

Informality and Small Business Development in the City of Kabul

for

HARAKAT

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TABLE OF CONTENTS

LIST OF FIGURES	- 1 -
1. INTRODUCTION	- 2 -
1.1 Purpose of the Study	- 2 -
1.2 Why does informality matter?	- 2 -
1.3 Selective Informality	- 3 -
1.4 Structure of this Report	- 4 -
2. METHODOLOGY	- 5 -
2.1 Questionnaire Design	- 5 -
2.2 Sampling	- 5 -
2.3 Use of Case Studies	- 5 -
3. DEMOGRAPHIC INFORMATION ON RESPONDENTS	- 6 -
3.1 Sector and size of Business	- 6 -
3.2 Gender and Age	- 7 -
3.3 Education Level	- 7 -
3.4 Ethnicity	- 8 -
3.5 Home Province and Moving to Kabul	- 9 -
4. WORKING CONDITIONS	- 11 -
4.1 Income and Wages	- 11 -
4.2 Employment Situation and Dispute Resolution	- 13 -
5. FORMALITY OF ACTIVITIES	- 15 -
5.1 Legal Structure of the Business	- 15 -
5.2 Licenses and Permits	- 15 -
5.3 Taxation	- 16 -
6. CONSTRAINTS ON BUSINESS ACTIVITIES	- 18 -
6.1 Variety of Responses	- 18 -
6.2 Government Activities	- 19 -
7. CONCLUSIONS AND RECOMMENDATIONS	- 21 -
7.1 The Nature of Informality in Kabul	- 21 -
7.2 An Opportunity to Encourage Inclusion	- 21 -
7.3 How to Encourage Formality?	- 22 -
7.4 Government support to businesses and workers	- 23 -
7.5 Way Forward	- 23 -
ANNEXURE I – QUESTIONNAIRE	- 27 -
ANNEXURE II – KABUL CLUSTER MAP	XXXV

LIST OF FIGURES

Figure 2.1 – Business Category of Employees Interviewed	- 6 -
Figure 2.2 – Business Category of Owners Interviewed	- 6 -
Figure 2.3 – Number of Employees of Owners Interviewed	- 6 -
Figure 2.4 – Age of Respondents.....	- 7 -
Figure 2.5 – Education Level of Respondents	- 7 -
Figure 2.6 – Ethnicity of Employees Interviewed	- 8 -
Figure 2.7 – Ethnicity of Owners Interviewed.....	- 9 -
Figure 2.8 – Where Employees Lived Before Moving to Kabul	- 9 -
Figure 2.9 – Where Owners Lived Before Moving to Kabul	- 10 -
Figure 3.1 – Ethnicity of Female Employees.....	- 12 -
Figure 3.2 – Prior Residence of Female Employees.....	- 12 -
Figure 3.3 – Payment of Employees	- 13 -
Figure 3.4 – Hours worked by Employees.....	- 13 -
Figure 4.1 – Case Study, Kabir (Carpenter)	- 16 -
Figure 5.1 – Constraints on Business Activities	- 18 -
Figure 6.2 – Case Study Ali, (paint and construction store owner).....	- 19 -

1. INTRODUCTION

1.1 Purpose of the Study

The informal sector, commonly understood to be the sector not run by government codes and regulations, is a thriving part of the economy of Kabul. It could be a small business running entirely on family labour or it could be a small business hiring labour. Outside of agriculture, the private sector is overwhelmingly composed of informal family owned micro-enterprises, most of which are engaged in trading or basic services. 80-90 percent of all economic activity is informal. There are few small and medium enterprises and only a handful of large firms¹. This pattern of evolution of the informal sector is not unexpected; post-conflict societies often go through the burgeoning of informal sector in want of opportunities in the formal sector and the lack of institutional capacity within the state to regulate business. The question is how to take this sector forward?

Given the size of this sector it becomes important to understand it to be able to ensure that it works better for people working and engaged in this sector as well as the clients it serves. How can their productivity be improved? How can the state ensure that informality does not lead to exploitation? How is a degree of quality control ensured?

The objective of the study is to understand the informal sector, its strengths and challenges with the aim to build upon the strengths while minimizing the weakness for a more equitable growth as well as a first step towards integration with the formal market regulations.

The informal sector is usually dominated by small businesses. For the purpose of this study we will define small business as any business having less than 10 employees and an annual turnover of up to 5 million Afghanis. . There is no single definition of small business; it is variously defined. However, it is generally agreed that small business has five or less employees².

1.2 Why does informality matter?

¹ Investment Climate Afghanistan, World bank, 2005, pp 6

² Afghan Business Attitudes on the Economy, Government, and the Business Organizations, 2009-2010, Afghan Business Survey, National Endowment for Democracy, pp. 14

If we see informality as a ‘manifestation of the relationship between the state and economic agents’ (World Bank, 2007), informality matters because economic actors are excluded from the benefits that might flow from state actions:

‘Of the many lenses through which informal workers have been viewed, the most influential lens has focused on their exclusion from critical state benefits or the circuits of the modern economy.’ (World Bank 2007 p 2).

From the perspective of employees, such benefits might include regulation of employment, such as regular working hours, minimum pay standards, workplace safety and so on. From the perspective of business owners such benefits might include access to subsidies and access to capacity building activities. For both employees and business owners informality brings with it a risk of lawful enforcement by government officials, and also rent seeking behavior by government officials. Both activities – the first lawful and the second unlawful – create an environment of uncertainty. The various costs associated with informality are listed below³

- Sub-optimal production scales
- Low investment
- The free rider problem (overuse of public goods, low tax collection)
- Unfair competition
- Low innovation
- A large fraction of poor population uninsured against income shocks
- Workers unprotected by basic safety standards.

Informality also impacts the effectiveness of government actions as interventions to stimulate economic growth most often only address the formal economy. That being said, it is important to recognize that the informal sector has many linkages with the formal sector, and so, indirectly, it will often be affected by, or respond to, changes in the formal economy.

1.3 Selective Informality

³ Economic Informality: Causes, Costs, and Policies A Literature Survey of International Experience* Background Paper prepared by Ana-Maria Oviedo for Country Economic Memorandum (CEM) -2009, pp. 16

The type of informality referred to above illustrates a problem of peoples' *exclusion from the benefits* of the formal economy. Another type of informality is that where people make a rational choice not to operate in the formal economy because operating informally provides more benefits to the economic actor (whether employee or business owner). For example, an employee may choose to operate informally to avoid taxes. A business operator may choose not to obtain a license because, in his or her opinion, the cost of obtaining the license outweighs the risk of sanction for failing to have a license. This type of informality: *'results from a massive opting out of formal institutions by firms and individuals, and implies a blunt societal indictment of the quality of the state's service provision and its enforcement capability.'* (World Bank, 2007 p 3) This type of informality also implies that the economic actor makes a rational cost benefit analysis as to whether to operate formally or informally.

1.4 Structure of this Report

Chapter Two of this report sets out the methodology of this study. Chapter Three describes the respondents, including by age, gender, business activity, education level and so on.

Chapter Four of this report focuses on the working conditions of the employees interviewed. Chapter Five focuses on the formality of business activities. Whilst Chapter Six focuses on constraints facing businesses in Kabul Chapter Seven sets out the conclusions and recommendations.

2. METHODOLOGY

2.1 Questionnaire Design

Informed by available literature on the national and international experiences of informality, the First Phase of the study involved designing a structured questionnaire to be administered to people owning businesses in the informal sector or working in this sector. This structured questionnaire contained questions on their socio-economic background, their businesses, and their lives. A copy of this questionnaire is included as **Annexure I**. Please note that questions 22 to 57 of this questionnaire were only asked of the Business Owners and Questions 58 to 84 were only asked of employees. The second stage of the study documenting three detailed case studies to collect qualitative data both for purposes of triangulation as well as for in depth exploration not possible with a structured questionnaire.

2.2 Sampling

This questionnaire was administered randomly across major occupations in the informal sector. The sample size was 600, comprising 300 business owners and 300 employees.

In order to have a representative sample, we divided Kabul into ten clusters. A map of the clusters is included as **Annexure II**. In each cluster six business owners per business category and six employees per business category were randomly selected for the study. As the selection was random, both informal and formal businesses were interviewed.

For the purpose of case studies random selection or any other probability selection would make little sense. Therefore judgment sampling was employed to select cases for in depth exploration.

2.3 Use of Case Studies

In the Second Phase of the study, informed by the analysis of the data of emerging from the first phase, the study selected case studies to be captured with the help of life story approach and participant observation where enumerators spent time with selected cases, as these cases go about their lives, to be able to understand their worlds better. 3 such case studies were undertaken.

3. DEMOGRAPHIC INFORMATION ON RESPONDENTS

3.1 Sector and size of Business

As can be seen from the figures below, the respondents work in variety of sectors:

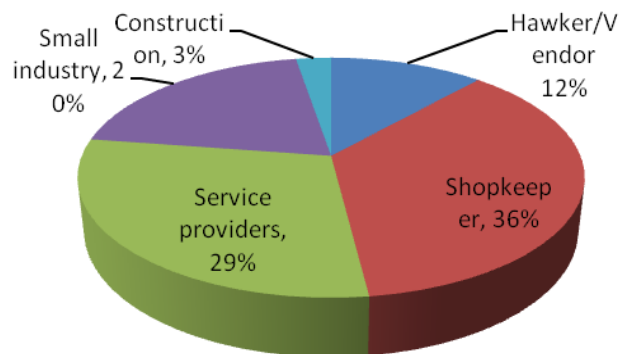


Figure 3.1 – Business Category of Employees Interviewed

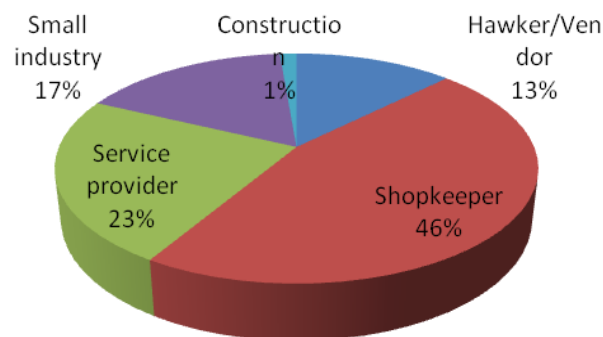


Figure 3.2 – Business Category of Owners Interviewed

Respondents who owned their businesses claimed to employ the following number of employees:

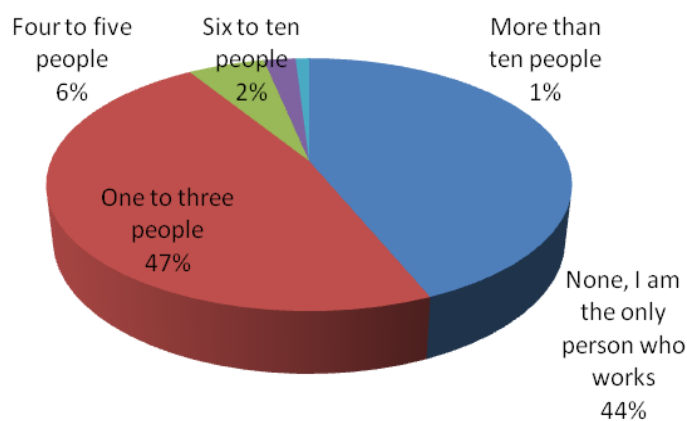


Figure 3.3 – Number of Employees of Owners Interviewed

3.2 Gender and Age

21 percent of employee respondents were women, compared with 19 percent of owner respondents. No female employee respondents were the head of the household and only one female owner was the head of their household, having never married.

The data in relation to age is as to be expected. Employees tend to be younger and business owners tend to be older. This data is presented on the graph on the following page. Only one employee respondent was above the age of sixty. No owner respondents were above the age of sixty.

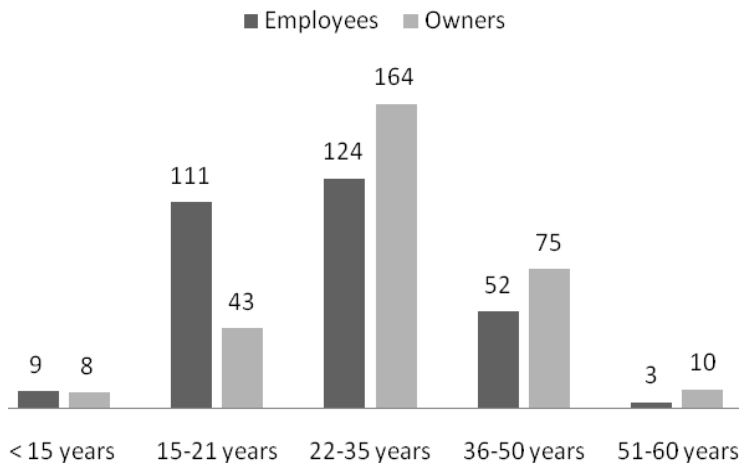


Figure 3.4 – Age of Respondents

3.3 Education Level

As can be seen from the graph below, there is a wide range of education levels.

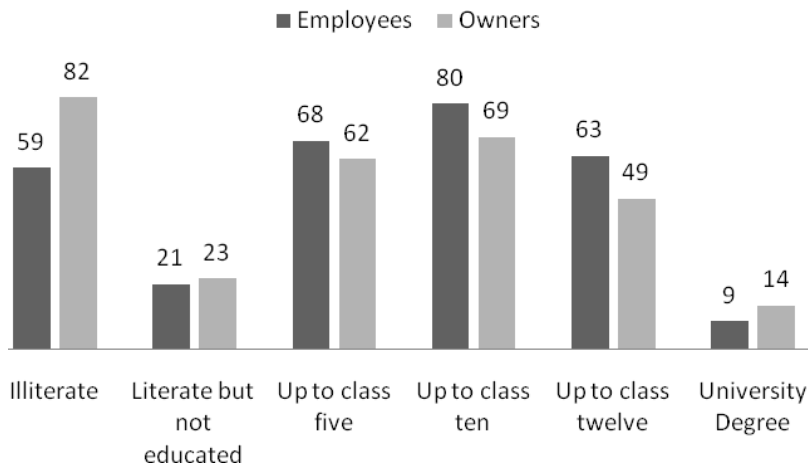


Figure 3.5 – Education Level of Respondents

Unfortunately, 10 percent of employee respondents aged 21 years or less are illiterate. The rate of illiteracy increases to 18.5 percent of employee respondents aged between 22 and 35.

In addition, 21.5 percent of owner respondents aged 21 years or less are illiterate and 23.2 percent of owner respondents aged between 22 and 35 are illiterate. This can impact the ability of owners and employees to engage with formal systems, particularly written rules and regulations, designed to improve the SME sector. While literacy is not a legal necessity to join the formal sector, it is, in many ways, a prerequisite for entry into the formal sector. The paperwork involved in the formal sector cannot be completed by an illiterate person. Surely help can be hired but the transaction cost of such an arrangement for a small business would be prohibitive.

3.4 Ethnicity

Ethnicity is an important indicator to capture because social and business ties are frequently formed along ethnic lines. As the figures below indicate, the respondents interviewed come from a representative cross section of ethnic groups.

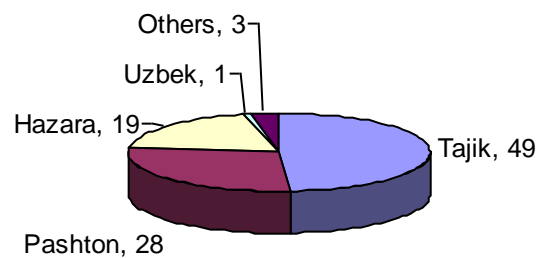


Figure 3.6 – Ethnicity of Employees Interviewed

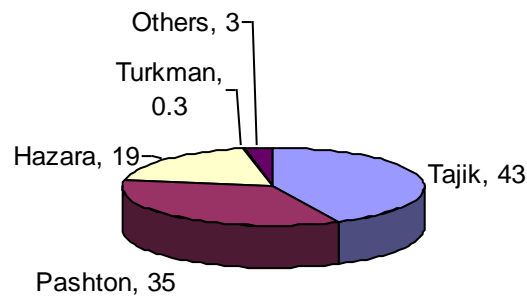


Figure 3.7 – Ethnicity of Owners Interviewed

3.5 Home Province and Moving to Kabul

In addition to ethnicity, home Province and place of former residence might also affect business ties. 49.6 percent of employee respondents noted Kabul as being their home Province, compared with 47 percent of owner respondents.

The place of former residence of respondents is noted on the graphs below. Some conclusions on the correlation between place of former residence and income levels are discussed in the following section.

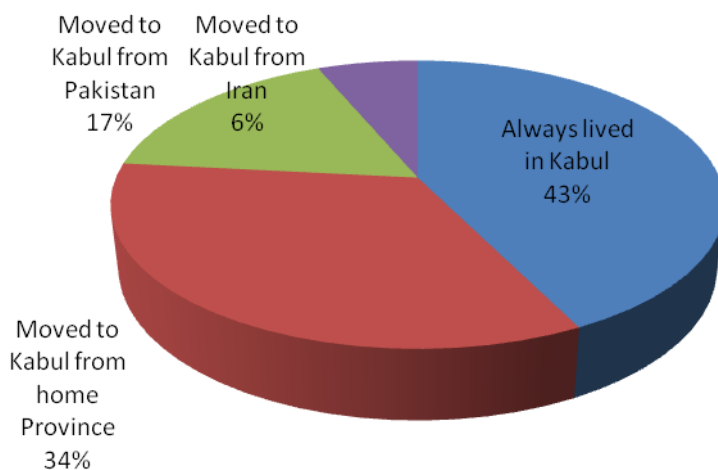


Figure 3.8 – Where Employees Lived Before Moving to Kabul

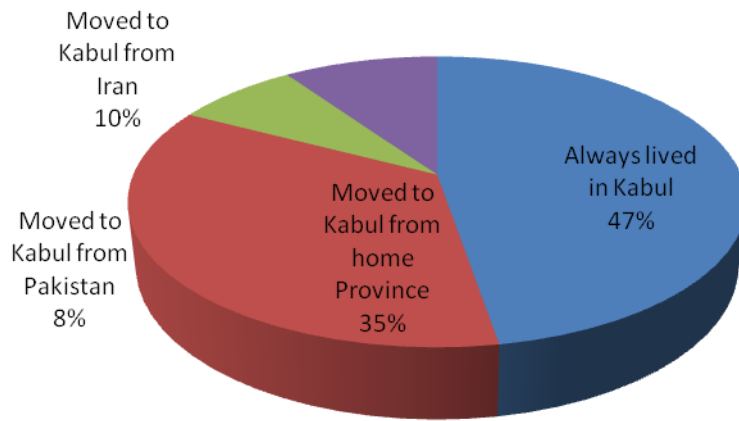


Figure 3.9 – Where Owners Lived Before Moving to Kabul

4. WORKING CONDITIONS

4.1 Income and Wages

4.1.1 Average Income

Questions on Income were asked at the household level. More than half of the employee respondents (53%) had a monthly household income of Afg. 9000 or less, only 3% of employee respondents had an income of Afg. 30,000 or more.

The average monthly household income for all employee respondents was Afg. 11,589. The average monthly household income for those employees who claimed that Kabul was their Home Province was actually less than the average at Afg. 10,804. This would counter any hypothesis that those who have Kabul as their home Province have an advantage in the labour market.

4.1.2 Place of Prior Residence

The average income of those who moved to Kabul from Pakistan is 15,167, high than the average for all employees of 11,589. However, if we remove the unusually high response of Afg. 120,000 referred to above, the average reduces to Afg 13,070. The average income of those who moved to Kabul from Iran is 11, 684. So whilst those who have moved to Kabul from either Pakistan or Iran have higher than the average income for employees it is not a very large difference. The difference, whatever it maybe, could while not explored, could be attributed to better background and connections leading to marginally better skills and better jobs. “For many migrants, labour migration is a coping mechanism to sustain families in their place of origin and to maintain the level of wealth acquired earlier, while at the same time providing the resources to accumulate to progress to the next stage in the life cycle – essentially enforcing social networks and society by marriage due to a transfer of goods, persons, and responsibilities”⁴.

4.1.3 Gender

The average income for female employee respondents is above the average at Afg. 14,865. Female employees are more likely to come from the Hazara ethnic group, and are more likely to

⁴ The Kandahar Bus Stand in Kabul: An assessment of Travel and Labour Migration to Iran and Pakistan, AREU, 2004, pp. 23

have moved to Kabul from either Pakistan or Iran. This finding maybe a result of various factors and not necessarily a result of causal relationship between gender and income for “it is often argued further that the burden of regulation is even larger for female business owners [and workers], because they have less time and money to overcome expensive and time-consuming barriers to registration.”⁵

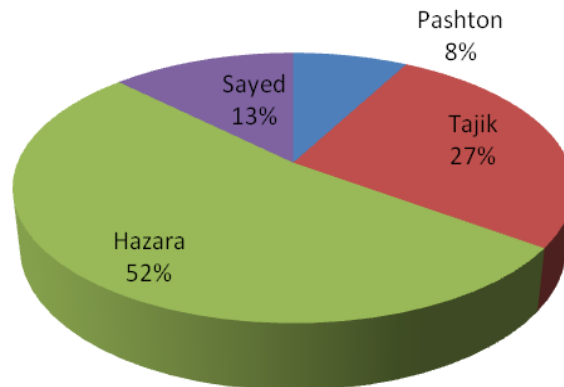


Figure 4.1 – Ethnicity of Female Employees

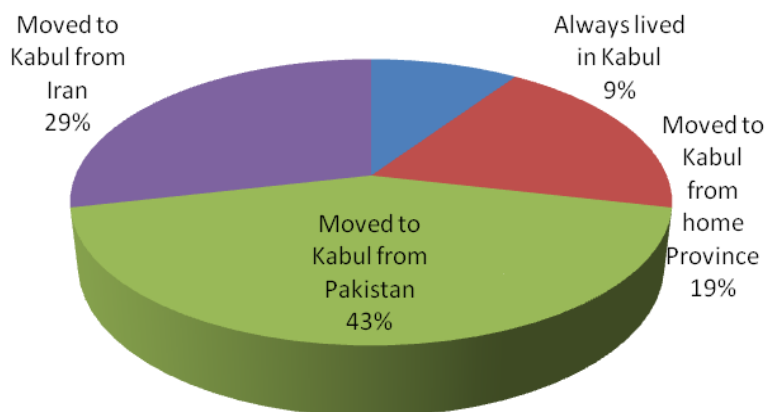


Figure 4.2 – Prior Residence of Female Employees

4.1.4 Payment of Wages

Over two thirds of employee respondents indicated that they were paid a fixed wage either monthly or weekly. 77 percent of respondents indicated that they were always paid on time. 65

⁵ Gender, Entry Regulations, and Small Firm Informality: What Do the Micro Data Tell Us? PREM Notes, World bank, 2009, pp. 2

percent of respondents said that their salary was sufficient. Whilst these figures are promising, in that regular and timely payment of a fix salary can contribute to the financial stability of the household, these responses should be taken with a degree of caution in that respondents might have been answering these questions whilst at their place of work.

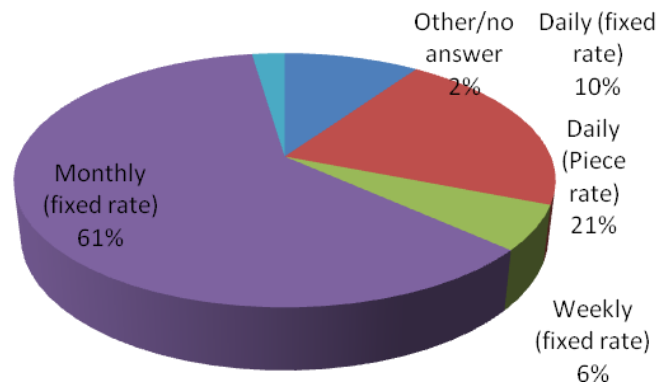


Figure 4.3 – Payment of Employees

4.1.5 Hours and Holidays

Over half the employee respondents indicated that they had a holiday during the week, and over two thirds of respondents indicated that they worked between 8 and 10 hours per day.

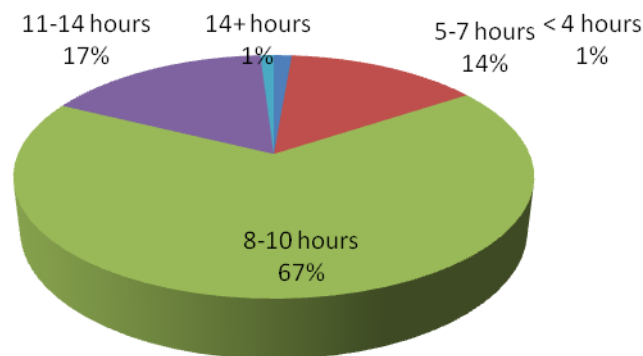


Figure 4.4 – Hours worked by Employees

4.2 **Employment Situation and Dispute Resolution**

Over 60 per cent of employee respondents were confident about their employment situation. Approximately one third of respondents believed that their employer did not pay enough. The respondents who were not satisfied with their salary came from a variety of sectors, had a salary of between Afg. 2000 and 40,000 and were paid in a variety of ways (approximately 40 percent

were paid a monthly fixed salary). So there is no clear trend in the pattern of dissatisfaction with salary. However, almost 80 percent of those who were not satisfied with their salary were aged 35 or below.

Over 77 percent of employee respondents were aware of a court to resolve any disputes that they might have with their employer. For details on how this question was asked please refer to the study questionnaire attached to this report as Annexure I.

5. FORMALITY OF ACTIVITIES

5.1 Legal Structure of the Business

11 percent of owner respondents said that the legal structure of their business was a company. Most of these respondents were engaged in the service sector. 83 percent of respondents were sole traders, and 6 percent of respondents were in a partnership.

5.2 Licenses and Permits

The case study below describes the experience of Kabir, a carpenter:

My name is Kabir and I am a carpenter. During the Taliban regime I was a carpenter's apprentice in Wardak province. I worked for a very good and hardworking carpenter.

I can very proudly say that we started carpentry business from zero, as we did not even have a workshop. Instead we would go to family homes and prepare their orders there. At that time we did not have these carpentry machines and we were working by hand.

After few years working in Wardak province I came to Kabul and opened a store in Qowa e Markaz using the initial capital of 300,000 Afghani (Taliban period). At this time I was still working by hand. After the collapse of Taliban regime I borrowed money from my friends and bought a machine. This machine completely changed the situation of my business, as I could produce wooden products with less time, high quality and have huge sales.

Three people work in this workshop, myself and two apprentices. We are not contracting with companies or NGOs, rather we produce products such as cupboards, windows, doors, beds and simple desks for individuals

I am very happy because I earn 15,000 Afghani per month, which covers my family expense of 10,000 Afghani per month, and my store rent of 4,000 Afghani per month. When I started the business I only had 300,000 Afghani (Taliban Money) which is equal to 300 Afghani to today's money, but now I have approximately 200,000 Afghani in savings.

I did not face any problems with Kabul municipality when obtaining and renewing my business license. Sometimes because of the limited space in my store we work on sidewalks, the municipality staff bothers us then, however, I don't consider this as a problem.

However, there are some other issues that we consider problems:

- *Electricity: we do not have governmental electricity; instead we have to use costly generators.*
- *Work Space: our shop is very small and we don't have enough space for working, if I get the opportunity to have bigger space I am planning to install new and modern carpentry machines, have more products and train apprentices, especially our brothers who don't have job and are interested in this field.*
- *High level of prices: the price of wood is getting higher day by day, now it 18,000 Afghani/m³ in one year which creates much problem for all carpenters.*

My only request to the government is to take strong actions to remedy these problems.

Figure 5.1 – Case Study, Kabir (Carpenter)

In contrast to Kabir's experience⁶, one respondent from the case study noted that obtaining the initial municipal license was easy, but that when renewing it he was asked for a bribe. Accordingly, he has not renewed his license.

84 percent of owner respondents claimed to be aware of the licenses necessary to undertake their business. Of this 84 percent, over half (at approximately 54 percent) claimed to have all the licenses required to undertake their business. Approximately 36 percent claimed to have some licenses, and approximately ten percent claimed not to have any licenses. Where licenses are not taken and operators decide to stay in the informal sector it could be a conscious choice, an exit from the formal sector as it suits the operators or it could be exclusion where barriers to formal sector are found to be insurmountable by operators. Where it is exclusion the process of joining the formal sector should be simplified and barriers to entry brought down. Where staying out of the formal sector is a conscious choice, benefits of joining the formal sector in the form of improved service delivery and other benefits such as access to credit should be increased. Alongside this suitable and effective punitive measures for those capable of joining the formal sector but staying out should be gradually introduced.

Over a quarter of respondents who claimed that they did not have a license reported that they had had problems with their business because of this. The problems could range from accessing services provided by the state or the formal sector to harassment by police and various government bodies including but not confined to asking for bribes. Just over 3 percent of respondents who claimed to have some licenses reported a problem because of this.

5.3 Taxation

32 percent of employees are registered to pay income tax, whereas over 78 percent of employers are registered to pay income tax. 72 percent of business owners claimed that they had paid income tax in the previous year. This is, it should be mentioned here, a reporting of the responses of various respondents. As the survey was not an audit, respondents were not asked to produce documentary evidence to back their responses.

⁶ According to the World Bank Investment Climate (2005) the most serious constraints reported by the surveyed firms is electricity and access to land. Over 64 percent of the surveyed enterprises cited electricity, and 60 percent cited access to land as either a severe or major obstacle to doing business in Afghanistan. Corruption and access to finance were also mentioned as significant constraints (pp. 8)

Only 20 percent of owners who claimed that they had not registered for income tax said that they had not registered because they did not understand the process. This figure is rather surprising and calls for a more detailed examination. Such an examination was, however, beyond the scope and reach of this study guided as it was by a structured questionnaire.

In Afghanistan, only those individuals (or businesses) that are required to pay income tax are obliged to register for a Tax Payer Identification Number. This means that those who are of low income are not 'visible' to the taxation system. It also means that once an individual cross the taxation free threshold, he or she must take steps to obtain a Tax Payer Identification Number.

6. CONSTRAINTS ON BUSINESS ACTIVITIES

6.1 Variety of Responses

We asked business owners to note what they thought the main constraints on their business were. Respondents could select up to three responses. As seen in the graph below the responses were varied:

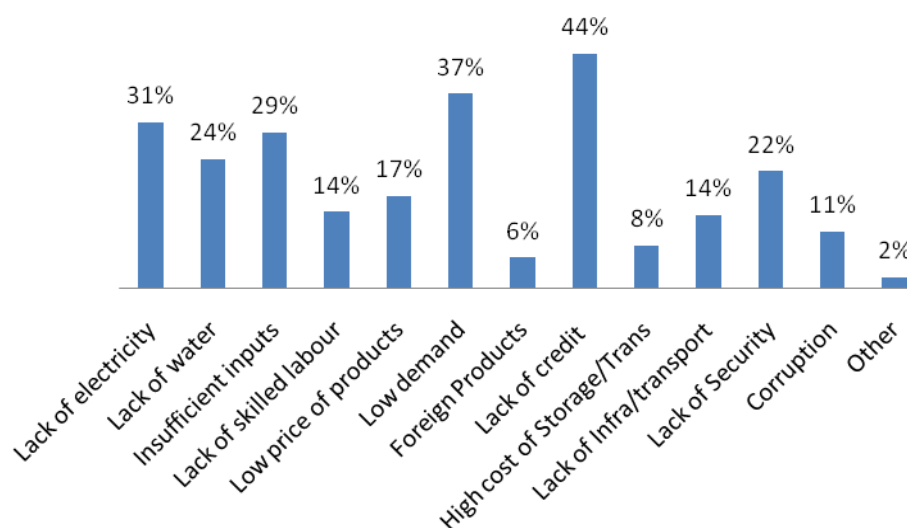


Figure 6.1 – Constraints on Business Activities

Lack of credit⁷ and low demand for products were the most common complaints. While in the case of formal business lack of access to credit reflects the lack of credit supply or inefficient credit delivery mechanism, in the case of informal business lack of access to credit is a structural problem. Almost a quarter of respondents who claimed that low demand was a problem also claimed that lack of credit was a problem. Of the 107 respondents who claimed that low demand was a problem, only three also selected that dominance of foreign products was also a problem.

⁷ Many businesses rely on informal funds transfer systems generally known as *hawala*. Informal financial sector credit is not adequate for long-term private sector development. There is a pressing need for bank and non-bank financial institutions to provide viable alternatives to the informal sector. Low household savings, poor infrastructure, low integration with complementary markets, high costs of service provision, particularly in rural areas, poor registries, and lack of credit information, a secured transaction law and insurance are the main factors constraining the growth of the formal financial sector. (World Bank, 2005; pp.11)

When conducting the case studies it became evident that there is a common perception that rising prices are adversely impacting the demand for products. The case study on the following page is an illustrative example.

I am Ali, and my brother and I established a small paint and construction material store between Pul Sokhta and Pul Surkh Square.

We opened our store using capital of 100,000 Afghani. Half of this initial capital was our own money and half we borrowed from another shopkeeper. We obtained our business licence from Kabul municipality without any difficulty.

Initially we faced many problems in running our business, as we did not know where to purchase materials from and how find the best wholesale markets with reasonable prices. With the passage of time and through experience, we improved our way of doing business. Our store has two types of businesses:

- Ordinary business – where we purchase materials from wholesale markets and on sell to customers; and*
- Middlemen business – where we take the commercial goods from whole sellers or producing companies and after selling them to the customers we pay back to whole sellers or companies.*

Our business is doing very well. It keeps us busy, and we earn about 10,000 Afghani per month. This is enough to cover our family expenses. The only problem and challenge and we are facing is the high level of prices. Prices are getting higher day by day, demands getting lower and sales are decreasing. This is affecting our business.

We don't have any specific problems with government or Kabul municipality staff, they always behave well with us. However we strongly request that the government help us by taking serious actions to decreasing the level of prices in markets. If this is not tackled we will not be able to cover our expenses. We and other may need to leave our businesses and this will badly affect the economic growth of the country.

Figure 6.2 – Case Study Ali, (paint and construction store owner)

6.2 Government Activities

Whilst there were some complaints about the behaviour of government officials towards their business activities, the majority of business respondents were of the opinion that government officials, including police and municipal officials behaved well with them. This response is surprising as the general impression emerging from Kabul and indeed the rest of Afghanistan is that harassment by government officials is rampant. It is likely that people have become so used to harassment and their expectations are so low that they do not see a few instances of harassment as a problem. This point is reinforced by a recent report on business environment in Afghanistan which says “in response to which three factors most adversely affect the growth of

the Afghan business sector, the combined top response was insecurity (78 percent), followed by corruption (53 percent) and lack of electricity (44 percent)⁸.

There was, however, an overwhelming response that more needed to be done to support businesses. Some of the suggestions included developing better infrastructure at marketplaces, to providing loans to businesses, to the very specific examples of ensuring that people were not using their private cars as taxis, or the blocking of illegally imported medicine.

To be expected, respondents also noted that the larger issue of security needed to be addressed before more specific activities, such as the development of infrastructure, could be developed.

Only 3 percent of business owners were of the opinion that the government had undertaken activities to support business development. Of the 13 respondents who were of this opinion, 6 were women. The examples of activities undertaken specifically referred to the formation of trade unions through which the government was undertaking training activities. Having said this, it should be pointed out that the responses maybe guided not only by business needs per se but by general experience of day to day living in Kabul where state is constrained by weak service delivery

⁸ Afghan Business Attitudes on the Economy, Government, and the Business Organizations, 2009-2010, Afghan Business Survey, National Endowment for Democracy, pp. 14

7. CONCLUSIONS AND RECOMMENDATIONS

7.1 The Nature of Informality in Kabul

Thinking of informality as either a problem of exclusion, or a rational business choice, does not accurately describe the nature of informality in Kabul. Literature on informality also sites new reasons for staying informal which include artistic license, flexible timing, the desire to be ‘one’s own boss, etc. Respondents have not reported many difficulties in obtaining licenses, nor have they reported that they suffer a high level of opportunistic rent seeking behaviour if they fail to have a license.

Informality in Kabul could possibly be characterized as an ‘informality of indifference’ – economic actors do not suffer a loss if they are currently outside the formal system, nor do they undertake a deliberate cost benefit analysis to decide whether or not to operate formally. Rather, formality or informality currently has little impact on their decision making processes. The World Bank report on Investment Climate in Afghanistan brings this point forth when it says “Regulatory issues such as business registration, tax administration and labor law were not cited [by businesses] as significant obstacles. This is not because they are efficient but because they are poorly enforced and hence do not impact on most firms” (World Bank, 2005; pp. 11) Operators would join the informal sector only if they see tangible benefits in joining the formal sector or in other words when the benefits of joining the formal sector exceed the cost of joining it. To encourage formality, State could improve service delivery to the formal sector. This service delivery could be in the form of space to operate businesses, credit and other input supply, access to power and water, training and capacity building. To make such transition to formality more effective, the paperwork around registration, payment of taxes, renewal of licenses, etc. could be simplified and streamlined. For instance there could be a single window for all matters related to paperwork in relation to small businesses. This will not only simplify the process but also reduce transaction cost for small businesses.

7.2 An Opportunity to Encourage Inclusion

As described in relation to informal settlements in AREU’s paper on *Urban Livelihoods in Afghanistan* (Beall and Schütte, 2006), this type of informality is a problem because it can make people invisible to the policy making process. This can have a significant impact on the nature of informality in the future. The need of the moment is to give them visibility, both to informal businesses and people engaged in them. “Informal workers who make the vast majority of its

citizens have been extremely invisible and rarely protected by the government in Afghanistan. The status of informal workers has not been determined in the Afghan Labor Code. As a result, they are not enjoying the legal rights guaranteed under the Afghan constitution. One of the most important ways to increase protection for informal workers is to provide them with legal and social protection. The simplest way to do this would be to include informal workers within the 2006 Labour Code. It might, however, be more beneficial to pass an entirely separate piece of legislation tailored to the specific needs of informal workers”⁹.

So, whilst enlarging the ambit of the formal sector may not have immediate benefits on improving the livelihood options of citizens, or the productivity of businesses, it is a necessary step to take to prevent future problems associated with informality, and to provide policy makers with greater visibility of all economic actors.

7.3 How to Encourage Formality?

‘If not balanced with clear evidence of benefits elsewhere in the system, taxation alone risks reinforcing public opinions of a predatory state’ (Country Report DFID, 2009). Drawing on this lesson, increasing enforcement activities by using a ‘stick approach’ to compliance with license requirements might not be advisable. Such an approach can actually be counterproductive in that businesses stop to operate or do not scale up leading to a loss of economic opportunities and employment potential.

An alternative option would be to continue to encourage formalization of business by awareness raising about the importance of government visibility of business activities. In relation to taxation, low income earners who are not *required* to register for a Taxation Payer Identification Number should nevertheless be encouraged to register. Again, this can be encouraged by highlighting the importance of their visibility to policy makers.

We would not recommend the use of inducements to encourage formalization of businesses and registration for taxation. This is because to do so would be rewarding those who have hitherto

⁹ Press Release- The Government of Afghanistan is failing to safeguard the basic constitutional rights of informal workers- Human Rights Research and Advocacy Consortium (HRRAC), May 24th, 2010

failed to register. Those who have ‘done the right thing’, by obtaining licenses, registering for taxation and paying their taxes, may interpret such behaviour of the state as unfair. Compliance with government regulation should be seen as a civic duty, as opposed to a financial strategy.

7.4 Government support to businesses and workers

The requests for support from government did not centre on regulatory activities. This is not surprising given the nature of informality in Kabul. The one concern that could be addressed through regulatory action would be the concern about inflation; however this is beyond the focus of this study.

Government activities should therefore be directed towards capacity building and technical assistance for business development. Lessons can be learned from the trade union based training activities that have supported women working in small businesses.

Whilst access to credit is an important element of business development, in the absence of business understanding such loans can be directed towards consumption rather than production activities. This could increase the burden on businesses and households.

We asked employees what they would like the government to do to improve their working conditions. This question was deliberately open ended so as not to guide responses. Interestingly, no respondents spoke about issues such as safety, work hours or rates of pay. The majority of employees responded by referring to the lack of jobs or the need of the government to developed factories for employment activities. Their concerns seemed to be focused on the economy as a whole, as opposed to their particular employment situations. This is not surprising given that the respondents may consider themselves fortunate, compared with others.

7.5 Way Forward

The way forward would depend on identifying the reasons for informality. The following reasons have been identified as being responsible for the growth of the informal sector¹⁰

¹⁰ Economic Informality: Causes, Costs, and Policies A Literature Survey of International Experience* Background Paper prepared by Ana-Maria Oviedo for Country Economic Memorandum (CEM) -2009, pp. 10

- Burdensome regulations (high entry costs, strict labor regulations, high taxes, complicated procedures, etc.)
- Low institutional quality
- Low human capital
- High economic inequality
- Low trust in institutions
- Low quality of public services (infrastructure, social protection)
- Lack of access to resources
- Low monitoring and enforcement
- Individual preference for independent work

Whether the businesses are in informal sector or in the formal sector they operate for one thing-profit. They also have similar requirements. We have noted that informality entails a cost even though it may benefit some people for some time, constraining the growth of those very institutions, support systems, and practices that could in the long run promote and establish formality. Developing a support system to encourage formality would require a multi-pronged approach and interventions at various levels.

Businesses need inputs to operate to which or through which they add value. In an environment where 80-90 percent of the businesses are in the informal sector, their inputs are also likely to come from informal sources, which is likely to put limits to growth, skewed distribution, unequal access, profiteering, etc. The State should identify what inputs constitute the major bottlenecks and make these available or smoothen the channels of delivery of these inputs. Provision of power, water, transport, credit and building the capacity of the workforce, etc. are some of the interventions that come to mind. The State could set up areas such as industrial park thus making space available to businesses where they also benefit from industrial agglomeration. Hawkers and vendors should be given licenses against designated spaces in town area. This will ensure that while they are rid of the need to shift constantly, they are also brought within the purview of State regulation. Torgler and Schneider (2007)¹¹ examined informality and institutional performance. They found that willingness to pay tax, the size of informal sector, and perceived performance of government

¹¹ Shadow Economy, Tax Morale, Governance and Institutional Quality: A Panel Analysis IZA DP No. 2563, 2007

institutions to report a very high degree of correlation. Ingram et al. (2007)¹² established a positive correlation between formality and the availability of electricity, access to finance, and access to land. They established a negative correlation between formality and rate of taxation and corruption.

Improvement of regulatory framework is also a critical area of interventions. This would include a vast array of subjects from property rights to legal reform to licensing arrangements. That workers in the informal sector are not recognized by the Labour Code 2006 was noted earlier. The overlap of customary law and adopted legal system is also a cause for confusion. This could be rationalized. Property rights and land tenure are not established. The conflicts around these are resolved via the use of force or informal mechanisms. Where they are taken to court, judges are poorly trained and likely to be corrupt. In all the above cases, the outcome is likely to favour the powerful. Insecurity of tenure and a confusing and erratically regulatory framework also place serious constraints on growth and expansion. “Indeed, informal businesses are mostly very small (with five or fewer employees, often operating from the household); some with little or no intention of, or potential for growth, while others facing serious barriers to expansion”¹³.

Social protection and safety nets currently effectively operating in Afghanistan are all informal in nature. This is also a reason for staying in the informal sector. Studies on business climate in Afghanistan have reported the payment of protection money to warlords, payment to policemen at check posts. However social protection has a connotation of helping tide over a crisis situation or a shock such as death of a wage earner, prolonged sickness of the wage earner, loss of livelihood, etc. As the State can't provide an effective social protection programme informal arrangements and the concomitant mode of doing business continue to hold sway. While it is true that a poor country like Afghanistan cannot be expected to provide an ambitious social protection programme, it could legislate to improve conditions of workers in the formal sector where they have attractive social protection package which prevents lapse into informality.

Investment in human capital is also essential in medium to long term. This would require massive investment in health, education, and skills building programme. Building the capacity of the

¹² Why Do Firms Choose to be Informal? Evidence from Enterprise Surveys in Africa The World Bank, 2005

¹³ Economic Informality: Causes, Costs, and Policies A Literature Survey of International Experience* Background Paper prepared by Ana-Maria Oviedo for Country Economic Memorandum (CEM) -2009, pp. 10

Afghan workforce has been identified by Afghan businesses as a critical input. This would also make available business development services critical to the growth of the formal sector. From the point of view of workers, literature and data suggest that “for self-employed workers with low human capital and low productivity, there may be few gains from becoming formal. This could be the case even in a relatively good investment climate, if an individual has low human capital, hence low productivity, and has low expectations about her own future, regardless of the actual possibilities available to her. Because low productivity translates into low profits for the self-employed, informal entrepreneurs might find it optimal to remain under the radar so as to avoid paying taxes and other contributions, even at the expense of being subject to fines or extortion from inspectors”¹⁴.

Flow of information about opportunities and requirements and enforcement of the established rules are central to formality. People should have access to information to know what they have to do, how, and where. People should also know what their options are and what are the advantages and disadvantages of behaving in a particular way. Finally more than the severity of law, it is the consistency of law that makes it effective. Consistency would require ability to enforce which in turn would require institutional capacity.

In conclusion, people are in informal sector for a variety of reasons related to both rationalization and exclusion. They would continue to be in the informal sector so long as there are barriers to entry (exclusion) or so long as the benefits of being out of the formal sector outweigh the cost of being in the informal sector. However, the informal sector constricts growth in the long run. Therefore, it makes sense to encourage formality. This requires strong action from the State at various levels. However, it is also important to note that the informal sector and formal sector have intricate linkages and that informal sector is there because it performs a function. To try to eradicate it ‘overnight’ could be disastrous. The process has to be, of necessity slow, well thought out, and planned for the long term

[END]

¹⁴ Ibid; pp. 21

ANNEXURE I – QUESTIONNAIRE

Small Business				
	Discussion Question	Answers		
1.	Serial Number*			
2.	Cluster Location in Kabul*			
3.	Type of Business Category*	1. Hawkers/vendors 2. Shopkeepers 3. Service providers (such as barber, taxi driver, electrician etc) 4. Small industry (such as bread making, milk processing, tailor, iron smith etc.) 5. Construction		
4.	Name & Location of Business*			
5.	Employee or Owner*	1. Employee 2. Owner		
6.	Name of Respondent			
7.	Age	1. Below 15 years 2. 15 to 21 years 3. 22 to 35 years 4. 36 to 50 years 5. 51 to 60 years 6. Above 60 years		
8.	Gender	0. Female 1. Male		
9.	Ethnicity	1. Pashtun 2. Tajik 3. Hazara 4. Turkoman 5. Uzbek 6. Other (Please note)		
10.	Name of <i>home</i> Province	1. Badakhshan 2. Badghis 3. Baghlan 4. Balkh 5. Bamyān 6. Dykundi 7. Farah 8. Faryab	12. Herat 13. Jawzjan 14. Kabul 15. Kandahar 16. Kapisa 17. Khost 18. Kunar 19. Kunduz	23. Nimroz 24. Nooristan 25. Paktika 26. Paktya 27. Panjsher 28. Parwan 29. Samangan 30. Sari Pul

* To be completed by Enumerator

Small Business

Discussion Question		Answers		
		9. Ghazni 10. Ghor 11. Helmand	20. Laghman 21. Logar 22. Nangarhar	31. Takhar 32. Uruzgan 33. Wardak 34. Zabul
11.	Education level (years of education)	1. Illiterate 2. Literate but not educated 3. Up to class 5 4. Up to class 10 5. Up to class 12 6. University Degree 7. Other (please note)		
12.	Marital Status	1. Never married 2. Married 3. Widowed 4. Divorced		
13.	How many people live in your household? (including yourself)			
14.	What is your relationship with the head of the household?	1. I am head of the household 2. Brother/Sister 3. Husband/ Wife 4. Son/Daughter 5. Parent 6. Other		
15.	What is the <u>approximate combined average monthly income of all members of your household</u> (in Afs.)?			
16.	Please mark up to a maximum of three major income sources of your household from the list:	1. Pension 2. Farming 3. Labor 4. Small business (i.e. shop, handicrafts, carpet weaving, driving a taxi, hawking, vending etc) 5. Rental income 6. Government or NGO Transfers (Cash or In-Kind) 7. Remittances (i.e. financial contributions from family members residing outside Afghanistan) 8. Other, please specify, in words, the source		
17.	What type of business are you working for, or do you own?	1. Hawkers/vendors 2. Shopkeepers 3. Service providers (such as barber, taxi driver, electrician etc) 4. Small industry (such as bread making, milk processing, tailor, iron smith etc.)		

Small Business

Small Business	
Discussion Question	Answers
	5. Construction
18. Please briefly describe the business	
19. Are you an employee or do you own the business?	0. Employee 1. Owner
20. Please describe where you lived before moving to Kabul?	1. Always lived in Kabul 2. Moved to Kabul from home Province 3. Moved to Kabul from Pakistan 4. Moved to Kabul from Iran 5. Other, please note
21. If you have not always lived in Kabul, for how many years have you been living in Kabul?	1. Less than one year 2. More than one year, but less than two years 3. More than two years, but less than three years 4. More than three years, but less than four years 5. More than four years, but less than five years 6. More than five years, but less than ten years 7. More than ten years
Questions 22 to 57 are for Owners of the Business	
22. How long have you been engaged in this business activity (number of years)?	
23. Why did you start this business?	
24. Where does your business operate?	1. Local area (suburb) 2. Across Kabul 3. Across the Province 4. Outside the Province
25. What is the legal structure of your business?	1. Registered company 2. Sole trader 3. Partnership 4. Other 5. Do not know
26. Do you have a personal bank account?	0. No 1. Yes
27. Do you have a bank account in the name of the business?	0. No 1. Yes
28. If you have a business bank account, how frequently do you use this account to receive or make payments in relation to your business?	1. Everyday 2. Every week 3. Monthly 4. A few times a year 5. Never
29. How many people do you employ?	1. None, I am the only person who works 2. One to three people 3. Four to five people 4. Six to ten people 5. More than ten people

Small Business

	Discussion Question	Answers
30.	Are you aware of any licenses/permits required to run your business?	0. No 1. Yes
31.	If you are aware of any licenses/permits required, can you please describe ALL the licenses/permits?	
32.	Do you have these licenses/permits?	0. None 1. Some 2. All
33.	Of the license/permits required for your business, which is the easiest to obtain?	
34.	Of the license/permits required for your business, which is the most difficult to obtain?	
35.	If you do not have all the licenses required to run your business, why have you not obtained all the licenses/permits? (Select one or more reasons)	1. Do not understand the procedure 2. Do not have the time to obtain the license/permit 3. When I tried to apply for a permit/licenses I was asked for a bribe/shereney 4. License is too costly 5. Do not think the license is important 6. Other, please note
36.	If you are not registered have you faced any problem on account of not being registered?	0. No 1. Yes
37.	If 'yes' could you briefly describe the nature of the problem	
38.	Is your business registered to pay income tax?	0. No 1. Yes
39.	If your business is not registered to pay income tax, why is it not registered? (Select one or more reasons)	1. Do not understand the procedure 2. Do not have the time to register 3. When I tried to register I was asked for a bribe/shereney 4. Do not think that I should have to pay tax 5. Other, please note
40.	Did your business pay tax in the last financial year?	0. No 1. Yes 2. Not Applicable
41.	List the major inputs required for your business.	

Small Business

	Discussion Question	Answers
42.	Where do you mostly get these inputs from?	<ol style="list-style-type: none"> 1. Buy locally: 2. Buy from within Kabul 3. Buy from within the Province: 4. Buy from outside the Province: 5. Buy from outside Afghanistan: 6. Other:
43.	Are you satisfied with the supply of inputs?	<ol style="list-style-type: none"> 0. No 1. Yes
44.	If you are not satisfied, why are you not satisfied?	
45.	Do you feel the need for credit to buy inputs for your business?	<ol style="list-style-type: none"> 0. No 1. Yes
46.	If yes, do you have access to this credit?	<ol style="list-style-type: none"> 0. No 1. Yes
47.	If you do have access to this credit please mention the source.	<ol style="list-style-type: none"> 1. Friends/relatives 2. Money lender 3. MFI/NGO 4. Bank 5. Other
48.	What are the main constraints on business activities in your area? (Select up to three responses)	<ol style="list-style-type: none"> 1. Lack of electricity 2. Lack of water 3. Insufficient input 4. Lack of skilled workforce 5. Low price for products 6. Low demand for products 7. Dominance of foreign products 8. Lack of sufficient credit 9. High cost of storage and transportation 10. Lack of infrastructure and transportation 11. Lack of security 12. Corruption 13. Other
49.	What government officials do you interact with on a regular basis in running your business? (for example, police, municipality, inspectors etc)	
50.	What do you think about the attitude of government officials towards businessmen such as yourself?	
51.	What can the Government do to encourage the expansion of business activities in your area?	

Small Business		
	Discussion Question	Answers
52.	Do you think the government has done anything to improve business activity in your area?	0. No 1. Yes
53.	If 'yes' can you please elaborate	
54.	Has there been any Government or non-governmental projects to improve the business environment in your area?	0. No 1. Yes
55.	If yes, please describe the projects (be sure to note whether Government or NGO project)	
56.	Do you think these projects benefited you and/or the sector?.	0. No 1. Yes
57.	Please elaborate on your previous answer	
Questions 58 to 84 are for Employees of the Business		
58.	How long have you been engaged in this business activity?	
59.	How long have you been working with this particular business?	1. less than one month 2. More than one month, but less than six months 3. More than six months, but less than one year 4. More than one year, but less than two years 5. More than two years
60.	Where does this business operate?	1. Local area (suburb) 2. Across Kabul 3. Across the Province 4. Outside the Province
61.	How many people work in the business?	1. One to three people 2. Four to five people 3. Six to ten people 4. More than ten people
62.	How are you paid?	1. Daily - fixed rate per day 2. Daily – on the basis of pieces produced or sold 3. Weekly salary – fixed rate 4. Monthly salary – fixed rate 5. Other, please describe
63.	On average, how many hours do you work a day?	1. less than four 2. five to seven 3. eight to ten 4. eleven to fourteen 5. More than fourteen
64.	Do you have a weekly off day?	0. No 1. Yes
65.	Does your employer pay you on time?	1. Always on time 2. Sometimes late 3. Frequently late

Small Business		
	Discussion Question	Answers
66.	Do you have a bank account?	0. No 1. Yes
67.	If you answered 'no' to the previous question, does anyone in your household have a bank account?	0. No 1. Yes
68.	Are you registered to pay income tax?	0. No 1. Yes
69.	If you are not registered to pay tax, why are you not registered?	1. Do not understand the procedure 2. Do not have the time to register 3. When I tried to register I was asked for a bribe/sherency 4. Do not think that I should have to pay tax 5. Other, please note
70.	Did you file an income tax return in the last financial year?	0. No 1. Yes 2. Not Applicable
71.	Do you think that your employer pays a fair wage?	0. No 1. Yes
72.	Please explain your answer to the previous question	
73.	How would you describe your employment situation	1. Very unstable 2. Relatively stable 3. Stable
74.	Please explain your answer to the previous question	
75.	If you had a complaint against your employer (for example unpaid wages), what would you do?	
76.	Is there a forum where you can take your work related complaints	0. No 1. Yes
77.	If yes, please elaborate	
78.	What government officials do you interact with on a regular basis in working? (for example, police, municipality, inspectors etc)	
79.	What do you think about the attitude of government officials towards workers such as yourself?	
80.	What do you think the Government can do to improve your working conditions?	
81.	Have been there been any Government or non-governmental projects to improve your	0. No 1. Yes

Small Business

	Discussion Question	Answers
	employment situation (such as skill and capacity building, regulatory frame work, inspections)	
82.	If yes, please describe the projects (be sure to note whether Government or NGO project)	
83.	Do you think these projects benefited you and/or the sector?.	
84.	Please elaborate on your previous response	

ANNEXURE II – KABUL CLUSTER MAP

