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Reforming the business environment in Afghanistan

Institutional reforms first



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Abbreviations

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| AISA | Afghan Investment Support Agency |
| AKDN | Aga Khan Development Network |
| BMZ | German Federal Ministry for Economic Cooperation and Development |
| DEG | Deutsche Investitions- und Entwicklungsgesellschaft |
| GoA | Government of Afghanistan |
| GTZ | German Technical Assistance |
| HCI | High Commission on Investment |
| IFC | International Finance Corporation |
| IPA | Investment Promotion Agency |
| KfW | Kreditanstalt für Wiederaufbau |
| MoC | Ministry of Commerce |
| MoF | Ministry of Finance |
| TIN | Taxpayers Identification Number |
| WB | Worldbank |
| WDR | World Development Report |

0. Abstract

Reforming the Business Environment in Afghanistan – Institutional Reforms first

After 23 years of war, the regulatory framework in Afghanistan is still outdated and the institutional capacities are very weak. The government has embarked into an ambitious agenda to reform the business environment for Private Sector Development, but its capacities to design and implement the reforms are lacking. The international community is supporting the reform of the regulatory framework on a large scale – with mixed results.

The Government of Afghanistan (GoA) with support of Germany and by implementation of GTZ (German Technical Cooperation) has started at an early point to introduce a new institution as a “One-Stop-Shop” for investors, the Afghan Investment Support Agency (AISA). Without a clear regulatory framework, this investment was a great risk, but is now seen as a success story. The registration time for new businesses was reduced to less than a week; by benchmark of the Worldbank’s/ IFC “Doing Business 2006” survey one of the best in the developing world and the best in the region. After nearly two years of operations, AISA has registered more than 3300 businesses with a planned investment of 1.3 billion USD and more than 130 000 direct jobs envisaged.

AISA was set-up as One-Stop-Shop. Domestic and foreign investors in Afghanistan can register with AISA. The institution is taking care of all the registrations and licenses needed to invest. AISA is accompanying investors before and after the registration to cope with the difficult environment. It is analysing and marketing the business opportunities at home and abroad. In addition, AISA became an important voice in the reform of the business environment of Afghanistan.

Lessons learnt: In stable political environment we would like to see the regulatory framework before we start the implementing agency. In a fragile state the contrary might be true: **We should start the implementation by the right institution even if the regulatory framework is not in place. The institution might create an appropriate regulatory framework for its own operations and for the benefit of the business community.**

In an unstable environment, the set-up of an institution could be successful, if the political will and continuous donor support is in place. A dedicated national institution is better suited to introduce the regulatory set-up needed for its own operations than a donor driven approach.

A non-discriminatory approach between domestic and foreign businesses is the most successful way, not only for institutional or regulatory reasons, but for political reasons: If the international and

domestic business community are sharing the same interests, they might build a powerful political force for reforms.

Business registration services are the entry gate to the formal economy and therefore crucial to connect the informal economy with the resources of a modern economy.

The limited absorptive capacities in weak countries lead to an approach focussing on long term financial and technical support with limited short term consultancies.

In weak environments a multi-level approach is needed to connect practical support with political and institutional change.

Donors should not refrain from institutional reforms, even if such investments are risky.

1. Background

A. Political background

In 2001, after 23 years of war and civil war, Afghanistan was a failed state, the industrial production was near to zero and the country was one of the poorest and most underdeveloped in the world. And still it is.

Reforms in the business environment are political reforms which are changing the distribution of power and limiting rent seeking behaviour. In a country with a very difficult history, it is important to look at some of the dynamics behind the current political situation to understand why some reforms might work and others not. A paper about one of the first newly built institutions in a post-conflict country must be in its core more political than technical co-operation usually wants to be. For our argument, that institutional set-ups and capacity building are at the core of the reform of the business environment in Afghanistan, we need to lead the reader for a while through the past and present of the political landscape.

Afghanistan never experienced a strong central government. Only beginning in the 1920ies, the government was slowly reformed into a modern administration, but the central power was reaching the remoter regions only to a limited extent. The force of modernization was accelerated after a coup in the 1970ies, but it resulted in nationalizing industries and starting an industrial base by State-Owned-Enterprises. This development was re-enforced by communist governments after 1978 in a more and more Soviet style manner. After the downturn of the communist system in 1992, the country hasn't seen a stable government for nearly ten years. Since the Taliban were ousted by western forces and the mudjaheddin, a modern government is trying to govern the country as a whole.

By no means, the new Government of Afghanistan (GoA) was starting at point zero. It was a surprise for most of the western advisors how deep the newly installed government was rooted in old structures. But as new ideas, new approaches for the regulatory framework and also new personalities (in government and business) are entering the scene, different structures and realities are overlapping.

In legal terms, the old laws were reinstated at the Bonn Conference. But in various cases, it was impossible to determine what laws and directives were valid. In addition, the ownership of nearly all bigger companies and banks was and is disputed. The same holds true for land as most of the land

usable for industrial purposes is owned by State-Owned-Companies, companies with mixed ownership or government entities.¹

Looking at the personal side of governance, to a large extent the existing elite (including most of the current ministers) is based in a social system which was existing before the communists came to power. This elite was fractionalised in the exile, but survived. In addition to the old elite, some of the commanders made it into the government, but this group was mostly sacked after last year's presidential election².

B. Security and the drug business

Of course, nothing in Afghanistan can be analysed without referring to the weak security situation and the drug business in the country. Without any doubt, it is a must for the government and the international community to reform the security sector so Afghans can guarantee their safety by their own means. Also, it is a must for the international community to assist the Afghan people by military for the next years; even if the methods might be a point of discussion.

The drug economy has about the size of half of the legal economy. Of course, no stable, modern economy can be developed if we see such a misallocation of resources.

At least, some of the old power affiliations are weakening substantially as the disarmament has made great process in the last two years and the remaining disbandment of the small illegal bandit groups is on its way. This picture might contrast conventional perception in the west, which is largely determined by the continuing anti-terror fights in the south and south-east of Afghanistan. But in the central, the northern and the western regions of Afghanistan, the central government has consolidated its power, is largely undisputed by competing war lords and has established some kind of legitimacy with its people. With continuing assistance of the International Security Assistance Force (ISAF) and the ongoing security sector reform (means a growing and better trained Afghan National Army and Afghan police) we see a more and more stable Afghanistan as the most likely scenario.

But for the next years, the fight against drug production and trafficking will be a continuous challenge for the government and the international community. In addition, the situation in the south-east will remain unstable for quite some time. But we have to keep in mind that these regions were never in history under the control of the central Afghan government.

¹ In a country scarce of resources, land remains as one of the few resources in which corruptive behaviours really pays out.

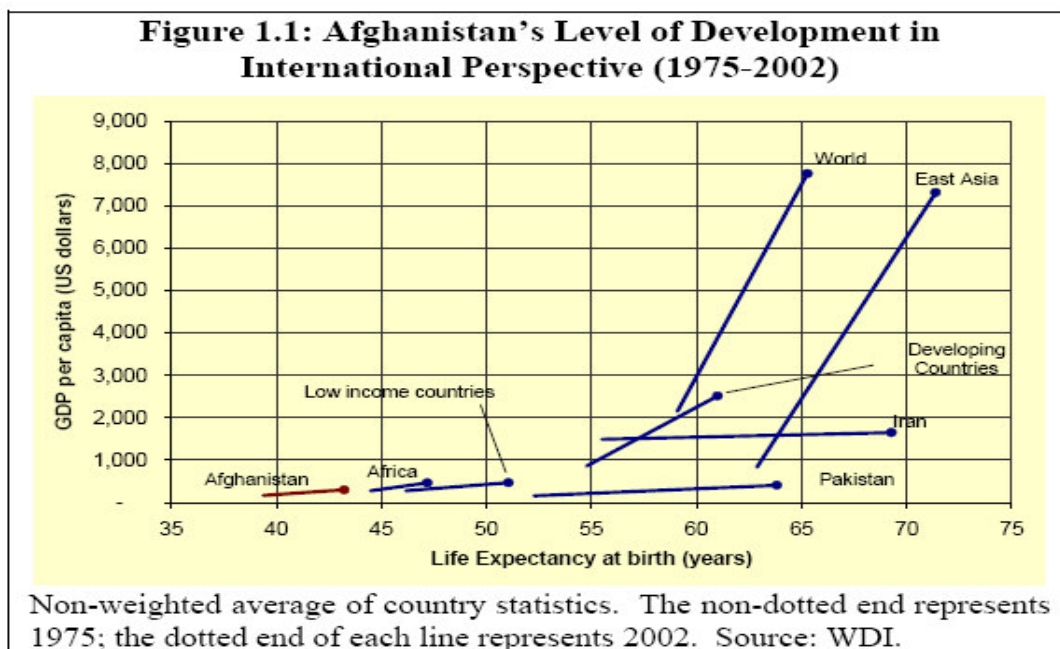
² The term „warlord“ is in lots of cases misleading. Also the western perception of warlords/commanders was not always helpful as some of them were not only mudjaheddin fighters but also governed regions over years. The Mudjaheddin structures were more open than the traditional Afghan society.

These factors will lead to a situation in which reforms in the business environment are mainly affecting the urban areas of the western, northern and central region with about half of the Afghan population.

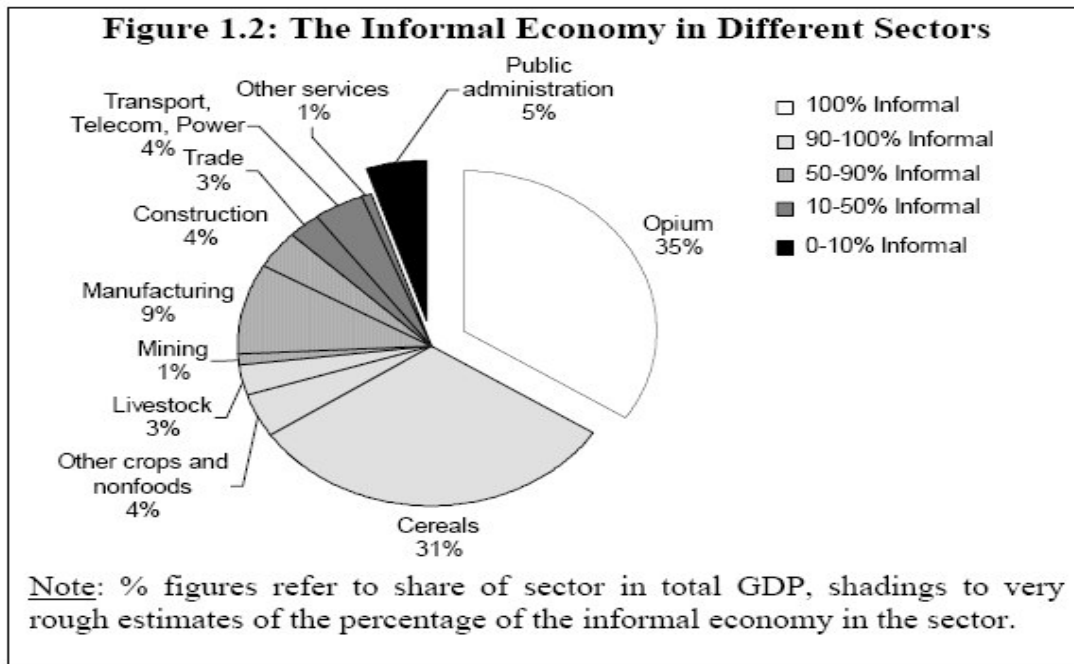
C. Economic and social background

Afghans are faced with 25 lost years. It is one of last countries in terms of Human Development, only followed by the worst war torn countries in Africa. The per capita is app. 250 - 300 USD, including the drug economy about 315 - 350 USD, leaving more than two third of the population under 2 USD per day (last figure in Purchasing Power Parity adjusted terms). All social indicators are still extremely low with a life expectancy of 43 years and an analphabetism of around 80%. Only the enrolment rate increased to about 67% country wide; for girls from close to zero under the Taleban to two thirds in the cities and 40% countrywide.

Afghanistan never had a strong productive base which is illustrated by the following graphic (from Worldbank 2004b).



The economy relies mainly on the agriculture. Manufacturing contributes less than 10% to the GDP and is mainly based on small scale agricultural processing.. The economy is largely informal (from Worldbank 2004b):



The cereal output increased between 2000 – 2003 by 150% and is now at least at the level of the mid-nineties. No doubt, there is still large room for a further expansion of the agricultural output, both for cereals and livestock products. But only about 12% of the land is arable, of which just the half is used due the limited availability of water. Even if an annual growth in agricultural output of about 5% p.a. might be feasible, private sector-led growth in manufacturing and services is badly needed.

Without any doubt, Afghans have a high entrepreneurial spirit and hard work has a high value. But traditionally, the economy is shaped by subsistence agriculture plus trade. Manufacturing never really left the craftsmanship scale with the exemption of a few state-owned companies.

D. Strategies for Afghanistan's Future

The government wants to achieve a (legal) GDP/capita of 500 USD/year by 2015. This leads to an envisaged annual growth rate of app. 9%. The growth rate in the last years was about 20%, but this will slow down as a first "peace dividend" is paid, the agricultural growth will slow down and donor's contributions will stay at the best at current levels.

Therefore, the government and the international community has put in their joint strategic paper "Securing Afghanistan's Future" broad based economic growth at the centre of the strategy. The private sector is in all papers called "the engine of growth". At the last donor conference, the Afghan Development Forum 2005, there was broad consensus to focus – besides security issues – on accelerated capacity building in the government. But under the surface, there is a dispute remaining, how much of the resources should be invested into infrastructure and how much into governance

projects, capacity building and private sector development. The government seems to prefer a focus on “tangible results” in terms of infrastructure reconstruction.

2. The business environment in Afghanistan

A. General conditions to do business

Macro economy: We have seen a very good progress in the macroeconomic conditions. After the successful currency reform in 2002, the inflation remains at one-digit-level and the exchange rate is stable against the US Dollar and Euro.

Financial markets: Also the financial markets are developing with good progress: More than 10 international banks are operating in Afghanistan, international currency transfer runs smoothly and it is no problem to access some basic financial services like letter of credits. But besides the rapidly developing micro-finance business, the local credit market is in its infancy. We expect some developments by recent donor and private sector investments in banks, refinancing schemes, equity finance and credit guarantee schemes. The credit market will remain weak for the near future as the lacking regulatory framework and weak judicial system are limiting the law enforcement and the use of collaterals.

Infrastructure: Power availability in Kabul is around two hours per day (that is better in other cities in Afghanistan), so businesses rely on generators resulting in very high energy costs. Kabul might be the last capital in the world without a central water/ waste water system. The road connections have improved greatly and the ring road connecting all major cities is near to complete. But still some parts of the road (in the south) are not advisable to use for foreigners, but are safe for freight. Two mobile phone operators are active in most of the country; two more licenses were just issued. Internet connections via satellite are available, but expensive.

Transport: Kabul is getting connected to the world: Kabul – Dubai and Kabul – Islamabad are served daily, a few other cities in the region regularly and Frankfurt two times a week. Air freights to Frankfurt are around 5 USD/ kg and shipping via Pakistan and Iran is possible. Internally, the major cities are served daily.

Services: The market for business services is limited. In particular foreign investors will have problems to rent offices, to find assistance in any administrative or external trade related matters. Hotels with international standards are not available, but some guest houses are catering for the needs of international travellers. Restaurants for international visitors are getting better, but only in Kabul.

B. The legal framework

The legal framework is nearly non-existing or completely outdated. As stated before, the main problem is the uncertainty about what rules and regulations apply. The progress in this area was disappointing.

For most of the issues related to a sound business environment it was clear that the situation was difficult. It was even impossible to determine how bad the situation was: When we issued a study about the obstacles in company registration, we got a very bad picture about the situation (about 30 steps with several payments were needed). It was even more worrying that a similar study issued by USAID came to even worse results (54 steps, 18 payments). Both studies tracked the registration process very differently. If specialists in registration procedures are unable to find out what are the procedures, how should a business man be able to do it? For a business man, it is bad to have a complicated process, but worse if the process is intransparent and unclear.³

How did the donors respond to this situation? A main focus, in particular of USAID, has been to support the government in a complete overhaul of the legal framework. In a huge program (in the high double-digit millions) advisors were sent in most of the ministries with relevance for the private sector (finance, commerce, telecommunications, mining,...). In association with the US bar association, drafts for almost everything in the business environment were developed. Also the German Development Cooperation did some work and developed for instance an Investment Law and a Privatisation law. In theory, Afghanistan has a full modern business code ready for adoption.

In April 2005 a list of the progress in lawmaking was prepared. 120 laws are in the making, of which only 10 were finalised (means gazetted). More than half of the 120 laws are part of the business environment, but in this area only two core financial laws plus a first investment law were finalized.

Why was the progress so slow?

Even if the different draft laws were made under the guidance of one or sometimes several ministries, the technical input relied mainly on foreign advisors and to some extent of Afghans from abroad. The staff in the ministries lacked the technical skills to fully engage in the drafting. In the ministries, the trust between the top-management and the middle management is widely lacking, so the decision making is centralised in the hands of the ministers. The GoA was over flooded with too many legal proposals. The capacity, in particular in the Ministry of Justice, was overstretched and the political debate between a few ministries (or better ministers) went on and on in circles. A core problem was the above mentioned high number of ministries. Their responsibilities were never clarified. In a post-conflict situation, in which different fractions are represented in the cabinet in a delicate balance of

³ This argument is similar to the argument, that little bribery is not harming business as long as it is clear when and how you have to bribe. In Afghanistan this is not clear, even not for Afghan people.

power, struggles over technical problems are perceived as power struggles. So compromises might be seen as defeat by the constituencies of the different fractions.

Different attempts of donor co-ordination in collaboration with the Government of Afghanistan (GoA) to work on a legal masterplan with prioritising a few key laws resulted in different competing masterplans or roadmaps. So the attempts of better co-ordination complicated of the debate, absorbed again scarce resources and couldn't solve the core problem of the weak capacities of the GoA.

In the beginning, there was a vision to fully revamp the legal system with a big bang. Soon, it became clear this was impossible. Any attempt to adopt a complete new set of legislation would ignore existing entitlements. But a step by step evolution of a fully outdated legislation is a long and delicate process as reforming one law depends on many other old laws.⁴

In the end, after the conclusion of the core financial laws (and even they were not done in full compliance with the law making procedures), only pieces of the planned legislation (like customs law, income tax law) were called effective by several presidential decrees. Moreover, the implementation of the laws is still weak, e.g. when the new customs law and procedures were adopted, the customs stations were not informed and continued to impose rules arbitrarily and with a high degree of corruption.

C. The institutional framework

The above mentioned fractionalized policy making is one of the major obstacles for an effective reform of the regulatory framework. Still today, the structure and the understanding of the government rely to a large extent on the command-and-control style of the pre-war governments. For example, the Ministries of Light Industries and the Ministry of Heavy Industries and Mines were merged only after the election of President Karzai in late 2004. But even nowadays (this article is written at the time of the parliamentary election in September 2005), a Ministry of Finance (MoF), a Ministry of Economy (built by a merger between the Ministry of Planning and the Ministry of Reconstruction), a Ministry of Commerce and the Ministry of Industry and Mines) are fighting over the responsibilities in economic governance. Moreover, the presidential office, the Ministry of Foreign Affairs and different sector ministries (telecommunications, transport, agriculture etc.) are involved in economic policy.

Besides the later described Afghan Investment Support Agency (AISA), the government is in nearly all of its operations barely accessible for foreigners and even local investors. Up to date land registries and legislation are not available, but a major USAID funded project is working on it. Therefore, hiring

⁴ So too many lawyers focussed on single laws without really understanding the linkages in between and were lacking the understanding for the judicial system (the civil code of Afghanistan is based on a continental European structure).

land is difficult and very expensive. Foreigners are not allowed to buy land (by constitution). Customs procedures are despite all good efforts in the regulatory environment still cumbersome and corrupted, even at Kabul airport.

D. The role of the private sector in reforms

The government showed a high reluctance for a transparent law-making progress. The business community was involved in the process at very late stages. But the business associations barely showed an ability to comment on the drafts, so some of the imprecise comments fired back and the decision-makers completely lost their interest in starting public debates about pending laws.⁵

The dialogue between business community and politics is very limited and unstructured. For example, the US-backed new “Afghan International Chamber of Commerce” which is composed mainly of bigger businessmen, lots of them US-Afghans, is only finding slowly its way to influence politics. The old Chamber of Commerce and Industries is co-opted by the government and only to a limited extent legitimized for dialogue and to a limited extent able to comment on regulatory reforms. This divide between government and business community is one of the factors contributing to the mixed results of economic governance and reforms in the business environment.

3. Business Environment Reforms in post-conflict countries in the international discussion

The literature on (business environment) reforms in post-conflict countries is featuring some approaches which we would like to present in the following as they give some insights in the Afghan situation.

1. In the first years, donor engagement in political reforms is only possible to a limited extent, because the absorptive capacity of the partners is too low. Only after 3 years, post-war countries reach their full absorptive capacity (Collier/ Hoeffler 2002). The absorptive capacity is related to growth which is highest between the 4th and the 7th years after the conflict (Collier/ Hoeffler 2002: 5). This additional growth is typically spurred by aid, so the both are interlinked through the absorptive capacity in the first years. The study suggests a peak in aid between the 4th and the 7th year and a gradual phase out to normal levels until the tenth year. Interestingly, in Afghanistan the growth peak started

⁵ As an example, when the Ministry of Finance presented a very liberal, transparent customs law and code, the traders marched to Kabul and protested against too high rates. But the maximum tariffs were at 16% and most of the budget lines were at 4 or 8%, a record low tariff for a LDC. This posed the question, whether the traders really wanted a transparent new system or preferred the old intransparent system with lots of chances for cheating and corruption. The same is true for the ongoing discussion on the income tax with a two-step flat rate of 10 and 20% including provisions of loss-carry forward. Again, this liberal law came under fire when businessmen calculated an effective taxation of businesses by including VAT and the withhold income tax of their workers to the nominal corporate tax.

already in the 2nd year, but we have to keep in mind, that the end of the war was also the end of a several year long draught, so these two factors influenced growth positively. The quantitative analysis of Collier/ Hoeffler clearly suggests that the positive effects are conditional to policy. So aid levels in Afghanistan should remain for the next years on high – or even higher – levels, but policy is crucial. There is a hope that Afghanistan is now entering a phase of higher absorptive capacity. But the analysis of 2002 might hold for Afghanistan: aid was arriving too early and might be fading out too soon. According to their analysis, governance and social policies should come first, followed by structural policies (which in their analysis includes much of the private sector related policy framework) and macro policies last (Collier/ Hoeffler 2002: 12 and 21). Also, this analysis seems for us to support our strategy to invest in the practical governance by institution building and not too much in the legal framework.

2. The time frame for effective reforms is usually very long, so donors should look at realistic aims and gradual reforms. If we look at the top reformers in the recent report “Doing Business in 2006” by IFC/ Worldbank, Serbia & Montenegro, Georgia, Vietnam and Slovakia come first as the best reformers. All of these economies have been reforming their economies for 10 – 15 years, but are stepping up their reform pace now. This might be an indicator that effective reforms do not come directly after political turnarounds, but quite some years later. But we shouldn’t refrain from reforms which are feasible. Afghanistan jumped to place 16 in the world for the regulatory environment for business start-ups according to “Doing Business in 2006” .

3. It is necessary to focus on some small institutional reforms first. J. Aaron is arguing in the Journal of International Development on the basis of African experiences for a specific reform sequence in post-conflict countries with low institutional capacities. She advocates for reforms in which small solutions of rule based systems are the most critical and should come first. Based on such successes, more complex rules might be added. Also the implantation of a full set of new laws is no quick way out as it does not work (Aaron 2003).

4. Small first reform steps might trigger bigger reforms. Olofsgard argues in a background paper for the World Development Report 2005 that first small reforms steps might raise the credibility about future reforms. Based on first successful (and irreversible) reforms, the public demand for reforms will grow and support more far reaching reforms (Olofsgard 2003).

4. Core Problem

After 23 years of war, the regulatory framework in Afghanistan is still outdated and the institutional capacities are very weak. The government has embarked into an ambitious agenda to reform the business environment for Private Sector Development, but its capacities to design and implement the reforms are lacking. The international community is supporting the reform of the regulatory framework on a large scale – with mixed results.

Business people – domestic and international alike – need transparent and reliable ways to deal with the legal and regulatory environment. **If it is not possible to redefine the legal and regulatory system itself in an efficient and timely manner, well designed semi-autonomous institutions as the government's face to the business people can solve many of the day-to-day problems of the entrepreneurs.**

Of course, the costs of doing business are an important factor, but if risk and uncertainty in a country is extremely high, the latter factors become the bottleneck as they determine the “real options” for the investor (Worldbank 2004a: 45ff.). This can be seen in Afghanistan, where many promising projects with a high and quick return of the investment are not taken up. But nevertheless, just very few of the many chances are used. The costs are in some sectors somehow higher than in neighbouring countries (in particular electricity and transport costs), but they are not prohibitive. On the other hand, the high transport costs for imported goods make the local production of some goods (cement, building materials and processed foodstuff) attractive.

In a risky country, investors should be provided with a foreseeable regulatory system. Moreover, they need to trust in the long term direction of politics.

One part is a transparent process for business registration. Or to put it differently, after the government with help of the IFIs greatly reduced the risk of the macroeconomic conditions for investment, there was high need to “**tackle the more microeconomic questions of improving the investment climate**” (Kessing 2005: 7).

A long term thought

If the short political analysis above was right, the crucial point for a long-term strategy to reform the business environment is a new Afghan elite, based in the realities and the people of the country, but well-educated and with a sound understanding of the economic problems of the country. Step by step, new and young people make their way, most of them quite well educated in Pakistan or Iran if not in the UK, Germany, US or Australia. Some of them are culturally westernized and a lot of them are lacking a written knowledge of Dari (the main language in Afghanistan, written in Arabic letters). Very often, they are sharing the concepts and values of the donor community and very often they come with donor contracts into a country only known by tales from their parents. The development of a new elite is a long term process, involving the growth of a civil society and a better education system. Moreover, donors will only have a limited impact in building such an elite.

As business registration is the entrance into Afghanistan or in the formal sector respectively the modern business world, it is crucial to start here. In short, a one-stop-shop is the place to navigate Afghan and foreign businesspeople through the difficult surroundings.

Of course, they are interested in a sound legal framework. They are not interested in the legal texts, but in the outcome. They want to know: Is there somebody to deal with my problems quick and effective?

In stable political environment we would like to see the regulatory framework before we start the implementing agency. In a fragile state the contrary might be true: We should start the implementation by the right institution without the regulatory framework. The institution might create an appropriate regulatory framework for its own operations and for the benefit of the business community.

5. The project and the intended development goals

The project “Economic Promotion” was commissioned by BMZ (the German Ministry for Economic Co-operation and Development) and implemented by GTZ (German Technical Co-operation). It had two main pillars, the first one was to advise the Ministry of Commerce of Afghanistan on several political issues including some work in capacity building. The second pillar was the creation of a “One-Stop-Shop for investors” as a tool to rapidly improve the investment climate/ business environment in Afghanistan. In addition, some smaller aspects related to investment policies were included in the project e.g. the development of an approach to develop industrial parks.⁶

The overall programme aims to create legal and administrative conditions for a better investment climate and a business-friendly framework in Afghanistan. These conditions should improve investment and economic growth with the goal to create jobs and consequently income for the Afghan population.

In this paper, we will discuss only the part of investment promotion through the establishment of the Afghan Investment Support Agency (AISA) as an One-Stop-Shop for investors in Afghanistan. We will look in particular how AISA managed to streamline the investment procedures despite the lack of a sound legal framework. We will look how AISA managed to survived in the difficult political landscape. We will conclude with some lessons learnt about how an institution should be set-up and managed to improve the business environment in country with limited regulatory capacities.

⁶ This approach was successfully developed and later used by a USAID-funded project to built industrial parks under the auspices of AISA. This was an “enclave approach” to better the investment climate to strategic important investors (Kessing 2005: 9).

A. Results

AISA has shaped the business environment in Afghanistan. Without a clear regulatory framework, the investment in a new institution was a great risk. But it is now seen as a success story as the registration time for new businesses was reduced to less than a week. In the latest IFC/ Worldbank “Doing Business” Report, Afghanistan was rated as worldwide 16th for business start-ups, the best of its region!⁷ As mentioned above, before AISA the registration process took several months, involved at least 28 if not more than 55 steps and about 18 fees. The reports about corruption in the process were common and investors estimated that they needed at least 500 USD of illegal fees to get them registered.

Since its starts of operations, AISA has registered investments for about 1.3 billion USD. The total of registered projects is 3 350 of which 2 814 are of domestic and 536 of foreign origin. The total of direct jobs as envisaged by the investors is 136 000. Even if these figures are judged cautiously as they are based on the plans of the investors and only half of the projects are in implementation (by the guess of AISA), a good dynamic in the formal private sector in Afghanistan is certainly there.

AISA was always designed to be non-discriminating in its assistance between domestic and foreign investors. Domestic investors are still allowed to follow the different procedures of the different institutions that are behind the one-stop-shop. If they want to use the service of AISA, they have to pay registration fees between 100 up to 1000 USD. Still, a lot of companies prefer to do it via AISA. Why?

It seems that the additional regulatory compliance costs for starting and running a business without AISA are more than the registration fees. We guess, that most businesses are not only keen saving the time to register via AISA. AISA might give them an “insurance” against arbitrary actions by the government. This might be the reason in particular for local SMEs, because they are faced with the highest compliance costs compared to their size (Worldbank 2004a: 63) and the possibilities to defend their case are the lowest (Worldbank 2004a: 101 f.). In general, small companies benefit more from well implemented pro-investment policies as they have more problems to adopt to bad policies (Worldbank 2004a: 47).

⁷ The ranking would be even better, if IFC wouldn't use a problematic indicator. This is the ratio between fees for company registration and local GNP/ capita. Of course, with the extreme low GNP of Afghanistan, any reasonable fee will result in a bad fee/GNP ratio. If it is common knowledge, that we have to create a fee for service attitude to reach sustainable business services, why is IFC contradicting this in their “Doing Business” reports? But AISA needs the fee as the main source of its income (besides the German contributions) to sustain its operations as independent actor from day-to-day political operations – and in the medium term independent from donor funding.

Today, AISA is much more important for the general business environment as it was planned. AISA is now the central gate for small and medium informal businesses, to integrate in the formal economy. AISA has also contributed to bring informal economic activities in the middle of the business dynamics. This change from informal to formal was the leading issue of the Afghanistan Economic Report 2004 of the Worldbank (Worldbank 2004b). Formalizing businesses is important to the government as the tax basis and the possibilities for regulations are widening. But it is also important for the Afghan businesses, if they want to have access to modern markets (finance, marketing, production systems).

In addition, AISA is serving investors in many different ways. For investors from abroad, the pre-investment services include information provision, organisation of trips, etc. It is helping all investors with visa requests. The major role for domestic investors is the assistance of AISA to the private sector in all kind of discussions and disputes with the government. In particular, AISA helps investors in getting licences for sectors which are controlled somehow by the government, e.g. health services and alike. It is also instrumental in land disputes, questions about taxes and the privatisation process.

With this role, AISA is seen by many of the Afghan business men as the advocator in the government. Because of the weak business associations, AISA is filling a gap in the dialogue between the private sector and the government in Afghanistan.

The feedback of the clients of AISA is very good. In an evaluation in July 2004, 80% of the clients were positive about the time until they were received by an investment manager, 98 % of the clients saw the institution well structured and easy to understand and 100% said, they received the information and assistance requested. This achievement relies mainly on the staff. As a new institution, AISA was able to attract a group of very well educated and enthusiastic professionals. The atmosphere and good work spirit at AISA is a major reason why investors like to work with AISA.

AISA has now entered a new phase and is marketing the investment opportunities of Afghanistan by studies on such opportunities, workshop and conferences at home and abroad and increasingly with partnerships with foreign business associations like the German BDI (German business umbrella organisation).

AISA is used by different donors as the gateway to SME programs (UNDP) or as the national contact point for political risk insurance (MIGA).

All together, AISA has been quite successful in reducing the “appropriative activities” by parts of government by ways of intransparent and arbitrary fees, changes in the regulation ex-post of an investment, the reduction of kafkaesk procedures and a dedicated policy to make bribery in the

registration process near to impossible (for the concept of appropriative activities related to AISA see Kessing, 2005: p. 5 ff.).

6. Implementation and approach

A. Process

The German Development Cooperation started – based on an agreement during the visit of German Chancellor Schröder in 2002 – to advise the Government of Afghanistan (GoA) on trade & investment issues. Soon, it became clear that the administrative procedures and the marketing of Afghanistan were unsuited to attract any investment from abroad. On the other hand, with a fully destroyed industrial capacity and no excellence in services, the need for an influx from capital and knowledge from outside was evident. So the idea of an Investment Promotion Agency (IPA) was born. The concept paper by Dr. Stephan Kinnemann (GTZ) was distributed in November 2002. A Memorandum of Understanding between GTZ and the GoA was signed in September 2003 (the implementation was de facto already under way for some months).

GTZ with the GoA searched for a suitable building, renovated and fully equipped it with state-of-the-art IT and other business equipment. The business registration process was assessed and a proposal for the redesign drafted. A plan of operations for AISA was prepared and the staffing of the core positions (CEO and first investment managers) was undertaken, of course in alignment with the Ministry of Commerce.

The Afghan Investment Support Agency started its operations in October 2003. In the first months, AISA was constantly accompanied not only by technical assistance, but also with political support in the struggles with different ministries to ensure the non-intervention of the government in the daily operations of AISA. In the first months, AISA had to fight a lot to ensure smooth operations. With great success, further unnecessary steps in the registration process were abolished and therefore the registration time reduced to about 3 days for the non-complex business registrations. AISA is now serving fully as a One-Stop-Shop and the government shows “one face to the customer”.

The operations of AISA are still accompanied by GTZ. The two long-term advisors in the Economic Promotion project are dedicating about 40% of their time to AISA. It was important to have a German-Afghan advisor (Shafic Gawhari) in the team, who was able to “translate” the technical advice and problems in the implementation to the high-ranking officials (in particular the first Minister of Commerce Kazemi) and could ensure their support.

For specific tasks short-term consultancies are prepared and major events are jointly organised with AISA. Such highlights were e.g. the first major international conference after 20 years of war, the Economic Cooperation Organisation (ECO) Trade & Investment Conference plus a trade fair in 2004

(more than 1000 participants). Different international and local workshops were looking at business opportunities in specific sectors, some of them with up to 400 participants. Roadshows in Europe were organized jointly. In addition, some studies were undertaken to evaluate the investment opportunities and provide investors with better information.

B. Alliances and political landscape

From the beginning it was obvious that AISA would have to fight to sustain its mandate. Before, various ministries and agencies had some roles in the time-consuming registration process. The possibilities to collect bribes were obvious as 18 different fees were to pay. Therefore, it was important to reach a solid political alliance to back the operations of AISA and give the institutions enough autonomy to operate efficiently.

A High Commission on Investment (HCI) is the supervisory board of AISA. The ministries with relevance to Private Sector Development (Commerce, Finance, Industries, Economy, Housing & Urban Development, and Agriculture) are member and the meetings take place on minister-level. The HCI appoints the CEO of AISA, and gives the political guidance for its operations. This supervisory board also recognizes investments above the threshold of 3 Mio USD. The HCI was very instrumental to overcome the fractionalized structure of the government. In the commission, some core decisions for the business environment were debated, e.g. the provision of land to businesses. With the HCI AISA has a board to feed back the problems of the Private Sector to the highest political level.

An interesting alliance could be built with the Ministry of Finance (MoF). MoF is interested to broaden the tax base. AISA is obtaining for all investors a Taxpayers Identification Number (TIN), which means all companies registered with AISA are also registered with the tax collector. In addition, for the yearly renewal of the licence some basic data about the investment progress must be provided. This additional source of information for the MoF was often criticized by the investors, but is a step to strengthen the tax system.

AISA wouldn't have survived, if not the first CEO (Noorullah Delawari, now Governor of the Central Bank) had been a very strong political figure. He was able to discuss the problems of AISA's operations face to face with the ministers and had good access to the president.

As soon as AISA started its operation, a self-reinforcing process started to stabilize the organisation. In the government and in the business community, the support was increasing and it was possible to streamline further the procedures and strengthen AISA. AISA is now an influential part in policy discussion about the business environment. AISA built on several occasions a forum for the most open discussion between Private Sector and the government.

C. Institutional Approach

AISA's structures were designed to combine the capacity to deliver government services with a private sector like customer orientation. It was necessary to find ways how potential political opposition could be channelled.

"Entrusting discretion on sensitive subjects to more autonomous agencies" is in any case an adequate way to give investors some certainties in risky markets (Worldbank 2004a: 49). In Afghanistan, the case was to make investment registration on the one hand rule-bound and on the other hand to delegate the remains of discretion to a semi-autonomous agency.

But there were different options how to transfer such decisions. In particular, it was completely open how the institutions could be fitted into the governing system and how it should be structured internally.

Semi-autonomous, parastatal agency: There exist different models of Investment Promotion Agencies (IPAs) depending on their duties. In our case, the agency shouldn't take over the different governmental duties in registering companies, but building the interface between the investors and other government entities. In addition, the public service in Afghanistan is very weak and the salary schedule does not allow attracting competent staff. The solution was the construction of a semi-autonomous parastatal agency. Because Afghanistan was lacking some models of juridical persons, a limited liability company with shares in the hand of the government was chosen.

Greenfield institution: There would have been the option to build this institution on the basis of the former Office for Private Investment (originally under the presidential office), but the staffing and the tradition of that institution was completely different from what was planned with the new IPA. So the old office was integrated in the Ministry of Commerce and the new institution AISA was founded. This was in a transitional time not without conflict as the old office tried to continue its operations even after a presidential decree was issued. In addition, it took about a year until the documents were transferred from the old office to the new agency.

One-Stop-Shop as facilitator in administrative procedures between the Private Sector and Government: AISA is issuing an investment licence, but behind this licence are a few administrative steps which are prescribed by law. While establishing AISA the necessary steps (before according to different sources/ studies between 28 to over 50) were reduced to less than ten. In the first months of operations, AISA was successful in getting rid of some more steps. No, AISA is doing all the steps for the investors including company registration at the commercial court, obtaining the Tax Identification Number (TIN) and gazetting the registered company. The administrative steps are done by different institutions outside AISA. The Ministry of Finance has agreed to send some staff to AISA to issue the TIN directly which would cut down the duration of the process another two days.

In practice, the investor is only visiting AISA which is obtaining the different permits etc from other governmental agencies. It should be mentioned, that domestic investors can choose whether to register via AISA or do all the registration steps themselves.

Investor guidance and assistance: AISA was assigned the responsibility to accompany the investors in all his questions pre- and post-investment. This very broad mandate means today support for domestic investors to get passports, visa and customs allowances. With regard to international investors, AISA is accompanying some investors including transport arrangements, preparation of meetings, information gathering etc. If the market for private service providers is increasing, AISA should cut down some of the services not to compete unfairly with such providers.

Investment promotion: AISA is now very good at responding to the demands of investors. Also it has started to pro-actively analyse and promote investment opportunities by studies, workshops, international conferences, international roadshows, advertisements etc.

Internal structure and staffing: AISA is staffed with approx. 10 professional. 6 of them are “investment managers” responsible for advising and guiding investors. AISA is divided in an investment support and in an administration department. In addition, the Industrial Parks Development Authority is now a third wing, but autonomous.

Regional representation: So far AISA is only present in Kabul, but it is planned to open offices in the biggest cities of the country (together with the Chamber of Commerce); the first two offices should open this year.

D. Finance and sustainability

Finance: AISA’s institutional set-up and the hardware were financed by the German Development Cooperation. For the first five years, the running costs are born to a decreasing amount by the German government through GTZ. The remaining costs are covered by the income of AISA based mainly on the issuing and renewal of the investment license. In addition, AISA is charging for a few other services. AISA is ahead of the projections to reach its financial sustainability.

E. Regulatory framework

AISA was started without having a clear regulatory framework in place. Still, it is lacking.

To reach quick results, a new business-friendly investment law based on a draft provided by a German consultant was enacted by presidential decree in 2002. Since then, a more detailed law with state-of-the art international dispute resolution mechanisms has been under discussion. More than two years after different ministries agreed upon a draft, it is not enacted. Only the new and not enacted law would give a clear legal framework for AISA. So far, only some core responsibilities were defined by presidential decree in March 2004 (one and half years after starting its operations).

7. Lessons learned

A. People before paper - institutions before laws

In an unstable environment, the set-up of an institution could be successful, if the political will and continuous donor support is in place. A dedicated national institution is better suited to introduce the regulatory set-up needed for its own operations than a donor driven approach.

Is it better to have the institution before its own regulation framework? Of course, a clear legal framework is desirable. Also AISA would have performed smoother if it had been based on a sound law. But as legal reforms tend to need very long, a small solution with an institution using the flexibility of a given framework might solve most of the issues ahead the legal reform.

In addition, the institution – if working successfully and being legitimized in politics and business – has a good chance to create its own legal framework. Such a framework might be more appropriate than one drafted by foreign consultants.

B. Alliances for reform: Business environment reforms are highly political

Improving the business environment is a highly political task. A technocratic attempt will fail. The political will and the active engagement of the partner at least at minister level is necessary. In addition, the business community must be supportive.

Donors have to determine, what is the “sweet spot” for reforms between being desirable (for public wealth), manageable (by institutional capacities) and political feasible? (Worldbank 2004a: 68). This spot determines the space for reforms. The space could be enlarged if one of the three factors is changing. This could be done by increasing the capacity to reform or by a strengthened political support.

Therefore, a sound management of the external relations of a semi-autonomous institution is crucial. To our experience, it will stabilize the institutions if potential losers of the reform are embedded in the institutional set up (e.g. through advisory boards etc.). If strong ministries/ political powers could be “co-opted” by offering them a clear benefit, the probability for success is increasing (in our case the incorporation of the MoF by issuing the tax numbers).

Incorporating the business community could build more pressure for reform and therefore enlarge the “sweet spot”.

C. Long term process needs a long term approach

Our experience – and the literature – clearly shows that reforming the business environment is a long term process (Worldbank 2004a: 71ff.) incorporating many players with different interests and strategic

decision making. To influence them, a long term commitment of the donor is necessary. To be successful, the long term commitment must be demonstrated by long term experts.

To our experience, we have seen in Afghanistan far too many short term experts flying in and out, writing papers which are even not read by their fellow long terms advisors in the country – not to speak by the partner. **The current trend in technical co-operation - away from long term presence to short term advice, intermediate experts etc. - is not suitable in a post-conflict situation or a LDC.**

D. Trust

Even if it is difficult to state in such a paper: the longstanding economic, historical and cultural relations between the partner country and the donor country have been a factor for the project success. In addition, it was important to establish longstanding relationships between the government, the Afghan investment promotion team and the implementing agency.

E. Greenfield investments in business environment

In the debate about the right institutions in microfinance, greenfield investments became very popular over the last ten years. The same seems to become true in setting up Business Development Service providers. Is the Greenfield approach also the best way to go for institutions shaping the business environment? We believe much more thought should be given to create new institutions (greenfield investments) instead of reforming old governmental structures.

In the case of Afghanistan, the new structure of AISA (a limited company owned by the government) was later on used as model to reform other policy fields.

F. Donors Input

Donor must invest in the business environment with a long term view. Shaping the process is the key to success. Culturally and politically sensitive interventions are needed. To do this, the staffing of the project should reflect such an approach. A good mix of experts, including a consideration to work with the diaspora of a country could be a promising way (but never on the cost of the quality of the staff!).

G. Flexible projects

In particular in post-conflict situations, we see a need to work with flexible project concepts combining technical co-operation with possibilities of financial contributions and the provision of hard ware.

H. Non discriminatory promotion of investors

Institution should be non-discriminatory towards investors/ business people regardless of size or origin. Most problems for businesspeople come up similar for big and small, foreign and domestic

companies. In addition, if the institution is serving a broad community, its political support by the clients should be higher.

I. From formal to informal

In reducing the regulatory costs (including time) to register a company, some already existing companies have been legalized their formerly informal business. This is in the medium term not only benefiting the company in terms of better access to resources and markets. It is also helping the government to broaden the tax base and to regulate the economy.

J. Political advocacy by parastatal organisations

It was an unintended consequence to create a powerful advocacy structure. In a country where the official Chamber of Commerce is still very much co-opted by the government and the newly built business associations are weak and mistrusted by the government, AISA filled a gap in raising the voice of the business community in political debates about the regulatory environment (taxes, customs, etc.). We expect this role to decrease as other actors are getting stronger.

But for a transitional time, the workshops and conferences by AISA were one of the very few places where the government and the business community engaged directly in a structured dialogue over the business environment. In addition, the cases brought forward by AISA stimulated change in various cases for the benefit of the private sector.

Such a role could be taken on by a parastatal if it is well constructed as a facilitator between the political and the business sphere. But if government or the business community is not prepared for a dialogue, the effects will be limited. Still, the institution itself can stimulate the discussion and raise awareness for a more in depth dialogue.

K. From business environment to an open society

What are the long terms approaches to contribute to a change towards a society open for change and open for equal participation of all parts of the society? Should donors influence the deep rooted perceptions and attitudes towards a better participation and openness for business?

Discussing the investment climate might be in the long run a too narrow approach. Approaches to invest in the formation of a new elite and an active civil society might be crucial to free the entrepreneurial forces of developing countries.

Stimulating the dialogue between politics, business and civil society should accompany more technical approaches if the long term success of private sector development should be ensured.

Investing in the education and the exchange of “young leaders” could be promising part of a broader engagement in shaping the business environment towards an open society.

8. The German contribution

- Hardware (Building renovation, equipment including furniture, IT, cars) including oversight for construction and purchases getting close to 0.5 Mio USD.
- Experts: At least one long term consultant and perhaps 6 months of short term consultancy per year are necessary for such a project. In our project, two long-term experts dedicated half of their time for the IPA-component of the program. One expert was an Afghan – German (Shafic Gawhari) with excellent capabilities to connect the ideas of German co-operation to the Afghan decision makers at the highest ranks. In addition we had a senior consultant (Stephan Kinnemann) who led the discussion at the highest levels and was a credible partner for the GoA based on his lifelong career in investment banking and public sector institutions. In future the long-term presence at AISA will be even stronger as one person will be placed constantly inside AISA for the further development of the investment promotion activities.
- Direct financial contribution for running costs: 360 000 USD in the first year, now decreasing, at the moment around 300 000 per year (over 5 years about 1.5 Mio USD).
- Different activities like conferences etc. were done jointly.
- A public-private partnership between AISA and the German business umbrella organisation (BDI) was co-financed by the German government.

Altogether, the set up of AISA might be an investment over five years costing roughly 3.5 Mio USD.

9. Literature

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