

Afghanistan Research and Evaluation Unit

Working Paper Series

**ENABLING OR DISABLING?
The Operating Environment for
Small and Medium Enterprises
in Rural Afghanistan**

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Glossary

<i>gilim</i>	flat tapestry-woven carpet or rug
<i>seer</i>	unit of measurement equivalent to 7kg

Acronyms

AISA	Afghanistan Investment Support Agency
ANDS	Afghanistan National Development Strategy
AREU	Afghanistan Research and Evaluation Unit
DAGRIS	A French textiles corporation
NAPCOD	Northern Afghanistan Project for Cotton and Oil Development
SME	Small and Medium Enterprises

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I. Introduction

Government's investment programs in agriculture and rural development reflect the priority needs of the majority of Afghans, who reside in the provinces. Agricultural reform will help to diversify and restructure the agricultural economy, creating high value production... Government's goal is to achieve pro-poor growth in rural areas by enhancing licit agricultural productivity, creating incentives for non-farm investment, developing rural infrastructure, and supporting access to skills development and financial services that will allow individuals, households and communities to participate licitly and productively in the economy.

(Interim Afghanistan National Development Strategy, pages 131 and 145)

Agriculture and rural development are emphasised in the January 2006 Interim Afghanistan National Development Strategy (IANDS) as important factors in effecting much needed transition from a largely informal economy to a formal and prospering one geared toward improving Afghan livelihoods and strengthening the revenue base for the national government. According to the Afghanistan Millennium Development Goal Report (2005), agriculture accounts for over 50 percent of the licit economy and provides employment to almost two-thirds of the workforce. In 2003, the National Risk and Vulnerability Assessment (NRVA) estimated that agricultural activities contributed to the income of 63 percent of Afghan households, with significant diversity on a provincial, district and even village level.

This paper provides an overview of the key challenges faced by small and medium-sized rural enterprises (SMEs) in Afghanistan. The evidence is drawn from secondary sources as well as primary data collected during fieldtrips to the provinces of Bamyan, Balkh, and Nangarhar. The secondary data are from widely available government and non-government sources such as reports and briefings, while the primary data are from interviews with SMEs involved in commercial agricultural production, food processing, marketing and trading in the three provinces. The case studies, combining the data from secondary and primary sources (interviews with key informants in Kabul and in the field), are analysed to formulate a series of recommendations aimed at improving the operating environment for rural SMEs. We begin with a general description of the regulatory context and some of the formal institutions with key roles in rural enterprise development.

II. Regulatory and Institutional Background

In the Interim Afghanistan National Development Strategy (IANDS), the Afghan government has committed to develop, by the end of 2010, a policy and regulatory framework to support the establishment of small and medium-sized rural enterprises in the 34 provinces. IANDS commits to investments in both agricultural and non-farm enterprises in rural areas as part of its growth and employment generating rural economic development.¹ The document also emphasises the facilitation of light industry in rural areas to add value to agricultural production. A number of ministries and agencies have been charged with the responsibility to implement measures likely to add value to agricultural products and foster the growth of agri-businesses. However, the roles and responsibilities are far from settled and undergoing continual change and evolution. Periodic name changes of key government ministries are accompanied by redefinitions of roles and responsibilities,

¹ Existing rural enterprises include the cotton and leather industries, manufacturing and agro-processing including the processing of plant oils, vegetable and fruit conservation, flour milling, and dairy production. Additional farm-based enterprises include milk and meat processing. Non-farm rural enterprises include carpet weaving, sewing and tailoring, fertiliser production, and collecting and selling of wild plants.

which continue to change in size and importance. This renders attempts to map formal institutional arrangements difficult and perhaps not very useful at the present time.

The Ministry of Agriculture, Animal Husbandry and Food (MAAHF), renamed in 2007 as the Ministry of Agriculture and Irrigation (MAI), has been responsible for the commercialisation of agriculture and encouraging greater agricultural productivity through use of improved seeds and the cultivation of crops with good market opportunities. The five-year Agriculture Master Plan contains provisions and budgeted funds for assisting entrepreneurs' and farmers' associations in gaining access to credit and government land, as well as cooperation with other ministries in finding regional and international markets for agri-business products. Donors such as the World Bank have been very supportive of the Ministry's attempts in this regard, committing significant funds for the next five years. Other key donors have been the Asian Development Bank (ADB) and USAID. ADB is currently preparing a commercial agriculture project that will focus on value addition and support of the private sector in exploiting domestic and regional markets for agri-business products. For the last few years USAID's Rebuilding Agricultural Markets Program (RAMP) has focused on elevating Afghan agricultural products along the value chain through encouraging local processing, improving irrigation, enhancing storage capacity, improving road access, identifying foreign markets for Afghan agricultural products, and facilitating links between local producers and foreign markets.

Because of the emphasis on the role of private sector in rural development, the Ministry of Commerce, recently renamed as the Ministry of Commerce and Industry (MoCI), has also been deemed as having a role though at the present time it is unclear exactly what this role entails. The MoCI could potentially provide advice based on their current endeavours to streamline the regulatory environment to promote and nurture national and international private-sector activity in the Afghan economy as a whole.

The Ministry of Rehabilitation and Rural Development (MRRD) plays – and will continue to play – a key role in advancing the agenda for further development of agricultural production systems. In the period immediately following the fall of the Taliban regime, the MRRD was at the forefront of emergency aid provision and food security programmes in rural areas. The MRRD's most important role to date in rural business development has been linked with the National Solidarity Programme (NSP) and the National Area Based Development Programme (NABDP) under which the Ministry is currently undertaking a significant research project on rural economic development with the aim of producing a detailed policy strategy.² Under the Master Plan, MRRD is charged with leading the efforts in creating an enabling environment for rural private sector, a task inconsistent with MRRD's functions to date and one requiring a substantial shift in the Ministry's approach and the "mental model" of providing for people rather than arm's length facilitation for private-sector development. Carried through with diligence, there are grounds for optimism that the implementation of the Master Plan objectives will provide the impetus and support for the MRRD to assume its new role.

The 2005 Master Plan is committed to measurable economic growth in agricultural activity while emphasising local participation and ownership. The two sectors targeted are horticulture and livestock. A key feature of this strategy is to create an enabling environment for rural SMEs to thrive in areas and regions with the potential to yield the highest productivity and return on initial investment. This focus raises numerous issues in relation to transport and energy infrastructure, production technologies in use in agriculture, and rural wellbeing. In the next section these issues are investigated in case studies drawn from the Balkh, Bamyán, and Nangarhar provinces.

² Of key importance in these developments is how Community Development Councils (CDCs) for community-based development will evolve in the local governance structures and the role they will play in rural economic development.

III. Case Studies

This section presents some of the key issues related to the commercialisation of agriculture and related rural SME development through ten sub-sectoral case studies conducted in the provinces of Bamyan, Balkh, and Nangarhar. Based on the analysis of the case studies, the picture that emerges for the SME operating environment is mixed. Like most rural and other enterprises, productive activity suffered significantly due to the years of conflict which translated into scarce or unreliable supply lines, erosion or disappearance of market shares and supporting institutions, and outright hostility (particularly under the Taliban) toward some farming communities, creating an operating environment best described as “disabling” for rural entrepreneurs. Although the conditions have improved significantly since 2001, certain aspects of business activity continue to demand further improvement. In the remainder of this section, the findings from the case studies undertaken for this research are presented in summary form.

Case Study 1: Potato production and marketing in Bamyan

Mostly people produce potato and wheat. Wheat they produce for themselves to survive. Potatoes they produce for market but because we do not have good facilities like roads . . . the people do not have easy access to the markets. This is why Bamyan people are poor.

Bamyan governor Habiba Surobi³

Potatoes are the most important cash crop produced in the Bamyan province. Key issues related to the commercialisation of potato production can be summarised as follows:

- **Pressures to sell at low prices directly after harvest:** Potatoes are harvested in August and September. Farmers needing to sell their harvest to traders in September, directly after harvesting, would receive around 50 Afghanis per *seer* (7kg), but at other times of the year they could sell for up to 80 Afghanis per *seer*. This is particularly a problem of the poorer farmers.

Ineffective traditional storage methods: The traditional storage method which involves storing potatoes in the ground leaves the stored potatoes vulnerable to frost damage and dehydration resulting in reduced tonnage and quality.



Traditional potato storage methods



³ Tselim Saheb Ettaba, AFP, 12 October 2006, In *Afghanistan, Bamyan suffers for being calm*, www.metimes.com/storyview.php?StoryID=20061012-062048-3480r

- **No direct access to the market:** Most farmers in Bamyan City sell their potatoes to traders and truckers, as they are unable to arrange transport to the market in Kabul themselves. Traders selling the potatoes in Kabul could make a profit as high as 30-40 Afghanis per *seer*.
- **High costs due to poor road conditions and inadequate road infrastructure:** The lack of adequate infrastructure within the Bamyan province and between the province and Kabul and Mazar-i-Sharif were pointed to by some interviewees as the largest obstacle to development of potatoes as a commercial crop. Poor road conditions result in increased costs for the producers as shipments take longer and the produce is likely to be damaged due to uneven road surface and transportation time. As a result, Bamyan potatoes cannot effectively compete with potatoes imported from Pakistan and Iran, served by better transportation routes than those leaving Bamyan for Kabul. Pakistani suppliers also have access to cold storage for fruit and vegetables in Peshawar and Jalalabad, putting the Bamyan traders at a significant disadvantage.
- **Lack of a market for processed potato products:** The potential for further value addition in potato farming is limited not only due to the poor infrastructure but also the lack of knowledge about the market for processed potato products. In any event, setting up a commercially viable potato drying project, for example, would need to take place on a larger scale than is currently feasible in Bamyan. There is currently a lack of market research, which makes it difficult to establish whether there is in fact a large enough market in Kabul for potato-based products to justify large scale investment in potato processing.

Initiatives to overcome some of the above listed impediments include the following.

- **The use of genetically modified potato seeds:** There has been some assistance to Afghan farmers, including some in Bamyan, in using improved and “virus-free” potato seeds. The International Potato Centre, based in Peru, increased the supply of virus-free potato seeds in Afghanistan for local needs as well as future export to neighbouring countries. The successful training of farmers and the testing of new varieties expanded from Jalalabad to Kabul and Bamyan districts. Some farmers in Bamyan have used virus-free seed produced in Jalalabad since 2003.⁴

Trader-initiated market intelligence system: Digital connection through the Roshan mobile phone network has been very useful as a channel for farmers and traders in Kabul to communicate market information so that farmers can plan their shipments to Kabul more effectively.

- **Building modern storage facilities:** A number of organisations have been involved in building modern potato storage facilities in Bamyan. The new facilities have helped farmers plan the marketing of their products so as to get a better price. Two organisations are currently involved in building storage sites: the French NGO, Solidarités, and the Citizens Network for Foreign Affairs (CNFA). CNFA has built 22 potato storage facilities in the Bamyan province with funding from the US Department of Agriculture. CNFA provides the wood and stone and oversees the building process, whilst the farmers themselves provide the labour. The farmers involved are not in the poorest categories, however, as only farmers able to produce beyond subsistence levels require storage facilities.

⁴ International Centre for Agricultural Research in Dry Areas (ICARDA) www.icarda.org/Afghanistan/PDF/FHCRAA.pdf. It has to be noted that the long term ecological impact of modified seeds, if any, are currently unknown but will need to be monitored closely.



Modern potato storage facility, built with CNFA assistance

The size of storage facilities varies, but farmers interviewed in this study reported that the sites had an average storage capacity of around 8,000 *seers* (1.1 tons) of potatoes. The full impact of these initiatives on the scale of production for the Bamyán province could not be determined. It is certain, however, that increased access to storage facilities is likely to lead to increases in the capacity of some farmers to produce higher volumes of potato while maximising returns on the sale of their crops.

Case Study 2: Apricot production, processing and marketing in Bamyán

The marketing of processed fruits, mainly apricots, has a long tradition in Kahmard, Saighan and Yakawlang districts of Bamyán. Traditional fruit drying methods are very small scale and rudimentary. Apricots are dried in the sun on the roofs of houses. Currently, processing fruit is the only effective way to market Bamyán fruit in Kabul, as the poor road infrastructure and lack of refrigerated trucks make transport of fresh fruit to markets outside Bamyán very difficult. There are a number of small-scale, pilot initiatives aimed at increasing the profit margins of producers and traders through improved processing methods and better access to markets. These are implemented through the local NGO Spring of Construction, Rehabilitation Cultural and Social Organisation (SCRCO) under the Community Empowerment Programme for Women (CEPW) of the Ministry of Women's Affairs and the Aga Khan Development Network. Some of the key issues are as follows.



- **Insufficient supplies:** Acquiring sufficient fruit for drying has been difficult as many fruit trees in Kahmard have been damaged by drought and parts of the first crops have been prone to frost damage.
- **Lack of electricity and poor road infrastructure:** A number of respondents reported that small scale processing such as the production of juices and jams would be a viable commercial proposition in Bamyán, were it not for the lack of electricity, the prohibitive added cost of running diesel generators, and inadequate road infrastructure to transport finished products to various markets. While some village households are gaining access to electricity through small scale

hydroelectric generators constructed as part of the NSP programme, the electricity produced through these schemes is not sufficient to support small scale industrial production.

Initiatives to overcome some of the impediments include the following.

- **Introduction of new processing technologies:** There has been some success in introducing new drying methods using sulphur to improve the appearance of the product and increase the appeal to the consumers in Kabul. Apricots dried without sulphur are sold to traders at around 100 Afghanis per *seer* (7 kg) whereas sulphur dried apricots are sold for up to 500 Afghanis per *seer*.
- **Improving access to markets:** The SCRCO project has organised marketing expeditions to take the apricots to the bazaar in Kabul in attempts to bypass intermediaries between the producers in Bamyan and the retailers in Kabul.
- **Product diversification:** SCRCO is aiming to extend the apricot project to more beneficiaries and has submitted a proposal for a small fruit processing plant to produce juice from grapes, apples, and cherries.

Despite some of the major issues such as poor road transportation and absence of reliable energy supply, the picture that emerges from the two case studies in the Bamyan province is positive. Government and donor assistance seem to be directed at areas of rural production which have the potential of increasing productivity and/or moving up the value change, given the opportunity and facilitation. It is too early to state definitively and in precise terms the impact of assistance initiatives in Bamyan. Future research will be needed to assess this impact after sufficient time has elapsed and production patterns have become better established. It is doubtful that the situation would improve significantly over time, however, if the infrastructure issues remain unresolved.

Case Study 3: Cotton production and marketing in Balkh province

Balkh province produces a significant quantity of high quality cotton. To get a sense of the operating environment for cotton processing, two plants were visited in the course of this research. One was the formerly state-owned factory "Jenopress", and the other was a locally owned and operated plant. Since 2005, Jenopress has been operating under the auspices of the Northern Afghanistan Project for Cotton and Oil Development (NAPCOD), a joint venture of DAGRIS, the Agence Française de Développement, and the government of Afghanistan. It is hoped that the consortium now managing the plant will create over 300 permanent and around 150 seasonal jobs when in full operation. The personnel interviewed had a long list of concerns about what they perceived as barriers to business activity:

- **Outdated machinery:** Most of the machinery at the factory is of German or Russian origin, dating back to the 1940s and 1960s.
- **Lack of adequately trained staff:** The plant does not have a sufficient number of trained technical operating staff. Most of the existing technical staff are Russian-trained and spend most of their time fixing old and dilapidated machinery.
- **Unreliable electricity supply:** To deal with constant power outages, the plant has recently purchased two large generators to maintain continuous production. The use of generators is more costly than grid-supplied electricity.
- **Unreliable supply of cotton through contract farmers:** Agreements have been reached with the local cotton growers to sell their crop to the plant at a pre-set price in return for receiving genetically modified cotton seeds and fertilisers.

However, the black market for harvested cotton offers a higher price than the pre-set price and many of the farmers sell their crops on the black market, depriving the plant of a reliable source of raw material. According to one interviewee the only way the black market could be eliminated would be by raising the pre-set price, something that the plant cannot afford to do financially. Without some degree of assistance from the government to discourage farmers from selling on the black market (through subsidies to the farmers, for example), a senior management official at the plant expressed pessimism about the long-term sustainability of the business.

A more optimistic picture emerged during the interview with the second cotton producer. In the past this producer used to ship everything to Mazar-i-Sharif for processing. In order to increase revenues, the proprietor decided to purchase processing machinery and to do some of the processing on-site. During the past eight years the plant has acquired a number of machines for ginning and seed oil extraction. Steadily, the plant has established itself in the local market and its oils are sold in markets of nearby provinces. However, three issues were raised as main concerns as follows.

- **Lack of quality control systems:** In response to a question regarding the quality and the grading of the oil products, the interviewees said that to date they had not felt having a quality control system was necessary. No laboratory tests are conducted to determine the quality (or the safety) of the products. Testing of the finished product (oil) is particularly necessary since many locals collect their own seeds, bring them to the plant for processing, and are allowed to feed the extraction machines with their collected seeds. This represents a potentially serious threat to the reputation of the plant as the consumption of contaminated cooking oil can be fatal. The safety issue is particularly important since some processes involve use of toxic and corrosive chemicals such as caustic soda.
- **Inadequate energy supply:** As with all other SMEs interviewed, concern was raised at this plant about the higher cost of generator-supplied electricity as compared to power supplied through the grid.
- **Fear of demands by government officials to pay taxes, fees and other charges:** The plant was not willing to share detailed financial and operational information with the interviewers because of a fear of being forced, by officials, into paying taxes and other charges on the account of owning production machinery and other equipment. This fear of revealing information is a major barrier in attempts to formalise economic activity.

No information was found on initiatives by government or non-government organisations to address these concerns.

Case Study 4: Raisin production and marketing in Balkh province

Despite over two decades of strife and a long period of drought, agricultural business has continued in Balkh province – albeit with significant fluctuations in the volume of production, productivity, and deterioration in the operating environment for SMEs. While traders of agricultural products have continued to operate during and after the years of conflict, the conditions have not been conducive to emergence and sustenance of other, more productive enterprises involved in value-adding activities. Agro-processing has suffered from a lack of capital investment, resulting in outmoded production machinery, reduced product quality, and a loss of markets.

Of the thirty or so raisin processing factories that once operated in Afghanistan only a few remain.⁵ There are five raisin processing operations in or around Mazar-i-Sharif with only two working at full capacity at the time of fieldwork for this research.

At the time of visit, one of the two raisin processing plants was operating at full capacity. In addition to processing raisins, the plant processed cotton, extracted oil from cotton seeds, and processed almonds, pistachios, and walnuts. The plant makes its own packaging cartons using cardboard and polythene, employs around 70 people, and purchases raw materials from numerous local sources as well as from outside the province. The second raisin processing plant visited has been in operation for only a short while. It employs 30 men and 20 women. The raisins are packaged for export. To reach foreign markets, the plant has an agreement with a Russian trade company which markets the raisin along with many other products from Russia. No specific difficulties were expressed at the interviews and a general air of optimism about the future prospects was noted during the visit.

A dried fruits trader in the bazaar underlined some of the key issues faced by raisin producers in the province as follows.

- **Lack of processing capacity:** Much of the raisin on sale in the bazaar is of Afghan origin but processed in Uzbekistan. This points to inadequate or uncompetitive processing facilities within the province for adding value to primary farm produce.
- **Loss of local market for local producers:** During the height of the conflict and the drought, many traders had to look for new suppliers from the surrounding countries. While this practice has sustained retail trade, it has adversely affected the demand for locally grown produce.

No specific government or non-government initiatives to improve the operating environment for local producers and processors were identified during this research. Regaining the lost market share by local fruit growers is likely to be a function of time, given sustained socio-political stability, normal annual rainfall, and external impetus to re-establish a strong local production system capable of value addition.

Case Study 5: Fertiliser production in Balkh province

Production at the fertiliser plant near Mazar-i-Sharif has continued during and after the years of war. However, production today faces a number of serious challenges:

- **Reduced production volume:** Under the Soviet-backed governments the plant operated 24 hours a day producing 320 tons of fertiliser per year. The plant also produced a number of industrial gases. Currently the plant still operates 24 hours a day but produces only 100 to 120 tons of fertiliser per year.
- **Outdated machinery and lack of technical expertise:** The machinery is antiquated and the engineering expertise provided by Russian engineers is no longer available as before.
- **Threatened or costly fuel supply:** The pipeline from Shabarghan gas fields supplying the plant with natural gas is tapped into illegally by local strongmen. This threatens the supply line and adds to fuel costs for the plant.
- **Reduced product diversity:** The plant no longer produces industrial gases in order to streamline its production.

⁵ Lister and Brown, 2004

- **Loss of market and unfavourable marketing arrangements:** The Soviet-backed government had a purchasing agreement with the plant under which all the fertiliser produced would be purchased and distributed by a government agency to the farmers. This agency no longer exists. Currently a private dealer purchases the entire production and sells it in the free market to the highest bidder.

The fate of this fertiliser plant is symptomatic of most other state-owned or previously state-owned industrial operations. Because of the years of conflict and changing government priorities, in the post-Taliban period state-owned operations in general have suffered from being under-resourced in many respects, particularly in terms of raw material, energy sources, and market access or selling arrangements for the products or services produced. The move from centrally planned and controlled industrial management to market-based industrial management has meant that during the transition, state-owned operations have been largely neglected. Deprioritisation of support for these operations by the state has meant uncompetitive salary structures, resulting in a flight of experienced personnel and expertise, a diminished market share, and outmoded production machinery. Given the current trend of corporatisation and privatisation of state-owned operations, it is likely to be long before socio-economic stability can act as an impetus for sustained, economically competitive production.

Case Study 6: Carpet and *gilim* weaving in Balkh province

Carpet and *gilim* weaving has been and continues to be an important economic sector in Afghanistan as a whole. Interviews were conducted with two carpet/*gilim* weaving and cleaning workshops in Balkh. Key issues that emerged during the research include the following:

- **Domestic supplies:** Wool supplies have been chronically unreliable. To meet demand, the carpet weaving and cleaning workshop imports wool from Pakistan, Saudi Arabia, Iran and some European countries such as Belgium. The dyes are almost entirely imported from abroad with German dyes being of the best quality.
- **Market access:** Afghan traders working on commission purchase carpets and *gilim* at wholesale prices on behalf of larger and more established Pakistani traders. The interviewees reported that much of this trade is illicit and the purchased carpets are smuggled out for wholesalers and exporters based (mainly) in Pakistan. In Pakistan the carpets are cleaned and if necessary, repaired, and labelled as “Manufactured in Pakistan” for sale in domestic and foreign markets. Most Afghan producers and traders have little or no direct access to the markets in Pakistan or beyond.
- **Institutional support:** The main problem was described as a lack of a well-coordinated and institutionally supported marketing offensive to capture sizable segments of the very lucrative export market for handmade carpets. This problem has been recognised by government and development aid officials who have paid numerous visits to the carpet workshops in the area and have made assistance commitments to increase access to markets. According to the interviewees, however, to date nothing has been done by the officials to remedy this situation.
- **Access to credit and corruption:** A second problem is the difficulty in obtaining credit from major national banks which, according to the interviewees, have “extremely difficult” qualifying requirements. Some loans intended for business development are reportedly widely misused by the recipients and spent to serve personal purposes.

- **Access to import/export licences and corruption:** Licenses are very difficult to obtain and those who manage to obtain them for importing cleaning materials or certain types of wool, for example, have a *de facto* monopoly on the supply and thus the prices. The interviewees expressed a wish to have the right to import their own production inputs so as to have more of a say on the quality and the price. There were also remarks about corruption and how the monopolists were being protected by officials so as to maintain the status quo.
- **Pressure from imports of finished products from neighbouring countries:** A relatively new feature in the business of carpet traders is the import of finished products from neighbouring countries such as Tajikistan, Uzbekistan, and Iran. There is also an increase in the import of raw materials such as dyes and wool from these countries. Nevertheless, much of the value-adding activities reportedly continue unabated in the province.

Some carpet weaving workshops have experimented with more innovative ways of organising production. One of the workshops set up a work area for women who had traditionally worked from home. The purpose was to increase productivity and a more structured and controlled work environment. However, this experiment proved impractical: The women found it more convenient to work in their home environment because they could simultaneously attend to carpet weaving and (unpaid) domestic work. Based on a mutual agreement with the employers the women reverted back to working from home and being paid on the basis of the amount woven.

According to the traders interviewed in the bazaar, rural businesses such as carpet making remained largely intact despite the many years of turbulence. The supplier-producer arrangements were said to have persisted throughout these years.

Case Study 7: Animal skin production in Balkh

The first one of the two animal-products SMEs interviewed provided a similar view of trading arrangements and market access as those of the carpet makers:

- **Availability of skins:** The animal-products sector was severely affected by the persistent recent drought, which wiped out 70 per cent of the sheep population in the area. In the post-drought period there has been a rebound in the sheep population.
- **Low profits due to lack of direct access to markets and lack of processing capacity:** The SME interviewed reported that it collects raw animal skins and intestines, carries out very minimal preparation, and ships the packaged products to Kabul and Peshawar for further processing. After grading, sorting, and repackaging, the products are taken to Pakistan for distribution and sale. The total value of the trade in animal products was estimated at 10 million Euros, of which a small fraction accrues to the Afghan producers while the rest goes to the larger, technologically better equipped, and more established and organised Pakistani traders.
- **Lack of security:** During the interview a request for taking photographs of the operations was rejected on the account of “unnecessary exposure” which might be used against the SME by ill-wishers and extortionists.
- **Corruption:** According to the second animal products producer, SMEs face insurmountable problems with widespread corruption of officials at all levels and a general failure by the government to create an enabling environment for business activity:

They [the government] keep telling us about free trade and competition. What does all of this really mean when we have corrupt and unhelpful officials, no title to the land we operate on, no access to finance, insufficient fodder to feed the sheep from which we get our skins, and no basic services such as electricity?

Despite these difficulties, this SME has been exporting prepared sheepskins to a number of foreign markets for the last 20 or so years. The production volume has varied depending on the availability of fresh skins. The situation is likely to improve further in the post-drought period. However, many of the fundamental issues regarding security, lack of access to markets, and inadequate energy and transportation infrastructure will continue to undermine initiatives by local producers to expand and grow.

Case Study 8: Production of olive oil and other products in Nangarhar

The Nangarhar Valley Development Authority (NVDA), an Afghan government agency, owns and operates 2,170 hectares of olive plantation and 70 hectares of orange groves in Nangarhar. The land is divided into four state-owned farms located 5 km to the south of Jalalabad. There is also an on-site plant for processing produce and pressing olive oil. NVDA is accountable to the Ministry of Agriculture and Animal Husbandry.

In 1980, the plant produced 50 tons of olive oil and over 1,700 tons of pickles. For 2001, production was 8.5 tons of olive oil with no other products. In 2005, the re-opened plant produced 50 tons of olive oil. The oil pressing plant was built by the Soviet Union in the late 1970s with an installed capacity of 500 tons of olive oil and 4,000 tons of pickles. The plant was once one of the largest produce processing plants of its type in Asia.

With the departure of Soviet technical expertise, the onset of internal strife in Afghanistan, the resultant inability to maintain the equipment, and lack of investment to modernise and expand, the plant's production capacity suffered significantly. The pressing plant was visited in February 2007. At the time of the visit the plant was not operating. The senior staff present underlined the following as the issues faced by the plant.

- **Outmoded machinery:** The production equipment is old, inefficient, and prone to costly breakdowns. Because of the prospect to privatise, the government has not been forthcoming with assistance to modernise the operations.
- **Inadequate remuneration:** The plant's most senior manager earns 2,000 Afghanis per month. He said he was doing the job because he liked it. To sustain himself, like other senior staff at the plant, he keeps another job elsewhere. On various occasions the plant has had to take on war widows as employees by government directive.
- **Lack of equipment:** At the last pressing, the plant produced between 8 and 9 tons of olive oil. The plant does not have the equipment to produce its own bottles and cannot afford to pay for ready-made bottles. As a result, the pressed oil is stored in large vats at the plant or sold in bulk. The cost of building a bottling plant on-site is estimated at around \$70,000.
- **Inadequate storage facilities:** Pressed olive oil is stored in large wooden vats which are then kept in a covered storage area. The area is not insulated and there is high risk for the pressed oil to spoil due to excessive heat of over 40C during summers. The optimum range of temperature for storing olive oil is 16-22C. To compensate for the heat, the vats are periodically hosed down to cool. Part of the reason for the plant not pressing olives at the time of the visit was lack of storage capacity due to an inability to sell oil already produced.

- **Electricity:** As with all other cases, there was concern about the lack of available and economical energy. Because of the lack of reliable, affordable energy, building a bottling plant on-site was said to be uneconomical since it would have to rely the significantly more expensive generator power.
- **Poor distribution:** A plant-owned outlet in Jalalabad sells olive oil from the plant to the general public. The outlet is poorly maintained with no electricity or display arrangements likely to entice the would-be buyer. The attendants at the outlet said that it was not their responsibility to worry about presentation.
- **Point of sale quality control:** All the labels on the shelved bottles of olive oil at the distribution outlet were a few months out of date. When asked why this was, the attendants said they had run out of labels and had to use old labels. Olive oil was kept in plastic containers commonly used for carrying water and fuel. The oily containers had gathered a significant amount of caked dust and gave the impression of a fuel store selling petroleum products rather than olive oil.

Measures taken to address these issues include:

- **Resuming regular production:** Over the years, the FAO, USAID and the Government of Italy have attempted to resume olive oil production and other processing activity at the plant.
- **Replenishing olive tree stocks:** Many olive trees were lost during the years of conflict and the drought. New olive trees have been planted since 2001 with aid provided by the FAO.
- **Identification of new markets:** Through its Alternative Livelihoods Program (East), USAID has been involved in identifying markets for the olive oil in Pakistan.
- **Privatisation:** USAID has also provided its services in introducing prospective private interest buyers to NVDA which is directed to sell off the operation as part of the government of Afghanistan's privatisation programme.

According to the plant's senior management there have been no fewer than 30 private sector prospectors to purchase the plant in the recent past. In all cases the facility's total size (the supplying farms and the plant) have proven too large for a single investor to purchase.

Case Study 9: Manufacture of grain threshers in Jalalabad, Nangarhar

This SME had about 60 employees and was founded in 1998 by a young Afghan who had grown up in Pakistan and trained as a toolmaker. On return to Afghanistan in 1997, the young technician set up a workshop to repair grain threshers for a number of local SMEs who processed grains grown locally. He was soon inundated with repair orders because he was the only entity in the Jalalabad region with the expertise to repair the equipment. Ceasing on this opportunity, the entrepreneur decided to expand operations so that he could assemble and, later, manufacture the threshers. The SME now has customers in many parts of Afghanistan.

With progressively more orders for repairs, he started to take on young apprentices and trained them in all manner of carrying out repairs and, later, tool making and assembly of threshers. The main imported components are the motor and the rubber belts used in the threshers. The business is now fully licensed with an annual licence fee of 120,000 Afghanis. A customs fee is also paid on imported components, mainly from Russia and Pakistan. The entrepreneur and his senior personnel identified the following issues faced by the plant.

- **Import Restrictions:** The business is not able to import components from other countries at will. Sometimes there are unexplained restrictions on importing components from Pakistan, for example.
- **Transport:** Until recently the road from Jalalabad to Kabul was notoriously bad and caused unnecessary delays for outgoing equipment delivery and incoming equipment to be repaired and spare parts and machine components. Since the reconstruction of Jalalabad Road in 1385 (2006), transit times and costs and damage to equipment have been minimised significantly.
- **Electricity:** A key concern for the SME was the unavailability of continuous, reliable, and affordable energy. The SME has its own generators for emergencies. However, the costs would be simply too high to run on diesel-powered generator power for extended periods of time.
- **Competition:** The entrepreneur complained about unfair competition by thresher manufacturers based in Pakistan, who have unlimited supply of energy, access to formally trained personnel, and a plethora of domestic parts suppliers.
- **Import duty:** The imported threshers, mainly from Pakistan, are valued at \$700 and taxed on a percentage basis accordingly. The SME entrepreneur objected to this practice since the going market price for the threshers in Afghanistan is \$3,200. This effectively preferential treatment of importers presents a disincentive to Afghanistan-based assemblers and manufacturers.
- **Zoning:** Access to land zoned for industrial use is extremely difficult and causes unnecessary constraints to site expansion for this SME.
- **Finance:** The SME has had to turn down orders to manufacture threshers due to an inability to raise sufficient funds. The lending regulations by national lending institutions “are too complicated and time consuming”. The proprietor also said that “it takes a few months to go through the whole process arranging a bank loan and by the time the money is here, the customer has found another source for purchase, usually an import from Pakistan”.

The SME has been increasing its customer base and expanding production and repair capacities despite the odds that it has been facing. The main reason for the ability to overcome the numerous constraints has been the expressed desire by Afghan customers to want to deal with a local Afghan supplier of equipment and repair services. This desire has been re-enforced by the young entrepreneur through offering after-sale maintenance contracts and warranties on its threshers. Currently the SME has a growing customer base spread across the Kabul, Balkh, Kunduz, Logar, Ghazni, and Nangarhar provinces.

The senior officials at the Jalalabad branch of Afghanistan Investment Support Agency (AISA)⁶ stated that they were aware of, and were actively dealing with, many of the issues raised by the thresher manufacturer. The services offered by AISA to local SMEs include assistance in acquiring operating permits, acquiring import or export licences, arranging bank loans, zoning issues, marketing, and business management. AISA has also been lobbying the law makers for more enabling regulations, particularly in relation to domestically manufactured or produced goods and services. The current regulations, according to the AISA interviewees, are more focused on imported goods rather than exports. While nationally this AISA office has been able to engage policy and lawmakers, the interest has not been as evident among the local government officials. The branch has a growing registry of local businesses that pay a membership fee and are kept informed through a quarterly newsletter.

⁶ AISA played a key facilitating role in arranging the Nangarhar interviews for this research.

Case Study 10: Soap Manufacturing in Jalalabad, Nangarhar

This SME has between 20 to 30 employees, depending on demand for its products and availability and cost of raw materials. The range of products includes cotton seed oil and a variety of soaps. Soap production requires cotton seed oil, water, caustic soda, sodium silicate, and animal fat. The major issues underlined by this SME were as follows.

- **Electricity:** As with other SMEs visited and interviewed for this research, the soap manufacturer also complained that it was uneconomical to rely on generator power for electricity. At the time of the interview, the plant had not had municipal power for over one week.
- **Competition:** The main source of competition for this SME was said to come from neighbouring countries, particularly Pakistan and Iran. Both of these countries have a large number of better established and mature producers, supported by relatively much better infrastructure and operating environments than present in Afghanistan. Pakistan, for example, was said to have over 3,000 soap producers.
- **Weak or immature factors market:** Animal fat is a major ingredient in soap making. The SME owner complained that Pakistani traders come to Nangarhar to purchase animal fat for importing into Pakistan, to be used by Pakistani soap makers. The market for animal fat in Afghanistan is volatile, and suppliers often sell to Pakistani traders because they pay higher prices and because domestic demand is unreliable.
- **Overheads:** Factors of production are not always present at the same time. When there is no electricity the machinery can be idle for long periods of time. When the machinery is idle there is no reason to purchase raw materials such as animal fat even if it can be afforded. When there is no electricity and raw materials are lacking the labour force is of course idle, but still has to be kept on for times when all factors of production come to place. Under these circumstances, the SME sustains a minimum workforce in preparation for when everything is in place to resume production. This is a considerable cost to the SME.
- **Credit:** Bank loans are very expensive and difficult to arrange. The owner of this SME also objected to the immorality of lending money for interest and suggested that he would be hesitant to borrow for both economic and religious reasons.

The SME is a registered member of the local AISA office. The AISA officials are aware of the issues raised by this SME but unable to provide solutions in the short-term. It appears that, despite all the difficulties, the SME finds it economical to remain in operation as there is a market for its products. This resilience can be in part attributed to the market positioning of the SME. On being asked how it was that the firm survives, the proprietor explained that his father, having arrived as a returnee from Pakistan, carried out an extensive product and factor market research before setting up the soap producing operation. According to the current proprietor, "our operation owes its existence to that initial research by my father".

IV. Discussion and Conclusions

Rural business development in the provinces of Bamyan, Balkh, and Nangarhar will continue to be challenging, given the poor infrastructure and lack of liquid assets. There may not be a sufficient surplus in any of the provinces to support large-scale agricultural-business development. However, there is clearly room for significant measures to promote the marketing and quality of agricultural commodities in these provinces to support small

businesses. The most obvious measures with a potential to bring tangible and widely distributed benefits are improvements in infrastructure, specifically roads, and the availability of basic services such as electricity and storage facilities.

Given the size of the world market for dried fruits and nuts, carpets, and animal products, investments in post-farm rural production is likely to pay off in some areas. For example, the value of dried fruits and nuts market is estimated at \$2.2 billion, only 2% of which is captured by Afghan producers. During peace, the volume and quality of Afghan produce were significantly higher. Afghan-produced raisins used to account for around 60% of the world market. The dried fruits and nuts industry has suffered in its entirety from serious setbacks including drought, socio-economic instability, and outdated production methods and machinery. Immediate improvements can be made, however, through the provision of storage facilities and introducing incentives for the adoption of modern techniques for sorting, drying, and packaging.

Designed carefully to take full advantage of available production inputs such as abundant unskilled local labour, modernisation programmes could create jobs, increase production volume, and productivity. A modernised dried fruits and nuts industry might be able to recapture its traditional markets in Russia, Pakistan, and India. It could also target the markets in Europe and North America.

To the extent possible, programmes and projects to revive or expand the activity of rural SMEs need to be knowledge-based. Projects need to be geared toward the production of commodities suited to local production factors and for which there is market demand. Support and representation for existing businesses is important in raising the profile of the rural private sector. The provincial Chambers of Commerce, AISA offices, and other similar formal institutions need to have the capacity to provide representation for their business constituents and to support them.

If the commitment to *broad-based* private sector-driven growth at the heart of the Afghanistan National Development Strategy is to be realised, support to the private sector from institutions such as the MoCI, AISA, and the Afghan International Chamber of Commerce needs to extend to small-scale entrepreneurial activities. This could help to mitigate the uneven trajectory of economic development in Afghanistan.

Governments, NGOs and international donors must recognise that the situation in Afghanistan has evolved from one of emergency aid provision to one where the parameters for a functioning political economy need to be set. Government ministries and agencies lack experience and suffer from not being fully embedded in Afghan society. A continuing challenge in efforts to rebuild Afghanistan is the common counterproductive view of people and their enterprises as "the needy", who need to be assisted rather than as a resource for reconstruction.

Reconstruction efforts are generally frustrated by a tension between the cooperative-oriented approaches of successive regimes prior to and during Soviet rule in Afghanistan, on the one hand, and the private-sector centred approach promoted by development actors and the Afghan government. This tension has resulted in a shifting of boundaries for government and private-sector roles and an impasse in reconstruction efforts. As one interviewee pointed out, "the discourse should not be about the choice between cooperative or private-sector approaches. Rather, policymakers and international donors need to agree on what type of private-sector development is suited for Afghanistan, given the badly damaged infrastructure, weak government, diminished trust, and the cooperative institutional tradition."⁷

⁷ Interview with an FAO/MRRD official on October 25, 2006. For a discussion of this tension and its implications for the privatisation efforts, see Paterson, Blewett and Karimi, 2006.

Adopting such a cooperative approach would maximise the efforts of all actors in the sector, minimising disagreements by turning contenders into de facto stakeholders. A pragmatic and inclusive approach based on this line of reasoning would also lay the foundation for setting attainable objectives and defining evaluation criteria to assess policy effectiveness. The emergence of common rules and a division of labour are likely to lead to the formation of learned communities and social networks that last beyond the lifetime of reconstruction programmes.

The promotion of private sector activity in rural areas needs to be done thoughtfully. Against the odds, many rural enterprises continue to thrive. The success of these usually very small enterprises does not necessarily imply that more of the same type or larger enterprises will also succeed. The success of a locally owned and operated dairy plant in Mazar-i-Sharif has apparently inspired the Dairy Industry Revitalisation Project for Afghanistan (DIRPA) as a two-year initiative funded by a \$7.2 million cooperative agreement with USAID. The project involves the international Land O'Lakes Corporation, the U.S.-Afghanistan Reconstruction Council, and the Aga Khan Foundation, as the principals in the establishment of a new dairy plant in the vicinity of Mazar-i-Sharif, to be named Mountain Pastures Dairy. A pragmatic and socio-economic approach, as opposed to a purely economic one, to building such a plant would ensure that locally owned and operated SMEs are not threatened by its operations due to diminished supplies or loss of market share. In other words, success cases should be complemented or replicated elsewhere, not replicated in a way that causes competition through co-location.

Reconstruction efforts must be designed to increase economic as well as social wellbeing. The Rural Economic Regeneration Strategies (RRERS), a recent study commissioned by the MRRD, is a potentially important step toward a socio-economic policy making environment in rural business development. RRERS calls for the establishment of a framework for *integrated* rural development planning in Afghanistan. RRERS is intended to provide in-depth understanding of local contexts and issues, region-specific as well as broader social and economic trends, opportunities and barriers faced by rural communities, the potential for growth based on local specificities, and potential regional development scenarios and their long-term viability. A key promise of this study is to identify pathways for scaling out (replicating local success elsewhere) and scaling up (building on local success as the foundation for national development). The recommendations in the next section are formulated in the same spirit as the RRERS study.⁸

V. Recommendations

The many improvements needed to overcome the disabling factors in the operating environment for rural SMEs can be grouped into the three categories of immediate, medium to long-term, and general as follows:

Immediate Measures

- **Strengthen and expand transport networks:** Lack of access to transportation routes or absence of adequate road infrastructure has been raised as a major determinant of the sub-optimal performance by rural SMEs. While efforts continue to address the shortcomings of the road system in Afghanistan, attention needs to be paid to how well, or badly, the proposed plans serve rural SMEs as far as access to markets outside of their immediate surroundings.

⁸ More information is available at: www.undp.org.af/jobs/projects/nabdp/EOI-RRERS-FesibilityAnalysis-BusinessPlans.pdf, accessed on February 15, 2007.

- **Increase energy production capacity:** Energy continues to present major challenges for rural value-adding production. This is particularly the case for smaller rural producers who cannot afford generator power for production purposes. Innovative solutions based on micro-power generation from solar, wind, and hydro sources can and should be considered by agencies charged with improving the operating environment for rural SMEs.
- **Strengthen existing markets:** Local institutions such as local government offices, chambers of commerce, and development aid agencies need to collaborate on developing monitoring mechanisms to gauge why and how some businesses succeed and maintain their markets while others fail. Such collaboration is also needed to provide assistance and facilitation when necessary and to diffuse learning.
- **Increase direct exports:** In many cases raw or minimally processed produce are purchased by traders for value addition elsewhere, often outside Afghanistan. Addressing this problem requires much closer cooperation with neighbouring countries aimed at reaching trade and tariff agreements. This task requires leadership and assistance from the government and international donors.
- **Reduce red tape:** In line with the MoCI's recent attempts to simplify and formalise the process for obtaining licenses and permits for foreign investors, similar attempts need to be made to enable rural SMEs to obtain the necessary licenses and permits.

Medium and Long-term Measures

- **Micro-credit facilities for post-farm production:** Easier access to credit should be provided for small-scale producers. This calls for an increase in the current number of micro-credit providers in rural areas with preferential terms for rural SMEs.
- **Establishing new markets and regaining traditional markets:** Historically, dried fruits from Afghanistan have had market shares in India, Russia, Iran, and other Middle Eastern countries. Many of these markets have been lost due to unreliable supply sources from Afghanistan during the years of conflict. Concerted attempts need to be made to recapture these markets.
- **Increase accountability:** A number of interviewees from donor and government agencies had serious concerns about the lack of accountability in how funds earmarked for infrastructure development were being deployed. One example given by an interviewee was the manner in which infrastructure contracts are implemented. Because there are often multiple levels of sub-contracting, by the time the work commences, only a fraction of the initial funds remain to do the actual construction. Awarding infrastructure contracts needs to be re-examined and streamlined through instituting a system of accountability, formalised through legislative and other measures.
- **Formalise rural business activity of SMEs:** The system of registration for businesses in rural areas needs to be strengthened and expanded. Many rural SMEs opt not to expand formally because they fear being "noticed" and coerced by various corrupt elements. Little or no tax revenues are generated from rural business activity, particularly from SMEs. Moving toward a more enabling environment requires formalisation of business activity based on trust, which cannot be established overnight and requires continuous attempts by national and local governments to earn the trust from rural SMEs.

General Measures

- **Quality Control:** In less developed economies, quality and hygiene are key issues in the manufacturing and processing of foodstuffs. In response to this potentially serious problem facing Afghanistan's rural SMEs, the following measures need to be taken with guidance and assistance from government and business communities:
 - Provide incentives for rural SMEs to recognise the link between quality and hygiene standards and maintaining and increasing market share.
 - Develop hygiene and quality protocols based on consultations with the rural producers and their representatives (if any).
 - Establish a quality and hygiene monitoring system.
 - Establish a system of quality and hygiene certification.
 - Create incentives for meeting hygiene and quality standards.
- **Coordination of scientific research:** Research and development work carried out by government agencies, donors, the private sector, and universities need to be coordinated to eliminate duplication and to utilise synergy.
- **Increased collaboration:** Linkages between provincial educational institutions and rural SME representative bodies need to be strengthened to increase access by the SMEs to local technical and other expertise.
- **Strengthen rural business representation:** Establish local producer associations by reaching out to the informal local networks that have traditionally governed business activity in rural areas.

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