AFGHANISTAN'S PRIVATE SECTOR

Status and ways forward

RICHARD GHIASY, JIAYI ZHOU AND
HENRIK HALLGREN

EXECUTIVE SUMMARY

STOCKHOLM INTERNATIONAL
PEACE RESEARCH INSTITUTE

Näringslivets Internationella Råd
International Council of
Swedish Industry

October 2015

Executive summary

Afghanistan's economy has a complex mix of informal, formal, illicit and aid-sustained elements. This is foremost the product of a decades-long convergence of protracted conflict, low state capacity, foreign interference and external aid dependence. The formal Afghan private sector contributes a mere 10–12 per cent to the country's official gross domestic product. In its current state, the Afghan private sector is not the engine of economic growth or instrument of social inclusion it has the potential to be. Popular dissatisfaction with unequal access to economic resources, flawed public services and goods, the adverse security situation, and predatory government activity undermine an effective and sustainable private sector.

There is a prospect of reversing this dynamic. The Afghan private sector could, in addition to leading economic growth, contribute to improving human and traditional security conditions in the country. Immediate action by the Afghan Government is needed to catalyse this process. The Afghan Government will need to create a more facilitating environment for the private sector, particularly for the many disadvantaged smaller players that form the bulk of the economy. In light of weak state capacity as well as the dismal fiscal outlook new partnership modalities with the private sector are recommended. Support from the international community through private sector development (PSD) will still be needed. However, a number of critical conditions for effective PSD apply.

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

Historically, the Afghan population has not been able to count on the government or the formal market to provide welfare. Limited state capacity and geographic reach are a congenital problem, and this has helped sustain a fragmented society. Pre-1979, Afghanistan's private sector was predominantly informal, agrarian and subsistence-based. As a war economy emerged formal institutions collapsed, the social fabric was torn, and illicit crops and criminal cross-border activities became ingrained in the country's economy. This resulted in a complex backdrop and a very low baseline from which internationally assisted state rebuilding and economic growth efforts began in 2001.

However, the introduction of new organizational structures after 2001 did not constitute a decisive break with preceding economic patterns, processes or players. The Karzai administration allowed the post-intervention conflict and aid economy to create new revenue channels for an existing and emerging oligopoly. Lack of interest and incapacity by political authorities have resulted in weak formal economic institutions, largely unaccommodating economic policies and regulatory failure. Moreover, neither government nor donors have been sufficiently focused on accelerating trade and transit, agriculture and the extractive industry, which are cornerstones for long-term structural economic stability for Afghanistan. International community PSD efforts were slow and limited throughout the first decade of engagement, with the bulk of donor attention focused on security or on other developmental challenges.

In the absence of a free market with functioning state regulation, the oligopoly and local power holders determine access to economic resources in many markets across the country. Critical infrastructure is largely absent, particularly in rural Afghanistan. Both these factors inhibit economic activity and integration. These constraints are compounded by extra-market conditions: concerns over the National Unity Government's (NUG) longevity and effectiveness, lingering and rampant corruption, a deteriorating security situation and external aid flows that distort the domestic marketplace. The politicized regional economic environment is also unfavourable to Afghanistan's private sector and is exacerbated by the fact that the country is landlocked. A number of (extended) neighbours' geopolitical agendas trump regional economic integration initiatives.

Currently, the NUG's attention is largely focused on security issues and political infighting. The initial transition landscape has given little indication that the security situation will improve in the short term. While the NUG has initiated a number of economic reform processes, unpredictability and uncertainty remain key negative factors for the private sector. Accordingly, capital flows are largely outbound, and investments are put on hold or have a short-term horizon. An improved security situation is necessary to stimulate foreign as well as domestic private investment.

Consequently, the country's economy is largely deadlocked. Its large yet functional informal economy (accounting for 80–90 per cent of total economic activity, and which also comprises the illicit economy) and a weak fiscal regime limit the NUG's ability to collect tax revenue and provide essential public services and goods. This in turn erodes government legitimacy and hampers state building efforts, including the creation of the conditions needed to stimulate economic growth. Indeed, the lack of suitable conditions for the private sector may even be driving anti-government sentiment. New partnership modalities with the private sector are needed.

Clearly, at its current capacity levels and in the present environment, the Afghan private sector cannot make use of the country's economic potential. There exist substantial untapped human capital resources in Afghanistan since informal institutions tend to, among other population groups, marginalize women, who make up around half of the potential labour and entrepreneurial force. Unemployment levels also remain worryingly high and could continue to rise as around half a million people, mostly rural-based and illiterate, enter the labour market each year. Beyond providing legitimate employment, the private sector has a role to play in providing a tax base, mitigating poverty, and granting the broader population, as well as the elites, an economic stake in the survival of the state. Yet, in its current embodiment, small(er) players and marginalized sections of the population have great difficulty participating, competing and expanding in the private sector. Afghan Government interventions to promote more inclusive private sector growth are therefore urgently needed. However, the NUG is still weak in its administrative and technical capacity. In the light of this, strategic PSD support from the international community in the medium- to long-term time horizon is required.

The way in which this support is provided is critical to its sustainable impact. Despite the obvious benevolent intentions behind PSD work, failures of coordination and implementation by the international community are well documented. A number of direct market interventions, for instance, have fed into corruption and patronage networks, distorted markets and reinforced dependency. PSD efforts have also had limited success due to fragmented and uncoordinated approaches, and lack of contextualized knowledge. Some of these miscalculations might have even worked to the detriment of government legitimacy and private sector development. Therefore, coordination among all stakeholders is essential, as is addressing root causes of market failures at the structural and policy level. How, then, can stakeholders assist the Afghan private sector to become a source of economic growth and an instrument of social inclusion?

Recommendations to the Afghan Government

I. Provide direction by developing a realistic private sector growth strategy with clear measurable milestones, division of labour between international and national actors, and implementation, monitoring and follow-up mechanisms;

II. Increase the capacity of state economic institutions that support the productive potential of the private sector, including through continuous training of the civil service. Relevant public institutions must be given unambiguous mandates;

III. Take immediate carefully tailored measures to curb corruption starting at the highest government echelons. Curb corruption in regulatory processes through increased use of digitalized processes;

IV. Improve the business climate in close coordination with the organized business community through realistic growth-promoting economic policy reforms and by prioritizing sustainable development of strategic industries. Instruments such as tax relief, state supply contracts and public-private partnerships (PPPs) should be considered;

V. Evaluate and update the strategy for trade policy instruments that can enhance Afghan competitiveness and protect infant industries. Full digitalization of customs procedures could help to eliminate exiting gaps in regulation;

VI. Tackle the hurdles that limit access to economic resources, in particular land and capital. Access to resources should be combined with clearer and enforced property rights. Mobilize state landholdings for use by the private sector through favourable long-term lease agreements. Leverage the potential of existing and developing unbanked credit mechanisms. Sector-oriented banks that provide demand-led financial products are recommended;

VII. Invest in infrastructure critical to economic activity. In light of government financial limitations, rapidly move to pass and implement the new PPP law; and

VIII. Prioritize women's full and equal participation in the economy, leveraging women-to-women economic networks, while promoting male endorsement. Support policies should be mainstreamed within all economic plans.

Recommendations to the international community

I. Support the Afghan Government with all the above-stated eight recommendations. Direct but careful market interventions can also be considered;

II. Set up a formal cooperation and coordination mechanism for the development of the private sector in conjunction with the NUG;

III. Establish a new formal international aid database that incorporates former and running PSD efforts, including off-budget development programmes;

IV. Support full value-chain development projects in the agricultural sector, which have high labour intensity and job creation potential, including for women;

V. Consider diversifying geographic focus: aid interventions should aim to target communities based on need rather than on political or security priorities; and

VI. Incorporate consumer demand perspectives into PSD programming. Demand is a critical component of commercial feasibility and sustainability for PSD programmes.

Recommendations to the private sector and other Afghan stakeholders

I. Strengthen the capacity, transparency and member representation of organized business. The views of smallerscale business actors, including informal and rural-based businesses, should be given greater weight; and

II. Strive to curb supply-side corruption. Leverage collective action, engage officials, utilize media and engage organized civil society to promote clean business.

For the full details on the way forward, the research supporting it and the private sector's larger historical and politico-economic context, download the complete report. For more detail and rationale on the recommendations listed here, see chapter 6.