporting of the quantity exported. The Customs Directorate has displayed tendencies to underreport exports of mineral commodities at several border points.

- **Afghanistan Revenue Department**

The Afghanistan Revenue Department (ARD), which calculates revenues and profit for profit tax, often relies on the Ministry of Mines and Petroleum's production data and mining companies' submitting operations and sales data. It is often recorded that companies, despite engaging in operations, nevertheless report having no operations. Most of those companies that indulge in tax fraud are left unaudited by the ARD. Instead of auditing operations, ARD simply ignores them, allegedly in return for kickbacks. This has been widespread until recently; mine operators continue to extract and export minerals, while on paper they are non-functional. This leads to massive revenue losses to the government.

The existing revenue collection system in Afghanistan is not effective for collecting mining company dues. The non-tax revenue streams, such as royalties, often constitutes the basis for the profit tax calculation. Since there is a production data gap due to weaknesses and lack of adequate data in the Inspection and Cadaster departments, real royalty calculation and collection has become a challenge. This has led to massive loss of revenue to the government of Afghanistan. The system is currently being exploited due to lack of effective monitoring and accountability mechanisms. This runs the risk of increasing corruption, posing serious challenges to revenue collection and any significant reforms in the Ministry Mines and Petroleum.

⁸ Author's interview with senior official of MoMP who sought anonymity.

Recommendations

1. Develop an integrated system that connects different parts of the government and records data.
 - i. Move from reports to reporting, link back to EITI mainstreaming as proposed by EITI Secretariat and the World Bank.
 - ii. All EITI compliance requirements should be included in the work plans of relevant government agencies.
 - iii. Develop a digital payment system where possible to reduce cash transactions and, thus, opportunities for corruption and misuse.
2. Develop mechanisms for coordinating among the main ministries and their departments such as Customs, ARD (LTO), Cadaster and Inspections.
3. The contracts must be digitized, with Customs, LTO, Cadaster and Inspection all having access and being on the same page.
4. The MoMP must clearly project non-tax revenues from the sector and it must collect weekly production data.
5. The fiscal regime should clearly mention the cost-recovery formula, the capital transfer and tax exemption issues.
6. All companies applying for mining contracts must disclose beneficial ownership to clearly protect the sector from political influence and conflicts of interest.



This Policy Note was prepared as a contribution to Governance Forum Afghanistan (Govern4Afg). Govern4Afg has been launched by German and Afghan partners to establish a platform for policy dialogue on governance topics identified as being highly relevant for Afghanistan. The two-year initiative brings together representatives of research, governance practitioners and decision makers to discuss and further develop on governance mechanisms that guide state-building as well as enhance the overall understanding of the governance context in Afghanistan. In this context AREU as a consortium partner implementing Govern4Afg has published a whole series of related research papers on governance in Afghanistan.

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Editor Toby Miller

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The Afghanistan Research and Evaluation Unit (AREU) is an independent research institute based in Kabul. AREU's mission is to inform and influence policy and practice by conducting high-quality, policy-relevant research and actively disseminating the results, and by promoting a culture of research and learning. To achieve its mission AREU engages with policy makers, civil society, researchers, and students to promote their use of AREU's research and its library, to strengthen their research capacity, and to create opportunities for analysis, reflection, and debate.

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