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THE AFGHANISTAN INVESTMENT CLIMATE IN 2008
GROWTH DESPITE POOR GOVERNANCE,
WEAK FACTOR MARKETS, AND
LACK OF INNOVATION



THE WORLD BANK
FINANCE AND PRIVATE SECTOR DEVELOPMENT
SOUTH ASIA REGION



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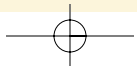


TABLE OF CONTENTS

ACKNOWLEDGMENTS	v
EXECUTIVE SUMMARY	vi
INTRODUCTION AND BACKGROUND	1
OVERALL FINDINGS	6
THE GOVERNANCE CHALLENGE	19
GETTING FACTOR MARKETS TO WORK BETTER	27
SERVICED LAND	28
ACCESS TO FINANCE	33
LABOR MARKETS	38
INNOVATIVE AND PRODUCTIVITY-ENHANCING BEHAVIORS	39
CONCLUSIONS	41
ANNEX 1. AFGHANISTAN AT A GLANCE	45
ANNEX 2. THE ENTERPRISE SURVEY	47
SAMPLE	47
METHODOLOGY	49
CHALLENGES AND LIMITATIONS	51
INTERVIEWER PROFILE	52
RESPONDENT PROFILE	52
ANNEX 3. METHODOLOGY FOR PRODUCTIVITY ANALYSIS	53
ANNEX 4. AFGHANISTAN AND COMPARATOR COUNTRIES	56

Currency Equivalents

(Exchange Rate effective May 31, 2009)

Currency Unit = Afghani (Af)

Af 1 = US\$0.01907

US\$1 = Af 52.45

Government Fiscal Year

March 21 – March 20

Abbreviations and Acronyms

ADB	Asian Development Bank
AISA	Afghanistan Investment Support Agency
ARTF	Afghanistan Reconstruction Trust Fund
DB	Doing Business
DFID	UK Department for International Development
FDI	Foreign Direct Investment
GoA	Government of Afghanistan
IBRD	International Bank for Reconstruction and Development
IC	Investment Climate
ICA	Investment Climate Assessment
ICS	Investment Climate Survey
IDA	International Development Association
IFC	International Finance Cooperation
IMF	International Monetary Fund
NBFI	Non banking Financial Institution
NGO	Non Governmental Organization
NRVA	National Risk and Vulnerability Assessment
SME	Small and Medium Enterprise
USAID	United States Agency for International Development

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The survey findings were shared with stakeholders from the Afghan government, private sector, donors, UN and nongovernmental organizations, consultants, and research firms in January 2009, March 2009, and May 2009. There was broad consensus about the key findings. The inputs received through these interactions are gratefully acknowledged.

EXECUTIVE SUMMARY

The key finding of the survey is that strong private sector growth, albeit from a small base, is taking place in Afghanistan despite poor governance, weak factor markets, and a lack of innovation.

1. This report summarizes the findings of an enterprise survey conducted from September to November 2008, covering 1,066 firms in 10 Afghan cities. It complements an earlier survey of 338 firms in 2005. Both surveys used the standard World Bank enterprise survey methodology. This report presents the results of the 2008 survey, along with some comparisons with the 2005 survey and some international comparisons. The survey provides a good representation of firms operating in the major urban centers, but it does not cover rural firms, firms that tried to enter the market but failed, or firms that were operating but exited.

2. This work is part of a broader effort by the World Bank to understand growth and the prospects for growth in Afghanistan, and to stimulate dialogue on how to develop the levels of growth necessary to secure livelihoods and economic independence for the Afghan people. The report does not provide much in the way of recommendations; rather, it identifies the issues, summarizes the reform status, and, where action is required, identifies the next steps.

GROWTH FROM A SMALL BASE

3. The survey begins by confirming many of the key characteristics of the private sector in Afghanistan. It is small, and it includes few foreign firms (less than 2% of the sample), few exporters (7% of the sample), and few firms owned by women (3% of the sample). In the past two years, the rate of new firm entry appears to be significantly lower than immediately after the fall of the Taliban in 2002. Nevertheless, the private sector is growing fast: national accounts data suggests that the industrial and service sector has doubled in size since 2005. Average revenue growth in the surveyed firms is very high—220 percent—because of some strong performers. The survey suggests that this rate of growth will continue, as 77 percent of the surveyed firms plan to expand in the near future.

KEY FINDINGS

4. Despite the growth, the survey identifies a number of significant constraints clustered around the issues of poor governance, weak factor markets, and lack of firm-level innovation. While the survey cannot explain this contradiction between growth and these weaknesses, it is possible that strong demand arising from increased aid flows and catch-up effects as the economy moves from command to market mode are contributing factors. The survey results suggest that firms are quietly resolving and managing the bewildering array of constraints they face. The question is, what would growth be like without these constraints?

5. Six constraints emerge as dominant in all our analyses—by sector, by firm size, and by region. These constraints are (1) weak policy enforcement; (2) poor provision of electricity; (3) crime, theft and disorder (4) corruption; (5) access to land; and (6) access to finance. These constraints are more or less the same as those found in the 2005 survey, with a marked deterioration in policy enforcement and security related to crime, theft, and disorder. While the constraints are broadly common, there are some interesting variations. For example, the single biggest constraint is different in each city. Governance issues dominate in the less secure areas of the country, while factor markets are more constraining in the more secure areas. Women-owned firms identify the constraints as worse in all cases. The survey proposes additional work to understand the underlying causes.

POOR GOVERNANCE

6. The governance challenge has five main components: (1) policy enforcement; (2) crime, theft, and disorder; (3) corruption; (4) the court system; and (5) business licensing and permits. Perceptions have become more negative on all six components since 2005, except for corruption, which is perceived as near 2005 levels. The less affected firms below the radar screen are small and located in stable areas.

7. Policy enforcement is a dominating issue in the survey. It is hard to define accurately, but it has important productivity consequences, as firms that are constrained by it are 32 percent less productive than firms that are not. We have defined it as “state ineffectiveness in designing and implementing consistent policies.” Only 14 percent of the surveyed firms

reported consistency and predictability in the interpretation of laws. This point is critical, because it concerns an issue that firms cannot manage. They cannot control for unexpected changes in the rules of the game. While more work is required to fully understand the dimensions of this issue, it is clearly a major red flag for policymakers.

8. Crime, theft, and disorder have increased dramatically since the 2005 survey, with one in five firms reporting losses resulting from theft, robbery, arson, or vandalism. These firms are, on average, 63 percent less productive than firms that did not suffer such losses. Larger firms, retailers, exporters, and firms in Herat (where 90% of firms identified crime as a major constraint) are most affected. Firms have responded by paying for security and making protection payments.

9. The World Bank's 2009 *Doing Business* report shows that Afghanistan's business regulatory environment is quite weak (ranked 162nd out of 181 economies). This indicator is very important for entrepreneurs who are trying to enter the market; however, the survey did not cover this group. For this reason, this indicator emerges as one of the least constraining factors in the governance group, with just 23 percent of the sample seeing it as an issue. This can further be explained in part by the age of surveyed firms: most firms are well established by now and no longer have to face many of the regulatory burdens identified in this indicator.

10. In two instances, quantitative indicators identify a governance problem that is not confirmed by perception data. In the case of the courts, 84 percent of respondents say the court system is corrupt and unfair, while 19 percent consider this a major constraint to doing business. Corruption was rated as a problem by 44 percent of the respondents, and the survey shows that it touches virtually every aspect of a firm's dealing with government. Firms that are not able to manage corruption are 26 percent less productive.

WEAK FACTOR MARKETS

11. Little apparent progress has been made on the key factor markets of serviced industrial land, capital, and labor since the last survey. This is unfortunate, as these factors directly affect firm productivity and firm

entry into the market. For firms that want to grow, these issues are particularly constraining. When asked what their single biggest constraint was, access to formal finance was reported by 22 percent of the surveyed firms and access to land by 13 percent. In Kabul, 83 percent of firms that tried to acquire additional land in the past three years failed to do so.

12. Electric power is a hugely constraining factor, both on its own as a direct “tax” on productivity and combined with land as a fundamental barrier to entry. Firms report losing, on average, 9 percent of output because of power losses. Firms that have access to the grid are 49 percent more productive than those that do not. Generators provide 77 percent of electricity, which affects profitability. Other infrastructure sectors—such as telecommunications, transport, and water have also been identified as lower level constraints.

13. Modest improvement was reported in access to formal finance, but it remains a major constraining factor. Only a very small proportion of firms (5% of the sample) borrow from the formal financial sector, while 85 percent of all new investments are financed out of retained profits. Among the firms that do not seek formal credit are the 26 percent that report seeking Islamic financing. One area of improvement is the proportion of firms that have a bank account: 51 percent in 2008 compared with 30 percent in 2005.

14. Few firms identify lack of skills as a problem. Only 18 percent of respondent firms say they cannot get the skills they need, and only 20 percent identify this as a major constraint. Nevertheless, the lack of skilled workers is more of an issue now than it was in 2005, when only 3 percent of firms identified it as a major problem. This trend should be of concern to policymakers.

LACK OF INNOVATION

15. A number of indicators identified lack of innovation as an emerging area for policymakers: 94 percent of surveyed firms do not use foreign licensed technology; 86 percent do not offer on-the-job training; 95 percent do not have internationally recognized quality certification; and 70 percent do not have internet connectivity. Research shows that firms that engage in innovative practices are significantly

more productive and competitive. It is not surprising to find very few exporting firms in the sample.

CONCLUSIONS

16. The survey findings generally validate the government's current reform program, including efforts to improve governance and strengthen factor markets. Clearly, more efforts are needed in these areas, as the survey reports little measurable progress since 2005. Particular emphasis is required in the area of policy enforcement—it is crucial to ensure consistency in policy design and implementation to attract investment into Afghanistan.

17. The report also identifies a group of emerging issues that include the interlinked issues of competitiveness, innovation, and diversification. Despite strong growth, policymakers should be concerned about the lack of entry of new firms—especially foreign firms—and the lack of innovative behavior. These two factors indicate a lack of competitiveness and warrant further research. An undiversified manufacturing sector that is overwhelmingly (approximately 95%) linked to the agriculture and agro-processing sectors is also of concern.

18. The strong growth trend itself needs more evaluation. A country that has weak governance, poor factor markets, and firms that are not innovative is unlikely to achieve sustainable long-term growth.

19. The report discusses the issues noted above, summarizes the status of reforms, and suggests some next steps, including further analytic work on a number of topics, public private dialogue on certain issues, and stronger government reform efforts.

INTRODUCTION AND BACKGROUND

1.1 *This report summarizes the findings of an enterprise survey that took place from September to November 2008.* The report identifies some key issues, summarizes the reform status, and suggests next steps where action is required.¹ After the report is discussed with policymakers, a series of research questions will be identified that will be the subject of additional papers by the World Bank and its international partners. For example, a detailed financial sector assessment is planned to help answer questions about access to finance. After the additional reports and/or papers are completed, the World Bank will undertake a comprehensive economic review. This survey is expected to be an important input into all these research studies.

1.2 *This survey report will help the government of Afghanistan think through its approach to private sector development.* Historically, there has been a dearth of information and reliable statistics about Afghanistan's economy. This report reviews the constraints that firms currently operating in Afghanistan face and provides a basis for possible policy recommendations to address these constraints. It is hoped that the report will be a useful tool to support investment climate reforms and enhance the private sector dialogue in Afghanistan.

1.3 *The 2005 Investment Climate Assessment (ICA) is an important point of comparison.* The World Bank prepared an Afghanistan ICA in December 2005; it was one of the first post-conflict ICAs and used enterprise survey data on 338 firms and other secondary sources to assess Afghanistan's investment climate.² The 2008 survey is a follow-up to the ICA, in keeping with the objectives of monitoring the progress in removing investment climate constraints, sustaining dialogue with the various stakeholders to stimulate policy reform, and

¹ It is important to distinguish this report from a full investment climate assessment (ICA), which is comprehensive and contains detailed economic perspectives and policy recommendations.

² *The Investment Climate in Afghanistan: Exploiting Opportunities in an Uncertain Environment* (2005). World Bank.

providing input for the reform agenda at the central and provincial levels. A key objective of this report is to highlight areas of progress or lack of progress since the previous survey and to compile data to inform donors. It uses an evidence-based approach to foster dialogue and help develop a monitoring and evaluation framework.

1.4 An enterprise survey of 1,066 firms was conducted across 10 provinces in 2008. The 2008 survey generates firm-level quantitative and qualitative information through face-to-face interviews with senior managers.³ These data can be used to evaluate firm-level performance, identify constraints to doing business, and prioritize reform areas. The survey indicators are also useful in comparing Afghanistan's investment climate with those in other countries and for assessing the investment climate of regions within Afghanistan.⁴

1.5 Firms in the survey are examined over five dimensions: city, sector, size, type, and market (figure 1).

1.6 The report undertakes a limited analysis across time and space. Across time, the survey incorporates an analysis of 58 panel firms. This relatively small number reflects high sample attrition (over 80%) among the firms surveyed in 2005. There are various possible reasons for the attrition, including firm closure, difficulty in locating firms, and survey fatigue. Across space, the report undertakes an analysis across 10 Afghan cities and six comparator countries.

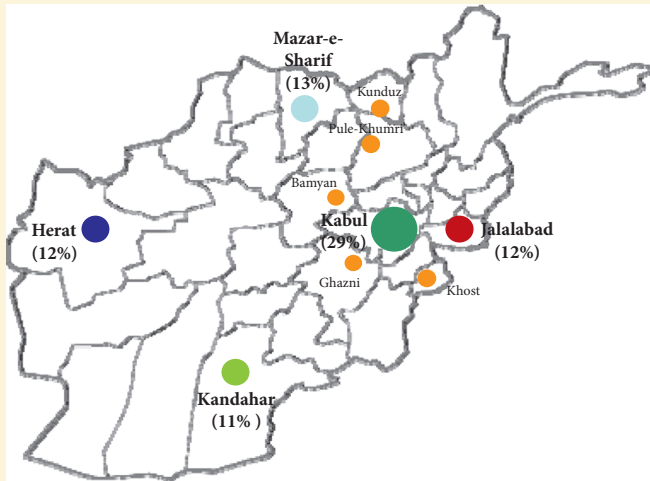
³ Details of the survey methodology and its limitations are provided in annex 2.

⁴ Note that the numbers presented in this report may differ from the indicator values as presented on the Enterprise Surveys website (<http://www.enterprisesurveys.org/>). The reasons for this are threefold: (1) For the purposes of this report, unregistered firms are included in the analytic sample whereas Enterprise Surveys methodology focuses on "formal" firms where formality is defined as being registered; (2) To gain a more robust snapshot of the Afghan non-agricultural economy, the Afghanistan Enterprise Survey included a strata of firms whose business activity (e.g. educational training, health services) are typically not interviewed in a standard World Bank Enterprise Survey. For this report, those firms are included in the analytic sample whereas for comparability reasons, firms whose business activity typically fall outside an Enterprise Survey are excluded in the computation of the website indicators; (3) In the Enterprise Surveys website, outliers, values that are 3 or more standard deviations from the mean are removed for website indicator computation purposes for select indicators. Further documentation regarding removal of outliers can be found on the Enterprise Survey website.

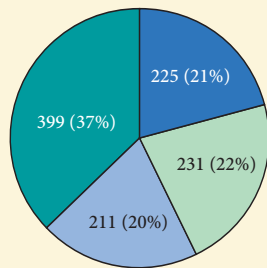
THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 1
Survey Profile

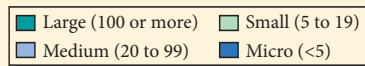
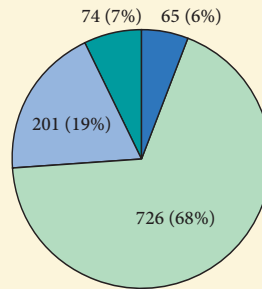
Coverage by Province



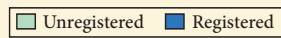
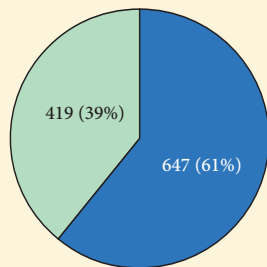
Coverage by Sector



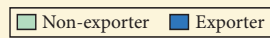
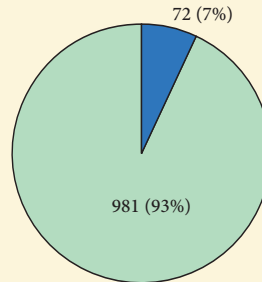
Coverage by Firm Size



Coverage by Firm Type



Exporter and Non-Exporter Firms



BOX 1

A User's Guide to Data in the Enterprise Survey

The assessment of Afghanistan's investment climate in the report is based on five kinds of data.

- 1. Perception data.** This information was collected as part of the enterprise survey. Two kinds of perception data are covered in the survey: (1) *single biggest* obstacle, a rank indicator derived from the respondent's choice from a list of 15 obstacles in the business environment, and (2) *severe constraint*, a rating indicator. Respondents were asked whether they considered a given constraint to be not an obstacle, a minor obstacle, a moderate obstacle, a major obstacle, or a very severe obstacle. This report focuses on constraints rated "major" or "very severe."
- 2. Quantitative data.** These data were also collected as part of the survey. The questions in this category are designed to gather specific, objective information about a given issue rather than information based on perception. Perception data and quantitative data, although collected as part of the same survey, may not yield the same interpretation. For example, Afghan firms' perceptions relating to corruption are not as negative as one might expect, even though quantitative data indicate that corruption is a serious constraint to productivity and growth. Placing too much importance on perception data is not recommended. These data are useful in pointing toward trends, but they can be misleading if respondents do not have adequate knowledge to accurately rate a constraint or if they underrate it because they have become accustomed to it over time.⁵
- 3. Data across time** (perception and quantitative). 58 of the 338 firms surveyed in 2005 also participated in the 2008 survey. However, given the small number of panel firms, only a limited panel analysis has been undertaken in this report.
- 4. Data across space** (perception and quantitative). Two sets of spatial data are covered in the report: (1) *across cities*—this survey covers 10 Afghan cities—and (2) *across countries*. The source of

(continued)

⁵ Perceptions data that measure the relative severity of issues do not lend themselves to analyzing changes over time. For example, at a certain point, crime might be the most prominent concern, and people might say that it is more of a concern than, say, transport issues. A year later, crime levels might be the same but transport problems might have increased dramatically, so survey respondents might say that transport is a bigger concern than crime. An incorrect interpretation of these data would be that crime had decreased. The truth is that crime stayed the same but transport problems increased.

these data is the World Bank's enterprise survey database. Numbers are comparable across countries, because they are based on questions from a common core survey. We chose six countries as a benchmark against which to measure the performance of Afghan firms. Comparator countries have geographic, socio-cultural, or economic similarities with Afghanistan and have been surveyed in the recent past. Four of the comparator countries were Ethiopia, Pakistan, Tajikistan, and Yemen. We also included Thailand and the Democratic Republic of the Congo—respectively, the highest and lowest ranked emerging market economies in the World Bank's *Doing Business 2009* report. Other countries are occasionally mentioned to emphasize a point.

5. **External data.** These data are used to support the hypotheses and findings of the report. Some of our sources are Afghanistan's Central Statistics Office, www.icasualties.org, the World Economic Forum, and the Development Economics Longitudinal Business Database.

1.7 *This report provides information that can help answer some key questions of policymakers.* However, while the report provides information on a large segment of the Afghan private sector, the report does not capture information from some firms:

- Firms that tried to enter the market but could not.
- Firms that entered the market but failed and dropped out.
- Firms in rural areas.

1.8 *The report flags issues but does not offer detailed recommendations.* The goal is to provide information and identify issues for policymakers. It is the responsibility of the Government of Afghanistan and other stakeholders to act on the findings of the report.

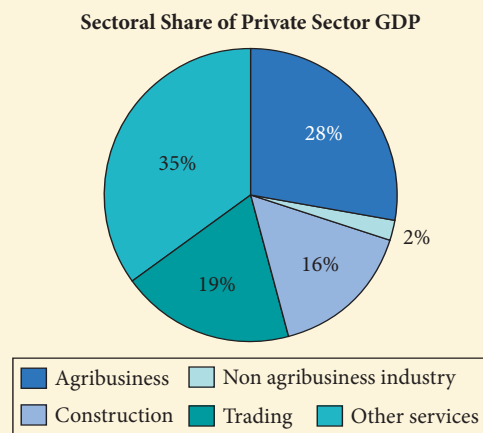
OVERALL FINDINGS

2.1 The key finding is that enterprises are showing surprising levels of dynamism in the face of a poor and deteriorating governance environment, continuing severe problems with factor inputs, and a lack of innovation by firms.

2.2 *The private sector in Afghanistan is in a formative stage, with the following characteristics:*

- The private sector is dominated by agribusiness, construction, and trading firms (figure 2). Private industry’s share of the economy is quite small, with National Risk and Vulnerability Assessment (NRVA) data suggesting that only a little over 5 percent of households earn income from industrial activity.⁶
- There are few registered firms—the Afghanistan Investment Support Agency (AISA) database listed just over 5,000 firms in the ten surveyed cities. Furthermore, there are very few large firms—we were able to identify only 74 firms with more than 100 employees.

FIGURE 2
Sectoral Profile of GDP in Afghanistan



⁶ National Risk and Vulnerability Assessment 2005, Afghanistan Central Statistics Office.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

- Afghan firms primarily produce for the domestic market. In our 2008 sample, less than 1 percent of firms reported selling their products mainly in international markets; less than 1 percent of the sales were direct exports, while indirect exports accounted for 5 percent.⁷ The survey also found that retail firms have a substantial presence in terms of indirect exports: 21 percent of retail firms reported such sales compared with 2 percent of manufacturing firms and 0.04 percent of construction firms.
- Less than 2 percent of the firms surveyed in 2008 were foreign owned, which is an indicator of the low levels of foreign direct investment (FDI) flows into Afghanistan.
- Afghan firms in general do not engage in innovative or productivity-enhancing behaviors such as quality certification or technology licensing.

2.3 The survey shows that Afghan businesses have been growing and want to grow more. Afghan businesses are ambitious in their expansion plans: 77 percent of respondents plan to expand in 2009. Between 2005 and 2008, the average growth in sales for the panel firms was 220 percent and median growth was 92 percent, with two-thirds of panel firms recording consistent growth. This is further corroborated by national accounts data, which report a doubling of industrial and service sector GDP since 2005 (figure 3). The strong

FIGURE 3
Growth in Private Sector GDP



Source: Afghanistan Central Statistics Office.

⁷ An example of indirect exports here is re-exports.

firms are getting stronger: the intention to expand is greater for large and medium-sized firms than for micro and small firms, and for registered firms than for unregistered firms. This is particularly true for Kabul-based firms. Eight percent of all firms say they plan to expand internationally.

2.4 Analyzing the single biggest obstacle identified by firms supports the notion of latent dynamism in the private sector. When firms were asked to pick just one constraint that is the single biggest obstacle to their business, factor markets led the way. Access to finance was identified as the single biggest problem for 22 percent of the sample, followed closely by electricity (21%), and access to land (13%). The governance-related indicators—crime, theft, and disorder (17%), policy enforcement (15%), and corruption (6%)—were cited as the single biggest obstacle less often than finance or electricity.

2.5 However, when firms were asked to rate the severity of individual constraints, both governance and factor markets emerged as major issues (figure 4). The following are the top six constraints:

- Policy enforcement
- Electricity
- Crime, theft, and disorder
- Corruption
- Access to land
- Access to finance

2.6 The main constraints are consistent across the survey.⁸ These constraints rank higher than others not only for Afghanistan as a whole but across all sectors, across all firm sizes except small firms, across most cities, and irrespective of firm type or market.⁹ However,

⁸ One constraint ranks higher in severity than another constraint if the percentage of firms that cite it as a major or very severe obstacle is higher than the percentage of firms that cite the other constraint as major or very severe.

⁹ Ninety-four percent of the surveyed firms reported one of these six constraints as their single biggest obstacle.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 4
Major Business Problems

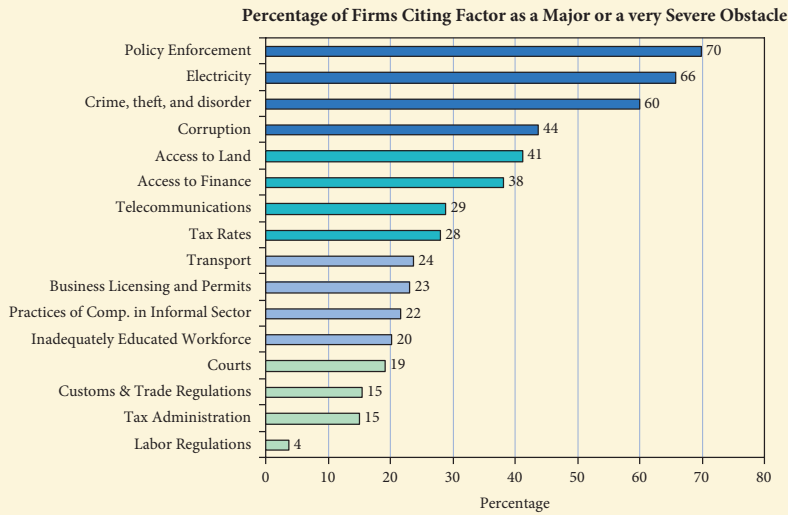


TABLE 1
Ranking of the top six investment climate constraints by sector

	Policy Enforcement	Electricity	Crime, Theft, & Disorder	Access to Finance	Corruption	Access to Land
Manufacturing	1	2	3	4	5	6
Construction	1	4	3	6	2	5
Retail	1	3	2	5	4	6

TABLE 2
Ranking of the top six investment climate constraints by firm size

	Policy Enforcement	Electricity	Crime, Theft, & Disorder	Access to Finance	Corruption	Access to Land
Micro	1	3	2	4	6	5
Small	2	3	4	7	6	5
Medium	1	2	3	6	4	5
Large	1	3	2	5	4	6

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

TABLE 3
Ranking of the top six investment climate constraints by city

	Policy Enforcement	Electricity	Crime, Theft, & Disorder	Access to Finance	Corruption	Access to Land
Kabul	1	2	3	5	4	6
Herat	1	5	2	4	3	7
Kandahar	1	2	3	13	4	6
Mazar-e-Sharif	1	4	2	3	7	8
Jalalabad	3	1	2	10	4	11

TABLE 4
Ranking of severe constraints by firm type

	Policy Enforcement	Electricity	Crime, Theft, & Disorder	Access to Finance	Corruption	Access to Land
Registered	1	2	3	6	4	5
Unregistered	1	2	3	5	6	4

TABLE 5
Ranking of severe constraints by market

	Policy Enforcement	Electricity	Crime, Theft, & Disorder	Access to Finance	Corruption	Access to Land
Exporter	1	3	2	6	4	5
Non-exporter	1	2	3	6	4	5

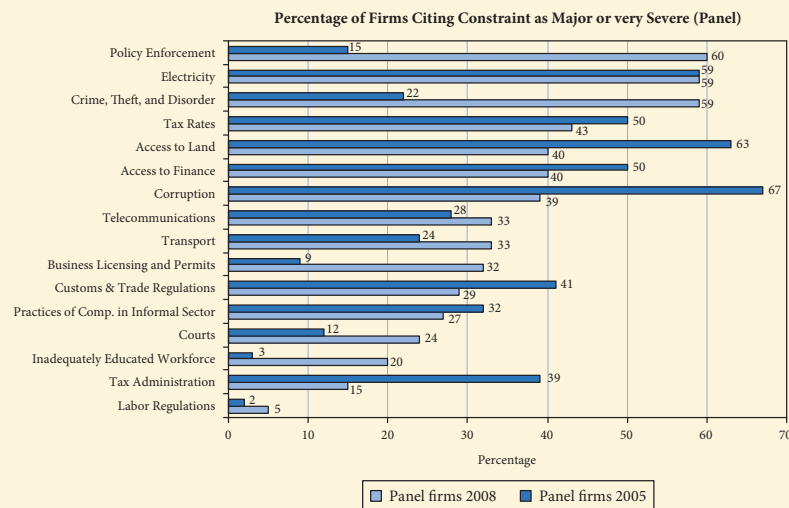
the ordering of the top six constraints varies within each group with policy enforcement almost always emerging as the top constraint.. We have defined the most severe constraint—policy enforcement—as meaning “state ineffectiveness in designing and implementing consistent policies.” Comparing these findings with a recent Department for International Development (DFID) study on binding constraints is illuminating. The DFID report highlighted the failure of governance: “From a public policy perspective, the most relevant result is confirmation that in Afghanistan, private investment decisions are being negatively affected by the uncertain environment, absence of rule of law, unpredictable tax structures and by widespread

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

corruption.”¹⁰ While our survey confirms these findings, it also points to weak factor inputs and lack of innovation by firms as acute shortcomings in the country.

2.7 Since 2005, there has been a serious decline in the perception of policy enforcement and crime prevention, and not much improvement elsewhere (figure 5). This is consistent with security statistics, which include coalition military deaths as one measure (figure 6). Even though perception data indicate that some issues had become less of a problem, the quantitative measures show little improvement in any category. For example, with respect to land, the *Doing Business* results showed no reduction between 2008 and 2005 in the 252 days it took to register property in Kabul, yet the enterprise survey recorded improved perceptions. In the area of corruption, there was a 20 percent increase in the informal payment required to secure a contract, yet surveyed perceptions improved. This could reflect the relative importance of other issues, as well as the maturation of businesses, many of whom started in the post-Taliban period (figure 7). The older firms have resolved—or, more likely, learned to live with—these constraints.

FIGURE 5
Major Business Problems (Panel)



¹⁰ *Understanding Afghanistan Report*, DFID, 2008.

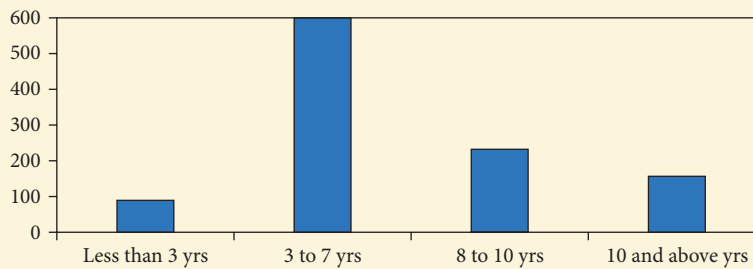
THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 6
Coalition Fatalities



Source: HSRP; iCasualties.org.

FIGURE 7
Ages of Surveyed Firms

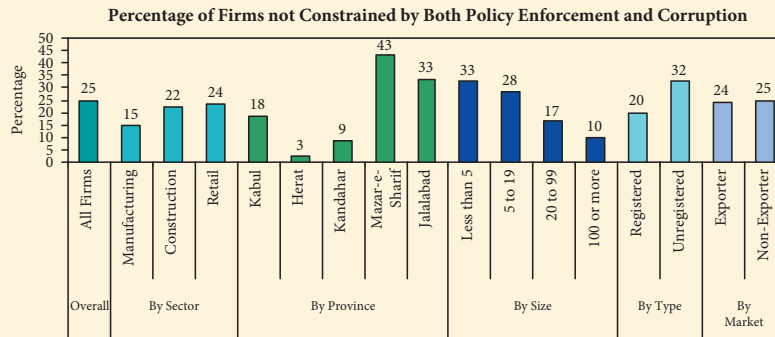


2.8 The aging profile of surveyed firms is unusual. Figure 7 shows that very few surveyed firms entered the market in the past two years. While the survey does not explain this phenomenon, it is relatively unexpected for a country that is moving from a command economy toward a market economy.

2.9 A review of firms constrained neither in terms of policy enforcement nor corruption identifies “below-the-radar” firms (figure 8). Such firms (one in every four surveyed), we believe, should enjoy strong productivity benefits relative to their peers. These are typically smaller firms located in relatively secure and politically stable areas. According to our analysis, firms that are constrained by weak policy enforcement are 32 percent less productive than firms that are not, and those constrained by corruption are 26 percent less productive. For policymakers, the analysis suggests the need to support larger firms, which in most economies are the engines of productivity and innovation. The security

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 8
Firms Not Constrained by Policy Enforcement or Corruption

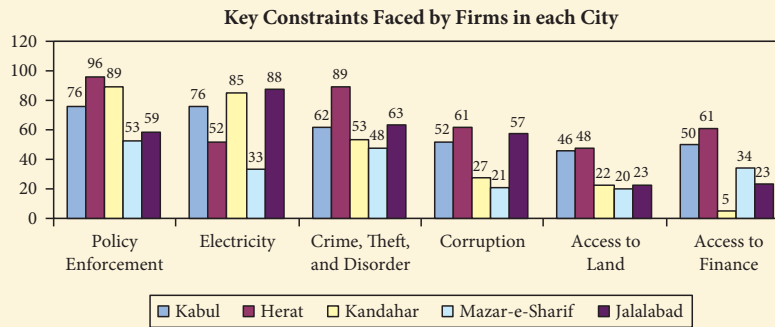


findings are also sobering and illustrate the benefit the private sector will gain from improved security.

2.10 While the main constraints are consistent across the five main cities, some interesting differences emerge.

In general, the same top six constraints (policy enforcement, electricity, crime and theft, corruption, land, and finance) are reported as the biggest problems in all five cities, although the order varies (table 3; figure 9). And when firms identified their single biggest obstacle, strong differences emerged among the cities (figure 10). Some of these differences can be explained; for example, electricity is a major problem in Jalalabad because it is not connected to the national transmission grid, and access in Kabul because it is the most economically dynamic city and there is a greater unmet need for finance.

FIGURE 9
Main Constraints Faced by Firms in Each City



THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

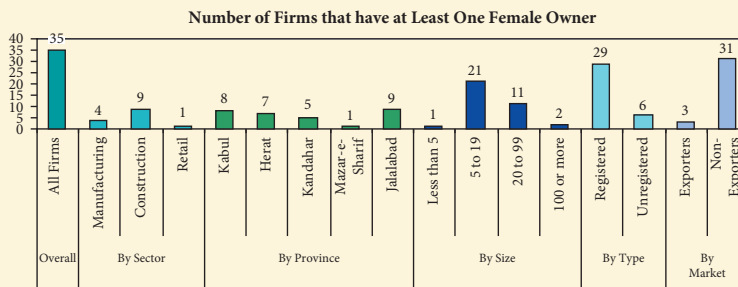
FIGURE 10
Single Biggest Obstacle in Each City



2.11 While Mazar-e-Sharif reports better perceptions compared with the national average in 14 of 16 constraints, the quantitative indicators reveal a mixed picture. The difference is most marked for electricity, which just one in three Mazar-e-Sharif firms considers a severe constraint, compared with two out of three firms in the overall survey. Other areas in which Mazar-e-Sharif fares significantly better than the national average are corruption, access to land, and transport. However, while the quantitative governance indicators for Mazar-e-Sharif are strong and support the perception findings, this is not true for access to finance and access to land. For instance, of the 142 surveyed firms in Mazar-e-Sharif, only 4 applied for additional land and 1 applied for a construction permit. The survey also reveals that the largest percentage of firms in Mazar-e-Sharif (39%) reported land as the single biggest obstacle. This, combined with the finding that Mazar-e-Sharif reports the lowest percentage of firms that plan to expand in the near future, raises the question as to why businesses are not growing or showing the dynamism they should in Mazar-e-Sharif (given its strong perception and governance indicators). It could be hypothesized that Mazar-e-Sharif's obvious strengths on governance have resulted in the perception that it has a relatively good business environment, but its weakness in factor inputs may be causing disinterest in the private sector in further investing and expanding in Mazar-e-Sharif. One clear finding of the survey is that different cities have different investment climates.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 11
Number of Firms that have One or More Women as Owners



2.12 Registered firms¹¹ and exporters¹² perceive themselves as more constrained in several ways. Registered firms are more constrained than unregistered firms in perceptions of all factors except access to finance and courts. Exporters find themselves more constrained than non-exporters with respect to crime, corruption, customs and trade regulations, an inadequately educated workforce, transport, and telecommunications.

2.13 The number of firms with at least one woman as the owner has increased since 2005 from 6 firms (2% of the sample) to 35 firms (3% of the sample) (figure 11). Such firms are mostly small, registered, and non-exporting firms.

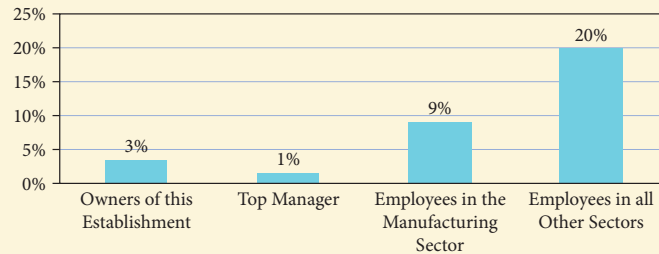
2.14 Women are participating in the Afghan private sector, but not in large numbers. Women constituted 1 percent of top managers, 3 percent of permanent full-time production employees, and about 2 percent of permanent full-time nonproduction employees in the surveyed firms. Of the 15 top women managers, 12 were from the professional, technical, or scientific sector, including teaching and health professionals. The 9 percent of manufacturers that employ women are from a more eclectic mix

¹¹ In this survey, a “registered firm” is a business that is registered with a central government body; for example, the Afghanistan Investment Support Agency (AISA) or any government ministry. An “unregistered firm” is a business that is not registered with any organization or only registered with the local municipality, business association, or union. The 2008 Enterprise Survey included 419 unregistered firms (39% of the surveyed sample). There could be a correlation between registered and formal firms, and between unregistered and informal firms; however, formality cannot be assumed on the basis of registration status.

¹² Firms are classified as “exporters” if they report a higher proportion of sales that are direct or indirect exports, and as “non-exporter firms” if all their sales are national sales. The 2008 sample includes 72 exporter firms and 981 non-exporter firms.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 12
Roles of Women in the Surveyed Firms



of business activities, spanning production of biscuits, drugs, rugs, cabinets, handicrafts and electrical appliances, amongst others (figure 12).

2.15 Women-owned firms, where there is at least one female owner, are more constrained as compared to the typical Afghan firm. Perceptions of constraint severity in such firms are higher for 15 of the 16 constraints; although the top 5 constraints are the same as those for the overall sample (figure 13). Access to finance was ranked as the single biggest obstacle by the majority of these women-owned firms.

2.16 A comparison of Afghanistan with comparator countries reveals similarities in the major constraints and the degree of dissatisfaction. Table 6 shows that emerging market economies such as Thailand can be a source of best practices. (See annex 4 for more comparisons.) Afghanistan can learn much from other developing countries.

FIGURE 13
Constraints Faced by Firms with at least One Female Owner

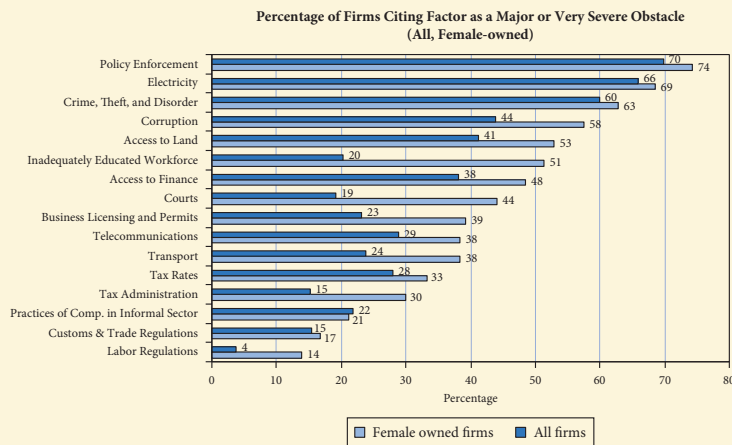


TABLE 6
A Snapshot of Quantitative Indicators Across Comparator Countries*

<i>Doing Business</i> 2009 Rankings (181 countries)	Duration of power outages (hours)	Annual cost of security (% of sales)	% contract value paid as informal payment to secure contract	% total annual sales to get things done	% senior management time spent on government regulations	% new investment from banks	% firms with internationally recognized quality certification	% firms using technology licensed from foreign companies	% firms that have a website
Afghanistan	11	3	6	2	7	2	5	6	15
Yemen	3	-	16	9	16	9	19	17	-
Pakistan	2	4	1	34	2	-	9	3	95
Ethiopia	-	1	-	-	4	11	4	4	18
Tajikistan	-	3	-	-	12	21	17	25	21
Thailand	-	-	-	-	1	75	45	-	34
DR Congo	18	3	81	84	6	3	4	4	6

*Note: Yellow boxes indicate best practices, while red boxes indicate worst practices.

2.17 A simple productivity analysis of manufacturing firms reveals the extent to which specific factors can constrain performance. Effective policies, a reduction in corruption levels, a secure environment, power, technology, and modern management practices are all critical factors that drive productivity. Details of the methodology are presented in annex 3. The key findings are shown in box 2.

BOX 2

Key Findings From the Productivity Analysis*

- **Firms that have access to the grid are 49 percent more productive than firms that do not.** Not having electricity negatively and significantly affects productivity.
- **Corruption and weak policy enforcement negatively affect productivity.** A negative correlation can be established between productivity and perceptions relating to corruption and weak policy enforcement. Firms that perceive policy enforcement as a major or very severe constraint are 32 percent less productive, while firms constrained by corruption are 26 percent less productive. However, the perception estimates are only moderately significant.
- **Firms that reported losses from theft, robbery, arson, or vandalism are less productive than firms that have not reported such losses.** This result is invariant to different regression specifications and is statistically significant in all results. In our final specification, a firm reporting output losses due to crime, theft, and disorder was found to be 63 percent less productive than a firm that did not suffer such losses.
- **Younger firms and firms that have an import license have higher productivity.** Firms that have an import license are 88 percent more productive than firms that do not. Younger firms were found to be more dynamic and productive than older firms.
- **Mazar-e-Sharif emerges as the most productive city.** The productivity gap between firms located in Mazar-e-Sharif and those in other cities covered by the survey was 170 percent and was statistically significant.
- **Unregistered firms and micro firms are only slightly less productive.** Registered firms were found to be just 2 percent more productive than unregistered firms, but this estimate is not statistically significant. Small, medium, and large firms fare better than micro firms with respect to productivity; this estimate is also not statistically significant.

* There could be a problem of measurement errors in this analysis due to limited sample size and possible data quality issues; also, there are econometric issues that cannot be resolved without panel data. We have nonetheless attempted a limited productivity analysis within the existing constraints, with the caveat that the findings should be viewed strictly as indicative. However, given that most of the productivity analysis findings triangulate well with the perception survey results, as well as with other studies on Afghanistan, there is a certain degree of confidence in the broad messages emerging from the productivity analysis.

TABLE 7
Firms Face Huge Productivity Taxes

Problem Area	Indicator
SALES	
Output losses due to power outages	9% of sales
Output losses from theft, robbery, arson, or vandalism	11% of sales
COST OF SALES AND OVERHEADS	
Cost of security	3% of sales
Percentage of contract value paid to secure contract	6% of sales
Bribes to get things done	2% of sales

2.18 *The impact of productivity taxes on firms is huge.* The survey identified a number of productivity taxes that directly affect firms' bottom lines (table 7). There could be other productivity taxes that were not captured by the survey.

2.19 *Several strong positive findings bode well for the future.* While significant challenges remain to be overcome, the survey identifies some good news for entrepreneurs and investors—see box 3.

THE GOVERNANCE CHALLENGE

2.20 *The survey highlights governance¹³ issues of policy enforcement, corruption and crime, and security as major problem areas.* As the survey shows, these factors impose a tax on productivity and competitiveness. Poor governance also limits the predictability of government interactions. The fundamental connection between governance and development is illustrated in figure 14. This finding is

¹³ "Governance" refers to the traditions and institutions by which authority is exercised in a country. This includes the process by which governments are selected, monitored, and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them (<http://info.worldbank.org/governance/wgi/index.asp>).

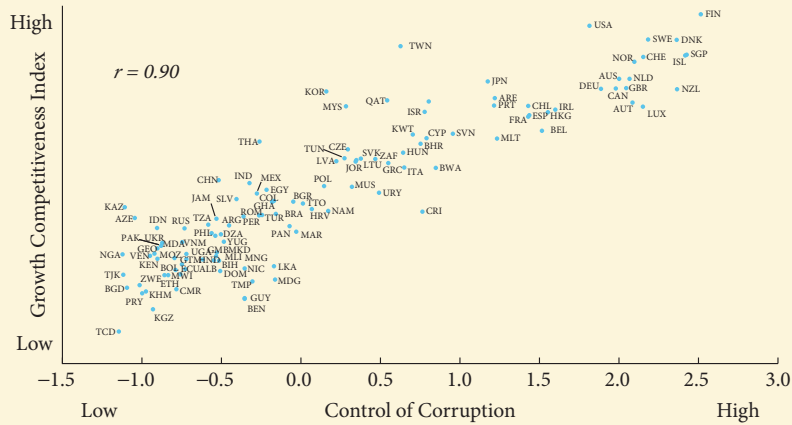
BOX 3

Celebrating the Good News in the Survey

- ***Private sector exhibits latent dynamism.*** There is clear evidence of latent growth and investment potential in Afghanistan. Seventy-seven percent of firms plan to expand in 2009, and 8 percent plan to expand internationally. Two out of three panel firms recorded growth, with average sales growth at 220 percent. Growth was higher among large and medium-sized firms, registered firms, and firms based in Kabul.
- ***Overall findings are positive.*** Panel firms recorded improved perceptions on several key indicators since 2005, including corruption, skills, access to finance, access to land, transport, tax rates and administration, and customs and trade regulations. Moreover, some Doing Business indicators including starting a business, employing workers and paying taxes – reinforce the survey findings that business licensing and permits, lack of skills, tax rates and tax administration are not perceived by firms as severe constraints. Afghanistan also performs better than comparator countries on several quantitative indicators. Mazar-e-Sharif reports better perceptions compared with the national average in 14 of 16 constraints, and the productivity gap between firms in Mazar-e-Sharif and those in other surveyed cities is 170 percent. The number of firms where at least one owner is female has increased since 2005.
- ***Governance displays elements of hope.*** The survey showed that in areas where security and services are better, productivity improves dramatically.
- ***Factor markets lead the way.*** Rigidities in labor markets and availability of skills are not generally perceived to be a problem. The majority of workers in Afghan firms is literate. Although only half of all firms have a bank account, this is an improvement over 2005. Several indicators of physical infrastructure—including transport, telecommunications, and water—were not found to be big issues.
- ***Innovative and productivity-enhancing behaviors exist in some Afghan firms.*** The survey established that firms that use technology and modern management practices, and those that trade internationally, do better. About 14 percent of the firms offer formal training, up from 5 percent in 2005. Since 2005, the proportion of firms using e-mail has doubled and the proportion of firms that have a website has risen by 67 percent. Twenty-one percent of retail firms reported sales via indirect exports.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 14
Governance and Competitiveness

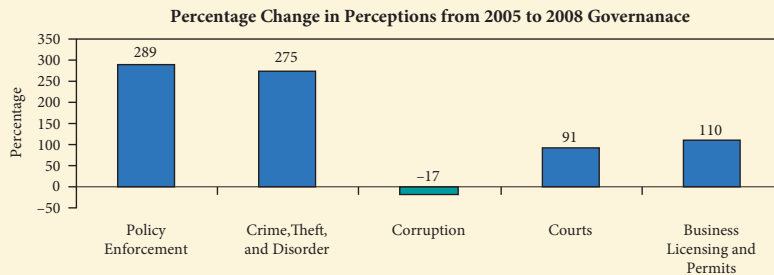


Source: GCI is based on 2006 data of the World Economic Forum; control of corruption is for 2004, from Kaufmann et al. 2005.

supported by other analyses: Afghanistan ranks 162nd of 181 countries in the World Bank’s *Doing Business 2009* report and 176th of 180 countries in Transparency International’s *Corruption Perception Index 2008* (annex 4).

2.21 Perceptions regarding governance appear to have deteriorated significantly since 2005. Figure 15 shows that severity perceptions on all governance indicators except corruption declined dramatically between 2005 and 2008.

FIGURE 15
Change in Perceptions on Governance Indicators Between 2005 and 2008



2.22 *Of the governance indicators, policy enforcement*¹⁴ *ranks highest in the percentage of enterprises that perceive it as a major or very severe constraint.* This is true across all sectors (manufacturing, construction, retail); for all firm types (registered and unregistered); for all firm size categories except small firms; and for most cities covered by the survey. Overall, 70 percent of the sample considers policy enforcement to be a major or very severe obstacle to their operations. It is noteworthy that its close kin— macroeconomic instability—did not rate as an issue in 2005.¹⁵

2.23 *Only 14 percent of respondent firms agreed that laws are interpreted consistently and predictably by government officials.* Across all sectors and cities—and irrespective of firm size, type, or market—at least 70 percent of firms reported a lack of consistency and predictability (relating to their establishments) on the part of government officials. Overall confidence in the judicial system is also low, with 84 percent of Afghan businesses finding the court system corrupt and unfair.

2.24 *There has been a marked deterioration since 2005 in the way crime, theft, and disorder are perceived by Afghan firms.* In 2005, crime was cited by just 16 percent of the sample as a major problem and ranked outside the top 10 constraints. In 2008, crime ranks third, after policy enforcement and electricity, and is perceived as a serious obstacle by 60 percent of Afghan enterprises. This is corroborated by

¹⁴ What is “policy enforcement”? The 2008 Enterprise Survey asked firms whether “political instability” (not “policy enforcement”) was a constraint. However, discussions with the government and other stakeholders revealed that this term—especially in view of the fact that it emerged as the number one constraint—could have several sensitive political connotations that were not necessarily implied by the questionnaire. To clarify the issue, 10 firms that reported “political instability” as the biggest obstacle to their business were recontacted to ask what they understood the phrase to mean, and three independent Dari-English bilingual speakers were asked to translate and interpret the phrase. Broadly, the phrase was understood to imply an unstable government or political turmoil leading to frequent policy reversals and weak enforcement of policies. This understanding was discussed in detail with key stakeholders, and a consensus emerged to rename this constraint “policy enforcement,” which would imply “state ineffectiveness in designing and implementing consistent policies.” It has also been agreed that future enterprise surveys will attempt to unpackage this indicator to better understand its exact impact on private sector enterprises.

¹⁵ An exact comparison of policy enforcement cannot be made with the 2005 survey, in which respondents were asked about “macroeconomic instability,” which may have been interpreted differently. In 2005, only 18 percent of firms ranked macroeconomic instability as a major constraint. In fact, this constraint did not even rank among the top 10 in the 2005 survey.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

panel firms: 22 percent complained about severity in crime in 2005, and 59 percent complained in 2008. Crime ranks among the top four constraints for all sectors, cities, firm sizes types, and for both exporters and non-exporters.

2.25 One in ten surveyed firms reported losses due to theft, robbery, vandalism, or arson (figure 16). Moreover, 36 percent of Afghan enterprises pay for their own security, including equipment, personnel, and professional security services. The average annual cost of security was 140,525 Afghanis (US\$2,679). However, security costs for all firms fell from 15 percent of sales in 2005 to just 3 percent in 2008. Six percent of surveyed companies also reported making protection payments to government officials or military commanders (figure 17).

FIGURE 16
Many Afghan Firms Are Victims of Theft and Vandalism

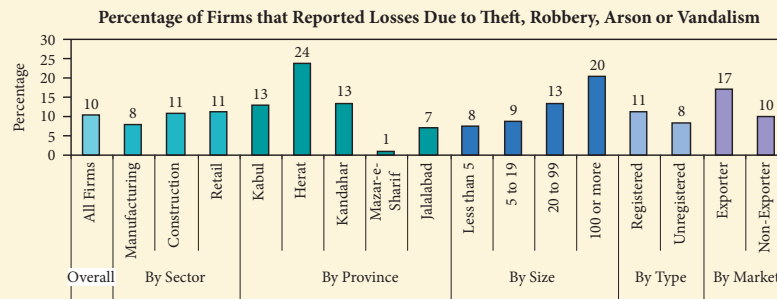
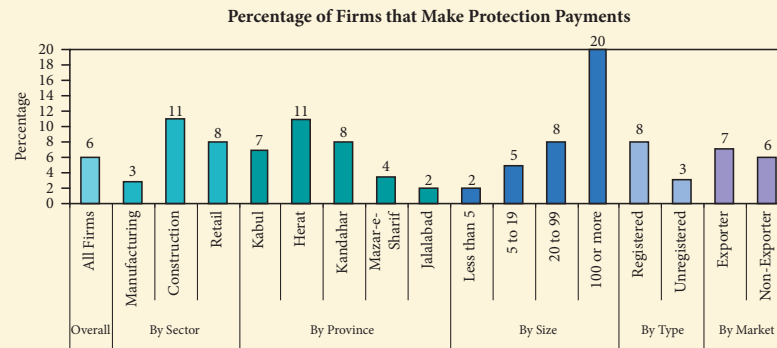
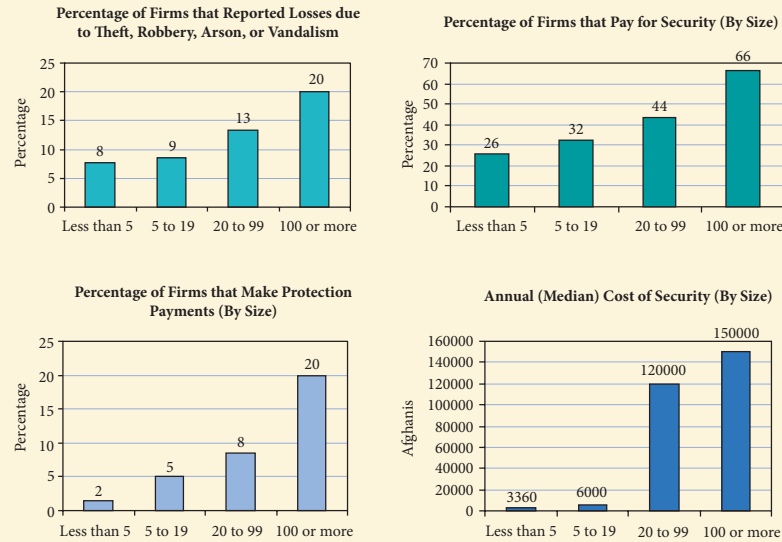


FIGURE 17
Some Afghan Firms Make Protection Payments to Government Officials or Military Commanders



THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 18
Effect of Crime on Different-Sized Firms



2.26 Crime significantly affects larger firms. Medium-sized and large firms tend to perceive crime, theft, and disorder as severe more often than micro and small firms. This perception is validated by the fact that the percentage of larger firms reporting losses from theft is more than double that of micro and small firms. Larger firms are more likely than smaller firms to pay for security or make protection payments, and they incur a higher annual average cost for security (figure 18).

2.27 Nearly 90 percent of firms in Herat cited crime as a major obstacle. Many firms in Kabul and Jalalabad also cited crime as a major obstacle. In these three cities, compared with other cities, a larger percentage of firms had to pay for security. Herat also had the largest percentage of firms that reported losses as a result of theft, robbery, arson, or vandalism. Mazar-e-Sharif fared best among the five cities, with just 1 percent of firms facing such losses.

2.28 Crime poses a relatively more serious obstacle for the retail sector and for construction firms. Eleven percent of firms in construction and retail (compared with 8% in manufacturing) suffered losses as a

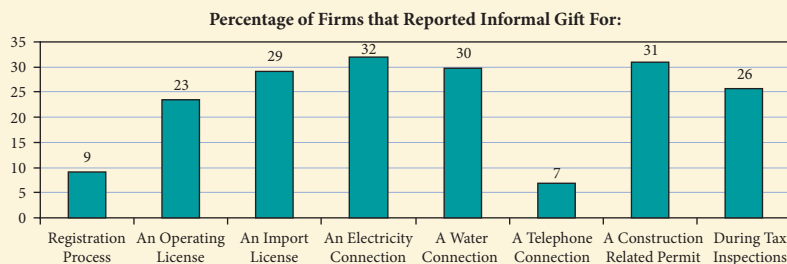
THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

result of crime, theft, arson, or vandalism. Construction firms were more likely than manufacturing or retail firms to report paying for their own security or making protection payments. The median cost of security was also higher for construction firms: 90,000 Afghanis, compared with 24,500 Afghanis for manufacturing and 6,000 Afghanis for retail firms. Crime, theft, and disorder pose a major challenge to medium-sized and large manufacturing firms, micro construction firms, and medium-sized retail firms in particular.

2.29 Exporter firms are relatively more constrained with respect to crime. Exporters are more likely to spend on security and make protection payments as compared to non-exporters. 17 percent of exporting firms, as opposed to 10 percent of non-exporting firms, also reported losses on account of theft, robbery, arson or vandalism. About 5 percent of the consignment value of exported products is lost in transit owing to theft.

2.30 While perception of corruption has improved since 2005, the 2008 quantitative indicators for corruption indicate that it is still a serious issue. In their dealings with public officials, Afghan enterprises pay over 2 percent of their sales as bribes to “get things done.” Afghan businesses were asked whether an informal gift was expected or requested in the course of their business transactions and the responses are indicative of the extent of corruption (figure 19). Firms are more likely to report an informal gift for an electricity connection, construction permit, or water connection. Corruption seems to be alive and well in Afghanistan, as also reported in the *Transparency International 2009* rankings (annex 4).

FIGURE 19
Informal Gifts Are Common Practice in Afghanistan

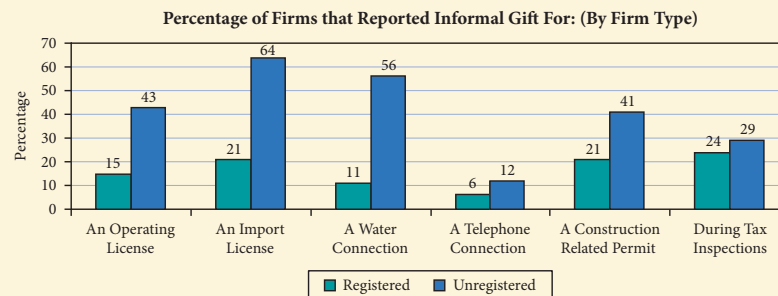


2.31 Corruption exists throughout the country, but its impact is uneven across firms of different sizes and across different cities.

Larger firms generally perceive corruption as a bigger issue, although many small firms report informal gifts or payments in their dealings with public officials, especially for the registration process, securing operating licenses, or obtaining a water connection. Over half the firms in Herat, Jalalabad, and Kabul reported corruption as a severe constraint. Over 20 percent of firms in Herat, Kandahar, and Mazar-e-Sharif (compared with just 4% of firms in Kabul and 6% of those in Jalalabad) reported that an informal gift was expected or requested for the registration process. For an operating license, two out of three firms in Mazar-e-Sharif and two out of five in Jalalabad report paying bribes. To secure an import license, about half of the firms in Mazar-e-Sharif and Herat, and a third of those in Jalalabad, pay a bribe or make a gift.

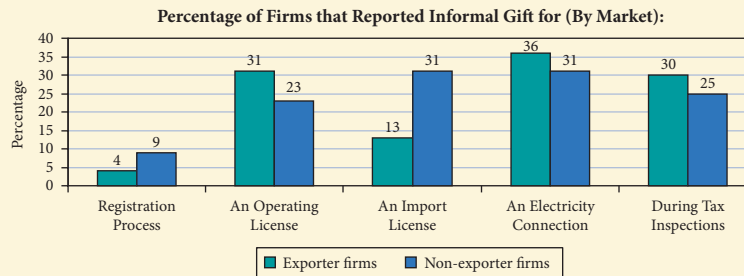
2.32 Almost all quantitative indicators of corruption suggest that this factor is a more severe constraint for unregistered firms than for registered firms.¹⁶ A larger percentage of unregistered firms than registered firms pay bribes in most kinds of dealings with public officials (figure 20).

FIGURE 20
Corruption Indicators for Registered and Unregistered Firms



¹⁶ This finding is in contrast with the perception data, in which corruption is perceived as a major or very severe constraint by 50 percent of registered firms and just 33 percent of unregistered firms. Corruption is also ranked higher for registered firms (fourth) than for unregistered firms (sixth).

FIGURE 21

Exporting Firms Face Higher Pressures From Corruption**2.33 Corruption is a very serious constraint for construction firms.**

Sixty percent of enterprises in the construction sector perceive corruption as posing a severe obstacle to their operations—much higher than in manufacturing (43%) or retail (48%). An analysis by size of construction firms reveals that small firms are relatively better placed. Less than half of the small construction firms complained about corruption; in all other size categories, the figure was over 70 percent. Even though perceptions relating to corruption are better for manufacturing, 60 percent of medium-sized manufacturing firms cite corruption as a serious obstacle. In retail, there appears to be a direct correlation between the size of the firm and the perception of constraint severity with respect to corruption.

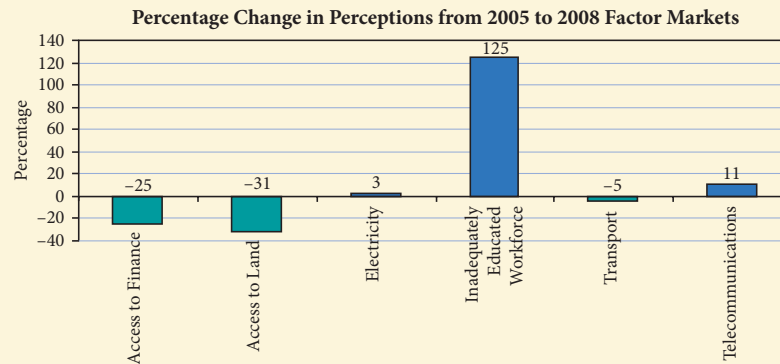
2.34 Exporters are more likely to make an informal gift or payment to get things done, except for registration and procuring an import license (figure 21). Exporters also pay a smaller proportion of the contract value as informal payment in order to secure contracts.

GETTING FACTOR MARKETS TO WORK BETTER

2.35 Factor markets have seen mixed improvements since 2005 (figure 22). The need to get factor markets to work better is another key message from this survey. We look at the traditional factor markets of capital, labor, and land. We define land as serviced industrial land, with electricity and water as the fundamental services.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 22
Change in Perceptions of Factor Market Indicators Between 2005 and 2008

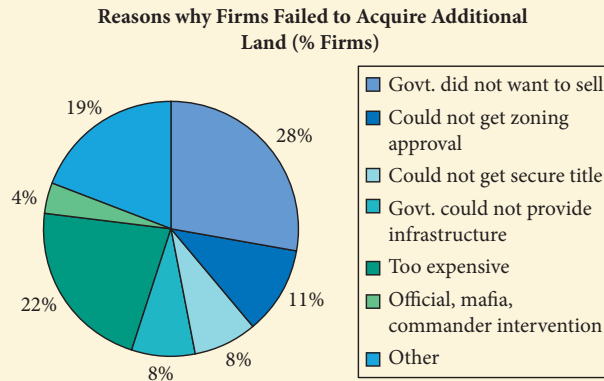


SERVICED LAND

2.36 *In 2008, 41 percent of surveyed firms reported access to land as a major or very severe constraint to their business operations.* While perceptions relating to the severity of this constraint have improved since 2005—when access to land ranked second after electricity—it is now perceived as the fifth most important constraint. The only major deviations from the overall ranking are seen in smaller cities, where as many as 65 percent of firms complain about land; and, conversely, in Jalalabad, where only 23 percent complain. Medium-sized and large firms (compared with micro and small firms) and the construction sector (compared with other sectors) are relatively more constrained by land access.

2.37 *Additional land is not easy to obtain—68 percent of the respondents who tried to acquire new land in the past three years failed to do so.* In fact, the figure for Kabul is as high as 83 percent. Overall, it took an average of 192 days to obtain land. Inability to acquire land can be attributed to several factors, primarily because the government did not want to sell it. One in five firms also found buying new land too expensive. Failure to obtain zoning approval, failure to get a secure title, and mafia-related issues were also cited as reasons for the inability to acquire land (figure 23). The fact that 4 percent of respondents

FIGURE 23

Reasons for Inability to Acquire Additional Land

reported being unable to acquire land because of mafia or military commander intervention may indicate a correlation between access to land and crime/security; however, the survey does not have enough information to confirm or refute this hypothesis.

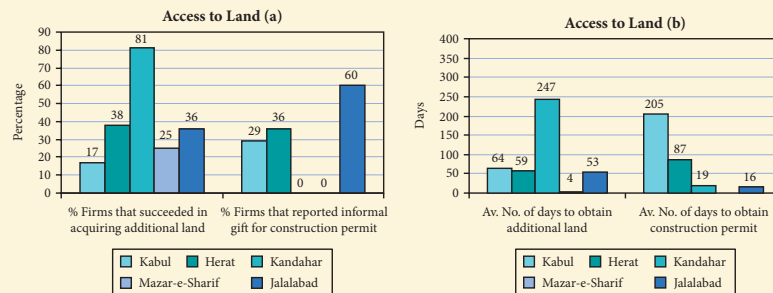
2.38 It took firms an average of 88 days to obtain a construction permit. Among Afghan businesses that applied for construction-related permits, 31 percent reported that an informal gift was expected or requested.

2.39 Obtaining additional land appears to be less of a challenge in Kandahar, although it takes longer. Of the firms that attempted to acquire land in this region, 81 percent succeeded. As a matter of fact, Mazar-e-Sharif, Kandahar, and Jalalabad reported a lower percentage of firms that cited land access as a major or very severe constraint compared with the overall average of 41 percent. However, it can take an average of 247 days to obtain land in Kandahar, compared with the 4 days reported by one firm in Mazar-e-Sharif.¹⁷ Kabul reported the highest percentage of firms that failed to acquire additional land; the main reason was the unwillingness of the government to sell. Kabul also fared

¹⁷ In Mazar-e-Sharif, only 4 out of 142 firms applied for additional land. Of these, only 1 firm succeeded in acquiring it. The other three firms found the land to be too expensive. Only one firm applied for a construction permit.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 24
City Variations on Access to Land Indicators



worst in the number of days needed to obtain a construction permit. Jalalabad was worst in terms of corruption related to construction permits (figure 24).¹⁸

2.40 The construction sector is relatively more constrained than others with respect to land access. The severity of this constraint is reported to be higher for medium-sized and large firms than for small and micro firms. A smaller proportion of construction firms than manufacturing or retail firms succeeded in acquiring new land. Failure to acquire land because of an inability to get zoning approvals was also cited by more construction firms than manufacturing or retail firms

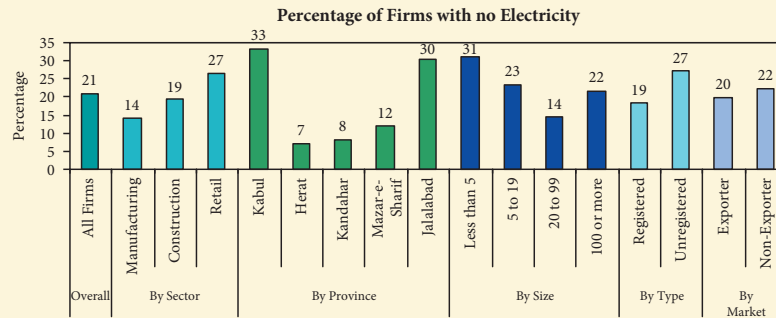
2.41 Electricity is a constraint for most firms, despite some improvements. This result is virtually unchanged from the last survey. In 2008, 66 percent of the sample cited electricity as a major or very severe obstacle to doing business. In 2005, the figure was 64 percent. Although several quantitative indicators for electricity show an improvement from 2005, it remains a serious obstacle constraining business operations.

2.42 Firms are either unconnected or suffer from unreliable connections. About 20 percent of surveyed firms do not have access to the grid. The problem is more acute for retail firms than for other sectors;

¹⁸ There were only a small number of responses to these questions, therefore further study is recommended to properly dimension this issue.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 25
Many Firms Have No Access to a Public Supply of Electricity



for Kabul and Jalalabad than for other cities;¹⁹ for micro firms than larger firms; for unregistered firms than registered firms; and for non-exporters than exporters (figure 25).

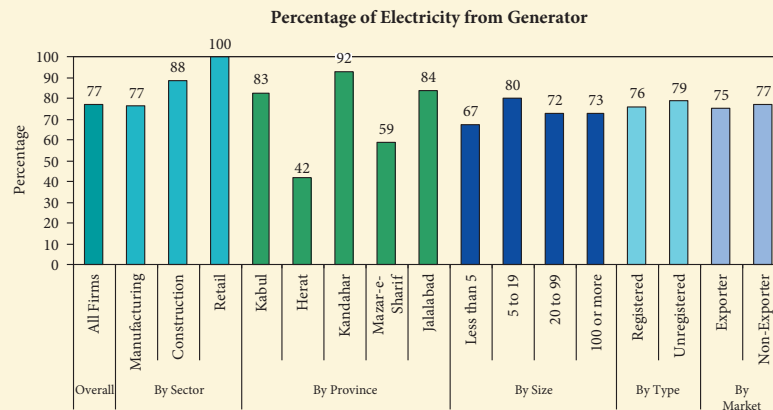
2.43 Power outages are a regular feature for Afghan businesses.

Among firms having access to the grid, 73 percent reported suffering power outages, with an average of 23 outages per month, each lasting about 11 hours. However, the situation has improved substantially since 2005. In the 2005 survey, firms reported having power for an average of just six and a half hours a day. For the panel firms, outage duration dropped from 20 hours in 2005 to 8 hours in 2008. Despite this, firms in 2008 reported output losses from power outages averaging 9 percent of sales. There is enormous dependence on privately generated electricity. Seventy-five percent of Afghan enterprises report having a generator, with 77 percent of electricity coming from private sources of power (figure 26). This is costly for firms—the industrial tariff for getting electricity from the grid is about US\$0.20 per KW hour, while private generation can cost upwards of US\$0.30 per KW hour.²⁰

¹⁹ When our survey ended in December 2008, Kabul received a total of 30MW of power per hour. In January 2009, a power line constructed between Kabul and Uzbekistan became active, delivering an extra 40MW of power per hour to Kabul. The availability of power is expected to increase further. Under a project funded by the Asian Development Bank (ADB), a transmission line will be constructed from Kabul to Jalalabad over the next two years to provide power to Jalalabad.

²⁰ These are approximate estimates; the cost varies by region.

FIGURE 26
Most Enterprises Rely on Self-Generated Power



*Note: The 100 percent figure for Retail is based on responses obtained from only 2 retail firms in the sample.

2.44 Perceptions relating to electricity are worse for manufacturing firms than for construction and retail firms. Managers in manufacturing firms are more likely to perceive electricity as a serious constraint compared with managers in construction and retail activities. In all three sectors, micro firms are less constrained by electricity problems.

2.45 Water is not as serious an issue as electricity for Afghan firms. About 8 percent of the firms reported experiencing insufficient water supply. Public sources of water account for 17 percent of the water used in the production process. The main problem with regard to water as a factor input is corruption—30 percent of surveyed firms said that an informal gift or payment was expected or requested for a water connection. This problem appears to be more acute for the construction sector, in Jalalabad and Kabul, for smaller firms, and for unregistered firms.

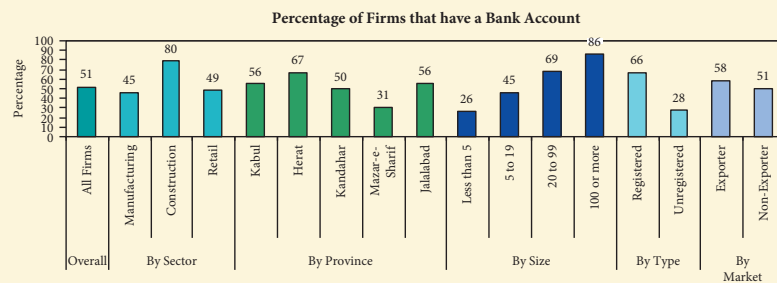
2.46 Lack of serviced land is a serious problem. Firms identified electricity as the second biggest problem and availability of land as the fifth. While steps are being undertaken to provide electricity for the entire country, tackling the issue of serviced land would deal with both these issues in a reasonably quick and practical way.

ACCESS TO FINANCE

2.47 Access to finance was perceived as a major or very severe constraint to doing business by 38 percent of the sample in 2008, compared with 51 percent in 2005. The corresponding figures for panel firms are 40 percent for 2008 and 50 percent for 2005. Despite improvement since 2005, Afghanistan performs poorly relative to comparator countries on quantitative indicators of access to finance (annex 4).

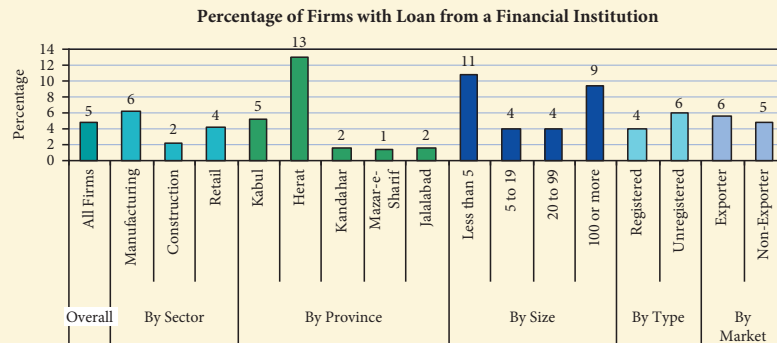
2.48 Afghanistan has made some progress in terms of financial deepening, but there is a long way to go. Only 51 percent of enterprises reported having a bank account, although this is a marked improvement since 2005, when only 30 percent had a bank account. Exporters (compared with non-exporters), registered firms (compared with unregistered firms), larger companies (compared with smaller companies), and firms in the construction industry (compared with manufacturing and retail) are more likely to have a bank account (figure 27). Moreover, 97 percent of enterprises that do have bank accounts are very satisfied or quite satisfied with the services provided by their banks—this sentiment is expressed across sectors, cities, firm sizes, firm types, and markets. Thirty-four percent of enterprises that use banking services also reported having an overdraft facility. However, electronic banking mechanisms need strengthening—only 1 percent, 5 percent, and 1 percent of the respondents reported using ATM cards, credit cards, and payment services, respectively.

FIGURE 27
Percentage of Afghan Firms That Have a Bank Account



THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

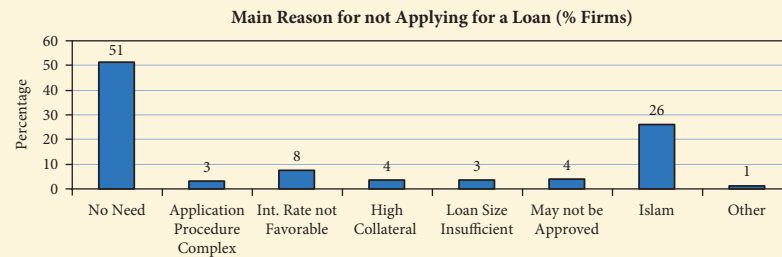
FIGURE 28
Percentage of Firms Accessing Formal Credit



2.49 Only 5 percent of Afghan enterprises have a loan with a financial institution (figure 28). This finding is reinforced by the World Bank’s *Doing Business 2009* report, which ranks Afghanistan 178th of 181 countries in “getting credit.” A major proportion of these loans is provided by private commercial banks (45%), followed by non-banking financial institutions (NBFIs) (29%). Nine in 10 surveyed firms had to supply collateral against their loans; just over half of the firms reported using personal assets, while just under half used land as collateral.

2.50 Close to half of all firms felt the need to access formal credit but did not do so. The reasons varied widely, as illustrated in figure 29. The finding that 51 percent of firms reported having no need for formal credit warrants further research.

FIGURE 29
Reasons for Not Accessing Formal Credit



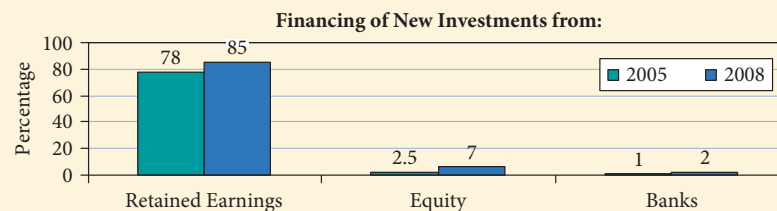
2.51 Working capital is overwhelmingly obtained from non-formal sources of finance. Firms across all sectors, cities, size categories, and firm types report financing between 80 and 90 percent of their working capital from retained earnings. Dependence on banks and NBFIs is just 2 percent.

2.52 Only 7 percent of fixed-asset purchases are made out of owners' contributions or issuance of new equity shares. This is an improvement over the 3 percent figure reported in 2005. Equity financing is relatively more important in manufacturing and retail than in construction; for smaller firms; and for registered firms compared with unregistered firms. Retained earnings are the primary source of financing, accounting for 85 percent of all fixed-asset purchases. Overall, dependence on banks, NBFIs, credit purchases, and other sources (friends, relatives, moneylenders) is miniscule. In fact, no micro firm reported purchasing fixed assets through financing from banks, NBFIs, or on credit.

2.53 Between 2005 and 2008, financing of new investments from retained earnings for all firms increased from 78 percent to 85 percent. While equity financing has shown a slight improvement, little progress is seen with regard to bank credit (figure 30).

2.54 Perceptions relating to access to finance are better for construction firms than for manufacturing or retail firms. Finance indicators reveal a mixed picture on access to and availability of financing across sectors. Four in five construction firms have a bank account—a higher proportion than that of firms in other sectors.

FIGURE 30

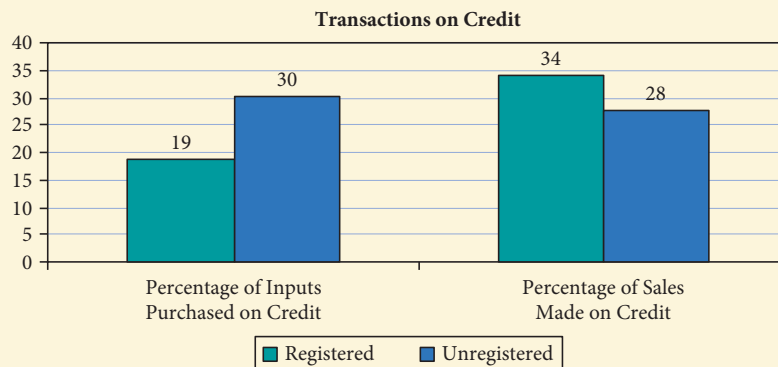
Source of Financing for New Investments

However, construction firms are least likely to have a loan with a financial institution (figure 28). Construction reports a higher percentage of sales made on credit, followed by manufacturing and then retail.

2.55 The quantitative indicators for access to finance place unregistered firms in a weaker position. Although the difference in perceptions is marginal with respect to access to financing, only 28 percent of unregistered firms reported having a bank account, compared with 66 percent of registered firms. Among the unregistered firms that do have a bank account, ATM or credit card use was nil. Relatively fewer unregistered businesses have an overdraft facility than registered firms. Furthermore, a higher proportion of inputs are purchased on credit by unregistered firms than by registered firms. The proportion of sales made on credit, however, is higher for registered firms (figure 31).

2.56 Unregistered firms are more likely to depend on NBFIs for a loan. Half of all unregistered firms reported obtaining a loan from an NBFIs, compared with 12 percent of registered enterprises, which relied more on private commercial banks or state banks for loans. Virtually every respondent in the unregistered sector was required to provide some collateral, compared with 80 percent of registered firms. The majority of unregistered firms used personal assets (e.g., a house) as collateral, while most registered firms used land.

FIGURE 31
Transactions on Credit by Firm Type



THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

2.57 A comparison of finance indicators with other countries reveals a mixed picture. Afghanistan has a larger percentage of firms with a bank account than Yemen does, but it has a long way to go to achieve, for example, the 94 percent figure of Jordan (figure 32). Afghanistan also has the lowest percentage of firms with loans from a financial institution (figure 33). With regard to new investments from banks and other financial institutions, Afghanistan, Jordan, and the West Bank and Gaza are comparable (figure 34). And even though Yemeni

FIGURE 32
Country Statistics on Firms With a Bank Account

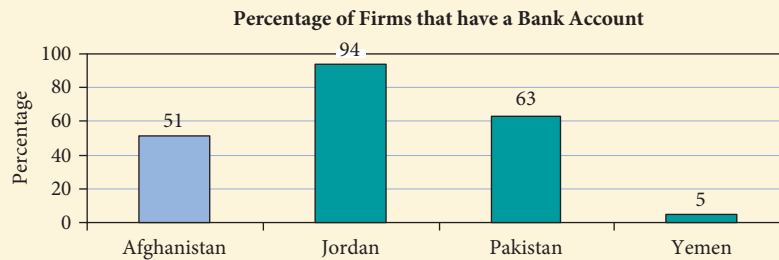


FIGURE 33
Country Statistics on Loans From Financial Institutions

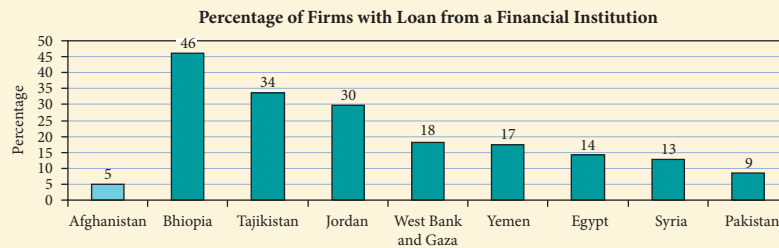
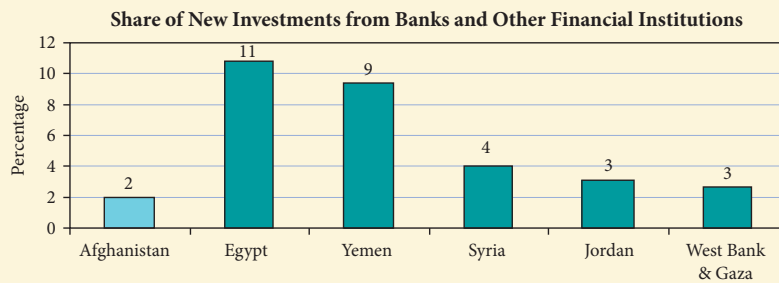


FIGURE 34
Country Statistics on Share of New Investments From Formal Sources



THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

firms are less likely to have a bank account, they are more likely to have loans or new investment from banks and financial institutions.

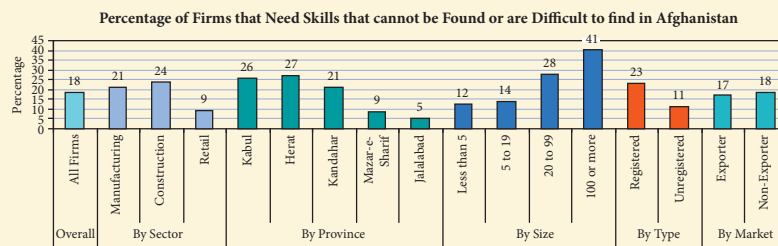
2.58 While there has been improvement, access to formal finance remains a problem. Access to finance was the single biggest obstacle reported by Afghan businesses, and it is generally recognized as a major problem area. The reform agenda is complicated and will take years to implement. In the meantime, it would be useful for policy-makers to develop practical solutions to improve access to finance for the underserved.

LABOR MARKETS

2.59 Rigidities in labor markets or in the availability of skills are not generally perceived to be a problem. While an inadequately educated workforce does not figure among the top investment climate constraints for Afghanistan, a comparison across sectors shows that construction firms are relatively more constrained than manufacturing and retail with respect to skills and education of the workforce.

2.60 While the majority of workers across the board is literate, less than one in three has a secondary education. Only 1 of the 220 manufacturing firms that reported the level of educational attainment of its workers said “college education.” While more than 80 percent of firms do not perceive lack of skills as an issue, a number of them—especially large and registered firms—report being constrained in terms of the availability of skilled professionals and experts (figure 35).

FIGURE 35
Some Afghan Firms Face Skill Shortages



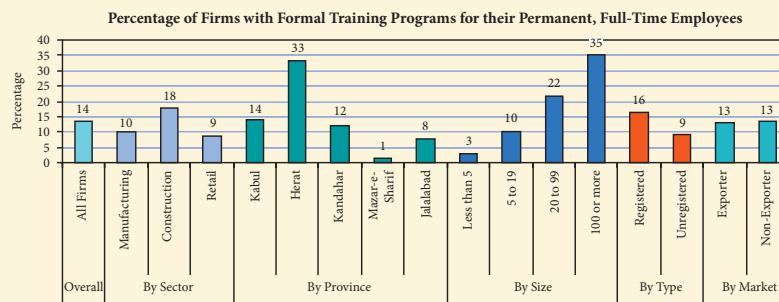
INNOVATIVE AND PRODUCTIVITY-ENHANCING BEHAVIORS

2.61 A key message of this report is that Afghan firms are not sufficiently exhibiting innovative and productivity-enhancing behaviors. While the survey indicates that the high growth witnessed by Afghanistan’s private sector may continue in the short term, a lack of innovative and productivity-enhancing behaviors on the part of Afghan firms could adversely impact the growth pattern of the private sector in the medium and long term. Some of these behaviors are examined below in terms of (a) education and training indicators of the workforce, especially IT skills; (b) efforts by businesses to improve their technology or product quality; and (c) expansion plans of Afghan businesses.

2.62 About 14 percent of the surveyed firms offer formal training (figure 36). This is an improvement over the 5 percent figure reported in 2005. There is a steady increase with firm size in the percentage of firms that train their permanent full-time employees. Formal training in computers is provided by over half of all surveyed firms. Registered firms do better on training and report a marginally higher staff literacy rate.

2.63 Computer and Internet use is weak. This is particularly true for micro and small firms, unregistered firms, and manufacturing and

FIGURE 36
Firms That Provide Formal Training for Employees



THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 37
Computer and Internet Use Varies Widely Among Afghan Firms

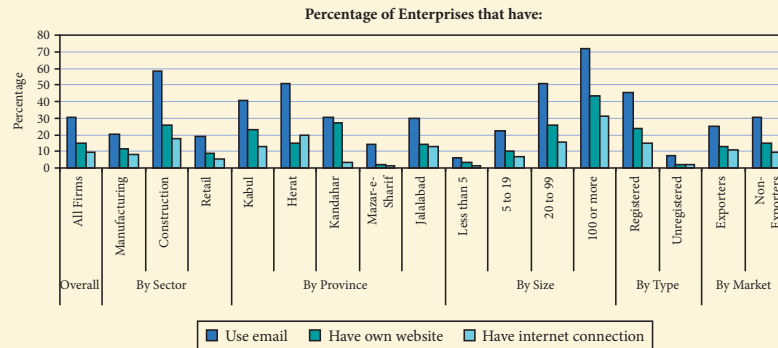
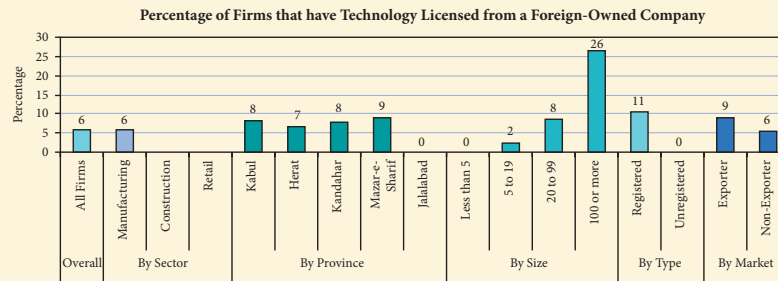


FIGURE 38
Percentage of Firms That Use Foreign-Licensed Technology



retail sectors (figure 37). There has been some improvement, however, since 2005: the proportion of firms that use e-mail has doubled and the proportion that have their own website has risen by 67 percent. Internet connectivity is a challenge: over half of all responding firms reported interruptions in Internet service, lasting an average of 50 hours (median) with a frequency of 13 interruptions each month. Very few Afghan firms report using technologies licensed from foreign-owned companies (figure 38).

2.64 Afghan firms primarily produce for the domestic market (figure 39). A larger proportion of retail firms and a higher incidence of Jalalabad-based firms applied for an import license. Exposure to international markets promotes productivity enhancing behaviors such as

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

FIGURE 39
Percentage of Afghan Firms That Applied for an Import License

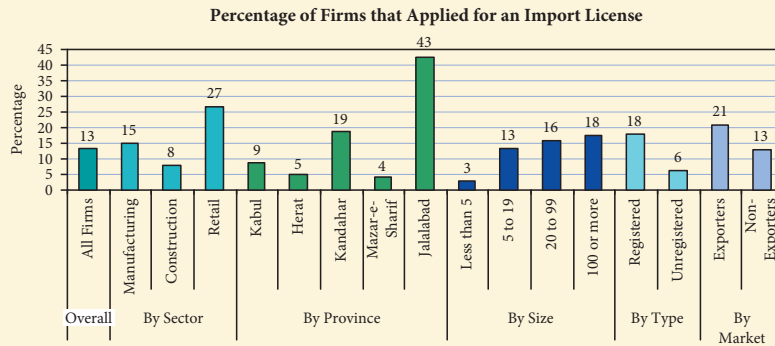
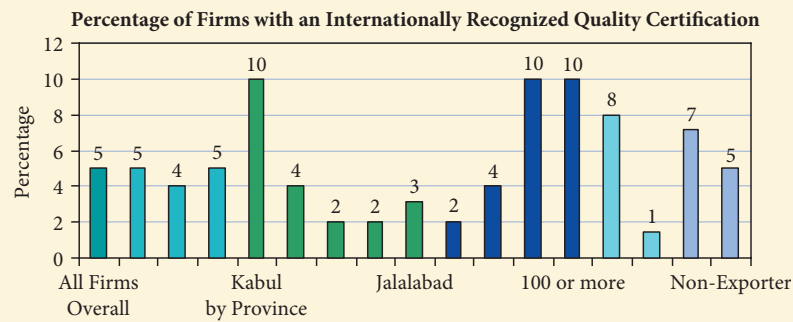


FIGURE 40
Percentage of Afghan Firms With Quality Certification



acquiring quality certifications. However, the incidence of this is very low in Afghanistan (figure 40).

CONCLUSIONS

2.65 The survey findings in general validate the Afghan government’s current reform program. The government is making efforts to (1) improve governance through better business regulation and stronger institutions, and (2) strengthen factor markets by improving access to finance, providing industrial land, and addressing infrastructure and

human capital issues. More efforts are required, as the survey reports little measurable progress.

2.66 Within the cluster of reform efforts, the one striking finding of the survey is in the area of policy enforcement. The matter has been discussed in detail with stakeholders, and many anecdotes emerged of policy reversals and failure to uphold commitments with respect to land access or licenses. As noted earlier, investors will not tolerate a lack of predictability; it is a key reason why Afghanistan has not attracted investment despite the potential for attractive returns and the existence of some relatively secure locations to do business.

2.67 The survey and the associated analysis also identify a group of emerging issues that require some attention. These include the interlinked issues of competitiveness, innovation, and diversification. Despite strong business growth, policymakers should be concerned about the recent lack of new firms, especially foreign firms, entering the market. The scarcity of new entrants and the lack of innovative behavior by firms are strong indicators of a lack of competitiveness; these areas warrant additional research. Another concern is the undiversified industrial sector, which is overwhelmingly (approximately 95%) linked to the agriculture and agro-processing sectors.

2.68 The strong growth also needs deeper evaluation. A thorough understanding of the key drivers of growth will be helpful for policymakers. In our experience, no country that has weak governance, poor factor markets, and non-innovative firms achieves long-term sustainable growth. The transition from what seems to be a catch-up and aid-driven demand growth to a more normal growth pattern requires careful planning.

2.69 The following chart lists the issues discussed in this report, summarizes the reform status, and suggests some next steps. The next steps include further analytic work, dialogue, and strengthening the ongoing reform efforts of the government. We suggest that the enterprise survey be repeated regularly to assess the impact of government policies on private sector growth and productivity.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

Afghanistan Enterprise Survey—Review of Findings and Next Steps

Issue	Current Status	Next Steps
Overall Findings		
The quality and sustainability of current levels of growth is not clear.	Very few growth diagnostics are available	Carry out a “sources of growth” study. Carry out an economic diversification study to explore potential areas and identify any policy, regulatory, or structural impediments to their development.
The investment climate in Afghanistan shows important regional variations.	No regional or city-level economic development strategies are available.	Undertake a dialogue to review local economic development opportunities.
Competitiveness challenges exist.	The topic of competitiveness has not received much attention.	Carry out a competitiveness study that looks at firm entry and exit.
Some topics were not adequately covered in this survey.	These topics include rural enterprises located outside the 10 surveyed cities, gender, worker skills, and the predictability problem.	Ensure that these topics are properly covered in future surveys.
Governance		
Government policy and regulatory predictability are very weak.	There is a general awareness of the need for predictability, but the importance of the issue is not well understood by policymakers and there is no systematic approach to address it.	Undertake a high-level dialogue with stakeholders on this topic.
Corruption is widespread and shows no signs of abating.	This topic is being addressed, but measures in place appear inadequate to reduce corruption.	Continue to monitor and report on the impact of corruption on the private sector. Undertake a dialogue to determine whether the private sector itself could take measures to manage corruption.
Crime, theft, arson, and vandalism problems are increasingly perceived as constraints.	This issue is receiving substantial attention and significant international support being made available to help.	Continue to monitor and report on the impact of these problems on the private sector.
Business regulation is weak.	A substantial amount of work is being done on this topic.	Continue to monitor and report on the impact of weak regulation on the private sector.

(continued)

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

Issue	Current Status	Next Steps
Court effectiveness is poor but not rated as a constraint, which suggests the use of parallel informal mechanisms.	Work is being done to encourage judicial reform. No work is being done on parallel informal mechanisms that deal with commercial and financial disputes.	Develop a deeper understanding of whether and how informal measures are used to resolve disputes and establish property rights.
Factor Market		
Accessing Land is difficult Accessing serviced land is very difficult	In parallel with efforts to reform the overall land registration system, there are plans to develop various types of special economic zones (industrial parks etc) throughout the country.	Continue to monitor and report on the impact on the private sector.
Electric power in the quantities and quality needed is not available	There is a substantial electricity infrastructure development program.	Continue to monitor and report on the impact on the private sector.
In general infrastructure needs to be strengthened.	There are development programs in all infrastructure sectors.	Continue to monitor and report on the impact of this issue on the private sector.
Access to finance is constrained.	A number of important efforts in the financial sector are beginning to produce results, including a number of programs designed to increase the availability of finance.	Carry out financial sector update. Continue to monitor and report on the impact of this issue on the private sector.
Human resource skills are weak	A number of vocational programs are under way, but their impact has yet to be felt.	Undertake a dialogue to develop a private sector-led approach to vocational training. Continue to monitor and report on the impact of this issue on the private sector.
Innovation		
There are a number of indicators of weak firm-level innovation.	This topic has not received any attention, with the exception of export development.	Undertake a dialogue to develop an integrated industrial innovation policy. Start monitoring and reporting on the impact of this issue on the private sector.

ANNEX 1. AFGHANISTAN AT A GLANCE

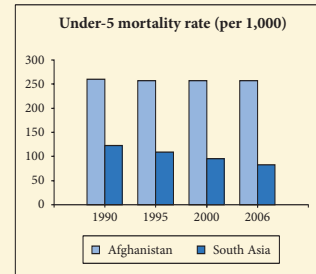
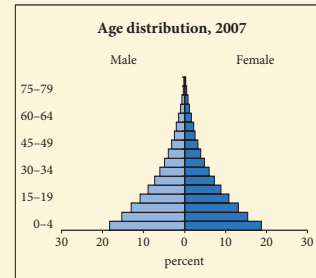
Key Development Indicators

(2007)

	Afghanistan	South Asia	Low income
Population, mid-year (millions)	27.1	1,520	1,296
Surface area (thousand sq. km)	652	5,140	21,846
Population growth (%)	3.9	1.4	2.1
Urban population (% of total population)	24	29	32
GNI (Atlas method, US\$ billions)	10.1	1,339	749
GNI per capita (Atlas method, US\$)	370	880	578
GNI per capita (PPP, international \$)	920	2,537	1,500
GDP growth (%)	13.5	8.5	6.5
GDP per capita growth (%)	9.2	6.9	4.3

(most recent estimate, 2000–2007)

Poverty headcount ratio at \$1.25 a day (PPP, %)	..	40	..
Poverty headcount ratio at \$2.00 a day (PPP, %)	..	74	..
Life expectancy at birth (years)	43	64	57
Infant mortality (per 1,000 live births)	165	62	85
Child malnutrition (% of children under 5)	33	41	29
Adult literacy, male (% of ages 15 and older)	43	70	72
Adult literacy, female (% of ages 15 and older)	13	46	50
Gross primary enrollment, male (% of age group)	126	111	100
Gross primary enrollment, female (% of age group)	75	104	89
Access to an improved water source (% of population)	22	87	68
Access to improved sanitation facilities (% of population)	30	33	39



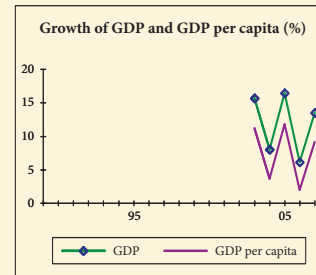
Net Aid Flows

	1980	1990	2000	2007 ^a
<i>(US\$ millions)</i>				
Net ODA and official aid	33	122	136	3,000
<i>Top 3 donors (in 2006):</i>				
United States	2	56	2	1,404
United Kingdom	1	2	13	246
European Commission	0	2	18	221
Aid (% of GNI)	0.9	..	16.4	31.9
Aid per capita (US\$)	2	10	7	115

Long-Term Economic Trends

Consumer prices (annual % change)	..	..	-11.8	12.7
GDP implicit deflator (annual % change)	..	..	..	9.4
Exchange rate (annual average, local per US\$)	44.1	50.6	67.7	37.6
Terms of trade index (2000 = 100)	..	..	..	..

	1980-90	1990-2000	2000-07
Population, mid-year (millions)	13.9	12.7	20.7
GDP (US\$ millions)	3,642	..	2,462
<i>(% of GDP)</i>			
Agriculture	..	..	49.8
Industry	..	..	20.1
Manufacturing	..	..	15.1
Services	..	..	30.1
Household final consumption expenditure	..	..	97.5
General gov't final consumption expenditure	..	..	7.8
Gross capital formation	13.9	..	28.1
Exports of goods and services	10.8	..	32.9
Imports of goods and services	13.9	..	66.2
Gross savings	..	..	24.7



1980-90 1990-2000 2000-07
(average annual growth %)

1980-90	1990-2000	2000-07
-1.0	4.9	3.8
..	..	11.5

Note: 2007 data are preliminary estimates.

This table was produced from the Development Economics LDB database.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

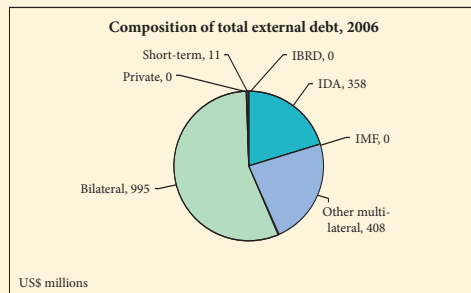
Balance of Payments and Trade	2000	2007
<i>(US\$ millions)</i>		
Total merchandise exports (fob)	69	755
Total merchandise imports (cif)	1,697	3,280
Net trade in goods and services	-1,363	-3,144
Workers' remittances and compensation of employees (receipts)	..	..
Current account balance as a % of GDP	-150	-70
	-3.7	-1.1
Reserves, including gold	425	1,662

Central Government Finance

<i>(% of GDP)</i>		
Current revenue (including grants)	..	11.1
Tax revenue	..	..
Current expenditure	..	9.9
Overall surplus/deficit	..	0.1
Highest marginal tax rate (%)		
Individual	..	..
Corporate	..	..

External Debt and Resource Flows

<i>(US\$ millions)</i>		
Total debt outstanding and disbursed	..	1,771
Total debt service	..	9
Debt relief (HIPC, MDRI)	546	..
Total debt (% of GDP)	..	18.9
Total debt service (% of exports)	..	..
Foreign direct investment (net inflows)	..	..
Portfolio equity (net inflows)	..	0



Private Sector Development	2000	2008
Time required to start a business (days)	..	9
Cost to start a business (% of GNI per capita)	..	59.5
Time required to register property (days)	..	250
Ranked as a major constraint to business (% of managers surveyed who agreed)	2000	2007
n.a.
n.a.
Stock market capitalization (% of GDP)
Bank capital to asset ratio (%)



Technology and Infrastructure	2000	2007
Paved roads (% of total)	13.3	23.7
Fixed line and mobile phone subscribers (per 1,000 people)	0	18
High technology exports (% of manufactured exports)	..	..

Environment

Agricultural land (% of land area)	58	58
Forest area (% of land area)	1.6	1.3
Nationally protected areas (% of land area)	..	0.3
Freshwater resources per capita (cu. meters)	..	2,194
Freshwater withdrawal (% of internal resources)	42.3	..
CO ₂ emissions per capita (mt)	0.04	0.03
GDP per unit of energy use (2005 PPP \$ per kg of oil equivalent)	..	..
Energy use per capita (kg of oil equivalent)	..	..

World Bank Group portfolio	2000	2007
<i>(US\$ millions)</i>		
IBRD		
Total debt outstanding and disbursed	-	0
Disbursements	-	0
Principal repayments	-	0
Interest payments	-	0
IDA		
Total debt outstanding and disbursed	-	411
Disbursements	-	56
Total debt service	-	7
IFC (fiscal year)		
Total disbursed and outstanding portfolio of which IFC own account	0	9
Disbursements for IFC own account	0	9
Portfolio sales, prepayments and repayments for IFC own account	0	0
MIGA		
Gross exposure	0	77
New guarantees	0	75

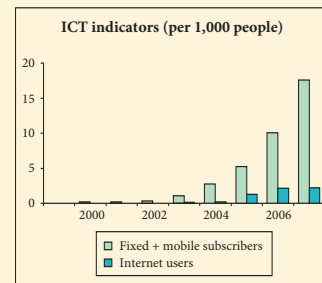
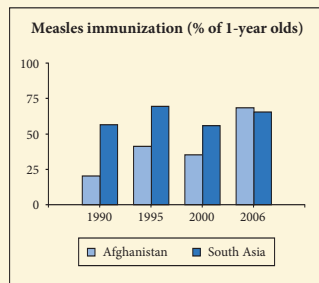
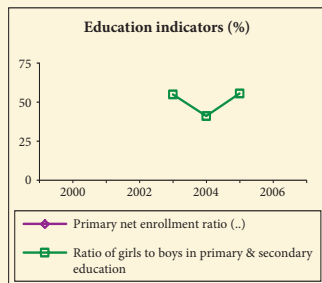
Note: This table was produced from the Development Economics LDB database.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

With selected targets to achieve between 1990 and 2015

(estimate closest to date shown, +/- 2 years)

	Afghanistan			
	1990	1995	2000	2007
Goal 1: halve the rates for extreme poverty and malnutrition				
Poverty headcount ratio at \$1.25 a day (PPP, % of population)	..	..	..	..
Poverty headcount ratio at national poverty line (% of population)	..	..	..	..
Share of income or consumption to the poorest quintile (%)	..	..	..	..
Prevalence of malnutrition (% of children under 5)	..	..	..	32.9
Goal 2: ensure that children are able to complete primary schooling				
Primary school enrollment (net, %)	25	..	..	..
Primary completion rate (% of relevant age group)	..	25	..	38
Secondary school enrollment (gross, %)	16	..	13	19
Youth literacy rate (% of people ages 15-24)	..	..	34	..
Goal 3: eliminate gender disparity in education and empower women				
Ratio of girls to boys in primary and secondary education (%)	54	..	..	56
Women employed in the nonagricultural sector (% of nonagricultural employment)	18	..	..	..
Proportion of seats held by women in national parliament (%)	4	..	..	27
Goal 4: reduce under-5 mortality by two-thirds				
Under-5 mortality rate (per 1,000)	260	257	257	257
Infant mortality rate (per 1,000 live births)	168	165	165	165
Measles immunization (proportion of one-year olds immunized, %)	20	41	35	68
Goal 5: reduce maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	1,800
Births attended by skilled health staff (% of total)	..	..	12	14
Contraceptive prevalence (% of women ages 15-49)	..	..	5	10
Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases				
Prevalence of HIV (% of population ages 15-49)	..	..	..	..
Incidence of tuberculosis (per 100,000 people)	248	247	208	161
Tuberculosis cases detected under DOTS (%)	..	3	15	66
Goal 7: halve the proportion of people without sustainable access to basic needs				
Access to an improved water source (% of population)	..	21	21	22
Access to improved sanitation facilities (% of population)	..	32	30	30
Forest area (% of total land area)	2.0	..	1.6	1.3
Nationally protected areas (% of total land area)	..	..	..	0.3
CO ₂ emissions (metric tons per capita)	0.2	0.1	0.0	0.0
GDP per unit of energy use (constant 2005 PPP \$ per kg of oil equivalent)	..	..	..	..
Goal 8: develop a global partnership for development				
Telephone mainlines (per 100 people)	0.3	0.2	0.1	0.3
Mobile phone subscribers (per 100 people)	0.0	0.0	0.0	17.2
Internet users (per 100 people)	0.0	..	0.0	2.1
Personal computers (per 100 people)	..	..	..	0.4



ANNEX 2. THE ENTERPRISE SURVEY

SAMPLE

97. Sample size. The sample target was 1,000 companies, but 1,066 companies were successfully interviewed.

98. Sectors. The sample was split into four sectors: manufacturing, retail, construction, and other services (hotels and restaurants; wholesalers; transport, storage, and communications; IT services; repair of motor vehicles; and professional, scientific, and technical services that include legal and accounting services, business and consulting services, architecture and engineering, advertising, research and media companies, private education institutes, and private health clinics).

99. Registration. The sample was split between 600 registered and 400 unregistered companies. Eventually, 647 registered and 419 unregistered firms were surveyed.

100. Location. Ten cities were covered for this survey, weighted according to size and the level of industrial activity in the city (table 8).

TABLE 8
Sample by City

City	Proposed no. of businesses surveyed	Actual no. of businesses surveyed
Kabul	300	306
Herat	125	131
Mazar-e-Sharif	125	142
Jalalabad	125	129
Kandahar	125	121
Ghazni	45	45
Khost	45	71
PuleKhumri	45	48
Kunduz	45	50
Bamyan	20	23
TOTAL	1000	1066

101. Size. While there were no fixed quotas for firm size, preference was given to the larger companies from the Afghanistan Investment Support Agency (AISA) database. To ensure that micro businesses (those with fewer than five employees) were covered, the proposal specified that these firms would make up a minimum of 5 percent of the sample.

102. Contacting registered companies. The fieldwork team sought registered companies through the following two sources, each of which contained telephone numbers and addresses. This approach enabled the team to target specific businesses that matched the sample criteria:

- World Bank panel list (the 338 businesses interviewed in 2005)
- AISA list (companies selected by the World Bank, based on size)

103. World Bank panel list. It proved difficult to reach these companies for the following reasons:

- After three years, many of the phone numbers had changed.
- The address listed was often not specific or was inaccurate.
- Twenty of the panel list companies reached by the team refused to answer the questionnaire, having been surveyed not only in 2005 but numerous times since then by various organizations.

104. AISA list. The AISA list also contained inaccurate information, including outdated or incorrect telephone numbers, contact names, and addresses. Again, this made it difficult for the fieldwork team to access the companies on the list.

105. Retailers. It proved challenging to reach sufficient registered companies from the retail sector, partly because there are proportionally fewer registered retailers in Afghanistan compared with other sectors. Also, retailers are not registered with AISA but with the Ministry of Commerce and Industry, whose privacy policy prevents the distribution of company lists. Thus, alternative methods were adopted to fulfil the sample criteria for retailers.

106. Alternative lists. In addition to the panel list and the AISA list, it was necessary to use other sources to reach companies. Local contacts included relevant nongovernmental organizations (NGOs) (such as the Peace Dividend Trust) and local AISAs, chambers of commerce, and industries. To reach retailers, we used locally obtained Ministry of Commerce lists or, more commonly, local knowledge of large retailers.

107. Contacting unregistered companies. Supervisors were able to contact local organizations—including municipalities, local business associations, unions, and NGOs—to obtain lists of unregistered companies that matched the sample quotas. Where this was not possible, the “snowball” technique was used: after a successful interview with an unregistered business, the interviewers asked the respondent to direct them to other unregistered businesses in the city.

METHODOLOGY

108. Questionnaire. The questionnaire used the World Bank’s core questions as well as some additional questions introduced by the local partner. Altai Consulting translated the questionnaire into the two local languages, Dari and Pashto, and then back-translated into English. Three versions of the questionnaire were generated to provide tailored tools for the fieldwork team:

- The core questionnaire was used for the construction and other services sectors.
- The core questionnaire and the manufacturing module were used for manufacturers.
- The core questionnaire and the services module were used for retailers.

109. Screening. A screener document ensured that potential respondents fit the sample frame. It contained basic questions relating to location, sector, size, and current operations. The screening was typically conducted over the phone, although interviewers made some personal visits because of the inaccuracy of phone numbers provided for specific firms.

110. Length of interview. Interviews lasted from one to two hours, excluding interruptions.

111. Training.: Training for the fieldwork team was in two phases: (i) one day training to the supervisors by the World Bank (ii) five more days of training by the consulting firm for the full fieldwork team.

112. Pilot interviews in Kabul: Each supervisor and interviewer undertook a pilot interview in Kabul, amounting to 24 pilot interviews in total.

113. Monitoring: This was done at three levels:

- The first layer was with local supervisors who reviewed questionnaires completed by interviewers, question by question.
- The second layer was directly ensured by national and international consultants who reviewed the questionnaires received in Kabul before passing them on for data entry.
- The third level was done by World Bank monitors, whose software checks picked up anomalies in the data.

114. Quality control. At the completion of fieldwork, 130 companies were randomly selected and re-contacted to verify that the interview took place in the correct manner and to confirm that accurate information had been collected. One hundred of these recontacts were conducted by the consulting firm; to ensure impartiality, 30 recontacts were undertaken by an independent monitor with no previous involvement in the project.

115. Security. Security was a significant factor in carrying out fieldwork across Afghanistan, where political unrest and criminal activity present notable risks and obstacles to effective work. Risks were minimized in the following ways:

- Engaging local interviewers for each city, if possible. Except for Bamyan (in a relatively peaceful part of the country), interviewers operated in their home towns.

- Flying members of the fieldwork team to training in Kabul, rather than going by roads that are partly controlled by insurgents or bandits. This was the case for supervisors and interviewers from Kandahar and Herat.
- Providing sufficient authority to the interviewers—including an Altai Consulting photo ID, a letter from the Ministry of Commerce and Industry, and a letter from the World Bank—to allay concerns of and potential hostility from prospective interviewees.

116. Incentives. Gifts were offered to respondents to encourage participation, including a leather-bound notebook, a pen, and a SIM card. A pamphlet in Dari was distributed that explained how the information from the survey would be used.

CHALLENGES AND LIMITATIONS

117. Refusal to interview. Some respondents who had been interviewed before expressed impatience at what they considered a waste of time, as well as disillusionment at never having received any tangible benefits from previous interviews.

118. Interview fatigue. Owing to the length of the interview, the quality of the data might have declined toward the end of the questionnaire.

119. Challenge for interviewers. Despite their interviewing experience, the level of business/financial concepts used in the questionnaire proved to be a significant challenge for some interviewers. Interviewers struggled with concepts such as indirect exports, ATMs and credit cards, and terms relating to the legal status of businesses. Monitors also observed a few errors in recording answers related to costs and revenues; the most common error was recording an insufficient number of zeros when the figure was over a million. In some cases, interviewers had trouble calculating percentages and required support from supervisors and consultants in Kabul. All such inaccuracies were corrected; however, a margin of error is to be expected with questions of this type. It is important to acknowledge the difficulties in conducting surveys and carrying out private sector research in Afghanistan.

INTERVIEWER PROFILE

120. Team size. The fieldwork team included 24 members: 6 supervisors and 18 interviewers.

121. Team qualifications. The interviewers were generally college educated in Afghanistan or a neighboring country, and/or had previous experience conducting interviews in the country. Supervisors were more experienced interviewers, typically with a professional background, and acted as managers for the cities they covered.

RESPONDENT PROFILE

122. Respondents were owners of the business or the most senior manager working in the establishment—the person considered the “boss” or CEO equivalent. If this person was not available, the second in command was interviewed, provided he or she indicated an ability to answer detailed questions relating to legal status, revenue, and operating practice.

ANNEX 3. METHODOLOGY FOR PRODUCTIVITY ANALYSIS

123. The 2008 Afghanistan Enterprise Survey dataset includes a rich set of variables relating to inputs and investment climate factors that affect productivity and growth. As noted by Escribano and Guasch (2005), the information collected by the World Bank on investment climate variables is not the kind of information that is routinely observed by econometricians.²¹ This information, therefore, allows controlling for several factors that go unobserved in econometric studies. The productivity dataset brings together survey data on firm-level performance by combining and processing key productivity questions from World Bank investment climate surveys carried out in different countries in recent years. Its main purpose is to support comparative productivity analysis.

124. A simple productivity analysis was carried out for the 225 manufacturing firms in the sample. Firms in the services and construction sectors were not included, because specific questions relating to input usage (value of raw materials and value of machinery, in particular) were designed specifically for the manufacturing sector and were not part of the core survey.

125. An augmented Cobb-Douglas specification was used to estimate, in a single step, the impact of investment climate variables on productivity (Escribano and Guasch 2005). The specification used was:

$$\ln sales_i = \beta_0 + \beta_1 \ln lab_i + \beta_2 \ln rm_i + \beta_3 \ln asset_i + \sum_{k=1}^K \gamma_k IC_k + regional\ dummies + \varepsilon_i,$$

where i indexes the firm, lab represents the number of permanent workers, rm the value of raw materials, and $asset$ the value of assets after depreciation. K IC variables are also included and refer to the investment climate variables that affect productivity. See table 9 below

²¹ [A. Escribano and J. L. Guasch. (2005). *Assessing the impact of the investment climate on productivity using firm-level data: Methodology and the cases of Guatemala, Honduras, and Nicaragua*. The World Bank, Policy Research Working Paper Series: 3621.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

TABLE 9
Variable Definitions for Productivity Analysis

Classification	Variable Definition**
Production Function Variables	
Sales	ln(value of total annual sales) – <i>dependent variable</i>
Employment	ln(total number of permanent workers)
Materials	ln(annual cost of raw materials and intermediate goods)
Assets	ln(value of assets after depreciation)
Investment Climate and Perception Variables, and General Information	
Power	dummy variable=1 if firm has no electricity
Theft	dummy variable=1 if firm experienced losses due to theft, robbery, vandalism, or arson
Security	dummy variable=1 if firm pays for security
Interpretation of laws	dummy variable=1 if firm finds government officials' interpretation of laws and regulations inconsistent and unpredictable
Banking	dummy variable=1 if firm has a bank account
Financing of working capital	ln(proportion of working capital financed from retained earnings)
Internet access	dummy variable=1 if firm uses e-mail or has its own website
Mobile phones	ln(percentage of employees that own a mobile phone)
Import license	dummy variable=1 if firm has an import license
Age of firm	ln(difference between 2008 and the year in which the firm began operations)
Perception of policy enforcement	dummy variable=1 if firm perceives policy enforcement as a major or very severe constraint
Perception of corruption	dummy variable=1 if firm perceives corruption as a major or very severe constraint
Firm type dummy	Dummy variable=1 if registered firm.
Regional dummies	These categories indicate the region where firm is located. Regions classified into Kabul, Herat, Kandahar, Mazar-e-Sharif, and Smaller Cities (Ghazni, Baghlan, Kunduz, Bamyán, and Khost). The omitted category is Kabul.
Firm size dummies	These categories indicate size of the firm in terms of number of employees. The categories are micro (<5), small (5–19), medium (20–99), and large (100 and above). Micro is the omitted category.

** "ln" in the variable definitions denotes natural logarithm.

for details of variables used in the regression analysis. The regression was estimated using ordinary least squares with robust standard errors.

126. Productivity gaps expressed in relative percentage terms were obtained from the estimated coefficients on the region dummies using the formula $[\exp(\text{coefficient of the region dummy}) - 1] * 100$, for any region other than Kabul, which is the base category. Similarly, the impact (in relative percentage terms) that the k^{th} investment climate dummy variable ($k=1,2, \dots, K$) has on productivity is given by $[\exp(\gamma_k) - 1] * 100$.

127. This productivity analysis should be viewed only as a preliminary step in understanding the impact of investment climate (IC) variables on firm productivity. Potential sources of bias and inconsistency in the results may arise due to endogeneity of some of the right-hand side variables and failure to account for some important IC variables due to an insufficient number of observations.

128. There could also be measurement errors in this analysis due to limited sample size and possible data quality issues; furthermore, a number of the econometric issues cannot be resolved without panel data. This report has nonetheless attempted a limited productivity analysis within the existing constraints, with the caveat that the findings should be viewed as strictly indicative. However, most of our findings triangulate well with the survey indicators and with other studies on Afghanistan, so we have a certain degree of confidence in the broad messages emerging from the analysis.

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

ANNEX 4. AFGHANISTAN AND COMPARATOR COUNTRIES

	Afghanistan	Yemen	Pakistan	Ethiopia	Tajikistan	Thailand	DR Congo
Country comparisons							
GDP (PPP) per capita (US\$)²²	758	2,412	2,739	897	2,019	8,225	328
Doing Business ranking 2009	162	77	98	116	159	13	181
Starting a business	22	77	50	118	168	44	154
Dealing with construction permits	140	93	33	59	178	12	141
Employing workers	30	136	69	95	128	56	175
Registering property	174	97	48	154	46	5	152
Getting credit	178	59	172	123	172	68	163
Protecting investors	181	24	126	113	150	11	150
Paying taxes	49	124	138	37	159	82	153
Trading across borders	179	71	126	152	177	10	160
Enforcing contracts	160	154	41	78	23	25	173
Closing a business	181	53	87	74	97	46	150
Transparency International CPI 2008	176	134	141	126	151	80	171
Electricity							
Percentage of firms owning generators	75	53	20	-	-	-	-
Frequency of power outages (avg. # of times in a month)	23	183	34	5	9	-	-
Duration of power outages (hrs)	11	3	2	-	-	-	18
Output losses for those firms that experienced power losses (% of sales)	9	10	10	1	15	-	-
Percentage of electricity from generator	77	51	6	-	-	-	-
Crime							
Annual cost of security (as % of sales)	3	-	4	1.1	3	0	3

(continued)

²² IMF (2008).

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

	Afghanistan	Yemen	Pakistan	Ethiopia	Tajikistan	Thailand	DR Congo
Corruption							
Percentage of contract value paid as informal payment to secure contract	6	16	1	-	-	-	81
Bribes as percentage of total annual sales to "get things done"	2	9	34	-	-	-	84
Percentage of senior mgt's time spent on govt regulation requirements	7	16	2	4	12	1	6
<i>Percentage of firms saying gift/ payment required for:</i>							
(a) an operating license	23	62	0	3	39	39	14
(b) tax inspections	26	-	28	4	33	-	-
(c) import license	29	45	0	-	-	-	-
(d) an electricity connection	32	46	5	-	-	-	-
(e) a telephone connection	7	31	1	-	-	-	-
(f) a construction permit	31	33	1	-	-	-	-
Finance							
Share of working capital from banks	1	9	2	-	-	-	-
Percentage of new investments from banks	2	9	-	-	-	75	3
Percentage of enterprises that have a bank account	51	<5	63	-	-	-	-
Percentage of enterprises with a loan from a financial institution	5	17	9	46	34	-	-
Permits and Licenses							
Days to obtain operating license	16	11	19	11	23	37	18
Days to obtain construction-related permit	88	18	30	61	63	37	22
Days to obtain import license	13	8	14	14	14	37	18
Innovation and Technology							
Percentage of firms with internationally recognized quality certification	5	19	9	4	17	45	4
Percentage of firms using technology licensed from foreign companies	6	17	3	4	25	-	4
Percentage of firms with formal training programs for permanent full-time employees	14	36	5	38	21	-	-

THE AFGHANISTAN INVESTMENT CLIMATE IN 2008

	Afghanistan	Yemen	Pakistan	Ethiopia	Tajikistan	Thailand	DR Congo
<i>Percentage of Enterprises that:</i>							
(a) use e-mail	30	-	26	-	-	-	-
(b) have own website	15	-	95	18	21	34	6
Trade							
Average time to clear direct exports through customs (days)	12	8	4	4	20	1	4
Average time to clear imports from customs (days)	15	14	7	14	15	4	13

