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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.*