



Kauffman Foundation Research Series:  
Expeditionary Economics

## **Bactrian Gold: Challenges and Hope for Private-Sector Development in Afghanistan**

February 2011

Jake Cusack and Erik Malmstrom  
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## I. Introduction

Headlines paint a bleak picture of Afghanistan. Among a host of seemingly intractable problems, the country faces rising insecurity, endemic corruption, and a struggling international effort. Many see significant cause for concern and little reason for hope. Yet as the United States, its NATO allies, and its partners in Afghanistan grapple to build a foundation for that country's long-term stability, there is potential for positive change within an area often neglected in the public discourse: the private sector.

During last year's review of U.S. policy in Afghanistan, the debate centered on the merits of a counterterrorism (CT) relative to a counterinsurgency (COIN) strategy. CT proponents emphasized the use of military force to disrupt, dismantle, and defeat Al-Qaeda in Afghanistan and Pakistan. In contrast, COIN advocates placed greater emphasis on political, diplomatic, and economic elements of power. Underlying this debate were questions surrounding the efficacy and utility of nonmilitary levers of U.S. power in Afghanistan.<sup>1</sup>

While the relationship between economic growth and security is complex, private-sector development undoubtedly will be critical to the long-term viability of the Afghan state.<sup>2</sup> By capitalizing on opportunities ranging from agriculture and mining to manufacturing and services, business growth can provide desperately needed tax revenue to a country that receives more U.S. official development assistance than any other country in the world.<sup>3</sup> It also can drive job creation and income growth for a population that is concerned as much about unemployment and poverty as security.<sup>4</sup>

In the post-Taliban era, efforts to develop Afghanistan's private sector have been inadequate. From an extremely low baseline after decades of war, Afghanistan's gross domestic product (GDP) has more than tripled in less than a decade. Afghanistan also has made progress building critical infrastructure, such as road and telecommunication networks, and in providing basic services, such as health care and education.<sup>5</sup> Despite these gains, in 2010, the country derived 40 percent of GDP from official development assistance, registered



### Case Study: Zarang Motorcycles

Before examining the different factors complicating the business landscape, it is worth emphasizing a baseline research finding that may surprise readers: despite western perception of Afghanistan as an economic wasteland, our research revealed businesses functioning and even thriving, albeit in a highly distorted environment.<sup>16</sup> Beyond Roshan Telecom and Moby Group—which have powered the robust telecommunications and media sectors—and other nationally notable companies, regional small and medium-sized enterprises (SMEs) have identified entrepreneurial opportunities and created profitable firms.<sup>17</sup> In Afghanistan, as in other conflict zones, the indigenous population responds rationally to economic incentives so long as violence remains below a certain threshold.

Entrepreneurship does not have to be invented in Afghanistan. Even in childhood, Afghan businesswoman Hassina Sherjan explained, "Afghan boys are buying here

an annual trade deficit of more than \$4 billion, and ranked at the bottom of the World Bank's *Ease of Doing Business* index in most categories.<sup>6</sup> All too often, aid dollars have benefitted foreign contractors and Afghan elites at the expense of the population.

Disproportionate attention to military and political lines of operation relative to economic considerations is culpable for this situation.<sup>7</sup> Even within the economic realm, private-sector development has been a second-tier priority, as direct support for business development has represented a very small share of U.S. assistance to Afghanistan.<sup>8</sup>

In response, critics have challenged the international community's approach to economic development in Afghanistan. In turn, they have advocated a model that emphasizes private-sector growth driven by entrepreneurship. According to this line of thinking, entrepreneurship can be an engine of growth, jobs, goods, services, and tax revenue, while growing "a class of people with a vested interest in stability and order."<sup>9</sup>

In order for entrepreneurship to take root in Afghanistan and other post-conflict societies, proponents emphasize the need for a number of fundamental shifts: accepting capitalism even when it appears chaotic; encouraging economic activity outside of the government's and international community's control; valuing dynamism in development rather than mere stability; involving successful entrepreneurs and investors in economic planning; and treating economic growth as an integral, not secondary, goal of stabilization and reconstruction strategy.<sup>10</sup> Centralized, heavy-handed government planning and activity can have a greater marginal impact in poor countries than in advanced economies, but should not be seen as the only or even the best option.<sup>11</sup>

This work builds on related studies of entrepreneurship in the developing world, which show that the incidence of entrepreneurship is twice as high in emerging markets as in the developed world.<sup>12</sup> They cite talent migration, a pent-up supply of entrepreneurs, and lower seed-capital requirements as key drivers of these trends. Moreover, they emphasize the role that

for a low price and selling over there for a higher price." Despite a general lack of formal education, many Afghan businessmen are smart and adaptable, an Afghan banker in Kabul explained: "They have their entire business in their head: accounts receivable, distribution channels; their laptop is a tiny notebook in their shirt pocket ... they need help for things like writing an e-mail to a distributor in Germany or writing a proposal—but they have the street smarts to get a container through Karachi or distribute their product to Kandahar." Moreover, Afghans often imitate businesses after seeing one company become successful—which has led, for example, to unusual growth in the plastic sandal and beverage sectors.

The Zarang Motorcycle Company, for example, might defy typical western expectations of what Afghans—even those with nothing beyond a high school education—are capable of achieving. Based in Herat, the family initially imported motorcycles from China. Observing the good

market, they decided to begin assembling their own lines of three-wheeled "rickshaws" that could be used for transport. Lacking the requisite human capital, they sent one of the family brothers to China, where he videotaped and photographed the assembly process, and subsequently returned to teach a select group of mechanics. They have grown from fifteen employees in 2005 to 200 workers in 2010, with branches across the country. They spend \$30,000 or more on advertising each year, with a nuanced marketing strategy that includes local "celebrity" promotions, lottery giveaways, promotional calendars printed in Dubai, and billboards. Despite the many imitator motorcycle assemblers who have sprung up, they focus on quality branding and continue to turn a profit. Their motorcycles can be seen throughout Afghanistan in such places as Herat, Kandahar, and Mazar. They recently purchased new land and are building a factory to start fabricating their own parts.

these companies play in generating jobs, income, and wealth, creating industries, satisfying domestic demand, and opening export markets.<sup>13</sup>

To inform the debate about how best to develop Afghanistan’s private sector, the authors of this report conducted more than 130 interviews with businesses and economic stakeholders in the Afghan cities of Kabul, Kandahar, Jalalabad, Mazar-e-Sharif and Herat. To better gain perspective from the people who matter most—the Afghans themselves—we traveled without security and maintained no organizational affiliation. Our goal was to understand the narratives, challenges, and opportunities of Afghan businesses in order to inform a more effective strategy to empower them. Our study aims to complement quantitative business surveys conducted by the World Bank and the Center for International Private Enterprise (CIPE) with qualitative research.<sup>14</sup> Our desire to conduct this study stems from our experience as combat veterans of Afghanistan and Iraq, where we saw firsthand the importance of investing in the long-term economic growth and human potential of those societies.

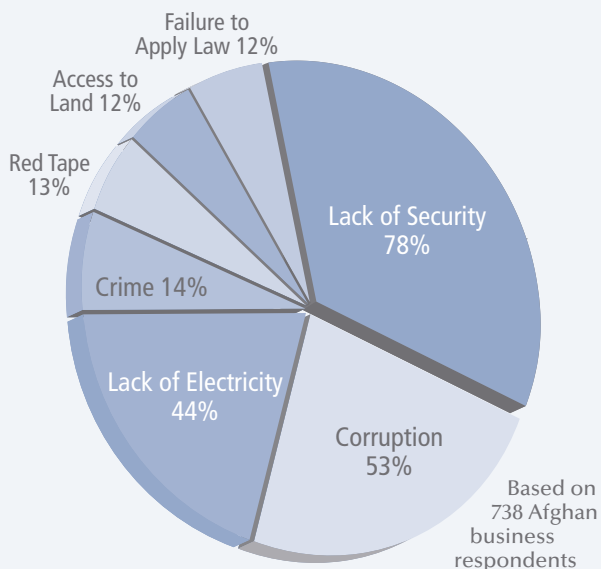
We argue that there is tremendous potential to nurture a vibrant private sector in Afghanistan.

In order to realize this potential, the Afghan government must address key obstacles to business growth, principally security, corruption, access to capital, infrastructure, and policies, rules, and regulations. Meanwhile, the international community must support the Afghan government in these efforts while reforming several components of its own efforts relating to its leadership, human capital, accountability, sector prioritization, and time horizons. While the substance of this report is broadly echoed in our November 2010 policy brief published by the Center for a New American Security (CNAS), we undertake a more thorough examination here.<sup>15</sup>

Section II addresses the implications of key obstacles to Afghan businesses. Section III highlights strategies that Afghan businesses implement to adapt to this highly distorted environment. Section IV examines five sectors of the economy through specific company profiles. The final section provides recommendations for those attempting to enable private sector development in Afghanistan.

It is necessary to establish what this paper will not do. Although we interviewed donors and officials from the U.S. Agency for International

CIPE Survey: Percentage of firms citing factor as one of “top three” barriers to growth



### CIPE and World Bank Business Surveys

CIPE’s survey of 738 Afghan businesses in early 2010 asked respondents to name the three factors that most adversely affected the growth of the Afghan business sector. “The top response was lack of security (mentioned by 78 percent), followed by corruption (53 percent) and lack of electricity (44 percent). No other factors were mentioned by more than 15 percent of respondents. The following answers were in double figures: crime (14 percent), red tape (13 percent), access to land (12 percent), and failure to apply the law (12 percent). Electricity shortages were the top concern in both Jalalabad and Kandahar; there were no other major geographic differences. Manufacturing companies, for understandable reasons, were more concerned about electricity (52 percent) than corruption (40 percent). By comparison, construction, services, and retail placed more emphasis on corruption.”

Development (USAID) in every major region of the country, we do not provide a comprehensive evaluation of international programs. Rather, we describe their most salient shortcomings and successes as identified by international development officers and Afghans themselves. Additionally, we draw on extensive work by many before us in writing about these issues. It is our hope that our recommendations lead to a renewed focus on private-sector development in Afghanistan.

## II. The Business Landscape of Afghanistan

The business environment of Afghanistan is not entirely unrecognizable. Problems similar to those in other developing countries or conflict zones coexist with the unique difficulties of Afghanistan. In this section, we frame our research observations within the context of five key problems described in enterprise surveys by CIPE and World Bank (see sidebar). Behind these headline issues—insecurity, corruption, infrastructure, access to capital, and policy complaints—we hope to provide texture from business owners and ground-level development

officials. In each sub-section, we provide a brief overview of each business constraint before delving into our research observations. In the final sub-section, we identify several ways in which the international community has hindered its well-intentioned efforts to address these problems.

### Key Problem: Insecurity

Most media coverage of Afghanistan focuses on rising violence, and elevated troop levels and activity. 2010 was the deadliest year ever for coalition troops, and overall violence was up threefold relative to 2007.<sup>18</sup> Businesses interviewed in the CIPE survey cited “insecurity” as their top concern. While the common western interpretation is that insecurity renders business impossible, the reality is more complex.

### Research Observations

**Despite increasing violence, business continues.** As of fall 2010, levels of violence in Afghanistan’s economic centers remained low enough that a semblance of normal life went on and markets continued to function. Even in Kandahar, the country’s most violent city by casualty rate, factories and glass office buildings remained open, although sparsely. This does not discount the possibility that escalating violence could result in a situation where civil society ceases to function in certain areas. Trend lines are not encouraging: the United Nations Assistance Mission Afghanistan (UNAMA) reported rising Afghan civilian casualties in the first half of 2010, despite more stringent U.S. rules of engagement.<sup>19</sup> The August 2010 murder of ten medical workers in the Badakhshan Province, one of the safest in Afghanistan, was troubling because low-profile aid workers were previously rarely targeted. As Taliban expert Michael Semple noted, it demonstrated the potential rise of “conflict entrepreneurs [who] adopt the mantle of government or opposition, to prey upon the civilian population or economic activity. Whether driven by zealotry or profit, fighters can engage in the ultimate anti-social activity of massacring health workers, free from the restraint of social norms, government law or Taliban discipline.”<sup>20</sup>

The World Bank’s “Afghanistan Investment Climate in 2008” Enterprise Survey of 1,066 firms asked respondents to rate severe constraints to their businesses. They most frequently named: policy enforcement; electricity; crime, theft, and disorder; corruption; access to land; and access to finance. The top constraint of “policy enforcement” was defined as “state ineffectiveness in designing and implementing consistent policies.” Beyond the top six, other issues included telecommunications, tax rates, inadequately educated workforce, regulation (custom, trade, labor, licensing, and permits), and the courts. Notably, when asked a similar, but differently phrased question—to name the single biggest obstacle to their particular business—respondents focused on their inability to acquire key resources, most often referring to problems accessing capital, electricity, and land.

However, according to resident U.S. officials and Afghans, many western companies and other outsiders overestimate security risks and avoid even safe areas of the country. The steady diet of media reports on violent actions dominates their consciousness. Turkish, Chinese, and Lebanese investors have seized business opportunities after doing more specific risk assessments of particular regions and sectors.<sup>21</sup> If westerners travel and act in a low-profile manner, they find that operating in cities such as Herat, Kabul, and Mazar can be reasonably safe.

Sadat Naderi, the chairman of Afghanistan's first insurance company, explained how he had been able to lower the average annual property premiums he received from underwriter Lloyd's of London from 10 percent to less than 1 percent over the last several years: "The small amount of claims has shown that market risk is not as portrayed." Covering 34 provinces, Naderi mitigates risk by tailoring risk premiums to each district in which he operates.

**Insecurity complicates development of infrastructure, transportation, and other critical areas.** Insecurity exacerbates many factors vital to economic growth. For instance, in order to cope with inadequate human capital, companies bring in technical/managerial talent from Pakistan, India, and European countries. As the perceived security situation worsens, outsiders become unwilling or unable to enter Afghanistan. An Afghan beverage manufacturer near Kandahar found that when complex equipment failed, he was unable to bring in foreign technical engineers to fix the problem. Roshan Telecom, the largest telecommunications company in Afghanistan, has found that one out of four westerners it recruits drops out due to safety concerns—even though the relevant jobs are not dangerous.

Efforts to improve infrastructure also can be derailed by security complaints, sometimes with legitimate reason, sometimes not. An American nongovernmental organization (NGO) worker said, "Sometimes security can be an excuse for not doing hard things." In such an environment, it may be too easy to blame unrelated failures on security or "incompetent and corrupt" Afghans, and too difficult for a Washington-based supervisor to question.

Poor infrastructure and security issues make transportation costs a significant constraint. Several Afghan business people noted that transporting a standard shipping container from the United States to Karachi (Pakistan) can cost roughly the same as it does to move that container from Karachi to Kabul. A senior U.S. development official stated that the primary impact of conflict is "driving the cost of transportation up, cutting business[es] off from their raw materials, marketplace, or both." Transportation options are also crowded out: "domestic freight is taken up by internationals; airfields are monopolized."

**Coalition-affiliated businesses are often most impacted by insecurity.** Physical security is a central challenge for certain businesses. Insurgents often target businesses known to work with international forces. Security issues along major roads, usually bribes paid for passage, impair access to raw materials and access to markets for businesses, particularly in the South, and for rural farmers bringing their goods to urban areas. Many high-profile businessmen fear kidnapping, so they avoid travel to branch sites and remove their families from the country.

The Taliban's choice of targets is nuanced. The owner of the Herat-based drink manufacturer, SuperCola, recounted one of his trucks being stopped on the road to Kandahar. Eventually, the Taliban hijackers released the truck because "they had decided that SuperCola was only sold to Afghans, and not to the United Nations or military." Another manufacturer in Kandahar noted that his large shipments of bottled water were specifically targeted, because the "Taliban said only foreigners drink lots of bottled water."

**Insecurity creates rent-seeking opportunities.** The conflict has forced international actors to allow and even encourage warlords who can provide protection. In some areas, warlords are seen as a "necessary nuisance," who at least can provide reliable help and some degree of order. This, in turn, creates an environment where such power brokers engage in rent-seeking behavior, making money by charging exorbitant fees for access to basic resources such as gravel. The most ambitious warlords stage attacks in order to prove that their security services are necessary.<sup>22</sup>



**Uncertainty, rather than physical insecurity, is the central problem.** Physical insecurity exacerbates existing problems and creates new challenges. However, it does not determine business outcomes in Afghanistan by itself. Even in dangerous circumstances, people respond to economic incentives in rational ways. Uncertainty, which refers not only to physical security but also to the lack of predictability concerning the current government, foreign involvement, infrastructure, policies, regulations, and a host of other factors, is the primary challenge for Afghan businesses.

In the CIPE survey of Afghanistan’s business climate, Afghans put “insecurity” at the top of their constraint lists.<sup>23</sup> But in detailed discussions with dozens of business owners, this concern was not primarily about actual physical and personal security for the specific individual or business. Instead, their concerns referred to the overall instability that fueled an unpredictable environment. Even in Kandahar, considered one of the most dangerous urban areas of the country, businesses highlighted uncertainty about the quality and timing of the power supply, about supplies flowing in through border crossing at Spin Boldak (between Afghanistan and Pakistan), about the local/national government, about financing, and about the sanctity of obligations should political power shift, rather than questions of physical security.

As in the rest of the world, markets hate uncertainty. Over and over again, businessmen complained that the tax structure, custom tariffs, local power brokers, American force posture and policies, and personalities in government were in constant flux. Two owners of newly created manufacturing companies said they were given seven-year tax break guarantees by the minister of finance, only to see them rescinded by the next minister who replaced him.

Uncertain risks pose greater challenges than large well-known obstacles. With a known constraint, businesses adapt or hedge by shifting operations, becoming more liquid, or buying protection. If security is an issue, the business can budget for it—the price of security guards or a bribe to local actors is simply a “tax” on business. As Jahid Mohseni, CEO of Moby Media said, “The problem for business is not the variables [security,

corruption] themselves, but the variability of the variables.”

## Key Problem: Corruption

Corruption is ubiquitous throughout Afghanistan. In the last several years, highly publicized incidents have highlighted this issue, including alleged fraud in the 2009 presidential elections, the near-collapse of Kabul Bank on charges of irregularities and related party lending, and dubious reversals of indictments against corrupt officials.<sup>24</sup> A United Nations Office of Drugs and Crime study published in 2010 reported that Afghan citizens viewed public dishonesty as a bigger problem than insecurity or unemployment, and found that total bribe payments were equivalent to 23 percent of Afghanistan’s GDP.<sup>25</sup> Moreover, corruption has extended beyond requested financial bribes, to include favoritism and nepotism in the dispersal of aid supplies, locations of infrastructure projects, and enforcement of regulations.<sup>26</sup> A 2009 Integrity Watch Afghanistan survey of 6,500 Afghans found that corruption was perceived as simply “a normal way of doing business with the state.”<sup>27</sup>

“On the radar” businesses—generally bigger firms dealing with government contracts—are more likely to face corruption problems.<sup>28</sup> For example, large firms in the World Bank survey ranked corruption their fourth-biggest constraint; as opposed to small and micro ones, who dropped it to sixth. Notably, construction companies ranked corruption second only to policy enforcement as their biggest concern.

Over the last year, U.S. policymakers have devoted increased attention to corruption surrounding international aid dollars in the wake of press reports of millions of dollars leaving Afghanistan daily and a Congressional report detailing the flow of U.S. money to Taliban parties via contractors.<sup>29</sup> To some degree, this problem is understandable—in a conflict environment, there will be “casualties” in attempting to efficiently allocate and spend financial resources.<sup>30</sup> But the rapid spending of large sums of money in small Afghan districts, without regard to their absorptive capacity, makes waste inevitable. Oversight of spending is made more difficult by the quick

rotations of contracting officers and security constraints that often impede field verification. In condemning corruption, the international community must acknowledge that their own practices have contributed to the problem.



Sewing machines at Tarsian & Blinkley, a primary manufacturer of Afghan military uniforms, located just outside of Kabul. (Jake Cusack)

### Research Observations

**Weak Afghan institutions and crony capitalism hinder entrepreneurship.** Weak institutions create an environment where only the well connected can thrive. Government postings, because of their connections, provide access to international contracts and opportunities for extortion. These positions are seen as potentially more lucrative than other business ventures. Some Afghans enter government to enable personal business ventures, occasionally “buying” certain posts. Others simply co-opt officials who can steer money to family enterprises tailored to match the international donor “flavor of the month.” A large portion of the lucrative Host Nation Trucking contract happens to go to the defense minister’s son; a sudden change in import regulations benefits a ministerial official’s brother who already has his supplies inside the country.<sup>31</sup>

Many businesses in urban areas view the government as both weak and malignant. It is not strong enough to protect or guarantee private property rights, yet it still wields enough power to make things very difficult for the disfavored or very easy for the connected. In such a landscape,

Afghans struggle to find powerful personal allies before having the confidence to invest in large visible businesses.

In an interview, Dr. Ashraf Ghani, noted academic and Afghanistan’s former minister of finance, described two possible thought processes for the government: a parasitical approach where it seeks only to extract revenue and prey on success, or conversely, a model where profit is recognized as legitimate and economies grow in partnership with individuals and firms. “Right now,” he said, “the regulatory environment is such that there is no certainty as to which of these states actually exists.” Other businessmen noted that high-ranking government officials closed off lucrative sectors through onerous regulations that protected their own entry into these markets.

In an interview in Kandahar, Mahmoud Karzai, a prominent businessman and the Afghan president’s brother, accused the government and ministers of seeing the private sector as a rival. “In some ways,” he said, “they are right, because an enabled private sector would eliminate the profit from their back door deals ... they only entered government to get contracts.” Such vehement criticism of the government is interesting given that many have accused Mahmoud of personally benefiting from powerful connections himself.<sup>32</sup>

**International money and practices can fuel corruption.** Rapid turnover of international personnel hinders the institutional memory of donor agencies, particularly regarding development spending and business contracting. Villains of one time period become saviors two years later; malicious Afghans are able to run the same scams again and again. One Afghan businessman complained that contract officers rarely take the time to complete due diligence. Attempts to consolidate information on contractor performance and long-term history have been sporadic and disjointed. Security constraints keep contract officers from visiting businesses and clients in the field, and there is a tendency to favor English-speaking and/or returnee ‘favorites’ regardless of their business acumen.

As of August 2010, some contracting commands had begun to establish a database of “good” and “bad” contractors and contracting

processes consistent with counterinsurgency doctrine. In a similar vein, General Petraeus commissioned “Task Force 2010” specifically to deal with contractor corruption, and issued new guidelines for military contract oversight.<sup>33</sup>

**Westerners are susceptible to corruption as well.** Some westerners take advantage of chaotic conditions and powerful connections to escape accountability, reap windfall profits, and fail to pay Afghan subcontractors. This summer, a local Afghan contractor in Kandahar never received payment from a British contractor and was subsequently beheaded by his own creditors.<sup>34</sup> Another common problem is misrepresentation. For example, contractors with access to western bases rebrand another business’s brochures as their own, sell a service, and take a huge cut as the middleman.

Not all foreigners working with local businesses act in the Afghan’s best interest, and implementing partners may be too willing to encourage flawed projects in order to preserve their own contracts. Mustafa Kazem, head of the Afghan Growth Fund, describes one consequence of “free money” and funding of projects that lack commercial viability:

“In an effort to promote private sector development, on occasion, donors have provided grant funding to private businesses that lack the management capacity and financial resources to operate in a sustainable manner. Often times, the grant provider decides what sector and type of business it wants to fund, writes the business plan, and then seeks an Afghan partner to implement the project. The success of this approach is limited and short term, as most of these businesses can not operate effectively beyond the grant or project assistance period. Furthermore, this approach of offering “free money” to Afghan businesses competes with financial services firms that are providing long term market appropriate capital.”

Liz Vallette at Peace Dividend Trust noted that several savvy international contractors are attempting to leverage the US Mission’s Afghan First local procurement mandate by making themselves “look Afghan,” in order to compete for contracts set aside for Afghan-owned companies.<sup>35</sup> In response, PDT dispatches Afghan employees to verify that businesses are Afghan-owned and

operated before adding them to its local supplier directory.

**Corruption adversely impacts business.**

Corruption is an added cost of doing business and barrier to attempted reforms. Beyond large-scale corruption, Afghan businesses note a micro level of government inefficiencies: frequent complaints about “intentional nonsense” for visa requirements, customs problems, company renewal, and the frustration of attempting to get any single piece of paperwork through Kabul. One businessman noted that every signature required for a document is seen as an opportunity by government officials to get an “expediting fee.”

In an interview, a high-level Afghan government official argued that some corruption is rooted in outdated, unclear, or poorly implemented regulation. Some laws have been reformed, but their translation into specific regulation is inconsistent. For example, a USAID development officer noted, the law might say that a municipality must issue a construction permit—but then the municipality might require between one and 100 steps to get the permit. Businesses lack a clear sense of their rights and obligations in relation to the government.

Because 85 percent of the Afghan economy is informal, the government hopes to widen its tax base.<sup>36</sup> But informal businesses (unlicensed/untaxed), one senior Afghan official explained, are afraid to show up in the system. The government fails to incentivize Afghan businesses to join formal economy. It can take six months to clear taxes in some cases. Moreover, being in the formal economy does not ease barriers to credit. According to Suleman Fatimie, CEO of the Harakat: “The security will heal; corruption is the major problem. So many companies are operating below the radar, public power is seen to be used for their own benefit.”<sup>37</sup>

**Drug trade reinforces corruption.** The Afghan drug trade is closely intertwined with corruption. Opium production is a large component of Afghanistan’s GDP and central to the economy of several provinces, particularly in the South. Some of the deposit growth in Kabul banks is allegedly fueled by laundering of drug money. While examining the drug trade is outside of the scope of

a paper on sustainable business, a relevant sidenote is that much of the appeal of poppy to farmers might be process rather than price.

As Navy Lieutenant Tim Graczewski, military advisor for economic development in the South, noted: “It is a Dell model. There is allure to farmers in having something that can be distilled to a portable product and picked up at your front gate for hard cash.” To get other licit crops to market, such as pomegranates, substantial infrastructure still must be developed. Goods have to be transported over unsecure or inadequate roads (requiring bribes), stored in generally nonexistent cold storage facilities, and eventually delivered for an uncertain price to markets that may be too far away to make delivery practical.

## Key Problem: Access to Capital

The banking sector has experienced strong growth since 2001, with seventeen commercial banks in Afghanistan holding \$2.6 billion in assets as of 2010.<sup>38</sup> However, only 3 percent of Afghan individuals have bank accounts, and an estimated \$3 billion of Afghanistan residents’ wealth remains outside the banking system.<sup>39</sup> Deposits also greatly exceed loans, with a loan-to-deposit ratio below 50 percent. The banking system as a whole has not inspired confidence—most recently, Kabul Bank, the largest Afghan bank which held one-third of all Afghanistan deposits, almost exhausted its liquidity when reports of irregularities and fraud triggered a run.<sup>40</sup>

Insufficient access to capital is a common complaint of Afghan businesses. In the World Bank Enterprise Survey, business owners note this as the single biggest constraint to their own firm.<sup>41</sup> The CIPE survey found that only 6 percent of businesses had received bank loans, instead relying on business profits or loans from friends to finance their business. The World Bank ranks Afghanistan 127th of 183 countries for obtaining credit, and dead last for protecting investors. Access to capital is worse outside of Kabul: unpublished donor studies viewed by the authors pointed to minimal lending to small and medium enterprises (SMEs) beyond the capital region.

## Research Observations

**The average business owner has limited options to access capital.** In our interviews, small firms to large multisector conglomerates identified access to capital as a major constraint to growth. A “missing middle” exists in credit markets: microcredit up to \$2,000, and large-scale funding for infrastructure projects is available, but there is little in between. Bank owners often use funds as lines of credit for personal businesses—credit is not available to average firms.<sup>42</sup> A well-connected businessman’s personal relationships with the management of a bank can help him win loans up to \$100 million with few strings attached.<sup>43</sup> The rescue of Kabul Bank from near collapse by powerful government allies is symptomatic of a poorly regulated banking sector that lends to related parties.<sup>44</sup>

**Applications for loans often are of poor quality.** Deeper problems belie access to capital for Afghan businesses. Mustafa Kazem, who manages the \$55 million Afghan Growth Fund that invests in Afghan businesses, explained that he received many applications that lack necessary information and do not include adequate business planning, “We have to provide significant pre-investment support to applicants. We spend a lot of time helping the client update its business plan, draft financial statements and projections, and perform feasibility analysis.”

Afghan businesses’ lack of audited financial statements and inability put a business plan on paper are major problems. Khalil Sediq, head of the Afghanistan International Bank, described how it could take forty days to approve or deny a small loan because the owners could not provide documentation and had to be walked through each step. In other cases, owners are reluctant to share information because they are afraid financials will leak to either competitors or the government and lead to more taxes. They worry, with good reason, that if outsiders learn that they are making a profit, criminals may kidnap family members for ransom; the government may try to extract additional revenue; donors may withdraw support; or family members may try to launch a copycat business. Mr. Sediq noted that because of the paucity of information, banks conduct “ancient

trust-type banking in a western model bank," seeking out other colleagues to provide reputation recommendations.

**Collateral and dispute resolution mechanisms are lacking.** Other systematic problems impair access to credit. Less than half of land is legally registered and is not trusted as collateral.<sup>45</sup> In Herat Industrial Park, businesses have been in place for over three years without acquiring an official deed to be used for credit.<sup>46</sup> Credit scores do not exist. Attempts to provide credit or collateral registries are in their infancy and do not provide assurances that a borrower has not already taken out multiple loans.

Afghanistan ranks dead last in the world for "protecting investors" and "closing a business" in the World Bank's 2009 Doing Business report. Businessmen consider the judiciary to be "corrupt to the core," and have no faith that their interests will be protected if a contract is not honored or a business collapses. The head of one major bank noted that debtors will simply pay small bribes to relevant judges in order to stall attempts to collect collateral.

**Islamic beliefs impact financial practices.** Conservative Afghan businessmen in rural regions and even more progressive "western" Muslim investors in Afghanistan stressed the importance of Islamic principles against interest and instead emphasized respect for the Islamic *musharaka*, *mudaraba*, and *ijara* (venture capital, partnership, and leasing models). However, some Afghan businessmen interviewed argued that this aversion to interest-bearing loans stemmed from common 25 percent interest rates and 200 percent collateral requirements rather than from religious principles.

## Key Problem: Infrastructure and Human Capital

In some respects, industrial infrastructure in Afghanistan has improved dramatically in the past decade. Thousands of miles of new roads connect Afghan commercial centers; several private airlines fly between Afghan cities, neighboring countries, the Persian Gulf, and Europe; and an estimated 12 million Afghan have mobile telephone subscriptions. However, major challenges persist. While total electricity capacity has increased fourfold since 2002, still only 15 percent of

households in urban areas and 6 percent of those in rural areas have access to electricity. Only an estimated 23 percent of Afghans have access to safe drinking water and 12 percent to adequate sanitation.<sup>47</sup>

However, the Afghan business community's perception of the country's industrial infrastructure remains low. Based on CIPE's business survey, 23 percent of businesses were dissatisfied with local roads and 14 percent said there were no roads in their area. Twenty-three percent of businesses were dissatisfied with local electricity and 43 percent said there was no electricity in their area. Four percent of businesses were dissatisfied with local water supply and 72 percent said there was no water supply in their area.<sup>48</sup>



Window frame manufacturer in Mazar-e-Sharif.  
(Erik Malmstrom)

**Insufficient supply and high cost of electricity constrain manufacturing.** Based on our interviews, Afghan industrialists cited the supply and cost of electricity as a top concern. Outside of Kabul, Mazar-e-Sharif, and Herat, the lack of reliable electricity makes many power-intensive ventures prohibitive. A Nangarhar businessman explained his predicament: "I use fourteen hours of power per day, three hours of electricity at six Afghani (approximately \$0.13) per hour and eleven hours of diesel generators at forty-five Afghani (approximately \$1) per hour." Running diesel-powered generators was as much as five to ten times more costly than grid electricity, constraining growth and eroding profit margins.

### **Transportation networks are deficient.**

Poor road networks reduced the efficiency and effectiveness of the Afghan businesses interviewed. In remote and rugged regions, agricultural and mining enterprises were particularly hard-hit. One farmer explained that poor roads did not just impair his access to markets—roads were so bumpy that traveling on them destroyed the quality of his agricultural goods. Poor road networks also caused the country to miss opportunities to develop domestic trade linkages. Border economies were more oriented on neighboring countries than on neighboring provinces. The international focus of major transportation projects sometimes reinforced these disparities. For example, rail initiatives between Herat and Iran and Mazar-e-Sharif and Uzbekistan have taken precedence over domestic rail projects. The limited interconnectedness of Afghanistan's domestic market and its consequences for the country's development has alarmed the U.S. Department of Defense's Task Force for Business and Stability Operations (TFBSO).<sup>49</sup>

**Human capital is underdeveloped.** Afghan businessmen identified the lack of local skilled labor as a major constraint. Dr. Mohammad Jalil Shams, Director of the National Electricity Authority, noted, "We are not Germany after World War II—with an educated class who is ready when the capital comes." Only 26 percent of the population is literate.<sup>50</sup> An Afghan banker added, "It's going to get worse before it gets better." He explained that the current "elite" class was generally educated before the Russian invasion and subsequent wars; since then there has been a twenty-year gap in Afghan education. Many businessmen complained of the insufficient supply of architects, engineers, managers, plumbers, and electricians. Frequently, those remaining in Afghanistan work high-paying jobs for international companies and donors, not for Afghan companies.

Similarly, we found that a lack of education and experience limits some Afghan entrepreneurs who cannot grow their business beyond what they contain in their head or a simple notebook. Moreover, some are reluctant to hire administrative staff or delegate significant responsibility outside their family.

### **Key Problem: Policies, Rules, and Regulations**

The Afghan National Development Strategy (ANDS), the country's private-sector blueprint, consists of three main components:

#### **1. Strengthening the enabling environment**

Key items include providing a stable macroeconomic environment and supportive financial system; attracting private investment; enacting and implementing commercial legislation to encourage private-sector involvement in social and economic development; ensuring that ministries and agencies are able to competently administer commercial laws and regulations in an unbiased and predictable manner; continuing privatization and corporatization of state-owned enterprises; improving private-sector access to finance; maintaining a pro-trade environment; providing firm-level technical assistance; and introducing trade facilitation measures to reduce the cost of moving goods

#### **2. Expanding opportunities for private investment in infrastructure and natural resources development**

Key items include establishing a multisector regulatory authority; developing opportunities for public-private partnerships in infrastructure projects; encouraging private provision of public services; and developing and promoting private investment opportunities through a concerted effort by the entire government.

#### **3. Concerted private-sector investment promotion**

Key items include promoting investment from domestic and foreign sources, including Afghan diaspora; making the Afghanistan Investment Support Agency (AISA) a central player in this process; making the responsibility for promoting increased investment a government-wide task and an integral part of all projects and programs undertaken as part of the ANDS; and educating potential investors on the opportunities available in Afghanistan, assuring them that the Afghan government recognizes the importance of increased private investment and that their investments will not fail due to unpredictable

and unfavorable changes in the tax environment or policies toward private investors.<sup>51</sup>

Despite this ANDS framework, Afghan businesses believe that many government policies impede growth. When Afghan businesses were asked to name three issues that should be among the government's highest priorities in order to promote economic growth and a strong private sector in the CIPE business survey, top responses included policy items such as reform of customs procedures and duties (59 percent), reducing unfair competition due to government officials giving preferential treatment to relatives (57 percent), facilitation in issuance of business and trade visas (42 percent), finding conducive transit routes to increase imports and exports (36 percent), reducing unfair competition from the informal sector (32 percent), providing accessible credit with reasonable interest rates (27 percent), and simplifying burdensome government regulations (24 percent).<sup>52</sup>

These results indicate that the Afghan government has a long way to go in realizing the goals set forth in the ANDS, as some elements within the business community view the country's commercial policy as cumbersome, unevenly applied, and harmful.

**Trade and land policies are unfavorable.**

Our interviews revealed nearly universal business concern about Afghanistan's trade policies, rules, and regulations. Traders complained of inefficiencies and corruption moving goods in and out of the country. Industrialists complained of high tariffs on raw materials and dumping by Pakistani, Iranian, and Central Asian companies.<sup>53</sup> In several regions, locals recounted stories of Pakistani or Iranian buyers collecting perishable produce during the harvest, moving it to cold storage in their own country, and then selling it back into Afghanistan during the winter. In the carpet and marble industries, Pakistani producers procure raw materials from Afghanistan and capture value by finishing and processing themselves. Across the board, outside actors have incentives to keep Afghan businesses from expanding into profitable areas of the value chain. Such examples are widely noted by entrepreneurs, and exacerbate the difficulties that new entrepreneurs, including women, face in entering even their local markets.<sup>54</sup>

Additionally, Afghan businesses expressed deep concern about the country's land policies. Though private ownership of land is not recognized without an officially registered deed, most land is unregistered or held under informal agreements, allowing the Afghan government to claim over 90 percent of the country's land.<sup>55</sup> A senior AISA official commented, "No land is available. If it available, it is inaccessible. There is no clear land policy. Most Afghans have no idea what it is."

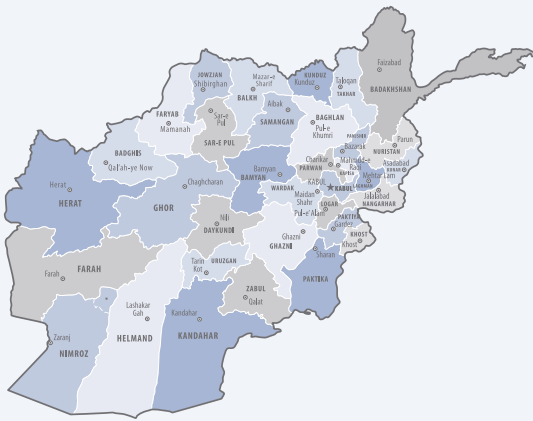
**Complicated public-private relationships compromise policies.**

Certain dynamics in the public-private relationship compromise policy-making and implementation. In some cases, incestuous relations between Afghan government officials and big business render the two parties indistinguishable. Powerful businessmen purchase positions in government, which they use to steer funding, contracts, and resources to personal business interests. In other cases, government officials perceive the private sector as a competitive threat to their power base. Finally, businesses without powerful allies in the government resent favoritism given to friends of the government, as well as their lack of involvement in the policymaking process.

**Key Problem: International Distortions**

The negative effects of international actions are neglected in many western evaluations of Afghanistan's business climate. Several factors—short-term time horizons, poorly monitored spending, and reliance on interlocutors—can make well-intentioned donor interventions counterproductive. International actors must be mindful of their own structures and methodologies. This section diagnoses such unforeseen second-order effects, while recommendations for changing international coordination, prioritization, and programs are outlined in Section V.

**Western policies and actions have short time horizons ...** The unpredictability of the business environment is exacerbated by the shortsightedness of international actors. The epithet of the U.S. military fighting "nine one-year wars" in Afghanistan applies equally to U.S. development



## One Country: Many Different Business Environments

Security, governance, infrastructure, education levels, and ethnic composition differ vastly across Afghanistan. The capital city of Kabul is disproportionately shaped by both the Afghan government and international actors, with the accompanying inflated prices and malignant rent-seekers. It also has many advantages for businesses—an airport with over a dozen international flights each day, many banks, and access to power brokers. In Herat, the culture, dress, and education are all heavily influenced by Iran. Access to reliable electricity, strong governors, and relative security have allowed the formation of many industrial enterprises without much coalition help. In Kandahar, heavy conflict and poor security on roads complicate realizing the potential of the large agricultural sector. Jalalabad's location on the main transit route between Afghanistan and Pakistan, not far from Afghanistan's main customs point of entry at Torkham Gate, creates a vibrant trading economy, which also is heavily influenced by agriculture, construction, and a heavy international footprint. Similarly, Mazar's proximity to Uzbekistan and Tajikistan creates a strong trading economy with Central Asia. Meanwhile its relative stability has led to what many consider the strongest business environment in Afghanistan, home to the country's carpet and dried fruits and nuts industries.

Ultimately, economic growth initiatives must be calibrated to each region. As Afghan businessman Tamim Samee explained, "The central planners sometimes think of the country as a single fabric ... but some parts of the country see access to land or water as their top issue, while another part may see access to finance as a first priority."

efforts. Aid officials give promises and build relationships, but then rotate out six months later—leaving the client businesses to renavigate the western bureaucracy.

Employment contracts can be as short as three months, hardly sufficient time to learn a new position. Afghan-American entrepreneur Sanzar Kakar noted: "Each new advisor starts from scratch and tries to do an assessment or a strategy with or without realizing that the same thing has been done eight years in a row. So now, we are exactly where we were back when advisors first started—actually worse because we wasted all that time and money." These problems make continuity nearly impossible when dealing with donor-funded contracts.

Donor priorities can also shift, leaving projects orphaned and without follow-up. In the summer of 2010, several American development officials made it clear that they were spending with a close eye to maximize impact before the July 2011 deadline. Others spoke of needing to expend budget dollars before the next fiscal year with little consideration for efficacy and impact.

USAID in Afghanistan relies heavily on contracted implementing partners, who operate on quarterly reporting schedules.<sup>56</sup> These contractors often are talented and motivated, but lack incentives to implement projects with results that may not be seen for three or four years, long after their contract performance will have been reviewed and re-competed. Military or economic development officers may hesitate to lay a foundation for a three-year investment when they are leaving in six months and their replacement is uncertain.

**... and exacerbate Afghans' short-term mentality.** In such a climate, many Afghans focus on short-term opportunistic profits and exit strategies to leave the country if and when the situation changes for the worse. There is little consideration for secondary effects of each deal: a raisin producer will mix in bad-quality raisins or add dirt into a shipment to Moscow in order to boost their product's weight and fetch a higher price—without thought for how this will affect his reputation the next time he tries to sell. One development official explained: "There is



little orientation towards the client or customer service—instead, [there is a history] of performing badly and then finding new targets. They often market/sell first and produce later.”

Even for business owners with a long-term orientation, the constant policy debates in the West inform and complicate their business calculus. Several small indigenous firms explicitly referred to waiting for the July 2011 deadline before making any major investment decisions. Other businessmen—the ones continuing to plow back profits into new business—said in private they had already reached a conclusion: Americans would be here in force for a long time to come. On this assumption they staked their bets for businesses that might take three or four years to break even, while they still longed for specific guarantees.

**The Economy is “Donor Drunk.”** Afghans rapidly adapt to the perceived priorities of international donors.<sup>57</sup> In some cases, this distortion can be beneficial, for example creating markets and opportunities for women-owned enterprises that would not otherwise exist. But in many instances, new incentives have emerged that are far from what either Afghans or the internationals community would have intended.

The heavy influx of international dollars has negative consequences.<sup>58</sup> Kabul real estate prices rival Manhattan. Inflated by hundreds of internationals competing for housing, an average six-bedroom residence might rent for \$8,000/month. The influx of money has inflated labor rates, rendering donor ideas that Afghans might compete in large-scale production of exported textiles difficult.

One education program manager explained that Afghans are willing to pay to learn English and information technology (IT) skills, but never for agriculture-related or accounting training. And for good reason: English and IT abilities can land a job at an NGO or international donor paying \$2,500/month, as opposed to \$200/month for an entry-level professional job at an Afghan firm in Kabul. One Afghan government ministerial official further complained that young Afghan professionals have no loyalty, because they are focused on simply making money and actually proud that they change jobs every six months. In a captive market with a

small supply of semiskilled labor, even established multinational companies, paying between \$350 and \$2,000/month, frequently find their local talent siphoned off by embassies and NGOs. Actual government employees earn as little as \$100/month while Afghan government “consultants” can earn twenty times this amount, and western consultants even more—all while working in the same building.<sup>59</sup> One development official put it bluntly: “Only untalented Afghans go to Afghan companies; the talented ones are all hired by the internationals.”

Some argue that easy donor dollars creates a “lack of paying culture” and engenders dependence. “You know the best way to get a free laptop?” one longtime Kabul expatriate explained, “Start an NGO.” She went on to describe how some local Afghans had asked for literacy training—but then lost interest when they found out they would not receive a salary for attending classes. A successful Afghan-English businessman added, “We appreciate donations, but the sooner you become self-sufficient, the better. Look at Africa, how they are stuck on aid. You beg once, you beg forever.” Such strong statements by business owners are common, though the rhetoric is sometimes motivated by the desire to secure donor capital for their own for-profit plans.

**Afghan Interlocutors and the Bagram Millionaires Club.** As worsening security constrains the travel of western donors and forces them to make point-to-point journeys from high-security compounds to other secured locations, they become more dependent on the select go-betweens who can navigate both military bases and Afghan culture. After nine years, one Afghan investor explained, there are a “group of Afghans who have gotten very good at the system: wearing the suit, speaking English, knowing who to talk to at embassies, and looking for the short-term gain.” After clearing the initial hurdles, becoming a contract recipient for construction, security, transportation, or services to the internationals can be hugely lucrative. One Afghan USAID implementing contractor told the story of his cousin who parlayed a low-level translation job into a contracting business that earned \$50 million over three years. The cousin had since moved to Dubai.

In bridging the gap between two worlds, the “hyphens” are vital—Afghan-Americans, Afghan-Australians, Afghan-Germans, Afghan-English—who were educated in the West but now have returned. Some of the most successful businessmen in Afghanistan come from the diaspora—such as the Afghan-Australian Mohseni family, which runs the well-respected Moby Media Group. However, some diaspora Afghans exploit seams between the international community and local business community to collect exorbitant returns on basic construction or transportation projects.

The closed circuit of international contracting creates monopolies. The “Bagram Millionaires Club” is a colloquialism in Kabul referring to the Afghans who have carved out niches in military contracting.<sup>60</sup> On Kandahar Air Field, Afghans cannot see tendered contracts without being on base, but they cannot get on base unless they have won a contract. In this Catch-22, the forty or so Afghan contractors who have base access are highly favored—though even they often still lose out to the international firms. The brother of Nangarhar Provincial Governor Gul Agha Shirzai, a military commander adjacent to Kandahar Air Field, runs many lucrative businesses and is alleged to charge a fee to any Afghan contractor accessing the base. In the absence of transparent competition, contractor-on-contractor violence occurs.<sup>61</sup>

Such issues of access are crucial barriers to programs such as Afghan First, which encourages procurement from local sources. An entire nonprofit organization—Peace Dividend Trust—has sprung up to bridge the vast gap between western procurement and Afghan contracts. Despite their laudable efforts, including facilitation of over \$400 million in purchases, only a fraction of possible procurement happens locally. The launch of AfghanFirst.org is a step toward improving access to request for proposals and providing information on bidding procedures.

### III. Business Adaptation

A brief theoretical overview assists in understanding firm behavior in Afghanistan. In equilibrium, the firm creates and manages markets and organizations.<sup>62</sup> It

increases economic value of transactions in a way that consumers could not realize through direct exchange and consumer organizations.<sup>63</sup> An entrepreneur is a consumer who expects that establishing a firm will improve economic efficiency relative to competing entrepreneurs, consumer organizations, and established firms.<sup>64</sup> In most cases, successful market entry by the entrepreneur requires innovations in business transactions, methods, technologies, and products.<sup>65</sup>

The Afghan business environment represents disequilibrium. Markets are imperfect. High-margin sectors such as energy, construction, and trade display characteristics of monopolies and oligopolies in which one or a few firms have enough control over a product or service to have a significant impact over the terms which other individuals have access to it. These firms maintain market power through economic, legal, and deliberate barriers to entry including price manipulation, patron-client relationships, and vertical integration.

In contrast, low-margin sectors such as agriculture and retail display characteristics of fragmentation. Few firms have significant market share to strongly influence industry outcomes. This fragmentation arises from low entry barriers, lack of economies of scale, and gaps in the value chain.<sup>66</sup> Additionally, insecurity, corruption, poor infrastructure, and lack of access to capital complicate the ability of businesses to overcome fragmentation.

Unsurprisingly, the Afghan business environment does not support entrepreneurial innovation in the same way that a developed economy does. Disequilibrium can deter, rather than encourage, the consumer to become an entrepreneur and establish a firm. When the consumer identifies a business opportunity, obstacles can be insurmountable: anticompetitive behavior of established firms may prevent market entry; gaps in the value chain may limit or negate the innovation's economic value; and the consumer's inability to access capital, markets, and inputs may inhibit the consumer from acting on the opportunity.

In response, Afghan businesses employed a number of common strategies to cope with disequilibrium and uncertainty.

## Vertical Integration

We observed Afghan businesses integrating vertically, often within familial and tribal ranks, to minimize reliance on untrustworthy business partners and the government. The Mazar-e-Sharif-based Barakat Group is illustrative of many import-export conglomerates dominant in the Afghan business environment. Founded as a family-run trading company in 1972, it operates throughout Afghanistan with 200 local staff and estimated revenues of \$100 million in 2009. It has subsidiaries in trade (agricultural machinery, automobiles, foodstuffs, LPG and petroleum products, steel products, furniture), production (bleached cotton, PVC windows and doors, greenhouse), and construction. It has investment stakes in Afghan Petroleum and Gas, Sungas, Sunpetrol, and a fruit processing facility. It also operates in Turkey, Saudi Arabia, Russia, Tajikistan, Kazakhstan, and Uzbekistan. Explaining his desire for vertical integration, the group's general manager stated, "We have the most corrupt government and people in the world. I don't like relying on people outside of my family if I don't have to."

A logical progression guides Afghan firm formation and growth. The process of vertical integration begins around a central business, often import-export, and grows to include supporting businesses, such as transportation and logistics. It then can grow to include other sectors such as construction, agriculture, and light manufacturing. The experience of the Jalalabad-based Zalmay Afghan Group is instructive. In 1996, a friend of company president, Haji Zalmay Stanakzai, encouraged him to start a construction company, offered him an office, and provided seed capital. Stanakzai started the company with \$25,000, two cargo trucks, and a Toyota Corolla. Explaining why he began in construction, he said, "Construction has the highest margins." Over time, his company's portfolio grew to include roads, bridges, clinics, retaining walls, and schools, contracted primarily through international organizations and military forces.

Growth was slow initially, but rapidly increased as the company strengthened its industry reputation and relationships with contractors and suppliers. Stanakzai reinvested profits into

the company, did not take out any loans, and received no donor grants. He created a trading subsidiary in order to secure cheaper, more reliable access to materials for his construction projects. Subsequently, he formed a transportation subsidiary to cut out the expensive middlemen that he had been employing to transport construction materials from Pakistan to Afghanistan. Last year, the Zalmay Afghan Group reported \$650,000 in revenue and increased its staff to 230 employees. In the next year, Stanakzai hoped to find a foreign partner and expand his business to Pakistan and India. However, he voiced concerns, "Security is worsening and donors are less willing to invest ... but if ISAF [International Security Assistance Force] leaves, I will shift my focus to trading."

## Trading Versus Producing

Businesses attempted to remain as flexible as possible to hedge against uncertainty, valuing short-term but dependable gains over developing long-term capacities. A western official commented, "Afghans go to the highest margin businesses that require the least amount of capital and that produce benefits in the least amount of time. This means that they start in trade, then pick off productive opportunities in services, agriculture, and construction. Even then, people are loath to invest in manufacturing relative to trade because it is easier and quicker."

Major challenges confront productive enterprises in Afghanistan, including:

- Limited access to capital constrains investment in land, equipment, labor, and other start-up costs.
- Companies have access to a few hours of state-provided electricity daily, then rely on diesel-powered generators at a significantly higher price.
- Damage to Afghanistan's productive capacities has disproportionately affected producers relative to traders who capitalize on industrial infrastructure in Pakistan, Iran, and other neighboring countries.
- Foreign companies maintain a strong foothold in the Afghan market, are better able to capture economies of scale than Afghan producers, and

benefit numerous stakeholders in the Afghan trading economy.

- Afghanistan's trade policies, which tax raw materials at a higher rate than finished good imports, increase producer operating costs, and favor traders and foreign competitors.
- Insufficient industrial infrastructure causes value to be added to Afghan products outside the country.

Liquidity, diversification, and flexibility help powerful traders manage Afghanistan's uncertain business environment. Additionally, these traders have mutually beneficial relationships with political and military power brokers: traders provide power brokers a "means of investment, potential for money laundering, and strengthening of influence by linking military, economic, and political power"; power brokers provide traders "security, tax exemption and credit, lucrative contracts," and access to critical production inputs such as land and water.<sup>67</sup> In contrast, small producers and traders have more limited access to markets, are trapped in negative relationships with middlemen, and make negligible margins.<sup>68</sup>

An Afghan official working for a USAID implementing partner commented, "It is impossible for Afghans to establish businesses. There are no protections for industrialists. There are no incentives except for importer tycoons who run our economy. They have friends in government, parliament, and the ministries. They play by a separate set of rules ... they have relationships with the government and with each other. While other traders pay 15 percent import tariffs, they pay 4 percent."

Engineer Ghulam Hasan, owner of the Jalalabad-based Riaz Packages Company and Director of the 93-member Nangarhar Industrial Association described the challenges for small-scale Afghan industrialists. "My association has eight sections: plastics, non-alcoholic beverages, ice, carpets, soaps, textiles, foodstuffs, and technical products such as bicycles. Ten percent of these companies are doing well and 90 percent are not. Power (electricity) is a problem for everyone. The government does not support us. It procures products from Pakistan and China. It places high

taxes on raw materials and low taxes on end products. It has no strategy for factories."

He continued, "Pakistani competitors undercut us all. They wage price wars against us. When Afghans starting producing cement, Pakistani companies dropped the price from 150 rupees to 120 rupees for 50 kilograms. After they put the Afghan companies out of business, they raised the price to 320 rupees. They dump their products here. Their government subsidizes exports from 10 percent to 50 percent...Afghanistan has no strategy to deal with this."

## Relations with External Actors

### Government

Firms exhibited wide variations in their perceptions of subnational governmental bodies, which were heavily influenced by their opinion of the provincial governor. In Balkh Province, many businesses praised the long-serving governor and former warlord, General Atta Mohammed Noor. They attributed the province's relative stability and strong business environment to his leadership while acknowledging corruption within his government. Syed Tahir Roshanzada, director of the Balkh Province Chamber of Commerce (ACCI) stated, "In Balkh, the governor supports the private sector. He is a problem solver. But, the central government is bad. It is not implementing its promises and it is not helping." A western official explained, "Because Balkh has remained safe under Atta, it is a magnet for FDI. He gets his take, but he also reinvests in infrastructure and municipal development."

In contrast, Nangarhar Governor Gul Agha Shirzai, also a former warlord with significant personal business interests, elicited more negative reactions. While some businesses credited him with stabilizing Nangarhar at the beginning of his tenure in the mid-2000's, others blamed him for the province's deteriorating security. They also complained about the negative effect of his government's corruption on their business activities. An Afghan businessman complained that the provincial government and police were stealing revenue from the Torkham Gate border crossing, from a donor-financed reconstruction fund, and from informal checkpoints along the

Torkham Gate to Jalalabad road. He stated that Shirzai, who owned a construction company, had intimidated competitors when bidding for Provincial Reconstruction Team contracts and threatened donors who attempted to monitor his company's work.

Those holding a positive opinion of the local government, such as those in northern Afghanistan, were more likely to rely on the government for security, arbitrating disputes, and providing basic services. In contrast, those holding a negative opinion of local government, such as those in southern and eastern Afghanistan, attempted to distance themselves from it as much as possible.

Business strategies for coping with government also varied based on the size and nature of the business. Large-scale traders were most likely to have a favorable impression of the government and be inclined to cooperate with it. In contrast, small-scale traders and producers were most likely to have an unfavorable impression of local government and were highly critical of it for failing to provide public services in an honest and accountable manner.

Most businesses viewed government relations as an added cost of operations. They were often disappointed with the level of services provided by the government, but saw bribes as a way of deterring the government from meddling in their affairs. Many businesses were resentful of paying these costs at multiple levels, ranging from high-level government officials to low-level police and customs officials. An Afghan trader and former director of a regional trade association commented, "The current situation makes you pay everyone, the Taliban, the government, the police. These costs are 30 percent of my budget. Everything is corrupt, it is our culture."

### **Insurgents**

Business opinions of insurgent groups varied widely. In the more volatile eastern and southern regions, businesses exhibited a higher risk threshold than those in the western and northern regions. They were more accustomed to threats posed by insurgents because they had dealt with these risks for much of the post-Taliban era. In the northern and western regions, businesses were concerned about rising insecurity and uncertain regarding how

they would handle these risks. In Mazar-e-Sharif, businesses anxiously watched the experience of Kunduz and Baghlan provinces, which had fallen under Taliban control in recent years. They were worried that insecurity was spreading and creeping closer to Mazar-e-Sharif proper, the commercial hub of northern Afghanistan.

*Businesses had four primary options for managing physical insecurity: 1) shifting operations geographically; 2) allocating up to 20 percent of an operating budget to formal security costs, including a security director, guards, etc.; 3) negotiating with government or insurgent power brokers through payment of informal taxes; and 4) negotiating with local communities to increase their sense of ownership in the business' operations in return for their protection of the business' interests.*

Two construction companies illustrate differing risk thresholds of business owners. Haji Zalmay Stanakzai, president of the Zalmay Afghan Group, detailed numerous attacks on his projects in Nuristan, Helmand, and Badghis. His security strategy included pricing security into his project budgets from 2 percent to 18 percent, employing a full-time security manager, holding a shura with local elders before beginning a project, and hiring as many local workers and security guards as possible. He had full confidence in this approach, stating, "I will do business anywhere."

Meanwhile, the president of another construction company, which employed a community-based security strategy in an unstable region of Afghanistan, was planning to shut down his business and move to Dubai. He explained, "Things are getting worse because of Karzai. People are starting to support the Taliban again. But I will never negotiate with them or support them. It is difficult to be honest and successful in Afghanistan."

Security was a significant consideration for mining companies operating in unstable regions of Afghanistan. An Afghan mining executive described insecurity as a fact of life. As his company became more successful, the Taliban increasingly targeted his management, workers, and truckers

transporting materials from an unstable rural area to his urban processing facility. His marketing strategy was a delicate balancing act: he tried to raise the company's profile while maintaining a low personal profile. Like many Afghan businessmen, he was fearful of kidnappings. He had decreased his quarry visits from three or four times a month to once a month. He concluded, "I worry about insecurity. It is worsening. It drives my costs up."

The president of another mining company was similarly concerned. Traveling to his quarries required a four- to six-hour escorted walk on a foot trail through lawless areas. Eight months ago, he had stopped visiting his mines due to fear of kidnapping. He had received night letters threatening him and his workers. He felt that support from the United States made him an even greater target. He mitigated security risks through negotiation with the local elders, which he described as "the only strategy I have. I can't afford more security so I need a local-focused policy. I don't involve the government and police. They are not trustworthy. You don't know who is working for whom."

Roshan Telecom, the largest telecommunications company in Afghanistan, successfully employed a community-based security strategy. Recently, the company transitioned responsibility for its tower site security from outside forces to local communities across the country. The shift allowed Roshan to support local communities through job creation and empowerment. The company said that these communities felt a sense of ownership over the site that they administered. The company recounted instances in which a site had been switched off at night, and the community has come to Roshan and said 'switch it on, we'll guarantee the security.' Roshan saw a decrease in the number of attacks to sites and has incentivized communities to ensure site safety through a quarterly bonus. Through this program, Roshan has been able to reduce operational costs per site and achieve an overall cost savings of about 30 percent each year.<sup>69</sup>

Most businesses were concerned about deteriorating security throughout the country, often stating that security underpinned a strong business environment. However, companies were

most concerned about uncertainty, including corruption, access to capital, infrastructure, and a variety of other factors beyond pure physical insecurity. In particular, they viewed the national government as weak, insurgents as emboldened, and the International Security Assistance Force (ISAF) as having a wavering commitment, all of which fueled this unpredictability and a variety of hedging strategies.



A modern shopping mall in Herat City. (Jake Cusack)

### International Actors

Many businesses interviewed viewed ISAF as a key guarantor of stability in Afghanistan. These companies wanted ISAF to remain in Afghanistan in the near term and feared the consequences of a withdrawal. A business owner in Nangarhar Province commented, "ISAF has a positive effect. When the U.S. came to Afghanistan initially, the warlords were weakened. If the U.S. leaves Afghanistan, it will be like the Northern Alliance versus the Taliban again. Nangarhar will have ten to fifteen governors." A Nangarhar trader added, "I am optimistic about the future. I have hope, inshallah. But it is connected to the foreign troops."

Simultaneously, businesses expressed resentment towards ISAF, international organizations, and donors for supporting corrupt government officials and foreign contractors and for failing to provide key needs for the business community. Beyond security and corruption, common complaints centered on the international community's inability

to provide power, roads, and access to capital, and to stop foreign dumping. A senior official at the Afghan Investment Support Authority stated, “Donors are spending millions of dollars, but for nothing. Many grants are wasteful. Factories have stopped...industries are not profitable. There are only a few small industries ... there are no industries in the rural areas.”

Businesses varied dramatically in how closely they were willing to work with the international community. Some, particularly in the construction sector, made work with foreigners a key component of their business strategy. Meanwhile, others sought to remain independent, concerned about security risks associated with working with foreigners or about the sustainability of these partnerships given the eventual ISAF withdrawal. Finally, many businesses viewed donor funding as a substitute for bank loans and the only external financing that they seriously considered.

## IV. Sector Analysis

### Overview

Business development has varied significantly across different sectors of the Afghan economy. For example, agriculture employs the majority of the country’s labor force but occurs largely at the subsistence level. The mining sector holds an estimated \$1 trillion of natural resource wealth, but is also largely underdeveloped, with mining’s contribution to GDP less than 0.3 percent.<sup>70</sup> Light manufacturing, carpets, crafts, gemstones, and other smaller sectors have experienced modest gains, while construction, security, and transportation sectors have proliferated with increased demand from the international community. Segments of the service sector, such as telecommunications, have flourished due to strong demand and innovative distribution methods, while information technology, urban services, and other areas remain nascent or underdeveloped.

The following section will examine five sectors of the Afghan economy, surveying each sector’s background and challenges, and profiling a specific company to illustrate key obstacles.

### Agriculture

Agriculture plays a vital role in the Afghan economy, accounting for 31 percent of GDP. It is the main livelihood for the rural population, responsible for 78.6 percent of national employment. Products include wheat, rice, corn, beans, melons, grapes, apricots, pomegranates, oranges, almonds, pistachios, and walnuts. After a severe drought in 2008–9, last year’s harvest led to agriculture output growth of 36 percent, with dried fruits and seeds accounting for half of total exports.<sup>71</sup> Donor initiatives have aimed to address gaps in the value chain, train farmers in modern agriculture methods, and provide basic infrastructure.



Modern raisin sorting and processing equipment is used at Tabasom Raisins, near Kabul. Tabasom has approximately 100 employees and can process between 20 and 25 tons of raisins per day. (Jake Cusack)

### Problems

- **Productivity:** Agriculture employs over three-quarters of workers yet accounts for less than one-third of economic output. Less than half of Afghanistan’s 19.5 million arable acres are under cultivation, with only 25 percent of irrigation systems currently operating. Many farmers do not have enough acreage to be self-sufficient. Additional problems include inadequate access to credit, poor road networks, and unreliable electricity.<sup>72</sup>
- **Value capture:** A lack of processing, packaging, and cold storage facilities causes most value-add to occur in neighboring countries.

- **Poppy:** Poppy remains Afghanistan's most lucrative agricultural export, complicating efforts to transition farmers to other crops.<sup>73</sup>

### Company Profile: Rahmani Dried Fruits and Nuts

The Jalalabad-based Rahmani Dried Fruits and Nuts Company is owned and operated by Ajmal Rahmani, who also is president of the Nangarhar Dried Fruits Association. He contracts with as many as 300 farmers of walnuts, almonds, peanuts, pistachios, raisins, corn, and berries. At harvest, he collects, cleans, and processes dried fruits and nuts, selling 30 percent domestically and exporting the remaining 70 percent to primarily Pakistan, India, and Dubai. He estimated annual sales growth of 10-12 percent in recent years. He has never sought external financing and allocates no money to marketing, using his reputation and position as association president to generate sales. He has leveraged initiatives by the US-Asia Foundation, the Afghanistan Chamber of Commerce and Industries (ACCI), and the Afghanistan Small and Medium Enterprise Development (ASMED) to attend international trade exhibitions, make promotional brochures, and fund measures to develop export markets for association members. In the future, he hoped to open processing, cold storage, and packaging facilities. He viewed increased export sales as key to his company and association's growth.

- **Security:** Rahmani commented that insecurity is worsening in Jalalabad and the surrounding provinces, requiring him to maintain a personal bodyguard. He detailed a recent incident in which criminals had stolen a shipment of his goods. He estimated that security accounts for 10-15 percent of his total costs. He paid a premium to truckers to insure his goods in transit. Moreover, security complicated his ability to find a location for a new factory. "I plan to make a new factory, but where? I can't find a good location because of security problems."
- **Middlemen:** Rahmani cited the challenges of "being independent and finding a direct market without middlemen. Pakistan always influences the market. I export to Pakistan and it

captures all the value." He used donor-sponsored international trade exhibitions in Dubai, India, Iran, and Russia to cut out unnecessary middlemen, better understand market demand, and establish more direct links to his customers. He viewed developing export markets as a main priority for his company and association.

- **Capacity:** Rahmani detailed a number of problems relating to a lack of domestic capacity. "Because I don't have storage facilities and my goods are perishable, I can't keep them for a long time. So I sell them quickly, often at a low price."

### Mining

Afghanistan is endowed with significant mineral wealth, particularly iron, copper, cobalt, gold, niobium, and lithium. A much-publicized New York Times report estimated the worth of these resources at \$1 trillion based on Afghan, Russian, and American surveys.<sup>74</sup> The Afghan government and international community view mining as a long-term source of sustainable revenue for an economy reliant on foreign aid, opium production, and narcotics trafficking. "This will become the backbone of the Afghan economy," said Jalil Jumriany, an advisor to the Afghan minister of mines.<sup>75</sup> A western official stated, "Exploiting Afghanistan's mineral resources is how Afghanistan can pay its bills when donors take off." However, outside of the China Metallurgical Group's venture at the Aynak Copper Mine, most mining in Afghanistan does not focus on rare earth minerals, but rather marble or gemstones.

#### Problems

- **Insufficient infrastructure:** Little industrial infrastructure exists to exploit Afghanistan's mineral wealth. Most mining occurs at a small-scale level, employs primitive extraction methods such as dynamite blasting that can destroy over 80 percent of the value of the mineral, and is impeded by poor road networks and power supply.
- **Governmental capacity:** The Ministry of Mines is inexperienced in developing and managing Afghanistan's mineral resources. The U.S. Department of Defense's Task Force for Business and Stability Operations and international accounting firms are mentoring the ministry



on the establishment of systems, contracting procedures, and technical data for multinational mining companies and foreign investors.<sup>76</sup>

- **Foreign Reluctance:** A western official explained the initial reluctance of foreign mining companies to work in Afghanistan, “The big multinational mining companies don’t want to get involved initially. What you want to do is incentivize small wildcat companies that can afford to go bankrupt. They will incur the high risk for the prospect of high benefits of handing over the rights to a larger company.” Additionally, this official mentioned outside fears of potential nationalization of contracts as another major deterrent to attracting foreign mining companies to Afghanistan.

### Company Profile: Afghan Marble Company (Name Changed)

Founded in 2004, this marble company operates in unstable areas of Afghanistan with forty to fifty local staff. Last year, it reported sales of \$100,000, 70 percent domestically and 30 percent abroad (China, Dubai, Italy). It extracts approximately three tons of marble per day through a dynamite blasting technique that destroys over 80 percent of the marble’s value. With the help of a \$228,000 three-year bank loan and an \$80,000 grant from the USAID-sponsored ASMED program, the company purchased a wire-cutting machine that it hopes will increase daily production by approximately 800 percent, curtail value destruction caused by dynamite blasting, and lead to increased revenues and job creation. A company executive remained cautiously optimistic about the future, hoping that that increased production, quality, and exports would lead to growth. However, he concluded, “It’s hard to say about the future. Things are uncertain.”

- **Power:** A company executive cited lack of electricity as his biggest constraint to growth. He complained about relying on expensive diesel generators for most of the day. He stated, “Progress in development is determined by power.”
- **Insecurity:** Insurgents threatened the company’s management, quarry workers, and truckers,

forced management to limit quarry visits due to fear of kidnapping, and drove up operational costs. A company executive explained, “I can’t complain to the police or the government because it will make the problem bigger. My only strategy is to negotiate directly with the Taliban. My last option is to pay them.”

- **Anti-business policies:** A company executive commented, “The government doesn’t understand what a market economy is. It is our Communist legacy.” He highlighted the bureaucratic contracting process with the Ministry of Mines, high fees and taxes, and a generally unsupportive policy framework for his company. He contrasted Afghanistan with Pakistan, stating, “Pakistan has lower taxes. It has good roads. It provides electricity. It has a better tax collection system.”

### Construction

A massive construction boom has characterized the post-Taliban era. Efforts have focused on rebuilding war-torn infrastructure and providing for the large foreign military contingent in Afghanistan. The international community has spent billions of dollars on real estate developments, roads, schools, clinics, culverts, bridges, and civil-military projects. In recent years, the construction sector has grown approximately 10 percent per annum, accounting for \$770 million in 2008–9 and 10 percent of GDP. While the number of Afghan construction companies has tripled since 2003, the overall number of jobs has been decreasing.<sup>77</sup>

#### Problems

- **Quality:** Fraud, waste, and abuse have reduced the impact of construction projects to the Afghan population.
- **Subcontracting:** The loss of accountability through multiple levels of subcontracting leads to shoddy project quality.
- **Sustainability:** Foreign donors have financed much of the construction boom, leading to sustainability concerns when ISAF draws down in Afghanistan.<sup>78</sup>

### Company Profile: Latifi Shigiwal Construction Company (LSCC)

Founded in 2004, the Jalalabad-based LSCC operates throughout central, eastern and northern Afghanistan. It employs fifty Afghan staff and two Pakistani engineers. Its projects include roads, bridges, schools, clinics, and irrigation systems. It contracts primarily through ISAF and the Afghan government. The company sources sand, gravel, and stones locally and procures most other construction materials from Pakistan, India, and Russia. It reported \$1 million revenues last year and annual growth of 10-20 percent in recent years. Prior to 2004, the company was an NGO named Hendokosh, working with Mercy Fund in support of the UN and international NGOs in rehabilitating Afghanistan through small-scale community development projects.

- **Security:** Security was a rising concern for LSCC President Abdul Latifi. His brother, who was an employee at LSCC, had been killed in the past year outside of Bagram Airfield. He was no longer able to visit his projects in unstable locations due to security risks and fear of kidnapping. He commented, "The situation is changing. Afghans are starting to support the Taliban." He recounted a recent incident in which fifteen local security guards at one of his projects guided the Taliban to his engineers. He added, "If I can't negotiate with the shura (council of local elders), then I quit. I will never negotiate with or support the Taliban."
- **Future:** Latifi estimated an 80 percent chance that he would move his family from Afghanistan to Pakistan or Dubai within the year. He viewed ISAF's continued presence as central to Afghanistan's future. "Donors are having a positive impact. But, the future situation depends on the U.S. government. Whenever it leaves, there will be a Punjabi government in Kabul."<sup>79</sup>

### Import-Export

Throughout history, Afghanistan's location on the Silk Road at the crossroads of Central and South Asia and the Middle East has created a vibrant trading economy. Even during the past thirty years

of conflict, trade has persisted and flourished. In recent years, total imports and exports have topped \$6 billion.<sup>80</sup> Key exports include fresh and dried fruits, medicinal plants, spices, seeds, skins, wool, carpets, and crafts. Key imports include machinery and equipment, petroleum, metals, chemicals, construction materials, foodstuffs, cigarettes, beverages, textiles, footwear, household items, and medicine.

#### Problems

- **Trade Deficit:** Imports dwarfed exports, leading to a harmful trade imbalance with far-ranging consequences for the Afghan economy.<sup>81</sup>
- **Infrastructure:** Afghanistan's poor road, rail, and air networks, inefficient customs processes, corruption, and insecurity limit the extent of trade occurring within the country and between neighboring countries.
- **Borders:** Afghanistan's lack of border control gives rise to a large informal economy and foreign dumping that undercuts domestic producers.<sup>82</sup>

### Company Profile: Afghan Trading Company (Name Changed)

Founded in 1973, this export-import company specializes in used trucks, automobiles, spare parts, appliances, electronics, toiletries, and medicines. It buys discounted goods from Germany, the Netherlands, and Japan and resells them at a profit in Afghanistan. The company imported goods from the Karachi port overland through Pakistan to Torkham Gate and distributed them in the eastern and central provinces. Last year, the company had approximately \$200,000 in sales, which had been declining in recent years. It employs eleven workers, a decrease from thirty-five in 2007.

- **Insecurity:** A company executive described a deteriorating security situation in Afghanistan and Pakistan that had damaged his business. A few years ago, he did not incorporate security costs into his budget. Now, he estimated that security represented 20 percent of his total costs and had been steadily rising in recent months. He described attacks on his containers in Pakistan. He was concerned about the future,

stating, “My whole business relies on security in Afghanistan and Pakistan.”

- **Corruption:** A company executive outlined a number of negative encounters with the national and provincial government. A dispute with a senior government official forced him to shut down his plaza in Kabul and move his family to Peshawar and relocate his business. He stated, “I brought up the issue to the high court, but received death threats and was told if I didn’t leave I would be killed.” Regarding corruption, he said, “The government is causing problems with traders. Officials purchase their positions and are connected to powerful people, especially in customs. I already pay high taxes and customs, but then they want bribes too. The big businessmen act like a mafia and defeat small businessmen.”
- **International community:** A company executive expressed anger at the international community for enabling the current government’s corruption. He asked, “Why is the U.S. supporting these people? This president, these ministers, and these provincial governors will never get better. The U.S. should change its strategy. It’s spending billions of dollars and soldiers are dying, but things are getting worse. It should send these criminals to jail. It should hire honest, skilled professional people. It should help our government develop our business policies.”

## Light Manufacturing

Afghanistan has a broad range of import-substitution and export industries. Some import-substitution industries, including foodstuffs, beverages, and motorcycles, represent some of the country’s most successful and entrepreneurial firms. Other industries such as shoes, plastic sandals, plastic dishes, and ice also have experienced rapid growth.<sup>83</sup> In 2010, carpet making was Afghanistan’s second-largest export industry, accounting for 38 percent of exports.<sup>84</sup> Donors have sought to grow import-substitution and export industries through Afghan First, directing the procurement of Afghan-made products by the international community, regional trade agreements, and international trade exhibitions.<sup>85</sup>

## Problems

- **Anti-producer environment:** Uncertainty, instability, and a strong trading economy have stunted development of Afghanistan’s productive capacities.
- **Dumping:** Dumping of Pakistani and Iranian imports and ruthless price wars have made it difficult for Afghan manufacturers to survive.
- **Infrastructure:** Problems related to electricity, land, and capital have inhibited manufacturing growth.

## Company Profile: Tajzada Group

The Mazar-e-Sharif–based Tajzada Group is a family-run conglomerate with a carpet-making business. Throughout Afghanistan’s northern provinces, the carpet-making company has ninety direct employees and 3,500 indirect employees involved in the weaving, cutting, and washing process. Last year, it had sales of approximately \$120,000 and 24,000 square meters of carpet. The majority was exported to Pakistan, Turkey, and Dubai. Since 2002, it estimated sales growth at 15-20 percent. Recently, Tajzada won a €65,000 German government grant to build a design center and a €100,000 grant to construct carpet-making facilities. Additionally, it has begun growing its own silk after receiving land from the Ministry of Agriculture. In the future, it hopes to generate growth by increasing sales in the U.S. and European markets.

- **Independence and diversification:** The group’s general director pursued a strategy of vertical integration, family ownership, and no external financing to maximize its operational independence. Five brothers, two working in Afghanistan and three working abroad, managed the group’s companies, including trading, trucking, jewelry, and craft subsidiaries. The group’s management felt that diversification allowed it to hedge against risk in the business environment.
- **Pakistan:** The general director complained about the negative impact of Pakistan’s anticompetitive practices on his business. He stated that Pakistani traders replaced the “Made in Afghanistan” tags with “Made in Pakistan” tags on his carpets and

collected an 18 percent subsidy from the Pakistani government before exporting them abroad. He hoped to establish direct market linkages in the United States and Europe in order to minimize the negative effect of Pakistan on his business.

- **Security:** The general director operated his business from Pakistan during the Taliban years and returned to Afghanistan in 2002. He was becoming increasingly concerned about the security situation in northern Afghanistan. He described a recent incident in which the Taliban burned two of his trucks twenty-five kilometers from Mazar-e-Sharif. He was forced to pay a ransom to release two of his drivers. Personally, he attempted to keep a low profile. He did not advertise his business, did not have company signs outside his facilities, and did not hire security guards, explaining, “It’s better not to have security guards. I would need a battalion of them anyway.” He concluded, “If the Taliban returns to power, I will shut down.”

### Summary

Across the agriculture, mining, import-export, construction, and light manufacturing sectors, several themes emerged:

- Many companies felt that security was worsening, but viewed this trend as a larger problem of uncertainty and unpredictability in the business environment.
- They felt constrained by a lack of infrastructure and capacity, especially regarding power supply.
- They were disenchanted and distrustful with the Afghan government, which they viewed as incompetent, corrupt, and predatory.
- Small-scale importer-exporters and industries complained of the monopolistic behavior of their large-scale counterparts and foreign competitors, respectively.
- They were worried about their respective businesses’ and the country’s futures beyond the departure of ISAF.
- They were often supportive of ISAF’s presence, but resentful of its support of corrupt government officials and disproportionate

spending on security initiatives relative to development initiatives.

- They employed many of the adaptive strategies outlined earlier in the report, i.e. vertically integrating, pursuing short-term over long-term opportunities, and buying security in multiple ways.

Of those businesses that had failed completely—and those that never really started—a common theme was the lack of powerful allies. Without the assistance of those with resources and influence, Afghan entrepreneurs often could not surmount the many obstacles facing them.



Inside a shop in the Aino Mina housing development outside of Kandahar. (Jake Cusack)

## V. Recommendations

Thousands of Afghans and internationals have worked to rebuild Afghanistan’s economy, sometimes even sacrificing their lives in the process. According to the Afghanistan Ministry of Finance’s “Donor Financial Review” published in November 2009, international donors had disbursed \$35 billion in development assistance from 2002 to 2009. As of September 2010, the United States alone had cumulatively allocated \$56 billion for relief and reconstruction.<sup>86</sup> These efforts have led to several notable achievements. USAID seed grants have launched Afghanistan’s promising media sector. The National Solidarity Program has allowed 24,000 rural communities to oversee small development projects, earning an economic rate

of return estimated at 20 percent on over \$750 million of disbursed funds.<sup>87</sup> Military procurement of water and soda from Afghan companies has assisted Afghanistan’s growing beverage industry. With international help, the Afghanistan Investment Support Agency has become a useful resource for investors and businesses by keeping financial records in the country.

Overlapping reports dating back to 2002 have identified key constraints to business in Afghanistan, on a sector-by-sector basis, but with questionable effects on policy.<sup>88</sup> In 2007, the Aga Khan Development Network hosted a conference on the “Enabling Environment for Business” that produced a detailed roadmap of areas requiring improvement. A July 2010 review found that implementation of its recommendations had faltered.

Good ideas have failed to translate into meaningful results due to uneven implementation. Without accountability, many white papers and studies have been written—several advocating similar recommendations to this paper—with no evaluation of their subsequent effectiveness.<sup>89</sup>

Ironically, while in some cases there is too much top-down planning—donors using a supply-driven approach to force unilateral changes in a sector—there also is very little central planning at the very top. ANDS is broad brush, but beyond that, there is no guidance for which sectors are prioritized, which donors are working in what areas, and how success should be measured.

Navigating and understanding the development landscape in Afghanistan is murkier and more difficult than acquiring information on military force disposition and kinetic operations. Even at a high level within the U.S. policy establishment, officials can be unaware of competing or overlapping projects. In some cases, donors undermine each other. For example, the Aga Khan Foundation began a program of providing seeds and saplings for a small fee to farmers, only to find that another donor started giving away the same inputs for free.

Our primary intent was not to assess the effectiveness of past programs but rather the challenges, opportunities, and narratives of Afghan

businesses. We believe that much as military strategy has shifted its focus to protecting the Afghan population, commercial policy must shift its focus to empowering the Afghan entrepreneur and firm. In doing so, donors must remain aware of their own limitations, and focus on setting the right context rather than being overly prescriptive. The following recommendations stem from common themes emerging in interviews with Afghans and development officials.<sup>90</sup>

## 1. Infuse private-sector talent to support Afghan businesses.

**Appoint a single coordinator for private-sector development activities.** Little business expertise exists within the U.S. military, the Department of State, and USAID personnel. While General Petraeus and Ambassador Eikenberry coordinate military and political efforts, no senior visible American representative is tasked with economic growth. The quiet DoD Task Force for Business and Stability Operations is a step forward, but insufficient by itself. A senior public official should be appointed and given operational control of the disparate American stakeholders in this field.

**Embed private-sector talent in the international effort and Afghan businesses.** When tactical military leaders need advice on economic growth issues, to whom can they go? The only option may be a USAID official at the provincial level—who is most likely more focused on governance, democracy, and capacity-building projects than on private-sector development. We believe that part of the reason that military counterinsurgency doctrine has embraced some staid development ideas rather than business solutions is because the military has no ready linkages to business expertise.

For the Afghan business, despite their many talents and entrepreneurial spirits, few are knowledgeable about how to expand a business. (Zarang Motorcycles, as previously mentioned, would be a notable exception.) Often unwilling to delegate or keep detailed records, they have trouble growing beyond family business or more than thirty or so employees. Too often, their idea of marketing does not extend beyond trying to

get their shop near the right locale—paper shops on “paper” street, bakeries on “bakery” streets.<sup>91</sup> One development official noted that in advising businesses, “you have to explain almost everything; they simply did not grow up surrounded by examples of [semisophisticated] business, as an American would.”

In attracting and leveraging private-sector talent, domestic gaps can be filled with expertise from the Afghan diaspora and foreign business professionals who wish to lend their assistance. Another less-obvious category of talent to consider is the burgeoning population of MBAs, many of whom have prior military or nonprofit experience in developing countries. Robert Mosbacher, former head of the Overseas Private Investment Corporation, has suggested a “BizCorps” model, similar to the Peace Corps, where graduating MBAs spend eighteen months working to develop businesses in partnership with entrepreneurs in post-conflict and developing countries. Initiatives leveraging this talent must be structured to avoid crippling bureaucracy that impedes many development projects—large security footprints, tight restrictions on freedom of movement, and an onerous reporting paperwork burden. Ideally, this new structure would allow for paying and incentivizing performance in a way similar to the private sector.

**Cultivate needed private-sector awareness.** Our research saw Afghans responding rationally to perceived incentives. Consequently, internationals must be sensitive to second-order effects of their actions. NGOs often undermine private-sector development by stealing top talent. Government corruption means that profit seekers find an office posting a much more lucrative route than starting a business, and thus the elimination of entrepreneurship in legitimate sectors drives corruption, drug trade, and cronyism. Lastly, free money from donors that funds everything from computers to business services drives out the nascent private competitors and creates the “donor-drunk” culture where Afghans expect something for nothing. As Jahid Mohseni notes, this means that Afghans often are starting businesses based on where donor funding is and not on what they actually think is sustainable. Mohseni suggests that parts of the manufacturing

sector have been inflated because of the American perception that it seems more “western,” and that Afghans tailor their proposals accordingly. Just as cultural sensitivity has been emphasized, so also should economic issues be stressed in the training and strategy of international forces.

## 2. Change development incentives to reward implementation and long-term results.

**Encourage experimentation and document results.** Unique conditions call for an experimental and pragmatic approach that seeks to rapidly adapt plans based on results. Unfortunately, in the wealth of studies on Afghanistan, there are few that measure a baseline, describe an intervention undertaken by donors or the military, and then measure the subsequent long-term outcomes. Even those that do document success or failure usually focus simply on program outputs—money spent, people trained, conferences held, buildings constructed—rather than more meaningful indirect measures, such as average income, price changes for needed goods, employment rates, import-export levels, etc. Because data on what has previously worked is hard to find, many implementers rely on anecdotal knowledge or past experience.

The rigorous multiyear Randomized Impact Evaluation of the National Solidarity Program (NSP) provides a useful model for monitoring and evaluating project efficacy. Led by a team of both academic researchers and development officials, it has conducted multiple surveys of 500 villages—half of which had the NSP intervention and half of which are a control group. A very comprehensive set of measured variables allow the evaluation to examine how NSP has influenced governance perceptions, the role of women, the status of infrastructure, agricultural yields, income, consumption, and more.<sup>92</sup> Within the context of the evaluation, they also have conducted subtreatment interventions, experimenting at the margins to evaluate the impact of different methods of project selection and implementation. More studies of this ilk, particularly in areas of attempted private-sector interventions, could provide an effective library of success and failure

factors to guide future development efforts. The rigorous compilation of military “after-action reports” that have proven effective for sharing the best tactics in dealing with roadside bombs and adaptive insurgents can be emulated in the economic realm.

Such long-term monitoring and evaluation also would allow for judging and rewarding performance in a meaningful way. In the absence of typical business incentives predicated on a deal being executed, development officers are rewarded equally for the appearance of progress as they are for real progress. Good media coverage and nicely written grant reports can inflate success or provide incorrect case studies for duplication.

**Get close to problems and enable “drivers.”**

Instead of having hundreds of people writing white papers and vaguely responsible for many different sectors, place people at the ground level accountable for a single task. One U.S. development officer noted that “all our people are getting stuck in internal policy meetings feeding the Washington information beast.” Navy Lieutenant Tim Graczewski told the story of going out to brief the economic growth plan to coalition officials in the most important district in Kandahar Province, and finding that there were only two people to receive the briefing—the Battalion Executive Officer, who certainly had many other issues on his plate, and a PRT (Provincial Reconstruction Team) representative, whose primary focus was governance. It is as if, he said, “Microsoft had a thousand people doing corporate strategy, but there are only two software engineers actually developing a product. And so the strategists arrive with their PowerPoints on market segmentation and value chain analysis, and the two engineers look at them like they just came from Mars.”

Lieutenant Graczewski went on, “The closer you are to the ground, the more obvious and simple the problems become.” Afghan businessmen echoed this sentiment in their own way, noting the disadvantages of trying to do business in Afghanistan from Dubai or London, even with longtime trusted local managers. Sadat Naderi, owner of grocery stores, an insurance company, and fuel distributors, said: “I need to be here, leading my troops.”

A possible model here could be similar to the special forces/transition team military concept, in which business personnel could be embedded in specific Afghan businesses with a focus on developing the Afghan’s abilities rather than doing it for them. The director of Afghanistan’s national electricity authority noted that one major problem with development consultants and their projects is that often no actual knowledge transfer to the resident Afghan workers takes place.

**Eliminate layers of aid spending.** Aid spending should be streamlined, removing inefficient layers of subcontractors, which erodes accountability and undermines project completion. Furthermore, the current reliance on subcontractors creates perverse incentives to actors who seek to make money as pure middlemen without creating value. The calls to push more aid through the Afghanistan national government should be moderated by the reality that such government-channeled aid often has delivered minimal results, enriched officials and their cronies, and pushed out private-sector enterprises.

**Be willing to accept failure and change approaches.** Unlike a business, which will cut its losses and move on, each layer of a traditional development project lacks incentive to acknowledge failure. Elegant reports with glossy pictures substitute for real performance and are rewarded with continued funding. One senior business development official described how the implementer, the beneficiary, and donor all will keep pouring effort into a misguided venture because they are evaluated on input metrics of money spent and hours worked and output metrics of social “intangible” factors.

**Be comfortable with enabling profitable enterprises.** Some within the State Department, USAID, and other development agencies seem fundamentally uncomfortable with the idea that a good business will enrich its owners. As Robert Mosbacher, former head of OPIC, noted to us, it is as if some believe that profit is illegitimate or immoral, and private-sector projects must deliver equal benefits to all. This has created a culture where Afghans applying for a grant hide the “profit” part of their business plan in inflated costs because they think the donors will not support a project that may reward the owners.<sup>93</sup> It also

enables a parasitic government that preys on the revenues of others and sees the private sector as a rival. In yet another perverse incentive, international donor organizations and NGOs often prefer to give contracts and business to other NGOs rather than for-profit ventures.<sup>94</sup>

### **Recognize profit as a legitimate metric.**

Interviewing business owners often was a refreshing change from too much time spent sipping chai with government officials. When asked about results, the latter tend to talk in intangibles buzzwords—coordinated governance, capacity building—while the former talk in survival terms. Ask a politician for a hard number and they almost always had to get back to you; ask a good business owner how much their costs are and they could rattle them off from memory.

Our experience ran parallel to an argument made by Ann Bernstein that was recently summarized in *The Economist*:

Companies benefit society simply by going about their normal business. In a free and competitive market, firms profit by selling goods or services to willing customers. To stay in business, they must offer lower prices or higher quality than their competitors. Those that fail disappear. Those that succeed spread prosperity. Shareholders receive dividends. Employees earn wages. Suppliers win contracts. Ordinary people gain access to luxuries that would have made Cecil Rhodes gasp, such as television, air-conditioning and antibiotics.<sup>95</sup>

In Afghanistan, distortions and insecurity create opportunities to profit in unhelpful ways—by extracting value rather than creating it. But this does not mean that all worthwhile projects need heavy subsidies. Indeed, allowing businesses to succeed or fail with the minimal necessary support can be a valuable barometer for donors to see through boisterous rhetoric and talented scam artists.

Additionally, in enforcing accountability, distinctions must be made between projects intended for social good and those intended to make a profit and scale for future growth. The muddying of the two metrics has resulted in projects that satisfy neither goal. Some projects that create valuable social change, such as enabling and empowering women through household

income generation projects, should not be accountable to pure for-profit metrics. As one development officer said: “If you want to run this like a business, the first thing you would do is fire eighteen of the twenty employees.”

Conversely, donors should neither support bad business ideas because of alleged community benefits nor weigh down a good business with additional “social” requirements. Another development officer described the creation of an apprenticeship program to replace foreigner labor in an industrial park: he was first required by superiors to employ ex-combatants for the project; then he was asked to additionally employ handicapped workers. Neither category of employee were necessarily best suited for a pilot labor replacement project in factories.

**Reward and protect safe areas.** In Afghanistan, certain areas are simply safer for cultural, geographic, ethnic reasons. Development expert Siri Trang Khalsa refers to such security havens as a “natural resource,” which should be similarly maximized for growth. A frequent complaint heard in more secure areas such as Mazar-e-Sharif and Herat is that they have seen comparatively little western support, which instead focuses on dumping money into the volatile and unstable districts in the country, often distorting the local economy. Stable areas should be reinforced with key infrastructure improvement—for example, already economically vibrant Herat would benefit greatly from having an international airport, allowing it to bypass Kabul for air transporting goods and people.

**Provide a risk/reward framework for military development projects.** One commonality between businesses and the military is that they both have developed frameworks that organize and account for risk. However, the weakness of the military is that while they are good at incentivizing and accounting for catastrophic risk to troops or civilians (casualties), they are poor at accounting for economic risk. There is no clear way that the military is held to account for the way they spend their emergency funds or propagate other methods of economic stimulus—indeed, the incentives often are perverse because they reward very short-term stabilization gains that can lead to long-term structural problems.



### 3. Support Afghan enterprises with a better regulatory and operating environment, public-private partnerships, and linkages to multinational firms.

The Afghan government, with international support, should aim to create a pro-business environment that provides incentives, protections, and access to domestic and foreign markets for Afghan industries. Poor infrastructure, corruption, foreign dumping and inability to access markets, insurance, and financing all hamper Afghan firms' ability to gain a foothold domestically and compete internationally.

The Afghan government and international community can facilitate the formation and expansion of enterprises in these sectors through a variety of measures: increasing public-private cooperation; incentivizing multinational companies to partner with Afghan firms while mitigating risk; increasing domestic production and reducing import tariffs on raw materials; improving industrial infrastructure, principally power supply and road networks; fostering trade linkages between different regions of Afghanistan, the economies of which often are oriented more toward neighboring countries than neighboring provinces; encouraging the international community to procure locally whenever possible; negotiating bilateral and regional trade agreements that curtail dumping and increase access to markets in the Persian Gulf, India, and the West; and increasing transparency and reducing corruption in the government's relationship with the private sector.<sup>96</sup>

#### **Provide public-sector help in the right places.**

Donor funds should be specifically targeted to the areas where returns are minimal or uncertain and donors may be the only ones willing to invest—for example, in electricity generation, road construction, hydropower dams, railways, international airports, and other infrastructure. In many cases, however, development funds can be partnered with private funds for jump-starting investment into Afghanistan's key producers in important sectors. Robert Mosbacher argues that public money can provide technical assistance to enable significant private capital investment that might not otherwise occur.<sup>97</sup>

Development also can play a crucial role in bringing buyers and producers together, so that the producer can understand how to capture more value. Examples include informing carpet makers of changing market preferences or educating raisin producers about the quality requirements for export to the European market. While several development organizations already try to do this, often the main result is a large general conference with questionable results rather than the targeted creation of an actual business deal or relationship.

Brock Dahl, who previously worked with the U.S. Treasury Department in Iraq and Afghanistan, emphasized the limited role of donor support: "The focus of USG programs should be on the issues that the businessmen cannot do anything about: infrastructure, corruption, security. Then try to support indigenous programs to do other things like train accountants, etc. Businesses will not emerge because of centralized planning, they will emerge because entrepreneurial Afghans see opportunities, and the right structural dynamics exist to enable them to pursue those opportunities."

**Improve tax collection and business trust in government services.** A central challenge for economic development in the context of counterinsurgency is how the legitimacy of government can be increased if aid is not channeled through government and if a robust private-sector can partially circumvent government. This is a key trade-off in combining traditional counterinsurgency doctrine and sustainable entrepreneurial economic growth. While a government role is required for aid in certain sectors such as infrastructure and education, given the current level of corruption, these may be better addressed at the regional and local governance level.

In theory, business development can strengthen the legitimacy of the government by providing tax revenues that allow the government to function. However, it also can undermine government by becoming a competitor, acting in a self-interested manner that is at odds with the public interest. In Afghanistan, the public-private relationship is complicated: in some respects, conflicts of interest blur the lines between public and private; in other

respects, a deep-seated hostility exists between the two parties. Tax collection is a useful indicator for gauging his relationship. Taxes represent a social compact: businesses pay taxes with the expectation that the government provides basic services and creates a favorable business environment. The failure of business to pay taxes can be a negative sign that businesses believe that government is not upholding its responsibility due to incompetence, corruption, or illegitimacy; that inconsistent tax collection demonstrates unfair exceptions made for certain players in the economy; that there is a power imbalance between the two parties; and that a lack of business activity leads to a lack of tax revenue. Currently, poor tax collection rates in Afghanistan indicate a fracture in the business-government relationship with negative consequences for the country's development.<sup>98</sup> However, it is an area of opportunity for the two sectors to cooperate, not compete, in a way that can be mutually beneficial.

### **Improve Afghan First and local procurement.**

The Afghan market should be properly incentivized to produce for western procurement. There is inevitable tension between military commanders who "need it yesterday and don't care how you do it" and a desire to procure through Afghan channels. In the case of satisfying the logistics chain, contractors will do whatever it takes to get materials there quickly, never mind the distortions caused or the local alternatives bypassed. Right now, Afghans cannot generally win contracts unless they already have the capacity to deliver, but they cannot invest in capacity or secure capital unless they have a guaranteed contract. A better method, and one beginning to be used by the Coalition, will issue contracts that state "The ISAF will purchase X good in one year's time from an Afghan company if it meets Y specifications," so business can develop to meet a foreseen need.

Incentives need to change within the western contracting ladder as well. For example, an Afghan businessman noted that ISAF's primary food contractor works on a cost-plus basis, so there is no incentive to switch from flying produce in from Dubai to using local goods. To align incentives, one option might be to offer to pay the same Dubai prices for goods for a full year after the switch to Afghan procurement, so the contractor

realizes the cost savings. However, one important qualification to promoting local procurement is that internationals must be careful not to create entirely artificial industries. It is reasonable to worry what might happen to a service industry that has grown bloated in support of solely the international community.<sup>99</sup>

Lastly, laudable recent efforts to improve contracting oversight and ensure responsible allocation should not discourage local procurement. New contracting guidelines need to be balanced with continuing to proactively give Afghans the opportunity to provide goods and services for international forces. An NGO worker in Kandahar noted that new oversight efforts in fall and winter 2010 may have destroyed trust with local businesses: "Lots of effort and resources have gone into trying to get S2 [intelligence] types to vet and approve businesses and contracts, but very little effort and resources have gone into positively trying to expand access to the contracting process or other economic tools."

**Improve trade relationships.** In July 2010, Afghanistan and Pakistan signed a bilateral trade agreement providing Afghanistan with sea access, Pakistan with direct routes to Central Asia, and a joint chamber of commerce. Proponents believe that the deal will reduce average transit costs by half, lower import costs, and make exports more competitive for the two countries.<sup>100</sup> The pact is a positive step in redressing Afghanistan's \$4 billion-plus trade deficit. Future steps should ensure implementation of the agreement, push for greater Afghan access to the Indian market, pursue similar initiatives with Afghanistan's northern and western neighbors, and provide protective measures for Afghan agricultural and industrial producers.<sup>101</sup>

### **Prioritize and sequence sector support.**

As businessman Tamim Samee joked, there is no magic single sector in Afghanistan besides opium. Afghanistan's economy will have to be cobbled together from many different areas. The international community has prioritized agriculture and mining relative to other sectors due to their potential for income and job creation.

- **Agriculture:** Attracting private investment, supporting public-private partnerships, and coordinating efforts locally, regionally, and

nationally will be critical to developing this sector.

- **Mining:** The Afghan government and international community view mineral resources as key to the country's long-term fiscal woes and budget deficit. The Afghan government and international community must attract foreign investors and multinational mining companies, structure negotiations in a way that benefits the Afghan population while allaying outside fears of insecurity, corruption, and potential nationalization, and prevent its mineral wealth from becoming a resource curse.

However, overemphasis on agriculture and mining has led to neglect of sectors more amenable to entrepreneurship.<sup>102</sup>

- **Light Manufacturing:** In an anti-manufacturing environment dominated by monopolistic traders and foreign importers, domestic success stories are exceptions rather than the norm. The Afghan government and international community must address key industrial constraints, including problems relating to electricity, land, and roads, and incentivize Afghan production and consumption rather than relying on imports. Developing manufacturing linkages to the agriculture and mining sectors could be a major area of growth.
- **Services:** The growth of the telecom sector, including \$1 billion in investment and 60,000 new jobs in the past five years, has been one of the biggest private-sector success stories in the post-Taliban era. Successful companies have provided basic needs in an innovative way to Afghan consumers. Information technology, transportation, logistics, and other service sector opportunities have similar potential, but need to be accompanied by proper policies, incentives, and supports.

#### 4. Increase access to capital and business advisory services.

While not as simple as bringing venture capital to Afghanistan, there is a clear need for institutions that can provide access to capital in equity and structured lending forms, with a robust

and embedded advisory business development component.<sup>103</sup> Some basic recommendations for such institutions include:

- Lending should be relationship-based with a high degree of involvement of the lender in the business, to include ownership stake and ongoing advising. This is necessary because of a lack of normal lender protections, a high degree of corruption and scams, and an internal lack of business development skills. For example, instead of simply giving a check, lenders might go to purchase the equipment with the owners. In the absence of secure collateral and exit options, financing will often be based on the current and future cash flows of the business, with the potential for an eventual management buyout of the outside capital providers.
- Equity-type incentives on the provider side will ensure that they choose their projects wisely and work for the long term. However, this will be not as simple as declaring "30 percent ownership" of a company, because the concept of earning a profit for shareholders is not obvious to average Afghan business owners.<sup>104</sup> Alternate options would include full partnerships with additional payouts to both lender and recipient if certain performance targets are reached. While the majority of the financing may be in traditional debt forms, for example, royalty payments of a small percentage of gross sales could be required.
- Institutions have to be seen as giving money to businesses in an equitable fashion—providing equal chances to compete for loans and clear and transparent explanations for why applications are denied and others chosen. However, this should not translate into supporting four separate and competing businesses, as some donors have occasionally done.
- Inevitable conflict of interest should be announced publicly. (Afghanistan's business community is small, particularly in certain sectors.)
- Lending institutions and business owners must agree on a single bottom line. Bad business ideas should not masquerade as social good ideas.
- Institutions should balance working with already successful and connected entrepreneurs with

encouraging new and unconnected ones (so as to not reinforce existing political and tribal power disparities).

- A focus on the entrepreneur is the crucial element. In a long-term conflict climate, the person who shows up at your doorstep asking for investment money often cannot be trusted, as he may be a local who has become expert at gaming a donor system. It is better to identify the sector you are interested in, and go scour the countryside for the entrepreneur already making progress in that area. Once you find a good one, keep investing in him or her—human talent is the hardest to find and most irreplaceable factor.

### 5. Make clear long-term commitments.

The international community should pair its short-term approach to stabilization with a long-term commitment to Afghanistan’s future in order

to reduce harmful uncertainty in the business environment. In interviews with Afghan businesses and foreign investors, the question of what would happen in July 2011 and beyond loomed large. Based on our interviews, businesses are less concerned with troop levels and aid dollars and more concerned with whether the international posture is predictable beyond the next six months. Commitments may be modest and nuanced to reflect regional realities, but they must be clear. Such statements of commitment should send a powerful message that allows businesses to plan for the long term, discourages rent-seeking and opportunistic behavior, and allays Afghan fears of abandonment. Corresponding trust-building actions also will be necessary. For example, donors can undertake public-private infrastructure projects in the more stable areas or provide future purchase guarantees to create predictable revenue for Afghan businesses. Once given a minimally certain framework, Afghan entrepreneurs will find a way.

## Recommendations

The five categories of recommendations we make roughly align with the classifications of key problems described at the beginning of the paper.

PROBLEM	RECOMMENDATION
<b>Insecurity/Uncertainty</b>	Make clear long-term commitments to security, governance, and economic development.
<b>Corruption</b>	Change incentives to ensure implementation and reward long-term results.
<b>Access to Capital</b>	Increase provision and access to combined capital and business advisory services.
<b>Physical and Human Infrastructure</b>	Facilitate public-private partnerships in the development of power, roads, and other key infrastructure, and infuse private-sector talent and resources to support Afghan business development.
<b>Policies, Rules, and Regulations</b>	Support Afghan businesses with a more conducive regulatory and operating environment, particularly in the areas of tax, land, and trade policy.

The Obama administration's recent comments about extending NATO's presence in Afghanistan until 2014 are a positive step towards stabilizing the business environment.<sup>105</sup> Such statements should be coupled with a renewed commitment to economic, and particularly private sector, development. Meanwhile, the international community should be careful about balancing the need for a longer-term commitment with not becoming open-ended and making Afghan businesses even more dependent on foreign aid and outside actors than they already are. International efforts should place as much responsibility as possible in Afghan hands with support from outside experts with relevant expertise.

## VI. Conclusion

Based on our field research, we conclude that private-sector development is possible and vital to Afghanistan's future. However, the international community must be thoughtful about how it attempts to enable progress. War should not be an excuse to resurrect flawed concepts—for instance, that centrally planned growth is necessary due to a chaotic environment or that, with enough money, donors can simply create a developed economy. A vibrant private sector must be built from the ground up, where government provides a basic level of security, removes as much unpredictability as possible, and provides a regulatory framework for success.

Our recommendations build on common sense thinking from the field. Many are basic. Private-sector development in Afghanistan requires recognition of its fundamental importance to Afghanistan's future; a comprehensive strategy; leadership by a senior official who is overall responsible for disparate and sometimes competing programs; incorporation of private-sector talent, western and Afghan, to drive this process;

establishment of incentives and oversight geared to results; prioritization of a handful of sectors with the highest potential rewards, rather than attempts to do everything; an examination of the past decade's successes and failures; and constant consideration of the Afghan entrepreneur at the grassroots who is trying to innovate and provide value to the Afghan economy and society.

Private-sector development offers hope for Afghanistan's future, but requires a long-term commitment with realistic expectations. A western official stated, "The main obstacle is time. You have generations that are uneducated. We are in a big hurry. We have aggressive goals for nation-building and are trying to implement a counterinsurgency strategy faster. But this process won't happen in a hurry. Our lessons learned are helping though. With more control in the hands of Afghans and less [development] money in the future, we will probably see better results."

Private-sector development is not a quick or easy solution to Afghanistan's ills. Moreover, it requires a fundamental shift: Afghan entrepreneurs must be empowered to be the key drivers. Outsiders must accept an enabling role while remaining aware of their potential to create harmful distortions. Importantly, this effort requires smarter policy and the right people, not necessarily more money. With targeted help, Afghanistan can see real and sustainable growth in the next decade and beyond.

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## Appendix: Additional Observations

Some of the anecdotal observations gleaned in interviews did not fit well into a discussion of the major problems faced by SMEs in Afghanistan; however, they may still provide valuable context to some readers.

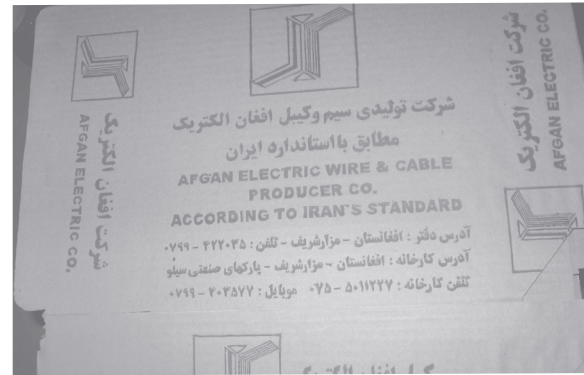
### Cultural Considerations

A number of cultural constraints to economic growth were mentioned often in interviews, though they should not be overly generalized. Many of these are symptoms of the lack of trust and survivor mentality developed by decades of war. Afghans often are wary of business partners and can be uncomfortable working together across ethnic lines. Carpet producers worry that rivals will steal their designs, and do not want to share cutting and finishing facilities with other producers. The formation of effective associations and lobbies to influence government policy is hindered by distrust.

Both Afghans and internationals also raised concerns about quality issues. In attempts to compete in niche high-end exports—such as traditional arts and handicrafts—some Afghans have trouble understanding the competition level of the world market and that their product must be “perfect” to deserve the high price required by the exorbitant costs of distributing to a western market. “I have to constantly send back items to be redone,” a manager of one such business explained, “and I worry that when I am no longer here, the quality will fall and they will again lose their portion of the world market.”

Development officials further noted that Afghans often do not have an appreciation for the value of quality control measures or certification processes—and therefore lose out on international contracting opportunities that instead go to Pakistan. Quality concerns have resulted in a very poor brand for Afghan products—within Afghanistan itself. These concerns have prompted some Afghan manufacturers to hide the fact that their products are made in Afghanistan. For example, one Mazar-e-Sharif–based cable and wire

manufacturer labeled his products “Made in Iran” to convey high quality to customers. He explained that many Afghans associated goods made in Afghanistan with shoddy quality.



Box of a Mazar-e-Sharif cable and wire company

On the opposite end from high-end issues, several Afghan business owners noted that Afghans were too proud and disdained certain jobs as beneath them or “not worth their while.” They explained that when some Afghans saw a Pakistani doing a basic job, such as sanitation or menial labor, the Afghans then would refuse to be employed in the same way.

### Advantages of a Developing Market

Although the aforementioned problems that typical developing countries face seems to present a particularly gloomy picture of the opportunities in Afghanistan, its situation is not entirely negative for business. In some cases, the lack of competition and the Afghan people’s eagerness for a service of any quality can prove skeptics wrong. There is more consumer forgiveness in a developing market. For example, Tolo Television (a subsidiary of Moby Group) initially was able to buy old Bulgarian rather than western broadcasting equipment because viewers and advertisers could handle a few minutes off air or a bad signal. One of the first private television stations, Tolo TV eventually became profitable and is now the market leader in Afghanistan.

Another advantage of developing countries—the ability to leapfrog technologies—has spurred the telecom industry, the biggest business success story in Afghanistan. One of the oft-told success stories of Afghanistan is how Ashraf Ghani resisted calls to contract a company to provide cell phone service, but instead tendered licenses in a transparent way.<sup>106</sup> Today, Afghanistan has nearly 12 million mobile telephone customers, a market penetration of almost 50 percent—astounding for a country that had virtually no telecommunications infrastructure a decade ago.

The Afghan market excuses even safety problems, for better or worse. One of Pamir Airline's six aircraft crashed on a flight in May 2010 killing all aboard, the accident blamed on a combination of poor equipment and bad judgment. Yet through the summer, the majority of Pamir's flights remained fully booked—and cheaper than the competition.

Some entrepreneurs complained that outside consultants and donors tend to be risk averse and historically focused in their predictions, leading them to erroneously reject business ideas as unfeasible. But as one businessman told me, "They don't realize that business in Afghanistan is all about scraping by on the margins, particularly at first. You pay your creditors late, get your customers to pay now, scrape by until you can reach daylight."

Once success is achieved, expansion becomes easier because of a dearth of competition—assuming the business does not attract the attention of a powerful government official or power broker. Michelle Morgan, contract director of USAID's ASMED program, attributed the common phenomenon of vertical integration to a lack of entrepreneurs who were both talented and resourced—successful business people find no shortage of additional unfilled needs.

## Biographies

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bridging the gap between international buyers and Afghan suppliers, with some successes. The recent launch of afghanfirst.org and afghanbids.com websites also attempt to improve Afghan access to bid information.

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- <sup>43</sup> Although unverified, multiple interviews with respected Afghans referenced a \$100 million Kabul Bank loan to Pamir Airlines without expectation of specific repayment, fueled by personal connections and a grudge against the owner of Kam Air. For additional reporting, see Andrew Higgins, "In Afghanistan, signs of crony capitalism," *The Washington Post*, February 22, 2010.
- <sup>44</sup> The inadequate regulation and bad practices of Kabul Bank in particular were noted in interviews with Afghan bankers, U.S. officials, and Afghan businesses during the summer of 2010. See also Alissa Rubin, Charlie Savage, and Rod Nordland, "Regulators Ignored Warnings about Afghan Bank," *New York Times*, September 18, 2010.
- <sup>45</sup> USAID's Land Titling and Economic Restructuring in Afghanistan (LTERA) project tried to address land registry issues, with mixed success. Deeds and titles are not trusted. Government officials grab lands and then give to supporters. In rural areas, transactions often are informal and not recorded. A development official stated that the minister of urban development had recently declared that only land titles since 1992 are valid. A new program to improve Afghan land titling has recently begun; see Walter Pincus, "Reinventing Afghan Real Estate," *The Washington Post*, September 20, 2010. USAID has estimated that 85 percent of all property transactions are informal, and 70 percent of all urban real estate is unregistered ([https://www.fbo.gov/download/336/33675a4e7a40ee71b3434a6bbce330ea/Amendment\\_No\\_\\_1\\_RFP\\_No\\_\\_306-10-0032\\_\\_LARA\\_\\_Land\\_Reform\\_In\\_Afghanistan\\_Project.pdf](https://www.fbo.gov/download/336/33675a4e7a40ee71b3434a6bbce330ea/Amendment_No__1_RFP_No__306-10-0032__LARA__Land_Reform_In_Afghanistan_Project.pdf)).
- <sup>46</sup> From interview with Herat's Afghan Investment Support Authority representative, and various Herat Industrial Park owners.
- <sup>47</sup> Ian Livingston, Heather Messera, and Michael O'Hanlon, "Afghanistan Index: Tracking Variables of Security and Reconstruction in Post 9/11 Afghanistan," Brookings Institute (2010).
- <sup>48</sup> "Afghan Business Attitudes on Economy, Government, and Business Organizations: 2009–2010 Afghan Business Survey Final Report," Center for International Private Enterprise, Charney Research, and National Endowment for Democracy.
- <sup>49</sup> Dowdy and Erdmann, "Private Sector Development in Afghanistan."
- <sup>50</sup> Literacy is 12 percent for females and 39 percent for males; "Summary of the National Risk and Vulnerability Assessment 2007/8: A Profile of Afghanistan."
- <sup>51</sup> Islamic Republic of Afghanistan, *Afghanistan National Development Strategy* (2008), 74–77.

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- <sup>52</sup> CIPE 2010 survey, 17.
- <sup>53</sup> Though anecdotal, such stories were relayed by both development officers and Afghan business people in Herat, Kandahar, Jalalabad, Kabul, and Mazar-e-Sharif.
- <sup>54</sup> The particular challenges and successes of women entrepreneurs are outside the scope of this paper, but are also very relevant to Afghanistan. Problems such as access to capital are particularly pronounced for women entrepreneurs—they frequently have no business history, no land collateral, and face additional cultural constraints. For women entrepreneurs who are able to find external markets, sometimes with help from international NGOs, profit margins are eviscerated by high transport costs, making fulfilling the contracting opportunity economically unfeasible. Gayle Tzemach Lemmon, among others, has done excellent work documenting this area; see: “Women Entrepreneurs in Post-Conflict Economies: A Look at Rwanda and Afghanistan,” Center for International Private Enterprise (April 26, 2006) and; *The Dressmaker of Khair Khana*, (New York: Harper Collins, forthcoming 2011).
- <sup>55</sup> Special Inspector General for Afghanistan Reconstruction (SIGAR), *October 2010 Quarterly Report to Congress*, 111th Cong., 2d sess., 106.
- <sup>56</sup> The perceived need to maximize short-term performance over long-term sustainability was described during in-country interviews with both USAID development officials and contract implementers. See also: Ben Arnoldy, “How USAID loses hearts and minds,” *Christian Science Monitor*, July 28, 2010; and Dowdy and Erdmann, “Private Sector Development in Afghanistan.”
- <sup>57</sup> “Donor drunk” is the phrasing of a senior Afghan government official. According to the Afghanistan Ministry of Finance’s “Donor Financial Review” published in November 2009, international donors had disbursed \$35 billion in development assistance from 2002 to 2009. As of September 2010, the United States alone has cumulatively allocated \$56 billion for relief and reconstruction. (SIGAR, *October 2010 Quarterly Report to Congress*).
- <sup>58</sup> Author observations. Monthly rent for a four-bedroom home could be more than \$10,000; see James Melik, “Property Market in Kabul Bucks Trend,” *BBC World Service*, November 23, 2009. Interviews with prominent Afghan businessmen Saad Mohseni and Tamim Samee described inflated wages for semiskilled labor (compared to Pakistan) beginning as early as 2002.
- <sup>59</sup> This sentence was derived from interviews with consultants (Afghan and Western), government officials, and the head of one ministry.
- <sup>60</sup> Derives from the “Bagram Air Base,” which is situated an hour’s drive outside of Kabul and is the major hub of the international presence.
- <sup>61</sup> This paragraph is based on interviews with development officers and Afghan contractors on Kandahar Airfield and in Kandahar City during August 2010.
- <sup>62</sup> This paragraph derives from Daniel Spulber’s *The Theory of the Firm: Microeconomics with Endogenous Entrepreneurs, Firms, Markets, and Organizations*. Cambridge University Press, 2009. Ch. 4, 151-155.
- <sup>63</sup> Ibid.
- <sup>64</sup> Ibid.
- <sup>65</sup> Ibid.
- <sup>66</sup> For a detailed discussion of industry fragmentation, see Michael Porter, *Competitive Strategy*. The Free Press. 1980. Ch. 9.
- <sup>67</sup> Adam Pain, “Trading in Power: The Politics of Free Markets in Afghanistan,” Afghanistan Research and Evaluation Unit (AREU), June 2004, 3.
- <sup>68</sup> Anna Paterson, “Going to Market: Trade and Traders in Six Afghan Sectors,” Afghan Research and Evaluation Unit (AREU), June 2006, 16.
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- <sup>69</sup> This paragraph is based on interviews with Roshan's CEO Karim Khoja, COO Altaf Ladak, and Farah Kurji.
- <sup>70</sup> World Bank, *Afghanistan Economic Update*, October 2010, 14.
- <sup>71</sup> World Bank, *Afghanistan Economic Update*, October 2010.
- <sup>72</sup> Greg Bruno, "Nourishing Afghanistan's Agricultural Sector," Council on Foreign Relations, May 26, 2009.
- <sup>73</sup> *Ibid.*
- <sup>74</sup> James Risen, "U.S. Identifies Vast Mineral Resources in Afghanistan," *New York Times*, June 13, 2010. Some observers questioned the reliability of this estimate while also noting that Afghanistan's mineral resources had long been known. Regrettably, the average Afghan reaction we heard to the announcement was less than productive—typical quotes were "when I am going to see my cut?", "so this is why the Americans are here," "we're rich—a hundred thousand dollars for every Afghan," and "why did the Americans wait to tell us?" The reaction of international actors was similarly mixed. Some viewed the news optimistically, hoping that the mineral wealth could translate into sustainable revenue for a country both heavily aid reliant and saddled with an onerous budget deficit. Others worried that the mineral wealth would become a resource curse, fueling further conflict and corruption and destabilizing the country. Regardless, Afghanistan's natural resource opportunities extend beyond minerals, including world-class marble in Herat province, and oil and gas deposits around the country.
- <sup>75</sup> *Ibid.*
- <sup>76</sup> *Ibid.*
- <sup>77</sup> Afghanistan Investment Support Agency (AISA), *Annual Report 2008*, 11–18.
- <sup>78</sup> See SIGAR quarterly reports for a more detailed discussion of fraud, waste, and abuse in the Afghan construction sector.
- <sup>79</sup> The executive is referring to Pakistan's influence on Afghan politics.
- <sup>80</sup> Afghan Customs Department website, <http://www.customs.gov.af/>.
- <sup>81</sup> World Bank, *Afghanistan Economic Update*, October 2010, 14.
- <sup>82</sup> For a more in-depth discussion of Afghanistan's trade issues, see <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/EXTSARREGTOPINTECOTRA/0,,contentMDK:20592515~menuPK:579454~pagePK:34004173~piPK:34003707~theSitePK:579448,00.html>.
- <sup>83</sup> International Monetary Fund (IMF), "Islamic Republic of Afghanistan Statistical Appendix," February 2008.
- <sup>84</sup> Carpets was second to dried fruits and nuts as an export. World Bank, *Afghanistan Economic Update*, October 2010, 3.
- <sup>85</sup> SIGAR, *October 2010 Quarterly Report to Congress*, 95.
- <sup>86</sup> *Ibid.*
- <sup>87</sup> NSP is perhaps the most-cited development success story of Afghanistan. See Robert Zoellick, "The Key to Rebuilding Afghanistan," *The Washington Post*, August 22, 2008; see also, Dr. John Nagl, Andrew Exum, and Ahmed Humayun, "A Pathway to Success in Afghanistan: The National Solidarity Program," Center for a New American Security, (March 2009).
- <sup>88</sup> For example, the On the Frontier Group, Afghanistan Research Evaluation Unit, and Altai Consulting all have produced excellent field research on constraints and opportunities in business sectors such as carpets, marble, raisins, media, construction, microfinance, etc.
- <sup>89</sup> It is also worth noting that in even some of the better military or donor economic development reports, there is little focus on firsthand input from Afghans. Surveys of economic strategy for particular regions of the country will overwhelmingly will interview mostly ISAF or international personnel—and the few Afghans interviewed will generally will all be in government. Security concerns and logistical difficulties are generally are cited for the lack of field interviews.
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- <sup>90</sup> The problems of Afghanistan and our recommendations have much in common with previously diagnosed development failures and proposed solutions. We benefited from the robust collection of literature on this topic, including: Joshua Lerner, *Boulevard of Broken Dreams: Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed, and What to Do About It* (Princeton, NJ: Princeton University Press, 2009); R. Glenn Hubbard and William Duggan, *The Aid Trap: Hard Truths about Ending Poverty* (New York: Columbia University Press, 2009); William Baumol, Robert Litan, and Carl Schramm, *Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity* (New Haven, CT: Yale University Press, 2007); and William Easterly, *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good* (New York: Penguin Press, 2006).
- <sup>91</sup> As is common throughout the developing world, most businesses in urban areas of Afghanistan cluster next to each other—all the bookstores in Herat line one block; car tire shops are all on one street in Kabul; etc.
- <sup>92</sup> More details are available at the NSP-IE website: [www.nsp-ie.org](http://www.nsp-ie.org). Interim results were partially documented in: World Bank, "Independent Impact Evaluation: National Solidarity Program Enhances Local Governance and Increases Involvement of Women," (May 2010).
- <sup>93</sup> These examples were recounted by an official for USAID's Afghanistan Small and Medium Enterprise Development (ASMED) project.
- <sup>94</sup> One longtime journalist covering Afghanistan noted reports that in 2001, the international community created a registry for NGOs, not businesses, so entrepreneurs seeking to register a business had to register as an NGO; the incentives were set early on.
- <sup>95</sup> Schumpeter, "Companies Aren't Charities," *The Economist*, October 21, 2010.
- <sup>96</sup> The idea of regional trade linkages was first voiced by Dowdy and Erdmann; see also a report from William Byrd of the World Bank, "Afghanistan Needs Pro-Private-Sector Growth" (June 2005).
- <sup>97</sup> This section in general benefited from Robert Mosbacher's paper, "A New Strategy to Leverage International Development" (Global Economy and Development: Working Paper 41, Brookings Institute, May 2010).
- <sup>98</sup> Domestic revenue collection has improved recently, to 8.9 percent of GDP in 2010, but still lags significantly behind the average of other undeveloped countries (average 17% of GDP). (World Bank, "Afghanistan Economic Update," December 2010. World Bank, "Afghanistan: Managing Public Finances for Development", April 2006.)
- <sup>99</sup> As has begun to happen in Iraq: see Jack Healy, "As U.S. Leaves, Iraqis Suffer Economic Toll," *New York Times*, December 5, 2010.
- <sup>100</sup> Andrew Quinn, "Afghanistan, Pakistan sign border trade pact," Reuters, July 18, 2010.
- <sup>101</sup> The potential of regional economic development is discussed by Joshua Foust in "Post-Soviet Central Asian Interests in Afghanistan," The Century Foundation, 2010.
- <sup>102</sup> From Dowdy and Erdmann, "Private Sector Development in Afghanistan": "Non-tradable industries in these sectors (trade, retail, construction, transportation, etc.) typically account for half of GDP and approximately two-thirds of employment growth in developing economies."
- <sup>103</sup> This section benefited from the thoughts of Mustafa Kazem, director of the Afghan Growth Fund, and Sanzar Kakar, CEO of Afghanistan Financial Services.
- <sup>104</sup> The authors owe a debt to Kim Davis, cofounder of Charlesbank, and his experience in Eastern Europe in illustrating some of the problems with equity ownership in SMEs of developing economies. Davis noted that the average business owner might be more oriented toward providing employment for his relatives than cutting costs to maximize "shareholder" profits.
- <sup>105</sup> Elisabeth Bumiller, "U.S. Troops Expected to be in Afghanistan in 2014," *New York Times*, November 10, 2010.
- <sup>106</sup> Documented in Karim Khoja, "Connecting a Nation: Roshan Brings Communications Services to Afghanistan," *Innovations: Technology, Governance, Globalization* 4, no. 1 (Winter 2009): 33–50; and
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Ashraf Ghani and Clare Lockhart, *Fixing Failed States: A Framework for Rebuilding a Fractured World* (New York: Oxford University Press, USA, 2008).



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