



# Final Report

Scoping the Need for Improved Access to Funding,  
Advisory Support and Business Skills Development  
for SMEs in Afghanistan

September 2014



In collaboration with the  
Afghanistan Public Policy  
Research Organisation





### Disclaimer

This report is provided on the basis that it is for the use of the UK Department for International Development only. Coffey International Development Ltd will not be bound to discuss, explain or reply to queries raised by any agency other than the intended recipients of this report. Coffey International Development Ltd disclaims all liability to any third party who may place reliance on this report and therefore does not assume responsibility for any loss or damage suffered by any such third party in reliance thereon. The views expressed in this report are the views of the writers and do not necessarily express the views of UKAID.

# Contents

	<b>Executive summary</b>	<b>I</b>
<b>1:</b>	<b>Introduction</b>	<b>1</b>
<b>2:</b>	<b>Methodology</b>	<b>2</b>
2.1:	Approach	2
2.2:	Inception Phase and literature review	2
2.3:	Data collection and in-country phase	3
2.4:	Reporting Phase	5
2.5:	Risk management and factors limiting research design	5
<b>3:</b>	<b>Findings</b>	<b>6</b>
3.1:	Findings of the literature review and desk study	7
3.2:	In-country findings on the demand and supply of SME business development services	11
3.3:	In-country findings on SME access to finance and the provision of funding	17
3.4:	In-country findings relating to the wider enabling environment	24
<b>4:</b>	<b>Options for donor-sponsored interventions</b>	<b>29</b>
4.1:	Options criteria and selection	29
4.2:	Menu of options	31
4.3:	Preferred options recommended to DFID and other development partners	40
<b>5:</b>	<b>Conclusion</b>	<b>49</b>
	<b>Annexes</b>	<b>50</b>
Annex 1:	Terms of reference	50
Annex 2:	Interview sheet guide	53
Annex 3:	SME definitions	55
Annex 4:	Literature review and references	59
Annex 5:	List of types of business development services	90
Annex 6:	Major donor programmes providing business development services	91
Annex 7:	Selected case studies on women-owned enterprises	95
Annex 8:	Guarantee schemes in Afghanistan	97
Annex 9:	APPRO research findings report	98

# Abbreviations and acronyms

<b>ABA</b>	Afghanistan Banks Association
<b>ABADE</b>	Assistance in Building Afghanistan by Developing Enterprises
<b>ABIF</b>	Afghanistan Business Innovation Fund
<b>ACCI</b>	Afghanistan Chamber of Commerce & Industries
<b>ACE</b>	Agricultural Credit Enhancement
<b>ADF</b>	Agricultural Development Fund
<b>AECF</b>	Africa Enterprise Challenge Fund
<b>AFI</b>	Alliance for Financial Inclusion
<b>AFN</b>	Afghan Afghani
<b>AGF</b>	Afghan Growth Finance
<b>AHG</b>	Afghanistan Holding Group
<b>AISA</b>	Afghanistan Investment Support Agency
<b>ANDS</b>	Afghanistan National Development Strategy
<b>ANMDP</b>	Afghanistan New Market Development Programme
<b>APPRO</b>	Afghanistan Public Policy Research Organisation
<b>ARD</b>	Agriculture and Rural Development
<b>AREDP</b>	Afghanistan Rural Enterprise Development Programme
<b>AREU</b>	Afghanistan Research and Evaluation Unit
<b>ASMED</b>	Afghanistan Small and Medium Enterprise Development
<b>AUAF</b>	American University of Afghanistan
<b>BDS</b>	Business Development Services
<b>BE</b>	Business Edge
<b>BEE</b>	Business Enabling Environment
<b>CARD-F</b>	Comprehensive Agriculture and Rural Development Facility
<b>CDC</b>	Commonwealth Development Corporation
<b>CEDAW</b>	Convention on the Elimination of Discrimination Against Women
<b>CIPE</b>	Centre for International Private Enterprise
<b>CSO</b>	Central Statistics Office

<b>DAB</b>	Da Afghanistan Bank
<b>DCED</b>	Donor Committee for Enterprise Development
<b>DFI</b>	Development Finance Institution
<b>DFID</b>	Department for International Development
<b>EAGR</b>	Enterprise and Asset Growth
<b>ECP</b>	Export Coaching Programs
<b>EPAA</b>	Export Promotion Agency of Afghanistan
<b>EU</b>	European Union
<b>FACT</b>	Federation of Afghanistan Craftsmen and Traders
<b>FAO</b>	Food and Agriculture Organisation
<b>FCAS</b>	Fragile and Conflict Affected States
<b>FAIDA</b>	Financial Access for Investing in the Development of Afghanistan
<b>FIEG</b>	Financial Inclusion Experts Group of the G20
<b>FINCA</b>	Foundation for International Community Assistance
<b>FMFB</b>	First Microfinance Bank of Afghanistan
<b>FNMD</b>	Facility for New Market Development
<b>GIRoA</b>	Government of the Islamic Republic of Afghanistan
<b>GIZ</b>	German Society for International Cooperation
<b>GPFI</b>	Global Partnership for Financial Inclusion
<b>ICAI</b>	Independent Commission for Aid Impact
<b>IFC</b>	International Finance Corporation
<b>IMF</b>	International Monetary Fund
<b>INVEST</b>	Introducing New Vocational Education and Skills Training
<b>JICA</b>	Japan International Cooperation Agency
<b>MAIL</b>	Ministry of Agriculture, Irrigation, and Livestock
<b>MENA</b>	Middle East and North Africa
<b>MIDAS</b>	Mining Investment and Development for Afghanistan Sustainability
<b>MISFA</b>	Microfinance Investment Support Facility for Afghanistan
<b>MoCI</b>	Afghanistan Ministry of Commerce and Industries
<b>MOM</b>	Ministry of Mines

<b>MRRD</b>	Ministry of Rural Rehabilitation and Development
<b>MSME</b>	Micro Small and Medium Enterprises
<b>MSMED</b>	Micro, Small and Medium Enterprises Development
<b>NAPWA</b>	National Action Plan for the Women of Afghanistan
<b>NGO</b>	Non-Governmental Organisation
<b>NPP</b>	National Priority Programme
<b>ODI</b>	Overseas Development Institute
<b>PEAKS</b>	Professional Evidence and Applied Knowledge Services
<b>PSD</b>	Private Sector Development
<b>RUFCD</b>	Rural Finance and Cooperative Development
<b>SEAF</b>	Small Enterprise Assistance Funds
<b>SEED</b>	Supporting Employment and Enterprise Development
<b>SIGAR</b>	Special Inspector General for Afghanistan Reconstruction
<b>SME</b>	Small and Medium Enterprise
<b>TAFA</b>	Trade and Accession Facilitation for Afghanistan
<b>ToR</b>	Terms of Reference
<b>TVET</b>	Technical Vocational Education and Training
<b>UNDP</b>	United Nations Development Programme
<b>UNIDO</b>	United Nations Industrial Development Organisation
<b>USAID</b>	United States Agency for International Development
<b>WB</b>	World Bank

# Executive Summary

## Introduction

DFID has commissioned this piece of work to assess the need for improved access to finance and advisory support and/or business skills development, for SMEs in Afghanistan. DFID wishes to improve its understanding of the demand for and the nature of existing support, the gaps, challenges, and the potential negative side-effects. Coffey has been tasked with undertaking a scoping study that will examine the key challenges, opportunities and effectiveness in funding SMEs and providing advisory support and business skills development in Afghanistan.

## Methodology

### Inception phase and literature review

We began the scoping assignment with an inception phase during which data were collected through interviews, a literature review and desk study. We then developed preliminary findings which covered the overarching context for SMEs, demand and supply side constraints, and benchmarking against private sector development (PSD) interventions in other similar contexts. An inception report was drafted, submitted and subsequently approved by DFID.

### In-country stakeholder engagements

We then carried out the bulk of the scoping research, visiting Afghanistan and undertaking field-work. This included interviews with key stakeholders in Kabul, and also in Mazar and Kandahar. International team members undertook more than 30 meetings in Kabul between 12 and 27 May 2014. The objective was to focus on the macro and meso levels, and meet a range of stakeholders including donors, implementing agents, banks, Non-government Organisations (NGOs) and institutions, and public and private sector actors. During this phase, the Afghanistan Public Policy Research Organisation (APPRO), the international team's key national partner, played a pivotal role in undertaking key informant interviews and analysis at the microenterprise level – particularly outside of Kabul.

### The development of options and conclusion

Our results then fed into this report, which is structured as follows. Firstly, a description of the methodology that was applied. Secondly, findings relating to the literature review and desk study followed by findings relating to in-country data collection, which is structured around access and need for business development services (BDS), finance, and the cross-cutting context, particularly where this relates to women and the political economy. Finally, it includes a menu of options and recommendations for donor-sponsored interventions, and specific options for DFID to consider further. This is followed by an overall conclusion.

## Findings

This section reviews the findings from the two stages of our methodology, the literature review and desk research; and then the in-country field research involving stakeholder engagements and informant interviews. In addition to findings relating to the demand and supply of BDS and funding, we also consider wider constraints relevant for women, the political economy context, and the wider business enabling environment (BEE).

### Demand and supply for business development services

SME demand for BDS is significant, and is based upon a combination of four factors: quality, relevance, turnaround time, and flexibility. In the past decade in Afghanistan, typically, a combination of two strategies has been adopted by donors and their implementing partners to ensure a supply for the rapidly evolving BDS needs of SMEs: outsource BDS to local firms (whilst training providers to improve their quality and enhancing the BDS provider market); and provide direct in-house donor/implementer BDS support to SMEs by training internal national staff, or hiring national or international specialists. The core challenges for BDS providers in the private sector in Afghanistan are achieving impact, outreach, cost efficiency and sustainability.

### Critical success factors for donor-funded BDS programmes

Critical success criteria for effective BDS provision in the Afghan market include: understanding the specific problem behind SME requests for support; effectively embedding these into the design of interventions; ensuring



## EXECUTIVE SUMMARY

continued support for SMEs beyond the initial BDS intervention; facilitating linkages amongst beneficiaries with their market; catering for the demands set by women-led enterprises and those that employ women; and, providing a balanced approach between in-house and outsourced BDS, with a view to supporting outsourced options to offer greater chances of sustainability and impact.

### The Afghan financial and banking system and access to finance

The Afghan financial and formal banking system is under-developed, narrow and fragile. Stakeholders alerted us to the possibility of another crisis in the financial sector in the next six months to two years. There are structural weaknesses within the financial sector, especially in the banking system, which need to be more energetically tackled. A high proportion of firms in Afghanistan identify access to finance as a major constraint. In addition, penetration of formal finance with micro, small and medium-sized businesses is comparatively low, and there also exists a phenomenon of self-exclusion for many Afghan SMEs from formal financial services given the major reservations against borrowing on interest from banks or microfinance institutions on religious grounds.

### Diversity of financial products, actors and instruments

There is much progress to be made in expanding the range of financial products, actors and instruments. The major gaps and weaknesses are a lack of competence in product design, unmet demand for Islamic finance, a lack of appropriate and bespoke financial products, a lack of diversity of providers, and high cost of service.

### The cross-cutting context

Afghan businesswomen continue to face difficulties in competing in male dominated markets. The vast majority of women involved in productive, licit economic activities continue to fill jobs lower on the value chain, and are mostly prevented from filling the positions higher up on the value chains where a male-dominated monopoly persists. However, women tend to achieve better results when they belong to networks of women, and can count on each other's support.

Building consensus around a market-driven strategy<sup>1</sup> to spur economic growth, rebalance the economy and enhance government revenues to pay for public goods can prove challenging in a country that has experienced decades of command economy management. The buy-in from the political and intellectual elite is recent and tenuous, while resistance remains amongst organisations with entrenched interests. Our findings suggest that donor and government strategies tend to favour new programmes rather than to look at existing businesses and ways to strengthen them. It is tempting to create new institutions, but the reality is that greater impact may be achieved if efforts are applied to improving and building capacity in existing institutions.

Many SMEs are positive about Afghanistan's future, and of the prospect of a new, democratically-elected president taking office in mid to late 2014. Some stakeholders interviewed believe that the Taliban are less effective than before, and are confident that the economy will continue to grow, and their businesses prosper<sup>2</sup> – especially in major urban areas such as Kabul and Herat.

## Options

Based on our findings, we have identified a number of options at the macro, meso and micro levels, and have proposed key criteria donors may consider when designing and implementing any future programming of support to SMEs.

Some of the options could be placed at multiple levels and within multiple thematic areas. However, for ease of reading, we have housed these particular options in the thematic area or level where we feel they are most suited.

---

<sup>1</sup> Afghanistan National Development Strategy "reflects the commitment of the Islamic Republic of Afghanistan to poverty reduction and private sector-led economic growth for a prosperous and stable Afghanistan" [http://www.undp.org.af/publications/KeyDocuments/ANDS\\_Full\\_Eng.pdf](http://www.undp.org.af/publications/KeyDocuments/ANDS_Full_Eng.pdf)

<sup>2</sup> This was the view expressed by a number of stakeholders interviewed. We recognise that the effectiveness of the Taliban, and confidence in the economy is a subjective matter open to discussion.



Table E1: Options matrix

	Business Development Services	Access to Finance	Business Enabling Environment
<b>Macro</b>	<ul style="list-style-type: none"> <li>Enhanced donor – government - private coordination to better support SME graduation.</li> <li>Mapping BDS providers.</li> </ul>	<ul style="list-style-type: none"> <li>More systematic coordination between donors and banks/businesses for PSD programming.</li> <li>Strengthen the financial sector through building its capacity to deliver finance that meets SME needs.</li> </ul>	<ul style="list-style-type: none"> <li>Strengthening the business environment to encourage investment and SME responsiveness to markets</li> <li>Capacity support to Da Afghanistan Bank in financial supervision and regulation.</li> <li>Policy implementation facility to enact financial sector improvements for SMEs.</li> </ul>
<b>Meso</b>	<ul style="list-style-type: none"> <li>Developing a BDS facilitation platform.</li> <li>Innovation fund to support the development of new business practices/business models and new financial products.</li> </ul>	<ul style="list-style-type: none"> <li>Support donor-managed guarantee schemes.</li> <li>Funding a wholesale facility to provide term funding to Afghan financial institutions.</li> <li>Attracting the new IFC MENA MSME facility to Afghanistan.</li> </ul>	<ul style="list-style-type: none"> <li>Capacity building to existing or new Afghan institutions providing PSD, access to finance and BEE support.</li> </ul>
<b>Micro</b>	<ul style="list-style-type: none"> <li>Direct support through a livelihood lens/strategy.</li> <li>Co-funding donor facilities and government ministries/agencies to directly implement BDS.</li> <li>BDS support to start-ups.</li> <li>Afghanistan Business Innovation Fund (ABIF) 2.</li> </ul>	<ul style="list-style-type: none"> <li>Supporting private equity models.</li> <li>Access to finance support for start-ups.</li> <li>Support mutual guarantee schemes.</li> </ul>	<ul style="list-style-type: none"> <li>Stocktaking exercise to understand needs of microenterprises, and especially of women.</li> </ul>

In the body of the report we briefly describe each of the options considered in the table, and specifically expand on five options we recommend for further consideration. These five options are:

- **Capacity building to existing or new Afghan institutions providing PSD, financial sector development and business enabling environment support.** DFID could commission a study, jointly with DFID Governance experts, the World Bank, Ministry of Commerce and Industry (MoCI), and other interested key donors to review existing donor-funded and Government-funded institutions engaged in supporting the private sector. It could propose to the Government of the Islamic Republic of Afghanistan (GIROA) opportunities to revitalise, rationalise and/or merge them whilst improving their governance.
- **Capacity support to Da Afghanistan Bank, with a focus on supervision and regulation of financial sector.** DFID or other interested donors could fund experts selected by the IMF and the World Bank to provide capacity-building to key departments of Da Afghanistan Bank, focusing on regulation and supervision of the banking sector. If sequencing is correct, better regulation and supervision should mean healthier and more confident financial institutions and the technical tools that create the platform to extend more credit to the economy and under-served segments.
- **Support donor-managed and/or mutual guarantee schemes.** Donors could support donor-managed and/or mutual guarantee schemes in order to encourage the financial sector to expand the scope and depth of services to SMEs. In the context of Afghanistan, de-risking financial support to MSMEs appears the best way to incentivise financial institutions to increase their exposure to this segment of the market.
- **ABIF 2.** An extended ABIF 1, with additional financing mechanisms, could be a relevant model to test quasi-equity types of financing (during the current transition period in Afghanistan) as a bridge toward private equity, prior to moving to more ambitious models. DFID or other interested donors could consider a

## EXECUTIVE SUMMARY

mix of technical assistance<sup>3</sup>; long term, patient capital that could be either equity, mezzanine, asset-backed/leasing/Islamic finance, or long term classical debt, with returns/remuneration embedded and as close as possible to market conditions.

- **Stocktaking exercise to understand needs of microenterprises and women.** There remains a lack of appreciation and contextual understanding of the realities and socio-economic structures of those at the base of the pyramid, who are often employed in the informal sector at the microenterprise level. The first step to filling this gap could be a stocktaking exercise of studies of Afghan MSMEs. In the longer term, this option should increase DFID's, other donors, and the GIRoA's knowledge and understanding of the informal sector, and enable stronger programme designs and better policies to address the key constraints faced by those at the base of the pyramid.

Based on a careful consideration of each of the preferred options' scope to contribute to inclusive growth and job creation, we recommend that the option to support an ABIF 2, and the option to undertake a stocktaking exercise to better understand the needs of microenterprises, and especially of women, offer the strongest prospects in the near and medium term.

## Conclusion

The rationale exists for donors to continue providing support for services to SMEs. In addition, with its experience in past and current programmes, DFID will be able to apply lessons learnt to future SME programming in Afghanistan.

As potential project participants adjust their behaviour to an era of greater donor scarcity and selectivity, DFID may experience greater traction with programme partners and beneficiaries. DFID could play an important role as convenor and coordinator as a result of its reputation and leadership, to champion programmes that effectively reach the base of the pyramid and benefit smaller enterprises.

However, business people are holding back on investment decisions, and we have been advised by other stakeholders that it is wise for DFID and other donors to avoid major interventions until the key economic appointees of the new cabinet and presidential advisory team are in place, and their first policy statements issued. Moreover, high risks persist, and a cautious approach is required, building on partnerships with proven partners and strengthening existing programmes with strong track records through improved monitoring, better evidence and data collection, and better results management.

Supporting resilience and more sophisticated risk assessment, management and mitigation will be of great importance. This means applying cross-cutting expertise to programming as many threats are beyond the private sector development sphere, such as corruption and lack of transparency, inefficiency of public systems, poor infrastructure, low literacy and numeracy skills, low financial capacity and security.

We conclude by stating that programming support to SMEs will require a blend of macro, meso and micro-level interventions to achieve systemic impact that ultimately leads to growth and employment generation.

---

<sup>3</sup> In this context, technical assistance is wider than simply business development services, and could include policy support to other donors and the GIRoA at meso and macro levels

# 1 Introduction

DFID has commissioned this piece of work to assess the need for improved access to finance and advisory support and/or business skills development, for SMEs in Afghanistan. There is currently considerable support for SME development from donors, multilateral financial institutions and development financial institutions (DFIs), and the Government of the Islamic Republic of Afghanistan (GIROA). However, DFID wishes to improve its understanding of the demand for and the nature of existing support, the gaps, challenges, and the potential negative side-effects.

Coffey has been tasked<sup>4</sup> with undertaking a scoping study that will examine the key challenges, opportunities and effectiveness in funding SMEs and providing advisory support and business skills development in Afghanistan. This includes an assessment of peer-reviewed and grey literature, including the official documents prepared by the GIROA and the donors, conducting in-country research, and organising stakeholder meetings and interviews to identify gaps and potential opportunities in key agriculture and non-agriculture sectors.

The findings incorporated include dedicated field-work and analysis of data by the team of field researchers in Mazar, Kandahar and areas in Kabul, as well as interviews and engagements conducted by our core international team in Kabul. Based on the findings of this research, a number of possible programmatic and strategic options for donor intervention and subsequent recommendations and future steps to be taken are provided.

In addition to this introduction, the report is structured as follows:

- **Section 2: Methodology.** This section details our methodology for undertaking desk-based and in-country research, as well as our risk management approach.
- **Section 3: Findings.** This section reviews the findings from the two stages of our methodology, the literature review and desk research; and then in-country field research involving stakeholder engagements and informant interviews.
- **Section 4: Options for donor-sponsored interventions.** This section focusses on opportunities for donor interventions. We discuss the criteria used when selecting options, provide a menu of options, and describe these options.
- **Section 5: Conclusion.** This section provides an overall conclusion to the study, based on our core findings and the options we recommend DFID consider for the future.

---

<sup>4</sup> Terms of Reference are provided in Annex 1.

## 2 Methodology

This section sets out the methodology employed when undertaking the study.

### 2.1 Approach

We implemented a two-stage approach to data collection and analysis for this scoping assignment. Firstly, we undertook desk research to collate data and information from donors, research institutes and other reputable sources (including grey and published literature); secondly, and based upon findings of the desk research, we undertook field research involving stakeholder engagements and informant interviews. For the purpose of this study, we expanded the scope of analysis to take into consideration the micro-enterprise level within our definition of 'SME'. However, where the report specifically refers to the microenterprise level only, this will be made explicit<sup>5</sup>.

### 2.2 Inception phase and literature review

The scoping assignment began with an inception phase during which data were collected through telephone interviews and a literature review. The team developed preliminary findings from initial interviews, and developed a comprehensive literature review which covered the overarching context for SMEs, demand and supply side constraints, and benchmarking against PSD interventions in other similar contexts. An inception report was drafted, submitted and subsequently approved by DFID.

#### 2.2.1 Inception phase meetings

During the inception phase, we undertook the following meetings (by phone and face-to-face) with key stakeholders to understand the background to this assignment:

- Kick-off meetings with DFID in Afghanistan and London, and with the Afghanistan Public Policy Research Organisation (APPRO);
- Interviewed PSD specialists in the World Bank and IFC, based in Delhi;
- Held discussions with microfinance institutions the Foundation for International Community Assistance (FINCA) and Hand in Hand, and representatives from the Commonwealth Development Corporation (CDC) and the Afghanistan Holding Group; and,
- An initial meeting with ABIF.

During this stage, we also developed a draft interview sheet guide, which was intended to guide our team as they undertook interviews during this stage as well as subsequent phases of the assignment. The interview sheet guide can be found in Annex 2.

#### 2.2.2 Existing literature

To complement the initial meetings, and to enable us to better understand the context, we undertook a comprehensive desk-based literature review. In doing so, we referred to the following documents:

- Recent papers relevant to SME finance and which include an emphasis on practical and conclusive lessons for DFID Afghanistan.
- DFID recent policy papers and annual reviews of similar programmes such as SEED Somalia; Propcom Maikarfi in rural Northern Nigeria; Growth and Employments in States in Nigeria; Palestinian Market Development Programme; Financial Inclusion Programme and Enterprise and Asset Growth (EAGR) programme Pakistan.
- Key documents by reputable research institutions such as APPRO and AREU, which provide nuanced analysis on the political economy context, including for women, as well as on the context for micro-enterprises.

---

<sup>5</sup> Annex 3 provides more comprehensive details relating to SME definitions.

## SECTION 2: METHODOLOGY

- Other donor documents pertaining to SME development in Afghanistan, such as from the German Society of International Cooperation (GIZ), the World Bank, USAID, as well as literature on past and existing donor PSD interventions in fragile and conflict-affected states more generally.
- GIRoA policy documents and industrial policy papers from, for example, the Ministry of Agriculture, Irrigation and Livelihoods (MAIL), Ministry of Rural Rehabilitation and Development (MRRD) and Ministry of Commerce and Industry (MoCI) which are relevant for understanding public strategies and interventions aimed at improving access to finance and BDS.
- Key documents from donor facilities such as AREDP, ASMED and others, as well as from NGOs such as Mercy Corps and Aga Khan Foundation, who are currently operating in Afghanistan in the access to finance and BDS space.

A synopsis of the literature can be found in Section 3 of the report, and a full literature review is included in Annex 4.

### 2.2.3 Value chain and cluster selection

To better understand the needs and gaps of various types of businesses, and to deepen the analysis of smaller businesses' needs, we adopted a combined value chain and cluster approach<sup>6</sup> when assessing the access to finance and BDS constraints and opportunities for SMEs. Five value chains were selected; 1) marble and construction, 2) dried fruits and nuts, 3) fresh fruits and vegetables, 4) gemstones and jewellery and 5) embroidery. The two clusters analysed were the dried fruit and nuts cluster in Kandahar, and the machinery repair cluster in Kabul. This was supported by market system development principles<sup>7</sup> to consider the wider constraints that affect SMEs, and to identify intervention options that could tackle the causes of these constraints.

### 2.2.4 Inception phase reporting

An inception phase report was provided to DFID outlining the findings of the desk research and outlining plans for the field research. DFID was able to review and provide comments that were incorporated into the next phase of the assignment.

## 2.3 Data collection and in-country phase

Subsequent to the inception phase, we undertook the field research phase of the scoping research study. This included interviews with key stakeholders in Kabul, and also in Mazar and Kandahar. International team members undertook more than 30 meetings in Kabul between 12 and 27 May 2014. The objective was to focus on the macro and meso levels, and meet a range of stakeholders including donors, implementing agents, banks, NGOs and institutions, and public and private sector actors. During this phase, APPRO, the international team's key national partner, played a pivotal role in undertaking key informant interviews and analysis at the microenterprise level – particularly outside of Kabul.

### 2.3.1 Stakeholder selection

The following key actors were targeted for interviews:

- Entrepreneurs and crafts-persons drawn from selected value chains or clusters in order to gain in-depth insights into how clustered enterprises cope, innovate, and perform; and how these processes could be assisted through increased access to financial products and business services;
- Intermediaries such as heads of local trade associations and local chambers of commerce, managers of donor funds, implementers of donor facilities and programmes that interact with microenterprises, academics and researchers, who have perception of the challenges of donor funded programmes, but also of successful pilots and programmes, partnerships and delivery models in Afghanistan, from the point of view of beneficiaries;
- Interviews with key informants and individuals from local, national, and international organisations charged with economic development and policymaking relevant for these selected value chains and clusters.

---

<sup>6</sup> A cluster is defined as a "localized network or geographically identifiable concentration of similar, related, or complementary businesses or producers bound together in a social division of labour" (APPRO, 2014)

<sup>7</sup> ITAD Paper for DFID on M4P Evaluation Methods- from section 4.4 page 27 on theory of change, sustainability and large-scale impact  
SCOPING THE NEED FOR IMPROVED ACCESS TO FUNDING, ADVISORY SUPPORT AND BUSINESS SKILLS  
DEVELOPMENT FOR SMES IN AFGHANISTAN – SEPTEMBER 2014

## SECTION 2: METHODOLOGY

### 2.3.2 In-country stakeholder engagements

As well as meetings with the DFID team, and undertaking a number of working sessions with APPRO colleagues, in-country activities were focused around two broad groups of stakeholders:

- Those at the micro-level, who are difficult to access, and who were met by APPRO, including with key informants from specific value chains and clusters from Kandahar and Mazar, as well as Kabul.
- Those at the meso and macro-level within the donor and government communities who were met by the international team.

The APPRO team undertook a regional trip to Mazar-e Sharif, and an in-depth assessment of a refrigerator/air conditioning/washing machine repair and parts cluster in Kabul; as well as a light touch assessment of the dried fruits and nuts value chain in Kabul – with a particular focus on women. In addition to this, the APPRO team undertook a comprehensive field trip to Kandahar, where they conducted informant interviews with key stakeholders within the priority value chains. Construction and marble, fresh fruits and vegetables, embroidery, and precious stones/jewelry were selected as proxies for analysis. This was then supported by an analysis of the dried fruit and nuts cluster in Kandahar.

In Mazar-e Sharif, three key informant interviews and one focus group discussion were held on 25 May 2014 and 26 May 2014. The key informants were the head of the provincial association of craftspersons, a manager from the Afghanistan Chamber of Commerce and Industries (ACCI), and the Head of the Association of Vegetable Retailers. The interview questions were designed to establish the current needs of micro and small-sized enterprises (MSMEs) as well as other issues affecting business activity.

Visits to Kandahar were then conducted from 2 to 6 June 2014 to conduct a rapid needs assessment of SMEs. Key informants were interviewed to collect data on general SME needs while a sampled survey was carried out with the dried fruits and nuts cluster located in Kandahar's main bazaar. The key informants were drawn from crafts association heads, ACCI, and the provincial craftspersons' association.

Between 23 and 28 June 2014, the refrigerator and electrical equipment cluster was assessed in Kabul, and female dried fruits and nuts traders in Kabul were also surveyed.

The key informants in all three locations were asked a number of open-ended questions on their current needs, types of services provided to (or received by) SMEs, and suggestions for measures to meet the needs.

The international team undertook meetings in Kabul between 12 and 27 May 2014. The objective was to focus on the macro and meso level, and meet a range of stakeholders including donors, implementing agents, banks, NGOs and institutions:

- To cover issues relating to donor policy and strategy, the team met with a number of DFID advisers – both in the PSD and economics space, but also cross-cutting advisers in areas including infrastructure, results, governance and livelihoods. As well as DFID, the team met with advisers from USAID, the World Bank and GIZ.
- It was critical to meet a number of implementing agents, both national and international, NGO and private sector, so as to understand the implementation of donor initiatives in the SME space. For instance, the Team met with ABIF, Mercy Corps, ASI, and the Aga Khan Foundation to ensure broad representation of donor activities.
- The team also met with a number of microfinance and commercial banks and public institutions, including First Micro Finance Bank, Hand in Hand and the American University of Afghanistan. By meeting these organisations the team was able to gain further insight into the SME market, particularly pertaining to access to finance and the role of entrepreneurship in SME growth.
- Finally, the team met with government ministries and implementing agents including the MoCI, Comprehensive Agriculture and Rural Development Facility (CARDP) (funded by DFID), Afghanistan Rural Enterprise Development Programme (AREDP), and Export Promotion Agency of Afghanistan (EPAA). This provided the team with an opportunity to draw out the local Afghanistan perspective, and link the findings with those identified through meeting donors.



### 2.4 Reporting phase

Once the in-country phase was completed, an analysis and write-up of the key findings was then undertaken and built into the final report. In particular, this included key findings relating to the literature review (which was further expanded on during this phase due to access to additional and relevant information) and from the interviews and field-work undertaken during both the inception phase and the in-country phase.

The key findings relevant for the demand and supply of BDS and finance formed the focus of the analysis, which then allowed for the identification and development of a number of options for DFID to consider. The paper concluded with specific recommendations which DFID can consider when devising strategies for future engagement in the SME space.

### 2.5 Risk management and factors limiting research design

#### 2.5.1 Operational and programmatic risk

During the assignment we took into account risks to the scoping assignment, and risks to overall PSD programming for SME development in Afghanistan. We have broadly categorised these risks into two areas – operational and programmatic, and describe how a flexible approach was adopted to mitigate risks and ensure value for money (VfM).

- **Operational:** Operational risks include the immediate risks to the successful delivery of the scoping assignment, and primarily comprise logistical and security risks. Regular dialogue with the Coffey Security Team and active monitoring of the security situation for the duration of in-country data collection was organised to ensure the work plan could be amended as and when the security situation demanded.
- **Programmatic:** Programmatic risks that had been identified during the inception phase were assessed, based on literature on PSD in conflict-affected countries. We assessed the impact of the political and security context in Afghanistan on SMEs and possible future interventions and programming. In the current uncertain environment surrounding the transition in Afghanistan, we went back to basics of PSD design in conflict settings:
  - Assessed the possible increase in crime and instability. For example: security forces are not paid by the State budget; there is a rapid growth of the opium economy; and money laundering of illicit activities negatively impact on the financial sector.
  - Identified other programmatic risks; including risks of business owners rapidly adapting to the perceived priorities of international dollars, thus turning to short-term trading at the expense of long-term productive enterprises.

#### 2.5.2 Factors limiting research design

There are no central databases or information points dedicated to SME analysis in Afghanistan that provide easy access to relevant information. There are also limited reliable data concerning SMEs outside the major urban centres. This is a challenge for most enterprise and access to finance assessments – especially in Afghanistan<sup>8</sup>. As a result, this study focuses on a few clusters and value chains as the means of complementing the current top-down approach of donors focusing on the top few hundred, as well as for cross-referencing information from NGOs more knowledgeable in the social dimension of rural Afghanistan.

Furthermore, there is a significant knowledge gap concerning the impact of transition phases on the wider business environment, and the base of the pyramid in particular. Some sources note that the departure of international troops is often followed by a phase of uncertainty that results in business actors repositioning themselves (as per ODI launch of the International Rescue Committee Report<sup>9</sup>). Similarly, there are concerns over increased criminal and drug related activity.

---

<sup>8</sup> See for instance House of Commons International Development Committee:  
<http://www.publications.parliament.uk/pa/cm201213/cmselect/cmintdev/403/40306.htm>

<sup>9</sup> <http://www.odi.org.uk/events/3907-afghanistan-rescue-uk-2014-humanitarian-response>



## 3 Findings

This section reviews the findings from the two stages of our methodology, the literature review and desk research; and then the in-country field research involving stakeholder engagements and informant interviews. In addition to findings relating to the demand and supply of BDS and funding, we also consider wider constraints relevant for women, the political economy context, and the wider business enabling environment (BEE).

Our findings are presented as follows:

- **Section 3.1: Findings of the literature review and desk study.** This section details our findings from existing literature and project documents from donors, NGOs, the GIRoA and other institutions. This also includes literature which was accessed during subsequent phases of the assignment, which we found pertinent to the scoping study. The full literature review is provided in Annex 4.
- **Section 3.2: In-country findings on the demand and supply of SME business development services.** This section specifically includes our in-country findings relating to the demand and supply of SME business development services. We also assess interventions and policies that are intended to encourage SME business development services in Afghanistan, and look at the critical success criteria for BDS.
- **Section 3.3: In-country findings on SME access to finance and the provision of funding.** In this section we specifically focus on access to finance for SMEs, and the provision of funding, and take a detailed look at the overall financial system in Afghanistan. This includes an assessment of the underlying issues in the sector, and how these relate to SMEs. We also assess financial product, actor and instrument variety, and the coupling of access to finance with business development services.
- **Section 3.4: In-country findings relating to the wider enabling environment.** In this section we firstly look at the cross-cutting challenges faced by SMEs, particularly in the context for women. Secondly, we then look at the political economy and conflict angle and its impact on SMEs, and then finally the political economy and macro-level context.

### Box 1: Key differences between literature review findings and in-country findings

One of the key objectives of undertaking in-country visits was to build upon our literature review findings by triangulating information found through interviews and discussions with stakeholders, and the field research undertaken by APPRO. Our in-country activities did not disclose anything significantly different from the literature, but did allow us to build a more granulated understanding of the constraints and opportunities related to BDS and access to finance for Afghan SMEs. Moreover, our interaction with practitioners helped us to better understand DFID's positioning, and made explicit the importance of identifying and settling on implementation strategies which are flexible and best suited to the current context on the ground in Afghanistan.

Some additional specific in-country findings include the following.

- Implementation/donor support agencies working at the micro level struggle to provide solutions which would enable SME beneficiaries to graduate to the next level of organisational development and growth<sup>10</sup>
- Many micro and small businesses do not consider skilled labour as a priority to grow their business. Requirements for skilled labour/staff are usually prioritized by technical or relatively sophisticated businesses<sup>11</sup> or by large businesses.
- The lack of GIRoA data relating to cross-border trade is an issue, and there appears little incentive for custom officials, specialised intermediaries and traders to register the real flow of imports into, and exports from, Afghanistan.

<sup>10</sup> Discussions with MISFA, Hand in Hand, Finca.

<sup>11</sup> Discussion with BIH.

## SECTION 3: FINDINGS

### 3.1 Findings of the literature review and desk study

A literature review and desk study was undertaken during the inception phase and updated to take into account new findings and additional references collected during the implementation phase. This synopsis of the literature review<sup>12</sup> covers the following areas: understanding the context for SMEs; demand for, and supply of, BDS and access to finance; and government policies and the wider BEE.

#### 3.1.1 Literature on the context of SME clusters and sectors

SMEs in Afghanistan are typically found in clusters in urban and rural areas. Within these clusters, SMEs collaborate and compete at the same time, have their own traditional vocational training system, and are resilient<sup>13</sup> to social and political upheaval. A cluster is defined as a “localised network or geographically identifiable concentration of similar, related, or complementary businesses or producers bound together in a social division of labour”<sup>14</sup>.

Economic clusters<sup>15</sup> have persisted, despite the recurring periods of instability. Moreover, clusters continue to provide livelihoods for urban and peri-urban households while generating added value for the domestic economy<sup>16</sup>. Competition occurs between microenterprises in design, quality, production speed, and after sale service. Among the needs of microenterprises identified in cluster research are: access to micro finance, access to technology, knowledge of business management and organisational experience, access to domestic and regional markets.

The government’s vision for Afghanistan is that by 2015 it will be less dependent on international development assistance, and achieve levels of donor support consistent with other least developing countries<sup>17</sup>. The GIRA has highlighted the need for investment in priority sectors that are critical to achieving economic growth: agriculture, mining and infrastructure (transportation, energy, and telecommunications). With regards to agriculture, the key constraints identified are low agricultural productivity, low private investment, and poor rural infrastructure<sup>18</sup>.

Regarding the mining sector, Afghanistan’s large resource base is undeveloped, even though the country is home to a portfolio of minerals and deposits. From the microenterprise perspective, there are opportunities to support small-scale mining and women jewellery producers<sup>19</sup>. However, the sector suffers from unlicensed operations, looting and raids, and vested interests.

---

<sup>12</sup> The full and comprehensive literature review can be found in Annex 4.

<sup>13</sup> APPRO have written extensively on the concept of resilience. Resilient SMEs are those that have the capacity and means to continue to operate, albeit at a basic level, during significant socio-economic and political shocks. They successfully employ strategies to allow them to overcome and mitigate these shocks.

<sup>14</sup> See APPRO’s analysis of clusters in Annex 9.

<sup>15</sup> Within this context, these traditional clusters comprise of agri-food processors, iron mongers, carpenters, silk textile, tailors and saffron.

<sup>16</sup> Some authors support the work undertaken by APPRO. For instance, Parrilli (2007)<sup>16</sup> underlines the capacity of clusters to persist and survive, particularly in turbulent operating environments and with a focus on developing countries<sup>16</sup>; and Green’s (2005)<sup>16</sup> focus on the interactions of Microfinance Institutions (MFIs) with clustered enterprises resonates most directly with the needs of traditional economic clusters in Afghanistan.

<sup>17</sup> Government of Afghanistan. ‘Supporting Self-Reliance in Afghanistan. Strategic Vision for the Transformational Decade’. 2012; World Bank, ‘Islamic State of Afghanistan: Pathways to Inclusive Growth’, 2014. To our knowledge, at the time of writing, there is not a more recent official document.

<sup>18</sup> On the other hand, the World Bank provides a list of primary potential drivers of agricultural sector growth, job creation and food security, etc., World Bank, ‘Islamic State of Afghanistan: Pathways to Inclusive Growth’, 2014.

<sup>19</sup> Ibid.

### Box 2: Defining ‘SMEs’

There are numerous definitions of SMEs across the international development field and preliminary analysis suggests that the “Small and Medium-sized Enterprise” or SME market in Afghanistan is diverse. Consequently global definitions and categorisation of what constitutes an SME must be adapted for the Afghan context. This study thus defines SMEs broadly to include enterprises ranging from micro enterprises (M)SMEs to larger ones.

**Upper bounds of SME:** At the upper end of the SME spectrum, the study has taken a broad interpretation to the concept of “medium-sized” Afghan enterprises, as well as pure SMEs, for the role they can play in supporting income growth and employment, and in leading or catalysing specific sectors, clusters or value chains. This is partly because they are currently the target of many donor programmes – and thus pertinent to DFID’s understanding of SME development.

**Lower bounds of SME:** Existing research conducted by APPRO, interviews with FINCA and Hand in Hand, coupled with prior reviews of the Islamic Finance Cooperatives shows that micro-enterprises encompassing 2-3 people contribute significantly to a productive private sector. However, given the micro nature of such enterprises in rural and agricultural areas the boundary between ‘enterprises’ and ‘households’ is blurred. An arguably generous definition has been used for this study.

### 3.1.2 Literature on the context of women in SMEs, and the impacts of corruption and conflict

The situation for women in Afghanistan has improved since 2001, creating numerous opportunities for them to set up their own businesses. Yet without an appropriate environment rooted in a favourable policy framework, women will not realise their full potential given companies’ hesitance to give them opportunities. Since 2006, security has steadily worsened and a number of earlier gains in gender mainstreaming have been rolled back or even reversed.

Rurally, beside home-based handicraft production, Afghan women’s professional activities are mostly limited to those at the lower end of certain agricultural value chains<sup>20</sup>. Beyond agriculture, considerable gender disparities exist in the private sector as a result of acute barriers to participation<sup>21</sup>.

Sub-ethnic entities at the local level, such as tribes and clans, form the foundation of the Afghan political and social landscape, reflected at times through violent conflicts over power and resources<sup>22</sup>.

Moreover, Afghanistan is beset with a range of conflicts. Violence is present in the form of local intergroup conflicts, conventional state power struggles, gang violence, organised crime and trafficking, and local conflicts with global ideological connections. It is difficult to quantify the impact of conflict on Afghanistan’s economy, specifically on SMEs, but numerous empirical studies point out a large negative impact on growth, poverty and equality<sup>23</sup>.

SMEs involved in trade face multiple problems such as political and security uncertainty, as well as corruption at customs and taxation offices<sup>24</sup>. Moreover, our initial findings indicate that, because the majority of Afghan micro and small enterprises remain informal<sup>25</sup>, Afghan exports are carried out by a mix of registered SMEs and commission workers who work with small producers. A number of actors with privileged ties within government avoid quality control channels<sup>26</sup>, impacting public revenues and perception of the quality of Afghan products<sup>27</sup>. Simplifying the licensing process is widely perceived as a potential way to bring most of the sector under formal supervision.

### 3.1.3 Literature on SME demand for business development services and financial services

The demand for BDS needs by SMEs can be typically categorised into common needs and technical needs (business specific). These needs can be basic or advanced in nature, and can evolve over time.

<sup>20</sup> Afghanistan Public Policy Research Organisation, ‘Gender and the Agricultural Innovation System in Rural Afghanistan’, 2011.

<sup>21</sup> World Bank, ‘Islamic State of Afghanistan: Pathways to Inclusive Growth’, 2014.

<sup>22</sup> The civil war of 1992-1996 revolved around ethnic power dynamics. The makeup of the 2014 Presidential tickets is also a useful reflection of this social trait.

<sup>23</sup> Such as Hoeffler, von Billerbank, and Ijaz, (2010), and Martin, Mayer, and Thoening, (2008).

<sup>24</sup> Afghanistan Research and Development Unit ‘SME Development and Regional Trade Working Paper, 2014.

<sup>25</sup> According to the MoCI (2013) Between 70 and 80 percent remain informal and unregistered, largely pushed to the margins out of fear of entanglement in bureaucracy and corruption.

<sup>26</sup> This has been confirmed by several interviewees, in confidence, that there has been a recent increase in bureaucratic interference and opportunities for corruption at customs, tax and licensing stages, creating a clear disincentive to formalise.

<sup>27</sup> Afghanistan Research and Development Unit ‘SME Development and Regional Trade Working Paper, 2014.

## SECTION 3: FINDINGS

BDS directly linked to increases in revenue are most likely ranked highest among microenterprise needs. Various studies have identified market knowledge, product quality, and competitiveness as immediate business development needs. Technical training, business and financial management have been highlighted as needs, although skilled labour seems to be less of a constraint in Kabul city<sup>28</sup>. Despite the demand for BDS, willingness to pay remains a challenge, as the BDS providers' value is often questioned<sup>29</sup>. However, demand could rise if perceived value and affordability develops.

Despite limited data on SMEs' access to finance, available data and studies for the total adult population suggest that these businesses are run without recourse to financial services. Compared to neighbouring countries and the international average, a higher proportion of firms in Afghanistan identify access to finance as a major constraint<sup>30</sup>.

Some cluster members have borrowed on interest but the vast majority object to interest-bearing loans on religious grounds. Moreover, even with the assumption that *Sharia*-compliant loans could become available, there exist additional concerns related to interest rates, short repayment periods and collateral requirements. Also, acquisition of modern tools and machinery through increased access to loans would need to be accompanied by relevant training, in conjunction with pre-existing traditional forms of learning through apprenticeship.<sup>31</sup>

### 3.1.4 Literature on the supply and provision of business development services and finance for SMEs

In the past decade, a combination of two strategies has typically been adopted by donors to tackle the rapidly evolving BDS needs of SMEs: 1) The outsourcing of BDS and/or training to local firms; 2) Providing direct BDS support to SMEs by training internal, in-house<sup>32</sup> staff complemented by the hiring of national or international firms/experts.

The first strategy has been promoted extensively by donors since the launch of ASMED. However, certain challenges such as achieving the collective objectives of impact, outreach, cost efficiency, and client satisfaction have been identified<sup>33</sup> by donors. The second strategy, which consists of providing in-house BDS support directly to SMEs, is adopted by large donor funded programmes<sup>34</sup>, as well as INGOs<sup>35</sup>. BDS support is usually a component of programmes that involve an access to finance facility, typically at no apparent extra cost for the beneficiary SME. Donor-funded programmes in this sphere have experienced varying degrees of success, as well as distinct methodologies<sup>36</sup>. Regarding INGOs, while there is an assurance for their long-term and sustainable support, their operational area is typically limited to a few pockets, unless there is donor funding to cover additional areas.

Although the total assets of the Afghan banking system have considerably increased since 2005 (US\$4.3bn in July 2013), the country's financial and formal banking system is under-developed and narrow. The microfinance sector is significantly less important than the formal banking sector, with only US\$150m in assets, corresponding mostly to loans. The formal banking sector is, on the opposite, very liquid (US\$3.7bn in deposits). The majority of the outstanding loans (US\$818m) are short term and concentrated in the trade and service sectors<sup>37</sup>.

Access to finance is especially limited for women. Although the government's efforts in promoting women's access to financial services have shown promising results, there are reported incidents where women have been handing over loan money to their husbands or male relatives. Therefore, there is a need for government and donor interventions to promote women's financial decision-making.

---

<sup>28</sup> The types of BDS resources, training and capacity-building services are provided in Annex 5.

<sup>29</sup> Afghanistan Small and Medium Enterprise Development – page 24 GIZ-BDS mapping, 2013.

<sup>30</sup> APPRO, 'Traditional Economic Clusters and Reconstruction in Afghanistan: The Case of Herat', 2012.

<sup>31</sup> Ibid.

<sup>32</sup> Defined as providing BDS support directly, rather than through a third party provider.

<sup>33</sup> The GIZ/GFA BDS project in Northern Afghanistan has emphasised the limits of such a strategy.

<sup>34</sup> Such as IFC Business Edge, supported by DFID SEED Programme. ABADE (2013-17); ANMDP (2012-16); NSDP & DM-TVET; Program II: National Comprehensive Agricultural Production and Market Development of Agriculture and Rural Development (ARD) clusters i.e. ADF (2010-14), CARD-F, IAPFE, AREDP and EVC (2012-16), MISFA as well as programs supported by Japan, Germany, Canada, and Norway. Some institutional BDS support is also delivered by ACCI; AISA; EPAA; HAKAKAT; Business Incubator Hub of American University of Afghanistan (shared cost, not free service).

<sup>35</sup> Such as Hand in Hand, Aga Khan Foundation, Mercy Corps, Peace Dividend Trust and Afghan Aid.

<sup>36</sup> Additional details of major donor programmes providing BDS support are included in Annex 6.

<sup>37</sup> It was not possible to identify size and share of SME loans or whether these include microfinance

## SECTION 3: FINDINGS

Although evidence on the link between access to finance and BDS is currently unclear in the literature<sup>38</sup>, feedback from Afghan stakeholders and claims from the IFC suggest that bundling the two would deliver greater impact<sup>39</sup>.

### 3.1.5 Literature on government policies and the business enabling environment

A positive enabling environment is a key requirement for thriving SMEs<sup>40</sup>. In Afghanistan, the key guiding documents for facilitating the enabling environment are the Afghanistan National Development Strategy (ANDS) and the Afghanistan Compact. The policy for Private Sector Growth and Development of ANDS incorporates all the recommendations and proposed actions suggested primarily by the government, the non-profit sector, as well as the private sector. This, the promotion of female leadership opportunities, and the many vocational training programmes funded by the international donors for women in urban and rural areas, signifies a move to the formalization of gender mainstreaming in Afghanistan. The government has also launched the National Action Plan for the Women of Afghanistan (NAPWA) in 2008, and the Ministry of Women's Affairs (MoWA) also formally deals with women-specific issues in the context of a predominantly patriarchal societal and political system. At a formal level the existence of the MoWA, solely devoted to women's affairs, is a significant achievement. Through its name and existence alone MoWA raises awareness about women and society, despite its weak position in the still predominantly patriarchal societal and political system<sup>41</sup>. This report specifically analyses the facilitation of the business enabling environment (BEE) as it affects SMEs. Several Afghan institutions address the BEE and a few major SME-focused programmes have a BEE component<sup>42</sup>.

In June 2007, The Enabling Environment Conference for Effective Private Sector Contribution to Development in Afghanistan was organized at a national level. The recommendations, specific actions, time frames and responsible agencies devised during the conference formed a road map for subsequent years. Given the challenging country context, there has been decent progress in the realisation of a number of the actions around developing policies. However, evidence based need of creating different kinds of policies for fragile states; the ability of the government to implement; and the non-facilitative risk of further complicating the doing of business which may result in encouraging corruption, all remain a question. The recommendations relevant to enabling SME BDS services were 1) streamlining regulation and procedures and improving the enforcement and 2) addressing human capacity constraints.

One of the key recommendations in June 2007 under 'Streamlining regulation and procedures and improving the enforcement' was to reform and revitalise the High Commission on Investment. One of the specific actions was to ensure that the Afghanistan Investment Support Agency (AISA) is an effective secretariat to promote investment and the private sector in Afghanistan. We observe that since 2007, AISA has facilitated and taken specific actions to achieve its objective.

Similarly, substantial efforts are being made in the direction of facilitating trade via promoting exports. The Afghan-American Chamber of Commerce; Afghan Business Council – Dubai, and Afghanistan Embassy are working to facilitate trade between countries. Regional and western countries are also providing additional support to promote trade.

Among the key initiatives are: investment promotion facilitation; conferences/workshops; export coaching programmes in home decoration/home textiles and the agricultural sector by the Dutch government; regular business conferences and meetings in India, Pakistan, Dubai, Turkey, USA, Canada and EU to encourage doing business with Afghanistan; facilitating local Afghan product stalls at national and international trade/business exhibitions; business-to-business learning exposure, study tours, and know-how trainings; and advising local businesses via chambers of commerce or AISA on export opportunity.

Regarding specific activities at both national and provincial levels, attention has been given to skills development, as well as advisory services and BDS promotion in license and trade-related regulatory policies. Training for

---

<sup>38</sup> Consulting and Capital Experiments with Micro and Small Tailoring Enterprises in Ghana by Dean Karlan, Ryan Knight and Christopher Udry - Yale University and Innovations for Poverty Action. See in Appendix 7 of page 37 a summary of similar research papers for more positive results such as De Mel in Sri Lanka.

<sup>39</sup> Successor to the Financial Inclusion Experts Group of the G20 (FIEG) - the Global Partnership for Financial Inclusion (GPFI) is a platform to implement the Financial Inclusion Action Plan, endorsed at the G20 Summit in Seoul – Sub-group on SME finance: [www.gpfi.org/subgroup-SME-finance](http://www.gpfi.org/subgroup-SME-finance).

<sup>40</sup> According to the Aga Khan Development Network (2014), such an environment stimulates local initiative and draws inward investment, both of which can have rapid and dramatic effects on employment and human resource development. In post-conflict countries in particular, the creation of jobs is one of the greatest determinants of a nation's success or failure.

<sup>41</sup> APPRO, 2014

<sup>42</sup> E.g. the Trade and Accession Facilitation for Afghanistan (TAFA).



## SECTION 3: FINDINGS

license holders on important topics such as marketing and procurement is also provided. In addition, the MoCI has passed an SME strategy for agro-business with the Ministry of Agriculture, Irrigation and Livestock (MAIL); and the Ministry of Mines and Petroleum (MoMP) has passed a law and other policies targeting small scale mining facilitation.

### Box 3: Literature on PSD approaches in fragile and conflict-affected countries

PSD is an integral part of the conflict management process, rather than a tool which solely contributes to economic development. The value chain approach can strongly benefit FCAS, inform and reinforce conflict analysis and address possible causes of conflict. The Market Systems approach is also well-suited within these difficult contexts, but the complexities linked to its implementation make it less attractive in FCAS<sup>43</sup>.

In 2008, USAID presented its results and lessons learned from projects that used value chain programming in conflict-affected environments. In 2009, GIZ released a guidebook on sustainable economic development in FCAS, which provides guidance on the design of PSD interventions in post-conflict situations, and identifies key approaches that can contribute to crisis prevention, conflict transformation and peace-building, while promoting systemic private sector competitiveness. In a 2012 publication, the World Bank Independent Evaluation Group developed a conceptual framework for PSD development in FCAS, which brings together three components for policy design – business constraints, government priorities, and proven results.

## 3.2 In-country findings on the demand and supply of SME business development services

In this section we include our in-country findings relating to the demand and supply of SME business development services. We also assess interventions and policies that are intended to encourage SME business development services in Afghanistan, and look at the critical success criteria for BDS.

### 3.2.1 SME demand for business development services

Based on discussions with key stakeholders, we find that the demand for BDS appears to be significant among SMEs, based on a combination of four main criteria: quality, relevance, turnaround time and flexibility<sup>44</sup>. Moreover, in line with the literature, SME's understanding of, demand for, and willingness to pay for BDS varies, depending upon the size and location of the enterprise<sup>45</sup>. The demand for BDS by SMEs can be either cross-cutting, such as common needs irrespective of the sector or nature of business, and/or customised in a technical, strategic, or bespoke nature to the business process. These cross-cutting and customised needs can be categorised as short term or long term, basic, advanced or specialised, and will vary from case-to-case. Moreover they can graduate from basic to advanced level<sup>46</sup>, depending on the evolving context of individual businesses. Based on triangulation of survey reports and primary data from interviews, we have divided the needs between 'micro or small enterprises' and 'medium or relatively large enterprises', as illustrated in Table 1.

<sup>43</sup> For further information on the links between PSD and conflict resolution, see DCED (2010) and Bray, J. 'The role of private sector actors in post-conflict recovery', 2009.

<sup>44</sup> This relates to the level of quality of the service provided; the relevance of the service in so far as it is tailored and bespoke to the needs of the beneficiary; the timeliness of service, and the flexibility to modify the service to reflect developments/changes in the needs faced by the beneficiary.

<sup>45</sup> The limited willingness to pay, in total or in part, therefore depends on the anticipation by the entrepreneur of the expected value of such business services. In this context, value means anticipated profit but can also be access to new or improved technology, business practices, or new markets. The problem is that information available to the entrepreneur is often partial, track record of BDS provision is rarely proven, and examples of established returns for the entrepreneur are rare.

<sup>46</sup> Although not always a linear progression from basic to sophisticated, as businesses grow, they do tend to require more sophisticated support.

## SECTION 3: FINDINGS

**Table 1: Business development services for micro or small enterprises, and larger enterprises**

Significance	Business Development Services	
	Micro or small enterprises	Medium or relatively large enterprises (customised support)
<b>Cross cutting = high demand</b>	<ul style="list-style-type: none"> <li>Marketing services, market information and market study</li> <li>Bookkeeping<sup>47</sup>, record keeping, account receivable</li> <li>Technical skills, technology upgrading, gaining or improving processing, machinery and technical know-how, product development</li> <li>Medium to long-term hand-holding or follow up support where applicable</li> </ul>	
<b>Prioritised demand by enterprises</b>	<ul style="list-style-type: none"> <li>Increasing income typically by working on revenue (mainly at the market angle)</li> <li>Technical skill or knowledge to improve product/service</li> <li>New idea or linkages for cheaper supply or distribution</li> <li>Basic accounting, budget and finance management</li> </ul>	<ul style="list-style-type: none"> <li>Profitability via working on increasing revenue and/or reducing cost</li> <li>Advanced accounting, account receivable</li> <li>Operation optimisation, technical know-how, machine sourcing/maintenance/operation, standard and quality, processing, energy</li> <li>Supply and distribution chain management, sourcing or vendor identification, transport</li> <li>Sales, design, packaging, storage, freight forwarding, import/export, MS office, English</li> <li>New ideas and business strategy</li> </ul>
<b>Second priority needs by enterprises</b>	<ul style="list-style-type: none"> <li>Basic quality and standard</li> <li>Better storage, product development or diversification</li> </ul>	<ul style="list-style-type: none"> <li>Financial analysis and modelling, cash flow forecast, costing and budgeting, finance software training</li> <li>Bidding knowledge, R&amp;D (major in food sector), recruitment (major in construction) and office/file/information management</li> <li>Business plan and business enabling or facilitating environment/support</li> </ul>

### 3.2.2 Identifying SME needs and donor targeting

Table 1 is merely representative of the BDS needs of SMEs. In reality, a large percentage of micro and small enterprises are likely to have an insufficient level of “business literacy”<sup>48</sup> to understand the meaning of BDS<sup>49</sup>. The majority do not have the literacy levels required to understand their real needs, and to graduate to the next level of enterprise size and sophistication.

We found that enterprises that do not have the willingness or potential for high growth appear to be significant in number, and sustain the informal economy<sup>50</sup>. Many opt for remaining small due to challenges of external factors in the business environment such as unwanted attention from corrupt officials<sup>51</sup>. Given the fragile nature of Afghanistan, entrepreneurs (particularly from this group) are often inclined towards opportunistic short-term gains, deal making, low or no risk/cost options, and high flexibility to change subject to emerging opportunities. These are fundamental obstacles that hinder the absorption of meaningful skills, thus affecting future growth.

In contrast to this, there are other SMEs that are likely to form a strong foundation for growth in the formal economy. We refer to these as promising enterprises, who incorporate a number of driving factors such as a willingness to grow toward formal systems; absorption capacity of knowledge and skills as well as potential to expand; strong backward (supply chain) and/or forward (distribution or market-side) linkages; and a balanced enterprising mind-set and attitude which enables effective organisational and business management.

Within this context, donor facility managers often find it difficult to identify and select promising enterprises to graduate from smaller to larger businesses, and for donors to maximise the effectiveness of their funding by selecting/targeting promising enterprises with the highest potential to play a major role in the economy by increasing jobs and reducing poverty.

Our discussions with the WB Office in New Delhi on the Afghanistan New Market Development Programme (ANMDP) identified an encouraging response to matching grant funds from the SME sector. The ANMDP team acknowledged two types of beneficiaries – those who were well-versed with the donor application process and

<sup>47</sup> Confirmed by APPRO field studies in Mazar Balkh and Kandahar – May 2014.

<sup>48</sup> Interview with GIZ team in Northern Afghanistan and interviews with micro enterprise support agencies (Hand in Hand, AKF).

<sup>49</sup> World Bank “Pathway to inclusive growth 2014” Fig 2.1 and 2.2 page 35.

<sup>50</sup> According to the MoCI (2013) Between 70 and 80 percent remain informal and unregistered, largely pushed to the margins out of fear of entanglement in bureaucracy and corruption.

<sup>51</sup> Interviews with Aga Khan Foundation and Hand In Hand,



## SECTION 3: FINDINGS

compliances, and those who were entirely new to such a system<sup>52</sup>. The pre-agreement formalities, as well as fulfilment of selection criteria, appear to be a complex and new system for first time grant seekers. Essentially, it highlights the demand for BDS services by SMEs who are new to donor-driven application and compliance systems. Thus, this new group of SME applicants may require more rudimentary BDS relating to developing business plans, filling forms, and understanding the needs of donors. It means that donors have to be flexible in defining the type of BDS they are ready to fund in a difficult market such as Afghanistan, where a sustainable and well-functioning BDS market does not exist<sup>53</sup>.

### 3.2.3 Insights from APPRO field assessments

Based on APPRO's field assessments, issues that are deemed as priorities for micro enterprises, notably based on additional research by APPRO on clusters, are as follows:

- BEE: relations with the administration on tax, custom procedures, zoning, rents and land regulation;
- BDS to support product competitiveness: a recognition of the challenges to improve Afghan quality and standards to (re)conquer domestic and overseas markets;
- Access to appropriate infrastructure and finance; and
- External factors: corruption and non-transparent practices that hinder business growth.

There is an acknowledgement amongst stakeholders met that baseline literacy is low, that attention needs to be paid to the fact that a large number of small business owners are illiterate, and thus the training programmes provided for them have to be adapted to reflect this.

Traditional informal methods of doing business in Afghanistan remain entrenched, due to the low literacy and numeracy levels of most entrepreneurs, a lack of market information, and insecurity. However, these traditional informal methods have proved to be a good risk management strategy, adapted to the fragile context which demands much higher resilience, flexibility, opportunistic and deal making behaviour. Not only this, but these methods demand maintaining a low profile, a small size, no formal accounts and quiet operations in order to retain distance from negative interest groups (such as corrupt government officials, kidnappers, insurgents, warlords, politically active individuals, competitive enterprises or ethnic groups).

Annex 9 pulls together all the key findings linked to APPRO's research in Kabul, Kandahar and Mazar, and links these findings with previous research undertaken. In terms of DFID's strategy for inclusive growth and job creation, the report highlights a number of interesting findings:

- Diversification of economies to create inclusive growth is one of the key focus areas of DFID's strategic framework for economic growth<sup>54</sup>. APPRO's research suggests that the almost exclusively macro level focus by other main donor organizations active in Afghanistan has resulted in a large but neglected number of clustered micro and small-scale enterprises present in all regions of Afghanistan<sup>55</sup>. These clustered enterprises employ many at the base of the pyramid, and are found across a broad range of economic sections within agriculture, manufacturing and services. Thus, any growth in these enterprises has the potential to be inclusive, given that they can be found across the economic spectrum, and the fact that they employ the poor – both formally and informally.
- Job-intensive activities and sectors represent another key focus area of DFID's strategic framework for economic growth<sup>56</sup>. Many of these clustered enterprises are job-intensive, especially within agriculture (such dried fruit and nuts, and fresh produce), and further growth in these sectors has the potential to increase job creation – both horizontally as a cluster, and vertically through stronger forward and backward linkages with suppliers and purchasers of goods and services.

---

<sup>47</sup> Discussions with World Bank New Delhi – 3<sup>rd</sup> April 2014.

<sup>53</sup> Some would call this "donor" failures when they believe that erroneous market perceptions have been created by a decade of misplaced incentives introduced by previous donor programmes.

<sup>54</sup> DFID, "Economic development for shared prosperity and poverty reduction: a strategic framework" (2014).

<sup>55</sup> APPRO, 2014

<sup>56</sup> DFID, "Economic development for shared prosperity and poverty reduction: a strategic framework" (2014).

### Box 4: Findings relating to business development services provision and improving SME access to domestic and regional markets

A number of specific advisory and BDS support for improving SME market linkages, and SME access to domestic and international markets was identified. These include:

- Case specific support via/to EPAA for promoting trade, which is currently being undertaken by GIZ. Similar support could also be extended to ACCI and AISA since objectives are overlapping for export promotion within these agencies.
- Transfer of skills/knowledge which emphasises the practical transfer of skills/knowledge via business-to-business training within Afghanistan and in the region.
- Market facilitation by building or strengthening linkages between buyers, suppliers and other business-to-business trade, and connecting trade agents within Afghanistan and at the international level to encourage trade deals. There is evidence that regional trade is being promoted through bringing in international standardisation agencies, technical agencies (such as for packaging and designing) and product quality certification/assurance agencies<sup>57</sup>.

### 3.2.4 The legacy of past BDS programmes

In Afghanistan, the development of the private sector began to emerge as a priority for government agencies from the mid-2000s. Despite this, the government did not have an SME strategy until 2009, and implementation of the strategy did not begin until 2011<sup>58,59</sup>.

In the past decade, typically a combination of two strategies has been adopted by donors and their implementing agents to ensure a supply for the rapidly evolving BDS needs of SMEs. These are:

- to outsource BDS to local BDS firms and/or train them to improve their quality for better performance as well as create a BDS provider market; and,
- to provide direct, in-house, BDS support, implemented by project staff. This is the model chosen by facilities such as AKDN, ASMED, AREDP that are hiring and training national staff for this purpose who will deliver the BDS with the support of expert advisors and specialists often hired in the international markets.

It is asserted by stakeholders that a moral hazard has been created by the first generation of private sector development (PSD) projects, due to the disproportionate disbursement by donor agencies in short periods within the context of a fragile socio-political, economic and security situation, thus resulting in ineffective and unsustainable interventions.

Expectations for free services appear to be shared by a majority of beneficiaries<sup>60</sup>, which were welcomed and which artificially boosted early market development, paving the way for current platforms of PSD interventions. Current trends suggest that the young generation (based around major cities, typical age 20 to 30, belong to business families, local power centre families or foreign returnees) are relatively better educated and able to understand and appreciate business concepts<sup>61</sup>.

<sup>57</sup> Discussion with EPAA. Recently, the Control Union opened a branch in Afghanistan for certification which is expected to significantly support Afghan export traders.

<sup>58</sup> Afghanistan Research and Evaluation Unit. 'Small and Medium Enterprises Development and Regional Trade in Afghanistan' Working Paper 2014.

<sup>59</sup> However, there were several donor-funded interventions to meet the BDS demand of SMEs prior to 2009 with an ultimate objective to support private sector development, such as ASMED (2006-11), National Area-Based Development Program (NABDP) (2002 onwards), followed by AREDP (2009-14); Microfinance Investment Support Facility for Afghanistan (MISFA) or International Non-Governmental Organisations (INGOs) such as Mercy Corps; Asia Foundation; Aga Khan Foundation, Hand in Hand, and others working in remote parts of the country.

<sup>60</sup> During the intervention of first generation PSD projects, the absorption capacity of new knowledge and skills by entrepreneurs, and the capacity of the BDS provider market were very low. Concepts of business planning (which still appears to be an alien notion, particularly among those SMEs who have never received donor-support), cost or revenue analysis, cash flows and accounting systems were virtually non-existent in a formal way. However, these systems existed in an informal way, mostly in the mind of the owners, especially in a context where many entrepreneurs spent their youth as overseas refugees or internally displaced people, during war-affected periods and under regimes that were not accommodating towards private sector enterprise.

<sup>61</sup> Education level among families returned from abroad or youths passing out in last 5 years from major universities/education centres/training institutes has increased noticeably in major cities, especially in Kabul.

## SECTION 3: FINDINGS

### Box 5: The Business Incubator Hub of the American University of Afghanistan

The Business incubator Hub (BIH) is an autonomous unit established within American University of Afghanistan to provide business consultancy services at cost<sup>62</sup>. According to the BIH an initial diagnosis is critical to understand the actual BDS requirements of a business. Often there is a variance between the BDS solution acquired or identified by the owner and a meaningful solution, which might make a real difference to the business growth or profitability and also in terms of value for money. It is observed that an in-depth initial interaction, visit to business locations and due diligence as a part of business diagnostics reduces the probability of deception. It also increases the prospects of identifying and solving actual business development challenges. It is the BIH's experience that actual BDS needs of most SMEs differ significantly from the priority list prepared by the applicant<sup>63</sup>.

### 3.2.5 Existing donor-funded business development services programmes

The current supply of advisory support, BDS and technical support is mostly provided through donor-funded programmes<sup>64</sup> and INGOs<sup>65</sup>. However there are isolated cases of more market driven supply, such as Afghanistan Growth Finance, established in 2007 by Small Enterprise Assistance Funds (SEAF), which supports larger SMEs through commercial financial products combined with advisory services. Table 2 illustrates the major donor programmes that have been developed to address SME BDS needs.

**Table 2: Fact sheet of major donor projects addressing BDS needs.**

Project name	Focus	Provision	Approach and process
ABIF, (DFID funded). National coverage	SMEs from specific sectors: horticulture; livestock; carpet; furniture; healthcare; mining services; household services	Grant as well as sector specialist guidance and support throughout the process such as business plan or strategy development.	Cyclic competitive rounds of call for concept note then shortlist for submission of full application (business plan, supporting documents and due diligence) followed by contract signing for grant approval. The process narrows down SMEs from a large pool, primarily based on pro-poor development benefits and risk assessment. It addresses internal institutional risk factors.
SME Unit (Enterprise Development Unit), AREDP, (World Bank Funded). 7 provinces coverage.	SMEs from rural/semi-rural areas, although not specific to sector but adhering eligibility criteria. Most SMEs are agriculture or non-farm related.	Provision for BDS needs which are majorly or fully subsidised by AREDP. Project assists in facilitation of linkage for provision of BDS. The support is primarily based on requests forwarded by SMEs. BDS could be basic, advanced, technical or specialised.	Cyclic competitive application call via simple application form. Technical feasibility, economic viability and due diligence of shortlisted SMEs followed by 2 <sup>nd</sup> shortlist for interactive basic business plan development followed by agreement signing. Typically, narrow down approach helps in identification of most relevant businesses and demand for BDS needs from enterprise prospective. Addressing: BDS needs primarily demanded by SMEs.
ANMDP, (Major funder is World Bank). 4 provinces coverage	SMEs operating in agro-industry, manufacturing (including artisans) and tradable services.	Reimbursable matching grants. Provision of product development; market development and technological upgrading.	Competitive call for applications followed by short listing and verifying organisational readiness followed by corporate strategy or business plan submission. Then signing co-financing agreement and seeking BDS from market and filing for partial reimbursement of the cost. It is addressing specific BDS needs primarily identified by SMEs themselves.
ABADE, (USAID Funded) National coverage	SMEs sector undefined. Support to existing, productive SMEs, consortia, or joint ventures	Grant; business advisory and technical assistance for operations and management: to solve technical issues related to market access, production, access to finance; achievement of quality	Competitive application process via call for proposals and identifying enterprises through existing institutional channels e.g. association, chamber and referrals. It appears to focus on mitigating internal and external risk factors associated with business, institution and market systems.

<sup>62</sup> It was launched in March, 2013 and operational in October 2013. Seed funding is provided by TFBSO, Department of Defense, USA.

<sup>63</sup> See Annex 6 for more details about the Business Incubator Hub.

<sup>64</sup> Such as ABADE (2013-17); ANMDP (2012-16); NSDP & DM-TVET; Program II: National Comprehensive Agricultural Production and Market Development of Agriculture and Rural Development (ARD) clusters i.e. ADF (2010-14), CARD-F, IAPFE, AREDP and EVC (2012-16), MISFA as well as programs supported by Japan, Germany, Canada, and Norway. Some institutional BDS support is also delivered by ACCI; AISA; EPAA; HARAKAT; Business Incubator Hub of American University of Afghanistan (shared cost, not free service).

<sup>65</sup> Such as Hand in Hand, Aga Khan Foundation, Mercy Corps, Peace Dividend Trust and Afghan Aid.

## SECTION 3: FINDINGS

		standards; support for business enabling environment addressing specific regulatory and procedural barriers	
Business Incubator Hub, AUA (TFBSO/DOD, start-up funding). Currently Kabul, future plan Balkh.	SMEs sector undefined. Support to owners with progressive, open to change and committed mind set	BDS consultancy service at cost (sharing revenues and/or cash). Typically, one person year of consultancy.	Initial mind set assessment through an interview then deep diagnosis of the business. Followed by signing contract as well as continued coaching and mentoring. Key factor is addressing the shift in mind-set of the entrepreneur and mitigating internal institutional risk factors.

### 3.2.6 Challenges, gaps and availability of BDS

The core challenges for BDS providers in Afghanistan relate to achieving impact, outreach, cost efficiency and sustainability<sup>66</sup>.

- **Selection and identification of enterprises:** It is difficult to find beneficiaries with the combined level of understanding, absorption capacity and motivation required by donor projects. Conversely, a major factor attracting beneficiaries (not necessarily entrepreneurs) towards donor-driven projects appears to be the low or no risk nature of involvement. It is also challenging and cost intensive to verify the authenticity of information provided by beneficiaries, since generating or creating documents and falsifying physical assets to win loans, bids or grants is not uncommon. Referral techniques are considered as a safer option, but are still not without risk of nepotism.
- **Identification of essential problems affecting small businesses:** The expertise needed to diagnose business needs has been pointed out by most of the implementing agencies (AREDP, ANMDP, and ABAD) and the capacity to identify the key problem(s) is a vital issue. Usually, business owners have lists of demands which they prioritise (see table 1) but business development needs diagnostics can become skewed if based only on demand rather than on further research or analysis. Limited skills in business analysis among project staff or/and BDS providers make this assessment difficult. The business diagnosis process is often based on face value and subjective facts which add on to the challenge. The Business Incubation Hub (BIH) particularly highlights the limited ability of entrepreneurs to critically understand their own needs, priorities and accept hard facts relating to their enterprises.
- **Quality, relevance, turnaround time and flexibility of BDS:** Useful BDS can only be provided when the problem is clearly defined in its context and/or there is a chain of problems which would require handholding, mentoring or coaching support for the recipient over a period of time. Meaningful BDS should comply with a combination of four factors: quality (knowledge and capacity to solve the problem); relevance (bespoke applications to solve the problem); turnaround time (time taken to provide or implement the solution); and flexibility (adaptability to the changing context and situation).
- **Identification of BDS professional providers:** The identification of capable service providers is a major problem in Afghanistan. It appears that the market of BDS providers has significant potential, but is primarily based on donor funds and interventions. As mentioned previously, SMEs cannot be expected to bear the cost unless they perceive real value of the service on their business, or if it can be measured by key performing indicators agreed beforehand. Furthermore, the satisfaction with BDS is often a problem, usually due to a mismatch between the requirement and provision, or because of the poor quality of service<sup>67</sup>.

### 3.2.7 Achieving sustainability of business development services

BDS providers surviving in the market are primarily donor-driven and often fulfil formalities<sup>68</sup> for enterprises seeking financial/non-financial assistance from donor-funded projects or banks. Moreover, the strategy to outsource from direct in-house provision to outside private (and more marginally not-for profit) providers has been promoted extensively since the launch of ASMED, with the idea that BDS providers could become private business training

<sup>66</sup> GIZ/GFA BDS project in the North identified Haraqat Moafaq, Skill Tree BDS and Ether BDS among the top performing suppliers. Despite assisting BDS providers for 4 years, the project was unsuccessful in bringing a systemic change in the distorted market of BDS services. Source: Mapping of BDS providers in Northern Afghanistan in 2013 and in 2014 - GIZ.

<sup>67</sup> AREDP Enterprise Survey 2009, BDS Mapping 2014.

<sup>68</sup> Such as proposal writing and business plan writing.

## SECTION 3: FINDINGS

centres, institutions, or local consultancy firms. However, creating a BDS provider market, and expecting them to be self-sustainable and non-donor dependent, is challenging in the current Afghan context. Discussions with the GIRoA and implementing agencies of donor funded programmes<sup>69</sup> suggest that it is unlikely that a BDS providers' market can be sustainable without support from donors in the short to medium term.

### 3.2.8 Critical success factors for donor-funded business development services programmes

The critical factors that have been evident in successful BDS provision include the following:

- Time is required for in-depth analysis of the nature of problems faced by SMEs. If the demand for BDS can be assessed smartly, the right services can be provided in a timely manner. This requires additional time and resource.
- To maximise the impact of BDS, hand-holding and continuous follow-up support from donors/service providers is required by SMEs, especially as capacity of absorption is low, and as the nature of demand changes over time.
- Facilitating linkages enables entrepreneurs to exchanging ideas with other businesses in their clusters or value chain and develop business relationships.
- Family-operated businesses are prevalent in Afghanistan, especially in the informal sector. Complex management arrangements and mind-sets need to be carefully understood by implementing agencies, donors and experts as well as BDS providers to design better programmes.
- Although representation of women leaders in the business community is expected to remain stagnant, BDS projects that advantage women-lead enterprises are likely to boost business families' willingness to encourage women in their businesses overall.
- Projects which consider a balanced approach between in-house and outsourced BDS, with a view to supporting outsourced options as a long term strategy, offer greater chances of achieving sustainability and impact.

Generally, the best performing BDS providers (in terms of quality, relevance, flexibility and affordability) are able to earn a full or partial livelihood from the provision of their services, without any salary support by NGOs. However, such a system is likely to face problems where the ratio between prospective clients and BDS providers is mismatched or the cost-benefit to reach remote customers is not feasible; or simply working without a minimum guaranteed salary<sup>70</sup>.

## 3.3 In-country findings on SME access to finance and the provision of funding

In this section we specifically focus on access to finance for SMEs, and the provision of funding, and take a detailed look at the overall financial system in Afghanistan. This includes an assessment of the underlying issues in the sector, and how these relate to SMEs<sup>71</sup>. We also assess financial product, actor and instrument variety, and the coupling of access to finance with business development services.

### 3.3.1 The Afghan financial and banking system

The Afghan financial and formal banking system is under-developed, narrow and fragile. In particular, after rapid growth of microfinance provision between 2002-06, the number of Afghans accessing microfinance loans has declined sharply (as illustrated in Figure 1). At December 2013 registered institutions, including First Microfinance Bank of Afghanistan (FMFB) and the Islamic Cooperative movement, had 337,000 clients including 227,000 savers and 163,000 borrowers<sup>72</sup>.

---

<sup>69</sup> SME directorate, MOCI; AREDP, MRRD; CARD-F, MAIL; GIZ, ASI, Kaweyan.

<sup>70</sup> Mercy Corp and Aga Khan Foundation interviews May 2014.

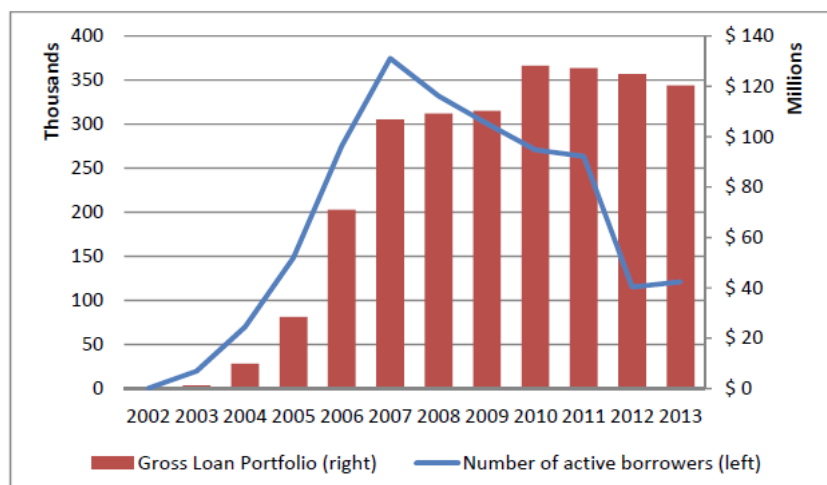
<sup>71</sup> A recent paper published by the PEAKS Resource Centre for DFID Economists and Private Sector Advisers summarises the evidence of the benefits of financial sector development on growth and jobs, and concludes that barriers to financial inclusion impede enterprise growth – Please refer to the Literature Review in Annex 4.

<sup>72</sup> Issue 3: Quarter 4 (Oct-Dec 2013) – by USAID, MISFA and AMA – released in April 2014



## SECTION 3: FINDINGS

**Figure 1: Evolution of Afghan microfinance sector 2003-13<sup>73</sup>**



It was not possible to underpin our analysis with audited accounts from banks as this information was not available, but feedback from stakeholders is consistent that commercial banks have limited exposure to SMEs<sup>74</sup>.

The World Bank, IFC and managers of donor facilities are optimistic that as the general business environment improves, banks will deploy a more pro-active strategy to increase their share of lending channelled to SMEs. However, stakeholders confirmed it will be necessary for programmes that support financial institutions to increase their exposure to SMEs to learn from the lessons of the recent past.

- The restructuring of the microfinance sector in 2010-mid 2013 after rapid growth in 2006-09 has left Afghan Microfinance Institutions (MFIs) with a poor reputation and operational capability. MFIs that belong to international networks (with good track records of working with DFID in other conflict-affected regions such as northern Uganda) have left Afghanistan with heavy losses<sup>75</sup>. The number of MFIs still active in the country has been reduced from 14 to 6 and their outreach reduced by almost 50 percent. The total gross portfolio looks stable, due to the rollover of bad loans and to the higher average amount lent by FMFB compared with its peer.
- The disappointment in the performance of Islamic financial cooperatives known as IIFCs, supported by two successive US-funded programmes, ARIES and Rural Finance and Cooperative Development (RUFCD), and in Helmand by DFID Helmand Growth programme. The restructuring of their network has been necessary as many were created based on security criteria rather than economic criteria. Moreover, operations in certain rural districts were disrupted by insecurity, and non-performing assets became too high (same as for MFIs).
- The Kabul Bank collapse after its loss and the constraints faced to turn around the “New Kabul Bank”<sup>76</sup>.

Some stakeholders also raised the possibility of another crisis in the financial sector in the next six to twenty four months. There are regular rumours of other commercial banks being in difficulty, and that bad debts may be alarmingly high in several state-controlled commercial banks.

This feedback may seem overly pessimistic but the inability to find and approve a credible investor to buy the assets of the New Kabul Bank is indicative of the current market reality<sup>77</sup>. There is a risk that Afghanistan may be put on the Financial Action Task Force (FATF) list<sup>78</sup> due to “strategic anti-money laundering and counter-terrorism financing deficiencies”<sup>79</sup>. Most interviewees confirmed structural weaknesses in the supervision and regulatory

<sup>73</sup> Source: MISFA and AMA.

<sup>74</sup> Commercially sensitive: when pushed, the Deputy CEO of AIB admits an objective of \$5m to test its new mid -market pilots targeting \$ 25,000-100,000 medium term finance within its “Banking for Small Business” initiative.

<sup>75</sup> It is rumoured that BRAC Bank may have lost up to \$60m. ASA, also one of the top 3 from Bangladesh has left. Finca and Aga Khan networks had to restructure their operations at a high cost.

<sup>76</sup> SIGAR latest quarterly Audit Report at April 2014 – <http://www.sigar.mil/pdf/quarterlyreports/2014-04-30qr.pdf>.

<sup>77</sup> The GfRoa has not approved the sale, although an investor has been identified.

<sup>78</sup> See <http://www.fatf-gafi.org/topics/key/public-statement-feb-2014.html>.

<sup>79</sup> Anti-Money Laundering and Counter Terrorism Finance -see below Chapter 6 for further analysis.

## SECTION 3: FINDINGS

capacity of Da Afghanistan Bank, and support the view that “the system [is] unstable and at risk of experiencing another crisis similar to the near collapse of Kabul Bank.”<sup>80</sup> The impact for SMEs was pointed out by the World Bank as early as 2012, whereby “under developed financial sector and low financial intermediation leave little scope to help Afghan businesses adjust to slowing growth”<sup>81</sup>.

Moreover, APPRO’s field research in Mazar, Kandahar and Balkh has confirmed feedback<sup>82</sup> that basic numeracy and literacy, as well as financial literacy, are weak; and clients cannot absorb easily the rudimentary aspects of finance and the sophistication of most modern financial products. Investing in financial capability would be of great importance and aligned with government and donor global priorities.

### 3.3.2 Access to finance at the base of the pyramid

APPRO field assessments in Mazar, Balkh and Kandahar confirm very low penetration of formal finance with microenterprises and small businesses. Banks are rarely used by microenterprises and small businesses in Kandahar, but more by larger businesses, mostly for depositing funds received or to be transferred. Interviews with FINCA, Hand in Hand and First MicroFinance Bank (FMFB) and other INGOs confirm that micro-enterprises need basic financial services (such as a safe place to protect their savings; payment and remittances services). Currently they predominantly access these services through providers such as *Hawala*<sup>83</sup>, remittances circuits and currency changers.

In addition, the needs of the rural economy are not well served by microfinance products and expanding presence in rural areas is not a priority to an embryonic banking system. Technology-based solutions such as mobile banking are still unproven and pilots like M-Paisa have stalled. There is also scope to explore further models, especially based on Sharia-compliant financial products. The embryonic Islamic investment and finance cooperative movement has a higher average loan size than most MFIs, a higher percentage of loans going to small businesses (as opposed to microenterprise), and in the most successful northern provinces, 35 percent of loans are financing agriculture. There is also scope to explore further models, especially based on Sharia-compliant financial products.

### 3.3.3 Systemic risks to the financial system

The latest IMF assessment praises many efforts by the Afghan authorities to push for essential reforms but stresses that delays have been encountered in introducing “the value added tax and submitting to parliament the laws on anti-money laundering and countering of financing of terrorism, and amendments to the central bank law.”<sup>84</sup>

There are still structural weaknesses within the financial sector, especially in the banking system, which need to be more energetically tackled. In particular:

- the capacity of Da Afghanistan Bank is still limited in its ability to implement its regulatory and supervisory mandate;
- not all restructuring decisions<sup>85</sup> have been taken by Da Afghanistan Bank after the World Bank shared results of the twelve bank audits in 2012<sup>86 87</sup>; and,
- the national payment system remains too embryonic and cannot compete with traditional informal and unregulated cash and *Hawala* transactions.

Although of a technical nature<sup>88</sup>, the risk that Afghanistan may be transferred to the black list of the Financial Action Task Force/General Authority for Investment and Free Zones international cooperation agreement is of grave

---

<sup>80</sup> SIGAR, Audit Report 14-16: Afghanistan’s Banking Sector - The Central Bank’s Capacity to Regulate Commercial Banks Remains Weak, 1/2014.

<sup>81</sup> Afghanistan in Transition: Looking Beyond 2014 – Volume 2 – May 2012.

<sup>82</sup> From Hand in Hand, FMFB, Finca and the IIFCs.

<sup>83</sup> *Hawala* is an informal value transfer system based on a large network of money brokers, primarily located in the Middle East, North Africa, the Horn of Africa, and the Indian subcontinent, operating outside of, or parallel to, traditional banking, financial and remittance systems.

<sup>84</sup> Country Report No. 14/128: Islamic Republic of Afghanistan: 2014 Article IV Consultation-Staff Report; Press Release; and Statement by the Executive Director for the Islamic Republic of Afghanistan - <http://www.imf.org/external/pubs/cat/longres.aspx?sk=41571.0> and for further diligences see the 98-page detailed report: <http://www.imf.org/external/pubs/ft/scr/2014/cr14128.pdf>.

<sup>85</sup> Restructuring decisions relate to addressing systemic weaknesses, systems, staff capacity, and likely the treatment of non-performing loans as well as regulation capacity from DAB

<sup>86</sup> Co-funded by DFID and CIDA.

<sup>87</sup> The Review Team has not had access to these confidential documents.

<sup>88</sup> See <http://www.fatf-gafi.org/>.



## SECTION 3: FINDINGS

concern for the credibility and integrity of the Afghan banking sector, and will jeopardise its capacity to retain its correspondent banking relationships with the international community, especially in Europe and north America.

It was confirmed during interviews in Kabul that black listing would freeze many current efforts of extending donor programmes such as the German-managed and WB-funded Afghanistan Credit Guarantee Facility, and that this threat is already curtailing the capacity of Afghan banks to support international trade transactions, such as opening correspondent banking lines and accepting letters of credit on Afghan banks<sup>89</sup>.

Being cut from international banking relationships can have devastating effects on small business' access to basic payment services, as evidenced through the recent remittance crisis in Somalia<sup>90</sup> which drove microenterprises back to the services of traditional informal providers who are difficult to regulate.

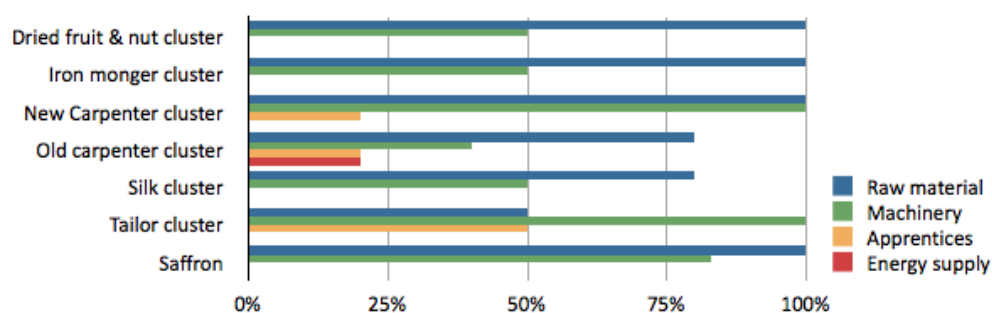
Since the IMF assessment both the Upper House and Lower House of Parliament have passed anti-money laundering legislation (according to DFID), but there are many other steps that remain to be implemented to meet international requirements as set out in Section 4.

### 3.3.4 SME needs for financial services

Although access to finance is only quoted as the 4th most critical barrier in the latest 2014 WB Enterprise Survey<sup>91</sup>, a higher proportion of firms in Afghanistan identify access to finance as a major constraint (43.6 percent), compared to the South Asia region (33.4 percent) and international averages (31.2 percent)<sup>92</sup>.

Clustered enterprises say that increased access to credit on acceptable terms would allow them to be more competitive (by investing in better technology and machinery) and open more possibilities for expansion. APPRO's analysis provides insights into the demand and need for financial services by SMEs as set out in Figure 2.

**Figure 2: Most urgent uses of credit – all clusters<sup>93</sup>**



#### Box 6: Alternative Dispute Resolutions (ADR) supported by IFC

Banks and MFIs are reluctant to lend because they are wary of becoming entangled in long and costly legal procedures with their borrowers. IFC, which has a long tradition of partnerships with DFID in this field<sup>94</sup>, and Harakat have been working on alternative dispute resolution mechanisms. There is a project of an Afghanistan Centre for Dispute Resolution. APPRO field findings confirm the importance for smaller SMEs to access a user-friendly and community-recognised mechanism to resolve commercial disputes.

<sup>89</sup> Interview with AIB senior management corroborated by DFID Economics Advisers and the Afghanistan Credit Guarantee Facility manager

<sup>90</sup> <http://www.theguardian.com/global-development/2013/nov/05/somali-remittances-dahabshiil-barclays-bank> and <http://www.ft.com/cms/s/0/54aca3a4-c557-11e3-89a9-00144feabdc0.html#axzz33D7BqUbO>.

<sup>91</sup> World Bank/IFC Enterprise Survey - 356 enterprises between May and July 2013 including 229 SMEs. Access to finance is cited as number 4 challenge – 14.4 percent - after “political instability, corruption and access to land”.

Some studies put access to electricity and transport infrastructure before access to finance as key constraints.

<sup>92</sup> The data available in Afghanistan may not represent remote rural areas and southern provinces most-affected by physical barriers to access finance, and the insufficient technology available to develop mobile services.

<sup>93</sup> Source: APPRO, 2012 : Urgent uses of credit” was a way to express the Financial priorities by interviewees to acquire raw materials, invest in modern machinery, recruit apprentices or ensure reliable energy; new carpenters are those who established themselves 50 years ago outside the crowded inner bazaar, compared with the historical cluster inside the Old City deemed “old” as it has been in existence for at least 300 years. Source: APPRO, 2012.

<sup>94</sup> See partnerships with DFID in Pakistan - <http://devtracker.dfid.gov.uk/projects/GB-1-203283/> - and the Bangladesh International Arbitration Center (BIAC) in the Region - [http://www.ifc.org/wps/wcm/connect/region\\_ext\\_content/regions/south+asia/news/adr\\_bangladesh](http://www.ifc.org/wps/wcm/connect/region_ext_content/regions/south+asia/news/adr_bangladesh).

## SECTION 3: FINDINGS

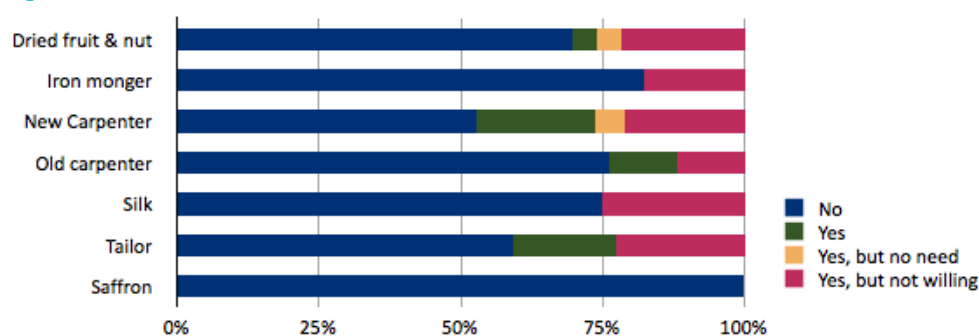
### 3.3.5 Obstacles to SME access to financial services

Although there is significant demand for credit, there are obstacles to support for credit delivery that future programmes will need to take into account, including the following:

- the majority of clustered businesses object to interest-bearing loans on religious grounds and believe that financial products and processes are not compatible with their religious beliefs<sup>95</sup>;
- concerns exist in relation to: high interest rates; long administrative processes; short duration of repayment periods and onerous collateral requirements (usually property title for banks and character reference by a locally appointed traditional community representative for MFIs);
- acquisition of modern tools and machinery through increased access to loans would need to be accompanied by relevant training, and in conjunction with pre-existing forms of learning through the apprenticeship system<sup>96</sup>; and,
- the size of loans (ranging between 5,000 and 25,000 Afghanis) is insufficient to meet most of the needs of small businesses; loans of \$25,000-50,000 that are particularly in demand from medium-sized businesses are difficult to meet today in the Afghan market; moreover, there is miss-match in repayment schedules as demand is for medium term facilities, whilst offers tend to be over the shorter term.

These factors may contribute to the self-exclusion by businesses from the formal financial sector as Figure 3 illustrates.

**Figure 3: Current demand for formal credit from traditional clusters<sup>97</sup>**



There are additional factors which influence self-exclusion; including lack of trust in banks after the Kabul Bank collapse (small and micro-entrepreneurs have negative perceptions of the banking sector<sup>98,99</sup>; and a lack of understanding of the role of self-sustainable financial institutions, due to low financial literacy.

### 3.3.6 Existing donor-supported programmes addressing SME access to finance

Our findings suggest that the US strategy in Afghanistan to support access to finance is not clear, whereas the interventions by the World Bank and IFC have more clout and are progressing well. Additional support to Microfinance Investment Support Facility for Afghanistan (MISFA) by the World Bank, adding to pre-existing donor funding, is going to be directed toward the poorest households and MISFA will need to focus all of its human resources to use the funds wisely. Progress is slow regarding the roll-out of the Collateral Registry<sup>100</sup> at Da Afghanistan Bank, and not much is happening at the institutional and capacity building levels since international experts previously seconded at Da Afghanistan Bank over the last decade have not been replaced. General progress is hampered by the electoral context, security concerns and lack of key positions in private and public institutions.

<sup>95</sup> Afghanistan Public Policy Research Organisation, 'Traditional Economic Clusters and Reconstruction in Afghanistan: The Case of Herat', 2012.

<sup>96</sup> Ibid.

<sup>97</sup> Source: APPRO 2012.

<sup>98</sup> This has been found by Finscope surveys in Pakistan in 2009—[www.finscope.co.za](http://www.finscope.co.za) - or in Nigeria - [www.efina.org.ng](http://www.efina.org.ng).

<sup>99</sup> Study commissioned by the Institute for Money, Technology and Financial Inclusion at the University of California deals with attitudes to savings and risks with M-Paisa users: [www.frogdesign.com/pdf/frog\\_In\\_The\\_Hands\\_Of\\_God.pdf](http://www.frogdesign.com/pdf/frog_In_The_Hands_Of_God.pdf).

<sup>100</sup> The roll-out of the Collateral Registry was work in progress at the time of writing. Central Bank unit staff were collecting the information to feed into a computerised system.

## SECTION 3: FINDINGS

Interviews with USAID suggest that:

- All future USAID interventions will be at the market facilitation level, to avoid market distortion. USAID will stop direct subsidies to beneficiaries.
- US teams are focusing on exit strategies to try to capitalise on what has worked, abandoning previous investments in the Islamic Cooperative movement, including the transition of ADF funds to Government, with possible additional support from Denmark Aid (DANIDA)<sup>101</sup>.
- Financial Access for Investing in the Development of Afghanistan (FAIDA), their flagship programme, will probably be prolonged under a no cost extension until Dec 2015.
- FAIDA will focus on capacity building and more structural reform of partner banks and (possibly) MFIs.
- USAID may consider expanding its partial guarantee schemes with selected banks.
- The Agriculture Development Fund (ADF) will continue under a no-cost extension until December 2015.

There is more detail about the expansion of the Afghanistan Credit Guarantee Facility with additional funding from the World Bank new Access to Finance programme in Annex 8.

The Microfinance Investment Support Facility for Afghanistan (MISFA) is the leading provider of wholesale funds and capacity for the microfinance sector at the lower end of the market. The World Bank will provide new resources and technical assistance directed towards poorest households ('Targeting the Ultra-Poor' component to their new Access to Finance Programme). For the foreseeable future, it is unlikely that MISFA will have the capacity and the organisational culture to serve the small and medium-sized segments of the market.

### 3.3.7 Financial product, actor and instrument variety

Interviews held confirm that there is much progress to be made in expanding the range of financial products, actors and instruments that are available to Afghan SMEs. However, there are a few donors working on addressing this issue, mainly the World Bank, which has approved the US\$50m Access to Finance Programme, and USAID that is re-focusing its FAIDA programme.

The major gaps and weaknesses can be considered as a lack of competence in product design, unmet demand for Islamic finance, a lack of appropriate and bespoke financial products, a lack of diversity of providers, and high cost of service. Each of these is considered in more detail here<sup>102</sup>.

#### Financial products

A general lack of competence in designing, marketing and selling the right financial products needed by SMEs is acknowledged across the financial sector, and has been repeatedly highlighted as a major bottleneck. A recurrent theme from interviewees in the public sector, Afghan institutions, MFIs and bankers is the urgent need to address the lack of middle and senior management competencies in banks in general, and of understanding the needs of the SME segment of the market in particular.

Many key institutions in the financial sector have several unfilled senior positions, and recourse to expatriates is expensive, and can raise security and cultural issues.

Facilities with longer timelines, better aligned with businesses' cash flow needs (and seasonal cycles in rural and agribusiness sectors), have been highlighted by interviewees and other sources as basic requirements<sup>103</sup>. In addition medium-term equipment finance appears to be in demand and techniques such as asset-backed finance, leasing, Islamic (*Ijara*) or hire-purchase could be provided to meet this demand.

#### Islamic finance

There has been consistent feedback from interviewees and field assessments, as well as during the inception phase, that there is cultural and religious unease with debt and interest products in vast segments of the Afghanistan business community. As such, enterprises of all sizes, forms and shapes expect the Government, regulators and donors to push financial institutions to increase their share of Sharia-compliant finance. However, practitioners who have been testing pilots of Islamic products say that providers and customers do not use them

---

<sup>101</sup> The outcome of an on-going process which can only be negotiated with the new government team is not clear.

<sup>102</sup> Despite this, there is goodwill, motivation and local expertise to mobilise and address low capacity in the financial sector in a systematic way, driven by local solutions, from universities and business schools to professional bodies (ABA and AMA) and inter-professional initiatives such as the Afghanistan Institute of Banking and Finance (AIBF).

<sup>103</sup> See for instance APPRO (2008) on issues related to microfinance in Afghanistan.

## SECTION 3: FINDINGS

extensively due to their complexity and cost, which act as barriers to uptake. There have been several failed attempts to address the enabling environment for Sharia-compliant financial products adapted to the socio-cultural context of Afghanistan<sup>104</sup>. The key lessons learnt from these programmes are captured within the options made by this report in Section 4.

### Box 7: What is Islamic finance?

Islamic finance refers to “a system of finance based on Islamic law (commonly referred to as Sharia). Islamic finance is premised on the general principle of providing for the welfare of the population by prohibiting practices considered unfair or exploitative. The most widely known characteristic of the Islamic financial system is the strict prohibition on giving or receiving any fixed, predetermined rate of return on financial transactions....Providers of funds are not considered creditors (who are typically guaranteed a predetermined rate of return), but rather investors who share the rewards as well as risks associated with their investment”<sup>105</sup>.

There will be a need for capacity building amongst a wide spectrum of stakeholders, including market regulators, officers, religious experts, legal/contractual advisers, and customary and legal courts<sup>106</sup>.

### Financial providers

In the absence of the detailed audit of banks in Afghanistan, and of consolidated audited data on the financial sector, assessments during the inception phase remain valid.

- The banking system that represents more than 80 per cent of the financial system is not aligned to serving the smaller end of the market<sup>107</sup>. Moreover, the data available on customer needs that are accessible are biased towards urban and more secure areas.
- There are few respected regulated financial institutions, including a few commercial banks such as AIB, and a few microfinance institutions dominated by First Microfinance Bank of Afghanistan (FMFB) that represent around 38 percent of microfinance clients and borrowers and around 50 percent in volume of the microfinance market<sup>108</sup>.
- Between 2010 and mid-2013, MISFA was focused on restructuring the microfinance sector and only recently considered a careful expansion of its support to new players and a development of its range of activities<sup>109</sup>. It will take time to make the microfinance sector attractive again to new players after the departure of reputed industry leaders such as ASA and BRAC bank.

The lack of diversity of formal providers, means that the financial needs of many Afghans is fulfilled through traditional and informal services<sup>110</sup>.

### Box 8: The Rural Finance and Cooperative Development (RUFCD) project

Supported by the World Council of Credit Unions, between 2009 and 2012 this programme received USAID core funding and support from DFID for its regional, Helmand based activities, and for product development. After a restructuring of loss-making cooperatives, IIFC members represented (at the end of October 2012) 92,000 members including 22,104 who had loans outstanding totalling approximately \$20.5m<sup>111</sup>. However, by December 2013 the number of members grew to 104,000 with 22 895 borrowers, a \$21.1m loan portfolio and \$3.9m of savings<sup>112</sup>.

<sup>104</sup> RUFCD, MISFA, IFC, USAID-funded technical assistance.

<sup>105</sup> CGAP definition in <http://www.cgap.org/sites/default/files/CGAP-Focus-Note-Islamic-Microfinance-An-Emerging-Market-Niche-Aug-2008.pdf>

<sup>106</sup> Bernard O'Sullivan – NMD – sent the team a long e-mail on needs for skilled officers and managers in Islamic Finance, suggesting solutions with Afghan universities, the Afghan Bankers Association and Dubai-based training centres. But he also refers to the huge needs at the regional level of 8,000 specialists which raises the risk of brain-drain once Afghan graduates have qualified.

<sup>107</sup> notwithstanding First Microfinance Bank of Afghanistan (FMFB) that is branded a bank, but is classified with MFIs in statistics.

<sup>108</sup> 55 percent in the latest AMA quarterly report at December 2013.

<sup>109</sup> Well summarised in MISFA Annual Report 2013 [www.misfa.org.af/site\\_files/13933914941.pdf](http://www.misfa.org.af/site_files/13933914941.pdf) pages 11-14.

<sup>110</sup> Businesses in clusters currently rely on traditional cooperation methods (they borrow from one another at no interest). Borrowing and lending is done horizontally, between businesses sharing the same rung in the value chain. Lending and borrowing is also done vertically within the same value chain, with businesses on higher rungs giving cash advances to businesses on lower rungs. Lower rung businesses pay back the loan after they complete production and sell their products / produce at discounted prices to the lending higher rung businesses. The economics of this interest free technique are not properly understood and further research will be needed by programmes interested in Islamic compliant financial products.

<sup>111</sup> USAID Rural Finance Cooperative Development (RUFCD) Final Report - December 2012.

<sup>112</sup> AMA microview\_report\_-\_3rd\_issue with data at Dec 2013.

## SECTION 3: FINDINGS

### Cost of finance

Even when borrowers do not object to paying interest on religious grounds, and find some banks and MFIs ready to lend them funds, they resist the high rates of interest being charged, especially by MFIs. This is a difficult issue and is likely to remain so as doing business is costly and risky for financial institutions in Afghanistan<sup>113</sup>.

In addition, the appetite to expand bank portfolios in priority economic sectors (such as manufacturing) is limited, while the agriculture sector is notoriously difficult to assess for commercial banks, or finance with traditional microfinance approaches. In addition, there is a low level of competition, which limits the downward pressure on prices.

The withdrawal of many donor programmes and the trend for new programmes to be closer to market conditions and to cost-sharing will put additional pressure on blended cost of finance.

MISFA, as a wholesale apex facility<sup>114</sup> refinancing the microfinance sub-sector is supposed to have an impact of lowering the cost of funds on the whole sector. However, according to interviews with practitioners, it is not clear if it has had any impact on the cost of funds for microfinance beneficiaries so far.

#### 3.3.8 Coupling access to finance and business development services

There is limited evidence from the literature regarding the link between access to finance and BDS.

Hand in Hand suggests that there is a need for a holistic and sequential approach to combining services where literacy/ numeracy, basic business skills and financial capability are low. Our findings indicate that a successful investment climate, BDS or skills interventions face a bottleneck as beneficiaries cannot access finance to implement their projects, establish, or grow their businesses.

However, it is challenging for one market actor to provide all of the necessary skills development services due to the lack of competence and expertise. In the context of Afghanistan it still makes sense to separate the delivery of business services from the provision of finance, for the reasons given below.

- Better able to manage the conflicts of interest that arise between two different purposes, extending sustainable solutions to access to finance as close as possible to market conditions, and providing capacity building that may be more ad hoc.
- Facilitates the design and monitoring of more appropriate milestones in logframes that effectively differentiate between BDS and access to finance.
- Takes into account the diversity of donor-funded programmes that have different instruments (ANMDP for instance covers only immaterial expenses but not the acquisition of hard assets; ABIF and ABADE have a wider scope).
- Encourages programmes to build early linkages with banks and others financial institutions (or a few private providers of services such as accountancy firms that may be close to sustainability) and accelerate the transition to market-driven solutions.

It has also been highlighted by many that a platform developed for facility managers to exchange information and knowledge of procedures (for instance on common diligences between donor-funded programmes) could be organised in a more systematic way than currently.

### 3.4 In-country findings relating to the wider enabling environment

As well as SME access to, and the supply of, BDS and finance, it is important to consider the wider socio-economic and political context for SMEs, and how this context relates to the demand and supply of BDS and funding. In this section we firstly look at the cross-cutting challenges faced by SMEs, particularly in the context for women.

Secondly, we then look at the political economy and conflict angle and its impact on SMEs, and then finally the political economy and macro-level context.

---

<sup>113</sup> World Bank Report – Pathways to Inclusive Growth – June 2014 refers to studies that estimate “the cost of civil war was equivalent to 1.6-2.3 percentages of GDP per year of violence”.

<sup>114</sup> An Apex Facility is a meso level, second tier wholesale organisation that channels funding (grants, loans and guarantees) to multiple microfinance institutions.



## SECTION 3: FINDINGS

### 3.4.1 Cross-cutting challenges for SMEs

With regards to the cross-cutting challenges faced by SMEs in Afghanistan, our findings in-country mirrors those of the literature, and the findings from other donors such as the World Bank. Box 9 below provides more details relating to the World Bank's findings through its Enterprise Survey 2014.

#### Box 9: Major challenges faced by SMEs in Afghanistan

According to the latest World Bank Enterprise Survey 2014, the top critical areas impacting on SMEs are 'political instability, corruption, access to land, access to finance'. To design adequate BDS it is also necessary to be aware of the World Bank Doing Business Indicators that are good at capturing the enabling (or disabling) environment and assess reform.

The top challenges for Afghan enterprises remain external, such as protecting investors, trading across borders, registering property<sup>115</sup>, political instability, corruption, access to land, and access to finance<sup>116</sup>. In addition to these, a weak labour market, low literacy levels and an unskilled workforce are highlighted as major challenges to inclusive growth<sup>117</sup>.

Some studies<sup>118</sup> put access to electricity and transport infrastructure (notably rural roads<sup>119</sup>) before access to finance as key constraints affecting SMEs in Afghanistan.

APPRO field studies in Mazar and Balkh highlight the importance of the status of commercial property tenancies and the disputes between landlords and tenants as well as difficult relationships with various levels of the administration on tax base and tax collection (see Annex 9).

Within Afghanistan, traditional ways of doing business are perhaps inconsistent with the World Bank Doing Business indicators. The fragile context appears to demand a much higher resilience ability<sup>120</sup>, favours trading activities, an opportunistic mentality and deal-making behaviour. In addition, the context encourages a survivalist strategy for informal microenterprises, in which maintaining a low profile, opting for a reduced business size, lack of accounts and quiet business operation to buffer against the interests of certain groups, such as corrupt government officials, kidnappers, insurgents, warlords, politically-active individuals can be seen as beneficial.

Nevertheless, improving doing business indicators contribute positively and can boost strong and resilient SMEs, aiding them to move towards formal systems that ultimately lead to strengthening the formal economy. Moreover, there is notable evidence in terms of hard (e.g. infrastructure<sup>121</sup>) and soft (e.g. skill, knowledge) market system development in the last decade, which further point to gradual shift in the mind-sets of entrepreneurs.

When undertaking field work in Kabul for this assignment, APPRO identified the following key constraints facing microenterprises in a number of clusters in Kabul, Kandahar and Mazar<sup>122</sup>. The most pressing constraints were:

- Access to modern production technology and tools in all clustered trades.
- Access to professional trainers to train the master craftsmen on modern production techniques and using modern production tools.
- Literacy and basic mathematics training for apprentices, a significant number of whom are functionally illiterate and thus limited in their ability to absorb formal learning.
- English literacy for some of the more senior tradespeople, such as master craftsmen or those who work in more complex trades such as auto mechanics.
- Tailor-made training for master craftsmen to standardize the knowledge of their trades, and to enable them to transfer their skills to apprentices more effectively.

<sup>115</sup> Afghanistan Doing Business Report 2013, Top three worst performing critical areas.

<sup>116</sup> Top four most challenging factors?, Enterprise survey data of Afghanistan-2014.

<sup>117</sup> Inclusive Growth: Pathway to Inclusive Growth, World Bank, 2014.

<sup>118</sup> AsDB preparatory studies for the recent tranche of the AITF and 2008-10 Enterprise Survey

<sup>119</sup> ICAI review of DFID Afghanistan Growth Portfolio - Annexes on HGP road in Helmand or de-mining Halo Programme

<sup>120</sup> Inclusive Growth: Pathway to Inclusive Growth, pg. 29, World Bank, 2014.

<sup>121</sup> APPRO field studies in Mazar, Balkh and Kandahar insist on the lack of storage facilities for fresh agriculture produces and constraints regarding the use of transport facilities such as the railway with the Uzbek border.

<sup>122</sup> APPRO research findings in Kandahar, Mazar, and Kabul can be found in Annex 9

## SECTION 3: FINDINGS

- Access to affordable finance.<sup>123</sup>
- Access to other markets (domestic and beyond).
- Access to reliable electricity.
- Access to basic amenities such as running water and sanitary facilities at the workplace.

As can be seen, many of the constraints are directly linked to BDS and access to finance, but others are linked to broader constraints which incorporate challenges relating to appropriate infrastructure and a regulatory and trade environment that is conducive to internal and external trade.

### 3.4.2 Overarching risks faced by SMEs

Listed below are overarching risks impacting SMEs in Afghanistan, based on discussions with stakeholders.

- Growth slowed from 14 percent in 2012 (boosted by a bumper harvest) to an estimated 3.6 percent in 2013.<sup>124</sup> The absence of an economic model that would detail the impact of slower growth on the lower tiers of key sectors of the economy will not help policy making<sup>125</sup>.
- The withdrawal of troops may have some benefits in eradicating the artificial bubble linked with foreign military expenses (despite the efforts of programmes such as The Peace Dividend Trust, which attempted to encourage the localisation of procurement). However, the reduction in foreign inflows will likely affect sectors where SMEs are present, such as construction and services in urban centres, transport, logistics, retail, maintenance, and repair<sup>126</sup>.
- Agricultural SMEs in rural areas that are dependent on rainfall<sup>127</sup> and climate conditions may not be as solid as in the recent two years when good rains have led to exceptional crops that have contributed towards healthy growth rates<sup>128</sup>. Afghanistan is high on vulnerability indexes. For instance Germanwatch ranks the country 17<sup>th</sup> out of 180 countries for weather-related loss events between 1993 and 2012<sup>129</sup>.
- During discussions and research, there was not much disclosed relating to business preparedness or contingency against likely risks such as higher prices of imported goods; higher inflation; tensions on the availability of foreign currency and the impact of potential devaluations – especially on several value chains that rely on imports and re-exports of raw materials and inputs.
- There is a risk of expansion of criminal activities<sup>130</sup>, including a widening and deepening footprint of the drug economy<sup>131</sup>.

### 3.4.3 Context for women

Our findings from the literature review evidence a number of constraints faced by women. Businesswomen continue to face difficulties in competing in male dominated markets domestically and internationally. The vast majority of the women involved in productive, licit economic activity continue to fill jobs lower on the value chain and are mostly prevented from filling the positions higher up on the value chains, where the bulk of the mark-up

---

<sup>123</sup> Microfinance from Microfinance Institutions is not advisable in this case due to the short period of repayment and extortionately high interests charged. See APPRO (2008) on some of the issues related to microfinance in Afghanistan.

<sup>124</sup> Country Report No. 14/128: Islamic Republic of Afghanistan: 2014 Article IV Consultation-Staff Report; Press Release; and Statement by the Executive Director for the Islamic Republic of Afghanistan: <http://www.imf.org/external/pubs/ft/scr/2014/cr14128.pdf> - May 2014.

<sup>125</sup> APPRO collected feedback from ACCI on a series of 2012 workshops where numerous scenarios appear to have been discussed with WB experts but have not been documented in papers shared with this review.

<sup>126</sup> A good insight is the report by the World Bank to assess impact of the transition on “employment” in Afghanistan in Transition: Looking Beyond 2014 - pages 36-39.

<sup>127</sup> That there is neither too little nor too much rainfall, as recent landslides recall the fragility of economic and human activities faced by natural disasters - <http://www.bbc.co.uk/news/world-asia-27261783>.

<sup>128</sup> In its 2011-2012 scenarios, the World Bank reports that historical average growth in agriculture has been only 3.6 percent p.a. and that. “Depending on the weather and investment, average GDP growth could produce volatility of 5–6 percent annually on average.”[...] “Agricultural production is particularly susceptible to the weather. During 2003/04–2010/11 annual real agricultural growth ranged from 22 percent contraction to 45 percent expansion and the sector accounted for between a quarter and a third of GDP”.

<sup>129</sup> <http://germanwatch.org/en/download/8551.pdf>.

<sup>130</sup> It is interesting to note a remark from APPRO field investigation that “Businesses that deal in valuable commodities such as jewellery complain that they need protection through insurance, currently not offered by the financial sector”.

<sup>131</sup> We have not been able to access further information on the work done by Ashley Jackson – former Research Fellow, Humanitarian Policy Group as discussed during the ODI event “Afghanistan after 2014: what’s next? On 2 April 2014.



## SECTION 3: FINDINGS

accumulates and where persists a male-only monopoly<sup>132</sup>. Building Markets<sup>133</sup> has compiled a number of findings relating to Afghan businesswomen, which are detailed in Box 10.

### Box 10: Afghan businesswomen statistics<sup>134</sup>

Women work in a wide variety of sectors, many of which are non-traditional, and in multiple sectors including construction and construction materials, which represents 24 percent. Over 5,500 workers are employed by businesswomen, and eight percent of women-owned businesses are small businesses (1-10 employees). In addition, 38 percent of businesswomen report a monthly income between AFN 30,000 and more than AFN 50,000 (545 to more than 908 USD) with over half in the highest income bracket. Around 80 percent of the women have attended an institution of higher education.

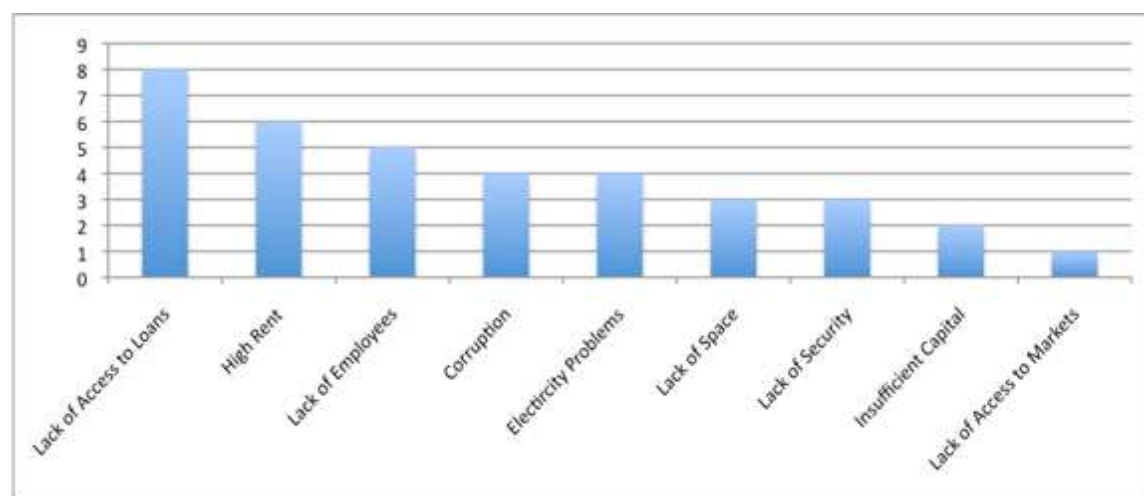
However, women-owned businesses are marginal. In terms of constraints, 81 percent of women-owned businesses are unable to access credit or financing, 90 percent do not have partnerships with other businesses or institutions, and 75 percent do not belong to business associations.

These businesses need most help in marketing support, access to buyers, financial management and technical support, and face a number of challenges relating to corruption, lack of capital, and insecurity.

Annex 7 sheds more light on the nature of women-owned businesses by expanding on two case studies provided to us by AREDP in the handicraft and potato chips value chains.

Our in-country findings corroborate with the literature, and confirm that women-owned enterprises, and enterprises that employ women, face a complex array of constraints. Women may face physical, psychological and/or social violence if they disturb accepted family and social norms<sup>135</sup>, and the extent and level of independence of women depends on familial and social acceptance. Moreover, those who are able to manage these issues and have a supportive family are faced with a further level of constraints to grow their businesses, including access to finance and markets. Figure 4 details the main constraints faced by businesswomen, based on APPRO's field-assessment of the dried fruits and nuts cluster in Kabul.

**Figure 4: Primary constraints facing businesswomen in Kabul<sup>136</sup>**



The highest recorded constraint is a lack of access to loans. However, there are a number of constraints that are beyond the narrow scope of BDS and access to finance, and which are linked to the wider enabling environment, which were regarded as major constraints such as corruption, electricity issues and lack of security. These findings

<sup>132</sup> APPRO, 2014.

<sup>133</sup> Building Markets is a 501(c)(3) non-profit organisation headquartered in New York City. It aims to build markets, create jobs and sustain peace in developing countries by championing local entrepreneurs and connecting them to new business opportunities (<http://www.buildingmarkets.org/about-us>)

<sup>134</sup> Building Markets (2013), in APPRO (2014).

<sup>135</sup> Discussions with Zardozi revealed tougher conditions for businesswomen in remote areas and in micro-enterprises.

<sup>136</sup> Figures on the 'Y' axis denote number of respondents

## SECTION 3: FINDINGS

illustrate the broad constraints faced by businesswomen in Afghanistan, and point to an enabling environment that is currently insufficient and disabling, with regards to enabling sustained SME growth and development.

Despite the systemic constraints that women face in Afghanistan, there are moderate examples across the country of successful enterprises where family or community support is extended to women entrepreneurs. It is found that women tend to achieve better results when they belong to women networks, and can count on each other's support. Thus, special attention must be paid to platforms to exchange best practice and to role models as references.

### 3.4.4 Political economy

Building consensus around a market-driven strategy to spur economic growth, rebalance the economy and enhance government revenues to pay for public goods can prove challenging in a country that has experienced decades of command economy management<sup>137</sup>. The buy-in from the political and intellectual elite is recent and tenuous, while resistance remains amongst organisations with entrenched interests. This is one of the reasons why MoCI has developed an Industrial Policy Paper<sup>138</sup> that highlights the issues in a fragile and conflict affected country such as Afghanistan that markets alone cannot address (though it reiterates that private sector must remain the driver<sup>139</sup> and public sector intervention should only be temporary<sup>140</sup>).

Moreover, our findings suggest that donor and government strategies tend to favour new programmes supporting new institutions and new delivery mechanisms, rather than to look at existing institutions and ways to strengthen them. It is tempting to create new institutions, but the reality is that our in-country findings and the literature suggest resources may be better spent, with greater impact achieved, if efforts are applied to improving and building capacity in existing institutions.

One example of the drive to create new institutions at the expense of building existing capacity is the idea to develop an SME Development Bank or an SME Development Agency.

The MoCI SME Strategy 2012-15 “Growth During Transition” details access to finance constraints and proposes arguments for an SME Development Bank. In our interview with senior civil servants at the MoCI, it appears that there is an acknowledgement that the idea that its seed capital will come from mining royalties may not be realistic. There is also a subsidiary argument advocating an SME Agriculture Development Bank, largely based on regional models such as the National Bank for Agriculture and Rural Development in India, promoted by MAIL and seed funded by the Agricultural Credit Enhancement (ACE) funds left by the USAID programme.

In addition, MoCI senior managers stated with us that the Industrial Policy Paper included a plan to create a new SME Development Agency, which would be based on regional models such as Small and Medium Enterprise Development Authority in Pakistan, the Ministry of MSMEs in India, and/or the SME Corporation in Malaysia. The Industrial Policy Paper also makes reference to Small Business Advisory Services and Manufacturing Advisory Services.

### 3.4.5 The impact of macro-economic trends on SMEs

The latest DFID funded growth diagnostic in Afghanistan dates back to 2006<sup>141</sup>. It does not take into account the impact of seven years of massive inflows of military-related overseas funding (and the distortions these created), and the fact that these flows will cease by the end of 2014 and, in accordance with the Tokyo Mutual Accountability Framework, ought to be redeployed towards traditional aid targets. Moreover, the World Bank forecast undertaken in 2011<sup>142</sup> and 2012<sup>143</sup> was targeted at macro-level issues and mostly aimed to guide decision-makers in public

---

<sup>137</sup> Afghanistan National Development Strategy “which reflects the commitment of the Islamic Republic of Afghanistan to poverty reduction and private sector-led economic growth for a prosperous and stable Afghanistan”  
[http://www.undp.org.af/publications/KeyDocuments/ANDS\\_Full\\_Eng.pdf](http://www.undp.org.af/publications/KeyDocuments/ANDS_Full_Eng.pdf)

<sup>138</sup> Industrial Policy Paper dated May 2011 and published at the end of 2012. The status of this Paper is not clear but seems to be a component of the Integrated Trade and SME Support Facility, the Private Sector Development Cluster, one of the National Priority Programs of the ANDS – Afghan National Development Strategy – see for instance MoCI Business Plan section 1.3.2:  
[http://moci.gov.af/Content/files/MoCI%20Annual%20Business%20Plan%202014\\_19\\_05\\_2014%20Final%20Eng.pdf](http://moci.gov.af/Content/files/MoCI%20Annual%20Business%20Plan%202014_19_05_2014%20Final%20Eng.pdf)

<sup>139</sup> Section 7 of the report

<sup>140</sup> Sections 7, 29 and 44 of the report

<sup>141</sup> “Growth Diagnostic Scoping Study” by Sharon Miller, Anna Paterson (and Alfie Ulloa), within Sultan Barakat – “DFID Understanding Afghanistan”, 2008.

<sup>142</sup> Transition in Afghanistan: Looking Beyond 2014 - World Bank, November 2011” – see also quotes in “Growth During Transition” MoCI SME Strategy 2012-15.

<sup>143</sup> Afghanistan in Transition: Looking Beyond 2014 - Volume 2: Main Report – May 2012.

## SECTION 3: FINDINGS

finance management. There is limited information on modelling the impacts of the economic transition on SMEs in key economic sectors at a more micro level<sup>144</sup>.

Through discussions with stakeholders, our findings reiterate the possible negative economic affects the drawdown may have on SMEs. For instance, as International Security Assistance Force troops continue to leave the country, those SMEs that are involved in supply services to international forces are likely to suffer significantly. Beyond certain winning and losing sectors, the prospect of increased instability and conflict could have negative effects on the national economy, through a fall in investment and a reduction in the tax base (due to increased corruption and possible lawlessness in rural areas). Resilient micro and smaller enterprises will revert back to a survival mode, which is not conducive to growth, expansion and employment generation. In addition, negative impacts will be felt by those most vulnerable in society, such as women or young people looking for work.

However, in saying this, our findings also demonstrate that many SMEs are positive about Afghanistan's future, and of the prospect of a new, democratically-elected president taking office in mid to late 2014. Some stakeholders interviewed believe that the Taliban are less effective than before, and are confident that the economy will continue to grow, and their businesses prosper – especially in major urban areas such as Kabul and Herat.

---

<sup>144</sup> Even though there is an effort of synthesis from the World Bank in its chapters on the agriculture sector in "Afghanistan - Pathways to Inclusive Growth", the space to analyse the promising but rather long term prospects of the extractive sector is not matched by the lack of depth in analysing the prospects of the real sectors to provide growth, income and jobs now and in the next 2-3 years.

## 4 Options for donor-sponsored interventions

In this section we focus on opportunities for donor interventions. First, we discuss the criteria used when selecting options; second, we provide a menu of options summarised in matrix form; third, we briefly describe these options from the macro, meso and micro level; and we finish by expanding on the five options that we believe DFID could specifically consider.

### 4.1 Options criteria and selection

This report provides a snapshot of where beneficiary needs lie, where there are gaps in donor programming, and where there are opportunities for donors to engage. Based on these needs, gaps and opportunities, we have selected a number of options, and have proposed key criteria donors could consider when designing and implementing any future programming of support to SMEs. We focused on identifying and selecting options in the context of delivering inclusive economic growth and job creation.

#### 4.1.1 Options at the macro, meso and micro level

We have categorised each option at the macro, meso or micro level, in order to illustrate that we have carefully considered various entry points.

- At the **macro**-level, programmes are aimed at delivering long term change. Interventions that target the macro-level are more likely to be systemic and focus on regulatory environment, the political economy context, and cultural norms.
- At the **meso** or mid-level, there is a focus on institution building, to strengthen the functioning of institutions charged with regulating markets and maintaining professional standards.
- At the **micro**-level, interventions directly support businesses and entail building support services to enhance longer term private sector development and growth.

Although we recognise that previous direct interventions may have been costly, unsustainable, and their efficiency and VfM questionable, there is a need to keep testing and piloting direct interventions. By learning lessons from past and current donor or NGO-funded programmes, there is an opportunity and a role for donors to test interventions aimed at addressing market and coordination failures through these pilots, in order to ensure the appropriate mix of public policies and private sector (or not-for profit social investors) long term investments.

#### 4.1.2 Overarching criteria to guide donor programming

Several interviewees have insisted that *how* programmes are delivered is as important, if not more, as *what* is designed. We have therefore set out some overarching factors for donors to consider when developing strategies for SME engagement in Afghanistan. These are drawn from our research, and from cross cutting lessons from donors' successful interventions<sup>145</sup> in Afghanistan and similar geographies.

- **Patience and long term vision:** It should be acknowledged that results for projects in conflict environments take longer to become evident. Few projects (ASMED, AREDP and ABIF) have achieved initial milestones (such as identifying enterprises for support, then providing initial support to them) within one or two years. Thus, another three to five years might be required to evaluate the economic results of the businesses supported during the initial period.
- **Implement realistic results and timeframes:** The SEED Review<sup>146</sup> points out that "elements of the programme suffered from over optimistic results and timeframes which have since been revised down to better reflect the context in Afghanistan."
- **Undertake Afghan-wide outreach:** As programmes are planned and implemented from Kabul, the needs of beneficiaries all over the country must be heard, and donors should find ways to incorporate businesses' voices and support public-private dialogue mechanisms. This question of outreach (a necessary condition

<sup>145</sup> Economic and Private Sector PEAKS – Private Sector Development in Fragile States - by Simone Datzberger and Mike Denison - LSE Enterprise - September 2013

<sup>146</sup> Supporting Employment and Enterprise Development (SEED) Annual Review undertaken in March 2014 and shared with our review team in end May 2014

## SECTION 4: OPTIONS

of effective implementation) in the Provinces is complex in the current security context, which precludes informal visits and spot checks by donor staff and agents. However, there may be opportunities to work through networks and systems that have capability and proven ethics (AREDP, selected banks and MFIs<sup>147</sup>, and selected INGOs), after undertaking thorough fiduciary risk assessments.

- **Develop the evidence base, in order to inform programming:** Donors could upgrade their respective strategic frameworks to take into account the impact of seven years of significant inflows of military-related overseas funding and the fact that these flows will cease by the end of 2014<sup>148</sup>
- **Avoiding market-distortion:** Avoid, where possible, market distortion that may arise from implementing direct interventions that may jeopardise or hinder the private sector's ability to achieve ownership of market functions (such as the provision of direct in-house BDS support services with no strategy to build the capacity of the Afghan BDS market). This will require patience as current capacity in the market and in public institutions is low. The market systems approach remains a strong methodology for analysing the BDS and access to finance markets (how to make markets work better for poor people, and for financial institutions and businesses that serve the needs of the poor).
- **Consider focusing on the base of the pyramid in instances where there is clear evidence that this can lead to inclusive growth:** It is important to provide the right level of incentives to reach these complex, costly and hard to reach segments where the majority of the poor engage with market systems. This necessitates strengthening partnerships with Afghan organisations that have the reach to access those at the base of the pyramid<sup>149</sup>.
- **Consider innovation and new financial instruments:** Innovative instruments, such as debt financing, by donors should be undertaken with caution, and after considering the macro-level situation (post-transition) as the level of maturity and capacity in the market may not be conducive for many years. However, depending on the development trajectory of Afghanistan, such innovative instruments may become increasingly possible options.
- **Embed lesson-learning processes from the outset, and apply these continually:** SEED stakeholders claim that "the lessons learned at the beginning of the programme have enabled them to work much more effectively since". This can be seen most clearly in the progress made by DFID's Afghanistan Business Innovation Fund (ABIF) and IFC's Business Edge.

It is therefore necessary for donors to take into account their own internal constraints (for example, their often limited capacity to travel to the field, and engage with entrepreneurs and implementers where they do business) when formulating future programmes. These constraints are often compounded by the difficulty to acquire appropriate external expertise due to security issues.

Delivery models can learn from lessons of past successes and failures. An interesting example is included in the post evaluation review of the Helmand Growth Programme Bost Industrial Park by DFID, which resulted in closing off support. In particular:

- the need for a thorough upfront assessment of partners' delivery capacity (now done through the new DFID due diligence process), combined with clear and enforceable roles and responsibilities for each partner;
- the adoption of a phased approach which enables projects to be planned, monitored and controlled on a stage-by-stage basis is highly recommended; and,
- regularly revisiting and testing assumptions to better understand and sequence complex linkages between key issues of the enabling environment such as land rights, electricity provision, transport/physical access to markets, border crossing and security.

With regards to DFID, whilst it could favour solid sponsors and implementers with strong credentials over the next few years, given the limited current visibility, it could also leave space for new entrants, building on DFID's reputation for flexibility and innovation. But whatever its partnership choices, managing a PSD portfolio in such a

---

<sup>147</sup> An example can be found in Nigeria with the seminars organised in many States (equivalent to Afghan Provinces) with local business communities by Diamond Bank to disseminate what is SME banking: <http://www.coffey.asia/our-projects/africa-msme-finance-program-advisory-services-to-diamond-bank-plc> or <http://thenationonline.ng.net/new/diamond-bank-engages-entrepreneurs-on-capacity-building/>

<sup>148</sup> For example, DFID could revisit its Growth Diagnostic framework, which it is using to assess constraints to economic growth in Afghanistan, which dates back to 2006

<sup>149</sup> Smart subsidies may be even more justified when public policy wants to reach the most difficult segments in the market, such as female entrepreneurs

## SECTION 4: OPTIONS

complex context implies coordinating resources. This is confirmed by the SEED 2013-14 Annual Review: “As was highlighted in the 2012 Annual Review, DFID staff’s management time remains a key cost. This is not a surprise however given the size and complexity of this programme, and the fact that the £3.5m support agent and advisory council originally envisaged for the programme was removed without redesign.”

### 4.2 Menu of options

Table 5 sets out various options we have identified that could be considered by donors. Each option is categorised based on whether the intervention falls at the macro, meso or micro level, and whether the thematic area covered by the option is business development services, access to finance, or the wider business enabling environment.

Some of the options could be placed at multiple levels and within multiple thematic areas. However, for ease of reading, we have housed these particular options in the thematic area or level where we feel they are most suited.

**Table 5: Options matrix**

	Business Development Services	Access to Finance	Business Enabling Environment
<b>Macro</b>	<ul style="list-style-type: none"> <li>Enhanced donor – government - private coordination to better support SME graduation.</li> <li>Mapping BDS providers.</li> </ul>	<ul style="list-style-type: none"> <li>More systematic coordination between donors and banks/businesses for PSD programming.</li> <li>Strengthen the financial sector through building its capacity to deliver finance that meet SME needs</li> </ul>	<ul style="list-style-type: none"> <li>Strengthening the business environment to encourage investment and SME responsiveness to markets</li> <li>Capacity support to Da Afghanistan Bank in financial supervision and regulation.</li> <li>Policy implementation facility to enact financial sector improvements for SMEs.</li> </ul>
<b>Meso</b>	<ul style="list-style-type: none"> <li>Developing a BDS facilitation platform.</li> <li>Innovation fund to support the development of new business practices/business models and new financial products.</li> </ul>	<ul style="list-style-type: none"> <li>Support donor-managed guarantee schemes.</li> <li>Funding a wholesale facility to provide term funding to Afghan financial institutions.</li> <li>Attracting the new IFC MENA MSME Facility to Afghanistan.</li> </ul>	<ul style="list-style-type: none"> <li>Capacity building to existing or new Afghan institutions providing PSD, Access to finance and BEE support.</li> </ul>
<b>Micro</b>	<ul style="list-style-type: none"> <li>Direct support through a livelihood lens/strategy.</li> <li>Co-funding donor facilities and government ministries/agencies to directly implement BDS.</li> <li>BDS support to start-ups.</li> <li>Afghanistan Business Innovation Facility (ABIF) 2.</li> </ul>	<ul style="list-style-type: none"> <li>Supporting private equity models.</li> <li>Access to finance support to start-ups.</li> <li>Support mutual guarantee schemes.</li> </ul>	<ul style="list-style-type: none"> <li>Stocktaking exercise to understand needs of microenterprises, and especially of women.</li> </ul>

We briefly describe each of the options considered below, except for the five specific recommended options which we expand on further in Section 4.3. We start at the macro level, and then describe those at the meso and micro levels.

#### 4.2.1 Policy options at the macro-level

With regards to inclusive growth and job creation, options and interventions at the macro-level deal with policy-making at a high level. Increasingly, evidence suggests that in order for growth to have the largest effect on sustained poverty reduction, donors should be focusing on the institutional and political arrangements that facilitate growth<sup>150</sup> Whereas the contribution to growth and inclusive growth can be assessed, rarely can one directly measure/attribute effects on job creation. However, we view interventions at this level as having a positive impact, and creating pre-conditions, that ought to improve the impact of GIRoA policies and donor funds to quantitatively

<sup>150</sup> DFID Economic development for shared prosperity and poverty reduction: a strategic framework (2014)



## SECTION 4: OPTIONS

benefit more Afghan businesses, deliver better value for money, and ultimately contribute towards employment and a more inclusive growth.

DFID is seen in Afghanistan, (as evidenced through the findings of the ICAI Review), as being able to play a particular role in championing the interests of under-served segments of the SME business community by investing resources into facilitating donor-government-private sector policy coordination, coherence, dialogue and design-to-implementation.

The following six options for interventions can be considered as essential pillars or building blocks at the macro-level.

### **Option: Enhanced donor - government - private coordination to better support SME graduation<sup>151</sup>**

We perceive a demand, and thus a potential coordinating role for a donor, to lead on improving public private dialogue relating to SME graduation. This would ensure donor-funded, publically promoted programmes are better communicated when implemented, and encourage a smooth transition between programmes for SME beneficiaries that could effectively graduate from one type of support to another, as they grow and develop. For example, the most promising SMEs in AREDP's portfolio could become clients for ABIF and/or for AIB medium term finance partially guaranteed by DEG or USAID schemes.

The benefits of improving coordination and information dissemination include:

- cost savings / improved VfM through avoiding costly duplicated diligences<sup>152</sup>;
- filling gaps in service provision for successful SME beneficiaries;
- better linkages between BDS and access to finance; and
- improved sustainability, as grantees would move more effectively towards market-driven solutions, especially those proposed by banks and other FIs.

### **Option: Mapping BDS providers**

The identification of capable BDS providers is a major problem in Afghanistan. It appears that the market of providers has significant potential, but is primarily based on donor interventions. Moreover, SMEs cannot be expected to bear the full cost of these business services unless they perceive them to be of real value, or if they can be measured by key performing indicators agreed beforehand.

A possible solution, and option for donors, would be to have an informative, accurate, and up to date list of BDS providers (individual or company) to consider engaging with, when designing and implementing programmes of support. This mapping may need up-gradation at regular intervals, and can become a component of a wider cross-cutting goal to build the evidence base on which DFID can design better programmes, as recommended by the DFID Afghanistan Results Strategy and the ICAI Review of DFID portfolio in 2013.

### **Option: More systematic coordination between donors and banks/businesses for PSD programming**

During this review, it has been repeated by interviewees that coordination between donors, between donor-supported facilities, and between Government Agencies was needed with the private sector at large (banks, business associations) – especially during the current transition phase, when new donor strategies post 2014<sup>153</sup> have not always been well communicated. At a higher level, DFID is seen as being able to take a significant leadership position to initiate such better coordination, due to its convening power. However, it is unclear which entity could manage such a donor platform responsible for information dissemination, due to possible conflicts of interest<sup>154</sup>.

In the financial sector, our interviews in Kabul and field investigations in the provinces suggest that it is seen as beneficial to all actors to increase opportunities for financial institutions to engage with decision makers in the

---

<sup>151</sup> In this context, SME graduation means the ability of SMEs to move from one programme of support to another, in order to access donor support that is tailored to the needs of that particular SME as it grows and develops.

<sup>152</sup> Feedback with various degrees of forcefulness from the AREDP Implementation Team; ABIF, AUA Incubator sponsors, AIB Deputy CEO, MISFA.

<sup>153</sup> For instance new 2014-2017 German Partnership.

[http://www.kabul.diplo.de/Vertretung/kabul/en/05/Entwicklungspolitik/Zusammenarbeit/New-country-strategy-for-Afghanistan-reliable-partners-in-times-of-change\\_s.html](http://www.kabul.diplo.de/Vertretung/kabul/en/05/Entwicklungspolitik/Zusammenarbeit/New-country-strategy-for-Afghanistan-reliable-partners-in-times-of-change_s.html); US stop and go support announcing a reduction by another third of its USAID staff then <http://www.usaid.gov/afghanistan/news-information/press-releases/us-gives-30-million-incentive-funding-afghan-government>.

<sup>154</sup> AsDB does not seem to have a current PSD/SME programme and can be seen as neutral as a Regional Development Bank  
SCOPING THE NEED FOR IMPROVED ACCESS TO FUNDING, ADVISORY SUPPORT AND BUSINESS SKILLS  
DEVELOPMENT FOR SMES IN AFGHANISTAN – SEPTEMBER 2014

## SECTION 4: OPTIONS

public sector, managers of donor-funded facilities, and the business community at large. Current leaders of the Afghanistan Bankers Association would be agreeable to supporting more public-private dialogue, and more donor-financial institutions/business associations dialogue.

Donors are also keen to reinforce the voice of civil society and may wish to consider how to better associate representatives of the business community, at both grassroots and more established levels, in confidence-building activities. There is a role for public-donor-private dialogue, such as the event sponsored by the Afghanistan Bankers' Association in autumn 2013 (attended by 3,500 people)<sup>155</sup> to take stock of progress and identify challenges.

An option is for donors to consider investing more human resources (in time and availability) on exchanges with principal stakeholders, donors, quasi-donors (such as Harakat); Government ministries and agencies (not only MoCI but also MoF and Da Afghanistan Bank); and business associations such as ABA and ACCI. DFID could play an important role amongst them as the champion of microenterprise and SME interests, and for achieving job creation and poverty alleviation objectives.

Any secretariat of such an improved donor-public-private coordination and dissemination platform would benefit from the initial mapping of research resources on SMEs, currently being performed by APPRO, as part of this scoping work<sup>158</sup>.

**Box 11: Effective coordination – An innovative option to explore is to work in partnership with the World Bank in Afghanistan, different from a Trust Fund, which is the Program for Results or P4R Framework<sup>156</sup>**

Introduced in 2012 by the World Bank at the request of its members, this new lending instrument supports government programmes and links the disbursement of funds directly to the delivery of defined results with a special focus on strengthening institutions.

It is suggested that DFID request the on-going evaluation of the first 28 projects (11 completed; 17 on-going) implemented by the World Bank worldwide. The main merit for our Afghan context would be “Disbursement Linked Indicators (DLIs), linked to output, intermediate outcome and final outcome results, with explicit verification protocols, including by independent third parties”.

This P4R framework seems to meet particularly the new requirements for DFID monitoring and evaluation strategy in Afghanistan<sup>157</sup>.

### **Option: Strengthening the financial sector through building its capacity to deliver finance that meet SME needs**

Stronger and better-resourced financial institutions can improve the conditions for investment and encourage growth<sup>159</sup>, and in line with this, a recent literature review commissioned by DFID and carried out by the London School of Economics<sup>160</sup>, recommends “Strengthening financial institutions that are specifically shallow and narrow in fragile states where access to finance is a big challenge”<sup>161</sup>. However, rebuilding the confidence and trust in the formal financial system in a country like Afghanistan, where the financial system has been shaken by major crisis, will take time.

<sup>155</sup> Source: South Asia Microfinance Network Newsletter – info@samn.eu.

<sup>156</sup> Slide presentation: <http://siteresources.worldbank.org/EXTRELENDING/Resources/7514725-1397159499488/Spring-meetings-April-2014-Final.pdf> - May 2014

<sup>157</sup> DFID Afghanistan Evaluation Strategy (May 2012) shared with the Team in meeting with DFID Results Advisor (15 May).

<sup>158</sup> Interviews conducted at MoCI have revealed that a knowledge database has been attempted in the past but was abandoned. Useful lessons can be learned from technical advisers to MoCI and Ministry of Mines and Petroleum (MoMP).

<sup>159</sup> See also pages 4-5 of DFID Growth Research Newsletter– December 2013.

<sup>160</sup> Economic and Private Sector PEAKS – Private Sector Development in Fragile States - by Simone Datzberger and Mike Denison - LSE Enterprise - September 2013 This 41-page document pointed out to us by DFID PSD Afghanistan is a response to a query to the PEAKS Knowledge Centre, “What does the literature say about the relationship between private sector development (PSD) and the stability of fragile states – i.e. what are the benefits and potential risks associated with private sector development programmes in fragile and conflict-affected states and how does fragility impact on how private sector development programmes are implemented?”. It subsumes well the references received from DFID Conflict Adviser.

<sup>161</sup> Hameed, Sadika and Mixon, Kathryn (2013): CSIS Working Group on Private-Sector Development in Fragile States, Centre for Strategic Studies.

## SECTION 4: OPTIONS

Our opinion is that there is goodwill, motivation and local expertise to mobilise and address low capacity in the sector in a systematic way, driven by local solutions, based on universities and business schools, on professional bodies, and inter-professional initiatives such as the Afghanistan Institute of Banking and Finance (AIBF).

There have been pilot programmes in the past to support AIBF by Harakat<sup>162</sup>, by USAID via FAIDA<sup>163</sup> and by the World Bank<sup>164</sup>, but a more strategic overview would be needed. An option for donors is to play a leading role in strengthening the financial sector by commissioning an institutional review with its partners' support, championing financial literacy and specific capacity building across the Afghan financial sector, and nurturing a cohort of professionals marketing their skilled services to financial institutions and their clients.

A coordination role for reform and capacity building within professional organisations will most likely be needed in the future, and may be implemented by the existing World Bank Financial Sector Rapid Response Project (FSRRP) that could be complemented by donor resources<sup>165</sup>.

Additionally, the role of a donor could be to champion financial literacy and specific capacity building across the Afghan financial sector so that SME finance is well understood. Donors could work in partnership with IFC Teams in charge of implementing the Global Partnership for Financial Inclusion<sup>166</sup>, a G20 Initiative supported by the UK.

A USAID expert has suggested nurturing a cohort of professionals (corporate lawyers, auditors, financial accountants) marketing their skilled services to financial institutions and their clients. This is an attractive proposal as it can create, with minimum seed money from donors<sup>167</sup>, a market that Afghanistan needs, and keep its most talented individuals in-country. This would need to be assessed in more detail with a market systems lens, and policy connections with poverty reduction would have to be better articulated. Lessons could be learned from Harakat support to the AUA School of Accounting pilot project since 2010<sup>168</sup>, which has just been completed.

### **Option: Strengthening the business environment to encourage investment and SME responsiveness to markets**

Strengthening the enabling environment to encourage investment and SMEs to respond to key requirements from markets and enterprises is a critical need. Evidently, the government has taken several actions to boost confidence, creating key policy documents and facilitating the business enabling environment (BEE) over the last few years<sup>169</sup>.

Addressing the challenges highlighted by the Doing Business indicators (for example, access to electricity and other infrastructure and better land titles) would greatly assist resilient and high growth formal SMEs, or MSMEs that are still informal, but with significant potential to grow and employ.

One major issue, according to our literature review and some feedback in confidence, is the worsening intensity of corruption, which is affecting this category of formal and formal-to-be SMEs. With like-minded donors, including the World Bank Group, an option for donors could be to specifically support those BEE reforms that can be implemented with minimised risks of interference, capture and malpractices. An empirical examination could assess the regulations with moderate dependence on weak and corrupt government systems needed to implement them.

---

<sup>162</sup> Harakat supported a distance learning pilot between 2009 and 2012: [http://www.harakat.af/site\\_files/13535803423.pdf](http://www.harakat.af/site_files/13535803423.pdf) and <http://www.harakat.af/news14f2013125724.html>.

<sup>163</sup> FAIDA assisted AIBF "in establishing a microfinance department, developing certificate courses, building training capacity, and creating a distance learning program" <http://www.usaid.gov/news-information/fact-sheets/financial-access-investing-development-afghanistan-faida>

<sup>164</sup> Afghanistan Financial Sector Rapid Response Project Component 3 that "supports the development and scaling up of AIBF activities and the diversification of training programs on offer and a larger intake of trainees".

<sup>165</sup> Donor's way of working may also be flexible in terms of duty of care / security footprint if implemented by technical advisers supplied like the current support to MoCI rather than by in-house IMF and World Bank staff.

<sup>166</sup> See for instance, Small And Medium Enterprise Finance: New Findings, Trends And G-20/Global Partnership For Financial Inclusion Progress [www.gpfi.org/sites/default/files/documents/SME%20Finance%20New%20Findings,%20Trends%20and%20G20%20GPFI%20Progress.pdf](http://www.gpfi.org/sites/default/files/documents/SME%20Finance%20New%20Findings,%20Trends%20and%20G20%20GPFI%20Progress.pdf)

<sup>167</sup> Of approximately £100,000 to £500,000.

<sup>168</sup> [http://www.harakat.af/site\\_files/13535803424.pdf](http://www.harakat.af/site_files/13535803424.pdf).

<sup>169</sup> Evidences are referring to actions taken on recommendation under 'streamlining regulations and procedures and improving the enforcement' at The Enabling Environment Conference Private Sector Contribution to Development in Afghanistan, June 2007. Also, USAID, DFID, World Bank, Dutch, German, Japan funded enabling support e.g. AISA, HAKARAT, ACCI, EPPA. Further details in Business Enabling Environment section in the literature review in Annex 4.

## SECTION 4: OPTIONS

### **Option: Policy implementation facility to enact financial sector and enabling environment for SMEs**

SME level constraints (or market or coordination failures) are such in Afghanistan that it may take time to make operational and effective the excellent policy reforms recently approved by the Afghan authorities after years of efforts by donors – notably IFC (often with the support of Harakat) and USAID.

These reforms, such as movable collateral registries, public credit registries or credit bureaus, updated leasing regulation, or new Islamic finance standards, are perceived as useful, as confirmed through interviews with bank Head Offices in Kabul. However, our field investigation shows that their benefit does not yet effectively trickle down in the Provinces, and to the level of small businesses.

We have also considered the opportunity to work more closely with MoCI to speed up the implementation of specific issues/actions identified by Working Groups they have set up to advise them on priority action points to help SMEs in several sectors of the economy.

An option is for donors to extend the scope and funding resources to the existing TA assistance programmes to the MoCI (currently deployed by seasoned experts). However, due to low capacity, there are concerns about the ability to implement within the lower rungs of the ministry or/and within implementation agencies. Otherwise, IFC is likely best suited technically to speed up implementation, and other interested donors could enter discussions with IFC senior management to assess the additional political and financial support IFC needs to bear<sup>170</sup>.

### **4.2.2 Options at the meso level**

Interventions at the meso level will build open and inclusive economic institutions<sup>171</sup>, and support pro-growth and pro-poor development<sup>172</sup>. We suggest options for interventions supporting financial and non-financial instruments, institutions, and innovative products that target SMEs in a manner that better serves their needs, lowers the cost of targeting hard to reach SMEs, and increases outreach to the microenterprise level, which will lead to inclusive growth and job creation. These interventions should enhance SME inclusion into the mainstream economy and enhance their growth, profitability and therefore employment generation opportunities (whilst also give them tools to better cope with shocks and improve their resilience).

Stronger, more competitive, and more profitable businesses more integrated in domestic and regional markets will access better tools, better products and better services from donor and government programmes that should encourage the uptake of more staff, or at the very least, lead to higher incomes for those currently employed.

The next four options can be considered as interventions at the meso level, and focus on institution building in order to strengthen the functioning of institutions charged with regulating markets and maintaining professional standards for SMEs.

### **Option: Developing a BDS facilitation platform**

The strategy to outsource BDS services has been promoted extensively since the launch of ASMED, with the idea that BDS providers could eventually become private business training centres, institutions, or local consultancy firms. However, creating a market for BDS providers, and expecting them to be self-sustainable and non-donor dependent is challenging in the current Afghan context<sup>173</sup>.

There is a possible alternative model, which is supported by INGOs, of nurturing technical BDS providers, individuals who will be trained and paid by NGOs as staff in the initial years. Generally, the best performers (in terms of quality, relevance, flexibility and affordability) are able to earn a full or partial livelihood from the provision of their services without any salary support by NGOs. However, such a system is likely to face problems where the ratio between prospective clients and BDS providers is mismatched or the cost-benefit to reach remote customers is not feasible; or simply working without a minimum guaranteed salary is not agreeable to NGO trained staff<sup>174</sup>.

---

<sup>170</sup> Discussions could include the role of Harakat, which may have been perceived in the past as a hurdle to a direct relationship between IFC and DFID policy teams.

<sup>171</sup> DFID Economic development for shared prosperity and poverty reduction: a strategic framework (2014).

<sup>172</sup> A strategy for the financial sector serving microenterprises and small businesses explained by David Roodman in his book "Due Diligence, an impertinent inquiry into microfinance".

<sup>173</sup> Business Edge provides training to the staff of selected business development service organisations. These organisations earn revenues directly or indirectly from donors or donor supported enterprises or projects. Therefore, there is a possibility that a small percentage of well trained, skilled and connected staff of these organisations could open new services, which could lead to the growth of the Afghan BDS market. When considering this approach, For lessons learning purposes, it is important to consider the failure of the North Afghanistan BDS market development project funded by GIZ (Source: Mapping of BDS providers in Northern Afghanistan in 2013 and in 2014 – GIZ)

<sup>174</sup> Mercy Corp and Aga Khan Foundation interviews May 2014.

## SECTION 4: OPTIONS

This means that these potential issues would need to be accounted for in the design of any future BDS programme<sup>175176</sup>.

Our suggestion would be to support a BDS facilitation platform to enhance Business-to-Business (B2B) linkages. A BDS facilitation platform can act as a catalyst for businesses (supported by donors) to facilitate specific market connections, particularly where suppliers, buyers, agents and/or clients can assess the credibility, opportunities for partnerships, and/or rate the quality of service of donor-supported businesses, or vice versa<sup>177</sup>.

This facilitation platform could be established through a contracting partner (for example, reputable business consultancy firm, or an international BDS provider) or consortium, with the capacity to identify BDS providers, vendors and suppliers within and outside Afghanistan through existing formal and informal networks. This could address effectiveness and efficiency via covering SME common needs and specifically tailored business development solutions through customised approaches within agreed timeframes<sup>178179</sup>.

Finally, as we move from micro to larger sized enterprises, business development approaches<sup>180</sup> should graduate to a medium-to-long term view, as found in more mature and formal economies.

### **Option: Innovation fund to support the development of new business practices/business models and new financial products**

A family of Programmes called Growth and Employment in States (GEMS) in Nigeria have tested innovative challenge funds, notably in sectors such as construction and wholesale-retail (GEMS 2 and GEMS 4 respectively). There are useful lessons to learn from the Construction Ideas Fund that has had interventions in women's economic empowerment; skills development for construction workers; recruitment for construction; membership services and construction materials supply chain; and from the Market Modernisation Fund that is testing distribution and supply chain management; local procurement schemes; improvement in business productivity and improved access to finance.

The key lesson learnt is that the development of a broader range of financing options than the standard matching grant product traditionally offered by challenge funds should be considered. Potential grantees do not all face the same development obstacles and it demonstrates a lack of imagination and local knowledge to offer a single financial instrument as a response. Fund managers could consider equity, loan and hybrid support as well as the scope for results-based aid.

It is not clear whether the conditions found in Nigeria (but also in Pakistan or even in Bangladesh), such as the size of the market and its diversity in terms of economic sectors and variety of actors, are met in Afghanistan, and if a

---

<sup>175</sup> AREDP have 3 to 5 positions of BDS officer at provincial level. The salary of these staff is among the best, thus the incentive for these staff to leave AREDP and start own business is significantly low, but it does exist. Further, anecdotal evidences suggest that there are a few staff having additional income sources (for example, through managing family business). Therefore, it is likely that if these BDS officers are trained and exposed to the particular trade of their interest, then they may opt to engage full time in either opening a new businesses, or providing BDS to other businesses. It is worth to note that AREDP's objective is to support enterprises or SMEs through their BDS officers, or through contracting out BDS services to local or international NGOs/firms.

<sup>176</sup> The alternative option to nurture individuals in technical services for business development could be a scalable subjected to matching it with market demand of explicit services in specific geographical areas. It is important to note that success cases quoted by Mercy Corp and Aga Khan Foundation are typically in rural areas where farmers need critical technical advice/services on their crop or livestock. Provision of such technical services would help in improving production per se, but not necessarily the overall market for produced goods or services. An individual may take 3 to 5 years (assuming a certain degree of literacy and educational level) to learn technical services required for specific line of business (such as livestock, wheat production, horticulture) as well as basic business development skills. At least a group of 5 to 7 individuals could be trained for each line of business for specific geographical area (for reach). Thus, assuming group of 6 individuals on average are trained in each of the 5 lines of business, chosen for 50 geographically accessible areas, then a total of 1,500 individuals could be trained over 3 to 5 years.

<sup>177</sup> Currently, the linkage role is generally performed by: 1. Project staff via publishing a bid or single sourcing, 2. by businesses themselves through their extent of knowledge, connections or contacts, 3. by INGOs via their own networks or, 4. by business associations or AISA, ACCI, EPPA or Embassy of Afghanistan, often at very low cost or free of charge for their members.

<sup>178</sup> Note on IFC Business Edge 2: Our suggestion of a BDS platform is different from IFC strategy with its current Business Edge Programme (supported by DFID via SEED) and from what we understand of its new Business Edge format (its on-going design was not finalised during our Review). IFC envisages supporting and training BDS providers who would further train donor funded project staff or SME staff to solve business problems. The customised needs of businesses may go beyond the BDS providers supported by IFC.

<sup>179</sup> It is assumed that BDS facilitation platform would not have an objective to be financially self-sustainable after the end of donor support. The core objective could be BDS provision and 'linkages' which, once created, would then be further explored by the benefited businesses themselves.

<sup>180</sup> The Business Innovation Hub is attempting to adapt a Business Development Approach by applying a profitability framework which includes medium to long term vision for businesses.

## SECTION 4: OPTIONS

critical mass exists to justify a challenge fund<sup>181</sup> managed at arm's length by donors<sup>182</sup>. However, there is an option for a donor such as DFID to establish a challenge fund that would likely support pilots on Islamic Finance, value chain infra-finance, micro insurance, or technology-based new delivery mechanisms targeted at SMEs.

### Box 12: Mobile banking in Afghanistan

Roshan, Afghanistan's leading telecommunications provider, has been a pioneer of the mobile money experience with M-Paisa.

"One would expect mobile money services to be well suited to Afghanistan: low levels of fixed banking infrastructure; rising mobile penetration; and a safer, cheaper, more convenient way of transferring money – especially one that removes the likelihood of graft. It all points to a rising adoption."

However a series of papers published by the leading Institute for Money, Technology and Financial Inclusion Institute (IMTFI)<sup>183</sup> shows that Afghan network operators "must overcome numerous consumer barriers to adoption including: textual<sup>184</sup>, mobile and financial illiteracy; a general distrust of institutions compounded by the well-established *hawala* agent network; a general distrust of non-tangible assets; and the (usual) challenge of investing in an agent network without sufficient customers – and customers less willing to experiment with the service without there being a strong agent network. It is also possible that the diversion of M-Paisa towards non-commercial purposes, such as monitoring the transparency of payments to police rank and file, may have created huge political economy obstacles that have killed some promising products.

At this stage of market development and capacity, as an alternative to a challenge fund, donors could consider a policy facilitation window that could be drawn upon by other development partners, or by donor-funded initiatives, that could top up their core programmes in order to test more innovative products, instruments or delivery channels.

From a policy and implementation perspective, it does not appear that the capacity and level of maturity (and fiduciary risk) of Da Afghanistan Bank are at the same level as the Pakistan Central Bank's when it was chosen seven years ago as the implementation agency of the DFID-funded Financial Inclusion Programme that supported MSME finance in Pakistan<sup>185</sup>. However, interested donors could consider a flexible, light touch Secretariat and an Allocation Panel made of, for example, DFID, a CDC-appointed expert, Da Afghanistan Bank and independent experts, until such capacity is improved.

### Option: Funding a wholesale facility to provide term funding to Afghan financial institutions

We advise that donors remain attentive to any initiative/option presented by a strong sponsor proposing to set up an interbank wholesale facility, providing term refinancing to existing or future FIs. These FIs could be banks, MFIs and future Non-Bank Finance Institutions, such as leasing companies or Islamic banks and cooperatives. It could operate side by side with MISFA<sup>186</sup> and focus on portfolios of larger SMEs. There would also be an opportunity for donors to use a range of more sophisticated instruments than grants, including returnable capital, debt or mezzanine finance<sup>187</sup>.

<sup>181</sup> We are talking here more innovation fund distributing grants that would test innovative products, different from ABIF that can be considered as much an investment fund – see debate in <http://www.tripleline.com/wp-content/uploads/2013/12/Challenge-Funds-in-International-Development.pdf> for instance.

<sup>182</sup> See the recent DCED Synthesis Note "Matching Grant Schemes and Systemic Approaches for Private Sector Development: are they complementary?"

<sup>183</sup> Frog Consultancy: <http://janchipchase.com/2011/02/mobile-money-afghanistan-2/>

<sup>184</sup> Relating to a text or texts.

<sup>185</sup> See sophistication of the governance in [www.sbp.org.pk/MFD/FIP/about.htm](http://www.sbp.org.pk/MFD/FIP/about.htm).

<sup>186</sup> MISFA is not perceived by all stakeholders as the best-placed, most independent institution to channel all donor support to MSMEs. A certain number of interviewees have aired their reservations about a possible conflict of interest between its APEX role of wholesale financier and technical assistance entity, with provision of long term capital, minority shareholdings and sponsor of Mutahid Finance. MISFA's core expertise is at the bottom of the market (acknowledged by the World Bank that will provide special support targeted at the "Ultra Poor" segment), and is not proven with the SME segment.

<sup>187</sup> In its design donors would have to take into account the recent NAO review – section 1.22 of its review of the Private Infrastructure Development Group – July 2014.



## SECTION 4: OPTIONS

### Box 13: The option to create an SME Development Bank

MoCI SME Strategy 2012-15 “Growth During Transition” details access to finance constraints and proposes arguments for an SME Development Bank<sup>188</sup>. In our interview with senior civil servants at the MoCI, it appears that there is an acknowledgement that the idea that its seed capital will come from mining royalties may not be realistic.

There is a sub-scheme advocating an SME Agriculture Development Bank, largely based on regional models such as the National Bank for Agriculture and Rural Development (NABARD) in India, promoted by MAIL and seed funded by the ACE funds left by the USAID programme.

There is a sound reminder in the MoCI SME Strategy 2012-15 “Growth During Transition” that the GIRoA has no experience with which to manage a development bank, and that this should be contracted to the private sector, possibly as a joint venture with a commercial bank.

There are a few commercial banks that are temporarily controlled by the State in Afghanistan, but in the absence of independent audited results, it is difficult to assess their performance and what would be the merit of merging them in total, or in part, into a state-owned development bank. Our opinion (shared by other donors) is that it would distort the market to align one public organisation with one commercial actor and that, in Afghanistan, so far, the track record of financial institutions has not been great, with the likes of Kabul Bank or BRAC MFB.

Our recommendation is for interested donors to remain alert to any initiative originating from a manager with a solid track record (such as a Development Finance Institution such as IFC or FMO or an Indian Development Bank). However this is unlikely for some time, as the saga of the acquisition of the New Kabul Bank illustrates.

### Option: Attracting the new IFC Middle-East and North Africa MSME Facility to Afghanistan

In two to three years, donors could consider attracting the new IFC Middle-East and North Africa<sup>189</sup> (MENA) MSME Facility, just launched by IFC and World Bank in Jordan and Tunisia. The adaptation of such innovative programming to a conflict-affected country like Afghanistan would necessitate an in-depth and candid analysis of the country context to gauge its feasibility. Thus, interested donors would have to be cautious during initial years not to disrupt the smooth implementation of this untested Facility in pre-selected countries.

### Box 14: The new MENA MSME TA just launched by IFC and World Bank<sup>190</sup>

A new MSME Trust Fund for the Middle-East and North Africa Region has just been launched in Jordan in mid-May. It is supported by 7 donors, including DFID and will cover in priority MENA countries post-Arab Spring (Tunisia, Egypt) or affected by regional turmoil (Jordan, Lebanon).

Of particular interest is the 3-pronged methodology:

- Pillar 1 = working in partnership with Governments on IDA resources to implement reforms targeted at enabling environment such as financial infrastructure, regulatory bodies and legal reform.
- Pillar 2 = advisory services delivered directly by IFC to financial institutions: (that can include programmes to support women banking or MFIs in Tunisia, for instance).
- Pillar 3 = Support to MSMEs by designing Business Development Services to MSMEs and innovative schemes such as Business incubator operations and Mentoring Entrepreneurs.

### 4.2.3 Options at the micro-level

At the micro-level, supporting fast-growing businesses with tailored and appropriate advice and finance will have a direct impact on job creation that can be measurable, and encourage inclusive growth by directly leading to employment and income growth, including for those at the base of the pyramid.

The following four options are aimed at benefitting Afghan businesses, especially those microenterprises that are situated at the base of the pyramid, and that are harder to reach (for geographical, cultural, or security reasons). Micro-level interventions invest in businesses and entail building support services to enhance longer term private

<sup>188</sup> Page 13 of the SME Strategy 2012-15 “Growth During Transition”

<sup>189</sup> IFC includes Afghanistan in its definition of MENA.

<sup>190</sup> MENA Trade & Competitiveness and Finance & Markets Strategy Meeting Jordan - May 06 – 08, 2014 - [http://www.ifc.org/wps/wcm/connect/region\\_ext\\_content/regions/europe+middle+east+and+north+africa/ifc+middle+east+north+africa+and+so+uthern+europe/news/world+bank+group+helps+smaller+businesses+in+jordan](http://www.ifc.org/wps/wcm/connect/region_ext_content/regions/europe+middle+east+and+north+africa/ifc+middle+east+north+africa+and+so+uthern+europe/news/world+bank+group+helps+smaller+businesses+in+jordan).

## SECTION 4: OPTIONS

sector development and growth. Examples include investments in businesses in technical and financial support to the private sector<sup>191</sup>.

### **Option: Direct support through a livelihoods lens/strategy**

Livelihood approaches, value chain approaches or collective support system mechanisms might be best suited to expand income, and drive the local economy and job creation in the informal sector. Thus, the comprehensive planning, design and implementation of such livelihood and value chain approaches targeting the informal sector are options for future donor support. Some donor programmes have tried a collective approach (and ABADE appears to test further this model with its innovative Component 2B) based, not on individual SMEs, but on providing support to collective entities (farmers' cooperatives and other groups).

It is not clear how effective this approach has been so far, but a comprehensive assessment of programmes run by INGOs or NGOs with a long track record in the country (such as Mercy Corps, Afghan Aid, Hand In Hand and Zardozi) and donor programmes focused on rural development, such as CARD-F, should shed light on such livelihood approaches.

Such programmes have components of interest such as forward and/or backward linkages<sup>192</sup>, product diversification, skills, and innovation models for inputs. Moreover, access to finance on a cost-sharing basis, sharia products, or other interventions on a community-driven basis, are other options. These programmes provide hands-on training, long term handholding and follow-up support. However, these interventions are not without their challenges and risks, such as a high cost of implementation, and a high risk/reward profile with a probability of failure that may not be palatable to a donor like DFID.

It should be noted that these programmes could be delivered in partnership with Business Membership Organisations (BMOs) such as ACCI or the Federation of Afghan Craftsmen and women (FACT) or other traditional institutions/associations representing clusters such as the *senfs* and *etehadia*<sup>193</sup> highlighted by APPRO's field work, on a cost-sharing basis.

### **Option: Co-funding donor facilities and/or government ministries/agencies to directly implement BDS**

There are a few recent donor programmes directly implementing BDS that donors could monitor and investigate further when a next round of funding may be needed. The most promising are ANMDP by the World Bank and the AUA Business Incubator Hub (BIH).

- ANMDP could benefit from more flexible procurement and disbursement techniques, less dependent on present Government systems that seem too cumbersome to allow timely service to small businesses. To note that the usual trust fund model – such as ARTF – is a possible instrument to jointly fund a programme with the World Bank, but may not be flexible enough to work with businesses, and especially with the smaller ones, when Government systems prove cumbersome<sup>194</sup>.
- Once the management team of the BIH has established its track record, it may be possible to consider funding a pilot that would test the next BIH innovation, a grant with a profit-sharing mechanism based on the performance of the business. Sponsors of the BIH make a point shared by many actors in the market – that business owners and service providers must have aligned interests, and share the same risks. However, this would mean a shift in Afghan mind-sets that may not yet be ready, but which will be key to the sound growth of a credible advisory market.

### **Option: Supporting a private equity model such as Afghan Growth Finance**

Lessons from Zimbabwe, Sierra Leone, and Liberia<sup>195</sup>, illustrate that venture capital and private equity can play an important role in post-conflict recovery. However, Afghanistan remains a risky environment in what looks more a

---

<sup>191</sup> "Investing in the Business of Development - Bilateral Donor approaches to engaging the private sector" for the Canadian Council for International Cooperation – <http://www.nsi-ins.ca/wp-content/uploads/2013/01/2012-The-Business-of-Development.pdf> quoted in ICAI review of DFID PSD Work.

<sup>192</sup> Backward linkages are referred to supply chain or input material suppliers and forward linkages are buyers, market or distribution.

<sup>193</sup> According to APPRO, each cluster is represented by a *senf* (traditional guild) and/or *anjoman* (formal trade association) which, in turn, has membership of the *etehadia* (the national apex organization or association).

<sup>194</sup> Feedback from several interviews – in confidence – having to channel their disbursement systems through Government procedures. The pace of the Administration is not compatible with the decision-making process of businesses that necessitates responding quickly to market opportunities.

<sup>195</sup> There are multiple examples supported by CDC or DFID such as Manocap or see this latest FMO Upsides letter highlighting Takura Fund II: <http://www.upsides.com/interview/challenging-investment-environment/>.

## SECTION 4: OPTIONS

current-conflict phase rather than post-conflict, and earlier attempts to promote private equity have proved difficult, as per discussions with the sponsor and manager<sup>196</sup> of the Afghanistan Renewal Fund (2004-2008).

The Afghan Growth Finance (AGF) is the main and possibly only success story so far of a private equity model. Supported by US grants and political risk comfort<sup>197</sup>, and by a US-based SME venture capital specialist, it has found its niche in the market, focusing on larger businesses<sup>198</sup>. Its portfolio is currently \$44m, which is well diversified across economic sectors<sup>199</sup>. In addition, AGF has demonstrated that there is a need for long term capital, flexible in terms of instruments and adaptable to the market and country context<sup>200</sup>.

The business case for ad hoc entities distributing private equity or venture capital, whatever their sources of funding, is not yet convincing in the country. Afghanistan does not offer the same prospects as Pakistan and the latter is hardly opening its private equity market<sup>201</sup>. Although, in the medium term (3-5 years), donors could leverage expertise from CDC or IFC in order to study the provision of long term capital (equity and quasi-equity) to a fund manager with track record that would compete with the AGF, whilst not distorting the market.

A slide presentation was shared by the USAID team working on a Social Impact Fund<sup>202</sup>. This is an interesting concept of venture capital, complementing the initial stage of investments made by the BIH. However, we perceived this as a very complex organisation in terms of governance (five different entities), mix of non-for-profit and for-profit objectives, a lack of private sponsorship, very donor-led, and lacking in market intelligence.

### **Option: Access to finance and BDS support to start-ups**

One option for a donor would be to provide a range of grant and BDS support to start-ups that have the potential to rapidly grow and employ.

The World Development Report 2013 on jobs wrote about the complexity of segmenting the businesses that are most likely to contribute to growth and jobs<sup>203</sup>, and we have been aware of the need to innovate in the support to start-ups, especially young secondary school leavers and graduates who will have to rely on self-employment.

Stakeholders have informed us about initiatives that are high risk but would be socially (and conflict-wise) important and could be of interest to DFID and other donors working on skills and labour market programmes. From a private sector perspective, these initiatives may nurture a new generation of entrepreneurs with a different mind-set. Evidence is sparse about what is working<sup>204</sup> but Enterprise Boot Camps, Business Idea Challenge Funds, and fellowships combined with apprenticeship programmes embedded in local businesses targeting high school leavers and university students, especially in the Provinces, may be worth exploring. Interested donors could look at lessons from programmes such as SPARKS Agri Business Creation programme that were monitored with attention by DFID South Sudan and DFID Yemen<sup>205</sup>.

## 4.3 Preferred options recommended to DFID and other development partners

We have applied specific criteria to screen the options listed, which were chosen in response to our findings, and have retained those that look the most promising, based on:

- impact and results for the targeted segment of Afghan SMEs;
- feasibility in the context of Afghanistan, a conflict-affected country with limited capacity;

---

<sup>196</sup> Pierre Van Hoeylandt, now Director of Frontier Investments, at CDC, met on 15 April.

<sup>197</sup> AGF was originally funded by a large subsidy from USAID then has benefited from 3 loan tranches from the Overseas Private Investment Corporation (OPIC) of a total \$61.5m.

<sup>198</sup> Average loan size \$1m, upper limit is \$12m and borrowers typically have an annual turnover of \$7-15m.

<sup>199</sup> See the pie chart at June 2013 on <http://www.afhangrowthfinance.com/detail.asp?CatID=17&ContID=35>. "Investments" is a raw definition as AECF interventions are construed as self-redeemable, debt-like instruments base on businesses cash-flow capacity to reimburse over 18-48 months. It is well-suited to Islamic profit-sharing philosophy actually.

<sup>200</sup> Several Team members have met AGF CEO in the past to have a detailed presentation of his concept and risk mitigation measures

<sup>201</sup> See EAGR design by Coffey and EAGR Business Case in DFID Quest database and the new generation of USAID-funded ventures with Abraaj/Aureos notably on <http://www.usaid.gov/news-information/press-releases/usaids-partners-abraaj-and-jspe-150-million-private-equity-pakistan>.

<sup>202</sup> Slide presentation received in May 2014.

<sup>203</sup> See Chapter 6 <http://siteresources.worldbank.org/EXTNWDR2013/Resources/8258024-1320950747192/8260293-1322665883147/Chapter-6.pdf>.

<sup>204</sup> See for instance the complexity of supply and demand constraints highlighted by the new J-PAL Youth Initiative: <http://www.povertyactionlab.org/sites/default/files/Youth%20and%20Labor%20Markets%20Overview.pdf>

<sup>205</sup> <http://www.spark-online.org/about-us/vision-mission/>.

## SECTION 4: OPTIONS

- efficiency, productivity and value for money for donors;
- credibility and track record of possible implementers and co-funders;
- time horizon and visibility; and
- what we perceive to be DFID and its partners' risk appetite.

The five options that we believe DFID and other donors could explore further are:

- Capacity building to existing or new Afghan institutions providing PSD, Financial Sector Development, and BEE support.
- Capacity support to Da Afghanistan Bank with a focus on supervision and regulation of financial sector.
- Support donor-managed and/or mutual guarantee schemes.
- Afghanistan Business Innovation Fund 2.
- Stocktaking exercise to understand needs of microenterprises and women.

We assess each option in turn by firstly stating why it should be considered, followed by what can be done. We then explore the expected results and cost of the option, and how it could be implemented taking into consideration possible risks.

### 4.3.1 Option of capacity building to existing or new Afghan institutions providing PSD, Financial Sector Development and BEE support

DFID Growth and Resilience Department has recently commissioned a review<sup>206</sup> that confirms the importance of building the right institutions to promote and sustain both pro-growth and pro-poor policies. Moreover, there are currently discussions within the GIRoA about the opportunity to create a series of new Government agencies to expand support to the private sector as part of the growth strategy. We had discussions with MoCI senior civil servants and advisers on this subject, and propose a multi-pronged approach.

DFID or another interested donor could commission a study, jointly with DFID Governance experts, with the World Bank, MoCI and other key interested donors (World Bank Group, US, Germany and Denmark) to review existing donor-funded and Government-funded institutions engaged in supporting the private sector. It could propose to the GIRoA opportunities to revitalise, rationalise and/or merge them whilst improving their governance. The following points could be covered by the review:

- in line with stakeholder feedback, a root and branch review of AISA's role, governance and practices is the most pressing;
- lessons learned from attempts to create "one-stop-shops" at the decentralised level that were particularly targeted at SMEs; and,
- APPRO's field assessments in Mazar, Balkh and Kandahar indicate that ACCI local and provincial chapters appear to play a significant role in interacting with these institutions. Therefore, they should be included in the review process as well as traditional representations of businesses.

Our view is that Afghanistan most likely cannot afford the efforts of creating a new Government Agency with its limited human and financial resources, and we are also unsure that a new institution would not replicate the governance challenges already faced by existing institutions. Additionally, we alerted hosts in the MoCI about the drawbacks to splitting a Ministry with an arm's length Agency, as this could ultimately weaken it, and also queried how this Agency would fit with the existing institutions (such as AISA, the Export Promotion Agency of Afghanistan (EPAA), and ACCI).

Creating new Afghan institutions out of MoCI, as per regional models (India, Malaysia or Pakistan), is not recommended at this stage, but could be considered once further institutional capacity is embedded in relevant institutions. Thus, DFID's PSD Team will have to ensure that any future programming that relates to the role of Afghan institutions such as EPAA, MoCI, Harakat, and AISA, is within the wider framework of the Tokyo Mutual Accountability Agreement, and work closely alongside DFID Governance experts to consider consensus amongst donors and the GIRoA with regards to the creation of new institutions.

---

<sup>206</sup> In "Governance, institutions, growth and poverty reduction: a literature review" – November 2013.

## SECTION 4: OPTIONS

There may be opportunities, once EPAA's governance management capability and fiduciary risk have been fully assessed, for DFID to consider a role for EPAA to deploy dedicated facilities to support exporters. It would have to be implemented by a donor such as GIZ, or service provider with a strong track record in export promotion and trade.

**Why:** It is of the utmost importance to support stronger more capable Afghan institutions for Afghans, and which are managed by Afghans. This is critical to ensuring sustainable development within Afghanistan through embedded capacity. Moreover, with the new political phase, there is an opportunity to work with the new Cabinet and its economic advisers on institutional models, to review the existing institutions and make them work better. Donors and the GIRoA have invested a lot of resources and energy in the past to create these institutions.

**What:** the primary targets for a preliminary phase of institutional and governance assessments are AISA, EPAA, and AIBF.

**Expected results/impact:** more efficient, better governed and less corrupt institutions should better serve the needs of businesses. They would deliver better VfM for DFID and, after restructuring, SME policies should be better informed by more efficient institutions.

With regard to inclusive growth and job creation, we reiterate the policy evidence<sup>207</sup> that reformed institutions will better serve the needs of businesses and SMEs, and thus support more inclusive growth, if the right governance arrangements are in place. Our recommendation is to utilise cross-cutting governance expertise from DFID and other donors who can implement public/private dialogue techniques in Afghanistan and have experience of ensuring civil society representation and mobilisation.

**Cost estimate:** £100-500,000.

### **How/implementation:**

- This could be a joint agenda for DFID PSD and Governance experts, or from equivalent experts from within other donor organisations.
- Need to build coalitions with BMOs as a voice for change and for the role they will play in improved governance. Engagement with BMOs such as ACCI, Afghanistan Industry Association, FACT, cluster and sector representatives Afghanistan Bank Association, and Afghanistan Microfinance Association.

### **Further considerations when preparing a possible Business Case:**

- DFID or other donors could consider using its existing programme supporting MoCI to drive this institutional strategy. However, an MoCI-lead may not drive optimum influence across Afghan decision makers and may raise conflict of interest as MoCI has its own views about these institutions and concepts for new agencies.
- DFID or other donors could include the role of Harakat within this review in order to draw upon its knowledge and understanding about the enabling environment.

**Primary risks:** this type of institutional intervention is always high risk as political economy analysis demonstrates such as risks of capture, vested interests, and entrenched corruption. Moreover, it is always difficult to define milestones and measure progress. Any reform is likely to be successful only over a long time horizon.

### **4.3.2 Option of capacity support to Da Afghanistan Bank in financial supervision and regulation**

The World Bank's FSRRP has been recently amended by the World Bank<sup>208</sup>, but would likely benefit from more energetic donor support, and DFID is seen by technicians at the World Bank and by many partners as an ideal champion to push the agenda approved, in principle, by the GIRoA.

DFID was recently considering with other partners (IMF, World Bank and possibly USAID) a strategic programme of support to Da Afghanistan Bank that has been postponed due to the worsening security situation after the attack of a restaurant causing the death of the IMF Head of Mission. However, seconding experts selected by the IMF and WB in a Central Bank has proven its merit in many post-conflict and post-crisis countries (such as Rwanda, Sierra Leone, and Nigeria).

---

<sup>207</sup> For instance highlighted by DFID in "Governance, institutions, growth and poverty reduction: a literature review"

<sup>208</sup> World Bank, 2013. Afghanistan - Additional Financing to the Financial Sector Rapid Response Project: restructuring-  
<http://documents.worldbank.org/curated/en/2013/11/18495956/afghanistan-additional-financing-financial-sector-rapid-response-project-restructuring> especially pages 10-12.



**Box 15: Nepal, a possible model to work in partnership with the World Bank on financial sector reform**

DFID has been working on financial sector issues closely with the World Bank since 2008. It has approved a US\$7.5 million equivalent technical assistance package for 2013-2015<sup>209</sup>; designed to support the implementation of the broader Government financial sector reform programme. There are useful lessons for Afghanistan: The technical assistance package is a mix of macro (resolution legislation, deposit scheme) and retail-targeted (diagnostics) interventions to support fragile banks, and is based on an in-depth review of the financial sector in 2008. This was done in partnership with the IMF, and complemented by First Initiative in 2011. The priority of the programme is to reinforce supervision, after having restructured several poorly performing public banks.

Due to the security context, it is a challenge to attract the right expertise from global centres of expertise that DFID or other donors directly sponsor, fund or politically support. There may be ways to engage with these centres by adapting their operational procedures (notably by supplementing their in-house staff by experts provided by consulting firms on different duty of care regimes). There are three areas where DFID or other donors could support the Da Afghanistan Bank, listed below.

- Afghanistan would need a root and branch review of its financial system (including insurance, treasury bills and public debt market, pensions and bond markets) and the most comprehensive instrument to achieve this would be the joint IMF/World Bank Financial Sector Assessment Programme (FSAP)<sup>210</sup>. DFID or other donors could support Afghanistan's application in the medium term.
- DFID Head Office has also been supporting the Aries Project that aims to mobilise IMF expertise<sup>211</sup> "to deliver improved public financial management, financial sector capacity, and domestic revenue collection in six priority fragile and conflict states", including Afghanistan. This project could be evaluated in Oct-Dec 2014 – an opportunity to discuss with IMF how their expertise could be again tapped.
- In the meantime, DFID or other donors can mobilise First Initiative<sup>212</sup> to respond to Afghanistan's requests to improve regulation and supervision of its banking sector. It could also support IFC to establish institutions strengthening the financial infrastructure<sup>213</sup>.

**Why:** the financial sector is still fragile after being through two major crises (Kabul Bank collapse and microfinance sector) and Da Afghanistan Bank must have the capacity to manage systemic risks. If the financial sector is not rigorously regulated, there will be no provision of financial services to SMEs. The first building block is to create a solid Central Bank.

**What:** Donors would fund experts selected by the IMF and the World Bank who would provide capacity building to key departments of Da Afghanistan Bank, focusing on regulation and supervision of the banking sector<sup>214</sup>.

**Expected results/impact:** If sequencing is correct, better regulation and supervision should mean healthier and more confident financial institutions and the technical tools that create the platform to extend more credit to the economy and under-served segments. It will also keep deposits safe and should discourage using informal channels that are more prone to money laundering and criminal activities.

**How/implementation:** Most likely with recourse to a consultancy firm as contractor, and to a procurement framework similar to the DFID Professional Evidence and Applied Knowledge Services (PEAKS), including duty of care constraints.

<sup>209</sup> DFID Nepal co-financed the World Bank Financial Sector Technical Assistance Project in 2008-11 - P071291, closed on December 31, 2011 – then provided technical assistance support to both the World Bank and the Government for the preparation of a proposed Development Policy Credit and now funds the Nepal Financial Sector Stability Programme co-funded by World Bank Group and DFID <http://www.worldbank.org/projects/P129929/np-financial-sector-stability-dpc?lang=en> and achievements: [http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/SAR/2013/10/23/090224b081fcdc90/1\\_0/Rendered/PDF/Nepal000NP00Fi0Rep0rt000Sequence001.pdf](http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/SAR/2013/10/23/090224b081fcdc90/1_0/Rendered/PDF/Nepal000NP00Fi0Rep0rt000Sequence001.pdf).

<sup>210</sup> A joint IMF-WB assessment that happen from time to time usually every decade – see <http://www.imf.org/external/np/fsap/faq/>.

<sup>211</sup> See Project Memorandum sent by DFID Afghanistan "Improved Macroeconomic Governance In Fragile And Conflict Affected States Through IMF" and Annual Review: "In Afghanistan the expert made good progress in working with the GIRA provided training to the financial supervision department as well as assisting in incorporating Islamic law principles into the a draft of the new banking law. Unfortunately the expert suffered health problems through 2013 and was not able to continue in Afghanistan. The IMF is currently recruiting a replacement.

<sup>212</sup> First Initiative is a partnership between IMF, World Bank and several donors to strengthen financial sectors. It is housed by the World Bank. DFID is a founder. There are relevant precedents in countries such as Nigeria or Rwanda in 2007/08 then 2011. See [www.firstinitiative.org](http://www.firstinitiative.org)

<sup>213</sup> Such as the new electronic collateral registry – see <http://www.ama.org.af/index.php/events/news/58-creating-opportunity-for-small-and-medium-enterprises>; and the work done by Harakat and IFC on the creation of the effective legal regime for secured transactions - <http://www.harakat.af/dabsnewsf2013114210.html>.

<sup>214</sup> Extended to other non-bank financial institutions that may pose a systemic risk such as the largest MFIs, insurance companies, remittances or forex bureaus.



## SECTION 4: OPTIONS

Evidence<sup>215</sup> suggests that inclusive growth and job creation can be supported through a sound financial sector that deploys and allocates capital, protects deposits, and which then subsequently expands access to targeted segments of the economy such as SMEs. This is a necessary pillar to growth and inclusion in a modern economy, as such improvements in the regulatory environment will encourage financial institutions to reach out and invest in SMEs, thus spurring broad-based growth and employment generation.

Methodically, this intervention would be designed in partnership with IMF and World Bank to assess capacity building needs.

**Cost estimate of donor engagement:** £3,000,000 over 5 years for 5 experts, taking into account duty of care constraints and off-site training seminars, secondments, bursaries, training courses with AIBF or local business schools.

### Further considerations when preparing a possible business case:

- Review precedent projects and consult the GIRoA, WB, IMF and a few key bilateral partners, such as the US, to define priorities and KPIs.
- Learn from DFID/IMF support to the Central Bank in Nigeria<sup>216</sup>.
- Design a model between in-house support and off-site (Dubai-based) coaching, a duty of care model that takes into account lessons from Aries' latest review (consistency of expertise), and recent security alerts in Afghanistan.
- Benchmark costs with standards from Aries Programme.

**Primary risks:** Operational insecurity worsening, a lack of competent personnel in Da Afghanistan Bank, and mission creep with Da Afghanistan Bank moving towards non-business friendly supervision, or regulation discriminating SMEs, are all risks that will need to be considered.

### 4.3.3 Option to support donor-managed and/or mutual guarantee schemes

DFID or another interested donor could support donor-managed and/or mutual guarantee schemes in order to encourage the financial sector to expand the scope and depth of services to SMEs. Annex 8 includes more details on guarantee schemes in Afghanistan.

**Why:** In the context of Afghanistan, de-risking financial support to MSMEs appears the best way to incentivise financial institutions to increase their exposure to this segment of the market. There are strong credible implementers and other donors who want to extend their exposure<sup>217</sup>.

DFID has had some experience in the past with the AIGF<sup>218</sup>. Moreover, there is a possibility to test more innovative formulas using portfolio-based techniques, in a measured way, to encourage collective and mutual schemes that spread the risk and go beyond the individual level towards smaller businesses.

**What:** Donors could provide a loss-reserve facility, alongside others, and a grant for capacity building and management.

**Expected results/impact:** Guarantee and risk-sharing schemes<sup>219</sup> allow financial institutions to build the confidence and the capacity to lend to SMEs, and increase their exposure to the economy. Over time, as risk analysis is refined and confidence is increasing, a wider group of businesses would become bankable. In addition:

- Smaller SMEs can regroup themselves to access finance via mutual schemes.
- Financial institutions are able to strengthen their systems and the capacity of their appraisal teams and to collect data on their customers that can be used to design better products.
- Decreasing the risk profile of lending to businesses in Afghanistan may have a positive impact on cost of finance in the medium term.

---

<sup>215</sup> DFID Afghanistan can find evidence in the Access to Finance World Bank Memorandum, or in DFID Business Case to support First Initiative.

<sup>216</sup> Annual Review [iati.dfid.gov.uk/iati\\_documents/3903581.docx](http://iati.dfid.gov.uk/iati_documents/3903581.docx) and recent Business Case [iati.dfid.gov.uk/iati\\_documents/3887263.docx](http://iati.dfid.gov.uk/iati_documents/3887263.docx).

<sup>217</sup> Annex 8 provides more details on guarantee schemes in Afghanistan.

<sup>218</sup> Admittedly mixed – see post completion reviews by the World Bank Group and by DFID

<sup>219</sup> See in PIDG business case the precedent of DFID support to GuarantCo and in EAGR Pakistan business case a recent discussion of guarantee options.

## SECTION 4: OPTIONS

With regards to inclusive growth and job creation, Guarantee schemes that are extended to lower rungs of the business community would allow for the inclusion of businesses in formal financial circuits, and fund investments that should rapidly increase growth in business activities (such as financial turnover and profitability). This, in turn, should spur hiring and employment.

**How/implementation:** Donors could invite current guarantee scheme funders and managers to bid for donor support<sup>220</sup>. In addition, Donors could design support so that managers would extend their range of products towards medium sized and smaller segments of Afghan businesses. This would incentivise managers to pilot collective mutual schemes for smaller businesses.

**Cost estimate:** £6-15,000,000 capital allocation and £1.5–3,000,000 grant for TA and management.

### Further considerations when preparing a possible business case:

- Review the various models in the Afghan market today: USAID DCA; DEG (World Bank), rural ADF/MRRD supported by US and Denmark (and the MIGA AIGF precedent).
- Leverage DFID PSD Department and other Whitehall (HMT, BIS) expertise<sup>221</sup>, or donor equivalents.
- Consider models and lessons from joint ventures in other countries such as with World Bank in Nepal; or between USAID and Sweden in Kosovo and Zambia.
- There is an opportunity to leverage the DFID-funded MIGA's new Conflict-Affected and Fragile Economies Facility (core funding has been announced by DFID Head Office)<sup>222</sup>.
- It may be beneficial to reflect on the kind of enterprises that would benefit most from political risk insurance in Afghanistan, and whether it would be acceptable, for instance, to insure Afghan investors from the diaspora who would increase their exposure to the country (or investors in new microfinance institutions and SME specialists).

**Primary risks:** Donor capacity to deploy innovative instruments in such a difficult environment. This could be mitigated by expertise leveraged by DFID Afghanistan Office. Other risks include inefficient implementation, which could be mitigated by applying lessons learnt from AIGF, and risk of capture by donor partner(s).

### Box 16: Credit Guarantee Schemes

#### 1. USAID Development Credit Authority

Since 1999, USAID has implemented a series of partial guarantee programmes over the world and has become a leader<sup>223</sup>: in 2013, it approved 26 new partial credit guarantees in 19 countries, which can mobilise nearly \$500 million in private capital.

A recent independent evaluation of 12 programmes showed some positive impact of these guarantee programmes, aligned with literature: 75 percent of the banks used the guarantee to start or increase lending to the targeted sector, region, or borrower, and 50 percent increased their lending after the guarantee ended.

#### 2. Multilateral Investment Guarantee Agency

As its promotion material explains, MIGA insures foreign direct investments against losses related to: "Currency inconvertibility and transfer restrictions; Expropriation; War, civil disturbance, terrorism, and sabotage; Breach of contract; Non-honouring of sovereign financial obligations". More generally, MIGA-insured businesses benefit from the clout of the World Bank Group. In Afghanistan, MIGA played an important role as the sponsor and anchor investor of the 'Afghanistan Investment Guarantee Facility' co-funded by DFID, to attract initial investment in the telecom and financial sectors, but was less successful with mid-sized businesses.

### 4.3.4 Option to support an Afghanistan Business Innovation Facility (ABIF) 2

**Why – Lessons from ABIF 1:** The latest DFID SEED Annual Review points us to the strong probability for ABIF grantees to become profitable by the end of 2014/beginning of 2015<sup>224</sup>. "ABIF has shown dramatic improvement

<sup>220</sup> Note: it could take also the form of a policy implementation facility other donors and managers would bid for.

<sup>221</sup> G20/AFI working group - Vogel Paper on guarantee schemes discussed in Thailand in 2013 - interview with Martin Alsop-DFID expert.

<sup>222</sup> <http://www.miga.org/documents/conflict.pdf> and DFID contribution that will include Afghanistan confirmed in <https://www.gov.uk/government/news/greening-uk-will-focus-on-frontier-economic-development>.

<sup>223</sup> See video animation: [http://www.youtube.com/watch?feature=player\\_embedded&v=g9ESqNNkxwl](http://www.youtube.com/watch?feature=player_embedded&v=g9ESqNNkxwl).

<sup>224</sup> ABIF grantees go through material investment and transformation programmes which, over time, enable many to become profitable.

## SECTION 4: OPTIONS

since the last Annual Review. A second round of bids took place, receiving 175 concept notes, of which 16 companies were awarded grants. This brings the total number of grantees to 23.” We endorse the recommendations by the SEED Annual Review for a no-cost extension until end of 2015, “as the longer-run success of ABIF grantees however will not be known until at least the end of 2015.” This could be the basis to assess the feasibility of a second phase of the programme.

### **What – Is there a business case for an ABIF 2:**

An extended ABIF 1, with additional instruments, could be a relevant model to test quasi-equity types of financing (during the current transition period in Afghanistan) as a bridge toward private equity, prior to moving to more ambitious models. DFID or another interested donor could consider a mix of technical assistance; long term, patient capital that could be either equity, mezzanine, asset-back/leasing/Islamic finance, or long term classical debt, with returns/remuneration embedded and as close as possible to market conditions. DFID Advisers, or equivalents from other interested donors could learn from AGF, from the Africa Enterprise Challenge Fund, and from CDC, how not to distort competition by undercutting market-led actors.

ABIF 1 played a pioneering role in an SME segment slightly lower than AGF investees, and above AREDP, ASMED or ANMDP. Moreover, there should be viable targets in the 500+ space of phase 1 targets that have not been reached due to limited marketing and outreach. If ABIF 2 were to diversify its range of instruments, it could also attract other applicants.

**Expected results/impact:** The statement by the current ABIF facility manager that “there is a decent pipeline of opportunities that are as good as (if not better than) the strongest ABIF 1 grantees” looks credible, and in line with the development of venture capital in pre-emerging markets<sup>225</sup>. The primary benefits would be direct, such as funding another group of performing businesses, creating jobs, exports and contributing taxes. A secondary impact would be at the demonstration level, to make venture capital and private groups realise that Afghanistan could be open for them to invest.

**How/implementation:** The same as ABIF1, it would be put to tender with a performance-related management contract.

**Cost estimate:** £12-18,000,000 to be disbursed over 3 years, and managed over 10 years.

Based on feedback<sup>226</sup> and supported by literature on investment and by the recent reviews by ICAI, **further considerations should be applied when preparing a possible Business Case:**

- Need for donors to have a long term perspective, of 5-10 years<sup>227</sup>, with a strategy for incentivising manager(s) and applying strict milestones.
- A more holistic approach to the grant component must be included as larger Afghan businesses face multi-level challenges along their life cycle, and should be able to tap into adequate support as they grow and develop.
- The linkages with the private financial sector (banks and non-bank financial institutions) must be reinforced. Donors may wish to consider rules such as those set up by the European Investment Bank (including an absolute limit of 50 percent; obligation to find co-financiers; not being the major financier and stakeholder; and de-scaling ratio at the second round).
- There are design and governance options to manage possible conflicts of interest that have been tested by DFID since AfriCap Microfinance Fund, and its associated TA window. Ideally, it is better if the finance window would be separated from the TA window<sup>228</sup> in terms of diligences; decision-making processes; contractual arrangements; and monitoring. However, limited human resource capacity in Afghanistan may hinder opportunities to best manage conflicts of interest.
- As competences are unlikely to be located in-house, it would be better to leverage CDC (or IFC) fund management competencies. An ancillary benefit would be to familiarise CDC Teams with Afghanistan and

---

<sup>225</sup> We would strongly recommend for DFID PSD experts the recent technical paper “Private Equity and Venture Capital in SMEs in Developing Countries – The Role for Technical Assistance” by Shanthi Divakaran, Patrick J. McGinnis and Masood Shariff – World Bank Policy Research Working Paper 6827 – April 2014.

<sup>226</sup> By the current ABIF Facility Manager, by bankers, and by other managers of pilot programmes such as AUA Incubator,

<sup>227</sup> Lesson from designing EAGR Pakistan.

<sup>228</sup> See Figure 5 “Governance Model of a Typical Paired PE and TA Facility” and discussion pages 16-17 in same paper.

## SECTION 4: OPTIONS

consider a possible extension of DFID funds under management, such as the Impact Investment Fund, in a 3-5 years' time horizon.

- The support by professional investors in PE funds would also help DFID or other interested donors and a future ABIF 2 fund manager to implement best practice in fund governance, monitoring, emphasise accountability and delegation and avoid bureaucratic micro-management.

There are cooperation opportunities for linkages should there be new phases of AREDP and Business Edge, as well as with initiatives such as the Business Incubator on the delivery of business services.

**Primary risk:** Particular attention should be given during design on risks to distort market conditions by underpricing ABIF support.

### 4.3.5 Option to undertake stocktaking exercise to better understand the needs of microenterprises, and especially of women

There remains a lack of appreciation and contextual understanding of the realities and socio-economic structures of those at the base of the pyramid, who are often employed in the informal sector at the microenterprise level.

The first step to filling this gap would be a stocktaking exercise of studies of Afghan microenterprises – and particularly clusters of microenterprises. The stocktaking could highlight what is known about business management practices of microenterprises, access to markets, technology and skills transfer needs, and finance needs. The stocktaking could also highlight areas where additional qualitative and quantitative research is required, including national surveys of traditional clustered enterprises gathering evidence in almost all population centres throughout Afghanistan. These national surveys could then be undertaken to strengthen understandings at the base of the pyramid.

Moreover, the context for women needs to be more comprehensively understood, and donors could therefore make efforts to commission research from local and international research organisations in order to strengthen contextual understanding which will ultimately strengthen programming.

**Why:** There is a lack of evidence, data and facts on micro and smaller enterprises, acknowledged by the ICAI Report and PCRs in Afghanistan.

In addition, APPRO's research suggests that the almost exclusively macro level focus by other main donor organizations active in Afghanistan has resulted in a large but neglected number of clustered micro and small-scale enterprises present in all major populations centres of Afghanistan<sup>229</sup>. Given this, there are ample opportunities for DFID and other development aid organizations to add value through their programming in private sector development with a focus on the Intervention with a focus on micro and small-scale enterprises, which is consistent with DFID's and other donor objectives for supporting job-intensive activities and sectors, export sectors, that facilitate growth.

#### What:

- Donors to commission further demand-led research on sectors, regions, value chains or clusters where there are large populations of small (less than 10 employees) and micro businesses (self-employed or/and family units).
- Donors to commission selected macro-economic sector and cluster modelling that would measure in a more refined way the impact of the current transition period on SMEs. This could complement the modelling done by World Bank economists in 2011-12, and thus further inform policy making by the new GIRoA and donors.

**Expected results/impact:** Better programming and baselines for results strategy (for example KPIs and M&E). In the longer term, it should increase DFID's, other donors' and the GIRoA's knowledge and understanding of the informal sector and the context for women, and enable stronger programme designs and better policies, such as those regarding taxation.

This should have benefits for inclusiveness as better knowledge of SME needs in particular geographies, sectors/clusters and of business cultural context (women-intensive activities and their constraints for instance, or expansion of urban artisan clusters) should have a direct impact on job prospects.

As APPRO conclude in their report (Annex 9): Continued analysis of data from additional cluster studies is likely to

---

<sup>229</sup> APPRO, 2014

## SECTION 4: OPTIONS

generate much needed additional systemic and systematic knowledge about the traditional forms of business organisation in the broader economy, the extent of their positive and legitimate contributions in generating livelihoods, their internal sustenance mechanisms such as apprenticeship arrangements, access to finance, and technology requirements. Continued analysis of these data can also reveal entry points for introducing value adding interventions to increase productive capacity of clustered enterprises and their contributions to economic growth and social stability. Ultimately, strengthening clustered enterprises is likely to provide incentives for individual enterprises to move up their respective value chains.

### How/implementation:

- A good starting point is the current work done by APPRO on mapping the available information on research on SMEs in Afghanistan.
- Find a joint venture arrangement between MoCI and a University or Business School to create a knowledge centre.

**Cost estimate:** £100-900,000.

Further considerations when preparing a possible Business Case:

- Request the International Growth Centre or/and DFID Research Team to provide methodological support.
- Refer to the EAGR Business Case on cluster approach to elicit value chains and clusters (or on prior work by APPRO on saffron, or from the AREU).
- PCR of Zardozi in order to better understand the context for women.

**Primary risks:** The findings are not appropriately considered when donor, or the GIRoA, design future programmes, or the research is not effectively conducted, resulting in poor findings and a weak evidence base. These risks could be mitigated by ensuring effective dissemination of research, making it easily accessible and publicly available, and ensuring an effective research strategy prior to undertaking any in-depth studies.

### 4.3.6 Prioritising the preferred options from the perspective of inclusive growth and job creation

Based on a careful consideration of each of the preferred options' scope to contribute to inclusive growth and job creation, we recommend that the option to support an ABIF 2, and the option to undertake a stocktaking exercise to better understand the needs of microenterprises, and especially of women, offer the strongest prospects in the near and medium term.

With regards to **ABIF 2**, there is ample scope to learn lessons from the implementation of ABIF 1, and apply these in a second phase programme which aims to provide more comprehensive finance and BDS support in response to the demand generated by successive funding rounds of the pilot phase. A second programme would benefit from optimised start-up costs for funders/donors as brand, systems and processes are now well established and a healthy pipeline has been accrued<sup>230</sup>. There is also an opportunity to work with other donor programmes which could support ABIF 2 grantees through the provision of complementary BDS support, and also to design more innovative financing instruments. An ABIF 2 has the potential to rapidly enable grantees to grow and employ, and to become sustainable enterprises. Moreover, the most established grantees should positively impact wider market development through stronger backward, forward, and horizontal linkages with other promising, smaller, enterprises within their value chains.

The **Stocktaking Exercise** presents a relatively low cost and low risk option, but which has the potential for significant benefits. By better understanding the nature of microenterprises and the role of women in clusters and value chains, then donors will be in a better position to design and implement interventions that have the greatest impact on inclusive growth and job creation. As mentioned previously, these enterprises are many, and employ vast numbers of poor people across agricultural, industrial and service sectors – both formally and informally. There is also a possibility to link the increased understanding of underserved segments of the market with current and future programmes, such as a potential ABIF 2 grantees, which could aim to strengthen backward linkages with clustered microenterprises (such as those identified by APPRO), thus further strengthening the scope for inclusive growth and job creation in Afghanistan.

---

<sup>230</sup> Discussion with ABIF 1



## 5 Conclusion

The rationale exists for DFID to continue providing support for services to SMEs – subject to careful consideration of the length of commitment that will be required to achieve meaningful impacts. By applying its experience with past and current programmes<sup>231</sup> DFID will be able to apply lessons learnt to future SME programming in Afghanistan.

As potential project participants adjust their behaviour to an era of greater donor scarcity and selectivity, DFID may experience greater traction with programme partners and participants. In addition, DFID may play an important role as convenor and coordinator as a result of its reputation and leadership, to champion programmes that effectively reach the base of the pyramid and benefit smaller enterprises that have not been the primary recipient of donor programmes to date.

However, business people are holding back on investment decisions, and we have been advised by other stakeholders<sup>232</sup> that it is wise for DFID to avoid major interventions until the key economic appointees of the new Cabinet and Presidential advisory team are in place, and their first policy statements issued. Moreover, high risks persist, and a cautious approach is required, building on partnerships with proven partners, and strengthening existing programmes with strong track records through improved monitoring, better evidence and data collection, and better results management.

Supporting resilience and more sophisticated risk assessment, management and mitigation, will be of great importance. This means applying cross-cutting expertise to programming as many threats are beyond the private sector development sphere, such as corruption and lack of transparency, inefficiency of public systems, poor infrastructure, low literacy and numeracy skills, and low financial capacity<sup>233</sup>. There will be a need for DFID conflict experts to assist PSD Team to assess the risks attached to any PSD programme.

We conclude by stating that programming support to SMEs will need a blend of macro, meso and micro-level interventions that require indirect targeting to achieve systemic impact that will ultimately lead to growth and employment generation.

---

<sup>231</sup> Such as the Helmand Growth Programme and current programmes (SEED-ABIF, support to MoCI; SEED-Business Edge).

<sup>232</sup> Unprompted, this note of caution “[DFID should] wait until we know the next MoCI/economic/finance... minister” was conveyed more by Afghan managers than by expatriates. Some names have been floated as trial balloons that may complicate donor support.

<sup>233</sup> The recent IMF May 2014 review concludes<sup>233</sup>: “2014 is a crucial year in the political and security transitions and the run-up to the “transformation decade” (2015–24). Assuming smooth political and security transitions, continued reform and donor financing, the outlook should be positive. [...]”. However “risks, mostly on the downside, are related to adverse domestic or regional security developments, political instability, inadequate implementation of economic policies, and donor fatigue.”

# Annex 1: Terms of reference

## Scoping the Need for Improved Access to Funding, Advisory Support and Business Skills Development for SMEs in Afghanistan

### Background

1. The UK Department for International Development (DFID) is placing increased importance on the collection and use of high quality evidence to inform its policies and programmes. As part of its strategy to decentralise its research efforts, the South Asia Research Hub (SARH) was established in New Delhi in June, 2010. The SARH supports DFID country offices in South Asia and their partners to become better users and commissioners of research and to ensure that South Asian concerns are reflected in centrally-commissioned research. At the same time, DFID is also ramping up its focus on driving economic development, as the best way to reduce poverty and bring prosperity
2. Afghanistan is one of the UK's top international priorities. DFID has been operational in Afghanistan since 2001 supporting a number of wide ranging projects and interventions including support to the growth of Private Sector Development and the promotion of Small and Medium-sized Enterprises (SMEs).
3. DFID Afghanistan has identified that improved access to funding, advisory support and business skills development for SMEs in Afghanistan will be critical for job creation and poverty reduction. There is currently considerable support for SME development from donors, multilateral and development financial institutions (DFIs), and the Government of the Islamic Republic of Afghanistan (GIROA). However, DFID Afghanistan wishes to improve its understanding of the demand for and the nature of existing support, the gaps, challenges, and the potential negative side-effects.
4. This scoping study will examine the key challenges, opportunities and effectiveness in funding SMEs and providing advisory support and business skills development in Afghanistan. It will review the peer-reviewed and grey literature (including the official documents prepared by the government and the donors), conduct country diagnostics and organise stakeholder meetings to identify gaps and potential opportunities in key sectors such as agriculture, mining, textiles, etc. The review should also identify key research institutions/consultants involved in policy research relevant to SME development.

### Objectives

5. To map the existing donor, DFI and GIROA support to SMEs in Afghanistan, and to map the key institutions doing research on SMEs in Afghanistan.
6. To assess the need for (i) improved access to finance; and (ii) advisory support and/or business skills development, for SMEs in Afghanistan.
7. To provide and assess one or more options for a medium to long-term (5-10 years) programme of donor-funded support for SMEs in Afghanistan that (i) offers improved access to finance (whether through one or more of grants or forms of returnable capital such as debt, equity etc.) together with advisory support and/or business skills development; and (ii) advances DFID's objectives of promoting economic stability, inclusive growth and job creation.
8. Options that involve working with or through other parties or programmes (whether or not donor-funded) should also be considered, if thought to be of interest.
9. Options should consider how improved access to finance, advisory support and business skills development could be best delivered, including how these could be best targeted so as to have maximum effect.

### The recipients

10. The direct recipient of the services will be DFID Afghanistan. Some or all of the work may be shared by DFID Afghanistan with other parties.

### Scope of work

The service provider (SP) will:

11. Identify and prioritise challenges and constraints to SME market entry and expansion in Afghanistan. Assess the relative importance of better access to finance and improved availability of advisory support and/or business skills development when compared with other challenges and constraints.
12. Identify and briefly review and assess interventions and policies of GIRoA and the international community to support SMEs through improved access to finance and improving advisory support and/or business development skills. This should include a brief assessment of current and past interventions and policies, their nature, size and any sectoral / geographical focus, and a mapping of the key institutions doing research on SMEs in Afghanistan.
13. Through a review of relevant literature (including country-level diagnostics) and stakeholder (including the private sector, GIRoA and the international community) consultations:
  - (i) identify SME funding needs and assess how the current availability of SME funding (including from the private sector, the international community and GIRoA) meets those needs; and
  - (ii) identify the key areas of need for advisory support and/or business skills development for SMEs, and assess how the current availability of such support and development meets those needs.
14. Explore how a donor-sponsored intervention that seeks to improve access to funding coupled with better access to advisory support and/or business skills development for SMEs could best meet these needs in a way that maximises pro-poor, developmental impact, delivering inclusive economic growth and job creation. This should:
  - (i) consider how the provision of medium-term advisory support and/or business skills development together with funding would allow SMEs to make the most of that funding;
  - (ii) include an assessment of the challenges and risks;
  - (iii) draw on lessons learned from current and previous interventions by the international community (including the DFID-funded Afghanistan Business Innovation Fund) and/or GIRoA in this area and consider how best to complement such other interventions;
  - (iv) identify key sectors of intervention e.g. agriculture, mining, textiles, etc. where SMEs have high growth and job-creation potential;
  - (v) consider how advisory support could improve SMEs' access to domestic and export markets, including through better linkages to multi-national and/or regional firms; and
  - (vi) consider how any such support could be best targeted so as to have maximum impact.

### Methodology

15. The research approach is expected to include (but not be limited to) reviewing of peer-reviewed and grey literature (including the official documents prepared by the government and the donors), country diagnostics and stakeholder consultations especially with the relevant GIRoA ministries, donors, and the multilateral and development banks working in Afghanistan.
16. The exact research design will be suggested by the SP in their proposal. At each stage of the study (including proposals) the SP is encouraged to suggest additional or alternative approaches that would add value to, increase the impacts or improve the value for money obtained from this research.

### The requirements

17. The SP selected will deliver a narrative report of state of the sector, key strengths, challenges, opportunities and the effectiveness of current SME support initiatives in Afghanistan, to meet the objectives described in point 5-9 above.
18. Deliverables will include:
  - 18.1. An inception report, which will present a preliminary review of literature on SME funding and advisory support / business skills development services, work plan for country diagnostics and stakeholder consultations, and set out the approach to answer the sub-questions discussed in scope of work within **3** weeks of starting the contract. The inception report should not be more than 20 pages.

- 18.2. A draft report, at the end of 2<sup>nd</sup> month, which will address all the issues listed under scope of work. The report will be in the form of a narrative description not more than 50 pages, and will be supplemented by tables, graphs and appendixes where relevant. DID will provide comments on the draft.
- 18.3. Final report, including an executive summary of not more than 5 pages, within one month from receiving the comments on the draft report from DFID, to be approved by DFID. The final report will be not more than 50 pages of narrative description, excluding the appendices / annexes, if any.

## Annex 2: Interview sheet guide

Team Member(s)
Interviewees
Date
Main subjects covered

### General:

- SME needs in the country and major obstacles to their expansion so far
  - [discussion can be improved by reference to latest WB Ease of Doing Business<sup>234</sup> and Enterprise Survey<sup>235</sup> knowing these mostly represent “larger” businesses]
  - Outlook after presidential elections = impact on business
  - [we have to keep the discussion focused; highlighting facts rather than perception and use a positive language: accentuating the new landscape after foreign troops have left and Afghans are masters of their destiny]
- Awareness of and comments on donor and GIRoA programmes supporting [Small] Businesses
  - What Donors/DFID/GIRoA have done so far?
  - What Donors/DFID/GIRoA have done well?
  - What Donors/DFID/GIRoA could be doing better?
- Are there other initiatives that interviewees find helpful and should be expanded? From Chambers of Commerce, Municipalities and Governorates, Business Associations, INGOs or local NGOs?
- How banks, microfinance institutions, BDS providers can help?
- Most beneficial initiative/programme/idea for enterprises benefiting women and solution/idea to boost, if any?

### Questions for actors in macro/policy/enabling environment:

- What new Government should do? Priorities? Pro-business / pro-growth and pro-poor drivers and institutions to nurture?
- How can DFID, World Bank and other development organisations help?
- Reforms to deepen from a demand point of view: *[unprompted then prompted around key Doing business themes such as access to finance ;electricity ; markets, transparency / bureaucracy / taxes; land ; competition – including from neighbours].*
- What are the needs and gaps?
- Role of civil society, researchers and academics to support knowledge, skills, M&E and impact measurement? Recommended names?

<sup>234</sup> <http://www.doingbusiness.org/data/exploreeconomies/afghanistan/>

<sup>235</sup> <http://www.enterprisesurveys.org/Data/ExploreEconomies/2014/afghanistan/>



- What are the knowledge needs for better, more specific and informed, assistance to (M)SMEs? Do we have sufficient knowledge or do we need to develop a deeper understanding based on new market and other forms of research?
- Views on the need of business regulations – need more (focus areas?) or it is balanced or is it better to be limited? Perceived challenges in implementing them and probable solution?

## Questions for facilitators and intermediaries; banks and other financial institutions; facility managers of donor-funded initiatives

- What are the challenges and opportunities they see for SME sector compared with general business sector? [We will need to listen carefully their feedback about cross-cutting themes such as risk, scale, cost, diversification, distance/geographical, security, skills and financial literacy, regional trade]
- What is their feedback about current institutions and programmes set up by donors? Let them spontaneously quote those they find helpful then probe with relevant examples such as recent
  - WB Afghanistan New Market Development;
  - USAID extended FAIDA, old ASMED and new ABADE
  - IFC Business Edge
  - AsDB Enhanced Value Chains
  - Harakat; ABIF
  - Guarantee schemes by DEG, MIGA
- Ask about the **how** they deliver as much as **what these programmes achieve**.
- How can donors such as DFID help? If DFID had more money, where and how should it be invested? Are there existing initiatives worth supporting? Or on the contrary is there a need for alternative ideas, even competition?
- What do they think about monitoring, logframes, results and impact measurement?
- Broadening versus deepening: casting a wider net versus refining the (M)SME segmentation and how to reach likely more difficult markets? [agri and rural sector; women entrepreneurs, Taliban-influenced zones; avoid criminal activities]
- A question or two on the willingness / ability of the main banks and MFIs to service (M)SMEs would also be helpful. For example:
  - What percentage of (the Bank's / MFI's) lending portfolio is made up of loans to (M)SMEs?
  - What are the conditions, e.g., collateral, for (M)SMEs to apply for a loan?
  - What is the rate for full loan repayment?
- What is the strategy (of donor funded programmes) to provide customised BDS/Advisory solution to individual SMEs given the disproportionate/limitation on staff-client (being the enterprise) ratio; turnover; and availability of required skilled BDS provider in Afghanistan market? What in case of women-specific client?

## Businesses and their representatives

- View on regulations around their businesses designed by government (do they know? If yes, is it useful to their business? What is the likely impact expected?)? Suggestion, if any?
- Key BDS/Advisory solutions they would be willing to pay for if available in Afghanistan or in other country?
- Are they (business) planning to employ skilled staff in near future? If yes, then technical or managerial or financial or other (unskilled labour, semi-skilled labour)?

## Annex 3: SME Definitions

One of the first policy questions to guide the Team was the discrepancy between a layer of 500-plus larger Afghan businesses<sup>236</sup> and the mass of the 400,000 small and micro-enterprises.

The first ones receive a disproportionate attention from donors as they are able to invest in the skills that donor funded-programmes are expecting. These however are the most likely, in accordance with the literature, to contribute positively to growth and jobs<sup>237</sup>. They will have the capacity to absorb the magnitude of donor transactions (\$15,000-25,000).

There is a second type of SME segment that one could take from the various registers in the AISA, Ministry of Justice, MoCI, EPAA that seem to be medium to large Afghan owned SMEs that are also good at engaging with Government and donor-funded programmes.

But to include in our analysis the wider informal sector, the definition of SMEs by AREDP below seems to be the most satisfactory and market relevant.

### SME Definitions – Afghanistan

**AREDP** (Ref: operation manual and AREDP SME component B, 2009-10)

businesses with a minimum of 5 and an average of 20-30 employees  
with 50, 000 - 100, 000 USD capital.

Note: The above definition was not adopted when the operation actually began in 2011.

SME definition used by **AREDP** (2011 onwards, Ref. AREDP-SME promotion material):

#### Eligibility criteria for SME support by AREDP:

SMEs with potential to grow with backward and forward linkages. For example: Agriculture produces or agro business, Carpet, Marble/Gemstone, Handicraft, Silk and Natural Fiber, value addition or cost reduction business etc.

SMEs involved in the business of promoting, supporting, developing and/or expanding locally produce goods, services or skills.

Priority will be given to SMEs involved in increasing purchase from rural areas of Afghanistan.

SME owner who has entrepreneurial qualities and are self-motivated to grow.

#### Type of SMEs those are not eligible for support from AREDP:

SME majorly involved in importing and reselling goods in Afghanistan which does not add value to local economy.

SME who's final product or services is for the sales of the imported good in Afghanistan.

SME involve in trade of locally produced goods or services without value addition. In other words, those SME owners who purchase finished goods and without value addition, they sell it further.

#### SME's Non-conformity with Environment and social safeguard framework:

For example, product or activity deemed illegal, production of poppy or poppy processing, business of arms and ammunitions, toxic and hazardous chemicals, business of alcoholic beverages, gambling, political campaigning etc.

### Reasons for not defining SME by sales turnover

According to information provided by our Access to finance unit of AREDP, a SME would require minimum of US\$35,000 annual sales turnover to be eligible for loan of \$5000 for 1 year @ 17 percent int. (which is minimum). Minimum SME loan provided by banks are not less than \$5000 in Afghanistan. Hence, it would be highly difficult for AREDP to link majority of the SME with small loan needs to banks unless they have significant annual sales turnover.

In the instance of exclusively mentioning sales turnover in the definition, it might encourage SME owners to adjust, change or manipulate their actual data to fit into the definition. This can further increase the task of BDS officers to extensively verify data provided by each SME or chances of selecting of SME outside the actual beneficiary.

The above definition would not allow or encourage SME to intentionally adjust their financial data. Further, it would encourage more number of SME to apply for AREDP.

It may provide a larger option with AREDP to select and to assist the high priority SME.

One of the major objectives of AREDP is to assist the SME to further increase employment and economy. The above definition clearly indicates SME those are covered and those who are not covered. It ultimately assists the SME owner to understand their position in terms of AREDP support in accordance with its objective.

It would be easier for BDS officer to explain the priority of government and AREDP to the SME owners.

### ASMED (Ref: Altai Consulting's report refers to the same definition as that by IFC)

**SMEs** are small and medium sized enterprises which employ up to 100 employees. In some cases, larger businesses will be tracked if they have substantial backward and forward linkages.

### MOCI (<http://moci.gov.af/en/page/6024>)

Enterprises	No. of Employees	Manufacturing sector investment in plant & Machinery	Services sector investment in equipment
Micro	<5	Up to AFN 2.5 million	AFN 1 million
Small	5-19	AFN 2.5-5 million	More than 2 million AFN but not exceed AFN 2 million
Medium	20-99	AFN 5-10 million	More than AFN 2 but does not exceed AFN 5 million

### Da Afghanistan Bank (DAB)

The enterprise employs between 10 and 100 person; *and* (ii) The enterprise's total assets are less than AFN 50 million (\$1 million), **or**

the enterprise's annual revenues are less than AFN 50 million (\$1 million), **or both**;

The loan amount is AFN 500,000 (\$10,000) or more. (Ref: khalil,A2F)

### IFC – Small and Medium Business Development Department

**Micro-enterprises:** up to 10 employees and total assets or total annual revenues of up to \$100,000;

**Small enterprises:** up to 50 employees and total assets or total revenues of up to \$3 million

**Medium enterprises:** up to 300 employees and total assets or total annual revenues of up to \$15 million.

[http://www.ifc.org/wps/wcm/connect/de7d92804a29ffe9ae04af8969adcc27/InterpretationNote\\_SME\\_2012.pdf?MOD=AJPERES](http://www.ifc.org/wps/wcm/connect/de7d92804a29ffe9ae04af8969adcc27/InterpretationNote_SME_2012.pdf?MOD=AJPERES)

## SME Definitions – Rest of the world

### EU

(Ref: The new SME definition, User guide and model declaration: European Commission -2005)

ECJ - An enterprise is 'any entity engaged in an economic activity, irrespective of its legal form'.

Enterprise category	Staff headcount (number of persons expressed in annual work units)	Annual Turnover	Annual Balance Sheet total
Medium Sized	<250	≤50 ml. euro	≤43 ml euro
Small	<50	≤10 ml euro	≤10 ml euro
Micro	<10	≤2 ml euro	≤2 ml euro

### India

(Ref: Bank of India and MSMED Act, 2006)

Enterprise	Engaged in Manufacturing / Preservation of Goods(incl. Processing Units)	Engaged In Providing/ Rendering of Services	Remarks
Micro Enterprise	Not to Exceed \$40,000.	Not to Exceed Rs. \$16,000	1. Separate threshold investment limits proposed by the Act for Manufacturing and Services Sectors.  2. Micro Enterprises newly introduced under both the sectors.
Small Enterprise	More than Rs.25 lakhs but does not exceed \$800,000.	More than Rs.10 lakhs but does not exceed \$322,000.	
Medium Enterprise	More than \$800,000 Rupees but does not exceed \$1,600,000.	More than \$322,000 but does not exceed \$800,000.	

### Pakistan

(SME Policy (2007) of SMEDA)

Enterprise Category	Employment Size (a)	Paid Up Capital (b)	Annual Sales (c)
Small & Medium Enterprise (SME)	Up to 250	Up to \$ 254,000	Up to \$2,548.000

Ref: [smeda.org.pk](http://smeda.org.pk)

Institution	Small	Medium
SME Bank	Total Assets of \$200,000	Total Assets of \$1,002,000million

## ANNEXES

Federal Bureau of Statistics	Less than 10 employees	N/A
Punjab Small Industries Corporation	Fixed investment. up to Rs. 20 million excluding land and building	N/A
Punjab Industries Department	Fixed assets with Rs. 10 million excluding cost of land	
Sindh Industries Department	Entity engaged in handicrafts or manufacturing of consumer or producer goods with fixed capital investment up to Rs.10 million including land & building	
State Bank of Pakistan (SME Prudential Regulations)	<p>An entity, ideally not being a public limited company, which does not employee more than 250 persons (manufacturing) and 50 persons (trade / services) and also fulfils one of the following criteria:</p> <ol style="list-style-type: none"> <li>1. A trade / services concern with total assets at cost excluding land and buildings up to Rs 50 million.</li> <li>2. A manufacturing concern with total assets at cost excluding land and building up to Rs 100 million.</li> <li>3. Any concern (trade, services or manufacturing) with net sales not exceeding Rs 300 million as per latest financial statements.</li> <li>4. Enterprises exporting up to US\$2.5 Million a year are considered Small by the State Bank of Pakistan</li> </ol>	



## Annex 4: Literature review and references

### Introduction

As per the Scope of Work detailed in the assignment ToR, we have undertaken a comprehensive literature review at inception phase, which has been further updated to take into account new findings during field-visits and additional references collected during the write-up of the report. Our findings from the review are detailed below, and can be broadly segmented into the following areas:

- **Understanding the context for SMEs:** We assess the SME literature from a cluster and sector point of view, and cross-reference this with an introduction of our findings for the context for women and women-owned enterprises, as well as assessing the conflict angle;
- **The demand side:** We then assess the literature on SME demand for BDS, skills and capacity building services; followed by literature on SME demand for access to finance and financial services;
- **The supply side:** After this, the supply and provision of BDS, as well as access to finance and financial products, is analysed – particularly in the context of donor and government support. This is then linked to the enabling environment;
- **Benchmarking – Review on PSD in conflict-affected countries:** Finally, we look at the experiences of PSD programmes in varying FCAS contexts. Firstly by other donors such as the Donor Committee for Enterprise Development (DCED), USAID, GIZ and the World Bank, and then followed by DFID;

### Understanding the context for SMEs – Clusters, sectors, gender and conflict

APPRO's findings from previous studies suggest that MSMEs are typically organised as clusters in urban and rural areas, where they simultaneously collaborate and compete. They have their own traditional vocational training system, have been around for generations, and are resilient to social and political upheaval. Analysis suggests they also have many needs that could be relatively easily addressed through PSD policy interventions. Among the needs identified in APPRO's cluster research are: access to micro finance, access to technology, knowledge of business management (including book keeping), access to domestic and regional markets, and knowledge of more efficient organization of work.

The following section, in line with the approach taken during field research analyses the data from both a cluster and sectoral perspective has been used. Similarly given the emphasis in field research on the political economy and the role of women in conflict, a similar focus on these topics has also been taken.

#### Clusters and sectors

##### Clusters

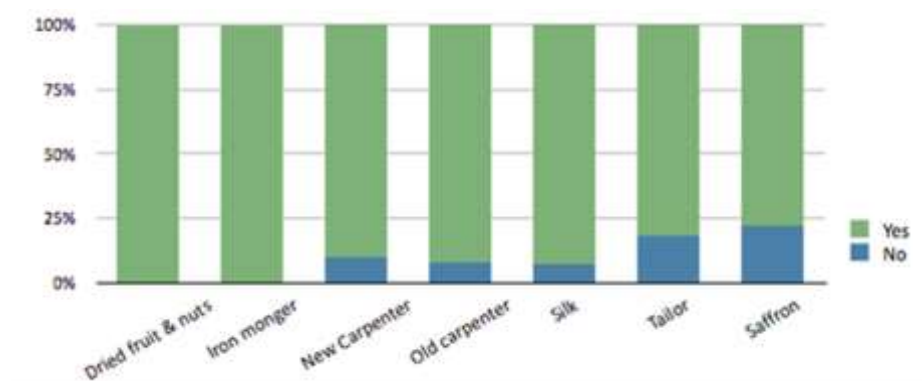
APPRO define an economic cluster as 'a localized network or geographically identifiable concentration of similar, related, or complementary businesses or producers bound together in a social division of labour'. Clusters 'may be vertically-integrated and consist of enterprises linked together through buyer-seller relationships or horizontally-integrated where the clustered enterprises share a common market for their end products, use similar technology, utilize the same labour pool, or depend on similar inputs'. The vast majority of enterprises (many of which are MSMEs) are embedded within clusters, as illustrated in Figure 1 below.

APPRO have found that, for a variety of reasons, traditional economic clusters<sup>238</sup> have persisted, some for more than 300 years, despite the recurring periods of instability. Moreover, they continue to provide livelihoods for urban and peri-urban households while generating added value for the domestic economy. Evidence on the economic and livelihood benefits of traditional economic clusters from studies in numerous developing and developed countries suggests that interventions to increase access to financial products, technology, skills and training, infrastructure development, and market intelligence are warranted and effective as means to enable clustered

<sup>238</sup> Within this context, these traditional clusters comprise of agri-food processors, iron mongers, carpenters, silk textile, tailors and saffron.  
SCOPING THE NEED FOR IMPROVED ACCESS TO FUNDING, ADVISORY SUPPORT AND BUSINESS SKILLS  
DEVELOPMENT FOR SMES IN AFGHANISTAN – SEPTEMBER 2014

small and medium-sized enterprises (SMEs) to expand, increase productivity, move up the value chain, and thus increase employment opportunities and contribute to economic wellbeing.<sup>239</sup>

**Figure A1: Enterprises belonging to a cluster**



Source: APPRO, 2012<sup>240</sup>

There are other authors in the field who have assessed the context of SMEs in cluster development. Parrilli (2007)<sup>241</sup>, focussing on developing countries, underlines the capacity of clusters to persist and survive, particularly in turbulent operating environments<sup>242</sup>. Similarly, Green (2005)<sup>243</sup> focusses on the interactions of Microfinance Institutions (MFIs) with clustered enterprises – this resonates most directly with the needs of traditional economic clusters in Afghanistan<sup>244</sup>. Specifically it was found that, due to the constraints on enterprise growth, innovation and access to markets arising from limited access to finance, improving the provision of financial services is a necessary condition for achieving cluster development in any country. Furthermore, in addition to promoting the development of clusters directly by improving enterprise performance, microfinance also has an indirect effect on cluster development through its impact on nutrition, health and education, which in turn increases productivity<sup>245,246</sup>. Others have assessed the main issues impeding SME growth. For example, the Afghanistan Research and Development Unit (AREU), in their most recent publication ‘SME Development and Regional Trade’ (2014), noted that the uncertainty and unpredictability of the business environment, dependence on donor organizations, lack of industrial level energy, access to markets, and a lack of clear links between the market-needs and what the education system offers were key constraints.

APPRO’s previous research findings indicate that despite the continued neglect by policy and policymakers, traditional economic clusters are able to persist and even expand. Indeed, they find that no formal links between clusters and policymakers aimed at strengthening and expanding clustered economic activities<sup>247</sup>. Given the resilient nature of traditional clusters (which comprise of many MSMEs) and the findings from others such as Green, coupled with the historical lack of aims and direction for policymakers, this presents a potential opportunity for future donor support, which we will explore within the next phase of the assignment.

<sup>239</sup> Afghanistan Public Policy Research Organisation, ‘Traditional Economic Clusters and Reconstruction in Afghanistan: The Case of Herat’, 2012

<sup>240</sup> Old carpenters are one of the most ancient clusters in Herat. This cluster is located in a small side alley off a main street that connects Chahar Su with the Iraq Gate. For the last 300 years the trade has been transferred through generations. In contrast, the new carpenters cluster is about 50 years old. It is the only selected cluster in Herat city that is not within the Old City.

<sup>241</sup> Afghanistan Public Policy Research Organisation, ‘Traditional Economic Clusters and Reconstruction in Afghanistan: The Case of Herat’, 2012

<sup>242</sup> Parrilli also argues that clustered SME development cannot be measured by quantitative indicators alone and requires an eclectic approach to establish the determinants of clusters as economic (joint actions, collective efficiency, external economies), governance-related (national and local policy inducement, social (social cohesion as a result of cooperative action, networking, and trust) and entrepreneurial spirit.

<sup>243</sup> Green, A. (2005). Combining Strengths: Synergies between Cluster Development and Microfinance. (Vienna: UNIDO)

<sup>244</sup> Focusing on microfinancing needs of clustered enterprises, this study was designed and conducted to establish demand features for microfinance products in seven traditional economic clusters in one of the major provinces of Afghanistan, Herat. The study sought to establish whether increased access to (micro) financial products could “trigger” cluster strengthening and/or better cluster performance and hence increase socio-economic benefits derived from clustered economic activity.

<sup>245</sup> Green, A. (2005). Combining Strengths: Synergies between Cluster Development and Microfinance. (Vienna: UNIDO)

<sup>246</sup> Nevertheless, stimulating the provision of microfinance is not a sufficient condition for pro-poor cluster development. Besides financial constraints, the economically active poor face a number of challenges, including lack of skills, information, quality products and markets that require urgent attention if cluster development is to make a significant contribution to poverty reduction.

<sup>247</sup> Afghanistan Public Policy Research Organisation, ‘Traditional Economic Clusters and Reconstruction in Afghanistan: The Case of Herat’, 2012.

## Sectors

During the inception phase, we met with DFID advisers in London. Our discussions disclosed that there are some key constraints specifically within the agriculture and agri-processing sectors. For instance, the supply of quality Afghan agricultural products needs to be improved, as there is a demand in the market for the Afghan brand, but the quantities and quality of produce is not to standard required by regional and international buyers and consumers<sup>248</sup>. Moreover, APPRO state that a large portion of raisins, almonds, and saffron produced in Afghanistan is likely to continue to be poorly processed or shipped in bulk to other countries for further processing and packaging. In part, this is due to a general lack of access to sufficient and adequate storage facilities, and production, processing, and transportation infrastructure. The impact of inadequate infrastructure is compounded by other factors such as lack of direct access to global markets, inadequate regulatory framework, poorly functioning ministries and cross-ministerial bodies, and a lack of rule of law and security. The most effective way to minimize the impact from these factors and to safeguard cash flow is to export produce and products as quickly and as conveniently possible. This often results in selling insufficiently or inadequately processed produce and unfinished products to intermediary countries for further processing and value-adding activities, the rewards for which go to other countries<sup>249</sup>.

With regards to the mining sector, Afghanistan's large resource base is undeveloped, even though the country is home to a portfolio of minerals ranging from well-documented assets such as copper, coal, iron ore, gold, gemstones and oil and gas, to more speculative deposits in those minerals and others such as lithium. From the SME and microenterprise perspective, there are opportunities to support small-scale mining and women jewellery producers.

As opposed to other minerals value chains, gemstones have the added benefit that most of the value chain can be developed domestically, thus forming a viable and strong sub-sector, with significant employment and skills creation, especially for women. Examples from other countries demonstrate the beneficial labour effects of women being integrated into the gemstone value chain at production, trading, cutting/polishing and jewellery design stages. As such, in the short run, smaller and traditional mines could contribute to Afghanistan's economic development<sup>250</sup>.

However, at current, the sector suffers from unlicensed operations, with miners often being underfunded, untrained, and ill-equipped. As a result, miners export only the raw, uncut stones across the border with Pakistan, and thus lose most of the value addition. Many gemstone mines are also subjected to looting and raids, and regulating illegal mining is currently difficult given the many vested interests involved in exploitation, smuggling and trading of gemstones. Not just this, but many livelihoods depend on the illegal mining and handling of gemstones, similar to that of opium production<sup>251</sup>.

## Government initiatives

Through developing their own SME Strategy Action Plan (2011), the Afghanistan Ministry of Commerce and Industries (MoCI) and Ministry of Agriculture, Irrigation, and Livestock (MAIL) have identified the following key facts about the Afghan Agri-business sector (Box 1)<sup>252</sup>.

### Box A1: Key facts about the Agri-business sector:

- SME constraints include a weak, risk averse sector, with limited access to capital, lack of exposure to innovation and technology, suspicion of outside world, and low capacity
- The sector constitutes 30.6 percent of GDP, with approximately 85 percent of Afghan population dependant on agriculture or agriculture related activities for their livelihoods (CSO, Afghanistan Statistical Yearbook, 2008-9)
- Horticulture and spices and medicinal plants present significant opportunities for export
- Cereals, animals products (meat, dairy, fish and honey), seeds and pulses have potential to substitute imports and meet significantly unmet demand (35 percent of Afghan population do not have sufficient

<sup>248</sup> Discussion with Jeremy Guthrie, DFID Investment Promotion Adviser, 2<sup>nd</sup> April 2014.

<sup>249</sup> Afghanistan Public Policy Research Organisation, 'Gender and the Agricultural Innovation System in Rural Afghanistan', 2011.

<sup>250</sup> World Bank, 'Islamic State of Afghanistan: Pathways to Inclusive Growth', 2014.

<sup>251</sup> Ibid.

<sup>252</sup> Implementing the SME Strategy – Action Plan for Agri-business Sector (MoCI and MAIL) 2011.

food)<sup>253</sup>

- Processing and packaging agricultural products adds value to the product(s) by increasing shelf-life, year round availability, flavour and attractiveness to the consumer
- There are challenges to processing and packaging. There exists infrastructural problems such as poor storage facilities, unreliable electricity, inefficient transport and lack of good packaging and labelling equipment; as well as capacity issues such as business planning and management skills
- Agriculture products represent 90 percent of licit exports (National Agricultural Development Framework, 2009) – dried fruit and carpets largest sub-sectors
- Traders face poor market linkages owing to limited access to and use of market information resulting in under-exploited markets in India, the Gulf and the West. Traders face barriers relating to corruption and bureaucracy at borders
- There is a lack of strategic focus and co-ordination around food safety and quality control efforts, which has held back progress on exports to markets globally
- There is an opportunity to take advantage of demand for organic produce and fair trade products in Western markets, as Afghanistan enjoys brand equity including reputation for ‘super foods’ and good tasting organic fruit and vegetables

The vision for Afghanistan is to become less dependent on international development assistance, and achieve levels of donor support consistent with other least developing countries by 2025<sup>254</sup>. The vision is embedded in the Afghan National Development Strategy (ANDS), and within it, the National Priority Programs (NPPs)<sup>255</sup>.

The NPPs highlight the need for investment in priority sectors that are critical to achieving economic growth: agriculture, mining and infrastructure (transportation, energy, and telecommunications). With regards to agriculture, the key constraints identified by the World Bank’s agriculture sector review (2014) are low agricultural productivity, low private investment, and poor rural infrastructure. Following this, the World Bank go on to state that the primary potential drivers of agricultural sector growth, job creation, and food security are improving irrigation water conveyance and use efficiency, increasing agricultural production (area), raising public investment in agricultural research and knowledge services and maximising job growth and inclusion by easing the constraints faced by poor households, smallholders, and women<sup>256</sup>.

From the microenterprise perspective, key constraints include the following.

- Lack of access to credit, marketing and technology. Smallholders are more likely to face strong financial constraints if they lack asset ownership that can serve as collateral or if they are reluctant to put at risk assets that are vital to their livelihoods. Smallholder farmers are therefore disadvantaged in accessing credit to finance productive investments because they lack the resources to take advantage of market opportunities and new productive technologies.
- Lack of crop diversification and of high-value commodities. Cash crops have traditionally been important sources of growth and employment in many parts of South Asia, and are more labour intensive than staple crops. Moreover, there are limited options for mechanisation and therefore well suited to small-scale production. Afghanistan has significant potential for increasing production of high-value crops, especially fresh and dried fruits and vegetables, to meet the expanding demand in the region and beyond. However, this potential remains largely unexploited due to poor marketing institutions, security concerns, and high transaction and transport costs resulting from low levels of infrastructure development.
- Socio-cultural norms, whereby men and women occupy different levels of the value chain (with women tending to occupy the lower levels). For example, this division of labour severely curtail women’s access to resources and services, including credit, training, and extension services as these opportunities are often based on land ownership and other privileges which are exclusively accessible to men only<sup>257</sup>.

<sup>253</sup> CSO, National Risk and Vulnerability Assessment, 2007.

<sup>254</sup> Government of Afghanistan. ‘Supporting Self-Reliance in Afghanistan. Strategic Vision for the Transformational Decade’. 2012.

<sup>255</sup> World Bank, ‘Islamic State of Afghanistan: Pathways to Inclusive Growth’, 2014.

<sup>256</sup> Ibid.

<sup>257</sup> Ibid.

SMEs involved in trade (including in agricultural products) face multiple problems that hamper their expansion. AREU state that the most serious of these constraints are political and security uncertainty and problems transiting the border, linked to corruption at customs and taxation offices<sup>258</sup>. Moreover, our initial findings indicate that, because the majority of Afghan SMEs remain informal<sup>259</sup>, Afghan exports are carried out by a mix of registered SMEs and commission workers who collect from small producers. Afghan officials also describe a “mafia”, with far-reaching ties within government, which exports to Pakistan and beyond, bypassing official quality control channels<sup>260</sup>. This impacts Afghanistan’s revenues as well as the perception of the quality of Afghan products<sup>261</sup>. It has been recognised that the GIRoA needs to simplify the licensing for SMEs if it wants to bring more of the sector under its formal supervision. The MoCI (2013) has found that between 70 and 80 percent developed informally and did not register with the authorities.

## Women

The GIRoA, with support from the international community, maintains gender equity as one of its principal concerns, and has committed to measurable improvements in women’s economic opportunities and access to and control over productive assets and income<sup>262</sup>. Gender equity is enshrined in the Constitution, while the GIRoA has signed a number of international protocols and agreements aimed at protecting gender equity – including the Convention on the Elimination of Discrimination Against Women (CEDAW)<sup>263</sup>. The number of women in business has steadily increased since 2001, mainly due to the commitment by the international community and the GIRoA to create and protect spaces for increased participation of women in social and economic life<sup>264</sup>.

By all accounts, the situation of women in Afghanistan has therefore improved significantly since 2001, creating numerous opportunities for women to set up their own businesses. The majority of Afghan businesswomen started their businesses in the last 10 years with the number of businesswomen progressively increasing in the last five years to 2013. Many of these businesswomen are young, having come of age during the post-2001 period, have some education, and are fully supported by their families to work in business. The estimates for the number of businesswomen in Afghanistan range from around 20-30 to a few hundred.<sup>265,266</sup>

However, without an enabling and appropriate environment for work that is rooted in a policy framework, capable women will not realise their full potential because companies are hesitant to give them opportunities. Women’s businesses also suffer from management capacity. For example, some are run with an “NGO-like mentality,” and therefore struggle in the face of competition. In the case of women-led businesses, the challenges are exacerbated by social limitations, as the support for women to work outside home seems to be declining<sup>267</sup>. A recent survey found that support for women to work outside the home fell from 71 percent in 2006 to 63 percent in 2013<sup>268</sup>.

Since 2006, security has steadily deteriorated and a number of earlier gains in gender mainstreaming have been rolled back or are being increasingly threatened. The steps taken by humanitarian aid organizations to negotiate settlements with armed opposition groups as a means to continue service delivery run the risk of further rollbacks of women’s rights, and even the potential obliteration of the many gains made since 2001.<sup>269</sup> Also, a round of interviews conducted by APPRO in June 2011 revealed that women’s rights groups in Afghanistan felt excluded from, and uneasy about, joining the peace negotiations<sup>270</sup>.

<sup>258</sup> Afghanistan Research and Development Unit ‘SME Development and Regional Trade Working Paper, 2014.

<sup>259</sup> According to the MoCI (2013) Between 70 and 80% remain informal and unregistered, largely pushed to the margins out of fear of entanglement in bureaucracy and corruption.

<sup>260</sup> This has been confirmed by several interviewees, in confidence, that there has been a recent increase in bureaucratic interference and opportunities for corruption at customs, tax and licensing stages, creating a clear disincentive to formalise.

<sup>261</sup> Afghanistan Research and Development Unit ‘SME Development and Regional Trade Working Paper, 2014.

<sup>262</sup> Afghanistan Public Policy Research Organisation, ‘Gender and the Agricultural Innovation System in Rural Afghanistan’, 2011

<sup>263</sup> Afghanistan Public Policy Research Organisation, 2014.

<sup>264</sup> APPRO, 2014.

<sup>265</sup> Ibid.

<sup>266</sup> There is a wide gap between the implied number by Building Markets (2013) of a few hundred and figures from Export Promotion Agency of Afghanistan of around 20.

<sup>267</sup> Afghanistan Research and Development Unit ‘SME Development and Regional Trade Working Paper, 2014.

<sup>268</sup> The Asia Foundation, 2013.

<sup>269</sup> See, for example, APPRO (2014), “Transition and NGOs: An Assessment and Prospects”, available from:

<http://appro.org.af/preview/transition-and-ngos-in-afghanistan-an-assessment-and-prospects/>

<sup>270</sup> APPRO, 2014.



## Women in agriculture

Within the rural context, apart from home-based handicraft production including carpet weaving and needle working, agricultural value chain employment is the only viable area for rural Afghan women to work outside their unpaid domestic responsibilities<sup>271</sup>. Afghan women play various roles in weeding, watering, harvesting, cleaning, drying, and grading activities within the grape/raisin, almond, and saffron value chains. However, their presence and prominence diminishes and almost disappears as one moves up these value chains. APPRO has conducted research into women's work in the three value chains, and has found that, particularly at the low end, the work is mostly unpaid while they are paid lower than men for comparable jobs further up the value chains. At the lower end of these value chains the women's involvement is versatile and flexible, allowing for economically optimal though socially inequitable female labour input which has been pointed to as a key reason for economic productivity in value chains around the world<sup>272</sup>. Key facts pertaining to Afghan businesswomen are included in Box 2 below.

### Box A2: Women in agricultural value chains in Afghanistan – Raisins, almonds and saffron

A gender-disaggregated study of raising almond and saffron value chains in 2011<sup>273</sup> shows that because men and women perform different functions, the difference in their wages is not comparable. Rural women perform harvesting and post-harvest processing of raisins, almonds, and saffron as a part of household chores; thus, their work goes unpaid. In the case of saffron, however, some women (most likely from women producer associations) are hired by small- or large-scale farmers at Afs 200-300 per day, because these activities are highly labor-intensive and time-bound. A similar wage (Afs 100-200 per day, or Afs 100 per 50-kilogram processed) is paid to women in urban or peri-urban areas, who are hired by processors or wholesalers to clean, sort, grade, and package raisins or almonds for national, regional, and international markets. Post-harvest processing is among the lowest paid work, in which men – who have other opportunities – would not be interested. For example, male laborers, who are hired by exporters to harvest, pack, and load crates of fresh grapes, are paid Afs 400 per day.

The above case studies show that it is vital for women producers to, firstly, remain in charge of harvesting and post-harvest processing and, secondly, be provided with women-to-women service delivery.

The World Bank (2014) has identified that in rural settings, female involvement is significantly higher than in cities, due to the predominance of agriculture as the main employment sector. Over half of the female workforce is engaged in agriculture. However, employment in agriculture tends to produce low earning for women, largely because most farms practice subsistence farming or because women are typically confined to activities that are not related to decision making or brokering trade exchanges with the market<sup>274</sup>.

It should be noted that Afghanistan has comparative and competitive strengths in the agriculture sector, particularly in the horticulture and livestock sub-sectors, in which women participate, largely in the primary stages of production and processing<sup>275</sup>. Moreover, future policy development and interventions to regenerate and strengthen agricultural production in Afghanistan will need to be guided by the learning from what has been accomplished to date, the intervention failures, and the creation and/or identification of new problems and challenges<sup>276</sup>.

As APPRO state, it should be noted that Afghan women's role in rural agricultural production needs to be differentiated from other rural value chains studies from around the world. Comparisons of Afghan women in rural production to that of women in Africa, for example, while useful for guiding the general approach to gender mainstreaming, have to be nuanced and contextualized to fit the Afghan conditions, particularly in relation to religious / traditional and renewed sensitivities about women's role in social, economic, and political activities<sup>277</sup>.

## Beyond agriculture

Beyond agriculture, there exists a large gender disparity in the non-agricultural private sector, mainly as a result of acute barriers to participation, since finding work in private enterprises often depends on activities and networks of

<sup>271</sup> Afghanistan Public Policy Research Organisation, 'Gender and the Agricultural Innovation System in Rural Afghanistan', 2011.

<sup>272</sup> Ibid.

<sup>273</sup> World Bank, 'Understanding Gender in Agricultural Value Chains: The Cases of Grapes/Raisins, Almonds and Saffron in Afghanistan', 2011.

<sup>274</sup> World Bank, 'Islamic State of Afghanistan: Pathways to Inclusive Growth', 2014.

<sup>275</sup> Afghanistan Public Policy Research Organisation, 'Gender and the Agricultural Innovation System in Rural Afghanistan', 2011.

<sup>276</sup> Ibid.

<sup>277</sup> Ibid.

relationships that take place outside the home. Other key obstacles to employment within the private sector include limited mobility, little social acceptance and the necessity to balance childcare and household chores with work<sup>278</sup>.

The World Bank (2014) identify key challenges to inclusive growth – particularly where this relates to the involvement of women. Their key findings relating to women in the Afghan labour force are as follows:

- Labour force participation is generally low and characterized by a large gender gap and a strong urban-rural divide.
- The labour force is male-dominated, due to significantly lower female participation rates.
- Literacy levels in the Afghan working-age population are extremely low, especially among adults and women.

Figure A2 below provides more details relating to the position of women in the Afghan labour market.

**Figure A2: Labour market indicators in Afghanistan**<sup>279</sup>

	Labour force participation rate	Employment to population ratio	Underemployment rate	Unemployment rate
<b>Urban</b>	<b>43.1</b>	<b>39.2</b>	<b>8.6</b>	<b>9.0</b>
Male	72.0	66.5	7.7	7.7
Female	12.9	10.8	14.1	16.7
<b>Rural</b>	<b>51.3</b>	<b>47.1</b>	<b>18.7</b>	<b>8.2</b>
Male	82.1	77.1	17.5	6.1
Female	19.3	15.9	24.0	17.6
<b>National</b>	<b>49.8</b>	<b>45.7</b>	<b>16.8</b>	<b>8.2</b>
Male	80.0	74.9	15.4	6.4
Female	18.5	15.5	22.8	16.5

Source: NRVA 2011/12

There are no simple solutions to reducing the gender gaps in countries where the gap is deeply rooted in cultural and social practice. However, there are a range of instruments available to promote female employment within the Afghan context, including mainstreaming gender in agriculture value chain programmes, providing women with better access to health and education services, providing incentives for female employment, providing incentives and regulations for better childcare, mobility and women-friendly work places, and encouraging active participation of women in access to finance programmes<sup>280</sup>.

#### Box A3: Afghan Businesswomen Statistics - National

- Over 5,500 workers are employed by businesswomen
- 78 percent of women-owned businesses are small businesses (1-10 employees)
- 81 percent of these businesses are unable to access credit or financing
- 38 percent of the women report a monthly income between AFN 30,000 and more than AFN 50,000 (545 to more than 908 USD) with over half in the highest income bracket
- Around 80 percent of the women have attended an institution of higher education
- Women work in a wide variety of sectors, many of which are non-traditional, and in multiple sectors including

<sup>278</sup> World Bank, 'Islamic State of Afghanistan: Pathways to Inclusive Growth', 2014.

<sup>279</sup> Underemployment defines all persons aged 14 and over who, during the reference period of one week, were (i) working less than 40 hours, and (ii) available and willing to work additional hours. Unemployment defines all persons aged 14 or over who, during the reference period of one week, were (i) without any work or working less than eight hours, and (ii) seeking work.

<sup>280</sup> World Bank, 'Islamic State of Afghanistan: Pathways to Inclusive Growth', 2014.

construction and construction materials which represented 24 percent

- 47 percent do business with the international community in Afghanistan
- 40 percent do business in the domestic market
- 13 percent have business opportunities with the GIRoA
- 90 percent do not have partnerships with other businesses or institutions
- 75 percent do not belong to business associations
- Most needed help: marketing support, access to buyers, financial management and technical support
- Challenges: Not being taken seriously in the business world, corruption, lack of capital, and insecurity

Source: *Building Markets* (2013), in *APPRO* (2014)

### Conflict, violence and corruption

Despite apparent significant urbanization trends, Afghanistan remains a rural and patrimonial society with a largely agricultural economy, and includes diverse ethnicities. Sub-ethnic entities at local level, such as tribes and clans, form the foundation of the Afghan political and social landscape.<sup>281</sup> This is reflected at times through violent conflicts over power and resources. The civil war of 1992-1996 revolved around ethnic power dynamics- the makeup of the 2014 Presidential tickets also reflects this social trait. The Afghan population is almost 100 percent Muslim, with a small Hindu minority whom the representatives elected by the majority are not yet ready to welcome or accommodate. Any intervention in Afghanistan must therefore take into account the role of religion and local interpretations of religion as a basis for understanding commonly-observed behaviours such as misogyny<sup>282</sup>.

### Conflict and Governance

As the World Bank (2014) recognises in its report 'Islamic State of Afghanistan: Pathways to Inclusive Growth', Afghanistan is beset with a range of conflicts, and its conflict vulnerability is inherently complex. Violence is present in the form of local intergroup conflicts involving militias, conventional political conflict to seize state power – as is the case with the Taliban offensive, widespread gang-related violence in the form of warlordism, organised crime and trafficking – especially relating to opium production and trade, and local conflicts with transnational ideological connections – such as Al-Qaeda. Moreover, these conflicts are partially interdependent and fuel each other, such as the illegal trafficking of opium which is also an important source of finance for armed groups in Afghanistan (UNODC, 2010)<sup>283</sup>

It is difficult to quantify the impact of conflict on Afghanistan's overall economy, specific MSMEs, and individual livelihoods, but there are numerous empirical studies which point to a large negative impact on growth, poverty and equality.

#### Box A3: Quantifying the impact of conflict

The effects of an on-going conflict on economic growth and poverty reduction have been confirmed in many studies<sup>284</sup>. For example, economic growth is directly affected through destruction or lack of maintenance of crucial infrastructure, lack of incentives to invest in physical capital, and the decrease in available labour for productive activities. It is primarily young men that are pulled into different forms of violence at the expense of seizing job opportunities. In addition, fiscal expenditures that could have been used for productive investments may in a conflict environment be directed towards the military or security forces.

Indirect effects often include a slowdown in human capital accumulation, due to the inability to frequently visit schools, the destruction of school infrastructure, or a diminished return on investments in human capital due to the risky environment (for example, children are kept at home). Conflict also has a distributional aspect – geographically but also in terms of income since the most vulnerable groups are frequently the most affected by conflicts. On

<sup>281</sup> Felix Kuntzsch, 'Afghanistan's Rocky Road to Modernity: Non-State Actors and Socio-Political Entities in the Process of State- and Nation-Building', 2008.

<sup>282</sup> Nijat, A. Afghanistan Research and Evaluation Unit, 'Governance in Afghanistan: An Introduction, 2014.

<sup>283</sup> World Bank, 'Islamic State of Afghanistan: Pathways to Inclusive Growth', 2014.

<sup>284</sup> Such as Bray, J. 'The role of private sector actors in post-conflict recovery', 2009; Goriunov, J.D. 'Job creation in fragile states through SME financing: Notes from post-war Liberia', 2011; and, Berdal, M. & Mousavizadeh, N. 'Investing in peace: The private sector and the challenges of peacebuilding', 2010.

average, a country in conflict over the period 1981-2005 had a poverty rate 21 percent higher than an average country without violence.

The effects of conflict are long-lasting. After peace, it takes an average of 14 years for a country in civil war to get back on the same growth path (Hoeffler, von Billerbank, and Ijaz, 2010), and 20 years on average to recover to the same trade levels (Martin, Mayer, and Thoenig, 2008). The main challenge is to reassure investors, domestic and international, to re-invest in the economy. Cross-country panel data estimates suggests a cost of civil war was equivalent to 1.6-2.3 percent of GDP per year of violence (World Bank, 2011b)<sup>285</sup>.

## Trade and Conflict

According to the AREU, for Afghan traders, conflict and corruption have a number of negative impacts. In the east, the Pakistani border is unreliable, with the gate closing down frequently due to protests over drone strikes. In the north, the freight capacity to carry goods is limited, with only up to four trains operating weekly. Moreover, the railway is only used for imports. The trains bringing goods into Afghanistan return empty because Uzbekistan only allows Afghan goods to arrive via ship. This leaves room for corruption. Additionally, because of corruption, transit goods coming from Pakistan are sometimes prioritised over local produce<sup>286</sup>.

Afghan observers/analysts also describe a “mafia”, with far-reaching ties inside the government. This “mafia” controls exports to Pakistan and beyond, bypassing the official quality control channels. This impacts Afghanistan’s revenues as well as brings down exports. In some cases, onions for example, the product exported by the mafia re-enter the Afghan market at a price three-to-four times higher than the original price. The mafia is also known to import low-quality foreign dried fruit, such as Iranian and Brazilian almonds, mix it with Afghan dried fruit, and re-export it, again bypassing quality control. This affects the perception of the quality of Afghan products and, in this case, decreases demand for Afghan dried fruits<sup>287</sup>.

## The Demand Side

### SME demand for BDS, skills and capacity building services

The demand by SMEs for Advisory Support and Business Skills Development services (in other words, Business Development Services, henceforth BDS) appears to be significant for high quality yet affordable BDS<sup>288</sup>. However, a wide range of empirical research indicates limited willingness to pay for such services by SME owners/managers<sup>289</sup>, as well as a gravely underrated perception of the value of BDS providers in the market<sup>290</sup>.

In 2013, the government identified specific advanced level skill needs in five focus sectors: mining; railways; food processing, packaging and storage; carpet weaving; and hotel management and tourism. Furthermore, specific occupations and skills’ needs across these five sectors were identified based on recommendations, for which the Ministry of Labour and Social Affairs, Martyrs and Disabled (MoLSAMD) is developing 40 National Occupational Skills Standards. It is these identified 40 technical skills that are supposed to be delivered by 90 Afghan Technical Vocational Institutes and Schools across Afghanistan<sup>291</sup>.

The Labour Market Intelligence Report (2013) provides an analysis for meeting the critical shortage of skilled and semi-skilled workers in Afghanistan. Since the access to this specific report is unavailable, there is a limitation to appreciate whether the regional context of decision to hire or retain ‘employees’ based on acquired vocational skills has been taken into consideration. It is worthy to note that the third party evaluation of the Introducing New Vocational Education and Skills Training (INVEST) program suggests that in the context of Helmand, the decisions to hire and retain “employees” are more influenced by tribal and kinship relations than concerns for individual merit

<sup>285</sup> World Bank, ‘Islamic State of Afghanistan: Pathways to Inclusive Growth’, 2014.

<sup>286</sup> Afghanistan Research and Evaluation Unit, Small and Medium Enterprises Development and Regional Trade in Afghanistan (Working Paper), Mujib Mashal, 2014

<sup>287</sup> Ibid.

<sup>288</sup> Afghanistan Small and Medium Enterprise Development BDS sector assessment - 2011, GIZ-BDS report.

<sup>289</sup> Afghanistan Small and Medium Enterprise Development BDS service assessment, GIZ –BDS-2013.

<sup>290</sup> Afghanistan Small and Medium Enterprise Development - 24pg GIZ-BDS mapping 2013.

<sup>291</sup> HAKAKAT, 2014.

and vocational skill<sup>292</sup>. It further proves the highly unlikely situation where an individual in Helmand would work for a business or employers who are unrelated to them.

Lack of skilled labour was supposedly observed as not a major constraint to business growth among the small businesses in Kabul city<sup>293</sup>. Out of 107 respondents, only 14 percent proposed lack of skilled labour as a constraint to their business. In addition, lack of skilled labour was projected as a constraint by just 4 percent SMEs in Afghanistan Rural Enterprise Development Program's (AREDP) SME survey report of 2009. Moreover, an exhaustive research on business enterprise by AsDB in 2009 suggests only 17 percent of enterprises identified 'lack of labour' among all problems faced by businesses in Afghanistan. Finally, 'Inadequate Educated Workforce' ranked 9<sup>th</sup> with only 4 percent of SMEs considering it as major obstacle to business in the Enterprise Survey report, IFC Afghanistan Country Profile 2014.

Consequently, a cautious observation would be required on the assumption that SMEs/businesses all across Afghanistan would absorb significant portions of labour based on their acquired merit, higher skill and/or vocational skill. Nevertheless, institutional trainings could make valuable contributions to improving household resilience and sustaining livelihoods or encourage entrepreneurs to venture into wider schemes of family diversification strategies specifically in the case of micro and small enterprises.

The scope of this study does not include sole entrepreneurs' needs or demands for BDS services. However it could be safely assumed that specific BDS linked directly to an increase in revenues is likely to be ranked highest among the needs by micro enterprises, as the experience of Hand in Hand International shows<sup>294</sup>. Though, the willingness or capacity to pay for such services remains unexplored, and these would, conceivably, be significantly weak, for micro and smaller enterprises.

Largely, literature supports the notion that demand for quality and affordable BDS services by SMEs does exist. However, the willingness to pay for such services would be subjected to a perceived intangible value of the specific BDS or BDS provider's ability to deliver quality service. The capability of BDS providers' market to respond to the fast evolving demand for affordable high quality service, specialized technical needs or advance level skills are expected to remain major issues, at least for the next 5-10 years. However, the demand for payable BDS services may continue to be considerably weak as compared to tangible goods or services.

USAID's Afghanistan Small and Medium Enterprise Development (ASMED) BDS Service Assessment Report (2011) specifically underlines: *'the real challenge is that the private sector does not have a clear idea of what it needs or why it has the needs it does. As a result, [they] as a collective group, cannot judge the value of BDS very clearly.'* Correspondingly, BDS as a constraint to the ability to grow is ranked 4th in Southern Afghanistan while only one third of business members of the Chamber of Commerce want a provision of such services<sup>295</sup>. The Center for International Private Enterprise (CIPE) Afghan Business Survey Report 2009-2010 also highlights that a mere 1 in 10 members claimed to be receiving advice on business development, advocacy and legal services from the Chamber. Interestingly, many small businesses are seeking traditional BDS, often unofficially, directly from their neighbourhood BDS providers<sup>296</sup>. The knowledge of the nature of services solicited is unclear, as is the length of time businesses have been employing such 'unofficial services'. However, the report highlights the demand from businesses for professional support on Marketing which was ranked as the highest, followed by Finance & Accounting and Sales. The demand for BDS needs by SMEs/business can be typically categorised into common needs (cross cutting needs, irrespective of the sector or nature of business) and technical needs (special needs, specific to the business). These common and technical needs could be of basic or advanced in nature, varying from case-to-case. Besides, the needs could graduate from basic to advanced level, depending on the evolving context of individual businesses.

Even though ASMED was not functional throughout Afghanistan, its Business Development Services Sector Assessment (2007) appears to be in line with the demand of BDS recommended in other research reports (such as GIZ-BDS; Assessment of Business Training Centers in Afghanistan, USAID 2008). The report specifically ranked the services in demand for which business owners or Managing Directors expressed willingness to pay with an acceptable level of work quality.

<sup>292</sup> Mid-Term Review of the Introducing New Vocational Education and Skills Training (INVEST) Programme. Coffey, 2012.

<sup>293</sup> HAKAKAT- Informality and Small Business Development in the City of Kabul, 2011.

<sup>294</sup> <http://www.hihinternational.org/Where-We-Do-It/Afghanistan.aspx>.

<sup>295</sup> Center for International Private Enterprise (CIPE) Afghan Business Survey Report 2009-2010.

<sup>296</sup> Assessment of Business Training Centers in Afghanistan, USAID 2008.



In addition to the above data, the World Bank's Enterprise Survey Report (2008) of over 1000 firms, identified gaining market knowledge, improving product quality to comply with international standards, building competitiveness, and regaining of market presence as the immediate business development assistance desires as well as needs for long-term growth. Regarding identifying leading constraints in SME skills and training, AREDP's SME Survey Analysis Report (2009) highlighted 'technical training' as highest in demand, followed by business management, and then financial management – despite the fact that 77 percent of SMEs had attended different types of training. The major problem reported by SMEs was that training provided to them was either of very short duration and/or not focused on their needs. With regards to access to information, the survey specifically indicated that marketing information and technical information were the leading constraints for SMEs. Overall, training and education was identified as the 4th biggest constraint by 6 percent of the respondents, in a sample of 1087 SMEs from 80 different types of business across 33 provinces.

Meanwhile, our discussion with the World Bank office in New Delhi regarding their Afghanistan New Market development Project (ANMDP) project divulged an encouraging response to matching grant fund from the SME sector. The ANMDP team acknowledged two sects of SMEs – those who were well-versed with the donor application process and compliances; and those who were entirely new to such a system<sup>297</sup>. Thus, it is likely that the latter group of SME applicants would demand more BDS services as compared to the former. Essentially, it highlights the demand for BDS services by SMEs for donor-driven application systems and/or compliance.

### **SME demand for access to finance and financial services**

#### **General context of Access to Finance in Afghanistan**

Even though there has been a recent announcement in autumn 2013 that 3 million people have bank accounts in Afghanistan<sup>298</sup>, we have yet to identify the evidence. The latest data coming from the Findex database<sup>299</sup> are based on a 2011 survey, which finds that: 9 percent of Afghans aged 15 or more have an account in a formal financial institution; 3 percent saved in a formal institution and 3 percent in savings clubs (there are overlaps); 5 percent had a credit card; and 7 percent had a loan. Moreover, according to Findex, it is very likely that this data is over-representing the 7 percent of salaried people, including from the public sector, whose accounts are "used to receive wages".

Data on microbusinesses is more difficult to come by. Most Afghan SMEs go about their business without recourse to formal financial services. According to MISFA data, only 3.4 percent of firms in Afghanistan held a bank loan or line of credit in 2008, compared to an average of 30 percent in South Asia; and only 1.4 percent of Afghan firms use banks to finance their investments, compared to a south Asian average of 15 percent. In addition, according to the CIPE 2009<sup>300</sup> survey, businesspeople rely on the profits generated by their activities, as well as relying on their own savings, and if needed on friends and family support, to re-invest in their business. Based on data from six large Afghan urban centres<sup>301</sup>, only 7 percent of these enterprises use bank loans.

#### **Access to finance at the bottom of the pyramid**

A recent paper published by the PEAKS Resource Centre for DFID Economists and Private Sector Advisers<sup>302</sup> summarises the evidence of the benefits of financial sector development on growth and jobs, and concludes that the long assumed idea that barriers to financial inclusion impede enterprise growth.

It appears to the reviewers that some findings by leading authors in the field, such as Beck, Levine, Kappler and Demirgüç-Kunt, may have to be further nuanced by a few observations specific to the Afghan context:

- Access to finance is only quoted as the 4<sup>th</sup> most critical barrier in the latest 2014 WB Enterprise Survey<sup>303</sup>. However, a higher proportion of firms in Afghanistan identify access to finance as a major constraint (43.6 percent), compared to the South Asia (33.4 percent) and the international average (31.2 percent);

<sup>297</sup> Discussions with the World Bank in New Delhi – 3<sup>rd</sup> April 2014.

<sup>298</sup> Announcement during the "Access to Finance (A2F) Exhibition in Kabul" by the Afghanistan Banks Association (ABA), an event jointly organised with USAID in October 2013.

<sup>299</sup> Findex is an initiative supported by the World Bank Group and the Gates Foundation to collect data on financial inclusion - <http://datatopics.worldbank.org/financialinclusion/country/afghanistan>.

<sup>300</sup> Centre for International Private Enterprise – Survey of the Afghan business community in 6 major cities in Dec09-Jan10.

<sup>301</sup> WB-IFC 2008 Enterprise Survey <http://www.enterprisesurveys.org/Data/ExploreEconomies/2008/afghanistan#finance--size>.

<sup>302</sup> Economics Topic Guide: Financial Sector by Howard Miller and Subhrendu Chatterji - October 2013

<sup>303</sup> World Bank/IFC Enterprise Survey - 356 enterprises between May and July 2013 including 229 SMEs. Access to finance is cited as number 4 challenge – 14.4 percent - after "political instability, corruption and access to land".

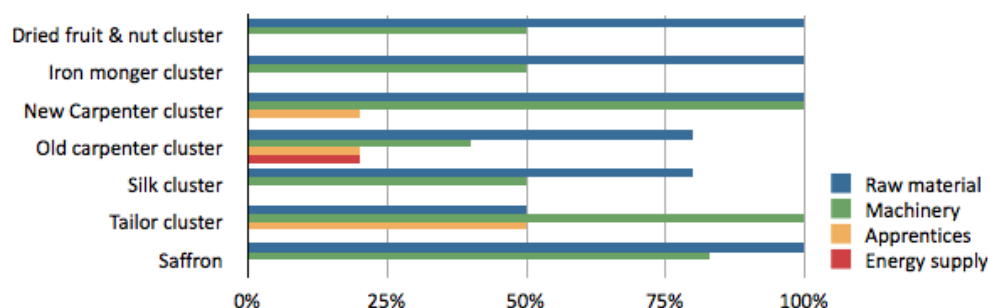
- Most of the data available in Afghanistan usually refers to enterprises in four or six urban areas, and therefore may not represent remote rural areas and southern provinces most-affected by physical barriers to access finance, and the insufficient technology available to develop mobile services;
- The PEAKS paper states that “the issue is not only access to any form of finance, but also the quality of financial services available to people. That is, access alone is not sufficient to ensure welfare-enhancing outcomes if the services are not responsible, convenient, appropriate to meet needs etc.”

Consistent with DFID policy over the last 15 years, financial sector development has a wider policy dimension of public good; including macro-stability; payment function; savings and (micro)insurance as buffer against shocks; fight against money laundering and other illicit activities. This is why DFID and other donors, supported by the World Bank Group and the G20, are investing heavily in interventions that address systemic weaknesses. Admittedly, these initially benefit larger SMEs first, but are nonetheless essential building blocks for the wider market.

### Clusters and Demand for Financial Services

A report by APPRO (2012) found that on-going information sharing on factor prices, production methods, bulk purchasing of input materials, and order sharing appear to be the fundamental benefits of being in a cluster. Competition usually occurs in design, quality, production speed, and in some cases, after sale service. Thus, all clusters can benefit from more modern tools and machinery, and production techniques. Recognising this need, all clustered enterprises expected that increased access to loans on acceptable terms would allow them to have better performance and more possibilities for expansion. Some cluster members have borrowed on interest but the vast majority object to interest-bearing loans on religious grounds.<sup>304</sup>

**Figure A3: Most urgent uses of credit – All clusters**



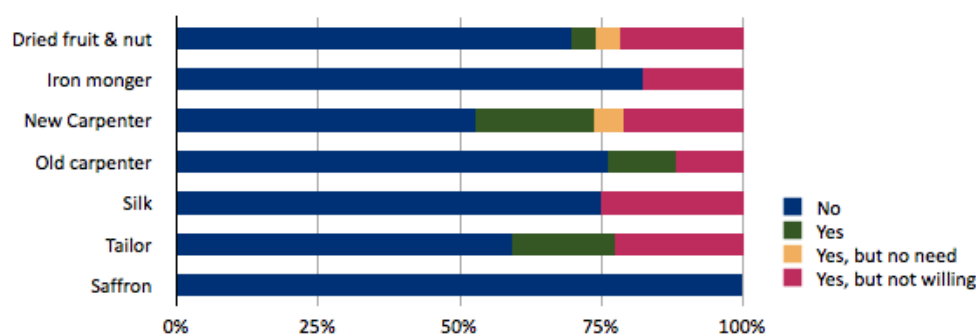
Source: APPRO, 2012

There is therefore significant demand for credit, although not without strong reservations about paying interest and the inability to protect against risks of borrowing. On the assumption that loans could be obtained in consistency with *Sharia* values, there would be additional concerns regarding interest rates, short duration of the repayment periods, and collateral requirements of the formal lending sources. Acquisition of modern tools and machinery through increased access to loans would need to be accompanied by relevant training, and in conjunction with pre-existing forms of learning through the apprenticeship system.<sup>305</sup>

Some studies put access to electricity and transport infrastructure before access to finance as key constraints.

<sup>304</sup> Afghanistan Public Policy Research Organisation, 'Traditional Economic Clusters and Reconstruction in Afghanistan: The Case of Herat', 2012.

<sup>305</sup> Afghanistan Public Policy Research Organisation, 'Traditional Economic Clusters and Reconstruction in Afghanistan: The Case of Herat', 2012.

**Figure A4: Current demand to formal credit for traditional clusters**

Source: APPRO, 2012

## The Supply Side

### Supply and provision of business development services

#### Development of Business Development Services (BDS)

In Afghanistan, the development of the private sector began to emerge as priority for government agencies back in the mid-2000s. Despite this, the government did not have an SME strategy until 2009, and its implementation did not begin until 2011<sup>306</sup>. However, there were several interventions to meet the BDS demand of SMEs prior to 2009, such as ASMED (2006-11), National Area-Based Development Program (NABDP) (2002 onwards) followed by AREDP (2009-14); Microfinance Investment Support Facility for Afghanistan (MISFA); Mercy Corps; Asia Foundation; Aga Khan Foundation, and many other International Non-Governmental Organisations (INGOs) working in remote pockets of the country. In the past decade, typically, a combination of two strategies has been adopted to ensure supply against the rapidly evolving BDS needs of SMEs. These are: 1) To outsource BDS to local BDS firms and/or train them to improve their quality for better performance; 2) To provide direct BDS support to SMEs by training internal national staff and/or hiring competitive national or international firm/expert/advisors/specialists.

#### Approaches to the Development of BDS

Currently, a major portion of the supply of advisory support, BDS and technical support are covered by donor-funded programmes<sup>307</sup>. Along with these, several eminent INGOs also offer services attempting to meet the needs of micro and small enterprises, such as Aga Khan Foundation, Mercy Corps, Peace Dividend Trust and Afghanaid. An innovative and interesting market-based firm is the Afghanistan Growth Finance, established in 2007 by Small Enterprise Assistance Funds (SEAF), which supports larger SMEs through commercial financial products combined with advisory services.

The strategy by donors to outsource BDS services has been promoted extensively since the launch of ASMED. BDS providers could be private Business Training Centres, institutions, or local consultancy firms. A follow-on assessment report of Mapping of BDS providers in Northern Afghanistan in 2013 highlighted the core challenge as achieving the collective objectives of impact, outreach, cost efficiency and sustainability. Furthermore, the actual satisfaction with a BDS service is proved often a problem, usually due to a mismatch in the requirement and provision or due to the quality of service<sup>308</sup>. GIZ/GFA BDS project in the North identified Haraqat Moafaq, Skill Tree BDS and Ether BDS among the top performing suppliers. Despite assisting BDS providers for 4 years, the project is restricted to bringing systemic change in the distorted market of BDS services<sup>309</sup>. It is evident that

<sup>306</sup> Afghanistan Research and Evaluation Unit. 'Small and Medium Enterprises Development and Regional Trade in Afghanistan' Working Paper 2014.

<sup>307</sup> Such as ABAD (2013-17); ANMDP (2012-16); NSDP & DM-TVET; Program II: National Comprehensive Agricultural Production and Market Development of Agriculture and Rural Development (ARD) clusters i.e. ADF (2010-14), CARD-F, IAPFE, AREDP and EVC (2012-16), MISFA as well as programs supported by Japan, Germany, Canada, and Norway. Some institutional BDS support is also delivered by ACCI; AISA; EPAA; HARAKAT; Business Courses & Enterprise incubator support (needs to be confirmed) offered by Professional Development Institute of American University of Afghanistan.

<sup>308</sup> AREDP Enterprise Survey 2009, BDS Mapping 2014.

<sup>309</sup> BDS mapping report 2014.

sustainability issues, services with real market value, and market competition for most of the firms resulted in severely limiting the success of such a strategy.

The assumption to provide high quality BDS services at affordable rates by charging a fee to SMEs, instead of being exorbitantly paid by donor funded programmes has its risks. In such an approach, most service providers – especially ones not based in Kabul – are susceptible to experiencing a sharp fall in their revenues, which may result in poor talent retention, impact profitability and longevity. Nonetheless, BDS providers do tend to reach out to MSMEs in their given capacity, context and service quality. This further leads to achieving the output of the programmes and have a partially successful impact. Our current understanding is that the literature appears to be silent on appreciating that such a strategy may not ensure a supply of BDS beyond the duration of donor funding, particularly for micro and small businesses. However, BDS providers' assistance could be supportive in reaching out to beneficiaries and achieving programme targets.

The alternative strategy of providing direct BDS support to SMEs by training internal staff, training of the trainers or hiring national or international expert/advisors/specialists is adopted by large donor funded programmes<sup>310</sup>, as well as INGOs. Technical assistance/BDS support/Advisory support usually forms a component in the design of the programme along with an access to finance facility to ensure the supply of BDS, typically at no additional cost to beneficiary MSMEs. ASMED reported a significant number of activities and outcomes on market information, business skill development, capacity building and formation of business association during the initial stage of SME promotion in Afghanistan (ASMED 2010). The ASMED reports highlighted a nationwide quick success in bridging SMEs gaps through various forward and backward linkage initiatives, as well as by providing fast track solutions. They primarily involved international firms and experts, as well as in-house national and international staff, to deliver the required BDS support. However, it is difficult to draw a conclusion on the impact and sustainability of ASMED intervention in the absence of a third party post-completion evaluation report<sup>311</sup>.

AREDP adopted an approach to provide BDS support entirely through internal national staff, along with the provision of collateral guarantee facility on commercial loan products. It is our understanding that AREDP was unable to implement the collateral guarantee facility<sup>312</sup>. Though, the progress of AREDP in systematically reaching out to SMEs and identification of their specific needs was swift, their activities related to BDS were noticeably low and slow compared to ASMED and other Agriculture and Rural Development (ARD) programmes. AREDP's design is intended to reach out to wide range of enterprises as compared to other ARD market development programmes. Conversely, programmes such as Agricultural Development Fund (ADF), CARD-F and IAPFE have relatively limited approaches, focusing on specific types of businesses within the agriculture sector. They also have an intrinsic design of support from international firms, experts and internal master trainers to deliver BDS.

### **INGO's, BDS and Finance**

There are a few eminent INGOs and banks providing both BDS, as well as finance. Specifically, First Micro Finance Bank of Afghanistan (more than 60,000 loans totalling \$100m), proposing Aga Khan-Habib Bank investment opportunities for entrepreneurs, and the burgeoning private sector – as well as market development support, particularly in Badakhshan, Takhar and Bamyan (2009 data from the organisation reports BDS assistance to 440 small enterprises, and vocational skill training to 1,300 individuals). A few examples of specific BDS support offered were: the Development of Ecotourism Programme in the north; the establishment of business associations; trained trainers; the development of curriculum and accreditation procedures; the provision of job counselling and enterprise start-up assistance; and a cashmere wool processing factory. While there is an assurance for the long-term and sustainable support from such INGOs, their operational area is typically limited to a few pockets, unless there is donor funding to cover additional areas.

Similarly, Mercy Corps has been present in Southern Afghanistan since 1983, and their economic opportunities' initiative provides BDS training and work opportunities in a wide range of enterprising activities. Moreover, Afghanaid has been operating since 1983, mainly in four provinces to provide BDS, which includes community development, vocation training, and microfinance. Care International, active since 1961, focuses in central, southern and south-eastern regions and works on income generation and skills training for vulnerable groups and demobilized soldiers. The Danish Committee for Aid to Afghan Refugees, functioning in 25 provinces since 1984,

<sup>310</sup> Such as IFC Business Edge, supported by DFID SEED Programme.

<sup>311</sup> We have had anecdotal feedback from some of our interviewees that hardly 2 out of 10 businesses engaged in non-subsidised training for further business modules for instance. It is not clear if and how "repeat business" is measured by M&E systems.

<sup>312</sup> Although this will be re-checked in the next phase.

has a special programme on Small Scale Enterprise Development. Most NGOs have enterprise support or BDS support as one of the subsidiary activities in addition to their larger programmes, and credible NGOs are likely to ensure quality and impact, but with limited sustainability, specifically in their geographical area of operation.

World Bank funded ANMDP's Facility for New Market Development (FNMD) will primarily finance, on a reimbursement basis, expenditures pertaining to BDS. In general, there are three broad service categories within which FNMD business plans can be approved for financing, including: 1) market research; 2) product adaptation; and 3) promotion<sup>313</sup>. The programme design has approved a comprehensive BDS support with focused needs of selected SME. These would be provided by facility administrators with ad-hoc consultative partners. It is premature to assess BDS support since the project has not yet entered into implementation stage. However, as of December 2013, 229<sup>314</sup> agreements had been signed with SMEs and business associations. Given that the project design is open to different types of business, similar to AREDP and ASMED, it would be worthwhile exploring the capacity to meaningfully manage the complexity and gap in BDS needs with the given number of FNMD staff. For example, an individual SME's business development needs could arise as group needs, basic needs, advanced needs, and/or technical needs, within three broad service categories. This could further lead to the demand for a non-generic approach, vast variations in provision (due to customisation needs), and limited in-country resources to fulfil it in real terms, in time and over geographical space.

Furthermore, it is unknown whether double or complementary BDS support by other programmes is acceptable since there are similar BDS services provided by Assistance in Building Afghanistan by Developing Enterprises (ABADE), Afghan Growth Finance (AGF) and ADF, all USAID funded programmes. Component 2 of the ABADÉ programme is Technical Assistance and Business Advisory Services. It provides services to sub-award recipients and programme stakeholders to improve their operations and management, and to solve technical issues related to market access, production, access to finance, and achievement of quality standards. Similar to ANMDP, the mechanism to address the complexity and gap of BDS needs by ABADÉ would require further exploration. This question remains to be explored with ADF, which primarily focuses on enterprises within the agro trading or processing sector.

Afghanistan Growth Finance is one of the most interesting commercial investment companies supporting SMEs in Afghanistan, using a venture capital or private equity model. In 2012, AGF had approximately 10 staff managing 17 active borrowers and 23 in the pipeline. They have multiple financial products and customized BDS support for their clients. Each staff typically manages 3-5 SMEs at each stage so as to be able to ensure client satisfaction and growth. The client growth is in fact an incentive for the growth of AGF, since it ensures returning customers and more borrowings. The assessment of current status would be of significant value in acknowledging the gaps in BDS provisions by AGF.

In addition to the above, there are a few institutions working in the space of Business Enabling Environment for SMEs, who also provide support on BDS to their members, such as Afghanistan Chamber of Commerce & Industries (ACCI), Afghanistan Investment Support Agency (AISA) and HAKARAT. Typically, they do not directly implement BDS projects or programmes, rather, they bridge the BDS supply gaps through line ministries, policy and/or macro market facilitation. Nevertheless, they all have a strong mandate to support SMEs in their best capacity.

In conclusion, the current literature has restricted knowledge on optimum solutions in Afghanistan to supply BDS which satisfies the needs of SMEs meaningfully.

## DFID

Among DFID funded programmes, Supporting Employment and Enterprise Development (SEED) is the umbrella name given to seven DFID funded programmes that support to MSMEs. Among these, the projects relevant to financial and BDS services are: 1) Business Edge (BE), which aims to enhance the performance and competitiveness; 2) AREDP, which has one component for SME development which provides business advisory and financial services to rural SMEs and the other is of community saving and supporting micro enterprises; 3) Turquoise Mountain, which provides training courses in the areas of carpentry, jewellery, tailoring and knitting; 4) ABIF, which supports private sector investment that will benefit poor men and women as producers, workers and/or

<sup>313</sup> ANMPD- PAD 2011.

<sup>314</sup> World Bank, 2013. The World Bank Implementation Status & Results quarterly report in Q1 2014 qualifies progress towards achievement as 'moderately satisfactory, but the views of the Scoping Team are that it is a good performance in the context of difficult operational conditions and a late start.

consumers; and 5) Zardozi, an Afghan NGO that links chronically poor female home workers (tailors, embroiderers) to local markets, through female sales agents<sup>315</sup>.

The programmes most relevant for SMEs and BDS support are, specifically, ABIF, AREDP-SME component and IFC's Business Edge programme. The BDS support provided by ABIF staff before and during the application procedure has been reported to be of considerable value for SMEs<sup>316</sup>. ABIF has provided grants to a total of 24 SMEs<sup>317</sup>, and it is expected that the output will be met after the grantees' projects become operational<sup>318</sup>. Irrespective of ABIF, individual businesses are constantly facing dynamic challenges and risks on a concurrent basis. Furthermore, mechanisms to estimate required staff client ratio to manage risk, BDS support as well as scale-up strategy within a given programme staffing and budget structure to continue maintaining existing quality are questions yet to be examined.

It has been pointed out in the 2014 ICAI Report, ABIF monitoring reports, and our discussions with ABIF Manager that more time is required to enable the grantees to deliver products and services to Afghans, and measure whether the programme is achieving its outputs, in addition to a return of £3 for every £1 invested<sup>319</sup>. The Business Plan is a significant document, as well as one of the key benchmarks for output and outcome indicators of ABIF targets.

It has been recommended (by SEED annual review 2013) to revise the indicators for ABIF in the logframe for future milestones, on the basis of grantees monitoring and evaluation plans. Hence it would be valuable to understand whether such a revision would require to be revisited at regular intervals, given the number of grantees, changing needs of businesses at different stages and levels, limited ABIF staff and budget, as well as in the context of constantly changing market situation. Also, ABIF achievements of a specific result, that is 7,241 men and 3,663 women received business skills training, may need further inquiry. It is difficult to correlate this particular achieved target in the given milieu of progress, operational design and direct beneficiaries of ABIF.

Conversely, the SEED Annual Report (2013) points out that the IFC's Business Edge programme to enhance the skills of local BDS service providers has experienced progress which is in line with the experience of the GIZ BDS programme in Northern Afghanistan<sup>320</sup>. However, the reason pointed out by IFC is the level of skills was well below what had been anticipated which is not the major cause of failure of BDS providers in Northern Afghanistan. The likelihood of better survival could be justified by the input from IFC that 50 percent of their training providers are not reliant on donor funding and six out of those eight charge clients for their services (SEED 2013).

One of the other constraints was the training of business skills trainers which was substantially lower than what was expected. Though, Business Edge has begun to address the low capacity amongst providers. as mentioned in the section 3.3.1 demand side, needs for quality BDS at affordable rate rarely exists in the market. Thus, it would be useful to explore the assumptions and risks involved in IFC's programme. In particular, applicability of the lessons learned from the experience of GIZ BDS support in Northern Afghanistan. Nevertheless, the aim to provide SME's in Afghanistan with quality BDS services at reasonable rates appears to remain an issue.

DFID support to Zardozi, Turquoise Mountain, Islamic Finance Cooperatives and Mercy Corps, resulted in engagement primarily with micro enterprises. It appears that BDS support provided by these organizations resulted in a gainful value for the beneficiaries, in terms of income, job and other indicators<sup>321</sup>. One of the common success factors in BDS supply appears to be technical training in line with market feasibility. One of such example is Mercy Corp's BDS intervention with plastic tunnel technology for Helmand farmers, which experienced an excellent response from beneficiaries<sup>322</sup>.

---

<sup>315</sup> It is important to note that the beneficiaries of Zardozi, Turquoise Mountain, AREDP community enterprise and enterprises covered by Helmand Agriculture Programme as well as Rural Development Programme, are closer to the definition of micro enterprise than that of SME. However, we will briefly discuss the BDS support among these micro enterprises at a later stage. The annual reviews and the recent ICAI report 2014 show a few programmes that are performing with good results against targets than others. Though, at this stage, the paper will assess the overview of supply of BDS support, SME needs and evidence of effectiveness.

<sup>316</sup> ABIF website, ICAI Report, 2013 - Evidently, individual vetting process while developing detail business plan (matched the BDS expectation of most of the SMEs (reports from 1<sup>st</sup> round and early second round).

<sup>317</sup> DFID Afghanistan – February 2014.

<sup>318</sup> Seed Annual Review, 2013.

<sup>319</sup> Discussions with ABIF

<sup>320</sup> GIZ BDS mapping report, 2013.

<sup>321</sup> SEED, 2013, and ICAI, 2014.

<sup>322</sup> ICAI, 2014 and Mid-Term Review of the Introducing New Vocational Education and Skills Training (INVEST) Programme. Coffey, 2012.



## Summary

The sustainability of micro enterprises is strongly associated with regular sales of their product or services without the subsidization of donors. Reduction in market demand, reducing advance order, along with premature pull out of BDS support are among the few reasons that could reverse the progress faster than otherwise. The question to examine is required duration of support and the sustainability of support it-self translates into meaningful impact.

Finally, it is important to observe that AREDP was able to collect high quality data for individual BDS needs of SMEs through its business plan. However, the percentage of actual BDS support provided compared to total BDS needs identified in all the 6 provinces was noticeably limited. Interestingly, RED HELMAND-AREDP funded by DFID reported considerable progress in providing BDS support in absence of access to financial (Biannual project report by UNDP 2013). Customized BDS support especially in terms of relevant technology input and know-how was provided to most of the target SMEs. Exposure to exhibitions, business to business training, technology input from successful enterprises in-country and in the regional, and on-site training were few of the methods adopted to ensure relevance and value of BDS services. However, it is difficult to comment on the actual and perceived value as well as impact created in absence of post completion an external evaluation report. ABIF has shown excellent - progress up to now and it needs to be carefully observed as the project may evolves in to further complexity. Optimum options are required to be assessed with the given changing context and volatile market dynamics.

## Assessing access to finance and the provision of financial services

### The Afghan financial and banking system

The Afghan financial and formal banking system is under-developed and narrow. As of July 2013, total assets of the banking system amounted to an equivalent of US\$4.3bn<sup>323</sup>, more than ten times the size of 2005. In contrast, as of December 2013, the total assets of the microfinance sector<sup>324</sup> are less than US\$150m (\$136m loans and \$22m savings). Moreover, the banking system is liquid with US\$3.7bn in deposits and with outstanding loans of US\$818m. Loans are mainly concentrated in the trade and service sectors (29 percent and 19 percent respectively) and geographically concentrated in Kabul (81 percent). This data is remarkable as it reflects the system after the collapse of the Kabul Bank in September 2010<sup>325</sup> that approximately cost US\$935m<sup>326</sup>.

In absence of consolidated audited data on the financial sector the below conclusions have been drawn:

- There are a few respected regulated financial institutions, including a few commercial banks such as AIB, and a few microfinance institutions dominated by First Microfinance Bank of Afghanistan (FMFB);
- Between 2008 and 2011, the microfinance sector experienced a severe restructuring phase under MISFA guidance when reputable international players such as ASA and BRAC left the country, and six or seven Microfinance Institutions (MFIs) merged and restructured into the Mutahid Development Finance Institution (DFI). It is only in 2012 that MISFA could consider an expansion of its activities<sup>327</sup>.

### Access to finance for women

According to the World Bank (2014), female self-employment is hindered by limited access to finance and limited authority over financial decisions given to women. Only 3 percent of Afghan women have bank accounts, compared to an average of 26 percent across South Asia. The GIRoA, supported by donors, is supporting an array of microfinance products available to women which have shown promising results. Nevertheless, there are reported incidents where women are handing over loan money to their husbands or other male family members to administer on their behalf. Based on these findings, there is a need for future interventions by both donors and the government to take cognizance of better opportunities to promote women's participation in financial decision-making.

<sup>323</sup> Most data come from the World Bank Project Appraisal Document on Access to Finance date November 2013; from sources that the World Bank has access to via its Financial Sector Rapid Response Project.

<sup>324</sup> Latest data from Microfinance Association [www.ama.org.af/index.php/publications/viewcategory/8-microview-report](http://www.ama.org.af/index.php/publications/viewcategory/8-microview-report).

<sup>325</sup> US Special Inspector General for Afghanistan "SIGAR" Audit on Afghanistan's Banking Sector – Jan 2014.

<sup>326</sup> Independent Joint Anti-Corruption Monitoring and Evaluation Committee, Report of the Public Inquiry Into the Kabul Bank Crisis – November 2012 - quoted by SIGAR.

<sup>327</sup> Well summarised in MISFA Annual Report 2013 [www.misfa.org.af/site\\_files/13933914941.pdf](http://www.misfa.org.af/site_files/13933914941.pdf) pages 11-14.

### Coupling access to finance and business development services

There is currently limited evidence from literature regarding the link between access to finance and BDS, however feedback from Afghan practitioners appears to be consistent. The IFC has consistently claimed that coupling financial services and advisory services together delivered better impact, and has provided further insight on the benefits as lead technical adviser of the Global Partnership for Financial Inclusion (GPFI)<sup>328</sup>. Conversely, recent evidence from academics is more mixed<sup>329</sup>.

Feedback from the ABIF, Hand in Hand, FINCA, and Helmand Growth Programme support to Vocational Training (delivered by Mercy Corps) is consistent that successful Investment Climate, BDS or skills interventions face a bottleneck as beneficiaries cannot access finance to implement their projects, establish, or grow their businesses. Thus, it may represent better value for money for donor-funded and DFID-funded programmes to propose a continuum of interventions covering both.

Hand in Hand summarises well the need for a holistic approach to a complex context where literacy/ numeracy, basic business skills and financial capability are low (see figure A5).

**Figure A5: Illustration of the Inter-linked nature of social mobility, access to support services and development**



Source: Hand in Hand (2013-2015 Strategic Plan)

### Initiatives to support and complement

The above analysis suggests that amongst donors and actors, recent initiatives bode well for the future but are still fledgling and therefore may not reach the 'bottom of the pyramid' in the immediate term. There are a number of obstacles to overcome:

- "A loss of consumer confidence"<sup>330</sup> in the banking sector after the Kabul Bank scandal that will need vigorous resolve by the new authorities;
- The banking system that represents more than 80 percent of the financial system is likely not geared towards the smaller end of the market, with the exception of FMFB. Moreover, the data we have access to is bias towards urban and more secure areas;
- There exist negative perceptions of the banking sector by<sup>331</sup> small and micro-businesspeople, who hold the view that banks are not for them<sup>332</sup>. A large minority believe that products and processes are not compatible with their religious beliefs.

<sup>328</sup> Successor to the Financial Inclusion Experts Group of the G20 (FIEG) the Global Partnership for Financial Inclusion (GPFI) is a platform to implement the Financial Inclusion Action Plan, endorsed at the G20 Summit in Seoul – Sub-group on SME finance: [www.gpfi.org/subgroup-sme-finance](http://www.gpfi.org/subgroup-sme-finance).

<sup>329</sup> Consulting and Capital Experiments with Micro and Small Tailoring Enterprises in Ghana by Dean Karlan, Ryan Knight and Christopher Udry - Yale University and Innovations for Poverty Action. See in Appendix 7 of page 37 a summary of similar research papers for more positive results such as De Mel in Sri Lanka.

<sup>330</sup> US Special Inspector General for Afghanistan "SIGAR" Latest Quarterly Report Jan 2014.

<sup>331</sup> This has been found by Finscope surveys in Pakistan in 2009 or in Nigeria – see [www.finscope.co.za](http://www.finscope.co.za) and [www.efina.org.ng](http://www.efina.org.ng).

<sup>332</sup> This study commissioned by the Institute for Money, Technology and Financial Inclusion at the University of California deals with attitudes to savings and risks with M-Paisa users: [www.frogdesign.com/pdf/frog\\_In\\_The\\_Hands\\_Of\\_God.pdf](http://www.frogdesign.com/pdf/frog_In_The_Hands_Of_God.pdf).

## Donor programmes supporting the Financial Sector and its capacity to support SME finance

### World Bank Afghanistan Access to Finance

The development objective of the Access to Finance Project for Afghanistan is to build institutional capacity to improve access to credit of micro, small, and medium enterprises. The project has two components.

The first component, which should be funded up to \$28m, is improving access to financial services for micro and small enterprises. This component aims to provide continuing support to the microfinance sector through Microfinance Investment Support Facility for Afghanistan (MISFA), as well as “supporting MISFA to take on a broader role as a catalyst for innovations to increase access and usage of financial services from the lower end of the market (notably micro and small enterprises) as per its new strategic plan”.

It has three sub-components: (i) strengthening of the microfinance sector through MISFA; (ii) targeting the ultra-poor; and (iii) strengthening of MISFA itself as an institution.

The aim of the second component, which should receive up to \$18m, is to increase commercial bank and microfinance institutions (MFIs) lending to SMEs in Afghanistan. This will be implemented via the expansion of the Afghanistan Credit Guarantee Facility, including providing coverage to selected MFIs lending to the lower end of the SME market.

### IFC activities in Afghanistan relevant to financial sector support

Within its Investment Portfolio, IFC is a shareholder of FMFB and of Roshan, the mobile phone operator in the country that has previously tested mobile money pilots. It has also provided trade finance facilities to Afghanistan International Bank (AIB). Nevertheless, the bulk of the programme’s involvement remains in an advisory capacity, in partnership with World Bank technical teams. It has supported the new legislation on public credit registries with its first phase of implementing a collateral registry for movable assets at Da Afghanistan Bank, and helping the GIROA to establish a regulatory framework for leasing.

### World Bank Financial Sector Rapid Response Project

Last autumn, the World Bank approved a reorganisation, extension (until July 2016) and additional financing for its Financial Sector Rapid Response Project Afghanistan. Its main purpose of this project is to assist Da Afghanistan Bank to develop action plans for improved banking supervision and to implement a modern national payment system for efficient and transparent payment transactions.

The additional financing will support various action plans to support regulation and improve supervision capability at Da Afghanistan Bank, and the development and implementation of action plans following audits of commercial banks.

### USAID Financial Access for Investing in the Development of Afghanistan (FAIDA)

So far, the USAID flagship programme to support interventions in the financial sector, FAIDA “assists USAID’s Afghan partners in building their capacity to deliver finance where it can be used most effectively, and in developing a legal framework and market infrastructure in which financial sector institutions and their business partners together create value that provides opportunity for all Afghans”. The programme is set to end in August 2014.

FAIDA is targeting SMEs, however it is difficult to get data about its achievements. It seems it has been quite active in supporting institutional reform and capacity building (Afghan Institute of Banking and Finance, Afghanistan Banking Association ABA Afghanistan Association of Microfinance AMA, mobile money initiatives).

### USAID Agricultural Credit Enhancement (ACE)/Agriculture Development Fund (ADF)

This agricultural credit project consisted of two complementary activities, the establishment of the Agricultural Development Fund (ADF), with a \$100 million grant from USAID to the Ministry of Agriculture, Irrigation and Livestock (MAIL), and a twinned technical assistance facility, ACE, to help implement the ADF. The ADF provides loans throughout the agricultural value chain through a broad range of partner intermediaries, including not only banks, but also non-bank channels such as farm stores, leasing companies, food processors.

The literature informs us that this programme has been through various organisational forms that are difficult to reconstitute. In 2012 it took over previous lending activities from other US-funded programmes, then in November 2012 the decision was made for ADF to become “a standalone government owned financial institution”. Initially, a

4-year project that started in July 2010, the priority for 2014 is for institutional consolidation and the finalisation of the transition of the ADF to Afghan control.

### Asian Development Bank Rural Finance Expansion

This is very much a project in design as implementation has been affected by logistical (and likely security) constraints. The proposed initiative aimed to “assist Afghan commercial banks and microfinance institutions to expand their physical presence and increase access to finance in rural areas. In addition to addressing more immediate capacity constraints of participating banks and microfinance institutions, the latter will also work with the central bank of Afghanistan (Da Afghanistan Bank) and the Afghanistan Institute for Banking and Finance (AIBF) in removing the underlying and structural impediments to rural finance expansion in Afghanistan.”

### Afghanistan Credit Guarantee Facility

The Afghanistan Credit Guarantee Facility (ACGF) was established in 2006, and is implemented and managed by DEG, the German bilateral Development Finance Institution. Its strong results have been acknowledged, evident through receiving additional funds from USAID.

**Figure A6: Performance of the Facility as of June 2013**

	Cumulative (2006-2013)			2011		2012		Jan-13 to June-13	
	Numbers(#)	Amounts (\$)	#	Amounts (\$)	#	Amounts (\$)	#	Amounts (\$)	
Loan Disbursement	2926	\$105,758,719	459	\$20,133,603	476	\$23,754,254	334	\$12,374,505	
Guarantees Issued	3097	\$76,742,334	479	\$14,058,381	512	\$16,402,253	326	\$8,577,543	
Loans Outstanding	842	\$19,569,967	550	\$15,881,911	709	\$19,388,587	842	\$19,569,967	
Guarantee Outstanding	879	\$16,928,913	587	\$11,828,636	759	\$15,449,338	879	\$16,928,913	
Write-offs	78	\$1,111,876	16	\$138,528	16	\$233,776	5	\$46,850	
Claims Disbursed	48	\$611,853	13	\$54,606	18	\$149,990	6	\$91,791	
Claims Refunded	24	\$64,024	9	\$27,693	6	\$7,107	6	\$10,831	
PAR(>30)	12	1.12%	14	0.69%	8	1.41%	12	1.12%	
PAR(>90)	9	0.83%	6	0.42%	2	0.22%	9	0.83%	

Source: Afghanistan Credit Guarantee Facility

### The wider business enabling environment

A positive enabling environment is characterised by political stability; confidence in the future; mutual trust, understanding, dialogue and collaboration amongst stakeholders; rule of law; protection of the rights of citizens; a diversity of stable, democratic institutions; and a streamlined legal, fiscal, regulatory, and administrative framework governing all spheres of private initiative. The key guiding documents for facilitating the enabling environment are the Afghanistan National Development Strategy (ANDS) and the Afghanistan Compact. The policy for Private Sector Growth and Development of ANDS incorporates all the recommendations and proposed actions suggested primarily by the government, the non-profit sector, as well as private sector. With regards to women, the government has initiated the National Action Plan for the Women of Afghanistan (NAPWA), approved in 2008. This, the promotion of female leadership opportunities, and the many vocational training programmes funded by the international donors for women in urban and rural areas, signifies a move to the formalization of gender mainstreaming in Afghanistan. At a formal level the existence of MoWA, solely devoted to women's affairs, is a significant achievement. Through its name and existence alone MoWA raises awareness about women and society, despite its weak position in the still predominantly patriarchal societal and political system<sup>333</sup>

### Institutions and the Business Environment

Currently, few institutions are playing a leading role in addressing the business enabling environment, such as AISA; HARAKAT; MOCI (SME directorate, Private Sector Development Office); ACCI, MOMP; MAIL; Export Promotion Agency of Afghanistan (EPAA), and Ministry of Foreign Affairs. Moreover, a few major programmes on

<sup>333</sup> APPRO, 2014.

SMEs such as TAFA (Trade and Accession Facilitation for Afghanistan)<sup>334</sup> which also had or currently has a component on business enabling environment; Mining Investment and Development for Afghanistan Sustainability (MIDAS), and the newly launched ABADE also have a component of business enabling environment (BEE).

USAID has funded several programmes for enterprise and business facilitation mainly under 1) Economic growth and trade (ASMED; Alternative livelihood –Helmand; Afghanistan rural investment and enterprise strengthening ; Expansion of SEAF-AFG in Afghanistan; FIADA; ABADE) and 2) Food and security (Agro-enterprise development alliance of Afghanistan; Alternative Development Program/Northern Region; IDEA NEW; Strengthening market chain for Afghanistan raisin and pomegranates; Private and Community Forestry project). Most of them are either completed or about to end in 2014. An exclusive project recently established is ABADE, which has a special component for Business Enabling Environment. The specific objective of this component is to improve the business climate by addressing specific regulatory and procedural barriers that affect the competitiveness of small and medium enterprises. This may include assessments and analytical studies driven by the sub-award applicants, as well as support for relevant ministries by drafting policy memoranda and regulatory guidelines for specific industries (ABADE website). Since the programme has just started, it is premature to observe the impact and benefit.

**International:** Similarly, substantial efforts are being made in the direction of facilitating trade via promoting exports. The Afghan-American Chamber of Commerce; Afghan Business Council – Dubai, and Afghanistan Embassy are working to facilitate trade between countries. Regional and western countries are also providing additional support to promote trade. Efforts such as Investment promotion facilitation conferences/workshops; Export Coaching Programs (ECP) in home decoration/home textiles and Agriculture (natural ingredients) sector by Dutch government; regular business conferences and meets in India, Pakistan, Dubai, Turkey, USA, Canada and EU for doing business with Afghanistan; facilitating local Afghan product stalls at national and international trade/business exhibitions; business to business learning exposure, study tours, know-how trainings; and advising local businesses via chamber or AISA on export opportunity are among the key initiatives.

**National:** In June 2007, The Enabling Environment Conference Effective Private Sector Contribution to Development in Afghanistan was organized at a national level. The recommendations, specific actions, time frames and responsible agencies devised during the conference formed a road map for subsequent years. Given the challenging country context, there has been decent progress in the realization of a number of the actions around developing policies. However, evidence based need of creating different kinds of policies for fragile states; the ability of the government to implement; and the non-facilitative risk of further complicating the doing of business which may result in encouraging corruption, all remain a question. The recommendations relevant to enabling SME BDS services could be 1) Streamlining regulation and procedures and improving the enforcement and 2) Addressing human capacity constraints.

One of the key recommendations in June 2007 under ‘Streaming regulation and procedures and improving the enforcement’ was to reform and revitalise the High Commission on Investment (HCI). One of the specific actions was to ensure that AISA is an effective secretariat to promote investment and the private sector in Afghanistan. We observe that since 2007, AISA has facilitated and taken specific actions to achieve its objective.

At national and provincial regional levels, attention has been given to skills development, as well as advisory services and BDS promotion in license and trade-related regulatory policies. Training for license holders on important topics (for example, marketing, bidding procedures - especially for domestic SMEs – tax, law, and business registration) is also provided. In addition, the Ministry of Commerce and Industry (MoCI) has passed an SME strategy for Agro-business in collaboration with the Ministry of Agriculture, Irrigation and Livestock (MAIL); and the Ministry of Mines and Minerals has passed law and policy including small scale mining facilitation.

A significant investment in BEE has been led by donor agencies. The legitimacy of such investment appears to be based on experiences in best practices of countries around the world, Doing Business ranking indicators, government requirements to generate revenues, as well as some research from Afghanistan and other fragile countries. The Doing Business Report of 2014 highlights that “[Good business] regulations put in place to safeguard economic activity and facilitate business operations, if poorly designed, can become obstacles to doing business. Striking the right balance in business regulation can be a challenge”. Even though the indicators refer to a specific type of business, generally a local Limited Liability Company operating in the largest business city, Afghanistan ranked 168 out of 185 countries in 2013. The data claims to highlight the obstacles in doing business

<sup>334</sup> It is our understanding that TAFA is/was an SME focused trade programme (between 2009-13) but it is not clear if all components have been completed at the time of writing.



and help identify the source of those obstacles and supporting policy makers in designing regulatory reforms for an improved BEE<sup>335</sup>.

There are several areas of key importance to business, especially in a fragile country, that are not directly studied by the report. Significantly, it neglects to consider, the economy's proximity to large markets, the quality of its infrastructure services (other than those related to trading across borders and getting electricity), the security of property from theft and looting (as well as armed attack), the transparency of government procurement, macroeconomic conditions or/and the underlying strength of institutions.

### Review of Existing Reports

According to the Doing Business report, the three worst performing critical areas among 11 relating to the life cycle of business in Afghanistan as per are: a) Protecting Investor – ranked 185<sup>th</sup>; b) Trading across border - 178<sup>th</sup> (performing almost 10 percentage points worse in 2013 than in 2005); and c) Registering property – 174<sup>th</sup>. Conversely, the top three obstacles for enterprises identified by Afghan enterprise are typically political Instability, access to land, and corruption<sup>336</sup>. Currently, we are unaware of any ranking or survey from the enterprise perspective underscoring rigorous examination of 11 life cycle areas of business as noted by the Doing Businesses report, combined with other business obstacles which are considered pivotal by enterprises in Afghanistan.

It is clear that access to land is the only issue which is identified as a top common obstacle between the two reports. This observation superficially underlines the priorities and direction in which the BEE may require to be facilitated. There appears to be a necessity of striking a careful balance in business regulations for BEE based on meticulously investigated demand, and appreciating the methodology limitations of the Doing Business report. Perhaps, at this stage, it might be more appropriate to exclusively encourage those BEE reforms which are in genuine demand from the private sector, as well as adopting minimalistic regulation approach by government to ensure reduced complication and corruption facilitation.

Government-led regulations are likely to be helpful wherever it is possible to implement them with reduced, minimum, or in the best case no corruption, and if they are directly relevant to investment facilitation, and market and enterprises of all size. Evidently, the government has taken several actions to boost confidence levels, creating key policy documents and facilitate BEE in last few years.

### Infrastructure and access to land

Agriculture and the natural resource sectors share common constraints with respect to infrastructure, specifically with respect to water and power supply. Here, developments in both sectors will add to the already high and increasing demand. While it is important to enhance existing infrastructure to reduce inefficiencies and improve distribution, it will be equally necessary to think about the development of new water resources and sources of power supply. Solutions to increase supply exist domestically but are ultimately best supported by fostering regional cooperation efforts<sup>337</sup>.

There remains a significant mismatch between electricity supply and demand, despite the fact that the GIROA has made tremendous strides in improving access to electricity for its people. While just 5 percent of all households had access to electricity in 2002, connections have increased to 30 percent of all households. As with water, demand is expected to increase due to population pressures, agriculture supply chain development, and mining<sup>338</sup>. Still, next to insecurity, access to electricity is considered one of the biggest constraints to private sector development<sup>339</sup>.

Land markets in Afghanistan suffer from a broad range of issues related to the legal, regulatory and institutional environment. Accelerating land title clearance processes for the resource corridor and develop better leasing schemes for small holders could directly support the development of the two key sectors, natural resources and agriculture, in Afghanistan. However, changes to land laws and regulations as well enhancing the institutional capacity of Afghanistan's land authority will be equally important to ensure that land issues, especially those of excluded population groups, are adequately addressed<sup>340</sup>.

<sup>335</sup> The relevance of such facilitation of BEE to policy makers should be carefully considered due to the limitations in the methodology of the Doing Business study.

<sup>336</sup> Enterprise Surveys data for Afghanistan, 2014.

<sup>337</sup> World Bank, 'Islamic State of Afghanistan: Pathways to Inclusive Growth', 2014.

<sup>338</sup> Ibid.

<sup>339</sup> USAID interview: <http://www.usaid.gov/news-information/frontlines/energy-infrastructure/powering-afghanistan>.

<sup>340</sup> World Bank, 'Islamic State of Afghanistan: Pathways to Inclusive Growth', 2014.



Land markets do not function well in Afghanistan, for two main reasons. First, the high intrinsic asset value of land in relation to use value and lack of financial institutions to facilitate land acquisition result in a very thin land market. Second, legal and regulatory impediments to the sale and purchase of land, combined with a lack of a transparent land records and an efficient land administration system, prevent the development of an efficient land market. Outdated systems, overlapping responsibilities, lack of capacity at local levels, conflicting systems for land ownership, and uncertain or incomplete legal frameworks, compounded by decades of conflict and widespread displacement, result in competing claims to land and conflicts between individuals, communities, and citizens and the state. These shortcomings result in abuses at all political levels and in high transactions costs for land transfers<sup>341</sup>. As a result, access to land is one of the major constraints to private and public investments across all sectors<sup>342</sup>.

## Benchmarking – Literature review on PSD in conflict-affected countries

To complement our findings in the above sections, we have looked at the wider PSD context, from a programmatic perspective, by drawing upon lessons learning from DFID and other donors. More details relating to this are included below.

### Donor Committee for Enterprise Development (DCED)

In the past PSD in FCAS programming has seen its impact limited only to the sphere of economic development. According to the DCED (2010), this leads to two significant challenges:

- PSD programming needs to be an integral part of the conflict management process, not introduced as an after-thought later on. In fact, a failure to introduce PSD programming early enough can seriously undermine conflict management efforts.
- PSD has historically been seen as impacting only on the economic development aspects of peace-building. This not only underestimates the value of PSD, but also leaves open the dangerous possibility that PSD programmes could actually undermine other aspects of the conflict management process.

The DCED has therefore developed a four-part assessment of the tasks that make up peace-building, and which should form the focus of activity for donors in conflict-affected environments<sup>343</sup>. The four tasks of conflict management are as follows: Building security, stability and trust; fostering good governance; creating modern infrastructure and economic development.

The DCED state that the value chain approach has particularly strong benefits when used in FCAS/CAE – regardless of what phase a particular conflict is in. Value chain analysis can inform and reinforce conflict analysis, and directly address possible causes of conflict. It is particularly helpful for leading advisers to prioritise particular sectors and to justify the decision to prioritise. The M4P tool is also well suited for FCAS, but is more comprehensive, more ambitious, and thus more difficult to implement in practice – which can, paradoxically, reduce its attractiveness in FCAS.

<sup>341</sup> World Bank, 'Islamic State of Afghanistan: Pathways to Inclusive Growth', 2014.

<sup>342</sup> Investment Climate Survey (2008) and Doing Business Report (2011) in World Bank, 'Islamic State of Afghanistan: Pathways to Inclusive Growth', 2014.

<sup>343</sup> <http://www.enterprise-development.org/page/cae>.

**Box A4: Key Lessons from the DCED:**

- The market must be the driver of a value chain programme
- Investment in rebuilding inter-firm linkages and trust is essential but time-consuming
- Specific attention needs to be paid to the business enabling environment and the constraints relating to public infrastructure, particularly roads.
- Planning for the delivery of support services is an integral part of developing a successful value chain program.
- Projects need to focus on sustainability from the outset and use subsidies with care.
- The most powerful champions are often private-sector participants within the value chain itself.
- A progressive model can provide early success that leads to larger results over time.
- Match life-of-project to value chain timeline.

**USAID**

At the behest of USAID, 10 organizations captured results and lessons learned from projects that used value chain programming in conflict-affected environments. The goal of this paper titled '*A Synthesis of Practical Lessons from Value Chain Projects in Conflict-Affected Environments (2008)*' was to extract larger lessons that emerge from these implementing organizations and the programmes they developed across 14 value chains in conflict-affected environments. Based on these lessons, the paper strove to articulate the potential of value chain programming in conflict-affected environments, and to highlight "better practice" that leads to greater programmatic success in such difficult contexts<sup>344</sup>.

While illustrating the magnitude of challenges facing these programmes, the cases demonstrated that the value chain approach can indeed deliver results in conflict-affected environments. Three cases in Rwanda and Kosovo demonstrated significant economic results in terms of sales, employment and private-sector investment<sup>345</sup>. Four other cases in Afghanistan, South Sudan, Northern Uganda and Nepal demonstrated that value chain programmes can be used to reach particularly vulnerable populations even during periods of on-going conflict<sup>346</sup>. Thus, findings from the work conducted by USAID in FCAS suggests that a value chain approach can be a valuable means of implementing PSD projects in challenging environments.

**GIZ**

GIZ, in their 2009 guidebook on sustainable economic development in FCAS, state that PSD interventions in (post) conflict situations can be designed on four levels:

- Meta level: Cultural norms and values constitute an important basis for PSD. PSD activities can influence important actors in the private sector to change their attitudes towards peace and conflict in general, and in particular towards disadvantaged groups or the opponents of conflict. A change in perceptions often constitutes the foundation for reforms at the other levels to become effective.
- Macro level: PSD activities can help to improve the framework for economic development and peace. This might involve support for good governance in extractive industries, or the promotion of tax rebates for enterprises operating in zones that have been heavily affected by conflict, or which employ socially disadvantaged people. Project activities might promote legislation on the just use of profits from the exploitation of natural resources, encourage trade between conflicting parties, launch anti-corruption measures, or support policies that foster the economic development of disadvantaged and discriminated

<sup>344</sup> USAID – A Synthesis of Practical Lessons from Value Chain Projects in Conflict-Affected Environments, 2008.

<sup>345</sup> 1) In Rwanda, eco-tourism receipts rose from zero to \$33 million/year over a five-year period, with \$20 million in new investment in infrastructure and assets; 2) In Kosovo, domestic dairy sales showed a €36 million increase over a four-year period and created 624 new jobs (in full-time equivalents). Domestic investments in dairy increased by €3.9 million over four years; 3) In Rwanda, the coffee value chain moved into export-ready coffee, with sales rising from zero to 940 tons after five years. Private-sector investments in the value chain totalled \$5 million over five years, and several thousand seasonal jobs were created.

<sup>346</sup> In Afghanistan, the poultry value chain program linked home-bound women to markets and each other, improving their social as well as business networks and raising their self-esteem.

regions and groups. Further, Private Sector actors can play a role in peace negotiations or support public initiatives for peace.

- Meso level: PSD activities can support private sector or civil society organisations that develop policy recommendations, initiate projects to improve the relationship between businesses and civil society, or foster an inclusive business culture. Such ‘connectors’ can be strengthened, for example, through the promotion of corporate social responsibility (CSR) amongst business associations, by bringing together members of conflicting parties in business support programmes, or by integrating members of different ethnicities.
- Micro level: PSD activities can contribute to crisis prevention and peace-building, for example by supporting people from disadvantaged groups to start or improve their enterprises; or by giving advice to entrepreneurs on how to apply social standards in their business operations<sup>347</sup>.

In the same guidebook, GIZ then identifies how three key PSD approaches can contribute to crisis prevention, conflict transformation and peace-building, while promoting systemic private sector competitiveness. The first approach is the development of a business-enabling environment (BEE), which focuses on the macro level but also, has impacts at all other levels. There is also high potential to link BEE interventions to existing national and international business initiatives for peace. The second approach is local and regional economic development (LRED), which is particularly relevant for addressing regional disparities and strengthening the micro and intermediate levels on local basis. The third approach is sectoral or value chain promotion, placing the focus of activities on sub-sectors of the economy, for example, those of high significance for employment; this approach can span all four levels but usually stresses the micro and intermediate levels<sup>348</sup>.

Complementing these PSD approaches with measures in the fields of skills development, employment promotion and financial system development can increase their potential to build peace. Microfinance services, such as those intended to assist micro-entrepreneurs and disadvantaged groups, can enhance the effectiveness of LRED and value chain promotion. Short-term vocational skills training courses are also often linked to these interventions, especially in situations where qualified workers have migrated or where ex-combatants and returning refugees need to be integrated into the local economy<sup>349</sup>.

## World Bank

In 2012, the World Bank Independent Evaluation Group, using project documents and other sources of information, compiled a comprehensive dataset on the Bank Group’s work in 14 African states<sup>350</sup>, which are classified as fragile by the World Bank Group. In terms of Project Outcome Performance, the private sector-related subsectors with the highest project outcome ratings included: telecommunications, oil and gas, transport infrastructure, and trade policy reform. At least half of the World Bank’s International Development Association (IDA) concessional assistance projects had at least “satisfactory” outcome ratings in these subsectors. The worst performing subsectors included: port infrastructure, banking, MSME finance, rail infrastructure and mining<sup>351</sup>.

However, it should be explicitly stated that this does not necessarily mean that IDA’s projects have a poor alignment with PSD subsectors with strong, proven results. More than half of road projects in fragile state environments have provided “satisfactory” outcomes – despite the subsector’s overall average rating of “moderately unsatisfactory.” This illustrates the imperative to focus also on the micro, macro, and operational factors that influence project outcomes, explored extensively in the literature. Several studies find that operational factors – such as project preparation, quality-at-entry, and project supervision – have significant explanatory power in determining project outcome ratings<sup>352</sup>.

In light of the above, the World Bank has developed a conceptual framework for PSD development in FCAS, which brings together three components for policy design – what is needed, what is wanted, and what works:

<sup>347</sup> GIZ – Sustainable Economic Development in Conflict-Affected Environments, 2009.

<sup>348</sup> GIZ – Sustainable Economic Development in Conflict-Affected Environments, 2009

<sup>349</sup> Ibid.

<sup>350</sup> Sudan, Central African Republic, Democratic Republic of Congo, Togo, Guinea-Bissau, Guinea, Liberia, Angola, Cote d’Ivoire, Republic of Congo, Zimbabwe, Eritrea, Chad, and Burundi

<sup>351</sup> Leo, Ramachandran, Thuotte, ‘Supporting Private Business Growth in African Fragile States’: A Guiding Framework for the World Bank Group, 2012

<sup>352</sup> Ibid.

- Business constraints ('what is needed'): To generate growth, policymakers must create a conducive environment for business owners and managers of SMEs and larger businesses. Understanding the business community's concrete and most binding constraints is the crucial first step towards good policy design;
- Government priorities ('what is wanted'): Policy makers in FCAS operate in very difficult environments. Understanding their perspective and private sector objectives is important, especially for policy-makers in multilateral organisations;
- Proven results ('what works'): We must use lessons learning from past project and policy interventions. Understanding what has worked in very difficult environments will be useful to the design of new policies, programmes, and projects – particularly when those findings are referenced against public and private sector constraints and priorities;

### DFID Private Sector Development initiatives and lessons learning

Practically, Coffey has a broad range of experience across a number of FCAS states, and has recent experience in Iraq, Pakistan, Nigeria and Somalia:

- In Iraq, Coffey implemented a project of support to the Provincial Reconstruction Team, which aimed to deliver on Iraqi reconstruction priorities, including support to sustainable job creation, technical training and livelihood support. There were a number of interventions which directly aimed to improve the investment climate and inflow of FDI to businesses.
- In Pakistan, Coffey is implementing a Sub-National Governance programme. As part of this, an Innovation Challenge fund has been set up to identify and fund innovative service delivery models<sup>353</sup> – many of which through the private sector – for education and health. We have also recently undertaken a design of a new DFID Enterprise and Asset Growth programme in Pakistan, which aims to improve access to finance for high-growth SMEs – especially those that have the potential to employ women and young people.
- In Nigeria, Coffey has experience implementing two large M4P programmes – GEMS 2 and GEMS 4. The former focused on improving the market for construction and real estate, whereas the latter is focusing on wholesale and retail markets. Both projects worked closely with small enterprises, and so a nuanced understanding of the operational and programmatic roll-out of both projects help inform our study. An additional benefit would be to review under which circumstances traders can promote vertical integration selected agribusiness markets.
- In Somalia, Coffey has been implementing a number of short-term assignments, including annual reviews of their SEED projects, as well as overseeing the design of a private sector innovation and growth programme<sup>354</sup>. Given Somalia's security status as a conflict environment, specific design lessons can be drawn from this, which assists us in informing the options to be proposed.

In 2014, The Independent Commission for Aid Impact (ICAI)<sup>355</sup> published a paper titled 'DFID's Private Sector Development Work'. The paper reviews the coherence of PSD rather than rate the specific country programmes analysed. The key findings of the report are as follows:

- Overall, DFID's approach is ambitious. However, these ambitions have not been converted into clear guidance for the development of coherent, realistic well-balanced and joined-up country-level portfolios.
- The impact of individual programmes is positive, particularly at the micro-level. However, when considered at the portfolio level, it is hard to identify overall impact and what distinguishes DFID's particular role in this area.
- Greater acknowledgement is required of the scale and complexity of achieving poverty reduction through PSD, and of the elements that are outside of DFID's control and experience and ability to address.

<sup>353</sup> The District Delivery Challenge Fund (DDCF) <http://www.pk-sng.org/challenge-fund>.

<sup>354</sup> This good blog explains well the objectives: <https://dfid.blog.gov.uk/2013/08/05/seeding-jobs-and-growth-in-somalia/>. Lessons from the recent Somaliland Business Fund could be also of interest.

<sup>355</sup> ICAI is the independent body responsible for scrutinising UK aid. It focuses on maximising the effectiveness of the UK aid budget for intended beneficiaries and on delivering value for money for UK taxpayers.

- Theories of change need to reflect the PSD context and business cases need to be flexible to cope with changing market conditions during delivery.

The key recommendations of the report are as follows:

- DFID should clearly define and articulate where it can add most value in PSD relative to other stakeholders. It should be more realistic in its ambitions and the impact it wishes to achieve.
- DFID should provide clearer guidance to its staff on how to design a coherent and well-balanced PSD country portfolio that matches its goals for an end to extreme poverty through economic development and transformational change.
- DFID needs to better calibrate and manage risks associated with PSD and so innovate in a more informed fashion.
- DFID needs to work harder to understand the barriers and business imperatives faced by the private sector in participating in development. Wherever it operates, DFID needs to be clear how and where it interventions can address these barriers.

## References

- **A Synthesis of Practical Lessons from Value Chain Projects in Conflict-Affected Environments**, USAID, May 2008
- **Access to Financial Services in Southern Afghanistan (What is the potential to increase SME access to financial services in the South?)**, Daniel Gies, Amjad Arbab, and Paul Wendland, ShoreBank International, December 2008
- **Afghan Business Attitudes on the Economy, Government, and Business Organizations – 2009-2010 Afghan Business Survey Final Report**, National Endowment for Democracy, 2010
- **Afghanistan and Pakistan: Public Opinion Trends and Strategic Implications**, Craig Charney, 2010
- **Afghanistan Development Note**, Asian Development Outlook 2014, Rehman Gul, Afghanistan Resident Mission, Asian Development Bank, Kabul, 2014
- **Afghanistan New Market Development – Implementation and Results**, World Bank, 2014
- **Afghanistan Overview of Economic Indicators No.5**, USAID, 2011
- **Afghanistan Small and Medium Enterprise Development (ASMED) – Annual Report 2008**, USAID
- **Afghanistan Small and Medium Enterprise Development (ASMED) – Annual Report 2010**, USAID
- **Afghanistan Small and Medium Enterprise Development (ASMED) - Business Development Services Fact Sheet**, USAID, June 2010
- **Afghanistan Small and Medium Enterprise Development (ASMED) – Human Capacity Building Fact Sheet**, USAID, June 2010
- **Afghanistan Small and Medium Enterprise Development (ASMED) – Market Information Fact Sheet**, USAID, June 2010
- **Afghanistan Small and Medium Enterprise Development (ASMED) – Quarterly Report – July through September 2009**, USAID
- **Afghanistan Small and Medium Enterprise Development (ASMED) – Quarterly Report – January through March 2009**, USAID
- **Afghanistan Technical and Vocational Education Training (TVET) Providers Inventory**, USAID, September-November 2011
- **Afghanistan Women’s Business Federation Fact Sheet**, USAID, June 2010
- **Afghanistan’s Rocky Road to Modernity: Non-State Actors and Socio-Political Entities in the Process of State- and Nation-Building**. Felix Kuntzsch, 2008



- **Aid and Conflict in Afghanistan**, Asia Report N°210, International Crisis Group, August 2011
- **Aid and Trust in Country Systems, Policy Research Working Paper 5005**, Stephen Knack, Nicholas Eubank, The World Bank Development Research Group, Human Development and Public Services Team, July 2009
- **An independent review of the World Bank's Doing Business rankings**, comments by the Bretton Woods Project, update 85, September 2012
- **Annual Review of the Afghanistan Investment Climate Facility (AICF), 2013**, DFID, February 2014
- **Annual Review of the Helmand Growth Programme**, DFID, December 2012
- **ASMED Business Development Services Sector Assessment**, Bradley J. Barnett, Development Alternatives, Inc. & USAID, May 2007
- **ASPEN-DFID Entrepreneurial Ecosystem Diagnostic Toolkit**, Jan 2014
- **Assessment of Technical Assistance to Ministry of Commerce & Industry**, DFID, Upperquartile, February 2013
- **Assessment of Technical Assistance to Ministry of Mines**, DFID, Upperquartile, February 2013
- **BDS Mapping Report – Business Development Services Project in Balkh, Kunduz, Takhar and Badakhshan Provinces of North Afghanistan**, GFA Consulting Group, GIZ, July 2011
- **BDS Mapping Report 2013 – Business Development Services Project in Balkh, Kunduz, Takhar and Badakhshan Provinces of North Afghanistan**, GIZ, March 2013
- **Beyond the Market – Can the AREDP transform Afghanistan's rural nonfarm economy?**, Adam Pain, Paula Kantor, Afghanistan Research and Evaluation Unit Briefing paper series, February 2011
- **Beyond The Market, Can the AREDP transform Afghanistan's rural nonfarm economy?** Adam Pain and Paula Kantor, Afghanistan Research and Evaluation Unit Briefing Paper Series, February 2011
- **CGAP Note “Financing Small Enterprises - what role for Microfinance Institutions MFIs”**, July 2012
- **Consulting and Capital Experiments with Micro and Small Tailoring Enterprises in Ghana** by Dean Karlan, Ryan Knight, Christopher Udry, Yale University, Innovations for Poverty Action, M.I.T. Jameel Poverty Action Lab and NBER, February 2014
- **Criminal Capture of Afghanistan's Economy**, Weeda Mehran, Integrity Watch Afghanistan, December 2013
- **DASTGAH Input to Helmand Growth Programme Project Completion Review**, May 2013
- **Demand Assessment for Sharia-based Financial Products - Findings from Research in Herat, Jalalabad, Kabul, and Mazar-e Sharif**, Saeed Parto, Afghanistan Public Policy Research Organization, 2011
- **DFID Afghanistan Operational Plan 2011-2015**, June 2013 update
- **DFID's Private Sector Development Work**, The Independent Commission for Aid Impact, 2014
- **DOING BUSINESS 2013 - Smarter Regulations for Small and Medium-Size Enterprises - Comparing Regulation for Domestic Firms in 185 Economies**, IFC, 2013
- **Doing Business in a More Transparent World, Comparing Regulation for Domestic Firms in 183 Economies**, IFC, 2012
- **Economic development for shared prosperity and poverty reduction: a strategic framework**, DFID, 2014
- **Economic Regeneration Programme**, Ministry of Agriculture, Irrigation and Livestock, 2009
- **Economics Topic Guide: Financial Sector**, Howard Miller and Subhrendu Chatterji, DFID-funded Professional Evidence And Applied Knowledge Services (PEAKS), October 2013



- **Emergency Project Paper on a proposed Emergency Recovery Grant in the Amount of SDR 14 Million (US\$22.0 Million Equivalent) to the Islamic Republic of Afghanistan for a Afghanistan New Market Development Project**, World Bank, April 2011
- **Evidence on Financial Sector Development**, DFID Growth Research Newsletter, Dec 2013
- **Final Evaluation Report: Developing Access to Skills & Trade for Growth of Agri-business in Helmand (DASTGAH)**, Ian Robinson, Mercy Corps Afghanistan, March 2013
- **Gender and Economic Choice: What's Old and What's New for Women in Afghanistan**, Chona R. Echavez, Afghanistan Research and Evaluation Unit, March 2012
- **Governance in Afghanistan: an Introduction**, Aarya Nijat, Afghanistan Research and Evaluation Unit, March 2014
- **Impact of private sector involvement on access and quality of service in electricity, telecom, and water supply sectors - A systematic review of the evidence in developing countries**, Thillai Rajan Annamalai. Ashwin Mahalingam, Akash Deep, September 2013
- **Implementing the SME Strategy – Action Plan for Developing Aghanistan's Agri-Business Sector**, Ministry of Commerce and Industry, and Ministry of Agriculture Irrigation and Livestock, 2013
- **Integrated Business Enterprise Survey 2009**, Central Statistics Organization Afghanistan, ADB, 2009
- **Integrated Trade and SME Support Facility, Private Sector Development Cluster, National Priority Program Proposal**, Ministry of Commerce and Industry, 2011
- **International Development Association Project Appraisal Document on Proposed Grant in the Amount of SDR 32.6 Million (US\$50 Million Equivalent) to the Islamic Republic of Afghanistan For a Access to Finance Project**, World Bank, November 2013
- **Investing in peace: The private sector and the challenges of peacebuilding**, 2010, Berdal, M.& Mousavizadeh, N.
- **Investment Climate Reform Program in Aghanistan (Short Progress Report, 2012-2013)**, USAID and IFC
- **Job Creation in Afghanistan: Putting Aid to Work**, Lucy Heady, Karla Newendorp, Hamid Ibrahimkail, and Saboor Arghandiwal Peace Dividend Trust, September 2011
- **Job creation in fragile states through SME financing: Notes from post-war Liberia**, Gorlorwulu, J.D 2011
- **Making Business Membership Organisations Work For The Poor**, Springfield/ASI Case Study, 2013
- **Micro, small and medium-sized enterprises in emerging markets: how banks can grasp a \$350 billion opportunity**, McKinsey, 2012
- **MicroView - A Quarterly Update on Development Finance Outreach in Afghanistan, Issue 3: Quarter 4 (Oct-Dec 2013)**, Afghanistan Microfinance Association, 2014
- **Mid-Term Review of the Introducing New Vocational Education and Skills Training (INVEST) Programme**, DFID/Coffey International Development, December 2012
- **MISFA: DFID Project Completion Report (Narrative Findings & Recommendations)**, 2010
- **National Area Based Development Programme – 2012 Annual Progress Report**, UNDP
- **National Area Based Development Programme (NABDP) Phase III, Project Document**, UNDP Afghanistan
- Notes taken during the **International Growth Centre Growth Weeks in 2012 and 2013**
- **Post-war Programme Implementation and Procurement - Some Lessons from the Experience of Afghanistan**, Alastair J. McKechnie, ODI, August 2011
- **Powering Up Afghanistan**, USAID, March 2014

- **Promoting SMEs in developing countries: Building on success**, David Irwin, November 2008
- **PSD in Conflict-Affected Environments-Key Resources for Practitioners**, DCED/DFID 2010 paper
- **Rethinking the role of the state in finance**, a reference to the Global Financial Development Report (GFDR), 2013
- **Rethinking Rural Poverty Reduction in Afghanistan**, Paula Kantor, Adam Pain, Afghanistan Research and Evaluation Unit Briefing paper series, October 2011
- **Rural Enterprise Development in Helmand, First Biannual Project Progress Report 2013**, UNDP (DFID-funded), 2013
- **Small and Growing Businesses: Investing in the Missing Middle for Poverty Alleviation** - Literature Review, Aspen Network of Development Entrepreneurs (ANDE), March 2012
- **Small and Medium Enterprises Development and Regional Trade in Afghanistan (Working Paper)**, Mujib Mashal, Afghanistan Research and Evaluation Unit, January 2014
- **SME Development Workshop Report: Achievements, Challenges and Suggested Next Steps**, USAID, November 2009
- **SME Survey Analysis**, Afghanistan Rural Enterprise Development Program (AREDP), July 2009
- **Somaliland Business Fund** (Presentation), Landell Mills
- **Statement on Industrial Policy**, Ministry of Commerce and Industry (The Government of the Islamic Republic of Afghanistan), 2011
- **Stimulating Microenterprise Growth: Results from a Loans, Grants and Training Experiment in Uganda**, Nathan Fiala, German Institute for Economic Research (DIW Berlin), December 2013
- **Supporting Employment & Enterprise Development (SEED) Economic Appraisal**, DFID, August 2009
- **Supporting Employment and Enterprise Development (SEED) Annual Review (July 2011-September 2012)**, DFID, 2012
- **Supporting Private Business Growth in African Fragile States A Guiding Framework for the World Bank Group in South Sudan and Other Nations**, Benjamin Leo, Vijaya Ramachandran, and Ross Thuotte, Center for Global Development, 2012
- **Supporting Self-Reliance in Afghanistan. Strategic Vision for the Transformational Decade.** Government of Afghanistan. 2012
- **Sustainable Economic Development in Conflict-Affected Environments - A Guidebook**, GTZ, 2009
- **Technical assistance, a development tool serving the private sector**, Proparco Private sector & Development Magazine number 11, July 2011
- **The demand for, and consequences of, formalization among informal firms in Sri Lanka**, Suresh de Mel, David McKenzie and Christopher Woodruff, World Bank Policy Research Working Paper 5991, 2012.
- **The doing business indicators, economic growth and regulatory reform**, Marek Hanusch, World Bank Policy Research working paper 6176, 2012
- **The Effects of Business Environments on Development: Surveying New Firm-Level - Evidence by Lixin Colin Xu** - World Bank Policy Research Working Paper 5402, 2010
- **The impact of consulting services on small and medium enterprises: evidence from a randomized trial in Mexico**, Miriam Bruhn, Dean Karlan, Antoinette Schoar, World Bank Policy Research working paper 6508, 2013
- **The impact of the investment climate on employment growth - does Sub-Saharan Africa mirror other low-income regions?** Aterido Reyes and Mary Hallward-Driemeier, World Bank Policy Research Working Paper 5218, 2010
- **The M4P approach has limited utility in post-conflict environments** - an M4P Hub Debate Q&A: By Panellists Diane Johnson, Global Economic Development Coordinator, Mercy Corps; Sarah Maguire, Chief

Executive, Social Development Direct; Andrew Ockenden, Senior Manager, Coffey International Development, M4P Hub March 2011

- **The role of private sector actors in post-conflict recovery**, 2009 Bray, J.
- **Tokyo Mutual Accountability Framework (TMAF) – Special Joint Coordination & Monitoring Board Meeting Joint Report**, January 2014
- **Topic Guide on Fragile States**, Claire McLoughlin, GSDRC, 2012
- **Transforming institutions to deliver citizen security, justice, and jobs**. World Development Report 2011 Chapter 5
- **UNDP Assessment of Development Results in Afghanistan 2009**, UNDP Evaluation Office, May 2009
- **What Have We Learned from the Enterprise Surveys Regarding Access to Credit by SMEs?** By Veselin Kuntchev, Rita Ramalho, Jorge Rodríguez-Meza and Judy S. Yang, World Bank Research Paper 6670, October 2013.
- **What is the evidence on the impact of employment creation on stability and poverty reduction in fragile states - an ODI systematic review**, Rebecca Holmes, Anna McCord and Jessica Hagen-Zanker with Gina Bergh and Franzisca Zanker, 2013
- **What is the evidence on the impact of employment creation on stability and poverty reduction in fragile states - A systematic review**, Rebecca Holmes, Anna McCord and Jessica Hagen-Zanker with Gina Bergh and Franzisca Zanker, ODI, May 2013
- **Winning Hearts and Minds? Examining the Effectiveness of Aid as a Stabilization Tool in Afghanistan – Summary of Preliminary Research Findings**, Feinstein International Center, Tufts University, August 2009
- **Women's Economic Empowerment in Afghanistan, 2002-2012 (Information Mapping and Situational Analysis)**, Afghanistan Research and Evaluation Unit, November 2013
- **World Bank Group Assistance to Low-Income Fragile and Conflict-Affected States**, Report by the Independent Evaluation Group of the World Bank, December 2013
- **World Bank, 'Islamic State of Afghanistan: Pathways to Inclusive Growth'**, 2014
- **World Development Report 2013 on Jobs**, Summary
- **World Bank 'Understanding Gender in Agricultural Value Chains: The Cases of Grapes/Raisins, Almonds and Saffron in Afghanistan'**, 2011.

## Annex 5: List of types of business development services

BDS Service	Comments
Accounting services	Significant demand in all sectors. Bookkeeping and recordkeeping had both demand and need, whereas account receivable strategy analysis was second most in demand.
Competitive Market Study	Small in demand probably because of lack of familiarity with the value. Significant need in Hirat and in carpet sector.
Consumer research	Ranked 6 <sup>th</sup> in demand over all
Demand study	Ranked 5 <sup>th</sup> in demand over all.
Financial analysis , modelling & access to capital	Small indication of demand and a slightly larger requirement of perceived need. Banks indicates the preference of BDS services in market for this particular service.
Legal services	Demand and needs are weak but perception to adopt formal legal channel is growing.
Market information	Ranked 3 <sup>rd</sup> highest in construction sector. Specifically in Kabul it was the 2 <sup>nd</sup> highest need in construction sector.
Market study	Ranked 3 <sup>rd</sup> highest overall. Kandahar and Badakshan registered highest demand
Marketing services	Ranked 1 <sup>st</sup> overall in all sectors. Although it was unclear how much businesses would be willing to pay for this. Further study may assist before encouraging consultant to grab opportunity.
Procurement	Very low in demand and weak in need.
R&D	Strongest demand in food processing industry and relatively significant in carpet industry.
Recruitment	Kandahar reported a significant in demand and construction industry.
Technical services	Most significant demand in Kandahar by specialised businesses. It is a niche market and most BDS do not have the skills to help.
Training	4 <sup>th</sup> highest in overall demand, particularly in accounting practises and MS Office application. Rest demands are too complex or too advanced for local BDS providers to meet with.

Source: ASMED 2011

Note: 'Demand' signifies the willingness to pay whereas 'needs' means desire to have but not specifically the willingness to pay

## Annex 6: Major donor programmes providing business development services

### Business Incubator Hub (BIH), American University of Afghanistan<sup>356</sup>

- BIH received two establishment grants from US Government Task Force for Business and Stability Operations (TFBSO), totalling \$4 million.
- It started in July 2013 and is aiming at reaching sustainability by mid-2016.
- It is currently charging for all business services, but is able to discount by 50 percent of the cost on a case-by-case basis in the first year. BIH state they are still establishing their benchmark standard rates as they work to understand costs and possible mark-ups for sustainability/profitability.
- BIH is currently supporting SMEs with turnover in the range of \$100,000 to \$2 million per year, but is targeting companies with the potential to become sector leading companies and grow to \$20 million.
- BIH have contracts with approximately 30 companies (with an objective of 45 by the end of 2014) and agreed 5 businesses for “deep” (i.e. full, holistic) services (expected to rise to 15 by the end of 2014).
- New development: BIH plan to create a city-wide competition of entrepreneurial ideas with the intermediate step of entering 30 entrepreneurs in a month-long business “boot camp” (similar to the US/UK TV programs The Apprentice and Shark Tank) and subsequent 15 winners entering a three month full incubator.

### Assistance in Building Afghanistan by Developing Enterprises (ABADE)<sup>357</sup>, USAID funded

- It is a 4-year programme approved in October 2012, managed by a non-for profit specialist, called Volunteers for Economic Growth Alliance, with a long experience of managing USAID-funded projects in MENA countries (Lebanon, Tunisia) and other fragile and conflict-affected countries in Asia (Sri Lanka, Cambodia), Africa (Liberia) AND Eastern Europe (Albania).
- To its traditional TA and BDS (Component 2), it deploys more original “Public-Private Innovation Alliances” and “SME Alliances” (Component 1A) where ABADE makes awards to existing businesses that have investment programmes. SME Alliance beneficiaries should have a substantial financial stake in the venture, by matching ABADE funding on at least a 1:2 basis.
- It is also providing more innovative support to “targeting investments that offer non-traditional business approaches to creating: [...] economic growth with a focus on jobs”, that can be awarded to both for-profit and non-profit entities. These are called “Innovation Alliances” (Component 2B). They should match ABADE funding on at least a 1:1 basis.
- ABADE includes also a Component 3 to support Business Enabling Environment reform. This may be driven by sub-award applicants of the 2 previous components. .

#### Target results

- Generate \$180 million in private sector investment.
- Form 365 public-private alliances.
- Form 41 Innovation public-private alliances.
- Create 46,000 full-time equivalent jobs.
- A 20 percent average increase in sales by public-private alliance SMEs.

<sup>356</sup> interview and email correspondence, May-June 2014

<sup>357</sup> <http://www.abade.org/about-abade/>

- A 20 percent average reduction in the number of days to obtain construction permits

## Afghanistan New Market Development Program, World Bank Funded

### Component 1: Facility for New Market Development (FNMD) (US\$ 18 million)

This component will finance:

- Business development technical assistance grants to participating firms and business associations (US\$ 11.2m)
- Information, communications, knowledge sharing of best practices on business development planning, results monitoring and dissemination activities associated with the implementation of the Facility (US\$ 1.3m), and
- Facility management consultancy services (US\$ 5.5m). Business development assistance will be provided on a cost-sharing basis. The project will reimburse:
  - 50 percent of eligible expenditures incurred by participating firms and
  - 70 percent of eligible expenditures incurred by business associations for activities aimed at developing and implementing business plans to access new markets through market research, product development, acquisition of new technologies and adoption of quality standards.

### Expected targets

- About 750 private sector Afghan firms in each of the four target cities – Kabul (about 300 firms), Jalalabad (about 150 firms), Mazar-e-Sharif (150 firms), and Herat (about 150 firms) – Rough some 10 percent of the total population of such firms in Afghanistan.
- About 10 groups of businesses – either consortia of individual firms self-organized or formally established Afghan business associations.

### Key Performance Indicators

- Number of firms benefited by the cost-sharing program - 750
- Increased sales (20 percent),
- Product or market diversification (20)
- Number of jobs (direct and indirect) - 1500.

### Status

- 229 agreements have been signed with SMEs and business associations.

## Afghanistan Rural Enterprises Development Program, MRRD and multi-donor<sup>358</sup>:

### Program Development Objectives for SME unit:

- At least 30 percent increase in direct and/or indirect employment by Small and Medium Enterprises (SMEs). At least 35 percent of those employed will be women;
- On average SMEs report at least a 50 percent increase in purchase of inputs produced in rural areas;

### Status

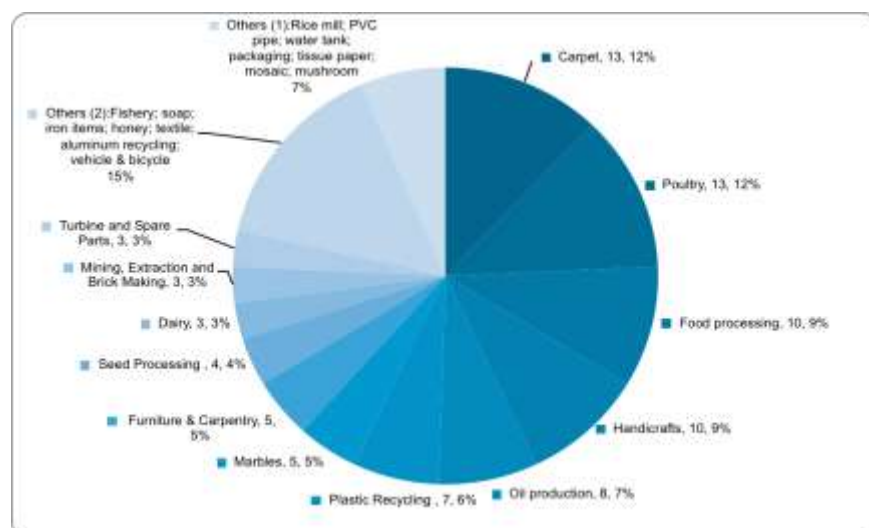
Expected outcome	Results achieved
At least 50 percent increase in the purchase of inputs produced in rural areas;	50 percent of 125 SMEs supported by the project. 50 percent increase in purchases from rural areas after project support.

<sup>358</sup> Interviews with AREDP staff; exchanges of e-mails; Annual Reports and <http://www.aredp-mrrd.gov.af/>

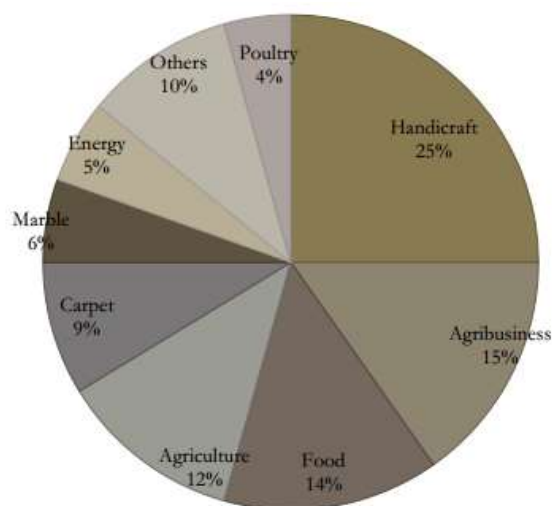


At least 30 percent increase in direct and/or indirect employment;	20 percent increase
50 percent SME to report increases the net revenue	50 percent have reported increase in revenues. 2013 data suggest average increase in sales by 22 percent among the supported SMEs.

**Figure 1: Detail distribution of 1st cycle of selection and support of 107 SMEs in 2011 by AREDP (Ref: AREDP 3<sup>rd</sup> quarter report 2011-12)**



**Figure 2: Details of 327 SMEs identified by AREDP up to 2013 for support:**



#### **Status: Increase in SME Sales after AREDP BDS Intervention (Ref: AREDP Annual Report 2013)**

SMEs after receiving trainings were expected to increase sales rate. According to the Impact Analysis the percentage of sales increased to 44 percent on average in all five Provinces sales after AREDP intervention. In Bamyan, sales increased by 153 percent, followed by Nangarhar with 72 percent. Rural SMEs in Herat and Mazar increased their sales by 20 percent and Parwan by 18 percent.

**Table 1: Lessons learned in context of BDS provision**

Strengths	Weaknesses
SCOPING THE NEED FOR IMPROVED ACCESS TO FUNDING, ADVISORY SUPPORT AND BUSINESS SKILLS DEVELOPMENT FOR SMES IN AFGHANISTAN – SEPTEMBER 2014	

<b>Business Incubator Hub (BIH), American University of Afghanistan</b>	
Core approach is focused on individual via 'mind set assessment' followed by deep business diagnosis to understand and define problem. Provide direct strategic business consultancy services to address internal constraints of the business. Flexible, quality assurance ensured and quick turnaround time.	Limitation in expansion as well as mismatch in available funds and disbursement timeframe. Free funds/donor projects for BDS in market are jeopardizing BIH efforts to charge fee for services. Not for businesses with turnover less than \$100,000 therefore limitation on pool of businesses which could be supported.
<b>Assistance in Building Afghanistan by Developing Enterprises (ABADE), USAID funded</b>	
A holistic approach towards addressing internal and external factors of business including A2F; BDS support and technical support and business enabling environment.	Project is at initial stage therefore it is too early to comment on its weaknesses
<b>Afghanistan New Market Development Program, World Bank Funded</b>	
Availability of grant with cost sharing option. Option for entrepreneurs to choose BDS service providers from open market for needs identified by SMEs themselves. Focused on solving internal factors of business.	Excessive delay in clearance of reimbursement bill claims negatively affected the entrepreneurs, BDS and project team. Challenge in verification increases possibility of false bill claims as well as internal fixing on claims. Limited availability of BDS providers (in terms of quality, relevance, turnaround time, flexibility) in domestic market as per needs and requirement of SMEs. No interaction or assistance by project to SME at initial stage of diagnosis of business problem.
<b>Afghanistan Rural Enterprises Development Program, MRRD and multi-donor</b>	
Extensive reach out to SMEs in 7 provinces of Afghanistan. Comprehensive and competitive SME identification process. Success is achieved via identifying BDS needs of SMEs and then assisting in availing the solution from the market e.g. B2B exposure and training; market exposure, practical and hands-on technical training. Focused on internal factors of business. Cost of BDS support is directly paid by project therefore no cash transfer to SMEs.	Unable to provide access to finance and business enabling environment support as per initial project document. Challenge in identifying technical BDS provider in local market and/or B2B technical training provider. Limitation in providing customised support demanded by individual SMEs. Too many different types, sectors and size of businesses, therefore difficulty in effective provision of support.
<b>IFC Business Edge</b>	
Provision of continued follow-up and mentoring support to BDS providers after training. This lead to strengthening of capacity of the staff of BDS providers as well as appreciation of training received from IFC by BDS providers. Typically, BDS providers are able to earn through proposal writing or assisting businesses in application process of donor funded projects.	Significantly low level of absorption capacity of trainee's therefore actual transfer of skill is limited. Knowledge and effectiveness of business consultancy services is restricted. SMEs unwilling to pay fee for BDS providers for business consultancy services.
<b>USAID Agricultural Credit Enhancement (ACE)/Agriculture Development Fund (ADF)</b>	
Provision of customized BDS support and A2F, case by case basis. Focused on agriculture based SMEs and solving internal business constraints.	No direct supporting to micro and small businesses. Main focus is on production side of businesses therefore market support for SMEs are restricted.

## Annex 7: Selected case studies on women-owned enterprises

### Potato Chips making SME, Bamiyan

**Introduction:** One year old business with total investment of \$10,000. The SME is owned by a woman and 95 percent of the employees are also women.

**Product:** Potato chips packets of 80gm at 10 Afs.

**Market:** School children and some shopkeepers in the city. However, there is a significant scope of increasing the market.

**Production and tools:** Traditional techniques are used to produce the chips such as hand peeler, local oil, gas stove and local household utensils. The production is carried out at a rented home. The ready stock and inventory is kept in another home close to the production site. The production per day is around 36.5 kg and 1,096 kg per month. The women work for 12 days a month. The chips are packed in locally available plastic bags which are generally used for selling dry fruits as well. No machinery is involved for commercial production of chips.

**Raw material:** 13,160 kg of potato is bought locally during the potato season, oil, gas and plastic wrapper.

**Employees:** The SME has 20 women working in two shifts. They earn approx. 1,000-1,500 Afs per month.

**Capital needs:** SME is not sure about the exact cash needs. However, they need cash for opening more branches in schools, better packaging, marketing and salaries for staff. Last year net profit was \$270.

**Constraints:**

- Method of peeling large quantity of potato.
- Method of frying to reduce the oil content in chips.
- Method of standardizing the thickness and size of potato chips.
- Method, tools, and techniques to develop different shapes and sizes of potato chips.
- Diversify/Increase/Expand SME's product taste line from 1 to 3 varieties/flavours.
- Market survey for promotion; selling plan & costing.
- No electricity available.
- Lack of skilled staff.
- Lack of storage place for large production.

## Handicraft SME, Balkh

**Introduction:** The business is a sole proprietorship run by its female owner for more than 8 years (2001) in Balkh province. The SME's initial and/or start up investments were small but it continued to grow decently for the last 5 years.

**Products:** Rugs, carpets, veils, silk process, textiles and many other handicrafts products. Moreover, these products are made from the best quality of silk and wool.

**Market:** The products are sold to a wholesaler or businesses and retailer. The specialised knowledge and skill of wholesalers increases the efficiency of the distribution network. The wholesalers provide important services and solve the problems of both the manufacturers and the retailers. The SME also has a shop for ladies items and a considerable customer base. Many customers are foreigners as well.

**Equipment:** Handicraft is a labour intensive business run by local technology. Such types of technology are easily available in local markets at cheaper prices than compared to the modern or imported ones. These technologies could be listed as wool thread machines, waving machines, sewing machines etc.

**Production:** Raw materials are purchased in cash, mostly from local markets. The seeds of silk are distributed to families in different villages across the districts in northern region. After a year, silk is produced. The SME purchases it back from those families for one Kg at 500 AFN. Supplying like this not only increases the income of the people but also creates a lot of job opportunities, especially for women. In a year, the SME utilizes 12 tons of wools and 1.5 tons of silk. Overall, the raw materials are sourced locally, but in some cases they are imported from Pakistan, India, China, and other countries.

There is a scope to increase the capacity of the production. Thus, in future, the factory would require even more quantity of raw materials. Local markets do provide good quality silk in sufficient amounts and there is no problem in accessing the raw materials.

**Employment:** Currently, the estimated direct and indirect employment is: 6 permanent, 200 temporary or seasonal employees for managing the business, whose salary ranges from 3000 AFN to 5000 AFN. Most of the employees are women. Availability for services like highway is there too, although there is lack of both water and electricity supply at the factory site.

**Capital need:** The SME is in need of loans to procure new and modern technology to run her business. The SME wishes to have long and medium term loans, with minimum 6 months gross period, low interest rate is desirable for the business. The SME has requested to for an Islamic loan of \$100,000 for a period of 3 years. The purpose of the loan is to purchase new machinery, and expansion of business.

The SME had a good profit margin previous year. In the next 2-3 years the margin of profit is expected to be more than the times as of now.

SME has neither applied for any sort of loan nor received any type of grant in the past 1-2 years. In the recent past, the SME had achieved a profit of \$60,000. Since the SME started this business, the production has increased consistently. The SME has had good and/or encouraging margins. The total investment in business has been \$97,000.

### Constraints:

- Lack of financial resources.
- Lack of technical know-how (colouring, designing).
- Lack of administration and financial management.
- Low capacity of production.

## Annex 8: Guarantee Schemes in Afghanistan

- DEG-managed and World Bank-funded Afghan Credit Guarantee Foundation (ACGF)<sup>359</sup> could envisage cooperation with mutual guarantee schemes. This is a mechanism well known in Continental Europe (for example in Germany, France, and Italy)<sup>360</sup> or in Canada and BRICs<sup>361</sup>, and has been recently re-assessed by the international community including DFID<sup>362</sup>. ACGF could provide technical assistance and screen mutual guarantee societies as co-guarantors.
- AREDP implementation team has explored, without success, the establishment of small guarantee schemes “Partial Guarantee scheme did not happen because there was no seed finance<sup>363</sup>” but also because the MFIs were in a restructuring phase and linkages could not be engineered to transform best performing Village Savings and Loans Associations. The last reason was the absence of Sharia-compliant products.
- US-funded Agricultural Credit Enhancement Programme ACE, implementation team<sup>364</sup>. This programme is deemed to close in its current guise in 2015 but some components have been consolidated in the Agricultural Development Fund (ADF), a nonbank stand-alone financial institution temporarily hosted by the MAIL such as Development Fund. We understood from our interview with USAID that Denmark considered funding a new phase of ADF.
- VEGA – Volunteers for Growth Alliance that implements the US-funded Assistance in Building Afghanistan by Developing Enterprises (ABADE)<sup>365</sup> and has developed what they call public-private alliances “to stimulate innovation-focused initiatives”.
- There may also be other pilots that have been tested in the past by donors and INGOs and that have been closed for various programmatic and security reasons (for instance by German GiZ decentralised projects) that would need to be mapped by the current efforts from the GfRoA and whose implementing teams in donors, management teams overseas and in Afghanistan may be rediscovered and replicated if DFID was publicizing a request for proposals.
- Finally this Team has entered a comprehensive policy dialogue that DFID will have to pursue with USAID DCA experts to see if their flagship programme could be extended to blue-chip financial institutions such as AIB or FMFB to reach smaller DFID SME targets. In Bosnia<sup>366</sup> and Mozambique, USAID has designed joint guarantee programmes with Swedish SIDA notably targeted at rural businesses.

<sup>359</sup> This will be the successor programme to the Credit Guarantee Facility for Afghanistan (CGF-A) managed by the German DFI and that has received prior support from German KfW-DEG and USAID – interview with its CEO-designate

<sup>360</sup> There is a simple presentation of Mutual Guarantee Societies on the European Association website: <http://www.aecm.eu/en/guarantee-societies.html?IDC=34>

<sup>361</sup> see for instance the OECD paper “SME and Entrepreneurship Financing: The Role of Credit Guarantee Schemes and Mutual Guarantee Societies in supporting finance for small and medium-sized enterprises” – Jan 2013

<sup>362</sup> There is an immense literature that has been discussed with DFID PSD Department Expert Martin Alsop last year during the drafting of the EAGR Business Case. Probably the most useful introduction for practitioners in developing countries remains the G20 Global Partnership for Financial Inclusion IFC SME Finance Policy Guide – Chap3 pages 55-59.

<sup>363</sup> Interview with AREDP Programme Management Team – and various AREDP quarterly reports up to 2012 assessing the challenges to deploying the Partial Risk Guarantee Facility (PRGF) provision

<sup>364</sup> <http://dai.com/our-work/projects/afghanistan%E2%80%94agricultural-credit-enhancement-program-ace>

<sup>365</sup> <http://www.usaid.gov/sites/default/files/documents/1871/ABADE%20Fact%20Sheet%20-%20Jan%202013%20FINAL.pdf>

<sup>366</sup> <http://www.usaid.gov/news-information/fact-sheets/fact-sheet-development-credit-authority-loan-portfolio-guarantee-bosnia>

## Annex 9: APPRO research findings report

### Overview of Findings from Cluster Analysis in:

**Herat, Kabul, Kandahar, Mazar-e Sharif, and Parwan**



#### Submitted by:

Afghanistan Public Policy Research Organization (APPRO)

Kabul, Afghanistan

August 14, 2014

#### Key Contact:

Saeed Parto

Mobile: +93 777 011 840

Email: [saeed.parto@appro.org.af](mailto:saeed.parto@appro.org.af)



## 1 INTRODUCTION

With some success, the bulk of the interventions since 2001 aimed at reconstruction in Afghanistan has been driven by economic models emphasizing the importance of private sector and need for increasing value adding activities by Afghan producers and service providers. However, there remain significant gaps in the knowledge base that informs reconstruction policy making and programming on strengthening the pre-existing (and resilient) bases of economic activity and growth.<sup>367</sup>

As with most traditional / older societies, Afghanistan's economy, particularly in urban areas, is to a significant extent made up of constellations of enterprises of the same or related trades clustered around a number of identifiable locations. These clusters have at least two defining features of relevance for efforts to increase the productive capacity of Afghanistan's workforce. First, in almost all clusters there are apprenticeship arrangements to train the future generation of tradespersons. Second, there are clearly defined structures through which the sustenance of these cluster is maintained. Each cluster is represented by a *senf* (traditional guild) and/or *anjoman* (formal trade association) which, in turn, has membership of the *etehadia* (the national apex organization or association).

For a variety of reasons *senfs*, *anjomans*, and the *etehadia* representing them, and the *senfs'* constituent businesses, have persisted, some for hundreds of years and despite the recurring periods of turmoil and instability and continued to represent and protect the interests of their constituent enterprises in licit, productive, and resilient economic activity. Ongoing research by Afghanistan Public Policy Research Organization (APPRO) has documented and analyzed the activities, economic contributions, and needs of bazaar-based (clustered) businesses in major cities of Afghanistan since 2010. This programme commenced with a study of traditional clusters in Herat, concluded in September 2011, followed by another study in Kabul, Parwan, and Balkh starting in 2011 and concluding in late 2012.<sup>368</sup> Also, in May 2014 a sampled survey of the dried fruits and nuts cluster was carried out in Kandahar City and Kabul, with the Kabul survey focusing on businesswomen.<sup>369</sup>

The findings from the earlier studies in Herat, Kabul, Mazar-e Sharif, and Parwan are synthesized in the remainder of this overview. The most recent findings from the data collected in Kabul, Kandahar, and Mazar-e Sharif during May-June 2014 are reported in Appendix 1, broadly confirming the key findings and conclusions reported in this overview.

The rationale for this overview and the additional research undertaken during May-June 2014 (Appendix 1) is to draw attention to the role, resilience, and potential of micro and small-sized enterprises for economic development and sustained growth in Afghanistan, consistent with DFID's "Strategic Framework for Private Sector Development in Afghanistan." The findings reported in this overview and Appendix 1 add to the body of knowledge on the workings of productive industry in Afghanistan and thus are of relevance to DFID's Strategic Framework, given the Framework's intention to "... highlight the institutions that encourage private sector development and export growth, free and fair markets, sound macroeconomic management, clear and consistently applied policies, regulations and laws, secure property rights, and functioning commercial courts."<sup>370</sup> As a means for sustained poverty reduction, the Framework focuses on:

- Job-intensive activities and sectors
- Export sectors (goods and services) to create deep and durable markets
- Diversification of economies to create inclusive growth
- The institutional and political arrangements that facilitate growth

<sup>367</sup> This section draws closely from an unpublished project report in 2012 on micro and small-sized enterprises in Kabul City, Charikar (Parwan), and Mazar-e Sharif (Balkh), funded by Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH (GIZ) and a published report on clustered enterprises in Herat, available from: <http://appro.org.af/preview/traditional-economic-clusters-and-reconstruction-in-afghanistan-the-case-of-herat/>

<sup>368</sup> See APPRO (2012). *Traditional Economic Clusters and Reconstruction in Afghanistan: The Case of Herat*, funded by MISFA and available from: <http://www.appro.org.af/Publications.html>. The subsequent study is in the process of being prepared for general release in 2014.

<sup>369</sup> The surveys in Kabul and Kandahar and additional data collection in Kabul, Kandahar, and Mazar-e Sharif were commissioned by Coffey International.

<sup>370</sup> DFID (2014), "Economic development for shared prosperity and poverty reduction: a strategic framework", page 1. SCOPING THE NEED FOR IMPROVED ACCESS TO FUNDING, ADVISORY SUPPORT AND BUSINESS SKILLS DEVELOPMENT FOR SMES IN AFGHANISTAN – SEPTEMBER 2014

- Better management of natural assets in the long term interests of the population, and limiting the effects of economic and climate shocks

The Framework is cognizant of the common and fundamental problems faced by private sector actors in least developed and in- or post-conflict countries such as Afghanistan including inadequate or unsuitable regulations, corruption, access to affordable and reliable infrastructure, especially power, access to finance, and skills shortages, particularly for larger enterprises.<sup>371</sup> The Framework also emphasizes that growth should be inclusive and benefit the most vulnerable, particularly girls and women.<sup>372</sup>

The assessment of DFID's Framework by the Independent Commission for Aid Impact (ICAI) recommends that, "DFID should clearly define and articulate where it can add most value in PSD relative to other stakeholders...."<sup>373</sup> Given the almost exclusively macro level focus by other main donor organizations active in Afghanistan, there are ample opportunities for DFID and other development aid organizations to add value through their programming in private sector development with a focus on the large but neglected number of clustered micro and small-scale enterprises present in all major populations centres of Afghanistan. Intervention with a focus on micro and small-scale enterprises will be consistent with the Framework's objectives for supporting job-intensive activities and sectors, export sectors, diversification of economies to create inclusive growth, and institutional and political arrangements that facilitate growth.

This overview begins with a framing of clustered micro and small-scale enterprises in value chains, followed by the key findings from the analysis of primary data from previous studies of micro and small-scale enterprises in the period 2010-2013. Since the key findings from the most recent rounds data collection during May-June 2014 confirm the findings in this overview, the analysis of the data from May-June 2014 is relegated to Appendix 1.

## 2 RELATIONSHIP BETWEEN CLUSTERED ENTERPRISES AND VALUE CHAINS

The premise for conceptualization of inter-firm relationships in terms of "value chains" and "clusters" arises from the fact that firms do not exist in a vacuum, often face shared constraints such as regulatory pressures or lack of access to markets or capital, and are thus often interdependent in overcoming constraints despite being competitive toward one another.

Whereas the value chain approach emphasizes the broader market conditions and the need for individual firms to strive to move up the value chain, the cluster approach is concerned about the more immediate operating and market environment of clustered enterprises which are typically co-located, share suppliers and customers, and are more likely to collaborate horizontally.<sup>374</sup> Figure 1 depicts the relationship between clustered enterprises and the value chain within which clustered enterprises operate.

---

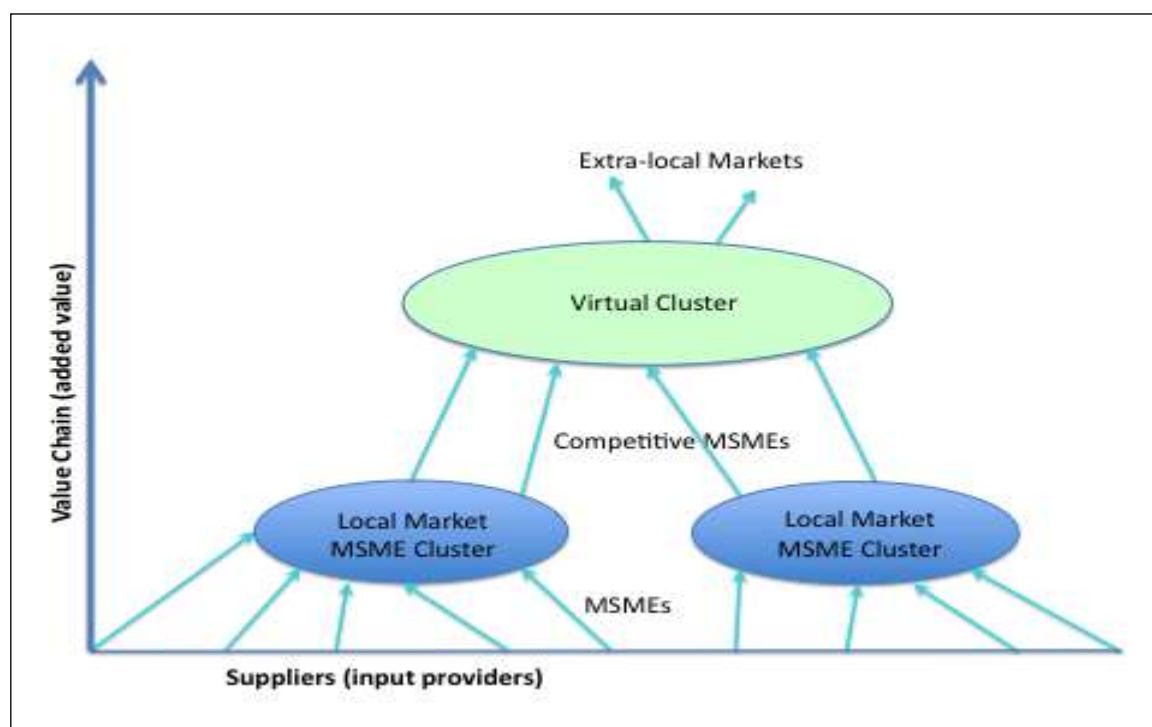
<sup>371</sup> DFID (undated), page 7.

<sup>372</sup> *Ibid.* Page 14.

<sup>373</sup> ICAI (2014), "DFID's Private Sector Development Work", Report 35 – May 2014, page 34.

<sup>374</sup> See, for example, USAID (2008), Value Chain and the Cluster Approach, available from:

[http://pdf.usaid.gov/pdf\\_docs/Pnadp044.pdf](http://pdf.usaid.gov/pdf_docs/Pnadp044.pdf)

**Figure 1: Clusters and Value Chains**

In contrast to the value chain approach, the cluster approach is more focused on consolidation of the cluster in terms of efficiency and resiliency. Efficiency (and effectiveness) of a cluster may be increased through securing shared agreements to secure cheaper supplies of raw materials, instantly increase supply of goods and services to meet spikes in demand by drawing on built-in redundancy within the cluster, and use the critical mass of the cluster to demand bring in operating conditions, secure loans, or undertake joint marketing. Clusters, particularly in a less developed context and without access to export markets, are prone to benefiting from realignments in the domestic market aimed at increasing demand for domestically produced goods and services. Realignment, carried through in a value chain context, is likely to lay the foundation necessary for domestic enterprises to move up on the value chain by gaining access to extra-local markets (Figure 1).

A key finding from the Herat pilot study was that knowledge was practically nonexistent on the importance of clustered enterprises and the role of senfs, anjomans, and the national etehadia in the economic policy discourse of the Government of Afghanistan and the international donors. Most key stakeholders knew little about clusters and their governing structures other than the fact that they existed. As with Herat, in Kabul, Mazar-e Sharif (Balkh) and Charikar (Parwan) there are numerous clusters of ironmongers, carpenters, carpet weavers, butchers, furniture makers, mechanics, agri-food processors / retailers, printers, tailors, and pottery workshops. Senfs, anjomans, and the national etehadia and its provincial branch offices have collectively played and continue to play a pivotal role in representing the interests of their constituent micro and small-sized enterprises at the municipality levels of governance and sustaining the apprenticeship mechanisms in the trades they represent.

### 3 KEY FINDINGS

The findings reported in this overview are based on 4 surveys conducted between 2010 and 2012 in Herat, Kabul, Mazar-e Sharif, and Charikar. To provide a full picture of the available datasets, the most recent cluster data from Kabul and Kandahar are also listed in Table 1.

**Table 1: Sample Sizes and Surveys**

Location	Type of Senf (trade)	Registered Trades	Sample Size	Sample Size Apprentices	Nr of Surveyed Trades	Nr of Surveyed Apprentices
Herat	Ironmongers	60	18	-	18	-
	Dried fruits and nuts	60	25	-	25	-
	Old carpenter	80	26	-	26	-
	Silk	14	14	-	14	-
	Tailors	40	22	-	22	-
	Saffron	100	18	-	18	-
Kabul	Ironmongers	52	34	51	35	56
	Leather makers	30	24	38	16	6
	Mechanics	100	50	66	54	93
	Motorcycle fixers	100	50	66	50	71
	Refrigerator fixers	150	59	73	48	87
	WC/ol	250	70	81	62	70
Mazar-e Sharif	Carpenters	10	10	17	10	21
	Ironmongers	25	21	34	21	30
	Mechanics	15	14	24	18	34
	Metalworkers	15	14	24	14	28
	Radio & TV fixers	20	17	29	13	19
	Refrigerator fixers	20	17	29	10	9
Charekar	Carpenters	34	26	41	24	21
	Ironmongers	30	24	38	23	29
	Metalworkers	67	40	57	44	67
	Refrigerator fixers	5	5	10	5	7
	Tinsmiths	30	24	38	22	26
	Vehicle Mechanics	150	59	73	59	92
Kandahar	Dried fruits and nuts	40	20	-	20	-

Total		1,497	701	789	671	766
-------	--	-------	-----	-----	-----	-----

The broad and crosscutting findings from these surveys of clusters in Herat, Kabul, Charekar, and Mazar-e Sharif (2010-2012) may be summarized as follows:

**Land Tenure:** Most of the enterprises rent their workspace. Land titles belong to different actors including private individuals and government.

**Kinship / Family Ties:** None of the clusters appears to be predominantly based on a clan-like structure. The incidence of family or kinship ties is higher in older trades such as iron mongering and carpentry than the others.

**Lending and Borrowing:** In Kabul the most common form of collaboration is borrowing and lending money. There are also high levels of lending and borrowing of tools and machinery, sharing energy sources, relying on human resources of other enterprises for rush orders, bulk purchases of input materials, and sharing workspace.

**Intensity of Collaboration:** There are different levels of collaboration among the cluster members in different locations with Mazar-e Sharif and Herat being the location with the most intense levels as compared to Charikar and Kabul.

**Modes of Learning:** Daily face-to-face interaction among clustered enterprises is the most widespread method of transferring knowledge and learning, pointing to the importance of tacit knowledge.

**Captured Customer Base:** A captured customer base is most apparent in Mazar-e Sharif, Herat, and Charikar where most customers come from within the town/city or the province. In Kabul the customer base appears to be much sparser.

**Debts, Savings, and Access to Credit:** The vast majority of the clustered enterprises have access to formal and informal credit. All enterprises have higher levels of debt than saving. A very substantial number of enterprises object to borrowing on interest as being against Islamic values. Many enterprises also find formal loans to be expensive or inadequate to their needs.

**Investment:** Investment in ongoing business activity is varied among cluster types and locations. A very high number of enterprises have made no investment in their businesses during the last five years. The purchase of tools and machinery is the most common form of business investment, followed by workspace improvement and education for employees.

**Supply Stock Management:** The vast majority of clustered enterprises operate according to just-in-time principle of not having high inventory levels of input materials. This is partially due to space shortage but also scarcity of funds for purchasing bulk supplies of input materials.

**Business Needs:** In Kabul the main business needs of the clusters were stated as:

- Cheaper and/or more readily available input or raw materials
- Tools and machinery
- Workspace, and
- Vocational training.

**Infrastructure:** The shortage and inadequacy of electricity is cited by all enterprises as an area needing attention. Although a significant number of the micro and small-sized enterprises operate with no electricity, businesses that rely on electricity are adversely affected by unexpected outages or wide variations in voltage, often damaging electrical tools and machinery. Reliance on individual or communal generator power is quite common among clustered enterprises.

**Business Management Needs:** The vast majority of the clustered enterprises do not have a system to document their business activity and transactions.

**Business Prospects:** The vast majority of the clustered enterprises in all four locations reported improvement in the economic conditions, stated in terms of a steady customer base and flow of revenue.

#### 4 MOST PRESSING NEEDS FOR MICRO AND SMALL-SIZED ENTERPRISES

The clustered enterprises in Herat, Kabul, Charekar, and Mazar-e Sharif were asked to list their most pressing needs. The responses are summarized below.

1. Modern production technology and tools in all clustered trades.
2. Professional trainers to train the master craftsmen on modern production techniques and using modern production tools.
3. Literacy and basic mathematics training for apprentices, a significant number of whom are functionally illiterate and thus limited in their ability to absorb formal learning.
4. English literacy for some of the more senior trades people, such as master craftsmen or those who work in more complex trades such as auto mechanics.
5. Tailor-made training for master craftsmen to standardize their knowledge of their trades and to enable them to transfer their skills to their apprentices more effectively.
6. Access to affordable finance.<sup>375</sup>
7. Access to other markets (domestic and beyond).
8. Access to reliable electricity.
9. Access to basic amenities such as running water and sanitary facilities at the workplace.

## 5 CONCLUSION

Continued analysis of data from additional cluster studies is likely to generate much needed additional systemic and systematic knowledge about the traditional forms of business organization in the broader economy, the extent of their positive and legitimate contributions in generating livelihoods, their internal sustenance mechanisms such as apprenticeship arrangements, access to finance, and technology requirements. Continued analysis of these data can also reveal entry points for introducing value adding interventions to increase productive capacity of clustered enterprises and their contributions to economic growth and social stability. Ultimately, strengthening clustered enterprises is likely to provide incentives for individual enterprises to move up their respective value chains.

Appendix 1 provides the analysis and findings from data collected in Kabul, Kandahar, and Mazar-e Sharif. The data collection in Mazar-e Sharif took place during interviews with key informants and a focus group discussion with beekeepers. In Kabul there were interviews with key informants and a survey of businesswomen from dried fruits and nuts cluster. In Kandahar there were interviews with key informants and a survey of businessmen from the dried fruits and nuts cluster.

The most recent findings from Kabul, Kandahar, and Mazar-e Shraif on the needs of clustered micro and small-sized enterprises, reported in Appendix 1, broadly confirm, broadly, the findings reported in the preceding paragraphs from earlier analyses of clusters in Herat, Kabul, Mazar-e Sharif, and Charekar (Parwan).

---

<sup>375</sup> Microfinance from Microfinance Institutions is not advisable in this case due to the short period of repayment and extortionately high interests charged. See APPRO (2008) on some of the issues related to microfinance in Afghanistan, available from: <http://appro.org.af/publications/>



## **6 APPENDIX 1: FINDINGS FROM FIELD VISITS TO KABUL, KANDAHAR, AND MAZAR-E SHARIF DURING MAY-JUNE 2014**

The focus of this brief overview is on micro and small-sized enterprises often operating in geographical or virtual clusters, sharing supply sources, production activities, personnel, and markets. As such, all these enterprises simultaneously collaborate and are co-dependent but they also compete against their own cluster members and others. A micro and small-sized enterprise typically employs between 3 to 10 individuals including the owner and the apprentice(s).

Data collection for Kabul took place from June 18 to June 27. Three key informant interviews were held with a refrigerator / air conditioning servicing and repairs cluster members. Also, a sampled survey ( $n=15$ ) was carried out with businesswomen working in the dried fruits and nuts trade.

Kandahar City was visited from June 2 to June 6. Six key informants were interviewed to collect data on general micro and small-sized enterprise needs. The key informants were drawn from crafts association heads, Afghanistan Chamber of Commerce and Industries (ACCI), and the provincial craftspeople's association. A sampled survey ( $n=20$ ) was carried out with the dried fruits and nuts cluster located in Kandahar's main bazaar.

In Mazar-e Sharif, Balkh, three key informant interviews and one focus group discussion were held on May 25 and May 26. The key informants were the head of the provincial association of craftspeople, a manager from ACCI, and the association head of the fresh fruits and vegetable retailers. The participants for the focus group discussion were the eight members of a beekeeping cluster initiated by Hand in Hand – Afghanistan.

The interview questions, focus group discussion questions, and the surveys were designed to establish the current needs of micro and small-sized enterprises as well as other issues affecting business activity. A number of closed and open-ended questions were asked at all three sites on the micro and small-sized enterprises' current needs, types of services provided to (or received by) micro and small-sized enterprises, and suggestions for measures to meet the needs.

## 6.1 Findings from Kabul

### 6.1.1 Comparative Advantage

As the capital city, Kabul has a sizeable domestic market and a wide range of businesses, the vast majority of which fall into the micro and small-sized enterprise category. The bulk of the imports into Afghanistan are destined for Kabul which also serves as the main distribution point for other centres around Afghanistan. In addition to land transit, Kabul International Airport is a major entry point for imported goods.

In addition to a booming construction sector and related trades there are numerous generations-old, well-established clusters of micro and small-sized enterprises around Kabul producing goods and services including ironmongers, carpenters, tailors, electrical equipment repairs, freighters, and mechanics.

Agricultural activity around Kabul province and in the smaller surrounding provinces produces fresh nuts, fruits, and vegetables as well as dried fruits and nuts, livestock and animal products, and handcrafts such as carpets, pottery, woodworking, and needlework.

Another, albeit temporary, advantage for Kabul city over all other domestic markets in Afghanistan is the high presence of NGOs and INGOs, international aid and development organizations, embassies, and international military, acting as major sources of demand and cashflow for the local economy. While the demand assists in sustenance of many types of businesses in Kabul, the uncontrolled cashflow exerts significant inflationary pressures on the factor markets causing hardship for the extremely poor.

### 6.1.2 Current Needs

A common complaint by clustered enterprises is the low quality of production input materials, technology, or parts for electrical and mechanical service enterprises. With cheap and low quality imitation parts flooding the supply market in Kabul, the enterprises are concerned about loss of reputation with their customers due to failing parts. Another major concern is lack of adequate skills. Much of the production and repairing methods are based on learning by doing and without skilled supervision. There is much demand for formalized and modern vocational skills training, particularly by the master traders / repairmen.

The uncertainties arising from the transition of security responsibilities from international to national security forces, the unsigned bilateral security agreement between the Government of Afghanistan and ISAF/NATO, and the turmoil in the aftermath of the presidential elections are said to have made a major negative impact on service and other businesses. Some enterprises such as those in electrical equipment repair clusters report a drop of 70 percent in their revenues.<sup>376</sup>

Zoning policies of Kabul Municipality, combined with the fact that an estimated 60 percent of all settlements in Kabul are informal, often result in displacement of the small enterprises that often cannot fight, or bribe to dispel, an eviction order by the Municipality or the private landlords.

### 6.1.3 Services Provided for Micro and Small-Sized Enterprises

There have been TVET programmes by such donor organizations as GiZ but reportedly many of these programmes have discontinued prematurely. The current focus of GiZ in relation to clustered enterprises is standardization and expansion of the traditional apprenticeship system.<sup>377</sup>

Until 2006-2007, there were a number of projects by international donor organizations to reduce the use of CFCs in the electrical repair businesses. Many of these programmes have ended though the knowledge of using environmentally benign gases remains among the cluster members. However, without reliable, and affordable, sources of supply and no enforced regulation against the use of CFCs many of the micro and small-sized enterprises in electrical repair are forced to use CFCs.

### 6.1.4 Access to Finance

Micro and small-sized enterprises borrow on an in-kind basis. Typically, a start-up micro and small-sized enterprise borrows tools of trade or input material from other cluster members and repays in cash or by

<sup>376</sup> This is the estimate given by the three key informants interviewed in Kabul.

<sup>377</sup> This is based on a recent study of clusters in Kabul, Parwan, and Mazar-e Sharif by APPRO, commissioned by GiZ in 2012-2013. Follow up with the clusters covered under this study in mid-2014 revealed that GiZ had started working with some of the clusters to improve apprenticeship training.

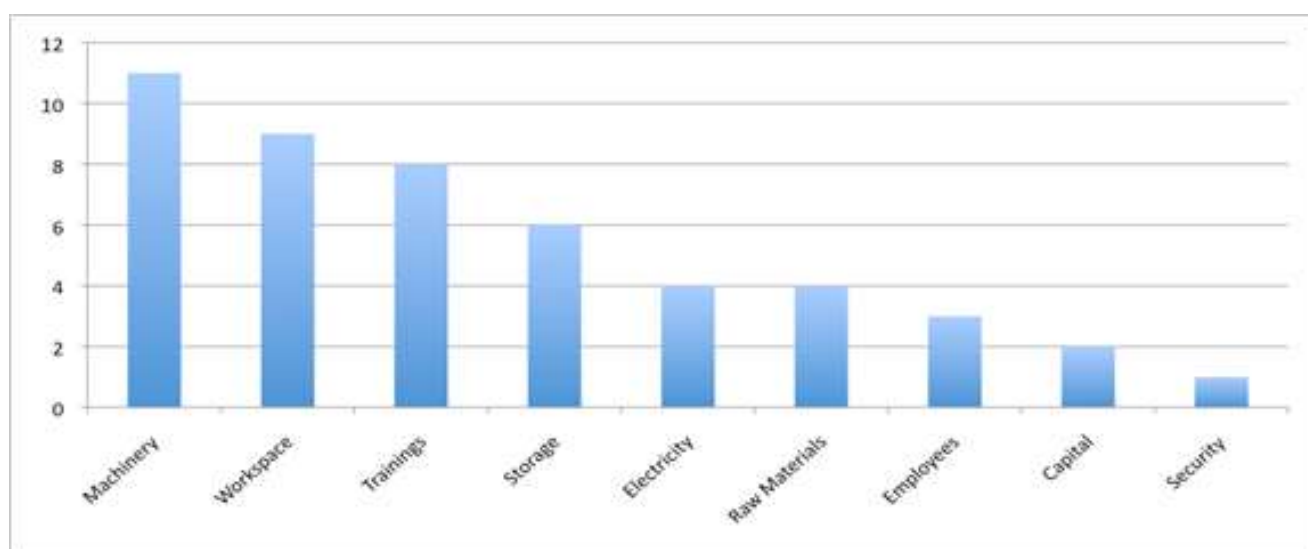
replacement after the new business begins to generate income. The rationale for this type of borrowing is threefold: tradition based on mutual aid, objection to paying interest on money on religious grounds, and prohibitive cost of micro loans. The key informants interviewed were adamant that they did not need direct access to loans and other finance though they could benefit from other forms of assistance (see below). Rather than loans from financial institutions, the preference is for subsidized and secured inputs and machinery.

### 6.1.5 Women in Work

Other studies have shown that women are generally marginalized by men, particularly when operating higher up on the value chain and in markets, and are subject to widespread corruption as are the businessmen. The following figures are based on a survey of women owned and operated micro and small-sized enterprises ( $n=15$ ) in a dried fruit cluster of enterprises in Kabul. The topics covered in the survey were collaboration, competition, basic challenges, current needs, and access to finance.

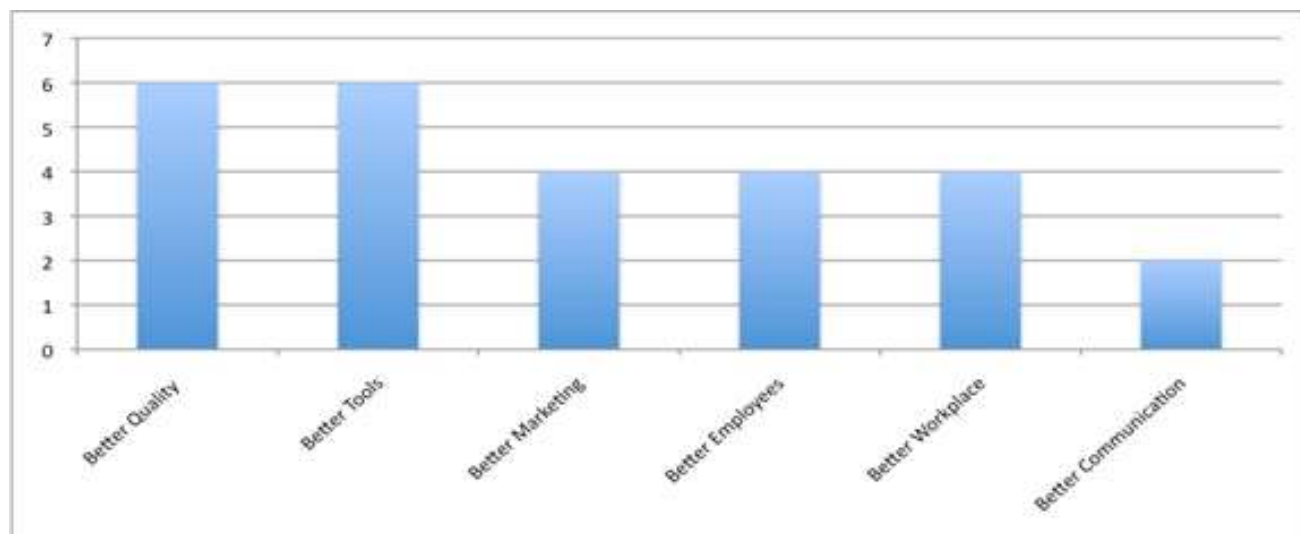
There are high levels of collaboration among most of the cluster members through sharing business information (100 percent), willingness to resolve other members' business-related problems (100 percent), energy (from a source), bulk supplies, personal loans for business purposes on different bases including interest free and open-ended loans. The women in the dried fruits and nuts cluster expressed a need for acquiring basic skills to run their businesses, including vocational training to learn more about marketing and production, and basic literacy (Figure 1).

**Figure 1: Businesswomen's Needs**



$n=15$

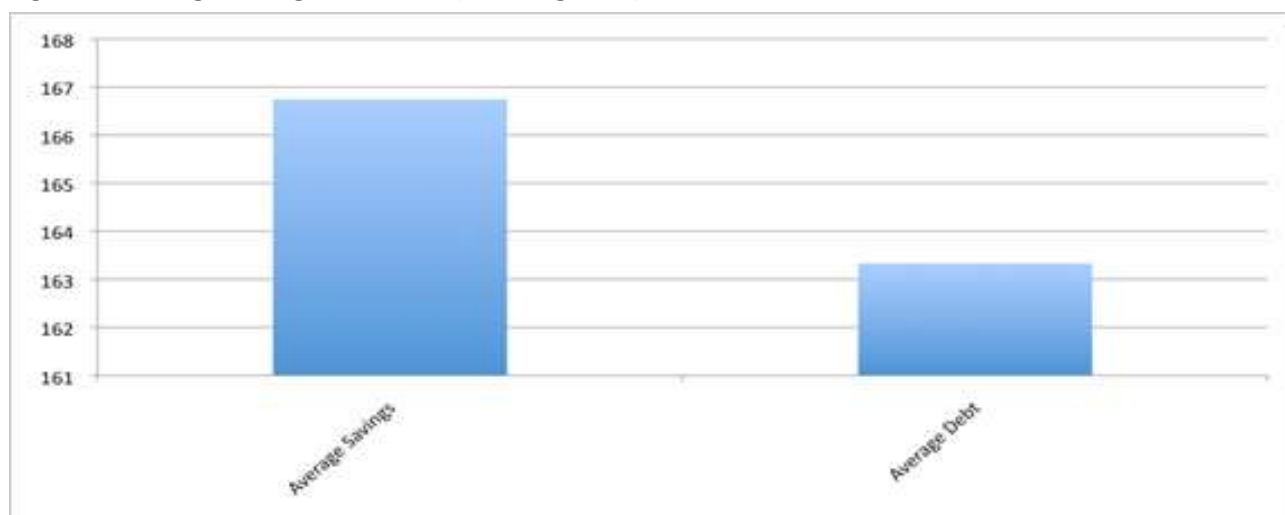
All cluster members stated that they competed against other cluster members. The women were asked how they competed, as a proxy to establish what their businesses require, apart from basic needs reported in Figure 1, to become more competitive and what types of intervention they would benefit from the most. Figure 2 shows the range of responses.

**Figure 2: How Do You Compete Against Other Cluster Members?**

*n*=15

Figure 2 points to demand by micro and small-sized enterprises for different types of business services. While the need for Better (production) Tools and Better Workplace (better space and conditions) are standard challenges for all micro and small-sized enterprises in Afghanistan, the emphasis by the businesswomen on Better Quality, Better Marketing, Better (more skilled) Employees, and Better Communication (marketing) is significant since all of these responses point more specifically to what types of business services businesswomen could benefit from. It is worth noting that twelve businesswomen out of 15 reported that they had received some form of training from international donors, the government, or their own association.

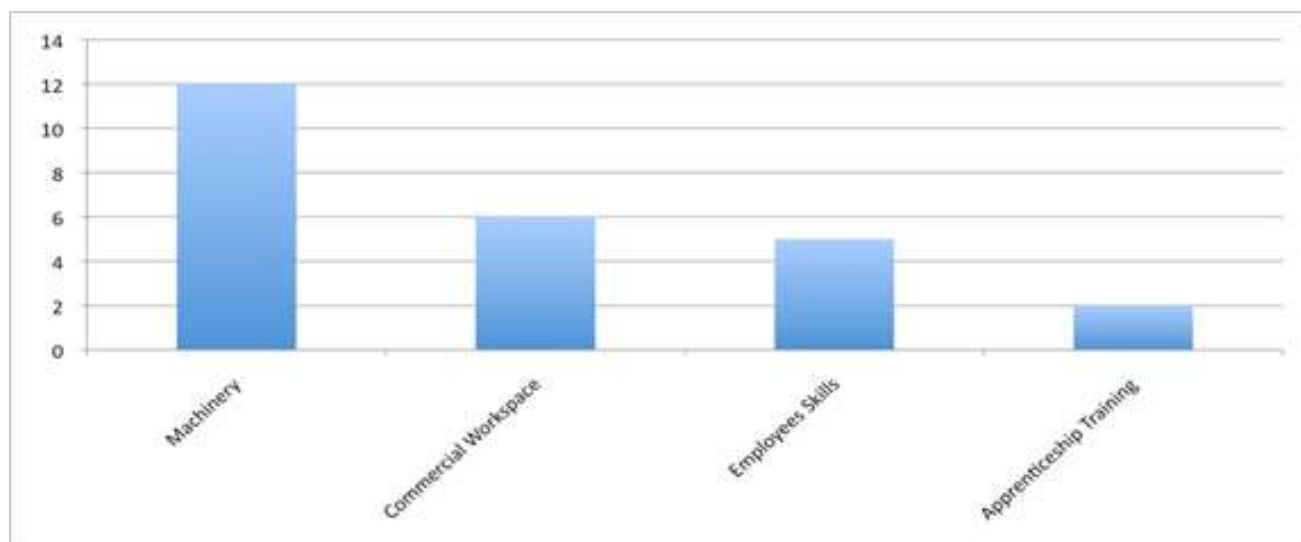
Twelve out of 15 businesswomen stated that they had no debts. The average savings and debts among the women does not fully reflect the low number of businesswomen with debts, indicating that those with debts have quite large loans or liabilities (Figure 3).

**Figure 3: Average Savings and Debts (000s Afghanis)**

*n*=15

Eleven of the 15 businesswomen stated that they had access to formal loans, nine businesswomen reported that they would borrow from a bank, and 14 stated that they had bank accounts.

The businesswomen's suggestions on how to improve their businesses environment are summarized in Figure 4.

**Figure 4: Where Should Government / International Donors Invest to Assist micro and small-sized enterprises ?**

*n=15*

#### **6.1.6 Suggestions for Improvement**

The following key suggestions were made to overcome the most pressing challenges faced by micro and small-sized enterprises:

- Co-financing for purchasing capital equipment
- Standardized and modern vocational skills training in Dari and using demonstrative methods of training rather than text-based learning, given the high level of illiteracy.
- Zoning plans more favourable to clustered enterprises and other businesses, and
- Longer term and larger loans at affordable interest rates and preferably on Sharia terms.

## 6.2 Findings from Kandahar

### 6.2.1 Comparative Advantage

Geographical proximity of Kandahar to the Pakistani border, and Pakistan's domestic market and Pakistani ports on the Arabian Sea, is a major advantage for Afghan exporters though not without problems with border crossing. Agricultural produce from Kandahar, particularly nuts, grapes, pomegranates, melons, and watermelons are of very high quality, coming to season earlier than the neighbouring regions due to shorter and milder winters.

### 6.2.2 Current Needs

Fourteen out of the 20 clustered enterprises surveyed stated that they share supply sources for their raw materials and help other cluster members with business related problems while 17 reporting sharing business information, indicating a high level of cooperation among the cluster members and needs being addressed within the cluster. Despite energy being a major problem for businesses in Kandahar, none of the clustered enterprises reported sharing energy supply sources, such as communal generators.

Security and personal safety is a concern for farmers who sometime have to work during late evenings.<sup>378</sup> In addition to general concerns about worsening security, micro and small-sized enterprises have numerous other concerns and needs in Kandahar. These include insufficient and unreliable electricity, poor infrastructure in water and road works, poor quality raw materials such as seeds for agriculture, fertilizers, lack of storage space, lack of basic business management know-how, and insufficient access to markets. The shared border with Pakistan is not always passable for Afghan exporters, sometimes resulting in fresh produce rotting in truck containers held up by Pakistani border officials.<sup>379</sup>

Without reliable supply of pesticides, there is a high risk of diseases destroying crops such as nuts, grapes, and other fruits. The provision of pesticides by international donor-funded entities has been reduced significantly over the last 2 years.<sup>380</sup>

Some of the more specific needs expressed during the site visit were lack of modern equipment for jewelry making<sup>381</sup>, packaging materials<sup>382</sup>, low or inadequate quality standards of products, for example, inability to meet international standards such as ISO9000 in dried fruits and nuts production and packaging<sup>383</sup>, and inability to compete in the domestic market with better packaged products imported from neighbouring countries.<sup>384</sup> One key informant lamented:

We have a kind of raisin that we used to sell for 15 USD per kilo to Russia and other Central Asian countries but now we sell the same raisin for 0.5 USD because of poor quality of packaging and competition from our neighbouring countries.<sup>385</sup>

There were complaints that municipal authorities were inattentive to basic business needs including running water and sanitary facilities.<sup>386</sup>

The surveyed members of the dried fruits and nuts cluster in Kandahar were asked to list their main needs. Thirteen out of 20 enterprises stated the lack of electricity the most important need. Other main needs were listed at adequate machinery and vocational training, better qualified personnel, and adequate storage. Only one enterprise stated availability of raw materials as a need (Figure 5).

---

<sup>378</sup> KI-M-AH-Kan-2

<sup>379</sup> KI-M-AH-Kan-2

<sup>380</sup> KI-M-AH-Kan-2

<sup>381</sup> KI-M-AH-Kan-3

<sup>382</sup> KI-M-AH-Kan-5

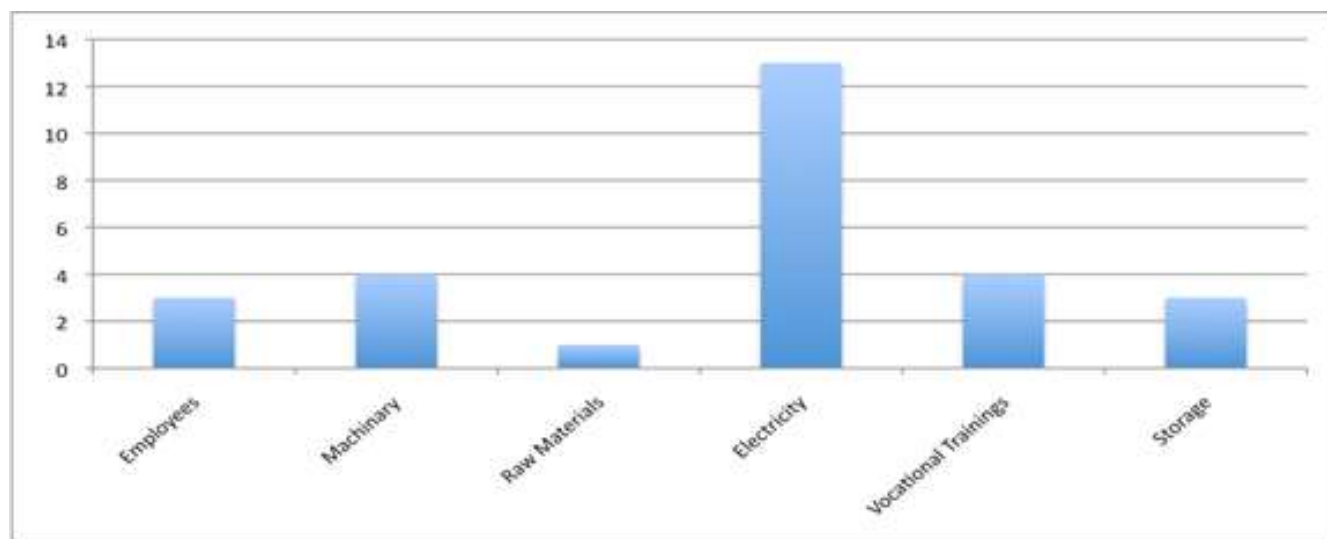
<sup>383</sup> KI-M-AH-Kan-5, KI-M-AH-Kan-6

<sup>384</sup> KI-M-AH-Kan-6

<sup>385</sup> KI-M-AH-Kan-5

<sup>386</sup> KI-M-AH-Kan-4



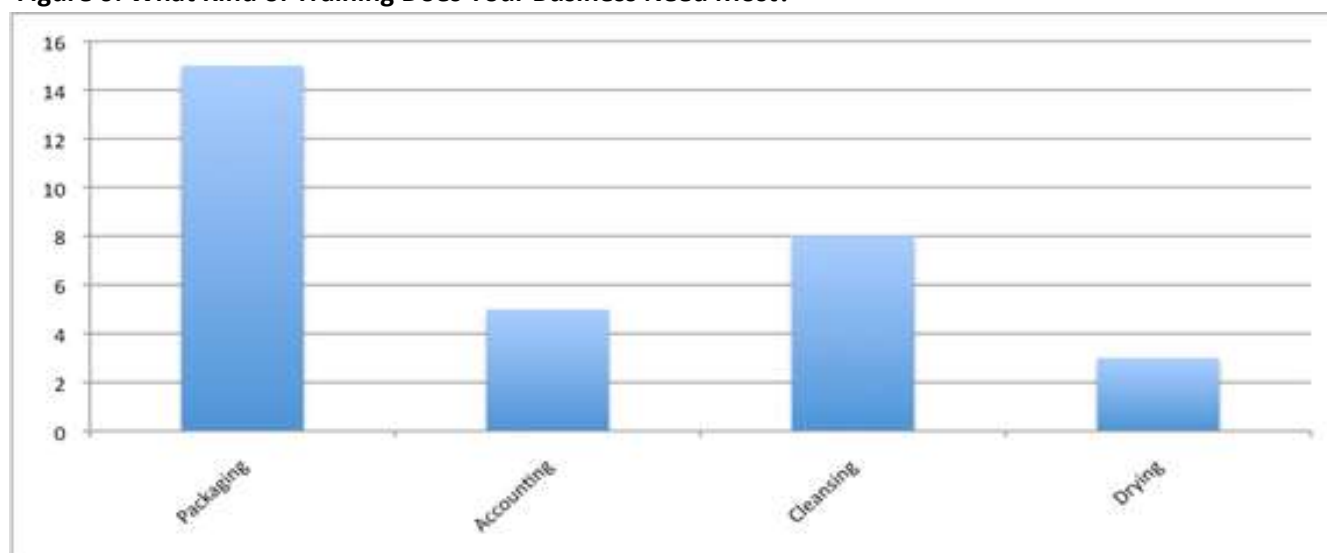
**Figure 5: What Are Your Main Needs to Do Better in Business?**

n=20

### 6.2.3 Services Provided for micro and small-sized enterprises

Among the services provided to micro and small-sized enterprises by ACCI are preparation of business plans, networking businesses with prospective customers and markets, obtaining work permits for non-Afghan business employees, tax-related advice, and organizing meetings between Afghan businesses and regional business and government officials from neighbouring countries.<sup>387</sup> There have been a number of business assistance programmes since 2002, supported by international donors, to provide technical assistance in agriculture by providing genetically modified seeds, modern methods in cultivating and irrigation, and loans.<sup>388</sup>

When asked what types of training they would benefit from, regardless of having to pay for the training, packaging was listed as the highest need as a business skill, followed by modern methods cleaning and drying fruits and nuts, and basic skills in business accounting (Figure 6).

**Figure 6: What Kind of Training Does Your Business Need Most?**

n=20

<sup>387</sup> KI-M-AH-Kan-1

<sup>388</sup> KI-M-AH-Maz-1, KI-M-AH-Kan-6

None of the key informants knew of cases where businesses would pay for business services such as business management skills or marketing, however.

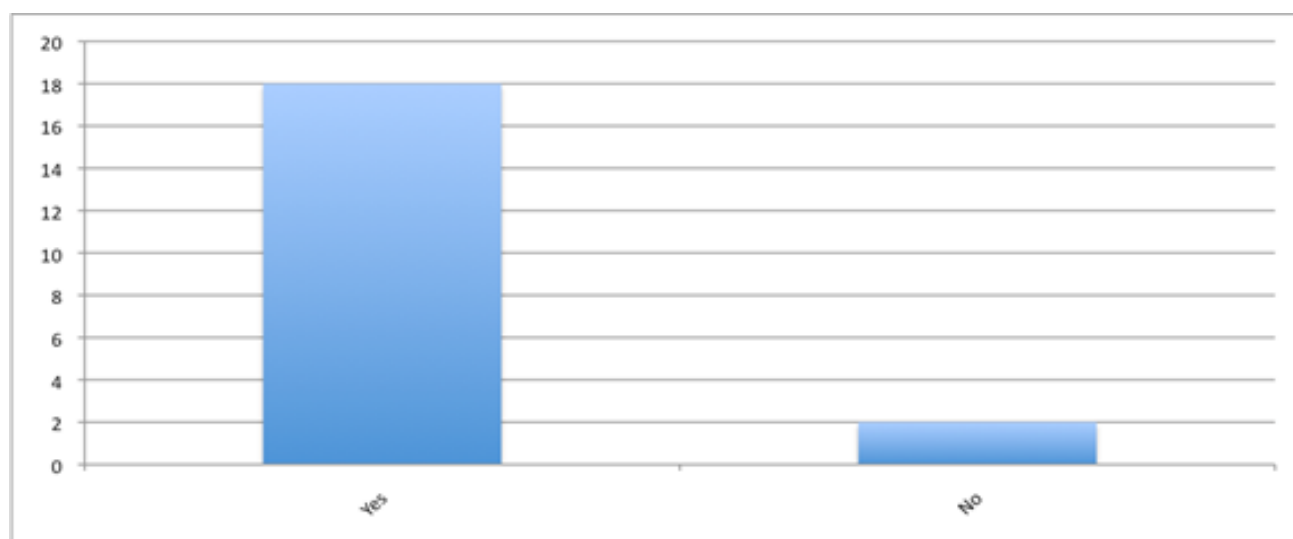
#### 6.2.4 Access to Finance

Banks are rarely used by micro and small-sized enterprises in Kandahar, except by larger businesses and mostly for depositing funds received or to be transferred. If in need of funds, advances are requested from the regular Pakistani or other buyers whose incentive to lend is discounted prices for the produce / products they buy from Afghan micro and small-sized enterprises.<sup>389</sup> Similar arrangements are in place for jewelers who, in return for receiving advances from their buyers, sell products at a discount.<sup>390</sup>

There are major reservations on religious grounds against borrowing on interest from banks, which are inaccessible for micro and small-sized enterprises in any case, or MFIs.<sup>391</sup> However, even if the issue of paying interest is resolved, providing collateral is beyond the vast majority of clustered enterprises.

Financial needs are addressed through no interest borrowing, gharz-e hasana, with no time limitation though these loans are usually paid to ensure access to loans in future. Eighteen out of the 20 clustered enterprises stated that they lent money to other cluster members on a regular basis while 19 of the enterprises stated that they would give interest free loans to others (Figures 7 and 8).

**Figure 7: Do [You?] Lend Capital to Other Cluster Members?**

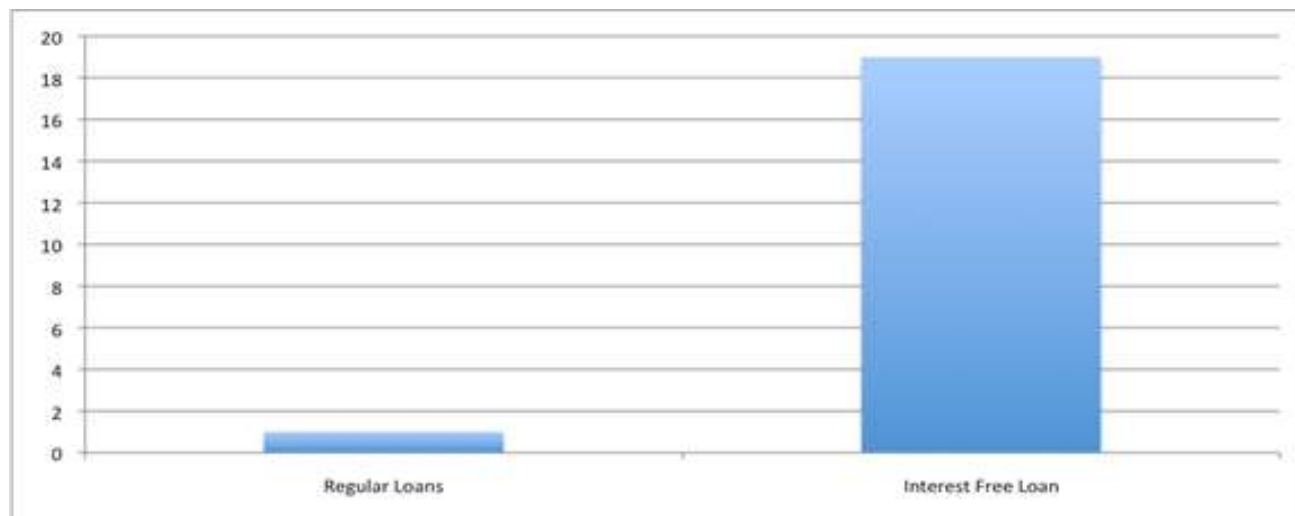


*n=20*

<sup>389</sup> KI-M-AH-Kan-2, KI-M-AH-Kan-5

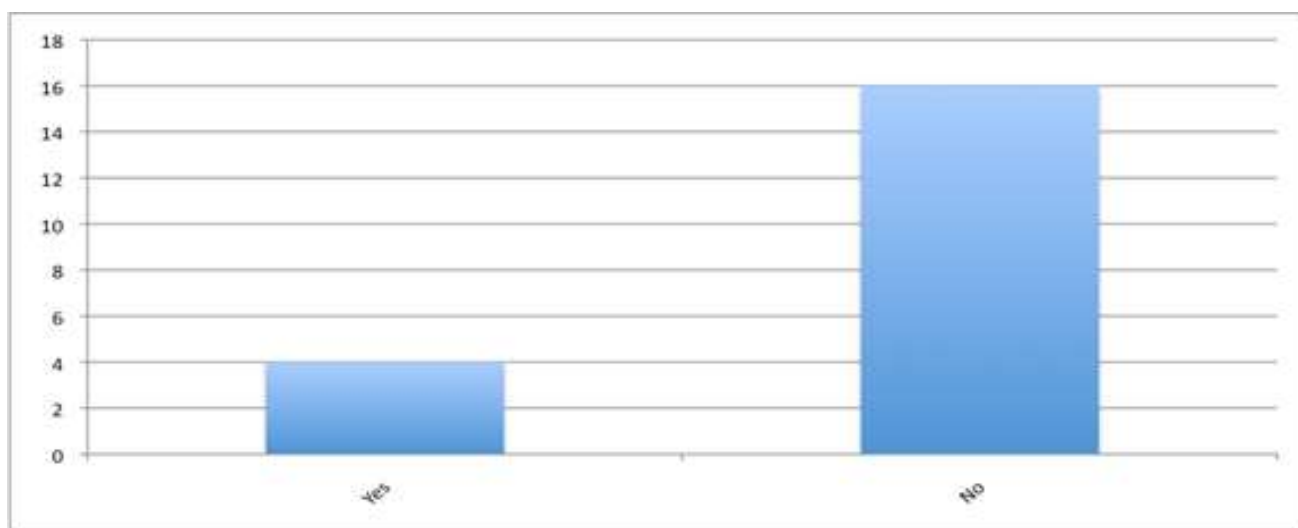
<sup>390</sup> KI-M-AH-Kan-3

<sup>391</sup> KI-M-AH-Kan-2, KI-M-AH-Kan-4

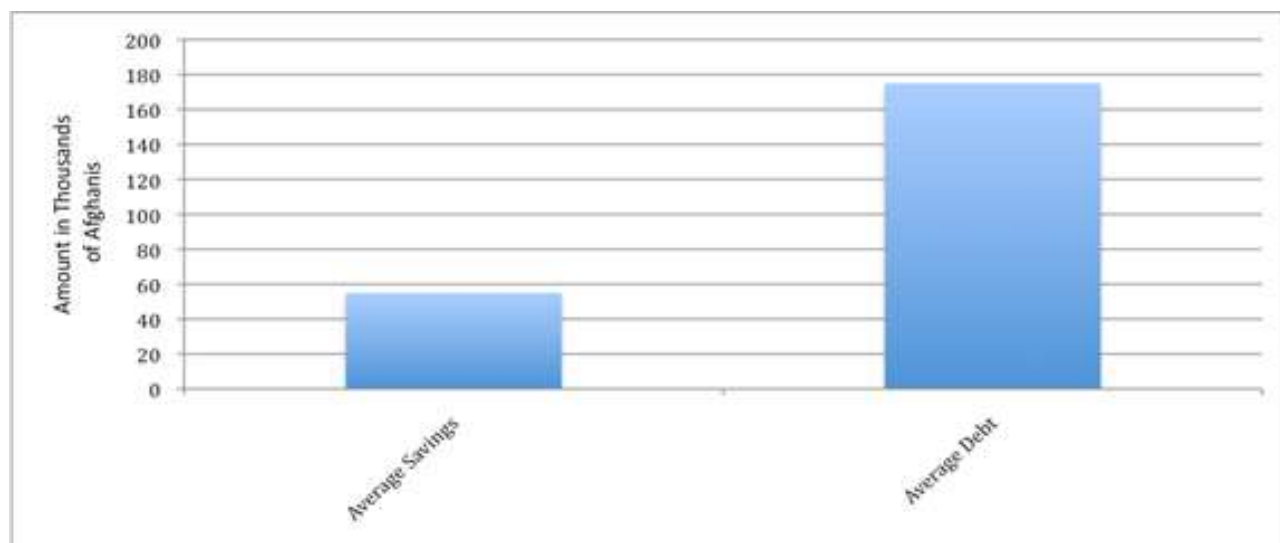
**Figure 8: In What Ways do You Lend Capital?**

*n=20*

None of the enterprises has a bank account. Four of the 20 micro and small-sized enterprises stated that they had debts. However, the level of debts averaged out across the cluster is substantially higher than the average level of savings, indicating very high levels of debts for those who carry them (Figures 9 and 10). Seventeen of the enterprises stated that they would borrow from a financial institution.

**Figure 9: Do You Have Debts?**

*n=20*

**Figure 10: Average Savings and Debts**

*n*=20

#### 6.2.5 Women in Work

Women generally do not work in businesses that involve interaction with the public. However, some interviewees were of the view that if women could work in public, their businesses would do better, particularly in businesses where the bulk of the customers are women such as jewellery and tailoring. Some suggested that women were more reliable than men and more serious about their work responsibilities.<sup>392</sup> Also, it appears that some male-run businesses prefer female workers because they are paid less than men. According to one micro and small-sized enterprise, women are paid 200 Afghanis per day compared to 500 Afghanis for men.<sup>393</sup>

#### 6.2.6 Suggestions for Improvement

The following specific suggestions were made by the interviewees:

- Many businesses would be willing to pay for business services if they were offered at affordable prices.<sup>394</sup>
- Cold storage on the Afghan side of the borders to store perishables held up for various reasons.<sup>395</sup>
- Businesses that deal in valuable commodities such as jewellery need protection through insurance, currently not offered by the financial sector.
- Government should honour its commitment to the private sector and help them with their many needs, in line with the Constitution.<sup>396</sup>
- The business community of Kandahar must find a way to protect international organizations that no longer want to operate in Kandahar because of the security situation.<sup>397</sup>
- Businesses should work with local authorities to improve clinics, fire fighting facilities, parks, and designated markets including women's markets.<sup>398</sup>

<sup>392</sup> KI-M-AH-Kan-3, KI-M-AH-Kan-6

<sup>393</sup> KI-M-AH-Kan-2

<sup>394</sup> KI-M-AH-Kan-3

<sup>395</sup> KI-M-ACCI-Kan-1

<sup>396</sup> KI-M-AH-Kan-6

<sup>397</sup> KI-M-AH-Kan-2

<sup>398</sup> KI-M-AH-Kan-5

## 6.3 Findings from Mazar-e Sharif

### 6.3.1 Comparative Advantage

Balkh province has extremely hot summers and extremely cold winters. Combined with reasonable availability of water, the province has a potentially productive and robust agriculture sector. The province is also in close proximity to Tajikistan and Turkmenistan with rail link to Uzbekistan. There is a sizeable industrial base consisting of fruit and vegetable processing, traditional and modern manufacturing, and crafts.

### 6.3.2 Current Needs

Availability of commercial properties is not regulated and the private owners of commercial properties often act arbitrarily in raising rents, as soon as they see that their commercial tenants are succeeding in business.<sup>399</sup>

Payment of taxes on business income is not regulated. Tax inspectors from the Ministry of Finance make unannounced visits to businesses and demand unreasonably high taxes based on their own estimates of business earning. Often, businesses pay bribes to the inspectors to lower the estimate of business earnings or to look the other way.<sup>400</sup>

Most businesses do not have business management skills such as bookkeeping. Even if they can afford to have automated accounting packages, lack of basic skills such as literacy prevents them from using the systems adequately or at all.<sup>401</sup>

Many businesses retailing fresh produce need storage facilities since in hot weather there is a high ratio of produce loss to produce sold. Many smaller businesses operate on borrowed capital with no prospect of ever increasing their capital.<sup>402</sup>

The beekeepers need assistance in how to manage bacterial diseases that afflict honeybees. Access to funds for purchasing the necessary chemicals is limited. Varied and low productions standards are key concerns for the cluster members. Packaging is *ad hoc* and not standardized and access to consistent packaging materials and labeling is limited.

Developing and expanding the market for the honey produced by the cluster is a major challenge for the beekeepers. While domestic market has developed significantly, further growth of the sector will require access to non-domestic regional and even extra-national / regional markets through marketing (including advertising) and quality improvement and standardization.<sup>403</sup>

Businesses in Mazar-e Sharif struggle with being vulnerable to commercial property landlords, who could evict them without reason or recourse for the business tenant. The Mazar-e Sharif Municipality does not appear to apply zoning policies serve businesses and encourage business activity. Unannounced zoning decisions continually force micro and small-sized enterprises to relocate and hence undermining business stability and growth.

With some exceptions, e.g., some beekeeper clusters, the concept of markets for products or produce is mostly missing from the thinking of micro and small-sized enterprises who measure their success in terms of only remaining in business and financial survival, and not growing their business.<sup>404</sup>

The rail line between Mazar-e Sharif and Hairatan on the Uzbek border is reportedly used only to import goods into Afghanistan and not for exports by Afghan businesses to Uzbekistan. Afghan exporters are not allowed to the rail line and use road and riverboats to transport their export goods.

### 6.3.3 Services Provided for micro and small-sized enterprises

Businesses typically do not have membership of formal governmental organizations. Most businesses know about having to pay taxes and remaining within the law in their operations. Businesses are usually members of a *senf* (traditional business association). The *senf* is the first port of call for solving business related problems, including problems with the government, or conflict among businesses. The Governor of Mazar-e Sharif is said to be very

<sup>399</sup> KI-M-AH-M-1, KI-M-AH-Maz-2

<sup>400</sup> KI-M-AH-Maz-1

<sup>401</sup> KI-M-AH-Maz-1

<sup>402</sup> KI-M-AH-Maz-2

<sup>403</sup> FGD-M-CA-Maz-1

<sup>404</sup> KI-M-AH-Maz-2

supportive of businesses.<sup>405</sup>

There are 73 senfs in Mazar-e Sharif with every senf having a minimum of 10 members. Car mechanics, vegetable and fresh fruits traders, mobile telephone fixers, ironmongers, jewelers, and metal workers all have their own senfs. Neither the senfs nor the provincial etehadia (provincial apex association for senfs) have the resources or means to provide loans to their business members.<sup>406</sup>

ACCI in Mazar-e Sharif claims to have 1,500 business entities as members. Large businesses such as Kam Air and Ghazanfar Bank make up around 20 percent of the members, medium-sized businesses around 60 percent, and small-sized businesses around 20 percent. The small-sized businesses are rather large in size and revenue compared to the many more micro and small-sized enterprises that are not members of ACCI. Services provided by ACCI to its members include conflict resolution, obtaining visas, signing agreements with businesses based outside Afghanistan, short courses in bookkeeping and business management, and organizing product exhibitions in and outside Afghanistan.<sup>407</sup>

Hand in Hand (HiH) – Afghanistan was praised for its role in setting up a honey producing sector in Mazar-e Sharif. HiH engaged the local officials and other community actors including the governor, elders and religious figures on providing assistance for farmers willing to keep honey. As a result of this consultation eligible and able farmers were selected as beneficiaries and a honey keeping project was started in 2011. Loans and technical advice were provided by HiH to a group of men and women on how to keep honeybee and produce honey.

During from mid-2013 to mid-2014, the beekeepers have been making a profit and some have started to save some of their income as a result of selling honey. The saved money is used for a variety of purposes including buying seeds for agriculture and livestock. As of June 2014 the honey keepers reported having a total group saving of 35,000 Afghanis. The objective is to save a total of 75,000 Afghanis for use in starting up additional initiatives such as raising chickens and keeping livestock.<sup>408</sup>

#### 6.3.4 Access to Finance

Traditionally businesses borrow from one another at no interest. The borrowing and lending is done horizontally, between same businesses or businesses sharing the same rung in the value chain. Lending and borrowing is also done vertically within the same values chain with businesses on higher rungs giving cash advances to businesses on lower rungs. Lower rung businesses pay back the loan after they complete production and sell their products / produce at discounted prices to the lending higher rung businesses.<sup>409</sup>

The main issues with borrowing from banks are high rates of interest (compared to no visible interest on traditional loans), long administrative process, requirement by banks of collateral (usually title to a property) and character reference by wakil-e gozar (locally appointed traditional community representative), insufficient size of loans (ranging between 5,000 and 25,000 Afghanis) for business purposes, short duration for repayment, bad reputation of businesses as borrowers (because of defaults on repayment by a significant number of businesses), and new requirements by banks for guarantors.<sup>410</sup>

Beekeeping cluster members claimed that they were confident they could meet their collective objective of increasing their savings to expand current operations or diversity into other areas of production such as raising chicken, fish, and livestock. They felt that the percentage of interest charged on MFI loans were too high while the larger banks did not lend to small borrowers. Those in need of loans go to other cluster members or members of their own families.<sup>411</sup>

<sup>405</sup> KI-M-AH-Maz-1

<sup>406</sup> KI-M-AH-Maz-1

<sup>407</sup> KI-M-AH-Maz-3

<sup>408</sup> FGD-M-CA-Maz-1

<sup>409</sup> KI-M-AH-Maz-1, KI-M-AH-Maz-2

<sup>410</sup> KI-M-AH-Maz-1, KI-M-AH-Maz-3

<sup>411</sup> FGD-M-CA-Maz-1



The Union of Beekeepers in Mazar-e Sharif has 260 families as members. Loans for non-business purposes can be borrowed from the collective saving funds contributed to by all families and managed by the Union. These loans are provided without charging interest.

Some micro and small-sized enterprises have a joint savings account. One such example is the honey farmers assisted and organized by Hand in Hand. The rationale for setting up a joint savings account was the high cost of borrowing from banks, the various difficulties in securing a bank loan, and the contravention of Islamic values by paying interest on loans.<sup>412</sup>

Some banks and Microfinance Institutions (MFIs) give loans to micro and small-sized enterprises but even if the borrowers do not object to paying interest on religious grounds, they object to extortionately high rates of interest being charged, especially by MFIs.<sup>413</sup>

### 6.3.5 Women in Business

A number of women work with their husbands or other male family members in beekeeping, for example, but also other areas. The involvement of women in beekeeping is limited to the lower steps in the value chain of honey production such as maintenance of hives and harvesting the honey. Without exception, men do the selling.<sup>414</sup>

### 6.3.6 Suggestions for Improvement

Revive some of the traditional industries for which Afghanistan has plentiful raw materials, and at competitive prices, such as leather shoe and bag making, honey production, woodworking, and carpet weaving. A major step in strengthening these sectors is to secure the domestic market by winning the confidence of Afghan customers in domestically produced, and competitively priced, Afghan products.<sup>415</sup> Also,

If [development organizations and government] help with making some special stickers for our products as Afghan products, our customers can differentiate them easily from imitative and imported products.<sup>416</sup>

Access to markets beyond the domestic market requires expertise, personnel, and additional resources for marketing (including advertising) and quality improvement and standardization. One suggestion was to seek funds and assistance for a showroom in Mazar-e Sharif to display the products produced by the beekeepers. Another suggestion / request was assistance with securing reliable supply sources for packaging and labeling materials.<sup>417</sup>

The key recommendations from the head of the association of fresh produce retailers were:

- Rent on commercial property should be regulated by the government.
- More greenhouse space for vegetables so farmers can continue to grow and produce during winter months and more storage space for keeping produce during winter months for personal consumption and for selling excess produce during winter months to generate income.
- Corruption must be curbed as it hurts businesses.
- Better access to finance should be provided but based on sharia.
- More business skills need to be provided to Afghan businesses but attention needs to be paid to the fact that a large number of business owners are illiterate and thus the training programmes provided for them have to be adapted to reflect this.
- Better access to domestic and regional markets.
- Demand creation for Afghan products by increasing product quality and raising awareness of Afghan customers.<sup>418</sup>

Attention needs to be paid to zoning the city in a way that also serves business needs. The municipal authorities

---

<sup>412</sup> FGD-M-CA-Maz-1

<sup>413</sup> KI-M-AH-Maz-2, FGD-M-CA-Maz-1

<sup>414</sup> FGD-M-CA-Maz-1

<sup>415</sup> KI-M-AH-Maz-1, FGD-M-CA-Maz-1

<sup>416</sup> FGD-M-CA-Maz-1

<sup>417</sup> FGD-M-CA-Maz-1

<sup>418</sup> KI-M-AH-Maz-2

should invest in regenerating bazaars and assist businesses to re-establish themselves in designated areas of the bazaar as a way to increase access by the businesses to the domestic market.<sup>419</sup>

In addition to designated spaces in traditional bazaars, certain zones in the city should also be designated for businesses, complete with affordable rent and access to basic municipal services.<sup>420</sup>

The municipality can solve these problems for craftsmen if they have a master plan and they make a rent law for example when a craftsmen rent a shop the duration must be 5 years. If the duration of rent is short a craftsmen cannot do better business and they will loss their customers.

Many businesses in Mazar-e Sharif want to be able to compete in regional, non-Afghan markets but they cannot do that due to the high costs of production, lack of access to markets domestically and regionally, and not knowing how to do marketing.<sup>421</sup> More needs to be done to link up Afghan businesses based in Mazar-e Sharif with markets and businesses in neighbouring Uzbekistan and Turkmenistan.

---

<sup>419</sup> KI-M-AH-Maz-2

<sup>420</sup> KI-M-AH-Maz-2

<sup>421</sup> KI-M-AH-Maz-2

## 7 APPENDIX 2: LIST OF ORGANIZATIONS WITH INTEREST IN SMES

There is no formal listing of entities involved in the various aspects of private sector development in Afghanistan. The table below is based on a search on the internet and phone communication with Harakat.

No	Name	Works Type	Remarks
1	ABADE	SME extension and other services	ABADE assists SMEs with better planning, appropriate equipment and technologies, better management skills and business specific skills, innovative-supporting alliances, and by facilitating a business environment conducive to SME growth.
2	AISA	Entity established to facilitate private sector activity and investment in Afghanistan. Also issues business licenses on behalf of the Government of Afghanistan	Business advice to national and international business persons wishing to start up in Afghanistan
3	ALTAI	Research	Ongoing research on agriculture, food retail and distribution, and other aspects of private sector development funded by USAID, World Bank, and others
4	AKDN	Research and Support	Research including baseline for own extension projects, mostly in rural areas and focused SMEs and private sector development.
5	APPRO	Research, Evaluations, Training	Extensive research based on primary data collected through surveys on clustered micro, small-sized enterprises analyses of microfinance and SMEs in Afghanistan, analysis of gender and agricultural production value chains, analysis of trade between Afghanistan and its neighbours (Iran, Pakistan, and Central Asian countries)
6	AREU	Research	A number of studies of emerging markets in pharmaceuticals, oil, and agricultural produce in 2005-2007
7	ASMED	USAID-funded business extension services	Supporting private sector development in Afghanistan with a focus on SMEs and women owned and operated businesses and associations nationally and internationally linking Afghan businesswomen with businesswomen elsewhere
8	Hand in Hand – Afghanistan	Agricultural and SME extension projects	A number of projects focused on agricultural business start-ups, including a number of projects on businesswomen.

## ANNEXES

8	Harakat	Research	Commissions research projects in support of private sector development on a wide range of issues from land titles to customs regulation, banking and women's access to property
9	MEDA	Research	Agricultural market research for microfinance and SME interventions, mostly for own projects but also other donors
10	Strategic Social Survey	Research	Survey of SMEs (scopes unknown), funded by USAID
11	UNODC	Mapping	Mapping of Alternative livelihood projects in Afghanistan
12	UNDP	Assessments	Market Sector Assessments for SME Development
13	World Bank	Support SME	Best known for multi-country "Enterprise Survey", surveying between 100-120 medium-sized and large enterprises in Afghanistan.