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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.