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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

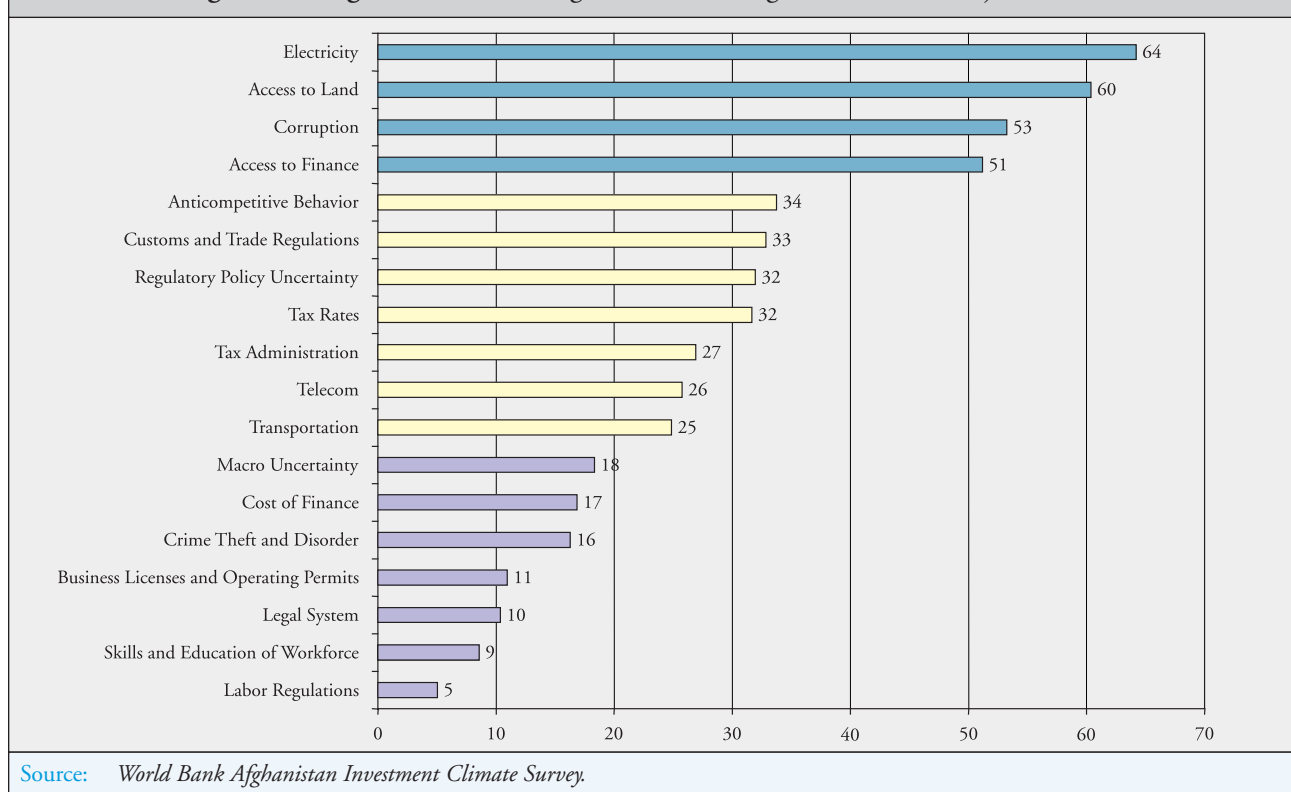
managers in other cities. In Mazar-e-Sharif anticompetitive practices is cited more often than it is elsewhere, which could reflect deeply entrenched local business interests that use their close ties to powerful political patrons to restrict competition. (See Annex B for charts on investment climate 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



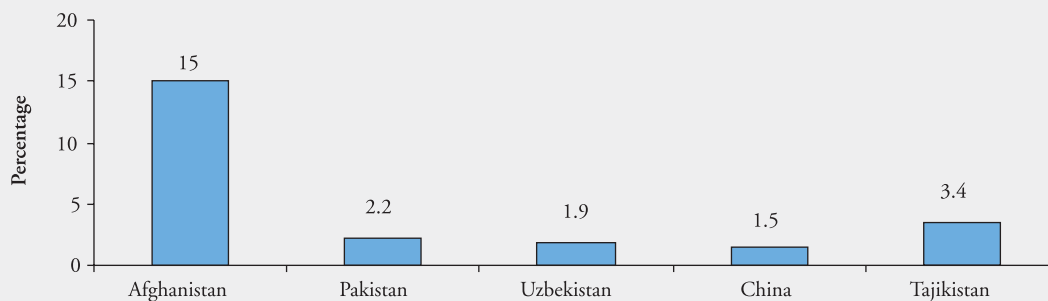
Afghanistan becoming a narco-state. Thus, it is counterintuitive that most managers in the ICS did not rank crime and disorder as a major or severe constraint. This paradox partly reflects the real improvements in security, especially in the major cities and in the north and west. However, it also reflects 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 Mazar-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

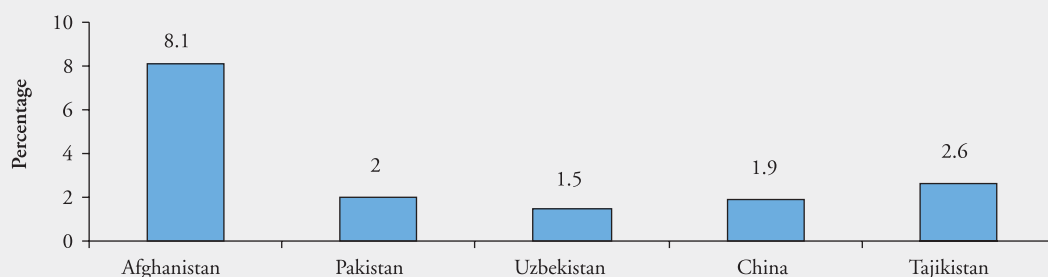
Corruption is endemic in Afghanistan and adds to the uncertainty facing businesspeople. It is especially threatening to foreign investors or Afghans returning from overseas who do not have powerful patrons or understand the system. In the 2005 Transparency International Corruption Index, Afghanistan 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 <i>hawaladar</i>	21
% of firms with some form of bank credit	.9
% of domestic firms that primarily pay by <i>hawala</i> transfer	10
% of domestic firms that primarily pay by bank transfer, check, or bank draft	11
% of exporting firms that primarily pay by <i>hawala</i> transfer	14
% of exporting firms that primarily pay by bank transfer, check, or bank draft	30
Average time to clear <i>hawala</i> transfer from domestic customer	28 days
Average time to clear a bank draft from domestic customer	7.3 days
Average time to clear <i>hawala</i> transfer from export customer	9.2 days
Average time to clear a bank draft from export customer	7.2 days
Source: <i>World Bank Investment Climate Surveys and World Bank/European Bank for Reconstruction and Development Business Environment and Enterprise Performance Surveys.</i>	

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

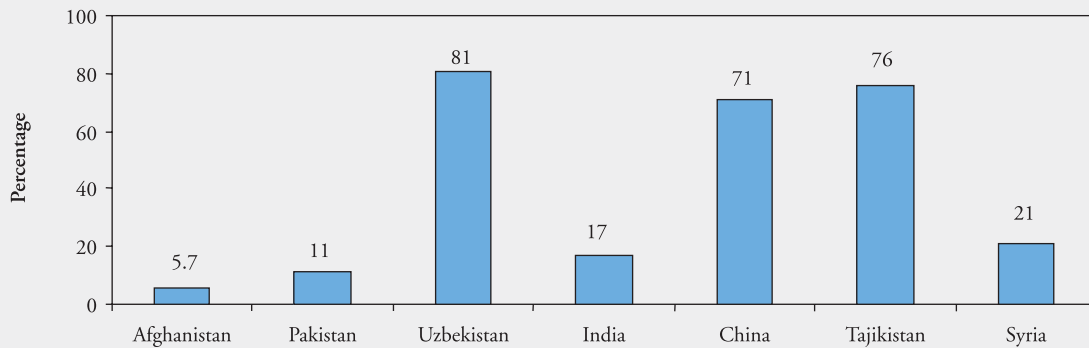
employees is exacerbated by the barriers to educating girls and employing women in most jobs outside of the home. Afghanistan is caught in a trap. The lack of opportunities discourages workers from improving their skills and education. But opportunities are lacking partly because investors do not want 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 harvesting 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

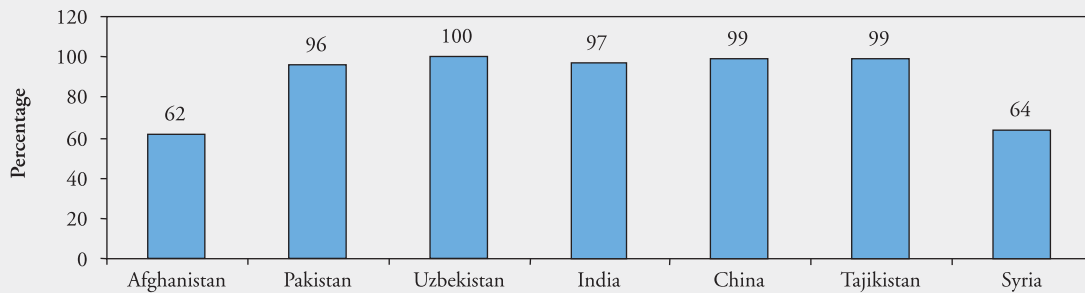
In addition to insecurity, poor land tenure, and corruption, the high level of uncertainty and risk facing investors in Afghanistan comes from the absence of a clear legal framework. Many of the basic laws that are necessary for the private sector to operate in confidence are missing and government actions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

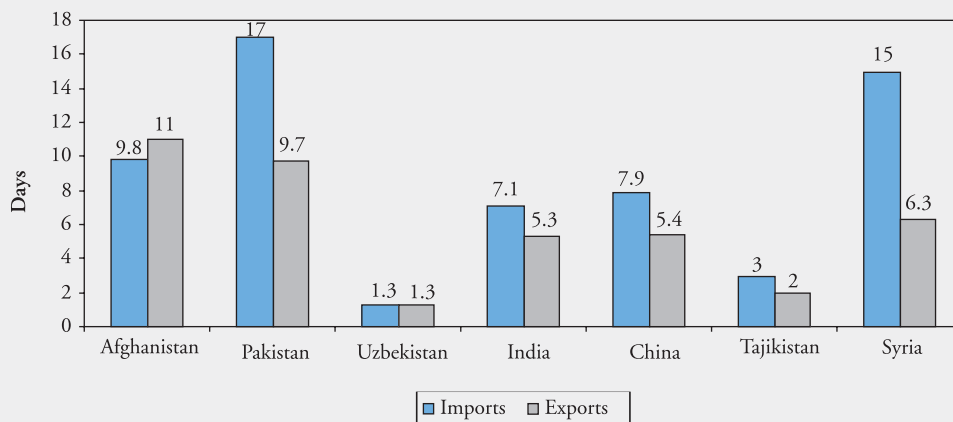
The government has made trade a cornerstone of its development strategy and the Ministry of Commerce has made WTO accession within the next five years a key goal. Ultimately it envisions Afghanistan becoming a land bridge between the rest of Central Asia and South Asia. In addition, the vast majority 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.