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# AFGHANISTAN'S PRIVATE SECTOR

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## Abstract

Afghanistan's economy has a complex mix of informal, formal, illicit and aid sustained elements. This is foremost the product of a decades-long convergence of protracted conflict, low state capacity, foreign interference and external aid dependence. The formal Afghan private sector contributes a mere 10-12 per cent to the country's official gross domestic product. In its current state, the Afghan private sector is not the engine of economic growth or instrument of social inclusion it has the potential to be. Popular dissatisfaction with unequal access to economic resources, flawed public services and goods, the adverse security situation, and predatory government activity undermine an effective and sustainable private sector. There is a prospect of reversing this dynamic. The Afghan private sector could, in addition to leading economic growth, contribute to improving human and traditional security conditions in the country. Immediate action by the Afghan Government is needed to catalyse this process. The Afghan Government will need to create a more facilitating environment for the private sector, particularly for the many disadvantaged smaller players that form the bulk of the economy. In light of weak state capacity as well as the dismal fiscal outlook new partnership modalities with the private sector are recommended. Support from the international community through private sector development (PSD) will still be needed. However, a number of critical conditions for effective PSD apply. This Swedish International Development Cooperation Agency (Sida) funded report is the product of a one-year field and desk research study of the state of the private sector in Afghanistan and its nexus with development and security. Based on the study's findings, this report provides input on how the Afghan Government, national stakeholders and the international community could facilitate a more inclusive, productive and competitive Afghan private sector. The findings are likely to be of interest to all stakeholders in Afghanistan's reconstruction. Afghanistan's economy has a complex mix of informal, formal, illicit and aid sustained elements. This is foremost the product of a decades-long convergence of protracted conflict, low state capacity, foreign interference and external aid dependence. The formal Afghan private sector contributes a mere 10-12 per cent to the country's official gross domestic product. In its current state, the Afghan private sector is not the engine of economic growth or instrument of social inclusion it has the potential to be. Popular dissatisfaction with unequal access to economic resources, flawed public services and goods, the adverse security situation, and predatory government activity undermine an effective and sustainable private sector. There is a prospect of reversing this dynamic. The Afghan private sector could, in addition to leading economic growth, contribute to improving human and traditional security conditions in the country. Immediate action by the Afghan Government is needed to catalyse this process. The Afghan Government will need to create a more facilitating environment for the private sector, particularly for the many disadvantaged smaller players that form the bulk of the economy. In light of weak state capacity as well as the dismal fiscal outlook new partnership modalities with the private sector are recommended. Support from the international community through

private sector development (PSD) will still be needed. However, a number of critical conditions for effective PSD apply. This Swedish International Development Cooperation Agency (Sida) funded report is the product of a one-year field and desk research study of the state of the private sector in Afghanistan and its nexus with development and security. Based on the study's findings, this report provides input on how the Afghan Government, national stakeholders and the international community could facilitate a more inclusive, productive and competitive Afghan private sector. The findings are likely to be of interest to all stakeholders in Afghanistan's reconstruction.

# Introduction

## 1. Economic backdrop

## 1.1. A brief history of Afghanistan's economy

### 1.1.1. The pre-war economy to 1979

Even before the devastation wrought by near-consecutive wars beginning with the Soviet invasion in 1979, Afghanistan was marked by widespread poverty and its human development indicators ranked among the world's lowest. Challenged by geography, topography and limited infrastructure, the country has always been decentralized, with low connectivity to and between communities, some of which remain beyond the capacity of the central government to administer and monitor. Traditionally a trading and agrarian society, nearly 80 per cent of the Afghan labour force throughout the pre-war 20th century was engaged in rural agriculture.

Economic modernization and nascent industrialization began in the 1930s with state-led infrastructure projects followed by the limited emergence of a variety of small- and medium-scale light industrial enterprises.[1] These activities created a modest hub of capital in Kabul, and profits were often reinvested towards expanding industrial growth. Export markets did widen, and Afghanistan's agricultural products and specialty items even reached Europe.[2] Political elites played a supportive and largely backseat role to private sector[3] decisions until Mohammed Daoud Khan became prime minister in 1953, after which much of the burgeoning formal economy was nationalized to promote more rapid growth and modernization. These efforts were to be carried out through a series of five-year development plans between 1956 and 1972, the first two of which were focused on infrastructural projects, government enterprises and heavy industry.

However, government ministries proved technically incapable and administratively too weak to implement an effective state-managed economy. On the eve of war, modern industry had contributed relatively little to Afghanistan's economy: domestic production was unable to meet the internal demand for consumer goods, and exports remained based on traditional agricultural goods, which constituted 60 to 75 per cent of exports in 1977.[5] Despite advances in irrigation and infrastructure, agriculture continued to be subsistence-based and only a fifth of wheat production made its way to markets.[6] It was also highly vulnerable to the elements: devastating drought and famine of the early 1970s contrasts with near food self-sufficiency achieved under positive weather conditions at the end of the decade.[7]

From the 1950s onwards, Afghanistan's state-led economy also became deeply tied to international financial aid, benefitting greatly in monetary terms from, mainly, the competition between the Soviet Union and the United States for political influence. Foreign sources provided an average of 75 per cent of the capital for Daoud's five-year plans, and by 1973, they were providing In fact, the Taliban only cemented an illicit economy centered on smuggling goods and drugs. Despite promises to rid the country of opium, Taliban leadership instead issued an Islamic sanction of it and derived revenue from its transport.

Increased security expanded the area available for cultivation, although the bulk of production continued to come from the same two provinces: Helmand and Kandahar.[21] Illegal cross-border trading and smuggling became the Taliban's largest source of official revenue,[22] and it reoriented economic activity from the capital to provincial cities. This trade, which included goods imported from Arab states of the Gulf and smuggled into Pakistan, was estimated at over $2 billion a year.[23] The newly independent, post-Soviet Central Asian states as well as Iran provided additional export routes for heroin taxed by Taliban. Beyond the service sectors surrounding the illegal trade and opium, there was little regular economy of which to speak. The brain drain initiated by the Soviet invasion continued. Women, who were gradually being integrated into urban and public sector employment in the pre-war era, were no longer allowed to participate in the economy.

However, regular agricultural production did begin to recover: cereal production improved throughout the 1990s, and by 1998 nearly reached 1977 levels as a result of enhanced security and good precipitation. Livestock production also improved.[24] However, these gains were quickly reversed in the next year, due to a massive drought that by 2001 had brought production down to half those levels.[25] With the influx of repatriating Afghans and population growth post-2001, there would continue to be tremendous food insecurity for many parts of the country and segments of society.[26] Rather than being met in greater capacity by domestic supply, demand was, and continues to be, predominantly met through imports of staple crops and international humanitarian aid.

### 1.1.2. International intervention: 2001-14

The international intervention that toppled the Taliban and destroyed al-Qaeda cells in late 2001 was followed by notable economic development. From 1980 to 2001 Afghanistan had no growth or negative growth, economic growth in the years after the 2001 intervention has been inconsistent but robust at an average 10.5 per cent between 2005 and 2012.[27] However, much of the growth was not driven by either domestic demand or supply, but by international community presence, particularly after the surge in combat and stabilization operations post-2009. The growth is also a function of the initial low baseline against which is measured. Military and civilian aid grew from the 'light footprint' figure of $404 million in 2002/2003 to a massive $15.7 billion in 2010/2011, which was about the same in size as Afghanistan's total gross domestic product (GDP) that same year.[28] From 2009 to 2012, Afghanistan was the world's largest annual recipient of official development assistance (ODA).[29] As during the cold war, Afghanistan has again become a rentier state highly dependent on foreign aid rather than domestically driven economic dynamism.

The intervention established that Afghanistan's economy would be rebuilt on free market-based principles. The National Development Framework of 2002 stated that one of the three pillars of the post-war state-building would be the 'creation of sustainable growth through a competitive private sector, which becomes both the engine of growth and the instrument of social inclusion through the creation of opportunity'.[30] Yet, economic development took a backseat to overwhelmingly security-oriented priorities of the international community. Neither was it prioritized by the presidential administration of Hamid Karzai. In 2008 an agenda to develop the private sector was formally delineated through the Afghan National Development Strategy (ANDS),
whose main economic goals for 2008-13 were to reduce poverty and ensure sustainable development through a private sector-led market economy. While this strategy had some notable flaws, the main reasons for its

weak implementation was little input from ministerial stakeholders in its design and limited implementation support from top-level government.

Despite wide consensus by domestic and foreign state-builders that Afghanistan's economy should be propelled by the market, little has been effectively done in the last decade to build the governance mechanisms necessary for an inclusive, formalized, and competitive marketplace. Insufficient effort has been made to support the economic engagement of the underprivileged: the (rural) poor, women and Afghan youth. The state's administrative umbrella is far from able to cover, or even account for, much of the economic activity in the country.[31] Informal and unregulated markets have continued to dominate, stretching from licit but unreported micro-, small- and medium-enterprises (MSMEs) to criminal activities, of which opium production and smuggling continue to form the bulk. In the absence of sustainable alternative livelihoods and strong demand, Afghanistan's drug economy has soared since international intervention. Despite the billions of dollars spent on counter-narcotics efforts, poppy production has expanded to nearly all of Afghanistan's provinces from its concentration in two during the Taliban years. The export value of opium was 61 per cent of the licit GDP in 2004, and while this figure has since declined in relative terms (partially due to overall national economic growth) the area under poppy cultivation was Afghanistan's highest on record in 2014.[32] Along with the black market trade and smuggling, such activities represent flourishing markets outside of government control. Indeed, such illegal activities form what Weinbaum refers to as 'a capitalist intensity that in another enterprise would be laudable', with spillover effects to the rest of the economy.

## 1.2. **Macroeconomic policies**

While the Afghan Government and the international community have provided only nominal support to Afghanistan's private sector, relatively stable macroeconomic policies have been in place since intervention. This has been quite remarkable considering how insecurity, and at times looming political instability, overshadowed the economy. Debt has largely been relieved (it was 6.5 per cent of GDP in 2014) and the average inflation rate (consumer price index) has been single digit in the past 10 years (it dropped to 4.6 per cent in 2014 from an average 8.1 per cent in 2005-14) The currency has been stable, even if overvalued and as a result of constant US dollar influx.[43] The overvalued exchange rate has benefitted Afghanistan's imports but has negatively affected the private sector's export competitiveness. While the exchange rate has been steady since 2002, it has progressively depreciated vis-à-vis the US dollar and euro since 2011-12. This places the private sector in a more volatile and uncertain situation. Foreign reserves, which were stable as of the end of 2013, were utilized to make up the shortfall in revenues in 2013-2014.

The triple (political, security, and economic) transition has augmented a number of vulnerabilities: a fiscal gap (the budget deficit excluding international aid) has risen, an estimated 20 per cent of the 2015 GDP, that can only be filled through external financial support this year and most likely in the foreseeable future. As an extension of the political transition, rampant corruption and the poor enforcement of tax collection and customs control, tax revenues fell from 11.6 per cent of GDP in 2011 to 8.4 per cent in 2014.[45] Fiscal revenue collection, which has been a perennial challenge in Afghanistan, remains weak and vulnerability will remain high over the medium term. The Afghan Government needs revenue—tax or non-tax—to independently fund the Afghan National Defense and Security Forces (ANDSF), which at approximately $5 billion per year is equivalent to approximately 20 per cent of the GDP and is currently financed by the international community,[46] and to fund the mounting public goods and services the country needs. Non-traditional forms of finance (e.g. sovereign wealth funds, SWF) and new project financing modalities such as public private partnerships (PPP) should be considered.

In 2010 the banking and financial system was rocked by the Kabul Bank fraud case: this has made formal finance channels less diverse and more difficult to access, as well as a less appealing for many private sector actors.[47] Protracted insecurity, doubts over the longevity of the National Unity Government (NUG), and sensitivity to drought, fuel and food prices compound this impediment and work destabilizing for macroeconomic stability. The NUG needs to urgently mobilize revenue, pursue financial sector reform, and instill confidence in the Afghan economy. In its bid to greater self-reliance, the NUG has commenced macro-fiscal reforms, yet these require time to mature.

Finally, Afghanistan faces a tremendous trade imbalance: $7.12 billion in 2014, resulting in a nearly 1:14 ratio.[48] The total estimated trade deficit was 37.9 per cent of GDP in 2014. Afghanistan has a trade deficit with its four largest trading partners (Pakistan, India, USA, EU, by rank in 2014)[50] and its imports account for 80-90 per cent of total consumer market value.

Neighbors continue to utilize Afghanistan as a dumping ground for lowgrade goods and edibles that its own private sector could, to a certain degree, competitively produce itself. Well-designed and tuned economic policies that protect infant and strategic industries from unfair foreign competition, keeping in mind possible negative spillovers from these measures will be necessary to mitigate prospect of an uncertain macro-economic future.

## 1.3. The Afghan economy in transition

At the dawn of the transformation decade (2015-24), the Afghan economy continues to be spurred by external aid. The significant amount of aid and vast international military spending post-2001 has re-ingrained a culture of aid-rentierism: the Afghan elite competes internally for political rents from the international community. The Karzai administration was disinterested in facilitating a more inclusive private sector. The little wealth there is in the country is inequitably distributed, and the rich-poor gap has been widening.[52] In 2014 the United Nations Development Programme ranked Afghanistan 169th out of 187 in human development worldwide and the lowest in Asia.[53] Afghanistan's GDP in 2014, $20.8 billion (in current prices) and still a mere $659 per capita,[54] ranked at the bottom 15 worldwide (where the country was positioned in 2001) and was also placed last position in Asia. Average GDP growth in 2015 is anticipated to be 1.9 per cent, inadequate to alleviate poverty when set against the population's 2.7 per cent growth rate. Now that the triple transition has been largely concluded, the business climate is affected by an additional three major factors: (*a*) uncertainty over longevity and effectiveness of the NUG; (*b*) a thus-far deteriorating security environment; and (*c*) economic reorientation. Doubts about the longevity of the forced marriage by means of the NUG between President Ashraf Ghani and Chief Executive Officer (CEO) Abdullah Abdullah and corresponding alleged bipolarization of political bases have contributed to discouraging domestic investment. The insurgency that has recently spread activity vigorously throughout the north and northeast of the country only exacerbates the situation, as does the presence of the Islamic State of Iraq and the Levant (ISIL) the country.[56] Peace talks between the government and the Taliban have been held in 2015, but it is too early to assess the outcome of this. As the security situation is likely to remain unstable over the short term it would be ideal for the private sector if the state would bear return on investment risk and lay the foundation for economic development by investing in hard infrastructure to support and link domestic markets and attempt to secure safe(r) access to neighbouring countries and sea ports. To do this, the state will need to increase its revenues (both tax and non-tax sources). In doing so, the state will need to provide incentives to the informal economy to formalize, but without security and public service delivery in return this will be an impossible mission to accomplish. Public-private partnerships (PPP) are a possibly viable alternative. The promising extractive industry could be leveraged by PPPs and/or the setup of state-owned enterprises (SOE) to generate much-needed tax and non-tax revenues for the government. In its need to reorient the economy towards one that is indigenously driven, the Afghan Government and the international donor community face some serious hurdles: more than 80 per cent of the population lives in underdeveloped rural areas and urban centers do not have the current capacity to host or employ them. About half a million new entrants join the labour market each year: they unite with about the quarter of the labour force, some 1.8 million, who are either unemployed or underemployed.[57] In theory, and depending on a number of determinants, the agricultural sector could absorb many of them, yet international donors have surprisingly neglected this sector until about 2008. The vast majority of the labour force—60 per cent in urban Afghanistan and nearly 70 per cent in rural Afghanistan—is employed in the agricultural sector, many of which are still family-run and done so on a subsistence level.[58] During the period 2001-2005 the formal agriculture and service sectors averaged near equal shares of the Afghan GDP each totaling just under 40 per cent of the GDP. In 2012-13, services (dominated by transport and storage) contributed to over half of GDP (50.29 per cent), with agriculture following at 25.45 per cent and industry at 20.52 per cent.[59] A reorientation is anticipated, as the services' share is unsustainable against a backdrop of decreasing international community presence.

## 2. Framing the private sector

### 2.1. Formal vs. informal economy

Formal jobs represent only around 9 per cent of the total share of employment in Afghanistan, 20 per cent of which are in the public sector. The public sector dominates the formal labour market and provides twice the number of private sector salaried jobs.[60] At least 65 000 enterprises are formally registered, but this figure may not accurately represent the myriad businesses that may register with local authorities and municipalities.[61] Comprehensive national data on this has not been aggregated, collected or updated. Even less is known regarding the informal sector.[62]

Formal economic institutions have only recently been re-introduced in Afghanistan and still have limited reach. In fact, estimates made in 2005 that 80-90 per cent of Afghanistan's economic activity is informal have not changed over the past decade.[63] Informal economic activity encompasses all economic activities that take place outside of the government's regulatory framework, from subsistence and in-kind transactions, licit but unregistered activity, to irregular or illegal distribution and production of goods and services.[64] In Afghanistan as well as other developing countries, the relationship between the formal and informal economy is often fluid, encompassing the same human networks, as well as utilizing the same unregulated economic resources.

There has been positive spillover from informal sector-led growth. Capital accumulation in the informal sector can serve to the benefit of the formal sector, by increasing consumer purchasing power and providing a source of investment.[65] The informal sector also plays a strong role in poverty reduction through employing and servicing markets at the bottom of the pyramid. Indeed, as the World Bank in 2005 stated, informal activity 'has been largely responsible for [Afghanistan's] recent economic recovery and dynamism'.[67] At the same time, however, widespread informality—even when licit—does place a ceiling on development. By acting parallel to and competing with official economic governance systems, informality leads to a vicious cycle in which the government is unable to generate the resources necessary through taxation to provide an enabling environment for formal businesses. Roles that the state could play related to welfare and labour protection are also reduced; currently, socioeconomic safety nets are provided through informal channels, which create additional disincentives to formalize.[68]

In general, incentives for formalization by licit actors remain low. A survey conducted in 2011 with small-scale business actors revealed that registration brings few benefits in terms of government service delivery, contract and law enforcement, government protection (including for labour), or access to affordable finance.[69] Formal businesses instead often face costs in terms of entry requirements, taxes, extortion and corruption by officials, as well lengthy and complex bureaucratic processes. conscious decisions to stay informal based on the above cost-benefit analysis. Policy interventions are necessary at both ends. However, research has also found an 'informality of indifference'—whereby formal procedural and legal changes but low state capacity has simply not altered pre-intervention economic patterns. To date, little has been actively done to encourage or foster informal businesses to build a relationship with the government, and it will take time before the government earns the private sector's trust and decides to formalize.

As the Ministry of Commerce and Industries (MOCI) has stated, 'for the private sector to expand . . . and fulfill its role as the main engine for growth, additional efforts must be made to address the needs and maximize the contribution of the many informal enterprises, family-run farms and self-employed men and women that conduct business there'.[70] There is a need for the state- and policy-shapers to build a relationship with licit informal sector actors, to include Afghanistan's more traditional trade associations.[71] Government and stakeholder processes and forums should not only take into account the thin formal sector of registered businesses, the public sector, and non-for-profit organizations, but also include the viewpoints of the vast majority of Afghans whose activities remain unaccounted and unspoken for. Informal workers, for instance, are not included in the 2007 Labour Law. In this, particular care should also be taken to unpack the differential layers of vulnerable or disadvantaged populations—including women, child labourers, migrants and refugees—who are involved in informal activities.

## 2.2. Economic integration

Integration with global markets has been both a curse and a blessing for Afghanistan's struggling economy. The availability of foreign products and services increases consumer options, but goods from more mature, developed, as well as state-supported economies crowds out market space for competitively disadvantaged Afghan producers. Imports allegedly account for more than 80-90 per cent of the consumer market, and the trade imbalance is Severe. Regional economic integration has been widely touted as a panacea for development. Afghanistan, indeed, has the potential to become the transit hub that connects Central Asia with South Asia, and South Asia with the Middle East. There are prospects of positive economic spillover with loosened sanctions against Iran, whose Chabahar seaport could be a critical access point for Afghan trade. However, dialogue on regional economic projects continues against a backdrop of a heavily politicized regional environment (see 3.1.4). In many respects regional economic integration, particularly with neighbours Iran and Pakistan, is strong, albeit unbalanced. Trade agreements with neighbours often disadvantage Afghanistan—that is, when they are enforced. What is needed is equitable and more rule-based economic integration.[73] Beyond the competitive advantages they have over Afghan businesses, a number of foreign producers are also backed by government subsidies and higher import tariffs—which further disadvantage Afghan exports.[74] Currently, Afghanistan is in the third stage of its ascension process to the World Trade Organization (WTO). This will bring national industries and policies (closer) in line with global standards, but questions remain as to how Afghanistan can be competitive on world markets, and how nascent and budding industries can survive if the country is plunged into these international institutions. Precaution is advised. Afghanistan's current liberal trade regime is a product of low state capacity as much as design: trade channels remain mostly irregular, and the bulk of what could be appropriated as customs revenue continues to be lost to smuggling and corruption .Thus ,while Afghanistan serves as dumping ground for neighbours products, those neighbouring market stream in more closed to Afghan goods, with trucks often stalled and stopped at border crossings, damaging perishable products. Afghanistan's power to negotiate better terms over the past decade has been weak. Furthermore, what licit goods do cross over are often raw materials or lower-value products that to which neighbours add-value and capture the bulk of profits. Higher-value products are exported, but are often relabeled and resold at higher prices to other parties. Afghanistan's domestic market is weakly integrated. Rather than a single economic space, there are instead a number of localized markets. Urban centers are weakly connected with rural areas in infrastructural (and by extension economic) terms. The largest provincial capitals—Herat, Mazar-e Sharif, Kandahar and Jalalabad—are more economically integrated with their adjacent neighbours than they are with each other. At the same time, in cross border trade policies, beyond problems of heavy corruption, customs are often not harmonized across borders. These price differentials are liable to, and have been, exploited by traders to the detriment of local producers. Fragmentation also goes beyond limited infrastructure and physical connectivity, to include challenges of socially closed and relational trade and business networks. This lack of internal integration exacerbates the problem of broken value chains and market access, keeping the economy at the lowest rungs of domestic, regional, and global economic value chains. Existing domestic needs—not only for final products but also for pre- and postproduction inputs that could be met in-country—often remain unmet and supply-demand linkages underdeveloped.

## 2.3. Private sector actors

The vast majority of Afghan (some 90 per cent) are employed in establishments with less than five employees, a clear majority of those with a sole proprietor.[75] A facilitating private sector environment for microenterprises[76] is instrumental in overcoming poverty and in employing the country's workforce, particularly for women and youth. While Afghanistan's few large enterprises are currently relatively marginal to employment, they do play an important role in generating government revenue, attracting foreign direct investment (FDI), providing certain critical services (such as telecommunication and construction), introducing technology and management standards and catalysing the establishment of smaller enterprises. Foreign ownership outside of the services sector connected to the international presence is limited and mainly concentrated to technology-intensive industries, such as extraction and telecom. Large Afghan-owned enterprises typically have an ownership and management structure involving male members of the same family.[77] A handful of large business groups date back to before the Russian invasion, while a new set of successful entrepreneurs emerged with the post-2001 service-driven economy. Even when they maintain a core line of business, the large corporate groups tax tend to be active in several sectors, foremost logistics, trade, finance, security and construction, as a means to support their main business, spread the risk or to reinvest profit. Many Afghan business groups, even when headquartered overseas, maintain a strong commercial base in their region of origin, where they often have ties to the ethno-political establishment. While this model reinforces the existing configuration of interests and sidelines entrepreneurs, it is, however, also a way for these enterprises to reduce risk in the volatile and insecure environment, and, at large, maintain investment in the Afghan economy. While formal business organizations have only recently been introduced in the country, the numerous urban micro- and small-enterprises in manufacturing, retail and services have long organized in *senfs* (sector-based guilds) where they cooperate on common issues and resolve disputes. This model makes them more resilient to external shocks, while it should be noted that it may also create entry barriers to outsiders by setting limits to free competition.[78] With perhaps 500 000 such micro-enterprises active across the country, they are a substantial source of employment and apprenticeship, largely in the informal sector.[79] The Federation of Afghanistan Craftsmen and Traders (FACT) for instance, has 75 000 members, many of them with informal businesses, organized in some 1000 *senfs*.[80] Considering the rapid rate of urbanization and the role of these actors in engaging mainly male youth (particularly as apprentices), the sustainability sustain ability and adaptability of these longstanding economic institutions will only increase in importance. The more contemporary organized private sector emerged through cooperation between Afghan businesses and the international community which shared a mutual interest in improving business conditions. Several of the important recent business-environment initiatives in the country have been grant funded through Harakat, a non-governmental organization supported by the British Government's Department for International Development (DFID).

## 2.4. Sectorial conditions

### 2.4.1. Agriculture

Agriculture is commonly cited as the sector with the greatest potential for job absorption and economic impact on rural Afghanistan, where over 80 per cent of the poor are located. As of 2014, 40 per cent of the labour market is employed the agricultural sector, but much of this employment remains on a low-productivity basis and/or is at subsistence levels. In order to keep pace with population growth, the World Bank estimates that agriculture will need to grow at 6 per cent annually for poverty reduction to be achieved. On the ground, however, there have not been structural and sustained productivity increases. Output primarily depends on weather conditions in any given year: for example, negative agricultural growth in 2008-2009 was followed by high productivity upwards of 40 per cent the next year, which in 2010-11 was yet again negative.[84] Absent more structural improvements such as in irrigation, the sector remains highly vulnerable to environmental stresses. Beginning in 2002, a variety of strategies and plans have been developed to enhance and improve the agriculture sector of the country. Approaches have not been entirely consistent, and certain major donors have worked on assumptions that increased production and market linkages would very naturally lead to increased food security and a reduction of poverty (i.e. an emphasis on 'growth' versus 'pro-poor growth').[85] However, evidence reveals that, for the country's most vulnerable, commercial agriculture may still be a step too far. Programmatic evidence from rural enterprise development programmes shows that when farmers are unable to guarantee basic sustenance, the riskier endeavor of producing for markets is much less appealing.[86] Likewise, the World Bank's 2014 agricultural sector review recognizes that promotion of commercial agriculture, while necessary to stimulate quick results in agricultural growth, will have limited impact on those who are engaged in rain-fed farming, for nomadic livestock systems and, in fact, for the majority of farmers who operate on a prohibitively small scale, with limited access to factor inputs. Noting that these will require more developmental interventions, the World Bank has identified three key commodities ('first movers') that have the greatest commercial agriculture potential and have been assessed to be able to quickly generate jobs and incomes: irrigated wheat, horticulture (encompassing vegetables, fruits, nuts, spices and other higher-value cash crops) and intensive livestock and animal husbandry (meat, poultry, dairy and animal-derived products). As a staple crop, wheat is essential for basic food security, but the comparative and competitive advantages of domestic production are not clear. Horticulture is comparatively labour intensive compared to wheat, and women are substantially engaged in cultivation and harvest. In quality terms, Afghanistan's horticultural products have proven to be internationally competitive. For example, Afghan saffron is widely recognized to be of very high quality; it is also a labor-intensive crop that can generate employment opportunities for women in particular.[88] Fruits grown in Afghanistan have also won first-place awards in international competition.

Livestock and animal husbandry 'constitute(s) perhaps the most inclusive production activity in Afghanistan'.[90] Women are heavily involved in the care of livestock and in the dairy sector, with most farmers in general operating on a small-scale. Demand for meat is strong and growing (an estimated $3 billion in annual consumption); with two-thirds of this demand being met through imports, there is an ample market for domestic producers.[91] Despite having 2 million dairy cows, Afghanistan still imports the bulk of its dairy products, worth $42 million annually.[92] In principle, the perishability of milk products favours domestic producers, but the lack of dairy processing and pasteurization plants is a major hindrance. In instances where facility investments and market linkages have been made, this study has found that domestic dairy production is commercially viable. Altogether, agriculture— almost entirely horticulture and/or livestock derived products, not including rugs or carpets which also depend on wool material—constituted 75 per cent of Afghanistan's official exports in 2014-15.
These and similar commodities valuations may be useful to both development, private sector and government actors, but the question remains as to what support mechanisms are provided on the ground. The World Bank recommends 'commercial development of selected value chains, targeting commercially oriented farms that can be linked to these chains on a business basis'.[94] A variety of programmes have taken this approach and preliminary evidence, including fieldwork for this study, shows that there have been positive outcomes from these market support programmes.[95] As in other sectors of the economy, commercial agriculture still faces key constraints at every part of the fragmented value chain—from limited irrigation, to perishability and transport, as well as many other post-production processes that are necessary to bring Afghan products into, and make them competitive in, the marketplace. Finally, while agriculture does indeed have substantial absorptive potential, rural-to-urban migration, as laborers flock to cities both seasonally and more permanently in search of economic opportunities, may also limit the transformative economic impact of the sector.

**2.4.2. Mining**

Afghanistan has rich resource deposits of mineral and natural resources. In the medium to long term the extractives industry is among the most viable export-led growth and revenue generation options for Afghanistan. Should the extractive industry take off, it would be a significant and sorely needed source of revenue for the state. However, even optimistic estimates regarding the sector's development are clear that these resources 'will not in itself be transformative and may not be a source of inclusive growth'. According to the World Bank and assuming the sector even moves forward, by the 2020s mining would only likely create 10-20 000 direct jobs, mostly skilled or semi-skilled labour—with little benefits going towards the poor or to women.

Furthermore, the derived revenue—an estimated 700 million to 1.5 billion by the 2020s—would be 'insufficient to replace aid flows'.[96] The Afghan Government is more optimistic about this sector and estimates that in the best-case scenario it could possibly create an economic turnaround in some 10 years. There are ideas for linking resource development to pro-poor growth, however. The World Bank's 'resource corridor' concept suggests that the mining sector could have great spillover effects: stimulating local and diverse downstream enterprises, creating indirect jobs and providing infrastructure (hard and soft) that could be utilized for other key sectors with more poverty alleviating impacts. The MOCI also suggests the establishment of a special fund utilizing mining revenues that would go towards stimulating more diverse industries and smaller actors.[98] These remain at the ideational phase, as mining in the country has stalled. Innovative partnerships between the Afghan Government, the Afghan private sector and international investors will be necessary to tap the potential of the extractive industry. Responsible economic management of these natural resources will be necessary, without which resource dependency can have negative impacts on governance, development and stability.

**2.4.3. Industry**

Industry encompasses a little over 20 per cent of Afghanistan's official GDP.[99] It remains relatively unsophisticated, with 90 per cent of manufacturing accounted for in agricultural processing.[100] As the relevant ANDS National Priority Program (NPP) put it, 'the manufacturing sector is tiny, export-orientation is minimal, and most producers, with the exception of a few agro- processors, source their raw materials from abroad'.[101] Manufacturing is seen as a higher-risk, with larger upfront and fixed investment, longer maturation and dependence on a more complex production supply chain. Competition from foreign producers also reduces profit potential. Where productive industries have been successful, such as in beverages, this is due in part to the raising of tariff barriers, large-scale contracts with international military presence, as well as the transportation-shielding effect of shipping imports. In the interviews conducted for this study with Afghan industrialists, they noted that the overwhelming constraint on their growth was unfair competition from neighbouring countries: illegal dumping, export and customs problems, and non-tariff barriers that fly in the face of trade agreements.

Nevertheless, a low-risk industrial policy was developed by the MOCI in 2011, to encourage the growth of small- and medium-enterprises (SMEs), substitute imports, increase exports, and to facilitate 'pro-poor growth'. The policy identified as priority those sectors in which Afghanistan is competitive across entire value chains, in which raw materials were readily available in-country, that are 'labor-intensive with a strong rural presence', with low entry barriers, low technological requirements, and which used existing human resources and skills. Furthermore, the sectors were identified as ones within which Afghanistan can move up the value chain. These sectors were agri-processing, livestock skins and leather, carpets, construction (and construction materials), marble and gemstones. Action plans were developed by line ministries to boost each of the sectors. Certain concrete gains have been made, but it is difficult to attribute most them to organized to these public interventions.

### 2.4.4. Services

An overwhelming amount of SMEs are engaged in trade and retail, up to 80 per cent according to the MOCI. While trade and retail are key for providing goods to markets, they are of limited value in terms of job creation.[103] Trade is attractive for a number of reasons. As research has found, the uncertain Afghan business climate creates strong incentives to 'focus on short-term trading at the expense of long-term productive enterprises' and to invest in the 'highest-margin businesses that require the least amount of capital that produce benefits in the least amount of time'.

But the tertiary sector more broadly has accounted for most of the economic growth in the country over the past years. From 2003-2009, 59 per cent of the new GDP growth came from logistics, construction, and other services— driven in large part by the international presence. This had some albeit limited job creation and trickledown effect.[105] These sectors were hard hit during the triple transition, with a net negative impact on GDP in 2014-15.[106] This may be particularly in pronounced in regions with larger international presence. The construction sector in Kabul has remained remained surprisingly stable due to strong urban housing demand and potentially provides jobs for casual urban labourers. New housing units themselves, however, remain largely unaffordable for the bulk of the population. Telecom has been the major success story of Afghanistan, with 90 per cent of the country covered and over 80 per cent market penetration.[108] This digital network—which links all but the most remote parts of Afghanistan—can no doubt be used to produce development results, not only for educational outreach and public service provision (including e-governance) but also to promote economic activity through access to information on markets and pricing. Financial services are still nascent in Afghanistan, with only 3 per cent of the population banking through formal channels.[110] For the vast majority of Afghans, such financial transactions continue to take place through personal networks and the informal *hawala* system—though some banks are exploring sharia-compliant options to help penetrate this market. Commercial lending is key for business development, but for most SMEs, loans remain prohibitively costly for smaller actors. Microfinance more deliberately aims at socioeconomic inclusion, and in other countries it has played a strong role in stimulating growth at the bottom of the economic pyramid. In the Afghan context, microfinance may be of mixed or limited overall impact: among other problems, it has been noted in research that rural Afghans primarily borrow money for consumption purposes.[111] In many cases donors have also acted directly as financial service providers, through matching grant schemes or providing finance at programmatic levels.

## 2.5. **Government legitimacy and the social contract**

Since the Afghan state was established in 1880, the social contract has been a perennial experiment. Two socio-political experiments in the 20th century—King Amanullah Khan's in the 1920s and the Soviet-backed Communist effort in the late 1970s—failed. Historically, Afghan households have sought welfare through informal and even illicit means rather than through the formal economy since neither the state nor the formal market could adequately meet the needs of the population, particularly in rural Afghanistan. These two experiments further eroded trust in the state. Since 1978 the state has gradually become, for many, the enemy, and since the 2001 international intervention many, including urbanites, see the state as predatory,[112] and for some even as artificially imposed. This is despite the fact that 'firsts' in the Afghan social contract—such as political representation, human rights protection and electoral participation—have been introduced. Some see these as veneer, as the Karzai administration did not prioritize upholding their integrity. The social contract has thus to be proven efficacious by the new administration.

To understand Afghanistan's dysfunctional social contract and the manner in which it affects the private sector, its root causes need to be understood. These are multifold:

1. The Afghan Government has traditionally provided limited public service delivery, especially in rural

Afghanistan and to women and youth in particular, and this has affected how Afghan entrepreneurs and consumers still perceive the role of the state. Perceptions differ across the country and many perceive the state as an intruder or an obstructer. Some await the state to provide public services and goods that could foster their business.

2. The Afghan Government has been unable to provide stability to the Afghan people since 1979 and has failed to provide and facilitate either physical or human security since 2002. International community state building efforts following the Taliban collapse had an overly technical orientation, the domestic and regional politico-economic context was not sufficiently taken into account. The Taliban was kept outside of the political processes that followed the Bonn Conference in 2001, which reinforced the Taliban's view of the Afghan state as illegitimate and fueled the subsequent insurgency. Insurgent activity has and continues to severely hamper the business confidence climate.

3. Systemic kleptocracy and rent-seeking nurtured and sustained by the Karzai administration, from the top to the sub-district level, gravely undermined the state's perceived legitimacy as a guarantor for a facilitating private sector. The NUG now has the daunting task of uprooting engrained corruption and pursuing performance-based legitimacy.

4. Three decades of conflict have damaged the social fabric and affected the 'social covenant' (i.e. social bonds and trust). Business cooperation is preferably, but not exclusively, conducted intra-ethnically, while ownership is largely managed intra-family. While this is arguably more prevalent post1979, it should be noted that this has been the case prior to the events that have taken place since USSR invasion.

5. The largely rugged and harsh mountainous topography of landlocked Afghanistan is disadvantageous to social cohesion and public service delivery; this also affects market connectivity. To entrepreneurs in Afghanistan the disincentive to formalize and pay taxes is exacerbated by administratively and technically weak governing bodies, the absence of a functional and more inclusive private sector, and, as noted above, systemic kleptocracy. Afghan entrepreneurs are not incentivized to formalize their businesses and pay taxes if the state is perceived as predatory and fails to deliver public services and goods. The size of the informal economy bears witness to this. A section of Afghan youth eschews the private sector altogether in light its many insecurities and poor labour conditions and rights, and instead prefers public sector employment.[114] Poor livelihood prospects in the Afghan private sector are also an incentive for Afghan youth to embark on illicit and insurgent trajectories: some Afghans are willing to commit a major crime for as little as a one-off $200 payment.[115] Absence of employment opportunity and the deteriorating security situation has also led to a surge in illegal immigration to Europe and elsewhere.

## 2.6. Legislation, enforcement and government policies

Already in its earliest days the NUG reaffirmed the government's commitment to private sector growth as the driver of the country's development. However, not only does the government lack the financial and human resources, the administrative and technical capacity, and the provincial reach to foster the private sector—it has often been an active part of the problem. The government's strategy to support the private sector has not been consistent, and its implementation uneven at best. There has generally been a structural absence of coordination, sometimes even based in ministry and agency competition.[117] Thus, the Presidential Office and several ministries and agencies have been involved in various capacities. The Ministry of Commerce and Industry (MOCI) General Directorate for Private Sector Development has so far been the only agency with direct focus on supporting the private sector, but it has not had full control over policy implementation.[118] Nearly a year after

NUG was formed, private sector policy responsibilities within the state apparatus have also not yet been fully clarified and further reconfiguration seems likely. Commercial legislation has been the subject of ongoing reform since 2002, resulting in adopted laws on, for example, business structure, partnerships, arbitration and mediation, and several other laws are in the process of amendment.[119] The final version of the much debated minerals law,[120] adopted in 2014 and as of 2015 under further amendment, will be an indicator of the NUG's ability to reconcile the need for foreign investment with equitable resource and revenue utilization and public transparency. For domestic businesses of every size, the lack of a sufficiently unambiguous legislative basis for investment protection of fixed assets is a major problem.[121] The NUG has commissioned international law firms for a general oversight of national legislation, but the process of resolving inconsistencies, amending laws and obtaining parliamentary approval is likely to be lengthy, not least due to political-economic vested interests.

## 3.Impediments to inclusive private sector growth

The 2002 NDF claimed that the private sector would be the 'engine of sustainable growth and the instrument of social inclusion' in Afghanistan.[131] Follow-on national strategy documents, including the ANDS, made similar claims on the ability of private sector growth to lead to developmental outcomes. However, this growth has in reality has been neither sustainable nor inclusive. Despite the tenfold growth in the size of Afghanistan's GDP, poverty rates have not substantially been reduced. The 2011-12 National Risk Vulnerability Assessment (NRVA) finds an 'absence of progress in poverty reduction over the past four years' and that 'the poorest segment of the population have not benefited from the general improvement in economic conditions'.[132] The rate of people living below the poverty line and the number of people experiencing food insecurity have both increased (36 and 30.1 per cent, respectively), particularly for rural and nomadic populations, while consumption for the top quintile had increased.[133] The capital accumulated in connection with the international presence has gone primarily to economic, political, and war elite, or a segment of nouveau riche. This is in contrast to 81 per cent of the population which is still in what is considered 'vulnerable employment', with insecure sources of income. Regional disparities are also pronounced. In the developmental aid provided by donors there are 'well documented inequities and imbalance across provinces'. Circumstances for women have changed for the better in many ways, but the labour market remains dominated by men: women constitute 19 per cent labour force participation rate and have only an 11 per cent total share of nonagricultural jobs. Similarly, ethno-cultural groups have not benefitted equally in economic terms.[135] Overall, numbers such as per capita GDP do not reflect the inequality that has so marked Afghanistan's development—a gap that has even been growing. Finally, much of the growth, as has been noted, is not sustainable. Without the market created by the fleeting international presence and the ongoing injections of aid, the economy has experienced tremendous drop off in growth. Rather than being reinvested into the domestic economy, urban capital has been fleeing the country. Fluctuations in annual economic outcomes and in basic economic indicators have often been the result of annual variation in rainfall. Nevertheless, there has been little investment in structural improvement of the agricultural sector, despite its role in providing livelihoods for the most vulnerable.

The 2008-13 ANDS laid out an action plan for 'making investments that have a preferential impact on bringing the poor out of extreme poverty . . .' This poverty reduction paper made a case for policy that addresses the *quality* of growth rather than *quantity*. Its target of 'pro-poor growth' was defined as growth in which 'the incomes and livelihoods of the poorest rise faster than the average growth of the economy'.[138] But as the private sector currently stands—with only a handful of medium and large-sized business, and given the above sections' overview of some of the macro-level and durable constraints—the ability of the formal 'free' market alone to tackle poverty reduction may be in question.

## 4. The private sector and security

## 4.1. The private sector and the security nexus

Afghanistan has experienced an upsurge in insecurity and violent attacks since the 2014 transition. As the ANDSF assumed full combat responsibility in 2015, government casualties have increased 70 per cent in the first half of 2015 compared to the 2014, on tract to become the bloodiest year for pro-government forces to date.[235] Attacks in Kabul have likewise doubled. But physical insecurity in Afghanistan is wide-ranging, including: local intergroup conflict among militias, organized crime, threats posed by transnational extremist organizations, as well as the varied forms of conflict related to the Taliban and anti-government insurgents.[236] Such forms of violence are often heavily interconnected and are compounded by the availability of arms in the country, with an estimated 2 million weapons in circulation.[237] Although often less of a focus, non-organized crime—such as localized violent disputes for resources like land and water, as well as interpersonal and household-level violence—are also prevalent.

'Security' in Afghanistan encompasses a range of threats not only to the state but also the wellbeing of individuals. Civilian deaths caused by the post-2001 conflict are estimated at over 26 000[238]—with the highest civilian casualty rate yet in the first half of 2015.[239] Fear of attack is prevalent, with more than half of Afghans in a 2014 survey reporting always, often, or sometimes fearing for their safety or that of their family, and even more reporting fear for safety when traveling to a different part of the country—with clear implications for market integration and access.[240] But insecurity goes far beyond only the threat of physical force. Along a range of other human-oriented security indicators—for instance food, environmental, health, political, personal, community and economic security[241]—Afghanistan also performs extremely poorly. Despite tenfold growth in the GDP since 2001, for instance, Afghanistan is still ranked 169th in the Human Development Index, with 59 per cent of the population in 'multidimensional poverty'.[242] As surveyed in 2011-2012, 30.1 per cent is food insecure[243] in the two essential components of human security, 'freedom from fear' and 'freedom from want', challenges are substantial. With GDP growth sharply declining, foreign aid levels dropping, and the security situation still volatile, the prospects for improvement are uncertain.

The private sector has a complex relationship with both traditional and human security. Analytically, the 'private sector' refers to any profit-oriented activities and transactions outside of direct state control. When promoted in national strategy documents as driver of 'increased employment, higher living standards and a reduction in poverty', and as the primary instrument for 'sustained growth', these implicitly refer to a private sector that has a formal relationship with state authorities, or has the potential to build one.[244] Such private sector growth does have a role to play in contributing to a secure, viable and legitimate state, providing a tax base, creating legitimate livelihoods and jobs, mitigating poverty, and for giving the broader populace as well as elites an economic stake in the survival of the system. But 'private sector' also includes activities entirely out of the state's regulatory purview: not only licit informal activities (including in-kind, subsistence, and extra-legal activities that could potentially formalize), but also irregular and illegal activities, altogether comprising an estimated 80-90 per cent of the economy. Indeed, over the decades of conflict in Afghanistan, 'the link between war and illicit activities became progressively stronger'.[245] To this day economic opportunities and opportunism continue to fuel and be fueled by conflict.

# 5. An analysis of private sector development

## 5.1. An analysis of private sector development programmes

Private sector development (PSD) encompasses the efforts of actors in the public or non-governmental sector, as well as by corporations and individuals, to promote and enhance the development and growth of the private sector. Both in concept and in practice, PSD has been increasingly utilized by the international aid community to harness the private sector's presumed ability to create jobs, reduce poverty, and to contribute broadly to developmental goals. In Afghanistan, paper commitments to developing an inclusive and productive private sector were made very early on, including in the National Development Framework (2002), in which 'the creation of sustainable growth through a competitive private sector, which becomes both the engine of growth and the instrument of social inclusion through the creation of opportunity', was one of the three main pillars on which Afghanistan's progress was to be based.[267] The follow-on Securing Afghanistan's Future document made similar vision statements
Technical assistance by international actors put in place the general macroeconomic framework for Afghanistan's market economy, including basic economic institutions and its trade regime.[269] Donors have been instrumental in the creation of key private sector-related bodies: business registries, business support organizations and investment promotion agencies. While these contributions are laudable, both government and business actors have also noted in interviews that the economic institutions established by the international community in the early years failed to take full account of the Afghan context. On the ground, few holistic attempts were made to help transition Afghanistan out of what was and remains a largely informal economy. After the initial momentum subsided, PSD was low on the international community's list of priorities in Afghanistan, behind issues of security, governance and rule of law and human rights. At the same time, the Afghan Government was crippled by a general lack of capacity, when it was not being recalcitrant, uninterested or merely self-serving. While the US Government aid agency USAID has been involved since 2004 in PSD efforts, supporting business organizations in particular, very few initiatives were launched during the 2000s. A donor database operated by a department of the British Government shows that outside of major infrastructure and public service projects, and investments by the International Finance Corporation (IFC) and a few microfinance and credit schemes, most notable PSD efforts by other actors did not start until after 2009, with the majority beginning after 2010.[270] As an evaluation of World Bank programmes from 2002-11 noted, by the end of the period, 'the [Afghan] government's objective to use the private sector as the driver of sustained growth remain[ed] elusive', and 'progress in addressing critical constraints to PSD ... remain[ed] slow, with a lack of systematic and coordinated efforts by the Bank Group and other development partners to address these weaknesses'.

## 5.2. Private sector development coordination

Coordination is necessary at multiple levels to ensure the effectiveness of aid efforts in Afghanistan, including for PSD. It requires alignment and coordination between donors and the Afghan Government, as well as coordination between donors themselves and between relevant Afghan government bodies. In 2011 PSD represented 2 per cent ($218 million) of external assistance to Afghanistan—but only of the donor aid that the Afghan Government was able to account for. With 82 per cent of aid bypassing state channels that year, fragmented among donors and agencies, the figure does not represent the full picture of the PSD projects and programmes that have been attempted in the country. Donors committed to channeling 50 per cent of aid through the national budget at the Kabul Conference 2010 and aligning 80 per cent of this aid in accordance with national priorities (the ANDS NPPs) over the following two years.[285] But with only 18 per cent of aid delivered on budget at the end of 2011, follow-through on these promises was clearly lacking.[286]

The Afghan Ministry of Finance and donor counterparts have held a series of high-level Development Coordination Dialogues (DCDs) since 2006. In the past year, relevant actors have also been meeting for regular PSD donor coordination meetings.[287] But effectively coordinated aid needs more than information sharing. It also requires alignment with government priorities and harmonization of efforts—two key principles of the 2005 Paris Declaration of Aid Effectiveness.[288] Pooled funding mechanisms are important means by which both can be achieved, lowering transaction costs for donors while contributing to capacity building and ownership by the government. The ARTF, which has had 33 contributing donors over the years, has been assessed as a very effective vehicle for channeling on-budget aid, aligned entirely with government priorities.[289] However, the ARTF has on the whole not been used for economic development programmes. When support for microfinance was phased out of the ARTF in 2007-2008, this left the 6.5 per cent invested in agricultural growth and development as the only multilateral funding stream oriented towards economic growth.[290] The ARTF, moreover, does not fund the PSD cluster of the ANDS, although it provides funding for the other five priority clusters.

## 5.3. Principles of engagement and red flags

Limited coordination is one among a number of reasons why PSD efforts have been neither systemic nor sustained. But another recurring challenge for those involved in PSD is how to sequence and prioritize efforts given that resources and time frames are limited. In addition, Afghanistan's private sector faces many problems that are not only interconnected, but also may be beyond the capability of PSD to address.

PSD can be very broadly categorized into two types of interventions.[296] The first intervention focuses on the environment in which the private sector operates, removing obstacles at the institutional or policy level. Properly and carefully done, efforts by the state and other actors, to reform and implement regulations, provide public services, enforce basic rule of law, and improve the business climate can serve to the benefit of all market actors. However, many donors are also engaged in more targeted assistance, in sectors of the economy that they believe can deliver significant impact in relation to pro-poor growth. These interventions include providing resources to private sector actors through matching grants or challenge funds, supporting specific value chains, or otherwise actively encouraging enterprise development in select geographic areas. These more direct interventions to stimulate economic growth and reduce poverty are conceptually (and often in practice) problematic for a 'private sector-led' economy. Analysis of the effect of direct market interventions shows that the results have been somewhat mixed. While direct intervention may be more effective in terms of donor impact and reach (particularly when the Afghan state is seen to be an unreliable or ineffectual partner), such interventions may address only the symptoms of market failure rather than the root causes. Further, there are risks that poorly devised direct PSD can distort the marketplace by favouring certain sectors or actors, skewing supply and demand, or crowding out private sector investment.

### 5.3.1. Time frames and exit strategies

PSD is a long-term process. Donors often have unrealistic expectations about what can be accomplished in limited time frames, particularly given the extremely low baselines from which they are working.[299] Overly short time frames incentivize measuring success on short-term outputs rather than sustainable impact, undermine careful evaluative processes, and increase chances for opportunism.[300] Most donor aid initiatives are fleeting rather than structural, do not incorporate a clear and responsible exit strategy, and often leave behind orphaned projects and beneficiaries and value chains that remain broken. Thus, assessment of realistic time frames for results should be accompanied by an evaluation of responsible exit strategies that consider sustainability.

### 5.3.2. Sustainability

Post-intervention sustainability may be achieved on a number of different levels. When handing over to beneficiaries, donors should first determine whether there exists sufficient capacity in human, financial and technical terms to utilize or maintain the material or immaterial resources provided. Establishing commercial sustainability requires a rigorous assessment of the underlying context, the relevant value chains and the market. Maintaining the successful results and models produced by a programme after it comes to an end may require a handover to local actors, which may be easier to accomplish if government institutions are involved from the outset. This, according to Independent Directorate of Local Governance (IDLG), would help donors move from a 'programmatic' approach to a more 'institutional' approach, as well as help buttresses government capacity and legitimacy.[301]

### 5.3.3. Holistic perspectives

The uncoordinated and patchwork nature of PSD projects has prevented actors from taking a systematic and holistic approach to interventions. But many of the individual constraints are closely interconnected and cannot be solved in isolation. For instance, a project that supplied cold storage units to commercial farmers failed to take into account the financial context, including the cost of upkeep, and the units were subsequently sold to traders. In another case, a programme to provide land for industrial parks failed to address the interconnected issue of absent or inconsistent electricity supply. At the general level, support for domestic producers fails to take into account the regional trade environment. Moreover, in many instances, donors have intervened in only one section of the value chain, leaving the rest broken, and the efficacy of the entire endeavour in question.[302] Some issues, such as local human capacity, may lie beyond the capability of direct PSD to address. However, these should be rigorously assessed preintervention. Indeed, if there are too many structural barriers to a successful PSD intervention, donors should consider whether their funds would be better spent in helping to deal with those structural problems.

### 5.3.4. Clear objectives

Donors should differentiate between projects that aim to have a social impact and those intended to be genuinely commercially viable, as 'the muddying of the two metrics has resulted in projects that satisfy neither goal'.[303] Programmes to stimulate socially inclusive economic participation may be very meaningful, but it has been noted that these often amount to no more than salaried income for participants and, as such, should have different metrics and follow-through mechanisms from for-profit endeavours. On the other hand, commercial viability is critical for projects whose clear objective is to produce sustainable business models.

### 5.3.5. Market distortion

Donors should ensure that 'the market' is not an artificial one that is created by donor funds, but rather addresses a genuine consumer demand. The subsidizing role of donors, as noted, is ironic if not in what has been designed to be a neoliberal market economy. Without more careful considerations of the distortionary impact of aid, Afghanistan may suffer the worst of both systems: economic inefficiencies as well as limited state support and protections. In this, market assessments are key. The private sector should not be crowded out and donor aid should only be used to kick-start the market when the private sector cannot do so itself.[304]

### 5.3.6. Needs-based interventions

PSD interventions should be needs based, rather than supply driven, and should first consider what communities are ready, interested and able to absorb.[305] Numerous examples exist of donors first devising a project and then searching for potential beneficiaries, rather than working together with identified target groups to address meaningful or contextualized needs. In some cases, finding beneficiaries becomes one of the primary hurdles to implementation of the project.[306] In some instances, rural communities have perceived little to no benefit from market development or entrepreneurship programmes, and lack interest.

Needs differ depending on the target group. Some large- and medium- sized enterprises, for instance, have found training or capacity-building exercises offered through PSD programmes to be of only marginal significance. PSD may not even be suitable at smaller enterprise level, where beneficiaries' needs may be more developmental in nature (basic livelihood for example). While this does not mean that such programmes are not important, for PSD to have greater impact and sustainability, communities should be seen more as participants than as passive beneficiaries. Overall, as a recent Sida programme evaluation points out, 'it is better to start with analysing the situation on the ground first and then developing the programme accordingly'.

### 5.3.7. Developmental mafia

As in all areas where developmental and reconstruction efforts take place, there exist in Afghanistan groups of individuals who capitalize on opportunities available for personal gain. As one local actor noted, siphoning off development aid has become a for-profit private sector endeavour of its own. Pop-up 'businesses' with no long-term prospects have sprung up to take advantage of grant money and there are male-owned enterprises purporting to be run by women in order to receive special benefits from donors. Local interlocutors such as heads of business support organizations, neighbourhood headmen, or other authorities who have more contact with donors, may claim to represent others, when in fact they are merely presenting their personal agendas.[309] Information asymmetries can also compound unequal access. Very careful assessment of actors, and finding ways to reach out directly to intended beneficiaries rather than middle-men can help in this regard.

However, during the information gathering process for this report, the authors also discovered examples of projects being deliberately sabotaged because they did not have the endorsement of local community leaders or power-holders. It is therefore important to obtain the approval of such individuals in certain contexts. Intervening in markets is not a neutral activity; it can impact social hierarchies, and resource and power configurations, either reinforcing pre-existing structures or subverting them. While donors should 'identify ways to provide access to resources that challenge existing inequalities', efforts should also be highly contextualized and sensitive to local realities.

### 5.3.8. Monitoring and evaluation

The endemic corruption, inefficiency and waste linked to the aid effort in Afghanistan is well known, although not always documented. Vigorous quality control of contractors and implementers, and evaluations of impact on target beneficiaries should be built into any programme's structure, While compiling this report the authors learned of multiple complaints of corruption levelled against developmental actors. Donors can hold the Afghan state to account on the basis of their metrics, but there are no mechanisms for local Afghan people to hold donors to account for their actions in Afghanistan.[311] Third-party or community-based monitoring could be important in this regard, although in the latter case communities may lack the capacity or technical knowledge to effectively monitor developmental projects. Programmatic 'success' is usually determined based on predetermined metrics. But a running theme in evaluation reports is that these metrics emphasize only outputs rather than outcomes or meaningful impact.[312] Indicators for what may be immaterial social returns may be difficult to develop or rigorously assess, but proper pre-intervention baseline assessments can be of use in this process.

## Methodology

### Background and research questions

This Swedish International Development Cooperation Agency (Sida) funded report is the product of a one-year scoping study on the state of the private sector in Afghanistan, and its nexus with traditional and human security. By examining impediments to the private sector this report seeks to provide input on future Afghan Government and international community initiatives to facilitate private sector growth. In this regard, special attention is paid to inclusivity of economic development. This report's findings are therefore likely to be of interest to any stakeholder in Afghanistan's reconstruction, security and (socio)economic development.
The aim of this study is to contribute to the existing body of knowledge on the Afghan private sector and on private sector development (PSD) initiatives in the country by attempting to collect evidence to answer four key questions:

I. What are the attributes of the private sector in Afghanistan?
II. Which institutions, either formal or informal, support or discourage a functioning and more inclusive private sector, and which are detrimental?

III. Can the private sector and PSD contribute to human and traditional security in the Afghan context and, if so, under what conditions?

IV. What efforts to develop the private sector should the Afghan
government and the international donor community prioritize for a more inclusive approach to private sector growth and how could this be achieved?

### Provinces selection rationale

To answer these questions the three authors conducted three data collection visits to Afghanistan visiting five provinces: Balkh, Bamiyan, Herat, Kabul, and Parwan. The rationale for choosing these five provinces was the following:
—Kabul, the country's capital is the nexus of the government and most international and national organizations, as well as top policy advisors and policymakers in the country. Kabul also best represents the center of the Afghanistan's economy.
—Balkh, with its connection to Central Asia through shared borders with Tajikistan and Uzbekistan, has been

relatively secure from insurgency since 2002. Mazar-e Sharif is the largest urban center and economic cluster in the north of the country.

—Herat, with its proximity to Iran, has traditionally been a hub of economic activity in Afghanistan, even during the Taliban's rule. It is a key center of agricultural activity and is the most significant economic cluster in the west of the country.
—Bamiyan and Parwan: while Nangarhar province in the east is an important economic center with economic connectivity to Pakistan through Jalalabad, current security dynamics in Nangarhar province affected the selection process, and Bamiyan and Parwan were chosen in lieu. Bamiyan is a relative secure area and therefore has potential for intra-province commercial activity. Historically, the international donor community and the central government have also largely overlooked it. Parwan connects Kabul to the north of the country and could potentially become a major centre of food production in central Afghanistan. Private sector conditions and PSD opportunities in these five provinces are shared in Annex 1.

**Approach**
In attempting to answer the four research questions a combination of desk and field research was applied. The authors deemed it vital to interact closely with private sector actors in Afghanistan and to assess in person key formal and informal institutions, and extra-market conditions that shape the broader private sector environment. This study is limited to licit formal and informal private sector activities: except where noted, use of the term 'private sector' denotes these sub-sectors. Collected data was primarily qualitative and was analysed through interpretive methods. The rationale behind this approach is that in Afghanistan's context quantitative sources provide an imperfect indication of elements that influence the private sector's development, such as political will, relations with (extended) neighbours and religious and cultural factors, but which are hard to quantify. Semi-structured face-to-face interviews were held with a wide array of respondents in all five provincial capitals and occasionally in locations outside of city borders; and a total of 12 thematic workshops were held, comprising 10 to 15 interlocutors at each of them. Workshops took place in all the provincial capitals, with the exception of Kabul. The authors interviewed 164 respondents during this stage of the data collection process. This group comprised male and female entrepreneurs and union representatives of all ages and from a wide range of industries. Most of the interviews took place at the aforementioned workshops. Local chambers of commerce (ACCI) selected the respondents in line with criteria set out by the authors. The authors visited 16 factories and workshops producing goods in a variety of sectors. The authors also held 83 other separate meetings in Afghanistan with interlocutors that included government officials, officials associated with or assigned to foreign diplomatic missions, development practitioners at non-governmental organizations (NGOs) and international organizations, scholars, companies, business support agencies, organized business, policy advisors and analysts. The authors conducted a further 23 interviews outside of Afghanistan, including in Sweden, the USA, and the United Arab Emirates.

**METHODOLOGY**

To ensure that the data collected was as comprehensive as possible, the authors also consulted actors involved in political, regional and security affairs. These interviewees were chosen on the basis of their institutions' impact on or involvement in the Afghan private sector.
All data from respondents was transcribed. Collected data was added to the first-hand observations made by the

authors in Afghanistan and desk research conducted in Stockholm. In addition, the authors reviewed and took due consideration of relevant literature on the economic development of Afghanistan and various aspects of the current state of the private sector landscape and PSD. A draft report, including recommendations, was circulated internally and externally for peer review.

**Limitations**

The selected methodology certainly has its limitations: the territory and population of the areas chosen are both considerable in size and although much data was collected, it also widened the authors' perspective. Taking into account the extensive scope of the study, a set list of questions was not feasible and questions were often tailored. The authors' visits to the provinces were generally limited to their capitals. Except for Kabul, which was visited on all three data collection trips, other cities were merely visited once for a number of days each. The geographic focus, length and frequency of these visits were too limited to collect comprehensive primary data on the particularities of the private sector in and beyond the five chosen provinces. These dynamics also limited the scope of interlocutors. The authors did not visit the neighbouring countries of Iran and Pakistan, both of which have a strong impact on the Afghan private sector and would have provided noteworthy impressions. The lack of reliable and up-to-date data has been an impediment, but this is a hurdle faced by anyone conducting research on Afghanistan. Finally, since this is a scoping study of the complex Afghan private sector— and consequently covers much ground—further research on identified impediments and recommended PSD approaches shared in this report is strongly endorsed, particularly on direct market interventions and their specific contexts.

## 6. Conclusions

Afghanistan's pre-1979 economy was predominantly informal, agrarian and subsistence-based. The state's capacity and reach beyond the country's largest urban clusters have always been inadequate. Thus, limited domestic integration, informal economic activity and the socially fragmented tribal nature of Afghan society have persisted. Starting from the 1980s foreign interference, protracted conflict and a weakening government apparatus contributed to the degeneration of the existing fragile social fabric and facilitated criminal economic activity. By 2001, most formal economic institutions and infrastructure had been destroyed, resulting in a very low baseline from which to begin post-intervention reconstruction efforts. The international community's intervention did not necessarily constitute a decisive break with past economic processes, patterns or players. Indeed, although Afghanistan has received substantial amounts of aid intended to bolster state-building efforts, the sudden introduction of a market economy to a country beset by ongoing conflict has in some cases exacerbated existing problems. Afghanistan's private sector is today a complex synthesis of informal, formal, reconstruction, war-related and illicit activities. Lines between these elements are not always distinct, and private sector opportunities and opportunism continue to fuel and be fueled by conflict. An inclusive free market is ideally characterized by equality of access by all to economic resources and opportunities, and a rule-based playing field that permits and encourages competition. Yet, in Afghanistan economic activity is strongly impacted by extra-market conditions. These affect the production capability and competitiveness of micro and small enterprises, which employ the majority of Afghans. Furthermore, they influence the employment and (formal) start-up opportunities of marginalized sections of the population. Limited employment opportunities in turn increase the attraction of illicit activities or the likelihood of radicalization: young men are at the highest risk. Private sector constraints also erode NUG legitimacy, thereby jeopardizing political stability and thus the country's security situation. Efforts by the state and international actors to foster inclusive economic growth have so far been limited. Large family-owned business conglomerates with political ties have disproportionally reaped profits in the growth process, while for the vast majority of Afghans economic conditions have not improved. Unaccommodating economic policies and weak regulatory enforcement have even allowed some neighbouring countries to profit from the Afghan market through unfair competition. Opportunities for the Afghan economy to connect with neighbouring and world markets are complicated by its landlocked position in a politicized and often toxic regional economic environment. The culmination of these forces and conditions, compounded by the triple transition, has created a precarious business climate. Unpredictability, a weak regulatory system and physical insecurity dampen both domestic and foreign investment. Indeed, the flow of capital in Afghanistan often ends in Dubai. In addition, the fragile fiscal regime leads to a lack of public services and goods, and it prevents the government from establishing an attractive climate for investment. This in turn deprives it from (growing) fiscal revenue that could be ploughed back into providing essential public services and goods. Critical infrastructure, fundamental to economic development, is still unreliable, inaccessible or completely missing in large parts of the country. While the macroeconomic environment has been relatively stable, there remains no clear strategy to support the private sector. This is despite early paper commitments from the Karzai administration and the international community that deemed the private sector to be the engine of economic growth and an instrument of social inclusion. In the absence of an overarching strategy that involved all stakeholders and addressed market failures on a structural level, a number of direct market interventions have distorted markets, fed into corruption and patronage networks, and even eroded government legitimacy. PSD efforts have also had limited success due to fragmented and uncoordinated approaches, lack of contextualized knowledge and inadequate consideration of sustainability or institutionalization.

**References:**

Loans issued by the bank were *sharia*-compliant. Bank profit was obtained from stamps that borrowers were required to purchase and attach to repayment receipts. Ford, R. S. 'The economy', eds R. F. Nyrop and D. M. Seekins, *Afghanistan Country Study* (The American University: Washington, DC, 1986), p. 143.

[2] These included lambskin pelts, fruits, grain, cotton and opium, which constituted 80-90% of Afghanistan's exports in the 1930s and 1940s. Ford (note 1), p. 144; and Barfield, T., *Afghanistan: A Cultural and Political History* (Princeton University Press: Princeton, 2010), p. 203.

In this report, the 'private sector' refers to a basic organizing principle of economic activity where private ownership is an important factor, where markets and competition drive production and where private initiative and risk taking set activities in motion—as based on the OECD's Development Assistance Committee's (DAC) guidelines. See e.g. Organisation for Economic Co-operation and Development (OECD), *Support of Private Sector Development*, Development Cooperation Guidelines Series (OECD: Paris, 1995).

[4] Ford (note 1), pp. 147-48.

[5] Nijssen, S., 'The Afghan economy: a brief history', NATO Civil-Military Fusion Centre, 14 Oct. 2010; and Ford (note 1), p. 174.

[6] Barfield (note 2), p. 204; Nijssen (note 5); and Ford (note 1), p. 174.

In 1977, Afghanistan only needed to import an estimated 2500 metric tons of wheat. Clarke, P., 'Food security in Afghanistan', *Afghanistan Outlook Dec. 1999*, UN Office for the Coordination of Humanitarian Affairs, 31 Dec. 1999, <http://reliefweb.int/report/afghanistan/afghanistan-outlook-dec-1999>.

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[16] A 1999 World Bank study conservatively put cross-border trade with Pakistan at $2.5 billion in 1996/1997, of which some 84% was estimated to be unofficial re-exports of transited goods back into Pakistan. Naqvi, Z. F., 'Afghanistan-Pakistan trade relations', World Bank, 1999, pp. 3, 6.

[17] Rashid, A., *Taliban: Islam, Oil and the New Great Game in Central Asia* (I.B. Tauris & Co Ltd: London, 2002), p. 120.

[18] Although the farmers 'received less than 1 per cent of the total profits generated' in the overall process, according to the UN International Drug Control Programme. Rashid (note17).

[19] Favre, R.,'Exploring the roots of opium and illicit economy in Afghanistan', AIZON Report, Nov. 2005, p. 24.

[20] UN Office on Drugs and Crime (UNODC), *2004 World Drug Report, Volume 1 Analysis* (UNODC: New York, 2004). However, this was primarily concentrated in two provinces (Helmand and Nangarhar), which accounted for around 0% of the country's opium production between 1994 and 2000. Favre (note 19), p. 33. [21] It is notable that when the Taliban leader Mullah Omar declared opium growing un-Islamic' in 2000, output decreased by 95% the next year. This was reflective of how much effective control the Taliban had in the Afghan countryside. By the 2006, opium production had spread to nearly all the provinces of Afghanistan.