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Accelerating Private Investment: What needs to be done

Introduction

D*espite adverse conditions, the entrepreneurial spirit is alive in Afghanistan, investment opportunities are being exploited, and jobs are being created.* However, performance levels are still modest compared with the range of emerging opportunities. Much more needs to happen in the enterprise sector if it is to fulfill expectations and make a substantial contribution to job creation and improvement in the dismal human development indicators of Afghanistan. The challenges highlighted in chapter III—that the private sector is often oligopolistic, works through social and political networks, and is anticompetitive—need to be addressed. The key challenge is to broaden participation in the market by removing barriers to new entry and creating conditions that will encourage those already in the market to invest more.

The present investment climate challenges are not insurmountable. Many factors stand Afghanistan in good stead. A significant international effort to reconstruct Afghanistan is currently underway and increased rainfall from 2001 to 2003 has helped to alleviate the once dire agricultural situation. But most important, Afghanistan has a long entrepreneurial tradition of SME industries and services on which an active market-oriented private sector can be built.

Some of the actions required are outside the scope of any private sector development (PSD) agenda as conventionally

defined. There is a need for an overall political and security strategy that limits the power of those who have gained control of the markets through force of arms and illicit activities.¹⁶ This chapter focuses on actions that fall within the domain of PSD but that may address the paradigm of informality and provide entry points to break the vicious circle described in chapter III by weakening the nexus of informal relationships and extending the writ of formal arrangements. Some of these interventions, such as regulatory streamlining and improving the flow of information on PSD issues, will also support the anticorruption agenda. Four sets of actions are recommended. Together, these will increase incentives to invest (by reducing uncertainty and transactions costs) and improve capacity to carry out productive activities (by improving access to inputs, business services, and markets). There are many complementarities between these actions and some may affect both incentives and capacities.

- ♦ *Improve access to inputs.* Firms need factors of production, notably finance, land, skilled labor, and physical utilities and infrastructure including power, water, telecoms, roads, and ports. Improved access to such inputs is important to weaken the hold of informal arrangements that draw their strength to a large extent from control over such resources. Improved access will require an expansion in the supply of inputs and also a more transparent process of allocating them. Freeing up land currently locked up in nonviable SOEs, injecting money into the

¹⁶ Some interventions, such as those that help spread educational opportunities or help in the creation and accumulation of assets by poor people, indirectly promote security and a good political environment, albeit in the longer run.

banking system, and expanding the power-generating capacity are all examples of actions that increase the supply of inputs (land, finance, power). Though these actions will help, they may not substantially increase market participation and may largely benefit the well-connected incumbents if the allocation process is nontransparent and is subordinate to the informal arrangements described earlier.

- ◆ *Clarify and strengthen property rights* by creating a sound legal, judicial, and regulatory framework for investment. This framework is needed both for tangible property, such as land and equipment, and for intangible property, such as a license to operate or a permit to import raw materials. Strengthening property rights will require developing a sound legal framework and an effective judicial system that enforces decisions and helps resolve disputes so that recourse to informal means of dispute resolution is reduced.¹⁷ It is also important to make the regulatory system predictable, transparent, and simple in order to reduce the need to fall back on informal contacts to navigate the regulatory maze.¹⁸
- ◆ *Improve the flow of information.* Informal arrangements thrive when information flows are weak. When market players lack information—about market opportunities and trends, quality of products, availability of resources, and government policies and regulations—they become dependent on informal contacts and patrons both for information and because they do not know where else to go. Lack of information about government policies also increases uncertainty. Actions in this area will need to focus on increasing awareness of government policies, laws, and regulations, making the award of

public contracts transparent and competitive, building an effective MSTQ system, and regulating utility standards and credit bureaus. It is also important to develop private sector collective bodies, such as chambers and trade organizations, and mechanisms for effective public-private sector dialogue to gather feedback and disseminate knowledge about government policies.

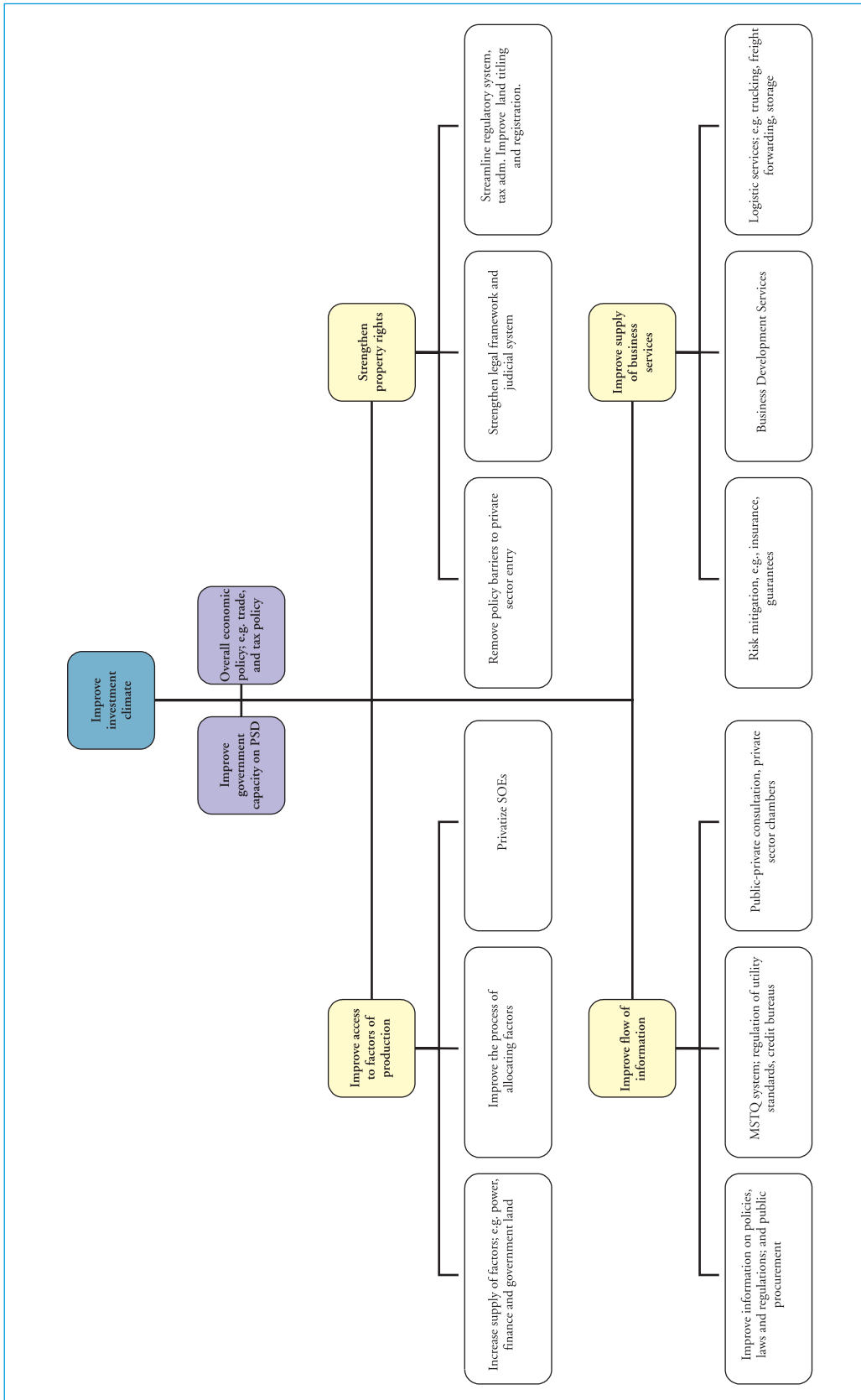
- ◆ *Improve the provision of business services.* Enterprises need a variety of business services to help them enter (e.g., help with preparing business plans and negotiating with creditors), operate and grow (e.g., trucking, freight forwarding, accounting, market information, quality assurance services, management services, and legal assistance), and manage risk (e.g., insurance). These services are best provided by the private sector but the government needs to put in place a policy and regulatory framework to facilitate private entry. There may also be scope for public-private partnerships to jump-start markets for services for which currently there are very few or no providers.

Underlying all the above efforts is the need to improve government capacity to analyze private sector issues and formulate and implement private sector development policies and programs. The overall economic policy of government, such as trade and tax policy, will also be relevant because it influences the broad incentive structure for private sector players.

Figure 4.1 describes in schematic form these broad categories of actions. The rest of the chapter provides detailed recommendations. For ease of exposition, these are organized in a different thematic format, but they will help further one or more of the objectives mentioned above.

¹⁷ The latter is particularly important in the current context where investors often fall back on the informal connections and relationships to help settle disputes.

¹⁸ The case studies reported in chapter III provide examples of permits being granted for limited periods and investors needing to go back to the authorities, including ministers, to get fresh permits. Reducing the need to interface with government officials is one way of weakening the hold of informal relationships because such relationships are often needed by businesspeople to intermedicate with government officials.



Legal framework for PSD

Currently, the legal framework for PSD in Afghanistan is characterized by gaps as well as lack of clarity. Progress in improving the legal environment for private investment has been limited since the fall of the Taliban. A Law on Domestic and Foreign Investment was gazetted in 2002. This law was followed by the enactment of the Central Bank and Commercial Banking laws in September 2003, paving the way for the issuance of prudential regulations in the months that followed. The legal agenda is broad and will take a number of years to be implemented. At this point, a number of laws are in draft stage and the priority areas are the revisions to the Law on Domestic and Foreign Investment and the enactment of a Business Organization Law, an insurance law, and a financial leasing law. Progress has also been made in introducing legislation indirectly related to the private sector (e.g., the Procurement Law).

The Ministry of Commerce has tried to push PSD-related legislation but has been handicapped by lack of capacity and technical understanding. The Ministry is now developing a program to help convert policy intentions into the relevant legal and regulatory framework. The program will include advocating legislative change in areas that do not fall within its domain. This overall program should be viewed as high priority. It will also be important to focus on building understanding and knowledge of the purpose, content, and implications of new legislation among the wider community of private sector development stakeholders, including the new elected parliament members. Specific legislative priorities are mentioned below.

Short-term priorities

- ◆ *The Law on Domestic and Foreign Investment.* The current law has a number of deficiencies and a revised version has been drafted, but enactment has been held up for several months.
- ◆ *Law of Business Organization.* The current law governing the formation of private companies

is archaic. A modern law that would help free business organizations from current constraints and encourage the use of the corporate entity has been drafted, reviewed by the private sector, and translated into Dari, the principal local language.

- ◆ *Insurance.* Current donor programs address political risk, but general liability, product liability, auto, fire, and other insurance are not available because of the lack of legal mechanisms to protect companies that want to provide such products. A new law is required to liberalize the sector and establish a new regulatory framework to supervise private insurance companies.
- ◆ *Financial Leasing.* This alternative to collateral financing has begun to fill in for the lack of any history of nonpossessory liens in Afghanistan. A legal framework for financial leasing is a higher priority than is secured lending law. Work on financial leasing has begun but needs to be speeded up.

Medium-term priorities

- ◆ *Secured Transactions Law.* Until the land tenure and registration system is improved, it will remain difficult to use land as collateral. A secured transaction law would enable enterprises to use a wider range of assets to secure loans. In many transition countries such as Albania and Romania, the introduction of secured transaction laws in conjunction with other reforms has increased firm-level access to credit.
- ◆ *Bankruptcy Law.* The proposed Business Organization Law contains liquidation provisions that provide for an orderly winding up of enterprises. However, a bankruptcy law will become important as the banking sector matures and starts demanding that its secured lending be accorded priority in the event of insolvency.

Access to land

The ICS revealed access to land as one of the most important, if not the most critical, constraints facing the private sector. The government needs to establish a clear legal framework that regularizes property rights. An enduring solution must consider and address how land had been acquired over the various periods of political upheaval. Policymakers should undergo a thorough analysis of the public sector institutions involved in the land ownership and registration process and eliminate redundancies and inconsistencies among the various institutions (both formal and informal). The government also needs to plan adequately for future land development.¹⁹

- ◆ *Land ownership.* Reducing the regulatory and bureaucratic complexity of the property ownership process is a key element to promoting effective property rights. Land-related legal reforms are complex and will be ineffective, or even counterproductive, if adequate work is not done in rebuilding the administration of deeds, and working out satisfactory dispute resolution mechanisms and a transparent means for enforcing judicial decisions.
- ◆ *Land registration.* Though land registration pilot projects have been proposed, their scale will need to be substantially increased to address urgent national needs. A significant commitment on the government's part will be required, which is critical for improving the investment climate in the country.

While work continues on establishing a functioning land tenure system, the establishment of industrial parks will loosen the land and infrastructure constraints faced by private investors. Industrial parks will also serve to reduce security-related costs discussed

in chapter III. By focusing infrastructure on a specific area, government will be able to service investor needs quickly, instead of forcing investors to wait for a general municipal infrastructure program that may or may not address their facility requirements. The government created an Industrial Parks Authority as a department within AISA and initiated work on an industrial park development program. Three industrial parks are currently being built, with plans for more.

An effective industrial park development program will require an appropriate policy and institutional framework. In particular, an independent, commercially oriented agency is needed to develop and maintain industrial parks with progressively greater involvement of the private sector.

- ◆ *Clarify institutional responsibilities in government.* In May 2004, the government relocated the industrial park planning department from the then-Ministry of Light Industry to the Ministry of Commerce. However, this decision has been recently reversed. Planning for future parks will reside in the Ministry of Mining and Light Industry (successor to the Ministry of Light Industry). The Ministry is not equipped to implement an effective industrial parks program and giving responsibility to a ministry, rather than an independent, commercially oriented agency, is inconsistent with global good practice. This responsibility should be given either to a separate Industrial Parks Development Authority or to AISA with a dedicated industrial parks department, as is currently the case. The agency should be given adequate authority and legal basis, and be adequately staffed with the right expertise. The role of other government agencies, such as the Ministry of Housing and Urban Development and the municipalities in this area, needs to be clarified.

¹⁹ The last land development plan for Afghan cities was prepared in 1978.

- ◆ *Enhance the role of the private sector.* The private sector can get involved early on in the management of the industrial parks. There is also scope for early private sector involvement in the development of some parks; in any case, the medium-to-long-term goal should be to have most, if not all, industrial parks developed and maintained by the private sector. In brief, public investment should be used to enable private investment, not to supplant it. Focusing public funds on off-site infrastructure provision for industrial parks conserves scarce infrastructure resources and allows proactive urban planning. The public sector should decouple the promotion and regulation functions of industrial estates, to avoid conflicts of interest and risk failure on both fronts.
- ◆ *Operate the industrial parks on commercial principles.* Parks developed in the public sector now should be run on commercial lines so that they can be privatized in future. In light of the scarcity of land and difficulty of obtaining clean titled land, the case for providing serviced land at highly subsidized rates is weak.²⁰ Charging prices at, or close to, market rates will not only help meet the land and construction costs, but may also generate surplus to pay for future industrial parks development activities. Currently, the pricing does not correspond with the costs of developing the parks.

Infrastructure

Poor infrastructure is one of the two leading constraints reported by the Afghan private sector, with access to land being the other. Establishing efficient infrastructure services after years of conflict requires not only massive investment but also reforms in policies, regulations, and

institutions. Along with building new infrastructure, it is also important to develop systems for operation and maintenance. With public resources limited, opportunities for private provision of infrastructural services need to be exploited.

Afghanistan inherited a highly centralized model of government service delivery in the infrastructure sector and with the exception of mobile telephony, which the private sector has entered in a big way, the main utility providers are likely to remain in the public sector for the foreseeable future. However, they may increasingly be run on commercial principles based on accountability for performance, cost recovery, and sustainable operations. There is considerable scope for corporatizing state-owned firms and private sector provision of infrastructure.

Improving public sector provision of infrastructure

- ◆ **Power Sector Development:** Government needs to further clarify its vision of the power sector, including its strategy regarding tariffs, investments, and private sector participation. There is an urgent need to corporatize DABM; strengthen its managerial, technical, and financial capacity; and restructure it in the form of regional business units. This needs to be accompanied by a new board of directors and commercially oriented managers, building capacity, a more businesslike corporate culture, better commercial cash management and pricing practices, and improved billing and collection, including through computerization. In the medium term, the government should embark on a relatively ambitious power tariff reform program as the quality of power supply is improved and the network is expanded and develop a rural energy strategy to bring electricity to rural areas.

²⁰ For the Bagrami industrial park being constructed near Kabul, the demand for industrial plots was oversubscribed by more than 200 percent. Excess demand is an indication that land prices were fixed at substantially below-market rates.

- ◆ *Transport:* The foremost challenge in the transport sector is to rehabilitate the primary road network and key airports to accommodate increasing traffic volume and promote trade. Inadequate transport facilities are a major impediment to exports and increase the costs of all products. Improvements in the transport system have been the top priority for the government during the past three and a half years. The Ministry of Public Works, which is responsible for the national highway system, needs to build technical and managerial capacity in order to oversee and coordinate the major donor-funded road investment program underway, and to prepare and evaluate bankable major road projects for future investments. The financing of recurrent costs of the road sector is far from adequate, and funding mechanisms for cost recovery need to be developed.
- ◆ *Telecommunications:* A priority in the telecommunication sector is to further improve the regulatory framework in the sector to open it to greater competition and strengthen the regulator, the Telecommunications Regulatory Board (TRB, to be renamed the Telecommunications Regulatory Authority of Afghanistan after the Telecommunications Law is passed). Substantial assistance will be required to further develop TRB's capacity to develop policies and implement them. Furthermore, the newly corporatized Afghan Tel needs to be strengthened. The Ministry of Communications has drafted two new laws, a telecommunications law and a separate law covering the corporatization of Afghan Tel. These laws need to be enacted and gazetted.

Encouraging private entry into infrastructure

The public sector will be unable to provide all the infrastructural needs of the private sector. This is

particularly true in the power sector, where large parts of the country will not have access to the grid for many more years to come. The private sector should be encouraged to provide services, particularly where public services are absent. Small local providers of power would be more efficient than each enterprise having its own generator. This is already happening in a small way. Nearly 5 percent of the ICS sample sells excess power from their generators. To expand private provision of infrastructure services an internal World Bank paper argues that the government should undertake a number of actions:

- ◆ *Removing policy barriers to private sector entry.* The government should clearly articulate, for all sectors, its position on the role of the private sector in delivering infrastructure services. Where the government is committed to encourage private entry, it is necessary to identify specific policy barriers that may impede private entry in practice despite overall government commitment. The government's reluctance to give up its interests in public transport is a good example of where the public provision of services could potentially damage the growth of the private sector through unfair competition. Specific examples of actions that can be taken in the power sector include (a) amending legislation and regulations largely dating from the period of Soviet occupation that for obvious reasons do not envision private sector participation in the economy; (b) allowing captive generation under all circumstances in which business activities are allowed; (c) allowing business-to-business sales of surplus production from captive generation; (d) explicitly allowing private generation and distribution to commercial and industrial consumers; and (e) adopting and proclaiming a policy of light-handed regulation for such circumstances-including for rural and peri-urban electrification.²¹

²¹ One approach could be to totally deregulate projects below a certain size (e.g., all hydro at 10MW or less). Above this threshold, regulatory requirements should be minimal and benchmarks established (e.g., issuance of license to generate within 10 days).

- ◆ *Regulation of standards.* The government should provide clear standards for the provision of infrastructure. For example, water quality and performance standards are very important if private sector provision of water is to be adopted. However, it is important to ensure that regulations are enforced in a hassle-free manner.
- ◆ *Regulation of tariffs.* In the power sector, for example, a key risk to private sector, particularly in the distribution business, is the risk that the government will not allow tariffs to rise to a level that covers costs. The experience in Afghanistan suggests that people are willing to pay higher tariffs for a reliable electricity supply. Tariffs should therefore be raised to a cost-reflective level as soon as possible. Similarly, if the private sector is to be involved in the operation of the public sector water systems, charges must be collected to cover the operations and maintenance costs, which means that tariffs will have to rise and bills collected.
- ◆ *Risk mitigation.* A number of risks are inherent in private investment in infrastructure and utilities, more in some activities than others.²² This would require risk mitigation arrangements such as political risk insurance and financing mechanisms to reduce the risk of nonpayment of revenues.²³ Operators may require political support for revenue collection, including disconnection as well as some form of protection against foreign exchange risk.
- ◆ *Aligning contracting procedures with private sector capacity.* As mentioned above, poor capacity

of local private firms, especially in dealing with contracting procedures, is a particularly important issue in the road construction sector but also of relevance to other sectors such as water and sanitation. A concerted and coordinated effort by the government and donors to create opportunities for Afghan contractors will help. This effort would include, for example, (a) an agreed-upon, common set of principles for encouraging Afghan companies; (b) ensuring the donor procedures for these contracts are at least consistent with each other; (c) common standards for quality supervision and slower supervisions of works; (d) common short-lists, and sharing of information on prequalification of companies and references; (e) a common approach to the provision of direct technical assistance to construction companies; and (f) ensuring that small-scale tender documents are written in the local language, where possible.

Access to finance

Despite recent advances in the financial sector system, Afghan firms have almost no access to external sources of credit from formal sources. Expanding formal credit faces many challenges, some of which are as follows: (i) the legal and regulatory environment remains weak beyond the banking sector, (ii) DAB still remains behind basic standards of modern central banking, (iii) little progress has been made with regard to the three publicly owned commercial banks that have been relicensed (These banks have rural bank branches that could be used to deliver formal credit to rural communities.), and (iv) the financial system needs to be expanded to the rural economy.

²² For example, private investment in electricity infrastructure may be discouraged by the following risks: (a) investments generally have long payback periods; (b) the majority of the investments are in fixed assets, which are difficult or impossible to move and often have low resale value; and (c) revenues are often paid by government or government-owned parastatals.

²³ An alternative approach is to encourage small-scale projects that may have higher rates of return and shorter payback periods. Generation projects may also be more attractive to private investors if they also own the distribution network and collect revenues, which allow investors to limit the political risk of nonpayment.

In considering the feasible options for providing immediate and long-term finance to entrepreneurs, the following working principles are especially important for Afghanistan:

- ◆ That no single solution is capable of addressing the present and future finance needs. All options—commercial banks, input dealers, microfinance institutions, leasing companies, informal lenders, cooperatives, and state banks—are complementary rather than exclusive choices.
- ◆ That both the short- and long-term options must be developed as part of an overall strategy to strengthen the financial system, including (1) improving the legal regulatory and enforcement environment for lending and (2) maintaining a level playing field in the financial sector and supporting a competitive environment.
- ◆ That private-sector-led reforms work best. Subsidies for specialized banks distort the market interest rates. Lessons learned around the globe indicate the restructuring of agricultural development banks to be costly, unsustainable, and largely unsuccessful.

In applying the principles stated above, it is recommended that the government focus on three principal objectives: (1) improving the institutional mechanism for delivering credit, (2) improving access to financial services for SMEs and rural communities, and (3) broadening and deepening the financial sector.

Improving the institutional mechanisms for delivering credit

Institutionally, the following short-, medium-, and longer-term interventions are recommended.

In the short term, it is recommended that the government focus on initiatives that help increase access to finance, in particular creating the policy, legal, and regulatory framework that encourages private financial

intermediaries to expand credit. Examples include the following:

- ◆ *Dealer credit:* In the short term, dealer credit to entrepreneurs may work best for short-term credit, primarily to finance primary inputs for basic farming or manufacturing. Dealer credit programs often require the active participation of formal financial institutions lending to importers and other formal dealers who would lend to retailers and then to farmers or other nonfarm producers. Lending could be on terms that recognize the lack of collateral at the firm level. The government could play a role in bringing together the commercial banks and the input dealers to work out a system of larger credit flows to entrepreneurs. Aggressive dealer financial management training would be required to pursue this option. To start with, the dealers would likely focus on medium- to large-scale entrepreneurs; smaller firms would probably have to rely on microfinance.
- ◆ *Microfinance:* Microfinance is desirable in the context of rapid entrepreneurial growth among small-scale enterprises that lack collateral. To scale-up current microfinance finance operations, microfinance institutions (MFIs) require further technical assistance to strengthen their operations (e.g., management information systems, new product development, business planning, financial analysis, internal control). MFIs will also need to develop strategies to reduce their dependency on donor funds, such as developing partnerships with larger financial institutions to fund the growth of their microfinance portfolio. MFIs will also need to develop innovative strategies to address the needs of the rural sector (such as agricultural lending and offering financial services in low population density areas).
- ◆ *Strategic partnerships:* Commercial banks initially do not want to provide resources

directly to small- and medium-scale enterprises, especially those in rural areas. But the work to encourage enterprise lending by banks needs to start now. Strategic alliances between banks and nonbank financial institutions, such as MFIs, with closer links with firms are worthy options to explore. The private commercial banks have the resources, skills, and capacity to finance long-term agricultural development.

In the medium to long term, it is recommended that efforts be made to increase the capacity of formal financial institutions with sizeable branch networks to provide credit. Options include:

- ♦ *Integration with traditional systems:* Traditional credit providers, such as hawalas, with their extensive informal networks can play a role in Afghanistan. Unfortunately, at present integration of the traditional credit providers into formal national and global financial markets is modest. More effort is required to gain full value of the wealth of information that these traditional systems hold; and also, more competition is required to ensure that interest rates are appropriate for agricultural purposes.
- ♦ *Rehabilitation of State-owned banks:* A promising medium-to-long-term option is to restructure Bank Mille and Pashtany Tejaraty Bank. With strong political will, support from DAB, and an independent management company, a new, modern financial institution could be created out of these two banks. In the longer term, this bank should be put into private hands and a timetable for privatization should be part of the plan. Experience has shown that to be successful, privatization requires improvements in the financial sector

infrastructure and the regulatory environment along with enduring political support. The decision to privatize a bank should therefore be part of a broader policy plan to privatize the financial sector and should be implemented in a systematic and sequenced manner.

- ♦ *Credit Bureau:* Another medium-term goal would be to create a private sector credit bureau. The lack of information on borrowers and the difficulty in enforcing agreements are the main impediments to increasing credit from formal institutions. Experience in a number of countries has shown that credit bureaus that provide information on the credit worthiness of borrowers help increase the availability of bank credit. In some countries, efforts to establish credit bureaus have been thwarted by banks and other lenders who see such information as proprietary and a source of their competitive advantage. Establishing a credit bureau in Afghanistan now, when banks welcome it, would increase available credit and eliminate the chance that established interests would prevent its establishment in the future.

Improving access to financial services for SMEs and for rural communities

The old model of directed lending to SMEs and to rural communities through publicly owned and managed development-finance institutions or specialized banks has become redundant and outdated. Universal experience shows that a strong, market-based, competitive financial system comprising banks as well as capital markets serves these needs in a much more efficient and cost-effective manner.²⁴ At the same time, market failure, particularly in postconflict countries, justifies public policy intervention on behalf of underserved SMEs and rural communities.

²⁴ Provision of funds through directed and subsidized credits by development-finance institutions contributed to the current state of the financial sector in Afghanistan.

Bringing the commercial financial system closer to rural customers will require improving the business environment and regulatory framework to facilitate rural finance operations and increase the perceived creditworthiness of clients; using technology to lower transaction costs and improve transfer mechanisms; introducing new products and risk-reduction techniques; and encouraging the use of agency arrangements to leverage scarce or expensive infrastructure and to create flexibility and mobility in service provision.

One option for increasing the availability of finance to small enterprises would be to develop "downscaling" programs with interested commercial banks (i.e., to support these banks to develop small-business lending operations). Considering the size of the informal economy and the current weakness of the financial sector, Afghanistan represents an ideal ground for such downscaling operation. The downscaling model was successfully undertaken by the European Bank for Reconstruction and Development in the former Soviet Union and in the Balkans, and in countries such as Russia, Kosovo, Georgia, and Tajikistan. Support to commercial banks to downscale usually includes a technical assistance component (to train the bank on how to lend to small businesses: development of new credit procedures, training of loan officers, strengthening of management information system, development of incentive system for loan officers, marketing, etc.) as well as a credit line when liquidity is an issue.

Broadening and deepening the financial sector

Achieving the high rates of growth necessary to reduce poverty significantly will require increased mobilization of domestic and foreign savings to support higher rates of private sector investment. Mobilizing savings implies a broadening and deepening of financial markets, institutions, and products, particularly long-term project finance. It also means supporting the creation of banks and nonbank financial institutions offering a range of products and services that compete with or complement those traditionally provided by banks.

Though the banking sector is likely to remain the largest component of the financial system for some time, there is also a need to develop complementary nonbank financial institutions, such as leasing companies, commercial credit companies, credit unions, factoring companies, insurance companies, a credit bureau, and pension and provident funds, and, in the longer term, to develop debt and equity markets. The establishment of a broad range of instruments into which savers can deposit their funds and through which companies and consumers can obtain access to capital and credit will spur the overall development of the economy.

- ◆ To enhance competition and make the intermediary role of the banks and nonbanks more efficient, DAB should maintain a competitive banking policy. Conventional means of enhancing competition within banking systems—such as bank privatization and changes in laws and regulations affecting companies, banks, foreign ownership, and bankruptcy—should constitute the basis of such a policy.
- ◆ Authorities must create an environment, through regulation, to prevent collusive behavior among banks and conglomerate relationships between banks and nonbank financial institutions. Therefore, the present ownership structure of the two state banks to be relicensed should be gradually changed through their privatization and through the entry of reputable new private banks and financial institutions. To ensure continuing effective competition, DAB should permit new banks to be set up only by qualified, professional, and experienced parties.

In the long run, financial sector reforms should produce the following outcomes:

- ◆ Only self-sustaining and commercially viable financial institutions that do not depend on the

government's support for resource mobilization or pricing should be allowed to operate in the market. The government should channel resources to priority sectors or subsectors in cases of market failure, for reasons of equity, or to achieve social objectives, but such allocations should be explicit budgetary costs and not subsidized through a tax on financial intermediation.

- ◆ The government's role should be confined to creating a regulatory environment and an incentive regime that will draw investors and savers to financial institutions. Where government participation in equity becomes necessary, it should be done without involvement in management.

State-owned enterprise reform and privatization

More than 75 enterprises in Afghanistan are classified as SOEs, with about 18,000 employees, limited liabilities, and assets largely in the form of land. In addition, the government has a stake in other firms that are not defined as SOEs under Afghan law. A prominent example of this is Ariana Airlines. Unlike in many other developing countries, Afghan SOEs do not impose a significant burden on the budget and are not major claimants on bank credit. This is because most SOEs are either not functioning or operating at very low levels of capacity utilization, and the government so far has been reasonably successful in imposing a hard budget constraint on them. Hence, Afghan SOEs do not have a significant crowding-out effect on the private sector as their counterparts do in many countries. However, in some cases, such as in cotton-ginning, SOEs have tried to stop private enterprises from operating, and risk remains that other SOEs may indulge in similar behavior.

Moreover, a substantial amount of assets, notably land, is locked up in these enterprises. Several SOEs are nonviable and should be liquidated. Even the potentially viable ones that could be privatized may have more land than they need. Unlocking these assets through liquidation and privatization will help loosen one of the most important constraints faced by private investors, that is, access to land, although it is not a substitute for the broader and urgent land-related reforms discussed earlier. Privatizing the SOEs would also provide an entry point for new investors, where the land assets are not in dispute and there are no entrenched monopolies.

There has been some progress in laying the ground for privatization. The government has carried out a preliminary classification exercise, based on a survey of SOEs, categorizing SOEs into those to be privatized, liquidated, or retained under public ownership. However, the preparations for a privatization program are moving slowly. So far, only two enterprises have been privatized.²⁵

To speed privatization and to put SOEs' assets to productive use in the private sector, the government among other things should undertake the following steps:

- ◆ *Adopt a privatization policy.* The government has recently adopted a formal privatization policy. It will need to be supplemented by detailed implementation guidelines that spell out the modalities of privatization and specify where in government lies the authority for initiating and implementing privatization. The SOE Law has provisions to liquidate or privatize SOEs that do not meet financial targets. However, in actuality privatizing an SOE requires agreement by the line ministry that owns it. For many ministries the income or potential income from the assets owned by the

²⁵ These are two ginning and pressing mills that have been given out on 31-year leases (with option to buy) to a French company.

SOE is seen as an important funding source for the ministry. Thus, obtaining agreement to privatize is difficult.

- ◆ *Develop an institutional framework for privatization.* Develop adequate institutional capacity to implement a privatization and liquidation program. No separate agency, such as a privatization commission or board, is entrusted with carrying out privatization. The SOE department in the Ministry of Finance is currently carrying out some preparatory work and it relies almost exclusively on external advisors.²⁶ However, the role of the Finance Ministry vis-à-vis other ministries in initiating and implementing privatization is still unclear despite the adoption of the privatization policy and the amendments to the SOE law. The government needs to clarify the institutional responsibilities and put in place an adequate institutional framework for carrying out privatization.
- ◆ *Adopt a mechanism for allocating surplus SOE land.* Articulate a clear policy and legal framework for ensuring that the freed-up land is made available for private investors. This may require consolidating ownership of such land, currently diffused across several ministries and government agencies, in a single authority with clearly laid-down procedures for its disposal.
- ◆ *Create a strong legal basis for privatization.* The SOE law, which has recently been amended to facilitate privatization, should be gazetted. The previous version of the law had no provision for private sector participation in

SOEs and did not cover privatization. It did have well-defined provision for liquidation of SOEs but these have not been invoked yet to carry out any liquidation. Some SOEs, especially utilities, will likely remain under public ownership for some time, and there may be some public investment in these enterprises. Such investments should be guided by a clear policy and rigorous criteria and within an appropriate corporate governance framework.

- ◆ *Address labor retrenchment issues.* Develop a program to deal with labor retrenchment. Privatization and liquidation could be socially contentious, especially because substantial job losses (currently estimated at about 6,500) will be involved. Indeed, this factor is partly responsible for the relative lack of commitment and action in government on this front. Its advisors have worked out a set of options on severance packages on which the government needs to make a decision, keeping in mind that severance payments should not be unduly generous. Any package for SOE employees will set precedent for other public sector retrenchment programs.
- ◆ *Introduce strong corporate governance for SOEs that will be retained.* It is very important to ensure that SOEs that remain in the public sector are run efficiently, do not become a significant fiscal risk factor for Afghanistan, and do not crowd out resources that have better uses. There should be regular reporting of key financial variables by SOEs (including those with less than 100 percent government ownership) and their compilation for use in monitoring and policy decisions. SOE

²⁶ The advisors working on privatization are mandated to work only with those enterprises that are classified as SOEs, that is, those enterprises that have a separate board and budget, and are controlled by a line ministry. Some enterprises, including the national airline company Ariana, which is a joint venture, are not classified as SOEs.

investments, including those occurring outside the Core Budget, should be carefully monitored, and financial transfers between SOEs and the government budget should be transparent. There should not be any investments in SOEs that are to be liquidated or privatized and there should be rigorous criteria for approving investments in SOEs to be retained.

Trade reform

Following reforms carried out in 2004 (simplification of tariff to a six-band structure, with a maximum rate of 16 percent and utilization of a uniform floating exchange rate), Afghanistan has one of the most open economies in the region, with an average tariff of 5.3 percent. The import license application process has been drastically reduced. Border and clearance times, while significant, are within a reasonable range for the region. However, the customs administration remains weak, several transit-related issues need to be addressed, and institutional responsibilities in the government need to be clarified.

- ◆ Improve customs infrastructure and reduce discretion in valuation and tariff collection.
- ◆ Define clear roles for different agencies to reduce multiple inspections.
- ◆ Further reduce the dispersion in tariff rates to avoid discriminating in favor of or against different activities.
- ◆ Improve trade infrastructure, especially storage facilities.
- ◆ Continue to negotiate more open trade, including allowing Afghan carriers to operate in neighboring countries.

Business services

Few, if any, business services are available in Afghanistan. Local consulting companies are focused almost exclusively on servicing the large donor community. Consequently, Afghan private sector enterprises have few options to obtain help on marketing, accounting, engineering, quality control, and other important services. Few private sector managers complain about this lack of services. Larger firms bring in experts from outside and for other firms it is probably an issue that they "don't know what they don't know." Having never had access to consulting services, they do not know the benefits to be gained from outside experts. The need for business services is clearly illustrated by the fact that the first enterprises to get loans from local banks needed extensive help from NGOs to write business plans and put together financial statements for their applications. Many businesses fail to access finance from the banks because their business accounts are not credible. There are no domestic accounting firms that can help prepare accounts or audit reports and the services of foreign accounting firms are beyond the reach of most Afghan businesses. It is important to develop the accounting and auditing profession within the country. Given the lack of a local consulting market, it may be necessary for government or donor agencies to initiate programs to spur their development.

A major constraint revealed by many sector studies in Afghanistan for both exporters and other producers is the lack of testing facilities and standards to ensure quality.²⁷ Exporters are required to obtain certificates of quality-but the government agencies issuing them are not able to test. The government has begun a pilot project in Metrology, Standards, Quality, and Testing (MSTQ) housed in the Ministry of Commerce, but to date little progress has been made. Initial plans call for a focus on testing imports for consumer protection. However, quality assurance for exports is equally

²⁷ See United Nations Development Program and Afghanistan Research and Evaluation Unit sector studies.

important, for without it the values of exports will always be constrained. Some current markets for Afghan products, such as India and Russia for dried fruits, may not have high-quality requirements, but western markets have exacting standards and traditional markets may raise standards in the future. A good MSTQ system will become increasingly important if Afghanistan wants to expand exports, especially of higher valued products. In addition, the focus on imports and consumer protection raises the possibility that it could become a source of nontariff barriers for influential firms seeking protection. The establishment of a viable MSTQ program is essential for private sector development, and substantial resources should be devoted to expanding the pilot project into a sustainable program that meets the private sector's needs.

Government capacity to promote and facilitate private investment

Policy reform in the investment climate area is handicapped by lack of capacity in the government to analyze private-sector-related issues, obtain systematic feedback from the private sector, and, on this basis, formulate appropriate policies and programs. This capacity needs to be built across the government because the work of several ministries and agencies is relevant to private sector development. However, in light of the limited resources, initial focus may be on the AISA-to help promote Afghanistan as an investment destination and to facilitate individual investors-and the Ministry of Commerce, as the main driver of private-sector-related policies.

Priority areas for capacity building in the Ministry of Commerce include (a) a mechanism for reviewing the regulatory interface between government and the private sector, identifying areas where regulatory streamlining is required and assessing the costs and benefits of proposed regulations; (b) identifying and pursuing legislative changes required to fulfill the government's PSD policy intentions; (c) coordinating

investment policy work with AISA's investment promotion activities; and (d) providing comprehensive, updated information on PSD policies to the private sector. In addition, some basic skills in such areas as English language, business language, computers, and financial management need to be developed.

Priorities for AISA are (a) further developing its role in facilitating investors; improving its capacity to operate as a one-stop shop for investors, defining interagency workflows, and establishing procedures to foresee and address client requirements; (b) developing policy advocacy capacity and a mechanism for obtaining feedback from the private sector; (c) clearer definition of the range of services it will offer to investors, both before and after they invest in Afghanistan; (d) developing a system to screen potential investors so that scarce AISA resources are not spread thin; (e) reviewing and clarifying staff responsibilities and providing adequate training to staff in areas such as sales presentation, negotiations, "closing the deal" with potential investors, and basics of accounting and corporate finance; (f) identifying career development paths for staff; and (g) developing investor tracking systems.

Clearly, these agencies will have to coordinate with other parts of government; the High Commission for Investment, in which several ministries are represented, can be one vehicle for this. Currently, coordination and collaboration among ministries is weak. Effective coordination will require an appropriate division of labor among the various ministries and agencies based on the comparative advantages of the different parts of government. Promoting private sector development in an era of globalization requires a good understanding of international and domestic market trends, sectoral knowledge, and appreciation of the needs of business. As was argued in the section on industrial park development, historical divisions of labor within government will have to be reconsidered if effective policies for private sector development are to be formulated.

Efforts should also be made to strengthen private sector collective bodies, such as chambers of commerce and industry organizations. These have a very important role in private sector development because they serve as a bridge between the private sector and the government's policymakers, providing two-way feedback. They may provide government with insights and knowledge on constraints faced by the private sector and may advocate policies and laws that help private sector growth. They may provide the private sector with information on government's policies, both actual and proposed, thus reducing uncertainty for the private sector and enhancing credibility of government

actions. Private sector organizations may also play a role in helping to develop a shared stakeholder vision on the role of markets and the private sector in Afghanistan. The government has taken some steps toward fostering the development of private sector collective bodies. It has formed a committee to review the future role of the quasi-government Afghanistan Chamber of Commerce and recommend actions that will convert it into a truly private sector chamber. However, it is important that this does not crowd out other private sector chambers and associations. AISA has started reaching out to the private sector through activities such as roundtables in provincial cities.

Policy Recommendations Matrix

Area	Short-term actions (less than 1 year)	Medium-term actions (2-5 years)	Long-term actions (more than 5 years)
Legal framework for PSD			
Investment Law	Enact revised Private Investment Law.		
Business Organization Legislation	Enact Law on Business Organizations.		
Legislation related to private property rights and land	Carry out the requisite background policy work for initiating legal reforms in this area.	Rebuild the land registration system. Work out satisfactory dispute resolution mechanisms. Introduce transparent means for enforcing judicial decisions.	
Bankruptcy legislation	Develop workable mortgage and collateral registries.	Enact Bankruptcy Law.	
Insurance legislation and regulation	Assess the practical legal needs of a future insurance industry; identify the views of potential investors. Formulate policy in government for regulating this sector. Draft suitable implementing legislation, perhaps based on the 1353 law.	Enact the new insurance legislation, perhaps based on the 1353 law, along with the implementing regulations. Establish regulatory agency for insurance; build capacity in agency.	
Financial leasing	Enact a financial leasing law.		
Infrastructure			
Overall infrastructure	Articulate, for all sectors, government policy on the role of the private sector in delivering infrastructural services.	Remove policy barriers to private sector entry. Move toward more commercial tariff regimes. Develop regulatory standards for private provision of infrastructure.	

Area	Short-term actions (less than 1 year)	Medium-term actions (2-5 years)	Long-term actions (more than 5 years)
Power	<p>Further clarify government's vision for the power sector, including its strategy regarding tariffs, investments, and private sector participation.</p> <p>Improve billing and collection, including through computerization.</p> <p>Identify and remove policy barriers, if any, to small-scale power generation and distribution by the private sector.</p>	<p>Develop risk-mitigating arrangements to address risks associated with private investment.</p> <p>Corporatize Da Afghanistan Breshna Moassesa (DABM) and strengthen its managerial, technical, and financial capacity. Restructure DABM in the form of regional business units. These actions need to be accompanied by a new board of directors and commercially oriented managers, capacity building, instilling a more businesslike corporate culture, and better commercial cash management and pricing practices.</p> <p>Develop capacity of the Ministry of Power and Water to lead the investment program and exert its regulatory role.</p> <p>Explore options for private sector contracting for the CGCT project in Shebagan.</p>	<p>Introduce greater cost recovery through further reforms in tariff setting.</p> <p>Implement a rural energy strategy to bring electricity to rural areas.</p>
Transport	<p>Rehabilitate primary road network and key ports (land and air).</p>	<p>Continue rehabilitation of road network and key ports (land and air).</p> <p>Build capacity in the Ministry of Public Works to oversee investment program.</p> <p>Develop mechanisms for cost recovery.</p>	
Telecommunications	<p>Enact and gazette the Telecommunications Law. Gazette the Law on Corporatization of Afghan Tel.</p>	<p>Improve the regulatory framework for the sector and strengthen the Telecommunications Regulatory</p>	

Area	Short-term actions (less than 1 year)	Medium-term actions (2-5 years)	Long-term actions (more than 5 years)
Access to finance			
Central bank	<p>Issue additional fixed-line licenses to open competition to Afghan Tel.</p>	<p>Authority of Afghanistan (to replace the Telecommunications Board after the Telecommunications Law is passed). Strengthen management capacity of Afghan Tel. Bring a strategic investor on for Afghan Tel and then fully privatize it.</p>	
State banks	<p>Continue the reform of Da Afghanistan Bank by focusing its activities on its regulatory functions (continuing to phase out its commercial activities) and strengthening its capacity. Encourage the expansion of existing private commercial banking activities and scaling up nonbank financial services.</p>	<p>Establish public credit bureau. Encourage competition and create an environment to prevent collusive behavior.</p>	<p>Complete the privatization of the rehabilitated state banks.</p>
Private banks	<p>Prepare a specific action plan for the resolution of state-owned commercial banks that includes dates for the appointment of a comprehensive management team, a capitalization plan, and short- and long-term plans for the rehabilitation and corporatization of their urban and rural banking. Introduce independent management in banks to be rehabilitated. Revive safe and sound operations. Encourage strategic public-private partnerships. Introduce loan guarantee facilities.</p>	<p>Commence the Voluntary Retirement Scheme, taking into account the government's fiscal commitments. Commence dedicated agricultural finance products and services.</p>	<p>Provide economic incentives for commercial bank branch expansions. Encourage full-scale private sector investment in agricultural finance.</p>

Area	Short-term actions (less than 1 year)	Medium-term actions (2-5 years)	Long-term actions (more than 5 years)
Traditional providers (Hawala)	Encourage applications for money service businesses from large money exchange dealers that meet legal licensing requirements.	Consider licensing compliant money service businesses as nonbanking financial institutions, thus permitting them to engage in a wider range of well-regulated financial activities.	Consider the transformation of some of the larger money exchange dealers into banks engaging in rural finance.
Dealer credit	Expand dealer credit programs.	Integrate dealer credit programs with mainstream financial sector.	Continue geographic and product expansion programs.
Microfinance	Provide additional finance to existing programs and encourage organic expansion.	Entrust larger, well-managed institutions to scale up dedicated agricultural finance programs to medium-scale farmers and rural enterprises.	Continue geographic and product expansion programs.
State-owned enterprise reforms and privatization			
	<p>Prepare a Privatization Policy to articulate the principles of privatization and lay out a transparent process for carrying out privatization and liquidation.</p> <p>Strengthen the legal and institutional framework for privatization; amend the SOE law to allow for private participation in SOEs and privatization; and clarify the institutional responsibilities for privatization.</p> <p>Develop a legal framework to facilitate allocation of surplus SOE land.</p> <p>Develop a clear policy to govern new investments and reporting requirements of the SOEs that will remain in government ownership.</p> <p>Develop a severance package for SOE</p>	<p>Carry out privatization in a transparent manner.</p> <p>Liquidate nonviable state-owned enterprises; make land available for other industrial purposes.</p> <p>Develop strategies to divest government enterprises that are not officially SOEs.</p>	

Area	Short-term actions (less than 1 year)	Medium-term actions (2-5 years)	Long-term actions (more than 5 years)
	<p>workers who are to be retrenched that is in line with international good practices and does not create an adverse precedent for future civil service restructuring exercises.</p> <p>Identify other government agencies that are not officially SOEs but could be privatized.</p>		
Land development and industrial parks			
	<p>Formulate a consistent national policy for industrial park development that should be based on a vision that includes private sector development and management of industrial parks.</p> <p>Clarify the institutional responsibilities within government for planning, regulation, and development of industrial parks: This should be done formally through a decree accompanied, if required, by implementing regulations.</p> <p>Build capacity in the Industrial Parks Development Authority.</p> <p>Formulate legislation to help allocate government-owned land for industrial park development.</p>	<p>Establish a regulatory framework for industrial park development, including provisions that facilitate private sector development and management of such parks.</p> <p>Separate the regulatory function from the promotion and development function in the public sector. Over time, phase out public sector role in development of industrial parks.</p>	<p>Privatize all publicly owned industrial parks.</p> <p>Rely primarily on private sector development of industrial parks.</p>
Trade reforms			
	<p>Clarify institutional responsibilities for trade policies, promotion, and reform.</p>	<p>Support harmonization of standards and procedures and curtail smuggling, notably with the establishment of a computerized transit management system.</p>	

