EXECUTIVE SUMMARY

The key finding of the survey is that strong private sector growth, albeit from a small base, is taking place in Afghanistan despite poor governance, weak factor markets, and a lack of innovation.

1. This report summarizes the findings of an enterprise survey conducted from September to November 2008, covering 1,066 firms in 10 Afghan cities. It complements an earlier survey of 338 firms in 2005. Both surveys used the standard World Bank enterprise survey methodology. This report presents the results of the 2008 survey, along with some comparisons with the 2005 survey and some international comparisons. The survey provides a good representation of firms operating in the major urban centers, but it does not cover rural firms, firms that tried to enter the market but failed, or firms that were operating but exited.

2. This work is part of a broader effort by the World Bank to understand growth and the prospects for growth in Afghanistan, and to stimulate dialogue on how to develop the levels of growth necessary to secure livelihoods and economic independence for the Afghan people. The report does not provide much in the way of recommendations; rather, it identifies the issues, summarizes the reform status, and, where action is required, identifies the next steps.

Growth from a Small Base

3. The survey begins by confirming many of the key characteristics of the private sector in Afghanistan. It is small, and it includes few foreign firms (less than 2% of the sample), few exporters (7% of the sample), and few firms owned by women (3% of the sample). In the past two years, the rate of new firm entry appears to be significantly lower than immediately after the fall of the Taliban in 2002. Nevertheless, the private sector is growing fast: national accounts data suggests that the industrial and service sector has doubled in size since 2005. Average revenue growth in the surveyed firms is very high—220 percent—because of some strong performers. The survey suggests that this rate of growth will continue, as 77 percent of the surveyed firms plan to expand in the near future.

Key Findings

4. Despite the growth, the survey identifies a number of significant constraints clustered around the issues of poor governance, weak factor markets, and lack of firm-level innovation. While the survey cannot explain this contradiction between growth and these weaknesses, it is possible that strong demand arising from increased aid flows and catch-up effects as the economy moves from command to market mode are contributing factors. The survey results suggest that firms are quietly resolving and managing the bewildering array of constraints they face. The question is, what would growth be like without these constraints?

5. Six constraints emerge as dominant in all our analyses—by sector, by firm size, and by region. These constraints are (1) weak policy enforcement; (2) poor provision of electricity; (3) crime, theft and disorder (4) corruption; (5) access to land; and (6) access to finance. These constraints are more or less the same as those found in the 2005 survey, with a marked deterioration in policy enforcement and security related to crime, theft, and disorder. While the constraints are broadly common, there are some interesting variations. For example, the single biggest constraint is different in each city. Governance issues dominate in the less secure areas of the country, while factor markets are more constraining in the more secure areas. Women-owned firms identify the constraints as worse in all cases. The survey proposes additional work to understand the underlying causes.

Poor Governance

6. The governance challenge has five main components: (1) policy enforcement; (2) crime, theft, and disorder; (3) corruption; (4) the court system; and (5) business licensing and permits. Perceptions have become more negative on all six components since 2005, except for corruption, which is perceived as near 2005 levels. The less affected firms below the radar screen are small and located in stable areas.

7. Policy enforcement is a dominating issue in the survey. It is hard to define accurately, but it has important productivity consequences, as firms that are constrained by it are 32 percent less productive than firms that are not. We have defined it as "state ineffectiveness in designing and implementing consistent policies." Only 14 percent of the surveyed firms reported consistency and predictability in the interpretation of laws. This point is critical, because it concerns an issue that firms cannot manage. They cannot control for unexpected changes in the rules of the game. While more work is required to fully understand the dimensions of this issue, it is clearly a major red flag for policymakers.

8. Crime, theft, and disorder have increased dramatically since the 2005 survey, with one in five firms reporting losses resulting from theft, robbery, arson, or vandalism. These firms are, on average, 63 percent less productive than firms that did not suffer such losses. Larger firms, retailers, exporters, and firms in Herat (where 90% of firms identified crime as a major constraint) are most affected. Firms have responded by paying for security and making protection payments.

9. The World Bank's 2009 *Doing Business* report shows that Afghanistan's business regulatory environment is quite weak (ranked 162nd out of 181 economies). This indicator is very important for entrepreneurs who are trying to enter the market; however, the survey did not cover this group. For this reason, this indicator emerges as one of the least constraining factors in the governance group, with just 23 percent of the sample seeing it as an issue. This can further be explained in part by the age of surveyed firms: most firms are well established by now and no longer have to face many of the regulatory burdens identified in this indicator.

10. In two instances, quantitative indicators identify a governance problem that is not confirmed by perception data. In the case of the courts, 84 percent of respondents say the court system is corrupt and unfair, while 19 percent consider this a major constraint to doing business. Corruption was rated as a problem by 44 percent of the respondents, and the survey shows that it touches virtually every aspect of a firm's dealing with government. Firms that are not able to manage corruption are 26 percent less productive.

Weak Factor Markets

11. Little apparent progress has been made on the key factor markets of serviced industrial land, capital, and labor since the last survey. This is unfortunate, as these factors directly affect firm productivity and firm entry into the market. For firms that want to grow, these issues are particularly constraining. When asked what their single biggest constraint was, access to formal finance was reported by 22 percent of the surveyed firms and access to land by 13 percent. In Kabul, 83 percent of firms that tried to acquire additional land in the past three years failed to do so.

12. Electric power is a hugely constraining factor, both on its own as a direct "tax" on productivity and combined with land as a fundamental barrier to entry. Firms report losing, on average, 9 percent of output because of power losses. Firms that have access to the grid are 49 percent more productive than those that do not. Generators provide 77 percent of electricity, which affects profitability. Other infrastructure sectors—such as telecommunications, transport, and water have also been identified as lower level constraints.

13. Modest improvement was reported in access to formal finance, but it remains a major constraining factor. Only a very small proportion of firms (5% of the sample) borrow from the formal financial sector, while 85 percent of all new investments are financed out of retained profits. Among the firms that do not seek formal credit are the 26 percent that report seeking Islamic financing. One area of improvement is the proportion of firms that have a bank account: 51 percent in 2008 compared with 30 percent in 2005.

14. Few firms identify lack of skills as a problem. Only 18 percent of respondent firms say they cannot get the skills they need, and only 20 percent identify this as a major constraint. Nevertheless, the lack of skilled workers is more of an issue now than it was in 2005, when only 3 percent of firms identified it as a major problem. This trend should be of concern to policymakers.

Lack of Innovation

15. A number of indicators identified lack of innovation as an emerging area for policymakers: 94 percent of surveyed firms do not use foreign licensed technology; 86 percent do not offer on-the-job training; 95 percent do not have internationally recognized quality certification; and 70 percent do not have internet connectivity. Research shows that firms that engage in innovative practices are significantly more productive and competitive. It is not surprising to find very few exporting firms in the sample.

Conclusions

16. The survey findings generally validate the government's current reform program, including efforts to improve governance and strengthen factor markets. Clearly, more efforts are needed in these areas, as the survey reports little measurable progress since 2005. Particular emphasis is required in the area of policy enforcement—it is crucial to ensure consistency in policy design and implementation to attract investment into Afghanistan.

17. The report also identifies a group of emerging issues that include the interlinked issues of competitiveness, innovation, and diversification. Despite strong growth, policymakers should be concerned about the lack of entry of new firms—especially foreign firms—and the lack of innovative behavior. These two factors indicate a lack of competitiveness and warrant further research. An undiversified manufacturing sector that is overwhelmingly (approximately 95%) linked to the agriculture and agro-processing sectors is also of concern.

18. The strong growth trend itself needs more evaluation. A country that has weak governance, poor factor markets, and firms that are not innovative is unlikely to achieve sustainable long-term growth.

19. The report discusses the issues noted above, summarizes the status of reforms, and suggests some next steps, including further analytic work on a number of topics, public private dialogue on certain issues, and stronger government reform efforts.

Introduction and Background

1.1 ***This report summarizes the findings of an enterprise survey that took place from September to November 2008.*** The report identifies some key issues, summarizes the reform status, and suggests next steps where action is required.[1] After the report is discussed with policymakers, a series of research questions will be identified that will be the subject of additional papers by the World Bank and its international partners. For example, a detailed financial sector assessment is planned to help answer questions about access to finance. After the additional reports and/or papers are completed, the World Bank will undertake a comprehensive economic review. This survey is expected to be an important input into all these research studies.

1.2 ***This survey report will help the government of Afghanistan think through its approach to private sector development.*** Historically, there has been a dearth of information and reliable statistics about Afghanistan's economy. This report reviews the constraints that firms currently operating in Afghanistan face and provides a basis for possible policy recommendations to address these constraints. It is hoped that the report will be a useful tool to support investment climate reforms and enhance the private sector dialogue in Afghanistan.

1.3 ***The 2005 Investment Climate Assessment (ICA) is an important point of comparison***. The World Bank prepared an Afghanistan ICA in December 2005; it was one of the first post-conflict ICAs and used enterprise survey data on 338 firms and other secondary sources to assess Afghanistan's investment climate.[2] The 2008 survey is a follow-up to the ICA, in keeping with the objectives of monitoring the progress in removing investment climate constraints, sustaining dialogue with the various stakeholders to stimulate policy reform, and

[1] It is important to distinguish this report from a full investment climate assessment (ICA), which is comprehensive and contains detailed economic perspectives and policy recommendations.

[2] *The Investment Climate in Afghanistan: Exploiting Opportunities in an Uncertain Environment* (2005).World Bank.