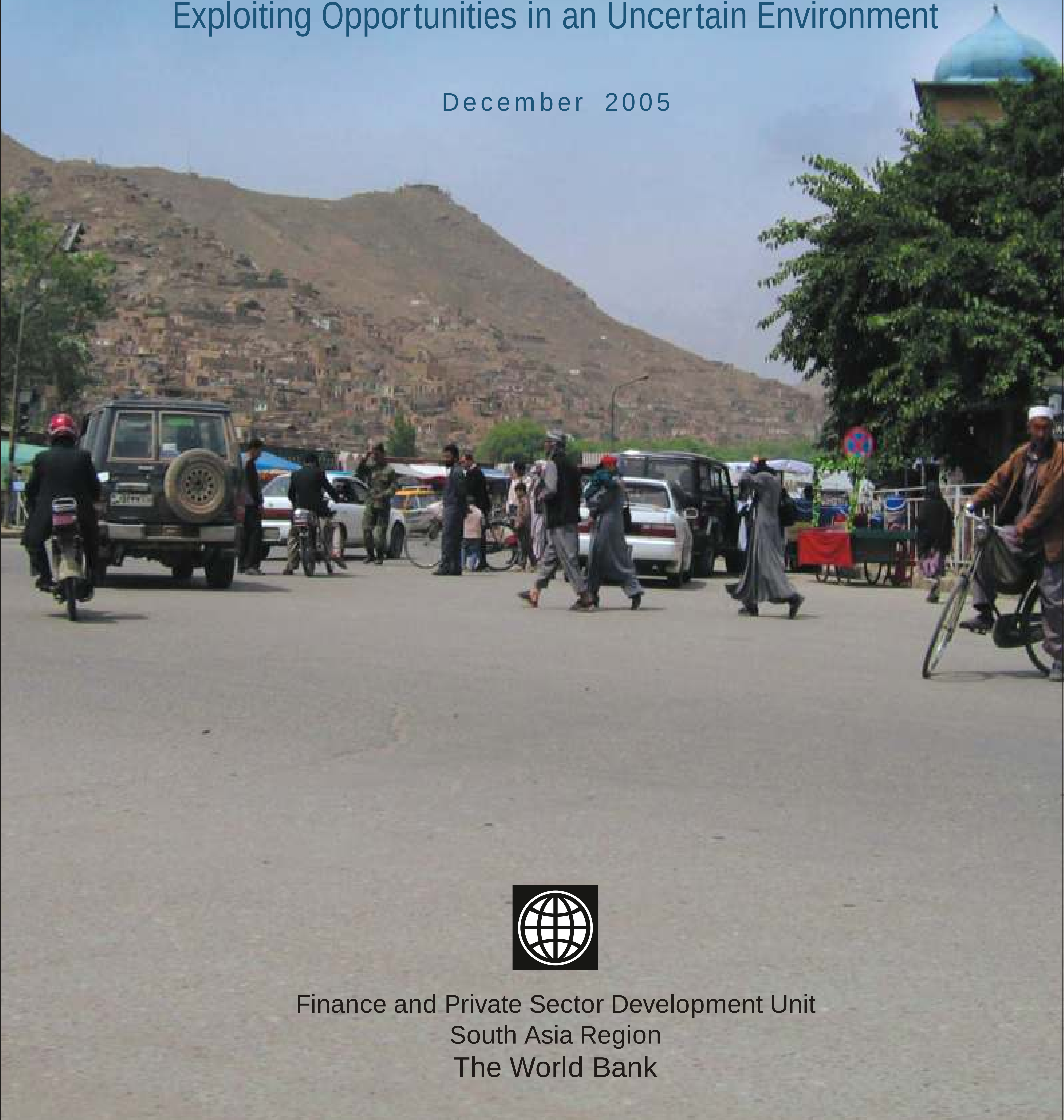
The Investment Climate In AFGHANISTAN

Exploiting Opportunities in an Uncertain Environment

December 2005



Finance and Private Sector Development Unit
South Asia Region
The World Bank

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Abbreviations and Acronyms

AISA	Afghanistan Investment Support Agency
AWCC	Afghanistan Wireless Communication Company
CIS	Commonwealth of Independent States
DAB	Da Afghanistan Bank
DABM	Da Afghanistan Breshna Moassesa
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
ICA	Investment Climate Assessment
ICS	Investment Climate Survey
IMF	International Monetary Fund
IPDA	Industrial Parks Development Authority
MAAH	Ministry of Agriculture and Animal Husbandry
MFI	Microfinance Institution
MMI	Ministry of Mines and Industry
MoC	Ministry of Commerce
MSTQ	Metrology, Standards, Testing and Quality
MWP	Ministry of Water and Power
NDF	National Development Framework
NEEP	National Emergency Employment Program
NGO	Nongovernmental Organization
OECD	Organisation for Economic Co-operation and Development
PRSP	Poverty Reduction Strategy Paper
PSD	Private Sector Development
SME	Small and Medium Enterprise
SOE	State-owned Enterprise
TRB	Telecommunications Regulatory Board
UNAMA	United Nations Assistance Mission in Afghanistan
UNDP	United Nations Development Program
UNODC	United Nations Office on Drugs and Crime
WTO	World Trade Organization

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US$1	=	Af 48.65

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Contents

Executive Summary

In a postconflict environment, attracting new foreign and domestic firms is central to private sector development. New decisions about investment (in existing or new firms) usually depend on the availability of five basic factors: political and economic stability and security; clear unambiguous regulations; reasonable tax rates that are equitably enforced; access to finance and infrastructure; and an appropriately skilled workforce. In Afghanistan, these conditions are lacking. The challenges facing the government of Afghanistan in addressing these constraints and in turn attracting further foreign and domestic investment cannot be underestimated. But, as the experience of other reconstruction efforts shows-for example, in Bosnia and Herzegovina and East Timor-reform can be achieved. This report was prepared to assist the government of Afghanistan in addressing its private sector development challenges. It is based on a survey of 338 firms and draws on numerous recent studies on Afghan private sector issues.

A. Recent Reforms and Progress

Afghanistan has taken tremendous strides toward reestablishing itself as a politically and economically viable state. Since the fall of the Taliban regime in 2001, the government, with the support of the international community, has reestablished a number of political institutions and spearheaded economic reforms. A new constitution has been adopted, nationwide elections were held to select Afghanistan's first democratically elected president, and, in September 2005, a parliament was elected. The security situation in the country has improved and a return to general warfare does not appear to be imminent. With the aid of the international community, the central government has begun to build a multiethnic army and police force that are able to exert the government's control in regions outside the capital. The current government is strongly entrenched in Kabul and has a high degree of legitimacy throughout the country. However, there remain many areas where the government is not very effective and provides few services, especially where the insurgency is strong.

Economic growth, which has received far less international attention than has Afghanistan's political process, has been dramatic during the recent recovery. The International Monetary Fund estimates that official (nonopium) gross domestic product (GDP) growth averaged 22.5 percent between 2002 and 2004. It estimates annual growth in 2004/05 at around 7.5 percent and predicts 14 percent growth in 2005/06. Investment is high and accounts for nearly 22 percent of GDP; however, the bulk of this investment (90 percent by some estimates) is public investment financed through international aid. This rapid expansion can be attributed to a number of factors including the low starting base, the end of major conflict and the associated revival of economic activity, and the end of the drought, which allowed sharp increases in agricultural output in many regions.

A stable macroeconomic environment has been established and a number of steps taken to foster trade. Currency reform was completed in early 2003 and since then inflation has been low and the currency stable, helped by strong fiscal discipline and a prudent debt policy. The tax code was restructured in 2004, expanding the tax base, simplifying the code, and providing clarification. Customs tariffs have been rationalized. Existing trade agreements have been renewed and new agreements entered. The government is working toward accession to the World Trade Organization (WTO) within the next few years. Trade has increased dramatically, with the value of annual exports and imports growing at double-digit levels. However, this increase does not reflect an increase in Afghanistan's international competitiveness: Most are reexports to Pakistan.

Despite rapid economic growth, the structure of Afghanistan's economy has changed little. Some 80 to 90 percent of economic activity is informal and agriculture accounted for 47 percent of estimated total GDP in 2003. One of the largest sectors in the economy is the illicit production of opium, which in 2003 accounted for nearly one-third of GDP. There was a 20 percent decline in area devoted to opium production in 2005, but opium remains a major activity and a serious threat to security and stability. Afghanistan remains one of the world's poorest countries with an estimated per capita GDP of only US$315. Social indicators are also some of the worst in the world as reflected in high rates of infant and maternal mortality, illiteracy, malnutrition, and gender disparity.

The government has been able to raise domestic revenues to almost 4 percent of GDP, but international assistance funds the majority of the government's recurrent expenses and almost all development programs. The government has clearly recognized that Afghanistan's success will depend on its ability to quickly develop a strong and vibrant private sector that will be able to provide jobs and generate the resources needed by the government to accomplish its development goals. Private Sector Development (PSD) was identified as one of the three pillars in the Afghan government's National Development Framework approved in 2002 and is likely to figure prominently in the country's poverty reduction strategy paper, the "Afghanistan National Development Strategy," to be adopted soon.

The government has taken a number of steps to foster private sector investment. There has been significant progress in developing the financial sector. The Da Afghanistan Bank (DAB) and Banking Laws have been gazetted (i.e., formally enacted), a number of private commercial banks have been licensed, and three state-owned banks have been relicensed. Progress has also been made in developing the microfinance sector. The government has established the Afghanistan Investment Support Agency (AISA) with the mandate of promoting and facilitating investment. The AISA has helped streamline the business registration process to the extent that Afghanistan now ranks among the best countries in the World Bank's 2005 Doing Business indicators of firm registration. However, a host of clearances and procedures are still required before a business can actually begin operating.

B. The State of the Private Sector

Long years of conflict destroyed most of Afghanistan's production capacity and forced the flight of many skilled workers and managers. Sabotage of infrastructure crippled domestic and international distribution channels and cut off industry from its traditional markets. The Soviet-backed government in the 1980s worsened the situation by attempting to set up a centrally planned economy. Many traditional industries, such as carpets, closed and moved to neighboring countries and others, such as horticulture products, basically shut down because of the lack of suitable inputs. Today, despite a recent resurgence, the Afghan economy is dominated by small-farm agriculture. Outside of agriculture, the private sector is overwhelmingly composed of informal family-owned microenterprises, most of which are engaged in trading or basic services. Eighty to 90 percent of all economic activity is informal. There are few small and medium enterprises (SMEs) and only a handful of large firms. The manufacturing sector is tiny, export orientation is minimal, and most producers, with the exception of a few agro-processors, source their raw materials from abroad.

The end of major conflict and the fall of the Taliban regime led to an increase in private investment, but investment has been limited relative to Afghanistan's potential. New entry and expansion have been far less than policymakers had hoped for. Only two enterprises have been privatized. AISA has registered nearly US$1.3 billion in new investment (not including the telecom firms) in the past two years, but most of this is merely approved investment; and just a fraction has actually occurred. Nearly 50 percent of the new investment approved by AISA has been in construction and construction material. The remainder is split almost equally between industry and services. The concentration on construction, which is not unusual in postconflict countries, reflects the massive flows of external aid and the need to rebuild Afghanistan's devastated infrastructure. The biggest sectors in industry include plastics, bottlers, and processors of simple packaged foods-all aimed at the local market. Most are technologically simple and need only small investments; examples include small producers of biscuits and other inexpensive packaged foods that aim to replace more expensive imports. For the most part, Afghan industrial enterprises are nascent and unable to effectively compete against imports or enter the export market.

Success in attracting investment from overseas Afghans has been limited. But they are a potentially important source of funding: Nearly 20 percent of the firms sampled in the survey are owned by investors who have returned to Afghanistan since the fall of the Taliban regime. Besides bringing capital, returnees also bring contacts in foreign markets and knowledge of international business methods. Policymakers have looked to foreign direct investment as a key source of funding for Afghanistan's reconstruction, so far with mixed results. In the risky environment of Afghanistan, foreign investors prefer government- and donor-funded reconstruction projects or services through which they can quickly recover their investment, to the longer-term process of building markets for manufactured goods. The government has touted Afghanistan as a land bridge that will facilitate trade between Central Asia and South Asia. However, so far there has been little foreign investment to support this trade.

Despite the difficult business environment, Afghan industry is steadily recovering and existing firms are coping well, performing on par with firms in neighboring Central Asian countries. Firms in the Afghan survey report a 67 percent average increase in employment over the past five years, with 22 percent in the past year alone. Average capacity utilization of manufacturing firms rose by 10 percent last year. The rapid increase in employment was matched by a similar increase in sales and reflects the low base from which Afghan firms are starting. The median value of sales per worker in Afghan manufacturing firms is around US$3,333-greater than that reported in Tajikistan or Uzbekistan but only around one-third that of small manufacturing firms in Pakistan or India and much less than reported by Chinese firms. Afghan industry's low capital intensity explains much of this shortfall in labor productivity. At 60 percent, average capacity utilization in Afghanistan manufacturing is only slightly below its neighbors and high for a country just emerging from sustained conflict. In 1997, Mozambique was also three or four years out of major conflict, and average capacity utilization in manufacturing was only 48 percent.

Industry's recovery is also evidenced by its investment activity. Though the rate of foreign investment and the return of expatriate Afghan investors may be disappointing, existing local firms are steadily adding to their capital stock. Nearly 70 percent of the surveyed firms reported investing in new equipment or machinery sometime in the past year. This is a much higher rate than found in postwar Mozambique where only about 56 percent of firms invested in the year before the survey. In addition, over one-third of the Afghan sample introduced a new product line and more than 40 percent upgraded an existing product line in the past two years. Clearly, the existing Afghan firms are engaged in increasing their capital stock and upgrading their capabilities in anticipation of future opportunities.

However, this optimistic view is tempered by the fact that industry is starting from a low base and most of the investment is in the most basic production processes. Afghan firms offer less training than do their neighbors and their managers, and workers are less skilled than are those in competitor countries. Many businesses in Afghanistan do not feel the threat of strong competition. These facts suggest that substantial barriers protect incumbent firms and relieve them of pressure to constantly upgrade their capabilities.

C. Today's Investment Challenges: Investment Climate Constraints

Overall

The Afghan government has taken a number of steps to improve the business environment and attract investment. Tax reform is a notable example. The gross profit tax is 21.4 percent, compared with 35 percent for the region and 46 percent in the Organisation for Economic Co-operation and Development (OECD). Afghanistan has made the process of registering a business, if not actually starting operations, simple and the country now ranks 16th in the Doing Business rankings for starting a business. Significant progress has also been made with regard to labor regulation, regarding which Afghanistan ranks 25th in the 2005 Doing Business list. Regulations governing hiring, firing, and working hours all give Afghan firms more flexibility than firms have in most other countries of the world, particularly among its neighboring countries. The government has made important strides toward creating an enabling investment climate, but much more remains to be done-particularly removing informal barriers to new entry, improving infrastructure, and reducing uncertainty.

The most serious constraints reported by the surveyed firms are electricity and access to land. Over 64 percent of the surveyed enterprises cited electricity, and 60 percent cited access to land as either a severe or major obstacle to doing business in Afghanistan. Corruption and access to finance were also mentioned as significant constraints. Surprisingly, "crime theft and disorder" was cited by few firms as a significant problem. When firms were asked to name the single biggest constraint, the rankings of land and electricity were reversed; nearly 34 percent of managers cited access to land as the biggest constraint, 15 percent reported electricity, and 18 percent reported corruption. Few reported security.

The perceived obstacles are similar across all regions in Afghanistan, with only slight differences. Electricity, access to land, corruption, and access to finance are the issues most often cited as either severe or major constraints. However, the ranking of these obstacles differs by area. In Herat, access to finance was the most often cited severe constraint, with electricity much less often cited, which may reflect the fact that Herat has been relatively more successful than other cities in restoring power supplies. In Kandahar, customs and trade regulations were cited as often as access to finance was, possibly because of the large number of traders found in the Kandahar sample. Also in Kandahar, the managers were much less likely to report obstacles as severe or major than were managers in other cities. In Mazar-e-Sharif anticompetitive practices is cited more often than elsewhere, which could reflect deeply entrenched local business interests that use their close ties to powerful political patrons to restrict competition.

Security

It is counterintuitive that most managers in the survey did not rank crime and disorder as a major or severe constraint. But this result can be explained. There have been real improvements in the security situation in the major cities covered by the survey. The central government has made significant progress in disarming militias and integrating them into the police forces. Regional commanders who once dominated

Afghanistan have been reined in, often by being co-opted in government. At the same time, existing firms have developed mechanisms to cope with insecurity, though at high cost. The surveyed firms reported spending 15 percent of sales for security infrastructure, significantly more than did firms in neighboring countries. Many firms have formed close ties with powerful elements in society, including warlords and government officials, to obtain protection in addition to resources. Security is thus a lesser concern for them.

However, new entrants and potential investors who do not have established contacts with powerful figures find the environment much more daunting and are often discouraged from investing. Many former commanders remain influential, increasingly forging close ties to the business world and using their power and influence to further their business interests. Relatively small groups of businesspeople dominate many trading activities in Afghanistan. These small groups of insiders use their contacts to access land, settle disputes, ensure security, obtain credit, and win contracts that others without connections could not. Wide-scale poppy production remains a security threat, despite some recent successes in restraining its spread.

Infrastructure

Most indicators of infrastructure availability in Afghanistan are among the worst in the world, well below the corresponding figures for Sub-Saharan Africa. Decades of fighting devastated the country's infrastructure and rebuilding it has been one of the government's foremost goals. International aid has poured in and many significant projects have been completed. But this is a long-term agenda; meanwhile, infrastructure remains a major constraint for business.

Power. Power supply is of poor quality, characterized by low voltage, intermittent supply, and blackouts. Only about 76 percent of the sample was connected to the power grid but even they received power on average about six and a half hours a day. Not surprisingly, 74 percent of businesses reported owning at least one generator; in one city, Jalalabad, the figure is 97 percent. Of the country's installed power generation capacity of 420MW, only 270MW is operational; moreover, transmission and distribution capacity are inadequate. With international help, the government is working to rehabilitate generation, transmission, and distribution facilities.

Transport. Like their counterparts in many other countries, a relatively small proportion of firms in Afghanistan (25 percent) report transport as a major or very severe problem. However, this result may reflect the limited horizons of many private firms that operate in a localized economy and have limited transport needs. When asked what factors constrain exports, a larger proportion (39 percent) identified lack of roads, air connection, railroads, and other infrastructure as a major constraint. Protracted conflict and lack of maintenance have led to the dilapidation of the transport network. Rehabilitating the road network has been a top priority for the government, which has developed a large investment program for major highways. Thousands of kilometers of roads have been built, including the ring road from Kabul to Kandahar. Some improvements in travel times have begun to materialize. But there is still a long way to go. Transport service was an important activity during the conflict, and private transport companies have expanded rapidly since the end of the war. However, the government remains heavily involved in the transport sector.

Telecommunications. The telecommunications sector in Afghanistan is developing very rapidly. Only 26 percent of the surveyed firms mention telecommunications as a major or very severe problem. Driven by a competitive market and US$200 million in private investment, the mobile footprint covers as much as 50 to 60 percent of the country's population, providing services in 23 provinces (as of March 2005). There are two private mobile operators, and two additional licenses for mobile telecommunications have recently been awarded. The publicly owned Afghan Tel has also started providing services and now carries approximately 22 million calls per month. An access agenda for rural areas remains, as does a need to considerably improve the quality and range of services and to further reduce prices. Nonetheless, progress to date has been remarkable.

Access to factors of production: land, labor, and capital

Access to land. In many countries, access to land is a problem only for firms wanting to significantly expand. In Afghanistan, even the majority of existing firms find accessing land, especially serviced land, a serious problem-which indicates just how severe a constraint it is. Nearly 56 percent of the surveyed firms who had tried to acquire new land in the past three years were unsuccessful and more than 10 percent reported having ongoing land disputes. The different waves of conflict, land reform, and nationalization have left the land tenure system in disarray. Properties have changed hands numerous times. Many plots of land are not registered and even if they were, records have been destroyed or are now inaccessible. Multiple claims are common and dispute resolution is difficult, especially given the overlapping, inconsistent, and ambiguous legal systems and ineffective judiciary. The lack of certainty in land tenure discourages existing business from making large new investments and effectively prohibits new investors, especially foreign investors, from entering the market.

Skills. High illiteracy, poor education, war, and political upheaval have resulted in a critical shortage of skilled labor in Afghanistan. During the conflict many of Afghanistan's best qualified workers, those with the best opportunities abroad, fled. Consequently, qualified management, skilled technicians, and educated professionals are scarcely available to today's enterprises. The problem is exacerbated by the barriers to educating girls and employing women in most jobs outside the home. Afghanistan is caught in a trap. The lack of opportunities discourages workers from improving their skills and education. But the lack of employment opportunities is partly caused by investors not wanting to expand because of the lack of skilled labor. Only a small fraction-5 percent of Afghan firms-offer training. Only about one-third of the workforce in Afghan enterprises has a secondary education or higher. Sixty-two percent of Afghan managers have secondary or higher education compared with 96 and 98 percent in Pakistan and India respectively. The shortage of skilled labor helps explain the low productivity of Afghan firms. Unless this shortage is solved, Afghan firms will find it very difficult to compete against imports or on the export market. The situation in government is similar. Though some returning Afghans have brought with them significant technical skills, the majority of the civil service lacks training, skills, and education to effectively provide services.

Access to finance. Afghanistan's financial system is just beginning to recover and businesses have almost no access to bank credit and only limited access to banking services generally. Most of the 12 commercial banks licensed to operate in Afghanistan are concentrated in Kabul and provide services primarily to international donors and businesses, foreign nongovernmental organizations, and foreign government agencies. Commercial banks in Afghanistan offer financing with a maximum tenure of financing of up to three years. There are a small number of nonbank financial institutions (11 microfinance institutions, one credit union, and one leasing company), but although growing, they are still nascent and can meet only a very small fraction of credit needs. There are no credit bureaus or credit rating agencies. Only three firms in the survey reported having bank credit.

Informal sources play an important part in supporting Afghan businesses. Many businesses rely on informal funds transfer systems generally known as *hawala.* Only 30 percent of the sample reported having a bank account whereas nearly 21 percent of surveyed firms had a loan from a *hawaladar* and 14 percent of exporters received payments through *hawala* transfer. Remarkably, *hawala* transfers for foreign trade appear to be more than or at least as efficient as bank transfers: The length of time to clear a *hawala* transfer is not significantly different from the time taken for a bank draft. However, informal financial sector credit is not adequate for long-term private sector development. There is a pressing need for bank and nonbank financial institutions to provide viable alternatives to the informal sector. Low household savings, poor infrastructure, low integration with complementary markets, high costs of service provision (particularly in rural areas), poor registries, and lack of credit information, a secured transaction law, and insurance are the main factors constraining the growth of the formal financial sector.

Governance: legal framework, judicial and regulatory enforcement, and the functioning of government

Legal framework. The absence of a clear legal framework compounds the high level of uncertainty and risk facing investors in Afghanistan. Many of the existing laws are holdovers from the communist era or even the earlier monarchy, and many of the basic laws necessary to encourage private investment are missing. With three overlapping legal systems (the *Sharia,* the *Shura,* and the formal system based on the 2004 constitution), managers are often confused about which laws actually apply to them. The new government has worked to propose, pass, and implement new legislation, but there remains a vast backlog of laws and regulations that need to be enacted.

Judicial and regulatory enforcement. Firms mostly use informal mechanisms, including force, to resolve disputes and enforce property rights. There are no formal alternative dispute resolution mechanisms such as arbitration or mediation. The formal court system suffers from a lack of qualified legal professionals, no method to hold judges accountable, and reportedly endemic corruption. Consequently, businesses do not rely on the formal judicial system. Only 3 of the 338 firms surveyed reported using the commercial courts to settle a payment dispute in the past two years. Many managers do not understand the benefits of a strong and efficient legal system and, given the arbitrary enforcement and lack of effective courts, do not spend much time worrying about it. Only 10 percent of the survey sample mentioned the legal system as a major or severe constraint. However, good laws, effectively enforced, are essential to encourage large-scale investment, especially by foreign investors and returning Afghans.

Regulatory issues such as business registration, tax administration, and labor law were not cited as significant obstacles. They are not seen as significant obstacles not because the registration, tax and labor requirements are clear and efficient but because they are poorly enforced and hence do not affect most firms. However, there are problems in some areas. Although illegal checkpoints established by local commanders and militias are no longer a major constraint, inspections by government officials remain a hassle. Traders report that they face frequent inspections and fees levied by different government agencies and local authorities. The government, led by the Ministry of Commerce, is attempting to resolve some of these issues, but currently, businesses report multiple inspections and delays as a serious issue that raises costs.

Predictability of government policies and actions. Because Afghanistan has a risky investment climate that deters investment, it is essential that whenever possible the government should engender certainty and predictability. In some ways the government is doing well on this score. Nearly 60 percent of the participants in the survey reported that they tended to agree or fully agreed with the statement that "in general, government officials' interpretations of regulations affecting my establishment are consistent and predictable." But the government is still in a precarious position. The recent experience with tax holidays shows that inadequate information about policy and specific procedures can create considerable uncertainty for investors.

Corruption. Corruption is endemic in Afghanistan and adds to the uncertainty facing investors, especially foreign investors or returning Afghans who do not understand the system. Nearly 58 percent of surveyed firms cited corruption as a major or severe problem, just behind access to land and electricity. Firms reported paying an average 8 percent of sales as bribes, more than four times the average reported in neighboring Pakistan. AISA's investment facilitation activities have helped many investors negotiate the regulatory maze without paying bribes, but this function is still limited in scope.

Weak government institutions. In nearly 25 years of war, Afghanistan's government institutions were devastated and the new government, with international assistance, has been striving to rebuild them. There has been some progress in rebuilding institutions. Most ministries are now staffed and functioning at some level. The central bank is functioning well and has issued a new currency. The customs department is collecting taxes and forwarding the revenue to the central government, and the security forces are loyal to the elected government. However, the government infrastructure is nascent and many ministries lack the capacity to provide some of the basic services. The courts and criminal justice system are inefficient and rarely used. Land registries are incomplete and inaccurate, and often fraudulently abused. There are no standards commissions and the once-extensive agriculture extension service barely functions.

Trade policy and trade facilitation

Trade policy. The government has made trade a cornerstone of its development strategy and envisions Afghanistan becoming a land bridge between the rest of Central Asia and South Asia. Accession to the WTO in the next five years is a top priority. A number of steps have been taken to facilitate trade. These include trade and transport agreements with neighboring countries, preferential trade arrangements internationally, passage of a customs reform package (2004) that makes Afghanistan one of the most open economies in the region by simplifying the tariff structure and reducing the range of tariffs from a maximum of 150 percent to a range of 2.5 to 16 percent, and initiation of a Customs Modernization Program. However, anomalies remain. For example, manufacturers complain that the tariff structure is such that they often pay more duty on imported inputs than traders do on imports of the finished goods.

Customs administration. According to the World Bank's Doing Business 2005 report, Afghanistan ranks 128 in cross-border trading, and importing requires 10 documents and 57 separate signatures. Businesses report that customs officials continue to use wide discretion on the valuation and inspection procedures, which leads to corruption and delays. The investment climate survey found that on average it took firms nearly 10 days to clear exports last year and about 8 days to clear imports. Shipping agents report that this time could be lowered to a few hours if they were willing to pay a large enough bribe. Medium-sized firms complain about discrimination by the customs regime. Small traders can evade duties, taxes, and informal payments, and the very large companies, particularly foreign companies, are able to negotiate tax incentives. But the average small Afghan company is too big to hide and too small to fight, so it bears the burden of the government taxes and regulations.

Trade facilitation services. Trade facilitation services are weak or nonexistent. Exporters and potential exporters covered by the survey identified the lack of trade finance, the lack of cold storage and other storage infrastructure, and the inefficient customs and clearance procedures as the biggest impediments to increasing exports. Trade credit is rare and expensive, forcing most producers to rely on middlemen who have connections and strong finances. In addition, there are no independent agencies that assure standards or certify quality. The Ministry of Commerce is forming an Afghan metrology, standards, testing, and quality (MSTQ) body to test the quality of goods in Afghanistan. Though badly needed, as of summer 2005 it was not yet functioning.

Some 38 percent of the surveyed exporters identified the cost of transport as either a major or very severe obstacle-the same percentage that identified inefficient or corrupt customs clearance procedures. Afghan shippers often have to transship goods into the carriers of neighboring countries, which raises costs and means loss of all control of goods once they cross the border. Surveyed firms reported losing up to 5 percent of international shipments to spoilage and loss on average; for some this loss was as high as 30 to 50 percent. Shippers say that some insurance is available, but apparently few can access it. Over 80 percent of the firms that experienced losses were not compensated. It is clear that transport is expensive and risky in Afghanistan.

The dominance of informal arrangements-a vicious circle?

Much of private sector activity in Afghanistan, even by significant business concerns, is carried out in an environment dominated by informal arrangements and practices. Firms lie on a spectrum of such arrangements ranging from formally registered, tax-paying firms engaged in legal activities but often using informal channels for protection and access to resources, to enterprises engaged in illicit activities (production and/or distribution) with even greater reliance on unofficial contacts to carry out business. In between are informal (i.e., nonregistered) enterprises carrying out legal activities within a nexus of informal arrangements. A subset of these informal arrangements and practices are similar to those found in patronage-based organized criminal networks (generally referred to as mafia-type networks), but it is difficult to say how large this subset is in Afghanistan. Some observers believe that informal markets and informal patterns of trading may have now become quite strong and be operating according to well-established patterns.

These informal arrangements may be useful for many investors in the short run but have negative effects for overall growth. They stop many participants from entering the market, lead to inequitable distribution of the benefits, and may have a negative effect on political governance and state-building. The informal economy is relatively free from official regulations because of poor enforcement but is nonetheless subjected to informal regulations that restrict entry and competition, even among incumbents. Many returning Afghans who have good ideas and capital to invest are reluctant to risk their capital because they fear they will be crowded out by those with connections. In brief, though existing firms in the nonformal economy may be growing, there is little new entry and low rates of investment. The informal mechanisms that allow firms to cope with the high levels of uncertainty are not conducive to long-term growth and equity.

D. Accelerating Private Investment: What needs to be done?

The key challenge is to broaden participation in the market by removing barriers to new entry and creating conditions that will encourage those already in the market to invest more. The present investment climate challenges are not insurmountable. Many factors stand Afghanistan in good stead. Afghanistan has a long entrepreneurial tradition of SME industries and services on which an active market-oriented private sector can be built. Some of the required actions are outside the scope of any PSD agenda as conventionally defined. There is a need for an overall political and security strategy that limits the power of those who have gained control of the markets through force of arms and illicit activities. Issues related to politics and security is beyond the scope of this report, which focuses on actions that fall within the domain of PSD. However, these actions may address the paradigm of informality and help weaken the nexus of informal relationships by extending the writ of formal arrangements.

Four categories of actions are recommended (specifics are provided in chapter IV). Together, these will increase incentives to invest (by reducing uncertainty and transactions costs) and improve capacity to carry out productive activities (by improving access to inputs, business services, and markets). There are many complementarities among these actions, some of which may affect both incentives and capacities.

Improve access to inputs. Firms need factors of production, notably finance, land, skilled labor, and physical utilities and infrastructure, including power, water, telecoms, roads, and ports. Improved access to such inputs is important to weaken the hold of informal arrangements, which draw their strength to a large extent from control over such resources. Improved access will require an expansion in the supply of inputs and also a more transparent process of allocating them. Freeing up land currently locked up in nonviable state-owned enterprises, injecting money into the banking system, and expanding the power-generating capacity are all examples of actions that increase the supply of inputs (land, finance, electricity). Though these will help, they may not substantially increase market participation and may largely benefit the well-connected incumbents if the allocation process is nontransparent and is subordinate to the informal arrangements described earlier.

Though a privatization policy has recently been adopted, more detailed modalities need to be developed to ensure transparent privatization transactions with clear institutional responsibilities for initiating and implementing privatization. With regard to improving access to land, an intermediate solution is the establishment of industrial estates. The government is moving in this direction. An effective industrial estate program will require an independent, commercially oriented agency to develop and maintain the estates with progressively greater involvement of the private sector. However, industrial estates are not a substitute for a functioning land tenure system, on which work needs to be accelerated.

Improving the supply of infrastructure services requires not only massive investment in new facilities but also reforms in policies, regulations, and institutions, including systems for operation and maintenance. Public utilities may increasingly be run on commercial principles based on accountability for performance, cost recovery, and sustainable operations. There is considerable scope for corporatizing state-owned firms and private sector provision of infrastructure. To encourage the latter, the government needs to take a number of actions including removing policy barriers to private sector entry, regulating standards, introducing tariff structures conducive to private participation, and helping to introduce risk mitigation arrangements.

To improve access to finance it is recommended that the government focus on improving the institutional mechanism for delivering credit, improving access to financial services for SMEs and rural communities, and broadening and deepening the financial sector. In the medium term, efforts should be made to increase the capacity of formal financial institutions with sizeable branch networks to provide credit. Afghanistan should abandon the old, discredited model of directed lending through publicly owned and managed development finance institutions. It should move toward a strong, market-based, competitive financial system that serves business needs in a much more efficient and cost-effective manner. This does not rule out some public policy intervention, especially given the postconflict conditions, on behalf of underserved SMEs and rural communities. Whereas the banking sector is likely to remain the largest component of the financial system for some time, there is also a need to broaden the financial sector by developing leasing companies, commercial credit companies, credit unions, factoring companies, insurance companies, and pension and provident funds, and, in the longer term, debt and equity markets. Actions should also be taken to enhance competition in the financial sector. Through regulation, authorities must create an environment to prevent collusive behavior among banks and conglomerate relationships between banks and nonbank financial institutions.

Clarify and strengthen property rights by creating a sound legal, judicial, and regulatory framework for investment. Property rights refer not only to tangible property such as land and equipment but also intangible "properties" such as a license to operate or a permit to import raw materials. Strengthening property rights will require developing a sound legal framework and an effective judicial system that enforces decisions and helps resolve disputes so that recourse to informal means of dispute resolution is reduced. A number of laws, such as the revised Law on Investment and Laws on Business Organizations, Insurance, and Financial Leasing, urgently need to be enacted. The administrative systems need to be developed in other areas as well before laws are put in place; the administration of land deeds is an example. It is also important to make the regulatory system predictable, transparent, and simple to reduce the need to fall back on informal contacts to navigate the regulatory maze.

Improve the flow of information. Informal arrangements thrive when information flows are weak. When market players lack information-about market opportunities and trends, quality of products, availability of resources, and government policies and regulations-they become dependent on informal contacts and patrons both for information and because they do not know where else to go. Lack of information about government policies also increases uncertainty. Actions in this area will need to focus on increasing awareness of government policies, laws, and regulations, making the award of public contracts transparent and competitive, building an effective MSTQ system, regulating utility standards, and establishing credit bureaus. It is also important to develop private sector collective bodies, such as chambers and trade organizations, and mechanisms for effective public-private sector dialogue to gather feedback and disseminate knowledge about government policies.

Improve the provision of business services. Enterprises need a variety of business services to help them enter (e.g., help with preparing business plans and negotiating with creditors), operate, and grow (e.g., trucking, freight forwarding, accounting, market information, quality assurance services, management services, and legal assistance), and manage risk (e.g., insurance). These services are best provided by the private sector but the government needs to put in place a policy and regulatory framework to facilitate private entry. There may also be scope for public-private partnerships to jump-start markets for services where currently there are very few or no providers.

Underlying all these issues is the need to improve government capacity to analyze private sector issues and formulate and implement private sector development policies and programs. Promoting private sector development in an era of globalization requires a good understanding of international and domestic market trends, sectoral knowledge, and appreciation of the needs of business. There is a need for effective coordination among different parts of government whose work has a bearing on private sector development. The High Commission for Investment, where several ministries are represented, can be one vehicle for achieving these goals, but effective coordination will also require an appropriate division of labor between the various ministries and agencies based on the comparative advantages of the different parts of government. The overall economic policy of government, such as trade and tax policy, will also be relevant because it will influence the broad incentive structure for private sector players.

1

Overview

Introduction

In a postconflict environment, attracting new foreign and domestic firms is central to private sector development. Existing firms at the end of sustained conflict are typically state-owned, are highly undercapitalized, have weak or nonexistent management, have a deskilled and underemployed labor force, and are in need of significant new capital investment. As is the case in any business environment, particularly in postconflict countries, new investment decisions (into existing or new firms) usually depend on the availability of five basic factors: political and economic stability and security, clear unambiguous regulations, reasonable tax rates that are equitably enforced, access to finance and infrastructure, and an appropriately skilled workforce. In Afghanistan, these conditions are lacking.

The challenges facing the government of Afghanistan in addressing these constraints and in turn attracting further foreign and domestic investment cannot be underestimated. But as the experience of other reconstruction efforts shows, as in Bosnia and Herzegovina and East Timor, reform can be achieved. Postconflict reconstruction is not new, and many countries have successfully rebuilt viable and modern private sectors after harsh devastation. Although war and conflict are not the same everywhere, those countries show that successes have been achieved in some of these countries under challenging circumstances.

This report has been prepared to assist the government of Afghanistan to address its private sector development challenges. It acknowledges the achievements that have been accomplished since the fall of the Taliban regime, and it highlights both the investments that have taken place and the opportunities that remain to be captured. More important, it reviews the constraints that firms currently operating in Afghanistan face and makes policy recommendations on how these constraints can be addressed. In addition to a survey of 338 firms, the study makes reference to the numerous studies on the private sector that have been conducted recently.

Background

Afghanistan has taken tremendous strides toward reestablishing itself as a politically and economically viable state. Since the fall of the Taliban regime in 2001, the government, with the support of the international community, has reestablished a number of political institutions and spearheaded economic reforms. However, as noted in this chapter, more needs to be done if the government is to consolidate the ongoing state rebuilding efforts and accelerate the economic development process.

Political reforms

Since the fall of the Taliban regime in late 2001 and the high level of international support that followed, Afghanistan has made significant progress toward forming a stable central government that has legitimacy throughout the country and with all major ethnic groups. In December 2001 a Loya Jirga [assembly] was held to select an inclusive interim government. This was followed by a Loya Jirga that adopted a constitution and nationwide elections to select

Afghanistan's first democratically elected president. Parliamentary elections were successfully carried out in September 2005.

The security situation in the country has improved and a return to general warfare does not appear to be imminent. The largest militia forces have been demobilized, almost all of the heavy weapons in the country have been cantoned, and many of the most significant militia commanders have been given positions in the government. With the aid of the international community, the central government has begun to build a multiethnic army and police force that are able to exert the government's control in regions outside of the capital. Currently, there are almost 21,000 trained and equipped soldiers and nearly 40,000 national police. The enhanced security has allowed large numbers of refugees to return from neighboring countries and most internally displaced persons have been resettled.

The current government is strongly entrenched in Kabul and has a high degree of legitimacy throughout the country. Its influence in the provinces is growing, but in many areas, especially where the insurgency remains strong, the government has limited influence. Until recently, war and poor infrastructure led to the rise of regional political powers that limited the ability of the central government to project its influence. Today, the government has made efforts to appoint strong provincial governors loyal to the elected president and has replaced militias with the central government security forces. Of greater concern is the very weak capacity of most provincial governments to deliver services effectively.

Economic reforms

Economic growth, which has received far less international attention than has Afghanistan's political process, has been dramatic during the recent recovery. The economy has grown by more than 50 percent since the end of the conflict, which has allowed nearly 2.4 million refugees and 600,000 internally displaced persons to return to their homes. Though there are few good statistics on the Afghan economy, the International Monetary Fund (IMF) estimates that official (nonopium) gross domestic product (GDP) growth averaged 22.5 percent between 2002 and 2004. This rapid expansion can be attributed to a number of factors including the low starting base, the end of major conflict and the associated revival of economic activity, and the end of the drought, which allowed sharp increases in agricultural output in many regions. The IMF estimates annual growth in 2004/05 at around 7.5 percent and predicts 14 percent growth in 2005/06. Investment is high and accounts for nearly 22 percent of GDP. The bulk of this investment (90 percent by some estimates) is public investment financed through international aid. These figures may be biased because private investment is most certainly underestimated but the primacy of donor-funded public investment is beyond question.

The Afghan government has been remarkably successful in establishing a stable macroeconomic environment. Currency reform was completed in early 2003 and since then inflation has been low and the currency stable. The government has shown strong fiscal discipline and has implemented a no-overdraft policy by which they refrain from printing money to finance a deficit. The government has also followed a prudent debt policy and has sought most of its external assistance in grants or highly concessional credits. The tax code was restructured in 2004 to expand the tax base, simplify the code, and provide clarification. The gross profit tax rate is 21.4 percent, compared with 35 percent for the region and 46 percent in the Organisation for Economic Co-operation and Development (OECD).

The government has taken a number of steps to foster trade and reestablish relationships with trading partners. Customs tariffs have been rationalized, existing trade agreements renewed, and new agreements entered. Afghanistan has obtained preferred trade status — or Generalized System of Preferences (GSP) status in the United States, receives preferential treatment from Japan, Canada, and the European Commission, and has signed trade agreements with India, Pakistan, and Turkey and bilateral investment treaties with Germany, Turkey, and Pakistan. A trade and investment framework agreement has been signed with the United States and the first meeting under this agreement was held in Washington, D.C., in December 2005. A decision to include Afghanistan in the South Asian Association for Regional Cooperation was made at the last summit of the Association in Dhaka, Bangladesh, in November 2005. The government has promised to build a trade regime that will allow Afghanistan to enter the World Trade Organization (WTO) within the next few years. Trade has increased dramatically, with the value of annual exports and imports growing at double-digit levels. However, most of the exports are reexports to Pakistan, which suggests that the increase in trade does not reflect an increase in Afghanistan's international competitiveness.

Yet, despite rapid economic growth, the structure of Afghanistan's economy has changed little. Some 80 to 90 percent of economic activity is informal (World Bank 2004, p. 5) and agriculture accounted for 47 percent of estimated total GDP in 2003. Other sectors are relatively small and will remain small. Though industry and services are projected to grow at nearly 30 percent, Afghanistan will remain an agrarian economy for some time. Industry is expected to remain about 24 percent of GDP in 2005, with manufacturing staying around 15 percent. Illicit production of opium is a major activity in Afghanistan and accounts for 87 percent of world production. In 2003, it accounted for one-third of GDP (World Bank 2004, p. 3-4). However, for the first time since 2001, there was a decrease in opium poppy cultivation in 2005. According to the United Nations Office on Drugs and Crime (UNODC), the area devoted to drug crops declined by 21 percent to 104,000 hectares, and one field in five that was planted with an illicit opium crop in 2004 was planted with a licit crop in 2005. It appears that the comprehensive eradication program initiated during the 2004-2005 growing season is bearing some fruit. The challenge is to sustain this momentum (UNODC 2005).[1]

Of even greater concern, Afghanistan remains one of the world's poorest countries with an estimated per capita GDP of only US$315. Social indicators are also some of the worst in the world: Infant mortality is 115 per 1,000 live births, maternal mortality is 1,600 per 100,000 births, and 57 percent of men over the age of 15 are illiterate. Malnutrition is a critical issue as 70 percent of children do not receive timely complementary feeding and 85 percent of households consume noniodized salt. There is a very large gender disparity. Illiteracy for women above 15 years of age is 86 percent and in some areas the net enrollment of girls in school is as low as 1 percent (World Bank 2004, p. 3).

Though the government has been able to raise domestic revenues to almost 4 percent of GDP, international assistance funds the majority of the government's recurrent expenses and almost all development programs aimed at redressing Afghanistan's economic woes. Under the government's scenario it will be able to fund recurrent expenses in nine years' time, but development programs would still be entirely dependent on donor funds. Donors have been generous and are poised to continue, but there is no certainty that international assistance will remain at such high levels over the medium term. If Afghanistan fails to meets its revenue requirements it would not only delay development, but would have far-reaching political effects.

The government has clearly recognized that Afghanistan's success will depend on its ability to

[1] Although acreage declined substantially, the total potential opium production decreased by only 2.5 percent because of favorable weather conditions and low rates of plant disease, which led to much higher yields in 2005 than in the previous year.

quickly develop a strong and vibrant private sector. Only a growing private sector will be able to provide the jobs and increasing income expected by the population and generate the resources needed by the government to accomplish its development goals.

The private sector

The government has taken a number of steps to foster private sector investment. There has been significant progress in developing the financial sector. The Da Afghanistan Bank (DAB) and Banking Laws have been gazetted (i.e., formally enacted) and a number of commercial banks licensed. DAB has divested its headquarters-based commercial banking activities and divestment will be extended to branches in provinces where commercial banks are active. Three state-owned banks (Mille, Pashtany, and Export Promotion) have been relicensed, with corrective action provisions to improve performance. Progress has also been made in developing the microfinance sector. In addition to reforming the central bank and establishing a new payments system, the government founded an institution to encourage private sector activity and streamlined the business registration process. It established the Afghanistan Investment Support Agency (AISA) with the mandate of promoting investment in the country. AISA provides information to investors and facilitates the registration and establishment of new businesses. The creation of AISA in general, and specifically the more simple registration process, has resulted in Afghanistan ranking among the best countries in the 2005 Doing Business indicators of firm registration.[2]

Despite the government's recent efforts, the present level of private investment is still not sufficient to meet Afghanistan's economic development needs. As the following chapters show, several factors still pose serious challenges to the emergence of a new and vibrant private sector. The most notable constraints, perceived and actual, include the following:

- ***Security concerns:*** Despite significant progress, security threats remain. Some demobilized fighters have retained their weapons. Many have been integrated into the police forces, but most have returned to civilian society where they have not yet fully integrated. An ongoing insurgency is aimed at the central government and the United States-led coalition forces. Though the insurgency is centered in the South and East, there is fighting throughout the country, and in some areas it is increasing in intensity. Possibly the largest security threat is the spread of poppy production. This vast illegal industry threatens the very stability of the Afghan government, although there are now signs of some success in curtailing its growth.

- ***Weak institutions:*** In nearly 25 years of war, Afghanistan's government institutions were devastated and the new government has been striving to rebuild them with international assistance. There has been some progress on this front. Most ministries have been staffed and are functioning at some level, including in some cases delivering services. The central bank is functioning well and has issued a new currency. The customs department is collecting taxes and forwarding the revenue to the central government, and the security forces are loyal to the elected government. However, government infrastructure is nascent and many ministries lack the capacity to provide some of the basic services. The courts and criminal justice system are inefficient and rarely used. Land registries are incomplete and inaccurate, and often fraudulently abused. There are no standards bodies and the once extensive agriculture extension service barely functions. And despite noteworthy progress in reestablishing banking services, reasonably reliable banking services are limited to Kabul. Provincial branches

2 Despite the ease of registering a company, a host of clearances and procedures are required before a business can actually begin operating.

of state-owned banks maintain low cash reserves and are often unable to pay depositors and claimants in a timely fashion.

- ***Poor infrastructure:*** Decades of fighting devastated the country's infrastructure, and rebuilding it has been one of the government's foremost goals. International aid has poured in and many significant projects have been completed. Thousands of kilometers of roads, including the ring road from Kabul to Kandahar, have been built and several important roads are under construction. Power generation and distribution facilities have been renovated and hundreds of kilometers of irrigation canals have been cleaned and repaired. Although the country is increasingly being linked, poor physical infrastructure remains one of Afghanistan's greatest challenges. Less than 13 percent of the population has access to safe water, teledensity is 2.6 percent, and there are no operational railroads.

- ***Unreliable power supply:*** Of the country's installed power generation capacity of 420MW, only 270MW is operational and in most areas service is available only for a few hours a day. About 6 percent of the population is connected to the public grid and the rest depends on generators and illegal connections.

- ***Limited human and technical capacity:*** During the war years, many of the educated and technically proficient civil servants fled. Those that remained were cut off from learning opportunities and lost many of their capabilities. Though some returning Afghans have brought with them significant technical skills, the majority of the civil service lack the training, skills, and education to effectively provide services.

- ***Weak legal framework:*** In addition to low capacity in the civil service, government effectiveness is also hampered by the lack of a modern legislative framework. Many of the existing laws are holdovers from the communist era or even the earlier monarchy. Though the new government has worked to propose, pass, and implement new legislation, there is still a vast backlog of laws and regulations needed to guide government activities and provide stability to the citizens. Currently more than 200 laws considered by the government to be high priority are waiting to be passed, and for those that have been enacted, enforcement is a major problem.

In addressing the constraints listed above and many others, the Afghan government's National Development Framework (NDF)-its principal planning tool-lays out three pillars of development: (a) security and human development, (b) rebuilding physical infrastructure, and (c) enabling the creation of a viable private sector as the engine for sustainable and inclusive economic growth. The NDF was completed quickly and now the government is preparing to update it with an Afghanistan National Development Strategy. To do this they are undertaking careful analysis and broad and thorough consultations with all stakeholders. Undoubtedly the strategy will also emphasize the private sector as the engine of growth. And ultimately, private sector development will depend on establishing an environment conducive to private investment.

Objective of the Investment Climate Assessment

The Investment Climate Assessment (ICA) is a standard World Bank Group product, but this is one of the first postconflict ICAs. Its objectives are to (a) evaluate the state of the private sector business environment; (b) identify the key constraints to increasing firm productivity and the growth of small companies; (c) evaluate how the investment climate in a particular country or subnational region compares to the investment climate in competitor countries and other regions of the same country, and (d) identify policies that will alleviate obstacles and improve firm productivity and export competitiveness.

The ICA is based on a number of sources. It relies heavily on an Investment Climate Survey (ICS), which generates firm-level quantitative and qualitative information through face-to-face interviews with senior managers. These data can be used to evaluate firm-level performance and identify constraints to doing business. The survey data provided indicators of Afghanistan's investment climate and business performance that have been used in this report to identify reform priorities to track changes over time. The survey results are useful in benchmarking Afghanistan's investment climate against neighboring countries and for comparing the investment climate of regions within Afghanistan. The ICS is designed to be repeated in three to five years to assess the impact of government policies on private sector growth and productivity increases. In addition to the ICS, the report synthesizes other available analytical information to identify investment climate constraints and policy recommendations, including the World Bank's Doing Business Indicators, academic research, government publications, and reports by other donor organizations.

The ICS sample covered 338 firms in five major cities in Afghanistan (Kabul, Kandahar, Mazar-e-Sharif, Jalalabad, and Herat). The sample was drawn from manufacturing, transportation, wholesale and trade, and other service sector firms. Financial institutions, consulting companies, and security companies were not included. A sample frame of firms in Afghanistan is not available. Any available lists were inaccurate and incomplete. Consequently, the survey proceeded by sampling based on a sector's share of the estimated GDP with a quota for size of firm (see Annex A for more details on sampling). The implementing agency was forced to initially rely largely on a list of enterprises it had compiled in the course of conducting other research on the Afghan private sector. Though this list focuses on the sectors of interest for previous projects, the sectors represent a large proportion of the private sector and the list includes many of the known medium to large companies in the country. The bias of the original list was mitigated by using the snowball methodology, which entails asking interviewed firms and other contacts for suggestions of firms that meet the sampling criteria. These new firms in turn are asked for their suggestions. Thus, the sample potentially included a large proportion of the firms operating in the sectors and cities covered by the survey.

Structure of the report

Chapter II reviews the present state of the private sector in Afghanistan. It considers the rate of foreign and domestic investment today and their growth and performance under present conditions. Chapter III synthesizes the constraints the private sector is facing as identified by firms that participated in the ICS. Finally, chapter IV presents the policy recommendations that will help Afghanistan exploit tomorrow's investment opportunities.

2

The State of the Private Sector

Introduction

Long years of conflict devastated Afghan industry. The fighting destroyed most of Afghanistan's production capacity and forced the flight of many skilled workers and managers. Sabotage of infrastructure crippled domestic and international distribution channels and cut off industry from its traditional markets. In addition, the Soviet-backed government in the 1980s worsened the situation by nationalizing large portions of the economy, imposing price controls, and attempting to set up a centrally planned economy. In response, many traditional industries, including carpet weaving, closed and moved to neighboring countries. Others, such as horticulture products, basically shut down because of the lack of suitable inputs. There was a brief recovery of agriculture (primarily horticulture and livestock) in the 1990s, which was wiped out by the drought of the late 1990s. Many of the large state-owned enterprises (SOEs), such as the cotton and transportation companies, continued to exist but by the end of the 1990s were essentially moribund.

Today, despite a recent resurgence, the Afghan economy remains agriculture based, mostly consisting of small farms. Outside of agriculture, the private sector is overwhelmingly composed of informal family-owned microenterprises, most of which are engaged in trading or basic services. Recent World Bank estimates suggest that 80 to 90 percent of all economic activity is informal. There are few small and medium enterprises (SMEs) and only a handful of large firms. The largest companies are among the 78 existing SOEs, which include financial institutions as well as manufacturing and service firms. The manufacturing sector is tiny and production is highly concentrated in a few industries. It is almost completely inward oriented and few firms export a substantial portion of their output. In addition, the sector exhibits a low degree of intrasectoral linkages. Most producers, with the exception of a few agro-processors, source their raw materials from abroad.

Investment

The end of major conflict and the fall of the Taliban regime led to an increase in private investment. But despite several high-profile investments, by such companies as Coca- Cola, Baghlan Sugar, and the mobile telecom firms, investment has been limited relative to Afghanistan's potential. Some of the moribund enterprises have been revived and new ones have been created. But overall, new entry and expansion has been far less than policymakers had hoped for. One of the common ways for new investors, especially foreign investors, to enter a market is by purchasing firms in the government's privatization program. Yet, though the Afghan government has made an effort to privatize the SOEs, there seems to be little political will to do so and to date only two enterprises have actually been privatized.

As of May 2005, AISA has registered nearly US$1.3 billion in new investment (not including the telecom firms) in the past two years. However, this figure must be carefully interpreted. It represents only the approved investment, and just a fraction has actually occurred.[3] Nearly 50 percent of the new investment approved by AISA has been in construction and construction material. The remainder is split almost equally between industry and services. The AISA figures represent very little agriculture, which is understandable as most agriculture is small scale and does not have an incentive to register investment.[4]

The concentration on construction reflects the massive flows of external aid and the need to rebuild Afghanistan's devastated infrastructure. The predominance of construction is not unusual in postconflict countries. Not only is there a need to rebuild basic infrastructure, but often investment is directed into construction because of a lack of other opportunities. This is particularly true when an influx of aid and donor organizations demands modern accommodations. The service sector includes hotels, restaurants, transportation, communications, and other basic services needed by an emerging economy.

The biggest sectors in industry include plastics, bottlers, and processors of simple packaged foods. All of these industries are aimed at the local market. Some, such as bottlers, have natural protection because of the high cost of transportation. Most are technologically simple and need only small investments. For example, many small producers of biscuits and other inexpensive packaged foods aim to replace more expensive imports. For the most part, Afghan industrial enterprises are nascent and unable to effectively compete against imports or enter the export market.

By some estimates, businesspeople in the Afghan diaspora are worth as much as US$5 billion, with much of it in Dubai.[5] Donors and the Afghan government hoped that the end of major conflict and the establishment of a stable government would prompt much of this money to return and drive the reconstruction process. However, there has been limited success in attracting back investment from overseas Afghans. Just over half of the investment approved by AISA has been from Afghans and not all of this has come from outside. Yet the returnees and outside funds are important. Nearly 20 percent of the firms sampled in the ICS are owned by investors who have returned to Afghanistan since the fall of the Taliban regime. In addition, another 7 percent of the sampled firms received substantial startup capital from friends and family outside of Afghanistan or have owners that still live abroad.

Returnees are important in many ways. Besides bringing capital, they also bring with them contacts in foreign markets and knowledge of international business methods that will strengthen Afghan business. In the ICS survey, nearly 35 percent of the owners who have returned since 2002 have a high school education or higher, compared with only 24 percent of the rest of the sample of business owners who were in Afghanistan prior to 2002. In addition, recent returnees are nearly three times more likely to have experience working for foreign-owned companies. Research has shown that both the manager's education level and experience working in a foreign company lead to a higher level of firm productivity.

[3] The AISA staff is making a valiant effort to track the approved investments and registered firms to determine if they are in fact operating. But the task is slow and difficult and to date they have verified only a few firms. There is no way of knowing just how much actual investment has taken place compared to approved investments, but the rule of thumb used by many observers is to discount the approved investment by half when estimating actual investments. On the other hand, only large firms, foreign investors, and investors wanting to do business with the government have an incentive to register with AISA. Thus, substantial investment in the formal sector is not accounted for by the AISA figures. Nonetheless, the AISA lists give a good idea of the direction and magnitudes of investment activity.

[4] The lack of regulations of non-governmental organizations has also led to a plethora of for-profit organizations masquerading as not-for-profit organizations-undermining the legitimacy of the formal economy and displacing the private sector.

[5] Press Briefing by David Singh, Office of Communication and Public Information, United Nations Assistance Mission in Afghanistan (UNAMA), 25 September 2003.

In addition to investment by overseas Afghans, policymakers have looked to foreign direct investment (FDI) as a key source of funding for Afghanistan's reconstruction, so far with mixed results. To date, AISA has approved over US$520 million in FDI. More than half of this is in the construction sector and one-third in services. Less than 20 percent of the approved FDI has been in the AISA industry classification, which is mostly manufacturing. Given the risks of investing in Afghanistan, foreign investors prefer government- and donor-funded reconstruction projects or services, where they can quickly recover their investment, to the longer term process of building markets for manufactured goods. The government has touted Afghanistan as a land bridge that will facilitate trade between Central Asia and South Asia. However, so far there is no indication that there has been any foreign investment to support this trade.

Turkey is the largest investor and accounts for over one-fifth of FDI approved by AISA. Almost all of the Turkish investment is in construction. The United States is next with around 17 percent of approved investment, followed by China and United Arab Emirates (Dubai) with less than 10 percent each. Pakistan and Iran account for only around 5 percent of AISA-approved investment. Because they are Afghanistan's traditional trading partners, this small share suggests that a significant amount of investment from neighboring countries may not be accounted for on the AISA list. It is also interesting to note that firms from Iran are more likely to be investing in food products and other manufactured goods than are firms from other countries.

Growth and performance

Despite the difficult business environment, Afghan industry is steadily recovering, and existing firms perform on par with firms in neighboring Central Asian countries. Firms in the Afghan survey report a 67 percent average increase in employment over the past five years. Much of this growth has been recent, with employment growth averaging around 22 percent in the past year alone. Also in the past year the average capacity utilization of manufacturing firms rose by 10 percent. The rapid increase in employment was matched by a similar increase in sales and reflects the low base from which Afghan firms are starting. Typically, new firms grow at higher rates than do older, established firms because they are starting from a lower base. However, in Afghanistan, firms that were established after the fall of the Taliban report the same growth rate for the past year as do older firms. This statistic indicates to how low a level of output many existing firms had fallen.

Firm performance in Afghanistan is similar to that found in other small Central Asian countries but is considerably behind India, China, and even Pakistan. The median value of sales per worker in Afghan manufacturing firms is around US$3,333 (see Table 2.1). Though greater than that reported in Tajikistan or Uzbekistan, the median value is only around one-third that of small manufacturing firms in Pakistan or India and much less than that reported by Chinese firms. At 62 percent, average capacity utilization in Afghanistan

Table 2.1: Median Output Per Worker (US$ for manufacturing firms with fewer than 100 workers)

Afghanistan	Pakistan	Uzbekistan	India	China	Tajikistan	Syria
3,333	10,043	567	9,146	20,374	1,859	4,333

Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development Business Environment and Enterprise Performance Surveys.*
For firms with 100 workers or fewer in comparator countries.

manufacturing is only slightly below its neighbors and high for a country just emerging from sustained conflict (see Table 2.2). In 1997, Mozambique was also three or four years out of major conflict, and average capacity utilization in manufacturing was only 48 percent. Afghan industry is very small and only just emerging, but those firms that do exist seem to be coping well.

Industry's recovery is also evidenced by its investment activity. Though the rate of foreign investment and the return of expatriate Afghan investors may be disappointing, existing local firms are steadily adding to their capital stock. Typically, investment at the firm level is lumpy and in any given year a firm may not invest as it absorbs previous investments. Yet, 71 percent of both Afghan manufacturing and service sector firms in the sample invested in new equipment or machinery some time in the past year (see Table 2.3). This proportion is higher than in any of the comparator countries except China. It is also a much higher rate than that found in postwar Mozambique where only about 56 percent of firms invested in the year before the survey. In addition, over one-third of the Afghan sample introduced a new product line and more than 40 percent upgraded an existing product line in the past two years. Clearly, the existing Afghan firms are engaged in increasing their capital stock and upgrading their capabilities in anticipation of future opportunities. However, this optimistic view is tempered by the fact that industry is starting from a low base and most of the investment is going toward establishing the most basic production processes.

Afghan industry's low capital intensity undoubtedly explains much of the difference in labor productivity between Afghanistan and its larger neighbors. But recent research indicates that a number of other firm characteristics, along with the investment climate and the capital labor ratio (see Table 2.4), also contribute to labor productivity differences. Enterprises that offer worker training and have well-educated workers and managers are more productive than those that do not offer training and have less-educated workers. Probably the most important factor affecting productivity is the level of competitive pressure a firm faces. Stronger competition forces unproductive firms out of the market and surviving firms to continuously improve their performance.

Table 2.2: Average Capacity Utilization for Manufacturing Industry (%)

Afghanistan	Pakistan	Uzbekistan	India	China	Tajikistan	Syria
62	N/A	73	78	71	91	60

Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development Business Environment and Enterprise Performance Surveys.*
For firms with 100 workers or fewer in comparator countries.
N/A = *not available.*

Table 2.3: Firms Investing in Equipment or Machinery Last Year (% of Sample)

Afghanistan	Pakistan	Uzbekistan	India	China	Tajikistan	Syria
71	5	26	38	74	36	42

Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development Business Environment and Enterprise Performance Surveys.*
For firms with 100 workers or fewer in comparator countries.

Table 2.4 : Median Capital/Labor Ratio in Manufacturing (US$ per worker)

Afghanistan	Pakistan	Uzbekistan	India	China	Tajikistan	Syria
1,500	2,063	229	2,307	3,170	721	567

Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development Business Environment and Enterprise Performance Surveys.*
For firms with 100 workers or fewer in comparator countries.

As will be discussed in chapter III, Afghan firms offer less training than do their neighbors. In addition, their managers and workers are less skilled than are those in competitor countries. Most important, many businesses in Afghanistan do not feel the threat of strong competition. Over 40 percent of surveyed firms said that both domestic and foreign competition was either not important at all or only slightly important. These facts suggest that substantial barriers protect incumbent firms and relieve them of pressure to constantly upgrade their capabilities.

Opportunities

Afghan industry is recovering and growing, albeit from a low base. Though foreign investment and new large-scale investment has lagged, existing firms are steadily increasing sales, adding workers, and investing in their capabilities. The better Afghan firms, which were what the ICS covered, have attained labor productivity and capacity utilization levels similar to those of small firms in other Central Asian countries. But they still fall far short of the performance of small firms in India, Pakistan, and China.

Moreover, investors in Afghanistan are exploiting only a small subset of available opportunities. As Afghanistan comes out of more than 20 years of conflict, a variety of investment opportunities are emerging. Some of these involve the revival of traditional activities. Some involve the breaking of new ground (e.g., mobile phones and nontraditional exports). Yet others represent activities that were carried out in the past but either on a smaller scale (e.g., construction) or exclusively in the public sector (e.g., power generation, banking, and airlines). These activities may be categorized into several groups:

- *Import-substituting activities.* As Afghanistan never had a broad, diversified industrial base, a substantial part of local demand was historically met through imports. With a large part of the industrial base destroyed, imports have become even more important in postconflict Afghanistan. Many of these products, especially the low value-added products that use simple technology, represent areas where Afghanistan may have a comparative advantage. Examples include food products, such as poultry and wheat-based products, and light consumer products such as soaps, shampoo, and laundry detergents (see Box 2.1).[6]

- *Traditional exports.* These include carpets and a wide range of fruits. The bulk of Afghanistan's carpets are produced in villages, by women weavers. During the conflict, many carpet weavers and traders migrated to Pakistan, mostly to Peshawar. As a result, a large proportion of

6 Some of these activities, such as home egg and chicken production, have proved to be useful sources of income for poor households, including those headed by widows. There is some concern that entry of large poultry farms may drive such households out of business, although, with proper linkages between large enterprises and microenterprises, this need not be the case and such a development could turn out to be beneficial for the latter.

carpet exports in Pakistan's trade statistics are attributable to the Afghan carpet industry. The production of raisins, once the most successful Afghan export, has been hampered by damage to orchards and processing plants, although the recent preferential trade agreement with India has seen significant increase in the market share of Afghan dried fruits in the Indian market.

- *Exotic exports.* A second potential area consists of "exotic" exports. Some of these are agro-based and some mineral based. Examples include cashmere, spices such as cumin and saffron, perfumes, herbicidal medicines, and gems.

- *Construction-related activities.* The current boom in construction spending, not an unusual feature in postconflict situations, has generated substantial opportunities in construction-related activities. It is unclear if this sector will continue to remain an important arena for investment activity, as experience in other postconflict countries shows a drop in construction-related spending after the initial boom. However, in the interim, this environment can be a breeding ground for entrepreneurship, which, in the future, may be channeled into other activities.

- *Infrastructure and utilities services.* Mobile telephony remains the best known example in Afghanistan of significant private sector entry in the infrastructure and utility sector. However, a wide variety of opportunities wait to be exploited across various sectors. These sectors include small-scale power generation, management contracts in power distribution, fixed-line telephony, value-added services in telecommunications, and construction and maintenance of roads and small-scale water systems.

What would it take for investors in Afghanistan to venture into these promising areas? And what would it take for existing firms to improve their performance and bring it to par with that of their counterparts in the region, if not better? The rest of this assessment addresses these questions. Chapter III looks at the key issues in Afghanistan's investment climate that help explain the current shortfall in performance. It examines investment climate constraints in greater detail and considers their implications for present business operations and the potential for attracting further international and domestic investments. Chapter IV then lays out a road map for addressing the biggest constraints.

Box 2.1: Examples of import-substituting activities

Poultry: Despite existing local demand, the poultry sector in Afghanistan remains underdeveloped when compared with neighboring countries. Startup costs are relatively small, and facilities can be established quickly, making the sector appealing for businesspeople of more limited financial resources.

Wheat-based Products. Wheat is the primary staple in Afghanistan. Though Afghanistan has yet to reach self-sufficiency, numerous business initiatives are currently underway to expand production and improve processing. The emergence of an Afghan wheat-based food sector could play an important role in the development of small and medium enterprises.

Soap, Shampoo, and Laundry Detergents: Afghanistan imports almost all of these consumer goods. Soap, shampoo, and laundry detergents share the common characteristic of transportation representing a disproportionately high share of their total cost. This cost structure indicates a market opportunity for soaps, shampoos, and detergents manufactured in Afghanistan.

Source: *United Nations Development Program Market Sector Assessments, March 2005.*

3

Today's Investment Challenges

Introduction

The Afghan government has taken a number of steps to improve the business environment and attract investment. Tax reform is a notable example. Afghanistan is now at number seven of 155 countries in the 2005 Doing Business rankings for paying taxes (World Bank 2005). The gross profit tax is 21.4 percent (compared with 35 percent for the region and 46 percent in the OECD), and the average medium-size company makes two payments and spends about 80 hours per year complying with taxes. Currently, entrepreneurs do not see tax administration as a big issue because there is little enforcement. But as the economy grows and becomes more formal, it will benefit from having an efficient system in place. As already mentioned in chapter I, Afghanistan has made the process of registering a business, if not actually starting operations, simple. Labor regulation is another area where Afghanistan has made significant progress. It ranks 25th in the 2005 Doing Business list. Regulations governing hiring, firing, and working hours all give Afghan firms more flexibility than firms have in most other countries of the world, particularly among its neighboring countries. The government has made important strides toward creating an enabling investment climate, but much more remains to be done, particularly in removing informal barriers to new entry, improving infrastructure, and reducing uncertainty.

Obstacles: An overview

Over 64 percent of the surveyed enterprises cited electricity as either a severe or major obstacle to doing business in Afghanistan. Electricity was closely followed by access to land, which was cited by nearly 60 percent of the sample. Corruption and access to finance were also mentioned as significant constraints (see Figure 3.1). Surprisingly, "crime theft and disorder" was cited by few firms as a significant problem. When firms were asked to name the single biggest constraint, the rankings of land and electricity were reversed; nearly 34 percent of managers cited access to land as the biggest constraint, 15 percent reported electricity, and 18 percent reported corruption as the biggest constraint. Few reported security.

The importance of access to land is highly unusual in investment climate surveys. The surveys target existing firms; even in other postconflict countries, such as Mozambique, where the land tenure system is in disarray and it is difficult to secure clear title, most of the surveyed firms have solved their land issues. Access to land remains a problem only for firms wanting to significantly expand, especially those seeking greenfield expansion. The fact that access to land is perceived as such a significant problem in Afghanistan even by existing firms indicates just how severe a constraint it is.

In investment climate surveys, the cost of finance is usually highly correlated with access to finance. However, in Afghanistan, the fact that access is seen as a significant issue and cost is not reflects the fact that for most firms external finance is unavailable at any cost. Regulatory issues such as business registration, tax administration, and labor law were likely not cited as significant obstacles not because they are efficient but because they are so poorly enforced that they do not have an impact on most firms. Likewise, the legal system is rarely considered. Firms have always used informal mechanisms to resolve disputes and to enforce property rights. Thus, it is unlikely that many managers even understand the benefits of a strong and efficient legal system.

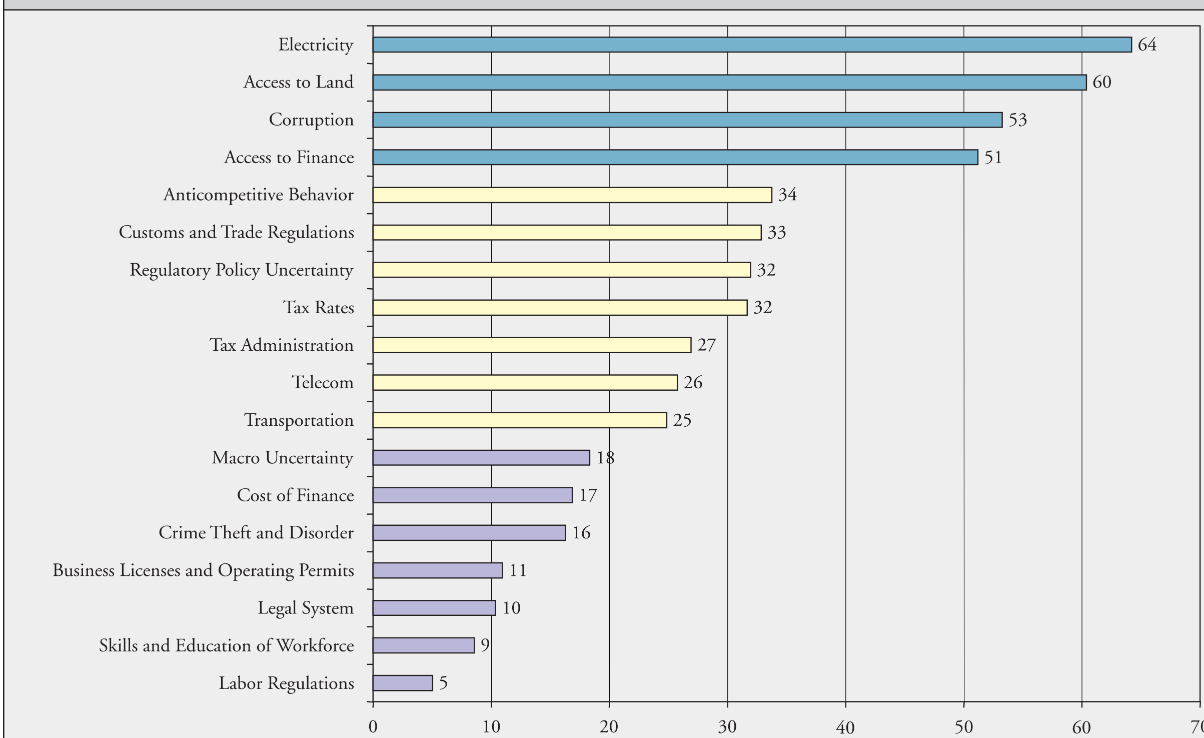
The perceived obstacles are similar across all regions in Afghanistan, with only slight differences. Electricity, access to land, corruption, and access to finance are the issues most often cited as either severe or major constraints. However, their order is not the same. In Herat, access to finance was the most often cited severe constraint, with electricity much less often cited, which may reflect the fact that Herat has been relatively more successful than other cities in restoring power supplies. In Kandahar customs and trade regulations were cited as often as access to finance, possibly because of the large number of traders found in the Kandahar sample. Also in Kandahar, the managers were much less likely to report obstacles as severe or major than were managers in other cities. In Mazar-e-Sharif anticompetitive practices is cited more often than it is elsewhere, which could reflect deeply entrenched local business interests that use their close ties to powerful political patrons to restrict competition. (See Annex B for charts on investment climate constraints by cities.)

The following sections consider these constraints in slightly more detail. Each section reports the survey findings and complements the results with both primary and secondary information collected during the survey process.

Security and informal arrangements

Afghanistan remains a dangerous country with a highly uncertain business environment. An ongoing insurgency appears to be accelerating in some provinces. Although there have been some recent successes in curtailing the growth of drug production, the illicit opium industry is a major part of the economy and there remains a risk of

Figure 3.1: Afghanistan: Percentage of Firms Citing Constraint as Major or Severe



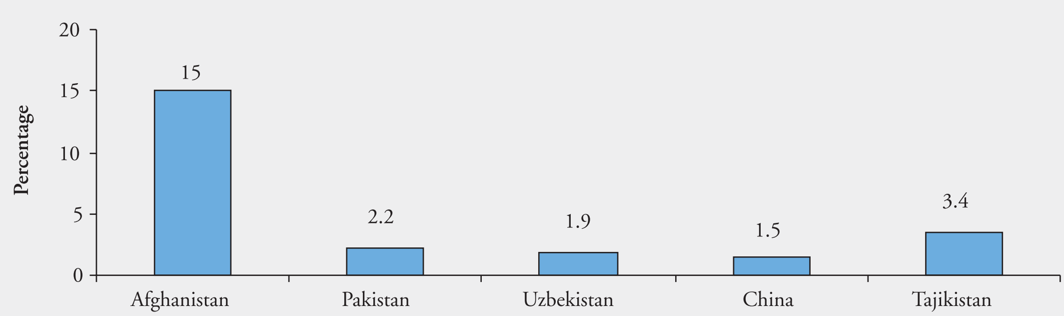
Source: *World Bank Afghanistan Investment Climate Survey.*

Afghanistan becoming a narco-state. Thus, it is counterintuitive that most managers in the ICS did not rank crime and disorder as a major or severe constraint. This paradox partly reflects the real improvements in security, especially in the major cities and in the north and west. However, it also reflects the fact that the survey covered established firms, most of which have been operating in Afghanistan for some time. To survive, these firms have had to find ways to cope with the lack of security. The most common way seems to be by forming close ties to former warlords and government officials. Consequently, for firms in the survey sample, security is now a less pressing issue than is the constant struggle to obtain adequate power and deal with corruption. Though the business environment imposes high costs, these established firms are investing and slowly growing. However, new entrants and potential investors, who do not have established contacts with powerful figures, find the environment much more daunting and are often discouraged from investing.

Providing security imposes a high cost on all businesses in Afghanistan. Because they have learned to cope with the lack of security, few managers ranked crime, theft, and disorder as a major or severe problem. However, security remains a significant problem and surveyed firms report that on average they spend an amount that is close to 15 percent of sales on security infrastructure, significantly more than do firms in neighboring countries (see Figure 3.2). They spend an additional 3 percent of sales for protection payments to commanders, government officials, or organized criminals. The cost of security is particularly high for foreign firms. Rent for secure buildings in Kabul can be similar to prime property in Tokyo, London, or other major cities.

The central government has made significant progress in disarming militias and reining in the regional commanders who once dominated Afghanistan. In many cases the commanders have been co-opted by giving them positions in the government and integrating their militias into the police forces. Despite this progress, the former commanders remain influential, especially within their home regions, and often continue to maintain significant military power. These former commanders are increasingly forging close ties to the business world and using their power and influence to further their business interest. Some observers argue that the reduction of outside support beginning in the early 1990s forced many of the commanders and political leaders to look to the local economy, including the illicit drug economy, to fund their political ambitions.[7] This trend intensified

Figure 3.2: Security Costs as a Percentage of Sales



Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development/Business Environment and Enterprise Performance Surveys.*

7 See work by Giustozzi and Lister for discussion on warlords and their entry into business.

after the fall of the Taliban and continues today. In some cases, the commanders have formed their own businesses or have openly established monopolies to capture rents. Examples include the well-known monopolies on fuel distribution and construction material in Kandahar. In other cases, the links are not as clear; the commanders work through close associates, and their businesses interests are not transparent.

In some ways, the entry of warlords into the business world has been beneficial, but the negative consequences are profound. The rapid removal of the checkpoints that once dominated Afghanistan's roads is often attributed to the interests that the commanders have developed in trade. Also, a return to full-scale civil war is less likely when commanders and their supporters are busy enriching themselves through economic activity. However, the negative consequences are more profound (Giustozzi 2005). Relatively small groups of businesspeople dominate most trading activities in Afghanistan, and it is suggested that to operate on a large scale it is necessary to have close relations with commanders or former warlords (Lister and Pain 2004, p. 3). These small groups of insiders use their contacts to access land, settle disputes, ensure security, obtain credit, and win contracts that others without connections could not. This closed network of commanders and their crony businesspeople effectively excludes new entrants and limits competition. Returnees, foreigners, and potential new investors without powerful contacts are reluctant to enter, fearing that they cannot cope in such an unsafe environment or that the costs would be too high to warrant investing.

Electricity and infrastructure

In many developing countries, private investors identify infrastructural deficiencies, particularly inadequate and unreliable power supply, as among the most binding constraints they face. It is no surprise then that this is also the case in Afghanistan, where the infrastructure either was destroyed during the conflict years or has been severely run down by lack of investment and maintenance. Indicators of infrastructure availability in Afghanistan are in most respects the worst in the world, well below the corresponding figures for Sub-Saharan Africa. For example, only 6 percent of the population has access to power from the grid. Power supply is of poor quality, characterized by low voltage, intermittent supply, and blackouts. Access to telecommunications remains limited particularly in rural areas.

Power

Power has a serious impact on private sector activity, with businesses citing power supply as the most serious infrastructural problem in Afghanistan (see Box 3.1). In

Box 3.1: Voices of Afghan Entrepreneurs: Waiting for power connections

"We have no power grid connection. Our factory is located outside the national grid area. Our machinery is old and manually operated and does not require power. But this creates problems in retaining workers who do not like to operate machinery by hand. We need to install modern machinery and for this we need land in the industrial estate. We use a small generator just for lighting during the night, if we work at night." - *beverage company 1*

"We expect to go for production in one month's time. However, we are not yet connected to the National Grid. We applied for power connection to the Ministry of Water and Power about three months back, along with a letter from the Ministry of Mines and Industry (MMI). The Minister of Water and Power approved the application, and gave an order of national grid access to the Directorate of Water and Power. The Director said that his office will contact me when the processing of the application is finished in the Ministry of Water and Power. We are still waiting to hear from the Directorate. Meanwhile, the validity of the Minister's approval, which is for a month, has expired. We will get the Minister's approval for the second time and again meet the Directorate. Meanwhile, we are also buying a generator, since power from the National Grid, even if I get it, is not reliable." - *beverage company 2*

"Power is one of the main problems we are facing. We are connected with the national grid since the area is outside the City power supply. We use generators for 24 hours in a day for the production of medicine. We need 7-11 liters of oil per hour to run the generators. Each liter costs 30 AFs which means we spend 210-330 AFs per hour for using generators." - *pharmaceuticals company* fact, more firms cite power as a severe or major obstacle than they cite any other business constraint. This is true for all cities except Herat, where it was mentioned as the third most important constraint, after access to finance and corruption, and in Kandahar, where it was a close second after access to land. Herat has been relatively more successful than other cities in restoring power supplies; however, even here more than half (56 percent) cited power as a major or severe constraint. In some cities the problem is acute. An example is Jalalabad, where 90 percent of the surveyed firms cited electricity as a major or severe problem.

The sector suffers from an array of problems. Generation capacity is grossly insufficient, although augmented somewhat by imports of power from neighboring countries. Transmission and distribution capacity is inadequate. Most of the equipment in the power sector is old, dilapidated, and failing, and backup equipment is rare. Even though the ICS covered the stronger, more established companies in urban areas, only about 76 percent of the sample was connected to the power grid. And for these firms power was available only an average of about six and a half hours a day.

Deprived of power from the public grid, businesses overwhelmingly rely on their own generators. Thus, although 76 percent of the surveyed firms are connected to the public grid, an equal proportion (76 percent) say that they have at least one generator (Table 3.1). In Jalalabad, almost all surveyed firms (97 percent) rely on generators. Even in Herat, where firms complain less about electricity than they do in other cities, 71 percent of firms use generators. In terms of reliance on generators, firms in Afghanistan are closer to their South Asian neighbors and in sharp contrast to their Central Asian neighbors. Firms report losing about 18 percent of their merchandise value because of power disruptions; the proportion is highest for firms based in Kandahar (30 percent), where the ownership of generators is least common (65 percent own generators), and lowest for those operating from Jalalabad (8 percent), where, as mentioned above, generator use is almost universal.[8]

A Power Sector Master Plan outlining an investment program to help rebuild the power infrastructure has been adopted. Implementation of the investment program has started and has focused on rehabilitation of damaged generation capacity for Kabul and Kandahar, construction of transmission lines from existing hydro plants to Kabul, and the Northern Transmission System, which will allow import of low-cost power from Uzbekistan to Kabul (expected completion by end of 2008). In addition, there is investment in rehabilitation and expansion of the distribution systems in Kabul and other cities. There is

Table 3.1: Percentage of Firms Owning Generators

Afghanistan	Pakistan	Uzbekistan	India	China	Tajikistan	Syria
76	42	2	64	18	0	73

Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development/Business environment and Enterprise Performance Surveys.*

8 Power generation, including by small generators, is heavily dependent on imported fuel, which is one of the biggest cost items in power production. High fuel prices are a global issue beyond Afghanistan's control, but distortions in this market could be amenable to policy actions. A recent study suggests there is abuse of market power, corruption in allocation of import licenses, barriers to entry, and unregulated imports of poor-quality fuel (Paterson 2005). The fuel market is dominated by a very small number of large players, who may be politically well connected. The small end of the market is more competitive, with a large number of small players making very small margins. Imports of low-quality and adulterated fuel pose health risks and reduce the life span of engines.

also a proposal for a combined cycle generation turbine plant at Shebergan that could add 100MW to 150MW of generation capacity and is a good opportunity for an international management contract. Currently, the Ministry of Water and Power (MWP) is in charge of the power sector in Afghanistan. A state-owned power utility, Da Afghanistan Breshna Moassesa (DABM), is in charge of generation, transmission, and distribution of electricity. Its several regional electricity departments are responsible for running electricity facilities in different parts of the country. Weak capacity in the MWP and DABM remains a huge challenge to the implementation of the investment program. DABM has neither an appropriate governance structure nor financial resources to improve electricity services.

Transport

As in many other countries, a relatively small proportion of firms in Afghanistan (25 percent) report transport as a major or very severe problem. However, this statistic may reflect the limited horizons of many private firms who operate mainly within a localized economy and may find the poor-quality transport infrastructure adequate for their needs. It is noteworthy that when asked about factors constraining exports, a larger proportion (39 percent) identified lack of roads, air connection, railroads, and other infrastructure as a major constraint. In fact, this was the second most important factor inhibiting exports after lack of trade finance. Firms reported losing 5 percent of their domestic merchandise value during transit because of breakage or spoilage and losing only 0.6 percent to theft. The proportions are not much different for international shipments: 4.6 percent and 0.9 percent, respectively. Firms rarely receive any compensation for such losses; only 2 percent said they were ever compensated by the transport operators.

Prior to the conflict, Afghanistan's paved highway network was of reasonably good quality though limited in coverage. Protracted conflict and lack of maintenance left this network largely dilapidated-road trips that took hours 30 years ago took days by the end of the war. Rehabilitating the road network has been a top priority for the government, which has developed a large investment program for major highways, including rehabilitation of the existing network, completion of the network, and, over time, construction of new roads. Despite some delays there have been noticeable improvements in some areas with some improvements in travel times already beginning to materialize. In addition to work on the main highways, there have been efforts to repair and improve smaller roads, primarily through public works employment programs, most notably the National Emergency Employment Program. Nonetheless, there is still a long way to go in rehabilitating the highway system and completing its segments including the remaining "ring" connection in Northwest Afghanistan.

Transport service was an important activity during the conflict, and private transport companies have expanded rapidly since the end of the war. There are a number of flourishing freight and passenger transport companies. (The government truck fleet has stopped working.) Estimates of the total size of the private truck fleet in Afghanistan range from 47,500 to 80,000 (World Bank 2004). The government remains heavily involved in the transport sector. There are a number of trucking companies among the SOEs and the government retains ownership of the largest bus fleet. In addition, the government has revived Ariana, the public sector airline. Though the government has also licensed a number of private airlines, any government favoritism to Ariana will undoubtedly impede the development of private airlines and competition in the air transport sector.

Telecommunications

The telecommunications sector in Afghanistan is developing very rapidly. Twenty-six percent of the surveyed firms mention telecommunications as a major or very severe problem. Driven by a competitive market and US$200 million in private investment, the mobile footprint covers as much as 50 to 60 percent of the country's population, providing services in 23 provinces (as of March 2005). The country has a teledensity of 2.6 percent (up from 0.1 percent in 2002), which puts it ahead of a considerable percentage of low-income countries. There are two private mobile operators and two additional tenders for mobile telecommunications are now being negotiated. The first, the Afghanistan Wireless Communications Company, offers prepaid GSM services in four major cities. It is a joint venture 20 percent owned by the Ministry of Telecommunications and 80 percent by Telephone Systems International, which is controlled by an Afghan investor who provides the management. An international competitive tender process in 2002 resulted in the award of a second mobile license in January 2003 to Roshan.[9] Competition between the two privately owned mobile networks has resulted in prices consistent with international norms; mobile prices have dropped approximately 70 percent over the past 18 months.

The Ministry of Communications has also started providing services, and approximately 22 million calls per month are carried by the publicly owned Afghan Tel network. With the government and District Communications networks, it is expected that Afghan Tel services will reach every provincial and district capital by the end of the year. The challenge of improving access to rural areas, improving the quality and range of services and more importantly the challenge of further reducing prices, remains. Nonetheless, progress to date has been remarkable. To sustain that progress, the Ministry is pushing the passage of a telecommunications law and a separate law covering the corporatization of Afghan Tel. Both are vital pieces of legislation that cover moving toward a unified licensing regime, opening up the sector to considerably greater competition, providing greater autonomy and power to the regulator, providing a framework for extending access, and giving Afghan Tel freedom from bureaucratic strictures covering areas such as pay and investment that hobble its ability to attract staff and financing as well as to compete in the sector.

The Internet has come to be one of the most efficient ways for firms to communicate and to conduct business with distant clients. However, in Afghanistan, business use of the Internet is nearly nonexistent outside a few of the largest cities. On average, 15 percent of the surveyed firms regularly use e-mail in interactions with their clients and suppliers and 9 percent use Web pages (Table 3.2). There is a distinct regional difference in the use of the Internet. Almost a quarter of enterprises in Kabul, Herat, and Mazer-e-Sharif reported using the Internet. But in Jalalabad and Kandahar no firms reported using Web sites and only 6 percent of the sample in Kandahar reported using e-mail.

Access to land

More firms cite access to land as their biggest problem. It is exceptionally difficult for businesses to get clear title to new land, especially serviced land (see Box 3.2). The lack of certainty in land tenure discourages existing

Table 3.2: Percentage of Firms Regularly Using E-mail and Web Sites in Interactions with Customers and Suppliers

Afghanistan	Kabul	Herat	Kandahar	Mazar-e-Sharif	Jalalabad
15	17	26	6	29	0
9	8	24	0	11	0

Source: *World Bank Afghanistan Investment Climate Survey.*

9 Roshan is owned by a consortium led by the Aga Khan Fund for Economic Development (51%), Monaco Telecom International (35%), MCT Corporation (9%), and Alcatel (5%).

business from making large new investments and effectively prohibits new investors, especially foreign investors, from entering the market. The difficulty of obtaining new land is borne out by the survey and the 2005 Doing Business indicators (see Annex C). Nearly 56 percent of the firms who had tried to acquire new land in the past three years were unsuccessful. The Doing Business database indicates that on average it takes 252 days and costs 9.5 percent of the value to register a property, which means it takes longer in Afghanistan than in most countries in the world.

The different waves of conflict, land reform, and nationalization have left the land tenure system in disarray. Properties have changed hands numerous times with few records. Many registries were destroyed or are not accessible and most land was never registered to begin with. The returning refugees and displaced persons have exacerbated the problem and now much of the best land has multiple claims. Different legal foundations exist for claiming land tenure and landowners variously use custom, Sharia law, or evidence from the land register to demonstrate their rights. All of these systems overlap and are inconsistent and ambiguous. In the absence of clear guidelines or procedures for land administration, asserting one's property rights is a costly, uncertain, and tenuous process. Even property with valid documentation is not free from litigation as often multiple titles may have been issued under different political regimes. Indeed, over 10 percent of the survey sample reported having ongoing land disputes.

Access to land is another area in which having powerful patrons can help. In many cases local commanders have illegally distributed government land to their supporters. In other cases they have used force or their positions in government to resolve land disputes in favor of their business partners. The policy of the government is to award ownership to whoever owned the land in 1978. However, the process is slow and it will take many years to make significant headway on establishing clear land tenure. In the meantime, having powerful allies is the best way to ensure security of land tenure.

Box 3.2: Voices of Afghan Entrepreneurs: The challenge of getting land

"Obtaining land has been the main problem for us. The former Ministry of Light Industries had allocated a plot of land for us in the Pul-e-Charkhi area of Kabul, but we are yet to get this government land and are not sure we ever will. We have applied for a plot of land to AISA but have not got a response yet. AISA has promised to help, but we do not know if they have the capacity to allocate land. We thus rented a house in Kabul in March 2002 and installed our machinery. We pay a rent of US$1,260 per month for the house. It has limited space and, being located in a residential area, it is not good for the local environment. Lack of land is constraining us in many ways. If we had the land we would construct a factory with modern systems used in Europe and North America, expand employment from the current 30 to 150 by expanding production capacity, marketing network, and sales volume, and help reduce the country's dependence on imported medicine and perhaps even export to the neighboring CIS countries." - *pharmaceutical company*

"We applied to the Ministry of Mine and Industry for land in 2003 and were allocated a plot of land by them. Unfortunately, a few days later, we received a letter from the Ministry saying that the allocation is cancelled. This was a big disappointment since we had to work hard to get the allocation and had faced many difficulties down the road. Meanwhile, we were running the factory on rented land, where we do not have water or connection to the national grid-both important for us. We contacted AISA for land where we were told that we can get land for which the payment will have to be made in three installments in three years, with an advance payment of the first installment of US$13,600. We got land allocation from AISA within three months of applying." - *iodine manufacturer*

"We approached the Ministry of Agriculture to obtain land. We did get an allocation from the Ministry and it was agreed that our project will be a joint venture with the government, with the Ministry owning 30 percent of the shares. While it was relatively easy to get the allocation letter from the Ministry, we are having a hard time getting the land title cleared. It is not enough to get the approval of the Ministry. We have to visit several offices to get all the clearances required and we do not think there is a single government office that we have not visited! Particularly difficult has been the Municipality, the Ministry of Water and Power, and the Kabul Provincial Office. They do not care whether you have a letter from the Minister or Governor. They will always find some problem with your documents. We would not tell you which offices we had to pay bribes to, but there are some where we had to pay a hefty amount. Finally, we got the title after one year." - *poultry farm*

Access to land with clean title is critical for private sector development. Not only does the uncertainty in land tenure discourage investment but, as property rights cannot be easily enforced, land cannot be easily used as collateral to generate the financial resources crucial to private sector development. Until Afghanistan institutes a land policy that establishes and enforces clear property rights, investment in the private sector will be hobbled.

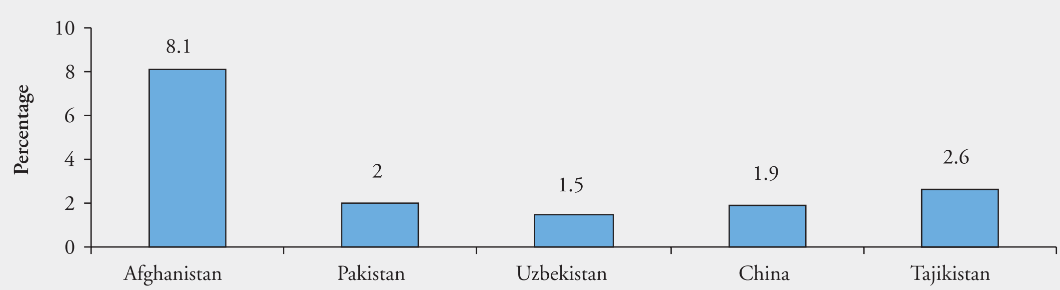
Corruption

Corruption is endemic in Afghanistan and adds to the uncertainty facing businesspeople. It is especially threatening to foreign investors or Afghans returning from overseas who do not have powerful patrons or understand the system. In the 2005 Transparency International Corruption Index, Afghanistan ranks 117th, which places it among the world's most corrupt countries.[10] Nearly 58 percent of the sample cited corruption as a major or severe problem, which ranks corruption just behind access to land and electricity. Corruption is especially threatening to foreign investors or Afghans returning from overseas who do not have powerful patrons or understand the system. Firms report that on average they pay an amount in bribes equivalent to over 8 percent of sales, which is more than four times the average reported in neighboring Pakistan. In addition, when firms obtain a government contract they have to pay almost 8 percent of the contract value in bribes (see Figure 3.3). AISA's investment facilitation activities have helped many investors negotiate the regulatory maze without paying bribes but this function is still limited in scope. Coupled with corruption is the general inefficiency of the government in delivering services. Government agencies are only slowly developing their capacities to deliver the services businesses need. When asked to generally rate government efficiency, nearly 75 percent of the sampled firms ranked it as somewhat to very inefficient.

Access to finance

Afghanistan's financial system is just beginning to recover and businesses have almost no access to bank credit and only limited access to banking services generally. In the most recent Doing Business rankings for Getting Credit, a measure of credit information sharing and legal rights of borrowers and lenders, Afghanistan ranks 153rd out of 155 countries. Although 12 commercial banks are licensed to operate in Afghanistan,[11] most are concentrated in Kabul and

Figure 3.3: Average Unofficial Payments Made to Get Things Done as a Percentage of Sales



Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development Business Environment and Enterprise Performance Surveys*

[10] Despite Afghanistan's poor performance, it still does better than its closest neighbors, including Pakistan and Tajikistan, which tie for 144th, and Uzbekistan, which comes in at 137th.

[11] Arian Bank, Habib Bank, National Bank of Pakistan, Punjab National Bank, Standard Chartered Bank, First MicroFinance Bank, Kabul Bank, Bank Mille Afghan, Pashtany Tejaraty Bank, and Afghanistan International Bank.

Box 3.3: Voices of Afghan Entrepreneurs: Getting registered and obtaining construction permits

"We are a pharmaceutical company and were first registered with the Ministry of Commerce in 2002. We then had to register with the Ministry of Public Health, the Ministry of Finance, and the Trade Court in order to get a legal approval for production and marketing of our pharmaceutical products in Afghanistan. Getting registration from these ministries was a hassle and, in some cases, required the payment of bribes to officials. We refused to pay bribes. This resulted in a two-and-a-half-month delay in getting the necessary approvals from various sections in the ministries. Our company was re-registered with the AISA in April 2003. The registration process in AISA was relatively easy and transparent and no unofficial payments were required." - *pharmaceutical company*

"We are in business since 1988. The company was registered with the Ministry of Commerce in January 2003-the whole process took two weeks. It was re-registered with AISA in September 2004. In AISA we paid 50 USD for reregistering and were also requested to show the operation work statement letter. It took us a few days to obtain it from the Ministry of Finance Taxation Office." - *metallic production and carpentry company*

"We registered with AISA in 2003. After completing registration, we started constructing the factory building in November 2003 and completed in January 2004. We had to make some unofficial payments (about 50% of the official fees) to the Municipality to obtain the construction permits." - *beverage manufacturer*

"We were allocated some land in an industrial park. After getting the title for the land, we hired a construction company and started constructing the factory building. After construction work had started, some officials from the Municipality came and stopped the work on the grounds that they had not obtained the necessary permits from the Ministry. We think the officials just wanted some money from us. We then contacted AISA who solved this problem and construction started after a delay of 10 days. We subsequently had problems with the construction company who turned out to be inexperienced-but that is another story." - *iodine manufacturing company*

provide services primarily to international donors and businesses, foreign nongovernmental organizations (NGOs), and foreign government agencies. No commercial banks in Afghanistan offer long-term finance. The maximum tenure of financing is three years. Most focus on opening commercial letters of credit (L/Cs). Transactions are very secure because the importer has to deposit the total imported costs of goods in the bank before opening the L/Cs or a secured contract, such as for construction or other awarded contracts, which are financed by donor agencies. A small but ever-increasing number of nonbank financial institutions, including one credit union and 11 microfinance institutions, provide limited services and small amounts of credit. In addition, a new leasing organization has just become active in Kabul and other areas. However, these institutions are nascent and able to provide only a fraction of what is needed. Thus, they are augmented by a wide variety of informal money lenders and other credit sources. There are no credit bureaus or credit rating agencies.

Because the financial system is so underdeveloped, Afghan firms are almost entirely reliant on internal funds and money from friends and family to fund their operations. Only three firms in the ICS sample reported having bank credit and on average nearly 94 percent of new investment by firms was funded by either internal funds or money from family and friends (Table 3.3). Remittances are also important, and on average funds from family and friends outside of Afghanistan financed 3 percent of investment.

Informal sources play an important part in supporting Afghan businesses. Because the banking system is so new and concentrated in Kabul, many businesses rely

Table 3.3: Average Percentage of New Investment Financed by Different Sources

Internal Funds or Retained Earnings	Family and Friends in Afghanistan	Family and Friends Abroad	Bank Credit	Other	New Equity
78	13	3	1	2.5	2.5

Source: *World Bank Afghanistan Investment Climate Survey.*

on informal funds transfer systems generally known as *hawala* to make payments and transfer funds. Only 30 percent of the sample reported having a bank account. Though the majority of business transactions are cash-based, more than 10 percent of the sample said that domestic customers usually pay them through money exchange dealers in a process known as a *hawala* transfer. The *hawala* system is even more important for foreign customers; almost 14 percent of exporters said that foreign customers usually pay them by *hawala* transfer. Remarkably, *hawala* transfers for foreign trade appear to be more than or at least as efficient as bank transfers. The length of time to clear a *hawala* transfer is not significantly different from the time taken for a bank draft. The *hawaladars* also provide short-term loans to finance working capital needs. Nearly 21 percent of firms responding in the survey reported having a loan from a *hawaladar* with an average term of 3.8 months (Table 3.4).

Though informal financial sector credit may be adequate for subsistence commercial activities, it is not adequate for long-term private sector development. At present the level of financing emanating from financial institutions in Afghanistan is severely limited. There is a pressing need for bank and nonbank financial institutions to provide viable alternatives to the informal sector. Low household savings, poor infrastructure, low integration with complementary markets, and high costs of service provision, particularly in rural areas, make it difficult to provide formal financial services. Moreover, the lack of a secured transaction law and poor property registries make it extremely difficult for borrowers to provide the necessary security. Currently, managers complain more about the availability of electricity and access to land than they do about access to finance. But as the economy grows and these more immediate problems are mitigated, the inability of firms to obtain external finance will become a crippling constraint to growth.

In addition to the lack of external finance, Afghan firms are faced with the almost complete absence of insurance. Many managers and potential investors have cited the lack of insurance as a major reason that they are hesitating to invest. The insurance sector in Afghanistan is in dire straits. The sole insurance company, the Afghan National Insurance Company, is substantially undercapitalized and in a weak financial position. The Afghanistan Investment Guarantee Facility has been established to mitigate political risk and not life and nonlife commercial risks. But until

Table 3.4: Hawaladars vs. Banks

% of firms with a loan from a *hawaladar*	21
% of firms with some form of bank credit	.9
% of domestic firms that primarily pay by *hawala* transfer	10
% of domestic firms that primarily pay by bank transfer, check, or bank draft	11
% of exporting firms that primarily pay by *hawala* transfer	14
% of exporting firms that primarily pay by bank transfer, check, or bank draft	30
Average time to clear *hawala* transfer from domestic customer	28 days
Average time to clear a bank draft from domestic customer	7.3 days
Average time to clear *hawala* transfer from export customer	9.2 days
Average time to clear a bank draft from export customer	7.2 days

Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development Business Environment and Enterprise Performance Surveys.*

there is a new insurance law, it is unlikely that there will be any new providers of normal business insurance. The existing insurance law is more than 40 years old (1962) and therefore requires substantial modifications or indeed replacement by a new law in order to be consistent with the new commercial environment.

Currently, the financial system provides little or no access to financial products and services for small urban or rural enterprises. Instead, an extensive array of informal money exchange dealers and some NGOs support urban and rural microenterprises with limited financial services. As the reconstruction effort progresses, there is a pressing need to address the burgeoning requirements of such enterprises, along with the needs of more formal enterprises and those of international investors. The development of rural financial markets is currently hindered by several factors: (a) dispersed populations and poor transport and communications facilities; (b) high risks associated with rain-fed agriculture; (c) absence of physical collateral and land-tenure systems that minimize the value and use of land as collateral; and (d) past history of state involvement and subsidized lending, which led to low recovery rates. These problems, some of which may affect urban microenterprise finance, tend to be more acute in rural areas.

Limited access to skilled labor

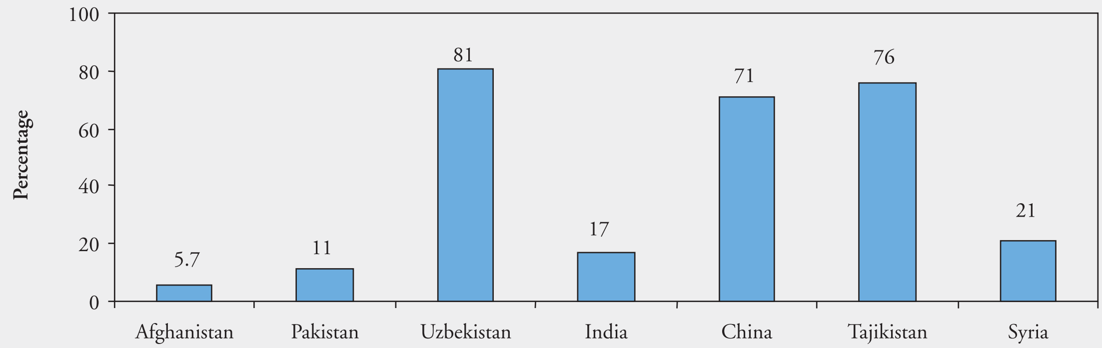
High illiteracy, poor education, war, and political upheaval have resulted in a critical shortage of skilled labor in Afghanistan. The low level of education, lack of training facilities and high illiteracy rate have always made for acute shortages of skilled labor. In fact, Afghanistan traditionally relied on foreign experts to direct the country's economic development: Germans, Americans, and Soviets had been heavily involved since the end of World War II. However, the problem was magnified by the recent war. During the conflict many of Afghanistan's best-qualified workers, those with the best opportunities abroad, fled. Consequently, qualified management professionals, skilled technicians, and educated professionals are scarce. The lack of qualified employees is exacerbated by the barriers to educating girls and employing women in most jobs outside of the home. Afghanistan is caught in a trap. The lack of opportunities discourages workers from improving their skills and education. But opportunities are lacking partly because investors do not want to expand because of the lack of skilled labor. The shortage of skilled labor is illustrated by what happens in Jalalabad during the poppy harvest season when much skilled labor goes to work in the harvest. With skilled labor able to find better pay havesting poppies, nearly 34 percent of the sample said that wages rise during the season, with an average increase of 39 percent.

In Afghanistan, only a small fraction of enterprises offer formal training and the level of worker and manager education is also low. Just over 5 percent of Afghan firms offer training (see Figure 3.4) and only about one-third of the workforce in Afghan enterprises have a secondary education or higher (see Figure 3.5). In comparison, in India almost 17 percent of small firms train and on average nearly half of their workforce has a secondary education or higher. Afghan managers are also less educated than in neighboring countries. Sixty-two percent of Afghan managers have secondary or higher education compared with 96 and 98 percent in Pakistan and India, respectively. The lack of training and low education and experience level of the Afghan workforce is an important cause of Afghan industry's low relative productivity. Until the shortage of skilled labor is solved, it will be extremely difficult for Afghan firms to be able to compete against imports or on the export market.

Legal and regulatory framework

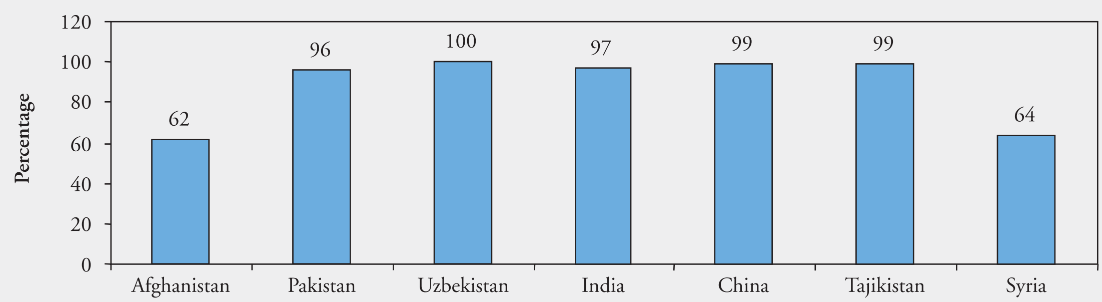
In addition to insecurity, poor land tenure, and corruption, the high level of uncertainty and risk facing investors in Afghanistan comes from the absence of a clear legal framework. Many of the basic laws that are necessary for the private sector to operate in confidence are missing and government actions are often unpredictable. The Afghan legal

Figure 3.4: Percentage of Establishments Offering Formal Training



Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development Business Environment and Enterprise Performance Surveys.*

Figure 3.5: Percentage of Firms Whose Managers Have a Secondary Education Level or Higher



Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development Business environment and Enterprise Performance Surveys*

framework consists of three overlapping systems: Sharia (Islamic law), Shura (traditional systems of informal justice), and the formal system based on the 2004 constitution (Asian Development Bank 2005, p. 23). Few managers are clear about which laws actually apply to them and, given the arbitrary enforcement and lack of effective courts, they do not spend much of time worrying about it. Only 10 percent of the survey sample mentioned the legal system as a major or severe constraint. However, establishing a strong legal framework would lower risk and encourage investors. In addition, an effective legal system that enforces property rights would reduce the power and influence of the former commanders, leading to new entry, increased competition, and higher growth.

In Afghanistan's uncertain business environment, individual firms experience many benefits from having close ties to influential commanders. Not the least of these is the ability to apply force to resolve disputes when the formal dispute resolution mechanisms do not work. There is nothing but anecdotal evidence on how often force is actually used or threatened, though the amount of such evidence is substantial. However, there are abundant indications that the formal dispute resolution mechanisms do not work.

The formal court system barely functions and most people rely on informal dispute resolution mechanisms. The formal court system suffers from a lack of qualified legal professionals, no method to hold judges accountable, and reportedly endemic corruption.

There are no formal alternative dispute resolution mechanisms such as arbitration or mediation. Consequently, businesses do not rely on the formal judicial system. Only three of the 338 firms surveyed reported using the commercial courts to settle a payment dispute in the past two years. For the three firms that did use the court system, on average it took over 34 weeks to decide the cases and then only one firm said the court decision was effectively enforced. The survey also revealed that fewer than half the incidents of crime or theft were reported to police and less than 30 percent of those reported were solved. In light of the failure of the formal system, it is not surprising that available data, though limited, indicate that as many as 80 percent of people rely on the Shura system as their primary mechanism to resolve disputes.[12] However, Shura rulings can contradict the principles found in Sharia and the constitutional system and there is no measure of the system's fairness or efficiency. In addition, it is usually assumed that powerful local leaders can heavily influence the Shura rulings. Thus, it is not possible for businesses, especially foreign ones, to anticipate how a dispute will ultimately be resolved.

Despite ongoing efforts at legal reform, the legislative process is slow and a number of important laws have been languishing, awaiting parliamentary approval, final drafting, or implementation. The private sector needs a new private investment law. The original version of the law, enacted in 2002, which sets out the requirements for investment, is deficient and despite more than two years of effort the revised version is yet to be enacted. A business organization law has been drafted but progress toward approval has been slow. This, and an insurance law, is an important priority. Afghanistan has no bankruptcy law and the country ranks 142nd in the Doing Business indicators for closing a business. Lack of legislation in this area increases risks and may serve as a barrier to entry because entrepreneurs do not know how much it will cost them if they have to close a business. Laws are also needed for land titling and registration but will need to follow ongoing policy and administrative work in this area. The need for a secured transaction law will become evident in the medium run because it would allow borrowers to use other forms of collateral besides land.

Above all, the government must be consistent and predictable. For the many reasons discussed, Afghanistan has a risky investment climate that discourages investment. Thus, whenever possible the government should attempt to engender certainty and predictability. In some ways the government is doing well on this score. Nearly 60 percent of the participants in the survey reported that they tended to agree, agreed in most cases, or fully agreed with the statement that "in general, government officials' interpretations of regulations affecting my establishment are consistent and predictable." But the government is still in a precarious position. The large amount of new legislation and regulation that is required will inevitably introduce uncertainty and add to the risk of doing business. Most recently, the government reversed itself on tax holidays offered to investors. Many new investors were lured to Afghanistan with the promise of a four- or seven-year tax holiday. Now, at least some of them are being informed that not only are they going to lose the tax holiday, but also they must pay tax retroactively for past years. The government states that the phaseout of the tax holiday is not retroactive and that only firms that did not complete the formalities to receive the tax holidays in a timely manner or were promised them by unauthorized persons are losing them. But many firms did not understand what the process was or who was authorized to grant them a holiday. The firms' perception is that they followed proper procedures and are now losing what was promised. This experience

[12] United Nations System. Common Country Assessment for the Transitional Islamic Sate of Afghanistan, October 2004, p. 26 as quoted in the Private Sector Assessment for Afghanistan, Asian Development Bank, 2005.

illustrates the uncertainty created by inadequate information about policy and specific procedures to be followed, on top of the already substantial risk and uncertainty of doing business in Afghanistan.

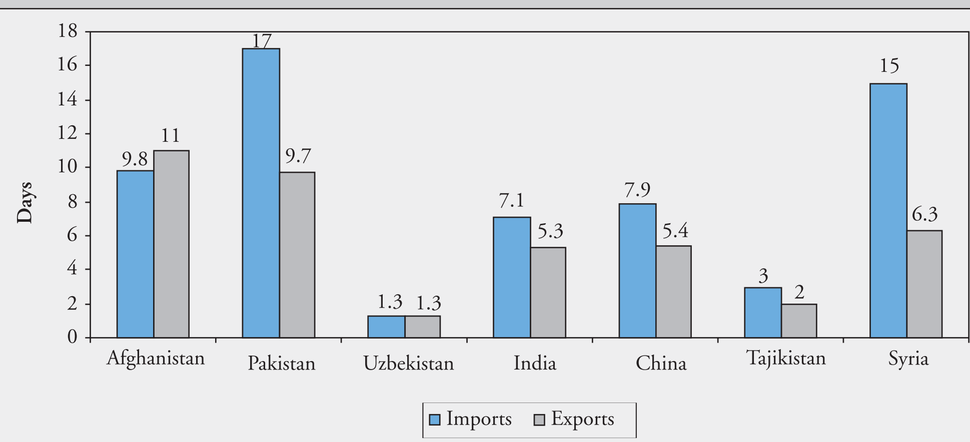
Trade policy

The government has made trade a cornerstone of its development strategy and the Ministry of Commerce has made WTO accession within the next five years a key goal. Ultimately it envisions Afghanistan becoming a land bridge between the rest of Central Asia and South Asia. In addition, the vast majority of Afghan industrial inputs are imported. Improving the efficiency of trade is necessary to reduce the cost of domestic production and increase the competitiveness of exports.

Afghanistan has taken a number of steps to facilitate trade. It has entered into trade and transport agreements with various neighboring countries and has negotiated trade preferences internationally. In 2004 the government passed a customs reform package that makes Afghanistan one of the most open economies in the region. Among other reforms, the new law simplified the tariff structure and reduced the range of tariffs from a maximum of 150 percent to a range of 2.5 to 16 percent. In addition, the Ministry of Finance with the Ministry of Commerce is implementing a Customs Modernization Program designed to clarify roles and responsibilities among government agencies and improve service by building capacity in the customs service. However, there is still much to do. In Doing Business 2005, Afghanistan ranks 128th in cross- border trading, and importing requires 10 documents and 57 separate signatures. Businesses report that customs officials continue to use wide discretion on the valuation and inspection procedures, which leads to corruption and delays. The ICS found that customs procedures in Afghanistan are significantly slower than among its neighbors, which further erodes the competitiveness of Afghan products. On average it took firms nearly 10 days to clear exports last year and about 11 days to clear imports (see Figure 3.6). Shipping agents report that this time could be lowered to a few hours if they are willing to pay a large enough bribe.

Despite the customs modernization, manufacturing firms report that the customs regime discriminates against them and adds to the burden of trying to set up a new production facility in the country. As is the case in many

Figure 3.6: Average Number of Days for Goods to Clear Customs



Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development Business Environment and Enterprise Performance Surveys.*

developing countries, the managers of manufacturing enterprises argue that because they are so big and prominent they cannot avoid paying required taxes and duties, must carefully follow regulations, and are often the targets of bribe-seeking officials. However, they must compete with small traders who are able to bring goods into the country without paying the required duty and also do not pay business taxes or a large amount of informal payments. The very large companies, particularly foreign companies, are able to negotiate tax incentives. But the average small Afghan company is too big to hide and too small to fight, so it bears the burden of the government taxes and regulations.

Manufacturers also argue that the tariff structure is such that they often pay more duty on imported inputs than traders do on imports of the finished goods. One entrepreneur attempting to establish a pharmacy company believes that a combination of high transport costs, import duties, and illegal payments add 25 to 30 percent to the cost of imported machinery. He reported paying a 5 percent tariff on imported inputs, but traders can import the final product and pay only 2 percent because it is a medicine. In this situation it will be very hard for the Afghan entrepreneur to break in and firmly establish himself in the market. The customs modernization has been a significant step forward, but work remains to be done on the actual implementation if it is to encourage local production.

Illegal checkpoints established by local commanders and militias are no longer a major constraint, but inspections by government officials remain a hassle. The new government has made remarkable progress in eliminating illegal checkpoints and few exporters cited them as a problem in the survey (Table 3.5). However, traders report that they face frequent inspections and fees levied by different government agencies and local authorities. In many cases the local police are in fact former fighters associated with commanders who are now in government. The responsibility for inspecting shipments beyond the border is not delineated among different agencies, causing shippers extra delays and costs. The government, led by the Ministry of Commerce, is attempting to resolve some of these issues, but currently businesses report multiple inspections and delays as a serious issue that raises costs.

The lack of trade facilitation services is another important constraint facing Afghan businesses. In the ICS, a group of exporters and potential exporters identified the lack of trade finance, lack of cold storage and other storage infrastructure, and the inefficient customs and clearance procedures as the biggest impediments to increasing exports. They did not cite the high cost of production in Afghanistan or the lack of knowledge about foreign markets as issues, but focused on trade services. Trade credit is rare and expensive, forcing most producers to rely on

Box 3.4: Voices of Afghan Entrepreneurs: Importing machinery

"We bought the machinery from China and transported them to Kabul by land transport. We used a clearing forwarding agent to transport and clear the machinery. We did not have to deal with the custom authority directly, and therefore, did not directly handle any financial transactions. We paid a total amount of US$13,000 for transportation and customs, which is over 8 percent of the total cost of machinery. Almost all the machinery is at the site and two Chinese engineers are expected to come and install the machinery. We faced a number of problems during transportation and tax clearing. The vehicles were not good, the road condition was bad, and the transportation cost is high. The machines remained in tax clearance office for 25 days. There were no rules or regulations in tax office, and it was not easy to find the person whom we needed to contact. The Tax Office does not have a fixed rate on taxation and it took them time to determine the value of the machinery." - *beverage company*

"Transportation of machinery to Afghanistan and custom clearance are major problems and barrier for investment in Afghanistan. We bought the machinery from Dubai, China, and Iran. Machinery was transported by land and air freight. Due to the lack of a good road system and corruption, unofficial payments were made at every transportation point. Since the taxation system is not standard and the amount of tax on imported good is fixed based on the discretion of the tax officers, the importers of goods are at the mercy of the tax officials. This arbitrary taxation system discourages domestic investment and encourages import of consumer goods, including medicines." - *pharmaceuticals company*

Table 3.5: Constraints to Exporting	
	% of Firms Reporting Constraint as Major or Severe Problem
Lack of trade finance	42
Lack of roads, air connection, railroads, and other infrastructure	39
Lack of cold storage, warehouses, and other storage infrastructure	37
Inefficient or corrupt customs clearance procedures	37
Cost of transport	37
Lack of shipping insurance	32
Tariffs and other barriers imposed by other countries	32
Illegal checkpoints	27
High cost of production in Afghanistan	21
Lack of knowledge about foreign markets	16
Low quality of product	5

Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development Business Environment and Enterprise Performance Surveys.*

middlemen who have connections and strong finances. There are few, if any, cold storage facilities or other facilities needed to transport high value-added products. In addition, no independent agencies assure standards or certify quality. Many industries are required to seek certification of exports from government agencies. However, these certifications are usually worthless and serve only as an opportunity for rent seeking. For example, raisin exporters are required to seek certification from provincial departments of the Ministry of Agriculture and Animal Husbandry. However, laboratory testing is rare or nonexistent (see Box 3.5 on charges levied on raisin shipment).[13] The Ministry of Commerce is forming an Afghan metrology, standards, testing, and quality (MSTQ) body to test the quality of goods in Afghanistan. Though badly needed, as of summer 2005 it was not yet functioning.

The high cost of shipping and the lack of insurance is another impediment to trade in Afghanistan. Some 38 percent of the surveyed exporters identified the cost of transport as either a major or very severe obstacle, the same proportion of exporters who identified inefficient or corrupt customs clearance procedures as a major or very severe obstacle. The fact that Afghan shippers often have to transship goods into the carriers of neighboring countries raises costs and means that they often lose all control of goods once they cross the border. In the survey, shippers reported that on average

[13] See the following studies: Understanding Markets in Afghanistan: A Case Study of Carpets and the Andkhoy Carpet Market; Understanding Markets in Afghanistan: A Case Study of Market in Construction Materials; and Understanding Markets in Afghanistan: A Case Study of the Raisin Market. These three studies, which were sponsored by the World Bank and conducted by the Afghan Research and Evaluation Unit, provide in-depth information on the costs and procedures of exporting as well as the use of trade facilities by traders in each industry. In addition there have been a number of other studies by On the Frontier and other NGOs identifying the lack of trade facilitation services as a significant constraint to exports.

Box 3.5: Typical charges levied on a trader's shipment of raisins from Mazar through Hairaton

The Afghan Side
Government' s charges:

- Trading license to be renewed annually at a cost of Af 3,500. A new, simplified and more transparent process for this was introduced in April 2004.
- Phytosanitary certificate from the Ministry of Agriculture and Animal Husbandry in duplicate or triplicate—Af 40–60.
- Certificate from Raisin Export Institute—50 Afs/ton
- Export tax—temporarily removed by presidential decree on September 24, 2002, but a 0.5 percent tax has been temporarily reimposed on all export and import operations and must be paid to Ministry of Finance (MoF) bank account in Mazar. Some exporters firmly assert that they are still paying a 2.5 percent export tax.
- Export license fee of 0.018 percent payable to MoF
- Income tax of 20 percent on trading profits payable to MoF
- Sales tax of 2.5 percent payable to MoF
- Additional "local government" taxes and payments at checkpoints
- Other additional taxes; for example, in the north a "security tax" of 0.5 percent of the market price of the raisin is levied. This tax is supposed to be refundable, but is never actually refunded.

In addition, total bribes and port handling fees payable on export are estimated at US$8/ton.

The Uzbek Side
Traders assert that if the trade is legal and all the relevant documents are in order, then there is no import duty. If documentation is not in order, then a 20 percent charge is levied by the Uzbek government. Bribes on this side are about US$4/ton.

they lose up to 5 percent of international shipments as a result of spoilage and loss (Table 3.6).

However, this average may understate the problem as many firms reported losing nothing as a result of delays and spoilage, which is unusual for most products. For those who reported at least some loss, the average was 17 percent, with some firms reporting as high as 30 to 50 percent. Shippers say that some insurance is available, but apparently few can access it. More than 80 percent of the surveyed firms that experienced losses were not compensated. The main reasons given were the lack of a carrier liability regime or the lack of enforcement of the existing one. Whatever the reason, it is clear that transport is expensive and risky in Afghanistan.

Conclusion: The dominance of informal arrangements-a vicious circle?

The analysis in this chapter suggests that much of private sector activity in Afghanistan, even by significant business concerns, is carried out in an environment dominated by informal arrangements and practices. There is a spectrum of such arrangements. At one end are enterprises that are formally registered, tax-paying, and engaged in legal activities but often using

Table 3.6: Cargo Loss Arising from Shipping Internationally (% of shipment)

Afghanistan	**Pakistan**	Uzbekistan	India	China	Tajikistan	Syria
4.6	NA	0.1	N/A	1.2	0.7	2.4

Source: *World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development Business Environment and Enterprise Performance Surveys.*
N/A = *not available.*

informal channels for protection and access to resources. At the other end are enterprises engaged in illicit activities (production and/or distribution) with even greater reliance on unofficial contacts to carry out business. In between are informal (i.e., nonregistered) enterprises carrying out legal activities within a nexus of informal arrangements.

A subset of these informal arrangements and practices is similar to those found in patronage-based organized criminal networks (generally referred to as mafia-type networks), but it is difficult to say how large this subset is in Afghanistan. However, it can perhaps be safely said that much of private sector activity in Afghanistan, whether legal or not, is carried out in an informal setting with numerous informal (extralegal) influences on their activities. According to a recent study on markets in Afghanistan, "…many aspects of market performance depend on extra-market conditions, including history and non-market institutions, which combine to exclude many from taking part and enjoying the benefits of participation. These aspects include social and economic structures, gender relations, ethnic identities and spatial patterns of production" (Lister and Pain, 2004).

Such networks are the legacy of the conflict in at least two ways. First, at one stage in the conflict when other funding sources dried up, warlords sought economic opportunities to raise money. Second, though business is inherently risky and uncertain, in Afghanistan the destruction of formal institutions have dramatically increased risk and uncertainty for the private sector. To cope, enterprises have developed a wide range of informal mechanisms, including close association with powerful political leaders and militia commanders, to ensure their security and access to markets and reduce uncertainty. Some observers believe that informal markets and informal patterns of trading may have now become quite strong and operate according to well-established patterns. The dynamics of informality are complex. Informality is driven by the comparison of the risks and benefits of being in the formal and informal sectors. It is possible that some firms frequently shift between the formal and informal sectors depending on business needs.

These informal arrangements may be useful for many investors in the short run but have negative effects for overall growth. As argued above, they stop many participants from entering the market, lead to inequitable distribution of the benefits, and may have a negative effect on political governance and state-building (Lister and Pain, 2004). The informal economy is relatively free from official regulations because of poor enforcement but is nonetheless subjected to informal regulations that restrict entry and competition, even among incumbents (see Box 3.6).[14] It is reported that many returning Afghans who have good ideas and capital to invest are reluctant to risk their capital for fear that they will be crowded out by those with connections.

In brief, though existing firms in the nonformal economy may be growing there is little new entry and low rates of investment. The informal mechanisms that allow firms to cope with the high levels of uncertainty are not conducive to long-term growth and equity. A vicious circle may be at work here. The Afghanistan Research and Evaluation Unit study referred to earlier suggested that "Businessmen receive security, tax exemption, credit and in some sectors (such as construction), access to lucrative contracts. For power holders, the linkages provide a means of investment and the potential for money laundering. The accrual

[14] However, as the Afghanistan Research and Evaluation Unit studies indicate, the absence, or lax enforcement, of regulations may be having an adverse environmental and health impact, such as natural resource depletion resulting from unregulated logging, vulnerability to earthquakes resulting from lack of building regulations, and poor working conditions in carpet production.

Box 3.6: Barriers to entry

Incumbents in business in Afghanistan may exclude competition and position themselves to be the major beneficiaries of growth through a variety of mechanisms and processes: (a) price manipulation through various means; (b) possession of capital (when credit is unavailable to others); (c) political influence; and (d) quite high levels of vertical integration at the "top" of the chain (that is, their companies own other companies or service providers with which they do business). Big and medium-sized traders deal in multiple commodities and hence, within a given region, the actors in the middle of commodity chains (i.e., not primary producers or retailers) tend to be the same. This form of commodity chain contributes to the dominance of a limited number of traders. It also reflects the lack of formal financial systems and issues of seasonality and risk. Even if traders have not themselves been involved in the illicit economy, they require good relationships with those who are involved because this latter group controls the supply routes and transport systems.

The social networks provide information, regular trade flows, trade credit, and risk sharing. The business-politician relationships are mutually beneficial; for businesspeople they provide security, tax exemption, and credit and, in some sectors such as construction, lucrative contracts. For power holders, they provide a means of investment, the potential for money laundering, and an overall strengthening of influence by the linking of military, economic, and political power. Power holders also often control the "inputs" to production processes such as water and land.

Source: *Lister and Pain 2004*

of benefits from these markets provides them with the resources to strengthen their military and political power still further."[15] Thus, some aspects of the current functioning of markets may compromise efforts at state-building and improving political governance, which in turn may reinforce these informal practices. What is the way out? That is the subject of the next chapter.

[15] See World Bank (2004), for an exposition of the vicious circle story in general for Afghanistan.

4

Accelerating Private Investment: What needs to be done

Introduction

Despite adverse conditions, the entrepreneurial spirit is alive in Afghanistan, investment opportunities are being exploited, and jobs are being created. However, performance levels are still modest compared with the range of emerging opportunities. Much more needs to happen in the enterprise sector if it is to fulfill expectations and make a substantial contribution to job creation and improvement in the dismal human development indicators of Afghanistan. The challenges highlighted in chapter III-that the private sector is often oligopolistic, works through social and political networks, and is anticompetitive-need to be addressed. The key challenge is to broaden participation in the market by removing barriers to new entry and creating conditions that will encourage those already in the market to invest more.

The present investment climate challenges are not insurmountable. Many factors stand Afghanistan in good stead. A significant international effort to reconstruct Afghanistan is currently underway and increased rainfall from 2001 to 2003 has helped to alleviate the once dire agricultural situation. But most important, Afghanistan has a long entrepreneurial tradition of SME industries and services on which an active market-oriented private sector can be built.

Some of the actions required are outside the scope of any private sector development (PSD) agenda as conventionally defined. There is a need for an overall political and security strategy that limits the power of those who have gained control of the markets through force of arms and illicit activities.[16] This chapter focuses on actions that fall within the domain of PSD but that may address the paradigm of informality and provide entry points to break the vicious circle described in chapter III by weakening the nexus of informal relationships and extending the writ of formal arrangements. Some of these interventions, such as regulatory streamlining and improving the flow of information on PSD issues, will also support the anticorruption agenda. Four sets of actions are recommended. Together, these will increase incentives to invest (by reducing uncertainty and transactions costs) and improve capacity to carry out productive activities (by improving access to inputs, business services, and markets). There are many complementarities between these actions and some may affect both incentives and capacities.

- *Improve access to inputs.* Firms need factors of production, notably finance, land, skilled labor, and physical utilities and infrastructure including power, water, telecoms, roads, and ports. Improved access to such inputs is important to weaken the hold of informal arrangements that draw their strength to a large extent from control over such resources. Improved access will require an expansion in the supply of inputs and also a more transparent process of allocating them. Freeing up land currently locked up in nonviable SOEs, injecting money into the

[16] Some interventions, such as those that help spread educational opportunities or help in the creation and accumulation of assets by poor people, indirectly promote security and a good political environment, albeit in the longer run.

banking system, and expanding the power-generating capacity are all examples of actions that increase the supply of inputs (land, finance, power). Though these actions will help, they may not substantially increase market participation and may largely benefit the well-connected incumbents if the allocation process is nontransparent and is subordinate to the informal arrangements described earlier.

- *Clarify and strengthen property rights* by creating a sound legal, judicial, and regulatory framework for investment. This framework is needed both for tangible property, such as land and equipment, and for intangible property, such as a license to operate or a permit to import raw materials. Strengthing property rights will require developing a sound legal framework and an effective judicial system that enforces decisions and helps resolve disputes so that recourse to informal means of dispute resolution is reduced.[17] It is also important to make the regulatory system predictable, transparent, and simple in order to reduce the need to fall back on informal contacts to navigate the regulatory maze.[18]

- *Improve the flow of information.* Informal arrangements thrive when information flows are weak. When market players lack information-about market opportunities and trends, quality of products, availability of resources, and government policies and regulations-they become dependent on informal contacts and patrons both for information and because they do not know where else to go. Lack of information about government policies also increases uncertainty. Actions in this area will need to focus on increasing awareness of government policies, laws, and regulations, making the award of public contracts transparent and competitive, building an effective MSTQ system, and regulating utility standards and credit bureaus. It is also important to develop private sector collective bodies, such as chambers and trade organizations, and mechanisms for effective public-private sector dialogue to gather feedback and disseminate knowledge about government policies.

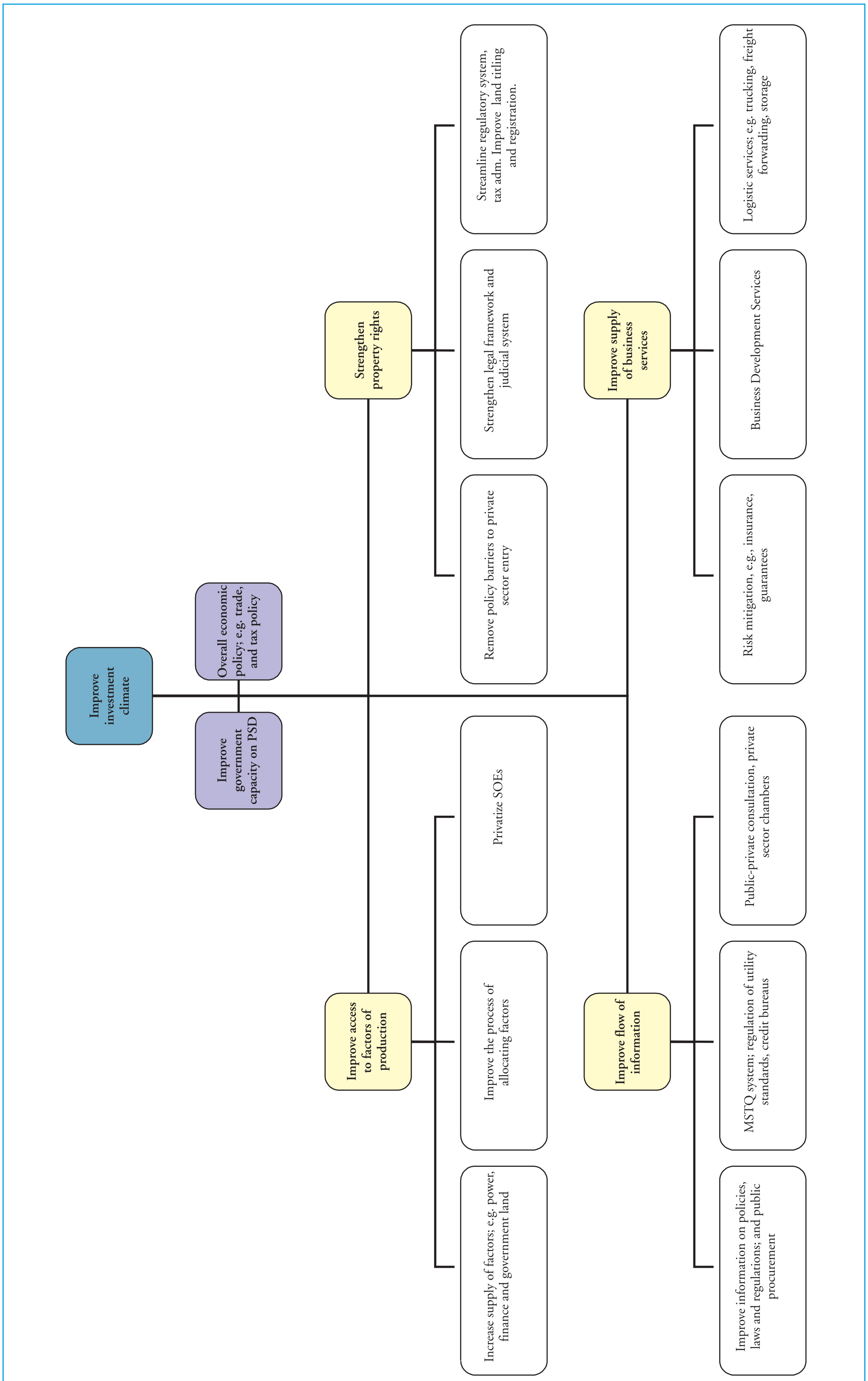
- *Improve the provision of business services.* Enterprises need a variety of business services to help them enter (e.g., help with preparing business plans and negotiating with creditors), operate and grow (e.g., trucking, freight forwarding, accounting, market information, quality assurance services, management services, and legal assistance), and manage risk (e.g., insurance). These services are best provided by the private sector but the government needs to put in place a policy and regulatory framework to facilitate private entry. There may also be scope for public-private partnerships to jump-start markets for services for which currently there are very few or no providers.

Underlying all the above efforts is the need to improve government capacity to analyze private sector issues and formulate and implement private sector development policies and programs. The overall economic policy of government, such as trade and tax policy, will also be relevant because it influences the broad incentive structure for private sector players.

Figure 4.1 describes in schematic form these broad categories of actions. The rest of the chapter provides detailed recommendations. For ease of exposition, these are organized in a different thematic format, but they will help further one or more of the objectives mentioned above.

[17] The latter is particularly important in the current context where investors often fall back on the informal connections and relationships to help settle disputes.

[18] The case studies reported in chapter III provide examples of permits being granted for limited periods and investors needing to go back to the authorities, including ministers, to get fresh permits. Reducing the need to interface with government officials is one way of weakening the hold of informal relationships because such relationships are often needed by businesspeople to intermediate with government officials.


Improve investment climate
Overall economic policy; e.g. trade, and tax policy
Improve government capacity on PSD
Strengthen property rights
Remove policy barriers to private sector entry
Strengthen legal framework and judicial system
Streamline regulatory system, tax adm. Improve land titling and registration.
Improve supply of business services
Risk mitigation, e.g., insurance, guarantees
Business Development Services
Logistic services; e.g. trucking, freight forwarding, storage
Improve access to factors of production
Increase supply of factors; e.g. power, finance and government land
Improve the process of allocating factors
Privatize SOEs
Improve flow of information
Improve information on policies, laws and regulations; and public procurement
MSTQ system; regulation of utility standards, credit bureaus
Public-private consultation, private sector chambers

Legal framework for PSD

Currently, the legal framework for PSD in Afghanistan is characterized by gaps as well as lack of clarity. Progress in improving the legal environment for private investment has been limited since the fall of the Taliban. A Law on Domestic and Foreign Investment was gazetted in 2002. This law was followed by the enactment of the Central Bank and Commercial Banking laws in September 2003, paving the way for the issuance of prudential regulations in the months that followed. The legal agenda is broad and will take a number of years to be implemented. At this point, a number of laws are in draft stage and the priority areas are the revisions to the Law on Domestic and Foreign Investment and the enactment of a Business Organization Law, an insurance law, and a financial leasing law. Progress has also been made in introducing legislation indirectly related to the private sector (e.g., the Procurement Law).

The Ministry of Commerce has tried to push PSD-related legislation but has been handicapped by lack of capacity and technical understanding. The Ministry is now developing a program to help convert policy intentions into the relevant legal and regulatory framework. The program will include advocating legislative change in areas that do not fall within its domain. This overall program should be viewed as high priority. It will also be important to focus on building understanding and knowledge of the purpose, content, and implications of new legislation among the wider community of private sector development stakeholders, including the new elected parliament members. Specific legislative priorities are mentioned below.

Short-term priorities

- *The Law on Domestic and Foreign Investment.* The current law has a number of deficiencies and a revised version has been drafted, but enactment has been held up for several months.

- *Law of Business Organization.* The current law governing the formation of private companies is archaic. A modern law that would help free business organizations from current constraints and encourage the use of the corporate entity has been drafted, reviewed by the private sector, and translated into Dari, the principal local language.

- *Insurance.* Current donor programs address political risk, but general liability, product liability, auto, fire, and other insurance are not available because of the lack of legal mechanisms to protect companies that want to provide such products. A new law is required to liberalize the sector and establish a new regulatory framework to supervise private insurance companies.

- *Financial Leasing.* This alternative to collateral financing has begun to fill in for the lack of any history of nonpossessory liens in Afghanistan. A legal framework for financial leasing is a higher priority than is secured lending law. Work on financial leasing has begun but needs to be speeded up.

Medium-term priorities

- *Secured Transactions Law.* Until the land tenure and registration system is improved, it will remain difficult to use land as collateral. A secured transaction law would enable enterprises to use a wider range of assets to secure loans. In many transition countries such as Albania and Romania, the introduction of secured transaction laws in conjunction with other reforms has increased firm-level access to credit.

- *Bankruptcy Law.* The proposed Business Organization Law contains liquidation provisions that provide for an orderly winding up of enterprises. However, a bankruptcy law will become important as the banking sector matures and starts demanding that its secured lending be accorded priority in the event of insolvency.

Access to land

The ICS revealed access to land as one of the most important, if not the most critical, constraints facing the private sector. The government needs to establish a clear legal framework that regularizes property rights. An enduring solution must consider and address how land had been acquired over the various periods of political upheaval. Policymakers should undergo a thorough analysis of the public sector institutions involved in the land ownership and registration process and eliminate redundancies and inconsistencies among the various institutions (both formal and informal). The government also needs to plan adequately for future land development.[19]

- *Land ownership.* Reducing the regulatory and bureaucratic complexity of the property ownership process is a key element to promoting effective property rights. Land-related legal reforms are complex and will be ineffective, or even counterproductive, if adequate work is not done in rebuilding the administration of deeds, and working out satisfactory dispute resolution mechanisms and a transparent means for enforcing judicial decisions.

- *Land registration.* Though land registration pilot projects have been proposed, their scale will need to be substantially increased to address urgent national needs. A significant commitment on the government's part will be required, which is critical for improving the investment climate in the country.

While work continues on establishing a functioning land tenure system, the establishment of industrial parks will loosen the land and infrastructure constraints faced by private investors. Industrial parks will also serve to reduce security-related costs discussed in chapter III. By focusing infrastructure on a specific area, government will be able to service investor needs quickly, instead of forcing investors to wait for a general municipal infrastructure program that may or may not address their facility requirements. The government created an Industrial Parks Authority as a department within AISA and initiated work on an industrial park development program. Three industrial parks are currently being built, with plans for more.

An effective industrial park development program will require an appropriate policy and institutional framework. In particular, an independent, commercially oriented agency is needed to develop and maintain industrial parks with progressively greater involvement of the private sector.

- *Clarify institutional responsibilities in government.* In May 2004, the government relocated the industrial park planning department from the then-Ministry of Light Industry to the Ministry of Commerce. However, this decision has been recently reversed. Planning for future parks will reside in the Ministry of Mining and Light Industry (successor to the Ministry of Light Industry). The Ministry is not equipped to implement an effective industrial parks program and giving responsibility to a ministry, rather than an independent, commercially oriented agency, is inconsistent with global good practice. This responsibility should be given either to a separate Industrial Parks Development Authority or to AISA with a dedicated industrial parks department, as is currently the case. The agency should be given adequate authority and legal basis, and be adequately staffed with the right expertise. The role of other government agencies, such as the Ministry of Housing and Urban Development and the municipalities in this area, needs to be clarified.

[19] The last land development plan for Afghan cities was prepared in 1978.

- *Enhance the role of the private sector.* The private sector can get involved early on in the management of the industrial parks. There is also scope for early private sector involvement in the development of some parks; in any case, the medium-to-long-term goal should be to have most, if not all, industrial parks developed and maintained by the private sector. In brief, public investment should be used to enable private investment, not to supplant it. Focusing public funds on off-site infrastructure provision for industrial parks conserves scarce infrastructure resources and allows proactive urban planning. The public sector should decouple the promotion and regulation functions of industrial estates, to avoid conflicts of interest and risk failure on both fronts.

- *Operate the industrial parks on commercial principles.* Parks developed in the public sector now should be run on commercial lines so that they can be privatized in future. In light of the scarcity of land and difficulty of obtaining clean titled land, the case for providing serviced land at highly subsidized rates is weak.[20] Charging prices at, or close to, market rates will not only help meet the land and construction costs, but may also generate surplus to pay for future industrial parks development activities. Currently, the pricing does not correspond with the costs of developing the parks.

Infrastructure

Poor infrastructure is one of the two leading constraints reported by the Afghan private sector, with access to land being the other. Establishing efficient infrastructure services after years of conflict requires not only massive investment but also reforms in policies, regulations, and institutions. Along with building new infrastructure, it is also important to develop systems for operation and maintenance. With public resources limited, opportunities for private provision of infrastructural services need to be exploited.

Afghanistan inherited a highly centralized model of government service delivery in the infrastructure sector and with the exception of mobile telephony, which the private sector has entered in a big way, the main utility providers are likely to remain in the public sector for the foreseeable future. However, they may increasingly be run on commercial principles based on accountability for performance, cost recovery, and sustainable operations. There is considerable scope for corporatizing state-owned firms and private sector provision of infrastructure.

Improving public sector provision of infrastructure

- Power Sector Development: Government needs to further clarify its vision of the power sector, including its strategy regarding tariffs, investments, and private sector participation. There is an urgent need to corporatize DABM; strengthen its managerial, technical, and financial capacity; and restructure it in the form of regional business units. This needs to be accompanied by a new board of directors and commercially oriented managers, building capacity, a more businesslike corporate culture, better commercial cash management and pricing practices, and improved billing and collection, including through computerization. In the medium term, the government should embark on a relatively ambitious power tariff reform program as the quality of power supply is improved and the network is expanded and develop a rural energy strategy to bring electricity to rural areas.

20 For the Bagrami industrial park being constructed near Kabul, the demand for industrial plots was oversubscribed by more than 200 percent. Excess demand is an indication that land prices were fixed at substantially below-market rates.

- *Transport:* The foremost challenge in the transport sector is to rehabilitate the primary road network and key airports to accommodate increasing traffic volume and promote trade. Inadequate transport facilities are a major impediment to exports and increase the costs of all products. Improvements in the transport system have been the top priority for the government during the past three and a half years. The Ministry of Public Works, which is responsible for the national highway system, needs to build technical and managerial capacity in order to oversee and coordinate the major donor-funded road investment program underway, and to prepare and evaluate bankable major road projects for future investments. The financing of recurrent costs of the road sector is far from adequate, and funding mechanisms for cost recovery need to be developed.

- *Telecommunications:* A priority in the telecommunication sector is to further improve the regulatory framework in the sector to open it to greater competition and strengthen the regulator, the Telecommunications Regulatory Board (TRB, to be renamed the Telecommunications Regulatory Authority of Afghanistan after the Telecommunications Law is passed). Substantial assistance will be required to further develop TRB's capacity to develop policies and implement them. Furthermore, the newly corporatized Afghan Tel needs to be strengthened. The Ministry of Communications has drafted two new laws, a telecommunications law and a separate law covering the corporatization of Afghan Tel. These laws need to be enacted and gazetted.

Encouraging private entry into infrastructure

The public sector will be unable to provide all the infrastructural needs of the private sector. This is particularly true in the power sector, where large parts of the country will not have access to the grid for many more years to come. The private sector should be encouraged to provide services, particularly where public services are absent. Small local providers of power would be more efficient than each enterprise having its own generator. This is already happening in a small way. Nearly 5 percent of the ICS sample sells excess power from their generators. To expand private provision of infrastructure services an internal World Bank paper argues that the government should undertake a number of actions:

- *Removing policy barriers to private sector entry.* The government should clearly articulate, for all sectors, its position on the role of the private sector in delivering infrastructure services. Where the government is committed to encourage private entry, it is necessary to identify specific policy barriers that may impede private entry in practice despite overall government commitment. The government's reluctance to give up its interests in public transport is a good example of where the public provision of services could potentially damage the growth of the private sector through unfair competition. Specific examples of actions that can be taken in the power sector include (a) amending legislation and regulations largely dating from the period of Soviet occupation that for obvious reasons do not envision private sector participation in the economy; (b) allowing captive generation under all circumstances in which business activities are allowed; (c) allowing business-to-business sales of surplus production from captive generation; (d) explicitly allowing private generation and distribution to commercial and industrial consumers; and (e) adopting and proclaiming a policy of light-handed regulation for such circumstances-including for rural and peri-urban electrification.[21]

[21] One approach could be to totally deregulate projects below a certain size (e.g., all hydro at 10MW or less). Above this threshold, regulatory requirements should be minimal and benchmarks established (e.g., issuance of license to generate within 10 days).

- *Regulation of standards.* The government should provide clear standards for the provision of infrastructure. For example, water quality and performance standards are very important if private sector provision of water is to be adopted. However, it is important to ensure that regulations are enforced in a hassle-free manner.

- *Regulation of tariffs.* In the power sector, for example, a key risk to private sector, particularly in the distribution business, is the risk that the government will not allow tariffs to rise to a level that covers costs. The experience in Afghanistan suggests that people are willing to pay higher tariffs for a reliable electricity supply. Tariffs should therefore be raised to a cost-reflective level as soon as possible. Similarly, if the private sector is to be involved in the operation of the public sector water systems, charges must be collected to cover the operations and maintenance costs, which means that tariffs will have to rise and bills collected.

- *Risk mitigation.* A number of risks are inherent in private investment in infrastructure and utilities, more in some activities than others.[22] This would require risk mitigation arrangements such as political risk insurance and financing mechanisms to reduce the risk of nonpayment of revenues.[23] Operators may require political support for revenue collection, including disconnection as well as some form of protection against foreign exchange risk.

- *Aligning contracting procedures with private sector capacity.* As mentioned above, poor capacity of local private firms, especially in dealing with contracting procedures, is a particularly important issue in the road construction sector but also of relevance to other sectors such as water and sanitation. A concerted and coordinated effort by the government and donors to create opportunities for Afghan contractors will help. This effort would include, for example, (a) an agreed-upon, common set of principles for encouraging Afghan companies; (b) ensuring the donor procedures for these contracts are at least consistent with each other; (c) common standards for quality supervision and slower supervisions of works; (d) common short-lists, and sharing of information on prequalification of companies and references; (e) a common approach to the provision of direct technical assistance to construction companies; and (f) ensuring that small-scale tender documents are written in the local language, where possible.

Access to finance

Despite recent advances in the financial sector system, Afghan firms have almost no access to external sources of credit from formal sources. Expanding formal credit faces many challenges, some of which are as follows: (i) the legal and regulatory environment remains weak beyond the banking sector, (ii) DAB still remains behind basic standards of modern central banking, (iii) little progress has been made with regard to the three publicly owned commercial banks that have been relicensed (These banks have rural bank branches that could be used to deliver formal credit to rural communities.), and (iv) the financial system needs to be expanded to the rural economy.

[22] For example, private investment in electricity infrastructure may be discouraged by the following risks: (a) investments generally have long payback periods; (b) the majority of the investments are in fixed assets, which are difficult or impossible to move and often have low resale value; and (c) revenues are often paid by government or government-owned parastatals.

[23] An alternative approach is to encourage small-scale projects that may have higher rates of return and shorter payback periods. Generation projects may also be more attractive to private investors if they also own the distribution network and collect revenues, which allow investors to limit the political risk of nonpayment.

In considering the feasible options for providing immediate and long-term finance to entrepreneurs, the following working principles are especially important for Afghanistan:

- That no single solution is capable of addressing the present and future finance needs. All options-commercial banks, input dealers, microfinance institutions, leasing companies, informal lenders, cooperatives, and state banks-are complementary rather than exclusive choices.

- That both the short- and long-term options must be developed as part of an overall strategy to strengthen the financial system, including (1) improving the legal regulatory and enforcement environment for lending and (2) maintaining a level playing field in the financial sector and supporting a competitive environment.

- That private-sector-led reforms work best. Subsidies for specialized banks distort the market interest rates. Lessons learned around the globe indicate the restructuring of agricultural development banks to be costly, unsustainable, and largely unsuccessful.

In applying the principles stated above, it is recommended that the government focus on three principal objectives: (1) improving the institutional mechanism for delivering credit, (2) improving access to financial services for SMEs and rural communities, and (3) broadening and deepening the financial sector.

Improving the institutional mechanisms for delivering credit

Institutionally, the following short-, medium-, and longer-term interventions are recommended.

In the short term, it is recommended that the government focus on initiatives that help increase access to finance, in particular creating the policy, legal, and regulatory framework that encourages private financial intermediaries to expand credit. Examples include the following:

- *Dealer credit:* In the short term, dealer credit to entrepreneurs may work best for short-term credit, primarily to finance primary inputs for basic farming or manufacturing. Dealer credit programs often require the active participation of formal financial institutions lending to importers and other formal dealers who would lend to retailers and then to farmers or other nonfarm producers. Lending could be on terms that recognize the lack of collateral at the firm level. The government could play a role in bringing together the commercial banks and the input dealers to work out a system of larger credit flows to entrepreneurs. Aggressive dealer financial management training would be required to pursue this option. To start with, the dealers would likely focus on medium- to large-scale entrepreneurs; smaller firms would probably have to rely on microfinance.

- *Microfinance:* Microfinance is desirable in the context of rapid entrepreneurial growth among small-scale enterprises that lack collateral. To scale-up current microfinance finance operations, microfinance institutions (MFIs) require further technical assistance to strengthen their operations (e.g., management information systems, new product development, business planning, financial analysis, internal control). MFIs will also need to develop strategies to reduce their dependency on donor funds, such as developing partnerships with larger financial institutions to fund the growth of their microfinance portfolio. MFIs will also need to develop innovative strategies to address the needs of the rural sector (such as agricultural lending and offering financial services in low population density areas).

- *Strategic partnerships:* Commercial banks initially do not want to provide resources directly to small- and medium-scale enterprises, especially those in rural areas. But the work to encourage enterprise lending by banks needs to start now. Strategic alliances between banks and nonbank financial institutions, such as MFIs, with closer links with firms are worthy options to explore. The private commercial banks have the resources, skills, and capacity to finance long-term agricultural development.

In the medium to long term, it is recommended that efforts be made to increase the capacity of formal financial institutions with sizeable branch networks to provide credit. Options include:

- *Integration with traditional systems:* Traditional credit providers, such as hawalas, with their extensive informal networks can play a role in Afghanistan. Unfortunately, at present integration of the traditional credit providers into formal national and global financial markets is modest. More effort is required to gain full value of the wealth of information that these traditional systems hold; and also, more competition is required to ensure that interest rates are appropriate for agricultural purposes.

- *Rehabilitation of State-owned banks:* A promising medium-to-long-term option is to restructure Bank Mille and Pashtany Tejaraty Bank. With strong political will, support from DAB, and an independent management company, a new, modern financial institution could be created out of these two banks. In the longer term, this bank should be put into private hands and a timetable for privatization should be part of the plan. Experience has shown that to be successful, privatization requires improvements in the financial sector infrastructure and the regulatory environment along with enduring political support. The decision to privatize a bank should therefore be part of a broader policy plan to privatize the financial sector and should be implemented in a systematic and sequenced manner.

- *Credit Bureau:* Another medium-term goal would be to create a private sector credit bureau. The lack of information on borrowers and the difficulty in enforcing agreements are the main impediments to increasing credit from formal institutions. Experience in a number of countries has shown that credit bureaus that provide information on the credit worthiness of borrowers help increase the availability of bank credit. In some countries, efforts to establish credit bureaus have been thwarted by banks and other lenders who see such information as proprietary and a source of their competitive advantage. Establishing a credit bureau in Afghanistan now, when banks welcome it, would increase available credit and eliminate the chance that established interests would prevent its establishment in the future.

Improving access to financial services for SMEs and for rural communities

The old model of directed lending to SMEs and to rural communities through publicly owned and managed development-finance institutions or specialized banks has become redundant and outdated. Universal experience shows that a strong, market-based, competitive financial system comprising banks as well as capital markets serves these needs in a much more efficient and cost-effective manner.[24] At the same time, market failure, particularly in postconflict countries, justifies public policy intervention on behalf of underserved SMEs and rural communities.

[24] Provision of funds through directed and subsidized credits by development-finance institutions contributed to the current state of the financial sector in Afghanistan.

Bringing the commercial financial system closer to rural customers will require improving the business environment and regulatory framework to facilitate rural finance operations and increase the perceived creditworthiness of clients; using technology to lower transaction costs and improve transfer mechanisms; introducing new products and risk-reduction techniques; and encouraging the use of agency arrangements to leverage scarce or expensive infrastructure and to create flexibility and mobility in service provision.

One option for increasing the availability of finance to small enterprises would be to develop "downscaling" programs with interested commercial banks (i.e., to support these banks to develop small-business lending operations). Considering the size of the informal economy and the current weakness of the financial sector, Afghanistan represents an ideal ground for such downscaling operation. The downscaling model was successfully undertaken by the European Bank for Reconstruction and Development in the former Soviet Union and in the Balkans, and in countries such as Russia, Kosovo, Georgia, and Tajikistan. Support to commercial banks to downscale usually includes a technical assistance component (to train the bank on how to lend to small businesses: development of new credit procedures, training of loan officers, strengthening of management information system, development of incentive system for loan officers, marketing, etc.) as well as a credit line when liquidity is an issue.

Broadening and deepening the financial sector

Achieving the high rates of growth necessary to reduce poverty significantly will require increased mobilization of domestic and foreign savings to support higher rates of private sector investment. Mobilizing savings implies a broadening and deepening of financial markets, institutions, and products, particularly long-term project finance. It also means supporting the creation of banks and nonbank financial institutions offering a range of products and services that compete with or complement those traditionally provided by banks.

Though the banking sector is likely to remain the largest component of the financial system for some time, there is also a need to develop complementary nonbank financial institutions, such as leasing companies, commercial credit companies, credit unions, factoring companies, insurance companies, a credit bureau, and pension and provident funds, and, in the longer term, to develop debt and equity markets. The establishment of a broad range of instruments into which savers can deposit their funds and through which companies and consumers can obtain access to capital and credit will spur the overall development of the economy.

- To enhance competition and make the intermediary role of the banks and nonbanks more efficient, DAB should maintain a competitive banking policy. Conventional means of enhancing competition within banking systems-such as bank privatization and changes in laws and regulations affecting companies, banks, foreign ownership, and bankruptcy-should constitute the basis of such a policy.

- Authorities must create an environment, through regulation, to prevent collusive behavior among banks and conglomerate relationships between banks and nonbank financial institutions. Therefore, the present ownership structure of the two state banks to be relicensed should be gradually changed through their privatization and through the entry of reputable new private banks and financial institutions. To ensure continuing effective competition, DAB should permit new banks to be set up only by qualified, professional, and experienced parties.

In the long run, financial sector reforms should produce the following outcomes:

- Only self-sustaining and commercially viable financial institutions that do not depend on the government's support for resource mobilization or pricing should be allowed to operate in the market. The government should channel resources to priority sectors or subsectors in cases of market failure, for reasons of equity, or to achieve social objectives, but such allocations should be explicit budgetary costs and not subsidized through a tax on financial intermediation.

- The government's role should be confined to creating a regulatory environment and an incentive regime that will draw investors and savers to financial institutions. Where government participation in equity becomes necessary, it should be done without involvement in management.

State-owned enterprise reform and privatization

More than 75 enterprises in Afghanistan are classified as SOEs, with about 18,000 employees, limited liabilities, and assets largely in the form of land. In addition, the government has a stake in other firms that are not defined as SOEs under Afghan law. A prominent example of this is Ariana Airlines. Unlike in many other developing countries, Afghan SOEs do not impose a significant burden on the budget and are not major claimants on bank credit. This is because most SOEs are either not functioning or operating at very low levels of capacity utilization, and the government so far has been reasonably successful in imposing a hard budget constraint on them. Hence, Afghan SOEs do not have a significant crowding-out effect on the private sector as their counterparts do in many countries. However, in some cases, such as in cotton-ginning, SOEs have tried to stop private enterprises from operating, and risk remains that other SOEs may indulge in similar behavior.

Moreover, a substantial amount of assets, notably land, is locked up in these enterprises. Several SOEs are nonviable and should be liquidated. Even the potentially viable ones that could be privatized may have more land than they need. Unlocking these assets through liquidation and privatization will help loosen one of the most important constraints faced by private investors, that is, access to land, although it is not a substitute for the broader and urgent land-related reforms discussed earlier. Privatizing the SOEs would also provide an entry point for new investors, where the land assets are not in dispute and there are no entrenched monopolies.

There has been some progress in laying the ground for privatization. The government has carried out a preliminary classification exercise, based on a survey of SOEs, categorizing SOEs into those to be privatized, liquidated, or retained under public ownership. However, the preparations for a privatization program are moving slowly. So far, only two enterprises have been privatized.[25]

To speed privatization and to put SOEs' assets to productive use in the private sector, the government among other things should undertake the following steps:

- *Adopt a privatization policy.* The government has recently adopted a formal privatization policy. It will need to be supplemented by detailed implementation guidelines that spell out the modalities of privatization and specify where in government lies the authority for initiating and implementing privatization. The SOE Law has provisions to liquidate or privatize SOEs that do not meet financial targets. However, in actuality privatizing an SOE requires agreement by the line ministry that owns it. For many ministries the income or potential income from the assets owned by the

25 These are two ginning and pressing mills that have been given out on 31-year leases (with option to buy) to a French company.

SOE is seen as an important funding source for the ministry. Thus, obtaining agreement to privatize is difficult.

- *Develop an institutional framework for privatization.* Develop adequate institutional capacity to implement a privatization and liquidation program. No separate agency, such as a privatization commission or board, is entrusted with carrying out privatization. The SOE department in the Ministry of Finance is currently carrying out some preparatory work and it relies almost exclusively on external advisors.[26] However, the role of the Finance Ministry vis-à-vis other ministries in initiating and implementing privatization is still unclear despite the adoption of the privatization policy and the amendments to the SOE law. The government needs to clarify the institutional responsibilities and put in place an adequate institutional framework for carrying out privatization.

- *Adopt a mechanism for allocating surplus SOE land.* Articulate a clear policy and legal framework for ensuring that the freed-up land is made available for private investors. This may require consolidating ownership of such land, currently diffused across several ministries and government agencies, in a single authority with clearly laid-down procedures for its disposal.

- *Create a strong legal basis for privatization.* The SOE law, which has recently been amended to facilitate privatization, should be gazetted. The previous version of the law had no provision for private sector participation in SOEs and did not cover privatization. It did have well-defined provision for liquidation of SOEs but these have not been invoked yet to carry out any liquidation. Some SOEs, especially utilities, will likely remain under public ownership for some time, and there may be some public investment in these enterprises. Such investments should be guided by a clear policy and rigorous criteria and within an appropriate corporate governance framework.

- *Address labor retrenchment issues.* Develop a program to deal with labor retrenchment. Privatization and liquidation could be socially contentious, especially because substantial job losses (currently estimated at about 6,500) will be involved. Indeed, this factor is partly responsible for the relative lack of commitment and action in government on this front. Its advisors have worked out a set of options on severance packages on which the government needs to make a decision, keeping in mind that severance payments should not be unduly generous. Any package for SOE employees will set precedent for other public sector retrenchment programs.

- *Introduce strong corporate governance for SOEs that will be retained.* It is very important to ensure that SOEs that remain in the public sector are run efficiently, do not become a significant fiscal risk factor for Afghanistan, and do not crowd out resources that have better uses. There should be regular reporting of key financial variables by SOEs (including those with less than 100 percent government ownership) and their compilation for use in monitoring and policy decisions. SOE

[26] The advisors working on privatization are mandated to work only with those enterprises that are classified as SOEs, that is, those enterprises that have a separate board and budget, and are controlled by a line ministry. Some enterprises, including the national airline company Ariana, which is a joint venture, are not classified as SOEs.

investments, including those occurring outside the Core Budget, should be carefully monitored, and financial transfers between SOEs and the government budget should be transparent. There should not be any investments in SOEs that are to be liquidated or privatized and there should be rigorous criteria for approving investments in SOEs to be retained.

Trade reform

Following reforms carried out in 2004 (simplification of tariff to a six-band structure, with a maximum rate of 16 percent and utilization of a uniform floating exchange rate), Afghanistan has one of the most open economies in the region, with an average tariff of 5.3 percent. The import license application process has been drastically reduced. Border and clearance times, while significant, are within a reasonable range for the region. However, the customs administration remains weak, several transit-related issues need to be addressed, and institutional responsibilities in the government need to be clarified.

- Improve customs infrastructure and reduce discretion in valuation and tariff collection.
- Define clear roles for different agencies to reduce multiple inspections.
- Further reduce the dispersion in tariff rates to avoid discriminating in favor of or against different activities.
- Improve trade infrastructure, especially storage facilities.
- Continue to negotiate more open trade, including allowing Afghan carriers to operate in neighboring countries.

Business services

Few, if any, business services are available in Afghanistan. Local consulting companies are focused almost exclusively on servicing the large donor community. Consequently, Afghan private sector enterprises have few options to obtain help on marketing, accounting, engineering, quality control, and other important services. Few private sector managers complain about this lack of services. Larger firms bring in experts from outside and for other firms it is probably an issue that they "don't know what they don't know." Having never had access to consulting services, they do not know the benefits to be gained from outside experts. The need for business services is clearly illustrated by the fact that the first enterprises to get loans from local banks needed extensive help from NGOs to write business plans and put together financial statements for their applications. Many businesses fail to access finance from the banks because their business accounts are not credible. There are no domestic accounting firms that can help prepare accounts or audit reports and the services of foreign accounting firms are beyond the reach of most Afghan businesses. It is important to develop the accounting and auditing profession within the country. Given the lack of a local consulting market, it may be necessary for government or donor agencies to initiate programs to spur their development.

A major constraint revealed by many sector studies in Afghanistan for both exporters and other producers is the lack of testing facilities and standards to ensure quality.[27] Exporters are required to obtain certificates of quality-but the government agencies issuing them are not able to test. The government has begun a pilot project in Metrology, Standards, Quality, and Testing (MSTQ) housed in the Ministry of Commerce, but to date little progress has been made. Initial plans call for a focus on testing imports for consumer protection. However, quality assurance for exports is equally

27 See United Nations Development Program and Afghanistan Research and Evaluation Unit sector studies.

important, for without it the values of exports will always be constrained. Some current markets for Afghan products, such as India and Russia for dried fruits, may not have high-quality requirements, but western markets have exacting standards and traditional markets may raise standards in the future. A good MSTQ system will become increasingly important if Afghanistan wants to expand exports, especially of higher valued products. In addition, the focus on imports and consumer protection raises the possibility that it could become a source of nontariff barriers for influential firms seeking protection. The establishment of a viable MSTQ program is essential for private sector development, and substantial resources should be devoted to expanding the pilot project into a sustainable program that meets the private sector's needs.

Government capacity to promote and facilitate private investment

Policy reform in the investment climate area is handicapped by lack of capacity in the government to analyze private-sector-related issues, obtain systematic feedback from the private sector, and, on this basis, formulate appropriate policies and programs. This capacity needs to be built across the government because the work of several ministries and agencies is relevant to private sector development. However, in light of the limited resources, initial focus may be on the AISA-to help promote Afghanistan as an investment destination and to facilitate individual investors-and the Ministry of Commerce, as the main driver of private-sector-related policies.

Priority areas for capacity building in the Ministry of Commerce include (a) a mechanism for reviewing the regulatory interface between government and the private sector, identifying areas where regulatory streamlining is required and assessing the costs and benefits of proposed regulations; (b) identifying and pursuing legislative changes required to fulfill the government's PSD policy intentions; (c) coordinating investment policy work with AISA's investment promotion activities; and (d) providing comprehensive, updated information on PSD policies to the private sector. In addition, some basic skills in such areas as English language, business language, computers, and financial management need to be developed.

Priorities for AISA are (a) further developing its role in facilitating investors; improving its capacity to operate as a one-stop shop for investors, defining interagency workflows, and establishing procedures to foresee and address client requirements; (b) developing policy advocacy capacity and a mechanism for obtaining feedback from the private sector; (c) clearer definition of the range of services it will offer to investors, both before and after they invest in Afghanistan; (d) developing a system to screen potential investors so that scarce AISA resources are not spread thin; (e) reviewing and clarifying staff responsibilities and providing adequate training to staff in areas such as sales presentation, negotiations, "closing the deal" with potential investors, and basics of accounting and corporate finance; (f) identifying career development paths for staff; and (g) developing investor tracking systems.

Clearly, these agencies will have to coordinate with other parts of government; the High Commission for Investment, in which several ministries are represented, can be one vehicle for this. Currently, coordination and collaboration among ministries is weak. Effective coordination will require an appropriate division of labor among the various ministries and agencies based on the comparative advantages of the different parts of government. Promoting private sector development in an era of globalization requires a good understanding of international and domestic market trends, sectoral knowledge, and appreciation of the needs of business. As was argued in the section on industrial park development, historical divisions of labor within government will have to be reconsidered if effective policies for private sector development are to be formulated.

Efforts should also be made to strengthen private sector collective bodies, such as chambers of commerce and industry organizations. These have a very important role in private sector development because they serve as a bridge between the private sector and the government's policymakers, providing two-way feedback. They may provide government with insights and knowledge on constraints faced by the private sector and may advocate policies and laws that help private sector growth. They may provide the private sector with information on government's policies, both actual and proposed, thus reducing uncertainty for the private sector and enhancing credibility of government actions. Private sector organizations may also play a role in helping to develop a shared stakeholder vision on the role of markets and the private sector in Afghanistan. The government has taken some steps toward fostering the development of private sector collective bodies. It has formed a committee to review the future role of the quasi-government Afghanistan Chamber of Commerce and recommend actions that will convert it into a truly private sector chamber. However, it is important that this does not crowd out other private sector chambers and associations. AISA has started reaching out to the private sector through activities such as roundtables in provincial cities.

Policy Recommendations Matrix

Area	Short-term actions (less than 1 year)	Medium-term actions (2-5 years)	Long-term actions (more than 5 years)
Legal framework for PSD			
Investment Law	Enact revised Private Investment Law.		
Business Organization Legislation	Enact Law on Business Organizations.		
Legislation related to private property rights and land	Carry out the requisite background policy work for initiating legal reforms in this area.	Rebuild the land registration system. Work out satisfactory dispute resolution mechanisms. Introduce transparent means for enforcing judicial decisions.	
Bankruptcy legislation	Develop workable mortgage and collateral registries.	Enact Bankruptcy Law.	
Insurance legislation and regulation	Assess the practical legal needs of a future insurance industry; identify the views of potential investors. Formulate policy in government for regulating this sector. Draft suitable implementing legislation, perhaps based on the 1353 law.	Enact the new insurance legislation, perhaps based on the 1353 law, along with the implementing regulations. Establish regulatory agency for insurance; build capacity in agency.	
Financial leasing	Enact a financial leasing law.		
Infrastructure			
Overall infrastructure	Articulate, for all sectors, government policy on the role of the private sector in delivering infrastructural services.	Remove policy barriers to private sector entry. Move toward more commercial tariff regimes. Develop regulatory standards for private provision of infrastructure.	

Area	Short-term actions (less than 1 year)	Medium-term actions (2-5 years)	Long-term actions (more than 5 years)
		Develop risk-mitigating arrangements to address risks associated with private investment.	
Power	Further clarify government's vision for the power sector, including its strategy regarding tariffs, investments, and private sector participation.	Corporatize Da Afghanistan Breshna Moassesa (DABM) and strengthen its managerial, technical, and financial capacity. Restructure DABM in the form of regional business units. These actions need to be accompanied by a new board of directors and commercially oriented managers, capacity building, instilling a more businesslike corporate culture, and better commercial cash management and pricing practices.	Introduce greater cost recovery through further reforms in tariff setting.
	Improve billing and collection, including through computerization.	Develop capacity of the Ministry of Power and Water to lead the investment program and exert its regulatory role.	Implement a rural energy strategy to bring electricity to rural areas.
	Identify and remove policy barriers, if any, to small-scale power generation and distribution by the private sector.	Explore options for private sector contracting for the CGCT project in Shebagan.	
Transport	Rehabilitate primary road network and key ports (land and air).	Continue rehabilitation of road network and key ports (land and air). Build capacity in the Ministry of Public Works to oversee investment program. Develop mechanisms for cost recovery.	
Telecommunications	Enact and gazette the Telecommunications Law. Gazette the Law on Corporatization of Afghan Tel.	Improve the regulatory framework for the sector and strengthen the Telecommunications Regulatory	

Area	Short-term actions (less than 1 year)	Medium-term actions (2-5 years)	Long-term actions (more than 5 years)
	Issue additional fixed-line licenses to open competition to Afghan Tel.	Authority of Afghanistan (to replace the Telecommunications Board after the Telecommunications Law is passed). Strengthen management capacity of Afghan Tel. Bring a strategic investor on for Afghan Tel and then fully privatize it.	
Access to finance			
Central bank	Continue the reform of Da Afghanistan Bank by focusing its activities on its regulatory functions (continuing to phase out its commercial activities) and strengthening its capacity. Encourage the expansion of existing private commercial banking activities and scaling up nonbank financial services.	Establish public credit bureau. Encourage competition and create an environment to prevent collusive behavior.	
State banks	Prepare a specific action plan for the resolution of state-owned commercial banks that includes dates for the appointment of a comprehensive management team, a capitalization plan, and short- and long-term plans for the rehabilitation and corporatization of their urban and rural banking. Introduce independent management in banks to be rehabilitated. Revive safe and sound operations.	Commence the Voluntary Retirement Scheme, taking into account the government's fiscal commitments. Commence dedicated agricultural finance products and services.	Complete the privatization of the rehabilitated state banks.
Private banks	Encourage strategic public-private partnerships. Introduce loan guarantee facilities.	Provide economic incentives for commercial bank branch expansions.	Encourage full-scale private sector investment in agricultural finance.

Area	Short-term actions (less than 1 year)	Medium-term actions (2-5 years)	Long-term actions (more than 5 years)
Traditional providers (Hawala)	Encourage applications for money service businesses from large money exchange dealers that meet legal licensing requirements.	Consider licensing compliant money service businesses as nonbanking financial institutions, thus permitting them to engage in a wider range of well-regulated financial activities.	Consider the transformation of some of the larger money exchange dealers into banks engaging in rural finance.
Dealer credit	Expand dealer credit programs.	Integrate dealer credit programs with mainstream financial sector.	Continue geographic and product expansion programs.
Microfinance	Provide additional finance to existing programs and encourage organic expansion.	Entrust larger, well-managed institutions to scale up dedicated agricultural finance programs to medium-scale farmers and rural enterprises.	Continue geographic and product expansion programs.
State-owned enterprise reforms and privatization			
	Prepare a Privatization Policy to articulate the principles of privatization and lay out a transparent process for carrying out privatization and liquidation. Strengthen the legal and institutional framework for privatization; amend the SOE law to allow for private participation in SOEs and privatization; and clarify the institutional responsibilities for privatization. Develop a legal framework to facilitate allocation of surplus SOE land. Develop a clear policy to govern new investments and reporting requirements of the SOEs that will remain in government ownership. Develop a severance package for SOE	Carry out privatization in a transparent manner. Liquidate nonviable state-owned enterprises; make land available for other industrial purposes. Develop strategies to divest government enterprises that are not officially SOEs.	

Area	Short-term actions (less than 1 year)	Medium-term actions (2-5 years)	Long-term actions (more than 5 years)
	workers who are to be retrenched that is in line with international good practices and does not create an adverse precedent for future civil service restructuring exercises. Identify other government agencies that are not officially SOEs but could be privatized.		
Land development and industrial parks			
	Formulate a consistent national policy for industrial park development that should be based on a vision that includes private sector development and management of industrial parks. Clarify the institutional responsibilities within government for planning, regulation, and development of industrial parks: This should be done formally through a decree accompanied, if required, by implementing regulations. Build capacity in the Industrial Parks Development Authority. Formulate legislation to help allocate government-owned land for industrial park development.	Establish a regulatory framework for industrial park development, including provisions that facilitate private sector development and management of such parks. Separate the regulatory function from the promotion and development function in the public sector. Over time, phase out public sector role in development of industrial parks.	Privatize all publicly owned industrial parks. Rely primarily on private sector development of industrial parks.
Trade reforms			
	Clarify institutional responsibilities for trade policies, promotion, and reform.	Support harmonization of standards and procedures and curtail smuggling, notably with the establishment of a computerized transit management system.	

Area	Short-term actions (less than 1 year)	Medium-term actions (2-5 years)	Long-term actions (more than 5 years)
		Improve regional trade and transit issues, including development of efficient, safe, and reliable transport corridors. Further reduce the dispersion in tariff rates. Improve trade infrastructure, especially storage facilities. Continue to negotiate more open trade, including allowing Afghan carriers to operate in neighboring countries.	
Government capacity to promote and facilitate private investment			
	Build policy analysis capacity in the Ministry of Commerce. Build investment promotion and facilitation capacity in AISA.	Build capacity across government in PSD issues. Develop an effective channel of getting feedback from the private sector on the investment climate. Strengthen the statistical basis for monitoring developments in the private sector and in the investment climate.	
Business services			
	Make the Quality Standards Board functional. Build minimum capacity in the board. Initiate programs to spur development of business development services; rely as much as possible on private sector suppliers.	Further strengthen the Standards Board. Develop a network of quality testing laboratories.	

ANNEX A:
The Investment Climate Survey

A.1 Sample

The Afghanistan Investment Climate Survey (ICS) sampled 338 private sector enterprises spread across five major cities in May through July 2005. The survey was conducted through face-to-face interviews at the establishment level. At the time of the survey there was no accurate available list of enterprises in Afghanistan from which to construct a sample frame. The best list was provided by AISA, stating registered enterprises and enterprises previously registered with local chambers of commerce. Unfortunately, this list was completely inaccurate. Many of the listed enterprises no longer existed and for those that did, the location, size, and other information were inaccurate. More problematic was the fact that many of the active enterprises were not on the list. Currently, only large enterprises, foreign enterprises, or those that want to do business with the government has an incentive to register with AISA. Lists of registered importers and exporters could not be accessed.

Because there was no valid sample frame, the survey proceeded by sampling based on a sector's share of the estimated gross domestic product (GDP) with a quota for size of firm. The survey included manufacturing, trade and wholesale, other services, transport, and shipping and construction companies. It excluded healthcare, security, consulting, and financial sector enterprises. Agriculture processors were included in manufacturing but farms were excluded. Manufacturing was overweighted to make the sample more comparable to other ICSs. The sample was distributed geographically based roughly on population estimates in each city. For consistency with the sample from other countries included in the World Bank's Investment Climate Database, the sample was restricted to enterprises of five or more workers. Smaller enterprises do not show many of the organizational elements of a firm.

Table A.1: Sector Distribution: Afghanistan ICS 2005

Sector	% of Sample	Cities	Number of Establishments
Manufacturing	34	Kabul	99
Construction	15	Kandahar	55
Construction material	6	Herat	62
Services	17	Jalalabad	59
Trade and wholesale	23	Mazar-e-Sharif	63
Transport and communications	5		

A.2 Selection of enterprises

Because of the lack of a sample frame, the implementing agency (Altai Consulting) was forced to rely largely on a list of enterprises it had compiled in the course of conducting other research on the Afghan private sector and a "snowball" approach. The Altai list is limited because it consists of companies that Altai had already contacted and interviewed, in some cases multiple times. It also focuses on the sectors of interest for previous projects, including poultry, cumin and saffron, gems, services related to construction and construction materials, wheat-based products, cashmere, soap, shampoo, and laundry detergents. However, the effect of this bias was minimized by the fact that cited sectors represent a large proportion of the Afghan private sector and the list included many of the known medium-to-large companies in the country. In addition, the snowball method mitigated the bias. The snowball method entailed asking interviewed firms and other contacts for suggestions of firms that met the sampling criteria. These new firms were in turn asked for their suggestions.

A.3 Overall attitude of respondents

The survey lasted an average of 1 to 1.5 hours. Despite this length, the survey firm reported that the majority of respondents were interested in and cooperative with the survey and understood its purpose. Because of the low number of national businesses of significant size, many of the respondents have been interviewed before, some multiple times, on similar topics. These continuing studies have raised expectations; however, there has not yet been a corresponding level of visible activity to help the private sector. This lack of progress has caused a growing number of businesspeople to question the effectiveness of contributing their time and energies to further interviews and of the implementing agencies in general.

Table A.2: City Distribution: Afghanistan ICS 2005

City	No. of Observations	% of Sample
Kabul	99	30
Herat	62	18
Kandahar	55	16
Mazar-e-Sharif	63	19
Jalalabad	59	17
Total	338	100

Table A.3: Size Distribution (number of full-time workers): Afghanistan ICS 2005

Sector	% of Sample
Fewer than 20	55
20-49	25
50-99	10
100 or more	10
Average number of full-time employees	37

A.4 Interviewer profile

The interviewers trained for the survey were generally college-educated in Afghanistan or a neighboring country and/or had previous experience with conducting interviews in the country. However, it was not possible to find interviewers that had previous exposure to the level of business or financial concepts or terminology used in the questionnaire. The practical result of this limitation was that the presurvey training did not fully prepare the interviewers to conduct what for Afghanistan was a complex and sophisticated survey. In many cases, the interviewers may not have completely understood the implicit logic of the survey's structure and may not have realized its significance or function as an analytic instrument.

A.5 Respondent profile

All respondents were men. The large majority are owner-operators of their companies, which is typical in Afghanistan where large companies are few and most management staffs do not exceed a few individuals. Many are in business for the first time and nearly none have had formal management or business training. Few have had more than a basic general education. However, because of their relatively high position in a hierarchical society, some interviewers may have felt uncomfortable asking sensitive questions or pushing for more complete answers.

ANNEX B:
Managers' Perceptions of Major Constraints

Figure B.1: Afghanistan: Percentage of Firms Citing Constraint as Major or Severe

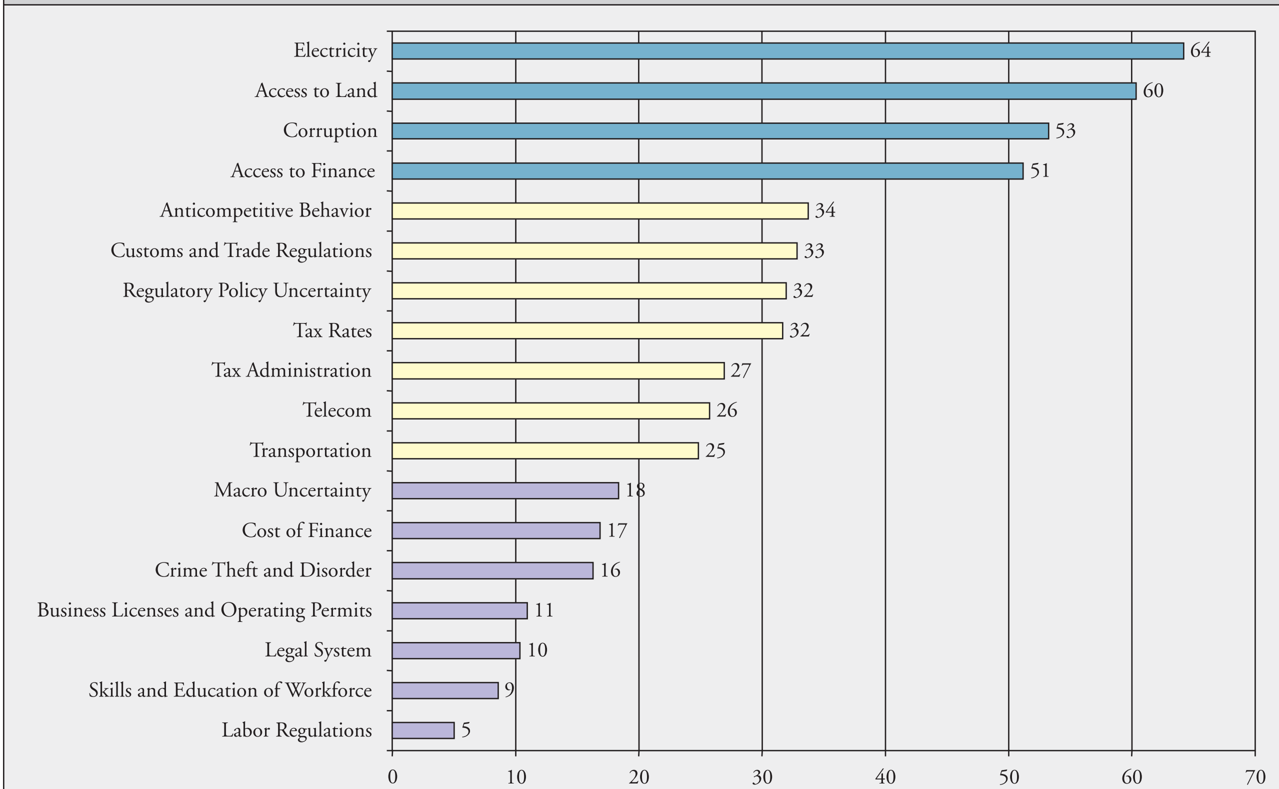


Figure B.2: Kabul: Percentage of Firms Citing Constraint as Major or Severe

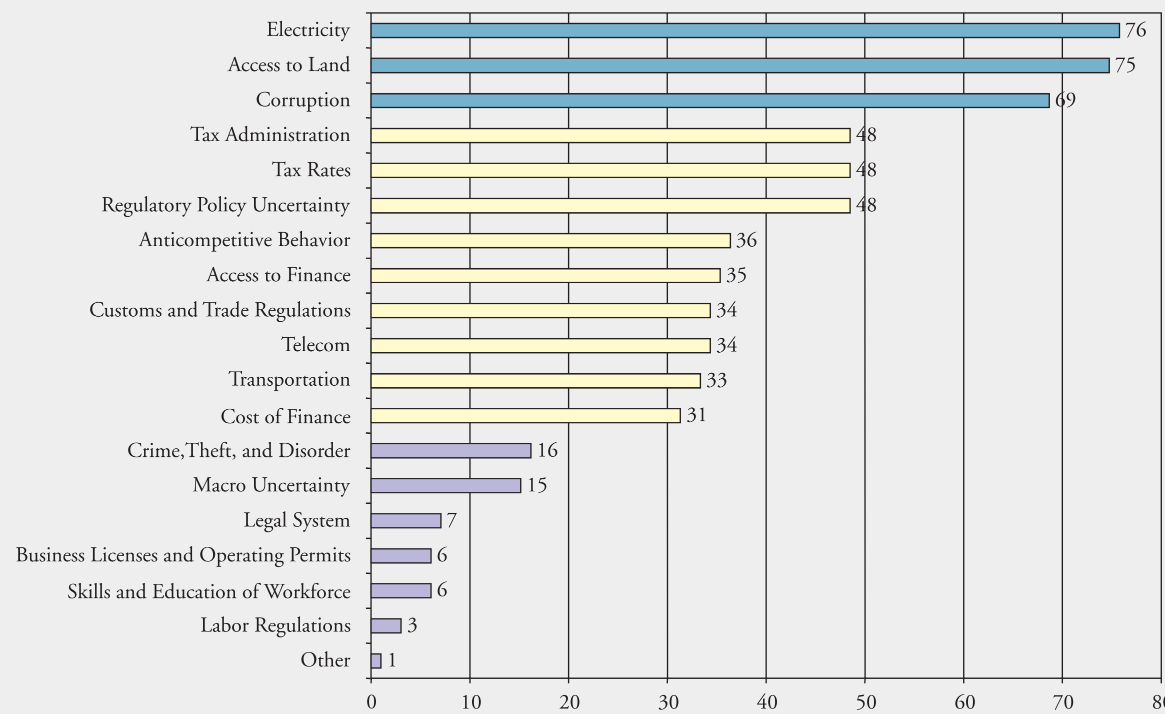


Figure B.3: Mazar-e-Sharif: Percentage of Firms Citing Constraint as Major or Severe

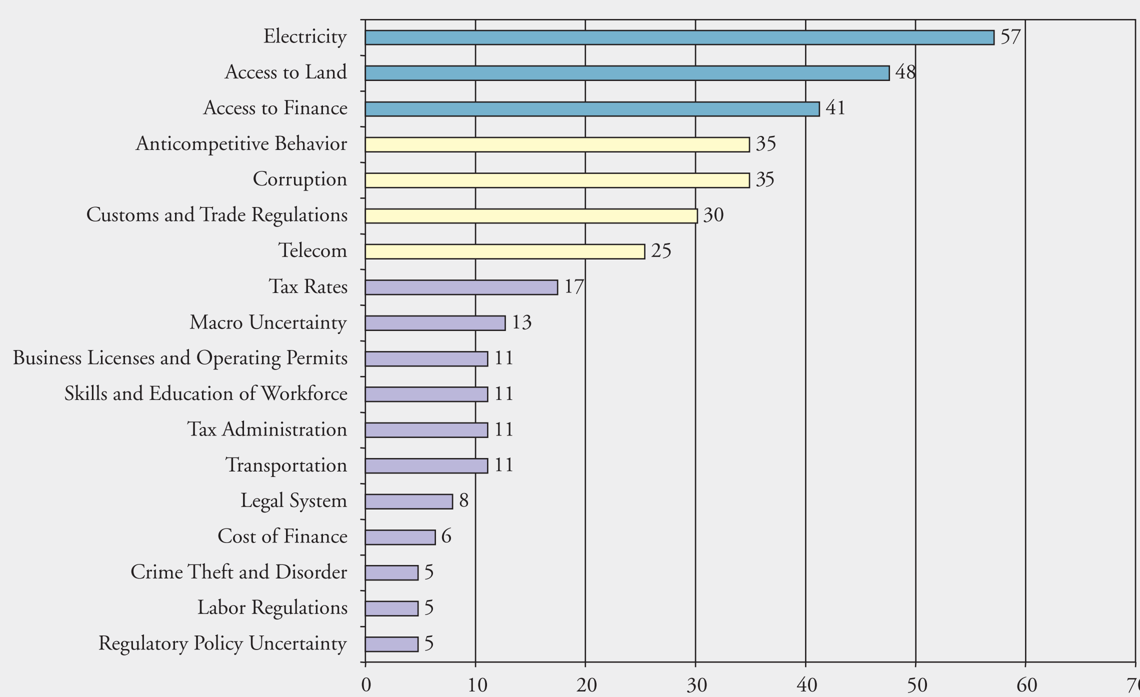


Figure B.4: Herat: Percentage of Firms Citing Constraint as Major or Severe

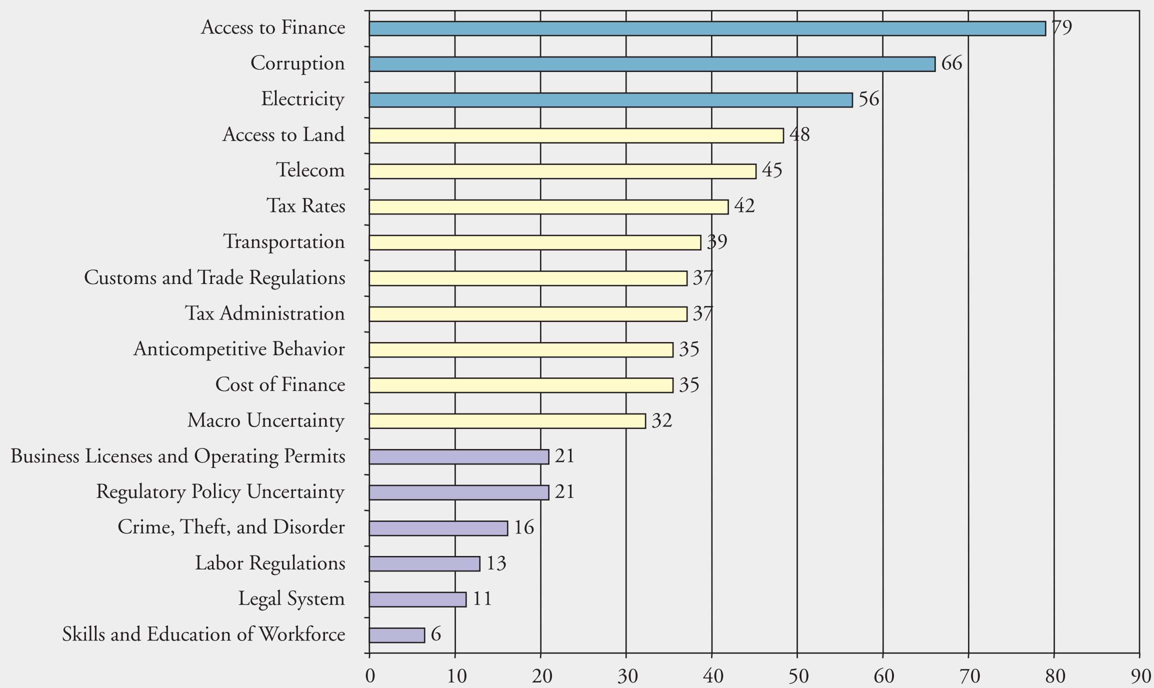


Figure B.5: Kandahar: Percentage of Firms Citing Constraint as Major or Severe

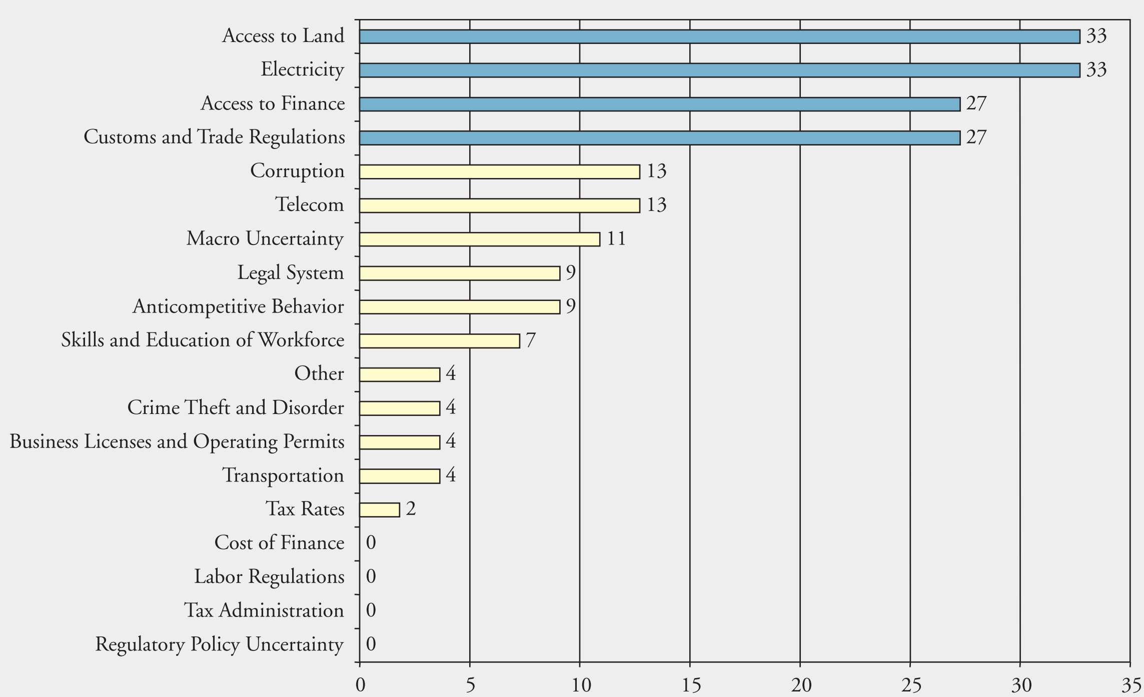
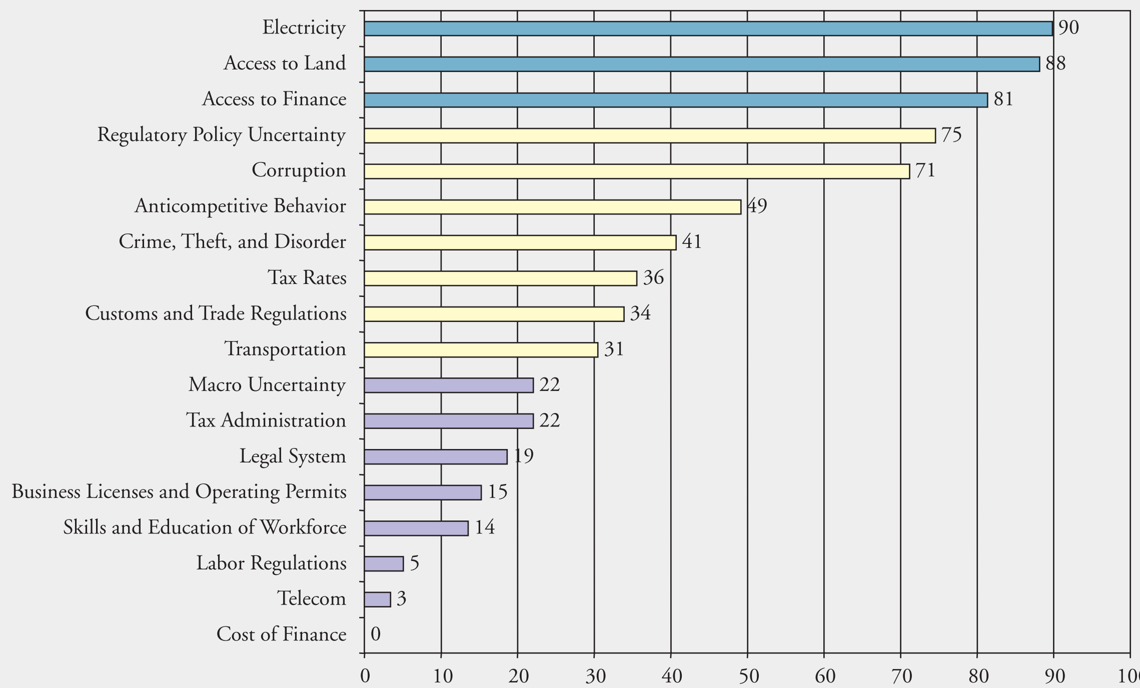


Figure B.6: Jalalabad: Percentage of Firms Citing Constraint as Major or Severe



ANNEX C:
Doing Business in Afghanistan

Afghanistan
Region: South Asia
Income category: Low income
Population: 23.9 million
GNI per capita (US$): 250

Ease of...	Economy rank	Best performer	Worst performer
Doing Business	122	New Zealand	Congo, Dem. Rep.
Starting a Business	16	Canada	Angola
Dealing with Licenses	..	Palau	Tanzania
Hiring and Firing	25	Palau	Burkina Faso
Registering Property	150	New Zealand	Nigeria
Getting Credit	153	United Kingdom	Cambodia
Protecting Investors	145	New Zealand	Afghanistan
Paying Taxes	7	Maldives	Belarus
Trading across Borders	128	Denmark	Iraq
Enforcing Contracts	93	Norway	Timor-Leste
Closing a Business	142	Japan	West Bank and Gaza

Starting a Business (2005)

The challenges of launching a business in Afghanistan are shown below. Entrepreneurs can expect to go through 1 step to launch a business over 7 days on average, at a cost equal to 52.8 percent of gross national income (GNI) per capita. No minimum deposit is required to obtain a business registration number.

Indicator	Afghanistan	Region	OECD
Procedures (number)	1	7	6
Time (days)	7	35	19
Cost (percentage of income per capita)	52.8	39.7	6.5
Min. capital (percentage of income per capita)	0.0	0.8	28.9

Hiring & Firing Workers (2005)

The difficulties that employers in Afghanistan face in hiring and firing workers are shown below. Each index assigns values between 0 and 100, with higher values representing more rigid regulations. The Rigidity of Employment Index is an average of the three indices. For Afghanistan, the overall index is 39.

Indicator	Afghanistan	Region	OECD
Difficulty of Hiring Index	67	37.6	29.5
Rigidity of Hours Index	20	35.0	50.0
Difficulty of Firing Index	30	42.5	27.3
Rigidity of Employment Index	39	38.5	35.7
Hiring cost (percentage of salary)	0	5.1	20.8
Firing costs (weeks of wages)	4.0	75.0	32.6

Registering Property (2005)

The ease with which businesses can secure rights to property is measured below. In Afghanistan, it takes 11 steps and 252 days to register property. The cost to register property there is 9.5 percent of overall property value.

Indicator	Afghanistan	Region	OECD
Procedures (number)	11	6	4
Time (days)	252	124	33
Cost (percentage of property value)	9.5	6.3	4.7

Getting Credit (2005)

Measures on credit information sharing and the legal rights of borrowers and lenders in Afghanistan are shown below. The Legal Rights Index ranges from 0 to 10, with higher scores indicating that those laws are better designed to expand access to credit. The Credit Information Index measures the scope, access, and quality of credit information available through public registries or private bureaus. It ranges from 0 to 6, with higher values indicating that more credit information is available from a public registry or private bureau.

Indicator	Afghanistan	Region	OECD
Legal Rights Index	0	3.8	6.3
Credit Information Index	0	1.8	5.0
Public registry coverage (percentage of adults)	0	0.1	7.8
Private bureau coverage (percentage of adults)	0	0.6	58.0

Protecting Investors (2005)

The indicators below describe three dimensions of investor protection: transparency of transactions (Extent of Disclosure Index), liability for self-dealing (Extent of Director Liability Index), shareholders' ability to sue officers and directors for misconduct (Ease of Shareholder Suits Index and Strength of Investor Protection Index). The indexes vary between 0 and 10, with higher values indicating greater disclosure, greater liability of directors, greater powers of shareholders to challenge the transaction, and better investor protection.

Indicator	Afghanistan	Region	OECD
Disclosure Index	0	4.1	6.0
Director Liability Index	0	4.6	5.3
Shareholder Suits Index	2	6.4	6.7
Investor Protection Index	0.7	5.0	6.0

Paying Taxes (2005)

The effective tax that a medium-size company in Afghanistan must pay or withhold within a year is shown below. Entrepreneurs there must make 2 payments, spend 80 hours, and pay 21.4 percent of gross profit in taxes.

Indicator	Afghanistan	Region	OECD
Payments (number)	2	25	16
Time (hours)	80	331	192
Total tax payable (percentage of gross profit)	21.4	35.3	46.1

Trading across Borders (2005)

The costs and procedures involved in importing and exporting a standardized shipment of goods in Afghanistan are detailed under this topic. Every official procedure involved is recorded, starting from the final contractual agreement between the two parties and ending with the delivery of the goods.

Indicator	Afghanistan	Region	OECD
Documents for export (number)	..	8	5
Signatures for export (number)	..	12	3
Time for export (days)	..	33	12
Documents for import (number)	10	12	6
Signatures for import (number)	57	24	3
Time for import (days)	97	46	14

Enforcing Contracts (2005)

The ease or difficulty of enforcing commercial contracts in Afghanistan is measured below. It takes 400 days to enforce contracts there. The cost of enforcing contracts is 24.0 percent of debt.

Indicator	Afghanistan	Region	OECD
Procedures (number)	..	29	19
Time (days)	400	385	232
Cost (percentage of debt)	24.0	36.7	10.9

Closing a Business (2005)

The time and cost required to resolve bankruptcies is shown below. The recovery rate, expressed in terms of how many cents on the dollar claimants recover from the insolvent firm, is 0.

Indicator	Afghanistan	Region	OECD
Time (years)	No practice	4.2	1.5
Cost (percentage of estate)	No practice	7.3	7.6
Recovery rate (cents on the dollar)	0.0	19.7	73.5

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Afghanistan has taken tremendous strides toward reestablishing itself as a politically and economically viable state. Since the fall of the Taliban regime in 2001, the government, with the support of the international community, has reestablished a number of political institutions and spearheaded economic reforms. A new constitution has been adopted, nationwide elections were held to select Afghanistan's first democratically elected president, and, in September 2005, a parliament was elected. The government has also taken a number of steps to foster private sector investment - particularly establishing the Afghanistan Investment Support Agency (AISA) with the mandate of promoting and facilitating investment. The AISA has helped streamline the business registration process to the extent that Afghanistan now ranks among the best countries in the World Bank's 2005 Doing Business indicators of firm registration. However, much more remains to be done, particularly removing informal barriers to new entry, improving infrastructure, and reducing uncertainty.

In a postconflict environment, attracting new foreign and domestic firms is central to private sector development. New decisions about investment (in existing or new firms) usually depend on the availability of five basic factors: political and economic stability and security; clear unambiguous regulations; reasonable tax rates that are equitably enforced; access to finance and infrastructure; and an appropriately skilled workforce. The challenges facing the government of Afghanistan in addressing these constraints and in turn attracting further foreign and domestic investment cannot be underestimated. But, as the experience of other reconstruction efforts shows, for example, in Bosnia and Herzegovina and East Timor, successful reform can be achieved

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