Executive Summary

In a postconflict environment, attracting new foreign and domestic firms is central to private sector development. New decisions about investment (in existing or new firms) usually depend on the availability of five basic factors: political and economic stability and security; clear unambiguous regulations; reasonable tax rates that are equitably enforced; access to finance and infrastructure; and an appropriately skilled workforce. In Afghanistan, these conditions are lacking. The challenges facing the government of Afghanistan in addressing these constraints and in turn attracting further foreign and domestic investment cannot be underestimated. But, as the experience of other reconstruction efforts shows-for example, in Bosnia and Herzegovina and East Timor-reform can be achieved. This report was prepared to assist the government of Afghanistan in addressing its private sector development challenges. It is based on a survey of 338 firms and draws on numerous recent studies on Afghan private sector issues.

A. Recent Reforms and Progress

Afghanistan has taken tremendous strides toward reestablishing itself as a politically and economically viable state. Since the fall of the Taliban regime in 2001, the government, with the support of the international community, has reestablished a number of political institutions and spearheaded economic reforms. A new constitution has been adopted, nationwide elections were held to select Afghanistan's first democratically elected president, and, in September 2005, a parliament was elected. The security situation in the country has improved and a return to general warfare does not appear to be imminent. With the aid of the international community, the central government has begun to build a multiethnic army and police force that are able to exert the government's control in regions outside the capital. The current government is strongly entrenched in Kabul and has a high degree of legitimacy throughout the country. However, there remain many areas where the government is not very effective and provides few services, especially where the insurgency is strong.

Economic growth, which has received far less international attention than has Afghanistan's political process, has been dramatic during the recent recovery. The International Monetary Fund estimates that official (nonopium) gross domestic product (GDP) growth averaged 22.5 percent between 2002 and 2004. It estimates annual growth in 2004/05 at around 7.5 percent and predicts 14 percent growth in 2005/06. Investment is high and accounts for nearly 22 percent of GDP; however, the bulk of this investment (90 percent by some estimates) is public investment financed through international aid. This rapid expansion can be attributed to a number of factors including the low starting base, the end of major conflict and the associated revival of economic activity, and the end of the drought, which allowed sharp increases in agricultural output in many regions.

A stable macroeconomic environment has been established and a number of steps taken to foster trade. Currency reform was completed in early 2003 and since then inflation has been low and the currency stable, helped by strong fiscal discipline and a prudent debt policy. The tax code was restructured in 2004, expanding the tax base, simplifying the code, and providing clarification. Customs tariffs have been rationalized. Existing trade agreements have been renewed and new agreements entered. The government is working toward accession to the World Trade Organization (WTO) within the next few years. Trade has increased dramatically, with the value of annual exports and imports growing at double-digit levels. However, this increase does not reflect an increase in Afghanistan's international competitiveness: Most are reexports to Pakistan.

Despite rapid economic growth, the structure of Afghanistan's economy has changed little. Some 80 to 90 percent of economic activity is informal and agriculture accounted for 47 percent of estimated total GDP in 2003. One of the largest sectors in the economy is the illicit production of opium, which in 2003 accounted for nearly one-third of GDP. There was a 20 percent decline in area devoted to opium production in 2005, but opium remains a major activity and a serious threat to security and stability. Afghanistan remains one of the world's poorest countries with an estimated per capita GDP of only US$315. Social indicators are also some of the worst in the world as reflected in high rates of infant and maternal mortality, illiteracy, malnutrition, and gender disparity.

The government has been able to raise domestic revenues to almost 4 percent of GDP, but international assistance funds the majority of the government's recurrent expenses and almost all development programs. The government has clearly recognized that Afghanistan's success will depend on its ability to quickly develop a strong and vibrant private sector that will be able to provide jobs and generate the resources needed by the government to accomplish its development goals. Private Sector Development (PSD) was identified as one of the three pillars in the Afghan government's National Development Framework approved in 2002 and is likely to figure prominently in the country's poverty reduction strategy paper, the "Afghanistan National Development Strategy," to be adopted soon.

The government has taken a number of steps to foster private sector investment. There has been significant progress in developing the financial sector. The Da Afghanistan Bank (DAB) and Banking Laws have been gazetted (i.e., formally enacted), a number of private commercial banks have been licensed, and three state-owned banks have been relicensed. Progress has also been made in developing the microfinance sector. The government has established the Afghanistan Investment Support Agency (AISA) with the mandate of promoting and facilitating investment. The AISA has helped streamline the business registration process to the extent that Afghanistan now ranks among the best countries in the World Bank's 2005 Doing Business indicators of firm registration. However, a host of clearances and procedures are still required before a business can actually begin operating.

B. The State of the Private Sector

Long years of conflict destroyed most of Afghanistan's production capacity and forced the flight of many skilled workers and managers. Sabotage of infrastructure crippled domestic and international distribution channels and cut off industry from its traditional markets. The Soviet-backed government in the 1980s worsened the situation by attempting to set up a centrally planned economy. Many traditional industries, such as carpets, closed and moved to neighboring countries and others, such as horticulture products, basically shut down because of the lack of suitable inputs. Today, despite a recent resurgence, the Afghan economy is dominated by small-farm agriculture. Outside of agriculture, the private sector is overwhelmingly composed of informal family-owned microenterprises, most of which are engaged in trading or basic services. Eighty to 90 percent of all economic activity is informal. There are few small and medium enterprises (SMEs) and only a handful of large firms. The manufacturing sector is tiny, export orientation is minimal, and most producers, with the exception of a few agro-processors, source their raw materials from abroad.

The end of major conflict and the fall of the Taliban regime led to an increase in private investment, but investment has been limited relative to Afghanistan's potential. New entry and expansion have been far less than policymakers had hoped for. Only two enterprises have been privatized. AISA has registered nearly US$1.3 billion in new investment (not including the telecom firms) in the past two years, but most of this is merely approved investment; and just a fraction has actually occurred. Nearly 50 percent of the new investment approved by AISA has been in construction and construction material. The remainder is split almost equally between industry and services. The concentration on construction, which is not unusual in postconflict countries, reflects the massive flows of external aid and the need to rebuild Afghanistan's devastated infrastructure. The biggest sectors in industry include plastics, bottlers, and processors of simple packaged foods-all aimed at the local market. Most are technologically simple and need only small investments; examples include small producers of biscuits and other inexpensive packaged foods that aim to replace more expensive imports. For the most part, Afghan industrial enterprises are nascent and unable to effectively compete against imports or enter the export market.

Success in attracting investment from overseas Afghans has been limited. But they are a potentially important source of funding: Nearly 20 percent of the firms sampled in the survey are owned by investors who have returned to Afghanistan since the fall of the Taliban regime. Besides bringing capital, returnees also bring contacts in foreign markets and knowledge of international business methods. Policymakers have looked to foreign direct investment as a key source of funding for Afghanistan's reconstruction, so far with mixed results. In the risky environment of Afghanistan, foreign investors prefer government- and donor-funded reconstruction projects or services through which they can quickly recover their investment, to the longer-term process of building markets for manufactured goods. The government has touted Afghanistan as a land bridge that will facilitate trade between Central Asia and South Asia. However, so far there has been little foreign investment to support this trade.

Despite the difficult business environment, Afghan industry is steadily recovering and existing firms are coping well, performing on par with firms in neighboring Central Asian countries. Firms in the Afghan survey report a 67 percent average increase in employment over the past five years, with 22 percent in the past year alone. Average capacity utilization of manufacturing firms rose by 10 percent last year. The rapid increase in employment was matched by a similar increase in sales and reflects the low base from which Afghan firms are starting. The median value of sales per worker in Afghan manufacturing firms is around US$3,333-greater than that reported in Tajikistan or Uzbekistan but only around one-third that of small manufacturing firms in Pakistan or India and much less than reported by Chinese firms. Afghan industry's low capital intensity explains much of this shortfall in labor productivity. At 60 percent, average capacity utilization in Afghanistan manufacturing is only slightly below its neighbors and high for a country just emerging from sustained conflict. In 1997, Mozambique was also three or four years out of major conflict, and average capacity utilization in manufacturing was only 48 percent.

Industry's recovery is also evidenced by its investment activity. Though the rate of foreign investment and the return of expatriate Afghan investors may be disappointing, existing local firms are steadily adding to their capital stock. Nearly 70 percent of the surveyed firms reported investing in new equipment or machinery sometime in the past year. This is a much higher rate than found in postwar Mozambique where only about 56 percent of firms invested in the year before the survey. In addition, over one-third of the Afghan sample introduced a new product line and more than 40 percent upgraded an existing product line in the past two years. Clearly, the existing Afghan firms are engaged in increasing their capital stock and upgrading their capabilities in anticipation of future opportunities.

However, this optimistic view is tempered by the fact that industry is starting from a low base and most of the investment is in the most basic production processes. Afghan firms offer less training than do their neighbors and their managers, and workers are less skilled than are those in competitor countries. Many businesses in Afghanistan do not feel the threat of strong competition. These facts suggest that substantial barriers protect incumbent firms and relieve them of pressure to constantly upgrade their capabilities.

C. Today's Investment Challenges: Investment Climate Constraints

Overall

The Afghan government has taken a number of steps to improve the business environment and attract investment. Tax reform is a notable example. The gross profit tax is 21.4 percent, compared with 35 percent for the region and 46 percent in the Organisation for Economic Co-operation and Development (OECD). Afghanistan has made the process of registering a business, if not actually starting operations, simple and the country now ranks 16th in the Doing Business rankings for starting a business. Significant progress has also been made with regard to labor regulation, regarding which Afghanistan 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 removing informal barriers to new entry, improving infrastructure, and reducing uncertainty.

The most serious constraints reported by the surveyed firms are electricity and access to land. Over 64 percent of the surveyed enterprises cited electricity, and 60 percent cited access to land as either a severe or major obstacle to doing business in Afghanistan. Corruption and access to finance were also mentioned as significant constraints. 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. Few reported security.

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, the ranking of these obstacles differs by area. 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 was, 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 elsewhere, which could reflect deeply entrenched local business interests that use their close ties to powerful political patrons to restrict competition.

Security

It is counterintuitive that most managers in the survey did not rank crime and disorder as a major or severe constraint. But this result can be explained. There have been real improvements in the security situation in the major cities covered by the survey. The central government has made significant progress in disarming militias and integrating them into the police forces. Regional commanders who once dominated

Afghanistan have been reined in, often by being co-opted in government. At the same time, existing firms have developed mechanisms to cope with insecurity, though at high cost. The surveyed firms reported spending 15 percent of sales for security infrastructure, significantly more than did firms in neighboring countries. Many firms have formed close ties with powerful elements in society, including warlords and government officials, to obtain protection in addition to resources. Security is thus a lesser concern for them.

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. Many former commanders remain influential, increasingly forging close ties to the business world and using their power and influence to further their business interests. Relatively small groups of businesspeople dominate many trading activities in Afghanistan. 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. Wide-scale poppy production remains a security threat, despite some recent successes in restraining its spread.

Infrastructure

Most indicators of infrastructure availability in Afghanistan are among the worst in the world, well below the corresponding figures for Sub-Saharan Africa. Decades of fighting devastated the country's infrastructure and rebuilding it has been one of the government's foremost goals. International aid has poured in and many significant projects have been completed. But this is a long-term agenda; meanwhile, infrastructure remains a major constraint for business.

Power. Power supply is of poor quality, characterized by low voltage, intermittent supply, and blackouts. Only about 76 percent of the sample was connected to the power grid but even they received power on average about six and a half hours a day. Not surprisingly, 74 percent of businesses reported owning at least one generator; in one city, Jalalabad, the figure is 97 percent. Of the country's installed power generation capacity of 420MW, only 270MW is operational; moreover, transmission and distribution capacity are inadequate. With international help, the government is working to rehabilitate generation, transmission, and distribution facilities.

Transport. Like their counterparts 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 result may reflect the limited horizons of many private firms that operate in a localized economy and have limited transport needs. When asked what factors constrain exports, a larger proportion (39 percent) identified lack of roads, air connection, railroads, and other infrastructure as a major constraint. Protracted conflict and lack of maintenance have led to the dilapidation of the transport network. Rehabilitating the road network has been a top priority for the government, which has developed a large investment program for major highways. Thousands of kilometers of roads have been built, including the ring road from Kabul to Kandahar. Some improvements in travel times have begun to materialize. But there is still a long way to go. Transport service was an important activity during the conflict, and private transport companies have expanded rapidly since the end of the war. However, the government remains heavily involved in the transport sector.

Telecommunications. The telecommunications sector in Afghanistan is developing very rapidly. Only 26 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). There are two private mobile operators, and two additional licenses for mobile telecommunications have recently been awarded. The publicly owned Afghan Tel has also started providing services and now carries approximately 22 million calls per month. An access agenda for rural areas remains, as does a need to considerably improve the quality and range of services and to further reduce prices. Nonetheless, progress to date has been remarkable.

Access to factors of production: land, labor, and capital

Access to land. In many countries, access to land is a problem only for firms wanting to significantly expand. In Afghanistan, even the majority of existing firms find accessing land, especially serviced land, a serious problem-which indicates just how severe a constraint it is. Nearly 56 percent of the surveyed firms who had tried to acquire new land in the past three years were unsuccessful and more than 10 percent reported having ongoing land disputes. The different waves of conflict, land reform, and nationalization have left the land tenure system in disarray. Properties have changed hands numerous times. Many plots of land are not registered and even if they were, records have been destroyed or are now inaccessible. Multiple claims are common and dispute resolution is difficult, especially given the overlapping, inconsistent, and ambiguous legal systems and ineffective judiciary. The lack of certainty in land tenure discourages existing business from making large new investments and effectively prohibits new investors, especially foreign investors, from entering the market.

Skills. High illiteracy, poor education, war, and political upheaval have resulted in a critical shortage of skilled labor in Afghanistan. During the conflict many of Afghanistan's best qualified workers, those with the best opportunities abroad, fled. Consequently, qualified management, skilled technicians, and educated professionals are scarcely available to today's enterprises. The problem is exacerbated by the barriers to educating girls and employing women in most jobs outside the home. Afghanistan is caught in a trap. The lack of opportunities discourages workers from improving their skills and education. But the lack of employment opportunities is partly caused by investors not wanting to expand because of the lack of skilled labor. Only a small fraction-5 percent of Afghan firms-offer training. Only about one-third of the workforce in Afghan enterprises has a secondary education or higher. Sixty-two percent of Afghan managers have secondary or higher education compared with 96 and 98 percent in Pakistan and India respectively. The shortage of skilled labor helps explain the low productivity of Afghan firms. Unless this shortage is solved, Afghan firms will find it very difficult to compete against imports or on the export market. The situation in government is similar. Though some returning Afghans have brought with them significant technical skills, the majority of the civil service lacks training, skills, and education to effectively provide services.

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. Most of the 12 commercial banks licensed to operate in Afghanistan are concentrated in Kabul and provide services primarily to international donors and businesses, foreign nongovernmental organizations, and foreign government agencies. Commercial banks in Afghanistan offer financing with a maximum tenure of financing of up to three years. There are a small number of nonbank financial institutions (11 microfinance institutions, one credit union, and one leasing company), but although growing, they are still nascent and can meet only a very small fraction of credit needs. There are no credit bureaus or credit rating agencies. Only three firms in the survey reported having bank credit.

Informal sources play an important part in supporting Afghan businesses. Many businesses rely on informal funds transfer systems generally known as *hawala.* Only 30 percent of the sample reported having a bank account whereas nearly 21 percent of surveyed firms had a loan from a *hawaladar* and 14 percent of exporters received payments through *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. However, informal financial sector credit is not adequate for long-term private sector development. 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, high costs of service provision (particularly in rural areas), poor registries, and lack of credit information, a secured transaction law, and insurance are the main factors constraining the growth of the formal financial sector.

Governance: legal framework, judicial and regulatory enforcement, and the functioning of government

Legal framework. The absence of a clear legal framework compounds the high level of uncertainty and risk facing investors in Afghanistan. Many of the existing laws are holdovers from the communist era or even the earlier monarchy, and many of the basic laws necessary to encourage private investment are missing. With three overlapping legal systems (the *Sharia,* the *Shura,* and the formal system based on the 2004 constitution), managers are often confused about which laws actually apply to them. The new government has worked to propose, pass, and implement new legislation, but there remains a vast backlog of laws and regulations that need to be enacted.

Judicial and regulatory enforcement. Firms mostly use informal mechanisms, including force, to resolve disputes and enforce property rights. There are no formal alternative dispute resolution mechanisms such as arbitration or mediation. The formal court system suffers from a lack of qualified legal professionals, no method to hold judges accountable, and reportedly endemic corruption. Consequently, businesses do not rely on the formal judicial system. Only 3 of the 338 firms surveyed reported using the commercial courts to settle a payment dispute in the past two years. Many managers do not understand the benefits of a strong and efficient legal system and, given the arbitrary enforcement and lack of effective courts, do not spend much time worrying about it. Only 10 percent of the survey sample mentioned the legal system as a major or severe constraint. However, good laws, effectively enforced, are essential to encourage large-scale investment, especially by foreign investors and returning Afghans.

Regulatory issues such as business registration, tax administration, and labor law were not cited as significant obstacles. They are not seen as significant obstacles not because the registration, tax and labor requirements are clear and efficient but because they are poorly enforced and hence do not affect most firms. However, there are problems in some areas. Although illegal checkpoints established by local commanders and militias are no longer a major constraint, inspections by government officials remain a hassle. Traders report that they face frequent inspections and fees levied by different government agencies and local authorities. 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.

Predictability of government policies and actions. Because Afghanistan has a risky investment climate that deters investment, it is essential that whenever possible the government should 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 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 recent experience with tax holidays shows that inadequate information about policy and specific procedures can create considerable uncertainty for investors.

Corruption. Corruption is endemic in Afghanistan and adds to the uncertainty facing investors, especially foreign investors or returning Afghans who do not understand the system. Nearly 58 percent of surveyed firms cited corruption as a major or severe problem, just behind access to land and electricity. Firms reported paying an average 8 percent of sales as bribes, more than four times the average reported in neighboring Pakistan. AISA's investment facilitation activities have helped many investors negotiate the regulatory maze without paying bribes, but this function is still limited in scope.

Weak government institutions. In nearly 25 years of war, Afghanistan's government institutions were devastated and the new government, with international assistance, has been striving to rebuild them. There has been some progress in rebuilding institutions. Most ministries are now staffed and functioning at some level. The central bank is functioning well and has issued a new currency. The customs department is collecting taxes and forwarding the revenue to the central government, and the security forces are loyal to the elected government. However, the government infrastructure is nascent and many ministries lack the capacity to provide some of the basic services. The courts and criminal justice system are inefficient and rarely used. Land registries are incomplete and inaccurate, and often fraudulently abused. There are no standards commissions and the once-extensive agriculture extension service barely functions.

Trade policy and trade facilitation

Trade policy. The government has made trade a cornerstone of its development strategy and envisions Afghanistan becoming a land bridge between the rest of Central Asia and South Asia. Accession to the WTO in the next five years is a top priority. A number of steps have been taken to facilitate trade. These include trade and transport agreements with neighboring countries, preferential trade arrangements internationally, passage of a customs reform package (2004) that makes Afghanistan one of the most open economies in the region by simplifying the tariff structure and reducing the range of tariffs from a maximum of 150 percent to a range of 2.5 to 16 percent, and initiation of a Customs Modernization Program. However, anomalies remain. For example, manufacturers complain that the tariff structure is such that they often pay more duty on imported inputs than traders do on imports of the finished goods.

Customs administration. According to the World Bank's Doing Business 2005 report, Afghanistan ranks 128 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 investment climate survey found that on average it took firms nearly 10 days to clear exports last year and about 8 days to clear imports. Shipping agents report that this time could be lowered to a few hours if they were willing to pay a large enough bribe. Medium-sized firms complain about discrimination by the customs regime. Small traders can evade duties, taxes, and informal payments, and 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.

Trade facilitation services. Trade facilitation services are weak or nonexistent. Exporters and potential exporters covered by the survey identified the lack of trade finance, the lack of cold storage and other storage infrastructure, and the inefficient customs and clearance procedures as the biggest impediments to increasing exports. Trade credit is rare and expensive, forcing most producers to rely on middlemen who have connections and strong finances. In addition, there are no independent agencies that assure standards or certify quality. 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.

Some 38 percent of the surveyed exporters identified the cost of transport as either a major or very severe obstacle-the same percentage that identified inefficient or corrupt customs clearance procedures. Afghan shippers often have to transship goods into the carriers of neighboring countries, which raises costs and means loss of all control of goods once they cross the border. Surveyed firms reported losing up to 5 percent of international shipments to spoilage and loss on average; for some this loss was as high as 30 to 50 percent. Shippers say that some insurance is available, but apparently few can access it. Over 80 percent of the firms that experienced losses were not compensated. It is clear that transport is expensive and risky in Afghanistan.

The dominance of informal arrangements-a vicious circle?

Much of private sector activity in Afghanistan, even by significant business concerns, is carried out in an environment dominated by informal arrangements and practices. Firms lie on a spectrum of such arrangements ranging from formally registered, tax-paying firms engaged in legal activities but often using informal channels for protection and access to resources, to 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 are 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. Some observers believe that informal markets and informal patterns of trading may have now become quite strong and be operating according to well-established patterns.

These informal arrangements may be useful for many investors in the short run but have negative effects for overall growth. 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. 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. Many returning Afghans who have good ideas and capital to invest are reluctant to risk their capital because they fear 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.

D. Accelerating Private Investment: What needs to be done?

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. 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 required actions are outside the scope of any 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. Issues related to politics and security is beyond the scope of this report, which focuses on actions that fall within the domain of PSD. However, these actions may address the paradigm of informality and help weaken the nexus of informal relationships by extending the writ of formal arrangements.

Four categories of actions are recommended (specifics are provided in chapter IV). 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 among these actions, some of which 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, which 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 state-owned enterprises, injecting money into the banking system, and expanding the power-generating capacity are all examples of actions that increase the supply of inputs (land, finance, electricity). Though these 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.

Though a privatization policy has recently been adopted, more detailed modalities need to be developed to ensure transparent privatization transactions with clear institutional responsibilities for initiating and implementing privatization. With regard to improving access to land, an intermediate solution is the establishment of industrial estates. The government is moving in this direction. An effective industrial estate program will require an independent, commercially oriented agency to develop and maintain the estates with progressively greater involvement of the private sector. However, industrial estates are not a substitute for a functioning land tenure system, on which work needs to be accelerated.

Improving the supply of infrastructure services requires not only massive investment in new facilities but also reforms in policies, regulations, and institutions, including systems for operation and maintenance. Public utilities 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. To encourage the latter, the government needs to take a number of actions including removing policy barriers to private sector entry, regulating standards, introducing tariff structures conducive to private participation, and helping to introduce risk mitigation arrangements.

To improve access to finance it is recommended that the government focus on improving the institutional mechanism for delivering credit, improving access to financial services for SMEs and rural communities, and broadening and deepening the financial sector. In the medium term, efforts should be made to increase the capacity of formal financial institutions with sizeable branch networks to provide credit. Afghanistan should abandon the old, discredited model of directed lending through publicly owned and managed development finance institutions. It should move toward a strong, market-based, competitive financial system that serves business needs in a much more efficient and cost-effective manner. This does not rule out some public policy intervention, especially given the postconflict conditions, on behalf of underserved SMEs and rural communities. Whereas the banking sector is likely to remain the largest component of the financial system for some time, there is also a need to broaden the financial sector by developing leasing companies, commercial credit companies, credit unions, factoring companies, insurance companies, and pension and provident funds, and, in the longer term, debt and equity markets. Actions should also be taken to enhance competition in the financial sector. Through regulation, authorities must create an environment to prevent collusive behavior among banks and conglomerate relationships between banks and nonbank financial institutions.

Clarify and strengthen property rights by creating a sound legal, judicial, and regulatory framework for investment. Property rights refer not only to tangible property such as land and equipment but also intangible "properties" 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. A number of laws, such as the revised Law on Investment and Laws on Business Organizations, Insurance, and Financial Leasing, urgently need to be enacted. The administrative systems need to be developed in other areas as well before laws are put in place; the administration of land deeds is an example. It is also important to make the regulatory system predictable, transparent, and simple to reduce the need to fall back on informal contacts to navigate the regulatory maze.

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, regulating utility standards, and establishing 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 where currently there are very few or no providers.

Underlying all these issues is the need to improve government capacity to analyze private sector issues and formulate and implement private sector development policies and programs. 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. There is a need for effective coordination among different parts of government whose work has a bearing on private sector development. The High Commission for Investment, where several ministries are represented, can be one vehicle for achieving these goals, but effective coordination will also require an appropriate division of labor between the various ministries and agencies based on the comparative advantages of the different parts of government. The overall economic policy of government, such as trade and tax policy, will also be relevant because it will influence the broad incentive structure for private sector players.