

AFGHANISTAN NEEDS PRO-PRIVATE SECTOR GROWTH

(William Byrd, Rough Draft, June 8, 2005)

Recent Economic Growth Performance and Issues

Afghanistan has achieved respectable economic recovery and growth during the past three years, with the real value of non-drug GDP increasing by 29% in 2002, 16% in 2003, and an estimated 8% in 2004 (despite a lower agricultural harvest in 2004). Economic growth in 2005 is forecast at a very healthy 14%, reflecting to a large extent excellent precipitation during the winter. Growth has raised incomes, provided jobs, and reduced poverty in many parts of the country. Agriculture has been a major driver of growth, reflecting better precipitation except in 2003/04; construction, trade, and other services also have been important, reflecting in large part demand from the reconstruction program and international presence (including military presence), as well as massive private construction (notably housing).

These drivers of non-agricultural growth, plus the opium poppy boom, have resulted in an uneven pattern of economic growth that has left many people out. Moreover **the sources of recent growth are to a large extent one-time or temporary in nature and are running into their limits.** (This includes agriculture, led by a resurgence of wheat production which is not the crop of Afghanistan's future because, among other issues like relatively low labor-intensity and its use of scarce water, there are no prospects for wheat exports.) Hence **the sources of recent growth will need to be replaced over time by more dynamic and sustainable growth drivers** (see World Bank, *Afghansitan—State Building, Sustaining Growth, and Reducing Poverty*, 2005, Chapters 1 and 3, for details).

Although private entrepreneurship (mostly on a very small scale) is evident throughout Afghanistan's economy, a striking feature of recent economic performance in Afghanistan has been **the slow progress in fostering the development of a strong, dynamic private sector that invests in Afghanistan's future** (including medium- and longer-term investments by sizable business enterprises) and itself becomes a source of dynamism. Symptoms of the weak linkages between recent growth in Afghanistan and robust private sector development include the following:

Growth has been highly import-intensive. In the past several years, estimated total imports of goods have been equivalent to more than 60% of non-drug GDP; in one year (2003/04) the figure reached 83%.¹ While perhaps understandable at the beginning, by now there should be more of a supply response from the domestic private sector to the high demand for goods and services from various sources. Trade regimes promoting import substitution have been rightly discredited by international experience, and

¹ Including the opium economy (which finances large amounts of imports) in GDP would result in a ratio of imports to total (drug-inclusive) GDP in the range of 40%, still very much on the high side. Viewed from another perspective, net imports have been equivalent to 45-50% of non-drug GDP in recent years. Estimates are from data in IMF reports.

moreover Afghanistan in any case cannot enforce high tariffs due to its very long and porous borders. However, it is striking that even very obvious opportunities for investments in local production to replace imports seem to be taken up very slowly if at all. Notable examples include bottled drinking water, various simple processed foods (consumed in large quantities by Afghans and expatriates), certain construction materials, and over a longer time horizon, goods like cement.

The production growth that has occurred (largely in agriculture) has been dominated by traditional products, notably wheat (as mentioned earlier). There is not yet much evidence of major growth in agro-based value-added activities, let alone agricultural exports except of relatively low-grade primary products. There are even reported cases of agricultural products being exported by Afghanistan to a neighboring country in raw form, undergoing simple but relatively high value-added processing there, and then being imported back into Afghanistan to meet consumer demand.

Some economic activities which have been relatively dynamic, like carpet production, have become detached from their domestic raw materials base and therefore have much more limited backward linkages than in the past. Due primarily to the drought in the late 1990s, Afghanistan's livestock herds (including notably sheep) have been decimated and have not yet fully recovered. In the meantime, and in particular because much carpet production occurred among Afghan refugees in Pakistan during the latter part of the conflict period, imported wool has become the dominant raw material in the Afghan carpet industry. Switching back at least in part to domestic wool should be possible and will result in a better product (the best wool from Afghanistan's mountain sheep is lustrous and far better-wearing than imported wool), and will stimulate demand for livestock products. How quickly this will occur, even in the case of such a traditional product, is however a question mark.

While the Afghan construction industry has responded to the reconstruction boom and has been an important source of growth, **sizable, formal-sector construction firms, with the capacity to progressively undertake larger and more complex projects and the ability to bid on international contracts, appear to have been slow to emerge.** There needs to be an evolution over time from small jobs and subcontracting to larger contracts and prime contracting. It would indeed be a tragedy if, after a decade-long construction boom, a dynamic and domestically competitive construction industry, with good prospects for achieving international competitiveness as well, does not emerge in Afghanistan.

In addition to being highly import-intensive in terms of goods, **Afghanistan's recent economic growth has been "import-intensive" in terms of labor imports.** Given the atrophy and destruction of Afghanistan's higher education system during the war, this is perhaps not surprising at the higher end of professional and managerial talent. But there is also anecdotal evidence of skilled labor coming in, notably in the construction industry, at relatively high wages, to take on various activities like carpentry, masonry, plumbing etc. While a flexible and fluid regional labor market is a great asset for Afghanistan and the region, and many Afghans work in unskilled or other

jobs in Pakistan, Iran, and elsewhere, many of the kinds of skills that are now being imported could be imparted to Afghans in a relatively short period of time through vocational training.

A final and very important symptom of the problem, as well as a causal factor in its own right, is **the “informality” of the Afghan economy.** (See World Bank, *ibid*, Chapter 1). Although data are lacking, it can be very roughly estimated that 80-90% of economic activity in Afghanistan is carried out by “informal” entities – defined basically as those which are not registered under the legal framework and do not pay official taxes. The informal economy is important in any country and especially in developing countries, and tends to be nimble and flexible in responding to short-term opportunities and in serving as a coping mechanism in the face of shocks. Thus the informal economy *per se* is not a problem. However, the lack of a substantial formal sector does seriously constrain longer-term growth prospects, as development of larger firms (which due to their visibility have to be in the formal sector), associated technological modernization, and robust export development (at least part of the value chain needs to be in and/or interact with the formal sector) are severely hindered.

Underlying Constraints on Private Sector Development

Behind these symptoms are some underlying factors whose relative importance is difficult to gauge and needs further analysis, but which certainly combine to constrain healthy private sector development. Many but not all of these factors fall under the overall rubric of the “informal economy” discussed above.

- **Insecurity** is clearly a significant factor – not solely or primarily the risk of outright conflict or destruction (although that remains in parts of the country), but especially the insecurity of contracts, lack of a legal framework, weak justice system, and vulnerability of private sector actors to extortion etc. The lack of a functioning commercial insurance system in Afghanistan may reinforce the adverse impact of insecurity on economic activities.
- Closely related to insecurity is **perceived uncertainty in the business environment.** Although at the broadest level Afghanistan’s development strategy and overall policy regime fully espouse the rhetoric of private sector-led growth, businesses face considerable uncertainties in their daily activities, for example over decisions on investment licenses (a relic from the period of Soviet occupation which should be abolished), tax laws and their application, availability of electric power and other infrastructural services, etc. It is very important in this regard that the Government minimize policy uncertainty faced by the private sector.
- **Access to land** is a very serious constraint faced by the private sector, including uncertainties about titling, availability of serviced land, etc. For many entrepreneurs, land appears to be a binding constraint on getting started.

- **Corruption and red tape** are rampant, particularly at municipal level but also in other spheres. The costs to the private sector in time required, administrative burden, and disruption to business activity are likely to be even more important than the monetary costs in many cases.
- More generally, and related to all of the above constraints, **the power of warlords and commanders is frequently used to extort resources from, distort, and often “capture” private sector activities.** These kinds of interactions, which reflect more generally the lack of rule of law and Government authority in many parts of the country, heavily burden the private sector, obstruct competition, and create further disincentives to private investment.
- **Limited sources of credit and financing**, particularly for slightly longer-term investments, are often cited as a serious constraint by businessmen. Only a few commercial banks are operating, many of which do not lend to private businesses at all, or only on a highly restricted basis.
- While the overall tax structure in Afghanistan is quite reasonable and probably the best in the region, there are **numerous small “nuisance” taxes** which put an administrative burden on private firms, drain significant resources from them, and are a source of corruption. As mentioned above, illicit levies imposed by many local and regional authorities further exacerbate the burden on the private sector.
- Some knowledgeable observers see a **traditional “trader mentality”** in the Afghan private sector, which leads the private sector to focus on short-term trading opportunities and not take advantage of profit opportunities to add value, including through manufacturing. How much this is a real constraint, or just a reflection of other underlying factors, is hard to judge. Certainly in the right environment (e.g. Dubai) Afghan entrepreneurs have thrived and are not shy about getting into manufacturing.
- Aside from any “cultural” issues, there may well be **interest groups who have no desire to see the development of value added production in Afghanistan.** The most likely candidates are trading and transport interests (including perhaps in Pakistan), as well as possibly to some extent export interests in neighboring countries.
- In some cases at least, it appears that the **lucrative opium poppy trade** has been such an attraction to private entrepreneurs that it has diverted their attention from legitimate business opportunities.
- With a strong balance of payments due to inflows from opium, aid, and remittances, Afghanistan shows symptoms of suffering from the so-called **“natural resource curse”** or **“Dutch Disease”**, type of syndrome, whereby these resource inflows result in an overvalued exchange rate, overly high wage rates, and high prices of

other non-tradables, which make (non-opium) exports uncompetitive and thereby retard productivity improvements and, over the medium term, growth.

- **Private sector capacity limitations** also constitute a significant constraint, closely related to the lack of relevant skills in the labor market. For example, many firms are unable to respond to tender advertisements, submit qualified bids, keep accounts, etc. Lack of business support services is another closely-related impediment to private sector activity.
- A final constraint is **lack and inefficiency of basic infrastructure**. For example, electricity is often an essential input for manufacturing; in the absence of a well-functioning power grid, alternative sources of power like small private generators can be prohibitively expensive, especially for smaller firms, discouraging such activities from starting up in the first place. At the other extreme, poor airport and civil aviation infrastructure may well discourage foreign investors from visiting or returning to Afghanistan, thus constituting a hindrance to foreign investment.

Toward Pro-Private Sector Growth

Afghanistan desperately needs sustained rapid economic growth, as advocated in the *Securing Afghanistan's Future* report. However, both for sustained growth itself to be achieved and in the interest of the country's longer-term development, economic growth must be "pro-private sector" in nature.

There is much concern among various stakeholders about the need for "pro-poor growth" and "equitable growth". The term "private sector-led growth" also is commonly used, intended to convey that the public sector cannot be the engine of growth and the private sector should play this role. All of these terms and concerns are legitimate and relevant, but more fundamental in the context of Afghanistan is the need for growth itself – in particular the pattern of demand and how it is transmitted to the private sector – to be highly supportive and encouraging to the Afghan private sector rather than leaving it out in important respects. If growth in Afghanistan does not become much more "pro-private sector" in its impact, neither will it be easy to sustain rapid growth nor will the dynamic private sector development, productivity growth, and improvements in competitiveness that are essential for Afghanistan's longer-term development materialize.

What does pro-private sector growth mean concretely? First, the **general environment for business** (the so-called "investment climate") must be reasonably adequate and should not constitute an overwhelming hindrance to private enterprise. In particular, it must facilitate rather than retard the normal competitive process by which some successful firms grow over time and a few of them become large companies, while others that are unsuccessful in market competition fall by the wayside. Firms must have adequate incentives to become "formal". At the same time, neither should the activities of small firms be inhibited by regulations and red tape (which tend to be a vehicle for corruption more than anything else). Having an appropriate, decently enforced legal framework is a critical ingredient in all this, but far from the only one.

A second key element is **the extent and quality of services available to the private sector**. These include notably financial services, basic infrastructure, and business support services, among others. Many of these services themselves should be provided by the private sector; thus their development directly contributes to private sector growth as well.

The above two elements are fairly standard and would be important in any country, although the issues related to them are felt particularly acutely in Afghanistan. The third element is to **pro-actively take advantage of the sizable demand associated with the reconstruction program**. A notable example is reconstruction contracts – ensuring that they draw in the Afghan private sector and that all possible measures are taken to encourage Afghan contractors to bid with a reasonable chance of success. Initially in the case of large, complex contracts, active subcontracting to Afghan firms can be encouraged. One neglected area (from the perspective of pro-private sector growth) is contracting by international military forces (Coalition and NATO/ISAF); these forces need to increasingly use transparent, competitive procurement procedures and encourage Afghan private sector firms to bid (at least at the subcontracting level if not for prime contracts) and provide construction and other services on a competitive basis with adequate quality control. Derived demand for goods required as inputs for construction is another very important example. It would be very disappointing if a decade of reconstruction does not result in a competitive cement industry in Afghanistan. Yet another important example is the goods and services demanded by the international community (military and civilian), ranging from food products to sanitation and other services.

A fourth element is to **actively pursue new and augmented sources of demand, most notably exports**. This is not a suggestion for an “industrial policy” but rather for a pro-active approach to supporting the Afghan private sector moving up the “value chain” and developing potential in exports. Effective pilot programs could play an important role in this regard.

Fifth, **human capital will be a crucial element of a pro-private sector growth strategy**. Development of professional and managerial skills will take time, but there is much scope for development of other skills and skills at a lower level, over a shorter time horizon. International experience provides numerous examples of unsuccessful vocational training programs so there is need for caution. A key lesson is that programs need to be designed and implemented around the demand, with strong (private sector) client participation.

Finally, it should be emphasized that **pro-private sector growth is fully consistent with pro-poor growth**. Given that Afghanistan’s economy is dominated by smaller concerns, and that most of the job creation as well as much of the economic dynamism in the country will have to be provided by small and medium-sized enterprises, there is no contradiction between the pro-private sector growth strategy put forward above and pro-poor growth.

Toward an Action Program in Support of Pro-Private Sector Growth

A number of different initiatives and efforts will be needed to get Afghanistan moving on a pro-private sector growth path. What is important however is not to get everything right and do all that is needed right away, but to inject a dynamic of urgency and change, and to accomplish some critical steps which will result in real improvements and open the way for further progress in the future, including in areas where it inevitably will take more time. Attention should be focused on a relatively small number of key actions where something can be done on a timely basis, to avoid dissipating scarce resources on too many initiatives, few or none of which fully succeed. A preliminary list of possible short-term actions is set forth below.

- **Put in place a pro-private sector legal framework:** There is a large backlog of more than 100 laws which have been drafted and agreed or at least basically agreed, but are log-jammed at the Ministry of Justice. Many of them relate directly or indirectly to promoting a pro-private sector business environment. Examples include, among others, the Mineral Law, Hydrocarbon Law, Law on Foreign and Domestic Private Investment, Procurement Law, and Business Organizations Law, as well as other laws that are of very high priority but relate to the private sector more indirectly, like the Public Finance and Expenditure Management Law. Getting the more important of these laws officially promulgated so that they are in place and effective is a critical, urgent priority. This has to be done in the next several months, before Parliament is formed – otherwise there are likely to be delays of a year and longer, with consequent damage to the pro-private sector growth agenda.
- **Get rid of “nuisance taxes”:** As mentioned earlier, there are numerous small taxes which have very low revenue yields and no impact at all except to enrich corrupt officials and exacerbate the administrative and financial burden on the private sector. These should be cleared out allowing the Government to focus on its main revenue sources (for which rates are reasonable), and removing a significant burden on the private sector. Similarly, stronger efforts need to be made to crack down on illicit levies collected by local and regional authorities outside the formal tax system.
- **Accelerated liquidation/privatization of state-owned enterprises:** While the theoretical and (based on international experience) empirical case against public ownership of manufacturing and other commercially-oriented activities is strong,² at least in some cases SOEs urgently need to be removed from the scene in order to promote pro-private sector growth. Some SOEs are actively hindering the robust development of private business. A notable example is the state-owned cotton ginning company in Helmand Province, which has been an obstacle both to cotton farmers and to private competitors in cotton ginning and trade.

² The Ministry of Finance has already classified SOEs into those that should be liquidated, those which should be privatized, and those which can continue under public ownership at least in the short run.

- **Pro-private sector procurement practices:** Dialogue should be initiated with international military force commands to encourage them to make maximum efforts to facilitate Afghan private sector participation in bidding and contracting (or sub-contracting, if prime contracting is not realistic), on a transparent, competitive basis. Similar efforts should be made in civilian reconstruction programs.
- **Building private sector capacity and developing business support services:** These are very important for most elements of a pro-private sector strategy, including not least because they enhance the ability of Afghan private firms to successfully participate in the reconstruction program. Some training programs can be organized quickly, but they need to be relevant to the private sector's needs and demand-driven.
- **Crash program to develop Industrial Parks:** An effective way to deal with shortages of infrastructure as well as concerns about land titling etc. is to develop Industrial Parks. These have to be under sound private sector management, and operated on an autonomous, cost-recovery basis that prevents their capture by local warlords or commanders or other corrupt interests. Some work on Industrial Parks has started, but this needs to be accelerated on an urgent basis as a top Government priority.
- **A role for pilot programs with demonstration/spillover effects:** Getting new or expanded business activities going on a pilot basis and demonstrating results to encourage broader private sector response should be a significant component of a pro-private sector growth strategy. This does not mean public sector leadership or dominance, or "picking winners", but rather catalytic encouragement of the private sector to engage in new/expanded activities on a pilot basis to demonstrate the potentials, benefits, and obstacles (which can then be addressed).
- **Developing value-added exports of agro-based goods:** This can build on work currently being done by the USAID funded RAMP and OTF programs, but it needs to be accelerated, with focus on all parts of the value chain including the far end (export markets). Pilot programs may be effective in this regard as noted above – by demonstrating results, they can encourage entry into agro-processing and agro-export activities by other entrepreneurs. Innovative approaches to break into export markets (including contractual arrangements with traders/wholesalers in the export markets, supported by necessary public investments (e.g in cold storage, power, logistics, quality control apparatus, etc.). More generally, development of metrology, standards, testing, and quality (MSTQ) infrastructure will be a critical ingredient for sustained export development.
- **Jump-starting financial support for the private sector:** Given that shortage of financing is widely cited as a serious constraint hindering private investment in Afghanistan, and the dearth of commercial bank financing available, innovative approaches can be explored to provide financing to encourage private investments and start-ups, in an incentive-compatible manner. Provision of matching grants to

support specified types of private sector investments (including those with strong spill-over/demonstration effects on other enterprises) is a good example. Consideration could also be given to providing start-up grants, combined with credit financing (e.g. through micro-finance institutions), to encourage new small-scale business activities and associated investments. Ensuring availability of commercial insurance also is a priority.

In conclusion, achieving pro-private sector growth on a sustained basis requires a combination of **unleashing the private sector** by means of pro-active efforts to improve the business environment and **supporting the private sector** through positive actions along the lines put forward above, carried out in a transparent and competitive manner that does not detract from private sector leadership and dominance in the economy.