

# The Impact of Tax Evasion on Afghanistan's Economy

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## Abstract

The simple regression model (SRM) is used in this study to look at potential economic growth-influencing factors. The sample's period runs from 2005 to 2019. The data was gathered from various ministries and government agencies such as the Central Bank of Afghanistan's Statistical Bulletin, the World Bank, the United Nations (UN), World Bank open data, NASA, Ministry of Finance (MoF), Ministry of Economy (MoE), and Central Bank of Afghanistan's Statistical Bulletin (CBA), as well as the internet and news. There is an urgent need to ensure that taxes are collected in the most efficient manner possible because one of the enormous management gaps in Afghanistan over the last two decades has been tax evasion. According to the results of this study, tax evasion has a negative and significant impact on Afghanistan's economic growth. We can affirm that the subject of this article is among the most significant topics recently discussed in my country. If the right solutions are implemented, It can significantly contribute to quickening the cycle of the developing Afghan economy and turning it from an unstable to a sustainable one.

**Keywords:** Tax Evasion, Corruption, Economic Growth, Afghanistan

**JEL Classification Code:** C35, H21, H26

## 1. Introduction

Taxation has always been an important and revitalized government objective in many developed and developing countries. According to economists, taxes generate revenue for the government and redistribute financial

resources from the richest to the poorest (Saez, 2004). Most governments' gain is determined by how they manage and collect tax revenues, which are a major source of revenue for governments. Tax revenues are an important component of developed-country economies because they ensure long-term economic growth and development (Mustafa et al., 2021).

Tax evasion is a term or description that is frequently used to describe situations in which an individual or business attempts to avoid paying taxes. Tax evasion can take many forms in business, such as when individuals or businesses report less or no income. Tax deductions on income and rents, business services, dividends, and employee salaries are also avoided by businesses and individuals. There is also a tendency in various industries, such as telecommunications, construction, commerce, and mining, to fail to report extreme profits. Tax evasion is a global issue, and most countries are suffering from this problem (Mo, 2003). Because the scope of tax evasion is broad, it depletes the government's resources (Otusanya, 2011).

Additionally, tax evasion is an illegal practice restricting government tax revenues critical to providing infrastructure and public services (Mo, 2003). There are several types of tax evasion, as follows: Individuals or Businesses underreport

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their income or fail to report it at all; companies and individuals also conceal or evade mandatory tax withholding on rental income and rental payments, business services, dividends, and staff salary payments, among other things. For example, telecommunications, construction, commerce, and extraction profits are under-reported (Sahebe, 2020).

According to previous tax literature in economics, tax evasion contributes significantly to a country's growth variability. That is, as a country's level of tax evasion rises, so does its economic growth; conversely, as a country's level of tax evasion falls, so does its economic growth. It is achievable to determine that tax evasion and growth have a contrary connection (Celimene et al., 2016).

Afghans have historically failed to establish a strong government based on a tax system capable of covering all their expenses. Since 1929, when the last dynasty relied on direct agricultural taxes, the Afghan government had never been able to exceed its share of GDP by 13.4 per cent. Throughout the Cold War, successive Afghan governments faced chronic financial deficits and responded by mobilizing foreign resources, particularly from the United Kingdom, the United States, and the Soviet Union. The Afghan government had relied heavily on foreign aid for revenue since 1958 (Isar, 2020).

Social norms and practices, tax injustice, weak collection systems, information processing and registration, tax delays, a lack of a unified system between government agencies, the complexity and number of laws, tax exemptions, Corruption, unconsidered tax policies, external problems, self-declaration and voluntary submission are the reasons for tax evasion in Afghanistan. Tax rates and burden, taxpayer income, inflation and unemployment rates, trade liberalization, government size, Etc, are all economic variables that influence tax evasion (BBC News, 2012). Taxation has the potential to stimulate economic growth. As a result, to get its finances in order, the Afghan government cracks down on tax evasion (Sahebe, 2020).

General economic and non-economic policies assist tax evasion when the policies are unsuitable according to people's situation (Isar, 2020). The misappropriation of government funds and Corruption are frequently used as moral justifications for tax evasion. Corruption and tax evasion frequently have strong and persistent correlations (Litina & Palivos, 2016). Due to the methods and tools of criminals in Afghanistan, tax evasion currently has no "borders." Regardless of the legal, economic, political, or social framework of the country in which we live, tax evasion will exist in various forms (Kempe et al., 2020).

According to economic experts, Afghans have never routinely taxed their income or assets in the past. The only active component of tax collection; is collected from customs and large corporations (Afghan Government, 2017). Large taxpayers claim that the tax collectors' only consideration is

to increase tax revenue, and they do not care how? According to the new taxation policy, the government doubled the core business income tax rate ( 2% to 4%), and now companies must pay four times a year, which has frustrated them. Most businesses will evade taxes because of this policy (VoA News, 2017).

According to officials in Herat province alone, approximately 351 commercial companies have not paid their taxes for several years due to Corruption (Ariana News, 2019), 4,893 companies have been reported inactive in the last five years. According to this office's officials, the main reason is that these companies are escaping from taxes payments, and most companies continue to operate secretly (Ariana News, 2020).

External factors are another tax evasion factor, meaning that all foreign companies were tax-exempt during this time. They were tax-exempt, according to a 2013 report on SIGAR worth \$ 921 million. Afghanistan would not require foreign aid if this large sum were paid from government revenues (SIGAR Report, 2020). Tax evasion and widespread Corruption in Afghanistan have resulted in tax revenues that are consistently lower than expected.

In this study, we investigated the impact of tax evasion on the country's economy. We used an Ordinary Least Squares Regression (OLS) model to analyze the statistical data and achieve this goal. The primary goal of this research is to analyze the impact of tax evasion on the Afghanistan economy, particularly economic growth, and to propose solutions to the problem. Other specific goals include researching the impact of tax evasion on government revenues and determining the impact of perceived government corruption on tax evasion. The following are the other components of this study: In the second section, we looked at the experimental literature. The third section discusses the research method used in this study. The fourth section discusses the results, and the final section is devoted to the conclusion and recommendations.

## 2. Literature Review

Taxation has been an important and fundamental issue throughout the history of empires such as Afghanistan's Samanid Empire (999–819), Ghaznavid Empire (1876–977), and Durrani (1726–1826). As there was no regular tax system in Afghanistan, the tax administration, in its current form after 2001, with the new government's agenda, necessitated a series of reforms (Bizhan, 2019).

Due to the standard taxation system deficiencies during the civil war in Afghanistan, taxpayers are now disinclined to solely pay a percentage of their income as taxes (BBC News, 2012). Furthermore, we can define tax evasion as the unlawful evasion of taxes committed by individuals, businesses, and trusts. According to another study on the

issue of tax evasion in Afghanistan, taxpayers intentionally provide false information to tax authorities about their true records to reduce their tax liability, for example, by reporting less income, benefits, or profits than they earned through their efforts or by exaggerating deductions. The reasons for tax evasion include not only economic factors but also political, social, and cultural factors. The Afghan government wants to combat tax evasion to manage its finances. Despite this, the economy is struggling because of renewed violence and the withdrawal of a large coalition that has supported the economy for years (Sahebe, 2020).

Because illegal activities are risky, tax evasion creates a random environment in which the consumer makes a portfolio decision by deciding how much private capital to hold in conjunction with the evasion and consumption. In this context, the rule of the equity market is like that of a tax exemption policy. In societies where private investment as a percentage of GDP is increasing. Tax evasion was defined by (Litina & Palivos, 2016) as “a deliberate, illegal, and unacceptable behavior or activity.” Richardson (2008) confirmed that tax evasion is illegal and violates tax laws, whereas tax avoidance is a legal way to reduce tax liability. Both are unacceptable, but the latter is less serious because it undermines the revenue used to fund government spending (Kim, 2008).

Tax evasion is typically committed by taxpayers who intentionally misrepresent or conceal their true circumstances from the relevant tax authorities to reduce their tax burden. Tax evasion, on the other hand, can be classified as total or partial (Fakile & Adegbe, 2011). Tax evasion will exist in various forms, regardless of our country’s legal, economic, political, or social framework. Through competent bodies and citizen education, the State must limit tax evasion to a level acceptable to the State’s general consolidated budget (Mehrara & Farahani, 2016; Szora et al., 2019).

### 3. Research Methodology

The information for this paper came from the Central Bank of Afghanistan’s Statistical Bulletin. The remaining data for this study were gathered from various ministries and government agencies such as the World Bank, the United Nations (UN), World Bank open data, NASA, the Ministry of Finance (MoF), Ministry of Economy (MoE), and Central Bank of Afghanistan’s Statistical Bulletin (CBA), as well as the internet and news. The sample spans 2005 to 2019, and the simple regression model (SRM) is estimated to investigate the factors that influence economic growth. A country’s GDP is the total value of goods and services produced over time. It is equal to the total of the economy’s income and expenditures. GDP is a measure of economic performance because it shows people’s concerns about their income. This study estimates gross domestic

product (GDP) indicators of Afghanistan’s economic growth. It is obvious that in tax evasion, taxpayers arrange their finances to pay as little as possible or no taxes without breaking the law. From 2005 to 2019, we used the difference between the total budget and actual tax revenue to measure tax evasion in Afghanistan. A simple regression model is used to investigate the effects of tax evasion on the economy, particularly economic growth: The simple regression equation is stated thus; Eq (1)

$$Y = \beta_0 + \beta_1 X_1 + \varepsilon \quad (1)$$

In eq (1);  $Y$  is a dependent variable,  $X_1$  is an Independent Variable,  $\beta_0$  is the Constant of the dependent variable  $Y$ ,  $\beta_1$  is slope coefficients, and  $\varepsilon$  is stochastic variables.

To write the model equation, we will use the following symbols.

TEV = Tax Evade

$\alpha$  = Regression equation intercept

$b$  = Regression equation coefficient

$\varepsilon$  = error term

Equation (1) will be rewritten to suit the study under four assumptions. Therefore, tax evasion does not have a significant positive effect on the Gross Domestic Product of Afghanistan, which is expressed as follows: Eq (2)

$$GDP = \alpha + bTEV + \varepsilon \quad (2)$$

### 3.1. Hypothesis

The study is conducted using the following hypotheses:

**H1:** *There is a significant impact of tax evasion on Afghan economic growth.*

**H2:** *Tax evasion has no impact on tax collection.*

**H3:** *There is no effect of perceived Corruption in government on tax evasion.*

## 4. Results and Discussion

### 4.1. Afghanistan GDP Annual Growth

Afghanistan’s GDP increased from Afs 308 billion in 2005 to Afs 1,469 trillion in 2019, with an average annual growth rate of 8.09 per cent, according to Figure 1. The top GDP growth rate was 17.7 per cent in 2009, down 0.4 per cent in 2011. It shows 13 per cent decrease from 2010. The reputation of foreign troops leaving Afghanistan is one of the most important factors. Because the United States (US) Congress declared that it would withdraw its forces from Afghanistan in 2014, it caused a capital flight outside. The drought is another factor contributing to this drop. In 2012, economic growth increased by 12% over 2011, but this

was reversed in 2014 holding of the presidential election, which went to a second round, and security shift due to the withdrawal of foreign forces from Afghanistan, both of which created uncertainty among domestic and foreign investors, resulting in reduced business activity and negative economic growth. Imports, foreign direct investment, and donor support declined, resulting in capital flight from Afghanistan.

In recent years, political unrest in our country has hampered potential economic growth. The growth rate in 2019 increased by 2.72 per cent compared to 2018. The main reasons for the rise are the alleviation of drought conditions and increased agricultural production. On the other hand, increased political uncertainty is expected to have continued to erode private sector confidence and investment.

#### 4.2. The Relationship Between General Revenue and GDP

As seen in Figure 2, government revenues in Afghanistan play a significant role in the administration because it covers half of the national budget. Domestic revenue as a percentage of GDP was from 13% to 28.5% between 2005 and 2019. Afghanistan’s domestic revenue in 2009 was one of the lowest in the world, at 8.2 per cent. Most developed countries typically have a revenue-to-GDP ratio of 40 to 50 per cent, whereas most developing countries have a revenue-to-GDP ratio of 15–20 per cent. In developed countries, high levels of pension entitlements and welfare measures necessitate high levels of taxation. Afghanistan’s low revenues are due to various factors, including a small private sector,

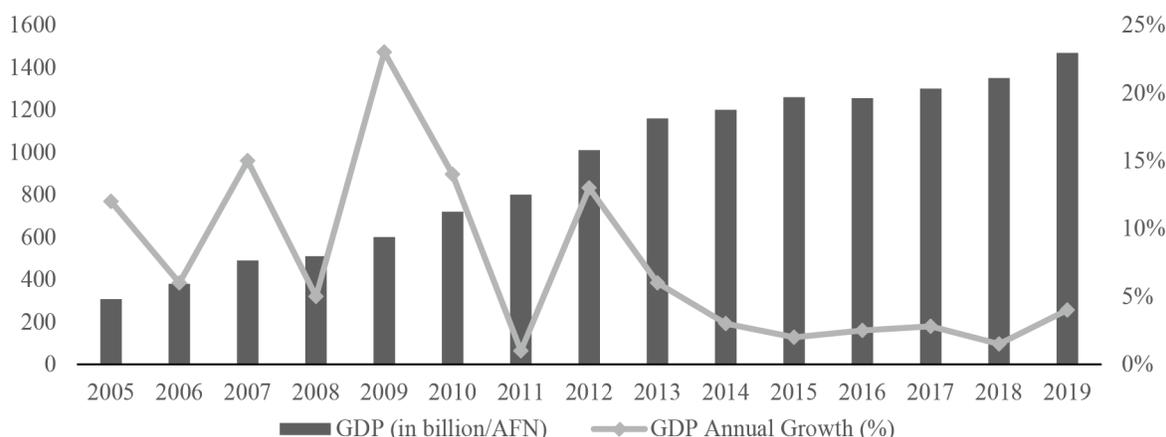


Figure 1: GDP Annual Growth Rate % (in Billion/Afs)

Sources: Government of Afghanistan, World Bank, World Development Indicators, 2019 GDP.

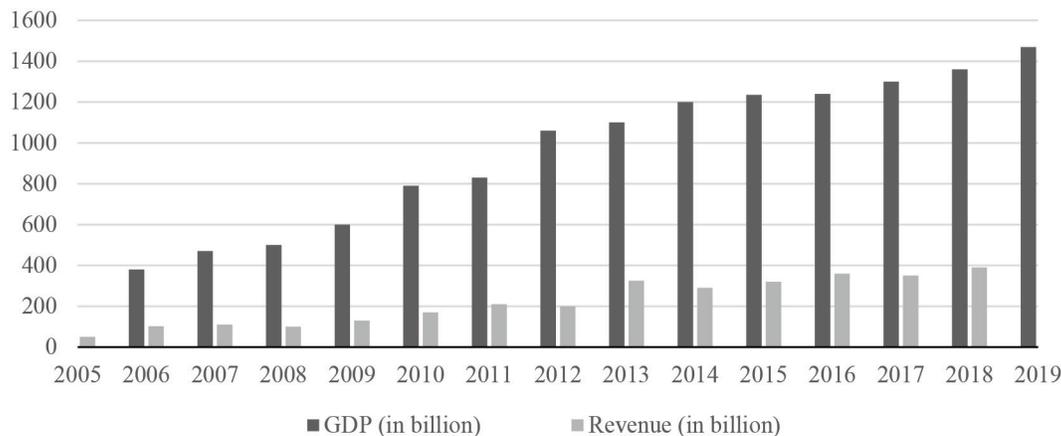


Figure 2: The Relationship Between General Revenue and GDP

Sources: World Bank, Asian Development Bank.

a large informal economy dominated by agriculture, low compliance, mobilization, and a weak government. Customs duties, which are relatively easy to collect in Afghanistan and most other developing and post-conflict countries, are a major source of revenue. Customs duties account for approximately 40% of total revenue in Afghanistan.

### 4.3. The Impact of Tax Evasion on Tax Revenues

Tax evasion jeopardizes government revenues (OECD, 2015). In an article, the US Institute of Peace (USIP) also expressed optimism. According to the findings, the proportion of tax levels and GDP rose again in 2016 after a decline. Following the Taliban’s fall, total government revenue increased to 11.6 per cent of total GDP, then to 9.7 per cent in 2013 and 8.7 per cent in 2014. However, this ratio rose to 10.3 per cent in 2015. The main reasons for this increase, according to the Ministry of Finance (MoF) and the US Peace Institute (USPI), are the doubling of the high level of trade tax from 2% to 4% and the increase of the high oil and gas tax from one Afs to two Afs. The new ten per cent tax on mobile credit cards resulted in a \$400 to \$500 increase in toll and air toll revenue and higher tariffs on some customs products (BBC News English, 2016).

While increasing government revenues is beneficial in an environment where foreign aid is declining. Apart from increasing toll revenues, these solutions may raise several concerns (BBC News English, 2016). Furthermore, goods entering Kunduz illegally have harmed customs revenue. Some people smuggle goods and pay militants, which has reduced our revenue. Furthermore, approximately Afs 600 million yearly in the pockets of smugglers and insurgents

because of the problem. Revenue decreased because the money went into private pockets rather than the government’s treasury (Pajhwok Afghan News, 2021).

Some NATO-affiliated companies have been accused of “tax evasion” by the Ministry of Finance. Foreign firms are evading taxes in the logistics, security, communications, and media industries. The missing tax revenue was evaluated to be \$70 million. Foreign firms, including eleven firms that provide logistics to NATO-led coalition forces in Afghanistan, use diplomatic channels and rely on NATO command to avoid prosecution and taxes (DW News, 2012).

According to Figure 3, tax evasion in 2005 amounted to Afs 1.873 billion, which reduced tax revenues by 20%. This figure was reported Afs 24.178 billion in 2014, with increased government tax revenues, which reduced tax revenues to 30%, and in 2019. The country’s total tax evasion figure was reported as Afs 42.429 billion, reducing the government’s tax revenues by 50 per cent. According to the statistics, tax evasion has a direct negative impact on government tax revenues. It means that whenever tax evasion rises and small, medium-sized, and large taxpayers evade taxes in different ways, the government’s tax revenues, which are an important part of the government’s total revenues, decrease. Conversely, the lower the level of tax evasion in the economy, the higher the tax revenue collection. Generally, there is an inverse relationship between tax evasion and tax revenue, which decreases or increases with one increase. The root cause of tax evasion is widespread Corruption in Afghanistan. The consequences of tax evasion are far-reaching; tax evasion reduces government resources and will face a shortage in allocating the necessary aid (Agostino et al., 2021).

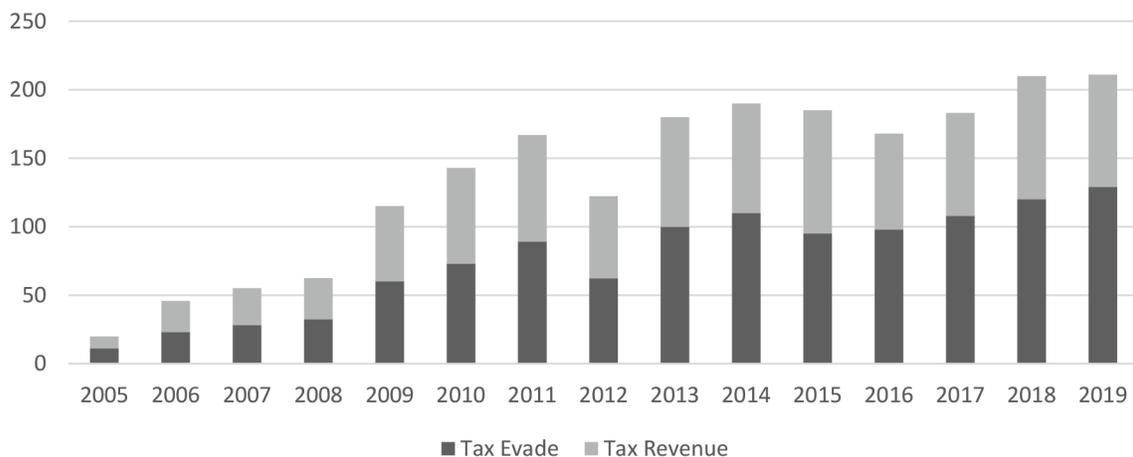


Figure 3: The Impact of Tax Evasion on Tax revenues

Sources: World Bank, Asian Development Bank.

#### 4.4. The Impact of Corruption on Tax Revenue

According to the US General Inspectorate for Cigarettes (SIGAR) and Afghanistan's Finance Minister, "Afghanistan's tax revenue will double when corruption is removed from Afghanistan's customs and tax offices." That is, Corruption has straight impacts on government tax revenues (Budget, 2015) and, according to a report from Foreign Policy (FP) of Congress and watchdogs, Corruption in Afghanistan is as "Big a Threat" as Taliban because of billions of taxpayer dollars wasted on Afghanistan's development (FP News, 2021). Further, widespread Corruption at customs has reduced government revenues, resulting in an annual loss of about Afs 600 million (FP News, 2021).

Moreover, corruption is a global problem (Figure 4); corruption costs developing countries \$1.26 trillion yearly (World Economic Forum, 2019). In the last 15 years, Afghanistan has suffered from widespread Corruption, which negatively impacts its ability to provide adequate security to citizens and generate enough revenue to meet its basic public service requirements (Integrity Watch Afghanistan, 2016).

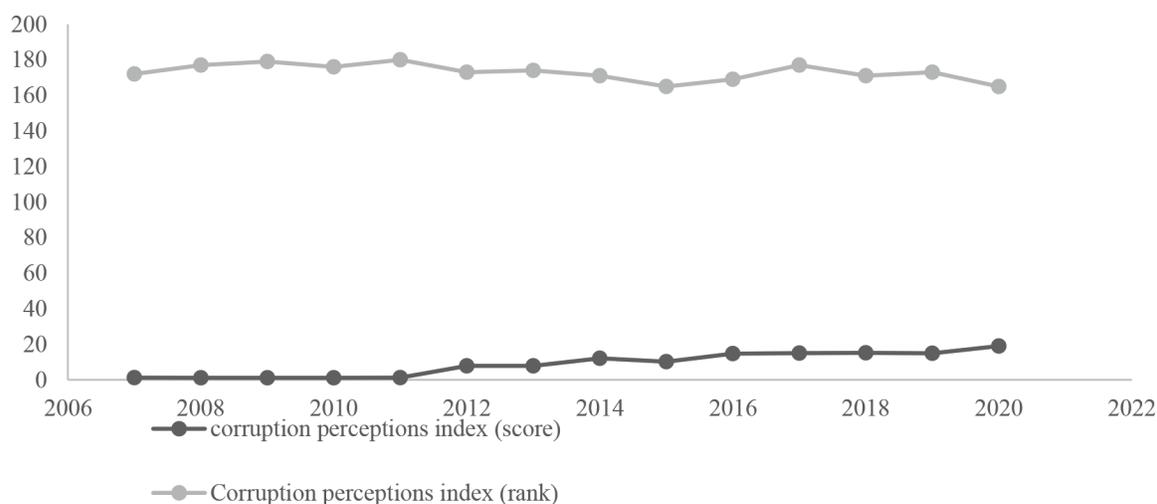
Afghanistan ranked 165<sup>th</sup> out of 180 countries in Transparency International's 2019 Corruption Perceptions Index, with a score of 19, on a scale from 0 (extremely corrupt) to 100 (very clean). Only 15 other nations fare worse (Transparency International, 2019). Widespread Corruption in Afghanistan has made the country dependent on global aid, and there is now a broad consensus that the flow of foreign aid has contributed to widespread Corruption (Transparency International, 2016).

According to Figure 5, tax revenues from 2005 to 2019 amounted to Afs 915.236 billion. But if there were no widespread corruption, these figures would have reached Afs 1830.472 billion. We conclude that Corruption functions in collecting tax revenues in Afghanistan. If Corruption increases, tax revenues will decrease; whenever Corruption decreases, tax revenues will increase. The anti-corruption watchdog has long ranked Afghanistan as the world's most corrupt nation (DW News, 2012).

Figure 6 compares government tax revenue in the event of tax evasion and Corruption and without tax evasion and Corruption. Government tax revenues from 2005 to 2019 amounted to Afs 915.236 billion. According to statistics and reports, in the absence of the practice of tax evasion, this figure amounted to Afs 1101.755 billion. Also, if there had not been any corruption in the tax offices, the figures would have reached Afs 1830.472 billion. As a result, if we calculate tax revenues without considering tax evasion and Corruption, the figures go to Afs 2016.99 billion.

#### 4.5. The Impact of Tax Evasion on GDP

As seen in Table 1, Afghanistan's GDP has increased over time. The annual growth rate averaged 6.88 per cent from 2005 to 2019. In 2005, GDP increased 11.2% to Afs 308 billion and 13.8% in 2007 to Afs 485 billion. In 2009, GDP grew by 21.4% (Afs 611 billion), the highest growth rate throughout this study. In 2012, the growth rate was 12.8% (Afs 1,028 billion). In 2013, grew by 5.6% (Afs 1,138 billion), 2.3% (Afs 1,223 billion) in 2016, 2.6% (Afs 1,285) in 2017, and 3.9 percent (Afs 1,469 billion) in 2019.



**Figure 4:** The Impact of Corruption on Tax Revenue

Sources: World Bank, Asian Development Bank.

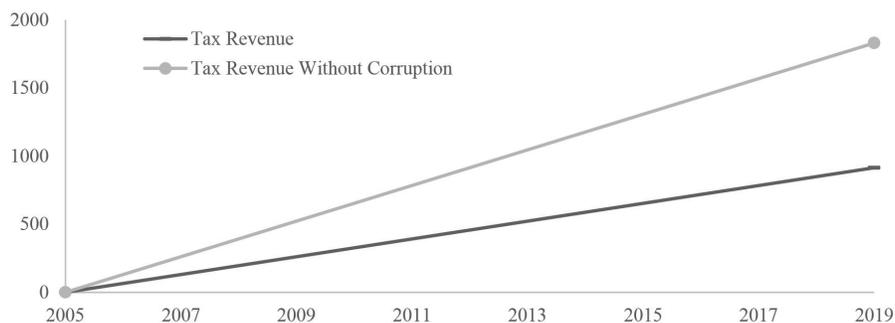


Figure 5: Tax Revenue without Corruption

Source: ADB, NASA, World Bank.

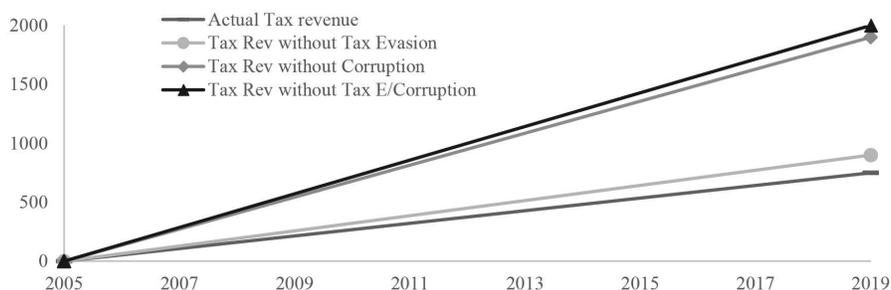


Figure 6: Tax Revenue without Tax Evasion and Corruption

Source: ADB, NASA, World Bank.

Table 1: Model Proxies' Quantum Values are Displayed

Year	Budget Tax Revenue in Billion/AFN	Actual Tax Revenue in Billion/AFN	Tax Evaded in Billion/AFN	GDP in Billion/AFN
2005	11.32	9.447	-1.873	308
2006	25.137	24.251	-0.886	348
2007	27.345	25.647	-1.698	485
2008	33.658	31.356	-2.302	515
2009	58.456	51.882	-6.574	611
2010	68.232	66.594	-1.638	726
2011	84.564	75.824	-8.74	850
2012	60.453	58.899	-1.554	1,028
2013	96.133	81.115	-15.018	1,138
2014	105.144	80.966	-24.178	1,176
2015	91.477	89.965	-1.512	1,222
2016	94.487	69.5	-24.987	1,223
2017	105.014	75.62	-29.394	1,285
2018	112.556	88.82	-23.736	1,327
2019	127.779	85.35	-42.429	1,469

**Table 2:** Regression Result

Dependent Variable: GDP				
Variables	Coefficient	Std. Error	t-statistic	Prob.
TAX_EV	-22.62594	5.070735	-4.462064	0.0006
C	632.7221	90.72276	6.974238	0.0000
R-squared	0.604983	Mean dependent var		914.0667
Adjusted R-squared	0.574598	S.D. dependent var		387.3425
S.E. of regression	252.6359	Akaike info criterion		14.02534
Sum squared resid	829723.9	Schwarz criterion		14.11975
Log-likelihood	-103.1901	Hannan-Quinn criter.		14.02434
F-statistic	19.91001	Durbin-Watson stat		1.152312
Prob(F-statistic)	0.000640			

Note: \*\*\*, \*\* and \* indicates significant at 1%, 5% and 10% level of significance based on *t*-statistics.

As shown in Table 2, tax evasion negatively and significantly impacts Afghanistan's GDP (TE coefficient = -22.62, *t*-value = -4.46). It means that a per cent decrease (1%) in Afghanistan's economic growth equals a 22.62 per cent decrease in tax evasion. The result's relevance is confirmed by the probability value of  $0.00006 < 0.05$ . The coefficient of determination, which reflects the model's goodness of fit as revealed by *R*-square ( $R^2$ ), indicates that fluctuations in the dependent variable explained 60.4 per cent of the variations observed in the dependent variable. The adjusted *R*-Square correctly corrected the test of goodness of fit shown by  $R^2$  to 57.4 per cent.

## 5. Conclusion

One of the government's main tasks is collecting tax and non-tax revenues to cover its economic expenses. To achieve this goal, governments formulate policies and laws and take serious action to implement them, but revenue-generating institutions face a series of problems and violations in implementing these policies and laws.

After analyzing statistical data from available sources, tax evasion threatens government revenue and directly affects government economic growth. It means whenever tax evasion rises, and small, medium-sized, and large taxpayers evade taxes in different ways, the government's tax revenues, which are an important part of the government's total revenues, decrease. Conversely, the lower the level of tax evasion in the economy, the higher the tax revenue collection.

Revenue in Afghanistan is a vital part of the government because the government finances half of its national budget from this section. There are several reasons for

Afghanistan's low revenues: a limited private sector, a large informal economy dominated by agriculture, and low compliance and mobilization. Tax evasion in Afghanistan has always caused the country's tax revenues to be lower than estimated. It means that the reduction in tax revenues harms the entire economy. Further, the lack of a unified system in tax collection and lack of coordination between government agencies, as well as political, environmental, and social problems, are the main causes of tax evasion, and it has a significant negative impact on Afghanistan's economic growth, which 22.86 per cent tax evasion causes a 1 per cent reduction in GDP growth.

In addition to the problems mentioned, it should be added that Corruption has made Afghanistan dependent on international aid and placed Afghanistan at the top of the most corrupt countries in the world. Afghanistan suffers from widespread Corruption; it directly affects government revenue and economic growth and changes it into a country dependent on global aid. Moreover, the root cause of tax evasion is widespread Corruption in Afghanistan. As outcomes of tax evasion are far-reaching, tax evasion reduces government resources. Afghanistan's tax revenue will double when Corruption is removed from Afghanistan's customs and tax offices. That is, Corruption directly impacts government tax revenues. By using the country's internal resources in a coherent structure, reducing unnecessary costs, and better managing national revenue collection, we can implement appropriate economic policies to strengthen economic foundations and establish sustainable stability, and take basic steps to achieve the pace of financial stability, economic self-sufficiency, and economic growth will increase as time goes by.

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