

CHAPTER 4: FOSTERING ENTERPRISE DEVELOPMENT

4.1 Chapter 3 detailed ways in which increased value added in agriculture could help change relative incentives between licit crops and opium poppy and provide viable alternative income and job opportunities in agriculture.

4.2 Experience in other opium poppy growing countries such as Thailand and Pakistan highlights the limitations of licit agriculture in terms of its ability to grow rapidly and, in effect, replace opium production. In addition, the capacity of Afghanistan's poor mountain economy to sustain the large and growing rural population at an increasing standard of living inevitably faces stark limits. Out-migration – internal, rural to urban, or external – is a way forward in this situation. Thus how to accelerate enterprise development and job creation in the urban sector and to assist migration also need to be examined.

4.3 This chapter first looks at the role of private enterprise and its growth potential, and at ways of adding value to labour (Section 4.1). The following sections then discuss current interventions to support business and human resource development (Section 4.2) and the scope for scaling up and for new initiatives (Section 4.3). Ways to overcome the pressing constraints to doing business are examined in Section 4.4, and a final section (Section 4.5) sketches out the possible impacts of further programme interventions and related policy and institutional changes.

4.1 CONTEXT AND OPPORTUNITIES FOR ENGAGEMENT

Private Enterprise in the Afghan Economy 4.1.1

4.4 *Government is committed to establishing macroeconomic stability and free enterprise, encouraging private sector-led development and foreign direct investment.* To this end, emphasis has been put on maintaining a freely convertible currency, low tariffs and no quantitative restrictions on imports (with very few exceptions, mostly on religious grounds). Afghanistan is also committed to fiscal prudence and has embarked on a macroeconomic and reform programme supported by the IMF's Poverty Reduction and Growth Facility (PRGF).

4.5 *GDP growth has been fast, but future growth will depend on the investment and productivity performance of private enterprise.* The very rapid growth and high levels of investment described in Chapter 1 suggest a dynamic economy on a fast development track. They have in fact resulted in strong income growth, high demand and rising labour absorption. However, growth has been from a low base and has been inflated by very high levels of external transfers, conditions typical of a post-conflict economy. Whether recent rapid growth can be sustained and consolidated depends on whether structural change can be effected, with more sustainable growth drivers. Provided that macroeconomic stability is maintained, growth will depend in large measure on the investment and productivity performance of private enterprise.¹³

4.6 *The economy is dominated by a strongly entrepreneurial informal sector accounting for 80-90% of business.* Despite its large size and energetic character, this dominant informal economy has structural characteristics that make it a poor springboard for sustained rapid economic growth over the medium- to longer-term. It lacks the flexibility for technological modernization and productivity improvements; it does not invest in staff development; growth is limited by lack of capital; product standards are erratic; and above all, informal sector

¹³ See IMF 2006b: 75, Perisic n.d.: 5; Pain 2006: 5

enterprises are too small, disparate and not organized to move beyond local markets and clienteles. Byrd (2007: 1-5) concludes that Afghanistan's economy is essentially in an "informal equilibrium not conducive to growth".

4.7 *The formal sector is relatively small and urban-focussed, and private sector representative bodies are weak.* There are reckoned to be about 150 major businesses in the country, and about 3,000 other businesses are large enough to be registered with the Afghan Investment Support Agency or with the Ministry of Commerce.¹⁴ Very few large or medium-sized businesses are rural-based. Construction is the most important single sector. Organization of the formal private sector is weak and fragmented: there are, for example, *three* chambers of commerce in Kabul. The strongest, the AICC (promoted by USAID), has some 7,500 members, including all the big 150. There have been hopes to use the AICC as a centre for promoting private sector enterprise, but it is currently "riven by discord". There are 82 Board members because "no one trusts anyone else".

4.8 *The lesson is that although the current high-growth environment does offer some opportunities to generate incomes and employment to counterbalance the opium economy, maintaining growth rates and scaling up business enterprise will require structural change.* The dominance of the informal sector with its low capital requirements and high labour absorption allows easy entry for rural entrepreneurs and rural-urban migrants. Scaling up, however, will be a significant challenge, and rapid improvements in productivity and incomes that could offer real alternatives to the wages and profits of the opium economy will be hard to come by. Formal enterprise clearly offers some potential but has high investment costs per job created and is dogged by constraints in the business and policy environment (see 4.4 below).

Employment and Adding Value to Labour 4.1.2

4.9 *Employment is an important component of rural incomes.* Most rural households include both farm and non farm employment in their incomes, and non-farm employment is a key means of improving livelihoods. It increases incomes and reduces vulnerability by offering employment at little or no entry cost to landless households. There is also complementarity with farming, especially where households are farming to feed themselves, as non-farm income allows purchase of cash inputs. In general, there is a strong linkage between farm and non-farm growth. Typical non-farm employment may be in downstream processing and packing activities which add value to agricultural production, or in unrelated activities such as carpets (which can be based on wool from Afghan sheep), the garment industry, construction materials, the gem industry, bicycle and vehicle repairs, services such as restaurants and cleaning, and retail (Perisic n.d.: 7,8; Pain 2006: 5).

4.10 *The opium economy has provided first-class employment opportunities for Afghanistan's rural population.* Many thousands of workers are migrating internally in pursuit of wages that can reach as high as \$10 per day during the opium poppy harvest (plus lodging, meals, etc.). In addition, where poppy is grown it provides employment for both household members and other local people, enabling them to stay in their homes and communities rather than embarking on migration in search of work. Residing in a poppy growing area has typically been correlated with low levels of migration (Ghobadi and all 2005). By contrast, when levels of opium poppy cultivation have fallen significantly, out-migration has increased. This has been witnessed in parts of Nangarhar following the implementation of the opium ban in 2005 and 2006, as well as in Ghor in 2006 following crop failure (Mansfield 2005a and 2006b).

4.11 *Nonetheless, the opium economy is vulnerable to increases in wage labour opportunities in other economic activities.* Experience in other opium producing countries

www.procurementdirectory.af¹⁴ Source:

highlights the crop's vulnerability to rising wage labour costs.¹⁵ Similar experiences have been seen in the provinces of Nangarhar and Badakhshan in Afghanistan (see Box 2 in 2.4 above). When salaried employment and substantial wage labour opportunities are available in licit activities, households have been unwilling to allocate family members to work on cultivating such a labour intensive crop as opium poppy – particularly when opium prices are falling. Neither, if there are relatively high wage labour rates, does it make sense to hire in labourers for opium poppy cultivation to substitute for this now gainfully employed family labour (Mansfield 2006b and 2007b).

4.12 *The non-opium economy will, however, be hard pressed to create the needed alternative jobs.* Growth in employment has been high during the recovery period, but this is not sustainable (4.1.1) – and non-opium employment will drop in the short run if the opium economy declines, due to multiplier effects on aggregate demand.

4.13 *Where local employment opportunities are not available, internal or external migration is the typical recourse when rural households are forced to shift out of the opium economy.* Current internal migration is ad hoc, without any kind of organization or support. Urban areas in Afghanistan offer few opportunities or lodgings for unskilled migrants (Opel 2005). Migration outside of Afghanistan also takes place in an informal and precarious manner. Often it has its own costs in terms of human smuggling. Afghans are targets of deportations and exploitation in neighbouring countries.

4.14 *Afghanistan's labour force is largely unskilled and hence cannot attract high wages.* Decades of war have left the Afghan workforce polarized between a small elite of foreign-educated professionals who are eagerly competed for and a huge mass of labourers with scant marketable skills.

4.15 *The lesson is that offsetting the employment and wage attractions of the opium economy will require significant efforts to develop rural employment opportunities, to add value to labour and to assist in migration and reinsertion.* Key ways to improve the quality of labor supply include: demand-driven vocational training and education, and facilitating internal and external migration.

Sources of Growth 4.1.3

4.16 *Opportunities for rural non-farm growth exist in agro-processing, precious stones and carpets, as well as services.* International experience has been that development of non-farm rural industry is feasible, and can contribute significantly to growth (see Box 10). In addition to the agricultural growth opportunities discussed in Chapter 3 above, studies show potential for revival of traditional rural non-farm exports – carpets, minerals, leather garments etc. Already growth has been rapid, but for many products Afghanistan has still not regained the position that it held in the 1970s. There is also scope for increasing value in-country to improve earnings (OTF 2006). One example is in carpets, where most of the cutting and finishing of Afghan carpets is currently being done in Pakistan. Some 60% of Pakistan's carpet exports in fact originate in Afghanistan. It is estimated that an extra \$63 per sq m of value could be readily captured through greater efficiency and improved design and branding alone, and that

¹⁵ Kusvie (1960) provides an interesting account of the impact post-World War II industrialisation had on opium poppy cultivation in Yugoslavia. "In some villages this has led to a decrease in the skilled labour which is essential at the time of the cutting of the capsules and collection of the opium, so that over considerable areas the capsules remain un-incised and no opium was obtained, or the incisions were made by unskilled labour, which resulted in a decreased yield." In India in 1995, "The concentration of poppy growing caused higher costs mainly due to higher labour prices for harvesting... Many farmers expressed disinterest in continuing to grow poppies due to higher labour costs and low profit" (Nystom et al 1995). A similar phenomenon was experienced in southern Afghanistan in 1999 (see UNDCP n.d.). In China a drop in production in 1999 was attributed to "the shortage of manpower for lancing, which is a labour expensive and expensive process" (International Narcotics Control Board 2000: 80).

the value of Afghanistan's entire carpet industry would increase between two and five times if companies finished goods in country and sold directly to overseas markets, rather than exporting through intermediaries. There is also potential for larger-scale operations, with possible foreign direct investment (FDI) in mineral extraction and marble mining and working.

Box 10 : Asian Countries Have Helped Rural Industry to Become an Engine Of Growth

Many Asian countries have relied on rural industries to raise rural growth rates, including product processing and construction materials. China is an example of success in an initially unpromising economic and institutional environment (Byrd and Lin 1990).

Pre-conditions for success include access to land, markets, finance and electricity. Afghanistan would not be alone in finding these pre-conditions challenging. In Asia, typical promotion measures have included: access to finance; market development; support to the development of associations and industry bodies; skills development and entrepreneurship development; and improvements in policy and the enabling environment.

Sources: Pain 2006: 5; Perisic n.d. 4,6, 13-14

4.17 *In view of Afghanistan's dramatically unbalanced trade position, import substitution presents very large opportunities.* In 1982 the country's trade was relatively balanced, with imports and exports of about \$700 million. Principal exports were natural gas, dried fruits, carpets and rugs, and karakul sheepskins (Illinois Institute of Technology, n.d.). By 2006 (1385) officially recorded exports were down to one-quarter of 1982 nominal levels (\$168 million), and imports had surged to \$3.2 billion. This enormous trade deficit reflects the unprecedented levels of international assistance that Afghanistan has been receiving in recent years, as well as large unofficial re-exports of goods that in many cases were officially imported. But nevertheless, the imbalance in agricultural products is remarkable, given that this was and is the sector in which Afghanistan has significant comparative advantage, as demonstrated by past export performance. Key agricultural products that are promising candidates for import substitution include edible oil, sugar, dairy produce, cotton and textiles, and wool.

4.18 *However, over the medium term development of exports of agriculture-based processed goods will be essential.* Over time, Afghanistan will need robust export growth in order to reduce the country's dependence on aid, and as the opium economy and associated financial inflows are phased out. Agro-processing should be a relatively attractive prospect for export development from a medium-term perspective, given Afghanistan's comparative advantage in certain horticultural and livestock products.

4.2 CURRENT DEVELOPMENT INTERVENTIONS IN THE SECTOR

4.19 A number of development interventions have been undertaken to promote private enterprise in Afghanistan. The most important are discussed in this section under the four categories of business development services and investment promotion (4.2.1), enterprise finance (4.2.2), industrial parks (4.2.3) and vocational training (4.2.4).

Business Development Services and Investment Promotion 4.2.1

4.20 *Business development services have been established to offer intensive (free or heavily subsidized) support to small businesses.* The leaders in the field have been the USAID-funded Rural Agricultural Market Program (RAMP) (2004-2006) and its successor project Accelerated Sustainable Agricultural Program (ASAP). These projects have acted as umbrellas for a range of facilitating partners to implement project activities. Some notable successes have been achieved in bringing Afghan produce to market and in creating awareness of what needs to be

done to increase competitiveness (see the agricultural examples in 3.2 above). Support includes market chain studies, trial shipments, assistance with storage facilities, business fairs, etc. More recently, the USAID-funded Afghanistan Small and Medium Enterprise Development (ASMED) programme has been established to build capacity for businesses to associate and provide mutual services to members, to carry out market studies and to collect regular market information for the agriculture sector. Both IFC directly and the IFC and World Bank-supported PEP/MENA programme also provide support to business development, including project identification and entrepreneur capacity building.

4.21 *These programmes tend to be focused on the more developed areas and on towns, and there are problems of coordination and overlaps.* Coverage under enterprise development programmes has tended to be where market linkages are already good. The RAMP project concentrated on the most agriculturally developed areas. New projects are even more focused on such areas. The Japanese/ADB \$18m Rural Business Support Programme will cover just four provinces where similar projects already exist – Balkh, Bamiyan, Kabul and Nangarhar. The ASMED project is concentrated in Kabul, Nangarhar and Herat with partner offices in Helmand, Kandahar and Badakshan.

4.22 *There have also been problems of sustainability linked to the dominance of foreign advisers.* Enterprise development can be made more sustainable if greater attention is given to creating locally-run business development services and investing more in support services. Too much reliance at present is on engaging international business development services and not enough on building local capacity.

4.23 *Attempts have also been made to attract foreign direct investment.* USAID has tried to attract international investors through a combination of financial support and an appeal to demonstrate “corporate citizenship”. Dole was invited to set up orchards and a juicing plant for the domestic market, and Land o’ Lakes to run a dairy plant at Mazar. Problems of land ownership, the high cost of doing business, and corruption make foreign direct investment an uncertain prospect. Experiments continue, however: Nestlé and the Dutch firm GSE are currently investing under partnership agreements.

Enterprise Finance 4.2.2

4.24 *Access to finance is a key driver of development – and of the opium economy.* The key role of finance in facilitating all aspects of rural development and agricultural production is well documented. In Afghanistan, after 30 years of disruption, there is very strong demand for financial services but scant institutional basis for providing the services. Interest in developing financial services has been sharpened by the fact that credit provision and advance payments are one of the strengths of the opium system. A backlog of opium debt has built up in some areas, exacerbated by drought and eradication (or coercion not to plant), which has locked the poor into the opium economy. In the absence of alternative financing mechanisms, the only solutions households can employ are returning to opium poppy cultivation, flight, distress sales or the handing over of a female child to creditors. Alternative sources of finance have been developed under a number of innovative programmes that have been started since 2001, mostly targeted at enterprise development but some at offering alternatives to opium-based credit (Mansfield 2007a: 22; Zia and all 2005: 8-9). The largest initiative is the Micro-Finance Support Facility for Afghanistan (MISFA), an apex organization set up for the micro-finance movement in 2002.

4.25 *MISFA has achieved phenomenal outreach – but still only meets 8% of projected credit needs.* By mid-2007 there were 15 micro-finance institutions (MFIs) with 224 branches in 23 provinces and 385,000 clients. The MFIs are currently disbursing \$7 million each month and adding more than 10,000 clients per month, with a target of 600,000 clients by the end of 2007.

As in other countries, micro-credit has been very successful in financial terms, with a repayment rate of 96%. The MFIs are able to cover 83% of their operational budget: three have reached operational self-sufficiency, and most are expected to do so by the end of 2007 (Zia and all 2005: 6 ff; World Bank 2007a: 17). MISFA was the subject of an independent review in mid-2006, and was rated “best practice”, with “phenomenal breadth of outreach” and good penetration of the poorest. However, unmet demand is still enormous: in mid-2006 only 5% of the bankable poor were serviced by MFIs, and only 8% of projected credit needs were being met (Islamic Republic of Afghanistan 2006: 10).

4.26 *Outreach to rural areas and lending to agriculture are more limited.* Most MFI activity is in urban and peri-urban areas. About 17% of lending is for handicrafts in both urban and rural areas. Some 16% of lending goes for agriculture. Innovative rural financing mechanisms include: (1) land mortgage, (2) contract growing (see 3.3.6 above), and (3) equipment leasing (Perisic n.d.: 20-1; Zia and all 2005: 7).

4.27 *Mechanisms were designed and tested to address the problem of accumulated opium debt.* In 2005 MISFA tried out an opium debt refinancing facility, with DFID providing \$10 million in financing. Overall, it was found that providing credit for opium refinancing or alternative livelihoods did not work unless other full-service programs were present to provide technical and institutional support.

4.28 *MISFA is trying to spread its rural programs nationwide.* MFIs are deepening the market by linking to existing community institutions and to trader networks, and by continuing to adapt products to the needs of agriculture and off-farm enterprise. This general expansion will certainly have an impact on the opium economy, although it is being constrained in some areas by insecurity (see 4.4.3 below).

4.29 *Credit for medium-sized rural enterprises has been lacking, but there are new initiatives in term financing for SMEs.* MISFA has an SME window (current funding \$9 million) which is disbursed through four local banks. The programme includes training for participating bank staff. IFC also has a line of credit of \$3.5 million to the First Microfinance Bank (a joint venture of IFC, GTZ and AKDN/ARMP) for SME lending (\$5-30,000). BRAC has joined with the Netherlands, UK and IFC to set up BRAC Afghanistan Bank: current activities are limited, with about 2,000 loans made, of an average size of \$8-10,000. The situation may also be improved by another USAID project, Afghanistan Rural Investment and Enterprise Strengthening (ARIES), which is scheduled to be rolled out in all 34 provinces. ARIES is aimed at strengthening funding for rural enterprises through existing local banks and MFIs, and through creation of credit unions. USAID has also promoted equipment leasing through the Afghan Financing Company. Lease facilities granted to date total \$3.5 million, largely for agriculture.

Industrial Parks 4.2.3

4.30 *Industrial parks are being established in major towns to provide a secure, fully serviced environment for businesses.* Under various projects, a number of industrial parks are being set up in the major towns. They provide full services in order to attract investors. A particular plus is that electricity is guaranteed through own generation. The World Bank is supporting the development of the Hassan-e Shahi Industrial Park at Jalalabad, a \$25 million investment in a Free Economic Zone and with good transport access to Pakistan. The Park will provide 300 serviced plots, including assured electricity supply from six 1.2 MW generators. It is expected that the Park will generate considerable employment, particularly in carpets, leather goods, garment manufacture, and food processing. Industrial parks may help draw surplus labour from the countryside, including from poppy areas, to urban areas. The Jalalabad park, for example,

will draw labour from the districts adjacent in which poppy has been grown. USAID (through its ALP-South) is developing a business park in Helmand.

Vocational Training 4.2.4

4.31 *Despite its importance for employment, little attention has been paid to vocational training so far.* Vocational training is an important element in enterprise development, helping to retrain persons for non-farm roles, either to use in the locality or providing a skill for them to use elsewhere (migration strategy). Vocational skills training is considered to be a National Priority Programme. Donors (predominantly the Government of Japan) have assisted in establishing 19 vocational training centres around the country. However, few courses have been offered, demand has not been matched with supply, and standards have been poor. It appears that there is a tussle between ministries over responsibility. Nevertheless, the market is vast: a UNDP report on markets for SMEs saw potential for development of commercial vocational education and training, especially in the construction industry (Altai Consulting 2005: 153).

4.3 POSSIBLE FURTHER INTERVENTIONS TO COUNTERBALANCE THE ADVANTAGES OF THE OPIUM ECONOMY

4.32 As in Chapter 3 (3.3), this section will discuss possible further interventions that might contribute to helping counterbalance the advantages of the opium economy. The interventions are discussed under three headings drawn from the development responses to the opium economy listed in Chapter 2 (Table 1): promoting enterprise (4.3.1); developing non-farm income opportunities (4.3.2); and financing (4.3.3).

Promoting Enterprise 4.3.1

ENTERPRISE DEVELOPMENT

4.33 *Government is proposing a massive and innovative rural enterprise development programme, AREDP.* Current enterprise development programmes are fragmented, not well linked to government strategy, and overly focused on urban areas. The Ministry of Rural Reconstruction and Development (MRRD), recognizing the importance of boosting business in the rural areas, is proposing a new national Afghanistan Rural Enterprise Development Programme (AREDP). The programme is still at a nascent design stage, so the specifics given in this report are only indicative. As presently conceived, the programme is designed to fill two major gaps in the rural economy that are constraining the growth of rural enterprises – absence of finance, and absence of skills, market knowledge and market structures. To ensure consistency of policy and programmes in the sector, AREDP would work under a policy coordinating body – the Enterprise Development Council consisting of major concerned ministries.

4.34 *AREDP would provide full services to both micro and small and medium enterprises.* Focusing on both import substitution and export development, AREDP would work at two levels: micro enterprises with less than 10 employees, and small and medium sized enterprises (SMEs) with 11-250 employees. AREDP would provide services adapted to the scale of the enterprise, facilitating access to finance, providing “end-to-end” business development service support, putting in quality control, providing policy support as needed, and promoting partnerships between micro enterprises and small and medium scale entrepreneurs. Management of these services would be contracted out. The institutional model would create links to other national programmes and work through the DDAs and CDCs (see Chapter 6), linking local mobilization of communities with business development. A key element would be the formation of groups and associations at the grass-roots level in rural areas, promoted and

facilitated by CDCs. One proposal for example is to contract with communities to supply raw materials for agro-processing.

4.35 *The programme is intended to be longer-term, nationwide and massive.* AREDP is intended to be a 10-year programme, highlighting the need for long-term commitment. The net financing requirement over this period is estimated at \$550 million. Currently indicated programme targets with this level of financing are very ambitious: 900,000 micro enterprises created, 12,000 SMEs, 2.1 million permanent jobs, and \$2 billion in annual product (MRRD 2007a).

4.36 *The proposal is to work with proven “champion products” where Afghanistan can be competitive, at least in the longer term, but also to respond to emerging demand.* The idea is to select a few proven “champion” product lines from possible import substituting products and from exportable products where there is scope for adding further value (see list of prospective champion products below). For each champion product, AREDP would carry out an economic feasibility study to check that there is potential for long-term competitiveness. Where imports currently undermine profitability and discourage investment, the study will analyse the measures needed in the short and medium term to get investment off the ground. The champion product approach is designed to induce investment into sectors with proven potential. But there will also be flexibility to respond to demand for other products or services – this would apply especially to farming and to enterprises supplying larger SMEs.

Table 6: Prospective Champion Products

Import Substitution	Adding Value to Exports
<ul style="list-style-type: none"> ▪ Vegetable oil ▪ Poultry ▪ Dairy products ▪ Wool and yarn ▪ Processed foods ▪ Soap and detergents ▪ Matches ▪ Iodized salt ▪ Bottled water ▪ Fish products ▪ Wood products ▪ Footwear ▪ Macaronis ▪ Potato chips ▪ Disposable utensils 	<ul style="list-style-type: none"> ▪ Medicinal herbs ▪ Saffron ▪ Silk ▪ Leather ▪ Karakul skins ▪ Dried fruits ▪ Fresh fruits ▪ Carpets

Source: MRRD 2007b

4.37 *Numerous issues surround the early draft of the proposal.* Among the issues at this early stage are the following: (i) coordination between the nine ministries reportedly involved; (ii) linkages to ongoing programmes, some of which by-pass the government process; and (iii) aligning with (and not undercutting) the financial terms of existing financial service providers.

- ***Next steps in the development of the AREDP proposal will be very important. All partners should work together, MAIL should share the driving seat, and government should make a special effort to bring in USAID and MISFA as principal partners. Particular emphasis should be given to building local capacity in business development.***

LOCAL PROCUREMENT

4.38 *The “Afghan content” of most international spending in the country is very limited.* A 2005 global study found that only 4-9% of benefits of peace-keeping budgets stay in-country.

Peace Dividend Trust (PDT), an NGO financed by CIDA, DFID and USAID (see Box 11), is working very actively on increasing the level of local procurement by all international groups in Afghanistan: *Buy Afghan* or *Afghan First*. The Afghanistan Compact contains a commitment to buy Afghan goods, but there has been little implementation and no monitoring of compliance. Currently the British military, for example, do not buy any food locally, on security and food safety grounds. Even drinking water has been imported, despite the existence of 36 local water bottling companies operating in Afghanistan. Extremely stringent regulations regarding food safety and security make it very difficult for Afghans to become vendors of agricultural produce to the international community, especially the military. Construction is another major sector where Afghans can find employment and where billions of dollars currently are being spent, yet the Afghan content of many contracts is extremely limited.

Box 10: Peace Dividend Trust Facilitates Business Development

An international NGO, the Peace Dividend Trust (PDT) was commissioned to carry out a study of the benefits of peace-keeping budgets. Subsequently, since 2006 CIDA, DFID and others have funded PDT to try to develop local procurement. With an initial target of facilitating \$5 million of business, in fact \$43 million has been achieved.

With a small staff (currently five expatriates and 12 national staff), PDT is managing five activities designed to increase local procurement:

- **Matchmaking:** PDT does market research for buyers, for example finding a supplier of water for the US military in-country. Currently, PDT is trying to match US army fresh vegetables requirements with a USAID-funded packaging plant at Jalalabad that is HAACP certified.
- **Website and directory:** PDT maintains www.procurementdirectory.af which has a roster of 3,000 businesses across 20 sectors. Most businesses have been visited. Employees and turnover are documented, with information updated every three months. The website is being expanded to become a “business to business platform”.
- **Advocacy:** With the slogans *Buy Afghan* and *Afghan First*, PDT works with ISAF and other agencies to promote local procurement. The most notable example is drinking water. The US army had been spending \$58 million a year to airfreight water in from Dubai. Now the US military has an Afghan First policy and is buying water from Cristal.
- **Tender distribution:** PDT collects tenders from ministries, gazettes etc., and advises local firms through a monthly publication, mass e-mailing and a library of tender documents.
- **Capacity building:** PDT does training in the new procurement law and regulations. So far they have trained 200 companies. As a result, nine businesses have won contracts worth \$4.8 million.

Source: PDT.

4.39 *A quick action that could have high impact on enterprise development would be a massive increase in local procurement by the international community in Afghanistan. Change is possible: the US army was spending \$58 million a year on imported bottled water alone. Recently, after advocacy and “matchmaking” by NGOs, the US military has developed an Afghan First policy under which it is buying locally bottled water and is also looking to buy peppers, tomatoes, cucumbers, and potatoes locally, including from a HAACP-qualified packing plant in Nangarhar. USAID is also promoting a “Mazar Farm” project, a large farm to be set up with the specific aim of supplying the international military forces in the country. It appears that this will be a foreign enclave operation, so that although employment will be created, there will be little other local value added and little local development dynamic.*

4.40 *Despite policy decisions and the evident benefits, there has been little progress. The UK – and ISAF forces generally – do have a local procurement policy, but there has been little implementation. This is an area for creative and energetic work: local purchase of food and a requirement to include local labour in construction contracts could inject up to \$1 billion every*

year into the Afghan economy. This could benefit exactly the rural populations who will suffer from the phasing out of opium, in particular those who might be involved in cultivation of, or labour supply to, opium. Increasing employment in construction would provide a very direct and rapid alternative to engagement in opium, particularly for the poorest. The dividend in terms of trust and “hearts and minds” would also be considerable.

- *All governments supporting the Afghanistan Compact should make firm commitments to sharply increase the value of local consumables procurement in 2008, with the objective of reaching, say, 50% by 2009; they should instruct relevant agencies to prepare feasibility studies and make institutional preparations (e.g. for recruitment of local purchasing and inspection staff) to meet this target. Construction contracts should specify maximum local materials and labour content, and give preference to Afghan contractors. Support to PDT should continue.*

Developing Non-farm Income Opportunities 4.3.2

SKILLS DEVELOPMENT

4.41 *To fill the critical local skills gaps, and to prepare Afghans for higher-tech employment at home and abroad, skills development is essential.* However, international experience demonstrates that unless vocational education and training programmes are tied to growing sectors and economic activities, demand-driven, and efficiently managed, they are likely to fail; these lessons must be factored into the design of vocational education and training (VET) programmes in Afghanistan. *A demand-driven VET programme needs to be drawn up and financed.*

FACILITATING MIGRATION

4.42 *Diplomatic and commercial initiatives to facilitate labor migration and employment of Afghans in neighboring countries could make overseas work opportunities a more serious tool for reducing dependency on opium.* Government could encourage overseas working through the development of bilateral protocols and commercial contracting arrangements: for example, the promotion of licit contract labour companies to recruit and train labour to replace Pakistani, Indian and Iranian labour. Similar efforts were undertaken in poppy growing areas in Pakistan in the 1980s and 1990s. *A study should be carried out to identify entry points to higher-value and less restricted migration, and to develop a roadmap for policies in this area.*

(LONGER TERM) URBAN DEVELOPMENT

4.43 *Investment in developing small and large urban centres would absorb labour and support out-migration from poor rural areas, including those prone to opium.* With only 25% of the population currently living in towns and growing land pressure in rural areas, urbanization will continue, and expansion of local industry to help absorb surplus labour will be critical. However, the I-ANDS plans only for urban services and land titling. Robust urban development could absorb labour and encourage people to migrate from the more overcrowded and remote poppy areas. Urban centres could act as “growth poles” that influence the economy and governance conditions in their hinterland, and help counterbalance opium in progressively increasing areas around them. *Although clearly a longer-term strategy, development of small and larger urban centres will be very important and will need to be supported by sound, private sector-based policies as well as necessary planning.*

Enterprise Finance 4.3.3

4.44 *Rural financial markets are developing faster than anticipated, and there is considerable further potential.* In the next phase of MFI development, more innovative solutions for financing rural businesses could be explored: further development of leasing, which is proving particularly appropriate for agriculture and agribusiness; targeting weak links in the product chain; matching grants for business development; lines of credit; and help to “kick start” new businesses and markets.

- ***MISFA and its family of MFIs need to work to complete the process of maturation of MFIs, with full support from government and donors, and – in coordination with AREDP – to push out into the newer lines of finance for rural areas and of small and medium scale enterprises.***

4.4 CONSTRAINTS AND POLICY AND INSTITUTIONAL RESPONSES

4.45 This section looks at the major constraints faced by business in Afghanistan and at some of the priority policy improvements and institutional reforms that could facilitate enterprise development. The constraints discussed are: the current lack of alignment of support programmes (4.4.1), the weak business environment and lack of competitiveness (4.4.2), and poor governance and insecurity (4.4.3).

Need for Alignment of Support Programmes 4.4.1

4.46 *There is a multiplicity and diversity of approaches that can lead to overlap and duplication, and sometimes programmes undermining each other.* The donor-driven nature of enterprise development programmes, weak leadership by government and poor coordination by donors, and the multiplicity of facilitating partners, each with its own different objectives, have resulted in a diversity of approaches. For example, in a country where private businesses of any scale number only a few hundred, there are no less than three chambers of commerce at the national level (Afghan Chamber of Commerce, International Afghan Chamber of Commerce, and American-Afghanistan Chamber of Commerce). A multiplicity of business development programmes are now being set up. Better coordination and information sharing – or, better still, joint programming – are required to ensure that services are spread evenly and do not undermine each other. Over-concentration of services in some areas should be avoided.

4.47 *Similarly, partial grant assistance can help establish businesses, but the terms should not be widely different across programmes.* Enterprise development involves reducing risk by improving knowledge (especially of markets) and through off-setting some of the investment costs through grants or subsidies. Use of matching grants to off-set business costs has been tried in a number of countries, and business development services have been successful in many places – for example export development services in Ecuador and India. The model has been successfully applied world-wide. However, a consistent and transparent approach to this endeavour will help avoid duplication and assist in fostering a more competitive environment. For example, MISFA expresses fears that AREDP may undermine credit services and repayment discipline with low interest or free services that up until now borrowers have been willing to pay for. These concerns are currently being discussed between AREDP/MRRD and MISFA.

- ***There is a need to have common and standard policies regarding the degree of financial support that may be offered in programs. A mechanism, led by government, needs to be established to ensure a fair and consistent approach (here AREDP could play a significant role). Incentives and subsidies implicit in current business development services need to be streamlined and transparent, and the services should be built up to be locally run. Pooled funding to administer matching grants for targeted investments should be considered.***

Strengthening the Business Environment and Competitiveness 4.4.2

4.48 *There are a number of structural and institutional problems which limit Afghanistan's competitiveness.* These include: (i) an over-valued foreign exchange rate; (ii) high labour costs; (iii) a weak enabling environment including widespread corruption; (iv) poor infrastructure; and (v) weak institutions. Related to all of these aspects, strong competition from imports, often further exacerbated by subsidies or other factors driving down production costs in neighbouring countries (e.g. nationwide subsidies on energy in Iran), is widely seen as an important factor hindering the start-up of domestic industries, giving rise to arguments for infant industry protection.

- i. *Appreciation of the Afghani is harming competitiveness.* This appreciation is probably largely a result of the high level of drug and aid related inflows. This could impede growth and diversification of exports and also hinder import substitution. More active exchange rate management, i.e. the classic macroeconomic solution of exchange rate depreciation, would help reduce over-valuation of the exchange rate. However, this option could be pursued only to a certain extent, and not to the point where it significantly increases inflation, as that would be counter-productive. The key to increasing exports will be diversification and improving productivity, including lowering the costs of doing business, and the same improvements would also enhance prospects for import substitution (IMF 2006a: 7-8).
- ii. *Wages in Afghanistan are significantly higher than in neighbouring countries.* One problem is the high levels of drug- and aid related transfers referred to above, which stimulate demand in the labor market and, in the case of the opium economy, push up rural wage rates directly. Daily agricultural wages in Afghanistan average \$1.90, compared with \$1.70 in Pakistan, \$1.10 in India, and \$1.25 in Iran. Afghan wages also, at least seasonally, reflect competition for labour from poppy. At harvest time, wage labour rates in opium areas can rise to as much as \$10 per day with food, accommodation, cigarettes etc. also provided (Pain 2006: 4; IMF 2006a: 12).
- iii. *The enabling environment for business in general and for exports as well as import substitution imposes considerable constraints.* The first Investment Climate Assessment (ICA) for Afghanistan identified access to land, electricity, financial capital and the problem of corruption as the main constraints businesses perceived hindering their activities. **Access to land** is slow, costly and insecure. Businesses are plagued by **lack of access to electricity** and the poor quality of supply when it is intermittently available from the grid. **Access to finance** is very limited despite the establishment of a number of banks in the country. And **corruption** is generally perceived to be widespread, with Afghanistan now ranking 172 out of 180 countries surveyed in Transparency International's corruption perceptions index. The **business environment** is generally poor: high cost and slow business start up, difficult credit access, untrustworthy judiciary and slow contract enforcement. With regard to exports in particular, there is a lack of **trade facilities** and slow, heavy and corrupt **export procedures**. **Transaction costs for exports and in general** are very high: efforts to improve customs procedures have lowered transaction costs somewhat,

but also made importation easier. Exports are hampered by other countries' procedures, in particular transit procedures in Pakistan (IMF 2006a:13-19).

- iv. *Productivity is impaired by poor infrastructure and services and by inadequate human resources.* Despite substantial investments, the road network remains inadequate (see Chapter 5), municipal services are poor, and electricity costs are very high, in addition to the problems of access to and quality of supply mentioned above. Lack of reliable electricity leads most businesses to rely on generators for power, which costs five times as much as the grid and requires additional investment. Human resources are generally poorly trained, with a largely illiterate population, and there is a serious shortage of skilled labour, especially managerial and technical skills, mainly reflecting lack of investment in human capital during the conflict (IMF 2006a: 17-19).
- v. *The institutional base is weak.* There is a lack of modern business institutions like effective business associations, efficient business support services, farmers associations, commercially oriented cooperatives, etc. Government institutions to support private sector development, as in the case of other sectors, suffer from major weaknesses in capacity, leadership and management.

4.49 *Strong import competition hinders start-up of domestic industries.* New enterprises typically have high failure rates, and risks are increased given the weaknesses outlined above: the business sector is weak and competition from imports is strong. Even well-established foreign firms may founder in Afghanistan's difficult environment. Land o' Lakes, for example, has withdrawn from the Mazar-i-Sharif dairy plant after failing to make money. Combined with cost advantages enjoyed by some neighboring countries and Afghanistan's relatively liberal trade and tariff regime, competition from imports may make it very difficult for even potentially viable businesses to get started. Thus measures need to be considered to encourage start-up of import-competing domestic economic activities on a sustainable basis.

4.50 *In the face of these constraints, Afghanistan has only a few compensating advantages to offer,* essentially those that have made the illicit economy so vibrant: a generally market-oriented overall policy environment, few legal constraints on labour markets, and a generally untrammelled informal sector. Although the agenda is long, any measures to rectify these constraints could have a considerable impact in enterprise development. The following paragraphs explore several areas where actions could be considered, including in the shorter term (Pain 2006: 3; IMF 2006a:15).

IMPROVING THE BUSINESS CLIMATE ON AN ENCLAVE BASIS (INDUSTRIAL PARKS)

4.51 *Industrial Parks can provide services and also act as a channel for development support.* While effectively addressing the problems with Afghanistan's business climate on a widespread – let alone nationwide – basis will take a long time likely measured in decades, it should be possible to provide the necessary improvements (in particular dealing with access to land, electricity, and to some extent finance as well as limiting corruption) on an enclave basis – especially through efficient, well-managed Industrial Parks. The main attraction of Industrial Parks is the provision of good services – land, electricity, bonded warehousing, and essential services. Industrial Parks also could be a suitable platform for innovative and effective measures to offset some of the more specific disadvantages suffered by Afghan businesses, for example matching grants for start-up investments, possible pricing of electricity at international rates on a transparent basis, access to finance through credit collateralized on the basis of land and facilities on Industrial Parks, business support services, etc.

- ***Following a review of experience thus far in Afghanistan, measures should be instituted to provide efficient, commercially-oriented management of Industrial Parks and to scale them up in response to business demand.***

SETTING AND SUPPORTING EXPORT STANDARDS

4.52 *Setting and supporting standards is critical for developing exports.* In order to be traded internationally, goods (especially agricultural and agro-processed goods) must meet international standards and have the requisite phyto-sanitary certificates. For these to be recognized, the necessary government inspection systems must be in place and up to standard. The government has set up an Afghanistan National Standards Authority as a semi-autonomous body under the Ministry of Commerce. Its mandate includes introducing and applying international export standards to assist Afghanistan's penetration of international markets. Strengthening this body should be a priority. In addition, private sector companies will need to increasingly improve their standards and look to certified production systems (such as HAACP) in order to be able to sell on foreign markets.

- ***Support should be provided to the Afghanistan National Standards Authority and to the development of private sector self-regulatory bodies.***

STRENGTHENING THE CUSTOMS SERVICE

4.53 *Improving the Customs Service is critical.* The Customs Service is a key actor in administering border protection, facilitating trade and raising government revenues. There are several programmes that support Customs. The World Bank-financed Emergency Customs Modernization and Trade Facilitation Project (\$31 million) aims to reduce transport related trade costs, reduce corruption and streamline border procedures through investments in infrastructure at key borders and through institutional development and capacity building. ADB and DFID also have been providing support. A Memorandum on the Foreign Trade Regime has been prepared, and transit and trade agreements are under preparation. However, much more remains to be done. Risks of corruption can only be overcome by strong systems and processes, capacity development, effective management, and adequate conditions of service and pay. Kosovo is a good example of where a landlocked country managed to develop an excellent Customs Service by providing good conditions of service, training and incentives. By paying better salaries than other government services and through comprehensive training, the Kosovo service attracted the best people to senior positions and managed to retain them (IMF 2006b: 92; World Bank 2007a: 10).

- ***Government and partners should work together to further strengthen the Customs Service.***

REVIEWING TRADE POLICY WITH AN IMPORT SUBSTITUTION (AS WELL AS COUNTER-NARCOTICS)

LENS

4.54 *The combination of an overvalued exchange rate, high domestic costs, relatively low import tariffs, porous borders, and other cost advantages of producers in neighboring countries exacerbate the difficulties in starting up new businesses and have generated pressures to increase protection.* Imports into Afghanistan are cheap and may overwhelm any incentives to establish import-competing businesses, even in activities for which Afghanistan should have a comparative advantage. In particular, agro-processing businesses, which would enhance value added in agriculture and expand downstream activities, may be vulnerable to import

competition and therefore difficult to get started on a viable and sustainable basis.¹⁶ In some cases, anomalies in the tariff structure (e.g. higher tariffs on inputs than on outputs) may exacerbate lack of competitiveness. These problems have led to pressures to increase protection. The government has already raised tariffs on dairy produce (from 5% to 16%) and on soft-drinks and bottled water (over time from 5% to 40%). This latter change has encouraged investment and production by Coca Cola, but it is not clear whether the import protection was necessary, as the domestic price of Coke has not risen, implying that for one reason or another the import protection has not been effective. More recently, Nestlé is considering investing after the government agreed to raise tariffs on competing imports and to reduce tariffs on critical ingredients and packaging. MRRD, in its presentation of AREDP, calls for extension of protection to other agro products – eggs, frozen and live chicken, sugar and vegetable oil.

4.55 *However, the measures taken so far have been ad hoc, often in response to lobbying, unclear in their actual impact, and quite possibly poorly targeted.* It seems likely that measures taken to date have been excessive and ineffective. They may have encouraged over-investment in activities where Afghanistan does not have a comparative advantage or would not generate a great deal of additional employment. In any case, given Afghanistan's porous borders, high tariffs beyond a certain point would merely encourage smuggling. Thus trade-offs have to be made where protection issues are concerned, and more careful analysis should precede any decisions on tariffs than has been the case with recent changes. The possible benefits of infant industry protection need to be balanced against other desirable objectives of a tariff system; for example a relatively more uniform and less distorted tariff structure can facilitate customs revenue collection and minimize corruption. And the specific context of Afghanistan – notably its porous borders and widespread smuggling – needs to be factored into trade policy decisions.

4.56 *Alternative support measures may be used.* One alternative to encourage export industries could be to levy an export tax on unprocessed low quality exports to encourage their being locally processed. In addition, start-up assistance, matching investment grants, special pricing of electricity (at international levels), marketing support, etc. could be employed, as they were successfully in Thailand (see Box 7 in 3.3.2 above). Other possibilities, including some mentioned earlier, could include value-chain contracting, support to enterprise development, etc.

4.57 *A study of trade policy is needed, which takes into account the considerations discussed above and the need to develop import substituting activities as well as exports in areas of Afghanistan's (actual or potential) comparative advantage.* In the context of Afghanistan's accession to membership in the World Trade Organization (WTO), which has been initiated but will take quite some time to reach fruition, a Diagnostic Trade and Investment Study (DTIS) is under active consideration and may be conducted in coming months. This would be an appropriate vehicle for a careful analysis of the issues and trade-offs involved in choices about the tariff structure and how to enhance international competitiveness in Afghanistan's difficult environment.

- *A careful review of trade policy, perhaps through a DTIS and including an import substitution and counter-narcotics lens, should be conducted, and appropriate policy recommendations for the government and international partners developed on the basis of this analysis.*

Poor Governance and Insecurity 4.4.3

¹⁶ There are reports of raw agricultural products (often of low quality) being exported from Afghanistan, processed in a neighbouring country, and then imported back into Afghanistan in processed form (e.g. raw cherries and fruit jam).

4.58 *Poor governance and insecurity are major handicaps to enterprise development.* Poor governance imposes very high costs, adding a quarter to firms' expenses. Afghanistan currently ranks 172nd out of 180 countries in Transparency International's corruption perceptions index (compared to 117th among 159 countries surveyed in 2005). Bribes reportedly average 8% of turnover, compared to 2% in Pakistan. Insecurity brings its own costs too: Afghan firms spend on average 15% of turnover on security, compared to 2% in Pakistan. As a result investors, particularly foreign investors, are risk averse and tend to avoid more insecure areas – or the country as a whole. The same constraints apply to public programmes supporting enterprise development. Insecurity seriously limits outreach, and working in insecure areas requires more to be spent on security by contractors and less on development. Programmes in insecure areas are also difficult to monitor and account for. The development of financial services, for example, requires a certain degree of security, and the expansion of MISFA programmes is being hindered by insecurity (IMF 2006a: 6-17).

4.59 *There is, however, a reciprocal relationship between enterprise and security.* Whilst a measure of security – and more generally of governance – is essential for the growth of businesses, the development of enterprises and wealth creation at the local level can also help promote security and governance. Licit businesses have a vested interest in the rule of law, good communications and markets, all of which help them to function more effectively. Chambers of Commerce or other business associations can be formidable lobbyists for improvement.

- *Further support should be provided to the development of representative business and civil society organizations that have a stake in anti-corruption measures and in improved security.*
- *For public programmes providing business development or financial services, there is a need to work through decentralized planning and programming mechanisms and to optimize community engagement (especially through CDCs). Implementing partners should use locally recruited staff, and work with a community security guarantee.*

4.5 EXPECTED GROWTH, POVERTY REDUCTION AND OPIUM ECONOMY IMPACTS

4.60 The job and wealth creation impact of enterprise development is considerable, and support to enterprise development could represent a good opportunity for poverty reduction and counter narcotics. However, there is a long agenda before Afghanistan can build a modern, enterprise-driven economy, and the impacts on the opium economy will be consequently no more than gradual. Some entry points in the short run, such as Industrial Parks, matching grants or other start-up support, and value chain development should be explored.

Poverty and Employment Impacts 4.5.1

4.61 *Enterprise development has direct poverty reduction impacts through job creation.* Although the measurement systems are far from perfect, existing enterprise development programmes do have significant employment impacts. ARIES, for example, claims to have created up to 70,000 jobs in just nine months. MISFA estimate that their programme has created on average 1.3 jobs per loan or about 800,000 in total.¹⁷ The AREDP proposal (perhaps overly ambitiously) targets creation of an extra 2.1 million permanent jobs over a ten-year period. No data are available on the likely impact of vocational training or migration support

¹⁷ Afghanistan: World Bank Support for Microfinance, <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/0,,contentMDK:21166200~pagePK:146736~piPK:146830~theSitePK:223547,00.html>

programmes, but these also could be significant if programmes are well designed and properly implemented.

Counter-Narcotics Impacts 4.5.2

4.62 *It is likely that greater counter-narcotics impacts would be obtained by an aggressive programme of rural enterprise development, especially if there is a focus on agriculture and agro-processing.* Counter narcotics impacts of enterprise development are naturally diffuse and hard to measure. The model of “counterbalancing the advantages of opium” developed in Chapter 2 suggests that impacts would be achieved through investment in promoting enterprise, in developing non-farm income opportunities (through skills development, support to migration, and urban development), and in improving outreach of financial services. It is likely that the most direct impacts would be obtained by focusing on rural enterprises, as that is where the opium farmers and labourers currently are. It is also in rural areas that lower costs per job or enterprise created would also be found. If even part of the objectives proposed by AREDP are attained – 900,000 rural micro enterprises, 12,000 rural SMEs, 2.1 million jobs and \$2 billion in annual turnover – this would cause a very substantial shift in incentives toward the licit economy, especially if the effects were spread throughout rural areas, including poorer and more remote areas.

4.63 *Investments in formal enterprise and in urban development are both more expensive and longer term, and less directly linked to the opium economy.* However, to the extent that urban and formal enterprise development contributes to stable governance conditions and helps create a market for agricultural raw materials, it can be expected to shift incentives toward licit production. Jobs created will also provide opportunities for the vulnerable over the longer term.

- *The policy implication is that, for maximum impact on the opium economy, investment in enterprise development and related services, policies and institutions should be focused principally on rural areas. Support to rural business development should be accompanied by dialogue, policy reform and institutional development to increase competitiveness and develop enterprise across all sectors. One high-impact immediate action should be to step up local procurement sharply in 2008, with the objective of reaching, say, 50% by 2009, which could inject hundreds of million of dollars annually into the local economy.*