Policy Insights

Boosting Private Sector Development and Entrepreneurship in Afghanistan

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Foreword

The creation of conditions for the emergence of a dynamic private sector – capable of diversifying exports, creating jobs and strengthening resilience – is one of the most challenging and important issues facing Afghanistan. As the country struggles with the legacy of decades of continuing conflict, questions of security and economic development are inextricably linked. Conflict resolution and economic reconstruction must go hand in hand. Armed conflict deters investment, damages physical infrastructure, and imposes enormous human and financial costs. At the same time, it is clear that the creation of economic opportunities, particularly for the young, will be critical to breaking the vicious circle of conflict and overcoming the limited state capacity and poverty in which much of the country is trapped. This will require strengthening institutions, fostering functional regulatory frameworks, and creating a business-enabling environment to support the private sector (OECD, 2018[1]).

In the long run, peace and stability could easily prove unattainable if the country fails to lay the foundation for broad-based, job-rich growth. With the economy suffering the consequences of the drawdown of foreign forces in the country and the decline in international aid, the government has redoubled its efforts to establish a basis for developing the domestic private sector.

This report and the work behind it represent a contribution to that effort by the OECD Eurasia Competitiveness Programme, at the request of the government of Afghanistan and with the financial support of the European Union. At the end of 2017, the OECD and the Afghan authorities put together a Public-Private Working Group to help design policies to address the barriers facing micro, small and medium enterprises in the country. The Working Group met three times in 2018, chaired successively by the Minister of Economy, the Minister of Industry and Commerce and the Senior Economic Advisor to the President. It brought together representatives of the government, public institutions such as the central bank and the land authority, banking and business associations, private financial institutions, start-ups, and development partners.

This note reflects the deliberations of the Working Group, as well as the contributions of experts from OECD member countries and the OECD Secretariat. The final recommendations presented in the note was peer reviewed during the Eurasia Competitiveness Roundtable at Eurasia Week 2018 in Paris.

The OECD will continue to work with the Afghan authorities and other partners to support implementation of the report's recommendations, including with respect to the elaboration of the SME strategy, and to monitor implementation progress, which is to be reviewed in the Roundtable in 2021. The Organisation is also ready to work with the Ministry of Industry and Commerce (MOIC) on the development of a set of monitoring and evaluation tools to ensure effective implementation of the recommendations, in close alignment with Afghanistan's Executive Committee on Private Sector Development (PRISEC), the Executive Committee on Sustainable Development Goals (SDGs), and other relevant bodies.

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Acronyms and Abbreviations

ABIF	Afghanistan Business Innovation Fund
ACBR	Afghanistan Central Business Registry
ACCI	Afghanistan Chamber of Commerce and Industries
ACGF	Afghan Credit Guarantee Foundation
ACIM	Afghanistan Chamber of Industries and Mines
ADB	Asian Development Bank
ADBI	Asian Development Bank Institute
ADF	Agricultural Development Fund
AFN	Afghani (currency)
AGF	Afghanistan Growth Fund
AIARA	Afghanistan Industrial Areas Regulatory Authority
AISA	Afghanistan Investment Support Agency
ANDPF	Afghanistan National Peace and Development Framework
ARFC	Afghanistan Rural Finance Centre
ARTF	Afghanistan Reconstruction Trust Fund
AWCCI	Afghan Women's Chamber of Commerce and Industry
BMZ	German Federal Ministry for Economic Co-operation and Development
bn	billion
BRT	Business Receipt Tax
CASA	Central and South Asia
CFG-A	Credit Guarantee Facility for Afghanistan
CGS	credit guarantee scheme
CIT	corporate income tax
CSO	Central Statistics Organisation
DAB	Da Afghanistan Bank
DBI	World Bank *Doing Business* Index
DLTs	distributed ledger technologies
EBRD	European Bank for Reconstruction and Development
ECP	Eurasia Competitiveness Programme
ETF	European Training Foundation
EU	European Union
FACT	Federation of Afghanistan Craftsmen and Traders
FDI	foreign direct investment
FIAS	Foreign Investment Advisory Service
GDP	gross domestic product
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit (German Society for International Co-operation)
HCI	Human Capital Index (World Bank)
HEC	High Economic Council
ICT	information and communications technologies
IDI	ICT Development Index
IDPL	Strategic Institutional Development Program for Land Administration
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards

ILO	International Labour Organization
ILOSTAT	International Labour Organization Database
IMF	International Monetary Fund
INFE	International Network on Financial Education (OECD)
IO	international organisation
ITC	International Trade Centre
ITU	International Telecommunication Union
KGF	Turkish Credit Guarantee Fund
KOSGEB	Small and Medium Industry Development Organization
KPI	key performance indicator
LML	Land Management Law
MCIT	Ministry of Communications and Information Technology
MDO	micro deposit organisation
MENA	Middle East and North Africa (region)
MFI	microfinance institution
MIGA	Multilateral Investment Guarantee Agency
MISFA	Microfinance Investment Support Facility
mn	million
MoF	Ministry of Finance
MOIC	Ministry of Industry and Commerce
MOOC	Massive Open Online Course
MoU	memorandum of understanding
MRRD	Ministry of Rural Rehabilitation and Development
MSP	money service provider
MTO	money transfer organisation
NES	National Export Strategy
NPL	non-performing loan
NPP	National Priority Programme
NUG	National Unity Government
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OECD/INFE	OECD International Network on Financial Education
OGPA	Open Government Partnership Afghanistan
OIC	Organization of Islamic Cooperation
OIZ	Organized Industrial Zones
PCR	Public Credit Registry of Afghanistan
PFIs	partner financial institutions
PPP	public-private partnership
PRISEC	Afghanistan's Executive Committee on Private Sector Development
PSD	private sector development
RIA	regulatory impact assessment
RIF	Mexico's *Régimen de Incorporación Fiscal*
SESRIC	Statistical, Economic and Social Research and Training Centre for Islamic Countries
SDGs	UN Sustainable Development Goals
SEZ	special economic zones
SIGAR	Special Inspector General for Afghanistan Reconstruction
SIGI	Social Institutions and Gender Index (OECD)

SIPRI	Stockholm International Peace Research Institute
SME	small and medium-sized enterprise
SMEPI	SME Policy Index (OECD)
SOE	state-owned enterprise
TVET	Technical and Vocational Education and Training (national strategy)
UN	United Nations
UNDP	United Nations Development Programme
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
UNFPA	United Nations Population Fund
UNODC	United Nations Office on Drugs and Crime
USAID	United States Agency for International Development
USD	US dollar (currency)
VAT	Value Added Tax
WB	World Bank
WEF	World Economic Forum
WTO	World Trade Organization

Key Indicators for Afghanistan

Afghanistan	
Population, 2017	35.53 million
Surface area	652 860 km^2
GDP (USD, current prices), 2017	20.8 billion
GDP per capita, (USD, current prices), 2017	585.85
Real GDP growth (y-o-y change), 2017	2.59%
Inflation (average consumer prices, y-o-y change), 2017	5.0%
Exports of goods and services (% of GDP), 2016	6.9%
Imports of goods and services (% of GDP), 2016	49.0%
FDI, net inflows (% of GDP), 2017	0.25%
General government net lending/borrowing (% of GDP), 2017	-0.6%
Official unemployment rate (% of total labour force), 2017*	23.9%
Labour force, total, 2017	10.9 million
Public sector debt (% of GDP), 2017	7.6%
Domestic credit to private sector (% of GDP), 2017	3.47%
Average rate on loans, 2017	15.0%
Non-performing loans (% of total gross loans), 2017	12.2%
Remittances (% of GDP), 2017	1.82%
Current account balance (% of GDP), 2017	-22.50%

Sources: (World Bank, 2017[2]; IMF, 2017[3]; Asian Development Bank, 2017[4]).
*Official data from (Central Statistical Office of Afghanistan, 2017[5]).

Executive Summary

Aid remains the main driver of growth and conflict the main impediment

After a run of volatile but relatively fast growth in the 2000s, Afghanistan's economic growth has slowed markedly in recent years as a result of declining aid, a reduction in the foreign military presence and a re-escalation of insurgent activity. Although official development assistance has fallen by almost half since 2009, the economy remains largely dependent on aid, with limited domestic resources to underpin a recovery. Weak and under-financed state institutions are unable to protect citizens and businesses or to deliver quality public services. This reduces trust in the government and thus further hampers state-building and economic recovery.

The domestic private sector's role as an engine of growth remains limited. Private businesses face numerous regulatory and non-regulatory barriers, including corruption, limited access to finance, burdensome regulations, lack of co-ordinated support for local industry, poor connectivity within the country and with neighbours, and physical insecurity. The economy is dominated by a large informal sector that generates little growth and often undercuts formal-sector firms. SMEs and start-ups suffer more than other firms from these problems, as their size and resources make it harder for them to meet such challenges, especially if they seek to operate in the formal sector.

Reforms to create a better business environment require further work

Since 2015, the government has made significant efforts to create conditions for more dynamic private sector development, but implementation and policy require further work. Afghanistan rose 16 places on the World Bank's *Doing Business* indicators in 2018-19, but it still ranks 167th out of 190 economies. In an effort to streamline implementation of business reforms, the government created the High Economic Council (HEC) and Executive Committee on Private Sector Development (PRISEC). These two bodies have improved co-ordination and the pace of implementation, including direct engagement with stakeholders from the private sector and international partners. The adoption of the 11 Private Sector Reform Priorities and the drafting of the first National Priority Programme for Private Sector Development (NPP PSD) could represent major steps forward, provided they are followed by effective, co-ordinated and transparent implementation. In particular, current and future initiatives could and should pay greater attention to the specific needs of SMEs and start-ups, which are the focus of this report.

Encouraging business formalisation could help strengthen growth

Up to 80% of economic activity in Afghanistan is informal (SIPRI, 2015[6]). While the informal sector can be a valuable source of economic opportunity, it has a negative impact on resource allocation, job quality and equality. Informality shrinks the available tax base and deprives workers of social and legal protections. In order to increase the share of formal activity while supporting growth, the government must create a better environment for *all* firms. At the same time, attention must be paid to the needs of new and small firms, since they are more immediately exposed to competition from informal businesses – and if their needs remain unaddressed, they may themselves prefer to operate informally. The government has taken a number of important steps in this regard, such as creating one-stop shops, significantly lowering the cost of starting a business, and eliminating municipal licenses. Further, the recent creation of a three-year visa-on-arrival may encourage foreign investors to travel to Afghanistan. Despite these improvements, however, the lack of supportive regulatory frameworks and incentives for firms to formalise remain important obstacles. This review outlines a number of priority actions for the government: 1) developing a proper institutional and legal framework to support the private sector, not least by further simplifying regulations and preparing an SME strategy; 2) designing specific incentives for formalisation; 3) improving the quality of public services, particularly in industrial parks; and 4) raising awareness of the benefits of formalisation.

Better access to finance will help businesses grow

Access to finance remains a major impediment to the establishment and growth of businesses in Afghanistan. Credit to the private sector amounts to only 3.5% of GDP, the lowest in the world. Collateral requirements are high, interest rates reach up to 25% for SMEs, and loans have short maturities. Only 5% of businesses have a line of credit or bank loan, and, with the exception of the informal *hawala* network, alternative sources of finance are underdeveloped. In addition, a lack of financial literacy hampers the expansion of both traditional and non-traditional financial instruments. A number of steps could help overcome these problems and allow SMEs and start-ups to grow and improve productivity: 1) designing and implementing a financial literacy strategy that reflects international good practices; 2) providing better loan conditions (rate, maturity) to SMEs, including by better co-ordinating and aligning existing (mainly donor-financed) programmes with government objectives and SME needs; 3) reducing collateral requirements by supporting the expansion of credit guarantees schemes, particularly the Afghan Credit Guarantee Foundation; 4) improving the framework for alternative financing, including the hawalas; and 5) developing diaspora financing.

Digital solutions can help improve public service delivery to businesses

If the private sector in Afghanistan is to grow and formalise, businesses must be provided with services that meet their needs and take into account local realities. Recent polling found that more than 50% of businesses perceive the quality and availability of government services to be a hindrance to development. The vast majority of government services remain analogue and offline, which limits the ability of businesses outside Kabul to access them. The development of new connective infrastructure has paved the way for the expansion of digital services, with an increase in mobile phone penetration opening up possibilities for mobile service delivery. Digital government services can ease economic formalisation for businesses by lowering the time and financial costs of administrative procedures. This report underlines ways to explore to improve service delivery to businesses: 1) developing a whole-of-government digital strategy to ensure co-ordination and alignment on priorities; 2) focusing on *mobile* delivery platforms to allow geographically dispersed businesses to access the services they need; 3) improving consultation with the private sector for service design and delivery; 4) enhancing co-ordination, both within the government and with the private sector, to prioritise services for businesses such as e-payment systems; and 5) ensuring consistency across government platforms and moving towards an integrated online one-stop shop.

The draft SME strategy could help make policy more consistent and coherent

The Ministry of Industry and Commerce should concentrate its efforts on preparing an SME strategy, which should complement the NPP PSD and address the specific needs of SMEs and micro-businesses. The strategy must include practical policy recommendations for business formalisation, access to finance, and digital services. Export promotion included in the National Export Strategy should complement these measures.

1. Introduction

Since 2001, international aid has been the main driver of economic growth

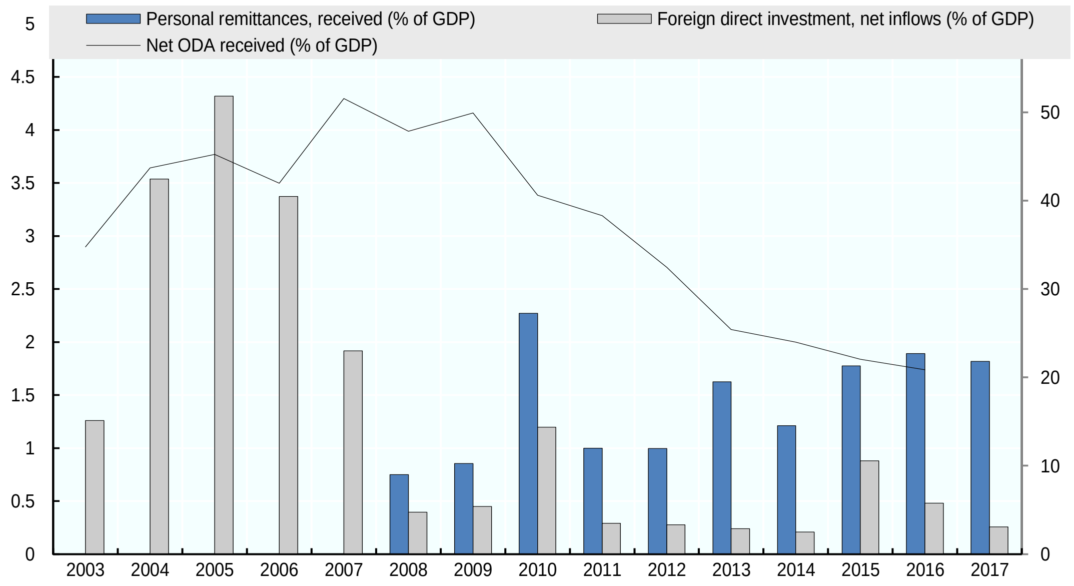
Since the fall of the Taliban regime in 2001, Afghanistan's reconstruction and recovery has been underpinned by a substantial international presence, which has provided large inflows of foreign funds in the form of security spending and official development assistance (ODA) and supported attempts to shape institutions and economic structures in order to establish a functioning market economy (SIPRI, 2015[6]). Afghanistan has been among the top ten recipients of ODA since 2001 and has received more financial support than post-war Europe under the Marshall Plan (OECD, 2018[1]; SIPRI, 2015[6]). Through the Afghanistan Reconstruction Trust Fund, established in 2002, 34 donors and the Afghan government came together to channel USD 10 billion towards reconstruction efforts.

While the security situation has remained fragile throughout the period, economic reconstruction efforts have been a central priority, reflecting a recognition that recovery and pacification needed to proceed in tandem and to reinforce one another (SIGAR, 2018[7]). These efforts are critical to improving the internal security situation. International evidence suggests that participation in insurgent groups, though not motivated mainly by money, declines as the opportunity cost of participation rises but increases in the absence of other opportunities. This is particularly true in a country like Afghanistan, with a young and rapidly growing population, where the labour market struggles to keep pace with the flow of new entrants. The World Bank (2018, p. 5[8]) observes, "there is strong evidence that violence increases in the context of a youth bulge and limited opportunities." Job creation and growth could thus do much to mitigate the forces that underlie the ongoing armed conflict in the country.

Security remains a major concern. According to SIGAR (2018[7]), as of 31 January 2018, roughly 65% of the population lived in "areas under government control or influence." Some 12% lived in areas under insurgent control or influence, while the remainder (23%) lived in contested areas. In 2017, the number of security incidents reached the highest level since 2001, with a 50% increase in suicide attacks in 2016. More than 200 000 Afghans were internally displaced by conflict and environmental problems in 2017 (World Bank, 2018[9]). Civilian casualties reached new peaks during the first half of 2018, with close to 1692 deaths (New York Times, 2018[10]; Reuters, 2018[11]).

ODA remains the main external driver of economic growth, far ahead of foreign direct investment (FDI) and remittances (Figure 1). In the late 2000s, ODA inflows peaked at more than 50% of GDP, though they have since fallen to around 20% (Aghaez, 2017[12]) (World Bank, 2018[9]; Aghaez, 2017[12]).[1] Merely 0.31% of ODA in 2016 went to the development of SMEs in fragile contexts. Both donors and the government have reported difficulties in formulating "clear strategies to engage formal and informal SMEs, in part because these enterprises are so embedded in the social fabric and rely upon social identity groups and existing power configurations" (OECD, 2018, p. 205[1]). The peak in FDI inflows was just 4.3% of GDP in 2005 and they have since fallen substantially. Insecurity, institutional weakness and corruption have been critical deterrents to private investment, which fell by 24% between 2011 and 2015 (SIGAR, 2018[7]).

Figure 1. Net ODA (right scale), FDI and remittance inflows (left scale), 2003-17



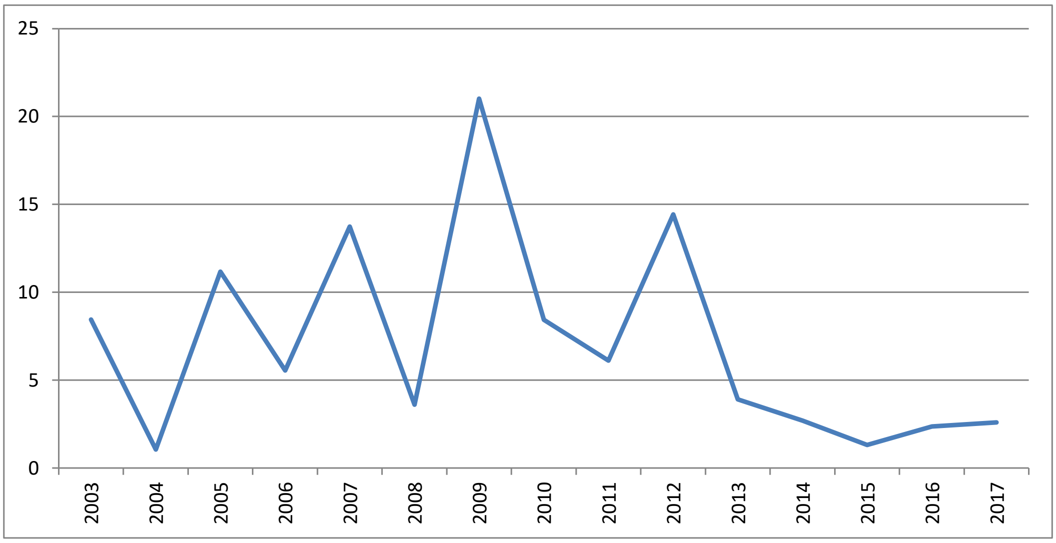
Source: (World Bank, 2017[2])

Although there are an estimated 2.6 million Afghans living abroad (around 7.5% of the population), recorded remittances are relatively low on the official data, amounting to 1.8% of GDP in 2017. By contrast, remittances amounted to 33% of GDP in Kyrgyzstan, with an estimated 11.5% of the population working abroad; the corresponding figures for Tajikistan were 31.6% and 7%, respectively (World Bank, 2016[13]; UN Department of Economic and Social Affairs, 2017[14]). This low figure for remittances partly results from the high usage of informal transfer mechanisms, which cover an estimated 90% of all financial transactions (SIGAR, 2018[7]).

Reliance on external inflows in combination with political and security incidents made for highly volatile growth performance during the first decade of reconstruction (Figure 2). Since 2012, growth has been consistently sluggish, as a result of declining aid and investment inflows and a reduction in the international security presence. An estimated 500 000 jobs were lost – roughly as many as had been created during the preceding decade. Unemployment rose from 7.1% in 2008 to 22.6% in 2014 (SIGAR, 2018[7]). In 2017, the Central Statistical Office and the Ministry of Labour and Social Affairs estimated the unemployment rate at 23.9% (Central Statistical Office of Afghanistan, 2017[5]).

Despite this challenging context, Afghanistan has made significant progress in improving human well-being. Mortality rates have fallen by a third, including those for children under five (World Bank, 2018[8]). Life expectancy at birth has risen by 20 years and enrolment in primary schools has grown from 1 to 8 million. Measured in constant dollars, GDP per capita increased 74% between 2002 and 2013, though it slipped by a cumulative 2.4% over 2014-17, as aggregate GDP growth failed to keep pace with the increase in population (World Bank, 2016[13]). The growth slowdown has led to increasing poverty, especially in rural areas.

Figure 2. Real GDP growth (annual %), 2003-17



Source: (World Bank, 2017[2]).

Improvements in development indicators fall within the objectives of the United Nations' (UN) Sustainable Development Goals (SDGs). Afghanistan has established a national high-level co-ordination platform on SDGs (the Executive Committee on SDGs) to monitor progress, improve data collection, and counter the downward trend of socio-economic indicators (United Nations, 2017[15]). Boosting private sector development and entrepreneurship in Afghanistan could contribute to progress on several SDGs, including SDG 5 on Gender Equality, SDG 8 on Decent Work and Economic Growth and SDG 9 on Industry, Innovation and Infrastructure.

Despite these improvements, however, women's economic empowerment remains limited in Afghanistan. Female labour force participation stands at around 19% (Leao, Ahmed and Kar, 2018[16]). Women still face systemic disadvantages, with a direct impact on business development. First, women tend to be disconnected from markets, as they have limited mobility, less experience and smaller networks through which to operate (Netherlands Enterprise Agency, 2016[17]). Second, they face more barriers in accessing finance (and in obtaining land and equipment) due to unfavourable inheritance and land titling systems, discriminatory laws, and limited income and savings to begin with. The 2019 OECD Social Institutions and Gender Index (SIGI) estimates that 45.6% of Afghan women have restricted access to productive and financial resources (OECD, 2018[18]). Finally, women tend be less educated, with a 17% female literacy rate compared to a national average of 31% (ITC, 2018[19]).

These barriers need to be addressed, as women's participation in the economy is indispensable for fighting poverty (OECD, 2014[20]; Ministry of Foreign Affairs, 2018[21]; OECD, 2018[1]). International organisations and local groups are working to strengthen the role of women within the private sector. The efforts of the Afghan Women's Chamber of Commerce and Industry, for example, focus on women's access to finance and on quality and branding of products; and in 2018 the World Bank launched a new initiative to support women's economic empowerment.

As explained in Box 1, the OECD has developed a framework to support fragile states such as Afghanistan and has applied the framework's principles to various contexts, including fragile states in the Middle East and North Africa (MENA) region. Designed to guide OECD work and donors' engagement in the country, the fragility framework emphasises the importance of donor co-ordination and of building capacity within the government, both of which are reflected throughout this report.

Box 1. Afghanistan and the OECD's fragility framework

The OECD has classified 75 countries as "fragile", including Afghanistan. The framework takes the perspective that "fragility is a multi-dimensional concept with economic, environmental, political and security and societal dimensions" which, if left unmitigated, may have negative development outcomes.

Afghanistan has been further classified as "severely fragile" in all categories. This implies that any type of engagement must be well-targeted and that donors need to support several areas: strengthening governance structures and institutions, investing in capacity building and functional regulatory frameworks, and fostering a business-enabling environment. Engagement in Afghanistan needs to be conducted in light of the 10 Fragile State Principles, which have resulted from the 2005 Paris Declaration on Aid Effectiveness:

1. Take context as the starting point.
2. Ensure all activities do no harm.
3. Focus on state building as the central objective.
4. Prioritise prevention.
5. Recognise the links between political, security and development objectives.
6. Promote non-discrimination as a basis for inclusive and stable societies.
7. Align with local priorities in different ways and in different contexts.
8. Agree on practical co-ordination mechanisms between international actors.
9. Act fast but stay engaged long enough to give success a chance.
10. Avoid pockets of exclusion ("aid orphans").

Source: (OECD, 2018[1])

Afghanistan needs to stimulate growth, job creation and productivity

The economy reached a turning point following the drawdown of international forces in 2011-12. Troop withdrawals and declining ODA inflows confronted the government with an urgent need to identify new sources of growth (PRISEC, 2018[22]). This has prompted it to undertake a raft of measures aimed at stimulating private sector development. Even the stronger GDP growth of earlier years did not allow the growth and job creation needed to keep pace with the demographic boom and declining mortality rates; 400 000 new entrants to the labour market each year generate tremendous pressure for job creation. It is estimated that real growth of 8% per annum or more would be required to accommodate this growing work force, while the actual growth rate reached 2.6% in 2017 (Business DNA, 2018[23]). The slowdown since 2014 has thus led to rising unemployment and poverty, likely fuelling the insurgency (World Bank, 2018[8]). This is a security issue, inasmuch as underemployed or unemployed youth are more likely to become radicalised (Bhatia and Ghanem, 2017[24]).

Policies that create opportunities for more profitable livelihoods can thus mitigate violent extremism and help break the vicious cycle of fragility (OECD, 2018[1]).

Most employment is also concentrated in low-productivity sectors – particularly agriculture, which accounts for 62% of employment but generates just 21.7% of GDP. The corresponding figures for industry and construction are 6.7 and 23.1%, respectively; for services they are 31.1 and 55.2%. The gradual shift towards the service sector is relatively recent: its employment share has more than doubled since 2001, while that of agriculture has fallen by 16%. The contribution of opium production to GDP is increasing and reached an estimated 7% of GDP in 2017, fuelled by a large expansion of cultivation areas (UNODC, 2017[25]). The growth of the illicit economy has created socio-economic challenges including income dependence for rural communities, further constraining the development of formal, legal activities.

Afghanistan has a large trade deficit; in recent years, it has exceeded 40% of GDP. In part, this has resulted from huge inflows of foreign assistance, which have sustained consumption but may also have created a sort of aid-driven "Dutch disease", fuelling imports and undermining domestic competitiveness. Aid inflows chiefly stimulated the development of non-tradable sectors (construction, health, education), pushing up wages and the exchange rate at the expense of tradable-sector competitiveness (Palaash and Ghosh, 2018[26]). Domestic producers have been unable to compete and keep up with international standards. In addition, production and export capabilities have been seriously affected by years of armed conflict, which led to massive imports of agricultural products, machinery and other manufactured goods (OEC, 2018[27]). The National Export Strategy (NES), approved in June 2018, aims to redress this imbalance (ITC, 2018[19]).

Afghanistan remains a low-income economy. In 2015, approximately 40% of the population fell under the global poverty threshold (Government of Afghanistan and PRISEC, 2018[28]).

Private sector development must become the new engine of economic growth

Private sector development is now the government's central growth priority. Particularly in fragile contexts, SMEs have the potential to create economic opportunities at the local level, by better adapting to intricate domestic conditions (OECD, 2018[1]). The size of the private sector remains difficult to assess in Afghanistan, though it is clearly limited. The most recent figures estimate the contribution of the formal private sector at 12-20% of GDP (SIPRI, 2015[6]). However, although these official estimates cover 700 000 companies, they exclude those "primarily engaged in agriculture, mining, small-scale construction, transport, banking and insurance" (Afghanistan Central Business Registry, 2015[29]).[2] Other available reports indicate that private sector activities mainly involve agriculture, transport, storage and communications, construction and production of food, beverages and tobacco and could represent a larger share of the GDP (Afghanistan Government Media and Information Center, 2017[30]).[3] In addition, the informal sector is large in Afghanistan and is not included in these figures. Illicit activities are also pervasive in Afghanistan and understandably difficult to estimate.[4] They foster instability, fuel corruption, and exacerbate the potential for conflict and violence (OECD, 2018[1]).

With the large predominance of agriculture and retail trade, the country needs to diversify tradable production and exports, and this will require creating more favourable conditions for entrepreneurship and the growth of new firms and sectors (ITC, 2018[19]). Entrepreneurs and SMEs[5] are estimated to represent 98.5% of businesses, generating approximately 17.5% of GDP and employing 19.5% of the labour force, according to the Central Statistics Organisation (CSO). However, other estimates, such as that of the Afghanistan Research and Evaluation Unit, suggest that their share in the economy is substantially larger when all economic sectors and regions are considered, at around 50% of GDP and 33% of the labour force (Afghanistan Research and Evaluation Unit, 2014[31]). With foreign assistance declining and the country still struggling to attract private investment from abroad, Afghan entrepreneurs and SMEs will have to be the engines for much of the needed development.

Afghan businesses operate in a context characterised by conflicts, corruption and political instability (World Bank, 2018[8]; ACCI, 2017[32]). The prolonged conflict has had a pervasive impact on private sector development: businesses and investors flee the country, taking capital, skills, jobs, and technology with them, further undermining the support the domestic private sector requires to develop (World Bank, 2011[33]). Successive governments so far have failed to provide reliable, transparent, fair public service delivery or to prevent systematic rent-seeking. The government has drafted a new anticorruption strategy to address these issues (Government of Afghanistan, 2018[34]).

Afghan business representatives also identify political and policy instability among the biggest obstacles to growth. The government still faces important challenges in internal policy co-ordination and implementation. This has served to undermine the trust of businesses in the government and to shift private sector activities further into the informal economy, reinforcing state fragility and corruption (SIGAR, 2018[7]).

The government has set ambitious targets and made efforts to boost private sector development, to integrate Afghanistan in the wider region and to increase domestic revenue collection, particularly through the Afghanistan National Peace and Development Framework (ANDPF) (Box 2).

Box 2. Afghanistan's reform agenda and National Priority Programmes

The Afghanistan National Peace and Development Framework (ANDPF) (2017-21) aims to help the country move towards self-reliance and achieve progress towards the SDGs. It provides a framework for reforms based on the agenda presented by the National Unity Government (NUG) to the international community in Brussels in 2016 "to achieve self-reliance, increase the welfare of the Afghan people and build a broad-based economy that creates jobs."

The government uses the ANDPF as a platform for reforms in a wide range of economic areas. It includes 12 National Priority Programmes (NPPs), with one focused on private sector development (2018-2023). It also acknowledges the potential of SMEs as engines of growth and job creation. Several other NPPs relate to economic development, including the Agricultural Development NPP and the NPP on Women's Economic Empowerment. It is therefore crucial that the NPPs align and further feed into relevant strategies, such as the SME strategy and the National Export Strategy.

The NPP for Private Sector Development (NPP PSD) is an outcome of substantial consultation between the government, the private sector and international entities (including the World Bank) along with strong participation by the ITC and the OECD.

It now includes four main areas of reforms in favour of private sector development:

1. restoring confidence and creating an enabling environment for businesses by improving security, implementing business climate reforms and increasing participation in global value chains;
2. increasing access to key inputs for businesses, such as access to finance and to land;
3. sharing risks and crowding in investment through investment promotion, PPPs and enhanced state-owned enterprise performance; and
4. facilitating and securing trade and transit, including customs.

Sources: (PRISEC, 2018[22]; Business DNA, 2018[23])

At the 2014 London Conference on Afghanistan, the government acknowledged "improving Afghanistan's business enabling environment" as the top priority (SIPRI, 2015[6]). Eleven Private Sector Reform Priorities, presented by the private sector representatives to the government and its international partners, were accepted by the government. Due to the cross-cutting nature of the priorities and to support and facilitate implementation of these reforms and those related to the World Bank *Doing Business* Indicators, the government made use of a cross-ministerial approach to form the PRISEC, which coordinated the development (Box 3).

Box 3. PRISEC and the 11 Private Sector Reform Priorities

Afghanistan's Executive Committee on Private Sector Development (PRISEC) was established under the office of the Chief Executive. Chaired by the Minister of Industry and Commerce, the Chief Executive, and the World Bank Country Director, it offers a platform for the government ministries and agencies, private sector and international partners to co-ordinate their private sector-related efforts and to support the following 11 reform priorities:

1. improve traditional irrigation systems and promote sustainable modern systems;
2. advance the development of a national railway system;
3. develop ancillary infrastructure around resource corridors to facilitate development and reliable transport of extracted minerals;
4. establish 'one-stop shops' for public services, with integrated electronic systems providing streamlined business administration services;
5. lower the cost and increase the availability of financing by expanding existing credit guarantee and microfinance schemes and by making the contract enforcement and debt collection environment more attractive to lenders;
6. develop a strategy for industrial parks which reflects comments and ideas from the private sector;
7. urgently approve an electricity law, relevant sub-laws and guidelines that facilitate the establishment of an independent electricity regulatory authority to implement policies that support private investment in the electricity sector;

8. upgrade the infrastructure/equipment of Technical and Vocational Education and Training (TVET) institutions;
9. protect investors and promote investment;
10. develop a national policy and a legal/regulatory framework for public-private partnerships (PPPs); and
11. establish an alternative transit route through Central Asia.

The NPP PSD (2018-2023) brings all the key PSD-related reform items under a single umbrella and, for the first time ever, allocates a budget and establishes timelines for the line ministries implementing the reforms.

Source: (Government of Afghanistan and PRISEC, 2018[28])

To further support the improvement of the business climate, the government is preparing and implementing a number of reforms and laws directly affecting the private sector in addition to the NPP PSD. These efforts have found reflection in the country's ranking in the World Bank's *Doing Business* indicators for 2018-19. Afghanistan moved up 16 places, from 183rd to 167th, largely due to reforms on starting a business, protecting minority investors and resolving insolvency (World Bank, 2019[35]). Further reforms to strengthen private sector development are still needed, and many are under way:

- The country has established air corridors to expand its reach to global markets. For instance, in July 2017, an air corridor was established between Kabul and New Delhi, offering 170 flights. By end-2018, more than 3 000 metric tons of goods had been exported via this route, exporting goods to China, Europe (20+ cities), India (50+ cities), Kazakhstan, Russia, Saudi Arabia and UAE (Office of Economic Advisor, 2018[36]; Embassy of Afghanistan to Italy, 2018[37]).
- The government aims to further develop Special Economic Zones (also referred to as industrial parks), mainly in close proximity to the airports.
- A revised Mining Law and a mining sector roadmap have been developed, setting out how the government aims to develop its mining and extractive industry. Because the sector has experienced continuous difficulties with illegal extraction, the new roadmap – developed by Ministry of Mines and Petroleum – emphasises increased transparency and an improved legal framework.
- A Land Management Law (LML) is currently being complemented by a five-year investment plan, the Strategic Institutional Development Programme for Land Administration (IDPL). The Ministry of Urban Development and the Independent Land Authority (ARAZI) have recently been merged; the newly created entity is called the Ministry of Urban Development and Land and aims to further streamline and improve land administration and urban development priorities.
- New insolvency and company legislation was passed in March 2018 and helped Afghanistan improve from 161st to 74th on the World Bank's "Resolving Insolvency" indicator (World Bank, 2019[35]). The new law strengthens the private corporate governance framework. A good insolvency framework is a crucial step toward easing access to credit; the government has implemented 13 reforms (including the payment of creditors during bankruptcy and insolvency

proceedings) and is improving its Insolvency Law. Proper implementation of the new act is now critical.

- In 2018, the government approved the National Export Strategy (NES), which was developed with the support of the International Trade Centre (ITC) and the EU. The NES focuses on six sectors with high export potential, mostly agrofood, textiles (carpets) and precious stones and jewellery (ITC, 2018[19]).
- In 2018, the government approved a National Trade Policy and adopted a new export procedure reform package, which reduces the number of documents required for export and can reduce time and cost of border compliance for export (ITC, 2018[19]).
- A new State-Owned Corporation (SOC) Law has created a significantly improved governance framework for all state companies. This includes a clear delineation of ownership rights, the inclusion of independent directors, and strengthened financial systems and audits at SOCs (Office of Economic Advisor, 2018[36]).

This report focuses on three private sector development challenges

1. Business formalisation is critical to successful private sector development

It is estimated that the informal sector accounts for 80% of total economic activity in Afghanistan (SIPRI, 2015[6]). This must change if policies aimed at stimulating private sector growth are to deliver; businesses must be encouraged to move into the formal economy. Otherwise, they remain beyond the reach of many initiatives and programmes and their growth is constrained by the simple fact that they are informal and thus have limited scope to invest in skills, technology or more sophisticated operations. To encourage businesses to move towards the formal sector, which might help create a "bandwagon effect",[6] Chapter 2. recommends that the government develop strong positive incentives for businesses to formalise and reduce the actual and perceived costs of formalisation.

2. Access to finance remains a barrier to business development

SMEs and start-ups report that credit conditions do not match their needs. In 2016, 57% considered the availability of finance as an issue, with the majority citing very high interest rates and excessive collateral requirements as the main deterrents (ACCI[38]). Due to the high costs of formal finance, limited connectivity, low trust in banks, little financial literacy and religious concerns (for interest-bearing loans), merely 2% of businesses resort to bank finance (World Bank, 2018[9]); instead, most rely heavily on kin-based or other unofficial financing mechanisms. Alternative sources of finance remain limited in impact and require further development. These challenges are addressed in Chapter 3.

3. The quality of public services for businesses is inadequate

Chapter 4. looks at the quality of public services and administrative processes for businesses in Afghanistan, such as registration, tax filing, and customs procedures. More than 50% of firms cite these as major barriers to businesses development, with even higher figures outside Kabul. Businesses continue to be burdened by overcomplicated procedures and informal profit-seeking during interactions with public agencies, as these services are mostly administered at government offices or one-stop shops (ACCI, 2017[32]). The low quality of government services and the inability to access critical services impede private sector development.

The analysis points to a number of actions, which include, but are not limited to, the following:

1. Further developing and implementing a **targeted and informed SME strategy and action plan** focusing on issues faced by SMEs such as access to finance, human capital, trade, innovation, infrastructure and tax; and in these efforts aligning the government, the private sector and development partners on priorities for SMEs. This should include creating **better conditions for formal SMEs and start-ups** through improved tax regimes; customised industrial parks; better and more targeted support programmes for SMEs and start-ups; improved regulations to establishing and developing a business; and better information channels to inform businesses of existing procedures.
2. Strengthening **access to finance** through financial literacy programmes; co-ordinated government programmes to support SME access to bank loans, including credit guarantee schemes; improved conditions for the development of alternative financial instruments, such as microfinance and Islamic finance; and targeted start-up initiatives, including mentorship and funding support.
3. Improving **public service delivery** through digitalised services, with an emphasis on mobile platforms; improved one-stop shops for businesses licensing; and expanded digital infrastructure, to enhance e-payments, ICT and mobile connectivity.

Notes

[1] This excludes security grants, which in 2016 were equal to more than 20% of GDP, down from close to 50% in 2009 (World Bank, 2018[8]).

[2] The Business Survey also acknowledges that it leaves out large establishments that did not respond to the survey and regions that interviewers could not access mainly for security reasons (Afghanistan Central Business Registry, 2015[29]).

[3] Private sector companies represent two-thirds of total manufacturing value added (21.7% of GDP) and are key players in retail trade (8% of GDP), transport (18.6%), telecommunication sectors (6%) and (2%) as well as in agriculture (20.8%), according to official statistics (Afghanistan Central Statistics Organisation, 2018[40]). Building on estimates from these official sources, the private sector contribution to GDP may well be larger than the current 10-20% currently estimated – and might reach a 35-50% range despite the lack of detailed statistics on businesses operating in many sectors.

[4] The United Nations Office on Drugs and Crime (UNODC) in 2017 estimated the (illicit) opiate economy at 20-32% of the GDP (2017[25]).

[5] The SME definition (if we include microenterprises) in Afghanistan includes companies with fewer than 100 employees, investing less than AFN 10 million (EUR 120 000) a year in plant and machinery in the manufacturing sector, and less than AFN 5 million (EUR 60 000) in equipment in the service sector (Ministry of Industry and Commerce, 2018[207]).

[6] The “bandwagon effect” refers to the probability of individual adoption increasing with respect to the proportion who have already done so.

2. Encouraging business formalisation

Afghanistan's large informal economy helps keep a significant share of the population out of poverty. But it also creates impediments for private sector development, including limited productivity and business development, as well as vulnerable jobs and competition for the formal sector. This chapter will suggest ways to boost business formalisation, create a better policy framework for SMEs, streamline business regulations, and develop incentives (such as streamlined tax procedures and industrial parks) to persuade informal businesses to formalise.

The importance of addressing business informality

Informality is pervasive in Afghanistan, in all sectors and regions. The informal economy is estimated to represent up to 80% of total economic activity, while informal employment could represent over 90% of the total, although these figures have not yet been officially confirmed (Ghiasy, Jiayi and Hallgren, 2015[39]; Afghanistan Central Statistics Organisation, 2018[40]). Moreover, data on firm registrations show a dramatic slowdown during 2012-16, with the number of new registrations per annum falling by around 60%. While some reduction might be expected, given the slowdown in growth over the period, the extent of the drop may suggest that more economic actors are retreating into the informal sector as economic conditions deteriorate. The high share (47%) of the population under 15 places a heavy burden on the labour market by increasing both labour supply, with 400 000 new labour entrants per year, and an age-dependency ratio[1] at 87% compared to an international average of 54% (Central Statistics Organisation, 2016[41]). This will put extra pressure on the formal job market to absorb new entrants and finance key social services especially for youth. Formal jobs account for a larger share of employment in urban areas (29%) than in rural ones (6%), with this reflecting both the urban concentration of formal public sector employment and the predominance of informal agricultural economic activity in rural areas (ACAPS, 2014[42]).[2]

A fragile political, economic and security context entails grave barriers to the growth of the formal economy, not least by deterring the investment needed to generate employment and productivity growth in the formal sector (World Bank, 2017[2]). Simultaneously, limited state capacity to deliver public services, policy uncertainty and abusive behaviour by public officials have severely undermined businesses' trust in the government in recent decades (SIGAR, 2018[7]). These have discouraged formalisation, and the informal economy has proven resilient through macroeconomic crisis, policy changes and security conditions. Insufficient attention by the government in the last decade and weak capacity to improve the business climate and implement public policies in a transparent and efficient manner have reduced the benefits of operating in the formal sector.

This chapter will discuss several important initiatives the government has taken to support business formalisation, including: reducing the cost of obtaining licenses by 98% (from AFN 30 000 to AFN 100); approving a law eliminating municipal licenses; and creating a one-stop shop in Kabul to ease the registration process. Additional changes include the creation of a three-year visa-on-arrival to support investors, and a new policy on industrial parks, which will simplify the process and reduce the cost of obtaining industrial parks land in Afghanistan. These changes are linked to an enhanced consultation process that has led to the creation of additional Chambers of Commerce such as the Afghan Women Chamber of Commerce and Industry and the Afghanistan Chamber of Industries and Mines.

Defining economic informality in Afghanistan

The International Labour Organization (ILO) defines an informal economy as one that encompasses "all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements". This does not cover illicit activities (ILO, 2015[43]). Considering the heterogeneity of informal firms and the broad category of formal arrangements, many international organisations, including the OECD, the World Bank and the ILO, have worked on the taxonomy of informal economic activity using three criteria:

1. Size, whereby an informal firm is any unregistered firm in which the owner is an individual whose capital is not separable from that of the firm, and for which there exist no accounting records with which the operations of the firm could be retraced (ILO, 2002[44]).
2. Registration, whereby the absence of registration with a government agency, for example a tax authority, is used as a defining characteristic of an informal firm (Gelb et al., 2009[45]).
3. Compliance with public regulation, whereby state intervention is the defining variable of informality, with firms' regulatory compliance being the determinant of their formality (World Bank, 2014[46]; Kanbur, 2009[47]).

While each of these criteria is useful in analysing certain characteristics of informality, they are, in isolation, incomplete for analysing the size and importance of the informal sector in a given economy. For example, a small firm may pay for an operating license, but no social security taxes. In this regard, this paper follows the argument that informality is best understood as a continuum, with characteristics specific to Afghanistan taken into account (World Bank, 2014[46]; Peel and Snodgrass, 2008[48]; La Porta and Shleifer, 2014[49]). A more open definition of what constitutes economic informality – with one or more of the above criteria being met – improves the ability of this report to reflect the economic heterogeneity of Afghanistan's informal sector, and therefore to ensure that policy recommendations are significantly expansive so as to positively affect the largest possible proportion of the country's informal sector.

When applying this definition, the informal economy does not include illicit trade. In the context of Afghanistan, this caveat is significant, since the production of opium continues to rise, with its export value estimated at 20-32% of GDP (UNODC, 2017[25]). Although illicit economic activity is not the focus of the formalisation policies in this report, the share of illicit activity in the Afghan economy poses a number of considerations that are relevant when trying to address informality. For example, one of the major demand-side barriers to formalisation is often the use of illicit profits in non-criminal business operations, which limits the ability of a firm to turn to formal institutions. Another demand-side barrier is the prisoner's dilemma of formalisation, whereby a firm may be reluctant to formalise due to expectations that competitors will not, thus distorting the playing field. Because formal economic activity and adherence to the laws that govern offer better returns when there is a critical mass of firms that agree, in the absence of clear incentives there can be little advantage to being an early adopter of formal strategies (Gans-Morse, 2017[50]).

Key features of the informal economy

This report takes *informality* to denote a reservoir of companies ("informal sector") and/or workers ("informal employment") that fail to contribute to formal economic growth and the overall functioning of the state, with the latter principally evidenced through a smaller tax base. This is a product of both obstacles to formal economic activity and the presence of economic activities that differ from practices and norms in the formal economy. Informal workers are most often self-employed – 60% of informal employment worldwide is estimated to be self-employment – and are usually younger (15-24), older (60 and above), and/or female (ILO, 2018[51]) (La Porta and Shleifer, 2014[49]).

Due to the prominent role of agriculture in Afghanistan's economy, a number of points regarding the intersection of informality and the agricultural sector are worth noting. Rural areas are disproportionately affected by informal employment and its concomitant insecurity – four out of five women employed in rural areas work informally. Informal employment is much more widespread than business informality – both because so much informal employment is self-employment (which since 2012 has risen again after a decade of decline) and because in many countries a significant proportion of firms in the formal economy systematically under-report wages and employment (ILO, ILOSTAT, 2017[52]).

Informality tends to be more prevalent in agriculture and basic services than in manufacturing or more sophisticated service sectors. This is largely because the investment in fixed capital required for manufacturing or advanced services creates important pressures to formalise. Afghanistan is exceptional in the degree to which *business* – as opposed to employment – informality is a critical challenge, even, as will be seen, in manufacturing. Informality is endemic in Afghan economic sectors that do not require large investments in fixed assets, particularly in the (largely subsistence) agricultural sector. It is also problematic in tradable sectors, in which SMEs are estimated to represent 80% of companies, with most operating informally (Leao, Ahmed and Kar, 2018[16]; Mashal, 2014[53]).

This is a crucial concern, because turning small private enterprises into engines of growth and job creation requires precisely the development of *firm* capabilities. It is not the skills or performance of individual entrepreneurs that will generate growth, since scaling up and productivity growth will depend on more-complex organisation of labour and more-sophisticated management. Rather, Afghanistan needs more growing *companies*. Closely linked to this is the need for effective, qualified *managers* to run those firms. La Porta and Shleifer (2008[54]; 2014[49]) emphasise the significance of *managerial* human capital as a determinant of firm productivity, finding that firms with more qualified managers substantially outperform other firms with similar overall workforce human capital – managers' skills can make the difference, even when workers have broadly similar skill sets.[3]

Following the registration and compliance dimensions of economic informality, Ulyssea (2015[55]) draws an important distinction between the *extensive* and *intensive* margins of firm informality. The extensive margin refers to whether or not firms register and the entry costs needed to achieve formal status; the intensive margin concerns the degree to which those firms operate wholly in the formal sector, as opposed to hiring workers wholly or partially "off the books". It is thus an oversimplification to regard informality/formality as a simple binary choice, or as a "dualistic economy" (La Porta and Shleifer, 2014[49]).

Many firms in the world straddle both the informal and formal sectors. This has implications for policy, as firms may choose to formalise, if entry costs and formalisation burdens are lowered, while still hiring workers and/or conducting a share of their business in the informal sector. Thus, firm informality and labour-market informality may not always move in the same direction in response to policy changes. In addition, formal firms may prefer working with informal subcontractors: while formal-sector managers complain of competition from informal firms, they often prefer to deal with smaller suppliers and service-providers informally, thereby reinforcing the formal/informal dual structure of the economy about which they may in other contexts complain.

Increasing formalisation on the extensive margin implies persuading informal firms to formalise, while formalisation on the intensive margin involves the growth of firms already in the formal sector and/or their migration from lesser to greater formality. When formalisation takes place via strong growth in the formal sector, resources and workers are drawn away from informal activities – very often as more new labour-market entrants (and also some of those who are self-employed in the informal sector) move into dependent employment in growing companies. This brings about a change in the overall balance between formal and informal activities (Ghani and Kanbur, 2013[56]).

Informality can be a barrier to economic growth

The informal sector plays a key role as a provider of jobs and basic revenues and can help lift people out of poverty (Rauch, 1991[57]). Informal enterprises can provide minimal economic opportunities and maintain a resilient socio-economic fabric at the local level, especially in challenging contexts (De Soto, 1989[58]; OECD, 2018[1]). In some instances, informality may represent a survival strategy for low-skill individuals who are too unproductive to become formal. The informal sector can also act as an incubator for small entrepreneurs in post-conflict situations, providing them with skills and experience that should be recognised and carefully accompanied towards formalisation (Demirguc-Kunt, Klapper and Panos, 2011[59]). Hernando de Soto (1989[58]) sees informal firms as “an untapped reservoir of entrepreneurial energy, held back by government regulations”.

However, informality can be a major barrier to higher productivity, better jobs and more inclusive growth. The development of an informal economy has a negative impact on resource allocation, quality of jobs and income distribution (La Porta and Shleifer, 2008[54]). Informal workers lack many social protections, and informal activities reduce the tax base and weaken both the rule of law and the reach of public institutions, thus contributing to higher economic and social vulnerability. Informal firms are less able to access finance or to invest in productivity-enhancing facilities or technologies, and since the difficulties of operating informally are increasing in firm size, they have limited scope to grow (Ulyssea, 2015[55]).

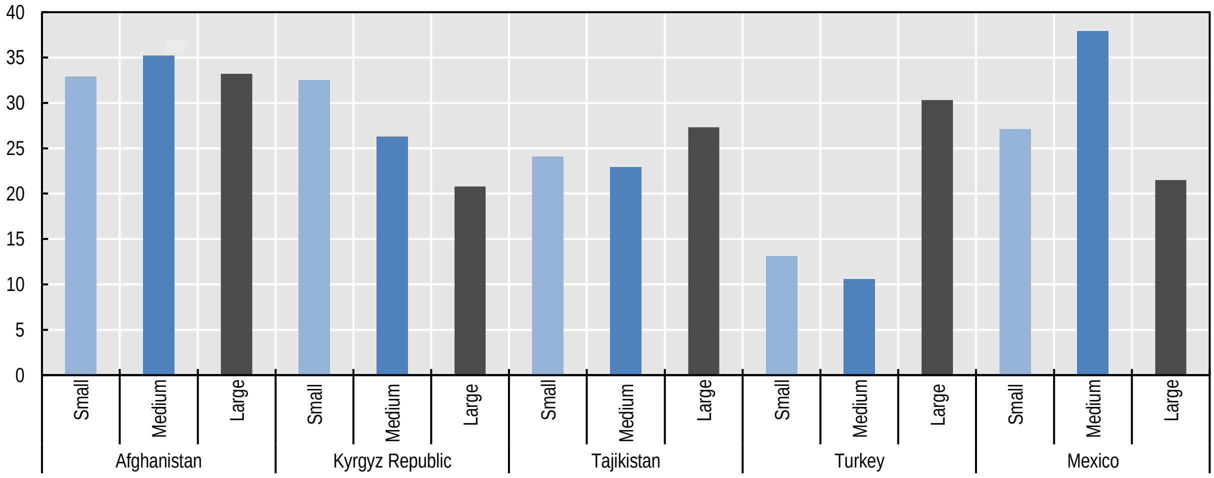
In a fragile context like Afghanistan, informal firms have been resilient to macroeconomic shocks, uneven rule of law and insecurity, often being the “backbone of coping capacity” (OECD, 2018[1]). In addition, operating in the informal sector has helped businesses escape from state predatory behaviours. However, it has also allowed them to fail to contribute to social protection mechanisms; participate in the formal, legal financial system; and create decent jobs.

Market distortions induced by informality undermine trust within the private sector itself. Informalities put a burden on formal activities in terms of taxation and unfair competition that grow along with the scale of informal activities and reduce the incentive to operate formally. Where institutions are weak, firms that are productive enough to survive in the formal sector may choose to operate wholly or partially in the informal sector (Levy, 2008[60]). In Afghanistan, they should be an important target for formalisation policies.

Since the decision to formalise is a strategic choice made by some firms, their competitors' formalisation matters and co-ordination failures may arise, leading to persistent informality (Kenyon, 2007[61]). Even if many/most firms would see potential benefits in formalising, the first-movers in this process may suffer significant competitive disadvantages. A co-ordinated approach on the part of the government may thus be critical in helping to overcome such collective-action problems.

In Afghanistan, for each firm size category, one-third of the formal firms surveyed identify competition from informal businesses as a major constraint (Figure 3) (World Bank, 2014[62]). At the firm level, perception of informal competition is particularly high in the manufacturing sector, where 59% of companies compete with informal businesses and 40% consider it a major issue, as it is in such countries as Mexico and Turkey (World Bank, 2014[62]).

Figure 3. Percentage of firms identifying practices of competitors in the informal sector as a major constraint, by firm size[1]



Source: (World Bank, 2014[63])
[1] Firm sizes are defined according to employees: small (5-19), medium (20-99) and large (100 or more).

The two-way relationship between productivity and informality has important policy implications

La Porta and Shleifer (2014[49]) observe that informality declines as countries develop. This is hardly surprising, as higher-productivity firms find it both easier to operate formally – they are productive enough to bear the costs of formalisation – and harder to grow while remaining informal. They thus conclude that "the cure for informality is economic growth" (p. 124[49]). This finding suggests several important points that should be borne in mind when considering policies to encourage formalisation:

- The critical drivers of formalisation are those that foster growth: reforms to the broader business environment and the development of human capital and, particularly, entrepreneurial skills. The greater the potential productivity of the firm or individual, the larger the opportunity cost of remaining informal. The growth of formal firms run by skilled and educated entrepreneurs is probably the single biggest factor reducing informality.

- While policy can help nudge firms towards formality, they will be more successful when the broader economic environment is conducive to firm growth. In a stagnant or contracting economy, formalisation may be unattractive, since the perceived scope for firm growth is limited and informality may offer a better survival strategy. In a growing economy, the opportunity cost of informality should rise.
- Policy makers should focus more on *encouraging formal activity* than on *discouraging informal activity*. Since most informal firms are relatively inefficient, policies designed with an enforcement focus, in an effort to tax or regulate informal firms, are more likely to drive them out of business than to prompt them to formalise. Particularly in an economy where most activity is informal, an enforcement-based approach is likely to increase unemployment and poverty.
- By contrast, policies that help make firms more productive could encourage them to formalise, at least on the "extensive margin", as defined by Ulyssea (2015[55]). Moreover, such policies are beneficial to firms already in the formal sector or to entrepreneurs ready to create new formal firms. Thus, the policy impact is felt through two channels that affect the balance of activity between formal and informal sectors: the formalisation of some existing informal firms and the growth of new and incumbent formal-sector firms. The second channel may ultimately matter more than the first in many contexts.[4] It may also have particular benefits for workers, since more-productive firms will offer better jobs to workers.[5]
- Policies designed to support the development of managers' and entrepreneurs' human capital could make a substantial contribution to formalisation, since better managers will have more to gain from operating in the formal sector.

This report places the emphasis on encouraging formalisation rather than cracking down on informal firms. While it focuses on measures that can make it easier for firms to become formal, it does so in the understanding that the larger economic context, particularly framework conditions for investment, will be absolutely critical to progress.

Policies to encourage formalisation should focus primarily on informal SMEs

Many informal sector entrepreneurs express little intention to formalise as they exhibit little desire to grow and sometimes do not even perceive themselves as business holders. This is especially true of smallholder subsistence farmers (de Mel, McKenzie and Woodruff, 2008[64]). Some small entrepreneurs, usually self-employed, are therefore unlikely to register despite incentives to formalise (Christoplos, 2007[65]).

However, the decision to formalise or not is very often a choice made by firms based on a cost-benefit analysis that does not include the negative externalities (such as competitive distortions, the lack of compliance with environmental and other regulations, and loss of tax revenues) resulting from their decisions. The magnitude of informality and the limited number of registered companies[6] in Afghanistan indicate that the bulk of informality stems from unregistered economic units that might have substantial activities. Many informal businesses are SMEs. At the same time, SMEs are important victims of informality, since 33% of registered small firms and 36% of SMEs say they compete against unregistered or informal rivals (Central Statistics Organisation, 2016[41]; World Bank, 2014[62]).

Informal SMEs constitute the main target group for formalisation policies, as those who operate at a suboptimal level can expect higher benefits from being formal than self-employed workers. Indeed, their own growth is at stake given that a growing business requires stronger legal protection, has higher financing needs, and needs to establish stable and sustainable work relations through contracts with commercial partners, including the government – these are strong justifications and incentives for formalisation. Regardless of whether the lack of scale is a cause or a consequence of low productivity, formalisation has a positive effect on firms that are able to expand their consumer base (de Mel, McKenzie and Woodruff, 2013[66]).

Institutions, regulations, tax and poor public services are major deterrents to formalisation

This chapter explores three main issues that hamper business formalisation: 1) an inappropriate institutional setting, with cumbersome regulations governing procedures such as licence renewals, 2) the complexities of the tax system and 3) the low quality of public services that could, if improved, give businesses greater incentives to formalise. A fourth main issue, the lack of access to finance, is the focus of the following chapter.

Issue 1: Weak institutions and cumbersome regulations discourage formalisation

The country lacks an appropriate setting for formal and informal companies

A more structured approach is required for SME policies in Afghanistan, considering the importance of SMEs to the economy. SMEs represent the majority of Afghan businesses: 90% of the 700 000 establishments operating in the private sector have fewer than 10 employees (World Bank, 2014[67]; Central Statistics Organisation, 2016[41]).

Informal companies have largely been missing from government plans, including the NPP PSD, which has no full-fledged strategy to formalise businesses and create incentives for companies to leave the informal sector. The lack of a strong enabling policy framework for formal companies and the limited scope and scale of support programmes weaken the incentives for firms to transition to the formal sector despite efforts to streamline registration procedures, create one-stop shops, and tackle corruption.

At present, the SME Directorate under the Ministry of Industry and Commerce (MOIC) is in charge of SME policy making and implementation, but it has not yet managed to produce an up-to-date, clear strategic document to guide its actions. The SME Directorate reports that it has started drafting a new SME strategy. It however lacks the human and financial resources needed to implement actions, and will need greater autonomy and resources if it is to implement the updated SME strategy. The previous SME strategy dates from 2009 and its implementation has not been monitored.

The 2009 strategy identified six priority sectors for SME development, including agribusiness, construction materials carpets, cashmere, gemstones, and marble, and set up action plans. The strategy underlined the role of the government to establish an enabling environment, encouraging PPPs and incentivising the private sector while improving public service delivery. The current elaboration of SME policies lacks co-ordination as the different policy documents are running in parallel, including the NPP PSD, the NES and the SME strategy. These initiatives highlight the government's willingness to improve the business environment for SMEs, but the authorities need to codify them into a coherent whole, such as the new SME strategy, accompanied by an action plan for implementation.

However, the large informal economy, the limited progress in improving the overall business climate and the outstanding issues identified by companies operating in

Afghanistan indicate that these policies have not yet succeeded in generating faster SME development.

Improvements in regulations are not yet sufficient to support firm formalisation

Despite recent progress, businesses still face issues with current regulations, starting with the registration process and its renewal procedure. Overall satisfaction regarding registration procedures hides significant regional disparities. While relatively few businesses report business registration as an issue in Kabul (16%) and Herat (12%), the picture is drastically different in Nangarhar (54%) and Kandahar (46%) (Afghanistan Microfinance Association, 2016[68]).

The most recent policy changes highlight a significant and continuous effort to streamline business procedures with the support of the Harakat Investment Climate Organisation,[7] USAID and the World Bank. Afghanistan now performs well in terms of "Starting a Business" according to the 2019 *Doing Business* indicators, as it now requires four procedures and takes eight days to register, at a much lower cost than in the past (World Bank, 2019[35]). In addition to removing registration from the commercial courts, the government has simplified entry procedures by establishing the Afghanistan Central Business Registry (ACBR) as a one-stop shop for business registration. The MOIC has streamlined business registration procedures by replacing the former dual procedure, merging the registration procedures at commercial courts and the Afghanistan Investment Support Agency (AISA), and by consolidating and streamlining licensing procedures previously dispersed among various government bodies. Physical one-stop shops for business registration are being created throughout the country and are expected to facilitate companies' interactions with the government. Entry costs have also fallen substantially following the reduction of the annual registration fee from AFN 30 000 to AFN 100 (from USD 400 to USD 1.34), a reduction of 99.67%. A new municipal law is aiming to eliminate all municipal licenses.

Despite these improvements, issues remain. There is still some redundancy in procedures, as many companies only register at the municipal level, while they need to register with the ACBR to be considered as registered by the government. Reluctance to register with the ACBR might reflect lack of knowledge of the procedure, the cost of going there or lack of perceived benefits of central registration. Informal companies are not necessarily aware, or persuaded, of the benefits of registering and formalising. Reporting figures are currently missing for the implementation of one-stop shops for business registration, particularly outside Kabul.

While first-time registration has been simplified, renewing licenses remains costly and time-consuming. Companies report license renewal as the main issue regarding business regulation: some 41% of companies consider the period of validity of registration licenses to be too short (Afghanistan Microfinance Association, 2016[68]). The yearly tax clearance procedure required to renew the license, combined with the uncertainty surrounding the delivery of the clearance certificate, negatively affects smaller firms' capacity and willingness to renew their licenses. The three-year validity of the business license introduced by the ACBR in 2018 is a step in the right direction, but with the cost being around 8% of income per capita and the need to pay it upfront, only large companies can afford this license (World Bank, 2019[35]). The cost of renewal is also considered prohibitive for SMEs, given that SMEs have fewer financial and human resources than larger companies. Once the company is registered, SMEs face the costs, burden and uncertainty of renewal due to the complex administrative procedures and come under the scrutiny of the tax administration with the requirement to comply with the heavy Business Receipt Tax (BRT).

Afghanistan needs to strengthen human capital and managerial capabilities to foster the growth of more productive firms

An educated and skilled labour force is critical for developing the private sector, entrepreneurship and SMEs. In 2018, the World Bank Group released its Human Capital Index (HCI), which assesses the extent to which human capital measures up to its full potential. Afghanistan fulfils 39% of its potential, compared to Kyrgyzstan at 58% and Tajikistan at 53% (World Bank Group, 2018[69]). Years of war and a nearly absent education and training system have resulted in a lack of skilled labour – a factor which is further heightened by the continuous emigration of educated and trained people (SIPRI, 2015[6]).

A business climate survey conducted in 2017 by the Afghanistan Chamber of Commerce and Industries (ACCI) highlighted the lack of training facilities and the shortage of qualified labour as a core obstacle to private sector development; the lack of qualified labour was mentioned by almost 79% of respondents in the service sector, by 80% of those in the trade sector, and by up to 90% of those in construction (ACCI[32]). The government has acknowledged these issues by adding human resource skills as a top priority within the ANDPF. Jones (2015[70]) argues that the lack of education has directly translated into meagre management skills. This is further underlined by a study that tested the management skills of approximately 200 Afghan managers, finding that such skills should be taught in universities (Bahaudin and Kaifi, 2011[71]). Managerial and entrepreneurial skills (such as critical thinking, problem solving, social skills, perseverance, creativity and self-control) are critical to establish, manage and expand firms; produce knowledge; and create economic opportunities (OECD, 2019[72]; OECD, 2013[73]; OECD, 2017[74]).

Issue 2: Tax complexity and tax rates affect SME development and formalisation

Afghanistan's tax-to-GDP ratio remains low (7.8% in 2016) compared to OECD members (34.6%) and lower-middle-income countries (11.6%) (World Bank, 2016[75]; OECD, 2017[76]). Revenue pressure creates conflicting objectives for the government: increasing tax revenues versus reducing disincentives to formalisation created by the tax system (SIGAR, 2018[7]). As the World Bank observes, the formal private sector is already fairly heavily taxed; increasing the tax burden would merely reinforce informality. Every company is subject to a flat corporate income tax (CIT) of 20%[8] and to the aforementioned business receipts tax (BRT) (2018[8]). The BRT is a turnover tax based on revenues that varies according to firm size and sector; SMEs are assessed at a rate of 4% of the firm's turnover[9] (Ministry of Finance, 2018[77]). Although these taxes provide the government with a guaranteed level of tax revenue from a firm's operations, they can have a large impact on profitability. Turnover taxes can hinder production efficiency and lead to very high tax rates in relation to profits, pushing firms into loss positions (Mirrlees and Diamond, 1971[78]).

The administrative burden of taxation on formal-sector firms is also significant: the World Bank (2018[8]) reports that Afghan businesses are required to make 19 payments and spend on average more than 270 hours per year on tax compliance.[10] There has been some recent progress, but much more must be done to reduce this burden.

Many businesses perceive procedural complexity in the tax system to be a greater barrier to formalisation than tax rates, according to statements made by representatives of the ACCI and other business associations during exchanges with the OECD. Two-thirds of small companies cite the tax system as a problem, and while issues are reported by a range of firms, taxation may disproportionately affect young businesses – with start-ups reporting that tax rates are a detriment to their growth, sometimes leading them to shut down, misrepresent their income or remain informal (ACCI, 2016[38]; Aghaez, 2017[12]). Concern about the tax system has grown over the last few years: in 2014, one-third of businesses mentioned the tax system as a problem (Afghanistan Microfinance Association, 2016[68]). Tax revenues as a share of GDP declined from 9.1% to 6.8% between 2010 and 2014 before a turnaround in 2015 supported by better collection efforts and, to a lesser extent, new taxes. The increase in the BRT from 2% to 4% in 2015 has hit SMEs hard, since the BRT accounts for the major part of the overall tax burden on companies. This burden has been estimated at 70.7% of commercial *profits*, up from 48% in 2016, which is well above the average for low-income countries (52%) and one of the highest in the world (World Bank, 2018[8]). It is likely that some of the increase in business dissatisfaction with the tax system reflects the increased BRT rate on SMEs (Aghaez, 2017[12]).

As noted above, tax compliance in general is costly in Afghanistan, and this could be easier to address. Private sector actors report cumbersome tax declarations, such as the monthly filing for withholding tax, the quarterly filing for the BRT and the annual tax report. When combined with high penalties, this imposes substantial costs on firms. The Ministry of Finance has reported progress, including the reduction of tax penalties by 50% through amendments in the tax administration law passed in October 2018. Further digitalised processes and general tax administration improvements could ease the process, as outlined in Chapter 4. (2018[77]).

Although SMEs and start-ups are for the most part treated in the same way as larger corporations in terms of both tax rates and administration, the direct and indirect costs of taxation are relatively higher for SMEs (OECD, 2015[79]; Aghaez, 2017[12]). There is no simplified tax regime in place in Afghanistan, which would likely help to tackle its informality challenge.

Issue 3: The low quality of business services harms private sector productivity and formalisation

The poor quality of public services – particularly electricity, security and business support services – is widely cited as a problem by businesses in Afghanistan (Afghanistan Microfinance Association, 2016[68]; World Bank, 2014[62]). This is a major disincentive to formalise, since firms understand the costs (in terms of taxes and regulatory compliance) but do not anticipate any real benefit in terms of access to services. Tax morale is positively correlated with the level of satisfaction with public services and negatively correlated with corruption (OECD, 2013[80]). The vicious circle between the under-provision of public goods and tax compliance creates a self-sustaining informal sector (Johnson, Kaufmann and Shleifer, 1997[81]). Reports and interviews in Afghanistan regularly highlight the under-provision of critical public goods such as security and electricity (World Bank, 2014[62]; Afghanistan Microfinance Association, 2016[68]). While the capacity to overcome the lack of reliable electricity and security in a conflict-affected environment is unevenly distributed across firms, smaller firms are less likely to pay taxes or to contribute to the provision of public goods they would need.

An overall improvement in the business climate and in the government's capacity to implement efficient public services should be the final objective of the government. Providing reliable, cheap public goods, including electricity and security, to all businesses across the country is crucial. However, in view of the country's limited resources and of the current security situation, creating conditions for successful business operations in selected areas, in terms of infrastructure and security, is an option worth exploring – hence the interest in creating industrial parks.

Industrial parks have existed in Afghanistan for some time, but they suffer from several operational flaws. There are currently 18 industrial parks, but only a few are fully functional. The key deficiencies of the current industrial parks include a lack of critical infrastructure (including reliable electricity and water provision), adequate security arrangements, and effective business administrative services (including one-stop-shop businesses services and technical services such as quality control, inspection and certification). In addition, insufficient connections to transport infrastructure (airports, ports, railway networks) outside the parks are a significant issue.

Industrial parks therefore fail to create incentives for businesses to enter, which may explain the severe under-utilisation of some facilities – including donor-funded industrial parks in Gorimar and Shorandam, which have failed to deliver the expected benefits (SIGAR, 2015[82]).

These problems stem in part from a fragmented institutional approach. Diverse initiatives carried out by the now-defunct AISA, the MOIC and donors like USAID have resulted in unstable management of industrial parks, with multiple transfers of responsibilities among the different institutions. There is little evidence of consultation and involvement of businesses in the design and organisation of current industrial parks (SIGAR, 2018[7]).

The MOIC has drafted an industrial parks policy, which was recently approved by the High Economic Council, outlining the types (public, public-private, and private) of industrial parks and their regulation and co-ordination by the various authorities involved. As a result, the MOIC has started issuing industrial land plots to businesses again. Co-ordination mechanisms between government entities, land authorities, agencies, energy-supply companies, municipalities, and the private sector are clearly defined, aiming to foster an inclusive process. The policy could serve to promote a bottom-up usage of the industrial parks as three chambers of commerce – the Afghanistan Chamber of Commerce and Industries (ACCI), the Afghanistan Chamber of Industries and Mines (ACIM), and the Afghan Women's Chamber of Commerce and Industry (AWCCI) – have been invited to provide suggestions (Ministry of Industry and Commerce, 2017[83]).

If properly planned with the utilities, telecommunications providers and security forces, the development of industrial parks could yet have significant benefits for the country's private sector. This being so, the government should outline measures for safeguarding the delivery of critical services to them.

Recommendations to enhance business formalisation in Afghanistan

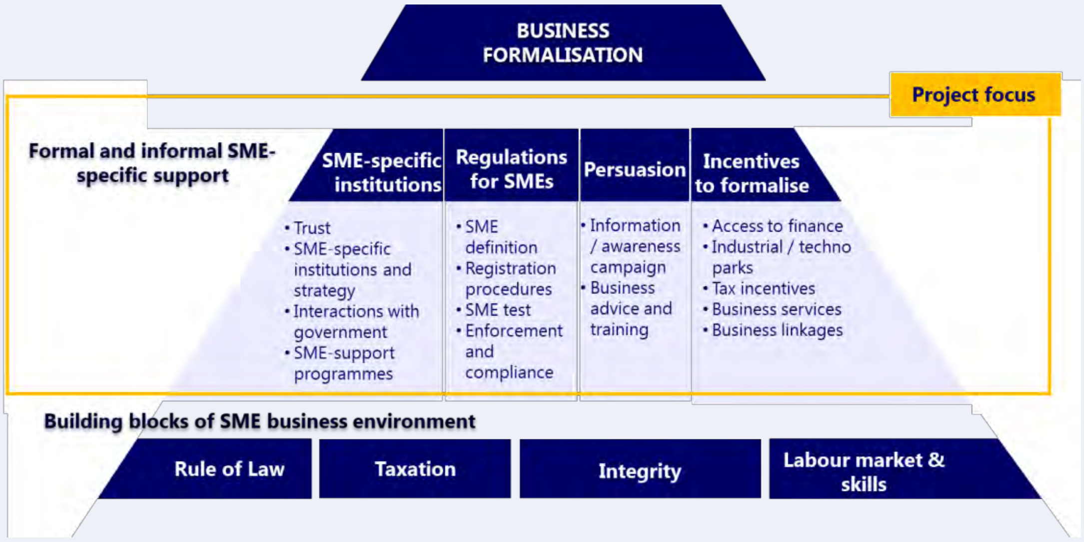
Fostering economic growth in Afghanistan and improving the business climate remain first-order priorities when it comes to promoting formalisation. The government has identified the need for cross-cutting private sector development reforms, and key policy measures have been included in the current NPP for Private Sector Development (NPP PSD) to enhance the overall business environment (see Box 2 in Chapter 1). This chapter will focus on measures designed to boost Afghanistan's formal economy that can complement the reforms included in the NPP PSD.

The OECD has designed a framework (Box 4) that can be used by the government to guide actions fostering business formalisation. The recommendations address the issues identified in this report and cover three lines of actions for the government:

1. enhancing the SME institutional and regulatory framework, including by streamlining and enforcing regulations, further developing a SME strategy and developing specific support SME programmes on skills and access to finance, to address the lack of an appropriate institutional setting and cumbersome regulations;
2. developing incentives in favour of formalisation with a focus on tax to deal with the complexities of the tax system;
3. increasing the quality of public services through incentives within industrial parks to address public services starting with pilot areas grouping services;
4. persuading businesses of the benefits of formalisation.

Box 4. A suggested framework for tackling business informality

The figure below illustrates a framework for tackling business informality that leverages the experience of OECD countries with regard to the informal economy. It can be applied to firms of all sizes and in economies at different stages of development. With this framework, policy makers can identify salient areas for action. As can be seen from the following figure, the building blocks – the rule of law, taxation, integrity, and labour market and skills – are the foundations of the NPP PSD.



Using this framework, this report has identified four areas on which efforts should concentrate:

- **Creating positive incentives for formalisation**, to offer real advantages to entering the formal sector. These incentives may cover tax (simplified tax regimes), skills (subsidised training courses for young workers), facilities (industrial parks that can provide security, land, electricity, and infrastructure to large companies and their partner SMEs) and basic government services, as well as specific programmes addressing such areas as access to finance.

- **Adopting policies to ease the implementation and enforcement** of regulations that are conducive to business formalisation and development. This can be achieved by reducing entry costs to the formal sector, compliance costs and additional administrative procedures, permits and licensing.
- **Persuading businesses of the benefits of formalisation** and the purpose of regulations, and better informing firms about existing procedures and improvements.
- **Developing SME-specific institutions** that will create a framework for formal SME development and include measures to tackle informalities. Market failures with respect to, inter alia, access to finance and skills undermine SMEs' productivity and hamper their capacity to operate formally. Institutions dedicated to entrepreneurship and SME development will help correct these failures, identify priorities, and support more effective implementation, including actions to support formalisation. This will create a better business environment for formal SMEs and encourage informal SMEs to formalise.

Sources: (OECD, 2017[84]; Andrews, Caldera Sanchez and Johansson, 2011[85]; Bruhn and McKenzie, 2014[86]; EU, OECD, 2015[87]; De Soto, 1989[58])

Recommendation 1: Develop a proper institutional and regulatory framework to support the private sector

SME policy making remains under-supported in Afghanistan in terms of institutions, programmes and funding, according to private sector actors and informal companies. While donors have continuously supported SMEs and businesses, as with the Harakat initiative, achievements for SME development remain limited to specific cases and have not supported the implementation of the overall SME strategy. Scattered interventions without a holistic view sometimes even lead to the crowding out of private investment and resource misallocation due to the survival of "grantrepreneurs", a class of unproductive businesses that are kept afloat by subsidies (SIGAR, 2018[7]).

The government can expand its role in supporting SME-specific policies. Limited institutional capacity, cumbersome regulations and the lack of business support programmes are significant issues faced by both formal and informal SMEs in the country. Co-ordination with the private sector (both formal and informal) and with donors is essential to ensure that needs and current capabilities are taken into account and to identify potential synergies among existing and future initiatives. Specific measures to tackle informalities need to be embedded in a stronger overall institutional framework for SME development.

Further simplify registration and other business procedures

The ACBR, building on the efforts of the World Bank[11] and USAID,[12] has brought about significant improvements in business registration. More can be done, however, particularly with regard to licence renewal. Avoiding duplication of procedures is a primary concern, and combining registration at the municipal level with the ACBR should be considered. The new law on removing municipal licenses should now be implemented. Future efforts must be reoriented towards reducing the ongoing cost of regulations. The use of the rate-of-registration renewal as a key performance indicator by the ACBR is a step in the right direction. Licence renewal might help track registered businesses' activities, but the high cost and burdensome procedures involved discourage businesses from registering. It would be advisable to remove the need to renew the licence.

Afghan businesses also suffer from other barriers to formalisation, such as deficient access to government administrative procedures in rural areas. Afghanistan has started to implement one-stop shops and there is now an export-focused one-stop shop at Kabul airport. Efforts to implement new physical one-stop shops are commendable and should continue. To increase their reach in the country, however, the government should also consider digitalising procedures, starting with the most common procedures and those already simplified in the framework of the physical one-stop shops. Chapter 4. explores the scope for further digitalisation of administrative procedures and public services.

Most regulatory improvements efforts are being supported by international organisations and should be pursued and intensified in the framework of the NPP PSD, including access to electricity, construction permits and property registration (Government of Afghanistan and PRISEC, 2018[28]). Efforts to streamline export procedures are also part of the National Export Strategy (NES).

Systematic needs assessment and prioritisation of new procedures need to be carried out in co-operation with the ACCI, the AWCCI, the ACIM and other business associations. Both PRISEC and the EU-Afghanistan Business Council can support this dialogue.

Develop a SME strategy and action plan for supporting small businesses

A clear, coherent institutional framework will create better operating conditions for formal SMEs, thus strengthening the case for formalisation. The framework should include specific measures and incentives for formalisation as well as robust, co-ordinated and well-structured policy documents such as a SME strategy.

The further development of a new SME strategy and action plan provides an opportunity for the government to 1) frame the issue of informality and to define actions, actors and objectives to address it effectively; 2) structure its approach to SMEs; and 3) clarify the separation between policy-making and implementation activities, which involve different challenges in terms of resources, roles and responsibilities.

The SME strategy must rest on a solid assessment of the current situation. Data on SMEs are crucial and it is necessary to assess more precisely the informal sector through the addition of an informality dimension to the CSO's household and labour surveys.

Key pillars of the strategy could include the main horizontal issues faced by SMEs, such as access to finance, human capital, trade, innovation, infrastructure and tax, as well as sector-specific priorities. Policies, actions and programmes need to be outlined to respond to these issues. Many of them have been identified by the ACCI through its survey and business monitor (ACCI, 2017[32]). Monitoring must be built into the strategy at the outset: its elaboration should include the definition of numerical targets and the requirement to conduct semi-annual reports. Collecting data on key indicators before implementing the strategy and at key moments throughout its implementation will allow the government to make adjustments in a timely manner as necessary. Combining the measures contained in different policy documents currently acting in parallel (the NPP PSD and NES) into a unified SME strategy could increase policy coherence.

The OECD earlier provided detailed comments as inputs for the NPP PSD regarding SME development, and these could be considered when structuring the strategy. In addition, Georgia has developed an SME strategy and an implementation plan that address the main concerns of SMEs in the country and could provide insights for Afghanistan; these are discussed in Box 5.

Box 5. Georgia's SME Development Strategy and Action Plan 2016-2020

Georgia is undertaking comprehensive reforms to support its private sector and enhance SME development. These reforms are embedded into a single policy document, the *SME Development Strategy 2016-2020*. The action plan based on this strategy includes:

- five strategic directions (further improvement of the legislative and institutional framework and operational environment for SMEs, improvement of access to finance, SME skills development and promotion of entrepreneurial culture, export promotion and SMEs internationalisation, and facilitation of innovation and R&D);
- twenty-three priority actions that identify key orientations within each strategic direction; and
- one hundred forty-seven actions, all of which contain a timeline, KPIs, sources of financing, budgets, and a list of lead institutions as well as other involved institutions (government agencies, development partners, private sector).

The action plan is designed to ensure the operational effectiveness of comprehensive reforms that require a multiannual framework and strong co-ordination between institutions. The actions indeed mobilise a wide range of stakeholders, including line ministries, the national statistics agency and the recently established SME Agency (Enterprise Georgia).

Source: (Government of Georgia, 2018[88])

Identifying the relevant priority areas requires setting up a platform for dialogue, involving more stakeholders from the private sector and from various ministries, so that SME needs are precisely assessed and addressed in a comprehensive manner. PRISEC brings together private sector representatives but more business associations can be involved – representing other sectors (agriculture, energy, transport) and types of businesses. Online consultation platforms can also support more-inclusive stakeholder consultations, using surveys, forums and systems for voting on government proposals.

Specific attention should be given to start-ups, which are currently rarely mentioned in these policy documents and which have specific needs. The vibrant start-up community needs policy support to keep growing (Box 6). For a start-up scene to develop, there must be synergies with the country's academic institutions, and the government must incentivise foreign investment. Actors in the start-up communities have exchanged ideas and provided these to the government, but closer, more regular, and more formal mechanisms for engagement are needed. The government should act as a co-ordinator for the start-up community by connecting the different actors and promoting the visibility of their activities to entrepreneurs, students and the donor community. Policy support as well as infrastructure could be provided through the establishment of a dedicated entity, such as a start-ups board, and the participation of start-up representatives in existing dialogue platform such as PRISEC. A start-ups board could gather the MOIC, the main incubators and members of the start-up community to discuss specific policy issues on a regular basis.

Box 6. Government interventions in supporting start-ups

In OECD countries, about one-half of start-ups fail within the first five years of their establishment, revealing the unique challenges facing young firms. Start-ups have even more limited resources than SMEs when starting their operations, with virtually no capital or human resources to cope with administrative and tax burdens. Their business model often relies on intangibles and unmet market demand, and they often operate using advanced technology – all of which makes them difficult to assess for banks, investors and public authorities.

A number of public policy measures can be made to alleviate some of these barriers for start-ups:

1. *Tax incentives:* Tax incentives can help encourage investment in start-ups. Adjustments to capital gains tax, in particular, have a significant influence over private investment in start-ups, with high capital gains tax rates having a negative impact on both the number of investments made and success rate in the start-up ecosystem. The OECD's experience has shown a trend towards using 'front-end' tax incentives (deductions for investment in seed and early-stage ventures) and 'back-end' tax incentives (such as the rollover or carry-forward of capital gains or losses).
2. *Administrative simplification:* There is evidence that start-ups in particular are constrained by regulatory complexity, creating disincentives for young innovative firms and/or investors. It is therefore important to simplify complicated and costly requirements involved in the creation of a business. These include barriers to opening a business and to market entry, bankruptcy laws, property rights and investors' protection, and labour market regulations. In addition, the administrative burdens and costs of growing and internationalising start-ups also need to be addressed.
3. *Managerial skills:* Providing training courses and mentorship opportunities for entrepreneurs can help them acquire management skills and support the development of growing companies.
4. *Access to finance:* This is a barrier for young firms that start with limited capital and physical assets to be used as collateral (See Chapter 3. Box 16).

Women entrepreneurs face additional barriers that discourage them to work. These include fewer skills and knowledge relevant to starting a business, less access to credit, and at times a greater fear of failure. Policy makers need to promote role models and ambassadors by, for instance, creating a network of women like the *Frauen Unternehmen* in Germany,[13] develop targeted entrepreneurship training courses for women, establishing specific funds earmarked for women (with donor support), and increasing access to social protection while promoting work flexible arrangements.

Source: (Wilson and Silva, 2013[89]; Aghaez, 2017[12]; EU and OECD, 2017[90]; OECD, 2017[84])

Strengthen programmes to support the development of managerial and entrepreneurial skills

Managerial and entrepreneurial skills are crucial for the development of growing companies that can create jobs, foster innovation and increase firm productivity. Qualified managers are more prone to produce, absorb, use and disseminate innovations and to structure their companies to thrive in evolving markets (OECD, 2017[74]). Further public and firm-level investments in education and lifelong learning should be encouraged to support the managerial and entrepreneurial skills needed by growing companies in the country.

One critical priority will be to engrain entrepreneurship and management skills within both educational institutes and training centres (Jones, 2015[70]). This could involve the creation of specific managerial and entrepreneurial courses based on case studies and examples, with the participation of experienced managers and entrepreneurs in delivering the curriculum. This could cover such topics as starting a business; planning; and managing business financials, teams, supplier relationships, and inventories. It also entails developing collaboration between schools and the business world, involving parent entrepreneurs, stimulating authentic learning (on-the-job activities such as tests in a real laboratory) and offering workplace training (OECD, 2019[72]; OECD, 2002[91]). Universities such as the University of Kabul and the American University of Afghanistan could also create entrepreneurship centres with programmes for future entrepreneurs and supervisory training. Finland has developed a General Manager Course delivered by the Employment and Economic Development Centres and focused specifically on SME managers; it includes two-day seminars and a one-day consultation. The use of Massive Open Online Courses (MOOCs), such as those provided (free of charge) by the University of Leeds, could complement the physical training and expand reach[14].

The ACBR could also consider developing a short seminar for new entrepreneurs upon registration. This could be free of charge, as in Canada's Small Business Enterprise Centres where entrepreneurs can obtain legal and financial guidance, thus providing basic management and financial training (OECD, 2002[91]).[15] These courses could be developed with experienced professionals or in partnerships with local universities and ACCI.

Industry associations and Chambers of Commerce and Industry (such as the ACCI and the Women CCI) can also help identify managerial skills needed by small firms, then develop training sessions accordingly with the support of internal and external trainers. In Germany, Chambers of Commerce and Industry provide a wide range of vocational training to firms[16]. Support to business intermediary organisations and their service delivery, in particular training activities, can prove efficient to support SME skill development and can be a target for donor programmes, as in the case of the EU-supported Central Asia Invest Programme (European Commission, 2015[92]).

Business incubators and hubs could also develop mentoring programmes with successful local entrepreneurs who can share their knowledge and train young entrepreneurs during workshops and mentoring sessions. Associations of entrepreneurs in OECD countries have developed similar services to train and mentor young managers and youth entrepreneurs; these include Reseau M in Québec, Canada, and Moovjee in France (Reseau M, 2019[93]).[17] The American University of Afghanistan has such a hub; it could expand its reach to a wider audience and contribute to the public programmes in ACBR and schools (American University of Afghanistan, 2019[94]). Key business events and meetings could also provide opportunities to better understand needed skill sets, promote education programmes and mentorships, and create opportunities for learning exchanges and networking. The

Afghanistan Business Summit – at which CEOs come together to share insights, best practices and management styles – is a good example of an annual gathering of Afghan entrepreneurs. Among the 340 attendees in 2017, 100 CEOs were present to network as well as provide recommendations to young entrepreneurs (Business DNA, 2018[23]).

Recommendation 2: Streamline tax procedures to encourage SME formalisation

The government is currently taking steps to simplify taxation, which will support formalisation. These reform efforts need to be pursued with a focus on SMEs.

Streamlining tax procedures can reduce the cost of operating formally and calls for close co-operation with the revenue department of the Ministry of Finance (MoF). The number of procedures and payments is a disincentive for SMEs. Introducing a fixed tax scheme for start-ups and SMEs similar to the current fixed tax scheme for natural persons (merging corporate income and business receipt taxes) could be considered. Exemptions from filing quarterly reports could be applied to trade and importing companies in the new income tax law, which has yet to be approved by Parliament (Ministry of Finance, 2018[77]); this exemption could be extended to SMEs and start-ups. Further, yearly presumptive taxes and single payments are options to consider for the government in light of the experience of Mexico's fiscal incorporation regime (Box 7).

Box 7. The *Régimen de Incorporación Fiscal* (RIF) in Mexico

Informality is a major drag on Mexico's economic performance. An estimated 57% of the Mexican labour force was informally employed in 2016. The 3.2 million of small companies in Mexico also exhibit the lowest level of labour productivity among OECD countries, while competition from the informal sector remains significant. Resource misallocation resulting from a persisting informal sector explains a major part of the stagnant productivity in the country between 2008 and 2014. Half of informal workers are employed in small and informal companies, where productivity is particularly low.

The government has undertaken a series of reforms to address the informality-productivity nexus through a strategy to "democratise productivity". These reforms include the 2016 Financial Inclusion Action Plan, designed to foster SMEs investment through an improved access to finance, as well as specific support programmes for SMEs implemented by the National Institute of the Entrepreneur, such as business incubators and skills upgrading programmes.

Taxation is also used as a formalisation tool by the government. The fiscal regime for incorporation (RIF) enacted in 2013 is aimed at addressing informality by encouraging informal SMEs to formalise through:

- presumptive taxes that allow SMEs to calculate taxes on a turnover and cash-flow basis;
- a reduction of the administrative burden for VAT and excise taxes through a simplified schedule of tax rates – which are based on the firm's turnover level and vary according to economic activity and the type of product sold; and

- the provision of services (including access to government-backed credit training programmes, and a special digital tool to help businesses with tax compliance.

The programme has seen 1.5 million informal companies join the formal tax system since 2014. A question mark remains over whether the short-term formalisation drive will extend into the medium and long terms. World Bank research has shown that tax incentives such as the RIF are most effective when they take place in an improving business climate.

Sources: (OECD, 2017[84]) (OECD, 2017[95]) (Bruhn and Loeprick, 2014[96])

Another example is the *Monotributo* (Simplified Tax Regime for Small Taxpayers) regime in Argentina, which combines several tax obligations into a single payment. Targeted at microenterprises and entrepreneurs (who must be below a gross-income threshold to be eligible), the regime includes social contributions as well as income tax and VAT payments. Payment fees are set according to eleven categories, depending on the characteristics of the firm (manufacturing/services, turnover, number of employees, land and electricity use), and companies can register online at the Federal Administration of Public Revenue (OECD, 2013[97]; OECD, 2018[98]).

Interviews with SMEs and start-ups in Afghanistan, as well as international data, indicate a very high overall tax burden for businesses in Afghanistan, in large part due to the country's BRT. World Bank data report a total tax rate up to 71.4% of commercial profit. This figure appears to be exceptionally high, most likely since the BRT is a turnover tax that could be the equivalent of (on average) a tax of 70% on profits (World Bank, 2018[9]; Aghaez, 2017[12]). The tax burden on firms should be reduced and aligned with low-income countries (where the recorded average is at 52% of commercial profit) – for instance, through the evolution of the BRT into a tax on profits. Consumption taxes could help offset some of this reduction, as could more-effective regulation of illegal mining and improved collection of royalties from licensed mines. Effective implementation of the new minerals law, buttressed by further steps to curtail corruption and abuses in the sector, could do much to turn the latter into an important source of revenue and growth. The government is aiming to introduce a VAT at the end of 2020 (Ministry of Finance, 2018[77]); however, it is likely that progress will be slow and the country's tax potential will remain limited for as long as the security situation remains unstable. It is considerably more difficult for a fragile state to raise tax revenue, as revealed by the average tax-to-GDP ratio of 16.1% in low-income non-fragile states, and 7.6% in Afghanistan. However, it is estimated that 15% or more of GDP in revenue are needed to finance basic public services (IMF, 2018[99]; OECD, 2018[1]).

Recommendation 3: Improve the quality of public services, particularly in industrial parks

The benefits of industrial parks include more reliable electricity and water provision, better connections to domestic and international logistics networks, proximity to suppliers and clients, and unified administrative services for businesses (including export-related services). These are strong incentives for companies to formalise – particularly in Afghanistan, where the government must focus its limited resources on a smaller number of areas where users and businesses can be concentrated.

Since the government's limited resources are insufficient to improve public goods and services across the country at once, this approach can serve as a catalyst for future nation-wide formalisation policies, as many incentives can be applied and tested in industrial parks (regulations, tax, access to finance, electricity, security). It could be very useful to use business parks to pilot reforms to the regulatory environment that could subsequently extend to the whole economy. Although limited resources may result in small or micro-industrial parks being established, the establishment of smaller parks should not independently be a policy goal, as research suggests a low but substantial correlation exists between a park's size and the achievement of its stated investment target (World Bank, 2014[100]).

The government has recently committed to improving the current industrial parks situation. Policy reforms are described in the NPP PSD as well as in a dedicated industrial park policy document. Two main areas of reforms are specified. First, institutional changes are planned regarding the management and regulation of existing parks. The recent transfer of industrial park management from the Industrial Parks Development Department within AISA to the General Directorate of Industrial Parks within the MOIC aims to enhance the governance of the parks. The creation of a state-owned company dedicated to the management of the parks, the Afghanistan Industrial Park Corporation (AIPC), and the establishment of the Afghanistan Industrial Areas Regulatory Authority (AIARA) help better split management and regulatory functions. AIARA has been established to regulate the industrial parks, in terms of drafting policies, laws and other guiding documents for attracting investment as well as to monitor their performance. The AIPC has been set up to manage the facilities of the industrial parks, thus act as the operational arm of the AIARA. Nevertheless, close attention needs to be paid to potential conflicts of interest between management and regulation, since the MOIC is also regulating the parks.

Increasing the supply of industrial parks has been stated as an objective in different policy documents. Public-private partnerships, either through the build-operate-transfer system or the pooling of private sector investment,[18] are the preferred models for new parks. Governance and appointments in these new institutions need to be transparent and competence-based and ensure wide stakeholder representation (central and local government, private sector, infrastructure players) to establish their credibility and efficient implementation, as has been done in the Organised Industrial Zones in Turkey (Box 8).

However, further considerations must be taken into account if these reforms are to generate the expected benefits. Greater private-sector involvement is crucial, as are institutional changes. Privately owned and operated industrial parks (or zones) tend to offer better infrastructure and amenities at lower cost than publicly operated ones. Since the early 1990s, there has been a dramatic shift worldwide from zones created and operated by the state towards zone models based on public-private partnership or private entrepreneurship.

The transfer of management to a state-owned enterprise (SOE) and the establishment of a dedicated regulatory body should provide an opportunity to bring the private sector into the management and regulation of industrial parks in Afghanistan. The composition of the SOE's board will be important in this regard. Site selection has to be carefully studied and follow a bottom-up approach. Again, the private sector must play a key role, as it is necessary to identify large companies that would act as the driving force for increasing the utilisation of industrial parks and generating actual benefits for the economy. Industrial companies with a large network of suppliers could be associated with the site-selection process. Successful industrial parks are usually close to existing large infrastructure connecting markets.

Box 8. Organised Industrial Zones in Turkey

Informality is a major issue for the Turkish economy. Informal activities are estimated at 23-30% of GDP, one of the highest ratios in the OECD area, while informal competition is the second main issue mentioned by domestic companies, behind tax. Many small firms have low productivity and survive in an “informality trap” due to the ineffective enforcement of rules and regulations. The government has undertaken comprehensive reforms regarding the institutional framework and the regulatory environment in order to foster formalisation.

Industrial policy is also a major tool through which the government aims to increase the benefits from operating formally. The 284 Organised Industrial Zones (OIZs) in operation in 2015 significantly improved working conditions for 40 000 industrial establishments and 1.53 million workers (representing more than 30% of total manufacturing employment). The development of OIZs included a large set of measures:

- Initial developments received financial support from international donors and businesses.
- Although the Ministry of Science, Industry and Technology is in charge and sets the rules; management and proposals were provided by the private sector.
- Simplified regulations have attracted the participation of private companies.
- Critical infrastructure such as electricity, water, transport and security are priorities for industrial parks located in South East Turkey – as is transport infrastructure, to connect the parks with the rest of the economy.
- Financial grants have been provided to support the development of businesses in OIZs.
- Productivity-enhancing services have been offered as well. For instance, vocational schools have received support from the National Employment Agency.
- Performance indexes have been developed to assess the effectiveness of the existing OIZs.

The emphasis on infrastructure in Turkey may be particularly relevant to Afghanistan: the creation of areas with dedicated infrastructure for industrial production has helped ensure that industrial activities have been carried out in appropriate areas and has simultaneously strengthened the government’s regulatory role. OECD observes that, in addition to cost-effective infrastructure provision, successful OIZs have fostered dissemination of knowledge and technology, enforcement of environmental regulations and co-operation between industrial firms and universities.

At the same time, the location of business parks in Afghanistan should be closely co-ordinated with regional and national infrastructure development, so as to facilitate their integration into the domestic economy – in terms of transfer of technology and know-how, investment by domestic firms into the parks, forward and backward linkages, etc.

Sources: (OECD, 2018[101]) (OECD, 2016[102]) (Farole and Akinci, 2011[103])

Administrative procedures and one-stop shop facilities in industrial parks should allow for simplified access to government services. In Afghanistan, security conditions are also an important feature to plan in industrial parks. Costs could be shared by the government and the largest private sector participants to provide SMEs with such services at limited or no cost. Consultations and workshops with SMEs can help the government prioritise measures to implement for SMEs within the industrial parks – as well as inform SMEs of the benefits, help them meet potential clients and business partners, and encourage them to develop their activities in the parks.

Industrial parks should also consider which businesses to attract. Manufacturing companies might be primary targets, considering the government's objectives; formal and informal SMEs supplying these companies are likely to follow their relocation. If parks are to strengthen the regional or national economy as a whole (the principle of "extra-territoriality"), they must be designed so as to engage deeply with the surrounding economy rather than developing as enclaves cut off from the rest of the country. OECD suggests two specific provisions that can help address this concern (OECD, 2009[104]):

- Consistent with the principle of extra-territoriality, indirect exporter benefits (i.e. duty-free access) should be extended to firms in the local economy that supply exporting services to firms based in the parks.
- Collaborative relationships should be encouraged between investment projects in the parks and local firms and research institutions.

Recommendation 4: Raise awareness of the benefits of formalisation

Many Afghan entrepreneurs do not perceive any benefit, such as legal protection or access to specific support programmes, from registering their businesses. Imperfect information is a crucial issue, and awareness campaigns thus constitute a necessary complement to streamlining procedures and rolling out incentives in order to encourage business formalisation. Persuasion efforts need to make the case for formalisation by emphasising the most important recent reforms and procedures (such as better access to finance and export promotion services) and how they could benefit formal businesses. This includes presentations and discussions with the ACCI, business associations, start-up initiatives and actors involved in the informal sector.

The government and donors need to carry out communication campaigns – on social media and TV as well as in newspapers, airports and other marketplaces – publicizing reform efforts and new measures for SMEs. Benefits can also be explained at current incubator sites, local government offices and business roundtables with the support of chambers of commerce and industry and local business associations. Written communication including leaflets and brochures can also be distributed there and by the ACCI. These efforts could be branded as a "simplification shock", as they are in France (Box 9).

Of course, communication efforts must be supported by concrete improvements and results on which the government can rely in order to restore trust and avoid empty or misleading communication. Measurement and reporting on progress by the MOIC and the ACCI could back these efforts and fuel communication materials. Difficulties and failures need to be acknowledged, shared and discussed to find common solutions and adjust programmes and actions accordingly.

Box 9. France's "Choc de simplification" ("Simplification shock") campaign

In 2016 France began carrying out a large modernisation programme to simplify administrative procedures for businesses and citizens by reducing the number of certificates and documents. A communications campaign aimed to promote these measures included the following elements:

- The "simplification shock" was announced by the President at its initiation (alongside the Prime Minister and representatives from other ministries) to present key dates and reforms to be implemented.
- Substantial media coverage was ensured, including press interviews and regional press conferences, promoting the role of businesses in the process.
- Several government websites announced and communicated simplification measures, including the "*ensemble, simplifions*" ("simplify together") initiative to collect ideas and feedback on new measures.

Source: (Gouvernement Francais, 2017[105])

Way forward

Implementation of measures to tackle informality can start at the local level

No single recipe exists for tackling informality; the Afghan government needs to find the appropriate mix of measures and incentives. In terms of implementation, the government could start to test a set of incentives at the micro level by encouraging co-ordination – between local tax and registration offices, local electricity providers, financial institutions (including microfinance institutions and donor programmes such as the Afghan Credit Guarantee Foundation), together with the ACCI and other sector associations – to pilot the measures. This experiment, which could be implemented over a period of three to six months, would assess the interest level of and impact on informal companies. Since a one-stop shop is already in place in Kabul, this would be a good place to start; the measures could then be piloted in other areas such as Mazar-e-Sharif, Kandahar and Herat.[19]

Examples from Latin America show how informal markets can be formalised. In the Gamarra market in Peru, major manufacturing groups and suppliers led efforts to engage municipal authorities to improve security and electricity that encouraged some of the smaller informal players to formalise and work with the larger formal players (Marsili, 2013[106]). In a similar initiative, authorities in the municipality of Quito, Ecuador, undertook a programme to formalise the activities of 6 000 street vendors, relocating them to 11 formal marketplaces.

However, while the majority of workers targeted by the initiative ended up moving into formal economic activity, the Quito initiative demonstrated that this does not necessarily result in an immediate improvement in the economic conditions of the affected workers (Ferragut and Gómez, 2013[107]). For Afghanistan, this means ensuring that top-down formalisation initiatives involve provisions for ensuring that the workers involved receive both incentives to participate in such programmes and the support needed to benefit from formal activity so as to minimise personal economic loss.

Measures to tackle informality require considerable co-ordination

Implementation of the specific measures to tackle business informality embedded in Afghanistan's SME strategy will be crucial, as will be the role of the MOIC in supervising and co-ordinating implementation. Most OECD member countries have established SME implementation agencies separate from the ministries in charge of policy making. However, this might be premature for Afghanistan, given the limited resources of the MOIC. At this stage, the implementation body should not be institutionally isolated from the MOIC in order to deliver its mandate. A dedicated team or entity within the SME Directorate could be put in charge of translating strategic directions into operational plans. This entity needs to assemble a team of experts with project management and monitoring skills to focus on concrete achievements while remaining in close contact with projects on the ground.

The strong interdepartmental dimension of the SME strategy requires high-level political commitment, while the actual implementation of SME programmes such as training, consulting, incubation, financing – which are all mentioned as crucial for SME development by interviewed private sector actors – must be implemented in close co-operation with key partners within the government, the private sector and the donor community in order to be efficiently delivered. The implementation plan needs to specify actions, key performance indicators, resources allocated and partners in charge. Donors need to be associated with the creation and conduct of the implementation plan to identify how their programmes and financing can be most helpful to support government actions, ensure alignment between priorities and programmes and guide the elaboration of new ones. The ACCI could use its expertise and its knowledge of the country's economic fabric to help providing informal entrepreneurs with such support programmes.

The OECD suggests an implementation roadmap for these measures with different timelines (Table 1). This could provide a baseline for activities to be included in the future SME strategy.

Informalities must be addressed within a comprehensive, long-term framework

It is critical to take a long-term view of Afghanistan's formalisation challenges, for at least three reasons. First, while workers can often shift back and forth between formal and informal sectors, this can be more difficult for firms, particularly if they grow beyond a certain size. The decision to formalise is thus potentially irreversible (or reversible only at high cost), and firms may therefore be slow to take it in response to policy changes. Secondly, progress on the "extensive" formalisation margin may be faster than on the "intensive" margin, as firms register and begin to operate formally while still employing some workers, or transacting with some counterparties, informally. Thirdly, as noted above, the growth of the economy and of economy wide productivity is key, which means that a great deal depends not only on structural policy settings but also on the security situation (La Porta and Shleifer, 2014[49]).

The framework for tackling business informalities presented here is thus not a panacea or a quick fix. However, it offers a comprehensive approach that encompasses both economy-wide challenges and targeted measures for informal SMEs. It builds on existing research and work by several international organisations including the ILO and the World Bank (Kenyon, 2007[61]; ILO, 2014[108]; La Porta and Shleifer, 2008[54]). A careful mix of policy measures included in the framework can support business formalisation and complement improvements in the overall business climate including on the rule of law, integrity, the general tax administration and policies, and labour market and skills.

Table 1. Roadmap to support companies' formalisation

Recommendation	Short term (6 months - 1 year)	Medium term (1-2 years)	Long term (3-5 years)
Recommendation 1: Develop a proper institutional and legal framework to support the private sector			
Further simplify registration and other business procedures	• Continue to implement physical one-stop shops beyond Kabul • Remove the need to renew the business license	• Identify additional priority administrative procedures to simplify with the private sector	• Digitalise key procedures through a single online one-stop shop
Develop an appropriate institutional framework for supporting small businesses	• Extend private participation to existing dialogue platforms such as PRISEC, including start-up and informal companies • Map donors' initiatives on support and funding of SMEs • Gather more data on informality	• Elaborate a unique SME strategy and action plan with the involvement of the private sector • Ensure donor commitment and alignment on the action plan for funding and implementation	• Monitor the action plan within the SME Directorate • Build capacities on programme and financial management in the MOIC with the aim of playing an active role in SME programmes funded by donors
Develop SME-specific skill programmes	• Consult main training providers to map existing programmes • Encourage hubs to provide further mentorship and suggest use of MOOCs	• Develop management training at the ACBR and at the ACCI • Develop specific programmes for female managers with the AWCCI	• Create entrepreneurship and managerial curricula in schools • Consider organisation training sessions with professionals at local MOIC offices
Raise awareness of the benefits of formalisation	• List the benefits of formalisation to build an effective communication	• Carry out communication campaigns about formalisation	
Recommendation 2: Develop tax policies to facilitate SME formalisation	• Streamline tax procedures • Identify areas where the impact of tax regulations on start-ups differs from that on other SMEs • Begin consultation on a new tax scheme for start-ups and relevant SMEs	• Set up a new, simplified tax regime for SMEs • Streamline back-office tax administrative procedures with the chosen one-stop-shop platform • Explore the use of investment incentives to encourage greater financial support for young businesses • Consider replacing the BRT with a tax on profit (or similar), with ease of compliance being a main goal	• Place streamlined administrative tax documents online and allow them to be submitted digitally • Incorporate tax payment and rebates into mobile wallet applications
Recommendation 3: Improve the industrial parks policy to offer higher-quality public services	• Improve the quality of public services in existing industrial parks • Further consult large companies and SMEs on the current draft policy paper on industrial parks as well as on its implementation	• Consult large industrial companies on site selection • Prevent conflicts of interest by establishing sound governance principles for the new management and regulatory bodies	• Build new industrial parks while ensuring a high level of formalisation opportunities

Source: OECD analysis.

Annex: Encouraging SME Development in policy documents

SME development is insufficiently developed in the draft NPP on PSD. Although SMEs and start-ups face a variety specific challenges, they also have a high potential for contributing to jobs and inclusive growth. The NPP touches upon the following topics, but the draft SME strategy could go much further to integrate the following specific measures for both SMEs and start-ups:

1. **Institutional and regulatory framework:** International experience shows that policy making to support SME development benefits greatly from inter-ministerial co-ordination to identify and discuss priorities, as well as a strong body (such as an SME agency, typically reporting to the Ministry of Economy or equivalent – in Afghanistan, the MOIC) responsible for implementing the action plan of the SME strategy. Good practice in setting up SME agencies includes recruiting staff with private sector experience, and adopting regular monitoring mechanisms to track progress in the implementation of the SME strategy. Many countries have developed SME-specific regulations and carry out regulatory impact assessments (RIAs) for SMEs to assess the costs and benefits of new legislations for SMEs.
2. **Access to finance**: Compared to other types of companies, SMEs have specific needs requiring different financial products and support. Public financial programmes that involve banks (and donors in the case of Afghanistan) are needed to support them with dedicated loan offers (and conditions). Most OECD member countries and Eurasia countries have such public financial programmes (usually run by a public bank or agency, sometimes with the support of international organisations). They include targeted financial offers for start-ups, including seed financing, equity participation and subsidised loans (with no guarantee nor collateral).
3. **FDI-SME linkages:** Foreign investors can provide growth opportunities to domestic SMEs by procuring their goods and services. The entry of multinational enterprises can also bring about positive economic effects in terms of raising quality standards, productivity, and integration in global value chains among local companies. In this respect, dedicated programmes can be designed for SMEs to facilitate their interaction and business linkages with foreign investors (e.g. matchmaking events, training courses, supplier development initiatives). Start-ups can benefit from acceleration programmes that include mentoring, study tours, and matchmaking with potential partners from key countries (Dubai, Turkey, and the United States could be considered) (BPIFrance and BusinessFrance, 2018[109]).
4. **Financial literacy**: Financial inclusion is mostly viewed in terms of digital payments, which is quite restrictive. The NPP PSD refers to the development of a financial inclusion strategy, which is a good step in the right direction. This topic is very broad and should target specific groups (such as SMEs) and include tools such as education programmes in schools, training for entrepreneurs, training by and for banks, and websites that citizens and businesses can access. As noted above, managerial skills are critical to firm productivity and thus to an enterprise’s ability to operate in the formal sector; La Porta and Shleifer (2014) specifically link the issue of managerial human capital to access to finance. Governance with a public-private working group led by the Central Bank is also instrumental. Further OECD guidelines can be found in the work of the OECD International Network on Financial Education (OECD/INFE) (OECD, 2015[110]).

5. **Skills**: SMEs have difficulty accessing formal training. Alternative instruments and incentives could be used, however, including informal training (through a network of business mentors, for example) or vouchers for training in TVET institutions. Entrepreneurial and managerial skills could be included in academic curricula (especially in universities) and be taught with the participation of successful entrepreneurs. Training sessions for new or would-be entrepreneurs could also be organised on incubators' premises.
6. **Exports**: In many countries SMEs have a lack of capacity, knowledge and intelligence with regard to foreign markets. The export promotion agency needs to develop marketing, consulting and financial activities to support them, including market studies, training on standards and certificates, export credit, etc.
7. **Business services**: It is crucial to support the development of business centres, hubs and incubators (private or public) that can provide technical, consulting and financial support to SMEs. This idea might be particularly suitable for the regions situated outside Kabul, where the government could play a role in promoting and supporting the many donor initiatives currently in place. Regarding start-ups, the development of incubators is crucial to support a conducive ecosystem where nascent projects can work and the various actors – start-ups, investors, financial institutions, academia, the public administration – can meet, usually in a shared physical space.
8. **SME statistics:** In many OECD countries, the national statistical services and central banks provide data on the business sector (turnover, value added, employment, enterprise birth and death rates, share of loans, etc.), with information broken down by enterprise size class (micro, small, medium, large). It is important to ground policy making on sound data – and then to set achievable targets and monitor the impact of national strategies to support SMEs over time. This is not currently the case in Afghanistan, and the lack of reliable, accurate statistics on the SME sector was frequently mentioned as a hindering factor during the interviews conducted for this report.

Notes

[1] The dependency ratio is calculated as the ratio of dependents (people younger than 15 or older than 64) to the working-age population (those ages 15-64).

[2] This is quite normal: worldwide, informality in emerging economies tends to be more pronounced in rural areas than in urban places, though there is great variation in the degree to which formalisation and urbanisation move together (Ghani and Kanbur, 2013[56]).

[3] Managerial skills include but are not limited to: "skills related to business planning; complying with regulations and quality control; human resources planning (recruitment, training and skills development); and allocation of resources" (OECD, 2013[73]).

[4] La Porta and Shleifer (2014[49]) are much more optimistic about the second channel than the first.

[5] La Porta and Shleifer (2014[49]) note that in most economies there is little difference between the labour forces employed by formal and informal firms. Instead, it is the education and skills of the entrepreneurs that count. Workers moving from informal to formal firms may see an increase in productivity – and wages – as a result of the shift. The productivity differential between the two groups of firms stems more from the efficiency of management, technology, etc. than from differences between the two groups of workers.

[6] The number of companies registered by the Afghanistan Central Business Registry (ACBR) is 120 000 (of which an estimated 25 000 to 30 000 are active). By way of comparison, Tajikistan, which has approximatively one-fourth the population and one-third the GDP of Afghanistan, has roughly the same number of registered firms; and Georgia, with around one-tenth the population of Afghanistan, has around 70 000.

[7] The Harakat Afghanistan Investment Climate Programme aims to promote the ease of doing business in Afghanistan by reducing institutional and regulatory barriers. It was founded by the UK Department of International Development (DFID) in 2009 and engages with donors and the government. It has supported more than 35 projects focused on four areas: public private partnerships, investment facilitation, legal and regulatory reform, and women's economic inclusion. This includes support for the development of the ARAZI land management authority and the Public Credit Registry as well as research on topics such as informalities in Kabul, special economic zones and the labour market. After recent difficulties delayed the implementation of new projects, Harakat resumed normal operations in 2018 (Harakat, 2018[221]).

[8] Article 4 of the 2009 Income Tax Law. The individual income tax rate is 2%, 10% or 20% percent according to the income of the individual taxpayer.

[9] The BRT rates are as follows:
A. 2% for small restaurants
B. 4% for the normal businesses
C. 5% for the airlines and medium-sized restaurants and wedding halls
D. 10% for telecommunications firms and "superior" restaurants (Ministry of Finance, 2018[77]).

[10] This includes the BRT, the CIT, personal income tax, fuel tax, vehicle registration tax and interest tax.

[11] For instance, the Inclusive Growth Development Policy Grant (2017-18).

[12] Through the programmes "Assistance in Building Afghanistan by Developing Enterprises" (2012-17) and "Afghanistan Small and Medium Enterprise Development" (2006-12).

[13] "FRAUEN unternehmen" is a German initiative that has created a network of "role model" women entrepreneurs who travel to universities, schools and economic development events to promote entrepreneurship among women.

[14] See https://www.leeds.ac.uk/info/130503/online_courses

[15] See for instance Small Business Centres in British Columbia (https://smallbusinessbc.ca/) or in Ontario (https://www.ontario.ca/page/small-business-enterprise-centre-and-community-based-provider-locations).

[16] See https://www.dihk.de/en

[17] See https://www.reseaum.com and https://www.moovjee.fr.

[18] "In the build-operate-transfer model, the government grants a concession to a developer to build and operate an industrial estate on government owned land for a defined period. In the pooling of private sector investment system, the cost of developing an industrial park on government owned land is estimated. Businesses are then invited to buy a right to lease one of the plots of developed land within the proposed park. Once sufficient interest has been generated, the government tenders out the development of the park with the private companies which have been successful in securing a lot being required to pay for the development in a series of instalments." (PRISEC, 2018[22])

[19] The cities of Kandahar and Herat can serve as usefully varied testing grounds for the incentives. Kandahar is an important trade city where fruit production and food manufacturing are key, whereas Herat is known mainly for agriculture (saffron) and manufacturing (marble).

3. Enhancing access to finance for private sector growth

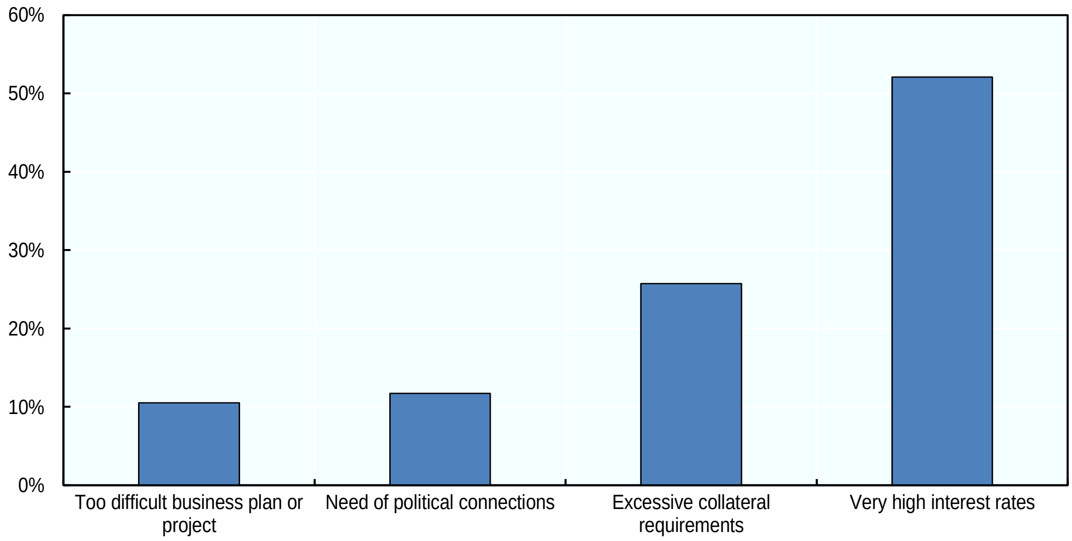
Access to finance is limited for SMEs and start-ups in Afghanistan. To improve financial conditions for both groups, the government needs to enhance financial literacy, improve loan conditions through credit guarantees and promote non-bank finance.

Limited access to finance is a crucial barrier for SME competitiveness in Afghanistan

Limited access to finance is a major obstacle for established firms and start-ups

SMEs and start-ups[1] in Afghanistan report that credit conditions do not match their needs. In 2016, 57% of SMEs considered the availability of finance as an important issue, with 52% citing very high interest rates as the main deterrent (ACCI, 2016[38]) (see Figure 4). This reflects both *supply*- and *demand*-side challenges. The *supply*-side challenges are associated with the weaknesses of the financial system and the market environment, including a lack of sufficiently developed non-bank financial institutions to adequately compensate for the lack of bank credit. The *demand*-side constraints, meanwhile, include the low financial literacy of, and poor recordkeeping by, SMEs – resulting in high collateral requests by banks.

Figure 4. Key issues for access to bank finance in Afghanistan in 2016



Source: (ACCI, 2016[38])

The formal financial system is very small and informal practices are dominant

The volume of domestic credit to the private sector in Afghanistan is extremely low, at just 3.6% of GDP in 2016, and it has been decreasing since 2010. This is far below the levels found in Tajikistan (21%), Kyrgyzstan (20.8%) or Turkey (69.9%) (World Bank, 2016[75]).

The use of bank credit remains limited, with just 2% of businesses resorting to bank finance in 2014 (IMF, 2017[3]). This is far lower than the rates observed in 2013 in Tajikistan (13.2%), Kyrgyzstan (18.4%) and Turkey (44.2%) (World Bank, 2014[63]). Alternative sources of finance have remained even smaller. Microfinance for instance represented 0.8% of GDP in 2017, compared to close to 2.8% in Tajikistan and 2.4% in Kyrgyzstan (IMF, 2017[3]; National Bank of the Kyrgyz Republic, 2018[111]; National Bank of Tajikistan, 2017[112]). The banking sector is facing important challenges in Afghanistan and is subject to close attention from policy makers (Box 10).

Box 10. Afghanistan's Banking Sector

The banking sector in Afghanistan comprises 14 banks: eight commercial banks, three government banks, and three branches of foreign institutions. In addition, 13 microfinance institutions operate in the country, along with one fully-fledged microfinance bank (with seven Islamic banking windows, supported by 493 bank branches) and three electronic money institutions. Bank assets are moderately concentrated: 80% of all assets were bundled within five banks in 2015, compared to 100% in Tajikistan and 97% in Kyrgyzstan. The size of bank loan portfolios stands at USD 700 million, including SMEs at USD 50 million.

The banking system is yet to recover from the 2010-11 Kabul Bank crisis, when a combination of embezzlement, mismanagement, and inadequate supervision led to the disappearance of nearly USD 1 billion from the country's largest bank. Banks are still hesitant to provide loans. Collateral requirements are high, interest rates can reach 25% for SMEs and maturity of loans is short. In December 2017, the total lending spread across the country's 14 banks (including three banks suspended from credit provision) amounted to 2.6% of GDP, compared with banking-sector assets of 23% of GDP; and the loan-to-deposit ratio was 19.9%, compared to an average of 101% in the Middle East, 85% in Asia, and even 25.6% in Libya. State-owned banks represent 27% of assets but only a marginal part of total credit. Reported weak credit and risk assessment capacity and poor governance have undermined their role and activities.

Systemic financial issues, such as volatile growth performance and low business activity, are aggravated by the difficulties of the banking sector. The Central Bank underlines "high operational costs,[2] but also high risk, weak contract enforcement, and the overall financial underdevelopment" – exemplified by a non-performing loan (NPL) ratio of 11.5%, the weak Afghani currency and the lack of a sovereign rating for the country from any of the major international credit-rating agencies. The Afghan financial sector also lacks a domestic regulator solely delegated to the monitoring of systemic financial risk, while Afghan banking norms still lag behind on the standards issued by the Basel Committee. The Central Bank is still aiming to abide by Basel II, which would include an operational risk framework that is needed by the banking sector.

Current reforms aim to address issues related to governance, asset quality and profitability. The 2003 Banking Law was amended to reflect the lessons of the Kabul Bank crisis and helped to create a more robust financial system in the country. New banking laws have improved information exchange and enforcement, enhanced the recovery of NPLs through a Bad Debt Commission, and strengthened vulnerable commercial banks. The regulatory framework and supervision mechanism of Afghanistan's Central Bank was recently extended to include oversight of Islamic banking and microfinance institutions; this led to the approval of the first fully-fledged Islamic bank in April 2018. Together with the World Bank, the DAB is aiming to assess how to further adapt Islamic banking principles to Afghanistan.

In December 2017 the government also approved a long-term strategy, supported by the World Bank, to modernise and improve the governance and operations of state-owned banks, with the aim of increasing competition and lending. Additional measures such as credit guarantee schemes (CGS) and the removal of the legal minimum credit guarantee could have positive effects on domestic credit, and enhanced training and partnerships between banks and international financial institutions could improve local capabilities. Financial inclusion must also be a priority to expand banking services and demand.

Sources: (IMF, 2016[113]; IMF, 2017[3]; GIZ, 2016[114]; The Banker, 2018[115]; World Bank, 2018[116]), OECD public-private working group meetings

However, traditional informal financial practices partly offset the lack of a structured formal system. It is estimated that 90% of all financial transactions occur through *hawalas*,[3] although this is a broad estimate because it has proven difficult to track the scale of lending of hawala dealers. Hawalas are informal financial service providers that deliver loans, currency exchange and other financial operations to customers. In Afghanistan, they have had a historic and stable presence throughout periods of financial turmoil. Typically, they have physical counters on open-air markets, some of which are even registered at the Central Bank (Hariharan, 2012[117]; Da Afghanistan Bank, 2018[118]). The hawalas have constantly supported efficient access to finance for small companies and citizens in Afghanistan, not least because of their role in handling migrant remittances. Yet even if the hawala sector is the largest informal financial service provider, Afghan SMEs still rely mainly on internal sources or international grants for finance (GIZ, 2016[114]).

Several financial programmes and institutions have been established with the support of donors to foster better credit conditions, particularly in the agriculture sector. Agriculture accounts for approximately 25% of GDP, with more than 75% of the working population engaged in the agribusiness sector. The Agricultural Development Fund (ADF), which is supported by the Ministry of Agriculture, provides loans to farmers in partnership with banks. The fund provides both technical and financial services, which are channelled through offices located throughout Afghanistan (Agricultural Development Fund, 2018[119]). The Multilateral Investment Guarantee Agency (MIGA) offers loan guarantees for agriculture advancement projects, coupled with comprehensive industry guidance on plans, storage capacity designs, business strategies and more. These strategies underline the importance of sectoral knowledge in allowing credit institutions to grasp the needs of the applicants. It will in turn help credit offers adapt to the needs of the sector and its applicants, which is of particular relevance in the agricultural sector (in the case of leasing, for example).

Afghanistan remains one of the most unbanked countries in the world

The large share of unbanked citizens and businesses is a distinctive feature of Afghanistan's financial system. In 2014, less than 10% of the population were estimated to hold a bank account, compared to 11% in Tajikistan, 18% in Kyrgyzstan, and 57% in Turkey (World Bank, 2014[62]). Similarly, in 2011 44% of firms in Afghanistan had a checking or savings account, compared to 87% in Tajikistan and 69% in Kyrgyzstan (World Bank, 2011[33]).

The lack of formal banking stems from several factors. Trust in banks was hurt by incidents such as the Kabul Bank crisis in 2011,[4] which exposed large-scale fraud and resulted in a government bailout equivalent to 5% of GDP. Furthermore, many individuals avoid interest-based banking on religious grounds. Limited connectivity and risks related to travel to the nearest bank branch also affect the provision of credit, which is a major reason why 75% of loans are made in Kabul province (International Trade Administration, 2016[120]). In this unstable context, credit conditions provided by banks are difficult and do not encourage businesses to apply (SIGAR, 2018[7]).

Banks face high risks when lending to companies

Banks in Afghanistan face high risks with regard to commercial lending. In 2016, the Central Bank of Afghanistan reported that 11.5% of loans were non-performing. This stands in comparison to 8.5% in Kyrgyzstan and 3.1% in Turkey in 2016 (World Bank, 2016[75]). The quality of bank loan portfolios has continued to worsen, with a slight rise in the 2017 share of non-performing loans (NPLs), due to deteriorating asset quality (SIGAR, 2018[7]). Causes for NPLs may be twofold, with banks either providing faulty risk assessments or the overall business environment being deficient. In Afghanistan, a combination of both is the case, causing a halo effect, as banks are prevented from identifying good projects (Rosenzweig, 2007[121]; SIGAR, 2018[7]). The difficult security context adds to these risks, particularly the risk of business discontinuity (PRISEC, 2018[22]).

Financial literacy is a major demand-side constraint

Financial literacy can contribute to the financial well-being of citizens, to sound financial and business decisions, and, in the long run, to financial market stability (OECD, 2015[110]). For SMEs in particular, it is critical to improving their access to finance. The OECD defines financial literacy for SMEs as the combination of awareness, knowledge, skills, attitudes and behaviour that a potential entrepreneur or an owner or manager of a micro, small or medium-sized enterprise should have in order to make effective financial decisions to start and run a business, and ultimately ensure its sustainability and growth (OECD, 2018[122]). This is a critical aspect of the managerial human capital discussed in the previous chapter.

In Afghanistan, financial literacy remains an obstacle for SMEs, as banks consider the loan applications and business plans provided by SMEs to be of poor quality. In 2009, 60% of SMEs in Afghanistan pointed out their need for more and better business development services, particularly to support the preparation of business plans and financial documents (Mashal, 2014[53]). Limited financial knowledge affects both sides of the equation: SMEs are said to lack financial reporting or management skills, while banks are not aware of the types and designs of the loans they offer and lack the skills necessary to conduct sound due diligence (International Trade Administration, 2016[120]).

It is estimated that only 14% of Afghan adults are financially literate, as compared with 29% in Turkey, 19% in Kyrgyzstan and 17% in Tajikistan (Klapper, Lusardi and van Oudsheusden, 2016[123]). Financial knowledge is low and restrains demand for financial services. Low financial literacy is in large part a reflection of low *overall* literacy: only 38.2% of adults in Afghanistan are literate, with 17% female literacy levels, compared to nearly 100% in Tajikistan and Kyrgyzstan (World Bank, 2014[63]).[5] Low financial knowledge is likely to hold back demand for formal financial services, both from consumers and SMEs.

SMEs use of bank finance is limited due to the loan offer and collateral requirements

Formal loans are expensive and have short maturities. They are usually provided on a one-to-three-year basis (GIZ, 2016[114]). As a result, many entrepreneurs reach out to relatives or other informal sources of finance to set up or invest in their businesses (SIGAR, 2017[124]).

Interest rates for businesses remained at 15% in 2016 (World Bank, 2016[75]), while Consumer Price Index (CPI) inflation was just over 4%, implying a very high real interest rate (Afghanistan Central Statistics Organization, 2016[125]). Interest rates for SMEs appear to vary more than those charged to bigger corporations, with rates reaching 25% in some cases (GIZ, 2016[114]). High interest rates are partly due to perceived repayment risk and the limited options banks have in case of default. This is linked to difficulties in identifying collateral and the lack of court enforcement (PRISEC, 2018[22]). The net interest margin for bank loans has fallen sharply, shrinking from 11% in 2009 to 4.7% in 2015, and is in line with conditions in economies such as Kyrgyzstan (7.1% in 2015) and Turkey (3.5% in 2015) (World Bank, 2015[126]). This suggests that the current interest rates reflect both local macroeconomic conditions and the uncertain context – which creates high risks, lower return prospects and higher costs for banks, and ultimately customers.

Banks lack information on the creditworthiness of SMEs

Information asymmetry is frequently cited by financial institutions as the reason for limited credit provision (IMF, 2009[127]). In the 2019 World Bank *Doing Business* indicator for "Getting Credit", Afghanistan ranked 99th, up from 105th in 2018, with slight progress made on credit registry coverage (World Bank, 2019[35]). The absence of a widely applicable credit registry makes it harder for banks to assess the creditworthiness of applicants. To address this, the Da Afghanistan Bank (DAB), Afghanistan's central bank, founded the Public Credit Registry (PCR) in 2008 to keep track of the credit histories of loan applicants.

In 2013, the PCR was expanded into an electronic platform, including the Afghan Collateral Registry, allowing for the use of moveable collateral registered in the PCR to secure loans, across any asset type and geographic location. However, only about 1.5% of the adult population are covered by the PCR, which prevents it from being counted in the World Bank's *Doing Business* Indicators, which amounts to 5%. To expand the PCR's reach, the DAB is assessing innovative methods of adding people to the system, for instance by including clients of state owned enterprises (SOEs), as well as customers of mobile and electricity companies (Da Afghanistan Bank, 2018[118]). Thus, a memorandum of understanding was signed in 2018 between Breshna, the main national utility company, and the DAB to expand the base of users and increase the depth of financial information.

Interviews with business representatives also highlighted limitations of the PCR: it remains unclear which information is selected to establish the credit score and how it influences the selection of loan applicants. Moreover, applicants currently cannot access their credit scores (Aghaez, 2017[12]). To make better use of the PCR, representatives of the banking sector in Afghanistan therefore recommend allowing access to, and automatic online exchanges between, the core banking system and the PCR. It should also allow restricted access and data sharing with further utility providers following the MoU between Breshna and the DAB.

Collateral requirements remain an issue and credit guarantees are still insufficient

To mitigate risks, banks in Afghanistan generally request high collateral. According to the Central Bank, collateral requirements amount to 120% of the total loan amount on average. This is lower than the figures found in Central Asia, where it ranges from 170% to 227% of the loan amount (OECD, 2017[128]). According to the World Bank, approximately 70.7% of loans require collateral. Other sources and SMEs interviewed by the OECD indicate that all term loans provided to SMEs request collateral, compared to 84.1% in Tajikistan (Aghaez, 2017[12]). This creates a strong barrier for SME lending, as banks request collateral even for small loans (from USD 5 000 onwards), as required by law in Afghanistan (World Bank, 2019[35]).

Weak property rights also hinder the provision of collateral. Afghanistan ranks 186th out of 190 on the World Bank's "Registering Property" indicator, with an estimated 80% of all land administered informally (World Bank, 2019[35]; International Trade Administration, 2016[120]). This is due to contradictory land laws, the lack of a fully operational cadastre or a functioning land titling system, commercial courts' limited enforcement capacity, and widespread corruption. The process of obtaining a land title is cumbersome, costly and estimated to take up to 250 days (SIGAR, 2017[124]). Representatives of banks also underline the difficulty of enforcing collateral recovery, which on average takes seven years and contributes to the banks' risk-adverse lending behaviour. The government has taken recent steps to improve the legal framework for property rights by enacting multiple land management laws.[6] Among other simplifications, the Independent Land Authority (ARAZI) – very recently merged with the Ministry of Urban Development – offers one-stop lease opportunities for investors from Afghanistan and beyond (PRISEC, 2018[22]).

Afghanistan is in the process of expanding existing credit guarantee schemes (CGS) to help reduce the risk for banks by providing a guarantee to the loan requested by SMEs.[7] There is already one CGS operating in Afghanistan, the Afghan Credit Guarantee Foundation (ACGF) (see Box 14). In addition, in November 2016, the Afghan government released a plan to foster credit guarantee programmes, which was further underlined in private sector reform priority number 5 (PRISEC, 2016[129]). This decision was based on the growing awareness of the potential of CGSs to mitigate SME lending risks for banks. In line with this, the DAB has developed an initial framework with the World Bank and USAID. This Credit Guarantee Facility will be entirely focused on SMEs, particularly industrial production and export in the priority sectors (USAID, 2018[130]).

Alternative sources of finance are expanding but are still underdeveloped

Given the limitations to bank financing in Afghanistan, multiple alternative sources of financing have flourished, but most of these remain limited in terms of both size and their impact on overall access to finance. The absence of a sound, reasonably well-developed banking system is itself an impediment to the development of many alternative forms of finance. Equity markets, venture capital and other alternative sources of finance would be easier to develop in Afghanistan if the banking system were already well developed. In any case, the critical issue concerns the creation of a legal environment in which both banks and markets can operate effectively (Levine, 2000[131]).

The traditional hawalas are a partial exception to this rule. Most Afghan businesses use them for payments, currency conversion, microfinance and money transfers. They are seen as efficient and are reckoned to be both less costly and more trustworthy than banks. In practice, the sender gives an amount to a *hawaladar*, who informs the receiving hawaladar in order for the other party to collect the amount through a code word given by the first hawaladar. Although the hawala system is largely informal, hawaladars can be registered with the DAB and operate on the money exchange market in Kabul. To date, approximately 1 300 hawala dealers have received official Money Service Provider (MSP) licenses from the DAB, on top of 1 697 licensed foreign-exchange (FX) dealers. In 2010, it was estimated that 3 00 to 5 000 brokers facilitated informal banking services (GIZ, 2016[114]; Hariharan, 2012[117]; Maimbo, 2003[132]).

Microfinance initiatives did not yield the hoped-for results

In 2002, an assessment estimated that "over one million Afghan households had an unmet demand for microcredit" (SIGAR, 2018[7]). Following the creation of the Microfinance Investment Support Facility for Afghanistan (MISFA) in 2003, the microfinance sector in Afghanistan rapidly expanded from 12 000 to 450 000 clients (Box 11). External factors, however, made the timely repayment of the loans complex: these included the 2007 drought, the fragile security situation, and economic instability, particularly high inflation. This was coupled with limited internal resources and capabilities, ultimately causing a repayment crisis and a drastic reduction in the number of MFIs (PRISEC, 2018[22]; SIGAR, 2018[7]).

Box 11. Afghanistan's Microfinance Investment Support Facility (MISFA)

In 2003, the Ministry of Rural Rehabilitation and Development (MRRD), supported by the World Bank and the Afghan government, set up MISFA to act as a channel for funding, co-ordinate donor support and provide technical assistance for other microfinance institutions. It channels its credits through 13 NGOs, a credit union and a microfinance bank. As of August 2018, more than 1.2 million loans worth USD 1.1 billion were disbursed, covering 14 provinces; 34% of borrowers were women. Its current gross loan portfolio is approximately USD 120 million, with 133 564 active borrowers.

In 2018, MISFA has been transformed from a government programme to an Afghan non-profit company with limited liability under the Ministry of Finance (MoF). It is governed by an independent board of directors, which gives it more autonomy to attract new donor funding and rekindle the microfinance sector in Afghanistan. To further stabilise the microfinance sector and develop a regulatory framework, the Cabinet has agreed to legislative amendments giving DAB regulatory oversight over MFIs. The amendments have been adopted and are being implemented by the DAB.

Source: (GIZ, 2016[114]; SIGAR, 2018[7]; MISFA, 2018[133])

The overall scale of microcredit remains limited, as interviewees state that microfinance loans are too small for SMEs (from USD 2 000 to 50 000) and that microfinance institutions request 15-20% interest as well as monthly repayments (with loan maturities of 6 to 12 months). In some cases, collateral substitutes may be required (AISA, 2012[134]).

There have been new developments in the sector, with more than 300 000 active MFI savers recorded as of June 2018, with an average loan rate of USD 55 000, according to Azizi bank figures.

The equity market is insufficiently developed to provide start-up financing

Due to the challenging business environment, asset financing and venture capital are underdeveloped in Afghanistan (ADBI and OECD, Forthcoming[135]). Business angels are almost unheard of. For instance, InFrontier remains the only private equity fund in Afghanistan with local staff and implementation on the ground. Donors have established crowdfunding platforms that allow for Afghan businesses to present their plans and collect funding online, but their size remains limited. The *Bright Future* platform has provided SMEs and start-ups with the opportunity to showcase their business ideas online for 30 days and collect a minimum of USD 1 000.

The underdeveloped equity market limits the opportunities for Afghan start-ups to seek financing. Start-ups have different financial needs compared to SMEs as they require more short-term cash, are very often looking for equity finance, can rarely provide collateral and have no credit history. While a start-up ecosystem is developing in Afghanistan in terms of business incubators and start-up events, most are supported in large part by donors (Wilson and Silva, 2013[89]; Aghaez, 2017[12]).

The regulatory framework on Islamic finance has yet to adapt to the reality of Afghanistan

Sharia-compliant loans, labelled *musharaka* or *mudaraba*, restrict interest and risk-taking, and aim to prevent banks from overcharging their clients (SIGAR, 2018[7]). In Afghanistan, these loans are provided through Islamic windows, which are now part of a dual-track approach in the banking sector. Afghanistan is aiming towards a dual Islamic-conventional banking system, though not all of its elements are fully in place and operational (OECD, 2016[136]). The Islamic Bank of Afghanistan (formerly Bakhtar Bank) is the first fully-fledged Islamic bank in the country. Sharia-compliant loans have been introduced and included in the portfolio of services and products of the DAB. The DAB is regulating the services and products of Islamic banking and issuing the licenses for banks aiming to offer Islamic windows. At the same time, the expansion of the Islamic banking windows is limited, given that provincial areas rarely accept their regulations, according to banking experts interviewed for this report. Licensed commercial banks must create a council with Islamic scholars to assess whether their offers are effectively compliant with sharia principles (PRISEC, 2018[22]).

Recommendations to improve access to finance in Afghanistan

PRISEC's *Finance and Banking* and *Legal* working groups address aspects of access to finance, bringing together relevant stakeholders from the government and the international community in the framework of reform priority 5 (PRISEC, 2016[129]).[8] An overarching priority in Afghanistan is to include access to finance within the draft SME strategy and subsequent implementation plan. This will help orient government action and can help restore trust by increasing co-ordination between the government, SMEs and financial institutions.

As part of the government's NPP PSD, several priority actions can guide the undertakings of the Afghan government: 1) addressing information asymmetries through financial inclusion programmes; 2) supporting bank credit by better co-ordinating existing SME financial programmes and expanding credit guarantees; and 3) facilitating alternative financing methods by establishing adequate legal frameworks and attracting investors.

Recommendation 1: Improve the financial literacy of citizens and entrepreneurs

The government has acknowledged the need to address the low rate of financial literacy in Afghanistan. In the NPP PSD, it mentions financial education as a wider national strategy for financial education, and the need to expand financial inclusion by improving access to a broad range of financial instruments (PRISEC, 2018[22]). In line with this, the DAB is finalising a National Financial Inclusion Strategy with a planned launch in 2019; to assess the needs and determine the beneficiaries of the strategy, it is planning to conduct a demand-side survey.

To better implement the strategy, the DAB has established a financial inclusion committee comprising the ministries of Industry and Commerce, Education, Higher Education, the Interior, Justice, Women's Affairs, and the Telecommunications and IT, as well as civil society groups and chambers of commerce, among others. This is a first step to help oversee the development of the financial inclusion plan and the financial literacy strategy and to ensure that existing initiatives are better co-ordinated, ultimately addressing low financial literacy in the country.

As part of the inclusion strategy, the government needs to cover financial literacy and develop a specific focus on financial literacy for managers of SMEs and start-ups. Better financial literacy allows for an informed judgment about financial products and financial decisions. Improved financial education for entrepreneurs and small businesspeople, in particular, would allow them to improve their skills in establishing sound business plans to apply for loans and to understand the loan application process (OECD, 2018[122]). The government also needs to improve the institutional framework, together with appropriate channels and targeted beneficiaries, to foster financial intermediation and limit information asymmetries for market participants. For instance, providing basic support through business and financial training for SMEs in every step of their firm's life cycle is crucial to increase the financial literacy of entrepreneurs and their likelihood of success. Specific recommendations are as follows:

1. The financial inclusion strategy now being drafted should be embedded in all other strategies (such as the NPP PSD and a wider national strategy for financial education) and should rely on the surveys conducted by the DAB. To receive guidance on financial literacy developments in other countries, the government, led by the Central Bank, should become a member of the OECD International Network on Financial Education (OECD/INFE). The network organises biannual symposiums to bring together public authorities with an interest on the topic to share experience and develop policy guidance, policy instruments and practical tools on financial education – including financial literacy data collections, policy handbooks on the implementation of national strategies and various sets of policy recommendations.
2. The government should further develop a specific national financial literacy strategy linked to the financial inclusion strategy that is already under development. Afghanistan can refer to the OECD/INFE High-level Principles and *Policy Handbook on National Strategies for Financial Education*. Key principles on how to design a financial literacy strategy are provided (OECD, 2015[137]; OECD, 2012[138]).
3. The DAB should prepare the national inclusion plan by defining its scope and purpose through 1) assessing the needs of the population and the main policy issues, 2) mapping and evaluating existing initiatives, 3) consulting and co-

ordinating with the various relevant stakeholders, and 4) carrying out an adequate national awareness and communication campaign (OECD, 2012[138]). The DAB should map existing initiatives to avoid duplication and better assess potential synergies among activities. Several organisations have already conducted financial literacy training courses, often focused on women or vulnerable groups. In that regard, future training needs to be better co-ordinated, to reach wider audiences and to diversify targets as needed. The DAB could further consult with OECD/INFE on types of national strategies and how these could be better adapted to the Afghan situation.

4. The government could finalise and implement its survey on financial literacy in the country and revise the current questionnaire in line with the OECD toolkit on measuring financial literacy, governance, objective-setting and concrete actions (OECD, 2015[139]).
5. The financial literacy strategy should include a section tailored to SMEs and start-ups, as in Georgia (Box 12). This involves measuring the exact needs of SMEs and grouping them by size and developmental stage. The DAB survey could be adapted to assess SME and start-ups needs. To include the needs of smaller firms, the OECD has established a framework on financial literacy for MSMEs structured around four competencies: the choice and use of financial services, financial and business management and planning, risk and insurance, and financial landscape (macroeconomic factors, financial protection). This tool can be adapted to Afghanistan's context, recognising that entrepreneurs may need or exhibit different competencies (OECD, 2018[122]).
6. Adapted tools and channels for SMEs and start-ups can be designed and implemented with donor support. Public and private training programmes for SMEs and start-ups can provide them with better skills to present their financial statements and establish sound business plans. Channels can include but are not limited to: universities, local seminars, mentorship sessions, business or financial sector advice, leaflets, online courses, social and other media. Boosting financial literacy is increasingly done using online tools – such as the Moneysmart website in Australia, which includes videos, calculators and presentations on key financial concepts (ASIC, 2018[140]).
7. For the longer-term vision, the DAB should co-ordinate with the Ministry of Education to better embed entrepreneurship in the curriculums of schools and universities. This will allow for a shift towards entrepreneurship and away from traditional professions. Summits at which Afghan entrepreneurs share their success are an example of how seminars may be held (Business DNA, 2018[23]).

Financial literacy activities should not only target those applying for loans but also credit providers, including banks and the Central Bank. Donor institutions could foster the exchange of DAB employees with international banking experts to help the Central Bank provide better oversight over commercial banks and abide by international agreements, as agreed upon in the Basel Accords. They could also support training courses conducted by international experts – for instance, on international banking standards that can help improve the capabilities of the DAB and of local banking institutions.

Box 12. Georgia's financial education programmes

The National Bank of Georgia (NBG) and its division for Financial Education made use of the OECD/ INFE survey to assess the state of financial literacy in Georgia. This served as the baseline for Georgia's 2016 *National Strategy on Financial Education*, which was designed and implemented in a multi-stakeholder process targeting SMEs as part of the broader population. Several actors are developing financial education interventions, including for SMEs:

- The NBG provided educational brochures for SMEs on tools and financial concepts for running a business, disseminated both digitally and through local banks.
- The Ministry of Finance (MoF) is establishing a framework for SMEs to align their financial statements with the International Financial Reporting Standards (IFRS). This new system is offered digitally and in a simplified manner.
- The MoF is working with banking and accounting associations, as well as the Chamber of Commerce, to establish awareness campaigns for accountants and CEOs.
- Between 2016 and 2017 the Georgian SME agency provided training courses to 11 500 beneficiaries. The courses teach basic principles of financial literacy so that SMEs can prepare business plans and conduct financial accounting and administration.

Source: (OECD, forthcoming[141]; Government of Georgia, 2016[142]; OECD, 2016[143])

Recommendation 2: Better define and co-ordinate government programmes to support SME access to bank loans

In OECD members and in most Central Asian countries, governments have established SME funding agencies and public banks to support access to finance for SMEs. These include BPI France, DAMU in Kazakhstan and KOSGEB in Turkey (Box 13). These agencies implement financial loan and guarantee programmes for SMEs in co-operation with local banks. They manage a wide array of financial products and services that respond to the needs of SMEs, such as direct lending to SMEs and start-ups, subsidised loans which are provided by banks, incubators and acceleration programmes, as well as training courses (OECD, 2017[84]; OECD, 2018[144]). The co-operation with banks on such programmes is vital to the success of the development fund and usually involves the participation of the banks in their executive board together with business associations, public representatives and donors.

Box 13. Financial services to SMEs in Turkey

KOSGEB is the agency under the Ministry of Industry and Technology that supports the development of SMEs in Turkey. KOSGEB currently helps approximately 1.1 million registered SMEs in Turkey through 93 centres. The total amount of support rose to EUR 463 million between 2010 and 2015. KOGSGEB covers a wide range of financial products including the following:

- *Credit interest support programmes*: KOSGEB pays the loan interest of the SMEs which receive loans from banks that have contracted with KOSGEB. More than 350 000 SMEs could thus benefit from bank loans with more favourable conditions, amounting to USD 370 million in loan interest support and USD 4 billion of credit volume.
- *Credit guarantee facilities*: Turkey created a Credit Guarantee Fund (KGF) to provide collateral services for the bank credits of SMEs. KGF can directly issue credit guarantees on bank loans but can also be a party to bank protocols for KOSGEB loans. From 2010 to 2014 the number of SMEs provided with credit guarantees amounted to 16 137, for a total credit volume of TRY (Turkish lira) 5.7 billion. The volume of credit created was TRY 8 billion. In 2016 and 2017 the volume of the guarantees dramatically increased due to the counter-guarantee supported by the treasury. In 2017, more than 323 000 enterprises benefited from KGF guarantees. Guarantee volume reached EUR 40 billion.
- *Start-up support*: Start-up capital is provided (in the form of a grant or a loan) to cover eligible costs such as registration fees, capital equipment and operating expenses. Every application to KOSGEB is followed by 32 hours of start-up support training. This has led to approximately 40 000 individuals establishing their business through KOSGEB, with KOSGEB in turn providing EUR 188.3 million in support.
- *Venture capital*: There have been numerous initiatives in this area, including the establishment of venture capital funds and the enactment of regulations regarding angel investments and funds of funds.

Source: (OECD, 2017[84]; KOSGEB, 2018[145]).

In Afghanistan, the SME Directorate does not have the internal capabilities and funds to act as a fully-fledged SME funding agency and finance programme. Considering the tight credit conditions and the vast needs of SMEs, the MOIC could consider increasing the co-ordination role and activities of the SME Directorate with respect to existing financial programmes, which are largely donor-supported and -implemented today. Funds operated by donor institutions, most of which are focused on specific sectors, should be included in this mapping exercise – including the Afghanistan Rural Finance Centre (ARFC), Afghanistan Business Innovation Fund (ABIF) and Afghanistan Growth Fund (AGF), without prejudice to their impact (GIZ, 2016[114]; SIGAR, 2018[7]). Programmes focused on start-ups, such as the GIZ-funded start-up training focused on supporting returnees and Internally Displaced Persons, should also to be considered in this mapping. The SME

Directorate could start by mapping the most important financial programmes run by donors, assess which ones are up to date and in line with the draft SME strategy, get involved in supervising and endorsing the programmes, and participate in communication and visibility efforts. This includes consulting SMEs, business associations like the ACCI, and donors to better understand the programmes and how the SME Directorate could be involved.

The MOIC could play a role in gathering and disseminating information on entrepreneurial and start-up initiatives currently in place in Afghanistan. Entrepreneurs have mentioned the lack of awareness on funding opportunities, revealing large information asymmetries in Afghanistan. The MOIC could address this market failure by acting as a single platform providing information and support on available grants, competitions, acceleration programmes, industrial parks, funding programmes, and upcoming projects available for start-ups. This could foster financial intermediation and provide the Ministry with a more important role in helping young businesses to access finance (Business DNA, 2018[23]; Wilson and Silva, 2013[89]).

The MOIC could also participate in the management and supervisory boards of these programmes. It could observe, host or open events organised by the programmes; participate in training events; and provide visibility to SMEs through endorsement, communication and awareness campaigns. One objective should be to better understand and build capabilities on how to design and run such programmes, with the ultimate aim of monitoring and advising on their design and implementation.

In the long term, once these capabilities have been strengthened in the SME Directorate, Afghanistan could consider running financial programmes for SMEs with a separate SME agency to implement them, under the auspices of the SME Directorate. The agency could participate in the management of initiatives funded by donors, as well as conducting its own programmes, although this would require funding from government budget, which is not an option at this stage. The agency would provide a diversified loan portfolio targeting SMEs that would allow for a wider array of loan offers through direct lending and co-financing mechanisms with banks. Considering the current budget constraints and government priorities, this can only be a long-term solution to strengthen the SME support system in the country.

Ease collateral requirements by expanding existing credit guarantee schemes

Against the backdrop of difficult collateral requirements, the experience of OECD members and partner economies suggests the potential utility of credit guarantee schemes (CGSs) to overcome credit constraints for SMEs (OECD, 2016[146]). Guarantee funds may safeguard a part of the loan provided by a commercial bank. SMEs lacking access to collateral may gain access to formal bank credit thanks to guarantees provided by the CGS. With this, banks also become acquainted with SME and start-up lending and allow for the improved assessment of their loan requests.

To further develop credit guarantee schemes in Afghanistan, it is crucial to leverage good practices in the country itself and in countries with similar backgrounds. ACGF (Box 14) has been successfully operating for several years. While there are plans to create a second CGS mechanism in the country with donor support, it might be more efficient to expand the activities of ACGF instead. New banks could be involved in its activities with the support of the government, and additional regions could be reached. Donors and the government should discuss ways to pursue this objective.

Box 14. Afghan Credit Guarantee Foundation (ACGF)

The Afghan Credit Guarantee Foundation (ACGF) provides partial credit guarantees to SMEs through its partner financial institutions (PFIs) for SME loans. It also operates a technical assistance (TA) facility to introduce better SME lending practices for PFIs and facilitate new lending opportunities.

In 2005, the Credit Guarantee Facility for Afghanistan (CGF-A) was established. The CGF-A was implemented by DEG (*Deutsche Investitions- und Entwicklungsgesellschaft GmbH*) and co-funded by the German Federal Ministry for Economic Co-operation and Development (BMZ) and USAID. It was founded as an independent charitable foundation in 2014 in Germany as the successor to CGF-A, along with its Kabul-based subsidiary, SME Client Support Afghanistan LLC (SCSA).

As of September 2017, ACGF had an estimated share of 56% of all SME loans outstanding in the financial sector of Afghanistan and, from 2005 to June 2018, CGF-A and ACGF have cumulatively guaranteed loans in the amount of USD 204 million supporting more than 4 850 SMEs. Its contribution to financial and private sector development in Afghanistan translates into the retention of more than 50 000 employees of the guaranteed SMEs and the creation of approximately 9 000 additional jobs.

ACGF utilises the following principles:

- ACGF supports loans between USD 5 000 and 500 000, up to a maximum duration of five years, via a 72% guarantee coverage, with a potential of higher loan size with a decrease in coverage.
- ACGF operates the only credit guarantee scheme in Afghanistan systematically working with Afghan PFIs. ACGF works with four financial institutions and forms long-lasting partnerships based on business principles. The partner financial institutions are in the driver’s seat in terms of loan origination, product definition, market approach, etc., which ensures demand-driven operations.
- ACGF follows a guarantee appraisal process that closely interlinks local PFIs. Loans are provided through PFIs, which act as the primary point of reference. After loan applications have passed the PFIs’ screening process (or in parallel with this process), guarantee applications are assessed on a case-by-case basis by the ACGF’s local SCSA (which comprises a team of more than 30 experts with specific expertise in SME lending in Afghanistan) and confirmed by the credit team at the headquarters in Germany.
- ACGF has set up and built functional SME lending departments at the PFIs and provides regular TA with national and international experts, to transfer know-how, build sustainable staff capacity and improve PFI credit risk management.
- ACGF maintains a historical average net loss rate of 1.2% p.a. while balancing business volume and portfolio quality.

In 2017 ACGF received additional funding from the MoF under the World Bank-funded *Access to Finance* project to scale up its activities. ACGF now aims to delve into other underfinanced areas, including agriculture, housing, women-led businesses, start-ups and entrepreneurship, refugee/returnee loans and renewable energy financing.

Sources: (ACGF, 2018[147])

To ensure a stronger Afghan participation in the process, it could be envisaged that the government – especially the MOIC and the MoF – explore ways to support ACGF's expansion by becoming gradually involved in the supervision of ACGF, supporting strategic guidance and learning about how the ACGF functions. The composition of the supervisory board could include ACGF management, donors, representatives of the government and relevant stakeholders, as is the case in countries like France. Capacity-building activities could allow the government to better understand how to supervise a CGS. However, the operations and the decisions on guarantees of ACGF should be left to a decision-making body made of credit experts to avoid any political interference.

Recommendation 3: Improve the conditions for the development of alternative financial instruments

The government needs to put in place adequate legal frameworks for the provision of non-bank financial products and services and further expand the DAB's supervision.

Microfinance could be better adapted to existing needs and conditions and incorporate Islamic finance

To make the best use of microfinance in Afghanistan and expand its reach requires models better adapted to the diverse range of microfinance beneficiaries, as well as a better understanding of local needs and barriers for microfinance. One example is the 2017 opening of the first women-only branch by the First Microfinance Bank, in which female staff cater to female customers, hereby "overcoming social and cultural hurdles to their economic empowerment" (Aga Khan Development Network, 2018[148]). This would also help the banking sector adjust to the needs of women. Women have problems accessing loans for cultural reasons, but also due to land titling, which mostly occurs under the name of men. Specific donor-led programmes now focus on women-run businesses, and plans are under way to open microfinance windows specifically for women (ACGF, 2018[147]). To further spot the demand for microfinance and develop products accordingly, the MOIC could reach out to international organisations or research funds to conduct an assessment which includes local informal credit mechanisms, levels of education, cultural and religious notions, and risks unevenly spread throughout the country (SIPRI, 2015[6]).

Microfinance institutions also need increased supervision from the DAB to ensure their financial stability and the transparency of their activities for borrowers. This includes granting licenses, defining high capital ratios and implementing adequate reporting standards (OECD, 2015[149]).

Microfinance institutions could better include Islamic windows that are already widespread and successful in Afghanistan. Islamic microfinance is a developing concept that has included the creation of the Islamic Microfinance Network in 2011 as a platform for Islamic MFIs to establish best practices for complying with sharia law. Islamic microfinance adheres to the same principles as Islamic finance, as it offers microfinance products compliant with sharia law, thus avoiding interest, uncertainty and deceit (Hurlburt, 2012[150]). This concept could be tested in Afghanistan by establishing a pilot project with financial institutions wishing to combine Islamic finance with microfinance.

Afghanistan could assess best practices in Islamic countries such as Morocco and Egypt, which have developed regulatory frameworks that include Islamic finance in their microfinance portfolios, outlining codes of good practice in more detail (OECD, 2016[136]). It could also reach out to the Islamic Microfinance Network for further collaboration and technical support. Financial instruments for Islamic banking need further support from the government. Internationally recognised standards offered by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)[9] are already applicable but are merely used as “guidance”, rather than binding.

Diaspora financing can support young firms

The government could encourage the Afghan diaspora to invest in the Afghan economy. One way of doing this is through diaspora bonds, which are sovereign bonds primarily targeting emigrants (Business DNA, 2018[23]). In India, diaspora bonds have raised up to USD 32 billion since their launch in 1991, and have allowed the Indian government to maintain ties with Indian expatriates (World Bank, 2007[151]; ADB, 2016[152]).

Private corporations could also aim to attract diaspora investors by issuing their own corporate bonds or equity shares. Considering the diaspora already own some of the largest businesses in the country, their knowledge, networks and experience could be further leveraged – in particular to finance other ventures.

According to a 2013 World Bank study, encouraging citizens abroad to invest in their countries of origin could foster investment and ultimately innovation (Box 15). With the OECD’s support, neighbouring Tajikistan, which has a vast diaspora representing 9.2% of the working population, is currently aiming to leverage the potential of Tajik migrants to support SME development (OECD, 2017[153]).

Box 15. Harnessing the potential of the diaspora

There has been a worldwide growth in diaspora communities, as well as diaspora-focused institutions. Indeed, for fragile states, remittances have represented the largest source of external financing. The trend in mobile banking worldwide has also been linked to the need for easier transfer of remittances – a demand further identified in Afghanistan and beyond.

Remittances to Afghanistan rose from USD 0.88 billion in 2008 to USD 1.99 billion in 2016. To further tap the potential of its diaspora, Afghanistan could consider using the following platforms, which focusing on the diaspora communities of fragile states:

- AFFORD Diaspora Finance[10] supports and stimulates African diaspora investments by providing both funding and mentorship to entrepreneurs in the countries of origin. It offers grants and accelerator competitions, as well as guidance on its website on how to become a successful entrepreneur.
- MicroMentor[11] provides a connecting platform for entrepreneurs and volunteering mentors to assess how to establish a business and best analyse the market and comparative advantages in place.
- Investment platforms such as India Investment[12] (based in India) or Raices[13] (based in Latin America) allow the diaspora to invest in enterprises in their home countries, thereby generating a social and financial return.

Sources: (World Bank, 2007[151]; Diaspora Alliance, 2018[154]; Afford Diaspora Finance, 2018[155]; OECD, 2018[156])

So-called “nostalgic investing” may also help support crowdfunding platforms, on which Afghan SMEs and start-ups could promote their business idea and seek both funding and guidance from the diaspora. These crowdfunding platforms could be identified and promoted by the government and included within the draft SME strategy. The MOIC could also devote more attention to promoting projects to the diaspora and researching equity investors. Organisations in Afghanistan, such as the Danish Refugee Council (DRC) and the United Nations Institute for Training and Research (UNITAR), have assessed the potential of diaspora finance in Afghanistan; the MOIC could tap into this assessment and thus better target diaspora investors.

The government can explore further options to address start-up needs

Asset financing, venture capital and crowdfunding are underdeveloped, and conditions are hardly propitious for their development and diffusion except over the very long term. Yet more can be done to help young firms access finance and receive the guidance they require, namely a mix of financing instruments at different stages of the firms' development. Start-ups in particular require a flexible support system that differs from that required by established SMEs and other businesses (Box 16). They especially require long-term financing, which is lacking in a risk-averse lending environment such as Afghanistan (Wilson and Silva, 2013[89]). Well-designed support can strengthen start-ups in all life cycles, increase the survival rates of firms and foster innovation. Alternative financing has particularly flourished in the Middle East; equity-based crowdfunding now accounts for 67% of the total alternative finance market volume in the Middle East, and donation-based crowdfunding for 16% (OECD, 2018[156]).

Box 16. Public support for early stage finance for young firms

Start-ups have specific barriers and needs when it comes to access to finance. Credit constraints are higher due to information asymmetries (i.e. a lack of information on the creditworthiness of the firm due to its undeveloped stage) and moral hazard (i.e. lenders cannot assess whether the entrepreneurs make appropriate use of the funds). To mitigate the risk, borrowers request collateral, which imposes an additional constraint on young firms that may not even have begun operations. Banks worldwide, but particularly in Afghanistan, tend to be risk-averse when it comes to lending to young firms. Although venture capital firms have aimed to fill this void, the financial crisis has constrained their lending as well.

As part of a broader economic development strategy, OECD governments have sought to address this financing gap (and circumvent a significant market failure) through initiatives designed to "provide critical mass and signal the merits of seed and early stage investments to private sector intervention". The idea is to engender a spill-over effect to facilitate the establishment of a seed and early-stage market. Government intervention has been observed to have a catalytic effect on the establishment of a well-functioning entrepreneurial and financial ecosystem. In 30 of 32 OECD countries surveyed in a recent OECD financing questionnaire, governments had at least one grant, loan or guarantee scheme for credit-constrained small, young and innovative firms, such as:

- Establishment of venture capital funds with state participation;
- Provision of guarantees to risk-capital investors and funds;
- Provision of fiscal incentives to funds or to investors to undertake investments; and
- Creation of equity instruments (direct public funds, fund of funds, co-investment funds).

Source: (Wilson and Silva, 2013[89]; World Bank, 2015[157]; Aghaez, 2017[12]; OECD, 2013[158]);

Supporting incubators and matching opportunities can help bridge financial gaps for start-ups

More financial services could be developed to replicate the model of OECD member economies where, besides providing entrepreneurship and management training and mentoring by experienced business owners, incubators are also set up to help create linkages with financial support agencies and investors that allow for the entrepreneurs to pitch their business ideas and raise seed capital (OECD, 2016[136]).

Because of the importance of supporting young firms in their early stages, the government needs to promote the potential of start-ups to international investors, particularly by organising matchmaking and financial events. These types of events have already taken place under the aegis of Startup Grind[14], an international community for entrepreneurs sponsored by Google as well as local partners. The MOIC could tap into their experience and endorse and/or attend their events; by doing so, it would become acquainted with the start-up "scene" and its needs. Start-ups are increasingly part of strategic documents, in particular the NES, which underlines the need to (ITC, 2018[19]):

1. establish a dedicated business association for young entrepreneurs;
2. promote entrepreneurship;
3. support incubators;
4. create a virtual entrepreneurship ecosystem to foster advice, information, and encouragement; and
5. foster the start-up environment in Afghanistan.

Box 17. Lebanon and its post-conflict start-up scene

After a civil war in 2006, the Lebanese government aimed to support economic recovery and new economic sectors and form a vibrant ecosystem led by tech start-ups. The government progressively recognised the natural development of a niche of tech start-ups between 2010 and 2012, and expanded on these early achievements, by implementing innovative and aggressive top-down policies to spur the growth of the start-up sector. The country is now a thriving tech hub for start-ups in the Middle East.

Thanks to a USD 600 million fund established by Lebanon's central bank, private funds crowded the market, all targeting the knowledge economy. The government also put in place regulations that allowed the entrepreneurship ecosystem to flourish. In addition**:**

- Infrastructure was established – including boot-camps, incubators, accelerators, and co-working spaces – along with services such as business advisory, mentorship and workshops. Currently eight incubators and accelerators are in place.
- Numerous funding opportunities were promoted, such as 1) equity finance, with seven venture capitals offering equity finance in Lebanon; 2) better loan and grant provision for young firms through *Kafalat*, a Lebanese financial company that provides loan guarantees, thereby reducing the lending risk for banks; and 3) crowdfunding platforms. Kafalat is co-owned by the National Institute for the Guarantee of Deposits and fifty Lebanese banks.

- Education and training programmes were established in the sectors requiring the most labour.
- An entrepreneurship culture was established, integrating the concept into workshops, talks, “innovation day” events and competitions.

Sources: (Republic of Lebanon, 2018[159]; Impakter, 2017[160]; Kafalat, 2018[161])

To foster financial intermediation, the government could provide more support to existing business incubators and possibly create new ones. Mapping the current state of incubators would be a first step. The government could:

- Survey participating entrepreneurs and managers of incubators regarding current barriers, with a focus on how to seek seed financing and additional capital at different stages during the life of the company (information could be collected on applicants to the incubators, their acceptance rate, the average incubation time, employment opportunities arising thereof, the number of businesses graduating, revenue figures at the point of graduation, financial needs and long-term survival rates of the graduated firms); and
- consult managers of incubators and start-up initiatives by including some of their representatives in PRISEC and in other consultative platforms.

Preliminary assessments suggest the government could begin to address start-up incubators’ needs in the following ways (Aghaez, 2017[12]):

- skills development for building business cases and preparing financial documents, including training courses at universities and in tertiary institutions;
- business mentorship, by reaching out to successful start-up managers and matching them with current participants of incubators;
- guidance on targeted funding opportunities, competitions, and acceleration programmes by supporting the development of handbooks to be distributed on government websites and offices; and
- support in accessing donor funding that aligns with local ideas of entrepreneurship, including by inviting them to government meetings with donors and mentioning projects to donors.

The government could further identify and address high-priority issues with the help of incubators’ managers. Donors could also play a role by supplying information on previous projects, financing start-ups and new incubators, advising on how to scale up existing incubators and, in the long term, supporting the launch of additional incubators. Over the long term, the MOIC could also create incubators abroad, perhaps in traditional locations for Afghan businesses, such as Dubai and Istanbul. For example, the BINA Initiative for Leadership and SME development for Libyan Youth supports access to finance and business opportunities for SMEs in Libya, including by creating business incubators in Istanbul, which is a key business location for Libyan companies and investors (Organisation of Islamic Cooperation, 2018[162]).

Way forward

Access to finance should be a central priority in the new SME strategy

Afghanistan is in the process of drafting a new SME strategy in which access to finance needs to be a cornerstone. The previous strategy, adopted in 2011, included the formation of an SME Directorate under the MOIC (Mashal, 2014[53]). The directorate remains understaffed, however, with its limited ministerial capacity hindering its planned outreach (SIPRI, 2015[6]). The government needs to incorporate the above-mentioned recommendations into the draft SME strategy.

Channelling donors' funding effectively also requires identifying the country's needs. The new strategy must therefore:

- define priority areas, such as fostering access to alternative sources of financing and improving financial literacy; and
- detail for each area a series of actions – in order to assess needs, define target groups among SMEs (by size/geography/sector) and implement new programmes and/or modify existing ones. Each action must specify a timeline, responsible institutions, performance indicators and sources of funding so as to facilitate both its implementation by the leading institution and the work of the Steering Group in charge of monitoring the SME strategy.

To implement the strategy, the government could design a roadmap with donor support. Given the government's limited internal resources and the challenging country context, the government needs to implement many actions to improve access to finance for start-ups and SMEs. An indicative roadmap for implementing the recommendations is provided in Table 2 to guide governmental action.

Table 2. Roadmap to support the enhancement of access to finance

Recommendation	Short term (6 months - 1 year)	Medium term (1 - 2 years)	Long term (3 - 5 years)
Recommendation 1: Improve financial education for entrepreneurs and citizens	• Map existing financial literacy initiatives • Conduct SME and start-up specific surveys assessing their needs and level of financial knowledge • Consider joining the OECD/INFE	• Draft a financial literacy strategy • Promote financial literacy among the public and build financial management and business planning skills among small business owners • Implement new actions	• Integrate entrepreneurship within the national curriculum • Launch a website
Recommendation 2: Better define and co-ordinate government programmes to support SME access to bank loans	• Increase MOIC co-ordination role between government bodies, donor and strategies • Map existing financial programmes supported by donors • Include access to finance as a priority in the SME strategy • Agree on ways to expand the ACGF and seek ways to create synergies with other programmes • Involve both the MOIC/MoF in the supervisory boards of funding programmes	• Consult SMEs and donors to adjust existing financial programmes and agree on the development of new ones • Develop capabilities in the MOIC to supervise and run financial programmes • Develop internal capabilities in the government on CGS	• Consider establishing an SME funding agency to diversify the loan offer for SMEs and start-ups • Have the government take a more active supervisory role in the ACGF, in line with international best practices in the supervision and regulation of public credit guarantee schemes (CGSs)
Recommendation 3: Improve the conditions for the development of alternative financial instruments	• Put in place adequate legal frameworks for the provision of non-bank financial products and services, including supervision by the DAB and regulations on Islamic finance • Map existing incubators • Consult existing incubators managers and take into account their needs and requests	• Carry out an analysis of existing incubators • Consult donors on how to scale up the existing incubators • Endorse and communicate on existing incubators, including events in Dubai and Istanbul • Promote and encourage investments in start-ups to international funds and the diaspora	• Launch additional incubators based on the identified good practice • Consider launching incubators for Afghan start-ups – for instance, in Dubai and Istanbul • Develop Islamic microfinance and possibly a fund that provides sharia-compliant loans

Source: OECD analysis based on (OECD, 2016[146])

Notes

[1] "Start-ups include all employer enterprises that are up to two years old, i.e. the newly-born enterprises plus those that are one and two years old" (OECD, 2017[84]).

[2] In 2017, according to the Central Bank, the total operational cost of all Afghan banks amounted to AFN 10 354 million, with security costs of AFN 1 152 million.

[3] Hawalas are informal financial intermediaries whose operations are based not on the movement of cash or electronic transfers between banks but on relationships of trust among the network of money brokers. Hawalas are scattered across much of the world, particularly the Middle East, parts of Africa and the Indian subcontinent (Hariharan, 2012[117]).

[4] The Kabul Bank crisis showed the limited capacity of the FSD to control commercial bank lending and revealed the wide-reaching interference of political actors in the banking sector. On-site examinations only started three years into the operation of the bank, and the backgrounds of shareholders were never thoroughly screened. An embezzlement system of immense dimensions occurred, leading to 92% of the banks loans (USD 861 million) being provided to 19 related parties. This was made possible through proxy borrowing, fake capital injections, salary and bonus payments to non-existent employees, fake asset payments, and more. The fraud went up to the highest political stratum, as the brothers of President Karzai and the Vice President himself were major shareholders of the bank. After the chairman of the bank exposed the fraudulent activities, widespread panic broke out among the 1 million Afghan customers, causing the DAB to have to intervene as a lender of last resort. Minor shareholders as well as the CEO and chairman of the bank were imprisoned, although their assets remain were never disclosed. The recovery of all assets is ongoing, with the bank having taken up its activities again in 2011; but the damage to the entirety of the banking sector has been done (SIGAR, 2018[7]).

[5] This paper is too limited in scope to assess how basic literacy skills (38.2% of Afghan adults) may influence the level of financial literacy in Afghanistan and thus ultimately impact the ability to fill in administrative and loan appraisal procedures.

[6] These include the 2017 Land Management Law and the 2018 Strategic Institutional Development Programme for Land Administration (IDPL).

[7] CGSs share the risk between banks, borrowers and the government and can help financial institutions increase their knowledge of and operations with beneficiaries, leading to better lending decisions (PRISEC, 2016[129]).

[8] PRISEC Reform priority 5 is to "lower the cost and increase the availability of financing by expanding existing credit guaranty and microfinance schemes and by making the contract enforcement and debt collection environment more attractive to lenders" (PRISEC, 2016[129]).

[9] See http://aaoifi.com/shariaa-standards/?lang=en

[10] See http://www.afford-diasporafinance.org/

[11] See https://www.micromentor.org/

[12] See https://www.investindia.gov.in/

[13] See http://www.calvertfoundation.org/storage/documents/Ra%C3%ADces_investment.pdf

[14] See https://www.startupgrind.com/kabul/

4. Digitalising public services for businesses

Half of Afghan firms cite the quality of administrative and public services as a barrier to their development. In addition to complicated administrative procedures, businesses face challenges with profit-seeking, which directly affects the formalisation process. This chapter recommends leveraging ICT solutions to improve the delivery of public services for businesses. In particular, it recommends that the government expand the number of mobile phone and internet connections (to reach a greater number of its businesses and citizens) and optimise its digital services for delivery on mobile channels.

Why focus on the digitalisation of public services?

Digital public services can better meet business needs, saving time and costs

Whether through digital or analogue channels, governments provide a range of services that are essential for businesses and entrepreneurs to thrive. These services range from the most basic administrative functions, such as business registration and licensing, to more complex issues, such as taxation, advisory services, export promotion, customs and innovation support. Table 3 provides an overview of selected public services.

Table 3. Typology of selected public services for businesses

Category	Public services for businesses
Administrative procedures	Registration; licensing and permits; land registration; land-use planning
Public order and safety	Security
Social protection for employers and employees	Health; education; pensions
Business development services	Advisory services (consulting, marketing, auditing); training; innovation support; environmental protection and compliance; access to finance
Trade	Market intelligence; trade financing; quality control; certification; export promotion; investment attraction; customs
Taxation	Tax filing and collection

Source: (OECD, 2011[163])

As the world has become more digitally connected and access to technology has improved, new tools have become available to governments as they endeavour to improve business environments. With regards to digital government, this means changing public service delivery channels from analogue to digital – making it possible to submit tax returns and registration documents online – and using digital technologies to create new public value, such as through open data policies and opening new digital channels for user feedback on services' quality.

By digitalising the services that are most needed by the private sector, governments can significantly lower transaction costs while facilitating quicker and more effective dissemination of information relevant to businesses and citizens (OECD, 2014[164]).

Digitalised public services allow businesses to save costs and time with administrative procedures, cutting out physical interactions in favour of submitting information securely and remotely online. Digitalisation can potentially also increase the predictability of service delivery. The removal of physical interactions also lessens opportunities for corruption, with integrated e-payment platforms allowing businesses to pay fees directly and avoid the risk of graft.

Digitalisation can help to improve the quality and accessibility of business services

In Afghanistan, where instability continues to be part of everyday life, the ability to make use of digital public services provides a safeguard against security risks associated with travel to Kabul and regional centres. By extension, the state can improve its ability to engage with businesses formally and provide similar services to businesses with access to a computer and the internet – without needing to multiply its workforce, as would be the case if done manually. While internet penetration is relatively low and infrastructure is poor, mobile phone usage is widespread, which suggests the potential of focusing on mobile-friendly platforms.

Service delivery is poor and services remain difficult for many businesses to access

The 2017 ACCI Business Monitor found that Afghan businesses perceive that a number of key services, such as those required for registration and renewal of business licences, have improved. Nonetheless, businesses continue to complain about overcomplicated procedures, vague processes, informal profit-seeking during interactions with public agencies, and an unequal geographic distribution of available services. At present, most key services are administered via government offices and in newly created (physical) one-stop shops.

The survey data show that more than 50% of businesses see a number of key government services, such as customs, tax systems, security and infrastructure provision, as problems. Private sector perceptions of such services have worsened since 2014 (ACCI, 2017[32]). It is also clear that the quality of services is markedly lower outside Kabul, with, for example, 54% of businesses in Nangarhar having negative perceptions of business registration procedures, compared to 16% in Kabul. Businesses in Afghanistan also express concerns about transparency in government interactions, reflecting low levels of trust in state bodies (ACCI, 2017[32]).

The low quality of government services and the inability to access critical government services hinder the development of Afghanistan's private sector and reduce the incentives to formalise businesses. Difficulties in formally registering, paying taxes and administrative fees make businesses more likely to operate informally. If they have limited access to finance, training, and business development services, the incentive to formalise, or indeed to start any business, is further reduced. In Afghanistan, these problems are further aggravated by geography and security: entrepreneurs might be deterred by the security risks and/or the time and cost required to travel to Kabul or a limited number of regional hubs where government services can be physically accessed.

Digitalisation can help lower security risks, tackle informality, reduce corruption and raise public revenues

Lower travel times and security risks

Digitalised services can make administrative procedures more transparent, accountable and efficient (European Commission, 2016[165]). They can also help reach previously difficult-to-access economic actors. In Afghanistan, where services are largely delivered in Kabul and a limited number of regional centres, and where travel to such places entails security risks and substantial costs, digitalising services such as registration would help reduce costs and risks by allowing businesses and entrepreneurs to perform these procedures remotely.

Enabling business formalisation

Digitalisation can significantly lower the barriers – such as market entry costs, administrative costs, and opportunities for corruption – that might dissuade or impede businesses from engaging in formal economic activity. Digital government is not a panacea for economic formalisation, but it can provide a powerful suite of solutions to address several barriers to formalisation in Afghanistan.

Fighting corruption

Informal profit-seeking occurs during physical interactions with the government and is an important concern for businesses in Afghanistan, ranking second among the issues identified by firms themselves (ACCI, 2017[32]). Digitalisation can bring transparency and accountability through open-access data and the minimisation of face-to-face interactions with officials (European Commission, 2016[165]; Open Government Partnership, 2018[166]; OECD, 2014[167]).

Increased public revenue-raising capacity

Public services involving payments – including customs, tax and access to finance – are regarded as some of the most problematic in Afghanistan (ACCI, 2017[32]). The ability to make online payments opens new digital government possibilities, such as e-filing of taxes and licenses, which could increase public and private sector productivity, and could significantly reduce corruption risks. The adoption of e-filing reduces tax compliance costs, the time required to prepare and pay taxes, the probability of being visited by tax officials, the number of visits by tax officials, and private sector perceptions of tax administrations as an obstacle to business operations and growth (Kochanova, Hasnain and Larson, 2016[168]). At the same time, digitalisation, by reducing the amount of paper-based bureaucracy, can significantly lower the cost of tax administration for the government (ICAEW, 2017[169]). The Ministry of Finance of Afghanistan is planning on launching an e-filing and e-payment system for tax purposes, which will allow tax payers to download their tax returns and forms online – after which they must print them, fill them in, and submit a hard copy physically to the DAB (Ministry of Finance, 2018[77]).

Afghanistan has set ambitious digital government objectives

Digital government has been established as a development goal

The government has long considered digital government to be a key enabler of its development strategy (Government of Afghanistan, 2008[170]). Its objectives in this regard were first articulated in 2003 in its *Information and Communications (ICT) Policy* document, in which the Ministry of Communications and Information Technology (MCIT) stated its intention for ICTs to be widely used within government, with a view to raising public sector efficiency and delivering better social services (MCIT, 2003[171]). The ICT Policy prioritised three areas for development: 1) the integration of ICT and digital government into the overall effort to modernise public services; 2) the rehabilitation and development of new infrastructure, including the establishment of a national data centre; and 3) the development of the National ICT Council. The council was created by presidential decree in 2007, and continues to function as the primary forum for all ICT stakeholders in Afghanistan. Building on previous work on digital government in Afghanistan, the government reiterated its vision for a digital transformation of the public sector through the 2018-2022 *ICT Policy for Afghanistan* (Afghanistan, 2018[172]). Importantly, anticipating some of the recommendations made in this report, the new strategy places a greater emphasis on the use of mobile platforms as a means of making digital solutions more inclusive in the country, particularly in the fields of service delivery and health care.

In 2011, the UN published the *E-Government Strategy Draft for Afghanistan*, which to date stands as the most complete roadmap for digital government in Afghanistan. The e-government strategy included recommendations on: creating a business portal for information relating to business regulations and licensing; providing online and mobile tax services, including SMS reminders and online payment; developing an online and inter-operable system of e-filing of financial reports; creating online SME finance applications; promoting and raising awareness of digital government in the public and private sector; and increasing the ICT capacities of the public and private sectors (United Nations University, 2011[173]). Though commendable, it appears that these recommendations have not been implemented.

A number of initiatives – such as the digitalisation of over 90 000 business license files for use by public officials, and the launch of the digital Public Credit Registry, among others – suggest that the Afghan government is pursuing a more data-driven and digital-focused culture in the public sector (Afghanistan Central Business Registry, 2015[29]). However, these initiatives are often scattered, dependent on donor funding, and disconnected from the 2011 strategy, which should have served as the roadmap for all major improvements.

The digital government strategies the Afghan government is pursuing need to be compatible with the country's economic, security, and connectivity realities – and, in particular, with the constraints imposed by infrastructure gaps, low levels of basic literacy and limited internet usage. Despite acknowledging the benefits that digital government can produce for service delivery, many governments have made misinformed decisions when it comes to project selection, and they have struggled in implementation. Of the World Bank-funded digitalisation and ICT projects that have been implemented globally, around one-quarter were considered by the Bank to be moderately unsatisfactory or worse (World Bank, 2016[13]). The high failure rate of digitalisation projects underlines the need for well formulated, realistic, and competently managed digital strategies that reflect the constraints imposed by a country's socio-economic situation. Cutting-edge technological solutions may fail in conditions where simpler solutions that better reflect the local context could succeed.

The government has begun work on physical one-stop shops, but few services are available in digital format

Afghanistan is conducting several initiatives to implement one-stop shops in the country. In 2016, the governments of Afghanistan and Azerbaijan signed a memorandum of understanding (MoU) to develop a one-stop shop service based on a model used by the government of Azerbaijan, consisting of physical locations and parallel online platforms (Afghanistan Microfinance Association, 2016[68]). The MoU led to the *Asan Khedmat* service, which consists of a physical one-stop shop in Kabul and a number of regional affiliates, though these have yet to be opened. The development of the Asan Khedmat platform is being supported through analytical and co-ordination work by the Harakat Afghanistan Investment Climate Program, with one of its key functions being to communicate developments to private sector stakeholders, keeping them abreast of changes in the government's provision of business services. The World Bank and USAID have also supported the establishment of one-stop shops in Kabul under the Afghanistan Central Business Registry (ACBR) with a focus on registration and tax services at this stage (World Bank, 2018[8]). The creation of the ACBR one-stop shop as well as the implementation of Afghanistan's Independent Land Authority (ARAZI) – which was very recently merged with the Ministry of Urban Development – were also supported by Harakat. A one-stop shop for exports has also been created at Kabul airport.

However, the full potential of these digitalisation efforts has not yet been realised. The leading factors are the lack of integration of the backend and systems, the lack of operational and maintenance funds after launch, and insufficient attention paid to the user-friendliness of the interface (including language accessibility):

- The creation of the Asan Khedmat online portal suggests that a number of the services currently provided to businesses at the physical centres will eventually be provided online. To date, online services have been limited to downloading application forms for services such as passport and visa applications (the forms must still be submitted at physical locations). The website provides a promising platform for increasing the number of services available digitally. The site is mobile-optimised, increasing the likelihood of its use in geographically remote sections (Government of Afghanistan, 2018[34]).
- The ACBR website provides information on registration and documents to download; the ACBR plans to digitalise these services, despite acknowledging its limited internet penetration it the country (World Bank, 2018[8]).
- The export one-stop shop is present only at the airport, with no online solution.

The barriers to digitalisation are substantial in terms of infrastructure, low business involvement and inadequate online solutions

There are a number of significant barriers to the development of digital government in Afghanistan, including:

- The lack of a recent, co-ordinated whole-of-government[1] digital strategy;
- Insufficient ICT infrastructure to support increased internet and mobile penetration;
- Limited consultation of businesses, which inhibits the government's ability to tailor digitalised public services to private sector needs;

- Lack of prioritisation of key services to digitalise in a context of limited resources and capacity; and
- *Ad hoc* application of digital solutions, with little adherence to a broader digitalisation strategy.

Issue 1: The lack of a recent, co-ordinated whole-of-government digital strategy

The government has prepared several strategic documents regarding ICT policies and e-government such as MCIT's *Open Access Policy* (MCIT, 2016[174]), but consistency and co-ordination in their design and implementation have been lacking. Most recently, the *National Action Plan 2018-19* of the Open Government Partnership of Afghanistan includes commitments to developing a platform for digital information management and dissemination and to involving civil society and private sector in development of digital priorities. However, it covers a limited number of public services for civil society (Open Government Partnership, 2018[166]). No consistent, whole-of-government framework has been provided to support government digitalisation since the 2011 e-government strategy.

Afghanistan's attempts to implement digital government solutions, whether the digitalisation of business services or improving citizens' access to basic administrative functions, have suffered from the lack of a co-ordinated approach. The failure of digital government initiatives in Afghanistan to follow a single Digital Strategy has led to duplication of work, atomisation of initiatives and data, and a poor user experience.

Issue 2: The lack of digital infrastructure in Afghanistan

As shown in Table 4, Afghanistan has very low levels of internet penetration, with access being both scarce and expensive. The coverage of the Afghan Optical Fibre Network, which was implemented as part of the Open Access Policy under the MCIT (MCIT, 2016[174]), remains limited to the east of the country. Although the development of optical fibre in Afghanistan has so far been a technical success, it has not yet improved the level of digital inclusion in Afghanistan due to difficult access and high prices for most of the population. The majority of the country, and rural areas in particular, continues to access the internet via costly satellite connections (MCIT, 2016[174]) (ITU, 2017[175]).

A 2015 study of the telecommunications sector in Afghanistan and Mongolia found that monthly broadband packages were "prohibitively expensive" in Afghanistan, reflecting a lack of available international bandwidth and underdeveloped access to international fibre networks. The study found that the average annual fixed-line internet connection in Afghanistan cost USD 828, or 118.3% of nominal GDP per capita, compared with an annual cost of USD 84 in Mongolia, or 2.1% of nominal GDP per capita (UN ESCAP, 2015[176]).

Although internet penetration in Afghanistan is low, an uptake in the use of mobile phones and an increase in cellular network coverage present an alternative route towards a more connected society. In 2018, 90% of the Afghan population was covered by the country's 3G network, with 6.5 million 3G subscribers and over 33 million GSM subscribers, double the total number of mobile internet subscribers recorded in 2010 (Afghanistan Telecom Regulatory Authority, 2018[177]). Moreover, 4G coverage has been introduced to the country, although – as with the fibre optic broadband network – it remains overwhelmingly concentrated in the east.

Table 4. Key connectivity indicators for Afghanistan

Indicator	Afghanistan (2010)	Afghanistan (2016)	Kyrgyzstan (2016)	Pakistan (2016)	Turkey (2016)
Internet Penetration					
ICT Development Index (2017 ranking)*	156	159	109	148	67
Percentage of individuals using the Internet	4	11	35	16	58
International internet bandwidth per 100 inhabitants (bit/s)	1,761	11,966	65,377	16,636	68,058
Mobile Penetration					
Cellular telephone subscriptions per 100 inhabitants	46	67	131	71	97
Mobile broadband subscriptions per 100 inhabitants	0.0	14	46	20	67

Source: (ITU, 2015[178]) (ITU, 2017[175]) (UN ESCAP, 2015[176])
Note: bit/s = bits per second.
* The ICT Development Index (IDI) is an index published by the United Nations International Telecommunication Union, ranking countries on a scale of 1 (best) to 167 (worst), based on internationally agreed ICT indicators. It is used to measure the digital divide across countries and regions. The indicators used in this figure are some of the key subcomponents of the IDI.

A large number of donor-funded initiatives have been undertaken to support the development and infrastructure of Afghanistan's digital government capabilities. These projects have produced policy documents such as the *IT Industry Development Policy for Afghanistan 2015-2020*, the *MCIT Open Access Policy* and the *Open Government Partnership Afghanistan (OGPA)* (World Bank, 2018[8]; MCIT, 2015[179]; MCIT, 2016[174]). Progress on internet penetration is expected following the opening of the fibre market network to the private sector through the government's Open Access Policy and with the support of the World Bank (World Bank, 2018[180]). Although uncertainties remain regarding the capacity of both government and donors to develop the country's ICT infrastructure for internet and fixed broadband, mobile penetration has experienced a strong growth (supported by a rather competitive market) and is expected to continue over the next five years, including the introduction of a 4G network (Harper, 2017[181]).

Although infrastructure gaps remain, there is scope within the limitations of current infrastructure provision to expand digital services delivery substantially. While the government should continue to address infrastructure gaps, it should not preclude the further rollout of digital service delivery, particularly via mobile platforms. In several countries that featured at the bottom of the World Economic Forum's 2016 Networked Readiness Index,[2] such as Nigeria and Tanzania, there are widely-used digital services, including e-payment (World Economic Forum, 2016[182]). Experiences in these countries demonstrate that a fully developed digital infrastructure is *not* a prerequisite for the successful delivery of mobile-optimised digital services.

Issue 3: Insufficient private sector consultation

Digital government initiatives tend to originate within the MCIT, as government reactions to perceived private sector needs. The ability of MCIT to do this effectively is undermined by the limited nature of its consultations with the key stakeholders (especially the private sector, consumers and the MOIC). Despite the establishment of the National ICT Council, whose responsibilities include collaboration between the government and private sector on digital government development, private sector representation remains limited to Afghan Telecom on the National ICT Council.

The ACCI has been involved in work around private sector development in Afghanistan, including PRISEC. The MCIT, as the ministry responsible for internet connectivity in the country, has not systematically engaged with private sector representatives, including the ACCI, to identify barriers and develop practical solutions. While other business organisations and representatives, such as the Afghan Women's Chamber of Commerce (AWCCI), work closely with the Ministry of Finance, the level of co-operation between private sector bodies and the government on the topic of digitalisation priorities could be better.

The absence of an effective feedback mechanism for users limits the data available to the government and therefore impedes efforts to refine and improve digital service delivery. The government does not collect or store data on which services are available on digital platforms or on the number of SMEs using mobile or digital government platforms, and it neither knows how SMEs use these platforms nor promotes their use.

The absence of private-sector engagement was also noted by the World Bank during preparations for the Digital Central Asia South Asia (CASA) project (World Bank, 2018[180]). Recognising the risk posed by a lack of private sector interest in developing the country's digital infrastructure, the Bank adopted a "Maximising Finance for Development" approach to the Digital CASA project, with the aim of crowding in private investment and supporting a competitive market.

Issue 4: Lack of clear digitalisation priorities that correspond to business needs

In order to provide the digital public services that best serve Afghan business needs, the government should make more effort to prioritise services for digitalisation – something it will only be able to do effectively if the issue of private sector consultation is addressed. It remains unclear how digitalisation efforts and projects carried out by the government and supported by donors are selected and to what extent they address priorities for businesses. However, currently there is no systematic planning or coordination of reform activities or priorities among the relevant ministries.

Furthermore, although an increasing number of services are becoming available on the Asan Khedmat online one-stop shop, these are primarily aimed at citizens, not businesses. The ACCI organises yearly business surveys that identify businesses' service-delivery priorities, but the government's use of these surveys is not clear. Greater use of the findings of private sector consultations, including those already done (such as surveys conducted by the ACCI and AWCCI), could help the government identify which services would be of greatest use to the country's private sector and prioritise these for development.

While significant efforts have been made to reduce administrative and regulatory burdens, businesses need further simplification of procedures, which could make the digitalisation of essential administrative services relevant for businesses. At present, the ACBR does not provide online business registration. The ACBR provides clear and accessible information on registration procedures, including a downloadable application form, but all documentation must be physically submitted either to the main office in Kabul or to one of a limited number of regional offices. The Asan Khedmat initiative likewise offers a number of application forms electronically. The forms, for services such as passport and e-Tazkira applications, are available online, but they must still be submitted in person. These services could be considered for further digitalisation.

Many businesses face difficulties relating to services involving payments and could benefit from the provision of a secure e-payment platform. This need was explicitly mentioned as a priority for both the public and private sectors in Afghanistan during OECD Working Group meetings and exchanges with Afghan stakeholders. Although numerous donor-funded initiatives have been undertaken to this end, the use of e-payments in Afghanistan remains limited, and many projects have been marred by failure. These failures highlight the need to ensure that any digital government project fits within the realities of Afghanistan's digital infrastructure and the legislative environment.

Box 18. Difficulties implementing e-payment initiatives in Afghanistan

Various e-payment initiatives have been attempted in Afghanistan by the government and donors, with limited success. A prerequisite for e-payment and mobile payment systems gaining wider use and legitimacy is the ability to electronically authenticate one's identity. The government took a step towards this when in 2017-18 the Ministry of Interior Affairs rolled out the MCIT "e-Tazkira" identity card programme. The e-Tazkira programme makes possible the use of e-signatures and mobile signatures, which could be a key enabler for broader use of electronic and mobile payment platforms.

In 2017, SIGAR reported that a component of USAID's Afghanistan Trade and Revenue (ATAR) programme did not manage to implement an e-payment system of customs duties. The objective of the programme was for 75% of all customs duties to occur electronically by the end of the four-year project, which cost USD 77.8 million. Yet by the end, merely 0.59% of the payments were conducted electronically. The report noted that the contractor charged with implementing the programme had complained of connectivity problems between the Central Bank and the customs authorities, as well as a lack of political will to move away from a cash-based system. The failure was broadly attributed to the inability of the authorities and international donors to sequence project implementation in line with realities on the ground – as in low levels of bank penetration, little electronic or mobile banking use, poor infrastructure linkages between major banks and public agencies, and a lack of digital skills and management capacity.

Beyond applications in customs, the MCIT has made some encouraging steps towards expanding the use of online and mobile payment platforms. In 2017, the second-largest bank in Afghanistan, Azizi Bank, introduced its first online payment system and agreed to co-operate with the ministry to encourage the uptake of online banking services in the country. As part of the new one-stop shop project inspired by Azerbaijan's model, an agreement was finally made between MCIT, Afghan Wireless and Roshan Telecom to pay salaries through a mobile phone platform.

Sources: (MCIT, 2009[183]; SIGAR, 2017[184]; Afghanistan Government Media and Information Center, 2017[30]; MCIT, 2017[185]; MCIT, 2018[186])

Issue 5: Lack of consistency in ICT solutions

Despite the efforts of the MCIT, there is a lack of consistency in the application of digital solutions, resulting from poor sequencing and a lack of policy coherence. For instance, efforts to popularise e-payment platforms have not been accompanied by the development of online authentication and security procedures;[3] and where government websites have been created, these are often not mobile-optimised, despite the fact that the vast majority of Afghans access the internet via mobile devices. Better co-ordination can help to identify and exploit potential synergies and to define digital priorities, which in turn will improve the consistency of digital service provision across agencies and facilitate the move towards a single unified platform.

The government has developed a number of platforms to present its activities and introduce digitalised services, most notably the ACBR and Asan Khedmat. However, although these services are available online, they are limited to information dissemination and a small number of downloadable application forms. Despite having identified the creation of an online one-stop shop as a priority as early as 2011 (it was proposed as part of a new "e-government complex" under the MCIT), no such platform has yet been created (MCIT, 2011[187]).

High-level policy ambitions are often, therefore, out of step with technical capacities, operational requirements and political will. Steps have been taken to digitise certain aspects of physical one-stop shop initiatives, such as the Asan Khedmat platform, but these have been limited to digitalising forms, which must still be printed and submitted on paper. Other initiatives that could facilitate the development of an online one-stop shop could be the proposed e-government academy, state-led incubator services, and platforms for citizen input into policy design (United Nations University, 2010[188]) (United Nations University, 2011[173]) (MCIT, 2011[187]).

Recommendations to improve the provision of digital services for businesses

The experience of OECD countries can help Afghanistan realise its digital government ambitions

The OECD has a wealth of experience in digital-government best practices that has been articulated through the "12 Principles for Digital Government", which serve as a roadmap for the development, implementation and monitoring of key enablers of digital government (OECD, 2014[164]). These principles resulted from the *2014 Recommendation of the Council on Digital Government Strategies*. The linked OECD *Digital Government Toolkit* includes information on each of the 12 principles, details on good practices, a self-assessment tool, and key indicators (OECD, 2014[167]; OECD, 2014[164]).

In line with the current level of digital development in Afghanistan, three principles have been identified as priorities for the country:

- *Principle 2: Engagement and participation in policy making and service delivery*. The key challenges facing Afghanistan are finding ways to engage with the private sector (particularly in identifying digital priorities); devising more-collaborative approaches to policy development; and making digital platforms inclusive, accessible, and effective.
- *Principle 6: Coherent use of digital technologies across policy areas*. Afghanistan needs to achieve a level of coherence across policy areas and the government in

terms of institutional realities, effective co-ordination mechanisms, and digital platforms to support service delivery across different policy areas.

- *Principle 11*: *Procurement of digital technologies.* The overall digitalisation of the country needs to occur in line with current ICT trends and Afghanistan's development objectives.

The following recommendations result from the challenges observed in Afghanistan and are informed by the most relevant OECD principles for digital government.

Recommendation 1: Create a whole-of-government Digital Strategy

The most recent document on digital government in Afghanistan was produced in 2011. Its recommendations were merely advisory and not subsequently codified into government policy (United Nations University, 2011[173]). The MCIT – with the support of the MOIC, other ministries, donors and the private sector – could first assess the result of the 2011 strategy, then produce a new, unified policy document for digital government to reflect updated priorities, such as e-payment and the digitalisation of customs. The Afghanistan Chamber of Commerce could support this work.

Most countries that have effectively integrated ICT solutions into their public service delivery channels and their internal processes (such as Georgia, Mexico and the United Kingdom) have developed comprehensive digital strategies that guide all areas of digital transformation. These strategic documents are drafted in consultation with all relevant public authorities, including co-ordinating ministries, and the private sector.

Afghanistan could follow the examples of OECD member and partner countries, such as Georgia (Box 19), and create a whole-of-government Digital Strategy. The qualitative focus of this strategy should be suited to the particular business and citizen needs in Afghanistan, but the highest priority is ensuring a strong, accountable and transparent mechanism for oversight and co-ordination. Therefore, this strategy should:

1. At the highest level of government (the Office of the President or the Chief Executive), establish the appropriate governance to design, co-ordinate and supervise the strategy: either the MCIT or another public agency should be empowered as the main party responsible for the development and implementation of the Digital Strategy. A senior civil-servant post for executive oversight and co-ordination of digital delivery should be created at the executive level, following the example of the Director of the Government Digital Service of the UK.
2. Establish the responsibilities of the various ministries and public agencies involved in the development and implementation of the digitalisation programme.
3. Establish a political- and technical-level working group, with these groups meeting at an agreed number of times per year. The first of these will ensure that the strategic vision is well understood by management at all implementation levels, securing the necessary political buy-in and promoting a cultural shift towards the integration of ICT and digital solutions into government processes. The second, for instance involving the head of IT of each Ministry, will ensure that technical co-ordination is decoupled from political process, therefore allowing a long-term approach to interoperability and systems management.
4. Cover all key priorities for digitalisation in Afghanistan, including those mentioned in this report as well as those included in the other current government documents

such as the National Action Plan. To avoid duplication, the strategy should ensure mapping of all current digital initiatives.

5. Ensure that common digital standards are used across the government. Afghanistan should look to the examples of scalable digital platforms, such as GOV.UK (www.gov.uk), and ensure that all digital initiatives use a common platform. Doing so will allow improvements to be implemented across the entire government network, and will ensure that strategic prioritisation at the early stage of digital development does not preclude future additions, which can be incorporated at a later date.

Web-based interfaces can also support the implementation and monitoring of government strategies. For instance, the National Export Strategy includes a Strategy Implementation and Management Tool for the MOIC to better translate a strategy solution into results. This web-based interface, in which the MOIC has been trained, may allow for an interactive platform to implement their strategy, retrieve up-to-date data, identify gaps, and more. Considering the NES is interlinked with the NPP PSD, as well as the currently revised SME strategy, this interface could be used to monitor and better implement all strategies underlying the MOIC (ITC, 2018[19]).

Box 19. e-Georgia Strategy and Action Plan 2014-2018

The e-Georgia Strategy and Action Plan is the guiding policy document of Georgia's digitalisation agenda. Drafted in co-operation with experts from Austria, Germany, the UK and Denmark, it contains findings derived from consultations with stakeholders from ministries, public agencies, and the private sector regarding their vision for digitalised government. Over the course of four workshops, these stakeholders met with digitalisation and technical experts, and the proposals were elaborated, reviewed, and strategic priorities agreed upon. Four main goals were identified:

1. organisational sustainability (e.g. IT infrastructure, databases, and security);
2. development and accessibility of the services to satisfy customers' needs;
3. enhancing the development of customer-oriented services for public and private entities and supporting reforms implemented in public sector; and
4. positioning and raising the visibility of public services delivered.

Given the need for improved co-ordination, the composition of Georgia's governance structure is of particular relevance to the development of digitalisation in Afghanistan: a co-ordination body for digitalisation was established, under the auspices of a central government agency or ministry. This body includes key actors from national, regional, and local government.

- Due to the prior existence of an e-government commission, a central unit was reconstituted as the new co-ordination body to take responsibility for implementing the strategic objectives of the e-Georgia Strategy and Action Plan. Operating under the Cabinet of Ministers, the e-government unit was given the powers necessary for deciding ICT developments and investments, as well as for measuring and monitoring the progress of investments related to the e-Georgia strategy.

- To ensure the smooth functioning of this unit, the Data Exchange Agency (DEA) – the body tasked with managing the country's e-government portal and delivering Georgia's digital and physical one-stop-shops – acts as the unit's secretariat, and was to carry out all relevant administrative functions. The DEA is an agency of the Ministry of Justice because the digitalisation of services has a regulatory impact.
- In addition, a civil society forum, with private sector representation, was set up to function in parallel, bringing together public and private expertise as well as channelling feedback to the co-ordinating unit.

Sources: (Krabina et al., 2013[189]; Georgia, 2016[190]; Data Exchange Agency of Georgia, 2018[191])

Recommendation 2: Better co-ordinate ICT infrastructure projects with a focus on mobile connectivity

Reliable ICT infrastructure is a prerequisite for digital government solutions, and its development in Afghanistan will require more investment and support from donors. Fixed internet connections are limited, but strong mobile penetration could create opportunities for digital solutions. For digital services to be widely used by Afghan businesses, it is important that the government continues to develop internet and mobile penetration in the country. If the government hopes to migrate businesses to digital platforms for registration and tax filing, then it must support efforts led by the private sector and international donors to develop online payment systems, optimising these for the country's low bandwidth.

The World Bank's Digital CASA project has developed an extensive roadmap for better digital connectivity in Afghanistan and in Central Asia. The explicit connection made by the project between infrastructure, private sector development, and digital government is an important step that would provide the necessary enabling infrastructure and business climate to support the government's digital strategy (Box 20).

Box 20. Digital CASA: An initiative for digital connectivity in Central and South Asia

The World Bank's Digital CASA project aims to improve digital connectivity and promote the use of digital government solutions throughout Central and South Asia. The aim of the first phase, which began in 2018, is to improve international connectivity in Afghanistan and Kyrgyzstan in three priority areas. For Afghanistan, this means:

1. improving regional and domestic connectivity by connecting provinces to the optical fibre backbone;
2. enhancing the Afghan MCIT's ability to establish and improve "Shared e-Government Infrastructure and Common e-Service Enablers", such as online authentication, e-payment gateways and security safeguards; and
3. creating an enabling environment for private sector involvement and investment in the ICT sector.

Source: (World Bank, 2018[192])

In Mexico, the government has developed a Strategic Plan of Information and Communication Technologies (as part of a Ministerial Agreement for ICT Policy and a Manual of ICT and Information Security) in line with its National Digital Strategy. The plan integrates all ICT projects and initiatives carried out by the different ministries. Each ministry can submit a maximum of seven initiatives for consideration. Managed by the central Digital Unit of the government, the Plan helps focus investment efforts and establish priorities for ICT development across the government (OECD, 2015[79]). If well-co-ordinated with donors, a similar initiative could better co-ordinate and support ICT investments and projects in Afghanistan, including the Digital CASA initiative, the MCIT Open Access Policy and the OGPA.

Recommendation 3: Improve private sector consultation

At present, digital government policy development in Afghanistan draws too heavily from a limited number of public sector sources, with insufficient private sector participation. While the E-Government Directorate of the MCIT has initiated some promising initiatives, they have originated within the public sector.

The government should pursue a more inclusive and systematic approach to policy design and implementation that increases the level of dialogue and engagement with private sector stakeholders. Drawing from the experience of the development of one-stop shops in Mexico4 and Sweden, the government should use business consultations and surveys to identify what aspects of business-related services would be of most use to the private sector, and prioritise these for digitalisation. The current surveys of the ACCI are a solid base for assessing private sector opinion on digital strategy and identifying priorities; these could be complemented by consultations with selected businesses. The government should also ensure that women's business organisations, such as the AWCCI, are consulted during this process; this is particularly important if the government is to ensure differences in preferences and accessibility for women and men are accounted for in the development of the government's digitalisation agenda. Lastly, business consultations would allow for the gathering of tailored feedback on how businesses use, or could use, digitised public services, and how these could be improved.

Box 21. Learning from existing private consultations and players in Afghanistan

The ACCI is the most visible representative of Afghanistan's private sector. It conducts an annual survey of its 65 000 member companies and 255 business unions, and produces a report on how Afghan businesses perceive such topics as obtaining land, the availability of finance, the tax system, customs, public tendering, business registration, infrastructure, skills, security, and attitudes towards women.

Part of ACCI's mandate is to communicate the private sector's concerns and priorities to the Afghan government. This co-operation with the government includes an annual meeting with the President and participation in various government committees where policies affecting the private sector are drafted.

Source: (Afghanistan Chamber of Commerce and Industries, 2018[193])

The government should broaden the membership of the National ICT Council to include greater representation from the private sector, and create working groups with a focus on key pillars of the digital government strategy. In New Zealand, for example, the government set up an ICT Strategic Leadership Group (SLG) supported by four working groups focusing on service innovation, technology, strategic investment and information. The SLG focuses on delivering a coherent strategy, informed by public and private stakeholders, while the working groups ensure that the strategy is deliverable and technically sound. The Council would benefit from a similar division of labour.

The government should ensure that digital government services, as well as the frameworks used for their development, include clear and responsive platforms for user feedback. The feedback should be made available to the working groups and the National ICT Council and should be incorporated into further development of digital policies.

Recommendation 4: Prioritise key government services for digitalisation

Building on its improved consultation with the private sector, the government should create a clearer framework for public service digitalisation, ensuring that efforts are concentrated on areas identified by the private sector as of the highest importance. A number of high-priority services have been already been mentioned in OECD-Afghanistan working groups, and still more have been identified through the ACCI business survey. In addition to the identification of priority services for digitalisation, the government should begin work on those already identified by the country's private sector.

The Principles of Public Administration, which are set out and applied in a number of OECD SIGMA[5] publications, have proven a useful assessment tool for providing best practices on user-centric service delivery design, monitoring and assessment (OECD, 2018[194]; OECD, 2018[195]). The government could use this tool to assess the quality of its current service delivery and its responsiveness to business priorities. This could help to compare Afghanistan with countries currently assessed by SIGMA, including the Eastern Partnership Countries. The government could evaluate its services using indicators of service quality as perceived by businesses, with these focusing on specific services linked to taxation, starting a business, and construction. It is important that the government both collects data on service quality and establishes a mechanism for this information to feed into service planning and delivery.

Registration and licensing

Digitising regulatory procedures such as registration and licensing would significantly streamline interactions between the Afghan government and businesses. Slovenia managed to reduce administrative costs by 71.3% by introducing its "e-Vem" automated business registration system (IFC/World Bank, 2009[196]). In addition to lowering the administrative burden, an online platform for government-to-business interaction, such as an online one-stop shop, would enable businesses located at a distance from the relevant authority to comply with regulations remotely and securely. Such an option would facilitate formalisation for entrepreneurs who have difficulties engaging in formal economic activity on account of travel security.

The government should also consider introducing time-bounded service delivery, wherein it commits to delivering key business services within a mandated time frame. This could be administered in one of two ways. First, it could use a structured fee system – such as that employed in Georgia, where a sliding scale of cost corresponds to a guaranteed delivery time. Alternatively, a softer approach could be taken through 1) the development of Citizen Charters displaying the public administration's commitment towards citizens (Government of Afghanistan, 2018[197]) or 2) the silence-is-consent principle, whereby the ministry or public body responsible for the backroom process establishes a timeframe for approvals, with the decision defaulting to a positive determination for the applicant if the application is not dealt with within the agreed time.

Registration and licensing services have already been included in one-stop shops with the support of the World Bank and USAID, and the planned next steps include their digitalisation. These efforts should be further pursued (World Bank, 2018[9]).

e-Payment

The question of e-payment services was frequently raised during OECD interviews and working groups with Afghan stakeholders. The government should involve the private sector in the development of any e-payment components of its digital strategy to ensure that proposed solutions effectively address business needs.

Afghanistan has very low rates of financial inclusion, with just 0.3% of the population having a mobile banking account (World Bank, 2018[198]). The development and introduction of e-payment systems has been shown, however, to accelerate the growth of financial inclusion, and thus to formalise economic interactions (Ernst & Young, 2013[199]). Given that ACCI survey data demonstrate low business satisfaction with tax and customs services, the government should consult private sector stakeholders to identify whether an integrated e-payment system for online filing would be advantageous and, if so, form a public-private working group to explore methods of realisation.

The government can learn from mobile and online banking providers in Afghanistan, whose money transfer services have become increasingly popular in the country. The expansion of these services, and their interoperability with government e-payment services, will be crucial if e-payments are to become a reliable and effective pillar of Afghanistan's digital government strategy. The example of M-Pesa in Kenya shows how the private sector can contribute to the expansion of mobile penetration and e-payment services (Box 22).

Box 22. M-Pesa: The m-payment experience in Kenya

In 2007, the telecommunications company Safaricom launched M-Pesa in Kenya. M-Pesa is a mobile money-transfer service that allows users to send money (via mobile messaging) and to pay for a range of goods and services, from groceries to utility bills. Within one year of launching, M-Pesa reached 2 million users, and by 2014 the platform was processing 7% of all national payments by value and two-thirds in terms of volume.

M-Pesa has significantly reduced the amount of cash that Kenyans carry and use, and has brought millions who were hitherto excluded from formal financial institutions into the formal economy. It also reduced opportunities for in-person corruption, since the electronic platform is easier to audit and thus more visible.

Programme piloting began in October 2005 and ended in May 2006. During this time, several challenges were identified which remain pertinent to a country in the early stages of e-payment adoption such as Afghanistan:

- Safaricom had to gain the trust of the users and merchants who took part in the trial. To do this, the firm provided analogue resources to help merchants keep parallel records until they sufficiently trusted the system.
- There was a need for ongoing training to ensure that merchants understood all aspects of the system so that they could assist customers with their transactions. Safaricom provided resources to assist merchants, and organised weekly visits from the company to provide "refresher" training.

The pilot demonstrated that there was a market demand for the services, and M-Pesa quickly proved popular among both individuals and businesses. Based on the pilot feedback, Safaricom expanded the services available to include mobile phone coverage and remittance payments.

The experience of Safaricom in scaling up the M-Pesa platform also provides an effective roadmap for expanding awareness and understanding of e-payments – such as the need to set minimum technical requirements for retailers wishing to use the service, the need for these retailers to train their staff so they can assist customers, and the need to maintain a minimum cash float to allow M-Pesa users to easily withdraw cash from their accounts.

Source: (IFC, 2017[200])

The government should also look to the experience of Asian economies where e-payment platforms have been built into broader digital strategies. In Thailand, for example, the government and the private sector have been jointly pushing for the use of e-payments for most transactions (OECD, 2018[201]) (Box 23). Since announcing its National e-Payment Master Plan and National e-Commerce Master Plan, the Thai government has seen rapid growth in the use of e-payment services (Government of Thailand, 2018[202]). Aside from improving expediency and convenience for consumers, these solutions, such as the use of QR code payment services linked to digital wallets, also improve the government's capacity to collect financial data on the country's SMEs, which in turn can inform policy making on issues ranging from taxation to access to credit.

Box 23. National e-payment services in Thailand

The government of Thailand has developed a 20-year Digital Master Plan (DMP) as part of its digital government development strategy. The plan aims to maximise the use of ICTs, using digital technologies to increase the capacity and competitiveness of all economic sectors, with a strong focus on SMEs. To support the country's digital transition, the DMP also provides for an e-Commerce Master Plan (2017-21) and an e-Payment Master Plan.

The e-Payment Master Plan is split into five modules:

1. a "PromptPay" platform;
2. electronic cards and electronic point-of-sale terminals;
3. e-tax;
4. government payment and subsidies; and
5. education and incentive campaigns.

The PromptPay platform is an initiative that allows funds to be received and transferred using a national ID or mobile phone number, with these linked to the user's bank account. Unlike other e-wallet applications, it does not replace a traditional bank account, but acts as a complement. PromptPay allows the government or businesses to transfer money, such as tax rebates or wages, directly into a citizen's bank account using their national ID details. Citizens may also pay with goods directly from their mobile phones, using QR codes to automatically deduct funds from linked accounts.

To encourage the uptake of the service, PromptPay provides one of the cheapest global rates for transferring money, with fees set at zero for all transactions under USD 150. The low cost and general convenience of the PromptPay platform compared with traditional payment platforms has translated into a rapid growth in users: as of the end of 2017, two years after its launch, PromptPay had 37 million registered users, with 35% of all financial transactions processed on a mobile device, up from 10% in the second quarter of 2015.

Sources: (OECD, 2018[201]) (Government of Thailand, 2018[202])

Online identification

One impediment to the use of e-payment services (including digital services such as e-filing and remote payment of administrative costs) is the inability of Afghan citizens to authenticate their identities online. The government should prioritise developing the authentication protocols required to allow users to submit data securely and digitally. This would dramatically broaden access to critical services for businesses outside Kabul. In this regard, the e-Tazkira initiative (see Box 18 earlier in this chapter) is an important step towards the possibility of digital and remote authentication, and its further development should be a major priority. Expanding the e-Tazkira initiative to include protocols for digital authentication would open up a broader range of digital government services.

Recommendation 5: Ensure consistency across government platforms and move towards an integrated online one-stop shop

The government should prioritise a digital government strategy that integrates the views and interests of relevant stakeholders, such as the private sector, business associations, frontline service providers and digital delivery units within government. In particular, it needs to rationalise the development of government platforms in line with real business needs, and work towards delivering these through a digital one-stop shop.

With donor support, Afghanistan should further prioritise the development of a single digital one-stop shop where registrations can be submitted online and where a "digital-by-default" approach is taken to licenses and permits.[6] Over 120 countries now process ICTs for business service delivery online, with 82 offering digital registration services: a prerequisite for a successful digital one-stop shop is making business registration records electronic, which Afghanistan is working towards (World Bank, 2018[9]). The experience of Mexico in implementing a one-stop shop for a wide range of services could guide Afghanistan in establishing a single online platform for government services (Box 24).

Box 24. The development of Mexico's online one-stop shop, gob.mx

To modernise and simplify service delivery for citizens and businesses, Mexico launched an online one-stop shop, "gob.mx" (www.gob.mx). It was designed to provide citizens and businesses with an integrated, modern interface with a government that is responsive to the people and able to deliver services quickly and effectively. Civil society and the private sector were consulted throughout the process, which was incorporated into the design. Private sector-orientated services earmarked for delivery on the national one-stop shop portal were tested in 2014, with a focus on refining the user experience, stress-testing the platforms, and checking the intuitiveness of the design. The project was scaled up and launched in 2015, and a permanent unit was established within the central government to oversee its future development and management.

The portal has been a success in Mexico: it is now the 6th most visited website in Mexico, with 73 million unique visits since its launch. Mexican public agencies have continuously migrated to the platform, with an increasing number of services put online. Some 39% of visits are registered from mobile devices, providing services to those with no access to a personal computer or with mobile preferences. The platform has processed over 27 000 online petitions, and gives access to over 4 000 public services. Acting as a conduit between the population and the government, the platform also has 1 250 questions that are open for public consultation and has a further 217 mechanisms for private-public participation and interaction.

The Mexican experience also underlined the need for a strong legal framework for the project to be successfully designed, tested, implemented and managed. This was provided, initially, via a top-down Presidential decree, which ensured political buy-in.

Source: (OECD, 2014[167])

This need not imply the creation of an entirely new online platform but can stem from expanding existing platforms – for example, the Asan Khedmat one-stop shop or the ACBR platform. The government could use existing co-ordination bodies, such as the ICT Council or the MCIT, or establish a new body, to map the existing platforms and websites, identify which ones are in use and most developed, and focus on supporting and updating a limited number of them while terminating others. The government could invite donors willing to support digital government initiatives to join the effort to develop the single platform. This will ultimately ensure that government services earmarked for digitalisation are digitalised and delivered through one platform, as opposed to being disparately located across multiple agencies.

The government should expand the services available on the Asan Khedmat one-stop shop or the ACBR platform to the extent that current technology allows. This could involve either creating links between the two existing platforms or selecting one in priority for integration of additional services. Currently, the digital services available are limited to accessing application forms, but users are not able to submit these digitally. Priority services for digitalisation should include business registration, license renewals, and e-payment, with the procedures for these also being simplified as part of the ongoing development of physical one-stop shops.

The government should also ensure that any digitalisation strategy has an integrated "once-only principle" (OOP), whereby businesses and citizens need only provide key data once, with the burden thereafter on the state to distribute or share the data with relevant government bodies. The European Union, in a study of the impact of a OOP, found its introduction in Member States were pursuing the implementation of OOP in digital service delivery due to a perceived reduction in the administrative burden on citizens and businesses, as well as a means of increasing efficiency of the government administration and reducing fraud risks (Euroepan Union, 2014[203]).

Finally, all digital government initiatives should be optimised for low-bandwidth mobile platforms, so as to maximise the number of economic actors who can make use of digital services.

Way forward

Limited government co-ordination on digital strategy hampers implementation

One of the principal barriers to the development of digital government in Afghanistan is a lack of co-ordination between government agencies on digital strategy. Though in some cases there have been limited successes, such as the co-operation between the MCIT and the Ministry of Interior on the e-Tazkira programme, the current arrangements are not conducive to the development of a long-term and sustainable digital government strategy.

Although the MCIT has established an E-Government Directorate responsible for digital government and ICT policy, its activities are not closely co-ordinated with those of other state actors involved in service delivery to businesses, such as the MOIC. Better co-ordination across all levels of government is needed between the involved ministries to help design, promote and implement a digital government strategy. This includes improving the governance of the National ICT Council and developing relevant Working Groups focused on digital topics as well as a network of IT heads from each key ministry.

Furthermore, initiatives promoted by donors and international organisations often fail to reflect realities on the ground in Afghanistan. Until an approach is formulated that takes proper account of conditions in the country, it will remain difficult for Afghanistan to translate one-off digital government successes into a coherent digital vision with more significant consequences for the country's economic development.

Better co-ordination across state bodies and greater awareness of digital initiatives will require that the digital strategy enjoys visible, high-level political support. Experience from Georgia and Mexico has shown that the creation of a dedicated digital government office, with representation from ministries and other executive branch institutions (as well as non-governmental stakeholders), can be an effective means of co-ordinating and implementing digital government strategies.

The government must ensure political buy-in at the central and local levels if its digital ambitions are to be successful. Useful lessons can be learned from Switzerland's e-Government Strategy, which provided for the creation of a dedicated working group of specialists from different levels of the Swiss federal system, ensuring that digital government policy was coherent and understood top-down from the central level to the local level (Government of Switzerland, 2017[204]).

Opportunities for blockchain technology solutions

A number of governments in both OECD and non-OECD member countries have begun to explore the use of distributed ledger technologies (DLTs) as part of their public sector modernisation programmes, with the most common of these being blockchain-based solutions (Berryhill, Bourgery and Hanson, 2018[205]). Given the inherent immutability and incorruptibility of blockchain, its employment is a particularly attractive prospect for low-trust jurisdictions where record-keeping is poor and subject to manipulation. The early stage of Afghanistan's digital development precludes certain advanced-use cases – such as in the financial sector – but there are areas where the government might consider blockchain promising.

One area that the government might consider utilising DLTs is in the formalisation of land rights. Given the links between the institutionalisation and protection of land rights with economic formalisation and access to finance (using land as collateral), two of the central topics of this report, this could be a particularly fruitful area for the government to begin its efforts.

As the formalisation of land rights in Afghanistan is poorly developed, blockchain could be integrated into institutional design from the outset. Experience from post-communist economies such as Georgia has shown that, even with a relatively limited level of digital development, blockchain can be an effective tool for formalising property rights, including rights over land. Working with the Georgian Ministry of Justice, the American firm Bitfury designed a system for land mapping and storing land titles on blockchain. This allowed people who hitherto had their land titles recognised informally or not at all to have their property rights recorded and stored in a universally recognised and secure format. The Georgian example also highlighted the possibility of governments leap-frogging stages of digital development by intelligently leveraging the experience of the private sector and targeting the most pressing and relevant use cases for their countries (Bitfury, 2016[206]).

Defining an implementation roadmap for digitalisation key government services

In addition to improving the institutional setting and the overall policy framework, the government needs to define a clear roadmap to implement some of the key measures included in this report. Table 5 provides an indicative roadmap.

Table 5. Roadmap to support the digitalisation of key government services to businesses

Recommendation	Short term (6 months - 1 year)	Medium term (1-2 years)	Long term (3-5 years)
Recommendation 1: Create a whole-of-government Digital Strategy	• Create/expand the digital Working Group co-ordinating the strategy • Appoint a senior civil servant / digital unit at the executive level • Consult businesses and users through meetings, workshops and surveys • Map existing IT solutions and platforms	• Draft the strategy and an action plan based on the existing documents • Create the office of Chief Information Officer, which will oversee and co-ordinate a whole-of-government digital policy	• Monitor the implementation
Recommendation 2: Better co-ordinate infrastructure projects with a focus on mobile connectivity	• Place greater focus on cellular network development in consultations with development partners and private sector • Improve data collection on mobile phone usage, mobile phone generation and capacities	• Support and incentivise the development of low-cost cellular internet solutions for businesses and households • Devise a national awareness and education strategy to prepare businesses and citizens for mobile services	• Expand 3G/4G network coverage to rural areas • Improve competition in high-speed cellular internet market to lower costs for users • Optimise all digital government services for mobile delivery • Build in a ‘mobile/low-bandwidth first’ principle to digital service design
Recommendation 3: Improve private sector consultation	• Collect data on SME use of mobile platforms • Broaden the membership of the National ICT Council to include more business representation • Raise awareness of digital solutions via private sector consultations, at the ACBR and the ACCI and other associations	• Expand the use of ACCI surveys to ascertain business needs for digital service delivery • Establish public-private working groups to work on digital government solutions on specific sectors and solutions	• Ensure private-public communication mechanisms are built into digital service delivery platforms • Develop online consultation of businesses including for a collection of voting systems on proposals
Recommendation 4: Prioritise key government services for digitalisation	• Use improved survey data, map existing mobile-delivered digital services, and identify the most useful ones in consultation with businesses • Prepare the digitalisation of services included in the physical one-stop shops • Identify key services needing e-payment and current solutions • Begin consultation with private sector on the e-Tazkira-linked authentication protocol for e-payment platforms	• Communicate on existing digital services to businesses through the ACCI and media • Create a roadmap for service digitalisation (consulting all relevant agencies) and monitor its implementation (led by MCIT with relevant ministries involved) • Improve co-ordination with banking and ICT sectors to expand e-payment system	• Expand all physically delivered one-stop-shop government services to digital platforms • Enforce a ‘once-only’ principle for service design, ensuring maximum convenience and security for businesses • Run nation-wide campaign to promote integrated e-payment solutions for all government interactions
Recommendation 5: Ensure consistency across government platforms and move towards an integrated online one-stop shop	• Map existing online solutions and websites (including digital services) and identify IT solutions used • Launch a network of heads of IT in each ministry to facilitate technical exchanges on IT solutions • Raise awareness and capacities of public sector employees with regard to digital government services and relevant ICT skills	• Identify which platform is the most relevant for a single online portal • Discontinue redundant sites • Design the new portal (involving users) and create links with other government websites	• Develop, test with businesses and launch the single platform

Notes

[1] A "whole-of-government" approach refers to collaboration between various ministries, public administrations and public agencies to solve a problem.

[2] The WEF Network Readiness Index is composite scoring of an economy's preparedness to support digital solutions.

[3] Online authentication is defined as "a function for establishing the validity and assurance of a claimed identity of a user, device or another entity in an information or communications system" (OECD, 2007[219]).

[4] See Box 20 under Recommendation 5 in this chapter.

[5] SIGMA (Support for Improvement in Governance and Management) is a joint initiative of the OECD and the European Union. Its key objective is to strengthen the foundations for improved public governance, and hence support socio-economic development through building the capacities of the public sector, enhancing horizontal governance, and improving the design and implementation of public administration reforms, including proper prioritisation, sequencing and budgeting.

[6] By "digital by default" we take the definition used by the UK government in its 2012 *Government Digital Strategy*, which defines the term as denoting digital services that are "so straightforward and convenient that all those who can use them will choose to do so whilst those who can't are not excluded." (UK Cabinet Office, 2012[220]).

Annex A. Defining SMEs and start-ups in Afghanistan

MSMEs in Afghanistan are defined based on the number of employees and the level of investment in physical capital. The thresholds vary according to the sector, as shown in Table 6.

Table 6. MSMEs in Afghanistan

		Investment in Equipment Services Sector	
	Number of employees	Manufacturing Sector	Services Sector
Micro	<5	<2.5 mn AFN	>1 mn AFN
Small	5-19	2.5-5 mn AFN	1-2 mn AFN
Medium	20-99	5-10 mn AFN	2-5 mn AFN
Large	>100	>10 mn AFN	>5 mn AFN

Source: (Ministry of Industry and Commerce, 2018[207])

In contrast, the EU defines SMEs as companies with fewer than 250 employees and/or a turnover of up to EUR 50 million. Small companies are defined as those with fewer than 50 employees and a turnover not exceeding EUR 10 million (Ministry of Industry and Commerce, 2018[207]).

The OECD defines start-ups as enterprises that are up to two years old (i.e. newly established enterprises) (OECD, 2006[208]).

Annex B. Data Collection

B.1. Country-specific SMEPI questionnaire

To align previous OECD work with Afghanistan's reform priorities, the OECD team conducted a mapping exercise. This involved assessing the overlap between the ten OECD SME Policy Index (SMEPI) dimensions (Box 25) as well as the key actions PRISEC had outlined to implement its 11 reform priorities. Finally, during the deliberations of the Working Group discussed below, three dimensions were chosen and thus analysed in the report: 1) institutional and regulatory framework for SME policy making, 2) operational environment for SMEs, and 3) access to finance for SMEs.

Box 25. The SME Policy Index

The SMEPI was developed by the Organisation for Economic Co-operation and Development (OECD), the European Commission, the European Training Foundation (ETF) and the European Bank for Reconstruction and Development (EBRD) as a benchmarking tool for emerging economies to monitor and evaluate progress in SME development policies. The SME Policy Index is structured around the ten principles of the Small Business Act for Europe. The methodology has developed since its first establishment in 2012, with an assortment of questions on the following ten dimensions:

1) Entrepreneurial learning and women's entrepreneurship
2) Bankruptcy and second chance for SMEs
3) Institutional and regulatory framework for SME policy making
4) Operational environment for SMEs
5) Support services for SMEs and start-ups and public procurement
6) Access to finance for SMEs
7) Standards and technical regulations
8) Enterprise skills and innovation
9) SMEs in a green economy
10) Internationalisation of SMEs

Source: (OECD, 2016[146])

A questionnaire focusing on these three dimension (plus a general statistics section) was sent for review to the Ministry of Commerce and Industries and to the Da Afghanistan Bank, which both provided extensive responses. The questionnaire was to be filled by an assortment of respondents, including relevant experts.

The questions were prepared by the OECD, and further adapted to the context of Afghanistan. The questionnaire assessed the design and implementation of Afghanistan's SME policies. The answers were to be selected using dropdown menus in the *Answers* column. "Additional Open Questions" sections were provided to allow respondents to offer additional explanations. Links to laws, legislation, websites, strategies and action plans could be added in the *Evidence/Links* column. All questions related to policies and measures under government co-ordination, as opposed to donor or private sector initiatives.

B.2. Interviews

In order to better understand the situation in Afghanistan, and to replace the missions which the OECD usually conducts, the OECD team held a series of interviews over a period of six months. The interviewees (see Table 7) ranged from business representatives to government authorities, international organisations, researchers, and more. The questions aimed at receiving an impression of the current business environment, including relevant challenges. Carried out over the phone, the interviews provided snapshots of individual perceptions; in aggregate, the interviews support crucial arguments given throughout the paper.

In general, it is important to note that surveys or interviews may not be regarded as unbiased information. Sources of bias may include the relationship of the interviewer and the interviewee, the social standing of the participants, or the wording of the questions (Holstein & Gubrium, 1997).

Table 7. Interviewees

Interviewee	Position
Omar Ansari	Founder, TechNation
Muhammad Nassim Attahi	Economic Advisor, USAID
Nicole Bogott	Social Entrepreneur and author
William Byrd	Senior Afghanistan Expert
Humayoon Chakhansuri	Operations Officer, IFC
Ahmad Fahim Didar	Founder, AGHAEZ
Emmanuel de Dinechin; Eric Davin	Project Managers, Altai Consulting
Murtaza Edries	Chief Editor, Business DNA
Suleman Fatimie	Managing Partner, Afghanistan Centre for Excellence
Annalena Fuchs	Technical Assistant Officer, ACGF
Guillemette Jaffrin	Team Leader, World Bank
Richard Ghiasy	Researcher, SIPRI
Gaël Griette	Attaché for Economic Development, EU Delegation to Afghanistan
Ewa Janikowska	Chief Risk Officer, Aziz Bank
Jawad Joya	Policy Advisor, PriSEC Co-ordination Body
Wagma Korakhail	Senior Country Officer, IFC
Anna Law	Cash Advisor, Norwegian Refugee Council
Abdul Mujeeb Mohmand	E-Gov Director, Ministry of Communication and IT
Sayed Reza Mustafavi	Industrial Park Government Directorate, Technical Assistant
Masood Parwanfar	Head of FoA III “Business Barrier Reduction & Private Sector Development”, GIZ

B.3 Working Groups

Within the framework of the OECD Eurasia Competitiveness Programme (ECP), the OECD and the government of Afghanistan established a public-private working group to develop guidelines and recommendations for boosting private sector development and entrepreneurship in Afghanistan. The Working Group brought together representatives from government agencies, SMEs, business associations such as the Chamber of Commerce and Industry, and other development partners. The OECD ECP, with contributions from international experts and peer reviewers from OECD member countries, carried out analysis, data collection and consultations with stakeholders in Afghanistan to identify the main issues and the most effective policy responses to strengthen the Afghan private sector.

Several missions took place in preparation for the peer review of Afghanistan:

- **24 January 2018:** first meeting of the Working Group to frame issues and share insights with local stakeholders, Dubai, UAE;
- **26-27 April 2018:** second meeting of the Working Group with international experts to discuss preliminary recommendations, Istanbul, Turkey;
- **2-3 October 2018:** third meeting of the Working Group with international experts to discuss the peer review note and its recommendations, Istanbul, Turkey.

This report was peer reviewed on 19 November 2018 at the sixth session of the OECD Eurasia Competitiveness Roundtable, a policy network that brings together high-level representatives and technical experts from Eurasia countries, OECD members and partner organisations. The Roundtable meets annually and serves as a platform for peer review and knowledge sharing on the implementation of competitiveness reforms in the Eurasia region.

The peer review aimed to help Afghanistan define further steps for policy reform implementation. In particular, the roundtable discussion was facilitated by the following experts, who provided an overview of the current situation in Afghanistan and insights into the experiences of OECD and Eurasian countries:

- Mr Tuna Sahin, Vice President, KOSGEB, Turkey
- Mr Kenan Bagci, Director, SESRIC, OIC

In addition, OECD experts from the Secretariat (on formalisation, access to finance, financial literacy, digitalisation, tax and private sector development in fragile states) – who had previously provided their insights and reviews to the peer review note – participated in the discussions.

Progress towards implementing these recommendations could be discussed in two years' time at the 2020 OECD Eurasia Competitiveness Roundtable.

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BOOSTING PRIVATE SECTOR DEVELOPMENT AND ENTREPRENEURSHIP IN AFGHANISTAN

The OECD has closely co-operated with the government, the private sector and international partners to formulate policy recommendations to support private sector development in Afghanistan. This report summarises this work and analyses the important hurdles firms face, ranging from lack of access to finance and public services to the burden of tax compliance. It suggests three sets of actions: (1) measures to encourage firms to move to the formal sector through better institutions and incentives, (2) steps to improve access to finance to allow firms to grow and (3) digital solutions to improve public service delivery to firms, with a strong emphasis on mobile-friendly platforms.

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