The case for Small and Medium Enterprises in Afghanistan:

Small and Medium Enterprises, Economic Growth, and Civil Society involvement in Afghanistan

Saurabh Naithani
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By Saurabh Naithani
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This glossary explains important economic terminology and associated issues from the Afghanistan National Development Strategy (ANDS). This guide primarily aims to better inform Afghan Civil Society Organizations on key economic terms in the context of the Afghan economy. English, Dari and Pashto versions are available online from the ACBAR website and serves as valuable tools for Afghan government ministries, the donor community, and Afghan organizations.

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ACBAR (Agency Coordinating Body for Afghan Relief) exists to facilitate the work of its NGO members in order to address efficiently and effectively the humanitarian and development needs of Afghans.

ACBAR aims to provide a platform for Afghan Civil Society Organizations and international NGOs for policy inputs into the ANDS and Afghan government policy process over 2006/2007.

ACBAR was created in 1988 to address aid agency and donor demand for a coordinated approach to humanitarian assistance in Afghanistan and for Afghan refugees in Pakistan.

ACBAR now has more than 90 member organizations and provides the framework within which NGOs, the Afghan government, UN and bilateral donors exchange information, share expertise and establish guidelines for a coordinated, efficient and effective use of resources. ACBAR has three aims:
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# Table of Contents

Executive Summary..................................................................................................................7

Part 1 Small and medium enterprises in Afghanistan and Economic Growth...........9
   1.1 The Case for SMEs development in Afghanistan......................................................10
   1.2 The Way Forward: Upgraded SMEs, the Formal Economy, and strengthened Economic Governance.................................11

Part 2 A note on interactions with businesses, traders and trade associations in Mazar-e-Sharif, Herat and Jalalabad (Sept - Nov 2006)........................21
   2.1 Civil society organizations......................................................................................25

Key References.......................................................................................................................27

Annex 1.................................................................................................................................28
Annex 2.................................................................................................................................29
Annex 3.................................................................................................................................30
Annex 4.................................................................................................................................32
Contacts.................................................................................................................................33
Executive Summary

This paper aims to provide Civil Society organizations, Afghan and international development organizations, private sector agencies and others, a brief note on SMEs in urban settings within Afghanistan. It addresses the need to focus on strengthening small and medium-sized businesses in the country and provides some suggestions regarding the manner in which Non-Governmental Organizations can contribute to this effort. Part I looks at what constitutes small and medium enterprises, their role in economic growth, and the need to ‘formalize’ Afghan enterprise – a majority of which operates in an informal economy due to past and present circumstances in Afghanistan. Part II is a note on the study undertaken by ACBAR on small and medium businesses by the author in Mazar-e-Sharif, Herat and Jalalabad that studied the nature of Afghan urban enterprises, their obstacles, and particular areas for constructive civil society involvement in Afghan private sector development.

{Also available in Dari and Pashto online at www.acbar.org}
Part I: SME’s in Afghanistan and Economic Growth

Small and Medium Enterprises in Afghanistan are the market realities of the economy today. Nearly all business units in rural areas and a large proportion of the enterprises operating in urban centers in Afghanistan today are small to medium-sized set-ups with varying levels of formalization. Typically, in an urban commercial setting such as Kabul, Herat or Jalalabad, Small and Medium Enterprises (SMEs) will comprise of almost every visible business outlet: retail stores selling groceries and office supplies, workshops and repairs by the roadside, tailors, pharmacies, drycleaners, restaurants and barber shops. There are perhaps a handful of formal enterprises today that are truly national in size and scope (Roshan Wireless for instance); the vast majority are localized individual or family-owned outlets and roughly 90% of them are retailers.

SMEs have also had significance as part of a livelihood strategy during the war years (and continued post-war economic uncertainties today): the small size and informal nature of these enterprises have arguably been shaped in part by the preceding two decades of economic instability and political turmoil. In the prevalence of intense civil conflict, small informal business units have offered sustenance and some limited economic mobility while showing an incredible resilience throughout the various phases of war. Furthermore, the continued lack of physical and financial security today has made informal SMEs conducive to the established trade patterns and networks where a large part of business is conducted through personal networks and patronage systems rather than through formal channels.

1. The focus of this paper is on SMEs in urban settings that are more formalized than their rural counterparts in terms of procedures such as registration, taxes, following certain product standards and official/legal obligations.
3. The ‘Opium Economy’ is not considered in this study and provides incredible facts in the face of this economic instability. According to UN, IMF and World Bank estimates, the production of poppy for opium and the trade in narcotics in Afghanistan is at such proportions that opium comprises a sector by itself and can be termed as an ‘economy’ in its own right. The size of the drug sector relative to the licit Gross Domestic Produce (GDP) in 2005/06 stood at nearly 40% and its contribution to overall economic activity was 27% (this can be compared to Colombia – main producer of the world’s cocaine with 57% of the world’s supplies – where the contribution of the drug sector to overall economic activity remained below 1% during the same year). Afghanistan today remains the world’s largest opium producer with its share in the world’s total supplies increasing from 42% in 1990 to 87% in 2005 (4,100 tons of opium are estimated to have been produced in 2004). The UN Office on Drugs and Crime (UNODC) estimated the potential export value of opium production in 2005 to be US$2.7 billion.
The definition and categorization of small and medium businesses is bound to vary depending on the country context. For instance, if taken on the basis of employment, a large business unit in Afghanistan might employ the same number of people as a small, rural enterprise in India. Similarly, taken on the basis of annual revenues (in terms of dollars) a small rural enterprise in Germany with just a few employees might be generating turnovers equivalent to an urban enterprise employing fifty workers in Kabul.

The International Financial Corporation’s (IFC) Small and Medium Business Development Department describes business levels as following: Micro-enterprises comprise of up to 10 employees and total assets or total annual revenues of up to $100,000; Small Enterprises are made up of up to 50 employees and total assets/revenues of up to $3 million; and Medium Enterprises comprise of up to 300 employees and total assets/annual revenues up to $15 million. This categorization would effectively place nearly all Afghan enterprises that are not rural micro-businesses under the SMEs’ list. Microfinance institutions and commercial banks in Afghanistan’s urban centers today tend to define formal SMEs by the loan size they can manage as well those with relatively sophisticated management systems such as business records. The definition by IFC therefore serves as a guideline rather than a standard.

1.1 The Case for SME’s development

The importance of SMEs as valuable

The main characteristics of Urban SMEs in Afghanistan today are:

- A large number of SMEs are composed of retail outlets operating individually on a very small-scale with localized operations set within an ‘informal’ economy.
- Poor working conditions for wage labor within such enterprises with weak social protection and representation; no minimum income guaranteed.
- Poor market access by most producers/businessmen and a clear ‘knowledge deficit’ regarding pricing, business development services and new trading networks. There is also a scarcity of intermediate suppliers in-between producers and retailers/wholesalers.

in Afghanistan is indispensable for the broader objective of achieving private sector-led economic growth as stated in the Afghanistan National Development Strategy (ANDS). The sheer size and market share of small and medium enterprises – up to 90% of the economy with an estimated 250,000 to 750,000 units – compels all agencies working towards private sector development in Afghanistan to focus on various aspects of SME growth; the rationale that SMEs create ‘pro-poor growth’ is subject to further analysis however.

5. See ‘Providing SME Credit in Afghanistan’ (2006) Shorebank International
6. ibid.
7. See Annex Two: Afghanistan National Development Strategy
9. See Annex Three: Pro-poor Growth for definition(s); broadly speaking, pro-poor growth is achieved when the lower income groups in an economy benefit proportionally higher to higher income groups as economic growth is achieved.
business entities contributing toward Gross Domestic Product (GDP) growth became an increasing worldwide phenomenon starting in the 1970s. Small set-ups were deemed to be more innovative than heavy manufacturing and bureaucratic state agencies. As educational levels increased in the developed countries’ economies – along with evolutions in the banking system that allowed for easier access to credit – business skills were vested in opening fresh startups. The perception of SMEs was shaped as entrepreneurial hubs of economic activity. They are seen to bring about agility, product innovation and labor flexibility to a sector. The developed country-SME model might be the wrong reference framework for such enterprises in Afghanistan however since a) SMEs here have not necessarily been designed by economic choice alone (protracted civil conflict has acted as a strong external factor; SMEs’ size and scale of operations has been a livelihood strategy), and, b) there exist severe structural constraints for business growth such as weak infrastructure and access to credit for businesses. There is also no particular rationale to promote small or medium-sized business units since it does not guarantee technical efficiency – size remains to a large extent a function of technology. Some production processes require large investments and operating space such as flour mills and electricity projects.

The relatively ‘compactness’ of such business units can help individuals get easier entry into markets. It has been observed that the current market economy within Afghanistan is based in a non-competitive environment where opportunities are captured and blocked by those who are in a position to do so. This situation inhibits the growth of smaller players in all trades who are unable to scale-up their activities and break the hold of big players. The right support infrastructure by the government will help smaller business gain entry in markets. A case study of the raisin market in Afghanistan illustrates these structural dynamics that need to be overcome. The quality of the raisins and the structure of marketing limit both current export potential and the value returned to different actors in the production chain – the benefits gained from expanding the raisin market limited mainly to big traders who already dominate the markets. The farmers/producers of raisins and small localized traders get a fraction of the returns that this major Afghan dry fruit generates. Lack of market information – such as pricing and alternative trading networks – greatly contributes to this disparity. SMEs are also perceived to be enterprising and offering localized solutions – using local conditions to suit their production needs and therefore engaging resources and manpower from within the immediate communities.

1.2 The Way Forward: Upgraded SMEs, the Formal Economy, and strengthened Economic Governance

Small and medium enterprises in Afghanistan also offer considerable employment opportunities in absolute numbers as well as for the local community where such business units operate
since by the nature of their operations they are relatively localized entities. They may not be offering the best terms of employment however; in Afghanistan’s case where a given business such as a retail outlet might have both formal and informal operations there is a considerable amount of ‘unrecorded’ / unprotected labor with no job security or social security to speak of. A majority of employees would also not have any legal recourse. The conditions are probably worse in semi-urban and rural centers where the labor is even more seasonal, transitional and subsistence-oriented. Given the stage of Afghanistan’s development and the crucial need to engage people with the formal economy, SMEs can be viewed as valuable employment generators. SME growth ties in with employment in total numbers and this simple logic cannot be overlooked.

SMEs also contribute with a measured step towards low-cost and basic value products’ import-substitution. Within the large agricultural sector itself, poultry, cumin and saffron, wheat-based products and cashmere are trades which can facilitate economic growth while contributing to SME development. Poultry for instance has a low start-up cost with easy infrastructural requirements – suiting small businessmen with limited capital. With the apparent ‘construction boom’ the economy is witnessing, a large part of the demand that has so far been met by imports can be harnessed by local producers (though some sectors clearly lag in terms of quality and standards). Tiles, frames, doors, wiring, fittings, and plumbing – all can be provided for by supporting industries from Afghanistan itself. Manufacturing in light industries can be a strong entry-point to transition the composition of SMEs from being predominantly retail outlets and towards light manufacturing. Lower capital investments are required along with existing raw material availability to materialize production in the trades mentioned above. A further source of indigenous growth of light manufacturing arises from consumer goods such as soaps, shampoos and detergents since

12. Detailed costs/benefits and feasibility for the following products and sectors is provided in UNDP report titled ‘Market Sector Assessments: SME Development’ March 2005; prepared by Altai Consulting
13. See Part II: A note on interactions with businessmen and associations in Herat, Mazar-e-Sharif and Jalalabad
they are not complex products and the demand is fairly consistent (coupled with arguably the notion of building brand-awareness in a sector where no foreign company has established a name for itself in low-end products such as soaps and toiletries, amongst others, as yet). At present, Afghanistan is importing almost all of the consumer goods in this category.14

SMEs therefore form a part of the bigger process of economic revival in Afghanistan. The long-term effects of SMEs are such that as per capita income (income per person) in an economy increases, the contribution of small and medium business units to the Gross Domestic Product (GDP) and labor force increases.15 The country possesses what the Ministry of Commerce characterizes as a ‘repressed economy’.16 An AREU study further points out, business enterprises are trapped in a ‘micro-level’ of economic activity with weak to modest prospects for growth and expansion.17 Most enterprises face serious structural constraints to growth such as the lack of infrastructure and access to credit;18 domestic revenues today make up just 5% of the national budget;19 up to 90% of economic activity is informal and outside the tax system; finally, illicit production of opium accounted for one-third of the GDP and while it forms an entire system employing many, it poses real challenges to national security and the legal economy. An overall sketch of the economy is equally revealing; the Balance of Payments of Afghanistan today are funded primarily by three sources – none of which are sustainable over the medium to long run: construction (a ‘post-war’ construction boom which, given experiences in other post-conflicts countries, inevitably slows down), foreign aid, and the opium economy.

The Afghanistan National Development Strategy (ANDS) points to the ‘predominance of informal economy and [a] weak tax paying culture’ as a context – and constraint – to Economic Governance and Private Sector Development. Most of the private enterprise undertaken by Afghans occurs in the informal sector/economy.20 The informal sector has been of immense significance; without adequate financial and legal infrastructure to conduct business in, informality has been the norm rather than an aberration in Afghanistan. The current

15. See ‘The Role of Small and Medium Size Enterprises in Economic Development’, Selcuk Caner, HSE Conference/Moscow
16. From presentation by the Private Sector Development team, Ministry of Commerce, Afghanistan, on the Investor Roadmap, 17th October 2006, at Ministry of Commerce and Industries (for the Technical Assistance and Capacity Building Project)
18. see The Investment Climate In Afghanistan: Exploiting Opportunities in an Uncertain Environment, World Bank South Asia Region: Finance and Private Sector Development Unit; December 2005
20. the informal economy refers to a general market often associated with developing countries where up to 60% of the labour force belongs to an income category whose sources are unregulated by government institutions – mainly in the fiscal (taxes) and legal (rules, regulations and standards) sense. Also termed as the ‘informal sector’, it lacks governmental control and is also characterized by weak to non-existent social security such as the lack of a tenure/job security and no medical insurance. The usual profile of informal units includes small services, retailers, light manufacturing and workshops. The informal economy is not easily compartmentalized since a formal sector business enterprise (that pays taxes to the government, follows rules and regulations of trade, and might be registered with a trading body) may have an informal branch. Some informal activities are transitory and seasonal (such as manual labour during a harvest). The informal economy is closely linked to livelihoods of rural and poor households that may engage in seasonal or permanent informal work. The informal sector helps them meet their subsistence needs and provides them with income in cash or kind while not offering any sort of protection such as healthcare, insurance or job tenure. People not only choose to engage in the informal sector but also often are forced out of the formal sector and into informal employment (due to natural disasters, civil strife/war, and economic dynamics). This ‘economy’ is typified by diverse, small-scaled and occasional members (street vendors, casual labourers) but can include much larger bodies within a trade (such as manual/ part-time labourers operating within a loose association that secures their wages and benefits). The agriculture sector in Afghanistan generates a considerable proportion of informal employment through farm, off-farm and related non-farming activities. Child labour is strongly related to the sector; the informal economy in general also engages a large portion of women workers. (source: CSANDS Basic Guide to the Afghanistan National Development Strategy; ACBAR 2006)
informal economic system in fact helps absorb a large portion of unskilled and semi-skilled laborers and provides livelihoods to millions. Private enterprise needs to be reigned back from the levels of current informality however in order to a) be accounted for (taxation/registration, standards and regulation, social security of laborers) and, b) enhance economic growth (through tax and other returns to the formal economy, stronger economic governance and business development services). The prevalence of the informal economy is not consistent with what the government is aiming to achieve. The Pillar Three (Economic and Social Development) of the ANDS envisages the private sector as the main source of growth, with agriculture and small and medium enterprises dominating the private sector in the short to medium term. While the private sector can remain the primary driver of this growth under the current economic landscape, it will be a growth that is not properly accounted for or harnessed and growth that remains constrained due to the lack of structural adjustments needed to maximize private sector/SME potential. The economy in general and SMEs – constituting the majority of business undertakings – in particular, need to be encompassed within the formal economy.

Economic revival in the country today will need to consider three crucial areas for 'upgrading' Afghan businesses:

a) The formalization of the economy

b) The increase provision of credit to Small and Medium Enterprises

c) A pronounced focus on business development services for Afghan enterprises

The process of formalization for business enterprises is necessary to achieve policy goals in economic governance and private sector development. Formalization, broadly speaking, is the process whereby private sector enterprise subscribes to the legal economy and follows economic governance as laid out by the government (and carried out through state agencies and business associations). This primarily involves following tax requirements, legal registration, following basic business/trading regulations (quality control, fair trading practices) and abiding by government rules and regulations while conducting business. Formalization essentially means that a given small or medium enterprise has been accounted for in the legal sense (being regulated without undue hindrance to economic activity) as well as is providing returns in the form of taxation to the state through which the state can then work towards private sector development (infrastructure, provision of security). The process of moving businesses towards this direction directly addressed concerns laid by the Afghanistan National Development Strategy and various agencies working on Private Sector Development. The process of SME growth has to be tied-in to the for-
Votal economy which at this stage of Afghanistan’s development necessitates a clear policy direction by the government. As business units develop and formalize they are encompassed within the legal, registered economy. This is a crucial aspect of state-building since they contribute to the government’s Gross Domestic Produce (GDP) through the payment of taxes and other dues needed to then provide infrastructural support by the state (municipal authorities providing power lines, sewage systems, water connections, etc. – and their upkeep). Revenues generated by the government also strengthens economic governance as more investments are made in the enforcement of legal frameworks for businesses (policing and legal recourse, for instance) and other private sector development services. Afghanistan has had a chronically distorted fiscal structure that reflects its historical legacies: traditionally low revenue mobilization, civil services wages greatly eroded and compressed by hyperinflation/extremely low currency value, and more recently, very high spending on reconstruction activities and priorities such as security. Formalization is a key agenda at the Ministry of Commerce in Afghanistan; stronger ties between the business community and the government will also strengthen the process of state-building further for there certainly is a ‘disconnect’ between official/formal policy making in Kabul and the diverse actors in Afghan economy. Economic development will therefore inevitably be tied into SME growth and formalization. Small and Medium Enterprises complement the formation of the market, the returns from taxes and adherence to standards and regulations – serving as a crucial accompaniment to what Ashraf Ghani calls ‘provision of the environment that enables the formation and expansion of the legal market [that has] emerged as one of the most important

Our economic vision is to build a liberal market economy in which all Afghans can participate productively without engaging in production or trafficking of narcotics or other criminal activities. To do this, we must develop an enabling environment for the private sector to generate legitimate profits and pay reasonable taxes, thereby enhancing public revenues that can then be invested in public services. Ultimately, we want to move beyond dependence upon international aid and build a thriving legal private sector-led economy that reduces poverty and enables all Afghans to live in dignity…

To achieve pro-poor growth while eliminating the criminal economy, we aim to make simultaneous investments across the security, governance, and economic pillars.

Chapter One: The Government’s Vision for Afghanistan

23. GDP is the total value of goods and service produced within a country; it is in effect a measure of economic activity within a country. A common method to calculate GDP is: GDP = National Expenditure + Investments + Government Spending + (Exports-Imports).

functions of the state.\^25

**Access to credit** by Afghans remains a serious constraint. Less than 2% of small and medium enterprises in the country are accessing formal credit;\(^26\) the majority depends on family and friends as sources of finance for their business. While these can be reliable networks, there is negligible credit creation in the economic system as the scale of holdings, savings and investment are extremely low. Weak financing has served as a chronic bottleneck that has restricted the potential for business growth. Commercial banks has valid reasons not to engage with SMEs more than they have so far. SMEs are what a commercial bank in Afghanistan terms as "informationally opaque" – lacking financial statements and bank records and having sketchy to non-existent credit histories. A private bank would not risk its capital with such enterprises. Furthermore, financial services providers cannot rely on the existing (weak-) legal framework in order to enforce collateral agreements with small businesses. Even Microfinance Institutions (MFIs) have largely stayed with rural micro-enterprises where their operations have been highly successful. A two-pronged strategy advocated has been the up-scaling of MFIs by providing them more capital through international donors and state agencies for disbursement to Afghan businesses - and - down-scaling requirements of commercial banks and readjusting them for small and medium-scaled businesses in areas such as security for loans, details in bank forms and the basic criteria for loan consideration.

\(^{25}\) see paper by Ashraf Ghani – Working Paper 253 'Closing the Sovereignty Gap: An approach to State-Building' by Ashraf Ghani (former Minister of Finance, Afghanistan), Clare Lockhart and Michael Camahan; Overseas Development Institute UK September 2005

\(^{26}\) formal credit implying money borrowed from registered commercial banks; source: Shorebank International Report titled 'Providing SME Credit in Afghanistan' (2006)

\(^{27}\) ibid.
Credit creation and growth in the economy:
Income (B) – Savings (C) – Investments (D) – Credit Creation (A)

The Cycle above illustrates economic growth through the creation of credit (in simple terms, the money generated through interest on monetary savings) and is regarded as a vital dynamic for any market-based system today. Increased credit and access to credit in the economy (under ‘A’ above) through private channels such as commercial banks, government schemes and through Microfinance Institutions will infuse the economy with more money for economic activity. As economic wealth is created and the formal economy is developed in parallel (in particular, the banking sector), Afghans will save and invest progressively a larger proportion of their income in commercial banks and investment schemes (C to D above). This entire cycle – though simplified above – generates exponential economic growth and money invested back in the economy results in there being more wealth created than originally invested. A crucial aspect that is not factored in here is the distribution of this wealth – and necessitates economic governance by the state.
Business Development Services (BDS) form a crucial part of strengthening economic growth. BDS includes a) improving business presentation and in effect making the enterprise more attractive to customers, b) developing capacity and skills in handling legal requirements (taxation, registration) and financial procedures (loan applications, bookkeeping/accounting) – a crucial aspect in Afghanistan’s case – and c) business expansion through developing information systems, business networks and making production more effective. Another important development is access to market information (for instance, small-scale raisin producers knowing what options they have in terms of retailers, and retailers knowing prices in different markets). It could be argued that as businesses develop, they will inevitably come within the fold of the legal/formal economy (regulated by government policies) as the increased scale and scope of their operation will place them within the range of government.

BDS is at various level of enterprise: from training small producers how to fill bank forms and maintain formal records of transactions to linking different players in a poultry supply chain. The more ‘macro’ dimensions of business development are being addressed at the Ministry of Commerce’s Private Sector Development directorate. Formalization of the economy (while removing unnecessary obstacles to operating in the markets such as excessive ‘red tapism’ (bureaucratic procedures), corruption, poor market information) facilitates a favorable environment for legal business and is therefore also relevant to counter-narcotics initiatives by the state. The Market and Business Development Department plan within the Ministry calls for an ‘inclusive market development approach’ that would take into account different players within the economy and how they can benefit from economic growth. Economic policy needs to consider variables outside the demand-supply mechanic and the government and the private businesses are not the only players. Trade associations, the not-for-profit sectors (NGOs and agencies under civil society) and the informal networks prevalent in the economy today are just as relevant.

There is also a case of misperceptions when it comes to the process of private sector development and pro-poor growth. The process of privatization and private sector growth need not be at the expense of poorer segments of society; and conversely, pro-poor growth does not have to come at the expense of national economic growth (measured through income standards, Gross Domestic Product, etc.). What economic growth means for Afghanistan depends a lot on how that growth is regulated and channeled. Given the circumstances under which the private sector in Afghanistan has to develop in, government-led economic governance is required. This control must not however lead to unnecessary hindrance, and obligations that businesses have to face. Economic profitability and efficiency requires a busi-

28. see Part II for suggestions for civil society organizations under BDS
29. the following is based on information provided by the MoC team at the Private Sector Development directorate, and interactions with team members over August-November 2006; in particular, the Investor Roadmap Project (Adam Smith International and MoCi)
30. see Annex Four: From Markets…to Market Systems (Ministry of Commerce, Afghanistan)
31. see Annex Three: Pro-poor Growth
ness environment conducive to a market economy, not one where the government dictates all aspects of market behavior. Economic development that engages small Afghan producers and retailers along with established business houses will certainly over a period of time result in poorer sections benefiting from economic growth. Another debate shaping up is the emphasis placed on foreign investment and interests in the Afghan economy and whether that is being carried out in government policy at the expense of policies that can strengthen domestic enterprises and investments. All these debates require intense civil society engagement with government policy; analyzing the direction of private sector development and its impacts for small and medium enterprises (‘small businesses’) needs to be undertaken by NGOs with the capacity to undertake such studies. They can also act as forums to bring together government agencies and Afghan enterprise for better economic literacy amongst the Afghans who ultimately are the recipients of this growth.
Herat and Jalalabad are possibly the two most important trading hubs of Afghanistan and a significant portion of economic activity in these cities is directed towards cross-border trade with the neighboring country: Iran in the case of Herat and Pakistan in Jalalabad’s case. Mazar is relatively quiet but retains important trading links with Central Asia. All three clearly display a higher standard of business development (and urban planning) than the other Afghan cities. Herat was in fact unique in the extent and duration of its (electric) power coverage and this has undoubtedly increased economic activity until late hours.

The CSANDS Initiative under ACBAR undertook a study in Fall 2006 in the three urban centers above. A number of business associations were engaged with the following objectives:

a) Identifying common problems that affected a large number of businesses in urban settings as well as those which were specific to Mazar, Herat or Jalalabad; and,

b) Looking at the prospects for increased civil society involvement in private sector growth (especially Business Development Services - BDS).

The meetings with actors from the Afghan private sector were mainly organized through the regional offices of the Afghanistan International Chambers of Commerce (AICC) and the Afghanistan Investment Support Agency (AISA).

The traders in Mazar-e-Sharif indicated problems that they were facing with Customs officials. Certain policies and measures were being incorporated within the Customs office without any consultations with the businessmen and traders. The Afghanistan National Chambers of Commerce gave the example of officials within the Customs department deciding what type of goods should be imported into the country (based on products that were arbitrarily judged to hurt domestic production). This decision was being forced on to the traders through a combination of taxes (higher on imports deemed ‘unnecessary’) and official instruction. All agencies and business associations we spoke with felt there was a need for strengthening business development. Services catering to better ‘business literacy’ such as book-keeping, market information(-sharing) and marketing would immensely benefit smaller business set-ups. Associations in Mazar approved of non-governmental agencies’ involvement in business development through services such as capacity-building workshops. Some of these could even help bridge the gap between national and provincial policy-makers on the one hand and traders on the other. In fact, the need for Business Development Services (BDS) gradually emerged as the key issue in all three urban centers.
A large number of businessmen in Herat were generally dismissive of Non-Governmental Organization (NGO) interventions since they did not see a role for ‘outsiders’ in what were seen as issues concerning the government. The businessmen we met through AICC complained that the government was not doing enough for the local Afghan producers. They wanted higher tariffs for Iranian goods coming in from across the border. An interesting conversation took place with Engineer Khairandish, head of a construction supplies’ company in Herat and the Business and Marketing Services of Afghanistan (BAMSA). BAMSA is trying to develop an ambitious business development services’ network across Afghanistan that caters to the needs of Afghan businesses in areas that have been traditionally underdeveloped for the modern economy – book-keeping/accounting, maintenance of business records and marketing, amongst others. Afghan producers were making compatible material, we were told, but construction materials coming from Iran and elsewhere were cheaper since they were of a lower quality. The government must be pressured to increase the tariffs on foreign goods. BAMSA suggested a major initiative for ACBAR and other NGO coordination bodies within the country: a partnership between Afghan producers/businesses and national and international agencies working on development and humanitarian projects. A network that connects local Afghan suppliers with development agencies and their logistical/operational needs could immensely help in securing contracts and sub-contracts from International NGOs and (re-)construction

33. this however conflicts with other exchanges where businessmen and companies have told us that Afghan materials – especially in the construction sector – are of inferior grade and both national and foreign companies have resorted to contracts with foreign producers through Afghan intermediaries
agencies for local and regional Afghan producers. Engineer Khairandish’s point was touched upon by others we met in Herat. A lot of donor activity was being logistically supported by foreign producers (supplied through Afghan intermediaries) and not catered directly for by Afghans producers. A more concerted effort to tie-up development agencies with producers could greatly benefit the local economy as well as generate more ‘buy-in’, some Afghan businessmen claimed, from the communities that NGOs were working in. Items that could be locally produced in small and medium enterprises included office stationery, house/office fittings, electronics and low-end electrical equipment and building materials.

Business agents for traders in Jalalabad, capital of the Nangrahar province that bordered Pakistan, showed concern about recent changes in the government’s tariff policies. A lucrative re-export trade in Nangrahar (and other border provinces in north-eastern Afghanistan) was being increasingly threatened by government intervention: Afghanistan has had very low tariffs on goods coming in from both Central Asia and China in comparison to the levies by Pakistani customs on the same imports (the examples included ball pens and low-end household fittings). As a result, Afghan traders in Nangrahar province and in Jalalabad in particular have engaged in a profitable re-export business involving selling imported goods from Central Asian countries and China to Pakistan.

The traders complained of the Afghan government raising the bar on imports over the last year (which, their perception interestingly read, was due to pressure from the World Bank and other international agencies; the reasons for this were not specified by the trading agents we met at the Jalalabad Customs House). The Afghans engaged in re-exports to Pakistan were particularly hit hard since the raising of tariffs in Afghanistan coincided with Pakistan lowering its tariffs on imports from the same countries.

34. The Customs House in Jalalabad housed an Association of Business Agents – a private association of 210 trade agents (or ‘middlemen’) that represented 717 companies and businessmen mainly from Nangrahar; the agents mainly negotiated cross-border trade deals, oversaw logistics and kept an eye on the tariff rates for their clients.

35. While this practice continues to be good revenue for many traders based in border provinces, how this trade causes real growth in regional economies is debatable.
countries. A reverse trade flow had started to take place according to the traders in Jalalabad. Traders in Pakistan were now purchasing from its northern neighbors and re-exporting the goods to Afghanistan. The traders also saw the tariff mechanism in place as ineffective since the Afghan traders who did not wish to comply with the rules could easily by-pass them by bribing customs’ officials and the police. This in effect penalized the traders who were passing through the proper channels in taking their goods from Jalalabad to Torkham and onwards to Peshawar (Pakistan) and visa versa (therefore making their imports and exports more expensive).

A serious concern amongst the traders regarded extortion by the Afghan National Police (ANP) and the border officials. Their trucks drivers were being asked for money from Jalalabad to the Afghan-Pakistan border at various check-points set up by the police. Failure to comply could result in unloading the trucks for inspection by the police – something the authorities were permitted to carry out. The agents at the Customs House went as far as telling us that some of them were under relentless pressure from their clients and had at times resorted to ‘financially supporting’ localized insurgent groups operating in the Nangrahar province in order to put pressure on these check-posts. It was a bit unusual to hear some agents point directly at the World Bank and other ‘foreign agencies’ as the driving force behind the central government raising tariffs on imports from Pakistan.

Another concern was the interest being charged by micro-finance institutions to small businesses. BRAC was cited as an effective finance provider but one with high administrative costs. The Deputy Governor of Nangrahar province conveyed the same, along with objec-
liberal tax regime on goods for import and export and that the new tariff policies should ‘not be imposed from other countries’. The staff at AICC proposed that the Ministry of Rural Rehabilitation and Development (MRRD) give funds directly to them instead of microfinance institutions such as BRAC and MISFA who they alleged charged ‘up to 20%’ in administrative overheads.

There could well be an ‘inverse correlation’ between the level of business development in an urban economy, and, the possibilities for civil society involvement in non-financial interventions such as skills/capacity-building. In Herat for instance the businesses we interacted with through AICC voiced very ‘formal’ concerns that only government interference can address (raising tariffs on imports) whereas businesses in Mazar-e-Sharif (with a relatively lower level of private sector development) had a stronger consensus for business development services conducted through NGOs. There was however a broad agreement in all the three cities regarding the importance of business development for Afghan small and medium enterprises. Mujeeb-ur-Rahman at AISA (Jalalabad) pointed to two basic impediments that Afghan business – particularly those business units with potential for expansion and formalization – faced: lack of market knowledge and the lack of capital. Afghan businesses were still very ‘localized’ and ‘simple’ in their operations (with very limited scope for business expansion or networking, for example). There was also little information regarding the market for their good and services beyond their established trading links. This feature related to a lack of marketing dimension in their enterprise. The lack of a working knowledge of English might be an impediment too he thought. Also, investments had to be geared towards SMEs that will work – niche markets such as Afghan handicrafts and carpets, and agro-businesses.

2.1 Civil Society organizations and in particular, Non-Governmental Organizations (NGOs), have undertaken intense engagement in the country. A large portion of this involvement is evident through development projects undertaken by a number of national and international organizations in the field of reconstruction, basic sanitation, healthcare, education and gender-related projects. Then there exist localized and national micro-credit initiatives that have proven to be invaluable for poor communities. Microfinance as an element of economic reconstruction enjoys a wide consensus amongst the stakeholders today. As mentioned earlier in Part I, most microfinance institutions (MFIs) are wary of engaging small and medium enterprises that display a high degree of informality and choose instead to cater to their traditional base of small-scale rural units. The need to ‘scale-up’ MFIs’ operations to cover urban and semi-urban businesses is acknowledged. Microfinance is responding to Afghan private sector needs through the private banking sector (which has taken tentative steps – Azizi Bank, First Microfinance Bank) and specialized agencies that have considerable expertise and committed resources for this purpose (World Bank, Aga Khan Foundation). A good way forward for other civil society actors to be involved with private sector development today would be through exploring ‘non-financial’ endeavors (apart from the microfinance initiatives undertaken by agencies such as MISFA, FINCA and other agencies) that fall un-
der the broad category of Business Development Services. As the interaction with businesses above indicates, there is a lot of scope for assistance in developing the ‘softer’ side of businesses in urban centers.

► **Skill-building workshops** organized through regional partnerships with the Afghanistan International Chambers of Commerce (AICC) and the Afghanistan Investment Support Agency (AISA) is a feasible way forward. Such workshops need to be precise in their agenda and carried out with some degree of permanence and consistency. The program under such workshops could cover marketing techniques, product promotion and business presentation. The need for basics such as understanding government procedures/forms and proposal writing for loans was expressed by many businessmen. This training can and should also be pursued in collaboration with the Afghan government. Vocational training to SMEs can be logistically supported by government agencies; generating such awareness of business rules, standards and procedures would be more effective when conducted along with government counterparts.

► Another area of work where NGOs could contribute is **procurement**. A large number of logistical contracts are signed annually between the various international and national development agencies and suppliers. The aim would be to strengthen links between local/regional Afghan producers and suppliers on the one hand and development/private agencies purchasing goods and services on the other. While it can be argued that only foreign suppliers (through Afghan intermediaries) can provide high-end goods (such as office products like printers, computer equipment etc.), a lot can be catered to by small and medium units (house fittings, wiring etc.). A listing of local/regional Afghan suppliers through ACBAR and other concerned NGO coordination agencies might be a good step in this direction.

► **NGOs having advocacy branches** (such as Christian Aid and OXFAM) need to be involved with the **Afghanistan National Development Strategy (ANDS)** process and actively participate in the consultation group (termed the ‘technical working groups’) that meets under the Economic Governance and Private Sector Development pillar. Government policies need to be drafted that are favorable to domestic enterprise (mainly, Small and Medium Enterprises). In particular, laws being drafted at the Ministry of Commerce and Industries, the Ministry of Economy, Ministry of Finance and others that relate to private sector development have to be looked at in-depth. Civil Society advocacy needs to work towards these government bodies placing strong(er) emphasis on domestic investment and credit-creating environments as much as their emphasis on enabling foreign investments in the country have been.
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'Civil Society' refers to the entire body of voluntary civic and social organizations and institutions that form the basis of a functioning society. These bodies are differentiated from government-supported structures (ministries, state-funded/managed agencies, security apparatuses). Civil Society includes:

- Non-Governmental Organizations (NGOs)
- Private Voluntary Organizations
- Trade Unions
- Charities
- Academic institutions
- Research organizations
- Media
- Social/Sports’ Clubs
- Cultural and Religious Groups
- Women’s Organizations
- Cooperatives and consumer organizations
- Environmental groups
- Business organizations

In Afghanistan, the categories above would comprise of national (and International) NGOs such as ACBAR, ANCB, SWABAC and OXFAM, the Afghan Media Resource Center, Kabul University, Afghan Women Network (AWN), and the Chambers of Commerce.

Due to the sheer breadth of what comprises civil society, what gets termed as a ‘civil society organization’ and what does not remains open to debate and discussion. An individual carpet shop is not civil society (primarily since it operates for personal profit) but an association of carpet sellers/traders in Kabul could be considered as a voluntary civic body functioning to address the concerns of a professional community, and therefore can be a Civil Society Organization (CSO). One major function of certain CSOs such as environmental groups, Trade Unions and NGOs is to act as checks on government policies (as ‘countervailing powers’) and as crucial links between the state and its organs on the one hand, and the wider public on the other.

A working definition helps us broadly understand the nature of CSOs:

Civil Society refers to the arena of uncoerced collective action around shared interests, purposes and values. In theory, its institutional forms are distinct from those of the state, family and market, though in practice, the boundaries between state, civil society, family and market are often complex, blurred and negotiated. Civil Society commonly embraces a diversity of spaces, actors and institutional reforms, varying in their degree of formality, autonomy and power.

Annex One

37. from the Centre for Civil Society (CCS, London School of Economics) definition; accessible online at http://www.lse.ac.uk/collections/CCS/what_is_civil_society.htm
Annex Two

The Afghanistan National Development Strategy (ANDS) is an Afghan Government medium-term development framework that sets the social, economic, governance and security agendas for Afghanistan over the next five years. The strategies present within this document also work towards the attainment of the United Nations Millennium Development Goals (MDGs).

The ANDS was initiated through a Presidential Oversight Committee chaired by the Senior Economic Adviser to President Hamid Karzai. The process began with a discussion of the Afghanistan Millennium Development Goals (MDGs) and a consensus towards a policy document that would help implement the MDGs and lay the foundations for a structured national development approach. Consultations followed with government ministries (such as the Ministry of Foreign Affairs/MoFA, the Ministry of Rural Rehabilitation and Development/MRRD, and the Ministry of Finance/MoF) and other organs (such as the Civil Services’ Reform Commission), major donors and international organizations (World Bank, Asian Development Bank, United Nations, amongst others). The ANDS was presented for the London Conference on Afghanistan in January 2006. The conference also witnessed the Afghanistan Compact between the Afghan government and the international community; foreign countries and donors agreed to support the Afghan government’s development strategy and the government took responsibility of the development process in order to meet national goals. Since then, work has begun on a final ANDS document due to be completed by mid-2008. A crucial function of the ANDS is in its role as a Poverty Reduction Strategy Paper (PRSP) supported by the World Bank and the International Monetary Fund (IMF). It is an economic development strategy document which serves to address and achieve preconditions for confessional financial borrowing and other aid from international financial institutions.

The government is currently undertaking a costing exercise for the ANDS strategy (the cost to the government budget in order to implement the ANDS), prioritization (of strategies) as well as comprehensive consultations in the center and provinces. Consultations with donors, NGOs, private sector and civil society representatives both before and after the London Conference have led to revisions in the strategies and benchmarks presented within the document.

Two important functions of the ANDS are:

- Presenting the nation and international community with a comprehensive study of development priorities within the nation and a unified strategy (that all ministries and state agencies subscribe to) for the security, economic and social development needs of Afghanistan as a nation-state emerging from protracted civil war in 2002; and,

- Synchronizing strategies between different ministries by being a central planning document, and helping bring about efficiency in projects and programs. The pillar structure of the ANDS helps categorize development needs and helps ministries, donors, international NGOs and the Afghan Civil Society identify areas of work and cooperation.
Annex Three

Pro-poor Growth is economic growth that is deemed beneficial for the poor. While economic growth implies that a nation’s economy is progressively improving and increasing in terms of measures such as the Gross Domestic Product (GDP) and indicators such as exports, employment and the growth of industries, it might not necessarily mean that the growth is distributive. Pro-poor growth places economic development away from absolute growth (growth just in monetary terms) and in the realm of social justice: are all sections of the society or income groups benefiting equally from the economic returns in this growth through higher standards of living?

One way to understand this is through the incomes generated by a particular sector. For instance, the post-war construction boom in Afghanistan has meant that the building sector has seen a lot of growth though investments; there has been a major increase in housing and commercial complexes in all the major urban centers. This translates into higher employment opportunities across the construction sector. This boom will undoubtedly contribute to overall economic growth of the nation as it contributes to the GDP. However, the distribution of the overall income (through salaries, rent) generated from this sector will unevenly benefit the actors involved. While the owners and the top management of construction firms might make profits and derive high salaries (along with foreign investors and employees), the Afghans working as manual and sem曼ual laborers will get a fraction of the returns. Therefore, high economic growth in a particular sector and in the overall economy does not necessarily translate into equitable, broad-based, or ‘pro-poor’ growth.

Pro-poor growth has been defined in two different ways: The absolute definition considers only the income of poor people. Pro-poor growth is judged by how fast the average income of the poor (defined by a measured such as the international standard of those living on less than $1 per day, or, through a national poverty line) rises with economic growth. This definition focuses on the rate at which absolute poverty is reduced – the income distribution between the rich and the poor might not have reduced but absolute poverty might have (the number of people living below the national poverty line or under $1 a day).

The relative definition addresses the change in the income of the poor in relation to economic growth; growth is pro-poor if the incomes of the poor people grow faster than that of the population as a whole. For growth to be pro-poor, the income inequality must fall as economic growth occurs – the gap in incomes between the highest income groups and the lowest income groups must decrease.

38. see Department for International Development’s (DFID/United Kingdom) ‘Pro-Poor Growth Briefing Note 1: What is pro-poor growth and why do we need to know?’ (February 2004); available online at http://www.enterprise-impact.org.uk/pdf/BriefingNote1.pdf
Both these definitions of ‘pro-poor growth’ are valid depending on the approach and objectives of national development. If a government is aiming to reduce absolute poverty amongst its population, then overall economic growth does indeed place more people out of poverty – if not narrowing their income gaps with the higher income groups. We can take the example of India and Ghana. Ghana performed better than India if we look at the relative pro-poor growth approach since income inequality fell in Ghana between 1987 and 1997. India, however, outperforms Ghana over the same timeframe if the absolute definition of pro-poor growth is taken: the incomes of the poor in India grew faster than those of Ghana and India’s higher economic growth resulted in more poverty reduction – but with higher inequalities.

39. ibid.
Annex Four

From Markets…to Market Systems

The model below is based on the work currently underway at the Ministry of Commerce and Industries (MoCI); the aim is to deepen engagement with the economy after considering all the actors involved in the Afghan markets. This ‘inclusive market development approach’ is in principle working towards pro-poor growth by involving all the stakeholders in a market sector. The basic Demand-Supply mechanism at the centre stands for any given trade; this exchange between buyers and sellers of a good (poultry, carpets, raisins) or service (automobile repairs, book-keeping) is then enveloped by supporting functions to be provided by the market and rules that are to be enforced (by both state agencies and private sector associations) and followed by the producers and consumers.

The government does not necessarily intervene in all aspects of the supports required or the rules to be implemented. Financial services (under supporting functions) is needed by all: farmers for purchasing inputs and operating needs and loans; traders need it for operating costs; and processors will need it for overdraft/loan facilities, leasing, and working capital/operating costs. Information similarly is to be provided by the government as well as civil society actors and the private sector. Information flows can greatly strengthen farmers’ bargaining position with intermediate traders and retailers. Regulation and enforcing of standards is also not necessarily the Afghan government’s domain; business associations that list businesses contribute towards registration and enforcing trade standards for individual enterprises. The key is for the government to work with different actors to bring about the right interventions and efficiency in the system.

40. the following is based on information provided by the Ministry of Commerce Private Sector Development team, and interac-
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