

Formalizing Informal Trade and Credit Institutions: Designing Effective Institutional Economic  
Reforms in Afghanistan and Beyond

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**Abstract**

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As part of the country's recent economic reforms, a number of banks have been established in Afghanistan. Although these banks hold large reserves, an increasing number of Afghan merchants are reporting problems getting the credit they need to expand their businesses. This dissertation explains why this situation exists and proposes that the government adopt a new approach to designing economic reforms, one that would improve access to finance for Afghan merchants and would generally better policymaking. This dissertation draws on more than eighty interviews with Afghan merchants, business leaders, *Sarrafs*, and government officials in five major provinces of Afghanistan to identify the barriers to access to credit and to understand the performance of formal institutions (banks) and their informal counterparts. This dissertation finds that Afghan merchants are often unable to benefit from the offerings of formal institutions for three reasons: a highly volatile business climate, uncertain contract enforcement, and an unsupportive property rights system. A number of informal institutions have emerged that alleviate some of the credit constraints on Afghan merchants. These informal institutions include risk-sharing trade credit operations, short-term working capital loans, *Gerawee*, and *Sar qufli*. Although these informal institutions have helped Afghan merchants survive, they are unable to support a growing economy. They have only limited capacity to pool savings for investment purposes, and furthermore, their

extra-legal practices may have negative consequences on long-term economic growth and attraction of foreign investment. In short, the existing “formal” institutions have sufficient capital, but they cannot operate effectively in an environment like Afghanistan. Conversely, the existing informal institutions, can operate effectively, but, *precisely because they are informal*, they cannot provide a country like Afghanistan the investment capital it requires. This dissertation argues that Afghanistan should try to address this dilemma using a new approach the author calls “Grounded Institutional Reform.” Using this approach, Afghanistan would formalize existing informal institutions, a development that would vastly increase their effectiveness. There are, of course, good reasons for Afghanistan to continue in its efforts to establish banks and to encourage Afghans to use them. Nevertheless, as the author explains, this policy is unlikely to be an immediate success. Instead, as the banking industry slowly takes root, the formalized “informal” institutions would promote slow, but significant economic development. While from an empirical standpoint, this dissertation focuses on credit and trade in Afghanistan, the analysis of how grounded institutional reform and a policy of “formalizing the informal” can easily be extended to solve other types of political and economic problems in Afghanistan and, indeed, in many other similarly situated countries.

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To my Mother, and  
the memory of my Father

## INTRODUCTION

There is a consensus among economists that the only effective way to alleviate poverty is through sustained economic growth.<sup>1</sup> Economists and legal scholars within the law and development movement generally agree that economic growth is promoted when businesses have access to credit, and that improving business' access to credit can contribute meaningfully to sustainable economic development and human security.<sup>2</sup> This point is so widely accepted that scholarship no longer focuses on demonstrating the importance of credit transactions to economic growth in developing economies, and it has instead begun to focus on the question of how best to facilitate and encourage credit financing for merchants.

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<sup>1</sup> See, e.g., DANI RODRIK, ONE ECONOMICS, MANY RECIPES: GLOBALIZATION, INSTITUTIONS AND ECONOMIC GROWTH (2007) 2 (stating that “Historically nothing has worked better than economic growth in enabling societies to improve the life chances of their members, including those at the very bottom”); Richard H. Adams, Jr., The World Bank, *Economic Growth, Inequality, and Poverty: Findings from a New Data Set* (Policy Research Working Paper 2972, 2003), [http://siteresources.worldbank.org/INTPGI/Resources/14021\\_WPS\\_2972\\_adams.pdf](http://siteresources.worldbank.org/INTPGI/Resources/14021_WPS_2972_adams.pdf); see also Martin Ravallion & Shaohua Chen, World Bank, *What Can New Survey Data Tell Us about Recent Changes in Distribution and Poverty*, 11(2) THE WORLD BANK ECONOMIC REVIEW 357, 380 (1997); see also Lant Pritchett on *Poverty, Growth, and Experiments*, EconTalk (May 22, 2017), [http://www.econtalk.org/archives/2017/05/lant\\_pritchett\\_1.html](http://www.econtalk.org/archives/2017/05/lant_pritchett_1.html). It should be noted, however, that while there is a general consensus amongst economists that the most effective way to alleviate poverty is through sustained economic growth, the distributional effects of economic growth are still hotly debated and studied. See Shahid Yusuf & Joseph E. Stiglitz, *Development Issues: Settled and Open*, in FRONTIERS OF DEVELOPMENT ECONOMICS: THE FUTURE IN PERSPECTIVE 227-268 (Gerald M. Meier & Joseph E. Stiglitz eds., 2000).

<sup>2</sup> There is a broad consensus that financial development is an independent variable of economic growth. See, e.g., Robert G. King & Ross Levine, *Finance and Growth: Schumpeter Might Be Right*, 108 Q. J. ECON 717, 719 (1993); Robert G. King & Ross Levine, *Finance, Entrepreneurship, and Growth: Theory and Evidence*, 32 JOURNAL OF MONETARY ECONOMICS 513, 515 (1993); Ross Levine, *Financial Development and Economic Growth: Views and Agenda*, 35 J. ECON. LIT 688, 688 (1997); Ross Levine, *The Legal Environment, and Long Run Economic Growth*, 30 J. MONEY, CREDIT, & BANKING 596, 598 (1998); Raghuram G. Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559, 584 (1998); Ross Levine et al., *Financial Intermediation and Growth: Causality and Causes*, 46 JOURNAL OF MONETARY ECONOMICS 31, 35 (2000); Ross Levine, *Finance and Growth: Theory and Evidence*, in HANDBOOK OF ECONOMIC GROWTH 865, 889 (Philippe Aghion & Steven Durlauf eds., 2005); Stephen Haber et al., *Political Institutions and Financial Development*, in POLITICAL INSTITUTIONS AND FINANCIAL DEVELOPMENT 1 (Stephen Haber et al., eds., 2008); DAREN ACEMOĞLU, INTRODUCTION TO MODERN ECONOMIC GROWTH 588 & 726 (2009); SAHAY ET AL., IMF STAFF DISCUSSION NOTE, RETHINKING FINANCIAL DEEPENING: STABILITY AND GROWTH IN EMERGING MARKETS 5 (SDN/15/08, 2015).

Within the field today, two different theories on institutional development and economic growth compete. One theory, which this dissertation calls “Entrepreneurial Institutional Theory,”<sup>3</sup> focuses on private entrepreneurs as suppliers of informal institutions and drivers of economic growth. It argues that private entrepreneurs tend to independently to develop the institutions and practices they need to grow their businesses.<sup>4</sup> To the extent that businesses need access to credit, they will develop institutions and practices that will make that credit available. As the private sector grows, the political power of economic entrepreneurs increases, allowing them to effectively demand better formal institutions that are responsive to their needs. A second theory, what this dissertation, following Nee and Opper, calls “State-Centered Theory,”<sup>5</sup> focuses on the importance of the state’s role as the supplier of formal institutions and creator of preconditions for economic growth. This theory proposes that if merchants need access to credit, they are unlikely to independently develop maximally efficient institutions.<sup>6</sup> Development will thus proceed more effectively if states develop formal institutions regulated by courts or state administrative agencies.

Each of these theories has a different normative implication for institution-building in the developing world.<sup>7</sup> Government officials today wishing to facilitate economic growth in a developing economy will tend to ally themselves with one of these competing theories. Depending on which of these theories she prefers, she will favor a different set of policies. A champion of Entrepreneurial Institutional Theory will take a reactive approach to institution building, allowing private actors independently to develop institutions, products and practices. The assumption is that

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<sup>3</sup> The term Entrepreneurial Institutional Theory is inspired by Nee & Opper’s book, *Capitalism from Below*. SONJA OPPER & VÍCTOR NEE, *CAPITALISM FROM BELOW: MARKETS AND INSTITUTIONAL CHANGE IN CHINA* (2012).

<sup>4</sup> This theoretical view is discussed in Chapter One.

<sup>5</sup> OPPER & NEE, *supra* note 3.

<sup>6</sup> This theoretical view is presented in Chapter One.

<sup>7</sup> Each theory’s model for institutional reform is discussed Chapter One and Chapter Five.

these organically developed institutions will be best fit to address the needs of private entrepreneurs, and when needed, the private entrepreneurs will advocate for the government to supply the formal institutions that they need. By contrast, a champion of State Centered Theory will urge the state to adopt institutions that have proven effective in other contexts (“best practices”), and will encourage the merchants to make use of the new institutions, most often by displacing the organically-developed informal institutions.

Afghanistan provides us with a case study that allows us to explore the pros and cons of Entrepreneurial Institutional Theory and of State-Centered Theory in a post-conflict state and to evaluate the advantages and disadvantages of pursuing policies based on each of these theories.<sup>8</sup> It suggests that in a country like Afghanistan, each of the theories is rooted in an important insight. Entrepreneurial Institutional Theory notes correctly that economic actors are well aware of the peculiar challenges that they face, and tend to design institutions that address, at least to some level, those particular problems. In support of Entrepreneurial Institutional Theory, the case of Afghanistan suggests that displacing entrepreneurially-developed informal institutions is most often unwise and infeasible. On the other hand, in line with the State-Centered Theory, the case of Afghanistan demonstrates that these institutions which develop organically are often insufficient to provide the structure necessary to promote sustainable development because poor infrastructure and limited market expansion opportunities seriously curtails their development. Therefore, save in cases where huge market expansion opportunities and strong infrastructure exist (i.e. the golden case of China), entrepreneurially-developed informal institutions, on their own, will not be able to facilitate significant economic growth. The recent history of Afghanistan also suggests, however,

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<sup>8</sup> Each theory’s insights and shortcomings in explaining the case of Afghanistan is discussed in Chapter Five where, drawing on the lessons from both theories and the case of Afghanistan, this dissertation proposes a new approach for institutional reform for countries like Afghanistan.

that in post-conflict states (and other weak states), the government may have only limited ability to create and enforce new, more effective institutions out of whole cloth. Thus, in a country like Afghanistan the government should recognize the genius of local institutions, even as it tries to improve upon existing, trusted institutions by formalizing them and supervising them, so that these institutions provide the level of predictability that State-Centered Theory says will be required.

After almost twenty-five years of civil war, Afghanistan was in 2001, invaded by an international force. Thereafter, officials in the new Afghan government and advisors from the international community committed themselves to an ambitious plan of economic and legal reforms all designed to promote sustainable economic growth in Afghanistan.<sup>9</sup> Among the goals of the new reform plan was, naturally, the promotion of more credit transactions. By this time, Afghan merchants had developed institutions and practices that could make a limited amount of credit financing available.<sup>10</sup> Even during the twenty-five-year period of political unrest and civil war that lasted from about 1975 to about 2001, merchants were able to use these institutions and practices to obtain some degree of credit financing for their commercial activities. While post-2001 improvements in infrastructure and new market expansion opportunities aided the improvement of informal institutions, their investment financing capabilities remained limited. These traditional mechanisms did not provide Afghan merchants with the same amount of credit

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<sup>9</sup> See ISLAMIC REPUBLIC OF AFGHANISTAN, AFGHANISTAN NATIONAL PEACE AND DEVELOPMENT FRAMEWORK 2017-2021 (2016), <http://policymof.gov.af/afghanistan-national-peace-and-development-framework-anpdf/>; ISLAMIC REPUBLIC OF AFGHANISTAN, AFGHANISTAN NATIONAL DEVELOPMENT STRATEGY 2008-2013 (2008), <http://mfa.gov.af/en/page/6547/afghanistan-national-development-strategy/afghanistan-national-development-strategy-and>; AFGHANISTAN MINISTRY OF COMMERCE AND INDUSTRIES, MINISTRY OF COMMERCE AND INDUSTRIES STRATEGIC PLAN 2016-2020 (2016), <http://moci.gov.af/Content/files/stratigic%20plan%202017.pdf>; DA AFGHANISTAN BANK, STRATEGIC PLAN 2017-2021 (2017), <http://dab.gov.af/fa/page/media/publications/strategic-plan>; AFGHANISTAN MINISTRY OF ECONOMICS, ECONOMIC POLICY OF GOVERNMENT OF AFGHANISTAN (2013), [http://moec.gov.af/Content/files/Policy\\_National\\_Economic.pdf](http://moec.gov.af/Content/files/Policy_National_Economic.pdf); AFGHANISTAN MINISTRY OF JUSTICE, FIVE STRATEGIC PLAN: LAW AND JUSTICE 2014-2018 (2013), <http://moj.gov.af/Content/files/Estrategi.pdf>.

<sup>10</sup> These institutions and their effects on access to credit is discussed in Chapter Three.

financing that merchants in advanced Western economies can access through Western banking systems and it did not provide the financing on the same terms. If Afghan merchants were unable to increase the amount of investment financing beyond what the informal institutions made possible, it seemed clear that long-term economic growth would likely be impeded. So how could the Afghan government best increase the amount of credit financing available to Afghan merchants, beyond the amount that was being made available through existing institutions?

Instead of formalizing the informal credit institutions that had already emerged organically and, thereby, to increase their efficiency, Afghan officials instead decided to displace them. Inspired by the champions of State-Centered development, Afghan officials and their allies adopted a series of official policies, the Government Strategic Policies, that aimed to replace the existing informal institutions and practices with formal institutions modeled on those that underpin the economies of developed Western economies.<sup>11</sup> Under these new policies, newly formed banks should displace all other sources of credit. Bank credit (mostly bank loans) would become the sole source of credit for merchants in Afghanistan. Banks, it was assumed, would offer loans on terms that Afghan merchants could accept, and merchants would seize the opportunity to borrow money on the terms that banks demanded. Easy access to credit would lead to sustainable economic growth and a measurable increase in Afghans' human security.

As an attempt to facilitate credit financing for Afghan merchants and increase their access to credit, the Government's Strategic Policies were a colossal failure. Since 2014, the number of Afghan businesses reporting problems accessing finance has actually increased.<sup>12</sup> At the end of

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<sup>11</sup> Afghan Government Strategic Policies and their approach to institutional reform is discussed in in Chapter Four.

<sup>12</sup> Calculated by the author based on AFGHANISTAN CHAMBER OF COMMERCE INDUSTRIES, BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, and III-2017, <http://www.acci.org.af/surveys-and-studies.html>.

2016, almost half of Afghan businesses surveyed reported they had a problem accessing finance.<sup>13</sup> Almost half of the Afghan population currently continues to live below the national poverty line, with more than one million people falling below that line over the last decade, and one fifth at risk of falling below it in the near future.<sup>14</sup> The stickiness of the informal credit institutions cannot explain the failure of the formal credit institutions because, as the research presented here shows, the reduction in the use of informal credit institutions in a province does not result in the increased use of bank loans by the merchants in that province.<sup>15</sup> Nor does religious objections to the use of interest explain the unpopularity of bank loans because, as the findings of research conducted for this dissertation demonstrate, the prevalence of pro-interest attitude in a province does not positively correlate with the increased use of bank loans in that province.<sup>16</sup> Additionally, Afghan judges regularly enforce interest-bearing loans under formal rules.<sup>17</sup>

This dissertation is divided into five chapters. Chapter One provides theoretical and background and details the research methodology used in this dissertation. Chapter Two offers an overview of state of Afghanistan's economy, a description of the actors involved in Afghanistan's credit economy, provides a social and institutional context. Chapter Two also identifies the fundamental problems that Afghan merchants face when they try to enter into credit transactions.

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<sup>13</sup> *Id.*

<sup>14</sup> See AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY (2005), <http://cso.gov.af/en/page/1500/1494/nrav-report>; AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY (2007-2008), <http://cso.gov.af/en/page/1500/1494/nrav-report>; AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY (2011-2012), <http://cso.gov.af/en/page/1500/1494/nrav-report>; AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY (2013-2014), <http://cso.gov.af/en/page/1500/1494/nrav-report>; AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY (2016-2017), <http://cso.gov.af/en/page/1500/1494/nrav-report>.

<sup>15</sup> This is further explained in Chapter Three.

<sup>16</sup> This is further explained in Chapter Three.

<sup>17</sup> This is further explained in Chapter Two.

Chapter Three focuses on informal institutions that have emerged over time in Afghanistan to overcome the problems of credit transactions consequences they pose for allocation of resources and economic growth. Chapter Four offers an overview of Afghanistan's formal financial institutions and Afghan government policies aimed at reforming formal institutions. Chapter Five defines and develops the approach of Grounded Institutional Reform and explains how it could be applied in Afghanistan to build formal institutions that are based on existing informal institutions. Chapter Five also explains the problematic theoretical positions that have hindered the adoption of Grounded Institutional Reform as well as the actual problems of implementing Grounded Institutional Reform in Afghanistan. The final section, Conclusions and Recommendations, establishes that Grounded Institutional Reform is the most effective way to create workable institutions that could improve access to investment financing for Afghan merchants.

To understand the failure of the Afghan government's attempt to create institutions that would give Afghan merchants greater access to credit than they could access through informal institutions, and to ascertain how Afghan officials could have developed more effective institutions, the author carried out more than eighty interviews with Afghan merchants, business leaders, and officials between March and August of 2017 in five major provinces of Afghanistan: Kabul, Herat, Kandahar, Nangarhar, and Balkh. While Afghanistan has 32 provinces, these five provinces collectively represent half of Afghanistan's economy,<sup>18</sup> one-third of Afghanistan's total population,<sup>19</sup> and more than four fifths of Afghanistan's urban population.<sup>20</sup> The commercial

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<sup>18</sup> Calculated by the author based on AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, BUSINESS ESTABLISHMENT SURVEY 2009 (2010), <http://cso.gov.af/en/page/1500/1494/6>; AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, BUSINESS ESTABLISHMENT SURVEY 2015 (2016), <http://cso.gov.af/en/page/1500/1494/6>.

<sup>19</sup> Calculated by the author based on AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, AFGHANISTAN DEMOGRAPHIC ESTIMATES FOR THE YEARS OF 2002/03 UNTIL 2017/18, <http://cso.gov.af/fa/page/demography-and-socile-statistics/demograph-statistics/3897111>.

<sup>20</sup> *Id.*

courts that sit in these five provinces hear more than 90% of the total commercial court disputes in the country.<sup>21</sup>

Building on the information gathered in these interviews, this dissertation describes the Afghan economy and the role of merchants within it. It describes the obstacles that Afghan merchants have historically faced when they have sought access to credit on terms that are commercially viable within the Afghan context. Afghan merchants operate in a business environment where credit transactions are inevitably risky. For merchants who want to negotiate a credit transaction, three problems are particularly acute. First, the business climate in Afghanistan is highly volatile. Second, it is difficult to efficiently enforce contracts in the Afghan court system. Third, the property rights system makes it difficult for merchants to securitize credit transactions.

Having identified the three problems that Afghan merchants find most taxing when trying to enter into a credit transaction, the dissertation describes three informal institutions that merchants have developed, institutions that allowed holders of capitals to make at least some capital available to merchants who needed commercial credit. These three informal institutions are: trade credit coupled with *Sarraf's* working capital loans, *Gerawee*, and *Sar qufli*. These informal institutions have been able to significantly improve access to working capital financing while marginally improving access to investment financing and liquidity in the capital market. These informal institutions have succeeded due to their ability to overcome the problems of credit transactions in Afghanistan. At the same time, however, the existing informal institutions have not been able to significantly improve access to investment financing and will likely have negative

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<sup>21</sup> Calculated by the author based on AFGHANISTAN SUPREME COURT, QUARTERLY JUDICIAL ACTIVITIES REPORTS FOR THE YEARS OF 2012 UNTIL 2017, <http://supremecourt.gov.af/fa/page/court-reporting>.

consequences for long-term economic growth and attraction of foreign investment. Informal institutions have not been able to improve access to investment financing because they are neither able to pool disparate savings nor are they capable of diversifying risk, as a result, they cannot be relied on to finance long-term and/or high-risk investments, investments that are instrumental in achieving economic growth. Similarly, while the existing informal institutions are very inclusive with regard to Afghans, they put outsiders at a disadvantage, which impedes foreign investment in Afghanistan.

Having described three informal credit institutions that emerged in Afghanistan, the dissertation analyzes the formal institutions that the Afghan government developed as alternatives to these informal institutions and determines that Afghan merchants in Afghanistan's commercial centers found that banks and bank loans proved inappropriate for the Afghan context. The terms under which banks offer to lend are unattractive to Afghan merchants. Bank loans entail high interest rates, inflexible repayment terms, and require real estate with formal deeds as collateral. Afghan merchants cannot pay the high interest rates or adhere to inflexible repayment terms because they operate in an uncertain business environment with unpredictable cash flows, which keeps the return on investment low and adherence to fixed repayment terms impractical. Furthermore, Afghan merchants have very limited access to formal deeds and thus cannot satisfy the collateral requirements that banks traditionally impose before lending. Informal institutions offer only limited amounts of investment financing. But they do so in the face of a volatile business climate and an unsupportive property right system. Formal banks in Afghanistan, which hold 3

billion US\$ in excessive reserve,<sup>22</sup> theoretically have more money available to borrowers, however, they offer loans on terms that only few Afghan merchants can meet.

The research presented in this dissertation demonstrates that merchants' failure to take out loans does *not* arise out of a sentimental preference for traditional institutions. Similarly, their resistance to using banks does not primarily arise out of a concern that taking out bank loans violates a religious prohibition on interest, as the demand for Shari'ah-compliant financing (which is offered through Islamic windows of many Afghan banks) is equally low. Indeed, Afghan merchants, even in provinces with strong anti-interest sentiments, regularly engage in credit transactions that incorporate the time value of money within the *Sarrafi* markets. Nevertheless, in light of the volatility that Afghan businesses face and the difficulties that they face both in enforcing contracts and producing collateral for loans, merchants simply find it impossible to meet the terms that banks (Islamic or conventional) require of their borrowers. Afghan merchants obtain credit from informal institutions that they understand are imperfect, and they obtain less credit than they would ideally like.<sup>23</sup> They do so because these informal institutions are the only ones that are willing to offer credits on terms that Afghan merchants can meet.

Having explained the reasons why Afghan merchants believe that these imperfect informal institutions and practices, remain the least bad option available to them, this dissertation explores the implications of these findings. The empirical data in this dissertation is not sufficient, by itself, to conclusively prove or disprove the claims of Entrepreneurial Institutional Theory or of State-Centered Theory. Nevertheless, the data leaves us with provocative evidence suggesting some

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<sup>22</sup> Calculated by the author as the difference between total of gross bank deposits and total of gross bank loans based on DA AFGHANISTAN BANK, QUARTERLY FINANCIAL SECTOR FINANCIAL STATISTICS FOR THE PERIOD OF I-2013 UNTIL II-2017, <http://dab.gov.af/en/page/financial-supervision/financial-statistics/banks>.

<sup>23</sup> Merchants do not consider these informal credit arrangements as short-term working capital loans or financing because they are most often short-termed and embedded in different transactions such as *hawala* or currency exchange. Therefore, they are not reflected in the statistics of access to finance used in this dissertation.

practical lessons for policy makers who wish to quickly build more effective state-regulated and supervised credit institutions—ones that a weak government can implement, and which can provide the lenders and merchants with enough added certainty and predictability that significantly enhances merchants' access to credit. The data collected in the interviews conducted for this dissertation suggests that policies rooted in Entrepreneurial Institutional Theory are not adequate to provide merchants with sufficient access to credit to ensure the economy will support sustainable economic growth. Entrepreneurs have developed institutions and practices that provide some credit, but not enough to promote sustainable growth on an ongoing basis because poor infrastructure and limited market expansion opportunities restrain the organic process of institutional development in countries like Afghanistan. In comparison, the proponents of State-Centered Theory have, to date, merely tried to displace the existing informal institutions by transplanting institutions and practices that are ill-suited to the Afghan context. This dissertation proposes that Afghan policymakers should, going forward, pursue policies that combine a respect for existing informal institutions with an appreciation for the advantages that formalization and state oversight can provide.

This dissertation proposes that the government of Afghanistan should develop effective institutions using an approach that this dissertation calls “Grounded Institutional Reform.” As explained in Chapter Four, the Afghan government has correctly to conclude that existing informal institutions are insufficient to provide the investment financing that its economy will need if it is to develop sustainably. The government should continue to develop and promote a series of formal, state regulated institutions that will provide more access to investment financing than the informal institutions are currently able to provide. These new institutions, however, should be improved versions of existing institutions. The government should absorb the working informal institutions

that are working into the formal system by reshaping and building on them because they provide tried models of workable institutions. Furthermore, Grounded Institutional Reform ensures a smoother transition to a formalized economy because it incorporates the existing institutional knowledge and networks, thus building on them. Grounded Institutional Reform reduces the need to rely on limited coercive power and administrative capacity of state. By absorbing working informal institutions, Grounded Institutional Reform makes it more likely that weak governments of less-developed countries can overcome the resistance from the invested users of informal institutions. Grounded Institutional Reform accomplishes this task by rendering formalization self-interest compatible. By incorporating informal institutions, Grounded Institutional Reform ensures that invested users will continue to have a role (albeit an altered role) in the formal system. This creates an incentive for the invested users to comply with the formal rules.<sup>24</sup>

A policy based on Grounded Institutional Reform retains the bottom-up and incremental approach to policymaking rooted in Entrepreneurial Institutional Theory. Grounded Institutional Reform leverages the problem-solving abilities of entrepreneurs and ensures user-readiness by absorbing the entrepreneur-developed informal institutions into the formal system. At the same time, however, because the modified institutions are formalized and integrated into the larger state legal apparatus, the institutions will allow lenders to lend (and merchants to borrow) with the added predictability and certainty that State-Centered theorists say, correctly, is necessary for the economy to thrive.

The following examples of reforms that could feasibly be undertaken illustrate what a policy of Grounded Institutional Reform would look like and demonstrate its feasibility.<sup>25</sup>

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<sup>24</sup> Chapter Five examines Grounded Institutional Reform in Chapter Five in greater detail and also addresses the challenges that the application of this approach poses in the context of Afghanistan.

<sup>25</sup> These illustrative examples are examined in greater detail in Chapter Five.

For example, while Afghanistan's Strategic Economic Policies during the post-Taliban period have correctly recognized the need to improve credit for exporters, however they have failed to recognize the potential of leveraging *Sarrafs*' short-term working capital loans for that purpose. Afghanistan's formal policies have proposed creation of an export bank, which would provide credit to exporters at a lower interest rate. The problem with this proposition is that it requires resources that Afghanistan government does not have, as well as institutional knowledge that Afghan merchants and officials do not possess. This is why this proposition has not materialized. A Grounded Institutional Reform approach, on the other hand, would leverage *Sarrafs*' short-term working capital loans, institutions that already help finance import, instead of creating export banks. Leveraging *Sarrafs*' short-term working capital loans would require fewer government resources because it would use the merchants' funds held by *Sarrafs* to provide credit and would build on existing institutional knowledge that Afghan merchants have (they already use short-term working capital loans to finance import).

In addition, while Afghanistan's Government Strategic Policies correctly try to improve land tenures in the cities to help release the value trapped in the housing market, their strategies fail to capitalize on the potential of *Gerawee* to release the untapped value of the housing market despite imperfect documentation of land tenures. This disregard of *Gerawee* as a financing mechanism deprives Afghan merchants of a valuable source of finance while the government undertakes the incredibly difficult task of reforming Afghanistan's property rights system. *Gerawee* has the added advantage of relying on existing institutional knowledge and networks. Grounded Institutional Reform's policy would seek to improve the efficiency of *Gerawee* by ensuring the protection of creditors' rights, which can be aided by placing *Gerawee* under the jurisdiction of commercial courts.

And while Afghanistan's Strategic Policies appropriately strive to reform property rights and lower interest rates to expand the provision of bank loans and stimulate economic growth, they fail to recognize the potential of *Sar qufli* in lowering the capital cost of construction projects and improving liquidity in the capital market. Nor do they recognize the role *Sarrafs'* short-term working capital loans play in lowering the capital cost of imports. Policies based on Grounded Institutional Reform would try to leverage *Sar qufli* and *Sarrafs'* short-term working capital loans to improve liquidity in the capital market and improve access to credit for Afghan merchants. Similarly, while Afghanistan's Strategic Policies identify the need to lower the cost of contract enforcement, their solution focuses on a formalized Alternative Dispute Resolution Center, disregarding the potential of common, and localized business collectives that currently resolve most disputes among merchants. Grounded Institutional Reform's policy would attempt to support localized dispute resolution within local business collectives.

Finally, Afghanistan's Government Strategic Policies also seek to address the information problems facing banks by proposing creation of a Credit Bureau to collect and process credit information on businesses. This type of institution will not solve the problem because, given Afghanistan's pervasive informal economy, formal credit information is essentially non-existent. However, Afghanistan's Strategic Policies disregard the wealth of information that *Sarrafs*, as the main financial service providers of most businesses in Afghanistan, already possess. If banks could access the information *Sarrafs* hold on their clients, it would greatly improve their ability to assess risk and issue loans. *Sarrafs*, through handling their clients' currency exchange and *hawalas*, have reliable knowledge about their clients' creditworthiness; they use this information to give their clients working capital loans without any collateral or written contract. The Grounded Institutional Reform approach would advocate incentivizing *Sarrafs* to share information with banks, for

example by requiring a *Sarrafi* to guarantee a bank loan issued to the *Sarrafi's* client. In this way, *Sarrafi's* could provide banks with reliable independently produced data on hard to measure metrics of creditworthiness such as cash flow and financial management. Thus, it would allow banks to reduce their reliance on scarce formal collateral to issue loans. Since banks' demanding collateral requirement is an insurmountable barrier for most Afghan merchants, this could greatly increase bank lending in Afghanistan.

This dissertation recommends that Afghanistan adopt the following institutional reforms to improve access to finance and stimulate economic growth:<sup>26</sup> (1) reform formal property rights to create clear rules to determine legal ownership, and to create an integrated system of legal, reliable, and up-to-date titling to reduce transaction costs for property and collateralization; (2) introduce targeted and performance-linked credit guaranty schemes to lower the cost of capital; (3) improve banking regulations to restore people's trust in banks and incentivize savings in banks; (4) improve the process of application for bank loans; support and implement financial literacy programs for Afghan businesses; implement training programs for banks' staff; (5) enact legislation based on the judicial jurisprudence developed in connection with *Sar qufli* to improve the *Sar qufli* market, thereby increasing the incentive for development projects; (6) bring *Gerawee* transactions under the jurisdiction of commercial courts in cases in which the borrower is a merchant, thereby improving the rights of creditors and unleashing the potential trapped in the housing market to finance productive activities; (7) reform commercial courts' procedures and judgment enforcement to improve the comparative competitiveness of formal dispute resolution in relation to informal dispute resolution; (8) promulgate regulations that facilitate the financing

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<sup>26</sup> These recommendations are discussed in greater detail in the Conclusion and Recommendations.

role of *Sarrafs*, especially for exporters; and (9) incentivize *Sarrafs* to share information with banks and the Credit Bureau when it is established.

This dissertation accomplishes three undertakings: (1) it identifies the reasons why it is difficult for Afghan merchants to access credit; (2) it describes the main institutional solutions that have emerged organically to improve access to credit for Afghan merchants; and (3) it critically assesses whether, how, and to what extent the emergent institutional solutions improve access to credit for Afghan merchants. Drawing on the case study of Afghanistan, this dissertation concludes by developing a new approach for institutional reform in countries like Afghanistan that are characterized by poor infrastructure, limited market expansion opportunities, and a reformist but weak government—namely Grounded Institutional Reform.

## Chapter One: LITERATURE REVIEW AND METHODOLOGY

Over the years, many have studied the question of how the prevailing rules affect the economic performance of different countries and how policymakers can design better rules to aid economic growth. In this dissertation, this dissertation draws on different literatures to analyze the problems of credit transacting in Afghanistan and critically evaluate the institutional solutions that have emerged to alleviate those problems. Leveraging the analysis of problems of credit transacting in Afghanistan and the diagnosis of the existing formal and informal institutions, this dissertation engages in the broader debate on the institutional development and economic growth. It explains why none of the current theories of institutional development can fully explain the failure of Afghanistan's institutions to provide adequate credit, and the failure of Afghan government programs designed to improve access to credit for Afghan merchants. It finds that current theories of institutional development each fail to provide models that would help to effectively create institutions in a country where merchants face the peculiar conditions facing Afghans, thus policies rooted in them were doomed to fail.

The research for this dissertation is designed and executed using Grounded Theory.<sup>27</sup> Grounded Theory is a qualitative research methodology that is best fit for studying an understudied, basic social process with the aim of producing a theory.<sup>28</sup> It entails a dialogical process where the researcher engages in constant comparison between empirical data and a theoretical explanation of that data to generate a theory that could account for the empirical findings.<sup>29</sup> This dissertation has used Grounded Theory to study the problems of and solutions to

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<sup>27</sup> Grounded Theory as a qualitative methodology was developed by Strauss and Glaser. *See* ANSELM L. STRAUSS & BARNEY GLASER, *THE DISCOVERY OF GROUNDED THEORY: STRATEGIES FOR QUALITATIVE RESEARCH* (1967).

<sup>28</sup> MELANIE BIRKS & JANE MILLS, *GROUNDED THEORY: A PRACTICAL GUIDE* 17 (2d. ed. 2015).

<sup>29</sup> *Id.* at 10.

credit transacting in Afghanistan. This dissertation explains how the existing theories of institutional development fail to account for the case of Afghanistan. Finally, this dissertation has generated a new approach for institutional reform based on the case study of Afghanistan for countries with poor infrastructures, limited market expansion opportunists, and reformist but weak governments.

### **1.1. A Review of the Literature**

A number of scholars writing in a variety of disciplines have developed theories that this dissertation uses to analyze the following questions: what are the problems that credit transactions raise in Afghanistan? What solutions have emerged to overcome those problems? Whether, how, and to what extent the emerging solutions have improved access to credit for Afghan merchants? And how Afghanistan can design institutions to effectively improve access to credit for Afghan merchants?

This dissertation examines scholarship from the literatures on Transaction Cost Economics, Neo-Institutional Theory, Property Rights Theory, Finance and Economic Growth, the literature on the relation between formal and informal sectors, and the literature on institutional development.

As explained in the introduction, Afghan merchants face a set of fundamental problems when attempting to engage in a credit transaction; primarily, a highly volatile business climate, property rights that cannot be used to securitize credit transactions, and ineffective formal dispute resolution institutions. These problems increase the cost of entering into a credit transaction for Afghan merchants. A merchant will only enter into a credit transaction if the expected value of the transaction exceeds its cost. Therefore, studying the transaction costs literature provides insights into the problems with credit transactions and its effects on access to credit. That is why, this

dissertation uses the concept of transaction costs to operationalize the effects of constraints on credit transactions in Afghanistan.<sup>30</sup>

In a world of perfect information, transacting would be costless.<sup>31</sup> Everyone would know the relevant descriptions of the thing being transacted; every eventuality in a contract would be known and accounted for; and parties would know, *ex ante*, whether and how the contract would be implemented. We do not live in a world of perfect information. Institutions help to solve the problems caused by transacting in a world of imperfect information.<sup>32</sup> Thus, institutions determine the prevailing transaction costs by determining how the problem of imperfect information should be resolved.<sup>33</sup>

North provides the most compelling and comprehensive institutional explanation for how institutions affect economic growth, work that led to his 1993 Noble Prize in Economics.<sup>34</sup> North's theory suggests that formal institutions reduce transaction costs by expanding the pool of possible transaction-partners and thus incentivizes economic growth.<sup>35</sup> North's theory offers a very useful way of thinking about the institutions by considering them solutions to the problems

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<sup>30</sup> For example, an absence of well-developed formal property rights has increased the information cost for banks when deciding to issue loans. The market failure this cost creates has been partly remedied by *Sarrafs* and sellers/creditors who have lower information cost due to their continuous interactions with the buyers/debtors. Formal property rights render the information about a borrower's assets, their market value, and possibility and ease of repossession transparent and easily accessible by positioning borrowers and their assets within an integrated and transparent formal grid. Without well-developed property rights, access to information about borrowers' assets and credit worthiness requires repeated and continuous interaction, intimate knowledge of local markets and business relations, and knowledge of the character and social positioning of borrowers. *Sarrafs* and sellers/creditors, compared to banks, are better positioned to access this information.

<sup>31</sup> See Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. ECON. 1, 43 (1960); Ronald H. Coase, *The Nature of The Firm: Origin, Meaning, Influence*, 4 J. L. ECON. ORG. 3, 4 (1988).

<sup>32</sup> DOUGLAS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 5 (1990).

<sup>33</sup> *Id.*

<sup>34</sup> Douglass C. North - Prize Lecture: *Economic Performance through Time*, December 9, 1993, NOBELPRIZE.ORG, [http://www.nobelprize.org/nobel\\_prizes/economic-sciences/laureates/1993/north-lecture.html](http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1993/north-lecture.html) (posted May 24, 2018)(North and Robert W. Fogel won the 1993 Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel).

<sup>35</sup> North (1990), *supra* note 32, at 46-47.

of transacting in a world of imperfect information. While North's theory provides a useful foundation or starting place, its usefulness is somewhat limited for an in-depth case study of credit transactions in Afghanistan, because it has a very broad scope. North attempted to produce a broad institutional theory that could explain the differences between economic performances of disparate countries. To do this, North had to greatly expand the definition of institutions and underspecify the relations between different components of his theory.

North defines institutions as the set of formal and/or informal rules, norms, beliefs, and conventions, as well as their enforcement mechanisms, that facilitate, coordinate, and constrain behaviors.<sup>36</sup> As Luis Angeles and Julio Faundez acknowledge, it is extremely difficult—if not impossible—to operationalize this definition.<sup>37</sup> As such, this dissertation will use a narrower definition of institutions for this dissertation.<sup>38</sup> North seems to define formal institutions as those that are comprised of legal rules.<sup>39</sup> As Faundez has observed, North does not seem concerned with the way legal rules are interpreted and applied.<sup>40</sup> However, the research for this dissertation shows that interpretation and application of legal rules can have fundamental consequences for the synergies between formal and informal institutions and hence institutional evolution.<sup>41</sup>

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<sup>36</sup> *Id.* at 3-4.

<sup>37</sup> Luis Angeles, *Institutions, Property Rights, and Economic Development in Historical Perspective* 64(2) KYKLOS INT. REV. SOCIAL SCIENCES 157, 161 (2011); Julio Faundez, *Douglas North's Theory of Institutions: Lessons for Law and Development*, 8 HAGUE J. R. L. 373, 388 (2016).

<sup>38</sup> See definition section later in this Chapter.

<sup>39</sup> NORTH (1990), *supra* note 32, at 46.

<sup>40</sup> Faundez, *supra* note 37, at 406.

<sup>41</sup> This is shown in Chapters Two, Three and Five, discussing the role of the judiciary in formalizing the informally-developed institutions of *Sar qufli* and *Gerawee*.

North's historical studies mainly focus on property rights.<sup>42</sup> He argues that improvement in property rights reduced the gap between private return and social return;<sup>43</sup> in this way, North emphasizes that increased protection of private property rights incentivizes technological advancement and productive endeavors by increasing the private gain.<sup>44</sup> Faundez has noted the lack of specificity offered by North's broad theory on relationship between transaction costs and institutions.<sup>45</sup> In the North's theory, institutions determine transaction costs, transaction costs, in turn, determine how institutions evolve because of path dependency.<sup>46</sup> Thus, under Northean theory, if the current institutions decrease the cost of making efficiency-enhancing transactions, those transactions are more likely to occur, and the efficiency of institutions are improved on margin.<sup>47</sup> Thus, current institutions evolve toward efficient institutions. Northean theory predicts, on the other hand, if current institutions make efficient-enhancing transactions costly, they are less likely to occur, and the inefficient institutions endure.<sup>48</sup> Thus, as Faundez observed, in Northean theory, *institutions are both determinants of, and determined by transaction costs.*<sup>49</sup>

Instead of endogenizing institutional development to the transaction costs of changing institutions (as North did), this dissertation posits that the constraints that Afghan merchants face (for example, volatile business climate and ineffective formal institutions) are the main determinants of the emergent institutional solutions. It takes these constraints to be exogenous to

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<sup>42</sup> See, e.g., DOUGLAS C. NORTH & ROBERT PAUL THOMAS, THE RISE OF THE WESTERN WORLD: A NEW ECONOMIC HISTORY (1973).

<sup>43</sup> *Id.* at 1.

<sup>44</sup> *Id.*

<sup>45</sup> Faundez, *supra* note 37, at 392.

<sup>46</sup> NORTH (1990), *supra* note 32, at 101.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> Faundez, *supra* note 37, at 392.

the emergent credit institutions and ameliorates the problem of endogeneity—without eliminating it—by describing the causal pathways that connects the prevailing constraints to the emergent credit institutions. It also highlights the historical roots of these constraints to diminish the problem of endogeneity.

Northeast theory on the relationship between formal and informal institutions and efficiency, also underspecifies. Informal institutions, according to North, are those that are comprised of customs, beliefs, and norms of behavior that are not legally enacted.<sup>50</sup> North advocates for formal institutions because formal institutions can better facilitate impersonal exchange which North argues lead to more specialization and growth.<sup>51</sup> Thus, he advocates for an economy that operates in accordance with the legal rules.<sup>52</sup> On the other hand, North argues that informal rules can render formal rules inefficient.<sup>53</sup> Therefore, as Faundez has observed, it seems that under a Northeast theory, informal rules are the determinant of efficiency, and changes in the formal rules, *ceteris paribus*, may have very limited to no impact on the efficiency of an economy.<sup>54</sup> That is why while North is an advocate of formal institutions he is very skeptical about the possibility of creating good formal institutions through institutional transplantation<sup>55</sup>—a

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<sup>50</sup> NORTH (1990), *supra* note 32, at 36.

<sup>51</sup> *Id.* at 46-47.

<sup>52</sup> *Id.*; See also DOUGLAS C. NORTH ET AL., VIOLENCE AND SOCIAL ORDER: A CONCEPTUAL FRAMEWORK FOR INTERPRETING RECORDED HUMAN HISTORY (2009) (where it is argued that open access order, which operates according to impersonal rules and allows for free formation of organizations, is the cause of sustained economic growth).

<sup>53</sup> “Economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy *because of different informal norms* and enforcement transferring the formal political and economic rules of successful Western economies to third-world and Eastern European economies is not a sufficient condition for good economic performance.” (emphasis added) Douglas C. North, *Economic Performance through Time*, 84 THE AMERICAN ECONOMIC REVIEW 359, 367 (1994).

<sup>54</sup> Faundez, *supra* note 37, at 401.

<sup>55</sup> North (1994), *supra* note 53, at 367.

position that runs contrary to the practice of international organizations<sup>56</sup> that purport to use Northean theory to pressure developing countries to adopt institutional “best practices”.<sup>57</sup> As Faundez has argued, Northean theory cautions against institutional engineering; however, the World Bank, International Monetary Fund, and other international organizations have justified massive institutional engineering programs in developing countries, including Afghanistan, based on a selective interpretation of Northean theory under the banner “institutions matter.”<sup>58</sup> North’s primary insight is that informal rules are deeply embedded in society and resist change in the face of changing formal institutions.<sup>59</sup> This makes transplantation of formal rules ineffective.<sup>60</sup> In this dissertation, this dissertation draws on this insight to propose a new approach to institutional reform, Grounded Institutional Reform.<sup>61</sup>

The relationship between economic growth and economic development *vis-a-vis* legal depersonalization (formalization) is complex, to say the least. The current literature is that the efficiency of different types of institutions depends on the context. As Faundez points out, North does not offer an explanation as to why and how different societies develop different informal institutions, nor does he explain how informal institutions are transformed into formal institutions.<sup>62</sup> The inconclusiveness and incompleteness of the institutional theory literature on this

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<sup>56</sup> International Organizations such as World Trade Organization, International Monetary Fund, and World Bank. The issue of practice of international organization is revisited later in this Chapters Four and Five.

<sup>57</sup> See Dani Rodrik, *The New Development Economics: We Shall Experiment, But How Shall We Learn?*, HARVARD KENNEDY SCHOOL FACULTY RESEARCH WORKING PAPER SERIES 100 (2008), <https://research.hks.harvard.edu/publications/getFile.aspx?Id=317>; Faundez, *supra* note 37, at 374; MATT ANDREWS ET AL., BUILDING STATE CAPABILITY: EVIDENCE, ANALYSIS, ACTION 44-45 (2017).

<sup>58</sup> Faundez, *supra* note 37, at 374.

<sup>59</sup> North (1994), *supra* note 53, at 367.

<sup>60</sup> With regard to Muslims countries, in particular, North argues that the reason Muslim countries fell behind the Western world in production of knowledge is their culture. DOUGLAS C. NORTH, THE PROCESS OF ECONOMIC CHANGE 44 (2005).

<sup>61</sup> See Chapter Five.

<sup>62</sup> Faundez, *supra* note 37, at 401.

point, coupled with the need to base developmental programs on sound theoretical grounds, highlight the importance of context-driven, in-depth studies that try to identify causal mechanisms. This dissertation, in part, is a response to this theoretical need and it will hopefully help create better policies in countries like Afghanistan.

### **1.1.1. Literature on Transaction Costs, Institutions, and Economic Growth**

Because this dissertation uses transaction costs to operationalize the effects of the constraints on credit transactions in Afghanistan, this literature review follows with a brief introduction to the literature on transaction costs. Next, it briefly introduces institutional theories that are focused on the institutions as the solutions to the problems of credit transacting and describes the consequences that different institutions have for economic growth.

What causes economic growth?<sup>63</sup> One answer is: specialization, trade and innovation.<sup>64</sup> An economy grows, i.e. output per worker increases, when individuals instead of producing all their needs, produce one thing and trade that for their other needs, and find ways to do it better and with less resources.<sup>65</sup> Even from this simple microlevel explanation it becomes apparent that transacting has paramount importance for economic growth.

Standard neoclassical economics assumes transacting to be costless; therefore, all mutually beneficial transactions take place, and transacting corrects any initial inefficient allocation of rights

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<sup>63</sup> There is a difference between economic growth and economic development. Economic growth refers to a sustained increase in real output of an economy as measured by the real GDP, while the economic development refers to an increase in living standard as measured by different criteria such as life-expectancy, literacy level, and health care. It is expected that the economic growth enables economic development, however, it is not guaranteed that it will. For a study of the relationship between economic growth and development, See Alejandro Ramirez et. al, *Economic Growth and Human Development*, (Economic Growth Center Discussion Paper No. 787) [http://www.econ.yale.edu/growth\\_pdf/cdp787.pdf](http://www.econ.yale.edu/growth_pdf/cdp787.pdf)

<sup>64</sup> See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 106 (1776).

<sup>65</sup> *Id.*

and resources.<sup>66</sup> Transaction Cost Economics, which is a strand of New Institutionalism, on the other hand, posits transaction cost to be positive.<sup>67</sup>

There is no agreement in the literature on the definition of a transaction cost.<sup>68</sup> Transaction costs have been defined as the cost of using the price mechanism,<sup>69</sup> the costs involved in exchange of ownership titles,<sup>70</sup> the costs of running an economic system,<sup>71</sup> the cost involved with the transfer, acquisition, and protection of rights,<sup>72</sup> the cost of monitoring the thing that is being transacted, and the cost involved in monitoring and enforcing the transaction.<sup>73</sup> The *ex-ante* cost of negotiating an agreement and the *ex-post* costs of contract governance and securing commitment.<sup>74</sup> More specifically, Libecap defines transaction costs as the costs of bargaining, information, measurement, monitoring, enforcement, and political action.<sup>75</sup> Furubotn and Richter, similarly, have defined transaction costs as the bargaining and decision costs, and policing and enforcement costs.<sup>76</sup>

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<sup>66</sup> See Coase (1960), *supra* note 31, at 43; Coase (1988), *supra* note 31, at 4; NORTH (1990), *supra* note 32, at 19; OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 23 (1996). Kenneth J. Arrow, *The Organization of Economic Activity: Issues Pertinent to the Choice of Market versus Non-Market Allocation*, in 1 THE JOINT ECONOMIC COMMITTEE OF CONGRESS, THE ANALYSIS AND EVALUATION OF PUBLIC EXPENDITURES: THE PBB-SYSTEM 59 (1969).

<sup>67</sup> See Arrow, *supra* note 66, at 59; NORTH (1990), *supra* note 32, at 19; WILLIAMSON (1996), *supra* note 66, at 23.

<sup>68</sup> Maliti Musole, *Property Rights, Transaction Costs and Institutional Change: Conceptual Framework and Literature Review*, 7 PROGRESS IN PLANNING 43, 46 (2009).

<sup>69</sup> Coase, *supra* note 31, at 4; Ronald H. Coase, *Blackmail*, 74 VA. L. REV. 655, 671 (1988);

<sup>70</sup> Harold Demsetz, *The Cost of Transacting*, 82 Q. J. ECONOMICS 33, 33 (1968).

<sup>71</sup> Arrow, *supra* note 66, at 59.

<sup>72</sup> YORAM BARZEL, ECONOMIC ANALYSIS OF PROPERTY RIGHTS 4 (1989).

<sup>73</sup> NORTH (1990), *supra* note 32, at 29.

<sup>74</sup> OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 20-21 (1985).

<sup>75</sup> Gary D. Libecap, *Property Rights in Economic History*, 23 EXPLORATIONS IN ECONOMIC HISTORY 227, 228 (1986).

<sup>76</sup> Eirik G. Furubotn & Rudolph Richter, *The New Institutional Economics: An Assessment*, in THE NEW INSTITUTIONAL ECONOMICS: A COLLECTION OF ARTICLES FROM THE JOURNAL OF INSTITUTIONAL AND THEORETICAL ECONOMICS 1-2 (Eirik Furubotn & Rudolph Richter eds., 1991).

As it can be seen, transaction cost is used differently by different authors. Allen distinguishes between two different uses of transaction cost in the literature: transaction cost as used by neoclassical economists and transaction costs as used by the property rights' scholars.<sup>77</sup> The former, according to Allen, refers to the cost of transacting, i.e., the costs incurred when a transaction takes place.<sup>78</sup> The latter, Allen argues, comprises of the costs of identifying and protecting property rights.<sup>79</sup> Thus, the latter costs are present wherever property rights exist independent of the transactions that take place. According to Allen's classifications, the neoclassicist's transaction costs include costs such as the cost of finding a trade partner, negotiating and enforcing contracts, while the property rights' transaction costs includes costs of protecting and monitoring property rights.

Transacting gives rise to numerous chances for opportunistic behavior engendered by the asymmetry of information, adverse selection, moral hazard, and boundedness of rationality.<sup>80</sup> Therefore, a transaction occurs—or gains from an exchange are actualized—only if the costs of transacting are lower than the benefits that can be gained from the transaction, parties can commit themselves, *ex-ante*, and the opportunism is reasonably curtailed.

Institutions are the solutions to the problems of transacting under the conditions of imperfect information, and as such, determine the prevailing transaction costs.<sup>81</sup> Institutions are the set of formal and/or informal rules, norms, beliefs, conventions, and their enforcement

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<sup>77</sup> Douglas W. Allen, *Transaction Costs*, in ENCYCLOPEDIA OF LAW & ECONOMICS 893 (Bouckaert et al. ed. 1999), <https://www.sfu.ca/~allen/allentransactioncost.pdf>.

<sup>78</sup> *Id.* at 894.

<sup>79</sup> *Id.* at 894.

<sup>80</sup> NORTH (1990), *supra* note 32, at 27-28; WILLIAMSON (1996), *supra* note 66, at 5; CHRYSOSTOMOS MANTZAVINOS, INDIVIDUALS, INSTITUTIONS, AND MARKETS 83 (2001); MARCEL FAFCHAMPS, MARKET INSTITUTIONS IN SUB-SAHARAN AFRICA 31 (2004).

<sup>81</sup> NORTH (1990), *supra* note 32, at 27.

mechanisms that facilitate, coordinate, and constraint behaviors.<sup>82</sup> Institutions can reduce information and search cost by facilitating the flow of information. They reduce the negotiation cost and solve the problem of bounded rationality by stabilizing contractual expectations and coordinating parties' behaviors. They allow parties to commit, *ex-ante*, and curtail opportunisms by credibly constraining party behavior. In short, they provide *a* solution to the problem of costliness of transacting and opportunism.<sup>83</sup> However, the solution need not be efficient.<sup>84</sup>

It is not a given that institutions are efficient.<sup>85</sup> Institutions are formed against background of existing institutions either spontaneously out of human interactions<sup>86</sup> or through bargaining among parties who have different interests and bargaining powers.<sup>87</sup> Even designed institutions tend to have both intended and unintended consequences because humans' rationality is bounded, and the environment is rife with uncertainties.<sup>88</sup> Although institutions change in response to exogenous and/or endogenous changes,<sup>89</sup> institutional change is highly path dependent.<sup>90</sup> This means institutions that were once efficient may become inefficient due to environmental change and path dependency.<sup>91</sup>

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<sup>82</sup> *Id.* at 4,

<sup>83</sup> *Id.*, at 27.

<sup>84</sup> *Id.* at 64.

<sup>85</sup> *Id.*

<sup>86</sup> 1 FRIEDRICH A. HAYEK, *LAW, LEGISLATION AND LIBERTY: RULES AND ORDER* 8-9 (1973).

<sup>87</sup> NORTH (1990), *supra* note 32, at 68.

<sup>88</sup> *Id.* at 67.

<sup>89</sup> *Id.*; Anver Greif & David D. Laitin, *A Theory of Endogenous Institutional Change*, 98(4) AM. POL. SC. REV. 633 (2004).

<sup>90</sup> NORTH (1990), *supra* note 32, at 68; Greif & Laitin, *supra* note 89, at 633; *see also* Michael T. Hannan & John Freeman, *Structural Inertia and Organizational Change*, 49(2) AMER. SOCIOLOGICAL REV. 149 (1984) (discussing structural inertia and organizations); Paul Pierson, *Increasing Returns, Path Dependence, and the Study of Politics*, 94(2) AM. POLITICAL SCI. REV 251 (2000) (discussing path dependency in the context of political institutions).

<sup>91</sup> NORTH (1990), *supra* note 32, at 68.

An economy's overall efficiency is a result of the net effect of its institutions (both efficient and inefficient).<sup>92</sup> In countries where the net effect is toward efficiency, economies grow, whilst in the countries where the net effect is toward inefficiency, the economies will stagnate.<sup>93</sup> For those who want to design institutional reform to improve economic performance, then the question becomes, which institutions are efficient? The answer is not simple because institutions are only successful if they are appropriate for the contexts in which they are set. The same institutions may have vastly different effects in different contexts. In this dissertation, this dissertation will argue the best way to design institutions that can effectively reduce transaction cost is to build on the existing informal institutions.<sup>94</sup>

### **1.1.2. Literature on Property Rights, Transaction Costs, and Economic Growth**

In framing the analysis of the current Afghanistan's economy and institutions and introducing good policies that would improve it, this dissertation draws on a variety of works. This dissertation does not adopt a broad institutional theory wholesale; rather, it focuses on the narrower issues of the role of transaction costs, and the solutions Afghans have devised to improve the market frictions that transaction costs create, i.e. informal institutions that have emerged to overcome the problems of transacting—in particular, credit transacting in a highly volatile business climate with ineffective formal institutions. In doing so, it draws upon the literature on the relation between property rights and transaction costs.

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<sup>92</sup> NORTH (1990), *supra* note 32, at 69.

<sup>93</sup> *Id.*

<sup>94</sup> *See* Chapter Five.

Property rights are not uniformly defined in legal and economic literature.<sup>95</sup> Legal scholars define property rights as a legally enforceable claim one person has against another concerning things.<sup>96</sup> Cole and Grossman argue that in economic literature, such consensus does not exist.<sup>97</sup> Allen suggests that attempts to go beyond legal property rights is common in economic literature.<sup>98</sup> While some economists adopt the legal definition,<sup>99</sup> others like Furubotn and Richter expand their definition to include property rights that are only protected by “the force of etiquette, social custom, and ostracism. . . or other non-legal instruments such as self-enforcement. . .”<sup>100</sup> North defines property rights as the rights people attain over their labor and other goods and services that they possess,<sup>101</sup> while Barzel defines property rights as the “...the rights, or the power, to consume, obtain income from, and alienate these assets.”<sup>102</sup> Barzel adds that legal rules enhance economic rights, but they are neither necessary nor sufficient for the existence of the property rights.”<sup>103</sup>

Different property rights enjoy different levels of protection based on how effectively the formal institutions can be used to protect them. For example, in Afghanistan *Sar qufli* has managed to gain more formal legal protection compared to *Gerawee* because the former has been more

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<sup>95</sup> Musole, *supra* note 68, at 52.

<sup>96</sup> Daniel H. Cole and Peter Z. Grossman, *The Meaning of Property Rights: Law versus Economics?*, 78(2) LAND ECONOMICS 317, 318 (2002).

<sup>97</sup> *Id.* at 322.

<sup>98</sup> Allen, *supra* note 77, at 897.

<sup>99</sup> *See, e.g.* Armen A. Alchian, *Some Economics of Property Rights*, 30(4) II POLITICO 816, 817 (1965); Harold Demsetz, *Toward A Theory of Property Rights*, 57(2) Am. Econ. Rev. 347, 348 (1967).

<sup>100</sup> EIRIK G. FURUBOTN & RUDOLPH RICHTER, INSTITUTIONS AND ECONOMIC THEORY: THE CONTRIBUTION OF THE NEW INSTITUTIONAL ECONOMICS 76 (2000).

<sup>101</sup> NORTH (1990), *supra* note 32, at 62.

<sup>102</sup> BARZEL, *supra* note 72, at 2.

<sup>103</sup> *Id.*

effectively incorporated into formal institutions while the holder of both types of property rights, arguably, have some legal claims that theoretically is protected by formal rules.<sup>104</sup>

As to the relation between transaction costs and property rights, in the world of zero transaction costs the initial assignment of property rights does not matter because rights can be voluntarily and costlessly exchanged to achieve optimal distribution—this is known as Coase Theorem.<sup>105</sup> When transaction costs are positive, allocation of property rights matter because exchange and transfer rights are constrained.<sup>106</sup> In such a case, which is the case in real world, initial distribution of property rights have significant effects on efficient allocation of resources, production, and hence, economic growth.<sup>107</sup> Where high transaction costs are present, creation, specification, and enforcement of property rights are harder making transformation of property rights more difficult.<sup>108</sup> Thus, the inability to restructure property rights, coupled with the fundamental role property rights play in market exchange, makes the ill-defined property right system the primary source of market failure.<sup>109</sup>

As to the effects of property rights on economic growth, Besely and Ghatak, drawing on the existing research, argue that property rights affect efficient allocation of resources and hence economic growth in two main ways: limiting expropriation, and facilitating market trades.<sup>110</sup> The former enhances investment incentives by limiting expropriation risks and reducing the need to divert private resources to protect property rights. Strong private property rights encourage

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<sup>104</sup> This is discussed further in Chapter Three.

<sup>105</sup> Ronald H. Coase, *The Institutional Structure of Production*, 82(4) AM. ECON. REV. 719 (1992).

<sup>106</sup> *Id.*; NORTH (1990), *supra* note 32, at 62; Musole, *supra* note 68, at 63.

<sup>107</sup> *Id.*

<sup>108</sup> Musole, *supra* note 68, at 63.

<sup>109</sup> Coase, *supra* note 105, at 719; NORTH (1990), *supra* note 32, at 62; Musole, *supra* note 68, at 63.

<sup>110</sup> Timothy Besley & Maitreesh Ghatak, *Property Rights and Economic Development*, in 5 HANDBOOK OF DEVELOPMENT ECONOMICS 4528-4529 (Dani Rodrik & Mark Rosenzweig eds., 2010).

investment by making efficient-enhancing activities self-interest compatible.<sup>111</sup> North argues that improvement in protection of private property rights narrows the gap between private and social return on productive activities inducing development of new technologies and more productive activities.<sup>112</sup> Besely and Ghatak, with regard to the second way that property rights effect economic growth, argue that formal property rights encourage market trades and facilitates credit transaction by improving the collateralization of assets and facilitating trade in assets.<sup>113</sup>

De Soto highlights another way private property rights induce economic growth, emphasizing on the effects of formal private property rights on capital formation.<sup>114</sup> He argues that formal property rights facilitate capitalization of assets.<sup>115</sup> According to De Soto, capitalism has succeeded in the West but failed in other places, because western legal systems were able to create formal systems of property rights that allows individuals to use their physical assets for productive activities.<sup>116</sup> De Soto maintains that historically formal property right systems in the West enabled individuals to turn their assets into capital.<sup>117</sup> Poor countries stay poor not because they do not have assets, but because their legal system does not allow individuals to turn their assets into capital and use it for productive activities.<sup>118</sup> Poor countries can achieve economic growth by

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<sup>111</sup> NORTH & THOMAS, *supra* note 42, at 1; John Shuhe Li, *Relation-based versus Rule-based Governance: An Explanation of the East Asian Miracle and Asian Crisis*, 11(4) REV. OF INTERNATIONAL ECONOMICS 651, 652 (2003).

<sup>112</sup> NORTH & THOMAS, *supra* note 42, at 1.

<sup>113</sup> Besley & Ghatak, *supra* note 110, at 4528-4529.

<sup>114</sup> HERNANDO DE SOTO, *THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE* 6 (2000).

<sup>115</sup> *Id.* at 5.

<sup>116</sup> *Id.* at 47.

<sup>117</sup> *Id.* at 5.

<sup>118</sup> *Id.* at 5.

removing the barriers to entry for assets that are owned informally so they can be integrated in formal property system.<sup>119</sup>

In essence, De Soto argues that formal private property systems increase the value of physical assets by lowering the cost of knowing what economically important descriptions of those assets are and reducing the cost of transactions involving those assets.<sup>120</sup> His work illustrates how the formalization of private property rights in the West has allowed individuals to create enormous surplus value by allowing individuals to extract the economic potential trapped in their physical assets.

The fundamental relationship between property rights, transaction costs, and economic growth is the reason that this dissertation focuses on property rights as a main constraint on credit transactions faced by Afghans. Property rights in Afghanistan are not well-defined, integrated, or secure. Most property rights are held extralegally, in the sense that their acquisition and transfer do not comply with the formal legal requirements.<sup>121</sup> This means that Afghans cannot use their assets to formally secure credit transactions, they do not have access to formal risk diversification products that rely on the unbundling of property rights, and they cannot be certain that they will be able to keep the benefits from investments they make. To ameliorate the constraining effects of

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<sup>119</sup> *Id.* at 227.

<sup>120</sup> Specifically, formalization of private property rights: (1) By fixing the economic potential of assets in a legal representation of physical assets (e.g. legal title, deeds, and property registry); thus, it reduces the transaction cost of trading in assets and collateralizing credit transactions by making the economically important information about the assets easily accessible. (2) It integrates disperse information into one system: all properties are recorded in one integrated system allowing individuals to use the entirety of the economy's assets to create surpluses value at a low transaction cost. (3) By making people accountable, a formal property system enables individuals to credibly commit, allowing them to leverage their physical assets to obtain credit. (4) Formalization of private property rights makes assets fungible: unlike physical assets, legal representation of assets can be divided, amended, or combined with other assets, allowing the economy to create complex risk management arrangements, and achieve an optimal level of risk diversification. (5) A formal property rights system creates a network of known individuals connected with the information about their assets, thereby lowering the information cost and ameliorating the problem of information asymmetry. (6) By protecting transactions, a formal *Id.*

<sup>121</sup> *See* Chapter Two.

formal property right systems, Afghans have devised a multitude of financial arrangements that recognize informal property rights and account for ownership interests that fall outside formal rules of private property system.

This research contributes to property rights literature by showing that institutional entrepreneurs can create property rights and use them to securitize trade credit, independent of and in relation to formal property rights, while acknowledging the constraints that informal arrangements entail. This research illustrates a vibrant demand-led process that does not portray the property-right users in societies with weak formal property rights as passive respondents to formal rules, rather as active institutional entrepreneurs who generate continued pressure on formal institutions to adopt to the actual practices in a society. This research also highlights the importance of judicial interpretation and the enforcement of informally developed economic rights as a point of synergies between formal and informal property rights.<sup>122</sup>

### **1.1.3. Literature on Contract Enforcement Institutions, and Enforcement Cost**

Contract enforcement institutions are the main determinant of enforcement cost. North had influentially argued that informal contract enforcement mechanisms increase production cost and limit the growth of the economy because they limit the partners with whom merchants can conduct business.<sup>123</sup> By limiting the pool of these transaction partners, he argued, they create inefficient

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<sup>122</sup> It will be discussed in Chapters Two and Three.

<sup>123</sup>NORTH *supra* note 32, at 46-47; *see also* ANVER GREIF, INSTITUTIONS AND THE PATH TO MODERN ECONOMY 3 (2006); Greif & Laitin, *supra* note 89, at 633; Avner Greif, *Cultural Beliefs and the Organization of Society: A Historical and Theoretical Reflection on Collectivist and Individualist Societies*, 102(5) J. POLITICAL ECON 912, 914 (1994); Fali Huang, *The Transition from Relational to Legal Contract Enforcement*, SMU ECONOMICS & STATISTICS WORKING PAPER SERIES 2 (Paper No. 23, 2006) (arguing that relational contracts are associated with elite ruling, low social mobility, and high income inequality.); Philip Keefer & Stephen Knack, *Why Don't Poor Countries Catch-up? A Cross-National Test of an Institutional Explanation*, 34 ECON. INQUIRY 590, 601 (1997) (they surveyed twenty-nine market economies and found, trust and civic norms are stronger in the countries with formal institutions that effectively protect property rights and contract rights); Marcel Fafchamps, *Trade Credit in Zimbabwean Manufacturing*, 25(5) WORLD DEVELOPMENT 795, 796 (1997) (arguing that relation-based institutions may increase the ethnic barriers of entry to the market as suppliers use ethnic-proxy to decide on creditworthiness of customers); Floortje Kljin,

allocation of resources and limit the gain from the exchange.<sup>124</sup> As such, North advocates for formal contract enforcement mechanisms.<sup>125</sup> Formal contract enforcement mechanisms allow merchants to do business with strangers; therefore, they lower the production costs and facilitate economies of scale by expanding the pool of transacting partners. Accordingly, North views formal dispute resolution as an independent variable of economic growth.

Some scholars, however, are not convinced that formal contract enforcement is an independent variable for economic growth.<sup>126</sup> They argue that informal institutions can effectively ensure enforcement of contracts.<sup>127</sup> In some contexts, the informal institutions can even do so at a lower cost than formal institutions, without negative consequences for efficiency.<sup>128</sup> The relationship between formal institutions and economic growth is very complex and largely depends on context.

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Afghanistan Research and Evaluation Unit, *Finding the Money: Informal Credit Practices in Rural Afghanistan* (A Synthesis Paper, 2007) (arguing that although microlenders can use informal institutions like *Shuras* to identify qualified borrowers and to enforce loans, the use of these informal institutions will reinforce the barriers of access for the minority and disenfranchised groups within the communities); Shahid Yusuf & Joseph E. Stiglitz, *Development Issues: Settled and Open*, in *FRONTIERS OF DEVELOPMENT ECONOMICS: THE FUTURE IN PERSPECTIVE* 227, 231 (Gerald M. Meier & Joseph E. Stiglitz eds., 2000).

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> See, e.g., NEE & OPPER, *supra* note 3, at 5 (arguing that good formal institutions are not a prerequisite for economic growth instead they are its by-product); Kevin E. Davis & Michael J. Trebilcock, *The Relationship between Law and Development: Optimists versus Skeptics*, 56(4) *AM. J. COMP. LAW* 51 (2008) (who surveyed the empirical literature on the relationship between law and economic development and concluded that empirical literature is at best inconclusive as to the relationship between legal reform and economic development), <http://www.fgv.br/processoseletivo/md/Ingresso2017/The-Relationship-between-Law.pdf>; Edward L. Glaeser and et. al, *Do Institutions Cause Growth?*, 9(3) *J. ECON. GROWTH* 271, 273 (2004) (who used multi-country comparisons to argue that human capital, not the strength of formal institutions, is the best predictor of economic growth); KELLE S. TSAI, *BACK-ALLEY BANKING: PRIVATE ENTREPRENEURS IN CHINA* 4 (2002) (arguing that informal can operate effectively beyond the shadow of formal rules); JEAN-PHILIPPE PLATTEAU, *INSTITUTIONS, SOCIAL NORMS, AND ECONOMIC DEVELOPMENT* 3-4 (2000); Richard A. Posner, *Creating a Legal Framework for Economic Development*, 13(1) *THE WORLD BANK RESEARCH OBSERVER* 2 (1998).

<sup>127</sup> *Id.*

<sup>128</sup> *Id.*

This dissertation finds that Afghan merchants are strategic in their choice of formal and informal dispute resolution institutions.<sup>129</sup> In cases where the court judgments are necessary and effective, they opt to use the formal institutions. When informal dispute resolution can produce equal or superior outcomes at a lower cost they use informal institutions instead. Given the current uncertainty of current of court judgments the latter is most often the case.

The research conducted for this dissertation also reveals that the informality of dispute resolution does not significantly limit the choice of transaction partners within Afghanistan.<sup>130</sup> Afghan merchants can draw on a host of social and institutional relations to transact with merchants who occupy a distant social and geographical position within Afghanistan. However, the informality of dispute resolution puts non-Afghans at a disadvantage and may hinder the depersonalization of business relationships in Afghanistan.

The findings of this dissertation also contradict some specific findings within the literature on informal and formal contract enforcement. While in the literature it is often argued that the business size and use of court is positively correlated,<sup>131</sup> the case of Afghanistan shows that there is no linear relationship between economy of scale and the use of courts.<sup>132</sup> In Afghanistan, larger firms do not use courts more often, rather, the opposite is the case; smaller and medium-sized firms are more frequent users of courts. This is because disputes that are resolved in courts are usually end-of-business and end-of-relationship disputes. This dispute-type is more common among smaller firms because they have less capital; therefore, they cannot internalize non-performance costs as well as larger firms. Larger firms have better access to out-of-court dispute resolution, and

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<sup>129</sup> See Chapters Two and Three.

<sup>130</sup> See Chapter Three.

<sup>131</sup> See, e.g., FAFCHAMPS (2004), *supra* note 80, at 10.

<sup>132</sup> See Chapter Three.

so they have more capital, which allows them to resolve their disputes informally and internalize non-performance costs. As a result, they use courts less often.

In other unexpected findings this dissertation finds that high barriers to entry does not foster more credit transactions.<sup>133</sup> In the literature on informal institutions in less developed countries, it is often argued, that high barriers to entry will foster credit transactions in informal economies by allowing parties to more credibly commit.<sup>134</sup> However, in Afghanistan there is no linear relation between a higher barrier to entry and prevalence of trade credit; rather, this dissertation observes the opposite. In Balkh, for example, higher barriers to entry resulted in reduced competition and reduction of the supply of trade credit.

#### **1.1.4. Literature on the Functions of the Financial System and Economic Growth**

Different types and combinations of information, enforcement, and transaction costs create incentives for development of distinct financial agreements, markets, and intermediaries with markedly different effects on savings and efficient allocation of resources and hence economic growth.<sup>135</sup> This dissertation describes the information, enforcement, and transaction costs that Afghans face, and the distinct financial arrangements, markets, and intermediaries that have emerged to ameliorate—though do not necessarily eliminate—their effects. As such, this dissertation analyzes the effects that emerging financial arrangements may have on efficient allocation of resources and savings and hence Afghanistan’s economic growth.

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<sup>133</sup> See Chapter Three.

<sup>134</sup> See e.g., Karen Clay, *Trade Without Law: Private-Order Institutions in Mexican California*, 13(1) J. L. ECON. ORG. 202, 224 (1997) (noting the diseconomy of scale in information); Karen Clay, *Trade, Institutions, and Credit: Contract Enforcement on The California Coast 1830-1846*, 34 EXPLORATIONS IN ECONOMIC HISTORY 495, 506 (1997) (noting the importance of information network in absence of public information institutions).

<sup>135</sup> Levine (2005), *supra* note 2, 869.

To provide a series of measures for evaluating the solutions that Afghans have devised to improve the constraints on credit transactions, this dissertation also makes use of scholarship that explains the functions of financial systems and their effects on savings and allocation of resources. Since trade credit is the main source of finance for Afghan merchants, it draws specifically upon the literature on trade credit and its comparative efficiency with relation to bank loans.

The prevailing financial system has an independent effect on economic growth.<sup>136</sup> Development in the financial system has positive effects on economic growth.<sup>137</sup> Less developed countries, in particular, can greatly benefit from further financial development.<sup>138</sup> A financial system performs a number of basic functions. The effects of the prevailing financial system on savings and investment and hence economic growth can be measured by observing how well the financial system performs its functions.<sup>139</sup> Afghanistan's financial system is comprised of two different sectors: formal and informal. Banks are the primary financial intermediaries in the formal sector while *Sarrafs*, real estate agents, and large businesses act as the financial intermediaries in the informal sector. Instead of adopting *a priori* assumptions about the efficiency of either sectors,

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<sup>136</sup> See Robert & Levine (1993a), *supra* note 2, at 719; Robert & Levine (1993b), *supra* note 2, at 515; Levine (1997), *supra* note 2, at 688; Levine (1998), *supra* note 2, at 598; Rajan & Zingales, *supra* note 2, at 584; Levine et al., (2000), *supra* note 2, at 35; Levine (2005), *supra* note 2, at 889; Haber et al., *supra* note 2, at 1; ACEMOĞLU *supra* note 2, at 588 & 726; SAHAY ET AL., *supra* note 2, at 5.

<sup>137</sup> *Id.*

<sup>138</sup> Sahay et al. argue that emerging economies can gain many benefits from further financial development. They define financial development as a combination of depth (size and liquidity of markets); access (ability of individuals to access financial services); and efficiency (the ability of institutions to provide financial services at low cost and with sustainable revenue; and the level of activity in capital market.) They use the annual data between 1980-2013 to evaluate 178 advanced, emerging, and low-income economies. They conclude that although the effect of financial development on economic growth weakens at higher levels of financial developments—because of possible distorting effects of financial deepening on financial stability and human capital markets—most emerging economies, *a fortiori*, low-income economies, can still greatly benefit from further financial development with positive consequences for economic growth. SAHAY ET AL., *supra* note 2, at 5.

<sup>139</sup> Levine (2005), *supra* note 2, at 869.

this dissertation measures whether each sector aids the performance of the financial system and if so to what extent.

In Chapters Three and Four of this dissertation, this dissertation uses the functions of the financial system as identified by Levine to evaluate the informal and formal financial institutions in Afghanistan. Levine identifies five main functions of financial systems.<sup>140</sup> Given the level of economic development in Afghanistan, however, only four of these functions are relevant here.<sup>141</sup>

**(1) Produce information, *ex ante*, about possible investments and allocate capital.**

Obtaining and processing information about investment opportunities entails costs.<sup>142</sup> If a financial system cannot efficiently acquire and process information about possible investment opportunities, this will likely hinder the flow of resources to its highest value use.<sup>143</sup> An important function of the financial system is to facilitate economizing on information acquisition and process cost.<sup>144</sup> How well a financial system performs this function will determine whether productive economic ventures are financed or not.<sup>145</sup>

**(2) Facilitate the trading, diversification, and management of risk.** By helping individual savers diversify their risks, financial systems can ensure that high risk-high return projects are financed.<sup>146</sup> Financial systems can do using three different methods: *intertemporal risk sharing, liquidity risk, and cross-sectional risk diversification*.<sup>147</sup> If a financial system includes

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<sup>140</sup> *Id.*

<sup>141</sup> The fifth function which I choose to omit here is: *monitor investments and exert corporate governance after providing finance. Id.*

<sup>142</sup> *Id.* at 870.

<sup>143</sup> *Id.* at 871.

<sup>144</sup> *Id.* at 872.

<sup>145</sup> *Id.* at 872.

<sup>146</sup> *Id.* at 875.

<sup>147</sup> *Id.* at 876.

durable, large financial intermediaries it can reduce the negative effects of macroeconomic shocks on the access to financing by spreading the negative effects of those shocks over a long period of time, balancing their returns at the time of economic slowdown against their gains at time of economic growth.<sup>148</sup> This will improve economic stability and sustain economic growth.<sup>149</sup> Financial systems can incentivize savers to invest in long-term projects by reducing the liquidity risk as well.<sup>150</sup> If a financial system possesses financial intermediaries that are able to hold an optimal mixture of liquid and illiquid assets it can insure savers against liquidity risk making it more likely that savers will invest in projects that require a longer time commitment.<sup>151</sup> Finally, if a financial system hosts financial intermediaries that are able to maintain a diverse investment portfolio they can contain and smooth sectoral shocks by spreading their negative effects.<sup>152</sup>

**(3) Mobilize and pool savings.** Probably the most prominent function of a financial system is pooling savings for investment purposes. Financial systems can pool capital from disparate savers and use the accumulated capital to finance entrepreneurs' profitable economic ventures.<sup>153</sup> Financial systems can incentivize savings and improve efficient allocation of resources depending on their transaction costs and ability to overcome the information asymmetry problem inherent in encouraging savers to depart from their savings, so they can be used to finance investment.<sup>154</sup>

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<sup>148</sup> *Id.* at 877.

<sup>149</sup> *Id.*

<sup>150</sup> *Id.* at 878.

<sup>151</sup> *Id.* at 879.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.* at 880.

<sup>154</sup> *Id.*

**(4) Ease the exchange of goods and services.** Financial systems can promote trade, thus improve specialization and economic growth by lowering the cost of making transactions.<sup>155</sup> Online payments, debt and credit cards are just few ways that a financial system can lower the cost of transacting and promote trade in goods and services.<sup>156</sup>

As Chapters Three and Four will show, measuring the performance of Afghanistan's formal and informal financial sector on these four functions reveal that the informal financial sector cannot adequately as a substitute for the formal financial sector in Afghanistan. As such, Afghanistan needs to improve formal financial institutions to stimulate economic growth. Financial intermediaries in the informal sectors have been effective at providing working capital financing and improving the ease of exchange. However, given their size, incentives, and non-specialization, they are not able to pool savings or diversify risks, thus, they cannot be relied on to finance long-term investments which entail high risk and/or require long-term commitments.

In the literature on finance in Islamic countries, it is often assumed that traditional Islamic positions on interest are the primary impediments to financial development.<sup>157</sup> However, this research shows that in Afghanistan there is no correlation between interest-friendly attitudes and development of financial market; instead, the opposite is true. Balkh has the least developed *Sarrafi* market, while Balkhis have the most interest-friendly attitude. Herat and Nangarhar, on the other hand, have the most sophisticated *Sarrafi* markets while merchants in these provinces are most likely to express anti-interest sentiments.

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<sup>155</sup> *Id.* at 881.

<sup>156</sup> *Id.*

<sup>157</sup> *See, e.g.*, TIMUR KURAN, THE LONG DIVERGENCE: HOW ISLAMIC LAW HELD BACK THE MIDDLE EAST 143 (2010).

### 1.1.5. Literature on Trade Credit as a Source of Finance

Trade credit is an important source of short-term finance for firms.<sup>158</sup> In fact, according to the World Bank, firms around the world typically finance 20% of their working capital with trade credit.<sup>159</sup> Often referred to as account payables and account receivables from the buyer and seller perspectives, respectively, trade credit is when a firm purchases goods and services but does not immediately pay for them—instead, promising to pay at a later date.

This dissertation has organized the literature on trade credit into four major themes: (1) determinates of trade credit, which seeks to explain why trade credit is used, (2) the comparative efficiency of trade credit with relation to bank loans, (3) the interaction between trade credit and bank loans, and (4) the role of trade credit at the time of bank loan contraction.

**(1) Determinants of Trade Credit.** The following reasons are suggested as determinants of trade-credit use: the relative strength of the legal system including weak contract enforcement and property rights, the degree of access to bank loans, the competitiveness of the markets, and the amount of corruption. Demirgüç-Kunt and Maksimovic argue that firms are more likely to rely on trade credit in an environment where legal systems are inferior.<sup>160</sup> Conversely, more secure contract enforcement can encourage the supply of trade credit.<sup>161</sup> Özlü and Yalçın found that in Turkey, firms with limited access to bank loans tend to substitute trade credit.<sup>162</sup> Fabbri and

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<sup>158</sup> ASLI DEMIRGU-KUNT & VOJISLAV MAKSIMOVIC, THE WORLD BANK DEVELOPMENT RESEARCH GROUP, FIRMS AS FINANCIAL INTERMEDIARIES: EVIDENCE FROM TRADE CREDIT DATA 1 (Policy Research Working Paper 2696, 2001), <https://openknowledge.worldbank.org/bitstream/handle/10986/19511/multi0page.pdf?sequence=1&isAllowed=y>.

<sup>159</sup> Account payables are more important than bank credit for short-term financing in more than half of the countries covered in *Worldscope*. Claudio Raddatz, *Credit Chains, and Sectoral Comovement, Does the Use of Trade Credit Amplify Sectoral Shock?* 92(4) REV. ECON. STAT. 985, 986 (2010) citing World Bank's entrepreneur survey.

<sup>160</sup> DEMIRGU-KUNT & MAKSIMOVIC, *supra* note 158, at 4.

<sup>161</sup> Simon Johnson et al., *Courts and Relational Contracts*, 18(1) J. LAW ECON. ORGAN. 221, 223 (2000) (studying the relation between contract enforcement and trade credit in Russia, Ukraine, and Eastern Europe).

<sup>162</sup> Pinar Özlü & Cihan Yalçin, *The Trade Credit Channel of Monetary Policy Transmission: Evidence from Nonfinancial Manufacturing Firms in Turkey*, 48(4) EMERGING MARKETS FINANCE AND TRADE 102, 106 (2012).

Klapper,<sup>163</sup> and Van Horen<sup>164</sup> found that firms with weak market power relative to their customers generally offer more trade credit. Finally, Yano and Shiraishi found corruption can hinder the supply of trade credit by making contracts unreliable and hindering market competition.<sup>165</sup>

In addition, Wu and his colleagues suggest that social trust likely influences the use of trade credit. They found that firms in intensive-social-trust tend to pay accounts payable and receive account receivable more quickly.<sup>166</sup> Menichini suggests another determinant for trade credit. Trade credit may be a way for a business to hedge its receivables.<sup>167</sup> It may occur, she argues, because a business has problems collecting the debt from its customers, so it delays paying its suppliers.<sup>168</sup> However, as Klapper and her colleagues have argued, no one motive can explain the supply of trade credit.<sup>169</sup> For example, it is often argued that trade credit is a way for suppliers to finance their customers.<sup>170</sup> Klapper and her colleagues have suggested, this assertion is contradicted by the observation that large established businesses/suppliers also receive trade credit and most often receive more and better trade credit as well.<sup>171</sup> This can be because of large buyers' market power but, as Klapper and her colleagues underline, it begs the question of why they do not use their

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<sup>163</sup> DANIELA FABBRI & LEORA KLAPPER, THE WORLD BANK DEVELOPMENT RESEARCH GROUP, FINANCE AND PRIVATE SECTOR TEAM, MARKET POWER AND THE MATCHING OF TRADE CREDIT TERMS 4 (Policy Research Working Paper 4754, 2008) <https://openknowledge.worldbank.org/bitstream/handle/10986/6913/WPS4754.pdf?sequence=1&isAllowed=y>.

<sup>164</sup> NEELTJE VAN HOREN, TRADE CREDIT AS A COMPETITIVENESS TOOL: EVIDENCE FROM DEVELOPING COUNTRIES, 4 (Munich Personal RePEc Archive, 2004), [https://mpa.ub.uni-muenchen.de/2792/1/MPRA\\_paper\\_2792.pdf](https://mpa.ub.uni-muenchen.de/2792/1/MPRA_paper_2792.pdf).

<sup>165</sup> Go Yano & Maho Shiraishi, *Factors in the Development of Trade Credit: Case Study of Provinces in China*, 50(2) EMERGING MARKETS FINANCE AND TRADE 114, 131 (2014).

<sup>166</sup> Wenfeng Wu et al., *Trust and The Provision of Trade Credit*, 39(C) J. BANK. FINANCE 146, 147 (2014).

<sup>167</sup> Anna Maria C. Menichini, *Inter-Firm Trade Finance at Times of Crisis*, 34(10) THE WORLD ECONOMY 1788, 1803 (2011).

<sup>168</sup> *Id.*

<sup>169</sup> Leora Klapper et al., *Trade Credit Contracts*, 25(3) REV. FINANCIAL STUD. 838, 840 (2012).

<sup>170</sup> *Id.* at 839.

<sup>171</sup> *Id.* 840.

market power to obtain discounts on payments instead of trade credit.<sup>172</sup> The reason for this may be because untrusted suppliers need to extend trade credit to guarantee the quality of their products.<sup>173</sup>

The empirical research conducted presented here suggests that in Afghanistan market competition is the main determinant for supply of trade credit while a highly uncertain environment and limited access to other forms of financing are the main reasons for trade-credit demand. Corruption, formal contract enforcement, and social trust have secondary effects on the use of trade credit in Afghanistan, according to the empirical research conducted for this dissertation.

As to why large businesses in Afghanistan do not use their market power to obtain payment discounts instead of trade credit, in Afghanistan, manufacturers receive trade credit from their domestic suppliers who are usually more capital-constrained. This is because manufactures have more market power with relation to their domestic suppliers. However, they do not use their market power to obtain discounted prices because they have to sell on credit, i.e. supply trade credit, to sale their products for which they will receive unpredictable payments. Therefore, they use their relative market power to buy on credit, so they can sell on credit in uncertain business environment. In addition to the volatility of the business climate, the quality guarantee explanation also plays a role in Afghan context. One reason why Afghan businesses with considerable market power opt to receive trade credit instead of discounted prices is to ensure the quality of the products. Hence, sellers/creditors of new products need to provide better terms of credit to get buyers/debtors to distribute their products.

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<sup>172</sup> *Id.*

<sup>173</sup> *Id.*; VAN HOREN, *supra* note 164, at 8.

**(2) The Comparative Efficiency of Trade Credit with Relation to Bank Loans.** There are studies that support the comparative efficiency of bank loans and trade credit. In supporting the comparative efficiency of bank loans, Fisman and Love argue that trade credit puts startups at a disadvantage because they are less likely to have established reputations.<sup>174</sup> Furthermore, Raddatz has argued that trade credit is not well diversified compared to bank loans because debtors are the customers of business.<sup>175</sup> This makes trade credit suppliers more vulnerable to sectorial shocks.<sup>176</sup>

On the other hand, there are studies that suggest trade credit maybe more efficient than bank loans. In a firm-produced research study in China, Go Yano and Maho Shiraishi argued that trade credit is more efficient because firm profitability is more strongly linked with the trade credit than with bank loans.<sup>177</sup> Their research corroborated Fisman and Love's findings that smaller firms have more difficulty obtaining trade credit because they have not established a reputation yet, but they found that profitability and access to credit is more strongly linked for medium and small firms compared to large firms. This means that credit helps with the entrance and survival of small and medium size firms. Medium size firms are most helped by trade credit because they have a reputation in addition to being more profitable.

**(3) The Relationships between Trade Credit and Bank Loans.** Concerning the relationship between bank loans and trade credit, Ying Ge and Jiaping Qiu distinguish between trade credit, as transactional tool which is short-term and less overdue debt, and trade credit, a

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<sup>174</sup> Raymond Fisman & Inessa Love, *Trade Credit, Financial Intermediary Development, and Industry Growth*, 58(1) J. FINANCE. 353, 355 (2003).

<sup>175</sup> Raddatz, *supra* note 159, at 17.

<sup>176</sup> *Id.*

<sup>177</sup> Yano & Shiraishi, *supra* note 165, at 131.

financing tool which is longer-term and more overdue debt.<sup>178</sup> According to their research in China, empirical firm-level data suggest that for non-state-firms trade credit is one method a supplier has to allow customers to finance purchases who otherwise have limited access to financing through a bank loan.<sup>179</sup>

Cull and his colleagues found that State-Owned Enterprises as well as profitable private firms did on-lending part of the loans they received from banks to their customers<sup>180</sup> which make the allocation of resources by banks more efficient, however, according to their search the size of this on-lending was not significant enough to explain Chinese economic growth.<sup>181</sup> Other institutions, either formal or informal, must have played more important roles, they argued.<sup>182</sup>

In the Afghan context, on-lending does not seem to be as important given the small share of bank loans in overall economy. On-lending seems to be important for improving the allocation of bank loans where legal system is weak, but a sizable banking market is present.<sup>183</sup> In Afghanistan, however, the latter condition is not present, i.e. the share of bank loans in overall finance is very limited.

**(4) The Role of Trade Credit during of Bank Loan Contraction.** The relationship between financial crises and bank loans, on the one hand, and trade credit supply and demand on

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<sup>178</sup> Ying Ge & Jiaping Qiu, *Financial Development, Bank Discrimination and Trade Credit*, 31(2) J. BANK. FINANCE 513, 514 (2007).

<sup>179</sup> *Id.* at 529.

<sup>180</sup> On-lending means that a firm receiving a loan from the bank lends part of this loan to its customer.

<sup>181</sup> ROBERT CULL ET AL., THE WORLD BANK, FORMAL FINANCE AND TRADE CREDIT DURING CHINA'S TRANSITION 21 (POLICY RESEARCH WORKING PAPERS 4204, 2007), <https://openknowledge.worldbank.org/bitstream/handle/10986/7022/wps4204.pdf?sequence=1&isAllowed=y>.

<sup>182</sup> *Id.*

<sup>183</sup> DEMIRGU-KUNT & MAKSIMOVIC, *supra* note 158, at 30.

the other hand, is not clear. The current literature is too contradictory to allow for conclusive statement on this issue.

Garcia-Appendini and Montoriol-Garriga argued that during the 2007-2008 United States financial crisis, cash-rich firms provided liquidity to their customers while bank loans contracted because their opportunity costs decreased in the form of increased trade credit.<sup>184</sup> There are other studies that suggest that during financial crises and bank loan contractions, trade credit supply decreases as trade credit demand increases, demonstrating that net trade credit is positively correlated with bank loans.<sup>185</sup>

Whether trade credit has a supply-driven dynamic, as shown by the decrease of supply, or has a demand-driven dynamic, as shown by the increase of trade credit demand at the time of bank loan contraction, is still an open question.<sup>186</sup> In Afghanistan, the economic slowdown has caused the contraction in the supply of trade credit, however, this effect is not caused by bank loan contraction, because bank loans have not historically been a primary source of finance in Afghanistan.

This dissertation contributes to the trade credit literature by illustrating how trade credit can be used as a risk allocation arrangement in uncertain environments. Currently, as explained above, the trade credit literature focuses on the use of trade credit as a source of finance. The only exception is Fafchamp's empirical research in Africa.<sup>187</sup> Fafchamp identifies that, similar to Afghanistan, buyer/debtors within African supply chains are often excused from frequent, short-

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<sup>184</sup> Emilia Garcia-Appendini & Judit Montoriol-Garriga, *Firms as Liquidity Providers: Evidence from the 2007–2008 Financial Crisis*, 109(1) J. FINANCIAL. ECON. 272, 290 (2013).

<sup>185</sup> Jaleel Ahmad et al., *Investigation of Causal Relationship Between Trade Credit and Bank Loan During 2008 Financial Crisis*, 5(5) J. ASIAN BUSINESS STRATEGY 90, 97 (2015).

<sup>186</sup> *See id.*; and Garcia-Appendini & Montoriol-Garriga, *supra* note 184, at 290.

<sup>187</sup> *See* FAFCHAMPS, *supra* note 80, at 30.

term delays in payments.<sup>188</sup> Thus, seller/creditors help their customers cope with a volatile business climate, which is caused by poor securities and fragmented markets.<sup>189</sup> He further finds that African seller/creditors minimize moral hazard through various monitoring mechanisms. This dissertation shows a similar dynamic in case of Afghanistan. Similarly, the case of Afghanistan shows that in highly uncertain environments, suppliers use trade credit in conjunction with a rigorous financial discipline system to maximize sales by retaining the market risk while transferring the products to distributors, so they can be sold to consumers.<sup>190</sup> Trade credit suppliers employ a rigorous financial discipline system, which relies on continued monitoring and short-cash-extraction intervals, to minimize the opportunities to cheat, generated by asymmetry of information and moral hazard.<sup>191</sup>

However, this dissertation brings insights from Afghanistan to add to Fafchamp's findings from Africa; it shows how *Sarrafs's hawala* is supporting this risk-sharing-based trade credit arrangements by offering seller/creditors credit *hawalas* which function as short-term working capital loans.

#### **1.1.6. Literature on Formal and Informal Institutions, and Their Effects on Economic Growth**

In Afghanistan, since most solutions devised to alleviate the constraints on credit transactions have developed informally to ameliorate the effects of deficient formal institutions, this dissertation

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<sup>188</sup> *Id.* at 31.

<sup>189</sup> *Id.*

<sup>190</sup> *See* Chapter Three.

<sup>191</sup> *See* Chapter Three.

makes use of the literature on the linkage between informal and informal economies, and formal and informal institutions.

Informal economy, informal institutions, and informal market are related concepts. The term informal economy generally refers to income generating activities that operate outside the regulatory framework of the state.<sup>192</sup> Informal institutions are generally defined as regulatory arrangements “created, communicated and enforced outside of officially sanctioned channels”. They often involve socially embedded practices and/or unofficial power structures.<sup>193</sup> Informal markets refer to the organizational arenas in which informal economies operate.<sup>194</sup> Informal markets are where labor, goods or services are traded outside the framework of formal institutions, but often subject to a range of informal institutions.<sup>195</sup>

There is a large body of literature on informal economies, informal institutions, and informal markets. Meagher organizes the literature on the linkage between formal and informal economies, and formal and informal institutions, around four major perspectives:

The first perspective focuses on the flow of resources (such as information, labor, finance, and output) between formal and informal economies.<sup>196</sup> Concerning financial market linkages, Meagher suggests, these studies highlight the potentials and limitations of improving linkage

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<sup>192</sup> MARTHA ALTER CHEN, WOMEN IN INFORMAL EMPLOYMENT: GLOBALIZING AND ORGANIZING, THE INFORMAL ECONOMY: DEFINITIONS, THEORIES AND POLICIES 7 (WIEGO Working Paper No. 1, 2012), [http://www.wiego.org/sites/default/files/publications/files/Chen\\_WIEGO\\_WP1.pdf](http://www.wiego.org/sites/default/files/publications/files/Chen_WIEGO_WP1.pdf).

<sup>193</sup> Gretchen Helmke & Steven Levitsky, *Informal Institutions and Comparative Politics: A Research Agenda*, 2(4) PERSPECTIVES ON POLITICS 725, 733 (2004).

<sup>194</sup> KATE MEAGHER, WOMEN IN INFORMAL EMPLOYMENT: GLOBALIZING AND ORGANIZING, UNLOCKING THE INFORMAL ECONOMY: A LITERATURE REVIEW ON LINKAGES BETWEEN FORMAL AND INFORMAL ECONOMIES IN DEVELOPING COUNTRIES 2 (WIEGO Working Paper No. 27, 2013) [http://www.vumelana.org.za/wp-content/uploads/2014/03/Document-49-Meagher\\_WIEGO\\_WP27.pdf](http://www.vumelana.org.za/wp-content/uploads/2014/03/Document-49-Meagher_WIEGO_WP27.pdf).

<sup>195</sup> *Id.* at 2.

<sup>196</sup> *Id.* at 5.

between formal and informal financial markets.<sup>197</sup> While some have argued, improving the linkage between formal and informal financing maybe more effective than formalization to improve access to financing for smaller businesses because of the high transaction costs assessed by formal financiers, others have disagreed arguing that informal financial markets tend to be exclusionary and constraining.<sup>198</sup>

The second perspective, according to Meager, focuses on utilizing the potentials of both formal and informal economies to fill the institutional gaps that exist in formal economies with weak formal institutions.<sup>199</sup> Authors who espouse this perspective have advocated for use of formal-informal linkages as first-best or second-best solutions to provide institutional support to the formal economy.<sup>200</sup> For example, Prahalad and Hart and Prahalad have suggested that formal-informal linkage can be used as first-best solution to provide institutional support for the formal economy by combining the best of formal economies, such as technological capacity, with the best of informal economy, such as indigenous knowledge, local embeddedness, and human face.<sup>201</sup>

The third perspective focuses on the effects of formal-informal linkages on the broader institutional environment.<sup>202</sup> For example, some scholars have studied the effects of outsourcing regulatory functions to informal institutions on the broader institutional environment, while others have studied the effects of formal-informal linkages on state building.<sup>203</sup> Finally, the last

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<sup>197</sup> *Id.* at 9.

<sup>198</sup> *Id.* at 10.

<sup>199</sup> *Id.* at 13.

<sup>200</sup> *Id.* at 17.

<sup>201</sup> See Coimbatore K. Prahalad & Stuart L. Hart, *The Fortune at the Bottom of the Pyramid*, Strategy+Business 14 (First Quarter of 2002) <https://people.eecs.berkeley.edu/~brewer/ict4b/Fortune-BoP.pdf>; see also COIMBATORE K. PRAHALAD, THE FORTUNE AT THE BOTTOM OF THE PYRAMID: ERADICATING POVERTY THROUGH PROFITS 69 (2004).

<sup>202</sup> MEAGHER (2013), *supra* note 194, at 18.

<sup>203</sup> *Id.* 21.

perspective, according to Meager, studies the formal-informal linkages, not as a mechanism for filling institutional gaps, but as ways of contesting the prevalent institutional arrangements and the power structure that they represent.<sup>204</sup>

In Afghanistan, the overwhelming majority of income generating activities operate outside the regulatory framework of the state.<sup>205</sup> These activities operate under informally devised rules and structures, and thus the economy is substantially informal. The working solutions to the problems of credit transactions studied here are, in effect, devised to substitute and ameliorate the deficient formal institutions. Hence, this dissertation is closely in line with the first and second approaches highlighted by Meager. It studies the linkages between formal and informal institutions in areas of finance with a focus on the potential of the formal and informal institutions to improve access to finance for Afghan merchants. It also accounts for the politics of formalization in proposing a new approach for institutional reform that this dissertation calls Grounded Institutional Reform, in line with the last perspective.

In addition, this research adds a dimension to the literature on linkages between formal and informal institutions by illustrating the importance of the institutional venue for formalizing informal economic practices. Different institutional venues may have different attitudes when deciding whether to recognize informally developed institutions. In Afghanistan, commercial courts, compared to civil courts, employ a laxer normative check for formalizing informal economic practices that may contravene the normative rules held by the broader society. This makes commercial courts a better institutional venue for formalizing informal institutions.<sup>206</sup>

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<sup>204</sup> *Id.* 22.

<sup>205</sup> See AFGHANISTAN MINISTRY OF COMMERCE AND INDUSTRIES, *supra* note 9; *see also* RICHARD GHIASY ET AL., INTERNATIONAL COUNCIL OF SWEDISH INDUSTRY, AFGHANISTAN'S PRIVATE SECTOR: STATUS AND WAYS FORWARD 5 (2015), <https://www.sipri.org/publications/2015/afghanistans-private-sector-status-and-way-forward>.

<sup>206</sup> *See* Chapter Three.

This research also contributes to *hawala* and informal moneylender literature by illustrating their intersectional function as a main source of short-term working capital loans enabling merchants to bridge the gap between a highly uncertain domestic business climate and a more stable foreign market.<sup>207</sup> Currently, the literature on *hawala* focuses on two functions: *hawala* system transfers money to remote places and poor clients whom formal banking system excludes, and (2) the *hawala* system is the financial system of choice in the illegal economy, helping its participants launder money and operate outside the legal boundaries.<sup>208</sup> The literature on informal moneylenders focuses on their role in the informal economy.<sup>209</sup> However, the case of Afghanistan illustrates a critical intersectional function of the *hawala* and moneylending systems. In Afghanistan, *Sarrafs* provide short-term working capital loans to their clients to help them bridge the gap between a highly uncertain domestic business climate and more stable foreign markets. *Sarrafs*' motive for issuing these loans is to retain the currency exchange and the *hawala* business that transnational trade generates. It illustrates an interdependent business arrangement that has helped Afghan merchants operate in an uncertain domestic climate while importing most of their needs from a foreign economy, where flexible risk-sharing norms do not exist.<sup>210</sup>

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<sup>207</sup> See Chapter Three.

<sup>208</sup> See, e.g., EDWINA A. THOMPSON, TRUST IS THE COIN OF THE REALM: LESSONS FROM THE MONEY MEN IN AFGHANISTAN 218 (2011) (which focuses on the role of opium trade and opium money in the *hawala* system); See also THOMAS A. TIMBERG, NATHAN ASSOCIATION INC., INFORMAL REMITTANCE SYSTEMS AND AFGHANISTAN (2003), [https://www.researchgate.net/profile/Thomas\\_Timberg/publication/241852212\\_Informal\\_Remittance\\_Systems\\_and\\_Afghanistan/links/55e09b6d08ae2fac471c2c6f/Informal-Remittance-Systems-and-Afghanistan.pdf?origin=publication\\_detail](https://www.researchgate.net/profile/Thomas_Timberg/publication/241852212_Informal_Remittance_Systems_and_Afghanistan/links/55e09b6d08ae2fac471c2c6f/Informal-Remittance-Systems-and-Afghanistan.pdf?origin=publication_detail); see also Patrick M. Jost & Harjit Singh Sandhu, Interpol General Secretariat, *The Hawala Alternative Remittance System And Its Role In Money Laundering* (2000), <http://www.nmta.us/assets/docs/hawala.pdf>.

<sup>209</sup> See generally MEAGHER (2013), *supra* note 194; see also TSAI, *supra* note 126.

<sup>210</sup> See Chapter Three.

### 1.1.7. Literature on Institutional Development and Economic Growth

The findings of this dissertation have implications for any policymaker intending to improve the economy in a country like Afghanistan. To find out how the Afghan government can design institutions to improve access to credit for Afghan merchants, this section reviews the theoretical debate on institutional development and economic growth and examines the models of institutional reform that each side of the debate offers.

What are the institutional requirements for economic growth? There are two theoretical answers to this question informing two different institutional reform models. The first theory posits that formal property rights and formal contract enforcement institutions are necessary prerequisites (although insufficient) for sustained economic growth.<sup>211</sup> Formal property rights and contract enforcement institutions enable actors in the economy to efficiently exchange, creating and accumulating capital that can be used to further foster economic growth.<sup>212</sup> Since the state is the provider of formal institutions, this theory places a premium on the state as the creator of the requisite institutional conditions for economic growth. Hence, it is called State-Centered Theory.<sup>213</sup>

State-Centered Theory is based on a reading of North's theory (although it is not the most faithful reading), and on the work of property-rights scholars like De Soto. It has a close affinity with neoliberalism, which sees the role of government as the sole enforcer of the basic rules of the game. State-Centered Theory forms the theoretical basis for institutional transplantation advocated

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<sup>211</sup> See, e.g., NORTH *supra* note 32, at 46-47; GREIF (2006), *supra* note 123, at 3; Greif & Laitin, *supra* note 89, at 633; Greif (1994), *supra* note 123, at 914; Huang, *supra* note 123, at 2; Keefer & Knack, *supra* note 123, at 601; Fafchamps (1997), *supra* note 123, at 796; Kljin, *supra* note 123; Yusuf & Stiglitz, *supra* note 123, at 231; DE SOTO, *supra* note 114, at 5.

<sup>212</sup> *Id.*

<sup>213</sup> Nee and Oppper use a similar terminology, See OPPER & NEE, *supra* note 3, at 5.

for and performed by international organizations such as the World Bank and International Monetary Fund. As Andrews, Pritchett, and Woolcock have observed, “promoting ‘good institutions’ has, by and large, meant attempts to transplant Weberian-styled bureaucracies (and their associated legal instruments) through the developing world.”<sup>214</sup> They argue, a powerful logic drives transplantation, “If Weberian organizations underpin modern economic, administrative, and political life in high-income countries, isn’t the shortest distance between two points a straight line? Why reinvent the wheel? If we know what effective and capable state organization look like—if indeed there is a ‘global best practice’—why not introduce them as soon as possible? Why reinvent the wheel?”<sup>215</sup> Rodrik has made a similar observation, “institutional reform promoted by multilateral organization such as the World Bank, and the International Monetary Fund, or the World Trade Organization is heavily biased toward a best-practice model. It presumes *it is possible to determine a unique set of appropriate institutional arrangements ex ante, and views convergence toward those arrangements as inherently desirable.*” (emphasis added)<sup>216</sup>

Afghanistan’s approach to institutional reform is based on the State-Centered Theory, and this can explain its failure. While this dissertation cannot prove this by showing that the policymakers in Afghanistan made a conscious choice to adopt State-Centered Theory when devising policies to reform Afghanistan’s credit institutions, it uses the content of Afghanistan’s Strategic Policies as evidence of the influence of State-Centered Theory. Afghanistan’s Strategic Policies, as this dissertation will show in Chapter Four, consistently resort to adoption of international “best practices” as solutions to the problems of credit transacting in Afghanistan (e.g. Credit Bureau and Export Banks) while completely ignore the potentials of entrepreneurially-

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<sup>214</sup> ANDREWS ET AL., *supra* note 57, at 44-45.

<sup>215</sup> *Id.*

<sup>216</sup> Rodrik, *supra* note 57, at 100.

developed informal institutions that have organically evolved in the Afghan context (e.g. *Gerawee*, *Sar qufli*, and *Sarrafi* markets).

A competing theory posits that strong formal property rights and contract enforcements are neither sufficient nor necessary conditions for economic growth.<sup>217</sup> Informal institution can sustain economic growth and create conditions for formalization.<sup>218</sup> Since informal institutions are developed by the institutional entrepreneurs outside the government to solve their immediate problems this theory puts a premium on entrepreneurs as creators of conditions for economic growth.<sup>219</sup> Hence, Entrepreneurial Institutional Theory.

Institutional entrepreneurs are most often economic entrepreneurs because they have the incentive to supply institutional solutions that would enhance their economic gains.<sup>220</sup> Thus, in Entrepreneurial Institutional Theory the suppliers and demanders of institutions overlap; they are the suppliers and users of the informal institutions.<sup>221</sup> Entrepreneurial Institutional Theory does not necessarily deny the utility of formal institutions; however, it argues the causal ordering is reversed. In contrast with State-Centered Theory, Entrepreneurial Institutional Theory argues that strong formal property rights and formal contract enforcements are not the prerequisites for economic growth rather they are its by-products.<sup>222</sup> Entrepreneurial Institutional Theory proposes a process-centered explanation of its causal ordering. Under Entrepreneurial Institutional Theory, economic growth changes the relative power of the economic entrepreneurs and the state.<sup>223</sup> It

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<sup>217</sup> See, e.g., OPPER & NEE, *supra* note 3, at 13; TSAI, *supra* note 126, at 4; Kevin & Trebilcock, *supra* note 126, at 51; Glaeser et al., *supra* note 126, at 273; Posner, *supra* note 126, at 2.

<sup>218</sup> See OPPER & NEE, *supra* note 3, at 13; TSAI, *supra* note 126, at 259.

<sup>219</sup> OPPER & NEE, *supra* note 3, at 72.

<sup>220</sup> *Id.*

<sup>221</sup> *Id.*

<sup>222</sup> *Id.*, at 13.

<sup>223</sup> *Id.*, at 220.

posits that the interests of the state, the suppliers of formal institutions, is not necessarily compatible with the interests of economic entrepreneurs, demanders/users of formal institutions.<sup>224</sup> Strong formal institutions impose constraints on the power of the state. Therefore, Entrepreneurial Institutional Theory argues, strong formal economic institutions are only supplied if a group of sufficiently politically powerful economic entrepreneurs demand them.<sup>225</sup> Since the political power of entrepreneurs is positively correlated with their economic importance, which in turn is positively correlated with economic growth, economic growth is the cause not the outcome of strong formal institutions.<sup>226</sup>

Both State-Centered Theory and Entrepreneurial Institutional Theory emphasize the importance of institutions for economic growth. Institutions are the solution to problems of information imbalance within economic transactions; therefore, the prevailing institutions have direct and significant consequences for economic performance. Given the assumption that strong formal institutions are a later development, however, Entrepreneurial Institutional Theory posits that informal institutions developed by institutional entrepreneurs are the primary determinant of economic growth and the consequent adoption of formal institutions.<sup>227</sup> Under Entrepreneurial Institutional Theory, a series of exogenous factors, such as a new-found opportunity to reap the benefits of new markets, motivate entrepreneurs to develop economic ventures, and supply institutions to support those economic ventures.<sup>228</sup> As these entrepreneurs grow powerful, they muster sufficient political power to demand the state to change the formal rules of the game, i.e.

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<sup>224</sup> *Id.*

<sup>225</sup> Daron Acemoğlu et al., *Institutions as A Fundamental Cause of Long-Run Growth*, in 1A HANDBOOK OF ECONOMIC GROWTH 385, 390 (Philippe Aghion and Steven N. Durlauf eds., 2005).

<sup>226</sup> *Id.*

<sup>227</sup> OPPER & NEE, *supra* note 3, at 13.

<sup>228</sup> *Id.*

supply strong formal institutions that further support their economic ventures.<sup>229</sup> Under Entrepreneurial Institutional Theory, institutional development is a self-reinforcing, bottom-up and incremental process that is driven by the material self-interest of economic entrepreneurs and is mediated by the prevailing political system.

In addition to the process-centered and transitional role of informal institutions, Entrepreneurial Institutional Theory underscores the incremental and bottom-up features of informal institutions that ensures they are fit for the context of their use (compared to formal institutions imposed from top based on “best practices” advocated for by champions of State-Centered Theory).<sup>230</sup> It is this context-appropriateness and close connection with the prevailing problems faced by their users (who are their developers too) that enable informal institutions to best solve problems. Thus, informal institutions help their users/developers (i.e. entrepreneurs) do business more efficiently which in turns reinforces those informal institutions. Once entrepreneurs’ become business ventures become large and complex, and they grow powerful enough, they will demand and force the state to supply formal institutions.<sup>231</sup> As a by-product of economic growth, which is instigated and sustained by informal institutions, strong formal institutions are supplied incrementally in correlation with the increases of the influence and importance of economic entrepreneurs.<sup>232</sup> The bottom-up, incremental, and demand-led process of institutional development (as opposed to top-down, shock-based, and supply-driven institutional engineering)

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<sup>229</sup> *Id.* at 72.

<sup>230</sup> *See id.* at 20; MATT ANDREWS, *supra* note 57, at 5; DANI RODRIK, GROWTH STRATEGIES 985 (2004); AVINASH DIXIT, LAWLESSNESS AND ECONOMICS 4 (2004); *see also* Jean-Francois Richard et al., *Economic Development, Legality, and the Transplant Effect*, 47(1) EUROPEAN ECONOMIC REVIEW 165, 192 (2003); Katharina Pistor, the Standardization of Law and its Effect on Developing Economies 17 (G-24 Discussion Paper No. 4, July 2000), <http://unctad.org/en/docs/pogdsmdpbg24d4.en.pdf>.

<sup>231</sup> *See* OPPER & NEE, *supra* note 3, at 70. *See also* Acemoğlu et al., *supra* note 225, 390.

<sup>232</sup> *Id.*

ensures the developed formal institutions are context-appropriate and their users (i.e. economic entrepreneurs) are ready to reap their benefits.<sup>233</sup>

The roots of Entrepreneurial Institutional Theory are in political economy. Entrepreneurial Institutional Theory draws on the historical studies of development of formal institutions and economic growth in the West such as Acemoğlu, Johnson, and Robinson's studies.<sup>234</sup> It is a critique of the dominant institutional reform discourse prevalent at the international organizations like the World Bank and the International Monetary Fund, which disassociates the historical context of development of strong formal institutions in the West from its institutional products.<sup>235</sup> Entrepreneurial Institutional Theory strongly cautions against institutional transplantation and top-down institutional engineering.<sup>236</sup> Entrepreneurial Institutional Theory historicizes formal institutions in the West to show the political and contingent process of the development of strong formal institutions.<sup>237</sup> It underscores the contingent and context-sensitive process of the development of strong formal institutions.<sup>238</sup> Therefore, it advocates for a bottom-up, incremental, and context-sensitive approach to institutional reform in developing countries.<sup>239</sup> Entrepreneurial Institutional Theory is also informed by a distrust of the willingness and power of the state to

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<sup>233</sup> See *id.* at 20; MATT ANDREWS, *supra* note 57, at 5; RODRIK, *supra* note 230, at 985; DIXIT, *supra* note 230, at 4; see also Richard et al., *supra* note 230, at 192; Pistor, *supra* note 230, at 17.

<sup>234</sup> See Acemoğlu et al., *supra* note 225, 390.

<sup>235</sup> See OPPER & NEE, *supra* note 3, at 20; TSAI, *supra* note 126, at 4; MATT ANDREWS, *supra* note 57, at 5; RODRIK, *supra* note 230, at 985; DIXIT, *supra* note 230, at 4; see also Richard et al., *supra* note 230, at 192; Pistor, *supra* note 230, at 17.

<sup>236</sup> *Id.*

<sup>237</sup> See, e.g., Acemoğlu et al., *supra* note 225, 390.

<sup>238</sup> See OPPER & NEE, *supra* note 3, at 20; TSAI, *supra* note 126, at 261; MATT ANDREWS, *supra* note 57, at 5; RODRIK, *supra* note 230, at 985; DIXIT, *supra* note 230, at 4; see also Richard et al., *supra* note 230, at 192; Pistor, *supra* note 230, at 17.

<sup>239</sup> *Id.*

administer effective institutional reforms.<sup>240</sup> Instead of the state, it puts a premium on a group of entrepreneurs who engage in problem-solving to reap the benefits of economic opportunities available to them and, in the process, interact and coordinate with other entrepreneurs and draw on their sociocultural context to supply institutions, independent of formal institutions, which help them expand their business ventures.<sup>241</sup>

In addition to historicizing the development of strong formal institutions in the West, Entrepreneurial Institutional Theory draws on in-depth studies of the process of economic growth in China. Nee and Oppper's award-winning book,<sup>242</sup> *Capitalism from Below*,<sup>243</sup> and Tsai's *Back-Alley Banking*<sup>244</sup> are great examples of this type of research project. China is the most important case study for Entrepreneurial Institutional Theory because China poses a puzzle to State-Centered Theory. China has managed to achieve remarkable economic growth not only without strong formal institutions that would support private economic activities but also despite formal institutions that were hostile towards private businesses.<sup>245</sup> Chinese economic growth started and flourished in a formal institutional context where private property was formally prohibited, and banks did not issue loans to private businesses.<sup>246</sup> Despite hostile formal institutions, Chinese entrepreneurs have managed to develop business ventures and supporting institutions to enforce

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<sup>240</sup> See, e.g., JACK KNIGHT, INSTITUTIONS AND SOCIAL CONFLICT 14(1992); and Acemoğlu et al., *supra* note 225, 390.

<sup>241</sup> See OPPER & NEE, *supra* note 3, at 20; see also TSAI, *supra* note 126, at 259.

<sup>242</sup> A Choice Outstanding Academic Title of 2012; 2013 George R. Terry Book Award, Academy of Management; Gold Medal, International Business/Globalization Category, 2013 Axiom Business Book Awards, Jenkins Group/Independent Publisher Online. See Harvard University Press, <http://www.hup.harvard.edu/catalog.php?isbn=9780674050204>.

<sup>243</sup> OPPER & NEE, *supra* note 3.

<sup>244</sup> TSAI, *supra* note 126, at 4.

<sup>245</sup> See OPPER & NEE, *supra* note 3, at 5; DANI RODRIK, GROWTH STRATEGIES 975 (2004); see also Lawrence J. Lau et al., *Reform without losers: An interpretation of China's dual-track approach to transition*, 108(1) THE JOURNAL OF POLITICAL ECONOMY 120, 136 (2000).

<sup>246</sup> See TSAI, *supra* note 126, at 4.

contracts and access finance fueling a remarkable economic growth.<sup>247</sup> This is this puzzle that Nee and Opper, and Tsai have tried to answer by offering an alternative theoretical explanation which focuses on private entrepreneurs and informal institutions.

While Entrepreneurial Institutional Theory is mainly developed based on a case study of China, Entrepreneurial Institutional Theory proposes that its insights are generalizable to contexts other than China.<sup>248</sup> It focuses on China because State-Centered Theory fails to explain the Chinese case and also because China's level of economic growth provides strong support for the Entrepreneurial Institutional Theory's posited processes.<sup>249</sup> However, it argues that similar processes are working in other contexts albeit with limited success due to exogenous constraints such as infrastructural underdevelopment.<sup>250</sup>

This research makes substantial contribution to the literature on institutional development and economic growth. It highlights the shortcomings of the two leading theories, State-Centered Theory and Entrepreneurial Institutional Theory, to explain institutional development in the context of countries like Afghanistan and offer policy solutions for the countries where merchants do not have access to good infrastructure, cannot access new markets and the government is weak. This dissertation provides a new approach to institutional reform for the countries like Afghanistan—Grounded Institutional Reform. The argument for Grounded Institutional Reform will be further developed in Chapter Five.

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<sup>247</sup> *Id.*; OPPER & NEE, *supra* note 3, at 13.

<sup>248</sup> See OPPER & NEE, *supra* note 3, at 5; see also DANI RODRIK, GROWTH STRATEGIES 981 (2004) (“The Chinese experience helps lay out the issues clearly because its institutional innovations and growth performance are both so stark. But China’s experience with non-standard growth policies is hardly unusual; in fact, it is more the rule than the exception.”)

<sup>249</sup> *Id.*

<sup>250</sup> *Id.*

## **1.2. Methodology**

This dissertation asks how Afghanistan can create better policies to improve its economy; specifically, how Afghanistan can design better policies to improve Afghan merchants' access to credit. To answer this question, this dissertation draws upon qualitative and quantitative data to investigate the following questions: what are the problems of credit transacting in Afghanistan? What are the informal institutions that have organically developed to overcome those problems? Whether, how, and to what extent these informal institutions work? And how well the formal institutions designed to improve access to credit for Afghan merchants work? If formal institutions have not been able to improve access to credit for Afghan merchants, what can explain their failure? And how Afghanistan can create better formal institutions in a way that would work for the Afghan context?

Subscribing to a broad definition of credit, in this research, this dissertation uses credit transaction to refer to any non-instantaneous transaction such as trade credit and bank loans. And for the purpose of this study, this dissertation has used the concept of transaction costs to operationalize the effects of different constraints on credit transactions in Afghanistan. Instead of endogenizing institutional transformation to transaction costs, this dissertation posits the fundamental problems of credit transactions in Afghanistan determine the cost of credit transactions, and the informal institutions emerged to overcome those problems. This proposition creates an endogeneity problem: do emergent informal institutions determine the transaction problems, or do the transaction problems determine the informal institutions? To overcome the problem of endogeneity, this dissertation describes the causal pathways that connect the fundamental problems of credit transactions to the emergent informal institutions aimed at resolving those problems. It has also reduced the problem of endogeneity by describing the causes

of the fundamental problems of credit transactions; although, it acknowledges that the endogeneity problem is not entirely eliminated.

### **1.2.1. Grounded Theory**

The qualitative research for this dissertation has been designed and conducted using Grounded Theory. Grounded Theory is a qualitative methodology that is specifically suitable for studying an understudied, basic social process with the aim of producing a theory.<sup>251</sup> It entails a dialogical process where the researcher engages in constant comparison between empirical data and explanations of that data to generate a theory that could account for the empirical findings.<sup>252</sup> Grounded Theory prescribes theoretical sampling to ensure theoretical saturation can be achieved.<sup>253</sup> It requires purposeful selection of a diverse sample, so it can produce data on different aspects and variation of the basic social process being studied.

This dissertation uses Grounded Theory to study the problems of and solutions to credit transacting in Afghanistan. It explains how the existing theories of institutional development fail to account for the case of Afghanistan. It generates a new approach for institutional reform based on the case study of Afghanistan for countries with poor infrastructures, limited market expansion opportunities, and reformist but weak governments.

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<sup>251</sup> BIRKS & MILLS, *supra* note 28, at 17.

<sup>252</sup> *Id.* at 11.

<sup>253</sup> ANSELM STRAUSS & JULIET CORBIN, *BASICS OF QUALITATIVE RESEARCH: GROUNDED THEORY PROCEDURES AND TECHNIQUES* 134 (4th ed. 2015).

### 1.2.2. Sampling and Data Collection

To answer this dissertation's research question, the author conducted eighty-three semi-structured interviews between March and August 2017 in five major provinces of Afghanistan: Herat (24, 29%), Balkh (18, 22%), Nangarhar (16, 19%), Kabul (12, 14%), and Kandahar (17, 20%).<sup>254</sup>

Following Grounded Theory's prescriptions on theoretical sampling,<sup>255</sup> this dissertation chose to focus on these five provinces because they collectively represent half of Afghanistan's economy,<sup>256</sup> one-third of Afghanistan's total population,<sup>257</sup> and more than four fifth of Afghanistan's urban population.<sup>258</sup> The commercial courts that sit in these five provinces hear more than 90% of total commercial disputes in the country.

The majority of merchants in the sample are sellers/creditors. However, the data collected from these interviews describe the operation of buyers/debtors, as far as credit transaction is concerned, because they are the receiver of trade credit issued by sellers/creditors. The sample also includes *Sarrafs*, judges, Huquq Department Judgment Enforcement Specialists,<sup>259</sup> and leaders of business associations.

The sample of interviews conducted for this dissertation does not include female merchants because the experience of women in business merits independent research.<sup>260</sup> While the number

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<sup>254</sup> See Appendix II for the pool of interview questions used for the interviews conducted for this dissertation.

<sup>255</sup> *Id.*

<sup>256</sup> Calculated by the author based on BUSINESS ESTABLISHMENT SURVEY 2009 (2010), *supra* note 18; ESTABLISHMENT SURVEY 2015 (2016), *supra* note 18.

<sup>257</sup> Calculated by the author based on AFGHANISTAN DEMOGRAPHIC ESTIMATES FOR THE YEARS OF 2002/03 UNTIL 2017/18, *supra* note 19.

<sup>258</sup> *Id.*

<sup>259</sup> Huquq, which literarily means rights or law, is a sub-department of the Department of Justice within Afghanistan's Ministry of Justice.

<sup>260</sup> Given that my sample only consisted of men, for the sake of accuracy, I use male pronouns throughout this dissertation.

of women-owned businesses in Afghanistan has been increasing since 2001, men still dominate commerce and industries in Afghanistan.<sup>261</sup> According to the Afghanistan's Investment Support Agency's Data, only 4.2% of the businesses registered between 2003 and 2013 were owned by women (i.e. 1600 out of 37,767 registered companies),<sup>262</sup> most of which are in handicraft and service industry and are subsidized by international donors.<sup>263</sup> However, this is not to underestimate women's contribution to Afghanistan's economy. Afghan women are active participants in the economy. For example, Afghan women account for 65% of workforce in agriculture, which constitutes one third of Afghanistan's GDP. Existing rough estimates on the contribution of Afghan women to the GDP, *which by definition excludes household work*, suggest that women are responsible for 11-14% of Afghanistan's GDP.<sup>264</sup>

The available data on the women-owned businesses suggest that female merchants have considerably less access to credit than their male counterparts. For example, 81% of 298 Afghan women business owners surveyed in 2013 reported that they were unable to access any credit or financing<sup>265</sup> whereas in 2014 only 36% of merchants in Business Climate Report's sample, which consist of all men-owned businesses, reported having a problem with access to finance. Although

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<sup>261</sup> BUILDING MARKETS, AFGHAN WOMEN'S ECONOMIC PARTICIPATION SURVEY REPORT 13 (2013) <http://buildingmarkets.org/products-services-/afghan-women-economic-participation>.

<sup>262</sup> EQUALITY FOR PEACE AND DEVELOPMENT, AFGHANISTAN GENDER EQUALITY REPORT CARD: EVALUATING THE GOVERNMENT OF AFGHANISTAN'S COMMITMENTS TO WOMEN AND GENDER EQUALITY 67 (2015) (citing Afghanistan Investment Support Agency's (AISA) "Investor Directory" "Investors Directory," AISA, 2013, <http://www.aisa.org.af/directory.php>, <https://reliefweb.int/report/afghanistan/afghanistan-gender-equality-report-card-evaluating-government-afghanistan-s>).

<sup>263</sup> *Id.* at 67.

<sup>264</sup> THE WORLD BANK, AFGHANISTAN NATIONAL RECONSTRUCTION AND POVERTY REDUCTION – THE ROLE OF WOMEN IN AFGHANISTAN'S FUTURE 112 (2005) <http://siteresources.worldbank.org/AFGHANISTANNEXTN/Resources/AfghanistanGenderReport.pdf>.

<sup>265</sup> AFGHAN WOMEN'S ECONOMIC PARTICIPATION SURVEY REPORT, *supra* note 261, at 8.

the smaller size of women-owned businesses may explain some of the difference,<sup>266</sup> it cannot account for the entire 45% difference. Likewise, the available data on the operation of women-owned businesses suggest that they have more difficulty establishing business relations. For example, 2013 Afghan Women's Economic Participation Survey found that almost 90% of women-owned businesses do not have partnerships with other businesses or institutions, and nearly 75% do not belong to a business association.<sup>267</sup> While some of the analysis presented in this dissertation (particularly concerning the property rights system and family businesses in Afghanistan), sheds light upon the ways the prevailing institutional arrangements handicap women-owned businesses, the vast differences between the experience of Afghan businesswomen and Afghan businessmen suggest independent studies are needed to illustrate the ways businesswomen interact with the prevailing formal and informal institutions in Afghanistan.

The author chose this sample through his own networks of relationships, and the networks of relationships of his local informants, while purposefully attempting to create as diverse of a sample as possible, with the aim of collecting data on different aspects and variations of credit transactions in Afghanistan. The author has also randomized the sample by (1) walking through the marketplace and randomly choosing merchants to interview, and (2) driving around industrial towns and randomly choosing factory owners to interview.

A goal of minimum fifteen interviews per province was set; however, the author stopped when he concluded that thematic saturation is reached. Alternatively, the author did more interviews in a province when additional interviews were needed to reach thematic saturation. The sectoral breakdown of the sample is presented below. A majority of merchants who were

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<sup>266</sup> 78% of businesses owned by women in Afghanistan are small businesses with monthly income of between 30,000 AFN and 50,000 AFN (approx. between 550 US\$ and 900 US\$). *Id.* at 9.

<sup>267</sup> *Id.*

interviewed are active in more than one sector. The most common combinations are: manufacturing/trade, service/trade, and manufacturing/service/trade.<sup>268</sup>

- 28/83: Manufacturers and producers who produce: cleaning products, furniture, wheel caps, UPVC, cookies, cooking oil, bricks, plastic bags, flavors, chocolates, non-alcoholic beverages, steel rods, aluminum plates, 3D panels, dairy products, iodized salt, carton boxes, stoves, and marble.
- 34/83: Traders who import, sell, and distribute: furniture, oil and gas, rugs and carpets, construction materials, power generators and construction machineries, tea, cooking oil, food items, cell phones, tractors, wheat, flavor, woods, household necessities, cleaning products, fabrics and clothes, medicines, valuable stones, electronics, seeds, blankets, and home appliances;
- 7/83: Merchants in service industry that provide construction, logistics, transportation, printing and processing services.
- 13/83: *Sarrafs*.
- 5/83: Specialists at Huquq Department.
- 8/83: Commercial judges.
- 8/83: Leaders of unions of *Sarrafs*, manufacturer, and chambers of commerce and industries.

### 1.2.3. Coding and Analysis

Grounded Theory requires a researcher to constantly check his codes, his organization of codes, and specifications of the relationships among categories of codes, against the data to produce an

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<sup>268</sup> See APPENDIX I.

explanation that is grounded in the data.<sup>269</sup> Thus, Grounded Theory requires a flexible approach to coding. Following Grounded Theory's prescriptions, the author coded the interviews based on the notes the he had taken during the interviews using an initial coding frame which had been developed to measure theoretically important variables. The author regularly compared the coding frame with the data, modifying and updating the coding frame. In doing so, he modified and expanded the coding frame based on the initial interviews to measure promising new variables.

The author aggregated codes into emergent themes, and further specified the relationships between emergent themes (such as province-specific themes, sector-specific themes, and merchant-type themes). Coding interviews produced a number of emergent themes about credit transactions across different provinces, different sectors, and different merchant-types. The emergent themes were leveraged to produce an analysis of the problems of and solutions to credit transacting in Afghanistan. Drawing on the data and this analysis, this dissertation offers an institutional description of credit transacting in Afghanistan, explaining how the existing theories fail to account for institutional dynamics of credit transacting in the Afghan context. Based on the findings of the empirical research conducted in Afghanistan, this dissertation has offered a new approach for institutional reform for countries with poor infrastructure, limited market expansion opportunities, and a reformist but weak government—Grounded Institutional Reform.

#### **1.2.4. Statistical Data**

In this dissertation, this dissertation has used macroeconomic and demographic statistics supplied by Afghanistan's Government (most often Afghanistan's Central Statistics Organization), Afghanistan Chamber of Commerce, the World Bank, and the International Monetary Fund, other

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<sup>269</sup> BIRKS & MILLS, *supra* note 28, at 10.

international organizations, and some academic sources. When reading these statistics, the reader must exercise caution because all quantitative data on Afghanistan, more or less, suffer from a set of systematic problems that stem from the incredible level of informality of Afghanistan's economy, the prevalence of insecurity that makes large part of country's inaccessible, the prevalence of a sizable underground economy that operates illegally, and political sensitivity that surround some types of data. As a result, for example, estimates on Afghanistan's population range from 29m provided by Afghan Government, and 31m provided by the World Bank. Similarly, the data on Afghanistan's GDP does not include income generated from opium, corruption, illegal trade, and a sizable war economy.

Statistics and surveys on the access to finance, used here and elsewhere, do not account for *Gerawee*, *Sar qufli*, trade credit, and *Sarraf's* short-term working capital loans because merchants do not consider them financing devices. This is because the credit provided by these devices are most often short-term and embedded in different transactions such as credit sales, *hawala*, currency exchanges, or leases. Additionally, in case of *Sarraf's* short-term working capital loans and *Gerawee*, the non-financing conceptualization allows actors to obscure the appearance of interest-bearing transactions, thereby avoiding possible religious objections to their use.

### **1.3. Definitions**

Here a number of terms that will be used throughout this dissertation are defined:

**Institution:** for the purpose of this dissertation, institutions are the set of formal and informal rules, norms, and conventions, as well as their enforcement mechanisms, that facilitate, coordinate, and constrain behaviors. This definition has close affinity with the North's definition

of the institutions. However, here this dissertation does not consider beliefs and “mental models” of individuals as constitutive parts of institutions.<sup>270</sup>

**Formal and informal institutions:** this dissertation uses the concept of formal institutions to refer to the use of legal rules and state-sanctioned mechanisms to facilitate credit transactions. It uses the term informal institutions to refer to the use of norms that are not legally enacted, and mechanisms that are not state-sanctioned, to facilitate credit transactions. This dissertation does not mean to dichotomize formal and informal institutions rather, in this dissertation, they are meant to represent two ends of a spectrum. When a merchant registers property in a court as collateral to receive a loan from a bank he is using formal institutions. On the other hand, when a merchant uses his/her relationship with a *Sarrafi* to receive a working capital loan, so he can transfer money to a foreign supplier, he is using informal institutions. Similarly, when a merchant goes to court to enforce a contract he is using formal institutions, however, when a merchant goes to a business association to enforce a contract he is using informal institutions.

**Trade credit:** trade credit is when a person purchases goods and services but does not immediately pay for them—instead, promising to pay at a later date.

**Credit transactions:** for the purpose of this dissertation, this dissertation uses credit transaction to refer to any non-instantaneous transaction such as trade credit and bank loans

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<sup>270</sup> NORTH (1990), *supra* note 32, at 4.

**Transaction costs:** this dissertation focuses on information, enforcement, and the costs of making transactions. Information costs encompass the costs involved in determining with whom one should transact and the economically important descriptions of the thing that is being transacted. Enforcement costs comprise of the costs involved in monitoring and enforcing transactions. The costs of making transactions refers to the costs one has to incur in order to make a transaction e.g. the cost of negotiating an agreement.

**Property rights:** this dissertation adopts a legal definition of property rights, i.e. a legally enforceable right with relation to a thing; however, it acknowledges that property rights are not uniformly protected by formal institutions. For example, in Afghanistan *Sar qufli* has managed to gain more formal legal protection compared to *Gerawee* because the former has been more effectively incorporated into formal institutions while the holder of both types of property rights, arguably, have some legal claims that are theoretically protected by formal rules.

**Merchants, Sellers/creditors, and Buyer/Debtor:** this dissertation classifies actors in Afghanistan's credit economy into three main actor-types: buyers/debtors, who are most often retailers and receivers of trade credit; sellers/creditors, who are most often importer and/or manufacturers, and suppliers of trade credit; and *Sarrafs*, who are the main financial service providers in Afghanistan.

In Afghanistan, merchants at the top of supply chains are importers, manufacturers, and service providers. They are the main source of trade credit; hence, this dissertation refers to them as sellers/creditors. Importers do not usually receive trade credit because it is difficult to receive credit from supplier located outside of Afghanistan.

Manufacturers, on the other hand, differ. If a manufacturer can procure the necessary input from domestic sources, he can easily do so on credit, in which case, he would become a buyer/debtor with respect to his domestic suppliers. If a manufacturer cannot procure the necessary input domestically he will have to import them, in which case, he usually cannot secure trade credit.

Service providers are sellers/creditors because they do sell their services with exchange of a promise to receive regular payment in the future. Service providers are often not debtors/buyers because their main input is labor, which is bought through a completely different process, i.e., employment agreements. In some instances, service providers import and sell goods that are connected to the service they provide. In those cases, depending on their position in the supply chain, they may be either a seller/creditor or a buyer/debtor.

Merchants at the lower end of supply chains are retailers who sell imported and domestically produced products directly to the consumers, hence, this dissertation refers to them as buyers/debtors. Within some supply chains, there are wholesale distributor who buy from importers/manufacturers and sell to retailers wholesale. These wholesale distributors fall in the middle. They are debtors/buyers with respect to importers and producers, and sellers/creditors with respect to retailers.

The impermanence of the buyer/debtor and the seller/creditor roles does not pose a significant analytical problem because wherever a seller/creditor-buyer/debtor exists, the analyses presented here apply. When discussing a topic that concerns both functions of sellers/creditors and buyers/debtors, this dissertation uses the term merchant.

## Chapter Two: BACKGROUND ON THE ECONOMY AND THE PROBLEMS OF CREDIT TRANSACTING IN AFGHANISTAN

This dissertation offers a microlevel analysis of credit transacting in Afghanistan hence it focuses on actors involved in Afghanistan's credit economy. It explains the behavior of these micro actors insofar as credit transacting is concerned with reference to the prevailing formal and informal institutions that create the incentive structure that they are facing. The first part of this Chapter provides an analytical description of actors in Afghanistan's credit economy along with an overview of their socioeconomic and institutional context.

The second part of this Chapter focuses on the problems that Afghan merchants have to overcome when forming a credit transaction. This dissertation identifies three main problems: unstable business climate; unsupportive property rights; and uncertain contract enforcement. The problems of credit transacting are central to this dissertation because the ability to overcome these problems is the ultimate test for the existing formal and informal credit institutions as well as different approaches to institutional reforms in Afghanistan.

### **2.1. A Brief Overview of Afghanistan's Economy Post-2001**

After Afghanistan was invaded by the United States in 2001, its economy experienced a period of transformation. In 2001, Afghanistan's GDP was 2.5 billion US\$, according to the World Bank's estimate.<sup>271</sup> Within the span of a little more than a year, Afghanistan GDP almost doubled,

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<sup>271</sup> THE WORLD BANK, WORLD BANK DEVELOPMENT INDICATORS, GDP AT CURRENT US\$, AFGHANISTAN'S GDP (Last Updated at Jan. 01, 2018) <https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=AF>.

reaching 4.5 billion US\$.<sup>272</sup> Between 2002/03 and 2016/17,<sup>273</sup> the real GDP (benchmarked 2002/03) grew from 4.5 billion to 7.4 billion US\$.<sup>274</sup> This represents growth of 66% over a fourteen-year period.<sup>275</sup>

In 2001, the World Bank estimated that Afghanistan's GDP per capita was 117 US\$.<sup>276</sup> Within one year, Afghanistan GDP per capita almost doubled to 205 US\$.<sup>277</sup> Between 2002/03-2016/17, real GDP per capita (benchmarked 2002/03) rose from 205 US\$ to 254 US\$, showing an overall growth of 24.5% over a fourteen-year period.<sup>278</sup> rGDP and rGDP/capita measured in Afghani<sup>279</sup> shows a higher overall growth, 150% and 87%, respectively.<sup>280</sup> This is because

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<sup>272</sup> Calculated by the author based on AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, AFGHANISTAN CURRENT GDP BY SECTOR FOR THE YEARS 2002/03 UNTIL 2016/17, <http://cso.gov.af/fa/page/ict/11328/888>.

<sup>273</sup> Afghanistan Central Statistics Organization organizes the economic data according to Solar Hijri years (SH). Solar Hijri year usually starts on March 20<sup>th</sup> and lasts for 365 days. To convert a Solar Hijri year to a Gregorian Calendar year you only need to subtract 621 from Gregorian calendar year or add 621 to the Solar Hijri year. For example, if you subtract 621 from 2017 you get 1396 which is the number of current year in Solar Hijri Calendar. This dissertation converts the years to the Gregorian calendars in most places and denotes them by the combination of two years that are covered by a SH year, e.g. 1381 SH is converted to 2002/03 or 1382 SH is converted to 2003/04.

<sup>274</sup> Calculated by the author based on AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, AFGHANISTAN GDP IN CONSTANT PRINCE BY THE SECTOR FOR THE YEARS OF 2002/03 UNTIL 2016/17, <http://cso.gov.af/fa/page/ict/11328/11330>.

<sup>275</sup> *Id.*

<sup>276</sup> THE WORLD BANK, WORLD BANK DEVELOPMENT INDICATORS, GDP PER CAPITA CURRENT US\$, AFGHANISTAN'S GDP PER CAPITA CURRENT US\$ (Last Updated at Jan. 01, 2018), <https://data.worldbank.org/indicator/NY.GDP.PCAP.CD?locations=AF>.

<sup>277</sup> Calculated by the author based on AFGHANISTAN CURRENT GDP BY SECTOR FOR THE YEARS 2002/03 UNTIL 2016/17, *supra* note 272 and AFGHANISTAN DEMOGRAPHIC ESTIMATES FOR THE YEARS OF 2002/03 UNTIL 2017/18, *supra* note 19.

<sup>278</sup> Calculated by the author based on AFGHANISTAN GDP IN CONSTANT PRINCE BY THE SECTOR FOR THE YEARS OF 2002/03 UNTIL 2016/17, *supra* note 274 and AFGHANISTAN DEMOGRAPHIC ESTIMATES FOR THE YEARS OF 2002/03 UNTIL 2017/18, AFGHANISTAN DEMOGRAPHIC ESTIMATES FOR THE YEARS OF 2002/03 UNTIL 2017/18, *supra* note 19.

<sup>279</sup> The currency of Afghanistan is called Afghani.

<sup>280</sup> Calculated by the author based on AFGHANISTAN GDP IN CONSTANT PRINCE BY THE SECTOR FOR THE YEARS OF 2002/03 UNTIL 2016/17, *supra* note 274 and AFGHANISTAN DEMOGRAPHIC ESTIMATES FOR THE YEARS OF 2002/03 UNTIL 2017/18, AFGHANISTAN DEMOGRAPHIC ESTIMATES FOR THE YEARS OF 2002/03 UNTIL 2017/18, *supra* note 19.

between 2002/03-2016/17, the exchange rate of Afghani/U.S. dollar rose by almost 51%.<sup>281</sup> rGDP per capita shows a lower growth compared to rGDP because Afghanistan's population, in the same period, increased by almost 34% reaching 29.2m in 2016/17.<sup>282</sup>

Since 2013, Afghanistan's economy has been in a recession caused by worsening of security conditions; increasing political instability caused by a contested presidential election; withdrawal of foreign forces; and significant decrease in foreign aid.<sup>283</sup> Unemployment and poverty have been rising while GDP growth has been on the decline. In 2015/16, Afghanistan GDP growth hit its lowest point, experiencing a negative growth of -2.37 for the first time since 2003/04.<sup>284</sup> Afghanistan's economy has been slowly recovering, reaching a positive growth rate of 3.4 in 2016/17, however this is still the third lowest growth rate the country has experienced over the last twelve years.<sup>285</sup>

The proportion of people living below the national poverty line has also increased. Data from three reporting periods show that between 2007/08-2013/4 at least one million more Afghans fell below national poverty line.<sup>286</sup> The initial report of 2016/17 period suggests no improvement

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<sup>281</sup> Calculated by the author Based on DA AFGHANISTAN BANK, CURRENCY HIJRI MONTHLY AVERAGE USD FOR THE YEARS OF 1385 HIJRI UNTIL 1396 HIJRI, <http://dab.gov.af/en/page/monetary-policy/rates-statistics/currency-hijri-average>.

<sup>282</sup> Calculated by the author based on AFGHANISTAN DEMOGRAPHIC ESTIMATES FOR THE YEARS OF 2002/03 UNTIL 2017/18, *supra* note 19.

<sup>283</sup> For a similar analysis *see* RICHARD GHIASY ET AL., *supra* note 205.

<sup>284</sup> Calculated by the author based on AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, AFGHANISTAN GDP GROWTH RATE BY SECTOR FOR THE YEARS OF 2002/03 UNTIL 2016/17, <http://cso.gov.af/fa/page/ict/11328/11333>.

<sup>285</sup> *Id.*

<sup>286</sup> Calculated by the author based on THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2005, *supra* note 14; THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2007-2008, *supra* note 14; THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2011-2012, *supra* note 14; THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2013-2014, *supra* note 14.

in the level of poverty.<sup>287</sup> According to the National Risk and Vulnerability Assessment (2007/08) (“Assessment”), of the five major provinces presented in this dissertation, Nangarhar and Balkh have the highest percentage of population living under the national poverty line (60%), while Kabul and Kandahar have the lowest percentage with only (23%).<sup>288</sup> Herat falls in between with 39% of the population living under poverty line.<sup>289</sup>

Da Afghanistan Bank, Afghanistan’s government-controlled central bank, has used expansionary monetary policies in an effort to reduce the effect of economic slowdown on prices. Da Afghanistan Bank executes monetary policy by buying and selling U.S. dollars in exchange for Afghani. Between 2002/03-2015/16 prices have risen by 263.8%.<sup>290</sup> Since 2009/10, however, the inflation rate has been on a declining trend. Afghanistan actually experienced deflation in 2013/14.<sup>291</sup> Prices have generally stabilized between 2014/15 and 2015/16.<sup>292</sup>

Unemployment, on the other hand, has been on the rise. In 2007/08, the unemployment rate was 7.1% and underemployment rate was 7.9%, which meant almost 85% of the labor force was gainfully employed.<sup>293</sup> In 2007/08, Afghanistan had a 67% labor force participation rate, and an employment-to-population ratio of 62%.<sup>294</sup> In 2001/12, the labor market started to marginally

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<sup>287</sup> See THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2016-2017, *supra* note 14.

<sup>288</sup> See THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2007-2008, *supra* note 14.

<sup>289</sup> *Id.*

<sup>290</sup> Calculated by the author based on DA AFGHANISTAN BANK, ANNUAL ECONOMIC AND STATISTICAL REPORTS FOR THE YEARS OF 2005/2006 UNTIL 2016/2017, <http://dab.gov.af/en/page/media/publications/annual-economic-and-statistical-bulletin>.

<sup>291</sup> *Id.*

<sup>292</sup> *Id.*

<sup>293</sup> See THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2007-2008, *supra* note 14.

<sup>294</sup> *Id.*

decline. Unemployment rose to 8.2%. Labor force participation rate and employment/population ratio were reduced by 10% and 16%, respectively.<sup>295</sup> In 2013/14, the situation further deteriorated.

In 2013/14, only 61% of labor force was gainfully employed.<sup>296</sup> Over a period of four years (2007/08-2013/14), unemployment and underemployment more than doubled, reaching 22.6% and 16.4%, respectively.<sup>297</sup> Labor force participation rate and employment/population ratio also declined to 55.4% and 42.9%.<sup>298</sup> In 2016/17 the labor market has marginally improved.<sup>299</sup> In 2016/17, unemployment and underemployment were each reduced by almost 2% (to 19.4%, and 14.9%), while the labor force participation rate and employment/population ratio have stayed roughly the same.<sup>300</sup>

The data reporting on distribution of employment across sectors is not consistent. However, the available data from three reporting periods show that employment in agriculture and livestock has decreased from 59% in 2007/08 to 44% in 2013/14.<sup>301</sup> Conversely, the employment share of manufacturing has increased by 3% in the same period. Trade has only expanded its share of total

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<sup>295</sup> See THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2011-2012, *supra* note 14.

<sup>296</sup> See THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2013-2014, *supra* note 14.

<sup>297</sup> Calculated by the author based on THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2007-2008, *supra* note 14.

<sup>298</sup> Calculated by the author based on THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2007-2008, *supra* note 14; THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2011-2012, *supra* note 14; THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2013-2014, *supra* note 14.

<sup>299</sup> See THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2016-2017, *supra* note 14.

<sup>300</sup> *Id.*

<sup>301</sup> The statistics in this paragraphs are calculated by the author based on THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2007-2008, *supra* note 14; THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2011-2012, *supra* note 14; THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2013-2014, *supra* note 14.

employment by 1% for the same period. The public sector has also consistently increased its share in total employment. In the same period, construction and mining have increased their share of total employment by 7%.

Unemployment is highest among Afghan youth. Afghanistan has an extremely young population; almost half of the population is fourteen or younger.<sup>302</sup> Three-fourths of the Afghans are twenty-nine or younger.<sup>303</sup> According to the World Bank data, between 2003-2015, youth unemployment (ages 15-24) in Afghanistan has fluctuated between 17.5% and 18.3%<sup>304</sup> while unemployment in the general population for the same period fluctuated between 8.2% and 8.6%.<sup>305</sup>

According to the 2007/008 Assessment, of five major provinces, Kandahar has the lowest unemployment rate with 4% unemployment and 22% underemployment while Kabul has the highest rate of unemployment with 11% unemployment and 19% underemployment.<sup>306</sup> Kabul is closely followed by Herat with 10% unemployment and 52% underemployment. Balkh and Nangarhar fall in between with 8% unemployment each, and 29% and 71% underemployment, respectively.

According to the 2005 Assessment, Kandahar and Kabul have the highest share of employed labor force engaged in commerce (14%) while Nangarhar has the lowest share (7%).<sup>307</sup>

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<sup>302</sup> Calculated by the author based on AFGHANISTAN DEMOGRAPHIC ESTIMATES FOR THE YEARS OF 2002/03 UNTIL 2017/18, *supra* note 19.

<sup>303</sup> *Id.*

<sup>304</sup> Calculated by the author based on THE WORLD BANK, WORLD BANK DEVELOPMENT INDICATORS, YOUTH UNEMPLOYMENT, AFGHANISTAN'S YOUTH UNEMPLOYMENT RATE BETWEEN 1991-2017, [https://www.theglobaleconomy.com/Afghanistan/Youth\\_unemployment/](https://www.theglobaleconomy.com/Afghanistan/Youth_unemployment/).

<sup>305</sup> Calculated by the author based on THE WORLD BANK, WORLD BANK DEVELOPMENT INDICATORS, UNEMPLOYMENT RATE, AFGHANISTAN'S UNEMPLOYMENT RATE BETWEEN 1991-2017, [https://www.theglobaleconomy.com/Afghanistan/Unemployment\\_rate/](https://www.theglobaleconomy.com/Afghanistan/Unemployment_rate/).

<sup>306</sup> The statistics in this paragraph is based on THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2007-2008, *supra* note 14.

<sup>307</sup> The statistics in this paragraphs are based on THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2005, *supra* note 14.

Nangarhar is followed by Herat (8%) and Balkh (9%). According to the same data source, of five major provinces, Balkh had the highest share of employed labor force engaged in crafts and production (5%) while Nangarhar has the lowest (almost 0%). Nangarhar is followed by Kandahar (1%), Herat (2%); Balkh is followed by Kabul (4%).

Afghanistan has a very large illegal economy. The size of Afghanistan's illegal economy, taking into account only corruption and opium, is estimated to be equivalent to one third of the country's GDP and is rising.<sup>308</sup> While the illegal economy has helped alleviate the effects of extreme poverty in some part of the country (e.g. in Kandahar), it hinders the development of private sector and legal economy.<sup>309</sup> It also ensures the continuation of insurgencies, inefficient formal institutions, and puts the legal private sector at a disadvantage.<sup>310</sup>

Afghanistan has a huge trade deficit (approx. 6 billion US\$).<sup>311</sup> Afghans heavily rely on imports from neighboring countries for consumption. The total annual value of imports is equivalent to half of the country's GDP, and it has been rising while the export level has stayed roughly the same over the past fourteen years (0.5 billion US\$).<sup>312</sup> Afghanistan finances its trade

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<sup>308</sup> Calculated by the author based on UNITED NATIONS OFFICE ON DRUGS AND CRIME, AFGHANISTAN OPIUM SURVEY 2015: CULTIVATION AND PRODUCTION, [https://www.unodc.org/documents/crop-monitoring/Afghanistan/ Afghan\\_opium\\_survey\\_2015\\_web.pdf](https://www.unodc.org/documents/crop-monitoring/Afghanistan/Afghan_opium_survey_2015_web.pdf), INTEGRITY WATCH AFGHANISTAN, NATIONAL CORRUPTION SURVEY 2016: AFGHAN PERCEPTIONS AND EXPERIENCES OF CORRUPTION (2016), <https://iwaweb.org/national-corruption-corruption-survey-2016/>, and AFGHANISTAN CURRENT GDP BY SECTOR FOR THE YEARS 2002/03 UNTIL 2016/17, *supra* note 272.

<sup>309</sup> GHIASY ET AL., *supra* note 205, at 4.

<sup>310</sup> *Id.*; INTEGRITY WATCH AFGHANISTAN, CURBING ILLICIT FINANCIAL FLOWS IN AFGHANISTAN: MONEY LAUNDERING, TERRORIST FINANCING, AND HAWALA 10 (2015), <https://iwaweb.org/wp-content/uploads/2016/04/IFF-report-English-2-for-screen.pdf>.

<sup>311</sup> Calculated by the author based on AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, AFGHANISTAN IMPORT AND EXPORT ANNUAL DATA FOR THE YEARS OF 2008/09 UNTIL 2016/17, <HTTP://CSO.GOV.AF/FA/PAGE/ECONOMY-STATISTICS/6323/ANNUAL-TRADE>.

<sup>312</sup> Calculated by the author based on *Id.* and AFGHANISTAN CURRENT GDP BY SECTOR FOR THE YEARS 2002/03 UNTIL 2016/17, *supra* note 272.

imbalance by international aids, personal remittance from Afghan diaspora, and limited Foreign Direct Investment.<sup>313</sup>

Afghan businesses have grown in number, durability and complexity over the past fourteen years, however, their growth has not kept up with the population growth. The private sector growth has been hindered by political instability, worsening of security conditions, poor infrastructure, and lack of access to finance.<sup>314</sup> Afghanistan has a very volatile business climate because of unstable political and security conditions.

Afghanistan's formal finance sector has not been effective in pooling savings for investments. Afghans' endemic distrust of banks was further deepened in 2010 when Kabul Bank, Afghanistan's largest private bank, was involved in a one-billion-dollar scandal (approx. 5% of GDP) involving some of the country's top-ranking politicians.<sup>315</sup> Banks in Afghanistan have excessive reserve of approximately 3 billion US\$.<sup>316</sup> Banks in Afghanistan are not able to distribute the deposits they hold in loans because the uncertain investment climate has driven lending interest rates too high, while an inefficient formal property system makes collateralization of loans difficult.<sup>317</sup> The existing formal property right system does not ensure high enough private return on investment.<sup>318</sup>

Afghan merchants face high contract enforcement cost. Afghanistan's formal dispute resolution system is burdensome, expensive and does not reflect the actual business practice of

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<sup>313</sup> This will be discussed further later in this Chapter in the context of problems of credit transacting.

<sup>314</sup> See, e.g., GHIASY ET AL., *supra* note 205.

<sup>315</sup> See Matthew Rosenberg, *Audit Says Kabul Bank Began as 'Ponzi Scheme,'* N.Y. TIMES (Nov. 26, 2012) <https://www.nytimes.com/2012/11/27/world/asia/kabul-bank-audit-details-extent-of-fraud.html>.

<sup>316</sup> Calculated by the author based on QUARTERLY FINANCIAL SECTOR FINANCIAL STATISTICS FOR THE PERIOD OF I-2013 UNTIL II-2017, *supra* note 22.

<sup>317</sup> The formal financial system is discussed further in Chapter Four.

<sup>318</sup> Afghanistan's property rights system is discussed later in this Chapter.

Afghan merchants.<sup>319</sup> Enforcement of court judgements are uncertain.<sup>320</sup> Bankruptcy and limited liabilities are not *de facto* enforced.<sup>321</sup> The high cost of contract enforcement has discouraged the use of formal institutions to structure business relations.

## 2.2. Main Types of Actors in Afghanistan's Credit Economy

To help the reader to better follow the analysis of credit transacting in Afghanistan, this section describes the way an archetype of each type of commercial actor would operate in Afghanistan's credit economy. This is a very generalized description and may not apply to every merchant, however, it will help the reader follow along with an analysis of credit transacting in the likely familiar context of Afghanistan. Below are three stories offered to illustrate the way archetypes of a buyer/debtor, a seller/creditor, and a *Sarrafi* would conduct their business; it brings together typical facts as presented in the data collected for this dissertation.

**Buyer/debtor:** Ahmad and his sons run a medium-sized supermarket in Herat's food and grain marketplace. Herat's food and grain marketplace is a specialized marketplace that holds a large number of medium-sized supermarkets that sell almost everything a household may need on a daily basis. Ahmad does not own his store, however, he has a *Sar qufli* on the store. This means the owner of the store cannot evict Ahmad and get most of his customers who recognize and trust the store unless s/he pays the market price for the business reputation that Ahmad has generated through his use of the store.

Before opening his store, Ahmad had been working in the same market as an apprentice. Through his time as apprentice, he learned the business and established relationships with

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<sup>319</sup> Afghanistan's formal dispute resolution system is discussed later in this Chapter.

<sup>320</sup> See Section 2.6.3.

<sup>321</sup> See Section 2.6.3.

suppliers. He used his savings and the money he made from selling his inheritance to raise enough capital to cover *Sar qufli* and open a supermarket. He stocked the store by buying on credits from suppliers whom he came to know through his years of apprenticeship in the market.

At his store, Ahmad sells almost all the products that a household may need on a daily basis: shampoo, cleaning products, grain, rice, tea, dairy products, beans, and etc. Ahmad's customers are ordinary Afghan households who buy their household needs in bulk, e.g. every month, or as they need to, e.g. every day or every week. Most of Ahmad's customers are regulars, and Ahmad knows them personally. They pay for their purchases in cash in Afghani, but Ahmad also accepts foreign currencies such as U.S. dollars and Iranian Rial. Ahmad may help out his regular customers sometimes if they do not have the money to pay him right away by letting them pay him back in a week, for example.

Ahmad buys most of his store's supply from a variety of larger merchants who import their products from Iran, Pakistan, China, India, Turkey and the UAE. Ahmad buys some of his store's supplies such as beverages, yogurt, milk, chicken meat, and snacks, from domestic manufactures and producers. Ahmad has an on-going relationship with all of his suppliers. He knows them, and they know him and his business too. Ahmad does not pay for his purchases in cash when he buys them rather he has an account with his suppliers. He purchases products from his suppliers with no payment, or some payment at the time of purchase, adding debt to his account. His suppliers send their employees at the end of each week to collect an installment on Ahmad's outstanding total. Ahmad collects the money he receives from his customers to make weekly payments to his suppliers. Ahmad has to make these payments if he wants to continue to receive products from his suppliers. However, if Ahmad has not been able to sell, or has sold very little of the products that he has bought from a supplier, he may share that fact with the supplier and make a small weekly

payment or avoid payment for that week entirely. Ahmad almost always owes money to his suppliers unless he or a supplier does not wish to work with him anymore, in which case he has to settle his account. The amount of this residual debt depends on the size and rate of turnover of his account with that supplier. These residual debts help Ahmad run his store with less capital than he would otherwise need.

Because of these weekly payments, Ahmad does not accumulate much cash. Nor does he withdraw much money from his store. After making his weekly payments, Ahmad uses most of the remaining income of his store to pay his business expenses (his biggest business expense is usually rent) and family expenses (which includes his employee sons' families too). If he has some extra cash after making weekly payments and covering personal and business costs, he usually uses it to expand his store, or save it to pay for large family expenses, like a son's wedding or a large personal purchase, such as a house, car, or jewelry.

**Seller/creditor:** Mahmud and his sons run a commercial company, *Mahmud and Sons Ltd*, in Herat. He imports shampoo and soaps from Iran. He has an office and a warehouse in another specialized marketplace which mostly hosts merchants who import cleaning products. In addition to his sons, he has four other employees who do bookkeeping, cleaning, manage the warehouse, and collect his receivables from the market. His sons help him with managing the business.

After being a retailer in the same market for a while, Mahmud used his family's wealth and his savings to import shampoo and soaps rather than just sell households' needs on a retail basis. Mahmud had some connections with Iranian businesses from the time he was a refugee in Iran; he also made several trips to Iran to talk to several Iranian exporters before starting his import business. Mahmud started importing shampoo and soap by paying in advance in Iranian Rial for each shipment via *Sarraf's* international *hawalas*, however, now that he has established a

relationship, he can occasionally post-pay some of the money for a shipment, e.g. for a week, to keep the import and distribution process smooth.

Mahmud sells the shampoo and soaps that he imports to many different retailers in the market, but he does not receive immediately payment for these sales; rather his customers have a revolving account with him. Mahmud has to wait until retailers sell his products to their customers, so they are able to make payments to him. To collect the money from sales of the products he has sold to the retailers, he sends his employees to the retailers' store at the end of each week to collect weekly payments. While Mahmud can be reasonably sure that he will collect some money at the end of each week, how much money he collects will depend on how much of his products have been sold in that given week and on the liquidity of his customers.

To make sure the currency exchange rate fluctuations (AFN/Rial and AFN/US\$) do not negatively affect his business, Mahmud deposits the money he collects each week (which are mostly in Afghani) with a *Sarrafi*. By doing so, he also wishes to build credibility with a *Sarrafi*, in case, he needs to send a *hawala* to his Iranian supplier, but he has not collected enough money from his domestic customers. Mahmud will often import a shipment every other month and pay for it in Iranian Rial by two international *hawalas* which he will execute via his *Sarrafi*.

If Mahmud is struggling because the market is slow, he cannot make payments to his foreign suppliers, and/or to his *Sarrafi*s for the *hawalas* that his *Sarrafi* had executed for him on credit; Mahmud may decide to raise capital by putting his house under *Gerawee*—especially if he thinks the market is going to improve. Mahmud may also decide to put his house under *Gerawee* to raise capital when the market is good, and he needs capital to expand and import other products, so he can capture more market share. If he puts his house under *Gerawee*, he may have to pay

monthly rent so he can keep living in his house, or he may forego the rent he was receiving from his property in exchange for a large sum of money he receives under *Gerawee*.

Mahmud will use the income that his business generates to cover his business costs (three big expense items are usually rent for warehouse and office, salaries, transportation and custom costs of the imported goods), and to cover his personal expenses (which includes his sons' and their families too). When the market is doing well and sales are high, Mahmud's business generates extra income that he can use to expand his business, e.g. import other products, or enter another sector, maybe produce shampoo and soaps, or buy large assets, e.g. house or land.

**Sarrafi:** Zubair is a *Sarrafi*. Zubair and his sons run a *Sarrafi* store in Herat's *Sarrafi* market where all other *Sarrafi*s are located too. Zubair does not own the store but has a *Sar qufli* on the store. Zubair's sons, his brothers, and his brothers' sons work in his *Sarrafi* with him.

Zubair spend most of his day recording and executing *hawalas* and currency exchanges that he makes. He receives money to *hawala* (to transfer) to other places inside and outside the country, or to exchange in other currencies, or to keep in a clients' account to be exchanged or transferred later. He gives out money for the *hawalas* that have been issued against him and accounts for withdrawals by his merchant-clients. Zubair spends most of his days on the phone or online talking to his network of *Sarrafi*s in other provinces and other countries to transfer *hawalas*. He also talks to other *Sarrafi*s in the market so he has a sense of what the prevailing exchange rates are and the directions of their possible fluctuations.

Before opening a *Sarrafi* store, Zubair used to buy and sell one or two currencies in the hallway of the *Sarrafi* market or on the street adjacent to the *Sarrafi* market. Zubair also had spent some time as an apprentice in an established *Sarrafi*'s store. After he learned the business, Zubair used the money he had saved and his family's wealth to partner with a friend to pay for *Sar qufli*

of a small store in the *Sarrafi*'s market. Zubair and his partner amicably split after they each established themselves as respectable *Sarrafs* in the market.

Zubair's *hawala* clients are mostly merchants who send, receive, and exchange currencies related to their business. Zubair's merchant-clients send, receive, and exchange currencies frequently and in large amounts. Zubair has relationship with his merchant clients and knows their businesses. Afghans working and living abroad, and their families inside Afghanistan, are the second customer group of Zubair's business. The second group sends, receives, and exchanges currencies, but less often and in smaller amounts. Zubair has a more limited number of merchant-clients compared to the personal users of *hawala* (the second group).

In his *Sarrafi* business, Zubair handles a lot of money on daily basis and has access to a large portfolio of different currencies. He may hold some of this money in multiple safes in his store. Some of this money is distributed in Zubair's *hawala* networks to other *Sarrafs* located inside and outside Afghanistan with whom he has accounts and executes *hawalas*. Zubair keeps some of this money in demands-accounts in several commercial banks inside and outside Afghanistan.

Zubair uses his large portfolio of currencies to execute *hawala* for his merchant-clients to keep their *hawala* and currency-exchange business when they do not have sufficient funds to pay for a shipment or to pay for custom clearance of a shipment. He uses some of this money to start his own business, or to partner in a business, e.g. open a UPVC factory. Zubair may use his access to this money to build shopping and business centers that he can sell, lease, transfer in *Sar qulfi*, or sell. Or Zubair may use his access to this money to buy and sell oil.

### 2.3. An Analysis of Businesses in Afghanistan

The data on the type, size, and number of business entities in Afghanistan are very scattered, and inconsistently collected.

As a general rule, businesses wishing to engage in import and export, or contract with a government and/or NGOs incorporate their businesses, most often as LLCs.<sup>322</sup> The World Bank's database contains the data on the number of new LLCs registered annually across Afghanistan 2006 and 2016.<sup>323</sup> The World Bank data show a strong correlation between the number of new LLCs registered and GDP growth in Afghanistan, in a sense that, the number of registered LLCs roughly tracks the GDP growth rate. In Afghanistan, the number of new LLCs generally increased between 2006 and 2012, peaking in 2012.<sup>324</sup> In 2013, the number of registered LLCs dropped by almost 40% and has stayed low until 2016.<sup>325</sup> This trend tracks GDP growth rate. Growth rate was generally on the rise between 2006 and 2012, peaking in 2009; it has been on a declining trend since 2012.<sup>326</sup>

The author has been able to secure data from the Afghanistan Central Business Registry (“Business Registry”) on the number of incorporated businesses—LLCs and other legal forms—registered in five major provinces: Kabul, Herat, Nangarhar, Balkh, and Kandahar between 2014/15-2016/17.<sup>327</sup> Business Registry data do not include incorporated businesses that are only

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<sup>322</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>323</sup> WORLD BANK DEVELOPMENT INDICATORS, NEW BUSINESS REGISTERED, AFGHANISTAN'S NEW BUSINESS REGISTERED 2006-2016, <https://data.worldbank.org/indicator/IC.BUS.NREG?locations=AF>.

<sup>324</sup> *Id.*

<sup>325</sup> *Id.*

<sup>326</sup> WORLD BANK DEVELOPMENT INDICATORS, GDP GROWTH BY ANNUAL PERCENT, AFGHANISTAN'S GDP GROWTH BY ANNUAL PERCENT 2006-2016, <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=AF>.

<sup>327</sup> BUSINESS REGISTRY DATA FOR THE YEARS OF 2014/15 UNTIL 2016/17 FOR KABUL, HERAT, KANDAHAR, BALKH, AND NANGARHAR, RECEIVED BY THE AUTHOR FROM AFGHANISTAN CENTRAL BUSINESS REGISTRY'S DIRECTORY

registered as manufacturing and processing business entities. However, almost all manufacturing and processing business entities are registered as commercial business entities as well because they most often engage in import and export, which requires registration as a commercial business.<sup>328</sup> The World Bank and Business Registry data are comparable because overwhelming majority of the incorporated commercial businesses entities in Afghanistan are registered as LLCs.<sup>329</sup>

The Afghanistan Central Statistics Office has conducted two nationwide surveys of business establishments (“Business Survey”) in 2009 and 2015.<sup>330</sup> The Business Survey defines an establishment as “an enterprise or part of an enterprise situated in a single location and in which only a single productive activity was carried out or in which the principal productive activity accounted for most of the value added.”<sup>331</sup> The Business Survey covers all non-agricultural establishments, whether owned by the government or the private sector.<sup>332</sup> The Business Survey employs the most inclusive definition of business which covers all income generating business activity units.<sup>333</sup> It counts each business establishment separately, even if they are owned and operated by the same corporation.<sup>334</sup>

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THROUGH HEAD OF OFFICE OF BUSINESS REGISTRY AT AFGHANISTAN MINISTRY OF COMMERCE (Received on Sept. 23, 2017).

<sup>328</sup> This finding is based on author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author’s personal observations over several years of his working as an accountant in the Afghanistan’s private sector between 2008-2013.

<sup>329</sup> *Id.*

<sup>330</sup> See BUSINESS ESTABLISHMENT SURVEY 2009, *supra* note 18; BUSINESS ESTABLISHMENT SURVEY 2015, *supra* note 18.

<sup>331</sup> BUSINESS ESTABLISHMENT SURVEY 2015, *supra* note 18, at 4.

<sup>332</sup> *Id.*

<sup>333</sup> *Id.*

<sup>334</sup> *Id.*

In Afghanistan, as a general norm, only those businesses that engage, or expect to engage, in import, export, or contract with a government and/or NGOs will incorporate, (and therefore would be reflected in the World Bank and/or Business Registry data source).<sup>335</sup> Businesses engaging in these activity-types are not necessarily required by law to be incorporated, however, the rules favour incorporated entities over non-incorporated entities. The overwhelming majority of large businesses in Afghanistan engage in one or several of these activities and therefore are incorporated. The majority of incorporated businesses in Afghanistan are members of the Chamber of Commerce and Industries (“Chamber”) in their province.<sup>336</sup> Manufacturers and producers in major provinces have founded a separate organization, the Union of Manufacturers and Producers (“Union”), and have overlapping membership in both the Union and the Chamber.<sup>337</sup> There is also a national Chamber of Commerce<sup>338</sup> and a national Union of Manufacturers and Producers in Kabul as well.<sup>339</sup>

Chambers and Unions act as special interest groups in Afghanistan.<sup>340</sup> They represent Afghan merchants and advocate for favourable policies and regulations. Also, local Chambers and Unions play a very important role in resolution of disputes among their members (discussed in Chapter Three)

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<sup>335</sup> This finding is based on author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author’s personal observations over several years of his work as accountant in the Afghanistan’s private sector between 2008-2013.

<sup>336</sup> *Id.*

<sup>337</sup> *Id.*

<sup>338</sup> See AFGHANISTAN CHAMBER OF COMMERCE AND INDUSTRIES, <http://www.acci.org.af/>.

<sup>339</sup> Author’s Interview with the President of Afghanistan’s National Union of of Manufacturers and Producers at Kabul (June 2017).

<sup>340</sup> Author’s Interview with the President of Afghanistan’s National Union of of Manufacturers and Producers at Kabul (June 2017); *see also* AFGHANISTAN CHAMBER OF COMMERCE AND INDUSTRIES, *supra* note 338.

If a person wishes, however, to open a store or place of business in the market without forming a corporation, he is allowed to do so, but must first obtain a license.<sup>341</sup> A person engaging in most forms of business activities requires a store or a place of business in the market, thus, the overwhelming majority of businesses, at least in the cities, obtain a form of license. Unincorporated businesses may obtain a business license from the local municipality. Unincorporated businesses tend to engage in retailing, craftsmanship, and provision of smaller services, and often form professional unions and associations. These unions and associations are often marketplace-wide, i.e., membership is based on having a store or a place of business in the same marketplace, or profession-wide, i.e., membership is based on being a member of a profession or a craft.<sup>342</sup> In some provinces, e.g. Herat, the members of these independent marketplace-wide and profession-wide unions have formed a province-wide association, the Craftsmen/Traders Union.<sup>343</sup> There is a National Union of Craftsmen/Trade Union in Kabul as well.<sup>344</sup> The Craftsmen/Traders Union acts as special interest group in Afghanistan, although their influence is far more limited than the Chambers and Unions.<sup>345</sup> Business unions, associations, and local Craftsmen/Traders Unions, in provinces where they exist, play an important role in resolution of disputes among their members (see Chapter Three).

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<sup>341</sup> Municipality's Directives require those who wish to open a store or an office in the city to obtain a license. The requirements for a license varies depending on the profession and/or the business the applicant wish to engage in.

<sup>342</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>343</sup> Author's interview with the President of Herat Craftsmen/Traders Union at Herat (April 2017).

<sup>344</sup> *Id.*

<sup>345</sup> *Id.*

### **2.3.1. Business Registry Data on Business Registry and Initial Capital Investment in Five Major Provinces<sup>346</sup>**

The Business Registry data from 2014/15 to 2016/17 covers five major provinces: Kabul, Herat, Balkh, Kandahar, and Nangarhar. These five provinces represent half of Afghanistan’s economy, one-third of Afghanistan total population, and almost 80% of its urban population.<sup>347</sup>

Business Registry data suggested, at least for the period reported, that Kabul and Herat had much more competitive markets while Balkh had the least competitive market—assuming per capita business registry (“registry/capita”) is used as a measure of ease of entering the market. Business Registry data show, at least for the period between 2014/15-2016/17, Kabul had the highest registry/capita by 13.59 commercial business registration per 10,000 persons. Kabul was closely followed by Herat with 11.42 per 10,000 persons. The remaining three provinces had much lower registry/capita. Kandahar was third by 6.64 registration per 10,000 persons followed by Nangarhar and Balkh with 3.25 and 2.84 commercial business registered. Balkh’s low registry/capita, despite being one of the most secure provinces, supports the hypothesis developed in Chapter Three that asserts Balkh has suffered the most from macroeconomic slowdown because it has the least competitive market, which has reduced the incentive for provision of trade credit and the development of its *Sarrafi* market.

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<sup>346</sup> The data on the business registry and initial capital commitment reported in this section is calculated by the author based on BUSINESS REGISTRY DATA FOR THE YEARS OF 2014/15 UNTIL 2016/17 FOR KABUL, HERAT, KANDAHAR, BALKH, AND NANGARHAR, *supra* note 327.

<sup>347</sup> According to the 2015 Business Survey, these five provinces account for almost 40% of business establishments, 60% of average value added by business establishments, 53% of gross fixed capital owned by the business establishments, and 40% of the employees employed by business establishments in the whole country. Calculated by the author based on BUSINESS ESTABLISHMENT SURVEY 2009, *supra* note 18; BUSINESS ESTABLISHMENT SURVEY 2015, *supra* note 18.

Business Registry data also included the amount declared by businesses as their initial capital at the time of registry. Most merchants exaggerate their initial capital at the time of registry because it is recorded on the license which can be observed by other potential transaction partners (these licenses are public).<sup>348</sup> These prospective transaction partners may consider the stated initial capital on the business license as an indicator of creditworthiness.

Businesses tend to exaggerate their capital to the Business Registry. This practice is enabled by the fact that there is no mechanism to check the accuracy of stated initial capital commitment, and exaggerating has no tax implications.<sup>349</sup> A higher stated capital commitment at the time of registration has two main consequences. First, it results in a higher one-time registration fee, which usually does not amount to a significant sum.<sup>350</sup> Second, and most importantly, it will determine the cap of each shareholders' liabilities if the corporation becomes bankrupt.<sup>351</sup>

Higher stated capital commitment at the time of registration means shareholders will have a greater personal liability in case of bankruptcy.<sup>352</sup> Each shareholder is responsible for his share of the stated capital of corporation in the case of bankruptcy.<sup>353</sup> In the case of bankruptcy, each shareholder is required to pay up to his/her share of the stated capital if he/she has not already done so.<sup>354</sup> However, in Afghanistan, formal bankruptcy proceedings are currently formally suspended, therefore, the bankruptcy effect of the stated capital commitment is not considered by most

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<sup>348</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>349</sup> *Id.*

<sup>350</sup> *Id.*

<sup>351</sup> See QANUN SHERKATHAI SAHAMI VA MAHDUD AL-MASULIAT AFGHANISTAN [CORPORATION AND LIMITED LIABILITIES LAW OF AFGHANISTAN] (LAW NO. 913, 1385 [2006]).

<sup>352</sup> *Id.*

<sup>353</sup> *Id.*

<sup>354</sup> *Id.*

merchants.<sup>355</sup> The public signaling effect of the stated capital commitment is most visible: if a corporation bids for a 1 million US\$ contract and the business license it provides for bidding shows the corporation's capital to be 100,000 US\$, it is not likely to win the bid.<sup>356</sup> As a result, merchants continue to exaggerate their capital to the Business Registry at the time of registry. Consequently, in case of bankruptcy, assuming the current halt is lifted, the rules of the LLC will provide very limited protection for the shareholders. As the Chief Judge of Kabul's Primary Commercial Court said, "corporations do not go bankrupt".<sup>357</sup> Shareholders go bankrupt because they do not have sufficient funds to meet the stated capital commitment. However, according to the decision of Afghanistan's Supreme Court, bankruptcy proceedings are *de jure* halted for individuals.<sup>358</sup> This results in final court judgments that are pending until assets are found or a payment schedule is agreed to.<sup>359</sup>

The institutional incentives of exaggerating a corporation's capital commitment hold regardless of the place of registration. Businesses face similar incentives nationwide; therefore, they are equally likely to exaggerate about their initial capital commitment no matter where they are. As a result, Business Registry data still can be useful for understanding provincial variation of business capital—despite the effect of exaggeration.

Business Registry data show that at least between 2014/2015 and 2016/2017, commercial businesses registered in Kabul have the highest mean of stated initial capital commitment:

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<sup>355</sup> This is discussed further later in this Chapter and Chapter Three.

<sup>356</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>357</sup> Author's interview with the Chief Judge of Kabul Primary Commercial Court in Kabul (June 2017)

<sup>358</sup> This is discussed further in this Chapter and also in Chapter Three.

<sup>359</sup> See Section 3.5. and in Chapter Three.

33,000US\$. Kandahar follows Kabul with a mean initial capital commitment of 30,000US\$. Balkh and Nangarhar both come third with a mean of 22,000US\$. Herat came last with a mean of 19,000 US\$.

Business Registry data on the capital commitment and registry/capita show that Kabulis are most likely to register a business, and they, on average, report the highest initial capital commitment. Heratis follow Kabul in likelihood of registering a business, but they have the lowest mean declared initial capital commitment.<sup>360</sup> Kandaharis are third most likely to register a business but report, on average, the second highest mean initial capital commitment. Balkhis and Nangarharis, on average, declare the same mean initial capital commitment while Balkhis are less likely to open a business. This dissertation draws on this data to identify the varying effects of provincial institutions.

### **2.3.2. The Business Survey Data on Business Establishments in Afghanistan<sup>361</sup>**

The Business Survey data show that between the period 2005 and 2009, the number of business establishments in the country increased by 71%. The primary driver for this growth was the increase in the number of trade and repairing establishments. Between 2005-2009, more than 300,000 new trade and repair establishments were created. According to Business Survey data, between 2009 and 201, business establishments (1) have grown in size; (2) have increased longevity; (3) are more likely to be owned by more than one person; (4) are more likely to be incorporated; and (5) have higher average value added.

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<sup>360</sup> *Id.*

<sup>361</sup> The data reported in this section is calculated by the author based on BUSINESS ESTABLISHMENT SURVEY 2009, *supra* note 18; BUSINESS ESTABLISHMENT SURVEY 2015, *supra* note 18.

Business Survey data indicates that the size of business establishments, measured by the number of employees, has considerably increased. In 2009, only 10% of the business establishments had more than five employees but in 2015 half the business establishments included in a sample of 1,943 firm, had more than eighteen employees. Similarly, the longevity of business establishment, according to Business Survey data, has also increased in the same period. In 2009, almost half of all business establishments were four years old or younger; 20% had been in existence for five to nine years; 22% of the business establishments were between ten and nineteen years old; and only 5% had run for twenty years or longer. Between 2009 and 2015, the share of business establishments that had been in existence for four years or less decreased by almost 20% while the share of the businesses running between five to nine years increased by 17%. However, the share of businesses that had been in existence for ten to nineteen years or more stayed roughly the same. Business Survey data also suggest that business establishments have increased their value added by an average of 50% between 2005-2009, for which the data exist.

#### **2.4. An Overview of the Social Context of Afghanistan's Economy**

Islam and ethnic tensions, arguably, are two defining features of Afghanistan's sociocultural context. Although the overwhelming majority of Afghans are Muslim they do not share the same understandings of what Islam entails in every context. More than 90% of Afghans are Muslims, the majority of whom follow the Hanafi school of jurisprudence (in Arabic called "madhab"), which is the biggest school of jurisprudence in Sunni Islam.<sup>362</sup> A sizable minority of Afghans are Shi'a who follow the Jafari school of jurisprudence.<sup>363</sup> For example, as discussed later in Chapter

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<sup>362</sup> See CENTRAL INTELLIGENCE AGENCY WORLD FACTBOOK: AFGHANISTAN, <https://www.cia.gov/Library/publications/the-world-factbook/geos/af.html>.

<sup>363</sup> *Id.*

Three, merchants of different provinces, as well as merchants and non-merchants in the same province, hold different views on what transactions violate the Islamic prohibition of interest.

In addition to being a Muslim majority country, Afghanistan is an ethnically diverse country with no single dominant ethnic group. Major ethnic groups in Afghanistan are: (1) Pashtuns, (2) Tajiks, (3), Hazaras, and (5) Uzbek.<sup>364</sup> Since the 18<sup>th</sup> century, when Afghanistan was reformed as a unified territory, Afghan rulers have come from the Pashtun ethnic group.<sup>365</sup> Since the 20<sup>th</sup> century the balance of power has changed among ethnic groups in Afghanistan. In the 20<sup>th</sup> century the dominance of Pashtuns was challenged by Tajiks whose influence increased as the size of government grew.<sup>366</sup>

Conflicts in the second half of 20<sup>th</sup> century have shifted power away from Pashtuns to Tajiks, Hazaras, and Uzbeks, all of whom played important roles in the conflicts.<sup>367</sup> The Taliban reign reasserted the Pashtun sovereignty.<sup>368</sup> The overthrow of the Taliban by the United States with the partnership of the Northern Alliance (predominantly a non-Pashtun military and political coalition) shifted the power from Pashtuns to non-Pashtun groups even further.<sup>369</sup> Over the last few years, however, the trend is being reversed and Pashtuns have been increasing their power.<sup>370</sup>

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<sup>364</sup> *Id.*

<sup>365</sup> *See generally* RICHARD S. NEWELL, *THE POLITICS OF AFGHANISTAN* (1972) (stating that Pashtuns have ruled Afghanistan over the past two centuries with limited interruptions.)

<sup>366</sup> *Id.*

<sup>367</sup> *See generally* AMIN SAIKAL, *MODERN AFGHANISTAN: A HISTORY OF STRUGGLE AND SURVIVAL* (2004) (arguing that Afghanistan's years of conflict has increased the political power of minorities in Afghanistan); *See also* GILLES DORRONSORO, *REVOLUTION UNENDING: AFGHANISTAN, 1979 TO THE PRESENT* (John King trans.) (2005) (making a similar argument about the rise of influence of minorities in Afghanistan because of conflicts which helped them organize and form political and military organizations).

<sup>368</sup> *See* AMIN SAIKAL, *MODERN AFGHANISTAN: A HISTORY OF STRUGGLE AND SURVIVAL* (2004) (noting the ethnic elements of Taliban); GILLES DORRONSORO, *REVOLUTION UNENDING: AFGHANISTAN, 1979 TO THE PRESENT* (John King trans.) (2005) (similarly discussing the ethnic politics of Taliban).

<sup>369</sup> *Id.*

<sup>370</sup> This is based on the current perception of non-Pashtun population of Afghanistan as assessed by the author.

These shifts in the relative power of ethnic groups and the fact that no ethnic group has enjoyed full dominance has created continued and rising ethnic tensions in all spheres of Afghan lives.<sup>371</sup> Research conducted for this dissertation, however, shows that ethnic tensions have had no discernible negative impact on the economy and businesses in sectors where the government influence is limited.

## **2.5. A Brief Overview of Institutional Context of Afghanistan's Economy<sup>372</sup>**

Afghan merchants struggle with significant challenges. They face a very uncertain environment characterized by poor infrastructures, poor and volatile security conditions, political instability, social tensions, and unreliable transnational trade routes, an environment that has its roots in ethnic tensions and a prolonged period of civil conflicts and foreign invasions. Formal institutions have low capacity and very limited reach. Corruption plagues formal institutions.

Afghanistan's economy is heavily dependent on foreign aid and the demand generated by presence of international forces which is unsustainable. More than half of the Afghan economy is based on service industry (e.g. logistics, construction, and transportation), the major demand for which is generated by international forces. The dependence on foreign aid and presence of international forces make Afghanistan's economy even less stable.

Property rights are generally insecure. Although the risk of expropriation by the government is currently low, Afghan investors fear that their properties can be taken away from them by powerful individuals inside and outside the government. Afghans spend considerable

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<sup>371</sup> For an analysis of the influence of ethnic tensions over Afghanistan's politics and political institutions See Mohammad Bashir Mobasher, *Understanding Ethnic-Electoral Dynamics: How Ethnic Politics Affect Electoral Laws and Election Outcomes in Afghanistan*, 51 GONZ. L. REV. 355 (2015-2016).

<sup>372</sup> This section is intended as an overview. It briefly summarizes the main descriptive findings of the research presented in this dissertation. Each of these findings is discussed and proven separately elsewhere in this dissertation.

resources on protecting their property. Wealthy Afghans hire bodyguards and pay protection fees to different groups. Trade in assets and collateralization of assets are constrained by the uncertainty of formal property rights and the absence of property registry.

Most Afghans distrust banks, which means that banks are less effective in pooling savings for investment purposes. Banks have difficulty financing investments using the deposits they hold. The highly uncertain investment environment of Afghanistan means that interest rates charged to borrowers are higher and repayment terms are shorter. Given high interest rates and short repayment terms, most Afghan merchants say bank loans are impractical because the return on investment simply cannot cover the capital cost. When an investment opportunity can cover the capital cost, given the scarcity of reliable formal deeds and lack of well-developed formal property rights, merchants have difficulties providing sufficient collateral for bank loans. This is why banks in Afghanistan have excessive reserve of more than 3 billion US\$ that they cannot distribute in loans.<sup>373</sup>

Afghans resolve commercial disputes, and enforce contracts, through informal bilateral and multilateral reputation-based mechanisms. These informal mechanisms are effective at resolving most commercial disputes and have limited exclusionary effects for Afghans. Despite a highly uncertain business environment, a formal property rights system that cannot be used to securitize credit transactions, and generally ineffective formal dispute resolution mechanisms, the Afghan economy is largely a credit-based economy. Most dealings are conducted on credit. Despite the constraints they face, Afghans have managed to fashion financial markets (*Sarrafi*, supply chain, and real estate markets), intermediaries (*Sarrafs*, sellers/creditors, and realtors), and financial

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<sup>373</sup> Calculated by the author based on QUARTERLY FINANCIAL SECTOR FINANCIAL STATISTICS FOR THE PERIOD OF I-2013 UNTIL II-2017, *supra* note 22.

arrangements (e.g. trade credit, *Sarrafs'* working capital loans, *Sar qufli*, and *Gerawee*) to support a largely credit-based economy.

Afghans effectively resolve most common commercial disputes through bilateral and multilateral mechanisms, like business collectives, *ad hoc shuras*<sup>374</sup>, and *jirgas*.<sup>375</sup> The informality of contract enforcement mechanism does not significantly limit the merchants' pool of transaction partners for Afghans; however, it puts outsiders at a disadvantage.

Faced with a highly uncertain environment and formal institutions that are unable to facilitate credit transactions in a way that effectively works in the Afghan context, Afghans have developed financial arrangements, markets, and intermediaries to support a credit-based economy. Sellers/creditors finance supply chains through trade credit and flexible risk-sharing arrangements to maximize sales. *Sarrafs* issue working capital loans to sellers/creditors which create a buffer against cash flow interruptions. Afghan developers and their customers have developed informal property rights based on future business reputation to recover construction cost of shopping centers and business centers for businesses where reputation is closely tied to the place of business. Afghans have developed informal mortgage-like transactions (*Gerawee*) to raise capital against the value of their houses.

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<sup>374</sup> *Shura*, which literarily means consultation or congregation, is an Islamic concept which drives from the Quranic command, "Those who hearken to their Lord, and establish regular Prayer; *who (conduct) their affairs by mutual Consultation*; who spend out of what We bestow on them for Sustenance;" (emphasize added) THE HOLY QURAN (Abdullah Yusuf Ali, trans, Wordsworth Classics of World Literature 2001) 42:38. In context of this dissertation, *shura* refers to a congregation of varying level of permanence and/or institutionalization that often consist of merchants or other respected individuals gathered with the aim of either consulting on an issue, or making a collective decision, or helping resolve a dispute.

<sup>375</sup> *Jirga* is a cultural institution of Pashtuns. It consists of a congregation of autonomous Pashtun men who gather with the aim of either consulting on a public issue, or making a public decision, or resolving a dispute. For more information on the institution of *Jirga* within Pashtun culture See THOMAS J. BARFIELD, UNITED STATES INSTITUTE FOR PEACE, AFGHAN CUSTOMARY LAW AND ITS RELATIONSHIP TO FORMAL JUDICIAL INSTITUTIONS 9 (2003), <https://www.usip.org/sites/default/files/file/barfield2.pdf>.

Supply chains are financed by sellers/creditors who act as financial intermediaries through risk-sharing and flexible repayment agreements. Sellers/creditors have easy access to working capital loans from *Sarrafs*. They can pay back these loans under flexible repayment terms as they receive payments from buyers/debtors. *Sarrafs* can make these loans using the deposits they hold for Afghan merchants. *Sarrafs* issue these loans because they have lower information costs, and because these are short term, low risk loans.

A highly competitive business environment animates the provision of trade credit and short-term working capital loans. Herein lies the feedback loop: lower barriers to entry create market competition, which animates the provision of trade credit and short-term working capital loans, while easing access to trade credit and short-term working capital loans which lower the barriers to entry. These existing informal institutional solutions allow Afghan merchants to finance supply chains despite a highly volatile business climate. However, they create inefficiency by locking merchants into existing supply chains. They also cannot be used to finance investments.

Developers can recover capital costs required to construct shopping centers and business offices through creation and sale of a property right in the future business reputation of shops or offices—called *Sar qufli*—where business reputation is tied to the place of business. *Sar qufli* has developed outside the formal legal system, however, the increased use of this method and increased demand by the users for courts to resolve disputes concerning *Sar qufli* has caused it to be sanctioned by commercial courts. *Sar qufli* is an example of effective synergies between formal and informal institutions achieved through the judiciary without legislation. Although *Sar qufli* is not mentioned in Afghanistan statutory laws, currently, a majority of disputes that are decided by commercial courts pertain to the *Sar qufli*. This is because court judgments are both necessary and effective for protection of *Sar qufli*. The Afghanistan Supreme Court has invoked the historical

precedent of practice in Islamic countries, and the general principle of commercial law, which privileges commercial agreements and commercial practices as the paramount source of commercial law, to justify the recognition and enforcement of *Sar qufli*. Afghan judges rely on a number of Afghanistan Supreme Court decisions, parties' contractual agreements, and local customs to resolve *Sar qufli* disputes.

Afghan merchants can raise capital against the value of their houses through a mortgage-like transaction called *Gerawee* that has developed completely outside the formal legal system, called *Gerawee*. Conservative rough estimates suggest that in year the 2016/17 in Herat alone, the total amount of capital raised through *Gerawee* was roughly 120 million US\$, which was almost triple the total value of outstanding bank loans in Herat for the same year. *Gerawee*, on the other hand, has not been effectively linked to formal institutions although court judgements are, arguably, both necessary and effective in *Gerawee* disputes. This is because *Gerawee* is understood to violate the prohibition of interest in Islamic law. *Gerawee* is not considered a commercial transaction. One party to a *Gerawee* transaction is almost always a non-merchant, and the subject of the transaction is most often a house. The transaction is often fashioned as a sale with a right of repurchase. The non-commercial characteristics of *Gerawee* means a different set of formal laws, actors, and attitude shape the interaction between *Gerawee* and formal institutions. While interest-bearing transactions are generally accommodated in formal institutions pertaining to commercial transactions, they are less tolerated in non-commercial contexts.

Despite the prevalence of ethnic tensions, cross-ethnic business transactions are the norm in Afghanistan. Afghans have managed to, for the most part, isolate the business world from the negative effects of ethnic tensions in sectors of economy where government influence is limited.

However, in the sectors where the government is influential, such as construction and logistic sectors, ethnic and political tensions have impacted business relations as well.

Afghans have managed to reduce, but not eliminate, the effects of a highly uncertain environment and inefficient formal institutions. *Sarrafs'* working capital loans cannot be used to finance investment and long-term assets because *Sarrafs* have limited capabilities to pool savings and diversify risk. *Sarrafs'* working capital loans cannot be used to finance high risk-high return investments like startup financing. *Sarrafs* cannot pool savings for investment purposes because they make profit from *hawala* and currency exchange not pooling savings for investment purposes. Trade credit locks sellers/creditors and buyers/debtors in existing supply chain relationships causing inefficient allocation of resources.

The Afghan government's inability and unwillingness to formalize *Gerawee* means that creditors enjoy very limited protections and the market is vulnerable to fraud and misuse. This means that engaging in *Gerawee* as a creditor involves a lot of risk. These risks have seriously circumscribed the expansion of the *Gerawee* market. Afghan merchants can only raise a fraction of the value of the property they put under *Gerawee* in the market (e.g. they can only raise 6,000 US\$ for a property worth 30,000 US\$). *Gerawee* cannot be used to pool savings for investment because it is a direct transaction between an individual saver, who often has housing needs, and an entrepreneur who needs financing. *Sar qufli* is only effective when the business reputation is closely tied to the place of business. It cannot be used to cover the capital cost of other types of construction projects.

Informal dispute resolution mechanisms generally put outsiders at a disadvantage and does not allow for risk-diversification because they do not recognize the principle of limited liability.

The informal contract enforcement mechanism also has a negative effect on the depersonalization of business relations in Afghanistan.

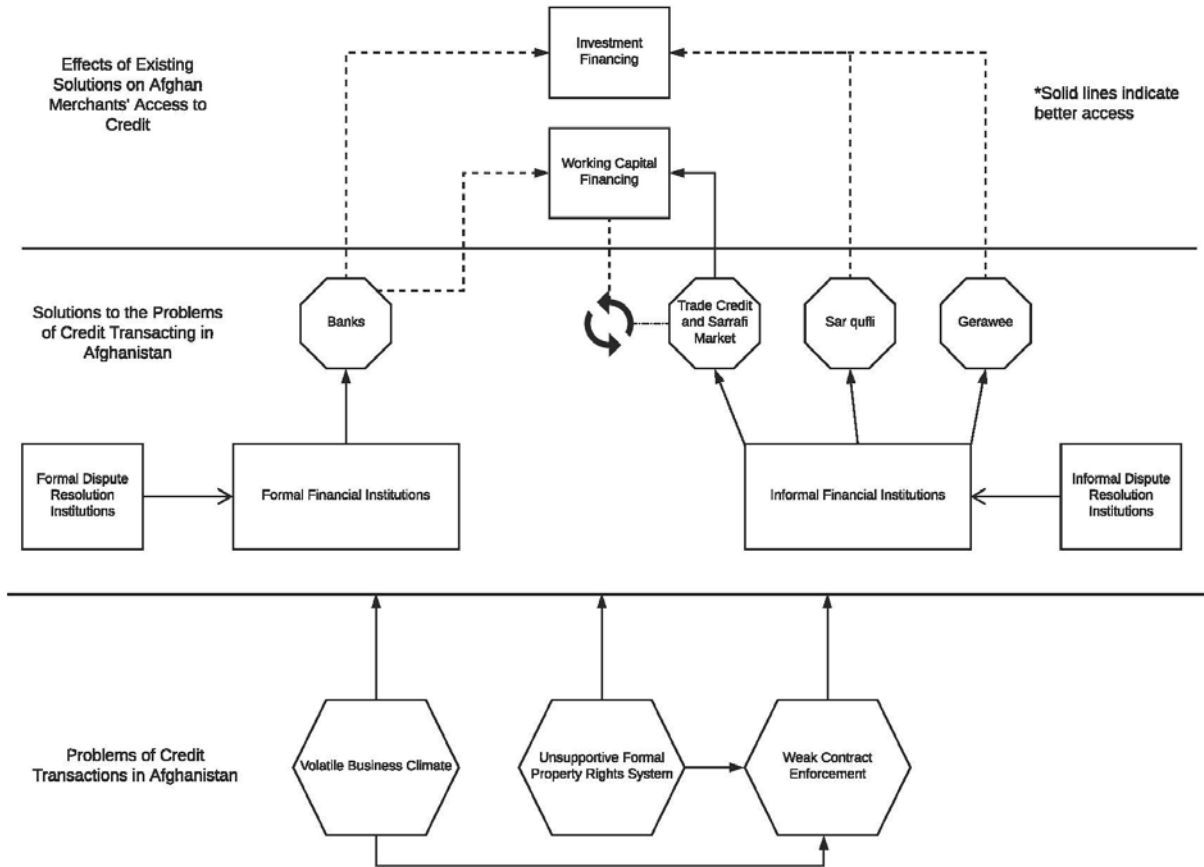


Diagram 1 Overview of Afghanistan's Credit Institutions<sup>376</sup>

<sup>376</sup> Constructed by the author based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

## **2.6. Fundamental Problems of Credit Transactions in Afghanistan**

Fundamental problems of credit transacting in Afghanistan determine the prevailing transaction cost and have led to the emergence of informal institutions. To reduce the problem of endogeneity, this dissertation describes the historical roots and the causes of the problems of credit transacting in the Afghan context. The three main problems of credit transacting are volatility of business climate; unsupportive formal property right system; and ineffective formal dispute resolution. These three problems are not necessarily independent of each other. In fact, two major reasons for the ineffectiveness of the formal dispute resolution is underdevelopment of the formal property right system, and high rate of insolvency, which is partly due to instability of the business climate. However, each of these three problems have direct and distinct effects on the prevailing transaction costs and the emergent informal institutions, hence, this dissertation considers their effects separately.

### **2.6.1. Afghanistan Has a Volatile Business Climate<sup>377</sup>**

Afghanistan has a very volatile business climate. Poor security conditions, political tensions, poor infrastructure, and import and aid dependency are the main factors contributing to the instability of Afghanistan's business climate. The volatility of business climate poses problems for credit transactions because they are intertemporal transactions. For example, the instability of the business climate makes it difficult for Afghan merchants to, *ex ante*, adherence to a fixed, inflexible payment schedule. It also increases investment risks, and the cost of borrowing. Formal credit institutions have failed to adapt to the volatility of Afghanistan's business context. Informal

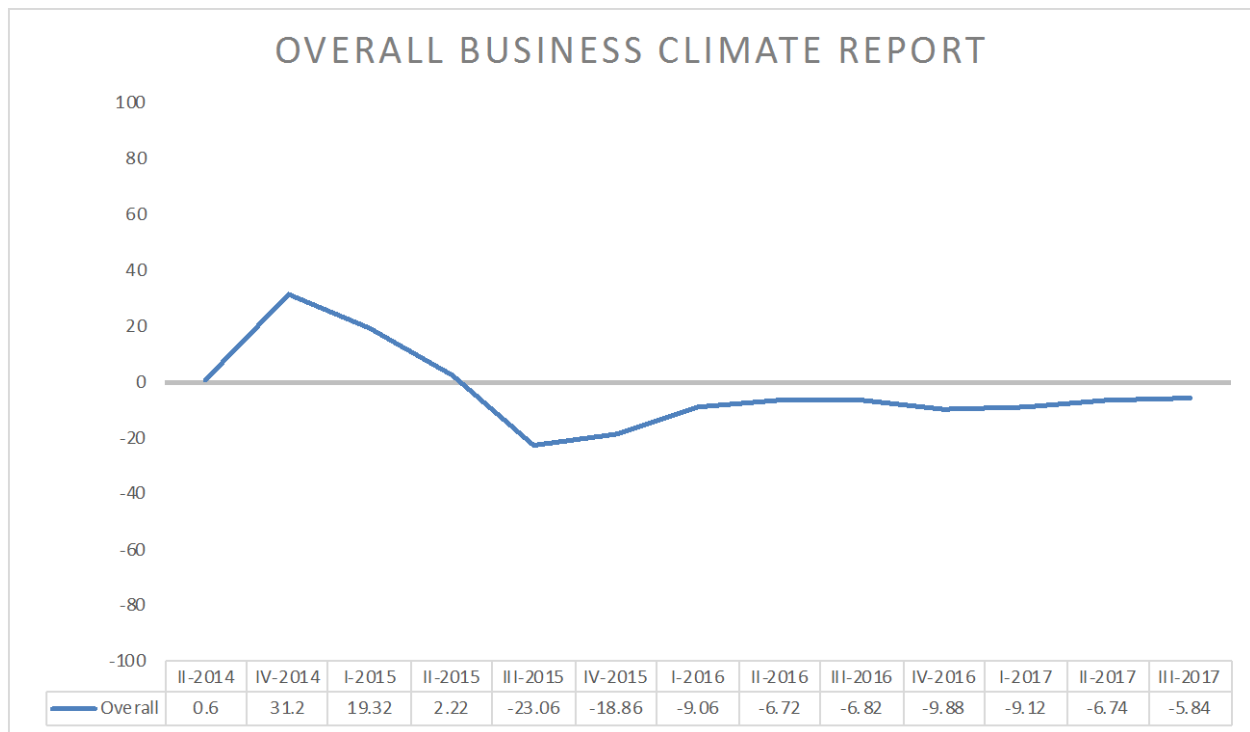
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<sup>377</sup> The data concerning the attitudes of Afghan merchants on current and future business conditions in Afghanistan reported in this section is based on BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, and III-2017, *supra* note 12.

institutions, on the other hand, have managed to provide credit despite these environmental uncertainties.

The fluctuating judgment of Afghan merchants on the state of business in the country illustrates the volatility of business climate in Afghanistan. The Business Climate Report is a quarterly report of Afghan merchants' perception of Afghanistan's Business Climate. The Business Climate Report is based on a periodic phone survey of 300-500 company managers, in five major provinces, working in manufacturing, construction, service, and trade sectors. The survey asks managers about their judgment on their present business situations and their business expectation for the next six months. The indicator values range from 0 (meaning: normal) up to a possible maximum of +100 for a positive climate, and from 0 to a possible minimum of -100 for a negative climate. The business climate is the mean of the situation and the expectations.

The Business Climate Report is a reliable and valid measure of Afghanistan's business climate. The Business Climate Report for the period between second quarter of 2014 (II-2014) and fourth quarter of 2017 (III-2017) traces the decline in GDP growth. Business managers expressed that their business situation and expectation have worsened throughout this period. The Business Climate Report data, tracing the GDP growth, show Afghan businesses' judgments on their present and future situations have been trending toward negative starting from end of 2014. Since the end of 2015, the business climate has started to marginally improve while still staying on the negative side of zero.



*Figure 1 Afghanistan's Overall Business Climate Report (II 2014 - III 2017)<sup>378</sup>*

While the overall business climate score, by virtue of being an average score, may obscure the level of volatility in Afghanistan’s business climate, the regional breakdown of the Business Climate Report data shows a high level of volatility. The graph representing Business Climate Report data for any of the five major provinces show that Afghan businesses experience high volatility (Figure 2).

<sup>378</sup> Constructed by the author based on BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, and III-2017, *supra* note 12.

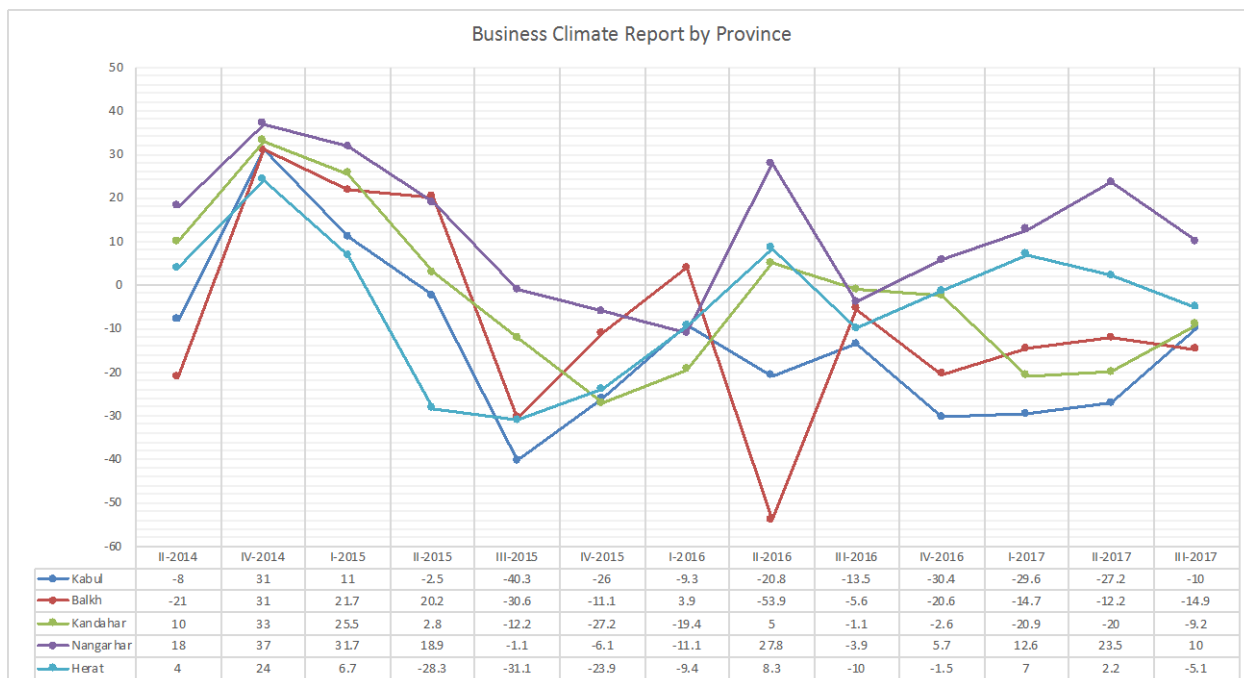


Figure 2 Afghanistan's Business Climate Report by Province (II 2014 - III 2017)<sup>379</sup>

The Business Climate Report data ranks the average business climate in five major provinces studied here, from worst to best, for the period II-2014 to III-2017 as follows: Kabul, Balkh, Herat, Kandahar, and Nangarhar. Of the five major provinces, Kabul, the capitol, receives the bulk of major terrorist attacks, and is affected the most by political instability; therefore, its climate was expectedly ranked the worst by the Business Climate Report data.<sup>380</sup> The situation in Balkh is less clear. Balkh was ranked the second worst, on average, in this period. Balkh is one of the safest and most stable provinces in Afghanistan.<sup>381</sup> However, it possesses the least developed

<sup>379</sup> Constructed by the author based on BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, and III-2017, *supra* note 12.

<sup>380</sup> See, e.g., provincial breakdown of civilian casualties for the year 2017 which is 1831 for Kabul, 862 for Nangarhar, 716 for Kandahar, 495 for Herat, and 129 for Balkh. UNITED NATIONS ASSISTANCE MISSION IN AFGHANISTAN, PROTECTION OF CIVILIAN IN ARMED CONFLICT 2017 ANNUAL REPORT 67 (2017), [https://unama.unmissions.org/sites/default/files/afghanistan\\_protection\\_of\\_civilians\\_annual\\_report\\_2017\\_final\\_6\\_march.pdf](https://unama.unmissions.org/sites/default/files/afghanistan_protection_of_civilians_annual_report_2017_final_6_march.pdf).

<sup>381</sup> *Id.*

*Sarrafi* market and the cash sales are the norm of business in Balkh. Therefore, there is a correlation between prevalence of cash sale and undeveloped *Sarrafi* market, on the one hand, and being affected the most by worsening of macroeconomic conditions.<sup>382</sup>

Despite being the most politically stable and safest of five major provinces, Balkh has the most volatile business climate.<sup>383</sup> Of the five major provinces, Balkh's business climate has experienced the most volatility. Balkh's business climate has a standard deviation of 22.21, while the standard deviations for Kabul, Herat, Kandahar, and Nangarhar are, respectively, 18.46, 15.36, 17.50, and 14.69. The absence of a well-developed *Sarrafi* market, and prevalence of cash sales has made the business climate in Balkh the least stable, even though it is the safest and politically most stable province (this argument is developed further in Chapter Three).

Despite having one of the most developed *Sarrafi* markets and the most pervasive credit-based supply chains, Herat has the third worst business climate in this period, according to the Business Climate Report. The share of small businesses likely explains this phenomenon. Herat's business climate is, however, the second most stable after Nangarhar. Herat has the highest share of small businesses—indicated by the lowest mean of initial capital reported by businesses at time of registry, and the second highest per-capita business registry, amongst the five major provinces. Small businesses are affected the most by worsening of macroeconomic conditions, according to the Business Climate Report data. The number of small businesses can explain why Herat is ranked the third worst business climate and Kandahar the second best. Kandahar has the lowest share of small businesses.

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<sup>382</sup> See Chapter Three.

<sup>383</sup> See Chapter Three.

It is not clear why Nangarhar has performed so well both in the overall business climate and in business climate stability. Nangarhar also has one of the lowest per capita commercial court use in the country.<sup>384</sup> What makes Nangarhar even a more puzzling case is that Nangarhar does most of its trade with Pakistan and the share of Afghanistan-Pakistan trade declined in this period.<sup>385</sup> Furthermore, of the five major provinces, Nangarhar has the smallest manufacturing base,<sup>386</sup> and according to the Business Climate Report data, the manufacturing sector has been affected the least by the worsening of macroeconomic conditions.

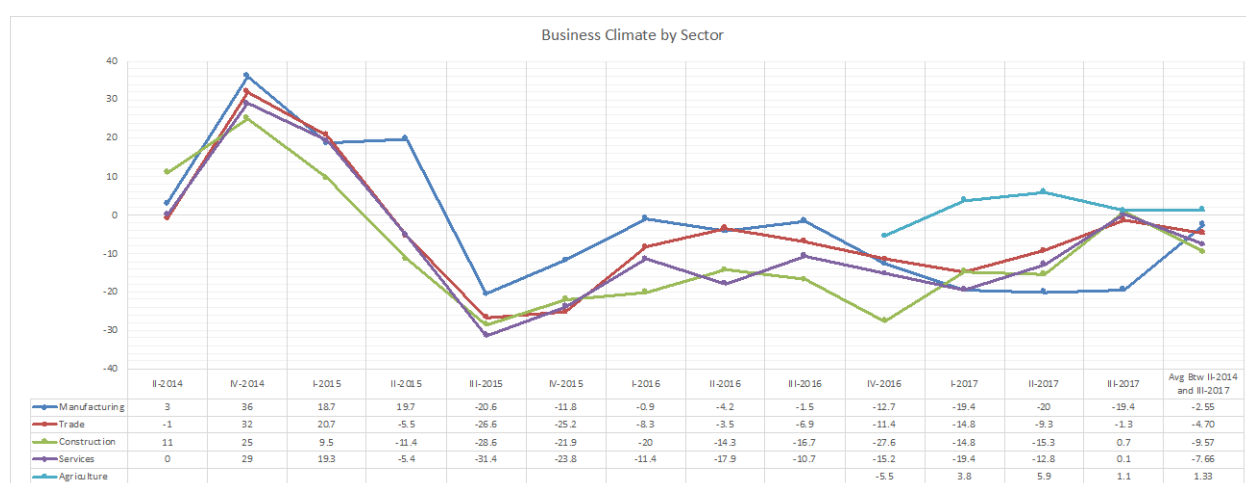


Figure 3 Afghanistan's Business Climate Report by Sector (II 2014 - III 2017)<sup>387</sup>

According to the Business Climate Report data, between II-2014 and III-2017, the manufacturing sector has experienced the least slowdown while construction and services have experienced the most negative climate; the latter is linked to the shrinking presence of foreign

<sup>384</sup> Calculated by the author based on QUARTERLY JUDICIAL ACTIVITIES REPORTS FOR THE YEARS OF 2012 UNTIL 2017, *supra* note 21.

<sup>385</sup> Calculated by the author based on ANNUAL TRADE DATA FOR THE YEARS OF 2008/09 UNTIL 2016/17, *supra* note 311.

<sup>386</sup> Measured by the number of people employed in manufacturing sector. See THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2005, *supra* note 14.

<sup>387</sup> Constructed by the author based on BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, and III-2017, *supra* note 12.

forces in the country. Agriculture and trade follow service in the list of sectors most affected by worsening of macroeconomic conditions.

The Business Climate Report data show that smaller businesses have consistently been affected the most by worsening of macroeconomic conditions. This is expected because smaller businesses usually have the least capital and are the least diverse businesses.

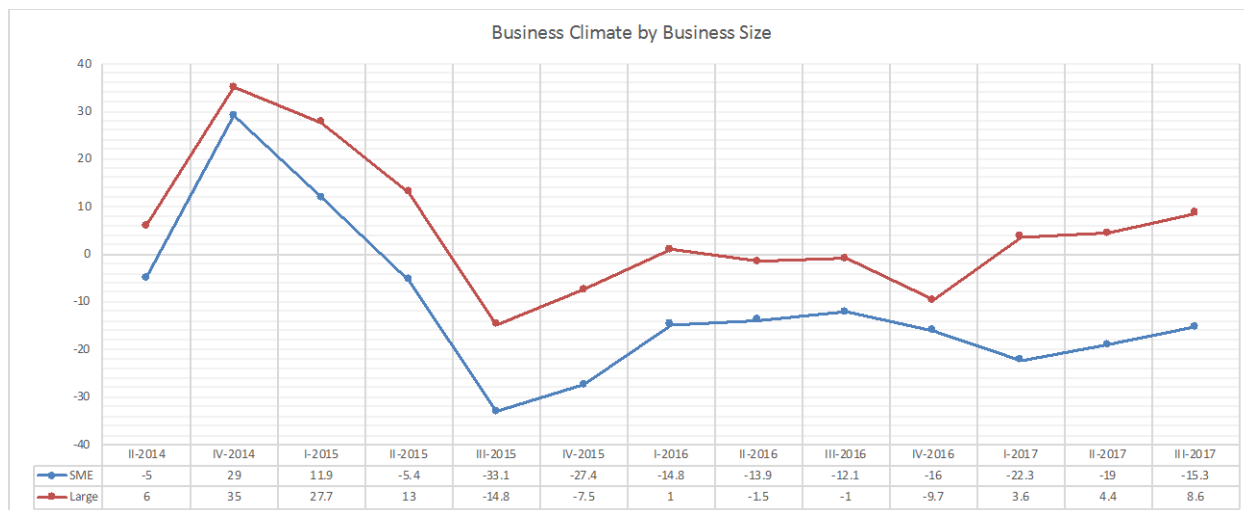


Figure 4 Afghanistan's Business Climate Report by Business Size (II 2014 - III 2017)<sup>388</sup>

### 2.6.1.1. Security Conditions in Afghanistan Destabilize the Business Climate

The main source of environmental uncertainty in Afghanistan is the deteriorating security condition. Poor security conditions have a direct and negative effect on the business climate in Afghanistan. A high level of insecurity renders Afghanistan's business climate very unstable. Afghan security conditions, measured by the number of civilian deaths, have been worsening since 2001,<sup>389</sup> however, security conditions started to significantly deteriorate in 2006, reaching record

<sup>388</sup> Constructed by the author based on BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, and III-2017, *supra* note 12.

<sup>389</sup> IAN S. LIVINGSTON AND MICHAEL O'HANLON, BROOKINGS INSTITUTION, AFGHANISTAN INDEX 12 (SEPT. 29, 2017), [https://www.brookings.edu/wp-content/uploads/2016/07/21csi\\_20170525\\_afghanistan\\_index.pdf](https://www.brookings.edu/wp-content/uploads/2016/07/21csi_20170525_afghanistan_index.pdf).

10,000 civil deaths in 2016/2017.<sup>390</sup> As of August 2017, according to the Special Inspector General for Afghanistan Reconstruction's report ("Special Inspector"), the Taliban either control, influence, or contest the government's control in almost half of Afghanistan's districts.<sup>391</sup>

The 2015 Business Survey data shows that more than a quarter of surveyed business establishments reported lack of security was the biggest problem they had faced within the last year of their operation.<sup>392</sup> Comparing Business Survey data from 2009 to 2015 suggests that lack of security has become a more serious problem for businesses between 2009-2015 (rising from 7% to 26%) as security conditions in the country deteriorated.<sup>393</sup> Since the security condition has been on a downward trend post-2015, it can be safely assumed that security conditions have become even a more serious problem for businesses since 2015. Of the five provinces studied here, measured by the number of terrorist attacks, Kabul is the least secure while Herat and Balkh are the most secure.<sup>394</sup> Kandahar and Nangarhar fall in between.<sup>395</sup>

### **2.6.1.2. Political Instability Creates Volatility for Businesses**

Political instability is another source of environmental uncertainty in Afghanistan, having a direct and negative effect on business climate. A high level of political instability renders Afghanistan's business climate unstable. Afghanistan is one of the world's least politically stable countries. In

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<sup>390</sup> *Id.*

<sup>391</sup> SPECIAL INSPECTOR GENERAL FOR AFGHANISTAN RECONSTRUCTION, QUARTERLY REPORT TO THE UNITED STATES CONGRESS 87 (Oct. 30, 2017) <https://www.sigar.mil/pdf/quarterlyreports/2017-04-30qr.pdf>.

<sup>392</sup> Lack of security followed temporary cutting of electricity (43%) and was followed by lack of infrastructure facilities (15%), lack of laborers (5%), and disagreement of partners (3%). 8% of surveyed business establishments named other problems as the main problems they had faced within the last of their operation. *See* BUSINESS ESTABLISHMENT SURVEY 2015, *supra* note 18.

<sup>393</sup> Calculated by the author based on BUSINESS ESTABLISHMENT SURVEY 2009, *supra* note 18; BUSINESS ESTABLISHMENT SURVEY 2015, *supra* note 18.

<sup>394</sup> *See* PROTECTION OF CIVILIAN IN ARMED CONFLICT 2017 ANNUAL REPORT (2017), *supra* note 380, at 67.

<sup>395</sup> *Id.*

2015, the World Bank gave Afghanistan's political stability score of -2.50 ranking Afghanistan 191 out of 194 countries.<sup>396</sup> This score (-2.50) is slightly lower than Afghanistan's mean political stability score for the period between 2001 and 2015, which was (-2.43).<sup>397</sup>

Since 2015, Afghanistan has experienced even more political instability. Following the contested presidential election of 2014, Afghanistan has experienced intense and sustained level of political instability. Unable to determine the winner of the election due to rampant corruption, in 2015, following a period of intense political turmoil, a National Unity Government was brokered by The United States Secretary of State suspending the constitutionally mandated process of government succession.<sup>398</sup> Under the National Unity Government Agreement, a power-sharing agreement was reached between the two candidates with the highest votes: Muhammad Ashraf Ghani assumed the Presidency and Abdullah Abdullah assumed the extra-constitutionally-created position of Chief Executive of the Government.<sup>399</sup> Since its inception, the National Unity Government has continuously dealt with a string of political crises, culminating in the refusal of the Balkh's strong governor, Atta Muhammad Noor, to vacate the governorship after President Ghani ordered his replacement in December 2017.<sup>400</sup> In March 2018, after three months, the National Unity Government was able to reach a deal ending the Balkh's governorship crisis in

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<sup>396</sup> See THE WORLD BANK, WORLD BANK DEVELOPMENT INDICATORS, POLITICAL STABILITY INDEX, AFGHANISTAN'S POLITICAL STABILITY SCORE FOR THE YEARS OF 1996 UNTIL 2016, [HTTPS://WWW.THEGLOBALECONOMY.COM/AFGHANISTAN/WB\\_POLITICAL\\_STABILITY/](https://www.theglobaleconomy.com/AFGHANISTAN/WB_POLITICAL_STABILITY/). The World Bank compiles and summarizes information from over 30 existing data sources to produce its index.

<sup>397</sup> *Id.*

<sup>398</sup> See the full text of the "government of national unity deal" as emailed to the journalists by the US Embassy on 21 September 2014 at the Afghanistan Analyst Network's website; articles of the Constitution cited in the agreement were given after the text by the Afghanistan Analyst Network, <https://www.afghanistan-analysts.org/miscellaneous/aan-resources/the-government-of-national-unity-deal-full-text/>.

<sup>399</sup> *Id.*

<sup>400</sup> See Matin Sahak, *Powerful Afghan Governor Defying President Ghani Agrees To Go*, REUTERS (March 22, 2018), <https://www.reuters.com/article/us-afghanistan-governor/powerful-afghan-governor-defying-president-ghani-agrees-to-go-idUSKBN1GY1PU>.

exchange for several high governmental positions to be filled by Atta's allies and members of Jamiat-e-Islami, the political party of Atta and Abdullah.<sup>401</sup>

A high level of sustained political instability in Afghanistan creates an unstable business climate especially for credit transactions and investment. For example, according to Balkh's Chamber of Commerce and Industries, the political crisis of Balkh's governorship has caused investment in Balkh to decrease by 30%.<sup>402</sup>

### **2.6.1.3. Poor Infrastructure Creates an Unstable Business Climate and Fragments the Domestic Markets**

Afghanistan has a poor and unreliable infrastructure, which precipitates an uncertain Afghanistan business and investment climate. Poor infrastructure is a nationwide and sector wide problem. According to the 2015 Business Survey, almost half of surveyed business establishments reported unreliable access to electricity was the biggest problem they had faced within the last year of their operation.<sup>403</sup>

However, the Business Climate Report data show significant variation in the regional distribution of business-reported infrastructure problems.<sup>404</sup> According to the average percentage of businesses that reported infrastructure problems, for the period between 2013-2016, of the five major provinces, Kandahari businesses have the most infrastructural problems (89%), followed by Nangarhari businesses (87%), followed by Kabul (74%). Herati and Balkhi businesses reported

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<sup>401</sup> *Id.*

<sup>402</sup> See Karim Amini, *Ongoing ARG-Jamiat Rift Affects Investment in Balkh*, TOLO NEWS (Feb. 02, 2018), <https://www.tolonews.com/afghanistan/ongoing-arg-jamiat-rift-affects-investment-balkh>.

<sup>403</sup> See BUSINESS ESTABLISHMENT SURVEY 2015, *supra* note 18.

<sup>404</sup> The data reported in this paragraph is based on AFGHANISTAN CHAMBER OF COMMERCE INDUSTRIES, BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, and III-2017, <http://www.acci.org.af/surveys-and-studies.html>.

the lowest percentage of infrastructural problems, 64% and 65%, respectively. These findings are not surprising because electricity is the number one infrastructural problem reported across the country and these findings correlate to the provinces with the electricity problems. Herat and Balkh have the best access to electricity in the country while Kandahar, Nangarhar, and Kabul, in that order have the least access to electricity.

There is no significant variation in sectoral distribution of infrastructural problems. However, the Business Climate Report data suggest that the infrastructure problems associated with sewage and waste disposal, and telecom have actually decreased between 2013 and 2016.<sup>405</sup> Infrastructural problems concerning water declined in 2014 and 2015, however, it has made a comeback in 2016 because of droughts.<sup>406</sup>

#### **2.6.1.4. Afghanistan's Economic Structure Is a Source of Volatility**

The structure of Afghanistan's economy is a cause of volatility in the business climate. Half of Afghanistan's economy, measured by contribution to the rGDP, is comprised of the service sector.<sup>407</sup> The other half is almost equally divided between agriculture and industry.<sup>408</sup> The main source of demand for service sector is generated by the presence of foreign forces; this is highly unsustainable.<sup>409</sup> This means half of Afghanistan's economy is driven by the highly unpredictable level of military commitment and presence of foreign countries.

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<sup>405</sup> Calculated by the author based on BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, AND III-2017, *supra* note 12.

<sup>406</sup> *Id.*

<sup>407</sup> Calculated by the author based on AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, SECTORAL CONTRIBUTION TO THE GDP FOR THE YEARS OF 2002/03 UNTIL 2016/17, <http://cso.gov.af/fa/page/ict/11328/11332>.

<sup>408</sup> Calculated by the author based on SECTORAL CONTRIBUTION TO THE GDP FOR THE YEARS OF 2002/03 UNTIL 2016/17, *supra* note 407.

<sup>409</sup> For a similar analysis See RICHARD GHIASY ET AL., *supra* note 205.

Since 2002/03, the service sector has consistently expanded its share of the GDP, agriculture's share has consistently shrunk, and the industrial share has roughly stayed the same.<sup>410</sup> In 2002/03 agriculture had accounted for 43.2% of the country's GDP. By 2016/17, agriculture's share reduced by almost half, accounting only for 23% of Afghanistan's rGDP. In the same period, the share of industry as a percentage of rGDP also failed to increase, decreasing slightly from 21.4% in 2002/03 to 21.1% in 2016/17. The service industry expanded its share as percentage of rGDP in the same period, increasing from 34.1% of rGDP in 2002/03 to 51.6% in 2016/17. Within that service sector, transport, communication, producers of government services, wholesale trade and retail trade, in that order, have been responsible for the increased contribution of the service sector to Afghanistan's GDP.

Examining each sector's monetary contribution to Afghanistan's GDP, between 2002/03-2016/17, of Afghanistan's three economic sectors, the service sector has experienced the highest growth while agriculture has experienced the lowest growth. The service sector contribution to GDP increased from 1.54 billion US\$ in 2002/03 to 3.93 billion US\$ In 2016/17, adjusted for inflation. Within the service sector, finance and insurance, transport and telecommunication, producers of government services, restaurant/hotel, wholesale services and retail services, in that order, have contributed the highest growth.

After the service sector, the industrial sector has accounted for the most growth. In 2002/03, the industrial sector had contributed 0.97 billion US\$ to the GDP. In 2016/17, the contribution of industry, adjusted for inflation, rose to 1.8 billion US\$. Within the industry sector, mining and

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<sup>410</sup> The data on the sectoral contribution of different sector to Afghanistan's economy reported in the following paragraphs is calculated by the author based on SECTORAL CONTRIBUTION TO THE GDP FOR THE YEARS OF 2002/03 UNTIL 2016/17, *supra* note 407.

quarrying, construction, electricity and gas and water, and manufacturing, in that order, have experienced the highest growth.

The agricultural sector actually showed negative overall growth during this period due to the declining value of the Afghani against the U.S. dollar. In 2002/03, the agricultural sector contributed roughly 1.95 billion US\$/87.42 billion AFN to the GDP. In 2016/17, the contribution of agriculture to the GDP in U.S. dollars, adjusted for inflation, dropped to 1.7 billion US\$ while in Afghani it increased by 31% reaching 114.6 billion AFN. This is because the AFN/US\$ exchange rate increased by a higher percentage of 51% in that period.<sup>411</sup>

The high share of the service sector in Afghanistan's economy introduces a new source of instability. The demand for the service industry, which is dominated by logistics and construction, is highly dependent on the presence of foreign forces.<sup>412</sup> This means half of Afghanistan's economy is heavily reliant on the unpredictable level of military commitment of foreign countries.<sup>413</sup>

Agriculture, a quarter of Afghanistan's economy, is also highly dependent on the change in climate patterns. Almost half of Afghanistan's work force is employed in agriculture (although service industry constitutes half of Afghanistan's economy, it only accounts for 11% of employment).<sup>414</sup> Agriculture in Afghanistan is predominately subsistence agriculture employing

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<sup>411</sup> Calculated by the author Based on CURRENCY HIJRI MONTHLY AVERAGE USD FOR THE YEARS OF 1385 HIJRI UNTIL 1396 HIJRI, *supra* note 281.

<sup>412</sup> For a similar analysis see RICHARD GHIASY ET AL., *supra* note 205.

<sup>413</sup> *Id.*

<sup>414</sup> Calculated by the author based on THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2005, *supra* note 14; THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2007-2008, *supra* note 14; THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2011-2012, *supra* note 14; THE NATIONAL RISK AND VULNERABILITY ASSESSMENT: AFGHANISTAN LIVING CONDITIONS SURVEY 2013-2014, *supra* note 14.

traditional farming technology.<sup>415</sup> As a result, agricultural output in Afghanistan is highly dependent on the patterns of rainfall. This introduces an additional source of uncertainty to Afghanistan's business environment.

#### **2.6.1.5. Afghanistan Relies Heavily on Imports from Unreliable Trade Routes**

Afghanistan relies on imports for most of its consumption. Afghanistan is a landlocked country and has to rely on transit routes through its neighboring states for trade. Afghanistan conducts more than half of its trade with its six neighboring countries: Pakistan, Iran, Tajikistan, Turkmenistan, Uzbekistan, and China.<sup>416</sup> Afghanistan has active trade ports with all its neighbors with the exception of China, which is connected to Afghanistan through an impenetrable mountainous corridor, *Wakhan*. Afghanistan has multiple trade ports with Pakistan and Iran, which constitute the country's main trade routes. However, Afghanistan has politically complicated relationships with its neighbors.

There are several examples of the tension between trade and politics. Afghanistan accuses Pakistan of supporting the Taliban and other insurgent groups within Afghanistan while Pakistan accuses Afghanistan of hosting Baloch separatist and Pakistani Taliban with the support of India.<sup>417</sup> Pakistan has often used the threat or actual blockage of its border with Afghanistan as a tool of pressure between the two countries' on-going political and economic disputes over support

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<sup>415</sup> Comparing the data on productivity of agricultural production from the country's two different time period separated by almost fifty years (1967-1968 and 2016-17) reveals that agricultural productivity has stayed roughly the same over the last half a century. See MAXWELL J. FRY, *THE AFGHAN ECONOMY* 52 (1974) and AFGHANISTAN CENTRAL STATISTICS ORGANIZATION, *AGRICULTURAL SURVEY DATA FOR THE YEARS OF 2008 UNTIL 2017*.

<sup>416</sup> Calculated by the author based on AFGHANISTAN IMPORT AND EXPORT ANNUAL DATA FOR THE YEARS OF 2008/09 UNTIL 2016/17, *supra* note 311.

<sup>417</sup> For an analysis of current state of relationships between Pakistan and Afghanistan, See Mujib Mashal & Salman Masood, *Cutting Off Pakistan, U.S. Takes Gamble in Complex Afghan War*, N. Y. TIMES (Jan. 5, 2018), <https://www.nytimes.com/2018/01/05/world/asia/pakistan-aid-afghan-war.html>.

of terrorist proxies.<sup>418</sup> The closure of Pakistan-Afghanistan trade routes, which on average has happened at least once a year over the last twelve years, causes prices to rise in Afghanistan.<sup>419</sup> The Afghan government has been pursuing an active policy to diversify its imports and its trade routes. As a result, since 2014/15 Iran has replaced Pakistan as Afghanistan's largest trading partner.<sup>420</sup> However, the Afghanistan-Iran relationship, although much better than the Afghanistan-Pakistan relationship, is politically complicated as Afghanistan has continuously accused Iran of supporting the Taliban within Afghanistan and meddling in the western side of the country.<sup>421</sup> Additionally, the resumption of United States' sanctions against Iran casts doubts on the further expansion of Afghanistan-Iran trade and transit routes.

In addition to expanding its trade with Iran, Afghanistan has established air corridors with India and Kazakhstan.<sup>422</sup> It is also pursuing air corridors with a number of other countries.<sup>423</sup> These air corridors are generally used to export Afghanistan's agricultural products, predominantly

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<sup>418</sup> For an example of recent blockages *See* Staff Report, Pakistan Reopens Key Afghan Trade Route for Trial Run, Daily Times (March 10, 2018), <https://dailytimes.com.pk/212864/pakistan-reopens-key-afghan-trade-route-for-trial-run/>.

<sup>419</sup> *Id.*

<sup>420</sup> Calculated by the author based on AFGHANISTAN IMPORT AND EXPORT ANNUAL DATA FOR THE YEARS OF 2008/09 UNTIL 2016/17, *supra* note 311.

<sup>421</sup> *See, e.g., Ra'is Amniat Melli Afghanistan: Iran va Russia ta hududi be Taliban kumak mikonan [The Head of Afghanistan's Intelligence Agency: Iran and Russia Help Taliban to Some Extent]*, BBC PERSIAN (Feb. 4, 2018), <http://www.bbc.com/persian/afghanistan-42937425>.

<sup>422</sup> *See* Anjana Pasricha, *India and Afghanistan Open Air Freight Corridor to Bypass Pakistan*, VOANEWS (June 21, 2017), <https://www.voanews.com/a/india-afghanistan-air-freight-corridor-opens/3909537.html>; *Start of Export via Kabul-Almaty, Kazakhstan by Kam Air Airline*, AFGHANISTAN CHAMBER OF COMMERCE AND INDUSTRIES (Feb. 21, 2018), ACCI.org, <http://www.acci.org.af/da/component/content/article/38-news/1313-n.html>.

<sup>423</sup> *See, e.g.,* Indonesia, Turkey, and Dubai, UAE, *see* Zarmina Mohammadi, *Afghanistan-Indonesia To Open Air Corridor*, TOLONews (Feb. 6, 2018), <https://www.tolonews.com/index.php/business/afghanistan-indonesia-open-air-corridor>; *BAZAR: Afghanistan-Turkey Air Corridor Discussed*, TOLONews (May 13, 2018), <https://www.tolonews.com/business/bazar-afghanistan-turkey-air-corridor-discussed>; *Kabul to have air corridors with Ankara, Dubai*, ITVNEWS.AF (April 28, 2018), <http://www.ltvnews.af/en/news/afghanistan/34318-kabul-to-have-air-corridors-with-ankara-dubai>.

fruits.<sup>424</sup> Afghanistan has also established a trade route that connects India to Afghanistan via Persian Gulf and Chabahar Free Trade Zone in Iran.<sup>425</sup> With the hope of expanding and diversifying its transnational trade, Afghanistan acceded to the World Trade Organization in December 2017.<sup>426</sup> The Afghan government is working in the context of the Regional Cooperation Conference on Afghanistan to establish a railroad that would connect Iran to Tajikistan, Turkmenistan, and China through Afghanistan.<sup>427</sup> The Afghan government is also working to establish the Lapis Lazuli Route that would connect Afghanistan through on-land and on-sea routes to Turkey and finally the Red Sea via Turkmenistan, Caspian Sea, Azerbaijan and Georgia.<sup>428</sup> Afghanistan is also working toward inclusion in China's One Belt One Road Policy which would connect Afghanistan to China through Uzbekistan and Kazakhstan.<sup>429</sup> The success of these transit projects is highly dependent on the ability of the Afghan government to establish and maintain the security of these routes inside Afghanistan. If successful, however, they will greatly improve the stability of Afghanistan's trade routes and hence Afghanistan's business climate. Until that happens, Afghanistan's heavily reliance on import from unstable trade routes perpetuates Afghanistan's unstable business climate.

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<sup>424</sup> See, e.g., *Kabul to have air corridors with Ankara, Dubai*, 1TVNEWS.AF (April 28, 2018), <http://www.1tvnews.af/en/news/afghanistan/34318-kabul-to-have-air-corridors-with-ankara-dubai> (“The country’s chamber of commerce said that dried fruits and herbal products were ready to be exported to Ankara and Dubai through air corridors.”)

<sup>425</sup> See Ministry of Foreign Affairs of Afghanistan, *Counting down the hours now to RECCA VII (Ashgabat, November 14-15, 2017)!*, VIDEO CLIP POSTED ON FACEBOOK (January 2018), <https://www.facebook.com/mfa.afghanistan/videos/1551999691524672/>

<sup>426</sup> See *Accession: Afghanistan*, WORLD TRADE ORGANIZATION, [https://www.wto.org/english/thewto\\_e/acc\\_e/a1\\_afghanistan\\_e.htm](https://www.wto.org/english/thewto_e/acc_e/a1_afghanistan_e.htm) (last visited June 4, 2018).

<sup>427</sup> See Ministry of Foreign Affairs of Afghanistan, *supra* note 425.

<sup>428</sup> *Id.*

<sup>429</sup> *Id.*

### **2.6.1.5.1. Afghanistan's Imports, Exports, and Cross-Border Trade**

Afghans rely on imports for a large portion of the products they use. Afghanistan's annual legal imports have been consistently on the rise over the past decade. The data on illegal imports is unavailable, however, given the country's limited control over its border, illegal imports are expected to be substantial.

In 2007/08, when the Afghan Government started regularly reporting imports data, Afghanistan had imports valued at a total of 3.02 billion US\$ in 2007/08.<sup>430</sup> Imports reached their height in 2012/13, valued at 8.93 billion US\$. Since then, imports have experienced some decline, dropping to 6.53 billion US\$ in 2016/17. Imports are expected to recover in 2017/18, reaching 8.4 billion US\$. Per capita imports, however, have enjoyed a steady increase, with the exception of a drop in 2015/16. In all import categories, per capita imports have risen over the last decade with an average rate of 280%. Per capita imports in 2008/09 were valued at 22.77 US\$. In 2016/17, they reached 63.09 US\$, dropping to 10 US\$ in 2015/16.

Food and beverages have been Afghanistan's number one legal import based on the total value imported. Afghanistan has imported 14.1 billion US\$ of food and beverages since 2008/09. Over the last decade, the annual import value of food and beverages has consistently increased from 0.536 billion US\$ in 2008/09 to 1.89 billion US\$ in 2016/17 and an expected 2.82 billion US\$ in 2017/18. The per capita import of food and beverages has also experienced a steady increase from 22.77US\$ in 2008/09 to 63.09US\$ in 2016/17 and an expected 90.96US\$ in 2017/18. This means Afghans are consuming more but they are not producing more of what they consume.

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<sup>430</sup> All of the data discussed in this section, unless otherwise specified, are calculated by the author based on AFGHANISTAN IMPORT AND EXPORT ANNUAL DATA FOR THE YEARS OF 2008/09 UNTIL 2016/17, *supra* note 311.

After food and beverage, oil products constitute Afghanistan's second largest import category, including petrol, gasoline, diesel, airplane fuel, lubricant, and paints. Over the last decade, Afghan merchants have imported 13.57 billion US\$ in oil products. Oil imports started from 0.49 billion US\$ in 2008/09 and reached their highest value in 2011/12 with the total value import of 2.24 billion US\$. Since then, oil imports have declined, falling to a total import value of 1.09 billion US\$ in 2016/17 and an expected value import of 0.94 billion US\$ in 2017/18. Per capital oil imports have experienced a similar trend: beginning at 20.90 US\$ in 2008/09, they peaked at 89 US\$ in 2011/12 and have been consistently falling since, reaching 39 US\$ in 2016/17 and expected to drop to 30.22 US\$ in 2017/18. Imports of oil, unlike food and beverages, is linked to the level of productive activities in the country; as a result, it generally tracks the downward trend of economic growth.

Construction materials, which include iron, glass, cement, and pipes, are the third import category. Over the past decade Afghan merchants have imported 9.12 billion US\$ worth of construction materials. Import of construction material has shown a similar trend to oil products as demand of construction material is similarly correlated with the level of productive activities and hence economic growth. The import value of construction materials started from 0.510 billion US\$ in 2008/09; reached the height of 1.5 billion US\$ in 2012/13 only one year after oil imports reached their highest point. Imports of construction material have experienced sustained declines since 2012/13 falling to 0.73 billion US\$ in 2016/17. Unlike oil products, import of construction materials is expected to increase in 2017/18 by 40%. This is because the demand generated from increasing urbanization is expected to sustain construction, at least in Kabul.<sup>431</sup> Per capita imports of construction material follow the same pattern of increase/decrease/expected-increase.

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<sup>431</sup> GHIASY ET AL., *supra* note 205, at 19.

Uncategorized imports, marked as “others” in the government statistics, is the fourth largest import of Afghanistan, followed by vehicles and vehicles’ parts. The latter category includes import of cars, construction vehicles, motorcycles, tricycles, bicycles, and their parts. Imports of vehicles and vehicles part have followed the same pattern as oil and construction materials, correlating with the level of productive activities and hence economic growth in the country. Vehicle and vehicle parts imports were 0.602 billion US\$ in 2008/09 and reached their height in 2010/11, a year before oil imports, marking imports of 1.85 billion US\$. Since 2010/11, imports of vehicles and vehicles parts have dropped to 0.296 billion US\$ in 2016/17. However, they are expected to recover in 2017/18 to an estimated of 0.615 billion US\$ in expected imports. Per capita import of vehicles and vehicles part follows the pattern of increase/decline/expected-increase.

Clothes, fabrics, yarn and footwear (soft goods) are the sixth largest import category in Afghanistan. Over the last decade, Afghan merchants have imported 3.57 billion US\$ worth of products from this category. In 2008/09, Afghan merchants imported 0.11 billion US\$ worth of soft goods. The import of soft goods increased to its height in 2013/14 with a total import of 0.504 billion US\$. Between 2014-2016, soft goods imports declined to 0.39 billion US\$ but have since recovered to a record import of 0.54 billion US\$ in 2016/17 and expected import of 0.62 billion US\$ in 2017/18. Per capita soft goods imports have steadily increased over the past decade, with exception of a drop in 2015-16 year raising from 3.92US\$ in 2008/09 to 19.50US\$ in 2016/17 and expected per capita imports of 20.01 US\$ in 2017/18.

These six categories (food and beverages, oil products, construction materials, others, vehicles and vehicles parts, and clothes and footwear) account for approximately 85% of Afghanistan’s total imports over the past decade. The remaining ten categories, in order of total

contribution, are: machinery and its parts; household and office items; electronics; medicine and medical equipment; electricity; household appliances; cigarettes; agricultural medicine and fertilizer; livestock; and gold. These collectively account for only 15% of total imports over the last decade. This shows a trend of import dependence because the latter groups include items which are important for productive economic activities such as machinery and agricultural medicine and fertilizer.

Afghanistan's legal exports, in terms of total value, consists of agricultural products; handicrafts; livestock products; minerals; and industrial products. The annual value of Afghanistan's legal exports has stayed roughly the same for the period between 2008/09 and 2016/17 with total annual export value of 0.5 billion US\$.

Afghanistan conducts more than half of its legal trade with its six neighboring countries, in order of total volume of trade (between 2008/09-2017): Pakistan, Iran, China, Uzbekistan, Turkmenistan, and Tajikistan. Between 2008/09-2017, Afghanistan obtained 61% of its imports from these six countries. In the same period, the same six countries accounted for 52% of Afghanistan's exports. Imports from these six countries have consistently increased over the past decade from 58% in 2008/09 to 67% in 2016/17, dropping to 61% in the second quarter of 2017 (measured as a percentage of Afghanistan's total imports). Exports to these six countries have been declining as Afghanistan has started to export to more countries; exports to these six countries have dropped from 56% in 2008/09 to 33% in the second quarter of 2017.

Cross-border trade plays a large role in Afghanistan economy. Four of its five major provinces (Herat, Nangarhar, Balkh, and Kandahar), representing one-third of Afghanistan's economy, are border provinces. Herat borders Turkmenistan and Iran, while Nangarhar and Kandahar border Pakistan, and Balkh borders Uzbekistan and Tajikistan.

### 2.6.1.5.2. Financing Afghanistan's Negative Trade Balance

Afghanistan has a negative trade. Over the last decade, the negative trade balance has been growing because Afghanistan's legal imports have steadily increased while the legal exports have stayed roughly the same. For example, in 2008/09 Afghanistan legally exported 0.54 billion US\$ while it imported 3.02 billion US\$.<sup>432</sup> Eight years later, in 2016/17, the total value of exports marginally increased to 0.6 billion US\$ while the total value of imports increased to 6.53 billion US\$. Between 2008/09-2017/18 Afghanistan's total trade deficit has amounted to 55.13 billion US\$.

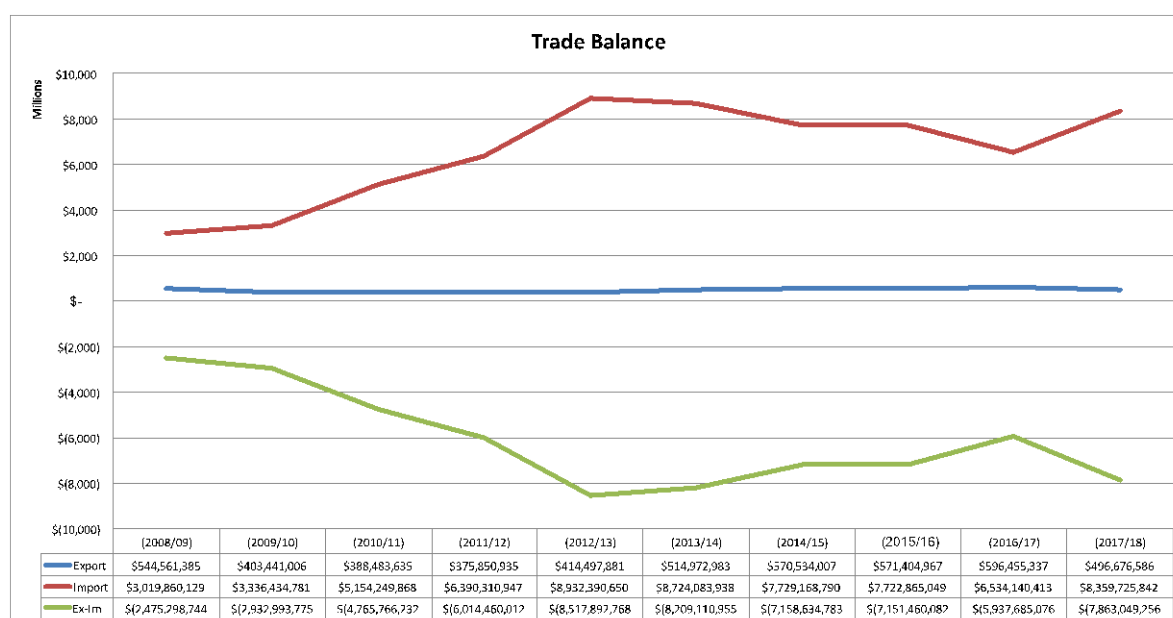


Figure 5 Afghanistan's Trade Balance (2008/09 - 2017/18)<sup>433</sup>

Afghanistan is only able to run such a high trade deficit because it relies on foreign aid.

According to the World Bank data, between 2001 and 2015, Afghanistan has received 61.84 billion

<sup>432</sup> The statistics on the Afghanistan trade balance reported in this paragraph is calculated by the author based on AFGHANISTAN IMPORT AND EXPORT ANNUAL DATA FOR THE YEARS OF 2008/09 UNTIL 2016/17, *supra* note 311.

<sup>433</sup> Constructed by the author based on AFGHANISTAN IMPORT AND EXPORT ANNUAL DATA FOR THE YEARS OF 2008/09 UNTIL 2016/17, *supra* note 311.

US\$ in net official development assistance and official aid,<sup>434</sup> however development assistance and foreign aid has been on decline since 2010.<sup>435</sup> Afghanistan's foreign aid dependency has introduced another source of volatility into Afghanistan's economy as the flow of foreign aid is much less predictable than domestic revenue.<sup>436</sup>

After development assistance and foreign aid, personal remittances are Afghanistan's largest source of financing the country's massive trade deficit. Accurate data on the value of personal remittances is scarce. The current estimates are inconsistent. According to the World Bank data, the total value of personal remittances received in Afghanistan between 2008 and 2016 was 2.22 billion US\$.<sup>437</sup> However, in a report released in 2018, the World Bank estimated that the money Afghans working outside Afghanistan have sent home over the last year could account up to 10% of the country's gross domestic income (approx. 2 billion US\$).<sup>438</sup> According to the same report, 16% of Afghan families have at least one member who is working abroad and sending money home.<sup>439</sup> The Afghanistan Ministry of Refugee and Repatriation estimates that over the last year, Afghans living abroad (including refugees and immigrants) have injected 7 billion US\$ into

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<sup>434</sup> See THE WORLD BANK, WORLD BANK DEVELOPMENT INDICATORS, NET OFFICIAL DEVELOPMENT ASSISTANCE RECEIVED IN CURRENT US\$, AFGHANISTAN'S NET OFFICIAL DEVELOPMENT ASSISTANCE RECEIVED IN CURRENT US\$ FOR THE YEARS OF 1960 UNTIL 2015, <https://data.worldbank.org/indicator/DT.ODA.ODAT.CD?locations=AF>.

<sup>435</sup> *Id.*

<sup>436</sup> See ALES BULIR & A. JAVIR HAMANN, INTERNATIONAL MONETARY FUND, VOLATILITY OF DEVELOPMENT AID: AN UPDATE 727, 728 (IMF Staff Papers 54, 2007).

<sup>437</sup> Calculated by the author based on THE WORLD BANK, WORLD BANK DEVELOPMENT INDICATORS, PERSONAL REMITTANCES RECEIVED IN CURRENT US\$, AFGHANISTAN'S PERSONAL REMITTANCES RECEIVED IN CURRENT US\$ FOR THE YEARS OF 2008 UNTIL 2016, <https://data.worldbank.org/indicator/BX.TRF.PWKR.CD.DT?end=2016&locations=AF&start=2008>.

<sup>438</sup> ROBERT HOLZMANN, WORLD BANK, MANAGED LABOR MIGRATION IN AFGHANISTAN: EXPLORING EMPLOYMENT AND GROWTH OPPORTUNITIES FOR AFGHANISTAN 12 (2018), <http://documents.worldbank.org/curated/en/746891516915310370/pdf/122987-WP-P158055-PUBLIC-SummaryReportFINALonline.pdf>.

<sup>439</sup> *Id.*

Afghanistan's economy.<sup>440</sup> United Nations International Funds for Agricultural Development estimated total value of remittance received in Afghanistan in the year 2006 to be 3.4 billion US\$.<sup>441</sup> Unlike development assistance and foreign aid, the contribution of Afghans living abroad is on the rise as outward immigration increases.

After personal remittances, Foreign Direct Investment is the third source of financing for Afghanistan's massive trade deficit. According to World Bank data, the total Foreign Direct Investment inflow between 2001-2015 was 1.64bnUSD.<sup>442</sup> Foreign Direct Investment inflow spiked in 2005 and 2009 but declined from 2009 until 2014 when it started to recover.<sup>443</sup> Foreign Direct Investment inflow in 2015 almost returned to the level it was at in 2009.<sup>444</sup> Foreign Direct Investment outflow from Afghanistan has been very scattered. Total Foreign Direct Investment outflow between 2003-2016 amounted to 0.36 billion US\$.<sup>445</sup> The total of net portfolio investment for the period between 2008-2015 for which data is available is 0.40 billion US\$ and has shown a steady increase.<sup>446</sup>

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<sup>440</sup> *Id.*

<sup>441</sup> INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT, SENDING MONEY HOME: WORLDWIDE REMITTANCE FLOWS TO DEVELOPING COUNTRIES 10 (2007), <https://publications.iadb.org/handle/11319/1072>.

<sup>442</sup> Calculated by the author based on THE WORLD BANK, WORLD BANK DEVELOPMENT INDICATORS, FOREIGN DIRECT INVESTMENT NET INFLOWS IN CURRENT US\$, AFGHANISTAN'S DIRECT INVESTMENT NET INFLOWS IN CURRENT US\$ FOR THE YEARS OF 2001 UNTIL 2015, <https://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?end=2016&locations=AF&start=2001>.

<sup>443</sup> *Id.*

<sup>444</sup> *Id.*

<sup>445</sup> See THE WORLD BANK, WORLD BANK DEVELOPMENT INDICATORS, FOREIGN DIRECT INVESTMENT NET OUTFLOWS IN CURRENT US\$, AFGHANISTAN'S DIRECT INVESTMENT NET OUTFLOWS IN CURRENT US\$ FOR THE YEARS OF 2001 UNTIL 2016, <https://data.worldbank.org/indicator/BM.KLT.DINV.CD.WD?end=2016&locations=AF&start=2003>.

<sup>446</sup> See THE WORLD BANK, WORLD BANK DEVELOPMENT INDICATORS, NET PORTFOLIO INVESTMENT IN CURRENT US\$, AFGHANISTAN'S NET PORTFOLIO INVESTMENT IN CURRENT US\$ FOR THE YEARS OF 2008 UNTIL 2016, <https://data.worldbank.org/indicator/BN.KLT.PTXL.CD?end=2016&locations=AF&start=2008>.

## **2.6.2. Formal Property Rights in Afghanistan**

The current property right system in Afghanistan poses fundamental problems for credit transacting in Afghanistan. The formal property rights system cannot be used to securitize credit transaction, and it does not incentivize private investment. Afghans have devised informal arrangements to securitize credit transactions (such as *Gerawee* and *Sar qufli*) which do not rely on formal private property right system.

Property rights in Afghanistan are insecure because of a host of legal and extralegal challenges that have their roots in the country's tumultuous history and corruption. The combination of legal and extralegal challenges has made transacting in properties in Afghanistan very costly.<sup>447</sup> Legal ownership of private property in Afghanistan is uncertain, which makes it difficult to collateralize loans. Due to the limited legal protections, rampant insecurity, and corruption, protection of private property is weak and uncertain which makes private return on productive activities uncertain and limited. This has reduced incentive for productive activities.<sup>448</sup>

### **2.6.2.1. Legal Problems of Formal Property Rights in Afghanistan**

Formal protection of property rights in Afghanistan is limited. The legal problems are most acute in the case of immovable property, while the extralegal challenges affect movable property as well. The formal private property system in Afghanistan suffers from both measurement and enforcement problems. Because of problems that have their roots in history, Afghanistan does not have a working titling system which makes transacting in immovable property very costly.<sup>449</sup>

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<sup>447</sup> This includes transfer of property as well as use of personal property as collateral.

<sup>448</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>449</sup> See generally CONOR FOLEY, NORWEGIAN REFUGEE COUNCIL, A GUIDE TO PROPERTY LAW IN AFGHANISTAN 32 (2d ed., 2011), <https://www.nrc.no/globalassets/pdf/reports/a-guide-to-property-law-in-afghanistan.pdf>; LIZ ALDEN

It is very costly to ascertain who owns immovable property and what are its economically important descriptions.<sup>450</sup> Afghanistan has not developed a unified system of measurement for land due to the fact that the land registry efforts in Afghanistan's history were met with failure.<sup>451</sup> The documents to prove and measure land that do exist are scattered and use local and heterogonous measurements that are not standardized or easily convertible.<sup>452</sup> As a result, the information cost of property transactions is very high.

In addition to the high information cost, legal protection of immovable property is very uncertain for four interconnected reasons: legal ownership and rules of determining ownership are unclear; majority of properties are owned and transferred informally; actual possession is not a strong evidence of ownership; and property rights of inheritors go unassigned for generations. Each of these factors is explained in greater detail in the following sections.

#### **2.6.2.1.1. Legal Ownership and Rules of Determining Legal Ownership in Afghanistan Are Unclear**

Several attempts at redistribution of land by different regimes in Afghanistan history, coupled with unclear rules of determining legal ownership, have created real uncertainty as to who can legally claim ownership of property in Afghanistan. Several past regimes have attempted land reforms distributing and redistributing private and public lands, however the subsequent regimes have

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WILEY, AFGHAN RESEARCH AND EVALUATION UNIT, LAND RIGHTS IN CRISIS: RESTORING LAND TENURE TO AFGHANISTAN 1 (2003), <https://reliefweb.int/report/afghanistan/land-rights-crisis-restoring-tenure-security-afghanistan>; LIZ ALDEN WILEY, AFGHAN RESEARCH AND EVALUATION UNIT PUTTING RURAL LAND REGISTRATION IN PERSPECTIVE: THE AFGHANISTAN CASE 1 (2004), <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.521.8602&rep=rep1&type=pdf>; TRES THOMPSON ET AL., STANFORD LAW SCHOOL, AFGHANISTAN LEGAL EDUCATION PROJECT, AN INTRODUCTION TO THE PROPERTY LAW OF AFGHANISTAN 46 (2015), <https://www-cdn.law.stanford.edu/wp-content/uploads/2016/05/ALEP-Property-Law-1st-Ed-English.pdf>.

<sup>450</sup> See FOLEY, *supra* note 449, at 32; THOMPSON ET AL., *supra* note 449, at 44; WILEY (2003), *supra* note 449, at 9.

<sup>451</sup> See FOLEY, *supra* note 449, at 34; WILEY (2003), *supra* note 449, at 3.

<sup>452</sup> *Id.*

explicitly or implicitly refused to recognize the legality of the ownership rights that those land reforms sought to create.<sup>453</sup> This, in effect, has caused a legal limbo, which has created legal uncertainty as to who legally owns property in the country. Despite several attempts since 2001, the Afghan governments has failed to create clear rules to facilitate the process of determining legal ownership, reducing uncertainty, and moving toward creating a uniform/unified system of titling.<sup>454</sup> As a result, protection of property rights is insecure not only because information of legal ownership is inaccessible but also because the rules of determining legal ownership are uncertain.

It is very difficult to prove land ownership in Afghanistan because, over the past 30 years, a piece of land could have been compulsory purchased; expropriated or re-designated as public land; transferred to another individual by a decree or a statute; privately transferred between private individuals formally or informally; abandoned by its owner; illegally occupied; inherited; or voluntarily or coercively sold, exchanged, or gifted to others.<sup>455</sup> As a result, protection of property rights is insecure not only because information about legal ownership is inaccessible, but also because the rules of determining legal ownership are uncertain.

Afghans have been paying taxes on their properties since the 1880s.<sup>456</sup> The records of these tax payments are still preserved in Afghanistan's Ministry of Finance.<sup>457</sup> The Books of Ownership, and records of tax payment are still continued to be used to prove ownership in courts today.<sup>458</sup> Throughout the 19<sup>th</sup> and 20<sup>th</sup> centuries, before the communist regime took over in Afghanistan, the rulers had often granted ownership of public (and often private) lands to different individuals and

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<sup>453</sup> See FOLEY, *supra* note 449, at 28; THOMPSON ET AL., *supra* note 449, at 89; WILEY (2003), *supra* note 449, at 16.

<sup>454</sup> See FOLEY, *supra* note 449, at 44; WILEY (2003), *supra* note 449, at 39.

<sup>455</sup> FOLEY, *supra* note 449, at 34.

<sup>456</sup> WILEY (2004), *supra* note 449, at 10.

<sup>457</sup> *Id.*

<sup>458</sup> FOLEY, *supra* note 449, at 34.

groups of people through presidential and royal decrees.<sup>459</sup> These special decrees were intended to buy political support, engineer ethnic composition of different regions of the country, or compensate loyalty. The records of these degrees are also still used as proof of ownership in courts today.<sup>460</sup>

Afghanistan first attempted to survey and register land ownership in 1960s.<sup>461</sup> Land Survey and Statistics Law of 1965 created a department of Cadastral Survey to conduct a nationwide land survey.<sup>462</sup> The survey also recorded the coordinates of the land, its owner, and its legal status.<sup>463</sup> The survey was aimed to improve tax collection, create a unified legal system for land ownership, which until then had been held under a mixture of customary, religious, and legal rules.<sup>464</sup> It was also hoped by achieving more legal certainty of the legal ownership, it would make it easier for landowners to use their land as collateral to receive loans.<sup>465</sup>

The policy proved extremely costly and difficult to implement and only produced partial results. To reduce costs, survey of land by cadastral personnel was replaced with self-reporting and confirmation of local government officials.<sup>466</sup> As a result, under 1960s Land Survey and Ownership Registration Policy a set of Books of Ownership were produced, and one-third of the country's total land and one-fifth of the country's arable land was surveyed and registered.<sup>467</sup>

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<sup>459</sup> *Id.* at 30.

<sup>460</sup> *Id.* at 35.

<sup>461</sup> See FOLEY, *supra* note 449, at 35; WILEY (2003), *supra* note 449, at 43.

<sup>462</sup> QANUN SURVEY VA EHSAYA ARAZI [LAND SURVEY AND STATISTICS LAW] 1344 [1965] ARTS.13 – 17.

<sup>463</sup> WILEY (2003), *supra* note 449, at 41.

<sup>464</sup> See FOLEY, *supra* note 449, at 32.

<sup>465</sup> See LIZ ALDEN WILY, AFGHANISTAN RESEARCH & EVALUATION UNIT, LOOKING FOR PEACE ON THE PASTURES: RURAL LAND RELATIONS IN AFGHANISTAN 80 (2004), <https://areu.org.af/wp-content/uploads/2015/12/437E-Looking-for-Peace-on-the-Pastures-Rural-Land-Relations-in-Afghanistan-SP-web.pdf>.

<sup>466</sup> See WILEY (2003), *supra* note 449, at 42.

<sup>467</sup> *Id.*, at 35.

However, some contemporary experts questioned the accuracy of the data collected especially concerning legal ownership of the land.<sup>468</sup>

In the 1970s and 1980s two different land redistribution policy were introduced in Afghanistan—the first by President Daud and the second by the Communist Regime. Under the Daud’s land redistribution policy, enacted in the Law Concerning Land Survey and Registration of Settlement (the Decree), a ceiling of 20 Hectare was instituted and the excess land was required to be distributed to landless farmers who would only obtain full ownership after compensating the former landowner, in installments, based on a fair price set by the government.<sup>469</sup> The Decree also sought to prevent private sales of redistributed lands without official permission and attempted (again) to determine the precise boundaries of all public and private land in Afghanistan.<sup>470</sup> In actuality, the process of implementation of the Decree was slow and only some properties were actually redistributed under Daud’s land reform.<sup>471</sup>

In the 1980s, a communist regime took power in Afghanistan through a military coup. The communist government suspended Daud’s land reform policy and instituted a more radical land redistribution policy setting a land ownership ceiling of six hectares, under The Land Reform Decree of 1980 (the 1980 Decree).<sup>472</sup> The regime also attempted to conduct a complete survey of lands in the country.<sup>473</sup> The government attempted to expropriate and redistribute the excess private lands without compensation.<sup>474</sup> Under the 1980 Decree, failure to register land, under

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<sup>468</sup> See FOLEY, *supra* note 449, at 33.

<sup>469</sup> QANUN SURVEY ARAZI VA SABT SURVEY SAKENIN [THE LAW CONCERNING LAND SURVEY AND REGISTRATION OF SETTLEMENT SURVEY] 1355 [1976].

<sup>470</sup> *Id.*

<sup>471</sup> See FOLEY, *supra* note 449, at 32.

<sup>472</sup> Farman Eslah Arazi [LAND REFORM DECREE] (NO. 8, 1359 [1980]) ART. 31.

<sup>473</sup> *Id.*

<sup>474</sup> See FOLEY, *supra* note 449, at 32.

communist government decree, was to result in confiscation, and attempt to destroy land or property was to be met with severe punishment.<sup>475</sup>

The communist land policy provoked considerable backlash and was a main cause of the subsequent popular revolt. In actuality, due partly to these revolts, the redistribution and survey of land was only implemented in a limited part of the country.<sup>476</sup> In 1987, when the popular Islamic resistance against the communist regime had grown powerful, President Najib, in an attempt to appease the opposition against the communist government, formally suspended the land redistribution policy.<sup>477</sup> A presidential decree promised that expropriated land would be restored to original owners, and in cases where restitution was not possible, former owners would be compensated.<sup>478</sup> This presidential decree was never in effect implemented.<sup>479</sup>

In 1992, the Mujahedeen government seized Kabul and a new constitution was drafted but never enacted which restored the protection of private property was restored under Islamic law.<sup>480</sup> However, the Mujahedeen government failed to overcome its internal divisions and a civil war ensued. The country descended into lawlessness. During this period, and the period of conflict before it, reportedly, people were forced out of their lands, or were forced to hand over their documents of ownership to powerful local commanders or warlords.<sup>481</sup>

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<sup>475</sup> LAND REFORM DECREE, *supra* note 472, art. 31.

<sup>476</sup> See FOLEY, *supra* note 449, at 33.

<sup>477</sup> See QANUN ASSASI AFGHANISTAN [AFGHANISTAN CONSTITUTION] 1366 [1987], arts. 29 & 30.

<sup>478</sup> See, e.g., FARMAN RAYEES JUMHUR AFGHANISTAN DAR BARA ISTERDAD AMVAL THAT MALIKIAT DUWLAT [THE DECREE OF THE PRESIDENT OF REPUBLIC OF AFGHANISTAN WITH REGARD TO RETURN OF THE PROPERTIES UNDER THE CONTROL OF THE GOVERNMENT TO THEIR OWNERS] (Law No. 715, 1369 [1991]).

<sup>479</sup> See FOLEY, *supra* note 449, at 34.

<sup>480</sup> See Shamshad Pasarlay, *Islam and the Sharia in the 1993 Mujahideen — Draft Constitution of the Islamic State of Afghanistan: A Comparative Perspective*, 3 *INDON. J. INT'L & COMP. L.* 183, 202 (2016).

<sup>481</sup> See FOLEY, *supra* note 449, at 31.

It was partly in response to this state of lawlessness that the Taliban emerged and finally took power in Afghanistan. The Taliban suspended the formal laws and created “Islamic Courts” which were supposed to apply Shari’ah or Islamic Law. The Taliban, reportedly, motivated by ethnic reasons, committed mass land seizures in some parts of the country.<sup>482</sup> However, they also issued a number of decrees that were aimed to restore land ownership to their pre-communist-revolutionary holder.<sup>483</sup> Similar restoration policies have also been followed by the post-2001 Karzai and Ghani governments.

In 2008, Karzai’s government enacted a new legislation, the Law of Managing Ownership Affairs.<sup>484</sup> This new legislation created a provincial-level commission headed by the governor to re-attempt to survey land, identify its legal owner, and refer disputes to the court.<sup>485</sup> This legislation, and the commission created under it, have had very limited achievements.<sup>486</sup> The current Ghani government has generally followed the same policy of creating especial tribunals and commissions to untangle the complex mess of land ownership in Afghanistan. However, as recently as February 14, 2018, the Afghanistan government has inaugurated a new land survey program: Development of Land Ownership System of Afghanistan (“Land Ownership System”). According to the President Ghani’s statement delivered in its inauguration ceremony, under the Land Ownership System, a complete land survey is going to be conducted in Afghanistan.<sup>487</sup>

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<sup>482</sup> *Id.*

<sup>483</sup> See QANUN ZAMIN [LAW ON LAND] (No. 783, 1376 [1997]); QANUN TANZIM UMUR ZAMINDARI EMIRAT ISLAMI AFGHANISTAN [ISLAMIC EMIRATE OF AFGHANISTAN’S LAND MANAGEMENT LAW] (No. 795, 1381 [2001]); QANUN ESTIMLAK ZAMIN [LAW OF LAND EXPROPRIATION] (No. 794, 1380 [2000]).

<sup>484</sup> See QANUN TANZIM UMUR MALIKIAT [LAW OF MANAGING OWNERSHIP AFFAIRS] 1387 [2008].

<sup>485</sup> *Id.*

<sup>486</sup> See FOLEY, *supra* note 449, at 31; and Section 2.6.2.1.3.

<sup>487</sup> See BBC Afghanistan Division, *Land Management Development Program Has Begun in Afghanistan*, BBC PERSIAN (Feb. 15, 2018), <http://www.bbc.com/persian/afghanistan-43073751>.

According to President Ghani, the program is going to retrieve usurped land in Afghanistan and pave the way for legal distribution of public land to farmers and Afghan repatriates.<sup>488</sup> The Land Ownership System is based on Turkey's land reform program.<sup>489</sup> Given the political and economic power of current land usurpers in Afghanistan, and the legal difficulty of determining land ownership in the country, the success of the Land Ownership System is suspect, and remains to be seen.

Although the majority of the historical land reforms have focused on rural lands where large landowners reside, they have serious consequences for urban real estate property as well. Since 2001, Afghanistan has gone through a period of rapid population growth and urbanization, which has significantly expanded the boundaries of cities.<sup>490</sup> Consequently, the legal uncertainty created by land reform policies has not been contained to rural areas. As a result of the unclear status of different historical land reforms and the enormous political consequences of formal property rights reform, the rules of determining legal ownership in Afghanistan have largely remained obscure. This lack of clarity renders the creation of an integrated formal property system that would position a property owner and its property into a transparent formal grid impossible. The absence of such a formal property system means Afghans cannot rely on formal property rights to securitize credit transactions, and Huquq Departments cannot identify parties' assets easily to enforce judgments.

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<sup>488</sup> *Id.*

<sup>489</sup> *Id.*

<sup>490</sup> *See* AFGHANISTAN DEMOGRAPHIC ESTIMATES FOR THE YEARS OF 2002/03 UNTIL 2017/18, *supra* note 19.

### **2.6.2.1.2. The Majority of Property Ownership Transfers in Afghanistan are Conducted Informally**

An overwhelming majority of the transfer of property ownership in Afghanistan is conducted informally, and arguably illegally.<sup>491</sup> Currently, 90% of land ownership in rural areas and 70% of land ownership in urban areas of Afghanistan is held informally.<sup>492</sup> The formal requirements for legal transfer of ownerships are burdensome and costly; therefore, most Afghans opt to transfer ownership informally.<sup>493</sup> Informal transfer of property is less expensive because the parties do not have to pay taxes or spend time and resources to go to different government offices.<sup>494</sup> Informal transfer of property is less burdensome because it relies on verbal confirmation of neighbors to verify ownership.<sup>495</sup>

A main reason for this formal burdensome process of transfer of ownership is the first-order problem of determining whether the person who wants to transfer the ownership is actually the legal owner. This first order problem stems from the uncertainty of ownership and rules of determining ownership in Afghanistan as well as lack of a complete land survey and registry in Afghanistan. As a result, most transfers of ownership occur without complying with mandatory legal rules of transfer of immovable property. In effect, the uncertainty of ownership and the rules of determining legal ownership have caused a decoupling between mandatory legal rules of transfer of ownership and the *de facto* practice of transfer of ownership forcing courts to recognize

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<sup>491</sup> In 2005, in Kabul, for example, 60% of the land transfers were not legally registered. See DAVID STANFIELD, JONATHAN REED, AND M. YASIN SAFAR, EMERGING MARKETS GROUP, DESCRIPTION OF PROCEDURES FOR PRODUCING LEGAL DEEDS TO RECORD PROPERTY TRANSACTIONS IN AFGHANISTAN 12 (2005), <http://www.terrainstitute.org/pdf/Description%20of%20Procedures.pdf>.

<sup>492</sup> LIZ ALDEN WILY, AFGHANISTAN RESEARCH AND EVALUATION UNIT, LAND, PEOPLE AND THE STATE OF AFGHANISTAN: 2002-2012 22 (2013), <http://www.areu.org.af/Uploads/EditionPdfs/>.

<sup>493</sup> See THOMPSON ET AL., *supra* note 449, at 60;

<sup>494</sup> *Id.* at 61.

<sup>495</sup> *Id.*

the informal transfers of ownership when deciding ownership disputes.<sup>496</sup> This has perpetuated and complicated the creation of uniform legal rules of determining ownership and a common system of property registration. This is a vicious cycle. The complexity of determining legal ownership compels Afghans to transact and transfer property outside the legal framework making it even more difficult to determine legal ownership.

Formal transfer of property in Afghanistan involves up to ten steps, depending on how one defines each step, and it can take months—even if the transferor holds a formal deed and the transferor’s ownership rights are not contested.<sup>497</sup> The steps involve verification of ownership by courts, land authorities, and land archive, which requires a site visit, an archive search, and testimony. If verification is successful and a formal deed is located and verified, the next step is appraisal, which involves multiple assessments from different realtors verified by the local municipality, and site visits by officials. After the appraisal is completed, the third step is paying the transfer tax which is 3% for the properties whose value exceed 2 million AFN (approx. 30,000 US\$) and 2% if the value of property is lower than 2 million AFN. The fourth step is the issuance of the deed, which requires bringing several contract witnesses to the court and paying for the deed form (which costs about 3 US\$). This is the process if the person who is transferring the land holds a formal deed. Currently only 10% of rural property and 30% of urban property owners have official deeds given by the court or government,<sup>498</sup> however, most of these deeds are old and do not reflect the current owners of the land.

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<sup>496</sup> *Id.*, at 59.

<sup>497</sup> The description of process of formal property transfer reported in this paragraph is based on Written Communication Between the author and Head of District Court for the District of Enjil, Herat via Facebook Messenger (Nov. 10, 2017); *see also* THOMPSON ET AL., *supra* note 449, at 54-64.

<sup>498</sup> WILY (2013), *supra* note 492, at 22.

If a person does not hold a formal deed, the process is even more complicated and involves using several property and legal documents to prove chain of transmission of ownership from the person who registered the formal deed to the person seeking transfer of ownership.<sup>499</sup> If the land is subject to dispute, which is often the case because of Afghanistan's turbulent history, there needs to be a trial where courts are tasked to determine, from a multitude of often conflicting legal and property documents who the legitimate owner is.<sup>500</sup> After determining the legal owner, courts have to address the longitudinal question of chain of title transmission by relying most often on customary documents of transfer or testimony—a practice which is against the *de jure* rules of transfer of immovable properties set in Afghanistan's Civil Code.<sup>501</sup> Courts have to rely on customary documents because an overwhelming majority of ownership transfer occurs informally.<sup>502</sup> Formal legal rules do not recognize the use of customary documents for transfer of

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<sup>499</sup> See THOMPSON ET AL., *supra* note 449, at 44;

<sup>500</sup> See FOLEY, *supra* note 449, at 35.

<sup>501</sup> LAND MANAGEMENT LAW, *supra* note 484, the followings are considered property and legal documents for the purpose of proving ownership: (1) Documents of the legal court are based on purchase, ownership, donation, patrimony, distribution of patrimony, land exchange, waiver, settlement, document of irrevocable decision which is issued based on the previous documents of property which include the following terms: (a) Should be registered within the judicial bureau. (b) Its dissolvent should not exist. (c) The land registered in the legal document, if taxable, should be registered in Tax Office. (2) Decree of The State/ Government (prime minister) and the document of land purchasing from the state ownership should include the following terms: (a) Should be issued by an authorized office. (b) Its dissolvent should not exist. (c) If taxable, should be registered in Tax Office. (3) Documents of tax payment which should include the following terms: (a) Its dissolvent should not exist. (b) Should be registered in the property/ land registry original books and (c) should have tax bill dated before 15/Assad/ 1354 (Solar Year). [1975]; (4) [...]. (5) Customary documents are legal based on the following terms: (a) Vendor of the land should have a legal document. (b) The conventional document should have been arranged before 15/ Assad/1354 (Solar Year) and the vendee of the land should have filled out the land-title form before 1357 (Solar Year) and after the confirmation of neighbors of the plot, handed into the relevant office. In areas where the land-title forms were distributed or not but the land registry office was removed somehow and there is no claim for the land and the purchase of the land and the possession taking of the vendee by the neighbors and should be approved. (6) The legal documents of the land which should include the following terms: (a) The legal document should exist. (b) The document should be issued after legal clearance of the land. (c) Should be registered in the property/ land registry original book and Tax Office. (d) There should be no claim for the land. (7) Document of the land ownership (land-title) which include the following terms: (a) The document should be arranged and issued via relevant court after legal clearance of the land. (b) Should be registered in the property/ land registry original book and Tax Office.

<sup>502</sup> See DAVID STANFIELD ET AL., *supra* note 491, at 25.

property.<sup>503</sup> This has created a decoupling between formal legal rules and the practice of court necessitated by the reality of life in Afghanistan. The formalization of customary practice is difficult because it may validate coercive and improper transfers. As a result, formal legal ownership has continued to remain in a legal limbo.

#### **2.6.2.1.3. Actual Possession Is Not a Useful Presumption of Ownership**

Afghanistan's prolonged period of conflict has caused significant internal displacement, and outward immigrations, creating a situation where the actual possession of property is not a strong indicator of legal ownership. As such, the conflict not only increases the number of ownership disputes, but also makes it harder to determine legal ownership.

As of December 31, 2016, 1.5 million people are internally displaced in Afghanistan.<sup>504</sup> Reportedly, 4.5 million Afghans are documented and undocumented refugees living predominately in Pakistan and Iran.<sup>505</sup> This means almost 6 million Afghans are living away from their immovable properties without begin able to return to or control their properties. According to the Norwegian Refugee Council, usurpation of personal property is a cause of immigration and a barrier to return for a large percentage of Afghan refugees.<sup>506</sup>

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<sup>503</sup> See QANUNI MADANI [CIVIL CODE] 1355 [1977] art. 1222, which states, (Ownership of real estate and other real rights, on which the conditions stated by law on registration of documents are not observed, shall not transfer.)

<sup>504</sup> INTERNAL DISPLACEMENT MONITORING CENTER, AFGHANISTAN'S COUNTRY INFORMATION (UPDATED MID-YEAR 2017) <http://www.internal-displacement.org/countries/afghanistan>

<sup>505</sup> See UNHCR, IRAN FACT SHEET (Feb. 2016), [www.unhcr.org/en-us/protection/operations/50002081d/iran-fact-sheet.html](http://www.unhcr.org/en-us/protection/operations/50002081d/iran-fact-sheet.html); UNHCR, PAKISTAN FACTSHEET (Dec. 2015), <http://www.unhcr.org/en-us/protection/operations/5000210e9/pakistan-fact-sheet.html>.

<sup>506</sup> See FOLEY, *supra* note 449, at 8.

#### **2.6.2.1.4. Inheritance Goes Undivided for Generations**

The common practice of not dividing inheritance for generations has created further legal uncertainty of individual ownership of property. Although traditional Islamic law requires the estate to be divided into fixed shares,<sup>507</sup> Afghan families most often do not divide inheritance to avoid upsetting family harmony, and/or to prevent the division of agriculture land, and/or to preserve the durability of a family business.<sup>508</sup>

The formal process of dividing up inheritance is also burdensome and complicated. Furthermore, some families evade the formal inheritance procedures as a way to avoid giving the female heirs their share of inheritance as required by state law and Islamic law.<sup>509</sup> As a result, inheritance disputes are the second most common property disputes, after usurpation of personal property, before Afghan courts.<sup>510</sup> This is discussed further in Chapter Three in the context of family-owned businesses in Afghanistan.

#### **2.6.2.2. Extralegal Challenges of Property Rights in Afghanistan**

Aside from the legal problems, Afghans fear a multitude of other extralegal threats to their properties stemming from poor security conditions and corruption. These can include expropriation of their land by powerful individuals inside and outside the government, among other threats. Although Afghan laws set forth fair procedures for the taking of the privately owned

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<sup>507</sup> For a comparative study of Islamic law of inheritance *See* HAMID KHAN, *THE ISLAMIC LAW OF INHERITANCE* (2008).

<sup>508</sup> *See* 3.1.8.

<sup>509</sup> *See, e.g.*, NOUCHINE YAVARI D'HELLENCOURT ET AL., *MINISTRY OF URBAN DEVELOPMENT & HOUSING AND UN-HABITAT, PRELIMINARY STUDY OF LAND TENURE RELATED ISSUES IN URBAN AFGHANISTAN WITH SPECIAL REFERENCE TO KABUL CITY* (2002).

<sup>510</sup> Calculated by the author based on *QUARTERLY JUDICIAL ACTIVITIES REPORTS FOR THE YEARS OF 2012 UNTIL 2017*, *supra* note 21.

by the government,<sup>511</sup> powerful individuals inside and outside the government often have used their power to usurp personal and public property. The usurpation of property in Afghanistan was rampant throughout Afghanistan prolonged period of conflict, however rather than decreasing since 2001, it has even accelerated.

According to the statistics of the Afghanistan Independent Land Authority in 2017, 3,200 square kilometers of public land has been usurped by ordinary and powerful individuals inside and outside the government in Afghanistan (this is roughly equivalent to three-fourths of the total area of Kabul province).<sup>512</sup> According to an Afghanistan Freedom House's report released in 2016,<sup>513</sup> an estimated 1800 square kilometers of private property has been usurped in Afghanistan (this is roughly equivalent to half of total area of Kabul province).<sup>514</sup>

Afghans face arbitrary taxes and expropriation by different insurgent groups who according to Special Inspector's report control 30% of the country.<sup>515</sup> There have been multiple reports of

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<sup>511</sup> QANUN ASSASI AFGHANISTAN [AFGHANISTAN CONSTITUTION] 1382 [2014], art. 14, (No one's property shall be confiscated without the order of the law and decision of an authoritative court. Acquisition of private property shall be legally permitted only for the sake of public interests, and in exchange for prior and just compensation.)

<sup>512</sup> See Samira Zafari, *One Million and Six Hundred Thousand Jarib of Public Land Has been Usurped in Afghanistan*, ARIANANEWS.AF (Dec. 21, 2017), <https://ariananews.af/%DB%8C%DA%A9-%D9%85%DB%8C%D9%84%DB%8C%D9%88%D9%86-%D9%88-%D8%B4%D8%B4-%D8%B5%D8%AF-%D9%87%D8%B2%D8%A7%D8%B1-%D8%AC%D8%B1%DB%8C%D8%A8-%D8%B2%D9%85%DB%8C%D9%86-%D8%AF%D9%88%D9%84%D8%AA%DB%8C-%D8%AF/?lang=fa>.

<sup>513</sup> See BBC Afghanistan Division, *Freedom House: More than One Million and Two Hundred Thousands Jaribs Are Grabbed in Afghanistan*, BBC PERSIAN (Feb. 21, 2016), [http://www.bbc.com/persian/afghanistan/2016/02/160221\\_k05\\_landgrab\\_house\\_of\\_freedom\\_report](http://www.bbc.com/persian/afghanistan/2016/02/160221_k05_landgrab_house_of_freedom_report)

<sup>514</sup> Afghanistan Freedom House reports lower figure of the area of public land usurped in Afghanistan, 2400km<sup>2</sup>, See BBC Afghanistan Division, *supra* note 513.

<sup>515</sup> See *Taliban Collect Taxes in Farah*, 8AM.AF (Sept. 13, 2017), <http://8am.af/1396/10/10/ghazni-has-become-the-talibans-tax-area/>; <http://8am.af/1396/07/22/the-taliban-collect-taxes-in-farah/>; *New Findings Reveal Taliban Collect Tax in Ghazni*, TOLO NEWS (Jan. 10, 2018), <https://www.tolonews.com/afghanistan/new-findings-reveal-taliban-collecting-tax-ghazni>; Ahmad Hanayesh, Yaqubi: *Taliban Collect Taxes from People in The Districts of Kapisa Where They Have Control*, RADIO AZADI, <https://da.azadiradio.com/a/28560065.html>; *Nimrooz Authorities: Taliban Collect Taxes from Merchants on Khashrood—Delaram High Way*, RADIO AZADI (Jan. 1, 2018), <https://da.azadiradio.com/a/28958957.html>.

the Taliban collecting taxes from businesses, business cargos, and agricultural products.<sup>516</sup> Merchants in major urban centers are not often targeted by these extralegal taxes, however, their shipments are often taxed by the Taliban.<sup>517</sup>

The Afghan government's weak control of transit routes inside Afghanistan means Afghan merchants' cargo is often taxed by the Taliban or corrupt highway officials.<sup>518</sup> The insecure domestic trade routes, coupled with poor road infrastructure, create a fragmented domestic market.<sup>519</sup> As a result, businesses in Afghanistan tend to be regional or province-specific; fragmentation of Afghanistan markets has increased costs for national businesses. The fragmentation of the domestic market hinders specialization because high transportation costs disincentivize regional specialization. Relatedly, a low level of domestic market integration privileges cross-border trade at the expense of in-country trade further driving the import-dependency of Afghanistan's economy.

Afghans also face high rates of property theft, ransom, and protection money. Powerful individuals inside the government also extract rents from businesses. Afghans pay up to 3 billion US\$ in bribes each year.<sup>520</sup> Most wealthy Afghans devote resources to protect themselves and their families. It is not uncommon for wealthy Afghan merchants to move around major urban centers in effectively armored motorcades. Wealthy Afghans hire multiple bodyguards, pay protection

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<sup>516</sup> *Id.*

<sup>517</sup> *Id.*

<sup>518</sup> *Id.*

<sup>519</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013. In addition, it is supported by the prevalence of cross-border trade discussed earlier in this Chapter.

<sup>520</sup> See INTEGRITY WATCH AFGHANISTAN, *supra* note 308.

fees, and remove their families from Afghanistan.<sup>521</sup> *Sarrafs*' unions have also recently organized a countrywide strike in response to a string of armed robbery targeting *Sarrafs* in different provinces.<sup>522</sup>

### 2.6.3. Formal Commercial Dispute Resolution in Afghanistan

Dispute resolution mechanisms are the main determinant of enforcement costs. Which mechanism dominates is thus a factor that has a direct effect on the type and volume of credit transactions that take place in a country. In Afghanistan, formal dispute resolution mechanisms are expensive, uncertain, and ineffective.<sup>523</sup> Thus, they cause fundamental problems for credit transacting in Afghanistan. Most merchants choose to resolve their disputes outside of the formal dispute resolution institutions. This has a dynamic effect on depersonalization and economic growth in Afghanistan. Informal dispute resolution institutions are discussed in Chapter Three. Section 2.6.3 describes the formal dispute resolution in Afghanistan and shows why and when merchants most often opt to use them.

This section also describes the rules of jurisdiction in Afghanistan to explain why *Sar qfli* falls under the jurisdiction of commercial courts while *Gerawee* does not. Given the marked difference in attitudes, laws, and actors involved in commercial and non-commercial formal dispute resolution, the jurisdictional rules are very significant for development of business-friendly judicial jurisprudence and hence the synergies between formal and informal institutions.

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<sup>521</sup> For example, while in Afghanistan for this research, I witnessed a TV interview on TOLONews with a Kabuli *Sarrafs* whose nephew was kidnapped for ransom (kidnappers asked for 4 million US\$) where he said that he had to hire 20 bodyguards to protect himself and his family.

<sup>522</sup> See Khairullah Rasooli, Saraffan dar Sarasar Afghanistan emrooz a'etesab kari kardan [Sarrafs in Afghanistan Staged a Nationwide Strike Today], VOADARI (Dec. 29, 2017), <https://www.darivoa.com/a/Afghan-money-changer-union-made-a-strike-across-Afghanistan/4182373.html>.

<sup>523</sup> See, e.g., MINISTRY OF COMMERCE AND INDUSTRIES STRATEGIC PLAN 2016-2020 12 (2016), *supra* note 9.

### 2.6.3.1. How a Formal Commercial Dispute Begins

There is a primary commercial court in each province's capital city.<sup>524</sup> Primary commercial courts hear all disputes arising from a commercial transaction at the first level.<sup>525</sup> In provinces where a primary commercial court has not yet established, commercial disputes are tried in the civil division of primary court.<sup>526</sup> There are two ways that a commercial dispute can find its way to a court in Afghanistan:

**(1) Huquq Department.** The plaintiff can file a complaint with the Huquq Department which is a part of the Ministry of Justice.<sup>527</sup> There is a Huquq Department in each province's capital city as well as at each district. Commercial claims are filed with the Huquq Department at each province's capital city.<sup>528</sup> Upon receive of a complaint, specialists at the Huquq Department upon receive of a complaint will subpoena the defendant. Specialists first attempt to mediate between the parties to help them reach an amicable resolution of their disputes.<sup>529</sup> If the successful mediation is successful, they will record the agreement which will end the proceedings.<sup>530</sup> If the mediation proves to be unsuccessful, the specialists will attempt to identify the points of contention and record the parties' claims and possible evidence to be sent to a court so the court proceedings can be expedited.<sup>531</sup> The court has the discretion to consider the records produced by Huquq Department or to ignore them completely.

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<sup>524</sup> QANUN TASHKIL VA SALAHAT QUVA QAZAIEE [LAWS ON ORGANIZATION AND JURISDICTION OF JUDICIARY] (NO. 851, 1384 [2005]) art. 61.

<sup>525</sup> *Id.*

<sup>526</sup> LAWS ON ORGANIZATION AND JURISDICTION OF JUDICIARY, *supra* note 524, art. 65.

<sup>527</sup> QANUN USUL MUHAKIMAT MADANI [LAW OF CIVIL PROCEDURE] (NO. 722, 1369 [1990]) art. 12(2).

<sup>528</sup> *See* QANUN TARZ TAHSIL HUQUQ [LAW OF ENFORCEMENT OF RIGHTS] (NO. 786, 1377 [1999]).

<sup>529</sup> *Id.*

<sup>530</sup> *Id.*

<sup>531</sup> *Id.*

**(2) Commercial Courts.** Nothing in the law requires a plaintiff to file his complaint at the Huquq Department prior to going to court. Therefore, a plaintiff can bypass the Huquq Department and file a complaint directly at a primary commercial court.<sup>532</sup> However, the court may decide to refer the case back to the Huquq Department or begin its own proceedings. After a final judgment is rendered in a commercial case (or any other non-criminal case), the judgment will be sent to the Huquq Department for enforcement.<sup>533</sup>

### **2.6.3.2. Jurisdiction of Commercial Courts**

There are marked differences in attitudes, laws, and actors involved in commercial and non-commercial formal dispute resolution. Therefore, the jurisdictional rules are very significant for development of business-friendly judicial jurisprudence and hence the synergies between formal and informal institutions.

When a case is sent to a primary commercial court by a Huquq Department, or a complaint is filed directly at a primary commercial, the primary commercial court must first determine if it has jurisdiction over the case. Concerning subject matter jurisdiction, according to Article 1 of Usul Muhakimat Tijrati [Principles of Commercial Procedure] (“Commercial Procedure”) enacted in 1965, any dispute arising from a commercial transaction falls under the jurisdiction of commercial courts.<sup>534</sup> Concerning personal jurisdiction, Commercial Procedure Articles 6-14 states that a primary commercial court has personal jurisdictions over a defendant if it the court sits in the domicile of the defendant,<sup>535</sup> or the principal of business of the defendant,<sup>536</sup> or a place

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<sup>532</sup> LAW OF CIVIL PROCEDURE, *supra* note 527, art. 12.

<sup>533</sup> *See* LAW OF ENFORCEMENT OF RIGHTS, *supra* note 528.

<sup>534</sup> USUL MUHAKIMAT TIJRATI [PRINCIPLES OF COMMERCIAL PROCEDURE] (No. 1-4, 1343 [1965]).

<sup>535</sup> *Id.* art. 6.

<sup>536</sup> *Id.* art. 12.

of business of the defendant that has nexus with the case,<sup>537</sup> or the place of formation or place of execution of the contract, provided that the defendant or its representative is present at that place at the time the complaint is filed with the court.<sup>538</sup>

Commercial transaction is defined in another piece of legislation, *Usulnameh on the Commercial Law of Afghanistan (Principles of Afghanistan Commercial Law)* (“Commercial Law”) enacted in 1955. Commercial Law is the core of Afghanistan’s current substantive commercial law.<sup>539</sup> Commercial Law’s first chapter enumerates different sources of binding rules applicable to commercial transactions, and their hierarchy,<sup>540</sup> defines which transactions qualify as commercial transactions,<sup>541</sup> defines who qualifies as a merchant,<sup>542</sup> and sets forth the fundamental rights and obligations of a merchant.<sup>543</sup>

Commercial Law Article 8 defines a merchant as anyone, whether an individual or a corporation, who possesses legal capacity and habitually engages in a one or more commercial transaction in his own name.<sup>544</sup> Commercial Law introduces three categories of commercial transactions: (1) primary commercial transactions; (2) inherent commercial transactions; and (3) auxiliary commercial transactions.

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<sup>537</sup> *Id.* art. 11.

<sup>538</sup> *Id.* art. 8.

<sup>539</sup> Commercial Law consists of five books: (1) General Regulation, (2) Partnership and Corporations, (3) Commercial Documents, (4) Commercial Agreements. Currently, only the first book of Commercial Law is in effect. Different legislations have mostly replaced the last three chapters. However, Commercial Law’s first chapter is still a critical piece of legislation in area of commercial law. *ASULNAMA TIJARAT [PRINCIPLES OF COMMERCIAL LAW]* 1336 [1958]

<sup>540</sup> *Id.* arts. 1-3.

<sup>541</sup> *Id.* arts. 14-23.

<sup>542</sup> *Id.* art. 8.

<sup>543</sup> *Id.* arts. 24-84.

<sup>544</sup> *Id.*

Primary commercial transactions are the main commercial transactions. If a person conducts these transactions habitually, under the law, that person is considered a merchant and that person's transactions will be presumptively regulated by commercial laws and any disputes arising from those transactions will fall under the jurisdiction of commercial courts.<sup>545</sup> However, if a person engages in primary commercial transactions incidentally and/or infrequently, that person is not considered a merchant under the law and that person's transactions are not regulated by commercial laws,<sup>546</sup> therefore, any dispute that may arise does not fall under the jurisdiction of commercial courts.

Inherent commercial transactions, on the other hand, are regulated by commercial laws and are subject to the jurisdiction of commercial courts regardless of the status of parties concerned.<sup>547</sup>

Auxiliary commercial transactions are those transactions that normally do not qualify as commercial transactions and do not confer the status of merchant on to the parties concerned even if conducted habitually. The latter transactions may nonetheless fall under the purview of commercial laws and jurisdiction of commercial courts if conducted by a person who, otherwise, is legally considered a merchant.<sup>548</sup> If a transaction is considered commercial only with regard to one party commercial laws still apply to the obligations arising from the transactions and any

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<sup>545</sup> *Id.* arts. 8 & 23; PRINCIPLES OF COMMERCIAL PROCEDURE, *supra* note 534, art. 1.

<sup>546</sup> PRINCIPLES OF COMMERCIAL LAW, *supra* note 539, art. 10.

<sup>547</sup> According to Commercial Law Article 19, inherent commercial transactions are as follows: (a) working for commission; (b) brokerage; (c) bill and draft transactions (whether recorded in the name of a person or a bearer); (d) money exchange transactions; (e) transactions made by private and public (special and general) banks; (f) transaction relating to current accounts and agreements thereof; (g) transactions relating to mortgage documents and receipts existing against goods placed in commercial general storehouses; (h) Establishment of commercial companies and buying and selling of shares; (i) contraction of contracting for any kind of insurance for all risks whether for fees or for reciprocal terms. *Id.*

<sup>548</sup> *Id.* art. 20.

dispute arising from that transaction where the merchant-party is the defendant will be tried in a commercial court.<sup>549</sup>

Primary commercial transactions include three main categories: (1) if a person purchases movable property with the intention of sale or lease to other persons in original or altered form, the sale or lease of such properties is considered a commercial transaction;<sup>550</sup> (2) if a person leases movable property to someone who intends to lease it to others, the original and subsequent lease are considered commercial transactions;<sup>551</sup> (3) it is considered a commercial transaction if a person employs other persons for the purpose of providing services.<sup>552</sup>

Under Afghanistan law the sale of agricultural products and livestock by farmers is not considered a commercial transaction, therefore, it does not fall under the jurisdiction of a commercial court, unless a permanent industrial establishment is setup to change the agricultural products and livestock to be sold.<sup>553</sup>

According to the Afghanistan Supreme Court, ownership disputes do not fall under the jurisdiction of commercial courts.<sup>554</sup> Therefore, a transaction concerning the transfer of ownership

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<sup>549</sup> *Id.* art. 21.

<sup>550</sup> *Id.* art. 14.

<sup>551</sup> *Id.* art. 15.

<sup>552</sup> The following types of transaction are also considered primary commercial transactions (Article 18): (a) agreement to provide any kind of movable property and accept any kind of activities and products; (b) establishment of a power plant or press, photography, printing, and selling of books; (c) establishment of theaters, movies, parks and public places, e.g., hotels, business compounds, restaurants and the like, employment offices, and auction places; (d) transportation of passengers, animals, and goods via land, air, and water; (e) distribution of water, gas, electricity and the establishment of telephone communication. *Id.* art. 16.

<sup>553</sup> “If a landowner, farmer, or a cattle-raiser sells his products or changes them to other forms before selling them, such action should be considered as normal or ordinary activities [not a commercial transaction]. Similarly, if a farmer with agricultural and industrial machines or plants exchange his product – or if a professional person or his employee (or his machines) produces his professional product and sells them; [...] But if a person for the purpose of changing his agricultural product opens a permanent establishment possessing the qualities of an industrial business, this is considered a commercial transaction.” *Id.* art. 17.

<sup>554</sup> AFGHANISTAN SUPREME COURT, JUDICIAL SEMINAR 190 (1395 [2017]).

of a non-fungible property (real estate by its nature is non-fungible) is not a commercial transaction and disputes arising from that transaction falls outside the jurisdiction of commercial courts. The Afghanistan Supreme Court, however, has decided that transactions concerning the benefits of non-fungible property can be a commercial transaction if it falls within one of the categories of commercial transactions.<sup>555</sup> Therefore, disputes arising from a commercial transaction concerning the benefits of a non-fungible property does fall under jurisdiction of commercial courts.

The Supreme Court has decided that if a person leases a store, or gives a store to *Sar qufli*, for commercial purposes, disputes arising from the lease and *Sar qufli* fall under the jurisdiction of commercial courts.<sup>556</sup> This is because, according to Afghanistan Supreme Court's jurisprudence, *Sar qufli* and commercial leases are transactions relating to the benefit of non-fungible properties rather than its ownership.<sup>557</sup> The subject of transaction in *Sar qufli* and commercial lease is the right to benefit from a non-fungible property (e.g. a store or a warehouse) not its ownership. Therefore, these transactions fall under the jurisdiction of commercial court. *Sar qufli* and commercial lease make up the most common disputes in Afghanistan commercial courts. *Gerawee*, on the other hand, does not fall under the jurisdiction of commercial courts because according to the Afghanistan Supreme Court, the *Gerawee*, or its formal legal form i.e. *Bai al-Wafa* (the sale with the right of repurchase) or a sale with a repudiation condition, constitute a transaction concerning the ownership of a non-fungible property (e.g. a house, a store, or a piece of agricultural land), and therefore fall outside the jurisdiction of commercial courts.<sup>558</sup> The

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<sup>555</sup> *Id.*

<sup>556</sup> *Id.*

<sup>557</sup> *Id.*

<sup>558</sup> *Id.*

jurisprudence of Afghanistan courts with regard to *Gerawee* and *Sar qfli* are discussed in greater detail in Chapter Three.

### **2.6.3.3. Regional Distribution of Commercial Disputes in Afghanistan Commercial Courts**

According to data from the Quarterly Judicial Activities Reports (“Judicial Report”) data, primary commercial courts and commercial dewans of appeal courts in Afghanistan’s five major provinces (Kabul, Herat, Nangarhar, Balkh, and Kandahar) account for roughly 90% of commercial cases received and decided by commercial courts at primary and appellate levels nationwide.<sup>559</sup> Even though these five provinces only represent half of Afghanistan’s economy<sup>560</sup> and one-third of Afghanistan’s population.<sup>561</sup> However, this does not necessarily mean that the merchants who do reside in the twenty nine other Afghan provinces, representing the other half of Afghanistan’s population do not utilize to commercial courts. Instead, as interview data reveal, businesses in Afghanistan tend to be regional and these five provinces are regional hubs; and also, commercial courts have very expansive rules of personal jurisdiction. Therefore, it is very easy for a commercial dispute involving merchants doing business in a number of neighboring provinces to gravitate to primary commercial courts in regional hub cities where courts are more competent, and rule of law is stronger.

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<sup>559</sup> Calculated by the author based on QUARTERLY JUDICIAL ACTIVITIES REPORTS FOR THE YEARS OF 2012 UNTIL 2017, *supra* note 21.

<sup>560</sup> Calculated by the author based on BUSINESS ESTABLISHMENT SURVEY 2009, *supra* note 18; BUSINESS ESTABLISHMENT SURVEY 2015, *supra* note 18.

<sup>561</sup> Calculated by the author based on AFGHANISTAN DEMOGRAPHIC ESTIMATES FOR THE YEARS OF 2002/03 UNTIL 2017/18, *supra* note 19.

#### 2.6.3.4. Commercial Court Procedure

Commercial court procedures disincentivize the use of courts because they are burdensome, and the rules of evidence are incongruent with the prevailing business practices in the country.<sup>562</sup>

After a primary commercial court decides it has jurisdiction over a case it commences its proceedings. However, before the primary commercial court hears preliminary motions, it advises the parties to consider mediation.<sup>563</sup> If the parties agree, the court will ask each party to choose a mediator.<sup>564</sup> The court records the name of the mediators, but the mediators conduct the mediation completely separate from the court.<sup>565</sup> Pre-trial mediation is not mandatory; parties or a party may refuse mediation.<sup>566</sup> Mediation is not “court-annexed”: the mediators work completely independently from the court. If the mediation is successful and parties reach to an amicable resolution, the court will incorporate their agreement in its judgment as it stands without any modification<sup>567</sup> and that will be the end of the proceedings. If mediation is unsuccessful, the mediators may submit their opinion to the court. However, this report does not have any evidentiary or binding value under the law.<sup>568</sup> Parties to the dispute can return to the mediation at any stage of the proceedings if they choose.<sup>569</sup> However, the court will only advise the parties to resort to mediation once.<sup>570</sup>

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<sup>562</sup> See, e.g., MINISTRY OF COMMERCE AND INDUSTRIES STRATEGIC PLAN 2016-2020 12 (2016), *supra* note 9, at 12.

<sup>563</sup> See PRINCIPLES OF COMMERCIAL PROCEDURE, *supra* note 534, and Section 2.6.3.1.

<sup>564</sup> *Id.*

<sup>565</sup> *Id.*

<sup>566</sup> *Id.*

<sup>567</sup> *Id.* art. 40.

<sup>568</sup> *Id.*

<sup>569</sup> *Id.* art. 37.

<sup>570</sup> *Id.* art. 40.

If parties refuse to try mediation or if a mediation fails, the primary commercial court begins its proceedings by inviting parties to file their preliminary motions.<sup>571</sup> After these motions are decided on, the court requests parties to file their briefs and present evidence.<sup>572</sup>

Commercial Law Article 2 sets forth the source of binding rules applicable in commercial disputes: “Commercial disputes are to be settled in accordance with legally binding agreements and in their absence, disputes are to be determined and settled by reference to the meaning and implication of existing commercial laws. In the absence of a law, local and special customs (those that are commonly recognized, consented to, and used) are applied. Local customs and practice are preferred to general custom. In the absence of any other of the above – mentioned methods any other laws which might apply to the dispute are used.”<sup>573</sup>

Parties may use any of the following as evidence in a commercial court: (1) witness testimony (Articles 131-143 Commercial Procedure);<sup>574</sup> (2) expert witness (Article 143-155 Commercial Procedure);<sup>575</sup> (3) written documents (Articles 156-199 Commercial Procedure);<sup>576</sup> (4) confession (Article 200-203 Commercial Procedure);<sup>577</sup> and (5) commercial books (Article 79 Commercial Law).<sup>578</sup>

Under Commercial Law Article 65, “[e]very merchant must keep three books – a book showing his capital, a ledger, and a journal.”<sup>579</sup> Under Commercial Law Article 68, “The books

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<sup>571</sup> *Id.*

<sup>572</sup> *Id.*

<sup>573</sup> PRINCIPLES OF COMMERCIAL LAW, *supra* note 539.

<sup>574</sup> PRINCIPLES OF COMMERCIAL PROCEDURE, *supra* note 534.

<sup>575</sup> *Id.*

<sup>576</sup> *Id.*

<sup>577</sup> *Id.*

<sup>578</sup> PRINCIPLES OF COMMERCIAL LAW, *supra* note 539.

<sup>579</sup> *Id.*

kept according to Article 65 are to be taken personally by the merchant or his agent to the local registration office [i.e. Provincial Departments of Ministry of Finance] for marking and sealing.<sup>580</sup> The registration should mark all the pages with ink and seal them. Then the office will note the total sheets of each book on its first and last pages. After noting the date besides the seals of the first and last pages, the registration office should also include there a certified signature.”<sup>581</sup> Only if this requirement is met, under Commercial Law Article 79, “during a dispute between two merchants over commercial transactions, the legal commercial books could be used [as evidence].”<sup>582</sup> If a book is kept according to the legal requirements, it can be used against or for the advantage of the possessor.<sup>583</sup> In practice, however, merchants do not avail themselves of this evidentiary advantage because doing so would require them to put their entire dealings under the review of the tax authorities.<sup>584</sup>

The process of accepting witness testimony in commercial courts is more expedient than civic courts. In civil disputes, witnesses must be secretly and publicly vetted.<sup>585</sup> In the secret vetting, the court sends letters to those who have knowledge of the character and affairs of the witness (e.g. employer).<sup>586</sup> In the public vetting, two individuals attend a court session to testify to the reliability and character of the witness.<sup>587</sup> Only if the two-step vetting process is successful

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<sup>580</sup> *Id.*

<sup>581</sup> *Id.* art. 68.

<sup>582</sup> *Id.*

<sup>583</sup> *Id.* art. 80.

<sup>584</sup> This finding is based on author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as author’s personal observations over several years of his work as accountant in the Afghanistan’s private sector between 2008-2013.

<sup>585</sup> *See* LAW OF CIVIL PROCEDURE, *supra* note 527.

<sup>586</sup> *Id.*

<sup>587</sup> *Id.*

will the witness testimony be accepted.<sup>588</sup> In commercial court procedure, however, according to the Afghanistan Supreme Court this two-step vetting process is not required.<sup>589</sup> Commercial judges hear witness testimony and assess their credibility unless they have a reason to inquire about the reliability and character of the witness.<sup>590</sup> This is a very important procedural advantage of commercial courts which increases the value of jurisdictional rules.

A panel of three judges at the primary commercial courts hear the case and the decision at the primary level is made by the majority of the three judges that preside over the case.<sup>591</sup> After the primary court reaches its decision and the primary commercial court's decision is announced to the parties, either party has the right to appeal the case to the Court of Appeals. The decision of the primary commercial court is binding and enforceable upon announcement. However, in certain cases, the decision of primary commercial court will also be final. Under Article 53 of the Laws on Organization and Jurisdiction of Judiciary, in the following scenarios the decision of primary commercial court is final: (1) parties accept the decision as final; (2) the time for filing an appeal runs out and an appeal is not filed; (3) the value of the subject of the decision does not exceed 100,000 AFN (i.e. roughly 2,000 US\$).<sup>592</sup> If none of these conditions are satisfied, the decision of the primary commercial court can be appealed as a matter of right to the commercial dewan of court of appeal.

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<sup>588</sup> *Id.*

<sup>589</sup> JUDICIAL SEMINAR (2017), *supra* note 554, at 180.

<sup>590</sup> *Id.*

<sup>591</sup> LAWS ON ORGANIZATION AND JURISDICTION OF JUDICIARY, *supra* note 524, art. 6(3)(1).

<sup>592</sup> *Id.*

Commercial disputes which are appealed to the Court of Appeal will be decided by the commercial dewan of Court of Appeal.<sup>593</sup> Under Afghanistan law, a panel of three judges at the commercial dewan of court of appeal will rehear the case in its entirety and render a decision by the majority.<sup>594</sup> The decision of the commercial dewan of court of appeal is binding and enforceable after it is announced to the parties.<sup>595</sup>

Decisions of commercial dewan of courts of appeal are reviewed by the commercial dewan of Afghanistan Supreme Court.<sup>596</sup> Two justices, advised by judicial advisors, review and decide the cases at dewans of Afghanistan Supreme Court.<sup>597</sup> Dewans of the Afghanistan Supreme Court only review the application of law in a case.<sup>598</sup> Dewans of the Afghanistan Supreme Court do not rehear the case or decide on a question of fact.<sup>599</sup> A Dewan of the Afghanistan Supreme Court may affirm, break and remand, correct, or annul a decision of a lower court that has been appealed to it.<sup>600</sup> If a dewan of the Afghanistan Supreme Court affirms the decision of the lower court that

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<sup>593</sup> There is one Court of Appeal located in each provincial capital, which decides all the cases from that province at the second level. A Chief Judge heads Court of Appeal in each province. Court of Appeals, in most provinces, consist of six Dewans: (1) General Criminal Dewan, (2) Public Security Dewan, (3) Dewan of Crimes Against Internal and External Security, (4) Dewan of Civil and Personal Affairs, and Public Rights, and (5) Commercial Dewan. *Id.* art. 32.

<sup>594</sup> *Id.* art. 6(3)(2).

<sup>595</sup> *Id.* art. 35.

<sup>596</sup> Afghanistan Supreme Court is the highest judicial organ in Afghanistan and heads the judicial branch. AFGHANISTAN CONSTITUTION (2014), *supra* note 511, art. 116. The high judicial council, which consists of all nine members of the Afghanistan Supreme Court, is the highest judicial body within the Afghanistan Supreme Court. LAWS ON ORGANIZATION AND JURISDICTION OF JUDICIARY, *supra* note 524, art. 17. The Afghanistan Supreme Court has five judicial dewans each of which is headed by a justice: (1) General Criminal Dewan, (2) Public Security Dewan, (3) Civil and Public Rights Dewan, (4) Dewan of Crimes Against Internal and External Security, and Military Crimes, (5) Commercial Dewan. The decision of each of these dewans will be enforced under the authority of the High Council of Afghanistan Supreme Court. LAWS ON ORGANIZATION AND JURISDICTION OF JUDICIARY, *supra* note 524, art. 18.

<sup>597</sup> LAWS ON ORGANIZATION AND JURISDICTION OF JUDICIARY, *supra* note 524, art. 6(3)(3).

<sup>598</sup> *Id.* arts. 26-27.

<sup>599</sup> *Id.*

<sup>600</sup> *Id.*

decision becomes final.<sup>601</sup> If a dewan of the Afghanistan Supreme Court determines that the decision of the lower court contains an error in application or interpretation of the law, it breaks the decision and remands the case to the same court for a new decision.<sup>602</sup> If a dewan of the Afghanistan Supreme Court finds the error to be inconsequential in the outcome of the case, it corrects the decision without remanding it to the court of appeal.<sup>603</sup> If the commercial dewan of the Afghanistan Supreme Court finds that the decision of the court of appeal lacks a fundamental condition for a dispute or it contains a gross violation of procedure, it annuls the decision and remands to the court of appeal to be re-decided by a new panel of judges.<sup>604</sup>

#### **2.6.3.5. Enforcement of Commercial Courts' Decisions**

Enforcement of the commercial courts' decisions are generally uncertain which makes use of commercial courts ineffective. The most likely outcome is a payment schedule; this can be long and requires continued supervision of courts and Huquq Department (See Figure 6 below). Merchants can usually achieve a similar, or even better, solution outside the courts.<sup>605</sup> However, non-fungible properties (especially immovable non-fungible properties) are an exception to this rule.

If a party obtains a final judgment in an ownership dispute concerning a non-fungible property (e.g. a store or a house), and the property is located in an area where the government has control, the judgment will most likely be enforced. It is because the subject of this judgment is an

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<sup>601</sup> *Id.* art. 28.

<sup>602</sup> *Id.* arts. 26-27.

<sup>603</sup> *Id.*

<sup>604</sup> *Id.* art. 27.

<sup>605</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

identifiable specific property. Under Afghanistan's rules of civil and commercial procedures, precise description of the specific property is a fundamental requirement of a lawsuits.<sup>606</sup>

*Sar qufli* and lease disputes relate to, by virtue of their subject, an immovable non-fungible property, fall within this category. This explains why parties most often resort to courts for *Sar qufli* and commercial lease disputes.<sup>607</sup> Court judgment is both effective and necessary when it comes to *Sar qufli* and lease disputes. It is because in *Sar qufli* and lease disputes, the lawsuit is brought against a party that has actual possession of an immovable property in an attempt to forcefully regain possession.<sup>608</sup> Therefore, the subject of the judgment is permanent, and the remedy requires use of force. This is the reason why *Sar qufli* and lease disputes make up the majority of case load of commercial courts.<sup>609</sup>

Under Afghan law, the department of Huquq is in charge of enforcing the judgments issued by commercial courts.<sup>610</sup> The following analysis of enforcement of commercial court judgments focuses on the judgments concerning fungible property and monetary claims, and is based on the interview conducted by the author with a Judgment Specialist at the Herat Huquq Department.<sup>611</sup> The enforcement of judgments concerning fungible properties and monetary claims has paramount importance because due to the nature of commercial transactions, non-fungible properties and monetary claims are the most common subject of disputes among merchants. Although disputes

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<sup>606</sup> LAW OF CIVIL PROCEDURE, *supra* note 527, art. 13.

<sup>607</sup> *Sar qufli* and lease disputes are the most common disputes resolved by commercial courts in Afghanistan; calculated by the author based on QUARTERLY JUDICIAL ACTIVITIES REPORTS FOR THE YEARS OF 2012 UNTIL 2017, *supra* note 21.

<sup>608</sup> Author's Interview with the Chief Judge of Kabul Primary Commercial Court (June 2017).

<sup>609</sup> Calculated by the author based on QUARTERLY JUDICIAL ACTIVITIES REPORTS FOR THE YEARS OF 2012 UNTIL 2017, *supra* note 21.

<sup>610</sup> *See* LAW OF ENFORCEMENT OF RIGHTS, *supra* note 528.

<sup>611</sup> Author's interview with A Judgment Enforcement Specialist at Herat Huquq Department (April 2017).

concerning non-fungible properties (e.g. lease of a store or warehouse) dominate the formal court cases, they constitute a small parentage of commercial disputes. In Afghanistan, after an enforceable judgment is rendered, the judgment will be sent to the Huquq Department for enforcement.<sup>612</sup> The Huquq Department will notify the losing part of the fact that a final and enforceable judgment has been rendered against him or her.<sup>613</sup> At this point, there are five possible outcomes:<sup>614</sup>

(1) If the losing party complies voluntarily, the Huquq Department will save the file and the proceedings end.

(2) If the losing party rejects the court's judgment and refuses to comply, the losing party will be considered in contempt of court, and will be referred to the prosecution office. The prosecutor will issue an indictment and the public security dewan of the court will convict him. The court usually starts with a six-month conviction. If the losing party does not comply and repeats the contemptuous behavior after the end of his sentence, he can be indicted and convicted of an increased sentence. Theoretically, this process can be repeated until the losing party complies.

(3) If the losing party accepts the court's judgment but claims that he does not have the assets to pay for the judgment, the Huquq Department will suggest setting up a payment schedule. If the judgment-holder agrees, the Huquq Department will submit the payment schedule to the provincial governor's office. If the governor grants approval, the court with jurisdiction over the case will issue an order against the losing party requiring him to pay the judgment per the payment

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<sup>612</sup> See LAW OF ENFORCEMENT OF RIGHTS, *supra* note 528.

<sup>613</sup> Author's interview with A Judgment Enforcement Specialist at Herat Huquq Department (April 2017).

<sup>614</sup> The facts concerning different enforcement outcome reported in the following paragraphs is based on author's interview with a judgment enforcement specialist at Herat Huquq Department (April 2017).

schedule. If the losing party violates the payment schedule he is found in contempt of the court. He will be referred to the prosecution office and will be tried for contempt.

While a provision of the law states that the payment schedule cannot exceed 9 months, and Afghanistan Supreme Court has reaffirmed this limit,<sup>615</sup> “another provision says that the courts determine the length according to the losing party’s financial status. Some courts have taken this to mean the court can approve a payment schedule that exceeds 9 months if the financial status of the losing side warrants it.”<sup>616</sup> The amount of each installment is determined in the following manner: the court determines the monthly income of the losing side (e.g. a daily wage of the simple laborer) then subtracts the losing side’s essential expenses and require him to pay the remaining amount to the winning side to satisfy the judgment.<sup>617</sup> According to Kamal, a judgment enforcement specialist at Herat Huquq Department, most payment schedules consist of four to nine monthly payments.<sup>618</sup>

(4) If the losing party accepts the court’s judgment but refuses to pay, claiming that he does not have the assets to pay for the judgment, or if either the losing side cannot pay the judgment in installments or the prevailing side does not accept the installments claiming that the losing side has sufficient assets and should not need a payment schedule, the Huquq Department, on the recommendation of the prevailing side, will send letters to the municipality, district, banks, or other places where the losing side’s assets can be identified to obtain a report on the possible assets. If any asset is identified, the Huquq Department will ask a court to order the confiscation (e.g. if

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<sup>615</sup> JUDICIAL SEMINAR (2017), *supra* note 554, at 129.

<sup>616</sup> Author’s Interview with A Judgment Enforcement Specialist at Herat Huquq Department (April 2017).

<sup>617</sup> *Id.*; JUDICIAL SEMINAR (2017), *supra* note 554, at 190.

<sup>618</sup> Author’s interview with a judgment enforcement specialist at Herat Huquq Department (April 2017).

it is a bank account), or auction (e.g. if it is real estate or car) of the identified assets so the prevailing party can be paid from the money that is received from the auction or confiscation.

(5) If no assets can be found and the losing side cannot pay the judgment in installments i.e., he does not make enough money, the Huquq Department will require the losing side to procure a guarantor—someone who will ensure that the loser will pay the judgment as soon as his financial status improves. After receiving a guaranty, the Huquq Department will defer enforcement of the judgment until such time as the losing party's financial status improves so he can pay in installments or in whole, or until such time that the winner can identify any assets of the losing side against which the judgment can be enforced.

Currently there are no formal bankruptcy proceedings in Afghanistan. According to the decision 307-369 (2007) of the High Council of Afghanistan Supreme Court,<sup>619</sup> courts are ordered not to initiate bankruptcy proceedings in commercial or non-commercial cases.<sup>620</sup> The courts are instead required to enter into a judgments and determine the obligation of the losing side.<sup>621</sup> If the winner can show that the loser has assets, the judgment will be enforced.<sup>622</sup> If the winner cannot show that the loser has assets, and the loser does not have assets, enforcement will be delayed until such time when the winner can show that defendant has assets that can be used to satisfy the judgment.<sup>623</sup>

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<sup>619</sup> AFGHANISTAN SUPREME COURT, MUTAHADULMAL [DECISION] (No. 307-369, 1385 [2007]).

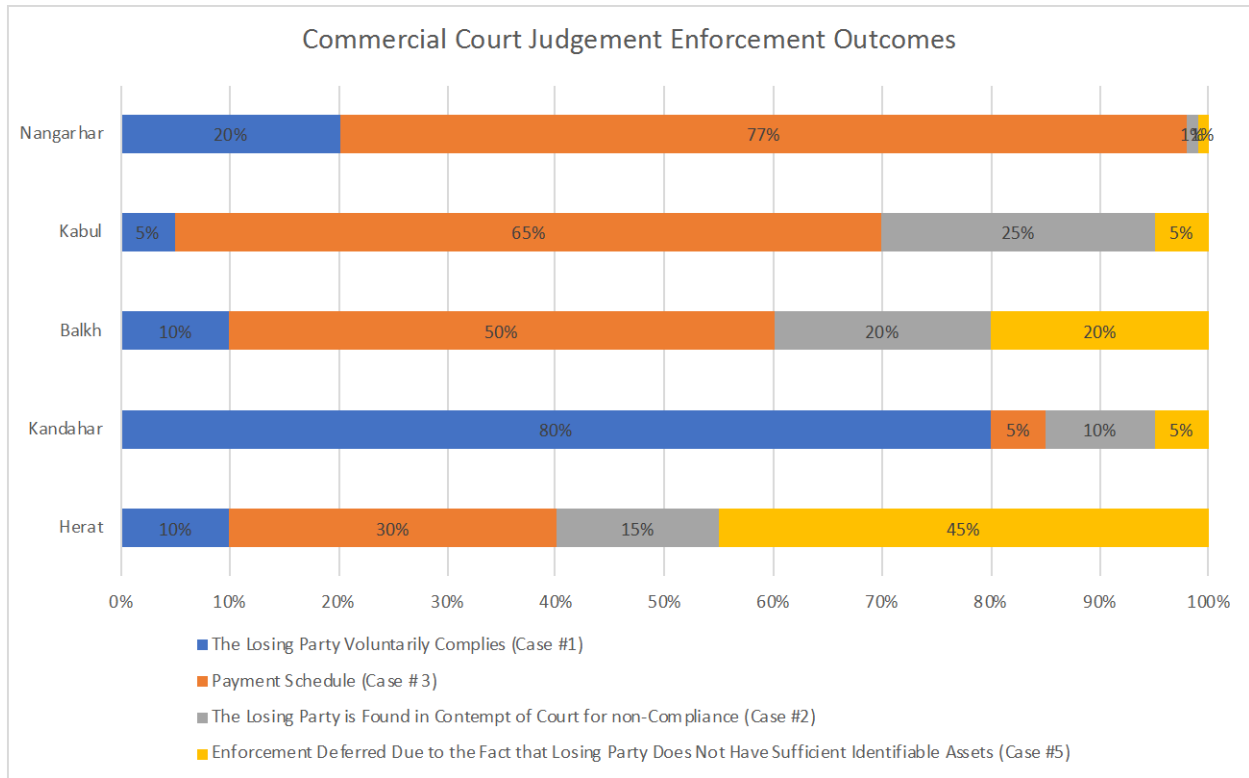
<sup>620</sup> *Id.*

<sup>621</sup> *Id.*

<sup>622</sup> *Id.*

<sup>623</sup> *Id.*

Figure 6 provides rough estimates of judgment enforcement outcomes for different provinces (excluding the judgment concerning the non-fungible properties detailed in Section 2.6.3.5 above) as provided by the Huquq Department Judgment Specialists:



*Figure 6 Afghanistan's Commercial Courts' Judgment Enforcement Outcomes by Province for the Last Hijri Year<sup>624</sup>*

According to these rough estimates, scheduled payments are the most common outcome of a commercial court's judgment. This is not surprising because defendants who have assets will usually pay before a final judgment is rendered. They know that their assets will be sold for a lower price in court-ordered auctions; therefore, only those who do not have identifiable assets wait until after the formal judgment is rendered. This also explains why court remedies are so unpopular.

<sup>624</sup> Constructed by the author based on written answers to the author's questionnaire by the Judgment Enforcement Specialist at Huquq Departments of Herat, Kabul, Balkh, Kabul, Nangarhar, and Kandahar (Sept – Dec 2017).

Creditors usually can reach an agreement for a better payment schedule, considering the time and money that litigation process takes, without going to courts.

However, there are two outliers in the enforcement of judgments. Commercial judgements are most often deferred in Herat province because the losing party does not have sufficient and identifiable assets, while Kandahar is the province where the losing party is most likely to voluntarily comply with a court judgment. These outliers can be explained if one takes into account the number of commercial judgements per year rendered in these five provinces adjusted for population: per every million people, the average annual number of commercial judgements rendered in the major provinces in the past six years are as follow: Kabul (258), Herat (204), Balkh (125), Kandahar (48), and Nangarhar (32).<sup>625</sup>

Herat has the highest rate of enforcement deferral because Heratis are much more likely to use the courts, making it more likely for a judgment to be rendered against a party with insufficient identifiable assets. In addition, Herat has the largest portion of small businesses. These are the most frequent court-users and most likely not to have sufficient funds.<sup>626</sup> Kandahar, on the other hand, has very low court-usage coupled with the lowest portion of small businesses which could explain why most judgements are voluntarily enforced. Nangarhar, on the hand, while having a low court-usage rate, has a much larger portion of small businesses which can explain why it diverges from Kandahar when it comes to the prevalence of schedule payments.

The sharp difference between the number of commercial judgements per million people for Kandahar (48), and Nangarhar (32), which are predominantly Pashtun and the most ethnically

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<sup>625</sup> Calculated by the author based on QUARTERLY JUDICIAL ACTIVITIES REPORTS FOR THE YEARS OF 2012 UNTIL 2017, *supra* note 21.

<sup>626</sup> The data reported in this paragraph is calculated by the author based on BUSINESS REGISTRY DATA FOR THE YEARS OF 2014/15 UNTIL 2016/17 FOR KABUL, HERAT, KANDAHAR, BALKH, AND NANGARHAR, *supra* note 327.

homogenous provinces, compared to Kabul, Herat, and Balkh, which are more ethnically heterogeneous and/or are dominated by the Tajik ethnic group, suggests ethnic homogeneity and Pashtun institutions of *jirga*, are likely responsible for making the out-of-court dispute settlement more effective, reducing the court-use rates. This hypothesis is supported by the comparison between per capita business registry and court use between Balkh, Kandahar, and Nangarhar. Balkh has a higher court use rate (almost double) compared to Nangarhar and Kandahar while Kandahar and Nangarhar both have higher per capita business registries. The prevalence of small businesses cannot explain this pattern because while Kandahar has a low number of smaller businesses, Nangarhar has a large number of small businesses.

In addition to the formal rules of enforcement, there are two other features of court procedures that have a direct effect on the popularity of the courts among merchants: judgment tax, and non-acceptance of verbal contracts. It seems that the tax on final judgment is an important deterrent against use of formal courts. The tax ostensibly is designed to do three things, however, it is not clear if it has achieved its goals: (a) cover the court's costs; (b) deter frivolous lawsuits; and (c) encourage amicable resolution of disputes outside the courts.

If a court enters a judgment against plaintiff, the plaintiff has to only pay 1% of the value of the judgment to the government.<sup>627</sup> However, if a court enters a judgment against a defendant, the defendant is required to pay 10% of the value of the judgment. If parties reach to an amicable solution outside the courts and want their agreement to be incorporated into a court's judgment each side has to pay 5%. The lower rate for plaintiff seems to be designed to encourage the use of formal courts; the higher rate for defendant seems to be designed to encourage a settlement;

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<sup>627</sup> The facts reported in this paragraph is based on author's interview with the head of Kabul's Primary Commercial Court (June 2017).

however, the court can only formally approve the settlement only if the parties pay 5% each. This last provision seems to penalize parties using the formal court system to effectuate an amicable resolution, which seems to be at odds with the government's policy to encourage the use of the formal court system. Additionally, this tax is collectable upon issuance of the first court's verdict despite the fact that the judgment can be appealed as a matter of right to the second and third court.

It is interesting that very few interviewees mentioned the judgment tax as a reason why they do not use formal court system. The most common reasons for not using formal court system cited by interviewees were corruption and ineffectiveness of the court. Few may have mentioned the judgment tax because merchants don't use the courts often, so they don't experience the judgment tax.

Afghan courts generally do not enforce verbal contracts.<sup>628</sup> This is despite the fact that an overwhelming majority of the business dealings in Afghanistan are conducted verbally.<sup>629</sup> In talking with judges in five major Afghan provinces that collectively handle 90% of commercial disputes in Afghanistan, it appeared that hostility toward verbal contracts stem from their uncertainty and non-specificity.<sup>630</sup> Verbal contracts are not invalid under Afghanistan commercial laws. Therefore, most judges do not claim that a verbal contract is *ipso facto* invalid. However, the commercial judges interviewed for this dissertation have cited reasons such as difficulty of proving the formation of a verbal contract, its content, and its terms to explain why they base most of their

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<sup>628</sup> Author's interviews with commercial judges of five major provinces of Afghanistan (Kabul, Herat, Balkh, Nangarhar, and Kandahar between March and August 2017).

<sup>629</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>630</sup> Author's interviews with commercial judges of five major provinces of Afghanistan (Kabul, Herat, Balkh, Nangarhar, and Kandahar between March and August 2017).

decisions on written contracts.<sup>631</sup> This dissertation hypothesizes that it is a formalist approach to the law and conservative attitudes of judges that are stopping commercial judges from enforcing verbal contracts rather than a legal obstacle.

#### **2.6.3.5.1. The Causes of Uncertainty about Court Judgment Enforcement**

A confluence of multiple factors—which are fundamentally related to the high volatility of Afghanistan’s business climate and underdeveloped formal property rights—render enforcement of commercial courts’ judgment uncertain.

The first factor is the difficulty in identifying the losing party’s asset. In absence of an inclusive formal property right system, information pertaining to the losing party’s assets is hard to locate. As explained in Section 2.6.2., the existing property right system in Afghanistan is highly fragmented. There is no central property registry for formal property rights and more than 80% of property is held informally.<sup>632</sup> Judgment enforcement officials are not optimally positioned to access the information about the losing party’s assets held informally (compared to local business associations, for example). Judgment enforcement officials have to rely on limited formal property recording, self-reporting, and the information provided by the winning party to identify assets against which a judgment can be enforced.<sup>633</sup> The uncertainty of rules to determine ownership further complicates judgment enforcement further.

The difficulty in identifying the losing party’s assets is precisely the rationale behind the Afghanistan Supreme Court decision to halt the use of formal bankruptcy proceedings in

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<sup>631</sup> For example, a primary commercial Court judge in Balkh said, “We do not enforce verbal contracts because it is very difficult to determine its terms and content.” Author’s interview with a Primary Commercial Court judge in Balkh (May 2017).

<sup>632</sup> WILY (2013), *supra* note 492, at 22.

<sup>633</sup> Author’s interview with a judgment enforcement specialist at Herat Huquq Department (April 2017).

Afghanistan. Given the scarcity of the property information, the Afghanistan Supreme Court ostensibly worries that the losing parties will misuse the bankruptcy proceedings by hiding their assets. As a result, genuinely insolvent merchants cannot avail themselves of the protection of bankruptcy proceedings. This institutional failure disincentivizes merchants from taking risks, which means, they are less likely to expand or invest in new businesses.

The second reason for the low enforcement rate is the type of disputes that find their ways to courts. Most often court disputes are end-of-business and end-of-relationship disputes among smaller and medium-sized merchants who are non-cooperative (compared to the disputes are resolved outside of court).<sup>634</sup> As a result, commercial disputes in courts most often are rendered against judgment-proof and obstructionist parties. This will be discussed further in Chapter Three. The third factor is the high insolvency rates caused by high business climate volatility. Commercial court judgments are hard to enforce partly because losing parties are more likely to be insolvent, rendering them judgment proof. Afghan merchants are more likely to be bankrupt because Afghanistan has a very volatile business climate.

The final factor is underdeveloped security rights. High insolvency rate in Afghanistan mean that security rights are of paramount importance for securitizing credit transactions. The fact that merchants do not have enough assets to satisfy court judgments means determining who has priority over the existing assets is crucial. However, outside formal mortgage laws, security rights are very underdeveloped in Afghanistan. Afghan laws and Afghan courts do not often recognize contractually created security rights.<sup>635</sup> This means informal credit transactions cannot be

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<sup>634</sup> This is why increased use of commercial courts in Afghanistan is correlated with worsening of macroeconomic conditions. This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>635</sup> See Chapter Three in context of judicial attitudes towards *Gerawee*.

securitized.<sup>636</sup> In common cases of insolvency, a majority of creditors, given the very low rate of formal mortgage law users, have limited protection—even if they have entered into transaction based on the confidence of a certain asset.

#### **2.5.6.5.2. Enforcement of Bank Loans**

Despite the challenges enumerated above, Afghan judges and Afghan laws are not the primary impediments or reasons why Afghan merchants have trouble accessing bank loans. Government Strategic Policies have assumed enacting mortgage and negotiable documents law based on international best practices and training judges in applying them will improve enforcement of formal credit contracts, expand bank-provided formal credit, and improve access to credit for Afghan merchants.<sup>637</sup> This dissertation reveals that the problem of formal credit in Afghanistan is related to low demand, not weak enforcement. Specifically, Afghan merchants do not use formal credit devices because bank-provided credit has not overcome the problems of credit transactions in Afghanistan. Chiefly, banks have difficulty collecting on defaulted loans primarily because of a volatile real estate market, and unreliable formal property right systems, not an uncooperative judiciary.

Afghan judges and Afghan laws are not the main impediment to the enforcement of bank loans. The Afghanistan Supreme Court has emphasized the primacy of the rights of banks, holding formal mortgages over other creditors.<sup>638</sup> According to the rules of commercial procedure,

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<sup>636</sup> *Id.*

<sup>637</sup> *See, e.g.*, MINISTRY OF COMMERCE AND INDUSTRIES STRATEGIC PLAN 2016-2020, *supra* note 9, at 12.

<sup>638</sup> JUDICIAL SEMINAR (2017), *supra* note 554, at 173.

authorization of sale of collateral does not require a trial and upon verification of registry of formal collateral, the court may issue an injunction (*qarar*) authorizing auction of the collateral.<sup>639</sup>

The interest-bearing nature of bank loans does not stop Afghan judges from enforcing bank loans. All commercial judges interviewed stated they enforce bank loans according to Afghan laws despite the interest-bearing nature of the transaction.<sup>640</sup> As the Chief Judge of the Primary Commercial Court in Balkh explained, “This is the law. I do think interest is prohibited under Islamic law, but I will enforce a bank loan because it is the law. The responsibility lies with the people who made the law not me.”<sup>641</sup> This suggests that formalism of Afghan judges may be, at least partly, due to the incongruity between the morality of judges and the morality of the laws.

Interview data reveals that, in case of default, courts can be relied on to enforce bank loans by selling the collateral if certain conditions are present.<sup>642</sup> The enforcement of bank loans most often is hindered, according to commercial judges, for several reasons. First, given the complexity of determining legal ownership, sometimes when a bank seeks to sell a mortgage, other parties claim ownership of the collateral; this requires courts to determine ownership before authorizing the auction.<sup>643</sup> Second, there are multiple liens on the collateral.<sup>644</sup> According to Afghan mortgage laws, a property can be used as collateral for multiple loans if the new mortgagee is informed of

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<sup>639</sup> *Id.*

<sup>640</sup> Author’s interviews with commercial judges of five major provinces of Afghanistan (Kabul, Herat, Balkh, Nangarhar, and Kandahar between March and August 2017).

<sup>641</sup> Author’s interview with the Chief Judge of Balkh’s Primary Commercial Court (May 2017).

<sup>642</sup> Author’s interviews with commercial judges of five major provinces of Afghanistan (Kabul, Herat, Balkh, Nangarhar, and Kandahar between March and August 2017).

<sup>643</sup> *Id.*

<sup>644</sup> *Id.*

the existing liens.<sup>645</sup> In such case, liens will be enforced in the order of registry.<sup>646</sup> Sometimes banks accept collaterals that are already subject to a lien, in which case, the courts will have to ascertain whether the mortgagee knew about the existing lien and determine the priorities of enforcement.<sup>647</sup> As a result, banks may not be able to collect on a non-performing loan. Third, volatility in the real estate market means the value of a collateral may depreciate below the amount of the debt, rendering it impossible for the banks to satisfy the debt by sale of the collateral.<sup>648</sup> In such case, banks will be treated as an unsecured debtor and may have to pursue collection through a trial or join other possible creditors in court to collect the remaining debt. Lastly, banks will only enforce a security right if the collateral is fully and precisely specified in the loan contract and the mortgage registration documents.<sup>649</sup> According to Afghan commercial judges, a common problem in enforcing a mortgage claim is that the property is not fully specified because banks did not diligently specify the mortgage in the loan contract and/or mortgage registration.<sup>650</sup>

Afghan judges, and to a lesser degree, Afghanistan mortgage laws, are not the main impediment to the enforcement of bank loans. Although this opposes the premise of most institutional reform policies,<sup>651</sup> it is the volatile real estate market, prevailing property rights

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<sup>645</sup> See QANUN RAHN AMWAL MANQUL DAR MUA'AMALAT BANKI [LAW ON USE OF MOVABLE PROPERTIES AS COLLATERAL IN BANKING TRANSACTIONS] (NO. 990, 1387 [2009]); QANUN RAHN AMWAL QAIR-MANQUL DAR MUA'AMALAT BANKI [LAW ON USE OF IMMOVABLE PROPERTIES AS COLLATERAL IN BANKING TRANSACTIONS] (NO. 990, 1387 [2009]).

<sup>646</sup> *Id.*

<sup>647</sup> JUDICIAL SEMINAR (2017), *supra* note 554, at 185.

<sup>648</sup> Author's interviews with commercial judges of five major provinces of Afghanistan (Kabul, Herat, Balkh, Nangarhar, and Kandahar between March and August 2017).

<sup>649</sup> See LAW ON USE OF MOVABLE PROPERTIES AS COLLATERAL IN BANKING TRANSACTIONS, *supra* note 645; LAW ON USE OF IMMOVABLE PROPERTIES AS COLLATERAL IN BANKING TRANSACTIONS, *supra* note 645.

<sup>650</sup> Author's interviews with commercial judges of five major provinces of Afghanistan (Kabul, Herat, Balkh, Nangarhar, and Kandahar between March and August 2017).

<sup>651</sup> See, e.g., MINISTRY OF COMMERCE AND INDUSTRIES STRATEGIC PLAN 2016-2020, *supra* note 9, at 12.

system, and failure of the banks to diligently comply with the legal requirements that impede the enforcement of banks loans.

In 2009, Pvalovic and Charap researched the variation in lending practices of banks in Afghanistan by interviewing top management of eight commercial banks in Afghanistan.<sup>652</sup> According to Pavlovic and Charap, bank executives expressed reservations about the legal system.<sup>653</sup> Banks that have used the formal legal system to collect loans opined that it was time-consuming, difficult, and highly bureaucratic.<sup>654</sup> Bank executives expressed preference for use of non-conventional enforcement methods such as blacklisting.<sup>655</sup> Bank executives also expressed reservations about use of collateral. The issues that reportedly impeded the use of collateral included: “(1) a 6% collateral registration fee, (2) invalid title deeds, (3) multiple title deeds held over the same property, and (4) ‘... using bribes or connections to get hold of property titles filed in other banks ... [to] bring the titles to ... [ask] for loans.’”<sup>656</sup> Given the expressed dissatisfaction with use of land as collateral, bank executives, according to Pavlovic and Charap, did not attach so much weight to the collateral, instead, they assigned priority to a borrowers’ reputation, business relations, and personal contacts when deciding to issue a loan.<sup>657</sup> This practice, which foreign bank executives whose banks did not engage in domestic lending, has been derogatorily described as “relationship banking.”<sup>658</sup>

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<sup>652</sup> JOSHUA CHARAP & JELENA PAVLOVIC, IMF MIDDLE EAST AND CENTRAL ASIA DEPARTMENT, DEVELOPMENT OF THE COMMERCIAL BANKING SYSTEM IN AFGHANISTAN: RISKS AND REWARDS 18 (IMF Working Paper WP/09/150, 2009), <https://www.imf.org/external/pubs/ft/wp/2009/wp09150.pdf>

<sup>653</sup> *Id.*

<sup>654</sup> *Id.* at 17.

<sup>655</sup> *Id.* at 18.

<sup>656</sup> *Id.*

<sup>657</sup> *Id.*

<sup>658</sup> *Id.* at 19.

It is difficult to determine whether this kind of “relationship banking” still continues in Afghanistan—especially after Kabul Bank scandal and the increased regulatory oversight that ensued. It is quite possible that domestic private banks, who are virtually the only banks issuing loans to the private sector in Afghanistan, continue to substitute and/or complement formal legal recourse and risk-assessment procedures with proactive business information gathering and private contract enforcement mechanisms. It should be noted that at the time of Pvalovic and Charap’s research in 2009, it appeared that almost 100% of bank loans in Afghanistan were performing.<sup>659</sup>

The reported attitudes of bank executives support the proposition put forward in this dissertation. Bank executives did not say that Afghan judges or Afghanistan laws do not enforce collaterals, instead they believed that formal dispute resolution is more time-consuming and expensive than reputation-based enforcement, and that Afghanistan’s formal property right system renders collateral unreliable. These two propositions are valid and in congruence with the argument put forward here; namely, it is property right system, not Afghan judges or Afghan mortgage laws that impede the enforcement of bank loans in Afghanistan.

#### **2.6.3.6. Formal Arbitration and Mediation**

There is no legally binding arbitration in Afghanistan yet. According to Faizy, head of Afghanistan Commercial Dispute Resolution Center (the “Center”), “although Afghanistan has passed an arbitration law, there is no arbitration in Afghanistan because there are no arbitration rules, and also there is no procedure or authority by which an arbitrator’s license can be issued.”<sup>660</sup> The Center only provides mediation, which is completely non-binding. Mediation services provided

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<sup>659</sup> *Id.* at 18.

<sup>660</sup> The following facts about the Center is based on Author’s interview with the Head of Afghanistan Commercial Dispute Resolution Center at Afghanistan Chamber of Commerce and Industries (Kabul, June 2017).

by the Center are not very popular. According to Faizy, there have been only 13 mediations held by the Center in the last three years (2014/15-2016/17) with most of them being held last year.

Faizy said, "The difference between our mediation and *jirgas* is that we use written documents and follow the law." While Faizy saw this as a positive point, the formality of the Center-provided mediation may be the reason for its unpopularity. This hypothesis is supported by the fact that according to Faizy, members of board of the Chamber conduct informal dispute resolution without referring disputes to the Center. This is despite the fact that the Center is a part of the Chamber.

Herat's Chamber of Commerce and Industries (Herat Chamber) is the only chamber in Afghanistan operating a formal dispute resolution center.<sup>661</sup> Herat's Center is party to an agreement which allows it to jointly operate with a chamber of commerce in Mashhad, Herat's neighboring province in Iran. According to the President of Herat Chamber, the Center provides binding arbitration as well as mediation services. However, the legally binding arbitration has not yet been used. The Center in Herat handles 4-5 cases each year, the majority of which, according to the President of the Herat Chamber, consist of disputes between Herati merchants and Irani merchants. The Herat Chamber is a party to a joint chamber of commerce between Herat and Mashhad. Disputes between Irani and Herati merchants who are member of the Mashhad Chamber and the Herat Chamber, respectively, can be resolved through the dispute resolution committee of the joint chamber. These services are used to resolve a few cases each year, according to President of the Herat Chamber.

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<sup>661</sup> The following facts concerning Herat Chamber of Commerce is based on Author's interview with the President of Herat's Chamber of Commerce and Industries (Herat, April 2017).

The low user rate of the centralized and formalized mediation, in contrast with the use of localized and informal dispute resolution conducted by unions and/or *ad hoc* group of merchants suggest Afghan government strategies should focus on policies that support the informal dispute resolution rather than attempt to formalize and centralize the resolution of commercial disputes using ADR center models.

Credit transactions in Afghanistan pose a number of fundamental problems. These problems have their roots in Afghanistan's history of conflict and the failure of state buildings in the Afghan context. Afghanistan highly volatile business climate makes credit transaction costlier while rendering adherence to fixed repayment terms, *ex ante*, challenging. Formal property rights are underdeveloped, and formal deeds are scarce; as such, formal property rights cannot be used to securitize credit transactions. The underdevelopment of formal private property rights, and a highly volatile business climate, make it difficult to hold debtors accountable using formal dispute resolution institutions. To overcome these problems, a number of informal institutions have emerged to facilitate credit transactions among Afghan merchants. Thus, the fundamental problems of credit transacting have determined the emerging of informal credit and dispute resolution to which this dissertation will turn in the next Chapter. The inability of formal institutions to adapt to the context of Afghanistan and provide credit in a way that works for the Afghan context is primarily responsible for the low demand for formal credit in Afghanistan, a subject to which this dissertation turns in Chapter Four.

### Chapter Three: INFORMAL FINANCIAL AND DISPUTE RESOLUTION INSTITUTIONS IN AFGHANISTAN

Afghans have developed a number of credit institutions to support credit transactions despite Afghanistan's highly uncertain environment and formal institutions that are unable to facilitate credit transactions in a way that works for the Afghan context. These institutions are not a substitute for good formal institutions, however, they have been able to provide access to working capital finance and to a lesser extent investment financing while the formal institutions have failed to offer credits on terms that Afghan merchants can use.

Sellers/creditors finance supply chains through trade credit and flexible risk-sharing arrangements to maximize sales. *Sarrafs* issue working capital loans to sellers/creditors which create a buffer against cash flow interruptions. A highly competitive business environment animates the provision of trade credit and short-term working capital loans. A feedback loop exists: lower barriers to entry create market competition, which animates the provision of trade credit and short-term working capital loans, while easing access to trade credit and short-term working capital loans lowers the barriers to entry. These existing institutional solutions allow Afghan merchants to finance supply chains despite a highly volatile business climate. However, they create inefficiency by effectively locking merchants into existing supply chains. They also cannot be used to finance investments. In addition to supply chain financing, Afghan developers and their customers have developed a property right in future business reputation to recover construction cost of shopping and business centers for businesses where reputation is closely tied to the place of business. Afghans have also developed informal mortgage-like transactions, known as *Gerawee*, to raise capital against the value of their houses.

### 3.1. Supply Chains and Trade Credit<sup>662</sup>

"If you walk to a store in Jalalabad [capital city of Nangarhar] you can see 30,000 US\$ worth of capital even though storeowner doesn't even have 10,000 US\$ of his own capital."<sup>663</sup> (A Nangarhari merchant)

In the four of provinces studies in this research, with the exception of Balkh, credit sale is the norm of business. In Afghanistan, sellers/creditors import products in cash from other countries. They then sell them, mostly on credit, to buyers/debtors using a weekly payment system, which in most of the country it is called “*ugraee*”.

Contracts are not a tool for *ex ante* allocation of risk; rather they are flexible risk-sharing arrangements forming the basis of an ongoing business relationship. Credit sales are the norm in Afghanistan despite the fact that the delays in payment, but not non-payment, are very common. Buyers/debtors commonly fail to make scheduled payments or underpay. Sellers/creditors strategy of response is wait-and-follow-up.

In Afghanistan, sellers/creditors bear the cost of capital and market uncertainties. If a buyer/debtor is not paid for a product he has bought on credit, he is excused from paying the seller/creditor on the agreed due date. This creates a veil between personal assets and business assets, and to a lesser extent, between asset personal assets and assets used for different business purposes. This is why a merchant with sizable assets is often excused from paying for a purchase

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<sup>662</sup> The description of Supply Chains and Trade Credit in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>663</sup> Author's interview with a merchant in Nangarhar (May 2017).

until he has been paid for the sale of a product he has bought on credit—even if he entered, *ex ante*, into a written commitment, to pay for the purchase on a specific date.

Under this arrangement, a contract is not a tool for allocation of risk. A buyer/debtor only pays when he is paid for the product he purchased on credit; this means, creditors receive irregular payments based on prevailing market conditions. As a merchant in Herat said, “I am owed a million dollars by people in the market, but I cannot be sure if I can collect 1,000 US\$ this week from the market!”<sup>664</sup>

Sellers/creditors cannot use contracts to allocate market risks because buyers/debtors are not willing to accept fixed payment terms even in exchange for a discounted price. As a manufacturer in Herat explained, “People would not pay in cash even if I give them big discounts. Everyone wants to buy on credit.”<sup>665</sup> Buyers/debtors are not willing to bear the market risk because the Afghanistan business climate is so uncertain, and profit margins are low because retail markets are very competitive. Therefore, in most sectors, bearing market risk by committing to an inflexible payment schedule requires significant capital or market power. If a buyer/debtor has the sufficient capital he moves up in the supply chain and becomes a seller/creditor, as often happens when a buyer/debtor accumulates enough capital.

No single variable can explain the supply and demand for trade credit. As explained in Chapter One, in the trade credit literature, the followings are suggested as the main determinants of trade credit: weak legal system (weak contract enforcement and weak property rights); lack of access to bank loans; competitive market; and corruption.<sup>666</sup> In the case of Afghanistan, market

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<sup>664</sup> Author’s interview with a merchant at Herat (April 2017).

<sup>665</sup> Author’s interview with an owner of manufacturing business in Herat (April 2017).

<sup>666</sup> DEMIRGU-KUNT & MAKSIMOVIC, *supra* note 158, at 1; Simon Johnson et al., *supra* note 161, at 223; Özlü & Yalcin, *supra* note 162, at 106; FABBRI & KLAPPER, *supra* note 163, at 4; HOREN, *supra* note 164, 4; Yano & Shiraishi, *supra* note 165, at 131.

competition combined with the risk-sharing features of the prevailing trade credit structure is the primary determinant of the supply and demand for trade credit. Lack of access to banks likely plays a role as well. However, it is impossible to know the role of access to bank loans because it would require observing Afghan merchants' behavior in an institutional environment where they had better access to bank loans.

Market competition animates the provision of trade credit in Afghanistan. A seller/creditor sells on credit because if he does not do so he loses market share. When asked about the reason he sells on credit despite complaining about payment delays, a Nangarhari merchant said, "If I don't sell on credit I won't sell."<sup>667</sup>

Afghan markets are highly competitive because it is far easier for newcomers to access trade credit than it is to access startup financing. This means newcomers crowd in, and rise up within existing markets, increasing the internal competition within already existing supply chains. In the trade credit literature, it is generally accepted that trade credit puts startup at disadvantage because they are less likely to have established reputations.<sup>668</sup>In Afghanistan, however, startup status is not as important as the sector that a startup enters. Newcomers can easily obtain trade credit even with minimum reputation, but they can only do so as distributors of the existing sellers/creditors. Startups cannot access credit to implement a new idea or create new markets.

The most appealing feature of trade credit for Afghan merchants, which has caused its popularity, is that it facilitates a risk-sharing system where the debtor/buyer can pass market uncertainty and capital cost to sellers/creditors, who are better positioned to bear the burden of risk. Given Afghanistan's highly volatile business climate, the risk-sharing feature of trade credit

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<sup>667</sup> Author's interview with a merchant in Nangarhar (May 2017).

<sup>668</sup> Fisman & Love, *supra* note 174, at 355.

allows larger firms (sellers/creditors) to act as financial intermediaries improving access to credit for smaller firms (buyers/debtors) while maximizing their sales. This process is perpetuated by market competition.

Ge & Qiu differentiate between trade credit as transactional tool, i.e. short-term and less overdue debt, and trade credit as financing tool, i.e. longer-term and more overdue debt.<sup>669</sup> According to their research in China, empirical firm-level data suggest that for non-state-owned enterprises, trade credit is a way for suppliers to help their customers with financing who have limited access to bank loans.<sup>670</sup> In Afghanistan, research for this dissertation suggests that trade credit is financing tool as well, but risk-sharing has a prominent role. In trade credit literature, however, risk-sharing is not a salient function of trade credit.

The hypothesis that trade credit is a way for suppliers to finance their customers (e.g. to keep them in business) is contradicted by the observation that large, established suppliers also receive trade credit and most often receive more and better trade credit (compared to capital-poor businesses). This is because large buyers have more market power; but it is interesting that they do not use their market power to obtain discounted prices rather than trade credit. Klapper and his colleagues suggest the reason for this may be because untrusted suppliers need to extend trade credit to provide guaranty the quality of their products.<sup>671</sup> Menichini, on the other hand, posits that trade credit may be a way for a business to hedge its receivables.<sup>672</sup> It also may be because a business has problems collecting the debt from its customer, so it delays paying its suppliers.<sup>673</sup>

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<sup>669</sup> Ge & Qiu, *supra* note 178, at 514.

<sup>670</sup> *Id.*

<sup>671</sup> Klapper et al., *supra* note 169, at 840.

<sup>672</sup> Menichini, *supra* note 167, at 1803.

<sup>673</sup> *Id.*

In Afghanistan, manufacturers, producers, or service providers who buy some of their input from domestic suppliers receive trade credits on better terms compared to smaller businesses. The main reason for this is market power. Larger businesses present less risk, as selling to a large manufacturing business poses less risk of non-payment and delays in payment compared to a smaller business. Most merchants would prefer to have a capital-intensive large manufacturing business as debtor/buyer than a smaller business. This gives large businesses market power which they use to extract better credit terms but not discounted prices. The reason why larger businesses opt to extract better credit terms rather than discounted prices are the hedging and guaranty functions of trade credit.

In Afghanistan, the use of trade credit as a hedging tool is clearly observable. Research interviews reveal that businesses, large or small, will demand trade credit because they have to offer it to their customers. Merchants want to be sure that if they are not paid for their receivables, they can pass a part of that burden on to their suppliers by not paying their payables. This is why most buyers/debtors opt for trade credit even when offered good discounts for a cash purchase. However, sellers/creditors who import their products do not have this option because they do not have access to trade credit when they purchase from suppliers located outside of Afghanistan. Section 3.1.9 discusses Afghan merchants' access to trade credit from suppliers located outside Afghanistan.

The use of trade credit as a guaranty of quality finds empirical support in Afghanistan as well. New producers and importers have to start by offering very good trade credit terms to get buyers/debtors to sell their products in their stores, whereas more established products do not have to be as generous with their credit terms because buyers/debtors will have to buy their products as consumers demand them.

The research presented here does not show a correlation between weak contract enforcement and increase of trade credit. As explained in Chapter Two, weak contract enforcement is not a main reason banks do not issue bank loans in Afghanistan. The weak system of property rights, however, impedes the collateralization of bank loans, and therefore, contributes to the prevalence of trade credit by reducing the bank loan supply. Lack of a strong property rights system, such as clear and reliable titles in land, is limiting the issuance of bank loans and increasing the need for trade credit. Similarly, the current property rights system also impedes the enforcement of court judgments reducing the effectiveness of formal dispute resolution in enforcing credit transactions.

Afghanistan is plagued with corruption; however, the research analyzed in this dissertation does not suggest a direct connection between corruption and the widespread use of trade credit in Afghanistan. Instead, market competition causes the supply of trade credit, and the risk-sharing-enabling drives the demand for it in Afghanistan. This finding shows that the relation between corruption and market monopoly is not a necessary relationship. While in the literature corruption is found to reduce market competition, and therefore, the supply of trade credit, in Afghanistan, despite highly corrupt formal institutions, corruption has not reduced market competition in most major provinces, with exception of Balkh, and therefore, has not impeded the provision of trade credit. This divergence is likely due to the risk-sharing-enabling feature of trade credit which reduces the barriers to entry in the supply chains, making trade credit most prominent in the supply chains in Afghanistan.

### **3.1.1. Market Competition and Provision of Trade Credit**

Afghan merchants can easily access credit inside Afghanistan. Sellers/creditors provide trade credit because buyers/debtors have more market power. Interviewed sellers/creditors indicate that

the reason they have to sell on credit, despite the fact that most payments are delayed, is market competition.<sup>674</sup> This finding is unexpected because in the literature it is often argued that in places where informal institutions prevail, high barriers to entry lead to better access to credit for insiders by solving the problem of credible commitment.<sup>675</sup> However, in Afghanistan, interview data suggest that in places where barriers to entry are lower, because of geographical location and/or the presence of a well-developed *Sarrafi* market, credit sales are more common.<sup>676</sup> Highly competitive supply chains give buyers/debtors more market powers in provinces with lower barriers to entry forcing, sellers/creditors to supply trade credit and bear the risk of an uncertain business climate to retain customers.

In Afghanistan, most consumers are very poor, therefore, it is difficult for Afghan merchants to distinguish their products by a factor other than price and credit. This may explain why the competitiveness of the market has not caused a competition for innovation and increase in quality. Instead, it has caused a competition toward price-cutting and providing better credit terms. Cash sales are associated with the markets with higher barriers to entry. Interview data suggest that only those sellers who have a quasi-monopoly in their respective markets can require their buyers to pay in cash without experiencing fewer sales. For example, a tire cap producer in Herat said that he only sells on cash.<sup>677</sup> “I can sell on cash without losing customers because I am the only producer of this product.”<sup>678</sup>

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<sup>674</sup> This finding is based on author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>675</sup> See, e.g., for example Clay (1997a), *supra* note 134, at 224; Clay (1997b), *supra* note 134, at 34.

<sup>676</sup> See 3.2.10.

<sup>677</sup> Author’s interview with the owner of manufacturing business at Herat (April 2017).

<sup>678</sup> *Id.*

The hypothesis that market competition is the main cause of an increase in credit sales is supported by the observation that credit sales are the norm in each of the five research sites with the exception of Balkh. As explained in Chapter Two, Balkh has the most monopolistic economy of the five major provinces studied here (measured by per capita business registry). Balkh has an underdeveloped *Sarrafi* market, which means there is a higher capital requirement for sellers/creditors. Balkh also borders with the Central Asian countries. It is harder for sellers/creditors to establish relationships with suppliers located in Central Asian countries because due to history of communisms in those countries, states still have large control in the market and competition is very low (Turkmenistan, Uzbekistan, and Tajikistan). This means only a limited number of Afghan creditor/sellers have the capital and connections to establish business relations and import products from Central Asian countries. In contrast, Herat, Nangarhar, and Kandahar are located on the border of either Iran or Pakistan, where, for reasons which will be examined later, it is easier for Afghan sellers/creditors to establish business connections and import products. In short, barriers to entry are lower in Herat, Kandahar, Nangarhar, and Kabul compared to Balkh due to their different geopolitical and geo-economic positioning, as well as their access to a well-developed *Sarrafi* market. This dissertation will return to the case of Balkh in the discussion of *Sarrafi* markets.

### **3.1.2. Weekly Payment System (*Ugrae*)<sup>679</sup>**

Sellers/creditors are paid for their credit sales through a weekly payment system, “*ugraee*”. *Ugrae* is basically a system of payment and a revolving line of credit. Under the *ugraee* system, a

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<sup>679</sup> The description of Weekly Payment System of (*Ugrae*) in Afghanistan presented here is based on typical facts reported by the interviewees in the author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

buyer/debtor purchases a product without immediate payments in exchange for a promise to make weekly payments that are made on a certain date at the end of every week. Buyers/debtors need to make weekly payments to receive further sale credit, however justified short-term delays are common and often excused. This is why when either party, seller/creditor or buyers/debtors, exists the markets, weekly payments are often discontinued, and disputes are likely to arise.

When a seller/creditor exits the market, the buyers/debtors do not have an incentive to continue making weekly payment as the supply of the product is discontinued. Additionally, the buyer/debtor will have to redirect weekly payments to a new supplier or another extant supplier to ensure continued supply of the product. If a buyer/debtor exits the market, the seller/creditor does not have a reason to excuse delays because the sellers/creditors do not expect further sales to existing buyers/debtors. Additionally, existing buyer/debtors poses a greater risk of non-payments due to their diminished incentive to pay (they no longer value the relationship anymore). Thus, the prevailing supply chain structure locks parties into existing supply chains creating market inefficiency.<sup>680</sup>

*Ugrae* is a tool that imposes financial discipline on the buyers/debtors. As a weekly payment system, *ugraee* has the following objectives: (1) to reduce the time lag between when a product is sold and when the seller/creditor is paid, so the buyer/debtor is not able to use the money for other purposes; (2) to reduce the amount of each weekly installments to a manageable amount so that the buyer/debtor is able to pay; (3) to stay informed of the financial status and solvency of the buyer/debtor—collecting these weekly payments most often means that the seller/creditor or his agent visit the buyer/debtor place of business every week. This way if a seller/creditor notices that buyer/debtor has sold the products, but he is not paying him in order to make payments to

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<sup>680</sup> The consequences of prevailing supply chain structure for innovation is discussed in Section 3.1.6.

other sellers/creditors, or because he is about to go bankrupt or exit the market, seller/creditor may discontinue his sales to the buyer/debtor, or in rare cases, repossess his products. In short, for sellers/creditors, *ugraee* is a tool to impose financial discipline on the buyers/debtors.

*Ugrae* is a very pervasive system; most interviewees said they operate under the *ugraee* system. However, the system is most visible within supply chains. The weekly payment system is so pervasive that it has conditioned the whole economy, even in the sectors where it is not necessarily used. For example, it has become a norm that creditors cannot expect repayment of debts in early in the week because it normally takes several days for the money, coming from cash sales to consumers, to get channeled through retailers and wholesale distributors, where it is accumulated and paid to importers and producers. This weekly payment system is part of the reason why *Sarrafs* need to give their clients short-term working capital loans—although they are not called loans—so they can meet their financial requirements to the suppliers located outside of Afghanistan where the flexible weekly payment system is not in place. These short-term working capital loans are often paid back using the weekly payment system.

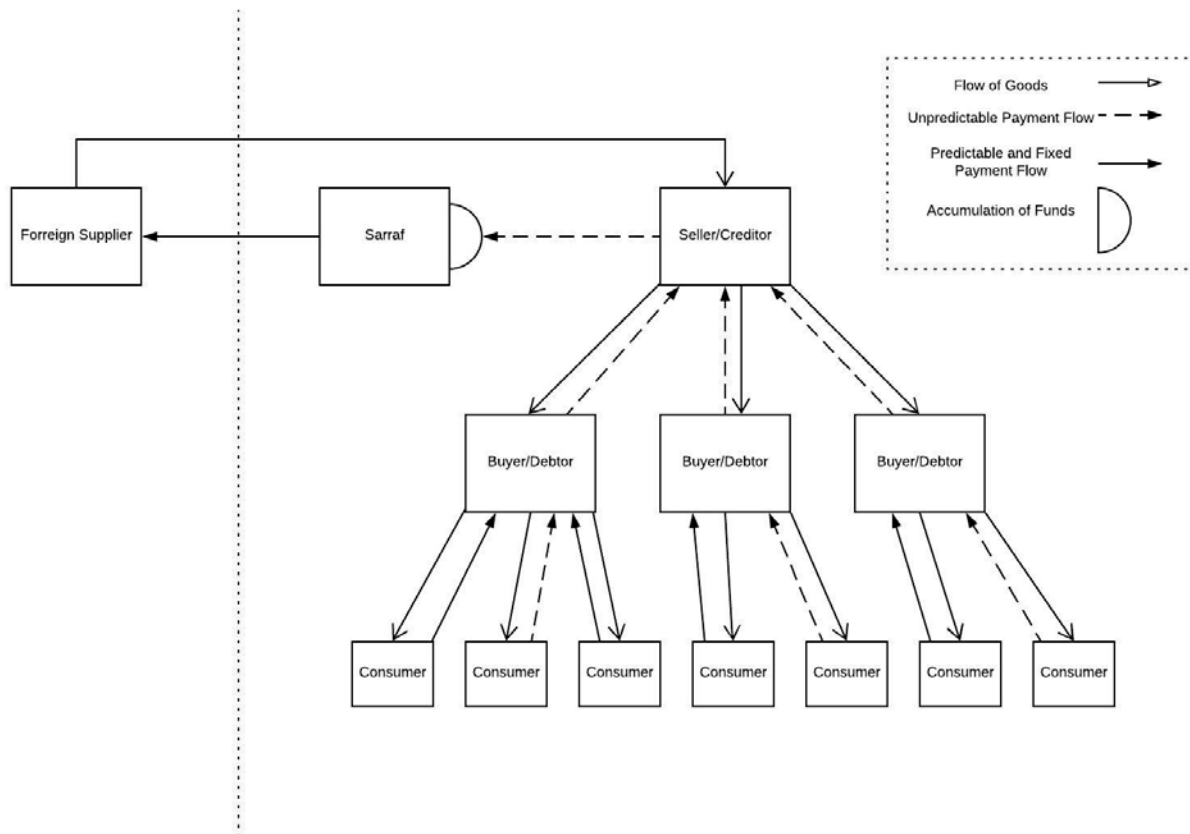


Diagram 2 Supply Chain Financing in Afghanistan<sup>681</sup>

### 3.1.3. How Businesses Come to Trust Credit Sales in Afghanistan<sup>682</sup>

It is not hard for a debtor/buyer to obtain trade credit inside Afghanistan (it is also not hard for sellers/creditors to obtain working capital loans from *Sarrafs*). Most dealings in Afghanistan are conducted based on “*shenakht*” i.e. knowing. It means a buyer/debtor can receive credit as long as the seller/creditor thinks that he can be trusted. There are a number of ways that *shenakht* can be

<sup>681</sup> Constructed by the author based on typical facts reported by the interviewees in the author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>682</sup> The description of the process of credit sale in Afghanistan presented here is based on typical facts reported by the interviewees in the author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

established. A buyer can start buying in cash and establish a relationship. Or a buyer has a personal link to the seller, i.e. they are friends, related, neighbor, part of a *qawm* (an imagined community of people with a common ancestor), etc., which enables a buyer to establish *shenakht* based on an existing relationship. Most commonly, however, it suffices that a buyer owns or runs a store or a place of business in a local marketplace. Buyer may also establish a relationship by using “*wasata*” or an intermediary, to make the connection with the seller.

Although all four means of acquiring *shenakht* are used in the five regions studied, there is variation among cases. When asked how they determine to sell to someone on credit, interviewees in Nangarhar attributed greater weight to the fact that the buyer/debtor has presence in the marketplace, meaning usually that the buyer/debtor has a store or a place of business in the market.<sup>683</sup> This implies a much more physical conception of market and business partners. Interviewees in Herat and Kabul talked about credit relations in a much more abstract way.<sup>684</sup>

When asked about problems with payment, most interviewees in Nangarhar responded that they were concerned primarily with the end-of-business nonpayment.<sup>685</sup> They assumed that the only occasion when a debtor/buyer will not pay is when he has left the market, e.g. has sold his store and his house (again a much more physical sense of market and credit relationship). They assumed that the person could not refuse to pay and still be active in the market. Because of this assumption, when they were asked under which conditions they would go to courts, they listed only non-payment and cases of insolvency. This is consistent with the data on the use of

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<sup>683</sup> Author’s interviews with merchants in Nangarhar (May 2017).

<sup>684</sup> Author’s interviews with merchants in Herat (April 2017) and author’s interviews with merchants in Kabul (Kabul, June 2017).

<sup>685</sup> Author’s interviews with merchants in Nangarhar (May 2017).

commercial courts discussed in Chapter Two. Of five major provinces, as discussed in Chapter Two, Nangarhar has one of the lowest rates of court use.

The fourth means of establishing *shenakht* is *wasata*. *Wasata* literally means the middle one or connector or intermediary, and it refers to the practice whereby a person uses his *shenakht* with a seller/creditor to vouch for a buyer/debtor who does not have a direct *shenakht* with that seller/creditor. The use of *wasata* allows people to get access to each other's social and business networks. Customarily this intermediary does not guarantee the payment, however *Sarrafs* when acting as *wasata* sometimes do guarantee the payment. Although the intermediary does not usually promise to make the payment if the debtor/buyer fails to pay the *wasata* will be called upon to locate and pressure the buyer/debtor if the buyer/debtor delays a payment or defaults. The assumption is that buyer/debtor values his relationship with the *wasata* enough that buyer/debtor would pay to avoid embarrassing the *wasata*. If buyer/debtor fails to pay, the *wasata* will lose his credibility in the market and in his social circle. In other words, the intermediary extends his reputation and social status to the buyer/debtor, so actions of buyer/debtor reflect on the *wasata* as well.

*Sarrafs* are the most reliable *wasata*—mostly because they are believed to be capital-rich and very protective of their reputation. *Sarrafs* provide *wasata* services using soft and hard methods. In soft methods they, like most other *wasata*, just call up a seller/creditor to make an introduction. In the hard method, *Sarrafs* guarantee the payment. They issue written guarantee letters—these are usually in form of post-dated checks. Before the recent economic slowdown, when the economy was booming, these post-dated checks could have been discounted to obtain

cash at any moment, but as the market slowed down the discounting of *Sarrafs'* checks became less common and, in some markets, it has been banned.<sup>686</sup>

Interview data suggest that *Sarrafs'* checks are used more often to guarantee payments among parties that cannot secure a credible relationship using *wasata*, past dealings, or personal relations, and do not operate in the same marketplace.<sup>687</sup> This means *Sarrafs'* checks are most common in sectors that involve one-time large deals between non-repeating parties. *Sarrafs* rely on their extensive nationwide networks to facilitate credit dealings between businesses that do not have direct relationships with each other. They provide devices that are comparable to a domestic Letter of Credit.

Written guaranties—which would be a legally enforceable guaranty in courts<sup>688</sup>—are not common in Afghanistan. With the exception of *Sarrafs'* post-dated checks, in Afghanistan's context, it is most common for a guarantor, e.g. a *wasata*, to verbally vouch for a debtor/buyer. Most guaranties are conducted verbally, in local vernacular called *lafzy* (adj. *lafzy*; noun. *lafz*). *Lafz* literarily means “word” but it has a stronger connotation akin to the English phrase of “giving your word” as a promise to someone.

Kabul interview data suggests that the use of written guaranty is also sector-variant.<sup>689</sup> Construction companies are required to provide a letter of guarantee issued by a bank to the government or international organization which solicit most of the construction contracts. Construction companies, in turn, require the subcontractors to provide them with written

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<sup>686</sup> Author's interview with the President of Herat *Sarrafi* Market (Herat, April 2017).

<sup>687</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>688</sup> See discussion of court enforcement of written and verbal contracts in Chapter Two.

<sup>689</sup> Author's interviews with merchants in Kabul (June 2017).

guaranties, as one Kabuli construction company owner said.<sup>690</sup> The same interviewee also mentioned that they require major subcontractors to deposit cash as a guaranty.<sup>691</sup> The use of cash as guaranty shows the ineffectiveness of other forms of guarantee that require extra steps, either judicial or non-judicial, before enforcement can be achieved.

Construction companies can require written and/or cash guaranties because they have considerable market power in relation to their subcontractors. To acquire a construction deal as a main contractor requires substantial resources and strong connections. The number of construction companies that can secure large construction deals are limited. The market for large construction and logistics deals is essentially an oligopoly (mostly dominated by well-connected players). The subcontracting market, on the other hand, is very competitive. It is much easier to enter into the subcontracting market for logistic and construction contracts. This creates a situation where large construction companies have a lot of leverage against subcontractors and can demand terms that are very favorable towards them. This is why large construction companies can demand cash deposits as guaranty before giving out a subcontract deal.

Interview data reveals that ethnicity (*qawm* i.e. an extensive network of imagined blood relations, and *madhab* (i.e. belonging to Shi'ta or Sunni religious grouping)) differences are NOT impeding trade in Afghanistan.<sup>692</sup> Inter-ethnic, inter-*qawm*, and inter-*madhab* dealings are the

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<sup>690</sup> Author's interview with the owner of a construction company in Kabul (June 2017).

<sup>691</sup> *Id.*

<sup>692</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

norm of business in all research sites. Ethnicity, *qawm*, and madhab not only fail to constrain trade, they actually facilitate trade.<sup>693</sup> They facilitate credit transactions by providing *shenakht*.<sup>694</sup>

### 3.1.3.1. Non-Afghans Are Disadvantaged as Credit Transaction Partners<sup>695</sup>

Institutions supporting credit transactions in Afghanistan are effective and inclusive for those who are part of Afghan society. Afghan buyers/debtors have easy access to trade credit from sellers/creditors located inside Afghanistan as long as buyers/debtors are part of Afghan society. A buyer/debtor does not have to be an insider with relation to a certain market, a certain ethnic group, or a certain province to obtain trade credit. Research for this dissertation shows it is not difficult for a buyer/debtor to draw on a cross-section of personal, social, economic, and/or financial networks of *Sarrafs* to obtain credit from a seller/creditor that occupies a distant social, ethnic, or even geographical position inside Afghanistan.<sup>696</sup> Conversely, if a debtor/buyer is not part of Afghan society, for example, a debtor/buyer who is a non-Afghan doing business in Afghanistan, he would be at a disadvantage.

A non-Afghan's disadvantage stems from his higher information costs and his lack of credibility. A non-Afghan merchant can partly remedy his informational disadvantage by residing in Afghanistan. However, he can only partly solve the problem because some sources of information stem from a range of social relations that even a resident non-Afghan cannot access (e.g. being a *qawm*-member). If a non-Afghan has a significant presence in Afghanistan, he will

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<sup>693</sup> *Id.*

<sup>694</sup> *Id.*

<sup>695</sup> The description of process of credit transaction in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>696</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

have more access and some of his disadvantage will be reduced. However, because institutions supporting credit transactions in Afghanistan rely heavily on social connections and the rich inflow of information that stems from those connections, a resident non-Afghan is still at a disadvantage.

Under this system, a non-Afghan is simply a less credible credit-transaction partner. The informal institutions that support credit transactions in Afghanistan rely on a stable connection between a debtor/buyer and a locality within Afghanistan. They assume that an Afghan buyer/debtor cannot just leave the whole social system, however a non-Afghan can. This reduces the ability of a non-Afghan to credibly commit. Formal contracts may help reduce the problem of credible commitment for a non-Afghan, however, it can only partially do so. Several interviewees in Kabul<sup>697</sup> and Kandahar mentioned that they were owed by foreigners doing business in Afghanistan.<sup>698</sup> The foreign debtor left the country without paying and they had no recourse against them. One interviewee said, “Afghan government was no help. I tried to sue him in Turkey, but it did not work.”<sup>699</sup> In short, institutions supporting credit transactions in Afghanistan are most often only effective and inclusive for those who are part of Afghan society.

A non-Afghan seller/creditor is similarly at a disadvantage because he does not have full access to the institutions that ensure the enforcement of credit transactions. A non-Afghan can remedy his outsider-status through partnership with a local Afghan merchant. This way a foreigner can gain access to the networks of the local partner and remedy his outsider status. This is why it is common for foreigners to form partnership with local Afghans. This often facilitates transfer of know-how in Afghanistan.

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<sup>697</sup> In an interview with the author, the owner of a construction company talked about an American contractor refusing to pay and leaving the country and his failed attempt to collect the debt. Author’s Interview with the owner of a construction company in Kabul (June 2017).

<sup>698</sup> Author’s interview with a Kandahari Merchant (July 2017).

<sup>699</sup> Author’s interview with a Kandahari Merchant (July 2017).

While some countries require foreign investors to form joint ventures as a condition of entering their domestic markets (a rule designed to facilitate technology and know-how transfer),<sup>700</sup> in Afghanistan the same effect is achieved through informal means. The informality of Afghan business forces foreigners to do business in partnership with local merchants which results in transfer of know-how and technology. Most often Afghan partners split from the foreign investors and create their own business or force out the foreign investors and gain control of the joint business. (I personally worked for a number of Afghan businesses as an accountant, and this is exactly what those businesses did.)<sup>701</sup> This dynamic points to the negative effect of the informality of the Afghan market when it comes to foreign investors: they have very limited power in relation to their domestic partners, and it disincentivizes entrance into Afghan markets by foreign investors. As such, Afghanistan needs to improve the legal protection of foreign investors to incentivize foreign investment in Afghanistan. This is another reason that improvement of formal dispute resolution institutions and depersonalization of business relations are necessary for long-term economic growth in Afghanistan.

### **3.1.3.2 Outsourcing of Buyers/debtors' Vetting and Debt Collection**

The research conducted for this dissertation shows sellers/creditors in Afghanistan do not outsource debt collection and vetting of buyers/debtors.<sup>702</sup> Sellers/creditors could outsource debt collection by using independent sale representatives who would vet buyer/debtor, collect the

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<sup>700</sup> See, e.g., GUOQIANG LONG, CENTER FOR GLOBAL DEVELOPMENT, CHINA'S POLICIES ON FDI: REVIEW AND EVALUATION 316 (2005), <https://www.cgdev.org/sites/default/files/9780881323818-Ch12.pdf>.

<sup>701</sup> This finding is based on author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>702</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

weekly payments, and bear the risk of irregular payments and/or non-payments, in exchange for a commission fee. This way, theoretically, sellers/creditors would be able to receive regular payments in predictable amounts in exchange for a premium. However, sellers/creditors, in Afghanistan, do not outsource vetting and debt collection.

There is a market gap here. Given the high cost of collecting debt, and the prevalence of the *ugraee* payment system in Afghanistan, one would expect sellers/creditors be eager to outsource debt collection and vetting of buyers/debtors. Sale representatives could arguably operate with lower marginal cost, taking advantage of the economies of scale and pooling of information. One would expect to see a great market for debt collection in Afghanistan, but that market has not developed yet. There is only one company, Bamsa, which collects debt and vets buyers/debtors as an independent business.<sup>703</sup> However, this company was established with the foreign aid funding, and it works only with consumer-buyers who are mostly government employees.<sup>704</sup> They ensure repayments of the debt by reaching an agreement with the governmental departments to subtract the payments from the buyers' salaries.<sup>705</sup>

A small percentage of sellers/creditors do use sale representatives who work on commission for marketing and sales. Only three interviewees mentioned that they use sales representative to sell their products, one in Kabul, one in Kandahar, and one in Balkh.<sup>706</sup> But these sale representatives do not bear the risk of irregular and/or non-payments.

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<sup>703</sup> See Website of Business and Marketing Services Agency of Afghanistan (last visited June 1, 2018), <http://www.bamsa.org/>

<sup>704</sup> *Id.*

<sup>705</sup> *Id.*

<sup>706</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

There may be several reasons as to why debt collection markets have not developed in Afghanistan. One reason for the absence of a debt collection market in Afghanistan is the personal nature of the debt. The debt is not easily transferable in Afghanistan, either legally or practically. Legally, it is complicated to transfer debt under Afghan laws.<sup>707</sup> But, as this dissertation has shown, law does not have much bearing on how businesses operate. Practically, buyers/debtors establish relationships with the sellers/creditors. This relationship is more like a risk-sharing and mutual cooperation arrangement without strict allocation of risk. This creates a problem for assigning debt to someone else because, in this context, debt is not a strict monetary claim against the debtor, but rather an uncertain financial interest. Furthermore, credit relationships are very personal. People care very much about with whom they work and to whom they owe money and who comes to their place of business to collect debt. As a Herati merchant stated, “our customers do not like anyone showing up at their place of business asking for payment.”<sup>708</sup>

### **3.1.3.3. Use of Written Contracts<sup>709</sup>**

Another institutional feature of business in Afghanistan which facilitates credit transactions is written contracts. Interview data reveal the following about the use of written contracts in Afghanistan’s business context. First, putting things in writing has an important symbolic significance. It could be surmised from interview data that making people sign a written document invokes a higher internal commitment. Afghans seem to take their written commitments more seriously. It is an interesting way of solving the problem of credible commitment. Merchants can

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<sup>707</sup> See PRINCIPLES OF COMMERCIAL LAW, *supra* note 539; AFGHANISTAN CIVIL CODE, *supra* note 503.

<sup>708</sup> Author’s interview with a hygiene product importer in Herat (April 2017).

<sup>709</sup> The description of use of written contracts by Afghan merchants in Afghanistan presented here is based on typical facts reported by the interviewees in the author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

often obtain trade credit that they otherwise would not have access to by signing a written paper saying that they will make payments on time.

The internal and symbolic force of written commitments is reinforced with an external enforcement mechanism as well. Interview data suggest the reason merchants sometimes put their dealings in writing is to make the transaction verifiable. Therefore, merchants are more likely to use written contracts when they believe they will likely need to prove the transaction to a third party. This third party may be, but is not necessarily, a court. In fact, when it comes to commercial disputes, most often the third party to which the merchants will refer their dispute is another merchant, or a group of merchants, who are willing to mediate the dispute.

Merchants are more likely to use written documents if they do not know the other party well enough, when the contract is complicated and is for a long time, and if the other person's financial status is a concern. Similarly, interview data show that it is common practice for a creditor to obtain a written certification of the debt after default in exchange for a discount or extension on the term of debt as part of intraparty negotiations. This is because the creditor is expecting that he will need to prove the debt and default in front of a third party at that point, whether a court or a union or a *jirga*, so having a written certificate will be useful.

There is variation among cases studied here when it comes to the use of written contracts. Kabulis, Heratis, and Balkhis are more likely to use written contracts.<sup>710</sup> Kandaharis and Nangarharis are less likely to write down their agreements.<sup>711</sup> There is an aversion to the use of written contracts in Nangarhar. Unlike Kabul, Herat, and Balkh where the use of written

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<sup>710</sup> Author's interviews with merchants in Kabul (June 2017), author's interviews with merchants in Herat (Herat, April 2017), and author's interviews with merchants in Balkh (May 2017).

<sup>711</sup> Author's interviews with merchants in Nangarhar (May 2017), and Author's interviews with merchants in Kandahar (July 2017).

agreements, such as written contracts, receipts, or checks are common, in Nangarhar there seemed to be a unanimous aversion to the use of written contracts.<sup>712</sup> As one Nangarhari merchant said, “People do not like to sign papers here. I cannot ask a customer to even sign the invoice let alone a contract.”<sup>713</sup> Based on interview data, this dissertation hypothesizes it is because the use of written contracts implies distrust and suspicion which is more strongly frowned upon in Pashtun culture—the dominant culture in Nangarhar which is a predominantly Pashtun province. This would also explain why Kandaharis, who are also predominately Pashtun, exhibit a similar aversion—although not to the same degree.<sup>714</sup>

The low rate of use of written and signed documents in Kandahar and Nangarhar, which is instrumental in formal dispute resolution proceedings, can also explain why these two provinces have considerably lower rate of per capita use of court. The low court-use rate in Kandahar and Nangarhar is discussed in greater detail in Section 3.5.5.

It should also be noted that the worsening of market conditions and increased risk of disputes affect the willingness of merchants to use written contracts. Interviewees reported that the use of written contracts has increased in the market because the economy has slowed down and credit dealings entail a higher risk. As the owner of a construction company in Kabul said, “In the past we only worked verbally (i.e. *laphzy*) but some people denied that we gave them marble. For example, we had sent three shipments they said they only received two. Now, we use written contracts where we specify the time of payment and number of shipment.”<sup>715</sup> He added, “Written

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<sup>712</sup> Author’s interviews with merchants in Nangarhar (May 2017).

<sup>713</sup> Author’s interview with a Nangarhari merchant (May 2017).

<sup>714</sup> Author’s interviews with merchants in Kandahar (July 2017).

<sup>715</sup> The facts reported in this paragraph is based on author’s interview with the owner of a construction company in Kabul (June 2017).

contracts are better. You are surer when you have a written contract. We wouldn't use it in courts but when there is a written contract the other party fears and complies. Also, if we decided to go to third party it is easy to prove the other party cannot deny it." He further stated, "we also add to the contract the condition for termination of contract. That helps too." He expressed, "if you have only a verbal contract, there is nothing you can do."

### **3.1.4. Trade Credit versus Bank Loans<sup>716</sup>**

As explained in Chapter One, the trade credit literature generally argues that sellers/creditors are better positioned, compared to banks, to issue credit because they have access to better information, and they have lower liquidation costs. Because sellers/creditors operate in the same market as their debtors/buyers, they have access to low-cost information about the financial status of their debtors/buyers, and also can resell the products should the buyers/debtors default. The former is true in Afghanistan, however the latter is not. Sellers/creditors in Afghanistan have continued interaction with debtors/buyers through *ugraee*. They also receive reputation information faster and cheaper since they operate in the same marketplace, and the same sector, as their debtors/buyers. Compared to banks, sellers/creditors have access to better and lower-cost information on financial status of debtors/buyers and their prospect of payments (as explained above, banks try to remedy their informational disadvantage by resorting to "relationship banking"). Conversely, in Afghanistan, lower liquidation costs cannot explain the difference between the ability of sellers/creditors and banks to evaluate debtors. This is because, according

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<sup>716</sup> The description of process of credit transacting in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

to interview data, repossession of sold goods is rare.<sup>717</sup> In Afghanistan, a seller/creditor cannot expect to be paid if the product has not been sold. This means that as long as a product is in the possession of a buyer/debtor, i.e. it is not sold, the creditor/sellers cannot expect to be paid. Therefore, repossession is not a remedy for default; instead, it is a precondition for payment.

Yano and Shiraishi argue that trade credit is efficient because profitability is more strongly linked with the trade credit than with bank loans.<sup>718</sup> Their research corroborated Fisman and Love's findings<sup>719</sup> that smaller firms have more difficulty obtaining trade credit because they have not established yet a reputation; however, they found that profitability and access to trade credit is more strongly linked for medium and small firms compared to large firms.<sup>720</sup> This means that credit helps with entrance and survival of small and medium size firms. Medium size firms are most helped with trade credit because they also have the reputations.

The case of Afghanistan confirms Yano and Shiraishi's findings<sup>721</sup> that trade credit is helping small and medium-sized firms, which are buyer/debtor, enter the market and survive. On the relative profitability of beneficiaries of trade credit and banks' loans, the data is not conclusive in Afghanistan. However, the data suggests that large businesses, who are the borrowers of banks' loans, are more profitable than smaller businesses in Afghanistan, businesses that are receivers of trade credit, in Afghanistan.<sup>722</sup> Therefore, in Afghanistan, bank loans may be more strongly correlated with profitability. This is expected because banks are very discriminating in issuance of

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<sup>717</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>718</sup> Yano & Shiraishi, *supra* note 165, at 131.

<sup>719</sup> Fisman & Love, *supra* note 174, at 355.

<sup>720</sup> Yano & Shiraishi, *supra* note 165, at 131.

<sup>721</sup> *Id.*

<sup>722</sup> Chapter Four discusses bank loans.

bank loans in Afghanistan. In China, on the other hand, banks are inclined to issue loans to State-Owned Enterprises which are less productive compared to private enterprises which rely on trade credit.<sup>723</sup>

Cull, Xu, and Zhu, in their research of formal finance and trade credit during China's economic transition, found that State-Owned Enterprises as well as profitable private firms did lend-on part of the loans they received from banks to their customers which made the allocation of resources by banks more efficient, however, according to their research, the size of this lend-on was not significant enough to explain Chinese economic growth.<sup>724</sup> Other institutions, either formal or informal, must have played more important roles, they concluded.<sup>725</sup> In Afghanistan, lend-on does not seem to be as important given the small share of bank loans as a source of capital.

Demirgiu-Kunt, & Maksimovic studied the role of firms as financial intermediaries.<sup>726</sup> They found that from a policy stand-point, lend-on is important because the use of trade credit decreases as legal system improves, meaning that lend-on is a way to make up for a weak legal system where a sizable banking market is present.<sup>727</sup> In the case of Afghanistan, this analysis does not hold because Afghanistan does not possess a strong banking sector.<sup>728</sup> In addition, although this research has not collected data on the temporal variation in the use of trade credit, most interviewees reported that over the last few years the demand for trade credit has increased while its supply has decreased.<sup>729</sup> While the quality of the legal system has arguably improved over the

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<sup>723</sup> See Yano & Shiraishi, *supra* note 165, at 131.

<sup>724</sup> CULL ET AL., *supra* note 181, at 21.

<sup>725</sup> *Id.*

<sup>726</sup> See DEMIRGU-KUNT & MAKSIMOVIC, *supra* note 158, at 1.

<sup>727</sup> *Id.*

<sup>728</sup> Afghanistan's Banking System is discussed in Chapter Four.

<sup>729</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

same period (if one takes the number of judges as a measure), it has not caused the decline in supply of trade credit in Afghanistan. Rather the decrease in the supply of trade credit in Afghanistan has been caused by worsening of market conditions. Worsening of macroeconomic conditions have decreased the willingness of the sellers/creditors to invest (so they do not import or distribute as much), while increasing the risk of debtors/buyers' default. Therefore, the positive correlation in Afghanistan between improvement of the formal legal system and increase in trade credit is spurious.

The research on the relationship between financial crises, and bank loans, on the one hand, and trade credit supply and demand on the other hand, has yielded contradictory findings. Garcia-Appendini and Montoriol-Garriga argued that during the 2007-2008 U.S. financial crisis cash-rich firms provided liquidity to their customers, as bank loan contracted, in the form of trade credit because their opportunity cost decreased.<sup>730</sup> There are other studies that suggest, during financial crises and bank loan contraction, trade credit supply decreases as trade credit demand increases and that net trade credit is positively correlated with bank loans.<sup>731</sup> Whether trade credit is a supply-driven dynamic as shown by the decrease of supply, or a demand-driven dynamic as shown by the increase of trade credit demand at the time of bank loan contraction, is still an open question.

Inasmuch as the relation between trade credit and financial crisis is concerned, Afghanistan is going through a period of economic slowdown. However, the dynamic of Afghanistan economic slowdown is not comparable to those of a developed economy. In Afghanistan's economic slowdown is mostly caused by an increase in insecurity, political instability, and decrease in the inflow of foreign aid. It would be impossible to draw a correlation between contraction of banks

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<sup>730</sup> Garcia-Appendini & Montoriol-Garriga, *supra* note 184, at 290.

<sup>731</sup> Ahmad et al., *supra* note 185, at 97.

loans and economic slowdown as banks play limited role in capital market to begin with. However, interview data suggests that as the economy slows down, buyers/debtors demand more trade credit, while seller/creditor contract the provision of trade credit.<sup>732</sup> In the meantime, it seems that seller/creditor demand for working capital loans from *Sarrafs* increase so they can continue to provide trade credit albeit at a lower rate.<sup>733</sup>

The pervasiveness of trade credit in Afghanistan means that Afghan economy is very vulnerable. Trade credit, compared to bank loans, is not well diversified because buyers/debtors are the customers of sellers/creditors.<sup>734</sup> If a sector experiences slowdown, there will be a ripple effect through the whole economy affecting buyers/debtors, sellers/creditors, and *Sarrafs*. This makes the Afghan economy very vulnerable to sectoral shocks.

### **3.1.5. Sources of Initial Capital to Start a Business<sup>735</sup>**

Almost all interviewees reported that they use the revenue from their previous business ventures as initial capital for their current business.<sup>736</sup> Merchants start small, most often as a retailer, which requires little capital, and then if successful, they grow by reinvesting their earnings and by increasing their debt/capital ratio. This suggests that businesses grow along very narrow market paths. For example, a successful businessman runs a store where he sells shampoo bought on credit from a seller/creditor. Next, he expands and becomes a wholesale distributor who distributes

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<sup>732</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>733</sup> *Id.*

<sup>734</sup> See Raddatz, *supra* note 159, at 986.

<sup>735</sup> The description of source of Merchants' initial capital in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>736</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

shampoo bought on credit from domestic sellers/creditors wholesale. Next, he becomes an importer of shampoo, and in rare cases, he may advance to become a shampoo producer. This means that existing markets become highly competitive and new markets do not get created. It is very difficult to find someone to finance a new idea. Similarly, it is extremely difficult to secure long-term loan to enter into a new market.

Bank loans are very difficult to secure without valuable real estate with a formal deed and, as seen in Chapter Two formal deeds are scarce in Afghanistan.<sup>737</sup> Although the law provides for the use of movable property as collateral for banks' loans,<sup>738</sup> *de facto*, banks in Afghanistan only accept real estate as collateral.<sup>739</sup> Afghanistan has created an online registry for registration of immovable property as collateral, but the project has generally been unsuccessful.<sup>740</sup>

Banks only accept real estate as collateral because it is easier to collect against real estate. Once it is formally registered as a collateral, banks, in the event of default, can bring an action to liquidate the real estate regardless of which person has possession. The purchase of a real estate under the name of a business is not common in Afghanistan—with exception of purchase of land for a factory. Manufacturers can only purchase land in an industrial town as a corporation. The fact that most businesses in Afghanistan do not own real estate means that to receive a bank loan, a person must put down his personal property as collateral. This represents a high degree of risk.

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<sup>737</sup> Bank loans are discussed further in Chapter Four.

<sup>738</sup> See LAW ON USE OF MOVABLE PROPERTIES AS COLLATERAL IN BANKING TRANSACTIONS, *supra* note 645.

<sup>739</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>740</sup> Da Afghanistan Bank's Public Credit Registry Department has set up a website where institutional and non-institutional users could check the existing security rights. However, until the date of writing this dissertation (May 2018), the website was not working. See Da Afghanistan Bank's Public Credit Registry, <https://pcr.gov.af/>.

In addition, in a business with a multiple equity partners, it would require one partner to accept higher risk—this is what a Kabuli merchant said.<sup>741</sup>

Even if a business or an equity partner owns real estate and is willing to use it as a collateral, banks only accept it if the owner has a formal deed. As explained in Chapter Two, in Afghanistan, formal deeds are scarce. Afghanistan lacks a property registry.<sup>742</sup> Most real estate is bought and sold informally without registration. Several decades of civil war and immigration mean that those who possess property may not be the actual owner. It is common for estates to go several generations without being divided and distributed among inheritors. In short, it is very difficult to verify someone's title over a real estate property, therefore, reliable formal deeds are scarce. Even if someone can secure a formal deed, the interest rate and the terms of payment render bank loans unappealing, according to interviewees.<sup>743</sup> *Sarrafi* long-term interest-bearing loans are easier to obtain but the interest rates are even higher.<sup>744</sup>

There is an added difficulty when it comes to borrowing from banks: banks require merchants to adhere to inflexible repayment schedules backed by threat of formal legal actions. Merchants sell on credit and take in highly unpredictable payments. It is very difficult for them to adhere to an inflexible repayment schedule. This is why they prefer trade credit and *Sarrafs'* loans.<sup>745</sup> Trade credit is the most flexible, however *Sarrafs'* loans payments are more flexible than bank payments.

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<sup>741</sup> Author's interview with a cell phone merchant in Kabul (June 2017).

<sup>742</sup> See Chapter Two for a more detailed discussion of Afghanistan Property Rights System.

<sup>743</sup> Bank loans further in Chapter Four.

<sup>744</sup> It is further discussed later in this Chapter.

<sup>745</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

Interview data also confirms that low financial literacy among the owners of Afghan businesses is impeding their access to bank loans.<sup>746</sup> A Kabuli merchant said, “the reason Afghan merchants do not take bank loans, but have no problem taking loans from *Sarrafs*, is poor management. They cannot work with banks but *Sarrafs* use old fashioned accounting and relation-based business, so Afghans are more comfortable working with *Sarrafs*.”<sup>747</sup>

Afghan businesses are also less likely to hire trained accountants. This may be the reason that they are not equipped to work with banks in terms of producing the required financial and business documents and reports. Poor financial management within Afghan businesses, in turn, makes it difficult for banks to assess loans’ applicants and/or measure risk. Compounding the problem is that, according to several reports, Afghan banks have limited institutional capacity to assess loan applicants and measure risk.<sup>748</sup> In addition, Afghan banks lack sufficient qualified staff that could review and assess loan applications and measure risk.<sup>749</sup> The low capacity on the side of applicants, along with the limited capacity on the side of banks, is a further constraint on the issuance of bank loans in Afghanistan.

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<sup>746</sup> This finding is based on author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author’s personal observations over several years of his work as accountant in the Afghanistan’s private sector between 2008-2013.

<sup>747</sup> Author’s interview with a Kabuli merchant (June 2017).

<sup>748</sup> See, e.g., CHARAP & PAVLOVIC, *supra* note 652; see also DA AFGHANISTAN BANK, STRATEGIC PLAN 2017-2021, *supra* note 9.

<sup>749</sup> *Id.*

### 3.1.6. Prevailing Institutions in Afghanistan Disincentivize Destructive Innovation and Creative Destruction<sup>750</sup>

Schumpeter identified creative destruction as a solution to the problem of diminishing return and an important source of sustained economic growth.<sup>751</sup> The probability of a destructive innovation in Afghanistan is very low because those who have the capital are invested in maintaining the existing supply chains and those who do not have the necessary capital cannot obtain financing except within existing supply chains.

The easiest way to start a business in Afghanistan is to enter the supply chain as a retailer.<sup>752</sup> Newcomers have to move up within existing supply chains because they can only rely on trade credit to start a business and to grow. Suppliers are willing to extend credit so they can sell already existing products in already existing markets. It is very hard to break through narrow market paths. This is why most merchants in Afghanistan, and many Afghans, complain that “businessmen just copy each other, and no one has a new idea.”<sup>753</sup>

Established businesses that have sufficient capital also have an incentive to stay within existing supply chains because, as sellers/creditors, a significant portion of their capital is locked-in within the existing supply chains. Some interviewees claim that almost half of their capital was

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<sup>750</sup> The description of process of credit transacting in Afghanistan presented here is based on typical facts reported by the interviewees in the author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>751</sup> See generally JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY (1943); Acemoğlu and Robinson have also credited the rise of the West to the change in political institutions that allowed creative destruction to happen. See Acemoğlu et al., *supra* note 225.

<sup>752</sup> This finding is based on author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author’s personal observations over several years of his work as accountant in the Afghanistan’s private sector between 2008-2013.

<sup>753</sup> *Id.*

locked in their receivables.<sup>754</sup> The rough median estimate was one-third.<sup>755</sup> A decision to move out of a supply chain would make it difficult to recover pre-existing receivables because the prospect of discontinuity of supply means that buyers/debtors have reduced incentives to pay. Buyers/debtors would need to replace their suppliers, which means they have to stop or reduce making weekly payment to the existing-suppliers to make payments to a new supplier.

When a seller/creditor exits the market, the buyers/debtors have no incentive to continue making weekly payment because the supply of goods will be discontinued. Additionally, the buyer/debtor will have to redirect weekly payments to a new supplier or another extant supplier to ensure the continued supply of the goods. If a buyer/debtor exits the market, seller/creditor does not have a reason to excuse delays because sellers/creditors do not expect to be able to make additional sales to existing buyers/debtors. Additionally, existing buyers/debtors pose a greater risk of non-payments because they have diminished incentive to pay (they do not value the relationship any longer.)

Nevertheless, business expansion and diversification does happen, as you can see from the list of interviewees, large businesses (most often sellers/creditors) do engage in multiple markets and sectors.<sup>756</sup> However, business expansion and investing in new ideas happen at a lower rate in Afghanistan. The probability of a destructive innovation in Afghanistan is very low because those who have the capital are invested in maintaining the existing supply chains, and those who do not have the capital cannot obtain financing except within existing supply chains. The Afghan institutional settings do not incentivize innovation because they lock both sides into a web of

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<sup>754</sup> *Id.*

<sup>755</sup> *Id.*

<sup>756</sup> *See* APPENDIX I.

interrelated credit networks. Afghanistan institutional settings disincentive productive investments and is bound to lead to economic slowdown.

Interview data suggest that most producers are former traders and/or importers of the products they produce.<sup>757</sup> Ease of access to trade credit domestically, on the one hand, and the difficulty of access to credit outside of Afghanistan, on the other, favors domestic production. However, it has not resulted in the flourishing of an Afghan manufacturing industry. This is because most raw materials have to be imported. Most Afghan manufacturers produce low value-added products: the difference between the final product value and the manufacturing input is not very high. Although domestic producers can easily buy their inputs domestically on credit, most of the necessary inputs are not available in the domestic market.<sup>758</sup>

Furthermore, the larger amount of initial capital required for manufacturing cannot be raised using the Afghan capital market. Manufacturing businesses require a lot of initial capital that the Afghan financial market cannot provide. Banks' and *Sarrafs'* long-term loans are very expensive and hard to secure.<sup>759</sup> In addition to these institutional failures, Afghanistan's manufacturing industry is plagued with corruption and poor infrastructures.<sup>760</sup> In addition, ease of access to credit inside Afghanistan is usually limited to trade credit and working capital loans, not investment financing.<sup>761</sup> These are the reasons why Afghans manufacturers usually only produce products which, if imported, would carry high tariffs and transportation costs, or products that do not require a lot of imported raw materials—such as beverages, dairy products, dried fruits.

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<sup>757</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>758</sup> *Id.*

<sup>759</sup> Bank loans are discussed further in Chapter Four.

<sup>760</sup> *See* Chapter Two.

<sup>761</sup> *See* Section 3.2.7.

### 3.1.7. Agency Costs Limit Business Expansion<sup>762</sup>

Merchants can decide to expand their operations by horizontally through distribution of labor, e.g., outsourcing debt collection or subcontracting a construction project, or vertically by expanding their business organization, i.e., hiring people to collect debt or perform a construction project and monitoring them. Agency cost refers to monitoring cost of ensuring agent acts in the interest of principal.<sup>763</sup> Therefore, agency cost is a useful concept to analyze the pattern of horizontal and vertical business expansion and their relations with prevailing institutions in Afghanistan.

According to economists, the institutions that underpin trade credit transactions determine the cost of horizontal expansion, however, they also affect the choice to use these institutions or internalize their objective operation by expanding a business organization. In short, prevailing institutions will determine whether a business decides to use market institutions (horizontal expansions) or hierarchical organizations (vertical expansion). Coase and Williamson's theories are concerned with explaining this choice.<sup>764</sup>

Afghan businesses face high agency costs because the informality of business relations in Afghanistan means business decisions do not easily lend themselves to external evaluation. In Afghanistan, most agents who are entrusted with financial authority in a business are relatives or people who have been made equity partners.<sup>765</sup> This is caused by high agency costs. The only way a principal can be sure that an employee, at the management level with significant financial

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<sup>762</sup> The description of business practices in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>763</sup> See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3(4) J. FINANCIAL ECON 305 (1976).

<sup>764</sup> See Coase (1988), *supra* note 31, at 4; see also WILLIAMSON (1985), *supra* note 74.

<sup>765</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

authority, would work in the principal's interest is to choose the employee from among current equity partners or to make that employee an equity partner. This is because financial decisions in the Afghan context does not easily lend themselves to objective evaluation.

It is difficult to hold a managerial employee accountable for a decision, e.g. a decision to sell to someone on credit, if payments are inherently uncertain and unpredictable. In this way, the Afghan business context provides ample opportunity for shirking and collusion. Sellers/creditors counter this risk by giving this financial authority to someone who has an equity interest. This is a reason why the separation of management and ownership is rare in Afghanistan.

High agency costs and the personal nature of business also contribute to the low number of national businesses in Afghanistan. (The other main reason is the poor transport infrastructure as discussed in Chapter Two). Most businesses are limited to a single province or a region. Multi-provincial businesses usually have direct personal presence in multiple provinces. For example, an equity partner or a very close friend or relative heads the business in another province. This may be because businesses need personal and direct knowledge of the other market to be able to work in a credit-based market without impersonal institutions.

### **3.1.8. Family Businesses in Afghanistan<sup>766</sup>**

The research presented in this dissertation shows that in Afghanistan, most large sellers/creditors, who make up the majority of sample of interviewees, are family businesses. Virtually all businesses in the sample are family business, meaning that equity owners are members of a single

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<sup>766</sup> The description of family businesses presented here is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

family.<sup>767</sup> Family, for the purpose of family business, generally includes first and second degree male family members, i.e., father, father's brothers (uncle) and their sons, brothers, and sons. Being a family business has several capital and survival advantages in Afghanistan. Family businesses can more easily pool capital. The literature on the capital market in China suggest borrowing money from friends and family is also a main way to raise capital and start a business in China.<sup>768</sup> In Afghanistan, raising capital from friends and families takes the form of equity financing, not debt financing. Members of a family commonly, pool their capital to start or expand a business and they all become equity partners.

Relatedly, family businesses last longer because, in the case of death of an equity partner, his share will transfer to other equity partners (who are each other's inheritors). In Afghanistan, often family businesses are started by one family member, commonly a father or a brother. A father or a brother will make his sons and brothers equity partners to ensure the continuation of the business after he dies. This is critical for two reasons. First, Afghanistan adopts Islamic rules of inheritance which are very egalitarian and anti-capital-accumulation.<sup>769</sup> This means that after an equity partner or founder of a business dies, his estate will be distributed among multiple inheritors. Second, in Afghanistan, separation of ownership and management rarely exist (partly because of high agency cost and informality of economic relations). Most businesses in Afghanistan are manager-owned LLCs, therefore restructuring of ownership, most often, means dismantling the business.

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<sup>767</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>768</sup> See TSAI, *supra* note 126, at 36.

<sup>769</sup> See AFGHANISTAN CIVIL CODE, *supra* note 503, arts. 1993-2102; See also HAMID KHAN, *supra* note 507.

For example, if a merchant dies who has three sons, two daughters, a father, and a mother, they all will inherit a share of his estate according to mandatory rules (this family size is common in Afghanistan). Family businesses ensure the longevity of the business by making all inheritors *de facto* equity partners. While the legal rights of all family members are not often specified, most inheritors *de facto* have some ownership share in the business.

The third advantage of a family business in Afghanistan is related to agency cost. Family businesses in Afghanistan have lower agency cost because they have access to a pool of agents: equity partners and their families (nephews, nieces, and etc.), who are invested in making the business thrive because they either own equity shares or expect to inherit equity shares in the future. Given the advantages of family businesses, large sellers/creditors in Afghanistan are most often family businesses.

In family businesses, women are not generally active equity partners. Most often, women's share of the inheritance is paid from non-business assets (e.g. house or land) or they become silent equity partners. In the latter case, they receive a share of business revenue—most often a smaller share—through irregular payments, but they are not directly involved in running of the business. Sometimes, women can become active equity partners through their husbands, most commonly when their husband is already part of family business as a managerial employee or an equity owner (e.g. when they marry a cousin from their father side).

The positive correlation between being a family business and longevity and growth of a business explains why virtually all interviewees in the sample said that they were from a merchant

family.<sup>770</sup> Given this research mostly comprises sellers/creditors, it can be argued that being a business family, success, and longevity of a business are positively correlated in Afghanistan.

### **3.1.9. Trade Credit from Suppliers Located Outside Afghanistan<sup>771</sup>**

Afghan merchants can easily obtain trade credit from seller/creditors located inside Afghanistan; however, access to trade credit from suppliers located outside of Afghanistan is much more challenging. The many ways that businesses can obtain credit inside Afghanistan (discussed earlier in this Chapter) shows that Afghan businesses have easy access to trade credit inside Afghanistan. However, when it comes to foreign business sellers/creditors, Afghan businesses face many challenges obtaining credit.

Sellers/creditors in Afghanistan who import products from outside the country have to pay almost exclusively in cash. There are two exceptions to this norm: Pakistan and Iran. Sellers/creditors that have a strong presence in either Pakistan or Iran—i.e. those who have lived and done business there or already have companies in those countries—are able to secure short to medium-term trade credit from Pakistan and Iran. This is mostly because a large number of Afghans have a long history of living and working in Pakistan and Iran. In the case of Pakistan, Afghan merchants can only access trade credit in sectors, and with businesses, with which they have established personal relations. This means that they are not able to secure credit from large Pakistani businesses. They can only secure credit from small and medium-sized Pakistani businesses, which conduct their dealings based on personal relations.

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<sup>770</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>771</sup> The description of credit transacting with suppliers located outside of Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

In the case of Iran, only those who have an Iranian checkbook can obtain trade credit. This is because in Iran, checks are the main instrument that are used to back trade credit dealings, according to interviewees.<sup>772</sup> Acquiring a checkbook in Iran requires strong ties, and a long and significant presence in Iran. This is probably why Kandaharis have a hard time obtaining credit from Iran while Heratis and Balkhis are better positioned for it. Herat sits on the border with Iran, and Balkh has a large Shi'a population. Iran, a Shi'a state, provides preferential treatment for Afghan Shi'as.<sup>773</sup>

Even when Afghan sellers/creditors receive trade credit from a foreign business, it is not the same kind of trade credit they issue inside Afghanistan. Credit from foreign businesses is based on a contract that strictly allocates market risk. Afghan sellers/creditors are required to pay for the product that has been imported, regardless of whether the product has been sold or not. This is in direct contrast to the way that domestic credit sales work. In domestic credit sales, a seller/creditor is most often paid if and only if the buyer/debtor has sold the products and has been paid for them.

Interview data suggest that the combination of credit-based business in Afghanistan and inability of most Afghan seller/creditor to obtain credit outside the country creates a barrier to entry for import-based businesses, which make up the majority of large businesses in Afghanistan.<sup>774</sup> In Afghanistan, the capital requirement to operate an import-based business is high because importers have to either buy in cash or on inflexible credit terms and sell in the domestic market on uncertain credit terms. As one Kabuli medicine merchant puts it, "If you want to do business in this market you need three times the capital that you would need if the market

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<sup>772</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>773</sup> *Id.*

<sup>774</sup> *Id.*

was more cash-based. You have to have 100,000 US\$ to pay the advance for an order to the Indian supplier, you need an extra 100,000 US\$ to give credit in the domestic market, and you must have an extra 100,000 US\$ of inventory in your warehouse so you can fill orders. This way you need to have 300,000 US\$ where under another model 100,000 US\$ would be enough because you are buying in cash and selling on credit.”<sup>775</sup>

*Sarrafs* play a vital role in mitigating the burden of buying in in cash from suppliers located outside of Afghanistan and selling in the domestic, uncertain credit-based market. This will be discussed in greater detail in Section 3.2.

### **3.1.10. Is the Solution Curbing Credit Sales?**

Would reducing reliance on credit sales help Afghanistan create sustainable economic growth? The answer is likely “No.” Contraction of credit sales or imposition of fixed payment terms, theoretically, could reduce merchants’ reliance on *Sarrafs*, and could improve a merchants’ ability to commit to the inflexible repayment terms required by bank loans. However, Afghans are poor (60% of the population is either below national poverty line or in risk of falling below the national poverty line.)<sup>776</sup> The only way to maximize sales is to sell on credit. That is why merchants are doing it. Credit sales help merchants maximize their sales and profits. Curbing credit sales would hurt Afghanistan’s economy by reducing sales and increasing prices. It would reduce market competition, by increasing the capital required to enter the supply chain, thus, increasing prices. Therefore, curbing credit sales is neither desirable nor possible.

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<sup>775</sup> Author’s interview with a medicine merchant in Kabul (June 2017).

<sup>776</sup> See Introduction and Chapter Two.

Curbing credit sales is likely impossible in Afghanistan because merchants cannot shift towards cash sales or credit sales with more inflexible repayment terms. This is because Afghanistan espouses a free market economy and has highly competitive retail markets. If a seller/creditor decided to reduce credit sales, he would lose his market share to another seller/creditor who is willing to offer better credit terms. Arguably, to transition toward a less uncertain credit model of business would require coordinated actions by all sellers/creditors. Such coordinated actions would be impossible since Afghanistan espouses a free market economic mode.<sup>777</sup>

Transition to a more certain credit model would mean that retailers and smaller businesses would need to take more risks as retailers—as opposed to the current model where the sellers/creditors who have the most capital bear most of the market risk. Such reallocation of risk would mean that to enter the supply chain, a merchant would need more capital. This would result in less competitive markets and higher prices.

Such a reallocation of risk would, in theory, improve access to credits by allowing businesses to borrow from banks, which would counter increased capital requirements. One could argue that such a transition would improve the overall capital market and access to credit in Afghanistan. However, such a position is premised on the assumption that banks can effectively allocate resources if merchants are more willing to commit to inflexible payment requirements. The data does not seem to support this assumption. First, as long as Afghanistan does not have a property registry and has not reformed the way formal titles are recoded and verified, it would be very difficult to collateralize a bank loan (even though banks do currently have 3 billion US\$

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<sup>777</sup> See AFGHANISTAN CONSTITUTION, *supra* note 511, art. 10 states, “The state shall encourage, protect as well as ensure the safety of capital investment and private enterprises in accordance with the provisions of the law and *market economy*”. (emphasis added)

excessive reserves).<sup>778</sup> Second, formal financial institutions in Afghanistan have limited reach and capacity.<sup>779</sup>

### **3.2. *Sarrafs* and *Sarrafi* Markets<sup>780</sup>**

*Sarrafs* conduct 90% of financial transactions in Afghanistan.<sup>781</sup> *Sarrafs* are the main providers of financial services to Afghan merchants. They provide a wide range of financial services: deposit-keeping; domestic and international money transfer (*hawala*); currency exchange; speculative trade of currencies; *Sarrafs*' check; short-term working capital loans; medium and long-term interest-bearing loans; and equity financing. Sellers/creditors generally deposit their money with *Sarrafs* and use *Sarrafs*' short-term working capital loans while sellers/creditors and buyers/debtors use *Sarrafs*' interest-bearing loans. Merchants (sellers/creditors and buyers/debtors) use *Sarrafs*' check. Both merchants and non-merchants use *Sarrafs*' domestic and international *hawala* services, as well as currency exchange services. *Sarrafs* are generally the only parties that engage in speculative trade in currencies.

*Sarrafs* make their profit from fees they charge on domestic and international *hawalas*; the difference between buying and selling price of a currency; return from equity investments; interest income from medium and long-term loans; income from speculative currency trade; and

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<sup>778</sup> See Chapter Four.

<sup>779</sup> See Chapter Four.

<sup>780</sup> The description of *Sarrafi* markets in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>781</sup> See THE WORLD BANK, AFGHANISTAN—STATE BUILDING, SUSTAINING, GROWTH, AND REDUCING POVERTY 6 (2005); see also CURBING ILLICIT FINANCIAL FLOWS IN AFGHANISTAN: MONEY LAUNDERING, TERRORIST FINANCING, AND HAWALA, *supra* note 310, at 28.

arbitraging the price difference in currencies in across locations.<sup>782</sup> *Hawala* fees and currency exchange fees are the main source of income for most *Sarrafs* followed by equity investments.<sup>783</sup> Medium and long-term loans, speculative trade, and currency arbitrage make up a small portion of *Sarrafs*' profits.<sup>784</sup>

The profit-makeup of *Sarrafs* explains why they are very ineffective at pooling savings. *Sarrafs* generally do not accept deposits from non-merchants. *Sarrafs* make most of their profits from *hawala* and currency exchange business generated by their merchant clients because merchant-clients conduct the most currency exchange and *hawala* transactions. Non-merchants do not have frequent, large *hawala* and currency exchange needs. *Sarrafs* do not make money from holding more deposits; they earn more from the *hawala* and currency exchange business. The main reason they offer short-term working capital loans is to retain merchants as their clients in a competitive market. That is why they generally do not charge interest on working capital loans.

*Sarrafs* cannot act as financial intermediaries to pool savings for investment purposes because they make most their profits from *hawala* and currency exchange business and only offer short-term working capital loans to retain the merchants as clients who are the main source of *hawala* and currency exchange business. Most *Sarrafs* do not generally issue medium and long-term loans for the same reasons banks have difficulties issuing loans: the Afghanistan business climate is very uncertain which increases the risk of long-term investment is high, and it is difficult to secure long-term credit transactions.<sup>785</sup> Banks are better positioned to offer long-term loans

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<sup>782</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>783</sup> *Id.*

<sup>784</sup> *Id.*

<sup>785</sup> *See* Chapter Two.

because they have more capital, they are better at pooling savings, and they have better access to legal collateralization tools.<sup>786</sup> This is why banks, not *Sarrafs*, are the main provider of investment loans. *Sarrafs* issue a very small percentage of investment loans.<sup>787</sup>

*Sarrafs* cannot substitute for banks in mobilizing savings for investments. Afghanistan needs to improve the formal banking system to facilitate mobilization of savings for investment and induce sustainable economic growth. However, *Sarrafs* do reduce the capital requirements for sellers/creditors by providing them low-cost working capital loans. These short-term working capital loans allows sellers/creditors to finance supply chains and bear the risk of market uncertainties.

Interestingly enough, most merchants surveyed in this research say they trust banks more than they trust *Sarrafs*.<sup>788</sup> *Sarrafs* are more likely to go bankrupt than banks. Therefore, the preference to use *Sarrafs* instead of banks for deposit-keeping and other financial services is not determined by culture or attitude, but rather by the incentive structure that merchants face. Low demand for bank loans is not caused by stickiness of informal financial institutions; it is caused by inability of formal institutions to solve the problems of credit transacting in Afghanistan.

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<sup>786</sup> Afghanistan's banking system is discussed in Chapter Four.

<sup>787</sup> See AFGHANISTAN FINANCIAL SERVICES, AFGHANISTAN CAPITAL MARKETS ASSESSMENT: A SURVEY AND ANALYSIS OF CURRENT CAPITAL MARKET ACTIVITIES, THE DEMAND FOR CAPITAL, AND THE BASIC STRUCTURE AND GOVERNMENT DEBT MARKETS (2010), <https://www.ahg.af/data/AFS-Afghanistan-Capital-MarketsAssessment.pdf>.

<sup>788</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

### 3.2.1. Deposit-keeping<sup>789</sup>

*Sarrafs*, generally only accept deposits from merchants, however, sometimes non-merchants keep their money with *Sarrafs* for safe-keeping.<sup>790</sup> *Sarrafs* do not pay interest on these deposits. *Sarrafs* are not interested in receiving deposits from non-merchants because their profits come from other services they provide to merchants.<sup>791</sup>

Merchants deposit their money in *Sarrafs* for several reasons. Most merchants in Afghanistan work with foreign currencies which makes them vulnerable to fluctuations in exchange rates of different currencies. To protect themselves against exchange rate fluctuations, merchants keep reserves of different currencies with *Sarrafs* where they can readily convert them. Relatedly, merchants expect that they may need short-term working capital loans to make inflexible payments to their foreign suppliers since cash flow from receivables is highly unpredictable. Merchants deposit their money with *Sarrafs*, so they will have good standing should they need short-term working capital loans. Even if a business does not deposit money with *Sarrafs*, *ex ante*, they can do so *ex post*. Merchants can compensate a *Sarrafi* for a short-term working capital loans by effectively exchanging a loan for a loan: a *Sarrafi* will give a merchant 50,000 US\$ for a month with the implicit expectation that the merchant will deposit 100,000 US\$ at his *Sarrafi* and leave it for a couple of months after the immediate financial difficulties are satisfied, as a Kabuli merchant said he has done. This model seems to fit with the *Sarrafi*'s model of business in Afghanistan. Unlike banks, which collect the money from savers to loan them to

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<sup>789</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>790</sup> *Id.*

<sup>791</sup> This finding is based on author's interviews with *Sarrafs* in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

investors and businesses, *Sarrafs* collect the money from merchants and loan them to merchants or use them for their own businesses so they are willing to accept a loan (usually a larger future loan) in exchange for a loan.

Merchants need to transfer money domestically and internationally. Banks in Afghanistan do not have a presence in most of the country (2.47 branches per 100,000 persons)<sup>792</sup> while *Sarrafs* have networks that reach even remote corners of the country. For international money transfers merchants prefer to use *Sarrafs* whenever they can because *Sarrafs* require no documentation. When using *Sarrafs*, merchants do not need to have documents like invoices or contracts, so they can manipulate contracts and invoices, or use fake ones, for the purpose of taxation and tariffs. As a Kabuli merchant put it, “Banks ask for formal documents, *Sarrafs* don’t, so if you want to put lower price on your customs documents, you need to work with *Sarrafs*.”<sup>793</sup> Merchants provide *Sarrafs* with domestic and international *hawala* (as well as currency exchange) to ensure they will receive short-term working capital loans when needed. This is because *Sarrafs* most often issue short-term working capital loans to retain *hawala* (and currency exchange) business of a merchant. Additionally, short-term working capital loans are most often excused in from of an international *hawala* (as explained in Section 3.2.7.)

Merchants who are involved in the illegal economy also need to work with *Sarrafs*. *Sarrafs* do not record or maintain information on the source of deposits or depositors.<sup>794</sup> *Sarrafs*, similarly, do not maintain or record information about the individuals to whom funds are transferred from a certain account. *Sarrafs* operate in a very non-transparent manner which makes them very

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<sup>792</sup> See Chapter Four.

<sup>793</sup> Author’s interview with a Kabuli merchant (June 2017).

<sup>794</sup> The problem of illegal funds in *Sarrafi* markets and its policy implications are discussed in Chapters Four and Chapter Five.

appealing to the those who would like to keep their financial dealings secret. This will be discussed in greater detail in Chapter Four and Five, including Da Afghanistan Bank efforts to regulate *Sarrafs* and impose reporting obligations against *Sarrafs*.

*Sarrafs* facilitate depositing money in banks and transfer of funds via banks by pooling deposits and funds.<sup>795</sup> *Sarrafs* pool their clients' funds and money transfers, however they may use banks to keep the funds safe to transfer the funds, therefore depositing money in a *Sarrafi* does not usually remove the money from banking system.<sup>796</sup> *Sarrafs* keep the majority of their funds in multiple personal bank accounts.<sup>797</sup> *Sarrafs* often transfer money inside Afghanistan and internationally using banks.<sup>798</sup> This is because holding money, and physically transferring money are very dangerous in Afghanistan. *Sarrafs* try to reduce security risks by using banks to store and transfer money. However, *Sarrafs* do physically transfer money because sometimes it is necessary (banks do not have presence in large areas of Afghanistan).<sup>799</sup> It may be less expensive to physically transfer money, and sometimes the physical transfer of money help *Sarrafs* profit from the difference in currency exchange rates prevailing in different countries (arbitrage).<sup>800</sup> *Sarrafs* pool their clients' funds and money transfers then use banks to keep the funds safe or transfer the funds.

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<sup>795</sup> This finding is based on author's interviews with *Sarrafs* in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>796</sup> See SPECIAL INSPECTOR GENERAL FOR AFGHANISTAN RECONSTRUCTION, QUARTERLY REPORT TO THE UNITED STATES CONGRESS 165 (APRIL 30, 2015), <https://www.sigar.mil/pdf/quarterlyreports/2015-04-30qr-section3-economic.pdf>.

<sup>797</sup> See Chapter Four in context of Da Afghanistan Bank effort to outlaw the use of personal bank accounts by *Sarrafs*; see also SPECIAL INSPECTOR GENERAL (2015), *supra* note 796, at 165.

<sup>798</sup> See SPECIAL INSPECTOR GENERAL (2015), *supra* note 796, at 165.

<sup>799</sup> This finding is based on author's interviews with *Sarrafs* in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>800</sup> *Id.*

### 3.2.2. Domestic Money Transfer (*Hawala*)<sup>801</sup>

As discussed above, *Sarrafs* have networks that reach every corner of the country where banks are not accessible (banks have only 2.47 branches per 100,000 persons in Afghanistan<sup>802</sup>). *Sarrafs* charge a reasonable commission fee for money transfers. *Sarrafs* execute *hawalas* via phone in real time. Once a sender deposits a sum of money with a *Sarrafi* to be transferred to a receiver in another location, *Sarrafs* give the sender a number of *hawala*, which usually corresponds to a serial number in the *Sarrafi*'s book of *hawala*. To receive the money, the receiver has only to go to an affiliated *Sarrafi* in the destination and present the serial number to receive the money. Merchants do not often collect *hawala* personally, instead the transferred money is collected to their account in the *Sarrafi*. In *hawalas* involving non-merchants, the cell phone number of the receiver is also recorded. When the receiver goes to the affiliated *Sarrafi* in the destination location, the affiliated *Sarrafi* will call the number and check that it is the number of the receiver. Thus, *Sarrafs* use phone numbers as identification (70% of Afghans have cellular subscriptions<sup>803</sup>).

*Sarrafs* usually relay *hawala* serial numbers every hour via phone or email, or in real time via online chat services. Sometimes sender-*Sarrafi* and receiver-*Sarrafi* are branches of the same *Sarrafi*, however, most often they are independent *Sarrafs* that have *hawala* arrangements. To run a successful *Sarrafi*, and to attract clients and their deposits, *Sarrafs* must be able to meet *hawala* needs of their clients. Therefore, inter-*Sarrafi* *hawala* arrangements are crucial and mutually beneficial to *Sarrafs*. However, this does not mean every *Sarrafi* needs to have a *hawala*

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<sup>801</sup> The description of *Sarrafi* markets in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>802</sup> See Chapter Four.

<sup>803</sup> See OFFICE OF THE ECONOMIC ADVISOR, MOBILE BANKING IN AFGHANISTAN (PowerPoint Presentation, April 2017), [http://afghaneconomics.com/research/Mobile\\_banking\\_scenario.pdf](http://afghaneconomics.com/research/Mobile_banking_scenario.pdf).

arrangement with another *Sarrafi* in every corner of the country (or the world). In fact, no individual *Sarrafi* has such an all-encompassing network, however, they are still able to successfully execute *hawala* as they do. *Sarrafs* are able to execute *hawala* to every corner of Afghanistan because they are part of a thick *hawala* network. If a *Sarrafi* does not have a *hawala* arrangement with a *Sarrafi* in Baghlan, for example, that *Sarrafi* can use a fellow-*Sarrafi* affiliate in Baghlan. *Sarrafs* execute other *Sarrafs*' *hawala* frequently; this is how each *Sarrafi* can provide one-stop *hawala* services to his clients. This process is easily facilitated because *Sarrafs* are concentrated in small number of connected buildings and operate in very close physical proximity to one another. This means each *Sarrafi* knows all other *Sarrafs* and has repeated and continuous personal and business interactions with other *Sarrafs*. In the *hawala* system, each *Sarrafi* functions as a hub immersed in a network of other hubs that run to every remote corner of the country.

### **3.2.3. International Money Transfer (*Hawala*)<sup>804</sup>**

*Sarrafs* execute international *hawalas* in basically the same way as domestic *hawalas* using *hawala* serial numbers and very short delays. The users of international *hawalas* fall into two different categories: those who use international *hawalas* for personal remittance (16% of Afghan families rely on these remittances for their income<sup>805</sup>), and those who use international *hawala* for business purposes. The former use *Sarrafs* because they charge lower fees (especially for small amounts which is common for remittances) compared to banks or international money transfer businesses, e.g. Western Union, and because they can transfer the money to any location within Afghanistan.

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<sup>804</sup> The description of *Sarrafi* markets in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>805</sup> See HOLZMANN, *supra* note 438, at 12.

The size of the Afghanistan *Hawala* market, including both domestic and international *Hawala*, was estimated to be between 5.6 billion US\$ and 6.1 billion US\$ in 2004-05.<sup>806</sup>

Merchants use international *hawalas* to make payments to their foreign suppliers. Merchants use *Sarrafs'* international *hawalas* as opposed to bank money transfer services, which are often cheaper in a business context, for two main reasons. First, *Sarrafs* do not require documents so merchants do not have to produce accurate invoices or other documents, which would subject them to taxation and tariffs, to justify a *hawala*. Banks are subject to money laundering reporting regulations, so they require extensive documents to transfer money internationally. The Da Afghanistan Bank efforts to impose anti-money laundering regulations against *Sarrafs* would have seriously undermined their appeal as provider of *hawalas* for Afghan merchants (which is responsible for a large share of their profit), so *Sarrafs'* fiercely resisted these regulations.<sup>807</sup>

Second, often an international *hawala* is a credit *hawala*. This occurs when a *Sarrafs* executes a *hawala*, i.e., a transfer of money to a merchant's foreign supplier when a merchant does not have sufficient funds with the *Sarrafs*. The merchant will then pay back the *Sarrafs* as he collects the money from his domestic receivables. In effect, often international business *hawalas* are a synthesis of a *hawala* and a short-term working capital loan.

*Sarrafs'* networks of internationally *hawala* is not as wide as their network of domestic *hawalas*. *Sarrafs* make strategic decisions to setup offshore branches, or to form network with *Sarrafs* in other countries, based on the distribution of the Afghan diaspora, who are the source of personal remittances, and the location of suppliers of imported products, who receive business

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<sup>806</sup> See EDWINA A. THOMPSON, TRUST IS THE COIN OF THE REALM: LESSONS FROM THE MONEY MEN IN AFGHANISTAN 221 (2011).

<sup>807</sup> See *infra* Chapter Four.

*hawalas*. At the time of this research, *Sarrafs* were able to execute *hawalas* to Pakistan, Iran, India, UAE, China, Singapore, and Germany, to name a few.<sup>808</sup> *Sarrafs*' offshore branches are not often *Sarrafi* as different countries have very different, and often strict, regulations on the operation of a *Sarrafi*; instead, they may be import/export corporations that facilitate money transfers.<sup>809</sup>

### 3.2.4. Currency Exchange<sup>810</sup>

The use of foreign currency permeates the Afghan economy. It is not an exaggeration to say that Afghanistan is a *de facto* multi-currency economy. Merchants, most often, either use foreign currencies for their domestic dealings or set the price for their products based on the prevailing currency exchange rate because most products are imported. Merchants, to protect themselves against fluctuation in currency exchange rates, convert the revenue they receive in Afghanis into foreign currencies regularly. Merchants maintain reserves of foreign currencies with *Sarrafs*. In some parts of the country, a foreign currency is the *de facto* currency in circulation, instead of Afghanis. For example, in Nangarhar, Pakistani Rupee is the currency used even for small and everyday transactions (e.g. when visiting Nangarhar for this research I used Pakistani Rupee to buy fruit as I was given Pakistani rupees as change when I paid for a taxi). In the province of Nimrooz, located on the border with Iran, Iranian Rial is the *de facto* currency in circulation.<sup>811</sup> Anywhere in Afghanistan, a person can pay for a goods or services, small or large, in virtually any

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<sup>808</sup> This finding is based on author's interviews with *Sarrafs* in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>809</sup> *Id.*

<sup>810</sup> The description of *Sarrafi* markets in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>811</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

currency. Some international organizations pay the salary of their local staffs in U.S. Dollars.<sup>812</sup> Most large transactions (e.g. purchasing a car or a house) is done using U.S. dollars. However, a person can pay for anything in Afghanis too, but the other party will calculate the price and accept equivalent Afghanis in accordance with the prevailing exchange rate. Since Afghanistan is, *de facto*, a multi-currency economy. Therefore, currency exchange is a very large business.

Currency exchange is the proto-*Sarrafi* service. *Sarrafs* often start out as mobile *Sarrafi* by buying and selling currencies in the *Sarrafi* market before they accumulate capital and open a *Sarrafi* store and expand their services.<sup>813</sup> Currency exchange is still a large source of revenue for *Sarrafs*, small or large.<sup>814</sup> *Sarrafs* make their profit from the difference between the purchase and sale price of a currency product. For example, at the time of writing, US\$/AFN is bought at 68.07 AFN and sold for 68.20 US\$/AFN. A medium-sized established *Sarrafi* exchanges a few hundred thousand dollars a day making up to 1,000 US\$ a day from US\$/AFN exchange alone. Iranian Rial and Pakistani Rupee generate even more profit for *Sarrafs* because the difference between their buy and sell price is higher and their values fluctuate more.

*Sarrafs*' medium and long-term loans are often executed in the form of a currency sale. For example, a borrower may buy 100,000 US\$ for a significantly higher price than the prevailing market price in exchange for a deferred payment of Afghanis in the future.

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<sup>812</sup> I personally received my Salary in the U.S. Dollar while working for the United States Institute for Peace in Afghanistan.

<sup>813</sup> This finding is based on author's interviews with *Sarrafs* in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>814</sup> *Id.*

### 3.2.5. Speculative Trade in Currencies (*Sita*)<sup>815</sup>

Some *Sarrafs* engage in speculative trade of currencies, called “*sita*”. *Sita* operates like an option contract. *Sita* can be performed using a call option or a put option. When a call option is selected, a *Sarrafi* (buyer of option) who thinks that US\$/AFN will appreciate in value, enters into an agreement with another *Sarrafi* (seller of option) to buy a certain amount of US\$/AFN on a certain date in the future for a price lower than predicted price. On the due date, if the prevailing market price is lower than the price option price, the buyer of the option will pay the difference to the seller of option, or he can buy US\$/AFN for the market price. If the prevailing market price is higher than the option price, the seller of option will pay the difference to the buyer of option or deliver US\$/AFN for the prevailing market price.

*Sita* is most often conducted with respect to a volatile currency. For example, according an interviewee in Herat, “*Sarrafi* market is usually largely based on one or two currencies. It used to be USD, then Pakistani Rupee but now it is Iran Rial [the rise of Iran Rial may be because Afghanistan has recently reduced its trade with Pakistan and increased its trade with Iran<sup>816</sup>]. Rial is very volatile so *sita* based on market changes can be very profitable.”<sup>817</sup>

*Sita* is a very risky practice, which is why most *Sarrafi* unions have banned it. It does continue today, but it is not very common. The *Sarrafi* union’s decision to ban the practice was motivated by a desire to protect the collective reputation of *Sarrafs* because reputation is a form of common asset.<sup>818</sup> According to the president of the *Sarrafi* union in Herat, “So many *Sarrafs* used

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<sup>815</sup> Description of *Sita* presented here is based on author’s interviews with *Sarrafs* in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>816</sup> See Chapter Two.

<sup>817</sup> Author’s interview with a *Sarrafi* in Herat (April 2017).

<sup>818</sup> Author’s interview with the President of Herat *Sarrafi* Union (April 2017).

to go bankrupt or default on their payments because they had lost money practicing *sita*. *We had to stop the practice or people would not trust the Sarrafs anymore.*”<sup>819</sup> (emphasis added)

*Sita* is also considered to violate the Islamic prohibition of interest (*riba*). *Sarrafi* unions also cite Islamic prohibitions as the impetus behind a crackdown on the *sita*.<sup>820</sup> Since the doctrine of *riba* existed long before the crackdown took place, however, the crackdown was more likely about protecting the collective reputation of the *Sarrafi* market rather than upholding Islamic law that animate the action against *sita*.

### 3.2.6. *Sarrafs*'s Checks<sup>821</sup>

*Sarrafs* issue checks for their clients to guarantee future payments. These are usually post-dated checks. *Sarrafs* issue these checks on the assumption that the client on whose account the check is issued will supply the necessary funds before the due date. In cases, where the funds are present, the merchants use *Sarrafs*'s checks to ensure they have access to the funds until the payment becomes due.

These checks contain the name, logo, and address of the *Sarrafi* that issued it. They may record the name of the payee or they may be payable to the carrier. The amount and date of payment are also recorded on the check. *Sarrafs*' checks are often used to facilitate credit sales between merchant who do not have a direct relationship with each other. *Sarrafs* checks are most often local, meaning they are only payable at a certain location i.e. the place of business of the

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<sup>819</sup> *Id.*

<sup>820</sup> *Id.*

<sup>821</sup> The description of use of *Sarrafs*'s checks in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

issuer. However, *Sarrafs* sometimes rely on their networks to obtain a check from another *Sarrafi* located in another location for their client.

*Sarrafi* checks are negotiable documents. They can be easily transferred by endorsement or exchange of the check. *Sarrafi* post-dated checks can be discounted at the market and they can ensure liquidity of debts. However, currently the practice of discounting the check is less common because the economic slowdown has increased the default risk and *Sarrafs* have less capital and fewer reserves.<sup>822</sup> This is a reason why Afghanistan needs to improve formal bank system to improve liquidity.

In addition, *Sarrafi* checks enjoy very high creditability. They are usually the most reliable guaranty of payment one can produce in Afghanistan (with the exception of using cash deposits as guaranty). Nearly all interviewees stated they accept *Sarrafs*' check.<sup>823</sup> It is common for a merchant to ask the *Sarrafi*-issuer to verify the check before accepting it. Once a check is verified by issuer, the check is payable on the due date. According to the norms of the market, *Sarrafs* are required to pay the specific amount on the check on the due date without any defense that may relate to the underlying transaction. *Sarrafs* undertake a large risk by issuing a check.

*Sarrafi* unions have tried to curb the use of *Sarrafi*'s check because they are very risky instruments. According to *Sarrafi* unions, numerous *Sarrafs* have gone bankrupt because a number of clients on whose account they issued a check did not supply the sufficient funds before the due date and the *Sarrafs* were unable to honor their checks.<sup>824</sup> Defaulting on a check will undermine a *Sarrafi*'s most valuable asset, i.e. his reputation, and will diminish the collective credibility of

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<sup>822</sup> *Id.*

<sup>823</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>824</sup> Author's interview with the President of Herat *Sarrafi* Union (Herat, April 2017).

*Sarrafs*. If a *Sarrafs*'s financial commitments cannot be trusted, a *Sarrafs* cannot work in the market. Therefore, a default on a check most often means the end of business for a *Sarrafs*.

While they are treated as informal negotiable instruments, *Sarrafs*'s checks are not formal negotiable documents under Afghanistan laws. Under Afghanistan's Negotiable Documents Law ("Negotiable Documents Law"), the issuer of a check does not have to be a bank, however, a check must possess a number of formal requirements to qualify as a formal negotiable document.<sup>825</sup> For example, the document must contain the word "check" (in Farsi, Pashto, or a foreign language) to qualify as formal check.<sup>826</sup> More importantly, the Negotiable Documents Law does not recognize a formal check as an instrument that can guarantee future payment, therefore, no formal law protects post-dated checks.<sup>827</sup> A formal check is payable upon presentation and a term that makes a check payable only on a future date is void.<sup>828</sup> Under the Negotiable Documents Law, the negotiable documents that can be used to guarantee a future payment must either take the form of a draft or a promissory note.<sup>829</sup> *Sarrafs*'s checks do not meet the formal requirements of either a draft or promissory note. For example, the word "draft" or "promissory note", as required by Negotiable Documents Law, does not appear on a *Sarrafs*'s check.<sup>830</sup>

Although the *raison d'etre* of *Sarrafs*'s checks is to guarantee future obligations, they do not comply with the formal legal requirements of a check, draft or promissory note, therefore, *Sarrafs*'s checks do not legally qualify as a formal negotiable document. In court cases, *Sarrafs*'s checks have been given the same legal status as any other written proof of debt, however they do

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<sup>825</sup> See QANUN ASNAD QABEL MU'AMELA [LAW OF NEGOTIABLE DOCUMENTS] (No. 971, 1387 [2009]), art. 6.

<sup>826</sup> *Id.*

<sup>827</sup> *Id.*

<sup>828</sup> *Id.*

<sup>829</sup> *Id.*

<sup>830</sup> *Id.*

not avail the holder of preferential procedural and substantive protections accorded to formal negotiable documents. *Sarrafi's* check avails its holder of the same procedural and substantive protection as any other written proof of debt. For example, a defense concerning the underlying transaction can be used to excuse payment because the *Sarrafi's* check is not a formal negotiable document.

These legal handicaps of a *Sarrafi's* checks are not relevant for merchants. This is because failure to honor a check is most often a death sentence for a *Sarrafi's* ability to function in the *Sarrafi* market. Therefore, check users know that if a *Sarrafi* has the funds, he will honor the check. If he does not have the funds, a court judgment will not be of much help.

In the past, according to President of the Herat *Sarrafi* Union, the union would endorse a *Sarrafi's* check upon request, therefore, in case of a default other *Sarrafis* would help pay the amount.<sup>831</sup> This process was in place to safeguard *Sarrafi's* collective assets, i.e. *Sarrafi* reputation. *Sarrafis* share this reputation. Merchants and people trust the name of *Sarrafis* and accord great weight to the fact that a *Sarrafi* has a store in the *Sarrafi* market. If a *Sarrafi* defaults on a check, it diminishes the reputation of all *Sarrafis*. After the economic slowdown, however, the Herat *Sarrafi* Union discontinued the practice of endorsing *Sarrafis'* checks. To protect the collective reputation of *Sarrafis*, *Sarrafi* unions have pressured their members to either refrain from issuing checks or only issue them to highly creditworthy clients. Some unions have banned the practice entirely.

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<sup>831</sup> The facts reported in this paragraph are based on author's interview with the President of Herat *Sarrafi* Union (Herat, April 2017).

### 3.2.7. Short-Term Working Capital Loans<sup>832</sup>

*Sarrafs* are the primary source of working capital loans in Afghanistan. Sellers/creditors rely on these short-term working capital loan to protect themselves against interruptions in cash flow caused by unpredictability of receivables payments. When sellers/creditors need to make a payment to a supplier located outside of Afghanistan and they do not have sufficient funds, *Sarrafs* usually transfer the money (credit *hawala*). Sellers/creditors will pay back the money as they collect their receivables from the debtors/buyers using the *ugraee*.<sup>833</sup> It usually does not take more than a month for a seller/creditor to pay the *Sarrafs* for these short-term working capital loans.

In addition to paying foreign payables, another common use of *Sarrafs*' short-term working capital loans is customs expenses. A seller/creditor need to pay a large sum of money to buy from a foreign supplier. When the product arrives at the border, most sellers/creditors have difficulty to finding enough cash to pay tariffs and customs clearance costs. These sellers/creditors often rely on *Sarrafs*' short-term capital loans to pay for tariffs and customs clearance costs. Sellers/creditors will pay these loans as they collect their receivable from the domestic buyers/debtors using the *ugraee* system.

Working capital loans present a limited risk to the *Sarrafs*; therefore, they are the easiest for a merchant to secure. Short-term working capital loans present limited risk to *Sarrafs* because: (1) they are short-term loans; and (2) they are attached to real products. *Sarrafs* issue working capital loans in form of credit *hawala* to pay a foreign supplier for a purchase of a product, or to

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<sup>832</sup> The description of *Sarrafs*' short-term working capital loans presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>833</sup> See Section 3.1.2.

clear a shipment from customs. Therefore, the loan is secured by real products. *Sarrafs* are confident that they are going to be paid as the product is sold.

*Sarrafs* help merchants bridge the gap between their inflexible financial commitments to their foreign suppliers and their flexible and uncertain financial payments from their domestic customers. As a Kabuli cellphone merchant put it:

when you sell in Afghanistan using a weekly payment system whilst buying in China where you have to pay in cash, you have to work with *Sarrafs*. You need *Sarrafs* to give you credit so you can make the large payments. Then you can pay *Sarrafs* as you collect the money throughout weeks when you are paid by your domestic customers in Afghanistan. *Sarrafs* allow you to bridge the gap between a cash-based market and a credit-based market (...) we use *Sarrafs* despite the fact that Bank's TT [transfer of money via banks] is cheaper.<sup>834</sup>

*Sarrafs* generally do not charge interest for the short-term working capital loans that they provide for their clients, which are most often executed in the form of a credit *hawala*. They do not charge interest for the same reason major businesses sell on credit: market competition. If a *Sarrafa* charges interest on short-term working capital loans, the client will go to another *Sarrafa* who would not, and there is no shortage of *Sarrafs*. Thus, if a *Sarrafa* charges interest on short-term working capital loans, it risks losing *hawala* and currency-exchange business generated by merchant-clients.

However, in some cases *Sarrafs* may charge interest. Some short-term capital loans may bear interest. The way the interest is usually charged is through higher *hawala* fees for credit

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<sup>834</sup> Author's interview with a Kabuli merchant (June 2017).

*hawalas* or a higher currency exchange rate. *Sarrafs* may charge higher *hawala* fees or higher exchange rates when the client does not have the sufficient funds.

There is variation among cases when it comes to access to interest-free short-term working capital loans. In Nangarhar and Balkh, compared to Herat and Kabul, *Sarrafs*' short-term working capital loans are less likely to be free of interest.<sup>835</sup> In Herat, interviewees were more likely to say that they receive short-term working capital loans from *Sarrafs*.<sup>836</sup> This may be due to the fact that Herat's market is bigger than Nangarhar's market so the *Sarrafi*'s financing model is able to provide credit at a lower marginal cost in Herat.

The interview data from this study shows that use of *Sarrafs*' short-term working capital loans has become more common in the market recently (post-2015), likely because the market has been slow.<sup>837</sup> "Everyone needs and uses these credit *hawalas*" as one Herati merchant stated.<sup>838</sup> This supports the hypothesis that *Sarrafs* have helped reduce the negative impact of economic recession in Afghanistan. Balkh, arguably, was hit worse by the economic slowdown because it did not have a well-developed *Sarrafi* market.<sup>839</sup>

Merchants do not consider this funding as working capital loans or financing because they are most often short-termed and embedded in different transactions such as *hawala* or currency exchange. Therefore, they are not reflected on the statistics of access to finance.

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<sup>835</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>836</sup> This finding is based on author's interviews with Herati merchants (April 2017).

<sup>837</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>838</sup> Author's interview with a merchant in Herat (April 2017).

<sup>839</sup> See Section 3.2.10.

### 3.2.8. Medium and Long-Term *Sarrafi* Loans<sup>840</sup>

Merchants sometimes use *Sarrafs'* medium and long-term loans. Like short-term working capital loans, *Sarrafs'* medium and long-term loans are working capital loans meaning they are not used to buy long-term assets, invest, start a business, or expand a business. Rather they are used often to pay account payables. These loans are usually given for a duration of between a month and a year.

Interest rates on these loans are so high that a merchant would only take them if he had no other choice, according to a Herati *Sarrafi*.<sup>841</sup> These loans are a last resort, often used to keep a business from failing. The clients for *Sarrafs'* interest-bearing loans may be struggling seller/creditors or debtors/buyers. The borrowers are those merchants who do not have access to bank loans because they do not have the necessary collateral. The borrowers also do not have access to short-term working capital loans because they cannot pay back the loan in a short period of time, or they cannot secure an interest-free short-term working capital loans because they do not generate enough *hawala* or currency-exchange business.

*Sarrafi* interest-bearing loans, most often, differ from bank loans in two ways: (1) the *Sarrafs'* borrowers are more likely capital-poor, so they would not qualify for a bank loan because they do not have the necessary formal collateral; (2) *Sarrafs'* loans are working capital loans while bank loans are more commonly used to buy long-term assets, invest, or expand a business. This is because banks' borrowers are merchants who are, most often, in a good financial position—they

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<sup>840</sup> The description of *Sarrafi loans* in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>841</sup> Author's interview with a Herati *Sarrafi* (April 2017).

have to be otherwise they would not qualify for a bank's loan<sup>842</sup>—while the *Sarrafs'* borrower are in a relatively poor financial condition—otherwise they would not agree to such high interest rates.

The Survey for Afghanistan Capital Markets Assessment of large businesses conducted in 2010 found that businesses that borrow from banks have a much larger capital investment compared to the average capital investment of the survey.<sup>843</sup> The average capital investment of the survey was 2.6 million US\$ while the average capital investment of the businesses borrowing from banks was 10.4 million US\$.<sup>844</sup>

*Sarrafs'* medium and long-term loans come with very high interest. A Herati *Sarraf*, for example, said, “*Sarrafs* charge 25-30% annual interest rate on their medium and long-term interest-bearing loans.”<sup>845</sup> It is because *Sarrafs* do not require collateral for their loans; and also, those who take on these loans are high risk borrowers because they are facing harsh financial conditions. Therefore, these loans present very high risk that needs to be compensated with very high interest rates.

As explained previously, these loans are often executed in form of a future currency sale. Most *Sarraf*'s interest-bearing loans are executed in form of a *hawala* or deferred money exchange, or a transaction involving transfer or exchange of currency. This way, it seems, they are trying to avert the immediate impression of *riba*-based transactions (prohibition against interest in Islamic law). In Herat and Nangarhar, use of these transactional techniques is more common compared to Balkh where merchants openly admit to using simple interest-bearing loans.<sup>846</sup> This may be due

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<sup>842</sup> See Chapter Four.

<sup>843</sup> AFGHANISTAN CAPITAL MARKETS ASSESSMENT, *supra* note 787.

<sup>844</sup> *Id.*

<sup>845</sup> Author's interview with a Herati *Sarraf* (April 2017).

<sup>846</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

to varying degree of permanence of religious norms in different provinces. Similarly, merchants in Balkh, compared to Herat and Nangarhar, are much less likely to mention the doctrine of *riba* as the reason why they have not taken a loan from a bank or a *Sarrafi*.<sup>847</sup> Interestingly enough though this welcoming attitude toward interest-bearing loans has not resulted in a noticeable increase in use of banks or *Sarrafi*'s loans among interviewees. Similarly, this pro-interest attitude has not resulted in development of financial market in Balkh; in fact, the opposite is the case.<sup>848</sup>

Interview data show although it is not common for an entrepreneur to use a *Sarrafi*'s loan to start a business or expand his existing business, *Sarrafi*'s line of short-term loans do help entrepreneurs start a business with less initial capital than otherwise would have been needed to overcome interruptions and delays in payments.<sup>849</sup> *Sarrafi*s enable businesses to sell on credit and stay competitive. It appears that in provinces with well-developed *Sarrafi* markets, *Sarrafi*s enable sellers/creditors to bear more market risk by providing them with a buffer against cash flow interruptions. *Sarrafi*s thus help sellers/creditors in Afghanistan handle very high level of market uncertainties.

*Sarrafi*s lending decisions mirror the criteria a seller/creditor uses when deciding to sell on credit, i.e., a combination of personal relations, *wasata*, business place, and past dealings. However, seller/creditors cannot obtain a *Sarrafi*'s loan, or a *Sarrafi*'s check, without a history of past-dealing whereas a buyer/debtor can obtain trade credit for his first purchase. This is because *Sarrafi*s' loans are often provided to retain clients. They attempt to be a one-stop financial shop, so they provide their clients with credit services. A *Sarrafi* would not offer credit services to a non-

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<sup>847</sup> *Id.*

<sup>848</sup> See Section 3.2.10.

<sup>849</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

client. Past-dealing is important with interest-bearing loans because those are risky; without a history of past-dealing, a *Sarraf* does not trust a merchant with an interest-bearing loan.

A merchant's ability to secure credit from a *Sarraf*, either through a working capital loan or medium and long-term interest-bearing loans, is directly related to the amount of capital, and *hawala* and currency business that that merchant brings to the *Sarraf*. This means that larger and more successful businesses have better access to credit whilst smaller and startup businesses have less access.

*Sarrafs'* medium and long-term loans are considered loans by Afghan merchants because they have longer terms and often bear interest. Therefore, they are reflected on the survey answers concerning access to finance.

### **3.2.9. Equity Financing<sup>850</sup>**

*Sarrafs* use the funds they hold for their clients to invest in existing businesses or to start a new business. A *Sarraf's* equity portfolio typically contains three main types of investments. First, *Sarrafs* use their funds to invest in ventures that have a fast and safe return. *Sarrafs* used to invest in oil deals, real estate deals, and construction deals when those markets were booming but all of these markets have slowed down. Many *Sarrafs* who had invested in those areas went bankrupt. Currently, *Sarrafs* do not invest in those fields. Second, *Sarrafs* may use their funds to buy equity shares in different businesses. Most *Sarrafs* are either silent or active equity partners in multiple businesses. *Sarrafs* may invest in their clients' businesses since they have good information on the financial state of their clients' businesses. Finally, *Sarrafs* most often use their funds to start a

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<sup>850</sup> The description of *Sarrafs'* equity investment in Afghanistan presented here is based on typical facts reported by the *Sarrafs* in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) in interviews with the author between March and August 2017.

business. Most *Sarrafs* own multiple businesses. In the last two cases, *Sarrafs*, like most other businesses in Afghanistan, will rely on a family model of business to invest in businesses or start a new business by investing in their family members' businesses or by providing startup capital for a family member to start a new business.

### **3.2.10. The Case of Balkh's *Sarrafi* Market<sup>851</sup>**

The case of Balkh highlights the importance of the *Sarrafi* market in Afghanistan. Research for this dissertation suggests that Balkh's *Sarrafi* market is the least developed among the five research sites<sup>852</sup> and Balkh has suffered the most from worsening of macroeconomic conditions.<sup>853</sup> This dissertation argues that underdevelopment of *Sarrafi* markets has made Balkh more vulnerable to worsening of macroeconomic conditions.

Balkh's *Sarrafs* do not have an exclusive marketplace. They share their marketplace with other businesses. They do not own their marketplace, so Balkh's *Sarrafi* Union has much less control over who can open a *Sarrafi* in the market. There are more likely to do other things besides *Sarrafi* in their stores, e.g. sell phone top-up credit or airline tickets. There are fewer *Sarrafs* in the market. They are less busy. And their market is much less vibrant and crowded. They do not have the same reputation of credibility as *Sarrafs* in other provinces. As one *Sarrafi* put it, "I am sometimes ashamed to say what my profession is."<sup>854</sup> Balkh *Sarrafs* have less capital of their own

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<sup>851</sup> Description of Balkh's *Sarrafi* market presented here is based on author's interviews with merchants and *Sarrafs* in Balkh (May 2017) as well as the author's observation of Balkh's *Sarrafi* market (May 2017).

<sup>852</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>853</sup> Measured by the combination of decline in the quality of business climate and business climate stability, See Chapter Two.

<sup>854</sup> Author's interview with a Balkhi *Sarrafi* (May 2017).

and handle much less capital of the Balkh market. They are less likely to invest in business ventures.

Although worsening macroeconomic conditions have caused merchants to reduce their credit sales and other credit transactions in all five of the studied provinces, credit transactions have been more severely impacted in Balkh.<sup>855</sup> Businesses in Balkh engage in credit transactions significantly less than their counterparts in other research sites.<sup>856</sup> They are less likely to sell on credit; have a revolving credit account with a *Sarrafi*; have access to interest-free short-term working capital loans from a *Sarrafi*; or and buy their supply on credit.<sup>857</sup>

The Business Climate Reports show that Balkh has been more severely impacted by Afghanistan's economic slowdown, and it has the most unstable business climate.<sup>858</sup> The Business Climate Reports data show Balkh, despite being a very safe and stable province, has the most unstable business climate, and also it has the second worst overall business climate.<sup>859</sup> Balkh also is the most monopolistic economy of the five major provinces, measured in the number of business registries/capita.<sup>860</sup> Given that Balkh has the least developed *Sarrafi* market amongst the five major provinces of Afghanistan, this dissertation argues that the underdeveloped of *Sarrafi* market has made Balkh more vulnerable to worsening of macroeconomic conditions.

*Sarrafs* help sellers/creditors supply trade credit despite unpredictable receivable payments by providing working capital loans that protect sellers/creditors against cash flow interruptions.

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<sup>855</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>856</sup> *Id.*

<sup>857</sup> *Id.*

<sup>858</sup> *See* Chapter Two.

<sup>859</sup> *Id.*

<sup>860</sup> *Id.*

Balkh merchants have limited access to these protections, therefore, they are less likely to supply trade credit, and they are more likely to suffer if the market slows down. *Sarrafs* distribute market risk by pooling their clients' funds and providing working capital loans to protect their clients against cash flow interruptions. Thus, they soften the blow of macroeconomic slowdown by spreading the market risk. In effect, short-term working capital loans functions as a system of cross-insurance where *Sarrafs*' clients contribute to a common pool by keeping deposits in a *Sarrafi*; these deposits then are used to provide relief in the form of working capital loans to the same clients should they need it. Merchants in Balkh are less likely to have access to short-term working capital loans, therefore, they are more affected by macroeconomic slowdowns and Balkh's business climate is less stable.

On the issue of causal ordering, the available of data on how the Balkh's market has responded to worsening macroeconomic conditions helps eliminate the possibility that underdeveloped *Sarrafi* markets are not the cause, but rather an effect of bad economic conditions. If causal ordering ran the opposite way, Balkh would have developed better *Sarrafi* markets when the Afghan economy was doing better. In this case, we would not see these effects when the macroeconomic conditions turned for worse.

There are two possible hypotheses as to why Balkh has not developed a strong *Sarrafi* market:

**(1) Neighbor-effect hypothesis.** Balkh has not developed a strong *Sarrafi* market because it sits on the border with central Asian countries<sup>861</sup> where credit sales are much less common due to the fact that governments exercise more control over exports. As a result, it is much harder for Balkhi seller/creditors to obtain credit from and establish relations with suppliers located in these

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<sup>861</sup> Turkmenistan, Tajikistan, and Uzbekistan.

neighboring central Asian countries. Since they do not engage in cross-border credit transactions as often as merchants in Nangarhar and Herat, there has been reduced demand for *Sarrafi* services so Balkh's *Sarrafi* market has remained underdeveloped.

**(2) The political-effect hypothesis.** Balkh has not developed a strong *Sarrafi* market because long Atta Noor, the long-lasting governor of Balkh (he was the governor for almost fourteen years (from 2004-2018)),<sup>862</sup> had a relatively strong grip over the economy in this province which has reduced competition and increased barriers to entry. Less competition means fewer sellers/creditors and more capital rich sellers/creditors active in the market, which means, less demand for *Sarrafi*'s financial services.

The low rate of credit sales is also unexpected from the point of view of the literature. The literature suggests that places where informal credit institutions prevail, the smaller the size of the economy, the better access to credit is expected because information costs are lower in smaller economies.<sup>863</sup> However, this dissertation posits that in Afghanistan, Balkh, which is a smaller economy, compared to Herat and Kabul, has a poor credit conditions because it does not have well-developed informal financial institutions.

The case of Balkh also discredits the hypothesis that it is the stickiness of informal institutions that is stopping formal institutions from gaining traction with Afghan merchants. In Balkh, a convergence of exogenous factors has reduced market competition, causing Balkh to diverge from the credit-based, supply chain structure pervasive in other major provinces. As a result, credit sales are less common in Balkh than in other major provinces. However, the absence of pervasive informal supply chain institutions has not resulted in increased use of formal

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<sup>862</sup> See Chapter Two.

<sup>863</sup> See, e.g., for example Clay (1997a), *supra* note 134, at 224; Clay (1997b), *supra* note 134, at 34.

institutions. This is despite the fact that Balkhis merchants have expressed the least religious reservation when discussing bank loans when interviewed. Despite having the fewest reservations about *riba*, Balkh's merchants have not been more likely to use bank loans.<sup>864</sup> This dissertation argues that the failure of formal financing to expand in Balkh shows that the reason Afghan merchants do not use formal credit institutions is not stickiness of existing credit institutions, but instead it is due to the failure of formal institutions to solve the credit transaction problems that Afghan merchants face.

### **3.2.11. Religious Prohibition of Interest and Access to Finance**

The case of Balkh also suggests that interest-friendly attitude has not led to the development of either a bank or *Sarrafi*-based financial market. Balkh has the least-developed financial market while Balkhis have the most welcoming attitudes of merchants in five major provinces towards interest-bearing loans.<sup>865</sup> Herat, Nangarhar, and Kabul have developed *Sarrafi*-based financial markets where *hawala* and currency-exchange-based transactions are often used to execute transactions that compensate *Sarrafs* for time-value of the money, while merchants in those provinces express stronger religious objections to the use of interest-bearing loans.<sup>866</sup> This shows religious objections to the use of interest-bearing loan is not a major impediment of development of financial market.

Islamic banks have been proposed by Da Afghanistan Bank and the Ministry of Commerce and Industries as solutions to the problem of the low demand for bank loans based on the idea that

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<sup>864</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>865</sup> *Id.*

<sup>866</sup> *Id.*

religious objection to interest is a main reason behind low demand for bank loans.<sup>867</sup> However, the research presented in this dissertation has demonstrated that merchants do not use bank loans primarily because formal institutions have not overcome the fundamental problems of credit transactions in Afghanistan (highly volatile business climate, inefficient formal property right system, and uncertain formal contract enforcement), not because of their religious objection to the use of interest. This finding is supported by the lack of popularity of existing Shari'ah-compliant financial products.<sup>868</sup>

Many banks in Afghanistan offer Shari'ah-compliant financial products, however, interviews show that most merchants do not use these products for the same reasons they do not use their conventional counterparts: high cost, short length of loans, and demanding collateral requirements.<sup>869</sup> These are the same problems as those mentioned about conventional banks. Therefore, it is the failure of formal financial institutions (Islamic and conventional) to overcome the problems of credit transacting in Afghanistan that deter merchants from using banks (either Islamic or conventional) rather than a concern that interest has been prohibited by Islamic law.

This is, however, not to say that if formal financial institutions could supply loans in a way that would work in the context of Afghanistan (i.e. overcome the problems of credit transacting), Afghan merchants, *ceteris paribus*, would not prefer Shari'ah-compliant financing to conventional financing. Most likely they would. After all, Islamic financial institutions use transactional

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<sup>867</sup> See DA AFGHANISTAN BANK, STRATEGIC PLAN 2017-2021 46, *supra* note 9, 46; MINISTRY OF COMMERCE AND INDUSTRIES STRATEGIC PLAN 2016-2020, *supra* note 9, 47. Da Afghanistan Bank has recently issued a license for Afghanistan's first Islamic Bank, "Islamic Bank of Afghanistan". See *Central Bank Grants IBA An Islamic Banking System License*, TOLONews (April 23, 2018), <https://www.tolonews.com/business/central-bank-grants-iba-islamic-banking-system-license>.

<sup>868</sup> The low rate of bank use, discussed in Chapter Four, occurs despite the availability of Shari'ah-compliant financing in Afghanistan.

<sup>869</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

techniques to avoid contravention of religious norms; *Sarrafs* use transactional techniques to achieve the same goals, however, with less doctrinal vigor.

### **3.2.12. Regional Variations within *Sarrafi* Markets<sup>870</sup>**

There are variations in *Sarrafi* markets in five major provinces studied here.

#### **3.2.12.1. *Sarrafs* in Kabul**

*Sarrafs* handle a significant portion of market capital in Afghanistan. They handle the largest share of market capital in Nangarhar and Herat. They handle the smallest share of market capital in Balkh. Kandahar and Kabul fall somewhere in between.

Kabuli merchants are more likely to say that they work mostly with banks, not *Sarrafs*; however, they use banks only (1) to transfer money to their suppliers in countries with strict financial regulations, which are most countries other than Pakistan, Iran, and UAE; (this is the case for merchants across Afghanistan and the reason for it is international money laundering regulations); and (2) to establish checking accounts. When it comes to using short-time working capital loans, most Kabuli merchants said that they have used *Sarrafs*' credit *hawala*, or at least they knew they could if they needed.<sup>871</sup> This higher use of the banking system by Kabuli merchants is likely because there are more large businesses in Kabul. It may also mean that more Kabuli businesses have (1) more capital so less need for *Sarrafs*, and (2) more of an international presence, which exposes them to more regulations.

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<sup>870</sup> The description of *Sarrafi* market presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>871</sup> This finding is based on author's interviews with merchants in Kabul (June 2017).

Interviewees in Kabul were more likely to use banks for money transfer and current account services while at the same time keeping their connections with *Sarrafs*.<sup>872</sup> Interestingly, the increased connections with banks have not resulted in an increase in the use of bank loans.<sup>873</sup> Similarly, underdevelopment of the *Sarrafi* market in Balkh has not caused its banking system to grow as far as provision of credit is concerned. Balkhi and Kabuli businesses are more likely to say that they work mostly with banks, but they are no more likely to say that they have a bank loan compared to Heratis or Nanagarharis.<sup>874</sup> Therefore, the increased use of banks is not necessarily correlated with a decreased use of *Sarrafs*. Similarly, as previously explained, depositing funds with *Sarrafs* do not necessarily remove the funds from banking system because *Sarrafs* ultimately store and transfer those funds via banks.

### **3.2.12.2. *Sarrafs* in Kandahar**

Kandahari *Sarrafs*, compared to their counterparts in three other major provinces, are less involved with other businesses as creditors or investors.<sup>875</sup> *Sarrafs* are not the richest people in Kandahar, while they are often among the richest people in Kabul and Herat.<sup>876</sup> This may be due to the influence of black money. Kandahari *Sarrafs* likely make most of their profit from handling revenue of illegal economy rather than investing in business ventures.

According to Thompson's field research on the *Sarrafs*, *hawala*, and drug money in Afghanistan, of the five provinces studied here, Kandahar has the highest estimated percentage of

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<sup>872</sup> *Id.*

<sup>873</sup> *Id.*

<sup>874</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>875</sup> This finding is based on author's interviews with merchants in Kandahar (July 2017).

<sup>876</sup> This finding is based on author's interviews with merchants in Kabul (June 2017).

drug-related funds in provincial markets.<sup>877</sup> According to Thompson's survey, in the years of her field research (2014-15), 80-90% of *hawala* funds in Kandahar are related to drug money, whereas the figures in Balkh, and Herat, are only 50% and 30%, respectively.<sup>878</sup>

### **3.3. Gerawee**

Trade credit and *Sarrafi* markets are the main source of working capital financing in Afghanistan; they reduce the need for investment financing by reducing the necessary capital to run a business. Trade credit lowers the capital requirement for entry into the supply chain and retail markets while *Sarrafs'* short-term working capital loans protect sellers/creditors from cash flow interruption reducing the amount of capital required to become a seller/creditor in Afghanistan. *Sarrafs'* short-term working capital loans also enable risk-sharing trade credit arrangements in Afghanistan by helping sellers/creditors diversify market risk. However, neither can be used to finance investment or buy long-term assets. *Gerawee* and bank loans are the main source of investment financing in Afghanistan. This section focuses on *Gerawee*;<sup>879</sup> bank loans will be discussed in Chapter Four.

#### **3.3.1. Size of Gerawee Market**

Conservative rough estimates of total values of *Gerawee* in four major provinces suggest *Gerawee* plays a large role in investment financing. According to rough estimates acquired from the President of Real Estate Agent Union, experienced real estate agents, or Huquq Departments, the

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<sup>877</sup> THOMPSON, *supra* note 208, at 248.

<sup>878</sup> *Id.*

<sup>879</sup> The description of *Gerawee* in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013, and interview data collected for the author's previously published article, Haroun Rahimi, *The Customary Practice of Gerawee in Afghanistan: A Case for Transitioning to Real Equity-Based Finance*, 4 *INDON. J. INT'L & COMP. L.* 743 (2015).

total value of *Gerawee*, over the last year (2017), in Afghanistan’s four major provinces is as follow: Herat (120 million US\$), Kabul (240 million US\$), Balkh (69 million US\$), and Nangarhar (0.4 million US\$).<sup>880</sup> Estimates for Kandahar were not available.

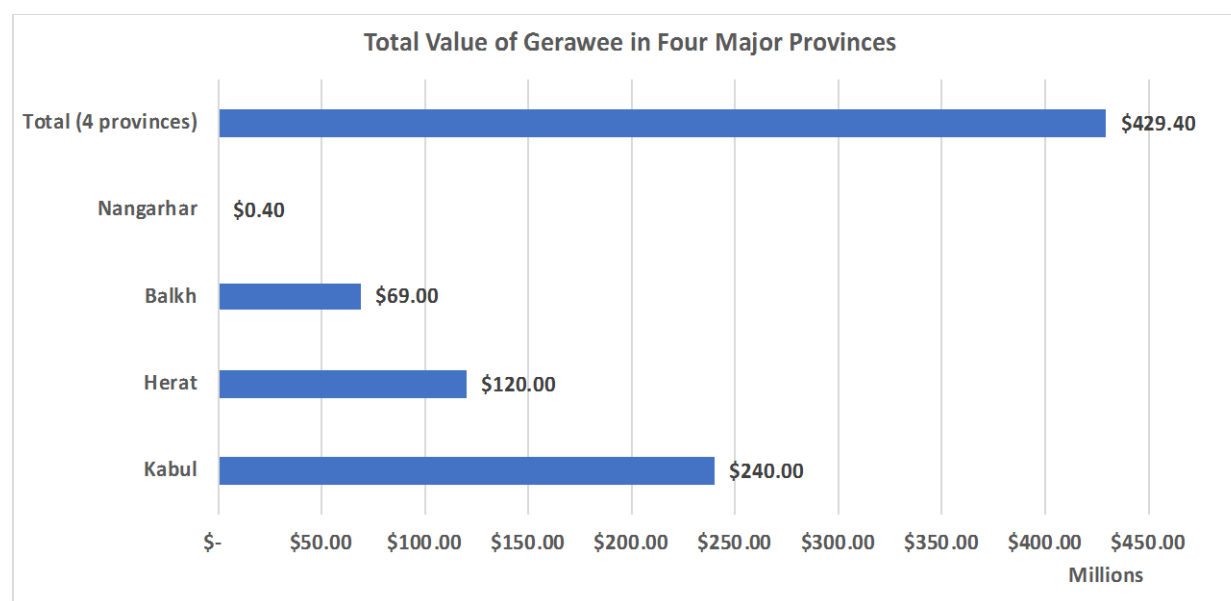


Figure 7 Total Estimated Value of Gerawee in Four Major Provinces of Afghanistan within the Last Year (2017)<sup>881</sup>

The estimated value of *Gerawee* for four major provinces indicates *Gerawee* plays a large role in investment financing in Afghanistan. The total value of *Gerawee* contracted within one

<sup>880</sup> The total value of *Gerawee* in a province is estimated according to the following formula: the total number of active real estate agents x the median number of *Gerawee* brokered by a real estate agent per year x median value of a *Gerawee*. These are rough conservative estimates because not all *Gerawees* are conducted via real estate agencies. If *Gerawor* and *Gerawee-ee* know each other they may decide to bypass going to a real estate agency to avoid paying commission. The number of active real estate agents, the median number of *Gerawees* brokered by a real estate agent per year and the median value of a *Gerawee* is based on the estimates provided by an experienced real estate agent and Huquq Department in Herat, the President of Union of Real Estate Agents in Kandahar, an experienced real estate agent in Kabul, and an experienced real estate agent and Huquq Department in Balkh.

<sup>881</sup> Constructed by the author based on the following formula: the total number of active real estate agents x the median number of *Gerawee* brokered by a real estate agent per year x median value of a *Gerawee*. The number of active real estate agents, the median number of *Gerawees* brokered by a real estate agent per year and the median value of a *Gerawee* is based on the estimates provided by an experienced real estate agent and Huquq Department in Herat, the President of Union of Real Estate Agents in Kandahar, an experienced real estate agent in Kabul, and an experienced real estate agent and Huquq Department in Balkh.

year in four major provinces amount to 429.40 million US\$ (see Figure 7). This is almost two thirds of the total value of outstanding bank loans for the whole country.<sup>882</sup> If one extrapolates the *Gerawee* numbers to reflect the value of *Gerawee* for the whole country (34 provinces), it could be safely argued that the total value of *Gerawee* in a year exceeds the total value of outstanding bank loans.<sup>883</sup> In Herat alone, conservative rough estimates suggest, in year 2016/17, total value of *Gerawee* was roughly 120 million US\$,<sup>884</sup> which was almost triple the total value of outstanding bank loans in Herat for the same year.<sup>885</sup> This comparison suggests that *Gerawee* is likely a more important source of financing investment in Afghanistan than bank loans.

It is difficult, however, to estimate what percentage of total value of *Gerawee* is used for investment purposes because *Gerawors* do not necessarily use the transaction to raise capital for investment. A *Gerawor* may use the *Gerawee* to raise money for personal expenses as well (e.g. paying for a wedding ceremony). However, research for this dissertation shows that merchants commonly use *Gerawee* for investment purpose.<sup>886</sup>

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<sup>882</sup> See *infra* Chapter Four.

<sup>883</sup> As explained in Chapter Two, these four provinces represent less than half of Afghanistan's economy and less than one third of Afghanistan's population, therefore, one could safely assume they only represent half of total value of *Gerawee*. Thus, extrapolating from that, the estimated total value of *Gerawee* would reach 900 million U.S. \$ which is almost 25% higher than total amount of outstanding bank loans.

<sup>884</sup> This is based on the estimates provided by Huquq Department and an experienced real estate agent using the following formula: the total number of active real estate agents x the median number of *Gerawee* brokered by a real estate agent per year x median value of a *Gerawee*.

<sup>885</sup> According to the data provided by the head of Da Afghanistan Bank regional office in Herat, the total amount of outstanding bank loans issued by provincial branches of banks in Herat for the year 2017 was 43.3 million US\$. The actual bank loans held by Herati merchants may be higher because most banks in Afghanistan issue loans through their Kabul office. Therefore, the data on regional distribution of bank loans are not representative of actual bank loan distribution. It was not possible to obtain the data on outstanding loans for other provinces.

<sup>886</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013, and interview data collected for the author's previously published article, Haroun Rahimi, *supra* note 879.

*Gerawee* sits on the intersection between housing and finance. The supply of *Gerawee* is determined by the need to raise capital while the demand for *Gerawee* is determined by the need for housing. Therefore, it is hard to explain provincial variations in distribution of total value of *Gerawee* in terms of access to investment financing. However, the data suggest that *Gerawee* is more common in Herat and Kabul compared to Balkh and Nangarhar (see Figure 7). According to the President of Nangarhar's Real Estate Agents' Union, stated that the unpopularity of *Gerawee* in Nangarhar is due to the belief that the practice violates the religious prohibition of interest (*riba*).<sup>887</sup> According to an experienced real estate agent in Balkh, most property owners prefer to lease their property rather than put it under *Gerawee* because the ratio of rent to *Gerawee*-value is high.<sup>888</sup> This means property owners in Balkh cannot raise enough capital through *Gerawee* to justify foregoing rent by putting the property under *Gerawee*.

If a party wishes to get court enforcement of a *Gerawee* contract, he would have to do so in a regional civil court since commercial courts do not have subject matter jurisdiction on *Gerawee* cases.<sup>889</sup> Despite its prevalence, *Gerawee* has not, to this date, been recognized by the civil courts. This is because judges believe that it violates the prohibition of interest in Islam.<sup>890</sup>

The difference between commercial and noncommercial cases is not caused but helped by formal laws. Afghanistan's commercial law explicitly recognize interest-bearing transactions while the non-commercial laws tend to prohibit such transactions.<sup>891</sup> However, the formal laws are

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<sup>887</sup> Author's interview with the President of Nangarhar Real Estate Agents' Union (Nangarhar, May 2017).

<sup>888</sup> Author's interview with an experienced real estate agent in Balkh (May 2017).

<sup>889</sup> See *supra* Chapter Two.

<sup>890</sup> The contrast between refusal of civil courts to enforce the terms of a *Gerawee*, on the one hand, and commercial courts' enforcement of interest-bearing bank loans and recognition of informally developed practice of *Sar qufli*, on the other, suggests attitude towards interest-bearing transactions and recognition of informal practices differ from commercial to non-commercial contexts. The prevailing attitudes in commercial courts is more business friendly than the prevailing attitude in non-commercial courts.

<sup>891</sup> See PRINCIPLES OF COMMERCIAL PROCEDURE, *supra* note 534 and AFGHANISTAN CIVIL CODE, *supra* note 503.

not the cause of varied judicial attitudes because civil judges cite religious reasons independent of legal reasons as to why they do not enforce transactions that they think violate the religious prohibition of interest, including *Gerawee*.<sup>892</sup> Commercial judges, while expressing concern about the religious aspects of interest-bearing transactions, accept that in a business context those transactions are allowed out economic necessity.<sup>893</sup> The relatively weak formal protection of *Gerawee* has increased the risk to creditors making *Gerawee* less effective as a financing arrangement. This is a reason why users can only raise limited capital through *Gerawee*—often less than one-tenth of the likely sale price<sup>894</sup> and why the most common form of *Gerawee* is possessory-*Gerawee*.

*Gerawee* also cannot be used to pool savings because it is a transaction between an individual saver, who often has housing needs, and an entrepreneur who has a financing need. This means that *Gerawee* cannot be used to diversify risk. It also means that *Gerawee* cannot be used to pool savings for investment purpose. As a result, *Gerawee* cannot substitute for a bank-based financial market.

### **3.3.2. *Gerawee* and its variations**

This section examines *Gerawee* in the context of Afghanistan, illustrating the various forms of *Gerawee* practices through hypothetical examples. The aim is to highlight the underlying economics of *Gerawee* and demonstrate the nuances of its various practiced forms in Afghanistan.

The following examples introduce the most common variations of *Gerawee* transactions:

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<sup>892</sup> This will be discussed later in this Chapter.

<sup>893</sup> See Chapter Two.

<sup>894</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013, and interview data collected for the author's previously published article, Haroun Rahimi, *supra* note 879.

Example 1. A, who needs a sum of money (*Gerawor*), may enter into an agreement with B, who is willing to provide him with a sum of money (*Gerawe-ee*). Under the terms of their agreement, B agrees to provide A with an amount of money to be fully repaid at a later date in exchange for the right to live in A's house. The amount of money paid by B usually is much lower than the market value of the house. It is common for the agreement to specify the length of the contract (i.e. the date of repayment), however, B usually will have the right to live in the house until the debt is fully repaid, even if the term of the contract elapses.

Example 2. B agrees to provide A with an amount of money to be fully repaid at a later date, in exchange for the right to lease A's house for considerably lower rent than market price. Like the previous scenario, the amount of money paid by B is usually much lower than the market value of the house. Similarly, it is common for the agreement to specify the length of the contract (i.e. the date of repayment). B usually has the right to retain the lease to the house until the debt is fully repaid, even if the term of the contract elapses.

Example 3. B agrees to provide A with an amount of money to be fully repaid at a later date in exchange for the right to lease A's house to a tenant. Under this scenario, B will receive the rent from the tenant. Like the previous scenarios, the amount of money paid by B usually is much lower than the market value of the house. It is common for the agreement to specify the length of the contract (i.e. the date of repayment); however, like the other arrangements described above, B usually will have the right to receive the rent from tenant until being fully repaid, even if the term of the contract elapses.

Example 4. Another example of *Gerawee* is an agreement under which B agrees to provide A with an amount of money to be fully repaid in a later date in exchange for the right to lease the A's house to a tenant. However, unlike Example \$, B will lease back the A's house to A (meaning

A will retain the possession of the house). B will receive the rent from the A. Like the previous scenarios, the amount of money paid by B usually is much lower than the market value of the house. Similarly, it is common for the agreement to specify the length of the contract (i.e. the date of repayment); however, B usually has the right to receive rent from A until the debt is fully repaid, even if the term of the contract elapses. This scenario is closest to a mortgage contract.

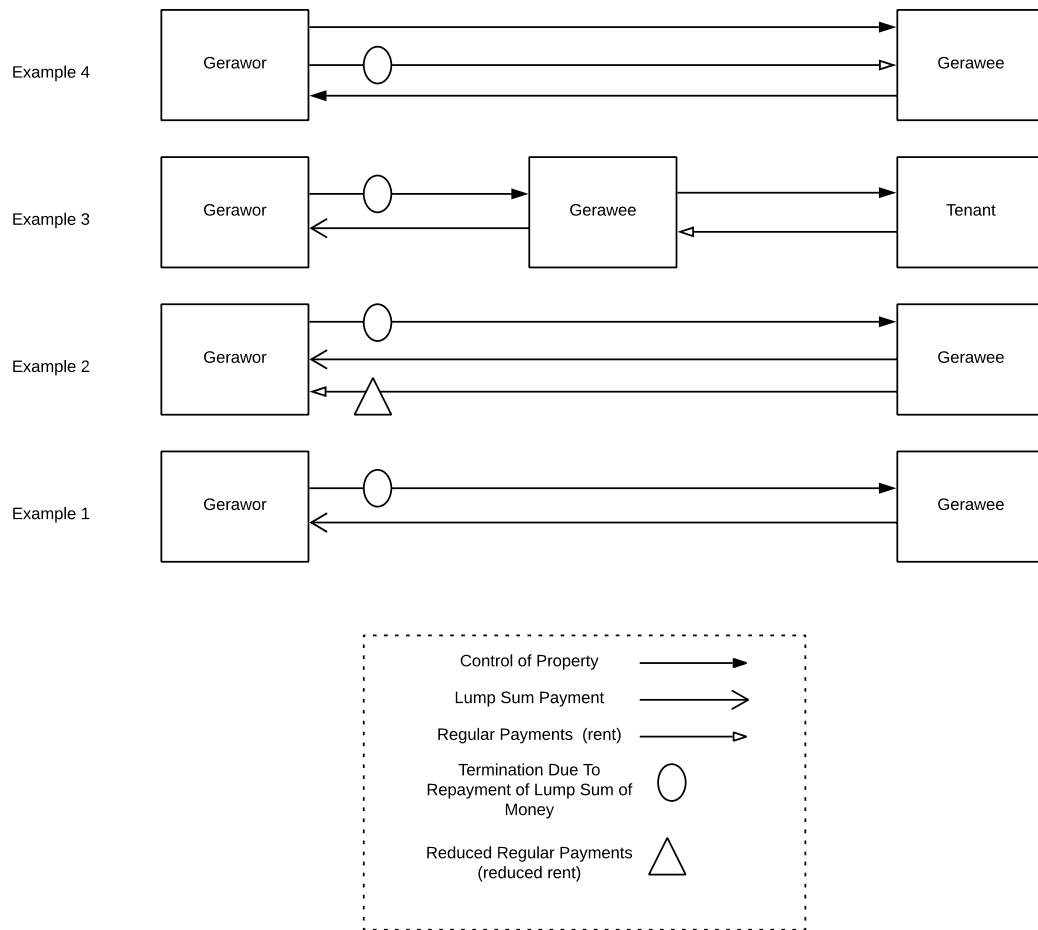


Diagram 3 Gerawee and its Variations<sup>895</sup>

<sup>895</sup> Constructed by the author based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013, and interview data collected for the author's previously published article, Haroun Rahimi, *supra* note 879.

### 3.3.3. Important Characteristics of the *Gerawee* Market

In order to thoroughly understand the practice of *Gerawee* in its social context, one must be acquainted with the five main characteristics of *Gerawee*. These characteristics illuminate the dynamic of the *Gerawor–Gerawee-ee* relationship. They also show the role of local real estate agents play in concluding a *Gerawee* agreement, and their economic interests in continuance of the practice. Real estate agents are therefore important players who have a stake in decreasing the Shari’ah frictions in the practice.

Concerning the subject of a *Gerawee*, houses are the most common subject or property in *Gerawee*; however, stores, warehouses, and agricultural land may also be subjected to the *Gerawee*, although with less frequency. Movable property, on the other hand, is not subject of the *Gerawee*.

Who are the usual *Gerawee* actors? The creditor/*Gerawee-ee* is usually an unsophisticated party. Creditor/*Gerawee-ee* are those who have small or medium size savings but are not capable of conducting their own business venture. They seek *Gerawee* to supplement to their income, or, in some cases, provide their sole source of income, or a way to save on paying rent. Hence, widows, orphans, elderly, and low ranking governmental employees are common creditors/*Gerawee-ee*. On the other hand. The debtor/*Gerawor* is usually an entrepreneur or small venture owner who needs financing and is capable of making profit on the amount of money he receives that exceeds the amount of money he is paying in rent, or the amount of rent that he forgoes. However, it is not uncommon for the *Gerawor* to use the money for extra living expenses such as, repaying an overdue debt, paying for a son’s wedding, or paying medical expenses.

Because of the imbalance of power between the *Gerawor*, who usually is a business-minded person, and *Gerawee-ee*, who usually is not, as well as the weakness of formal legal

protections, misuse is not uncommon in *Gerawee* market, decreasing its popularity and efficiency. For example, a common form of misuse in *Gerawee* is when a *Gerawor* enters into multiple *Gerawee* agreements with multiple *Gerawee-ee* for a cumulative amount of money that exceeds the value of the property. In essence by engaging in such fraudulent practice, the *Gerawor* is hoping to acquire a disproportionately larger amount of money against lower valued property. In another example, the *Gerawor* may refuse to pay back money owed and stop paying rent after only paying a few installments. In cases like this, a *Gerawor* may pay back money owed after a while but not the unpaid rent. In this way, the *Gerawor* exploits the weakness of the enforcement system when the *Gerawor* is in possession of the property.

The safest form of *Gerawee* for *Gerawee-ee*, which is also the most common form, is possessory *Gerawee* (see example 1 above). Under this form of *Gerawee*, the *Gerawee-ee* will retain the possession of the property, continuing to live in the house, until the *Gerawor* pays back the money he received under *Gerawee*. This form of *Gerawee* has been very popular because it provides a solution to the growing needs for housing in urban centers while supplying a source of capital for entrepreneurs. It secures a loan through transfer of possession, but it does not have the same inefficient consequences of traditional possessory security transactions because the creditor acquires the right to live in the house, solving the need for housing. This form of *Gerawee* has great potential because many Afghan merchants have invested a lot of money in real estate when the economy was booming so they currently own excessive real estate, and fast-growing urbanization ensures a continued and increasing demand for housing. These two dynamics will continue to sustain and growth *Gerawee* as a twin finance-housing solution and, if correctly managed can create positive consequences for economic growth by reducing financing constraints on Afghan businesses.

*Gerawee* agreements are usually concluded through local real estate agents called “*Rahnamya Mua’malat*.” Under the law, sale and lease of real estate must be conducted through a registered real estate agent who will record the agreement on government-issued agreement forms and report them to the finance department for tax purposes.<sup>896</sup> However, it is not uncommon for parties to reach an agreement between themselves without involving a realtor to avoid paying extra fees and taxes. Local real estate agents have small offices where a *Gerawor* registers the property, and *Gerawee-ee* visit to find out about potential *Gerawors*, and properties. These agencies are usually small in size and cover a local geographical area. They usually charge both parties for a fee (1% to 2%) of the amount *Gerawee* for their services. The real estate agents draft and keep copies of the *Gerawee* agreements. These agreements are usually standardized and are signed on a government-issued contract form. These real estate agents are licensed by the Department of Justice and have an obligation to report their transactions to the Department of Justice, and Department of Finance for taxing purposes.

*Gerawee-ees* rely on verbal confirmation from local real estate agents, neighbors, representative of the neighborhood (in Farsi: wakil *ghuzar*) (in urban centers), and head of a village (in Farsi: *Arbab*) (in villages) to verify ownership.

*Gerawee* can run for years allowing it to be used as a long-term financing device. A *Gerawee-ee* is entitled to the benefit the property (live in it, rent it, or receive rent) until the *Gerawor* is able to repay the sum of money paid by *Gerawee*. Depending on the financial status of *Gerawor* and the faith of the investment for which a *Gerawor* has used the money, *Gerawee* can last for several years. Most *Gerawee* last more than a year, however in some cases they can last up to ten years. The medium length of *Gerawee* is three years. A *Gerawor* controls the length

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<sup>896</sup> THOMPSON ET AL., *supra* note 449, at 59.

of *Gerawee*. *Gerawee* can be as long as the *Gerawor* needs it to be. If a *Gerawee-ee* wants to end the *Gerawee*, a *Gerawor* does not have to pay back the money because a *Gerawor* can find another *Gerawee-ee* for the property, given the generally increasing housing demand. It is very common for a *Gerawor* to retain the money and replace several *Gerawee-ees* until he is ready to pay the money and repossess the property or resume receiving its benefits.

In response to objections from local *muftis*, who tend to believe that the practice violates the prohibition of *riba* (and is therefore un-Islamic)<sup>897</sup>, real estate agents are increasingly concluding *Gerawee* agreements under the title of *Bai al-Wafa*.<sup>898</sup> This designation is an attempt to justify the legitimacy of the practice under Shari'ah by relying on the Hanafi jurisprudence. As will be discussed below, however, this attempt has had only partial success. In fact, *fatwas* condemning the practice have been increasing. The disapproval of *muftis* cannot explain the divergence of judicial opinions on formalization of *Gerawee*, on the one hand, and *Sar qufli* and other interest-bearing commercial transactions, on the other, because *muftis* often disapprove of *Sar qufli*. They also vehemently disapprove interest-bearing commercial transactions of any forms (especially those conducted by *Sarrafs*.)

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<sup>897</sup> The Shari'ah-standing of *Gerawee*, an explanation of the term *mufti*, and the opinions of Islamic jurists regarding the practice is discussed later in this Chapter.

<sup>898</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013, and interview data collected for the author's previously published article, Haroun Rahimi, *supra* note 879.

### 3.3.4. *Bay' al-Wafa*: Sale with a Right of Repurchase

*Rahn* (commonly translated into English as “pledge”) is the sole formal security mechanism over assets in Islamic law.<sup>899</sup> The *Majalla*<sup>900</sup> gives the following definition of *rahn*: “A pledge [that] consists of setting aside property from which it is possible to obtain payment or satisfaction of some claims. Such property is then said to be pledged, or given in pledge.”<sup>901</sup> Under *rahn*, the possession of the property must be transferred to the creditor. According to article 706 of *Majalla*, “If the pledge is not transferred to the effective possession of the pledgee...such contract is incomplete and revocable.”

Under *Bay' al-Wafa* (sale with right of repurchase), debtor A “sells” an asset to creditor B. Then B “pays a price” for it, \$1000 for example. The contract contains a repurchase condition, which authorizes A to repurchase the asset by paying back the same price (the \$1000) at a later date. Under the “sale” contract, the title in the property is transferred to B and remains with B during the term of the contract. Thus, B receives the benefit of the property (e.g. by living in the house or renting the house to a tenant) or receives rent from A for continued enjoyment of the property (e.g. A pays rent in exchange for continuing to stay in the house). B as the owner, i.e., holder of formal title, retains a legitimate and justified use of personal property. However, B cannot make any change to the title or the property that would render the repurchase condition ineffective.<sup>902</sup> Thus, the property is, in effect, a security for the debt. Some jurists have accepted

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<sup>899</sup> Nicholas Foster, *The Islamic Law of Real Security*, 15 ARAB L.Q. 145 (2000).

<sup>900</sup> *AL-MAJALLA AL-AHKAM AL-ADALIYYAH* [The Ottoman Courts Manual] (Hanafi), ([last visited](#) Feb. 19, 2015, 05:32 PM), [http://legal.pipa.ps/files/server/ENG%20Ottoman%20Majalle%20\(Civil%20Law\).pdf](http://legal.pipa.ps/files/server/ENG%20Ottoman%20Majalle%20(Civil%20Law).pdf). (Majalla is a manual of Hanafi jurisprudence that was developed by Ottoman to be used by judges in Ottoman courts. The Majalla is considered to be an authoritative collection of the rulings of Hanafis on most issues.)

<sup>901</sup> *Id.* art. 701.

<sup>902</sup> Like selling the property without the consent of seller/debtor A.

this kind of contract as valid because of what they deem as “economic imperatives.”<sup>903</sup> The *Majalla* acknowledges this position in Articles 396-403.

However, *Bai al-Wafa* has some weakness as security contract. First, like *rahn*, it is a possessory security: possession of the property must be transferred to the creditor. Second, according to Article 397 of the *Majalla* the creditor cannot sell the property without the consent of the debtor, even if the time of contract elapses.<sup>904</sup> Finally, because of the resemblance to *riba*, the opinion of the jurists has been widely divided on the question of which party is entitled to the revenue of the assets.<sup>905</sup> Article 398 of the *Majalla* allows the parties to agree that a portion of revenue goes to the creditor.<sup>906</sup> This version of *Bai al-Wafa*, which allowed for revenue sharing, has been widely practiced in Egypt, Algeria, Turkey, and restrictedly was practiced in Syria and Lebanon.<sup>907</sup>

### 3.3.5. *Gerawee* in *Fatwas* issued by the Afghan *Muftis*

Traditionally *fiqh*<sup>908</sup> has developed in a grass-roots bottom-up way. Muslims have referred their concrete questions to *mufti*, who have been recognized through an informal system of peer-

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<sup>903</sup> Foster, *supra* note 899, at 159.

<sup>904</sup> See the Ottoman Courts Manual, *supra* note 900.

<sup>905</sup> Foster, *supra* note 899, at 145.

<sup>906</sup> See the Ottoman Courts Manual, *supra* note 900.

<sup>907</sup> Foster, *supra* note 899, at 147.

<sup>908</sup> *Fiqh* refers to the human interpretation of Shari’ah. Shari’ah, i.e. Islamic law, is only accessible through application of human reasons to the scripture. However, since the human reason is inevitably fallible, Muslim jurists distinguish between Shari’ah, which is Islamic law as understood by Allah, and the *Fiqh*, which is human understanding of Shari’ah, and therefore, inescapably subject to debate, evolution, and disagreement. For an explanation of meanings *Fiqh* and Shari’ah and their differences See CLARK B. LOMBARDI, STATE LAW AS ISLAMIC LAW IN MODERN EGYPT Ch. One (2006). This dissertation, however, I often use Islamic law, Shari’ah, and *Fiqh* interchangeably.

evaluation as competent to answer them.<sup>909</sup> These scholars are called *mufti* (sing), *Muftis* (plural). *Muftis* then answer those questions in a non-binding ruling called a *fatwa*.<sup>910</sup> Although non-binding, these *fatwas* carry significant religious authority for Muslims who try to be faithful to the teachings of their religion.

This section explores the reasoning of the contemporary *fatwas* issued by Afghan *muftis*, some of which favor the practice of *Gerawee* and some of which oppose it.<sup>911</sup> The *fatwas* favoring the practice rely heavily on Hanafi jurisprudence, which has allowed *Bai al-Wafa*, and similar transactions on the ground that the transaction, if formally understood, does not violate the prohibition of interest (*riba*), and that the economic imperatives compel jurists to take a formalistic, not a functional, approach to understanding of the transaction allowing it to continue.

Other *fatwas*, on the other hand, oppose *Gerawee*. Specifically, they criticize *Gerawee* arguing that: (1) the practice is an obvious ruse to circumvent the prohibition of *riba*; 2) the practice discourages preferable Islamic practices such as benevolent loans (*qard al -hasana*), *mudaraba* (trust financing contract), and *musharakah* (partnership); and 3) the practice further increases social injustice. This opposition responds to the part of Hanafi tradition that favors the practice by arguing that parties engaging in the *Gerawee* do not have the genuine intention to conclude a sale contract (*bai*). These critics believe that a *bona fide* intention of transfer of title in the property is a salient characteristic of the *bai* (contract of sale) and is key to legitimization of the practice.

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<sup>909</sup> See Wael Hallaq, "What is Sharia?," in 12 YEARBOOK OF ISLAMIC AND MIDDLE EASTERN LAW: 2005-2006 151 (2007); Rudolph Peters, *From Jurists Law to Statute Law or What Happens When the Shari'a is Codified*, 7 MEDITERRANEAN POLITICS 82 (2002).

<sup>910</sup> *Id.*

<sup>911</sup> The *fatwas* discussed in this section are generally retrieved from these online sources of *fatwas*: <http://www.islampp.com/> (Web: Sunni Tradition Fatwa [Juristic Legal Ruling] Collection); [www.eslahonline.net](http://www.eslahonline.net) (Web: Afghanistan Rectification Society). The discussion is also informed by the authors many discussions with local *muftis* in Afghanistan.

### 3.3.6. Status of *Gerawee* under Afghan Civil Code of 1977

In addition to Shari'ah-based objection to the *Gerawee*, the practice has ambiguous standing under Afghanistan Civil Law. *Gerawee* as a customary practice does not conform to the Afghan Civil Law. Relevant provisions of the Civil Code of 1977 ["Civil Code"] are Articles 1136-1153, which deal with *Bai al-Wafa*.<sup>912</sup> These provisions are reflective of religious concerns with prohibition of *riba*. In most cases, these provisions are consistent with the arguments of those *muftis* who oppose the practice of *Gerawee*. Article 1136 defines statutory *Bai al-Wafa* as "... having the right of taking back the object of sale by seller and that of taking back price by buyer."<sup>913</sup> The mandatory provisions of statutory *Bai al-Wafa* set forth in the Civil Code, contradicts the common practice of *Gerawee* on several points.

According to Article 1137 of the Civil Code, the right of a seller and buyer to "take back" cannot be conditioned and limited to a specific period of time.<sup>914</sup> In particular, the agreement cannot specify that the seller (i.e. debtor/*Gerawee*-ee) cannot take back his property for a period of time. Even if parties agree to such a term, the second clause of the same article states that such agreement will be void.<sup>915</sup> Furthermore Article 1151 of the Civil Code explicitly states that, in contracts involving immovable properties, if the parties intend the agreement to be a pledge with right to use the property (i.e. mortgage), the sale and pledge both are voided.<sup>916</sup> Under this provision, the parties cannot use the statutory *Bai al-Wafa* as a means to secure credit for a loan.

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<sup>912</sup> AFGHANISTAN CIVIL CODE, *supra* note 503.

<sup>913</sup> *Id.*

<sup>914</sup> *Id.*

<sup>915</sup> *Id.*

<sup>916</sup> *Id.*

The parties must have the intention to transfer the title in the property: they must have the intention of concluding a *bona fide* sale contract.

Civil Code Articles 1136-1153 are a synthesis of provisions of different Arabic countries civil codes (drafted using al-Sanhuri's methodology, hence, Sanhuri codes). Afghanistan's Civil Code adopts the majority position of Sanhuri civil codes in disallowing *Bai al-Wafa* to be used as a security contract. However, it diverges from the majority position in adopting detailed provisions determining the rights and obligations of the buyer and seller under a non-security *Bai al-Wafa*. In determining parties' rights and obligations, the Civil Code adopts its provisions from the Lebanon Civil Code (1932) Articles 473-486.<sup>917</sup> The Lebanon Civil Code (1932) diverges from the position of majority of Islamic jurists, and majority of Sanhuri codes, by allowing *Bai al-Wafa* to be used as a security contract.<sup>918</sup> The Lebanon Civil Code position is based on the French Civil Code.<sup>919</sup> However, Lebanon shortens the term of validity of the right of repurchase from the French Civil Code's 10 years to three years.<sup>920</sup>

Most Sanhuri codes summarily address *Bai al-Wafa* (i.e. Sale with a Right of Repurchase). For example, the Egyptian Civil Code (1948) only has one article on this type of sale: Article 465, which says, "If seller adds a term to the sale contract whereby the seller can repurchase the thing that is being sold within a specified time the sale contract is void."<sup>921</sup> Similarly, the Syrian Civil Code (1949) and the Libya Civil Code (1954) each contain a single article on the sale with the right or repurchase (Article 433 and Article 454, respectively) which are identical to Egyptian

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<sup>917</sup> AL-QANUN AL-MADANI [CIVIL CODE] (Lebanon)

<sup>918</sup> *Id.* arts. 473-486.

<sup>919</sup> CODE CIVIL [CIVIL CODE] ARTS. 1659-1673 (FR.) (vente à réméré).

<sup>920</sup> LEBANON CIVIL CODE, *supra* note 917, arts. 473-486.

<sup>921</sup> AL-QANUN AL-MADANI [CIVIL CODE] (Egypt).

Civil Code Article 465.<sup>922</sup> While the Jordan Civil Code (1976) is silent on the issue of Sale with the Right of Repurchase,<sup>923</sup> the Iraq Civil Code (1951) has a single article on *Bai al-Wafa*, Article 1333, which states, “Bai al-Wafa is considered the same as a possessory rahn [pledge]”.<sup>924</sup> Iraq Civil Code Article 1333, in effect, states the provisions of Iraq Civil Code on possessory *rahn* is applicable to *Bai al-Wafa* as well.<sup>925</sup> It should be noted that this approach does not solve the *riba*-problem of use of *Bai al-Wafa* as a security contract because under pledge the ownership remains with the pledgor (seller), therefore, the pledgee’s (buyer) use of property raises a *riba*-problem.

Notably, the Lebanon Civil Code (1932) recognizes the validity of a term of repurchase in a sale contract which is subjected to a specified length of time under the condition that it cannot exceed three years (Article 474).<sup>926</sup> The Lebanon Civil Code sets forth the rights and obligations of buyer and seller under *Bai al-Wafa* within 15 articles (Article 473-486).<sup>927</sup> In effect, the Lebanon Civil Code, following French Civil Code, and the minority view among Muslim jurists, allows *Bai al-Wafa* to function as a security contract.<sup>928</sup> However, it adopts a shorter time period of three years (compared to French Civil Code’s 10 years) for the validity of the right of repurchase.<sup>929</sup>

The Afghanistan Civil Code adopts the majority position of Arabic civil codes, and a majority of Muslim jurists, by rendering the use of *Bai al-Wafa* void as a security device. The

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<sup>922</sup> See *Id.*; AL-QANUN AL-MADANI [CIVIL CODE] (Syria); AL-QANUN AL-MADANI [CIVIL CODE] (Libya).

<sup>923</sup> See AL-QANUN AL-MADANI [CIVIL CODE] (Jordan).

<sup>924</sup> AL-QANUN AL-MADANI [CIVIL CODE] (Iraq).

<sup>925</sup> *Id.*

<sup>926</sup> LEBANON CIVIL CODE, *supra* note 917, arts. 473-486.

<sup>927</sup> *Id.*

<sup>928</sup> See *Id.*; FRANCE CODE, *supra* note 919, arts. 1659-1673.

<sup>929</sup> *Id.*

Afghanistan Civil Code adopts Lebanon Civil Code's position in that it contains nineteen articles setting forth the rights and obligations of the parties under a *Bai al-Wafa* which is not being used to securitize a loan. Thus, the Afghanistan Civil Code takes on a more moderate stance on *Bai al-Wafa*. It allows the sale contract to include a repurchase clause for a purpose other than securitizing a loan and it sets forth a series of legal provisions based on Lebanon Civil Code's *Bai al-Wafa*'s provisions that would regulate a non-security *Bai al-Wafa*.

### **3.3.7. Gerawee cases before Afghan Courts<sup>930</sup>**

Because of the legal and Shari'ah related uncertainties associated with the customary practice of *Gerawee*, the civil courts, which have jurisdiction over *Gerawee* disputes, have had difficulty adjudicating the legal disputes that arise out of the practice. Hence, the opinions of Afghan courts vary on the issue of *Gerawee*.

Some judges do not recognize the *Gerawee* agreement as valid on the ground that it violates the Qura'nic prohibition of *riba*. They cite to the Article 3 of 2014 Afghan Constitution that reads: "[n]o law shall contravene the tenets and provisions of the holy religion of Islam in Afghanistan."<sup>931</sup> However, they usually compel the *Gerawor* to repay the amount received based on the notion of fairness. Other judges recognize the *Gerawee* contract as valid invoking the Hanafi jurisprudence on *Bai al-Wafa*, and the provisions of the Afghanistan Civil Code (Article 1137 and 1136).<sup>932</sup> They usually rely on the stipulation of the parties in in the agreement, that it is a *Bai al-Wafa*, and refrain from further inquiry which may render the agreement void.

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<sup>930</sup> This section is informed by the author's many personal discussions with Afghan judges. For the purpose of this paper, in particular, two prominent judges in Herat have been interviewed via skype: Judge Basir Ahmad Sediqi, seating judge in Herat Primary Court, Civil Division, and Judge Kamali, siting Judge in District of Gozara and former head of Civil Division of Herat Primary Court.

<sup>931</sup> AFGHANISTAN CONSTITUTION 2014, *supra* note 511.

<sup>932</sup> AFGHANISTAN CIVIL CODE, *supra* note 503.

Afghan judges, however, do not find that *Gerawee* creates a security right. The property under *Gerawee* is not treated as collateral. Courts, both opposing and favoring courts, do order the repayment of the price under *Gerawee*, however, they do not recognize priority for the lender under *Gerawee* if the *Gerawor* is insolvent.

### **3.4. *Sar qufli***

*Sar qufli* is an informally developed institution that is slowly being formalized through judicial decisions without legislation. The practice, in essence, commodifies the future reputation of a business in cases where reputation is closely tied to a place.<sup>933</sup> By commodifying the future business reputation of a place, it improves capital liquidity in the market. *Sar qufli* can be used to raise capital to develop a property (as evident in paradigmatic *Sar qufli* cases which will be discussed later.) It can also be used to raise capital against the value of developed property. Thus, *Sar qufli* relaxes the capital constraints on property development projects.

#### **3.4.1. What is *Sar qufli*?**

*Sar qufli* (which literally means *main lock* or *head lock*), in Afghanistan, has been adopted by merchants and developers as a response to their practical needs outside of formal institutions. As a customary transaction, the specifics of *Sar qufli* transactions may vary across localities. However, in its essence, *Sar qufli* can be best conceptualized as commodification of commercial reputation.

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<sup>933</sup> The description of *Sar qufli* in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

Williamson identifies asset specificity as a transaction problem that can give rise to opportunistic behaviors.<sup>934</sup> Since the reputation value created by the tenant is closely tied to the place of business, meaning it is specific to the property and is not easily transferable, it allows the landlord to extract quasi rent from the tenant by charging higher rents or capturing the reputation value of the place of business by opportunistically evicting the tenant. *Sar qufli* has evolved organically in Afghanistan and other places to curtail the opportunistic behaviors that Williamson argued arise from the problem of asset specificity in commercial lease of immovable property.<sup>935</sup>

*Sar qufli* is a transaction whereby a lessee protects himself against eviction by paying a lump sum of money to lessor. By paying a sum of money, the lessee acquires *Sar qufli* in the property. The lessor cannot evict a *Sar qufli*-holder lessee as long as he pays the comparable rent.<sup>936</sup> Lessees use *Sar qufli* to protect the value it creates by the use of the property (business reputation which is tied to a place, and therefore, is not readily movable). A lessor uses *Sar qufli* to retain ownership of the property while either raising capital to develop the property (e.g. build a shopping center) or raising capital (cashing in) against the value of an already developed property.

It is very common for a developer or owner to offer stores and offices in a commercial building that is being developed or is finished for *sar qufli*. This way if someone is interested in using an office or a store in the building, he will pay a lump sum of money, in addition or without additional regular payments, to obtain a *sar qufli* over a store or an office in the building.

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<sup>934</sup> See WILLIAMSON (1985), *supra* note 74, CH. 1, 2 & 3.

<sup>935</sup> *Id.*

<sup>936</sup> The comparable rent (in Arabic *ijarat al-meth'l*) refers to the amount of rent for a comparable property. For example, the comparable rent of a store would be the amount of rent for which a comparable store may be leased.

As the person uses the store/office for his business, the value of store/office will increase in correlation with the success and popularity of the business. Customers will know that they can go to this address to obtain a certain product or service. Similarly, if the business is successful, customers will trust the service and goods they obtain from that location. This means that rival businesses would be willing to pay a large sum of money for the chance to acquire the location for their own businesses.

Under this system, when the lease term expires, the developer/owner may be tempted to lease the store/office to a rival business or to keep store/office for himself and launch a similar business. As a result, the developer/owner will, in effect, take the value created by the lessee who had been using the property. *Sar qufli* protects the user of the store/office (i.e. lessee) against appropriation of the reputation-value created through use.

When someone has a *sar qufli*, he will get to keep using the property, subject to reasonable increase in rent, unless the owner/developer pays the market price of the value created by the usage, essentially buying back the *Sar qufli*. The owner/developer can only evict the *Sar qufli*-holder lessee by buying back the *Sar qufli*, by paying the *Sar qufli*-holder lessee to hand over his *Sar qufli*. The *Sar qufli*-holder lessee is only willing to hand over the *Sar qufli* for a price equal to or more than the market value of the reputation that has been created through use. The market value in essence is determined by how much a *Sar qufli*-holder lessee is willing to accept to vacate the place of business. Therefore, in essence, *Sar qufli* commodifies the reputation value of a place of business. This market price is determined through open market mechanism, i.e. how much other businesses (or the owner) are willing to pay to obtain the location for their own businesses, i.e. demand, and how much the *Sar qufli*-holder lessee is willing to accept to vacate the place of business (supply).

The market value of commercial reputation can be very significant. When a commercial building first opens it has a low value but when through use and over time commercial buildings become a hub for a certain market, such as sales from electronics to stationarity, or establishment of a *sarrafi* market, the value of the building and individual store/office can skyrocket. *Sar qufli* is a transaction that allows users of the property, who created the value created through use, to protect their investment and financial interest.

*Sar qufli* is transferable. The user of a property (a *Sar qufli*-holder lessee) can sell the right to use that property to someone, other than the developer/owner, for a price. However, in this case the developer/owner has the right of first refusal. *Sar qufli* is also inheritable.

The person who obtains a *sar qufli* does not obtain the ownership in the underlying property. This means that developer/owner can modify, expand, or renovate the building provided it does not substantially interfere with right of the person with *Sar qufli* to use the property.

The value of *sar qulafi* may go down too. If someone obtains a *sar qufli* for a large sum of money, and that store/office loses its commercial reputation for any reason he may incur loss as he is not guaranteed to receive back the money he paid when he obtained the *sar qufli*. In short, the value of *sar qufli* fluctuates like a commodity based on supply and demand.

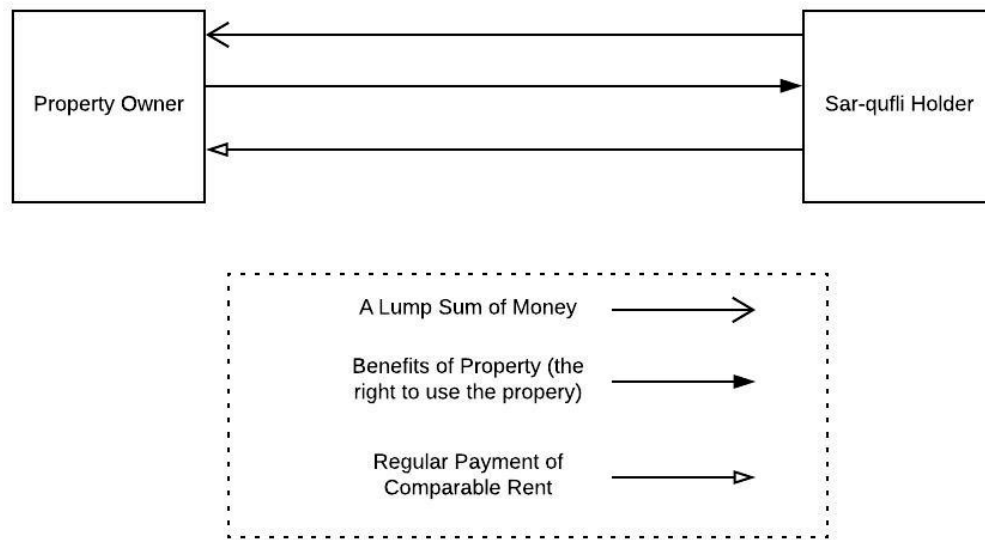
*Sar quflis* are particularly valuable in Afghanistan because most markets (such as a market where electronics are sold, *Sarrafi* markets, wholesale food markets, oil and gas markets, etc.) are geographically concentrated in a few market buildings. Therefore, the location of a place of business has a crucial role in its success. For example, it is practically impossible to operate a *Sarrafi* outside a few neighboring *Sarrafi* market-buildings. People associate having a store in the market with being credible. In effect by buying a store in the *Sarrafi* market-building or buying the right to use a store in the *Sarrafi* market-building, the buyer is buying into a collective

reputation. This is why a *Sar qufli* price for a store in the *Sarrafi* market-building can reach up to thousands of dollars.

From a developer/owner perspective, *sar qufli* is a way to raise or recover the capital without transferring ownership. The developer/owner will remain the owner. This means he enjoys a right of first refusal on the purchase of the reputation value created in the property by the user, and he can expand the property, for example, by adding another floor, while he receives reasonable rent payments.

While the most common subject of *Sar qufli* is a place of business (i.e. store or office), it does not have to be. The subject of *Sar qufli*, legally, can be any leasable property. Given the economic logic of transactions, the *Sar qufli* is used to protect the lessee against forced eviction after the lessee has added to the value of property. Therefore, it is used for properties for which such protection may be required. For example, a manufacturing business may opt to *Sar qufli*-lease a piece of land, rather than buy it, to erect a factory. This way, the *sar qufli*-holder lessee can make sure that as long as he pays a comparable rent, the lessor cannot take the erected structure (i.e. factory) by evicting him.

*Sar qufli* is a transaction developed outside of Afghanistan's formal legal system but it has come to be recognized by courts. Afghanistan's statutory laws do not mention *sar qufli*. It is a transaction that was created through practice in the market. As the practice became more and more common, courts were called upon to resolve the disputes concerning this practice. Although Afghanistan has yet to enact statutory laws regarding *Sar qufli*, the courts have responded by enforcing the customary norms that have grown surrounding the practice in marketplace.



*Diagram 4 Sar qufli*<sup>937</sup>

### 3.4.2. Recognition of *Sar qufli* by Commercial Courts

In Afghanistan, it is common to find transactions outside of the formal legal system. However, what makes *Sar qufli* interesting is the formalization of rules surrounding this practice as courts are used to resolving disputes arising from the practice. The use of courts to resolve disputes involving *Sar qufli* stems from the nature of *Sar qufli* as a claim, or rather a defense, involving an immovable property, most commonly a store or an office.<sup>938</sup>

The majority of non-criminal cases handled by courts in Afghanistan are disputes involving immovable property. According to the Head of Huquq General Department at the Ministry of Justice, in 2016/17, Huquq Departments across the country have processed 15,867 claims

<sup>937</sup> Constructed by the author based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>938</sup> See *supra* Chapter Two.

involving immovable properties, 9,966 claims involving monetary claims, and 3,266 involving family and personal affair disputes.<sup>939</sup> This means roughly 55% of request for non-criminal court proceedings in Afghanistan are related to immovable properties.

Court remedies are both necessary and effective when it comes to immovable property disputes.<sup>940</sup> Court remedies are necessary because immovable property claims are brought against the person who is in actual possession of the immovable property,<sup>941</sup> therefore, a coercive action is required to remove the property from that person's actual possession. According to Judge Sediqi, *sar qufli* disputes often arise when a landlord files a petition to evict a tenant claiming that the term of the lease has either expired or has been violated, and the tenant in response claims that the tenant is not a simple tenant and he has *Sar qufli* over the immovable property.<sup>942</sup> In response to *Sar qufli* defense, the court would require the tenant to prove the existence of *Sar qufli* to defend himself against an eviction petition.<sup>943</sup>

Court remedies are also effective when it comes to immovable properties. As the interviews show, a major factor that dissuades the merchants from going to courts is that even if they win a case they are not confident that the judgment can be enforced.<sup>944</sup> For example, in a monetary claim, if the losing party does not have identifiable assets, a judgment against him is useless. Conversely, a judgment recognizing a party's right over an immovable property will almost always will be enforced because the property exists and its possession can be transferred to the winning party. In

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<sup>939</sup> Author's written communication via Facebook with the Head of Huquq General Department at the Ministry of Justice (September 2017).

<sup>940</sup> See *supra* Chapter Two.

<sup>941</sup> See LAW OF CIVIL PROCEDURE, *supra* note 527.

<sup>942</sup> Author's interview with Judge Sediqi, Chief Judge of Kabul's Primary Commercial Court (June 2017).

<sup>943</sup> *Id.*

<sup>944</sup> See Chapter Two.

a *Sar qufli* case, for example, if tenant is able to prove the existence of a *Sar qufli*, he/she will not be forced to vacate the store.

According to the Chief Judge of Kabul Primary Commercial Court, no statutory laws recognize or address *Sar qufli*.<sup>945</sup> Judges across the country, following Afghanistan's Supreme Court's decision, rely on agreement of the parties, a number of decisions made at the Judicial Seminars (Seminar) and approved by the Afghanistan Supreme Court, and local customs to decide *Sar qufli* disputes.<sup>946</sup> The Seminar is a judicial seminar where chief provincial judges and the justices of Afghanistan Supreme Court convene, usually every two or three years, to discuss and resolve the most challenging legal questions that faces the judiciary. The questions are posed by the judges across countries. The Seminar answers these questions. The Afghanistan Supreme Court High Judicial Council then approves these answers making them binding for lower courts to follow. Questions about the legality of *Sar qufli* were first posed to the Seminar 1381/2002.<sup>947</sup>

The question of legality and Shari'ah-compliance of *Sar qufli* was raised in Afghanistan because *Sar qufli* limits the rights of the owner indefinitely. The owner cannot forcefully evict a *Sar qufli*-holder lessee indefinitely so long as he holds the *sar qufli*. The potential for an indefinite constraint of ownership rights made the legality and Shari'ah-compliance of *Sar qufli* suspect in Afghanistan. Therefore, the Seminar was asked to render an opinion on whether the practice of *Sar qufli*, "which is widespread in Kabul," existed in the formative ages of Islam or emerged thereafter? And if did not exist in the formative period of Islam, who first authorized the practice in Islamic history? And was the practice permissible or not?<sup>948</sup>

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<sup>945</sup> Author's interview with Judge Sediqi, Chief Judge of Kabul's Primary Commercial Court (Kabul, June 2017).

<sup>946</sup> *Id.*; see also JUDICIAL SEMINAR (2017), *supra* note 554.

<sup>947</sup> See JUDICIAL SEMINAR (2017), *supra* note 554, at 73.

<sup>948</sup> *Id.*

In effect, the 2002 Seminar was asked to decide whether the practice was Shari'ah-compliant, and therefore, legal<sup>949</sup>, or whether it violated the Shari'ah, and therefore, was illegal. The reason the legality of *Sar qufli* was entangled with its Islamic precedents and its Shari'ah-compliance is that 1964 Constitution, which was in force at the time, mandated judges to, in the absence of a pertinent legislation, resolve disputes according to Hanafi school of Islamic law jurisprudence.<sup>950</sup> The 2004 Constitution has reaffirmed this mandate.<sup>951</sup>

The Seminar rendered the following opinion: (1) *Sar qufli* (which the 2002 Seminar understood to be identical to the practice in Arabic called *khlow hawaniat*) did not exist at the formative age of Islam; (2) classical Sunni jurists did not issue an opinion on the permissibility of the practice; and (3) the practice originated during the reign of Sultan Ghor in the eleventh century when the Sultan collected money from his subjects to erect stores on public land with the promise that they would be able to use the stores as long as they paid reasonable rent (paradigmatic case of *Sar qufli*).<sup>952</sup> The practice then spread to the rest of the Islamic world. Muslim scholars, especially Islamic scholars of Cairo, issued fatwas approving the Shari'ah-compliance of the practice.<sup>953</sup> Some version of the practice has spread to different parts of the world. The practice is especially common in Kabul.<sup>954</sup> Therefore, the Seminar concluded the practice was Shari'ah-compliant, and hence legal, citing several supporting opinions concerning *khlow hawaniat* (which Seminar understands to be the Arabic term for *Sar qufli*) reflected in an authoritative compilation

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<sup>949</sup> Under QANUN ASSASI AFGHANISTAN [AFGHANISTAN CONSTITUTION] 1343 [1964] art. 69, which was in force at the time, in the absence of legislation, courts were required to use Hanafi jurisprudence to resolve disputes. Article 130 of AFGHANISTAN CONSTITUTION 2014, *supra* note 511, contains a similar provision.

<sup>950</sup> See QANUN ASSASI AFGHANISTAN 1964, *supra* note 949, art. 69.

<sup>951</sup> See AFGHANISTAN CONSTITUTION 2014, *supra* note 511, art. 130.

<sup>952</sup> AFGHANISTAN SUPREME COURT, JUDICIAL SEMINAR 73-74 (1381 [2002]).

<sup>953</sup> *Id.*

<sup>954</sup> *Id.* at 74.

of Hanafi fatwas (*al-Mukhtar*) and several exegeses of Majilla as proof that the practice is permissible under the Hanafi school of law.<sup>955</sup> It used these texts, especially *al-Mukhtar*, to elaborate on the rules governing different aspects of the *Sar qufli* in Afghanistan.<sup>956</sup>

The Seminar defined *Sar qufli* as a transaction whereby a lessee, upon payment of a lump sum of money to a lessor, is protected against eviction as long as he continues paying a comparable rent.<sup>957</sup> It answered several legal questions concerning *Sar qufli* (which were presumably raised during the Seminar):

(1) Only receipt of a lump sum of money by the owner of the property creates *Sar qufli*; therefore, if a lessee sublets the property in exchange for a lump sum of money, this does not circumscribe the ownership rights of the owner, therefore, the owner can evict the first or second lessee and the *Sar qufli* cannot be invoked by either lessee.<sup>958</sup>

(2) Islamic law prohibits excessive uncertainty in transactions (prohibition of *qarar*).<sup>959</sup> Therefore, a developer cannot accept payments from several people, in exchange for the promise that he will give them one or two stores, if the stores are not specified.<sup>960</sup>

(3) The government can collect payment from different individuals to build a shopping center on public land in exchange for the promise to lease the stores to those individuals.<sup>961</sup> In such

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<sup>955</sup> *Id.* at 74-82.

<sup>956</sup> *Id.*

<sup>957</sup> *Id.* at 74.

<sup>958</sup> *Id.* at 75.

<sup>959</sup> *Id.*

<sup>960</sup> *Id.*

<sup>961</sup> *Id.*

a case, those individuals will acquire a *Sar qufli* in the stores. In fact, this was the paradigmatic case of *Sar qufli*.<sup>962</sup>

(4) If the holder of *Sar qufli* leaves the property for a period of time, and then the owner leases the property to someone else in his absence, the holder of *Sar qufli*, upon return, is entitled to receive his *Sar qufli* payment back or evict the current lessee to resume his lease of the property.<sup>963</sup>

(5) *Sar qufli* is a transferable right, therefore, the holder of *Sar qufli* can transfer his right to another person and this transfer can occur for several times.<sup>964</sup> The current holder of *Sar qufli* can invoke *Sar qufli* against the owner as long as the comparable rent is uninterruptedly paid to the owner.<sup>965</sup>

(6) The owner cannot evict the *Sar qufli* holder until a comparable rent is uninterruptedly paid.<sup>966</sup> In case of failure to pay the rent, the owner can evict the *Sar qufli* owner upon payment of the same amount of the money that he has received upon creation of *Sar qufli*.<sup>967</sup>

(7) If a tenant with the permission of the owner performs improvements on the property, the tenant acquires a *Sar qufli* in the property, therefore, cannot be evicted as long as he pays comparable rent.<sup>968</sup> In case he fails to pay the rent, the owner can evict the *Sar qufli* holder upon payment of the value of the improvements.<sup>969</sup>

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<sup>962</sup> *Id.* at 77.

<sup>963</sup> *Id.* at 78.

<sup>964</sup> *Id.* at 80.

<sup>965</sup> *Id.*

<sup>966</sup> *Id.* at 81.

<sup>967</sup> *Id.*

<sup>968</sup> *Id.* at 82.

<sup>969</sup> *Id.*

(8) *Sar qufli* is an inheritable right; therefore, the death of *Sar qufli* holder does not void the *Sar qufli*.<sup>970</sup>

The 1395/2017 Seminar has confirmed that these 2002 Seminar's decisions, along with the agreement of the parties, and the local customs, form the legal framework of *Sar qufli* in Afghanistan.<sup>971</sup> The 1395/2017 decisions have especially emphasized the primacy of customs ('urf) in commercial matters as a rationale for continued recognition of *Sar qufli* by commercial courts.<sup>972</sup> The 1395/2017 Seminar stated,

Since *Sar qufli* is common in commercial customs and dealings, and under PCA commercial customs plays an important role in resolution of commercial disputes, and according to the decisions of the High Council of the Afghanistan Supreme Court commercial courts have the jurisdiction to resolve *Sar qufli* disputes, the courts shall decide *Sar qufli* cases in the following manner.<sup>973</sup>

The 1395/2017 Seminar reiterated and specified similar rules decided in 1381/2002 Seminar.<sup>974</sup> The 1395/2017 Seminar, in particular, instructs the courts to use expert witnesses to determine the prevailing *Sar qufli* customs when deciding *Sar qufli* cases.<sup>975</sup>

The 1395/2017 Seminar, in response to a clarification request, opined that judicial decisions concerning *Sar qufli* are not subject to taxation because imposition of a tax without legislation is unconstitutional, and there is no legislation concerning *Sar qufli*.<sup>976</sup> This has most likely

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<sup>970</sup> *Id.*

<sup>971</sup> JUDICIAL SEMINAR (2017), *supra* note 554, at 172.

<sup>972</sup> *Id.* at 336.

<sup>973</sup> *Id.*

<sup>974</sup> *Id.* at 336-337.

<sup>975</sup> *Id.* at 337.

<sup>976</sup> *Id.* at 184.

contributed to the continued use of courts to resolve *Sar qufli* disputes by reducing the cost of use of formal dispute resolution. This suggests reducing the judgment tax (discussed in Chapter Two) likely will improve the popularity of formal dispute resolution in Afghanistan.

A conflict often arises, according to a questioner at the 1395/2017 Seminar, when courts attempt to auction collateral held by banks in case of default, but the collateral is subject to *Sar qufli*.<sup>977</sup> How should this conflict be resolved? In case of a conflict between a security right and a *Sar qufli*, the Seminar opined that the court should accord primacy to the security holder (against *Sar qufli* holder) only if the security owner was unaware of the existence of *Sar qufli* at the time of creation of security right.<sup>978</sup> If the security right holder was aware of the existence of *Sar qufli* at the time of creation of security right, the right of *Sar qufli* holder is not affected by the security right.<sup>979</sup> The Seminar opined that it is a question of fact whether the security right holder had prior knowledge or not, and courts should resolve this question.<sup>980</sup>

According to Judge Sediqi, the majority of commercial judges have expressed discontent with the lack of codification on a transaction that makes up the majority of disputes in primary commercial courts, and the second most common disputes on appeal.<sup>981</sup> To remedy the situation, some chief commercial judges have drafted a directive proposal to be approved by the Afghanistan Supreme Court.<sup>982</sup> According to Judge Sediqi, the Afghanistan Supreme Court may soon adopt this directive.<sup>983</sup> The 1395/2017 Seminar also have mandated that a law should be drafted

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<sup>977</sup> *Id.* at 185.

<sup>978</sup> *Id.*

<sup>979</sup> *Id.*

<sup>980</sup> *Id.*

<sup>981</sup> Author's interview with Judge Sediqi, Chief Judge of Kabul's Primary Commercial Court (June 2017).

<sup>982</sup> *Id.*

<sup>983</sup> *Id.*

concerning *Sar qufli* which incorporate the judicial jurisprudence.<sup>984</sup> No such a law has been enacted at the time of writing (May 2018).

### **3.4.3. The Contrast between Judicial Treatment of *Sar qufli* and *Gerawee***

The contrast between judicial attitudes towards *Sar qufli* and *Gerawee* is reflective of the heterogeneous normative attitudes toward informal practices within different sectors of the Afghan judiciary. Judges within the commercial context are more willing to recognize customarily created institutions and interest-bearing transactions than judges in a non-commercial context.<sup>985</sup>

*Sar qufli* has been judicially formalized despite being an informally created institutions concerning an intangible asset, i.e. future business reputation, which indefinitely unbundles property rights, i.e. the owner of property is different than the owner of the business reputation connected to that property. Concerning the question of interest, although *Sar qufli* does not raise the same religious concerns as *Gerawee*, commercial judges routinely enforce interest-bearing loan contract.<sup>986</sup>

The divergent attitudes toward *Gerawee*, on the one hand, and *Sar qufli* and interest-bearing bank loans, on the other, is more interesting when one considers that Afghanistan does not have specialized judges. There is no difference between commercial and non-commercial judges. A criminal judge may get transferred to a commercial court and vice versa.<sup>987</sup>

The difference in attitudes towards formalization of informal practices has great consequences for the creation of efficient formal institutions. De Soto and North both suggest that

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<sup>984</sup> JUDICIAL SEMINAR (2017), *supra* note 554, at 341.

<sup>985</sup> See earlier discussions in this Chapter.

<sup>986</sup> See *supra* Chapter Two.

<sup>987</sup> This observation is based on the author's knowledge of Afghanistan's judicial system as he has witnessed such assignment and re-assignment.

the remedy for an informal economy is to make the law more user-friendly.<sup>988</sup> They suggest that formally held rights can be incorporated into formal institutions by removing the formal barriers for their inclusion with positive consequences for efficiency.<sup>989</sup> Formal institutions must be made responsive to actual needs of users.<sup>990</sup> Given the heterogeneous attitudes toward formalization, informal practices in commercial and non-commercial contexts, in Afghanistan, the jurisdictional rules, which are amenable to manipulation, can have great efficiency-enhancing potential. Afghanistan can facilitate formalization of informal financial arrangement through categorizing them as commercial transactions with positive consequences on efficiency and economic growth.

There are multiple reasons for the business-friendly attitudes in Afghanistan's commercial context. One reason has to do with the history of commerce and commercial law in Afghanistan.

Commercial law traditionally has had a unique status in Afghanistan in that it was never an exclusive domain of Shari'ah and religious scholars (*'uluma*).<sup>991</sup> Even before Afghan rulers, notably Amir Abdul Rahman Khan, attempted to centralize the juridical power in the late nineteenth century, it was generally accepted that commercial disputes could be resolved in special tribunals where commercial customs were the prevailing source of law, and experienced merchants acted as arbiters.<sup>992</sup> For example, the first commercial court in Afghanistan, created by Amir Abdul

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<sup>988</sup> See NORTH (1990), *supra* note 32, at 33; DE SOTO, *supra* note 114, at 227.

<sup>989</sup> *Id.*

<sup>990</sup> *Id.*

<sup>991</sup> AMIN TARZI, *Islam, Shari'a, and State Building under 'Abd al-Rahman Khan, in* AFGHANISTAN'S ISLAM: FROM CONVERSION TO THE TALIBAN 139 (Nile Green ed., 2017); AFGHANISTAN SUPREME COURT, TARISKH QAZA [HISTORY OF JUDICIARY], 95-97; MOHAMMAD HASHIM KAMALI, *LAW IN AFGHANISTAN: A STUDY OF THE CONSTITUTION, MATRIMONIAL LAW, AND JUDICIARY* 37 (1985).

<sup>992</sup> *Id.*

Rahman Khan, Panchat, consisted of several non-Muslim arbitrators.<sup>993</sup> Panchat was supposed to resolve commercial disputes based on prevailing commercial customs.<sup>994</sup>

Similarly, although Afghan rulers until the 1980s avoided codifying Islamic law in areas of private law out of fear of public backlash, especially from *'uluma*, major commercial law legislation based on French commercial codes was enacted without arousing backlash in the 1950s.<sup>995</sup> Afghanistan's first bank started issuing interest-bearing loans as early as the 1930s.<sup>996</sup> This is while efforts to centralize the juridical power in other areas of law were met with fierce resistance.<sup>997</sup> This shows that Afghans have generally accepted that commercial laws were subject to different norms.<sup>998</sup> The reason for this discriminating treatment could be because Afghanistan's commercial sector, until the start of prolonged period of conflict in the 1980s, included a significant number of non-Muslims.<sup>999</sup>

The Afghan financial industry, prior to Nadir Khan almost exclusive, and until the Taliban mostly was run by Hindus and Sikhs.<sup>1000</sup> In the 1970s, there were approximately 700,000 Hindus and Sikhs living in Afghanistan; they made up roughly 10% of the Afghanistan's population.

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<sup>993</sup> See AMIN TARZI, *supra* note 991, at 139.

<sup>994</sup> *Id.*

<sup>995</sup> Haroun Rahimi, *What Can History Teach Us About Legal Reform in Afghanistan? A Historical Study of Codification of Substantive Private Law in Afghanistan* (Forthcoming).

<sup>996</sup> See TRES THOMPSON ET AL., STANFORD LAW SCHOOL, AFGHANISTAN LEGAL EDUCATION PROJECT, AN INTRODUCTION TO THE COMMERCIAL LAW OF AFGHANISTAN 36 (2d ed. 2015), <https://www-cdn.law.stanford.edu/wp-content/uploads/2015/12/Intro-to-Commercial-Law-of-Afg-2d-Ed.pdf>.

<sup>997</sup> See AMIN TARZI, *supra* note 991, at 139; HISTORY OF JUDICIARY, *supra* note 991, 95-97; KAMALI, *supra* note 991, at 37.

<sup>998</sup> Haroun Rahimi, *supra* note 995.

<sup>999</sup> See Ruchi Kumar, *The Decline of Afghanistan's Hindu And Sikh Communities*, AL JAZEERA (Jan. 1, 2017), <https://www.aljazeera.com/indepth/features/2016/12/decline-afghanistan-hindu-sikh-communities-161225082540860.html>; see also SARA KOPLIK, A POLITICAL AND ECONOMIC HISTORY OF THE JEWS OF AFGHANISTAN 38 (2015).

<sup>1000</sup> See THOMPSON, *supra* note 208, at 117.

However, currently they are estimated to be less than 7,000 (i.e. approximately 0.023% of the population).<sup>1001</sup> Jews were active in the financial sector as well.<sup>1002</sup> Sikhs, Hindus, and Jews in Afghanistan did not operate under Islamic Law or tribal traditions.<sup>1003</sup> In fact, their ability to operate unbounded by the restrictive Islamic financial law doctrines was a reason that they were successful.<sup>1004</sup> They could charge interest.<sup>1005</sup> Another reason for their success, and perhaps the more important one, was their wide ethnic/religious networks in India, and, in the case of Jews, as wide as Europe and the United States. These broad networks allowed them to diversify their portfolios and operate a vast financial sector, and far-reaching *hawala* networks, without relying on formal legal institutions.<sup>1006</sup> Their influence in Afghanistan's commerce was so significant that Panchat, the Afghanistan's first formal commercial arbitration court, which was established by Amir Abdul Rahman Khan in the nineteenth century, included three Hindu arbitrators, who made up almost half of the Panchat's arbitrators.<sup>1007</sup> The reason that Amir was so accommodating toward Hindus, Amir Tarzi argues, was to ensure that Indian-Afghan trade would continue, and Hindu merchants would feel protected when they conducted business in Afghanistan.<sup>1008</sup>

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<sup>1001</sup> Ruchi Kumar, *supra* note 999.

<sup>1002</sup> See KOPLIK, *supra* note 999, at 38.

<sup>1003</sup> See THOMPSON, *supra* note 208, at 117.

<sup>1004</sup> *Id.*

<sup>1005</sup> Nadir Khan attempted to end the reign of non-Muslims (and non-Afghans for that matters) in the area of financial law. To do that, he summoned the assistance of a prominent Afghan businessman, Abdul Majid Zabuli, who founded Afghanistan's first joint stock company with a monopoly on export and currency exchange. He later founded Afghanistan's first bank as well. However, Zabuli's efforts were not successful at ending Hindu's control of Afghanistan's financial market. Although he was able to get around the prohibition of interest by charging a repayment fee instead of interest, his company did not run a sufficiently diverse portfolio and did not enjoy the same vast ethnic/religious network as Hindus. See THOMPSON ET AL., *supra* note 996, at 36.

<sup>1006</sup> The fact that there were not from any of the Afghan ethnic groups also helped Hindus to protect themselves against political turmoil and ethnic rivalry in the country. See THOMPSON, *supra* note 208, at 117.

<sup>1007</sup> See AMIN TARZI, *supra* note 991, at 139.

<sup>1008</sup> *Id.*

Another reason for the prevailing business-friendly attitude in Afghanistan's commercial context, even when it comes to interest-bearing transactions, may be that commercial space is a specialized space and does not include the general public. There are different actors who are active in commercial and non-commercial contexts. Non-commercial contexts include non-specialized and non-repeating actors, i.e. non-merchants, therefore, they are more sensitive to the general norms of behavior like prohibition of interest. However, commercial contexts include specialized and repeat actors who are bound together with the aim of making a profit. Therefore, in this specialized space, participating actors, formal institutions, and wider society are willing to carve a space where the general norms of behavior like prohibition of interest is tweaked by allowing transactional techniques to reduce the barriers to profit-enhancing transactions.

The normative divergence of attitudes within formal institutions concerning commercial and non-commercial contexts, coupled with the efficiency-enhancing potentials of formalizing informal institutions, suggest that Afghanistan can achieve some efficiency-enhancing outcomes by allocating certain transactions to the formal institutions concerned with commercial transactions. For example, the Afghanistan Supreme Court should designate *Gerawee* transactions and disputes arising therefrom, when the *Gerawor* is a merchant, to the commercial courts. This may facilitate the formalization of *Gerawee* and increase the legal protections available to creditors allowing the *Gerawee* market to realize its potentials of relaxing the financing constraints on Afghan entrepreneurs.

Currently, the Afghanistan Supreme Court, while recognizing the need to expand the definition of commercial transactions, and correspondingly the jurisdiction of commercial courts, is resistant against using judicial re-interpretation of commercial laws and jurisdictional rules to

expand the scope of commercial laws and commercial courts' jurisdiction.<sup>1009</sup> Under the Afghanistan Supreme Court's current jurisprudence, transactions concerning ownership of non-fungible property does not qualify as commercial transactions, therefore, these disputes thereof do not fall under the jurisdiction of commercial courts.<sup>1010</sup> Transactions concerning ownership of fungible property, and benefits of non-fungible and fungible properties, on the other hand, qualify as commercial transactions, therefore, these disputes do fall under the jurisdiction of commercial courts.<sup>1011</sup>

Under the Afghanistan Supreme Court's current jurisprudence, *Sar qufli* is a transaction concerning the benefit of a non-fungible property (or the right to use the property) while the formal title used to introduce *Gerawee* in courts, *Bay al-Wafa* (sale with the right or repurchase) is a transaction concerning the ownership of a non-fungible property. The court has ruled that *Sar qufli* is a commercial transaction while *Gerawee* is a non-commercial transaction. As a result, former falls under the jurisdiction of commercial courts while the latter does not.<sup>1012</sup>

The Afghanistan Supreme Court has welcomed legislation to expand the scope of commercial transactions since "commerce has expanded in complexity and scope."<sup>1013</sup> However, by deferring the formalization of *Gerawee* (or similar institutions) to the legislature, it removes them from the specialized space of the judiciary. This places the faith of formalization of informal institutions at the hands of the political institutions of legislature where the normative stance of the broader society holds sway. The Afghan legislature is dominated by representatives who hold

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<sup>1009</sup> JUDICIAL SEMINAR (2017), *supra* note 554, at 190.

<sup>1010</sup> *Id.*

<sup>1011</sup> *Id.*

<sup>1012</sup> *Id.*

<sup>1013</sup> *Id.*

conservative, normative stance,<sup>1014</sup> and the process of legislation is very political, meaning it is more sensitive to a broader normative stance in the society. Therefore, the deferral of specialized rule-making to the legislature is likely to hinder the formalization of informal institutions, which have enabled transactions that do not conform to the broader normative stance in the society to take place in a specialized context of, for example, commerce.

This problem can be remedied by expanding the general scope of commercial transactions and jurisdiction of commercial courts allowing commercial courts to judicially formalize informal institutions like *Gerawee*. For this solution to work, however, the judiciary must take a more proactive role in specialized rule-making. For example, allocating *Gerawee* to the jurisdiction of commercial courts in cases where *Gerawor* is a merchant can allow commercial courts to formalize *Gerawee* as an informal institution based on the prominence of commercial ‘urf (customs) and agreements of the parties in a commercial context rather than relying on the pseudo-category of *Bay al-Wafa*, which does not reflect the *raison d’etre* of the *Gerawee* (i.e. the securitization of a loan), to remedy the unfairness of the misuse of *Gerawee* by *Gerawee-ee*.

### **3.5. Informal Dispute Resolution Institutions in Afghanistan: Who Uses Them and**

#### **Why?<sup>1015</sup>**

Afghanistan’s formal dispute resolution system is generally ineffective.<sup>1016</sup> Contrary to commonly held beliefs, Afghan merchants avoid going to courts not because of their unchanging aversion to

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<sup>1014</sup> For an analysis of composition of Afghanistan’s Legislature See Mohammad Bashir Mobasher, *Understanding Ethnic-Electoral Dynamics: How Ethnic Politics Affect Electoral Laws and Election Outcomes in Afghanistan*, 51 GONZ. L. REV. 355 (2015-2016).

<sup>1015</sup> The description of informal dispute resolution in Afghanistan presented here is based on typical facts reported by the interviewees in the author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>1016</sup> See Chapter Two.

the use of formal, non-reconciliatory dispute resolution rooted in a cultural desire to maintain communal harmony<sup>1017</sup> but because formal dispute resolutions are ineffective. As explained in Chapter Two, court procedures are costly and time consuming while enforcement of court judgments is uncertain. The uncertainty in the enforcement of court judgments is due to the difficulty in identifying a person's assets, high rates of insolvency, and absence of clear security rights outside formal mortgage transactions.<sup>1018</sup> Most often, court judgments are enforced through repayment schedules that can be, in practice, as long as a few years.<sup>1019</sup>

In Afghanistan, the out-of-court dispute resolution options can in most cases deliver the same result as formal court systems in a cheaper and more effective way. Informal dispute resolution institutions, e.g. business associations, are often better at identifying a person's assets and dealing with insolvent parties. This is because users of informal institutions tend to be more cooperative (they choose to resolve their dispute there), these institutions have better knowledge of assets to which a person has access (even if he does not legally own those assets), and they are not bound by the formal rules of separation of ownership.

Afghan merchants *do* use courts when it is necessary and effective.<sup>1020</sup> For example, commercial courts in Afghanistan handle many *Sar qufli* and commercial lease cases. Merchants use courts for *Sar qufli* and commercial lease cases because these are property right claims brought against the party who is in actual possession of the property. In such cases, the court judgments

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<sup>1017</sup> “The Afghan mindset is more arbitration oriented, but people in Kabul clearly want to explore more formalized mediation. *The interest for formal mediation in the province [Balkh] the consultant visited was not as high.*” (emphasis added). PETE SWANSON, UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT, REPORT ON ASSESSMENT OF POTENTIAL FOR COMMERCIAL MEDIATION 6 (MARCH 17, 2010).

<sup>1018</sup> See *supra* Chapter Two.

<sup>1019</sup> *Id.*

<sup>1020</sup> See *id.* and discussion of *Sar qufli* earlier in this Chapter.

are both necessary and effective because they provide access to the coercive power of the state to repossess a specific immovable property.

Banks are less likely to have access to informal dispute resolution institutions. If the formal collateral is either insufficient or unreliable, banks are less likely to have access to the rich information about a borrower's assets that informal institutions provide; and if borrowers are insolvent, they generally cannot avail themselves of informal institutions that are generally more effective at handling of insolvency cases at informal institutions. Afghan courts, however, are generally effective in enforcing formal mortgages held by banks. As long as the market fluctuation has not caused the collateral to significantly depreciate, the collateral is clearly identified at the time of registry, and banks did their due process to ensure there are not multiple liens on the collateral, Afghan courts can be relied on to auction collateral in the event of default.

While informal dispute resolutions are effective in resolving most common disputes among merchants who are part of Afghan society, they put outsiders at a disadvantage. They also create path-dependency. By conflating a person's social reputation and business reputation, informal dispute resolution institutions increase the cost of dissolving business relations locking parties into the existing business networks. They also hinder the formalization/depersonalization of business relations with possible negative consequences for long-term economic growth. Informal dispute resolution institutions circumvent the application of formal legal rules of bankruptcy, limited

liability, and separation of private ownerships, thus they make it harder for the Afghan economy to formalize.

### **3.5.1. Afghan Merchants Prefer Informal Dispute Resolution Institutions**

Research for this dissertation shows that Afghan merchants have an aversion to the use of courts.<sup>1021</sup> In general, they prefer interparty negotiation and compromise, and to a lesser extent, multilateral dispute resolution institutions such as business community unions and associations. However, there are two outliers in the research sample in Herat. Both are well-educated, medium-sized merchants and who have a positive view of the formal court system.<sup>1022</sup> They resort to the courts for relatively low value claims.<sup>1023</sup> In most of these cases, the parties against whom these outliers brought claims (defendants) complied before the court can rendered a final decision.<sup>1024</sup> There are three possible explanations for these outliers' views on the court system:

It may be that when claims are of a low value, the defendant feels that going through the formal court procedures will be too costly (mainly because of perception of corruption) and time-consuming, therefore, they comply. In effect, the courts' reputation for ineffectiveness and corruption works in favor of a small number of plaintiffs who go to courts for small claims. Or it may be that courts are generally effective, and it is the false common perception that courts do not work which is keeping merchants from using the courts. The unique background of these two merchants (e.g. being well-educated) may be the reason why they do not share the same false

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<sup>1021</sup> The description of informal dispute resolution in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>1022</sup> Author's interview with a hygienic products manufacturer in Herat (April 2017).

<sup>1023</sup> *Id.*

<sup>1024</sup> *Id.*

perception. If this is true, one should wonder why the feedback from these few successful cases has not motivated other merchants to have to use courts. Alternatively, it may be that these two merchants' experience represent an exception either because of their connections, social status or some other reason.

### **3.5.2. Who Uses Formal and Informal Dispute Resolution Institutions in Afghanistan<sup>1025</sup>**

Research for this dissertation shows consistent attitudes in all research sites; small and medium-sized merchants are the most common users of courts, while large merchants use courts much less frequently.<sup>1026</sup> This finding is unexpected because the dominant position in the literature posits that the size of the business is positively correlated with the use of formal institutions, especially courts.<sup>1027</sup> In Afghanistan, this research shows that small and medium-sized merchants use courts more often than larger merchants.<sup>1028</sup> There are several possible explanations for this. First, this dissertation found that in Afghanistan, the use of court is usually an end-of-business occurrence. Smaller businesses, because of their limited capital, are more likely to get involved in such end-of-business disputes and therefore, they are more likely to use courts. Larger merchants, on the other hand, have a higher tolerance for non-payment and delays in payment. They can price in non-payments and other problems. Therefore, they are less likely to use courts. In addition, larger merchants better connected and more involved in the business community and thus are better positioned to take advantage of out-of-court remedies like unions, chambers, or *jirgas*. Larger

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<sup>1025</sup> The description of informal dispute resolution in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>1026</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>1027</sup> See, e.g., FAFCHAMPS (2004), *supra* note 80, at 10.

<sup>1028</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

merchants are better connected and more involved in business community; as such, they have better access to out-of-court forums. Similarly, decisions of multilateral dispute resolution forums, such as unions, chambers, or *jirgas*, are most effective against larger merchants because they have more to lose in the form of social status and reputation. Therefore, larger merchants are less inclined to use courts compared to smaller merchants.

This research also shows that the use of threat and force to enforce commercial obligations was rare in all research sites, therefore the fact that larger businesses usually are more powerful is less likely to be a reason they do not use courts. This is the case even though larger businesses are also more likely to have more resources to influence formal institutions, through money and political connections. Therefore, the political and social power of larger businesses are not likely a determinant in the choice between formal and informal dispute resolution institutions.

This research also shows that the availability of out-of-court and out-of-chamber solutions determines whether a merchant goes to court or to the chamber. Large businesses do not go to courts because they have better access to out-of-court dispute resolution. As an example, Pakistani merchants who do business with Afghan merchants tend to avoid the Kandahar Chamber of Commerce for informal dispute resolution because the Pakistani merchants, by virtue of their ethnic and personal relations, have access to out-of-chamber dispute resolution mechanisms that they trust. For example, they can resort to a *jirga* to resolve their dispute. Iranian merchants who do business in Afghanistan, on the other hand, have less access to out-of-chamber remedies; therefore, as an interview with the Vice President of the Kandahar Chamber revealed, Iranian merchants are more likely to resort to the Chamber to resolve a dispute.<sup>1029</sup>

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<sup>1029</sup> Author's interview with the Vice President of Kandahar Chamber of Commerce and Industries (July 2017).

### 3.5.3. Why Merchants Use Informal Dispute Resolution

This dissertation reveals that the effectiveness of court remedies dictates when and if merchants decide to pursue a dispute in court rather than some informal dispute resolution mechanism.<sup>1030</sup>

Merchants decide to go to courts (1) if they determine that the defendant has the assets that could be used to satisfy a possible court verdict; and (2) if they determine that the potential court remedy will be superior to anything they can achieve outside the courts using bilateral and multilateral informal schemes. Both of these are reasons why courts are used to resolve disputes concerning immovable properties.

Formal rules of enforcement of court judgments have a direct effect on a merchant's decision to pursue a court's remedy. As explained in Chapter Two, in Afghanistan, enforcement of court judgment is very uncertain and ineffective (for disputes that do not involve immovable properties). The outcome most often achieved via enforcement of a formal court judgment is a payment schedule.

Court remedies, in effect, compete with the out-of-court debt collection remedies. Currently, out-of-court debt collection remedies are generally superior to the formal court system. If the defendant refuses to pay, the out-of-court remedies range from bilateral negotiations, to harassment, and in some cases harsher tools of intimidation. In some cases, the creditors are willing to exchange one debt for another with a discount as a last resort. A Kabuli cell phone merchant said, "When a debtor is unable to pay, the creditor suggests that he buy something like a car on credit and then sell it for a very good price [a high price] to the creditor in exchange for the debt."<sup>1031</sup> This way the debtor is able to use his soft capital, i.e. his reputation and social

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<sup>1030</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>1031</sup> Author's interview with a Kabuli merchant (June 2017).

connections, to cancel part of the debt by selling the goods for a higher price, and/or get an extension on the debt by exchanging one long-delayed debt to another more recent one. This way the debtor gets to stay in business longer.

In multilateral dispute resolution, merchants involve market elders, unions, chambers, or even friends and families in a dispute.<sup>1032</sup> In multilateral mechanisms, a group of people (or a person) who are knowledgeable about the customary norms of the relevant market mediate between the disputants so they can reach to an amicable resolution. The mediators' incentive is to resolve the dispute in a way that would allow the disputants to continue doing business in the market, while upholding the norms of the market. Mediators are not interested in finding the party at fault. They often review the evidence provided by each disputant, but as the Vice President of the Kandahar Chamber said, "it is not about evidence. If the evidence were clear or helpful, they [disputants] would not come to us. We are conciliators. We persuade them to compromise."<sup>1033</sup> Mediators do make decisions, but mediators' decisions are not binding on the disputants. Disputants can, and sometimes do, decide to go to court after a mediation. Multilateral mechanisms are effective at resolving disputes. An overwhelming majority of disputes that are brought before multilateral mechanisms are resolved.<sup>1034</sup>

Multilateral mechanisms are effective because they are often the last resort. According to the same interviewee, "They [disputants] come to us as last resorts. We find a way to end the dispute. If courts were any help they would have gone to courts."<sup>1035</sup> However, it is also true that

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<sup>1032</sup> The description of informal dispute resolution in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>1033</sup> Author's interview with the Vice President of Kandahar Chamber of Commerce and Industries (July 2017).

<sup>1034</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>1035</sup> Author's interview with the Vice President of Kandahar Chamber of Commerce and Industries (July 2017).

going to a *jirga*, a *shura*, or a union, shows a willingness by all parties to resolve the issue because these forums do not have subpoena power to compel attendance, so a merchant has to decide to go to them.

Informal institutions pressure disputants to resolve their dispute by increasing the social and economic cost of non-compliance. They do so by increasing the number and quality of the people who are aware and involved in a dispute. As disputants refuse to reach to an amicable resolution of their disputes, the number and quality of the people who are aware of and involved in the dispute increases. For example, it may start with just few immediate neighbors of the disputants in the market trying to persuade them to agree on a resolution, then it moves to a market-wide association, then to a province-wide commercial chamber or a union. As the dispute persists, more merchants, who are potential business partners, and more important merchants, who are the main sellers/creditors in the market, become aware of and involved in the dispute. Thus, the increasing reputation cost of the dispute pressures parties to agree on a resolution.

Furthermore, although institutions, such as *shura*, *jirga*, or a union, are business institutions, they also wield significant social power too. This means that just because a disputant exits a market, as often these disputes are end-of-business disputes, he does not become immune to the social power of these institutions. This also means that the effectiveness of multilateral mechanism is directly correlated with the social and business status of the disputants in the market. Large businesses and influential members of the market and society care more about their social status and their standing in the market, so they are more likely to comply with a decision of a multilateral institution.

In the context of Afghanistan, multilateral institutions, such as *jirgas*, unions, and *shuras*, enjoy greater social legitimacy compared to the courts.<sup>1036</sup> Courts do not enjoy great social legitimacy because they are perceived as corrupt.<sup>1037</sup> This means that a disputant may be more concerned about defying a decision of a *jirga*, *shura*, or a union, than a court's judgment. The multilateral institutions in the *Sarrafi*'s market are particularly effective because they are backed by a collective desire to protect the reputation of the *Sarrafi* market, which is a form of common assets.<sup>1038</sup> The power of the *Sarrafi* Union to mediate disputes among *Sarrafi*s is formalized by the Da Afghanistan Bank's Regulation, which empowers *Sarrafi* unions to mediate disputes between *Sarrafi*s if *Sarrafi*s resort to the union.

Notably, the interviewees express discontent with the decisions of multilateral institutions. Interview data reveal common discontents with the decisions of *jirgas* and business forums. These discontents cumulates around two points: some merchants believe that these *jirgas* are not impartial, and some creditors believe they are pro-debtor. The latter is generally the evidence for the former. As one Kandahari merchant expressed, "They [*Jirgas*] ask us to accept 100,000 AFN for a 1 million AFN debt or they set up long repayment schedule. For example, they ask us to accept 100,000 AFN this year and 300,000 AFN next year."<sup>1039</sup>

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<sup>1036</sup> This observation is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author's personal observations over several years of his work as accountant in the Afghanistan's private sector between 2008-2013.

<sup>1037</sup> In 2017, 62% of the people pooled in 3,773 across 34 provinces of Afghanistan said that magistrate and judges are either all or most of them corrupt. This is the highest percentage of five institutions pooled. National Government Officers, Member of Parliament, Local Government Officers, and the Police were perceived as less corrupt. WORLD JUSTICE PROGRAM, THE RULE OF LAW IN AFGHANISTAN 10 (2017), [https://worldjusticeproject.org/sites/default/files/documents/WJP\\_Afghanistan\\_Report\\_2017\\_Final\\_Online-Edition-Reduced.pdf](https://worldjusticeproject.org/sites/default/files/documents/WJP_Afghanistan_Report_2017_Final_Online-Edition-Reduced.pdf).

<sup>1038</sup> See discussion of *Sarrafi* markets earlier in this Chapter.

<sup>1039</sup> Author's interview with a Kandahari merchant (July 2017).

At first these complaints may appear to be the shortcomings of informal dispute resolution. However, this is only when one compares the informal process to the court proceedings against a solvent defendant. Such a comparison would be misleading. This is because the informal process of *jirgas* and unions most often are invoked when the defendant is insolvent. These cases are end-of-business and end-of-relationship cases. Therefore, the correct comparison would be to compare the informal processes with a bankruptcy proceeding. If one does that, the decisions of informal institutions appear more reasonable and realistic rather than merely conciliatory or pro-debtor.

In Afghanistan, as explained earlier, formal bankruptcy proceedings have been formally suspended.<sup>1040</sup> The Supreme Court has formally instructed the courts not to initiate bankruptcy proceedings in both civil and commercial cases. This decision is ostensibly made to ensure that the losing party cannot avail himself of the protection of bankruptcy laws by hiding his assets, which he can do relatively easily due to the informality of property ownership in Afghanistan. Currently under Afghanistan's laws, the courts are required to enter into a judgment and determine the obligation of the losing side, however, the judgment will only be enforced if the defendant has sufficient identifiable assets. If the court cannot identify that the losing party has sufficient assets, and the winner is not able to show that the losing party has sufficient assets, enforcement is delayed until such time when sufficient assets are identified. In effect, because a debtor cannot enjoy the benefits of invoking bankruptcy in formal courts, informal forums provide a much-needed relief.

However, the formal suspension of bankruptcy proceedings, coupled with the informal norms of dispute resolution, means that in Afghanistan the usually protection afforded by limited liability, in effect, do not exist. Informal dispute resolution mechanisms do not recognize the principle of limited liability. They are instead guided by a moral understanding of obligation

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<sup>1040</sup> See *infra* Chapter Two.

coupled with a culturally informed notion of fairness. As a result, all of a debtor's assets are considered when settling a debt. The suspension of the principle of limited liability hinders effective risk diversification that would be legally available to a merchant. This dissuades merchants from engaging in risky businesses. This pro-creditor attitude is counterbalanced with the notion of fairness. Under informal dispute resolution institutions, the creditor is often expected, demanded, and advised to provide relief to the debtor based on the culturally informed notions of fairness, forgiveness, and mutual help.

The informal institutions are sometimes effective because they are not bound with the formal rules of property ownership. In an informal institution, all the assets to which the debtor has access, are considered a legitimate source for debt collection. While courts can only enforce judgments against property formally held by the losing party, informal institutions can pressure the debtor to use any asset to which he has access (regardless of formal property rules) to repay a debt. For example, jewelry of a debtor's wife cannot be used to enforce a court judgment because it is legally owned by the wife; however, in a *shura*, union, or a *jirga*, a debtor cannot claim he does not have sufficient assets to honor his debt if his wife has valuable jewelry.

#### **3.5.4. Variation in the Effectiveness of Informal Dispute Resolution Institutions**

The research presented in this dissertation suggests that there is a significant variation in the ability of business associations, such as unions and chambers, to resolve disputes.<sup>1041</sup> The interview data suggests that the ability of an association to effectively resolve a dispute is dependent on a series of factors which include: the geographical concentration of its members; the exclusiveness of the market; the number of players; the profession-type (whether it is a life-time profession or not);

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<sup>1041</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

whether the market's collective reputation is a common asset; and whether the structure of the market gives association leader gatekeeping power.<sup>1042</sup>

Dispute resolution is more institutionalized in associations like *Sarrafi*'s union that represent a market which is concentrated in few buildings, has a limited number of members who interact with each other regularly, and whose members pursue their business as a life career. Additional characteristics of *Sarrafi* unions are that the formal laws give the association some authority over admission and resolution of disputes, and its members share the collective reputation of the *Sarrafi* as a common asset.<sup>1043</sup>

Chambers are on the other end of the spectrum. Chambers' members are spread across a province and they do not necessarily have consistent interactions with each other. The members may easily join or exit the chamber. Merchant-members do not share a collective reputation and the chamber has no influence on who gets to be a merchant. The Unions and local associations fall somewhere in between.

There is also regional variation.<sup>1044</sup> Dispute resolution is much less institutionalized in Balkh as compared to Herat. In Balkh, there are fewer business unions. The unions that do exist do not engage in dispute resolution. The Balkh Chamber of Commerce, which is the only business association that engages in some dispute resolution practices, does so on an ad-hoc basis (there is no dispute resolution board/committee/center) and much less often than Herat. The Balkh Chamber does not offer transnational dispute resolution where Herat Chamber does most of its dispute

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<sup>1042</sup> *Id.*

<sup>1043</sup> See discussion of *Sarrafi* markets earlier in this Chapter.

<sup>1044</sup> The description of variation of informal dispute resolution practices in Afghanistan presented here is based on typical facts reported by the interviewees in the author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

resolution work in this area. The Balkh Chamber is not part of any transnational or joint chamber with Afghanistan's business partner (e.g. Iran or Pakistan).

Balkh's *Sarrafi* union is similarly less institutionalized. Until very recently, there has been no dispute resolution board/committee/center, or administrative body for the *Sarrafi* union. The President of Balkh's *Sarrafi* union only has a very small shop where he supposedly discharged his duties as the president of the union. This is in contrast to Herat where *Sarrafi* union has more space, more administrative staff, and a more developed organizational structure.

*Sarrafs* in Nangarhar and Herat, compared to Balkh, have exhibited more vigorous self-regulation. This self-regulation seems to be correlated with the development of local financial market and its credibility and the prevalence of credit sales. For example, in both Nangarhar and Herat, *Sarrafs* said that the union has banned *Sarrafs*' checks because too many *Sarrafs* were going bankrupt due to failing checks and it was ruining the reputation of *Sarrafs* (which is their most valuable asset). This banned did not stop the practice of issuance of post-dated checks entirely, but it helped contain the practice and has evidently helped restore the reputation of *Sarrafs*. Balkh's *Sarrafs* reported dissatisfaction with the ability of the union to safeguard the collective reputation of *Sarrafs*. Interviewee data suggests that *Sarrafi* unions in Nangarhar and Herat had more control over who gets to enter the *Sarrafs* market through controlling who can open a store in the physical *Sarrafi* market compared to Balkh's union.

In contrast to Herat, and similar to Balkh, in Nangarhar dispute resolution is less institutionalized in the unions or the chamber. In fact, interestingly enough, most interviewees talked about the union and the chamber as if they were part of the government and going to them would be similar to going to the government. This may be because the prevalence of another Pashtun cultural institutions, i.e. *jirga*. In Nangarhar use of *jirga* is more the norm. *Jirga* is an ad-

hoc council formed from influential people who have knowledge about the disputants. The *jirga* mediates between the disputants and seem to be very effective in resolving smaller disputes in Nangarhar. Another possible reason for the under-institutionalization of dispute resolution in Nangarhar, at least in regard to the chamber, is due to the proximity of Nangarhar to Kabul. Nangarhar is only three-hour drive away from the center of Kabul so most big disputes are referred and handled there because most large merchants have presence in Kabul as well. Smaller disputes seem to be handled locally by *jirgas*.

Kandahar follows more closely on the Nangarhar model of merchant dispute resolution. Like Nangarhar, Kandahar is similarly a majority Pashtun province where the use of *jirga* is the norm. However, unlike Nangarhar, in Kandahar *jirga* are institutionalized within the chamber and unions. In other word, Pashtun culture and *jirga* do not seem to be an impediment to institutionalization of dispute resolution. On the contrary, they seem to facilitate institutionalization of dispute resolution in Kandahar.

A sizable group of Kandahari merchants trade dried fruits with Europe and India.<sup>1045</sup> Their business partners in those countries are usually from the Afghan diaspora.<sup>1046</sup> They use the same model of risk-sharing and flexible contracts to trade with their Afghan counterparts in Europe and India. They employ the institution of *jirga* to resolve disputes with their Afghan counterpart in Europe.<sup>1047</sup> The migration of institution of *jirga* along with use of flexible, risk-sharing contracts is a very interesting phenomenon which merits further study.

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<sup>1045</sup> Author's interview with two dried fruits merchants in Kandahar (July 2017).

<sup>1046</sup> *Id.*

<sup>1047</sup> *Id.*

### 3.5.5. Informal Dispute Resolution and Pashtun Culture

The research presented in this dissertation suggests that informal dispute resolutions are more effective in Kandahar and Nangarhar.<sup>1048</sup> This observation is confirmed by the low rate of per-capita court use in these two provinces, compared to other three provinces which are either more ethnically heterogeneous or dominated by non-Pashtun ethnic groups.<sup>1049</sup>

The cultural roots of *jirgas* give them more coercive power in predominately Pashtun provinces such as Kandahar and Nangarhar. The cultural salience of *jirga* in the Pashtun culture provides a focal point and increases its coercive and persuasive power in predominantly Pashtun provinces.<sup>1050</sup> Defying and disrespecting a *jirga* has more severe social consequences in a homogenously Pashtun province. While *shuras* (which have Islamic roots and are generally understood as a generic counterpart to the *jirgas*) and business community unions were common across all research sites and provinces, they did not have the same cultural salience as *jirgas*. This is likely because Pashtuns have a longer history of autonomy and self-regulation in Afghanistan compared to non-Pashtun ethnic groups, who, by the virtue of being minorities, were more reliant on and controlled by the central authority in Afghanistan.<sup>1051</sup> For example, Tajiks have historically been more likely to settle in a city (compared to Pashtuns) and to staff the Afghan government's bureaucracy.<sup>1052</sup>

As explained earlier in this chapter, Pashtuns' cultural aversion to the use of signed written documents (to avoid offending their customers by doubting their trustworthiness) in the course of

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<sup>1048</sup> This finding is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

<sup>1049</sup> See Chapter Two.

<sup>1050</sup> For a historical discussion of *Jirga* in the Pashtun context See THOMAS J. BARFIELD, *supra* note 375.

<sup>1051</sup> See NEWELL, *supra* note 365, at 34.

<sup>1052</sup> *Id.* at 78.1

their business dealings, for example in Nangarhar, also contributes to the low rate of court use. Written signed documents are instrumental in court proceedings; it is much harder to win a case before a formal court without written signed documents as evidence. Thus, both the cultural salience of *jirga* in the Pashtun culture and their aversion to the use of signed written documents in the course of business dealings render the use of formal courts both less necessary and more difficult in Kandahar and Nangarhar.<sup>1053</sup>

### **3.5.6. The Use of Force to Resolve a Commercial Dispute**

The use of force/threat to collect a debt or to resist debt collection is rare in Afghanistan.<sup>1054</sup> It is mostly because business in Afghanistan is based on reputation and relationship. If a merchant uses force to resolve a dispute it will affect his ability to do business as it will dissuade other merchants from doing business with a merchant who has a reputation of resorting to force/threat. As a Nangarhari merchant said, “If you use force or threat you cannot work in the market.”<sup>1055</sup>

Although rare, use of force and threat in commercial settings does occur. Most often, the use of force is exercised by a non-merchant party in a commercial transaction. For example, a non-merchant who is a party in a one-time business deal (e.g. import of oil) may resort to using threats to resolve a dispute. Interviews conducted in Kabul suggest the use of force/threat is more common there.<sup>1056</sup> This may be because of two reasons: (1) there are more people with access to power in Kabul; and (2) because there are fewer wide-reaching cultural, ethnic, or social norms constraining

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<sup>1053</sup> Identifying the consequences prevalence of *jirga* and avoidance of use of signed written documents in the business dealings on economic performance of predominately Pashtun provinces compared to more ethnically heterogeneous provinces will require additional research.

<sup>1054</sup> This finding is based on author’s interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017, as well as Author’s personal observations over several years of his work as accountant in the Afghanistan’s private sector between 2008-2013.

<sup>1055</sup> Author’s interview with a merchant in Nangarhar (May 2017).

<sup>1056</sup> Author’s interviews with merchants in Kabul (June 2017).

power/use of threat due to the increased diversity in Kabul. Kabul's interview data suggest that use of force/threat is also sector-variant. Some sectors are more prone to use of threat/force due to their player types.<sup>1057</sup> For example, construction market is dominated with actors who wield significant political power, therefore, they are more prone to use force or threat in a business context.<sup>1058</sup>

Kandahar's interview data suggest that *qawm* (a perceived community of people with a common ancestor) is a factor that controls the use of force in both business and other settings in Kandahar.<sup>1059</sup> On the other hand, it seems that political connections may be a reason that has empowered Kandahari merchants in certain sectors that rely on political connections.<sup>1060</sup> The effect of *qawm* is possibly more felt in Kandahar because it is the least urbanized and least ethnically diverse of the five research sites.<sup>1061</sup>

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<sup>1057</sup> *Id.*

<sup>1058</sup> This assertion is based on author's interview with the owner of a construction company in Kabul (May 2017).

<sup>1059</sup> Author's interviews with merchants in Kandahar (July 2017).

<sup>1060</sup> Author's interviews with merchants in Kandahar (July 2017).

<sup>1061</sup> See AFGHANISTAN DEMOGRAPHIC ESTIMATES FOR THE YEARS OF 2002/03 UNTIL 2017/18, *supra* note 19.

## Chapter Four: AFGHANISTAN'S FORMAL FINANCIAL INSTITUTIONS

Afghanistan's formal financial institutions have not been able to provide credits in a way that can be used by Afghan merchants. That is why currently banks in Afghanistan hold 3 billion US\$ in excessive reserves<sup>1062</sup> while Afghan merchants are increasingly facing financing problems.<sup>1063</sup> The approach reflected in the Afghan Government's Strategic Policies on institutional reforms aimed to improve access to credit—which, if judged by their content, strongly reflect the policy prescriptions of the State-Centered Theory—has been ineffective. The current approach has failed because it completely disregards the existing informal institutions, seeking to displace them with formal institutions modeled on international “best practices”. This approach has led Da Afghanistan Bank to unsuccessfully attempt to outlaw deposit-keeping and loan distributions by the *Sarrafs*.

The first part of this chapter describes the state of formal financial institutions in Afghanistan. To do so, it starts by discussing the boundaries of formal financial institutions in Afghanistan. Specifically, it discusses the recent attempt by Da Afghanistan Bank to deny *Sarrafs* a formal role as a financial intermediary. This case perfectly illustrates the Afghan government's problematic approach to institutional reform. The impetus behind Da Afghanistan Bank's recent anti-*Sarraf* attempt, which can be gleaned from the discourse around the policy, has been to incentivize the use of banks in Afghanistan. However, this dissertation shows that this policy was based on false assumptions and could not be implemented. After determining the boundaries of

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<sup>1062</sup> Calculated by the author as the difference between total of gross bank deposits and total of gross bank loans based on QUARTERLY FINANCIAL SECTOR FINANCIAL STATISTICS FOR THE PERIOD OF I-2013 UNTIL II-2017, *supra* note 22.

<sup>1063</sup> Calculated by the author based on BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, AND III-2017, *supra* note 12.

formal financial institutions, the chapter describes the state of banking system in Afghanistan showing why and how the banks' role as credit provider not only has failed to improve, but also has been on a decline.

The second part of this chapter describes the content of Afghan Government Strategic Policies aimed at improving access to credit for Afghan merchants. The content of these policies is used to illustrate how the Afghan government's current approach to institutional reform follows the policy prescriptions of State-Centered Theory in that these policies completely disregard the current institutional landscape of Afghanistan's credit economy and the opportunities and challenges it presents for creating formal institutions that offer credit in a way that meets the needs of Afghan merchants.

#### **4.1. Formal Financial Intermediaries in Afghanistan: Are *Sarrafs* Included?**

The financial intermediaries of Afghanistan's formal financial system are difficult to identify. There are four main candidates for inclusion as financial intermediaries in the formal financial system of Afghanistan: (1) banks; (2) microfinance institutions, which are mostly run as charitable organizations; and (3) insurance companies, which currently play a minor role in the financial system due to underdevelopment of insurance industry in Afghanistan; and (4) non-bank actors (*Sarrafs*). The first three candidates can be easily included within formal financial system because, according to formal rules, they can, *inter alia*, perform the function of pooling savings for investment purpose. In other words, they move funds from the parties with excessive capital to parties needing capital. Of these three categories of financial intermediaries, this chapter focuses on banks and the formal rules that govern the operation of *Sarrafs*.

There are nine microfinance institutions active in Afghanistan<sup>1064</sup> whose estimated collective loan portfolio exceeds 131 million US\$ issued to more than 148,000 small borrowers.<sup>1065</sup> However, this dissertation does not focus on microfinance institutions because they are most often run as charitable organizations with an endowment and do not primarily hold deposits from savers (e.g. FMFB-A).<sup>1066</sup> This dissertation also declines to focus on insurance companies because the insurance industry is in its nascent stage of development in Afghanistan, and therefore, does not play a significant role in the financial system.<sup>1067</sup>

The fourth category of financial intermediaries is less straightforward. There are two types of non-bank actors in Afghanistan's financial system. The first are *Sarrafi* (FX),<sup>1068</sup> which literally means money exchanger. According to formal rules, they can only engage in exchange of different currencies.<sup>1069</sup> The second are Money Service Providers,<sup>1070</sup> which according to formal rules, in addition to currency exchange, can also engage in domestic and international money transfers, popularly known as *hawala*.<sup>1071</sup> Money Service Providers can also buy, sell, and discount checks.<sup>1072</sup> This dissertation has called FXs and Money Service Providers collectively by their

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<sup>1064</sup> DA AFGHANISTAN BANK, STRATEGIC 2017-2021, *supra* note 9, at 11.

<sup>1065</sup> See MIX MARKET, <https://www.themix.org/mixmarket/countries-regions/afghanistan>, (last visited Feb. 18, 2018).

<sup>1066</sup> See the First MicroFinance Bank of Afghanistan, <http://fmb.com.af/>

<sup>1067</sup> According to Da Afghanistan Bank, there are four insurance companies active in Afghanistan (one public and three private), See DA AFGHANISTAN BANK, STRATEGIC 2017-2021, *supra* note 9, at 11. The contribution of insurance industry to GDP in 2016/17, according to Afghanistan Statistics Department, measured in gross underwritten premium was 2.45 million US\$, SECTORAL CONTRIBUTION TO THE GDP FOR THE YEAR 2016/17, *supra* note 407.

<sup>1068</sup> DA AFGHANISTAN BANK, MUQARRARA TANZIM FA' ALIAT HAI SARRAFAN VA FRAHAM KONANDAGAN KHADAMAT PULI [REGULATION OF SARRAFS AND MONEY SERVICE PROVIDERS' ACTIVITIES] 1395 [2016] arts. 6(1)(g) and 6(1)(h).

<sup>1069</sup> *Id.* art. 3(2)(2).

<sup>1070</sup> *Id.* art. 6(1)(e).

<sup>1071</sup> *Id.* art. 3(2)(1).

<sup>1072</sup> *Id.* art. 3(2)(1).

popular name in Afghanistan *Sarrafi* (singular), *Sarrafs* (plural) and *Sarrafi* (adjective). *Sarrafs*, according to formal rules, are barred from keeping deposits and issuing loans,<sup>1073</sup> they, as explained in Chapter Three, nonetheless, *de facto*, perform these functions and other functions formally reserved for banks. Therefore, this dissertation has divided the discussion of formal rules concerning the operations of *Sarrafs*: this chapter analyzes the formal rules governing the operation *Sarrafs* while Chapter Three discussed the *de facto* functions of *Sarrafs* using interview data.

#### 4.1.1 Formal Regulations of *Sarrafs*

The different between FX and Money Service Providers is that the latter can, legally, exchange currencies and execute *hawala* while the former can only exchange currencies.<sup>1074</sup> However, both FX and Money Service Providers, in practice, do much more than execute *hawala* or exchange currency, as described in the previous chapter. The formal requirements for acquiring a Money Service Provider license are stricter compared to obtaining an FX license.<sup>1075</sup> The distinction between FXs and Money Service Providers is much blurrier in practice. They both perform *hawala* and execute currency exchanges and perform several other functions.<sup>1076</sup>

In addition to the many licensed *Sarrafs* that operate from a permanent places of business (such as a store or an office), there are many more mobile *Sarrafs* that hold neither a license nor operate from a permanent place of business. They have significantly less capital (not more than few thousand dollars) compared to established *Sarrafs* (whose capital can be as high as millions

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<sup>1073</sup> *Id.* 3.2.1.C.

<sup>1074</sup> *Id.* arts. 3(2)(1) & 3(2)(2).

<sup>1075</sup> *Id.* arts. 2(4)-2(7).

<sup>1076</sup> *See* Chapter Three for a discussion of the *de facto* functions of *Sarrafs*.

of dollars). Mobile *Sarrafs* stand on the street near the *Sarrafi* market, or inside the *Sarrafi* market, or on other streets, holding their money at hand. They do not execute *hawala*—because they do not have a permanent address no one would trust them with a *hawala*—but only buy and sell different currencies. They often have an account with an established *Sarrafi*. The Da Afghanistan Bank in 2016 made efforts to issue licenses to mobile *Sarrafs*, however, this has not happened, therefore, they are not, generally, reflected in Da Afghanistan Bank reports.<sup>1077</sup>

Between 2013 and 2017, according to Da Afghanistan Bank data, the number of licenses issued for FXs and Money Service Providers has increased from 1,900 to 2,600, which shows a 37% increase.<sup>1078</sup> The proportion of FX and Money Service Providers has been roughly 40% FXs and 60% Money Service Providers, while the number of FX has increased at a faster rate between 2013 and 2017.<sup>1079</sup> According to the latest Da Afghanistan Bank report, there are currently 3,200 FX and Money Service Provider license holders in Afghanistan.<sup>1080</sup> This number does not reflect the actual number of *Sarrafs* in Afghanistan. According to informal estimates, in Kabul only 80% of *Sarrafs* hold licenses; the figures for provinces is expectedly much lower.<sup>1081</sup>

Prior to 2016, *Sarrafs* were licensed from Da Afghanistan Bank but otherwise there were very few substantive regulations concerning the operation of *Sarrafi* markets. In 2016, Da Afghanistan Bank enacted a regulation concerning *Sarrafs*, Regulation of Organizing the Activities of *Sarrafs* and Money Service Providers (“Regulation”).<sup>1082</sup> The Regulation has been

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<sup>1077</sup> REGULATION OF SARRAFS AND MONEY SERVICE PROVIDERS’ ACTIVITIES, *supra* note 1068, art. 2(1)(d).

<sup>1078</sup> Calculated by the author based on QUARTERLY FINANCIAL SECTOR FINANCIAL STATISTICS FOR THE PERIODS OF I-2013 UNTIL IV-2017, *supra* note 22.

<sup>1079</sup> *Id.*

<sup>1080</sup> *Id.*

<sup>1081</sup> CURBING ILLICIT FINANCIAL FLOWS IN AFGHANISTAN: MONEY LAUNDERING, TERRORIST FINANCING, AND HAWALA, *supra* note 310, at 34.

<sup>1082</sup> In 2014, the international Financial Action Task Force (FATF), an independent inter-governmental body tasked with combating money laundering and financial crimes, had threatened to categorize Afghanistan as a “high-risk and

very controversial. Da Afghanistan Bank promulgated the Regulation with the aim of preventing money laundering and terrorism financing (I.2 Regulation).<sup>1083</sup>

One year after promulgation of the Regulation, when the Da Afghanistan Bank attempted to call an election to elect a new president of the *Sarrafi* Union, under a provision of the Regulation. *Sarrafs* staged a nationwide strike to protest the Regulation.<sup>1084</sup> The Regulation fundamentally disrupted the operation of *Sarrafs*. The National Council of *Sarrafs*, which is comprised of *Sarrafs*' provincial unions, was established in February 2016 to organize *Sarrafs* effort on the national level with aim of resisting the Da Afghanistan Bank regulations.<sup>1085</sup> In their public statements in relation to the strike, they demanded the changes in 22 provisions of the Regulation.<sup>1086</sup>

The strike lasted four days (from 6-10 February 2018) and disrupted the business and personal lives of Afghans.<sup>1087</sup> According to the International Monetary Fund data, 90% of financial

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non-cooperative jurisdiction", which would have effectively blacklisted Afghanistan's financial system, if Afghanistan failed to follow FATF's recommendation and enact effective anti-money laundering laws. Being blacklisted from the international financial system would have effectively shut Afghanistan out of the international financial system which would have had consequences for the Afghan economy effectively shutting Afghanistan out of international financial system. To avoid this, the Afghanistan government has passed a series of legislations and took several measures to create a robust system of financial oversight. As a result of these efforts in June 2017 FATF certified that Afghanistan met its commitment to implement FATF's recommendations and removed Afghanistan from the FATF's monitoring process for the first time after five years, effectively removing Afghanistan's from gray list. The Regulation was part of the Afghanistan's reforms to meet FATF recommendations. See FATF, Improving Global AML/CFT Compliance: On-going Process - 23 June 2017, <http://www.fatf-gafi.org/countries/a-c/afghanistan/documents/fatf-compliance-june-2017.html> (last visited April 10, 2018).

<sup>1083</sup> REGULATION OF SARRAFS AND MONEY SERVICE PROVIDERS' ACTIVITIES, *supra* note 1068.

<sup>1084</sup> Khairullah Rasooli, *Afghan Sarrafs Have Closed Saraya Shahzadaha [Kabul's Sarrafi Market] in Protest*, VOADARI (Feb. 2, 2018), <https://www.darivoa.com/a/money-changers-closed-saraye-shazada-money-changing-market/4242561.html>.

<sup>1085</sup> *National Council of Sarrafs is Established*, THE DAILY AFGHANISTAN (Sept. 29, 2017), [http://www.dailyafghanistan.com/national\\_detail.php?post\\_id=141831](http://www.dailyafghanistan.com/national_detail.php?post_id=141831).

<sup>1086</sup> Khairullah Rasooli, *supra* note 1084.

<sup>1087</sup> *Kabul's Sarrafs Have Ended Their Strike*, BBC PERSIAN (Feb. 21, 2018), <http://www.bbc.com/persian/business-43022961>.

transactions in Afghanistan are conducted through *Sarrafs*.<sup>1088</sup> Only 10% of the Afghanistan population uses bank.<sup>1089</sup> Another World Bank report discussed earlier suggested that 16% of Afghan families rely on the money sent by a family member working abroad which is almost exclusively transferred via *Sarrafs*.<sup>1090</sup> This means a *Sarrafs*' strike has great consequences for the livelihood of Afghans.

The National Council of *Sarrafs*, in a statement issued to declare the conclusion of the strike, stated that they reached an agreement with Da Afghanistan Bank to revise 22 provisions of the Regulation after Chief Executive of Afghanistan's Government Abdullah and Second Vice President Danish got involved.<sup>1091</sup> Da Afghanistan Bank spokesman, in a statement issued concerning the possible revision of the Regulation, said some provisions are based on Afghanistan banking laws and would not be changed.<sup>1092</sup> The provisions barring *Sarrafs* from deposit-keeping and lending is one of those provisions. It is not yet clear how the Regulation is going to be changed.

The Regulation sets forth conditions for obtaining an FX or Money Service Provider license, restricts the type of financial services *Sarrafs* can legally engage in, and grants FinTRACA (Financial Transaction and Reports Analysis Center for Afghanistan<sup>1093</sup>) broad monitoring and disciplinary authority over *Sarrafs*.<sup>1094</sup> Although it was not required by the Regulation, in early

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<sup>1088</sup> See CURBING ILLICIT FINANCIAL FLOWS IN AFGHANISTAN: MONEY LAUNDERING, TERRORIST FINANCING, AND HAWALA, *supra* note 310, at 28; see also AFGHANISTAN—STATE BUILDING, SUSTAINING, GROWTH, AND REDUCING, *supra* note 781, at 6.

<sup>1089</sup> SPECIAL INSPECTOR GENERAL (2015), *supra* note 796, at 165.

<sup>1090</sup> HOLZMANN, *supra* note 438, at 12.

<sup>1091</sup> *Kabul's Sarrafs Have Ended Their Strike*, *supra* note 1087.

<sup>1092</sup> *Id.*

<sup>1093</sup> FinTRACA is part of Da Afghanistan Bank's Financial Intelligence Unit.

<sup>1094</sup> REGULATION OF SARRAFS AND MONEY SERVICE PROVIDERS' ACTIVITIES, *supra* note 1068. According to the FinTRACA annual report for 2017, within one-year life of the Regulation FinTRACA revoked and suspended 33 MSPs' licenses and imposed 3.8 million AFN (approx. 56,000 US\$) fines on MSPs. FinTRACA has imposed almost the same amounts of fine (3.55 million AFN) against Banks in the same period. See DA AFGHANISTAN BANK,

2018 Da Afghanistan Bank has recently decided to suspend issuance of Money Service Provider and FX licenses in urban centers altogether in order to “contain the expansion of *traditional markets* and better control of the existing markets.”(emphasis added)<sup>1095</sup> The call for reelection of the head of *Sarrafs’* Union, who does not hold either a Money Service Provider or FX license as the Regulation required, was the straw that broke the camel’s back.<sup>1096</sup>

To illustrate the ways the Regulation aimed to regulate the *Sarrafi* markets in Afghanistan, this dissertation reviews the main points of contentions between *Sarrafs* and the Da Afghanistan Bank in the context of recent strike. These contentions illustrate the fundamentals of the regulatory scheme that Da Afghanistan Bank is seeking to impose on *Sarrafs*.

A main point of contention in the recent strike was Da Afghanistan Bank’s decision to halt the issuance of *Sarrafs’* license in the major urban centers. Da Afghanistan Bank has instituted a stay on issuing licenses for urban centers of five major provinces studied here (Kabul, Herat, Nangarhar, Balkh, and Kandahar) as well as Kunduz.<sup>1097</sup> Da Afghanistan Bank wanted to limit the number of active *Sarrafs* to incentivize Afghans to use the formal banking system. A main demand of the National Council of *Sarrafs* was to lift this stay.<sup>1098</sup>

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FINANCIAL INTELLIGENCE UNIT, ANNUL REPORT 2017: FINANCIAL TRANSACTIONS AND REPORTS ANALYSIS CENTER OF AFGHANISTAN (FINTRACA), <http://www.fintraca.gov.af/Report.html>.

<sup>1095</sup> Khairullah Rasooli, *supra* note 1084.

<sup>1096</sup> Khairullah Rasooli, *supra* note 1084 (quoting Da Afghanistan Bank’s Spokesman).

<sup>1097</sup> *Id.*

<sup>1098</sup> Haji Qzi Mir Afghan Safi, The President of Kabul’s *Sarrafs’* Union, FACEBOOK (Feb. 7, 2018), <https://www.facebook.com/qazishirinaqa/posts/350963322045553>. According to the spokesman of the National Council of *Sarrafs*, Da Afghanistan Bank has agreed to lift the stay as part of a deal to end the strike, Interview Clip, FACEBOOK, *End of Sarraf’s Strike* (VOA Dari, Feb. 2018), <https://www.facebook.com/voadari/videos/1718723204840376/>.

The authority of the FinTRACA to suspend and revoke *Sarrafs'* licenses was another contentious issue in the recent strike.<sup>1099</sup> The National Council of *Sarrafs* demands that FinTRACA should not be able to suspect or revoke a license without the agreement of the National Council of *Sarrafs*.<sup>1100</sup> *Sarrafs* also objected to provisions of the Regulation which imposed strict reporting obligations.<sup>1101</sup> To prevent tax evasion, the Regulation bars *Sarrafs* from using personal bank accounts for their business deposits (Regulation 3.3.a).<sup>1102</sup> The National Council of *Sarrafs* claims this rule jeopardizes the personal security of *Sarrafs* by making the information of their capital easily available.<sup>1103</sup>

A main driver of *Sarrafs'* recent strike was to protest against Da Afghanistan Bank's attempt to reject *Sarrafs'* status as financial intermediaries in Afghanistan. The Regulation prohibits *Sarrafs* from accepting deposits unless the deposit is held for *hawala* purposes (3.2.1.b Regulation and 3.2.1.c).<sup>1104</sup> The National Council of *Sarrafs* demanded this prohibition to be

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<sup>1099</sup> The Regulation provides FinTRACA with enforcement authority. 13.4 Regulation authorizes FinTRACA to impose pecuniary fine (between 50,000 AFN-500,000 AFN), suspend and revoke FX and MSP licenses. REGULATION OF SARRAFS AND MONEY SERVICE PROVIDERS' ACTIVITIES, *supra* note 1068. FinTRACA, using this authority, has revoked and suspended 33 MSPs' licenses in 2017. FINTRACA ANNUL REPORT 2017, *supra* note 1094.

<sup>1100</sup> The National Council of *Sarrafs* also demands that the revoked licenses be reinstated. *See* Haji Qzi Mir Afghan Safi, *supra* note 1098.

<sup>1101</sup> The Regulation requires *Sarrafs* to report every currency exchange transaction in excess of 500,000 AFN to FinTRACA. Furthermore, the Regulation requires *Sarrafs* to report a *hawala* (and other financial transactions) in excess of 500,000 AFN (approx. 7,250 US\$). *See* REGULATION OF SARRAFS AND MONEY SERVICE PROVIDERS' ACTIVITIES, *supra* note 1068, (6.4.a Regulation). The National Council of *Sarrafs* claims these requirements are impractical and demand that it be removed. It demands the Da Afghanistan Bank increases the transaction threshold to 1mAFN (approx. 14500US\$). *See* Haji Qzi Mir Afghan Safi, *supra* note 1098. According to FinTRACA 2017 annual report, FXs and MSPs reported 71,012 large cash transactions. *See* FINTRACA ANNUL REPORT 2017, *supra* note 1094.

<sup>1102</sup> REGULATION OF SARRAFS AND MONEY SERVICE PROVIDERS' ACTIVITIES, *supra* note 1068.

<sup>1103</sup> Currently, *Sarrafs* use multiple personal bank accounts to hold deposits at a number of banks. *Sarrafs'* owners objected to the requirement to combine these accounts into a centralized account because the consolidation would make them security targets if insurgents or criminals could easily determine their assets. *See* Interview with the Spokesman of National Union of *Sarrafs* *supra* note 1098; Haji Qzi Mir Afghan Safi, *supra* note 1098.

<sup>1104</sup> REGULATION OF SARRAFS AND MONEY SERVICE PROVIDERS' ACTIVITIES, *supra* note 1068.

lifted.<sup>1105</sup> According to the spokesman for the National Council of *Sarrafs*, the Da Afghanistan Bank has agreed to a compromise on this provision as a part of the deal to end the strike as well.<sup>1106</sup> However, Da Afghanistan Bank's spokesman has said that allowing *Sarrafs* to accept deposits and issue loans would violate Afghanistan banking law which restricts those functions to banks, therefore, a compromise is not possible.<sup>1107</sup> It is not yet clear how this contention will be resolved.

To prevent money laundering and transfer of funds for illegal activities, the Regulation requires *Sarrafs* to demand, record, and keep information (the identity of the parties involved, source of the money, and the purpose of transaction) on all their regular and non-regular clients, especially high-risk clients (e.g. political figures) (4.2 Regulation).<sup>1108</sup> The National Council of *Sarrafs* believes the current requirements are very demanding and it advocates for a more relaxed client information recording requirements.<sup>1109</sup> According to FinTRACA 2017 report, *Sarrafs* have not reported a single suspicious financial transaction since the Regulation came into force suggesting a low level of cooperation.<sup>1110</sup>

#### **4.1.2. What Is Wrong with the *Sarrafi* Regulation?**

The Regulation, along with a number of other pieces of legislations, are enacted to ensure the integrity of Afghanistan financial market; to ensure the continued inclusion of Afghanistan in

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<sup>1105</sup> Haji Qzi Mir Afghan Safi, *supra* note 1098.

<sup>1106</sup> Interview with the Spokesman of National Union of *Sarrafs supra* note 1098.

<sup>1107</sup> *Kabul's Sarrafs Have Ended Their Strike, supra* note 1087.

<sup>1108</sup> REGULATION OF SARRAFS AND MONEY SERVICE PROVIDERS' ACTIVITIES, *supra* note 1068.

<sup>1109</sup> See Haji Qzi Mir Afghan Safi, *supra* note 1098. For example, the Regulation prohibits *Sarrafs* from conducting a transaction without recording a copy of the National ID or Passport of the parties involved, REGULATION OF SARRAFS AND MONEY SERVICE PROVIDERS' ACTIVITIES, *supra* note 1068 (4.2 Regulation). The National Council of *Sarrafs* argues that a large number of Afghans, who make up a large percentage of their customers, do not have either of these documents, See Interview with the Spokesman of National Union of *Sarrafs supra* note 1098.

<sup>1110</sup> FINTRACA ANNUAL REPORT 2017, *supra* note 1094.

international financial systems; to curb the source of revenues for insurgent groups; and to increase the cost of illegal economic activities. For example, during 2016, under the Regulation, FinTRACA froze the bank accounts of 12 *Sarrafs* suspected of money laundering and drug trafficking.<sup>1111</sup>

However, the Regulation is based on false assumptions about the informal institution of *Sarrafi* markets—which is reflective of influence of State-Centered Theory. For example, another purpose for the Regulation offered by the Da Afghanistan Bank’s spokesman “is to contain the *traditional market*.”<sup>1112</sup> (emphasis added) In effect, Da Afghanistan Bank, by barring *Sarrafs* from accepting deposits and issuing loans, is trying to strengthen the position of banks as the main financial intermediaries in Afghanistan. The rationale for restricting the scope of legal activities for *Sarrafs* is that it will shift the supply of funds (deposits), and demand for funds (loans), to banks. As a result, the Regulation is meant to improve access to credit through banks by displacing the informal institutions of *Sarrafi* markets.

There are three main problems with the approach espoused by the Regulation. First, depositing funds with *Sarrafs* does not generally remove funds from banking system. *Sarrafs* currently hold the majority of their funds in banks.<sup>1113</sup> Therefore, outlawing deposit-keeping by *Sarrafs* will not increase the bank deposits significantly. Second, banks already have excessive reserves which they are unable to distribute in loans.<sup>1114</sup> Therefore, banning *Sarrafs* from issuing loans will hinder access to credit by restricting Afghan merchants’ access to short-term working capital loans. Short-term working capital loans are a vital source of financing for Afghanistan’s

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<sup>1111</sup> *Id.*

<sup>1112</sup> Khairullah Rasooli, *supra* note 1084 (quoting Da Afghanistan Bank’s Spokesman).

<sup>1113</sup> SPECIAL INSPECTOR GENERAL FOR AFGHANISTAN (2015), *supra* note 796, at 165.

<sup>1114</sup> *See supra* Chapter Two.

supply chain. Finally, given the low penetration rate of Afghanistan’s banking system,<sup>1115</sup> the Afghan government’s low regulatory capacity, and limited control in large parts of the country, unreasonable restriction of *Sarrafs* will only ensure illegal continuation of their functions, which will further reduce the impact of the formal rules over the *de facto* operation of financial system.<sup>1116</sup>

By conflating measures designed to combat illegal transfer of funds with measures to outlaw Afghanistan’s “traditional market,” State-Centered Theory-based Regulation not only will hinder access to credit for Afghan merchants, especially small and medium size businesses, but also hurts the chance of anti-money laundering efforts. The approach advocated for by this dissertation, Grounded Institutional Reform, proposes that instead of outlawing the effective working financial system in Afghanistan, Da Afghanistan Bank should use the offer of inclusion in the legal financial system, as a legal financial intermediary, to incentivize *Sarrafs* to comply with anti-money laundering efforts. This way Da Afghanistan Bank can introduce self-interest compatible incentives to encourage cooperation with anti-money laundering efforts despite the low regulatory capacity of the Afghanistan government. This approach will also improve access to credit for Afghan merchants by ensuring the continued supply of short-term working capital loans, and competition and cooperation between banks and *Sarrafs*—instead of a blind attempt to displace the informal institutions. This approach to institutional reform and its challenges is further discussed in Chapter Five.

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<sup>1115</sup> According to International Monetary Fund data, in 2015 there were 189 bank accounts per 1000 adults in Afghanistan, and there were only 2.5 bank branches for every 100,000 Afghans. INTERNATIONAL MONETARY FUND, BANK ACCOUNTS PER 1000 ADULTS, BANK ACCOUNTS PER 1000 ADULTS IN AFGHANISTAN FOR THE YEARS OF 2008 UNTIL 2015, [https://www.theglobaleconomy.com/Afghanistan/bank\\_accounts/](https://www.theglobaleconomy.com/Afghanistan/bank_accounts/); INTERNATIONAL MONETARY FUND, BANK BRANCHES PER 100,000 PEOPLE, BANK BRANCHES PER 100,000 PEOPLE IN AFGHANISTAN FOR THE YEARS OF 2004 UNTIL 2015, [https://www.theglobaleconomy.com/Afghanistan/bank\\_branches/](https://www.theglobaleconomy.com/Afghanistan/bank_branches/).

<sup>1116</sup> See *infra* Chapter Five.

## 4.2. Banks in Afghanistan

Afghans have a very low rate of bank use. According to the International Monetary Fund data for 2015, there were only 189 bank accounts per 1000 adult Afghans (Afghanistan was ranked 20<sup>th</sup> out of 23 Asian countries in 2014, only China and Yemen were lower).<sup>1117</sup> That said, the number of bank accounts has steadily increased between 2008-2015 (from 38 to 189 per 1,000 adults) mostly due to the government policy to distribute government employee's salaries through bank accounts.<sup>1118</sup>

Banks have not penetrated a large portion of Afghanistan population and territory. In 2014, the number of bank branches per 100,000 people was 2.47 (this is the lowest number amongst 40 Asian countries included in International Monetary Fund report).<sup>1119</sup> The number of branches has increased modestly by 10% since 2014 despite Afghanistan's fast rate of population growth.<sup>1120</sup> The number of ATMs per 100,000 adults in 2015 was 0.96 (this shows 4700% increase from 2004 figure of 0.02).<sup>1121</sup> Since 2015 the number of ATM has increased by 73%.<sup>1122</sup>

According to the Da Afghanistan Bank data, as of the second quarter of 2017, there are a total of 15 active banks in Afghanistan: three state-owned banks, nine private commercial banks, and three branches of foreign banks.<sup>1123</sup> The number of the banks has been generally stable since 2013 where the Da Afghanistan Bank started to issue regular report on the status of financial

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<sup>1117</sup> BANK ACCOUNTS PER 1000 ADULTS, BANK ACCOUNTS PER 1000 ADULTS IN AFGHANISTAN, *supra* note 1115.

<sup>1118</sup> *Id.*

<sup>1119</sup> BANK BRANCHES PER 100,000 PEOPLE IN AFGHANISTAN, *supra* note 1115.

<sup>1120</sup> Calculated by the author based on BANK BRANCHES PER 100,000 PEOPLE IN AFGHANISTAN, *supra* note 1115.

<sup>1121</sup> Calculated by the author based on INTERNATIONAL MONETARY FUND, ATM MACHINES PER 100,000 PEOPLE, ATM MACHINES PER 100,000 PEOPLE IN AFGHANISTAN FOR THE YEARS OF 2004 UNTIL 2015, [https://www.theglobaleconomy.com/Afghanistan/bank\\_branches/](https://www.theglobaleconomy.com/Afghanistan/bank_branches/).

<sup>1122</sup> *Id.*

<sup>1123</sup> The data in this paragraph is calculated by the author based on QUARTERLY FINANCIAL SECTOR FINANCIAL STATISTICS FOR THE PERIOD OF I-2013 UNTIL II-2017, *supra* note 21.

institutions in Afghanistan. During 2013 to 2017, only one branch of foreign bank was closed in Afghanistan. In the same period, the nine private commercial banks have increased the number of their branches from 242 to 281 branches, which represents a 16% increase. State-owned banks, in the same period, reduced the number of their branches from 138 to 130, while branches of foreign banks reduced the number of their branches in Afghanistan from 10 to 7.

The use of bank loans for Afghan merchants is very low. According to World Bank data for 2014, only 2% of Afghan firms used bank loans for investment<sup>1124</sup> while 3.9% of firms used bank credit to finance working capital.<sup>1125</sup> This percentage must have decreased because since 2014 the supply of bank loans in Afghanistan has experienced a 27% decrease, suggesting a corresponding decrease in the percentage of firms using bank loans.<sup>1126</sup> Throughout this period (2013-2017), however, banks have maintained an average excessive reserves of roughly 3 billion US\$, measured by averaging the difference between the total value of deposits and the total value of gross loans.<sup>1127</sup>

#### **4.2.1. Trust in Banks**

Afghans do not use banks for savings because: (1) they tend to not trust banks;<sup>1128</sup> (2) they have limited access to banks; and (3) when they have accounts with banks, it is costly to access their

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<sup>1124</sup> THE WORLD BANK, WORLD BANK DEVELOPMENT INDICATORS, PERCENTAGE OF FIRMS USING BANKS TO FINANCE INVESTMENT, PERCENTAGE OF FIRMS USING BANKS TO FINANCE INVESTMENT IN AFGHANISTAN FOR THE YEAR 2014, <https://data.worldbank.org/indicator/IC.FRM.BNKS.ZS?locations=AF>.

<sup>1125</sup> THE WORLD BANK, WORLD BANK DEVELOPMENT INDICATORS, PERCENTAGE OF FIRMS USING BANKS TO FINANCE WORKING CAPITAL, PERCENTAGE OF FIRMS USING BANKS TO FINANCE WORKING CAPITAL IN AFGHANISTAN FOR THE YEAR 2014, <https://data.worldbank.org/indicator/IC.FRM.BKWC.ZS?locations=AF>.

<sup>1126</sup> Calculated by the author based on QUARTERLY FINANCIAL SECTOR FINANCIAL STATISTICS FOR THE PERIOD OF I-2013 UNTIL II-2017, *supra* note 21.

<sup>1127</sup> *Id.*

<sup>1128</sup> In 2012, according to GALLUP® survey, when asked do you have confidence in the financial institutions or banks, 56% of Afghans answered NO while only 29% said YES (15% said don't know or refused). See Steve

savings. The government needs to encourage savings in banks because they are the only institutions that can effectively pool savings for investment in Afghanistan. Informal substitutes like *Sarrafs*'s loans and *Gerawee* have either limited or no long-term financing potential. Afghanistan needs to improve the regulatory framework to regain people's trust in banks and pursue policies to improve access to and performance of banks.<sup>1129</sup>

Afghans, in generally, distrust banks,<sup>1130</sup> arguably, because the highly unstable history of Afghanistan has undermined Afghans' trust in the durability of formal institutions. Furthermore, banks cannot be Afghans' main option for saving because banks have limited reach in Afghanistan.<sup>1131</sup> Furthermore, Afghans also do not save in banks because it is expensive to access their money when they need it. For example, I receive my university salary in Herat, Afghanistan, in form of a wire deposit in a Kabul Bank account but I try to withdraw a large sum of my salary at once as soon as I can and keep it in cash. I do so because I know that it would take me a long time to withdraw the money should I need it, so I prefer to keep the cash. When I was in Herat for this research, two available Kabul Bank's ATMs, in Afghanistan's second largest urban center, were not working. When they did work there was often a line.<sup>1132</sup>

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Crabtree, *European Countries Lead World in Distrust of Banks* (May 20, 2013)  
<http://news.gallup.com/poll/162602/european-countries-lead-world-distrust-banks.aspx>

<sup>1129</sup> See Chapter Three for a comparison of the functionality of *Sarrafs* versus bank lending.

<sup>1130</sup> See Crabtree, *supra* note 1128.

<sup>1131</sup> There are 2.47 branch per 100,000 persons. See BANK BRANCHES PER 100,000 PEOPLE IN AFGHANISTAN, *supra* note 1115.

<sup>1132</sup> The Afghan government is working to improve access to banking services through mobile banking with some success. According to the International Telecommunication Union, in 2016, the number of mobile cellular subscription per 100 people in Afghanistan was 66, THE INTERNATIONAL TELECOMMUNICATION UNION, AFGHANISTAN: MOBILE PHONE SUBSCRIBERS PER 100 PEOPLE, [https://www.theglobaleconomy.com/Afghanistan/Mobile\\_phone\\_subscribers\\_per\\_100\\_people/](https://www.theglobaleconomy.com/Afghanistan/Mobile_phone_subscribers_per_100_people/). That is a very high user rate compared to bank users. As of 2017, there are 357,000 mobile banking services provided by three main telecommunication companies in Afghanistan (Roshan's M-Pisa, Etisalat's M-hawala, and AWCC's My money). There are 10 Mobile banking users per 1000 adults in Afghanistan, according to a 2017 report. Mobile banking services include person-to-person money transfer, salary disbursement, bill payments, and top-up, and merchant payment. These services vary by provider. While mobile banking is still in its early stages of development in

Afghans have long distrusted banks,<sup>1133</sup> and the Kabul Bank scandal only served to confirm their skepticism. Kabul Bank, established in 2004, was the largest private commercial bank in Afghanistan. However, in 2010, Kabul Bank was taken over by the Da Afghanistan Bank due to fear that it might collapse after a 1 billion US\$ fraud in Kabul Bank surfaced.<sup>1134</sup> The 1 billion US\$ fraud consisted of fraud, embezzlement, and forgery involving powerful political and economic figures in Afghanistan.<sup>1135</sup> Almost half of the loss due to improper loans to the owners many of whom are also powerful political figures in Afghanistan.<sup>1136</sup> Kabul Bank is still under receivership of the Da Afghanistan Bank, as the few attempts at auctioning Kabul Bank to the private sector have proven unsuccessful.<sup>1137</sup> The Kabul Bank scandal has had a disastrous impact on Afghanistan bank industry, however, it is almost impossible to isolate the precise effect of the Kabul Bank scandal on the industry because there are numerous confounding factors and also because Da Afghanistan Bank only recently started to release periodic reports on the status of banking industry starting in 2012.

The low trust in banks does not mean that Afghans trust *Sarrafs* more. On the contrary, most interviewees expressed that they trusted banks more than *Sarrafs*. This is expected because *Sarrafs* go bankrupt more often than banks, and when do, they have limited assets for debt recovery. No bank has gone bankrupt in Afghanistan, at least post-2001. In short, although

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Afghanistan, it shows great potential for increasing financial inclusion. See MOBILE BANKING IN AFGHANISTAN, *supra* note 803.

<sup>1133</sup> See Crabtree, *supra* note 1128.

<sup>1134</sup> See INDEPENDENT JOINT ANTI-CORRUPTION MONITORING & EVALUATION COMMITTEE, MEC UPDATE ON KABUL BANK SCANDAL (Press Release, Oct. 2, 2016), <http://www.mec.af/index.php/news-events/press-releases>; *Kabul Bank Fraud: Ghani Reopens Afghan Corruption Case*, BBC NEWS (Oct. 1, 2014), <http://www.bbc.com/news/world-asia-29450821>.

<sup>1135</sup> *Id.*

<sup>1136</sup> *Id.*

<sup>1137</sup> *Id.*

Afghans do not generally save in banks, partly out of fear of losing their savings, *Sarrafs* are not a more credible saving option. As a result, saving in financial intermediaries remains low. Instead, Afghans usually use a portfolio of liquid and illiquid commodities to hold their limited savings.<sup>1138</sup>

The higher rate of *Sarrafs*' use by Afghan merchants, combined with a relatively higher level of trust in banks, indicate that it is the ability of *Sarrafs* to meet Afghan merchants needs that explains their popularity compared to banks, not a sentimental preference for the use traditional institutions. The flip side of this argument also holds true: low demand for bank loans is not a function of low trust in banks, but a result of formal lending requirements that Afghan merchants cannot satisfy for reasons described above.

#### **4.2.2. Banks' Total Assets<sup>1139</sup>**

According to Da Afghanistan Bank data, between 2013-2017, the total asset of banks measured in U.S. dollars based on prevailing US\$/AFN exchange rate has decreased by 5%. Banks' total assets measured in Afghani, however, showed a 26% increase. This discrepancy is caused by 31% increase in US\$/AFN exchange rate in for that period. The analysis that follows uses U.S. dollars because, given Afghanistan's dependence on external resources and pervasiveness of foreign currencies,<sup>1140</sup> it is a better indicator of the macroeconomic trends.

In 2013, banks in Afghanistan held total assets of 4.48 billion US\$. By second quarter of 2017, banks' total assets in Afghanistan decreased to 4.25 billion US\$. Of the total assets of banks,

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<sup>1138</sup> See LANDELL MILLS DEVELOPMENT CONSULTANT, UKAid, OVERCOMING THE ACCESS TO FINANCE PARADOX IN AFGHANISTAN: EXPERIENCE FROM THE AFGHANISTAN BUSINESS INNOVATION FUND 2 (2016) <https://static1.squarespace.com/static/553f9958e4b06d466cd3ce1e/t/599ea0eaf9a61e5bdb7a9087/1503568115954/PA-ABIF-financing-KP-010916.pdf>;

<sup>1139</sup> The data on the bank assets in this section is calculated by the author based on QUARTERLY FINANCIAL SECTOR FINANCIAL STATISTICS FOR THE PERIOD OF I-2013 UNTIL II-2017, *supra* note 22.

<sup>1140</sup> See *supra* Chapters Two and Three.

between 2013-2017, roughly 10% was held by branches of the foreign banks and their share has been shrinking; state-owned banks owned roughly a quarter of the assets and their share has been shrinking as well; private commercial banks have held more than half of the assets and their share has been expanding between 2013 and 2017.

According to the Da Afghanistan Bank data, at least between 2013 and 2017, almost half of the banks' assets was cash in the vault and claims on Da Afghanistan Bank. The second category of the banks' assets is inter-bank claims that make up almost a quarter of the banks' total assets. The third category is loans that make up roughly 15% of the banks' total assets. Banks' fixed assets have stayed roughly the same (3% of total assets). Investment makes up roughly 7% of the banks' total assets.

Between 2013 and 2017, the share of cash in total assets of banks has increased by 7%, the share of interbank claims has decreased by 3%, the share of investment has increased by 4%, and the share of loans has decreased by almost 5%.

#### **4.2.3. Banks' Total Deposits<sup>1141</sup>**

Between 2013 and 2017, the total amount of deposits in banks decreased by 3%, if measured in US dollars according to the prevailing US\$/AFN exchange rate. In contrast, the total bank deposits measured in Afghani for the same period increased by 24%. This discrepancy is due to a 31% increase in US\$/AFN exchange rate in this period.<sup>1142</sup>

At the end of 2013, the total amount of deposits held by banks was 3.68 billion US\$. At the end of second quarter of 2017, deposits held by banks fell to 3.57 billion US\$. However, the

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<sup>1141</sup> The data on the banks' total deposits in this section is calculated by the author based on QUARTERLY FINANCIAL SECTOR FINANCIAL STATISTICS FOR THE PERIOD OF I-2013 UNTIL II-2017, *supra* note 22.

<sup>1142</sup> Calculated by the author Based on CURRENCY HIJRI MONTHLY AVERAGE USD FOR THE YEARS OF 1385 HIJRI UNTIL 1396 HIJRI, *supra* note 281.

deposits have decreased at a lower rate compared to total assets (deposits were reduced by roughly 3% while the total assets were reduced by 5%). This means that the decrease in deposits was only partially responsible for the total decrease in banks' assets between 2013 and 2017.

Demand deposits make up roughly the three-quarters of total bank deposits and their share has been marginally increasing between 2013 and 2017. Savings deposits make up almost one-fifth of total deposits, but its share has marginally decreased in the same period. Time deposits have been increasing. They made up 4.48% of total deposits in 2013. In 2017 the share of time deposits rose to 5.38%. The smaller and decreasing share of saving deposits highlight the limited capacity of banks in Afghanistan to pooling savings.

The share of state-owned banks, commercial private banks, and branches of foreign banks in deposits is roughly the same as their share in total assets: 10%, 65% and 26%, respectively. The only difference is that state-owned banks have been able to increase their share of deposits from 11% in 2013 to 26% in 2014. From 2014 forward, the share of state-owned banks in deposits has stabilized.

#### **4.2.4. Banks' Loans**

Bank loans do not play a large role in financing businesses in Afghanistan. A Survey of Afghanistan Capital Market Assessment ("Capital Assessment") in 2010 found that only 5% of their sample relied on banks for capital (14.81 million US\$).<sup>1143</sup> Capital Assessment only included large businesses. Capital Assessment defined a large business as a business with more than 30

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<sup>1143</sup> The Assessment also found that only 1% of their sample of large businesses used *Sarraf* for investment (1.19 million US\$). The Assessment survey only asked about one-year or longer-term financing. *Sarrafs*, as I discussed in the Chapter Three, do not often provide long-term financing to large businesses. See AFGHANISTAN CAPITAL MARKETS ASSESSMENT, *supra* note 787.

employees or initial capital investment of 250,000 US\$ or more<sup>1144</sup> (however the 2009 Business Survey estimated that only 10% of the business establishments in Afghanistan had more than five employees.)<sup>1145</sup>

Two World Bank Enterprise Surveys in 2008 and 2014 found that only, respectively, 1.4% and 2% of firms used banks to finance investment.<sup>1146</sup> The same two surveys found that only 2.5% (2008) and 3.9% (2014) of firms used banks to finance working capital.<sup>1147</sup>

Since the last survey in 2014, the use of bank loans as a source of capital is on decline. According to Da Afghanistan Bank data, between 2013 and 2017, the total of banks' gross loans, measured in U.S. Dollars using prevailing US\$/AFN exchange rate, has decreased by almost 200 million US\$, which represents a 25% decline.<sup>1148</sup> Measured in Afghani, total gross loans show a lower decline rate of 7.3%.<sup>1149</sup>

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<sup>1144</sup> *Id.*

<sup>1145</sup> BUSINESS ESTABLISHMENT SURVEY 2009, *supra* note 18.

<sup>1146</sup> PERCENTAGE OF FIRMS USING BANKS TO FINANCE INVESTMENT IN AFGHANISTAN FOR THE YEARS OF 2008 AND 2014, *supra* note 1124.

<sup>1147</sup> PERCENTAGE OF FIRMS USING BANKS TO FINANCE WORKING CAPITAL IN AFGHANISTAN FOR THE YEARS OF 2008 AND 2014, *supra* note 1125.

<sup>1148</sup> Calculated by the author based on QUARTERLY FINANCIAL SECTOR FINANCIAL STATISTICS FOR THE PERIOD OF I-2013 UNTIL II-2017, *supra* note 22.

<sup>1149</sup> *Id.*

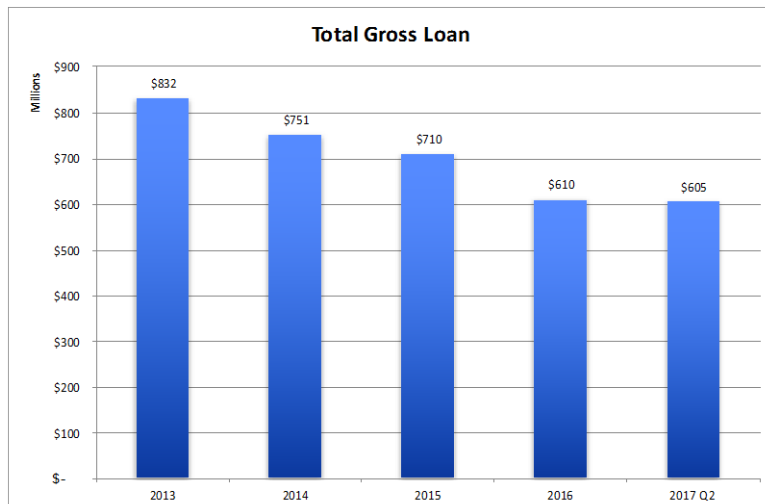


Figure 8 Total Gross Loans Distributed in Afghanistan (2013 - II 2017)<sup>1150</sup>

Banks in Afghanistan, as reported between 2013-2017, have had more than 3 billion US\$ excessive reserves, measured by the average of differences between total deposits and total gross loans, that they have not been able to distribute in loans.<sup>1151</sup> Banks' ability to pool savings to finance investment have declined as evidenced by decrease in deposits and deposit-loan ratios.

The decline in the bank loans issued is not due to decrease in demand. According to Business Climate Reports, the percentage of businesses reporting a problem with access to finance increased between 2014 and 2016.<sup>1152</sup> In 2014, according to the 2014 Business Climate Report, 36% of businesses surveyed reported that they had a problem accessing finance. In 2015, this percentage rose to 43.5%. By the end of 2016, the percentage of businesses reporting a problem accessing finance rose to 47%.

<sup>1150</sup> Constructed by the author based on QUARTERLY FINANCIAL SECTOR FINANCIAL STATISTICS FOR THE PERIOD OF I-2013 UNTIL II-2017, *supra* note 22.

<sup>1151</sup> Calculated by the author based on QUARTERLY FINANCIAL SECTOR FINANCIAL STATISTICS FOR THE PERIOD OF I-2013 UNTIL II-2017, *supra* note 22.

<sup>1152</sup> The Business Climate Report data in this section is calculated by the author based on BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, AND III-2017, *supra* note 12.

According to the 2016 Business Climate Report, Afghan businesses cite the following reasons as to why they do not use banks' loans: very high interest rate (52%);<sup>1153</sup> excessive collateral requirements (26%); need for political connections (12%); and too difficult business or project plan (11%).<sup>1154</sup> According to the 2016 Business Climate Report, this is a pattern that has been consistently observed since 2014.<sup>1155</sup>

These surveys, supported by interview data, reveal three main challenges to bank-based financing in Afghanistan: (1) a highly uncertain environment has caused interest rates to increase, making it difficult for merchants to use bank loans for investment; (2) an inefficient formal property rights system, making it difficult to collateralize bank loans; and (3) low economic literacy among Afghan businesses, making it difficult for businesses to comply with the banks' requirements and for the banks to assess loans' applicants effectively.

Interview data confirms the Business Climate Report findings. Interview data highlights two additional related challenges that prevent merchants from using bank loans for investment: (1) inflexible repayment terms make it difficult for Afghan businesses who operated in an unpredictable business climate to use loans from banks; and (2) the short term of bank loans (bank loans repayment terms in Afghanistan does not exceed three years). Since merchants operate in a highly uncertain environment, it makes it difficult for them to use bank loans to finance long term investment.<sup>1156</sup>

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<sup>1153</sup> According to the IMF data, real interest rate, defined as bank lending interest rate minus inflation in Afghanistan between 2008 and 2016 was on average 10.91%, *See* INTERNATIONAL MONETARY FUND, AFGHANISTAN: REAL INTEREST RATE (BANK LENDING RATE MINUS INFLATION) FOR THE YEARS OF 2008 UNTIL 2016, [https://www.theglobaleconomy.com/Afghanistan/Real\\_interest\\_rate/](https://www.theglobaleconomy.com/Afghanistan/Real_interest_rate/).

<sup>1154</sup> Calculated by the author based on BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, AND III-2017, *supra* note 12.

<sup>1155</sup> *Id.*

<sup>1156</sup> *Id.*

The Business Climate Report data shows significant regional and sectoral variation in the percentage of businesses that reported having a problem with access to finance.<sup>1157</sup> Access to finance, as used in the survey, is meant to represent access to investment financing, commonly bank loans. However, Business Climate Report data reflect the attitude toward bank loans, not the actual access/usage. This is because the overwhelming majority of surveyed businesses did not have a bank loan, nor had they necessarily applied for bank loans. Therefore, the survey reflects the business attitudes towards bank loans rather than the actual experience of participants.

According to Business Climate Report data, the five major provinces, ranked according to the percentage of businesses that reported having a problem with access to finance, from high to low, are: Kandahar, Nangarhar, Kabul, Herat, and Balkh.<sup>1158</sup> Balkh has both the lowest business registry of the five major provinces, and a low proportion of smaller businesses which may explain why Balkhis are less likely to say they have a problem with access to finance.<sup>1159</sup> Stated differently, low market competition in Balkh may reduce the need for financing.

The Business Climate Report data suggest that there is no significant difference in the percentage of business that report problem with access to finance based on business size.<sup>1160</sup> Similarly, the Business Climate Reports does not show any particular temporal pattern in the sectorial variation of percentage of businesses that report a problem with access to finance.<sup>1161</sup> The scattered temporal distribution of sectoral ease of access to financing illustrates the highly volatile

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<sup>1157</sup> Calculated by the author based on BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, AND III-2017, *supra* note 12.

<sup>1158</sup> *Id.*

<sup>1159</sup> *See* Chapter Two.

<sup>1160</sup> Calculated by the author based on BUSINESS TENDENCY SURVEY REPORTS OF II-2014, IV-2014, I-2015, II-2015, III-2015, IV-2015, I-2016, II-2016, III-2016, IV-2016, I-2017, II-2017, AND III-2017, *supra* note 12.

<sup>1161</sup> *Id.*

business climate in Afghanistan. According to the Business Climate Report data, business sectors that reported having a problem with access to credit from worst to best:: agriculture, manufacturing, construction, trade, and service, based on the percentage of access of businesses to finance.<sup>1162</sup>

The Da Afghanistan Bank data for the same period show that the distribution of loans by sector has drastically changed between 2013 and 2017. In 2013, the sectors that received most bank loans were ranked in the following order: trade; commercial real estate and construction; service; consumer loans; manufacturing; power and energy; and residential mortgage loans to individuals.<sup>1163</sup> The ranking in 2017 was: service; manufacturing; commercial real estate and construction; communication; trade; power and energy; mines and dams and infrastructure; agricultural loans; residential mortgages to individuals; and consumer loans.<sup>1164</sup> A small part of this transformation in distribution of bank loans between 2013-2017 is a change in categorization of loans as is evident by the decrease in share of the category of “other loans”.<sup>1165</sup> However, as it can be seen from the figure below this can only explain a small part of the change in the distribution of loans. The Da Afghanistan Bank data clearly show that the share of service and manufacturing has significantly expanded while the share of trade and commercial real estate and construction has significantly contracted.<sup>1166</sup>

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<sup>1162</sup> *Id.*

<sup>1163</sup> Calculated by the author based on DA AFGHANISTAN BANK, ANNUAL ECONOMIC AND STATISTICAL REPORTS FOR THE YEARS OF 1384 HIJRI UNTIL 1395 HIJRI, <http://dab.gov.af/en/page/media/publications/annual-economic-and-statistical-bulletin>.

<sup>1164</sup> Calculated by the author based on ANNUAL ECONOMIC AND STATISTICAL REPORTS FOR THE YEARS OF 1384 HIJRI UNTIL 1395 HIJRI, *supra* note 1163.

<sup>1165</sup> *Id.*

<sup>1166</sup> *Id.*

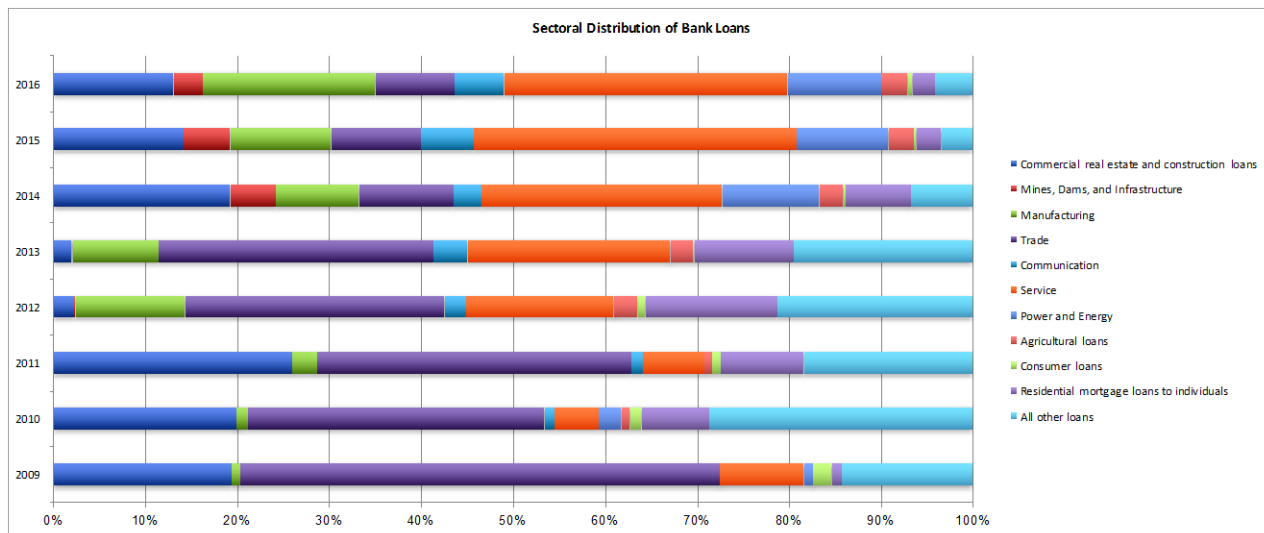


Figure 9 Sectoral Distribution of Bank Loans in Afghanistan (2009 - 2016)<sup>1167</sup>

Commercial banks are the main issuers of bank loans in Afghanistan. Private commercial banks issue more than 90% of the total bank loans in the country.<sup>1168</sup> Although state-owned banks hold a quarter of the banks' total assets and deposits, they only issue 7% of loans. Branches of foreign banks hold 10% of banks' total assets and deposits but issued only a little more than 1% of total loans in 2016. Between 2013 and 2017, private commercial banks have expanded their share of total loans by 3%, while branches foreign banks have reduced their share by 4%. State-owned banks' share of total bank loans overall had marginally increased by roughly 1%.

The percentage of non-performing loans has steadily increased in Afghanistan. In 2012, according to Da Afghanistan Bank data, only 5.31% of loans were nonperforming in Afghanistan. This rate has steadily increased from 2012 to 2016. In 2016, according to Da Afghanistan Bank,

<sup>1167</sup> Constructed by the author based on ANNUAL ECONOMIC AND STATISTICAL REPORTS FOR THE YEARS OF 1384 HIJRI UNTIL 1395 HIJRI, *supra* note 1163.

<sup>1168</sup> The data in the two following paragraphs is calculated by the author based on ANNUAL ECONOMIC AND STATISTICAL REPORTS FOR THE YEARS OF 1384 HIJRI UNTIL 1395 HIJRI, *supra* note 1163.

12.67% of loans were nonperforming. The increase in the rate of non-performing loans is expected as the economic conditions in this period deteriorated.

### **4.3. Afghan Government Strategic Policies Aimed to Improve Access to Credit**

The Afghan Government has adopted a number of strategic policies to improve access to credit for Afghans in general, and Afghan merchants in particular. The Afghanistan National Peace and Development Framework (“The National Framework”) (2017-2021), and its predecessor Afghanistan National Development Strategy (2008-2013), are the Afghan government’s national strategic plans for achieving self-reliance.<sup>1169</sup> The National Framework and National Development Strategy both formulate Afghanistan’s high-level developmental priorities and guidelines.<sup>1170</sup> Like the National Development Strategy, The National Framework, Afghanistan’s current national development framework, underscores key reforms and priority investments needed to achieve its developmental goals.<sup>1171</sup> The National Framework highlights institutional reforms needed to improve access to credit for Afghan merchants and achieve financial inclusion for Afghans.<sup>1172</sup>

Different units of the Afghan government have formulated strategic plans to achieve Afghanistan’s developmental goals in their respective jurisdictions. Afghanistan’s Ministry of Commerce and Industries, Afghanistan’s Ministry of Economics, and Afghanistan’s Central Bank (Da Afghanistan Bank) have developed strategic plans which set forth reform and investment priorities needed to improve access to credit for Afghan merchants and improve Afghanistan’s financial system. These strategies are Ministry of Commerce’s Strategic Plan 2016-2020

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<sup>1169</sup> See AFGHANISTAN NATIONAL PEACE AND DEVELOPMENT FRAMEWORK 2017-2021, *supra* note 9; AFGHANISTAN NATIONAL DEVELOPMENT STRATEGY 2008-2013 *supra* note 9.

<sup>1170</sup> *Id.*

<sup>1171</sup> *Id.*

<sup>1172</sup> See AFGHANISTAN NATIONAL PEACE AND DEVELOPMENT FRAMEWORK 2017-2021, *supra* note 9.

(“Commerce Strategy”),<sup>1173</sup> Ministry of Economics’ Afghan Government Economic Plan (“National Economic Plan”) 2013,<sup>1174</sup> and Da Afghanistan Bank’s Strategic Plan (“Banking Strategy”) 2017-2021.<sup>1175</sup>

These strategic plans, which are Afghan government’s latest strategic plans in their respective sector (in some cases they are the first or only strategic plan formulated for their respective sector), illustrate the Afghan government’s approach to institutional reform. It can be surmised from their content of the policies have been informed by State-Centered Theory as they only focus on reforms that feature using formal institutions that have proven successful in other contexts (e.g. Credit Bureau and export bank).

In line with the State-Centered Theory’s model for institutional reform, the Afghan Government’s Strategic Policies disregard the entrepreneurially-developed informal institutions that are currently the source of credit for most Afghan merchants, in effect, seeking to displace them with formal institutions modeled on international “best practices.” Currently, formal institutions make up a very small source of finance for Afghan merchants. Only 1% to 3% of Afghan merchants use bank credit.<sup>1176</sup> Reflecting State-Centered Theory’s limiting approach, the Government Strategic Policies aim to create new formal institutions and/or reform the existing formal institutions as if formal institutions are the only institutional recourse that Afghans have. However, none of the Government’s Strategic Policies appear to recognize the need to understand the existing institutions used by Afghan merchants nor prescribes the formulation of institutional reforms as a correction or supplement to the informal institutions. Government Strategic Policies

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<sup>1173</sup> MINISTRY OF COMMERCE AND INDUSTRIES STRATEGIC PLAN 2016-2020, *supra* note 9.

<sup>1174</sup> ECONOMIC POLICY OF GOVERNMENT OF AFGHANISTAN (2013), *supra* note 9.

<sup>1175</sup> DA AFGHANISTAN BANK, STRATEGIC PLAN 2017-2021 (2017), *supra* note 9.

<sup>1176</sup> *See* the discussion of bank loans earlier in this Chapter.

seem to assume that outside of formal institutions, Afghanistan is an institutional vacuum. Thus, they forgo the institutional knowledge and potential held by informal institutions in Afghanistan and overlook the interaction between formal and informal institutions.

Concerning the access to credit, in particular, Government's Strategic Policies' view of the credit institutions is limited to formal institutions, particularly bank loans. This explains why they correctly identify most of the problems of access to bank loans and some of the changes that must be made to improve access to bank loans. They have generally failed, however, to improve access to credit for Afghan merchants. This failure is rooted in a narrow understanding of Afghanistan's existing credit institutions and unwillingness to leverage existing informal credit institutions.

This section initially reviews the provisions of four Government Strategic Policies (The National Framework, Commerce Strategy, National Economic Plan, and Banking Strategy) aimed at institutional reforms to improve access to credit as well as the Afghanistan's Ministry of Justice's Strategic Plan ("Justice Strategic Plan") (2014-2018).<sup>1177</sup> This is followed by an analysis of the Government Strategic Policies' approach to institutional reform in Afghanistan. This section illustrates the current approach of the Afghan Government's institutional reforms which reflects the policy prescriptions of State-Centered Theory; Chapter Five will focus on a critical assessment of the theoretical approach informing Government Strategic Policies, offering an alternative approach for institutional reform for countries like Afghanistan.

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<sup>1177</sup> FIVE STRATEGIC PLAN: LAW AND JUSTICE 2014-2018, *supra* note 9. I was unable to find the Afghanistan Supreme Court's strategic plan.

### 4.3.1 Afghanistan National Peace and Development Framework (2017-2021)

The National Framework (2017-2021) sets forth Afghanistan’s government national development strategy aimed to achieve self-reliance and increase welfare for Afghans.<sup>1178</sup>It envisions transforming Afghanistan’s economy from “one of import and distribution to one where a thriving private sector—from small farmers and urban businesses and to large manufacturers—can successfully export Afghan products regional and global markets.”<sup>1179</sup>

The National Framework underscores the need to clarify property titles, provide reliable supply of electricity, provide access to transport, and ensure the personal safety of Afghan merchants.<sup>1180</sup> It also recognizes the need to promote exports by improving access to credit.<sup>1181</sup> Concerning the housing market, the National Framework highlights the importance of regulatory reform to unleash the value trapped in urban housing market. It states, “Regulatory reform can [...] unleash investment by the poor. We are offering incentives to the urban poor to invest in their houses and small businesses through a national program for *land certification* that provides *tenure security* in all large and medium-sized cities.”<sup>1182</sup> (emphasis added) The strategy acknowledges land tenure insecurity is a factor contributing to the creation of a poverty trap in Afghanistan’s urban centers.<sup>1183</sup>

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<sup>1178</sup> AFGHANISTAN NATIONAL PEACE AND DEVELOPMENT FRAMEWORK 2017-2021, *supra* note 9, at 1.

<sup>1179</sup> *Id.*

<sup>1180</sup> *Id.* at 19.

<sup>1181</sup> *Id.*

<sup>1182</sup> *Id.*

<sup>1183</sup> *Id.* at 26.

Mobile banking and e-payment is being hailed as an effective way to reach large section of the population. Recognizing this opportunity, the National Framework stresses the potentials of mobile banking and e-payment to reduce interest rates and transaction costs.<sup>1184</sup>

The National Framework's section on financial sector reforms focuses on two main strategies: (1) creating a robust financial regulatory system, and (2) incentivizing loan distribution by banks and savings in banks.<sup>1185</sup> It proposes a list of reforms aimed at creating a robust system of financial oversight such as establishing a unit within Da Afghanistan Bank to monitor financial system risk. While recognizing its importance, the National Framework does not offer a strategy to incentivize banks to lend to private enterprises. To incentivize savings in banks, the strategy proposes creation of a national financial inclusion strategy to allow citizens better access to banking services by December 2017.<sup>1186</sup> Despite his efforts, the author was not able to find the national financial inclusion strategy; it is very likely that the strategy is not yet developed. However, Da Afghanistan Bank has a financial inclusion department tasked with development of a financial inclusion strategy and implementing programs to increase financial inclusion in Afghanistan.<sup>1187</sup>

#### **4.3.2. Ministry of Economics' Afghan Government Economic Plan (National Economic Plan) (2013)**

In 2013 the Ministry of Economics has developed and adopted its National Economic Plan as a strategic instrument to unify the Afghan Government's institutional reform efforts to induce

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<sup>1184</sup> *Id.* 19.

<sup>1185</sup> *Id.* at 22.

<sup>1186</sup> *Id.*

<sup>1187</sup> Da Afghanistan Bank Financial Inclusion Department, <http://dab.gov.af/en/page/about-the-bank/departments/mortgage> (last visited April 10, 2018).

economic growth and trade.<sup>1188</sup> The National Economic Plan aimed to unify government institutional reform by setting unified developmental priorities.<sup>1189</sup>

As a priority for the agricultural sector, the National Economic Plan prescribed the creation of an agricultural bank to improve access to credit for Afghan farmers.<sup>1190</sup> As a priority for the industrial sector, the National Economic Plan prescribed creation of mechanisms of offering long-term loans for investment in large developmental projects.<sup>1191</sup> To stimulate urban development, the National Economic Plan proposed a supply of long-term loans to facilitate homeownership.<sup>1192</sup> The National Economic Plan has not offered an analysis of the viability of any of these propositions, nor does it contain specific mechanisms for operationalizing these propositions.

#### **4.3.3. Ministry of Commerce and Industries Strategic Plan (Commerce Strategy) (2016-2020)**

The Commerce Strategy contains strategies, plans, and projects in area of commerce and industry based on the Afghanistan government's strategic priorities set forth in The National Framework. Of all the Government Strategic Policies, the views reflected in the Commerce Strategy are most closely aligned with the views of Afghan merchants. It is likely because the Ministry of Commerce and Industries, compared to other ministries, has built better partnerships with business associations. The Commerce Strategy analysis of challenges to commerce and building of industries in Afghanistan underscores these root causes: (1) limited access to bank loans with

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<sup>1188</sup> ECONOMIC POLICY OF GOVERNMENT OF AFGHANISTAN (2013), *supra* note 9.

<sup>1189</sup> *Id.*

<sup>1190</sup> *Id.* at 8.

<sup>1191</sup> *Id.* at 9.

<sup>1192</sup> *Id.* at 14.

favorable terms; (2) poor infrastructure; (3) instability; (4) weak rule of law; (5) weak property rights; and (6) limited access to financial services.<sup>1193</sup>

The Commerce Strategy identifies ineffective formal dispute resolution and weak property rights as main challenges to commerce in Afghanistan. With regard to formal resolution of commercial disputes it states, “resolving disputes at commercial courts is inefficient and time consuming. Average length of a commercial dispute is 1258 days and commercial courts have no regard for the needs [of] businesses.”<sup>1194</sup> The Commerce Strategy also identifies weak property rights as a challenge impeding productive activities in Afghanistan. Acknowledging that “roughly 80% of land ownership is held or transferred informally without formal deed”,<sup>1195</sup> the Commerce Strategy recognizes the negative effects of the absence of a comprehensive and reliable titling system on development of commerce and industries in Afghanistan.<sup>1196</sup> To remedy the problems caused by weak property rights, the Commerce Strategy advocates for a fundamental transformation of the property right system in Afghanistan.<sup>1197</sup>

The Commerce Strategy recognizes that the industrial sector is dominated by small- and medium-sized and family enterprises engaging in trade and production of low value-added products,<sup>1198</sup> and identifies the problem of high transaction costs in Afghanistan. It states, “transaction cost in Afghanistan is still high because administrative procedures are complex, the registration procedures are complicated and cumbersome, there are excessive regulations, loan

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<sup>1193</sup> MINISTRY OF COMMERCE AND INDUSTRIES STRATEGIC PLAN 2016-2020, *supra* note 9, at 13.

<sup>1194</sup> *Id.* at 12.

<sup>1195</sup> *Id.* at 13.

<sup>1196</sup> *Id.*

<sup>1197</sup> *Id.*

<sup>1198</sup> *Id.* at 14.

distribution frameworks are weak, laws and regulations are inefficient.”<sup>1199</sup> The Commerce Strategy argues that Afghanistan’s low technology level and low trade volume contribute to high transaction costs.<sup>1200</sup> According to the Commerce Strategy, most Afghan businesses do not have access to foreign markets.<sup>1201</sup>

When analyzing the problems of Afghanistan’s financial sector, the Commerce Strategy highlights high interest rates, lack of access to long-term loans, and willingness of banks tendencies to only lend to highly qualified merchants through their Kabul office, as main problems of access to startup and investment financing in Afghanistan.<sup>1202</sup> Among its findings, the Commerce Strategy underscores the lack of credit information and scarcity of formal titles as main causes of problems of access to investment financing in Afghanistan.<sup>1203</sup> The Commerce Strategy also asserts that loan enforcement by the Afghan judiciary is unreliable, which disincentivizes banks from issuing loans. On the demand side, the Commerce Strategy maintains that Afghan merchants believe the cost of borrowing is too high and they cannot satisfy the collateral of bank loans.<sup>1204</sup> Citing a recent survey conducted by the Ministry of Commerce and Industries, the Commerce Strategy recognizes religious objection to interest as a main obstacle against bank loan distribution.<sup>1205</sup>

According to the Commerce Strategy’s assessment, limited access to formal credit has requires Afghans to continue relying on informal sources of credit, like personal savings and

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<sup>1199</sup> *Id.*

<sup>1200</sup> *Id.* at 14-15

<sup>1201</sup> *Id.*

<sup>1202</sup> *Id.*

<sup>1203</sup> *Id.*

<sup>1204</sup> *Id.* at 46.

<sup>1205</sup> *Id.*

family loans, and to rely on *hawala* system for transfer of funds.<sup>1206</sup> To address these problems, the Commerce Strategy strategic plans to strengthen the private sector in Afghanistan focus on thirteen objectives, including: (1) improvement of legal framework; (2) improvement of access to loans; and (3) increased inclusion of informal economic activities in formal economy.<sup>1207</sup> As such, the Commerce Strategy proposes adoption of a credit guaranty scheme that partially guarantees private-bank-issued loans as a way of lowering the cost of borrowing and improving access to loans in Afghanistan.<sup>1208</sup> In addition, as a way of alleviating the religious objections to bank loans, the Commerce Strategy underscores the need for enactment of laws and regulations, with collaboration of Da Afghanistan Bank, to support Islamic banking industry in Afghanistan.<sup>1209</sup> Further, the Commerce Strategy advocates for conducting a viability study, and enacting laws and regulations, with the aim of creating different programs to improve access to commercial loans, especially export credit devices.<sup>1210</sup>

The Commerce Strategy also proposes creating a Credit Bureau that would collect and process credit data and produce credit reports to help banks assess credit risk. It also advocates for conducting a viability study to assess creating a security and capital market in Afghanistan to increase liquidity of Afghanistan's capital market.<sup>1211</sup>

Concerning inclusion of informal economic activities in the formal economy, the Commerce Strategy claims, "features of informal economy are limited access to credit, low quality products and jobs, weak labor rights protection, unfair competition with businesses in formal

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<sup>1206</sup> *Id.* at 15.

<sup>1207</sup> *Id.* at 25-26.

<sup>1208</sup> *Id.* at 47.

<sup>1209</sup> *Id.*

<sup>1210</sup> *Id.* at 49.

<sup>1211</sup> *Id.*

economy, tax evasion, lower contribution to job creation and government revenue.”<sup>1212</sup> The Commerce Strategy maintains that the Afghan government should incentivize informal businesses to join the formal economy by proposing a two-prong strategy: (1) reducing the barriers for inclusion by simplifying registration processes, removing excessive tax burden, and improving property rights protection; and (2) offering incentives to joining the formal economy by offering better access to loans, and support for business expansion.<sup>1213</sup>

#### **4.3.4. Afghanistan Central Bank Strategic Plan (Banking Strategy) (2017-2021)**

The Banking Strategy sets forth a number of strategic objectives which include: (1) increasing the effectiveness of monetary policy to support economic growth and economic stability; (2) creating a better legal framework to ensure the integrity of financial system and increase people’s trust in banking system; (3) expanding financial services; (4) increasing the security and effectiveness of payment systems and reducing risk in payment system and creating a centralized system for a securities market.<sup>1214</sup>

In order to achieve its second strategic objective, the Banking Strategy proposes enactment and revisions of several laws and regulation including Da Afghanistan Bank law, negotiable document law, Islamic banking regulation, and anti-money laundering laws and regulations.<sup>1215</sup> Concerning securitization of bank loans, the Banking Strategy proposes revision of banks’ immovable mortgage law; creation of a collateral registration system; creating an electronic system of credit information reports; and a public awareness campaign to promote the use of a collateral

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<sup>1212</sup> *Id.* at 55.

<sup>1213</sup> Commerce Strategy refers to a Business Formalization Strategy that has already been adopted by the Ministry of Commerce. However, I was not able to access the Stagey. *Id.*

<sup>1214</sup> DA AFGHANISTAN BANK, STRATEGIC PLAN 2017-2021, *supra* note 9.

<sup>1215</sup> *Id.* at 35.

registration system.<sup>1216</sup> The Banking Strategy also proposes the creation of an especial Islamic banking fund to promote Islamic finance in Afghanistan.<sup>1217</sup> In order to achieve its third objective, the Banking Strategy proposes a study of obstacles and challenges of expansion of financial services in Afghanistan.<sup>1218</sup>

#### **4.3.5. Ministry of Justice Strategic Plan (Justice Strategic Plan) (2014-2018)**

The Department of Huquq, which is a department of the Ministry of Justice, is the primary enforcement authority when it comes to enforcing court decisions in non-criminal cases. However improving the enforcement of court judgments is not included in the Ministry of Justice Strategic priorities. The Justice Strategic Plan not only fails to recognize the effects of ineffective and uncertain judgment enforcement on the popularity of formal dispute resolution and hence stabilization of rule of law but also neglects to prioritize improving enforcement of court judgments.

The Justice Strategic Plan focuses on seven strategic objectives: (1) law reform and increasing the effectiveness of legislation; (2) public access to justice; (3) transparency and accountability; (4) capacity building; (5) infrastructure; (6) coordination and cooperation with domestic and international organizations; and (7) security.<sup>1219</sup> The Justice Strategic Plan proposes personnel capacity building, infrastructure projects, and promotion of cooperation and coordination mechanisms as ways to achieve its strategic objectives.<sup>1220</sup> However, the Justice Strategic Plan omits the issue of court judgment enforcement and thereby fails to address this

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<sup>1216</sup> *Id.* at 38.

<sup>1217</sup> *Id.* at 46.

<sup>1218</sup> *Id.* at 51.

<sup>1219</sup> FIVE STRATEGIC PLAN: LAW AND JUSTICE 2014-2018, *supra* note 9, 11-14.

<sup>1220</sup> *Id.* at 15-20.

problem. As this dissertation shows, uncertainty of court judgements' enforcement is a main impediment against the use of formal dispute resolution by Afghan merchants and thus is an important challenge to overcome to create an economy that operates according to formal rules.

#### **4.3.6. Analysis of Afghan Government Strategic Policies**

Government Strategic Policies have a narrow view of Afghanistan's institutional landscape, which this dissertation argues is reflective of the influence of State-Centered Theory. These strategies propose solutions which disregard the value of working informal institutions. While these strategies most often correctly diagnose the problems of credit transacting in Afghanistan, their solutions do not get traction in Afghanistan. The Government Strategic Policies' proposed solutions, if effectively implemented may solve the problem of credit transacting in Afghanistan, however they are attempting to replace working institutions rather than using them as building blocks to create better institutions. Therefore, their implementation requires much more regulatory and administrative capacity than the Afghan government currently holds. By ignoring the wealth of existing institutional knowledge and networks, Government Strategic Policies overstretch the limited regulatory and administrative power of the Afghan government in trying to overcome the resistance from the current users of working institutions to impose these new institutions.

The current governance expectations reflected in Afghanistan's Government Strategic Policies, as Thomas in his aptly named book, *Govern Like Us*, argues, is based on what governments in developed countries are capable of doing.<sup>1221</sup> He argues, it is impossible to require Afghanistan to build effective and universal-access institutions across the arrays of domains, as formulated in various plans and strategy documents.<sup>1222</sup> This dissertation concurs with Thomas

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<sup>1221</sup> M. A. THOMAS, GOVERN LIKE US: U.S. EXPECTATIONS OF POOR COUNTRIES 21 (2015).

<sup>1222</sup> *Id.* at 202.

that while most of Government Strategic Policies' proposed formal institutions are good institutional outcomes—given limited capacity of informal institutions to provide long-term financing—they are more likely to be created and penetrate Afghanistan's financial system if they are built incrementally using existing formal institutions as building blocks—based on Grounded Institutional Reform.

Afghanistan's Government Strategic Policies underscore the need for property rights reform and a titling system to unleash the value currently trapped in the housing market in Afghanistan cities. However, they do not mention *Gerawee* which is currently helping Afghans raise some capital against the value of their houses in absence of secure tenure and land certification. Instead of building on and correcting the working institutions, once again the Government Strategic Policies advocate for creation of new formal institutions.

In addition, the Government Strategic Policies underscore the need to improve access to credit information for banks to assess borrowers. However, they completely disregard the wealth of credit information that *Sarrafs* possess. *Sarrafs* conduct 90% of financial transactions in Afghanistan<sup>1223</sup> and have ongoing financial interactions with Afghan merchants. Providing banks access to this wealth of information can greatly improve banks' ability to assess risks and will reduce their reliance on scarce formal deeds. For example, the Government Strategic Policies could propose use of *Sarrafs* as guarantors for banks loans which would encourage banks to outsource creditworthiness assessment and monitoring to *Sarrafs*. Government Strategic Policies, on the other hand, propose creation of new formal institutions like a Credit Bureau.

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<sup>1223</sup> See CURBING ILLICIT FINANCIAL FLOWS IN AFGHANISTAN: MONEY LAUNDERING, TERRORIST FINANCING, AND HAWALA, *supra* note 310, at 28; see also AFGHANISTAN—STATE BUILDING, SUSTAINING, GROWTH, AND REDUCING, *supra* note 781, at 6.

Concerning the promotion of exports, the Government Strategic Policies acknowledge the importance of encouraging exports by providing better access to commercial and export financing. However, they disregard the potential of short-term working capital loans which are already financing import and supply chains. Instead, they propose creation of a new formal institution, namely an export bank. With regard to the capital market, they stress the need to improve liquidity in Afghanistan's capital market. However, they do not mention *Sar qufli* as a way of commodifying future revenue tied to a place of business. Instead, they focus on the creation of new formal institutions like securities markets.

State-Centered Theory-based Government Strategic Policies do not recognize the existing informal institutions in Afghanistan institutional landscape as possible building block of solutions to the problem of access to credit for Afghan merchants.

The only Government Strategic Policies that mentions the informal economy and informal institutions is the Commerce Strategy. This is most likely due to collaboration between Ministry of Commerce and Industries and business associations in Afghanistan. However, the Commerce Strategy only refers to informal economy and informal institutions in the context of incentivizing inclusion of informal businesses in the formal economy. While the Ministry of Commerce correctly underscores the need to design incentive-based mechanisms of promoting inclusion in the formal economy, it only discusses the need to reduce the barriers to and increase the benefit of inclusion in formal economy. The Commerce Strategy does not mention the need to build on and correct informal institutions to increase the reach and acceptance of the formal economy and formal institutions. The Commerce Strategy does not mention the need to draw on the existing institutions. Thus, while the Commerce Strategy highlights an important and often missing component of institutional reform in Afghanistan, it does not go far enough to advocate for the use

of informal institutions as building block for devising institutional solutions to the problem of credit transacting in Afghanistan, as Grounded Institutional Reform does.

The prevailing institutional reform approach in Afghanistan is discussed in more details in Chapter Five, where this dissertation proposes an alternative approach to institutional reform for countries like Afghanistan that have poor infrastructure, limited market expansion opportunities, and a reformist but weak government.

Formal institutions in Afghanistan have generally failed to provide credit to Afghan merchants in a way that works for the Afghan context, therefore, Afghan merchants generally do not use bank loans. This is why banks in Afghanistan hold 3 billion US\$ in excessive reserve, which they are unable to distribute in loans.<sup>1224</sup> The Afghan government's approach to institutional reform appears to strongly reflect the influence of State-Centered Theory and is responsible for the inability of the Afghan government to improve access to credit for Afghan merchants. Drawing upon a critical review of informal institutions and their effects on access to credit in the Afghan context (presented in Chapter Three), this dissertation, in the next Chapter, proposes a new approach to institutional reform which empowers the Afghan government to use the working informal institutions to create formal institutions that work for the Afghan context.

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<sup>1224</sup> See discussion of bank loans earlier in this Chapter.

Chapter Five: A CRITIQUE OF THE CURRENT APPROACH TO INSTITUTIONAL REFORM IN  
AFGHANISTAN, AND A PROPOSAL FOR A NEW APPROACH: *GROUNDED INSTITUTIONAL REFORM*

Formal institutions in Afghanistan have not been able to improve access to credit for Afghan merchants because they have generally failed to overcome the fundamental problems with and barriers to credit transactions in Afghanistan (highly volatile business climate, uncertain contract enforcement, and inefficient property rights system).<sup>1225</sup> In spite of deficient formal institutions, in Afghanistan, a number of informal institutions have emerged that alleviate some of the credit constraints on Afghan merchants. These informal institutions include as risk-sharing trade credit operations, short-term working capital loans, *Gerawee*, and *Sar qufli*.<sup>1226</sup> Informal institutions such as these have been able to significantly improve access to working capital financing, while marginally improving access to investment financing and liquidity in capital markets. The success of these informal institutions is due, primarily, to their ability to adopt to the context of Afghanistan, overcoming the fundamental problems of credit transacting in Afghanistan. However, the existing informal institutions have not been able to significantly improve access to investment financing due to their limited capacity to pool savings for investment purposes, and their extra-legal practices may have negative consequences on long-term economic growth and attraction of foreign investment. To improve access to investment financing, the Afghan government needs to undertake a series of institutional reforms to create formal institutions that work for the Afghan context using the working informal institutions as building blocks.

The existing theories of institutional development are not helpful in the case of Afghanistan. Accordingly, the models of institutional reforms developed based on the existing

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<sup>1225</sup> See *supra* Chapters Two and Four.

<sup>1226</sup> See *supra* Chapter Three.

theories do not respond to the financial reality of the Afghan context. As explained in Chapter One, the literature provides two distinct theories of institutional development, and correspondingly, two different models for institutional reform.<sup>1227</sup> One theory focuses on the role of state as suppliers of formal institutions and creator of preconditions for economic growth. As such, this theory's model for institutional reform posits that less-developed countries can achieve economic growth by creating good formal institutions based on institutional "best practices" (e.g., strong property rights, good contract enforcement institutions). The other theory focuses on private entrepreneurs as suppliers of informal institutions and drivers of economic growth. This theory's model for institutional reform posits that the informal institutions developed by the economic entrepreneurs to support and expand their economic ventures stimulate economic growth, and supply of formal institutions. However, neither theory is helpful in the case of Afghanistan where the government has failed to supply workable formal institutions and development of entrepreneur-supplied informal institutions are bounded by poor infrastructure and limited market expansion opportunities. As such, these models of institutional reforms do not work in the Afghan context. This dissertation proposes a synthetic approach to institutional reform in countries like Afghanistan, countries that have poor infrastructure, limited market expansion opportunities, and a reformist but weak government: this approach is Grounded Institutional Reform.

Designed to improve access to finance in countries like Afghanistan, Grounded Institutional Reform posits that the best way to create workable formal institutions is to leverage the working informal institutions. In this chapter, the Grounded Institutional Reform approach is applied to features found in Afghanistan to illustrate how it works in context. This dissertation argues that to ensure Afghanistan's economy can move towards reliance on formal institutions,

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<sup>1227</sup> See *supra* Chapter One.

and thereby remedy the shortcomings of the informal institutions, the Afghan government needs to use working, informal institutions as building blocks for creating formal institutions that work for Afghan context—i.e. Grounded Institutional Reform. By leveraging working informal institutions, the Afghan government can utilize the wealth of existing institutional knowledge and networks and incentivize inclusion in the formal institutions.

The Afghan government's institutional reforms, so far, have generally been unsuccessful. This dissertation argues that institutional reforms in Afghanistan have failed because they have only focused on formal institutions. Reformers have not been willing to use working informal institutions as building blocks to create formal institutions that work in the Afghan context. Institutional reforms in Afghanistan have failed to create formal institutions that gain traction either because the formal institutions fail to solve the problems of credit transacting, and/or the Afghan government does not have sufficient capacity to overcome the resistance from the existing financial intermediaries of working informal institutions (but not the users of the informal institutions who are responsive to the workability of institutions). Therefore, creation and expansion of formal institutions, which has often meant outlawing informal institutions, has resulted in increased decoupling. Nevertheless, outlawing the informal institutions has not resulted in increased prevalence of formal institutions; instead, it has ensured the continued operation of informal institutions illegally—decoupling the formal rules and rules-in-use.

Grounded Institutional Reform creates conditions under which invested users of informal institutions (i.e. financial intermediaries) can increase some of their gains, while accepting some losses (mostly during the initial period of transition), by voluntary inclusion in the newly created formal institutions. Thus, by rendering inclusion self-interest-compatible, Grounded Institutional Reform incentivizes voluntary compliance and reduces the need for overstretched and limited

coercive power and administrative capacity of the state. For example, as explained in Chapter Four, Grounded Institutional Reform-based regulation of *Sarrafs* would offer formal recognition of deposit-keeping and loan distribution to incentivize *Sarrafs* to comply with the reporting and transparency regulations.

Grounded Institutional Reform represents two fundamental differences from the current Afghan government strategy aimed to include informal businesses into formal economy (which is mostly found in the Commerce Strategy).<sup>1228</sup> First, the current inclusion strategy uses two basic tools to incentivize inclusion in the formal economy: (1) *ad hoc* incentive packages (e.g. tax breaks or pardon of fines for unpaid taxes) which increase the benefit of inclusion; and (2) reduction of barriers to entry into the formal economy by simplifying registration and compliance requirements, which decrease the cost of inclusion.<sup>1229</sup> While these are both important components of an inclusion strategy, they fall short. Grounded Institutional Reform posits that in order to incentivize the users of informal institutions to use formal institutions, formal institutions must incorporate the working informal institutions. Stated differently, in order to formalize Afghanistan's economy, formal institutions must absorb the working informal institutions.

Second, the current inclusion strategy only focuses on the users of informal institutions, i.e. users of financial services. Grounded Institutional Reform, however, posits that given the limited coercive power of the Afghan state and the significant influence of informal financial intermediaries, in order to successfully formalize Afghanistan's financial sector (and Afghanistan's economy in general), the resistance from existing financial intermediaries of informal institutions must be curtailed. Grounded Institutional Reform overcomes this resistance

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<sup>1228</sup> See Section 4.3. and MINISTRY OF COMMERCE AND INDUSTRIES STRATEGIC PLAN 2016-2020, *supra* note 9, at 55.

<sup>1229</sup> *Id.*

by ensuring the existing financial intermediaries continue to have a role (although an altered role) in the formal institution, and therefore, have an incentive to comply with the formal rules and cooperate with the reform process.

The tenets of Grounded Institutional Reform stem from three main observations borne out of field research in Afghanistan. The relationships between these tenets and this research is described in the following three points:

(1) A main impediment against acceptance of formal institutions is that they have failed to overcome the problems of credit transacting in Afghanistan. Existing informal institutions, on the other hand, have been able to overcome the problems of credit transacting (albeit mostly for working capital financing); therefore, they can serve as good models for workable institutions in the context of Afghanistan. Grounded Institutional Reform posits that by using existing informal institutions as building blocks for formal institutions, the Afghan government can tailor the formal institutions for Afghan context.

(2) Informal institutions are used to conducting the overwhelming majority of business dealings in Afghanistan (90% of financial transactions are conducted through *Sarrafs*<sup>1230</sup>). A move towards formal institutions requires incredible amount of institutional learning. The use of working informal institutions as building blocks for workable formal institutions will capitalize on existing institutional knowledge, and therefore, reduce the cost of transitioning to the use of these formal institutions.

(3) Existing informal institutions have created a powerful group of financial intermediaries who are heavily invested in the continued existence of these institutions. Any attempt to replace the existing informal institutions will have to overcome the resistance from this powerful group of

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<sup>1230</sup> See *supra* Chapter Three.

financial intermediaries (as the failed attempt to regulate *Sarrafi* market recently illustrated). Grounded Institutional Reform will reduce this resistance by ensuring a role (albeit an altered role) for existing financial intermediaries in the formal institutions. Thus, it incentivizes compliance and reduces decoupling by creating conditions under which inclusion in the formal institutions is self-interest-compatible for existing financial intermediaries.<sup>1231</sup>

Grounded Institutional Reform finds support in Dani Rodrik's writing. Drawing on the experiences of successful reforms in China, South Korea, and Taiwan, Rodrik argues against adoption of institutional "best practices". Instead, he argues that reformists are best served by operationalizing sound economic principles (such as appropriate incentives, property rights, sound money, and fiscal solvency) through policy experimentation.<sup>1232</sup> He argues that these sound economic principles come "institution-free," and should be implemented through policies that are designed best on the existing institutional landscape.<sup>1233</sup> In line with the premise of Grounded Institutional Reform, Rodrik argues, "[t]he pre-existing institutional landscape will typically *offer both constraints and opportunities*, requiring creative shortcuts or bold experiments. From this perspective, the 'art' of reform consists of *selecting appropriately from a potentially infinite menu of institutional designs.*" (emphasis added)<sup>1234</sup>

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<sup>1231</sup> Lau, Qian and Roland argue that China was able to liberalize agricultural sector because it managed to implement reform without creating losers. China employed a two-track system that allowed for the liberalization *on the margin* while keeping the plan system intact. The two-track system was critical, they argue, to achieving political support for the reform, maintaining its momentum, and minimizing its adverse social implications. Dani Rodrik, discussing Lau, Qian and Roland's research, observed that the two-track system was successfully because it "*preserved the income streams of initial claimants.*" (emphasis added) Lau et al., *supra* note 245, at 136 and RODRIK (2004), *supra* note 230, at 980.

<sup>1232</sup> RODRIK (2004), *supra* note 230, at 985.

<sup>1233</sup> *Id.*

<sup>1234</sup> *Id.*

Grounded Institutional Reform finds support in the legal reform literature as well. Dixit, summarizing the lessons for developing countries, argues that “it is not always necessary to create replicas of western style state legal institutions from scratch; *it may be possible to work with such alternative institutions as are available, and build on them.*”<sup>1235</sup> (emphasis added) Similarly, Berkowitz, Pistor and Richard found that countries that developed their legal systems internally, adapted the imported legal codes to the local conditions, or had knowledge of foreign legal codes achieved superior legal institutions compared to the countries that simply transplanted foreign legal orders.<sup>1236</sup>

Grounded Institutional Reform has close affinity with the approach proposed by Andrews, Pritchett, and Woolcock in their recent book, *Building State Capability: Evidence, Analysis, Action*.<sup>1237</sup> Drawing on their research and experience in education, health, public financial management, and governance, in line with the arguments presented here, they criticize the orthodoxy in the international development organizations like World Bank<sup>1238</sup> for failing to consider the implementation capacity of the states, “pushing states to do too much too fast”, and distorting the process of problem-driven institutional development in the developing countries by advocating for adoption of international “best practices”, effectively pursuing a policy of “institutional isomorphism”.<sup>1239</sup> In close affinity with the basic insight of Grounded Institutional Reform, they underscore the destructive hegemony of institutional transplantation over existing

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<sup>1235</sup> DIXIT, *supra* note 230, at 4.

<sup>1236</sup> See Jean-Francois Richard et al., *supra* note 230, at 197. See also Pistor who argues that legal transplantation can backfire, Katharina Pistor, *supra* note 230.

<sup>1237</sup> MATT ANDREWS ET AL., *supra* note 57.

<sup>1238</sup> It is worth nothing that all three authors have worked with different international organization like World Bank extensively.

<sup>1239</sup> MATT ANDREWS ET AL., *supra* note 57.

working institutions stating, “when certain forms are perceived as ‘best practices,’ their unwitting transplantation prevent *new forms from emerging, and displaces existing models*—or, as is often the case, is justified by simply *pretending they are not there at all*, succumbing to the ‘*illusion of the blank slate*’” [emphasis added].<sup>1240</sup>

Andrews, Pritchett and Woolcock argue that the institutional ecology created by the international organizations and local agencies alike, they argue, enables inefficient and effective institutions to persist through “isomorphic mimicry” causing developing countries to get stuck.<sup>1241</sup> Isomorphic mimicry allows an inefficient and effective institution to continue to receive resources and resist reform by looking like a legitimate institution conflating “looks like” with “does” and “form” with “function”.<sup>1242</sup> Drawing on their research and experience, they propose a new approach for institutional development, *Problem-Driven Iterative Adaptation*. It begins “with generating locally nominated and prioritized problems, and ... works iteratively to identify customized ‘*best fit*’ responses (sometimes by exploiting the existing variation in implementation outcomes).”<sup>1243</sup> (emphasis added)

Much like the arguments presented here, Problem-Driven Iterative Adaptation posits that institutional design must take account of implementational capacity of the state or it will result in decoupling. Divergence of the notional practice (*de jure*) and actual practice (*de facto*) does not only render the particular policy ineffective, but it also has lasting effects as it can result in a loss

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<sup>1240</sup> *Id.* at 46. Willful ignorance of potentials of *Sarrafs, Sar qufli, and Gerawee* to relax the credit constraints of Afghan merchants is a great example of justifying institutional displacement using “illusion of the blank slate”.

<sup>1241</sup> *Id.*

<sup>1242</sup> An example of isomorphic mimicry from Afghanistan would be ineffective lending model enduring because it looks like the lending model that has been successful in other countries.

<sup>1243</sup> MATT ANDREWS ET AL., *supra* note 57, at 5.

of what they call “normative traction”<sup>1244</sup> The continued enactment of “best practices” in low capability environments, they argue, can sever the connection between notional policy and the ground, exponentially reducing the ability of notional policy to enact change on the ground—loss of “normative traction”.<sup>1245</sup>

While Grounded Institutional Reform has close kinship with Problem-Driven Iterative Adaptation, it differs from it in several key aspects: first, the latter is generally proposed as a better approach to reforming government institutions such as education systems, while Grounded Institutional Reform is mostly concerned with economic institutions. Furthermore, Problem-Driven Iterative Adaptation focuses on creating an institutional environment where different institutions are judged by their ability to produce desirable outcomes by improving on their targeted problem areas rather than matching an acceptable institutional form. Grounded Institutional Reform, on the other hand, while recognizing institutional isomorphism and “isomorphic mimicry” as part of its diagnosis of the current approach, proposes an alternative approach to institutional reform which uses the existing informal institutions as building blocks for creating workable formal institutions. In other words, Problem-Driven Iterative Adaptation is an approach on how we should (or rather, should not) evaluate the effectiveness and fitness of different institutions. Grounded Institutional Reform builds on this evaluative approach by going one step further and positing how we should design formal economic institutions that can effectively ameliorate their targeted problems.

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<sup>1244</sup> *Id.* at 58.

<sup>1245</sup> *Id.* at 59. An example of loss of normative traction in Afghanistan would be the Da Afghanistan Bank’s attempt to outlaw deposit-keeping and loan distribution by *Sarrafs*. This policy if reinstated, would surely fail to stop *Sarrafs* from keeping deposits and issuing loans, ensuring that those practices continue despite being against the formal rules. Such outcome would undermine the Da Afghanistan Bank’s ability to regulate *Sarrafi* markets in the future as it severs any real connection between formal policies and laws, and the operation of *Sarrafs*. In effect, by doing too much too soon Da Afghanistan Bank would ensure it could not do much in the future.

This chapter develops the argument for Grounded Institutional Reform then applies it to the context of Afghanistan. This chapter describes the existing models of institutional development showing how they fail to explain the case of countries like Afghanistan. Next, it examines the rationale for the Afghan government's aversion to informal institutions, reflecting both the practical problems of formalizing (even revised) informal institutions and the problematic formulation of institutional reform based on existing institutional development model. The Chapter concludes by describing a number of ways the Afghan government can build on existing informal institutions to incentivize compliance and improve the workability of formal institutions in Afghan context, i.e. apply Grounded Institutional Reform. While here Grounded Institutional Approach is only applied to credit and dispute resolution institutions in the context of commerce in Afghanistan, this approach has broad application not only in other domains within Afghanistan, such as access to justice and state building, but also in other countries where the triangle of poor infrastructures, limited market development opportunities, and a willing but weak government is present.

### ***5.1. Grounded Institutional Reform: A Revised Approach for the Countries with Poor Infrastructure, Limited Market Expansion Opportunities, and a Willing Government***

Neither Entrepreneurial Institutional Theory nor State-Centered Theory can fully explain the institutional development in the case of Afghanistan. Research conducted for this dissertation has identified entrepreneur-driven institutional development in the context of Afghanistan. Like Chinese entrepreneurs, Afghan merchants have also developed informal credit institutions to ameliorate the constraining effects of deficient formal institutions.<sup>1246</sup> However, at the same time,

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<sup>1246</sup> See *supra* Chapter Three.

the empirical research conducted for this dissertation highlights the shortcomings of entrepreneurial institutional development in countries with poor infrastructure and limited market expansion opportunities. Afghan merchants have not been able to expand their economic activities because of poor infrastructure that fragments the domestic markets and limits production and export.<sup>1247</sup> As a result, they have not developed working informal institutions that can sustain and facilitate an expanding and diversifying business climate. Neither have they generated sufficient demand for formalization of existing informal institutions except in limited cases (e.g. *Sar qufli*).

This dissertation proposes a new approach to designing economic reform. Grounded Institutional Reform responds to the problems of developing workable formal institutions in Afghanistan in ways that Entrepreneurial Institutional Theory and State-Centered Theory cannot. The limitation of State-Centered Theory is that when applied to a context like Afghanistan, the formal institutions imported from outside based on “best practices” fail to take hold because they are not suited to solve the specific problems of transacting that local merchants face and instead aim to coercively replace the entrenched working informal institutions. Also, Entrepreneurial Institutional Theory does not fully suit the case of Afghanistan because entrepreneurs in Afghan-like contexts cannot expand their businesses due to poor infrastructure and limited market access. In the absence of innovation incentives generated by the possibility of market expansion, entrepreneurs have few incentives to continually improve the efficiency of informal institutions. Stated differently, Entrepreneurial Institutional Theory breaks down when applied in the context of countries like Afghanistan because private entrepreneurs are trapped in a vicious cycle and cannot, without external support, supply and sustain institutions necessary to stimulate economic growth.

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<sup>1247</sup> See *supra* Chapter Two.

Finally, the state, in the context of countries like Afghanistan, differs from the state envisioned by State-Centered Theory or Entrepreneurial Institutional Theory. It differs from the state envisioned by State-Centered Theory because it does not possess sufficient coercive power and administrative capacity to overcome resistance from the invested users of informal institutions. It differs from the state envisioned by Entrepreneurial Institutional Theory because it is willing to attempt to create strong formal institutions, either under pressure from the international community on which it depends for resources or under domestic pressures generated by a desire to achieve performance legitimacy. Thus, unlike Entrepreneurial Institutional Theory-envisioned states, the Afghan state is willing, but unlike State-Centered Theory-envisioned states, it has limited capacity to impose better formal institutions.

Grounded Institutional Reform corrects the problematic assumptions of Entrepreneurial Institutional Theory and State-Centered Theory about the role of states in institutional development in the context of less-developed countries. In a break with Entrepreneurial Institutional Theory, Grounded Institutional Reform overcomes the low entrepreneurial capacities of less-developed economies by allowing the state to play a proactive supporting role by incorporating working informal institutions. Grounded Institutional Reform incorporates the need for a proactive role for the state in less-developed countries with limited entrepreneurial capacities, advocated for by State-Centered Theory, but ensures context-sensitivity and user-readiness by absorbing working informal institutions within formal institutions. Grounded Institutional Reform overcomes the limited coercive power and administrative capacity of the states in less-developed countries by leveraging the existing informal institutions by incorporating the existing institutional knowledge, networks, and beneficiaries.

## **5.2. Rationales for Anti-Informal Institutions Positions: The Problems of Formalizing Informal Institutions in Afghanistan**

Institutional reforms in Afghanistan have generally been informed by State-Centered Theory.<sup>1248</sup> However, there are several specific theoretical and practical reasons why Afghan governments have shown an aversion to the absorption of informal institutions. While these reasons are borne out by research on Afghanistan's case, this dissertation argues, they also represent a general trend in less-developed countries which have poor infrastructure, limited market expansion opportunities, and a reformist but weak state.

There are several reasons why the Afghan government may not choose to absorb working informal institutions. These reasons are both theoretical and practical. The first practical reason is that informal institutions in Afghanistan are entangled with illegal economic activities. Secondly, informal institutions are hard to manipulate because they do not function according to transparent rules. Additionally, the users of informal institutions resist formalization to (a) safeguard themselves against predatory behavior of regulators; (b) evade taxes; and (c) ensure the continued use of informal institutions to support illegal economic activities. This dissertation argues that given the limited coercive power and administrative capacity of the Afghan state, absorption of informal institutions is the most effective way to remedy the practical problems of informal institutions in Afghanistan and can help fully eliminate these problems in the long-run.

In addition to these practical reasons, there are two main theoretical reasons, which are squarely rooted in State-Centered Theory, that further explain why the Afghan government may not choose to use working informal institutions to create formal institutions that work for the Afghan context. The first theoretical reason is concerned with the formal institutions and why they

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<sup>1248</sup> See Chapter Four.

have not worked in Afghanistan. There is a belief that formal institutions have failed to gain traction in Afghanistan because of the stickiness of informal institutions, and the absence of effective formal institutions. The former is generally evidenced by the pervasive use of informal institutions. Concerning the latter, in accordance with State-Centered Theory, good institutions are understood to use best institutional practices. Therefore, formal institutions that have worked well in other countries have been adopted as good formal institutions.

As to the second theoretical reason that the Afghan government may not choose to use working informal institutions, there is a belief that informal institutions have no place in a modern economy. Informal institutions are deemed to represent backwardness: to modernize the country and the economy informal institutions must be uprooted.<sup>1249</sup> This dissertation argues that these theoretical justifications are not valid: formal institutions have failed to gain traction because they cannot overcome the problems of credit transacting in Afghanistan; and informal institutions contain a wealth of useful institutional knowledge and networks that can contribute to the creation of workable formal institutions in Afghanistan and ensure a smooth transition to a more formalized economy.

### **5.2.1. Theoretical Underpinning of Anti-Informal Institutions in Afghanistan**

The Afghan government's theoretical approach to institutional reform generally reflects a preference for State-Centered Theory.<sup>1250</sup> Its approach to institutional reform is rooted in the idea that that stickiness of informal institutions is the reason formal institutions do not stick. From this point of view, curbing informal institutions and adopting better formal institutions based on

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<sup>1249</sup> See *supra* Chapter Four, the discourse around regulation of *Sarrafi* markets.

<sup>1250</sup> See *supra* Chapter Four.

institutional best practices will ensure that informal institutions gain traction in Afghanistan. The government approach is also rooted in the idea that informal institutions are backward and must be uprooted. Replacing formal institutions, and/or outlawing formal institutions, will ensure Afghanistan transitions from a backward economy into a modern economy. These two theoretical propositions can be surmised from the content of the Afghan Government's Strategic Policies for institutional reforms (Government's Strategic Policies) and the discourse around the *Sarrafi* regulation.<sup>1251</sup> They are also firmly rooted in State-Centered Theory.

The problem with these theoretical propositions is that they break down when applied to the Afghan context. They are imported insights from State-Centered Theory, and they are either generally held positions within the field of institutional reforms, informed by neo-liberal economic theories and writings of State-Centered Theory institutionalists, or they are normative propositions about what a developed economy (and country) should look like. Insofar as these theoretical propositions have empirical support, that support has been generated in entirely different contexts that do not share sufficient features or characteristics with Afghanistan. In short, these theoretical propositions either do not fit the Afghanistan's context, or when they do, they overreach.

Concerning the first theoretical proposition, i.e. stickiness of informal institutions, this dissertation shows that stickiness of informal institutions is not likely an explanation for the continued use of informal institutions. Afghan merchants do not use bank loans not because they are used to old way of doing business and are more comfortable with existing informal institutions but because the current model of bank loans does not work for the context of Afghanistan. Relatedly, this dissertation research shows that the theoretical proposition that adoption of institutional best practices (e.g. Credit Bureau) will ensure the success of formal institutions is not

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<sup>1251</sup> *Id.*

well-founded. Afghan governments should instead adopt institutions that overcome the problems of credit transacting with full consideration of the Afghan context. Therefore, due consideration should be given to the problems of credit transacting in Afghanistan, and the solutions that have emerged to overcome those problems, instead of seeking to adopt institutional solutions whose workability has not been tested in the context of Afghanistan.

Concerning the second theoretical proposition, backwardness of informal institutions, this normative statement is also not supported by the findings of this dissertation in Afghanistan. While the prevailing informal institutions having limited capacity to finance long-term investment and attract foreign investors, they have significantly improved access to working capital financing in Afghanistan, reducing the capital constraints on Afghan merchants and ensured competitiveness of Afghan markets and thus lower prices.<sup>1252</sup> Assuming *a priori* that informal institutions are inefficient closes the door on leveraging the institutional knowledge and networks that have emerged to solve the problems of credit transacting in a way that works for the context of Afghanistan. It closes the door on learning about the institutional solutions that have emerged and developed incrementally in a bottom-up way to inform the design of formal institutions that will be effective for the Afghan context.

While anti-informal-institutions critics often justify their positions by citing North's theory, this author believes that Grounded Institutional Reform finds equal or greater support in the North's writings. North contends that an economy which functions according to formal rules is more efficient than an economy that is governed by informal institutions.<sup>1253</sup> However, North also argues that formal institutions only enhance efficiency if they are appropriate for the context

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<sup>1252</sup> See *supra* Chapter Three.

<sup>1253</sup> See *supra* Chapter One.

in which they are used (hence, North's aversion to institutional engineering).<sup>1254</sup> This dissertation takes the position that appropriateness of formal institutions for the context of their use can be greatly improved if effective informal institutions are used as building blocks for formal institutions that work for that context, i.e. Grounded Institutional Reform. If formalization is conducted by building on and correcting the existing working informal institutions, the formal institutions will work for the context and formalization will be met with less resistance.

Ironically, stickiness of theoretical propositions which are not supported by empirical in-context studies are the reason why institutional reforms most often disregard the value of existing institutions that have developed in-context. The attempt to achieve institutional isomorphism based on unifying theory of institutional reforms, coupled with limited in-context studies, has biased reformists against using the effective elements of working informal institutions.

## **5.2.2. Practical Problems of Absorbing Informal Institutions in Afghanistan**

In addition to theoretical impediments to adopting Grounded Institutional Reform in Afghanistan, which are mostly problematic, this section explores the practical problems impeding the absorption of informal institutions in Afghanistan.

### **5.2.2.1 Informal Institutions Are Entangled with Illegal Economic Activities**

According to Afghanistan's Ministry of Finance, 65% of all financial flows in the country are illicitly earned, transferred, or used.<sup>1255</sup> *Sarrafs* are the financial service providers of choice of Afghans especially those who are involved in the illegal economy. *Sarrafs* handle 90% of financial

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<sup>1254</sup> *Id.*

<sup>1255</sup> CURBING ILLICIT FINANCIAL FLOWS IN AFGHANISTAN: MONEY LAUNDERING, TERRORIST FINANCING, AND HAWALA, *supra* note 310, at 34.

transactions in Afghanistan.<sup>1256</sup> Therefore, *Sarrafs* are closely entangled with illegal economic activities. According to Thompson's estimate for the years 2004-2005, almost 30% of *hawala* volume (approx. 2 billion US\$) came from opium trade alone.<sup>1257</sup> The production of opium has been consistently increasing since 2005, therefore, it is safe to assume that contribution of opium to *hawala* has correspondingly increased.<sup>1258</sup>

The prevalence of the opium industry, insurgency, and corruption together creates a large illegal economy in Afghanistan. The main components of that economy include poppy cultivation, opium trade and production, and corruption. According to conservative estimates, the value of Afghanistan's illegal economy, measured by corruption and opium alone, amounts to roughly one-third of the country's GDP.<sup>1259</sup>

United Nations Office on Drugs and Crime's estimated data for the period between 2008-2015 suggest that the production and trade value of opium received by Afghan farmers and traffickers was roughly the same as contribution of legal agriculture to the GDP.<sup>1260</sup> According to Integrity Watch Afghanistan biannual reports, in 2016, almost 3.5 million Afghans reported that they had paid 2.89 billion US\$ in bribes over the last year.<sup>1261</sup>

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<sup>1256</sup> See *id.*; see also AFGHANISTAN—STATE BUILDING, SUSTAINING, GROWTH, AND REDUCING, *supra* note 781, at 6.

<sup>1257</sup> THOMPSON, 806, at 248.

<sup>1258</sup> Annual poppy cultivation measured in hectare has increased from 8,000 hectares in 2001 to 74,000 hectares in 2002, and 183,000 hectares in 2015. Annual opium production in the same period has also risen. In 2001, Afghanistan only produced an estimated of 185 tons of opium. This number increased to 3,400 tons in 2002, and 3,300 tons in 2015, See AFGHANISTAN OPIUM SURVEY 2015: CULTIVATION AND PRODUCTION, *supra* note 308, at 12 & 33.

<sup>1259</sup> Calculated by the author based on CULTIVATION AND PRODUCTION, *supra* note 308, NATIONAL CORRUPTION SURVEY 2016, *supra* note 308, and CURRENT GDP BY SECTOR FOR THE YEARS 2002/03 UNTIL 2016/17, *supra* note 272.

<sup>1260</sup> *Id.*

<sup>1261</sup> See NATIONAL CORRUPTION SURVEY 2016, *supra* note 308.

The estimated total value of the illegal economy, taking into account only opium production and sales and bribes, can be calculated for 2010, 2012, and 2014. In 2012, the estimated value of bribes paid and money from the opium industry received by Afghans was 4.71 billion US\$ which is equal to 30% of the legal economy GDP (15.74 billion US\$ calculated at the current price).<sup>1262</sup> In 2014, the estimated total value of the illegal economy was 5.56 billion US\$ which is 27% of the legal economy measured by GDP at current price (20.25 billion US\$).<sup>1263</sup> In 2014, the total estimated value of Afghanistan's illegal economy was 7.06 billion US\$ which compared to 34% of the GDP calculated at current price for that year (20.48 billion US\$).<sup>1264</sup>

Interviews conducted for this dissertation show that the illegal economy interacts in several complicated ways with the Afghanistan's financial system.<sup>1265</sup> Money from opium exports are used to finance imports. According to several interviewees, some merchants, who are also engaged in the opium trade, import products (most often cars) in exchange for opium exports. Thus, they are able to sell the products (e.g. cars) for a lower price than legal importers in the Afghanistan market, make a good profit, and launder opium money at the same time. This puts the businesses which are not involved in the export of opium at a serious disadvantage.

*Sarrafs* are the main financial service providers that facilitate the financing of legal imports by opium export, and also transfer and launder bribes and revenue from opium trade. Therefore, a significant portion of funds that *Sarrafs* hold for their clients come from the illegal economy.

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<sup>1262</sup> Calculated by the author based on CULTIVATION AND PRODUCTION, *supra* note 308, NATIONAL CORRUPTION SURVEY 2016, *supra* note 308, and CURRENT GDP BY SECTOR FOR THE YEARS 2002/03 UNTIL 2016/17, *supra* note 272.

<sup>1263</sup> *Id.*

<sup>1264</sup> *Id.*

<sup>1265</sup> The description of interactions between Afghanistan's financial market and illegal economy is based on author's interviews with Afghan merchants in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

*Sarrafs* use these funds, along with the funds generated from legal business activities, to finance short-term working capital loans, medium-term loans, and equity investment. *Sarrafs* extensively use banks to hold and transfer funds, a significant portion of which comes from illegal economy, hence, illicit funds are not contained in the *Sarrafi* markets.

In short, given the pervasiveness of Afghanistan's illegal economy, illicit funds routinely mesh into legal economic activities, (e.g. finance import of legal products, supply of working capital loans to legal businesses, and legal business ventures), mix with the legal funds and travel through both the *Sarrafi* and formal banking system. As a result, finding and fighting illegal funds in Afghanistan is incredibly difficult.

The Afghan Government, under pressure from the international community, has enacted numerous pieces of legislation and created a number of oversight bodies to curb the illegal funds in Afghanistan's financial system. The Regulation of the *Sarrafi*, discussed in Chapter Four, was one of these efforts. Under the Regulation, a number of reporting and vetting processes were instituted to improve the transparency and accountability in the operation of *Sarrafi* markets. However, the Regulation was met with fierce resistance from *Sarrafi* Unions and was finally suspended.<sup>1266</sup> At the time of writing, the fate of the Regulation is unclear.

Fighting the illicit funds is of utmost importance not only because it jeopardizes the inclusion of Afghanistan's financial system in the global financial system, but also because the illegal economy finances and sustains the continued insurgency and weak governance in Afghanistan. However, the Regulation did not represent the right approach to achieve the desired result of curbing illegal funds in Afghanistan, hence, it failed. This dissertation argues that a

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<sup>1266</sup> See *supra* Chapter Four.

regulation designed based on Grounded Institutional Reform can practically contain illegal funds and ensure continued access to working capital finance in Afghanistan (see Section 4.1.2.)

The current Regulation, in addition to institution of transparency and accountability enhancing measures, outlaws deposit-keeping and loan distributions by *Sarrafs*. *Sarrafs* rely on deposit-keeping and loan distribution to ensure the continued demand for their currency exchange and *hawala* services. By outlawing deposit-keeping and loan distributions, the Regulation, in effect, removed any incentive for *Sarrafs* to comply with the regulation.

Unlike the transparency and accountability measures of the Regulation, which are based on a practical need to fight illegal funds in the financial system, banning *Sarrafs* from keeping deposits and issuing loans is based on problematic theoretical propositions. The first theoretical justification is that banks in Afghanistan have failed to gain tractions because merchants are used to using *Sarrafs* (i.e. stickiness of informal institutions), therefore, Da Afghanistan Bank's Regulation was aimed at increasing the use of banks by outlawing *Sarrafs*' financing services. The second theoretical justification was that *Sarrafs* represent and sustain Afghanistan's "traditional economy" which must be curtailed. This is a normative stance which is not rooted in a thorough understanding of Afghanistan's institutional landscape.

The banning of deposit-keeping and loan distribution by *Sarrafs* is not based on a practical analysis of the need of Afghanistan's economy rather it is based on a problematic theoretical position informed by State-Centered Theory. As this dissertation has shown, the failure of formal institutions to gain tractions in Afghanistan is due to their inability to overcome the problems of credit transacting—that is why the low rate of use *Sarrafs*' financing in Balkh is not correlated with an increased use of banks' financing. On the other hand, *Sarrafs*' short-term working capital loans are a very significant source of working capital financing in Afghanistan which ensures

Afghan merchants can issue trade loans despite Afghanistan's highly volatile business climate thus ensuring market competition and lower prices.

A regulation designed based on Grounded Institutional Reform can remedy the problems of the *Sarrafi* market while ensuring the continued supply of working capital finance for Afghan merchants. The Grounded Institutional Reform regulation, the *Sarrafs* would be allowed to engage in financing (deposit-keeping and loan distribution). This would ensure that *Sarrafs'* *hawala* and currency exchange services are continued to be demanded. Thus, *Sarrafs* would have incentives to comply with the Regulation. The Grounded Institutional Reform regulation would enhance some of the benefits of formalization for *Sarrafs*, based on empirical research that shows *Sarrafs* finance supply chains in Afghanistan, while imposing transparency and accountability enhancing measures to curb the negative influence of illegal funds on Afghanistan's economy and stability.

Unlike the current Regulation, Grounded Institutional Reform regulation is likely to be successful because it reduces the resistance of the powerful group of financial intermediaries by offering them targeted finance-enhancing concessions while imposing much needed transparency and accountability-enhancing measures. The Regulation of *Sarrafs* failed, in part, because it did not offer an incentive for *Sarrafs* to comply, therefore, they organized to resist the regulation at all costs, which resulted in failure of the regulation. The Regulation of *Sarrafs* failed because it attempted to bundle much-needed transparency and accountability-enhancing measures with anti-informal institutions measures ("containing the traditional market"), and offered the *Sarrafs* no incentive to comply with either.<sup>1267</sup>

Regulations based on Grounded Institutional Reform will likely face resistance, however, by absorbing the working informal institutions, resistance will be reduced because it will ensure a

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<sup>1267</sup> See *supra* Chapter Four.

role for *Sarrafs* in the formal financial system. Furthermore, Grounded Institutional Reform's approach to regulating *Sarrafs* has a better chance of success because the numbers of *Sarrafs* who knowingly engage in supporting Afghanistan's illegal economy is limited. Stated differently, a small number of *Sarrafs* handle the majority of funds from the illegal economy in Afghanistan.<sup>1268</sup> Therefore, the current Regulation, by targeting the entirety of the *Sarrafi* market, based on theoretical justifications that have limited grounding in the context of Afghanistan, alienated the entire *Sarrafi* markets which ensured its failure. Grounded Institutional Reform regulation, on the other hand, through targeted absorption of informal institutions of *Sarrafi* markets, increases its likelihood of success by targeting the practical problems of informal institutions.

#### **5.2.2.2. Informal Institutions Are Hard to Manipulate**

While the rules that make up the informal institutions are understood by those who use them, even though they may not be able to articulate them, they are not transparent to outsiders. Therefore, Grounded Institutional Reform which aims to use informal institutions as building blocks for workable formal institutions faces the problem of identifying how informal institutions operate. Stated differently, information about the mechanics of informal institutions is generally hard to obtain by those who design institutional reforms, therefore, it will be more difficult to design institutional reforms that takes into account the mechanics and working dynamics of informal institutions.

Due to hegemony of State-Centered Theory institutional reform discourse, reformists within the government and international organizations tend to focus on formal institutions because formal institutions are more transparent; they are easier to identify. The training of most reformists

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<sup>1268</sup> This observation based on author's interviews with *Sarrafs* in five major provinces of Afghanistan (Kabul, Herat, Nangarhar, Balkh, and Kandahar) between March and August 2017.

does not prepare them to look for or study informal institutions. Alternatively, the reformists' training most often biases them in favor of formal institutions, and against informal institutions. In short, institutional reformists tend to have an information deficiency, both in access to information and processing the information, when it comes to informal institutions.

This informational deficiency surrounding informal institutions makes it difficult to design institutional intervention to manipulate working informal institutions, making it more likely that reformists only focus on formal institutions inside the country and look to formal institutions in other countries for designing institutional reforms. Thus, reformists are likely to forgo the wealth of institutional knowledge and networks held within working informal institutions and inevitably resort to coercion to impose imported institutional solutions. As a result, institutional reforms run a high risk of failure especially in the countries like Afghanistan where due to historical underdevelopment of formal institutions, informal institutions are more pervasive.

This dissertation posits that informal deficiency surrounding informal institutions can be remedied. If institutional reformists change their attitudes toward informal institutions from one of contempt to one of learning, and commit to in-depth study of working informal institutions, reformists can overcome their informational deficiency. Thus, they can design and implement institutional reforms that use working informal institutions as building blocks for creating formal institutions that work for the context of Afghanistan and will ensure that the formal institutions will gain tractions and not be met with unsurmountable resistance.

The informational deficiency of reformists concerning informal institutions is a reason why, in the context of Afghanistan, courts have been the first to implement Grounded Institutional Reform through selective formalization of informal institutions. Courts have continuous interaction with the user of informal institutions who resort to courts to compensate for the

deficiency of informal enforcement mechanisms. This provides courts with information that can be used to devise targeted intervention to selectively formalize informal institutions. This explains why courts have been able to effectively formalize informal institutions like *Sar qufli* with positive consequences for capital liquidity and access to credit.<sup>1269</sup>

The judiciary has an informational advantage over other rule-making bodies due to its repeated interactions with the users of informal credit institutions. Court disputes are the main locus of interaction between formal and informal institutions in Afghanistan. The judiciary can draw on its informational advantage and rule-making power to lend support of formal institutions to the informal institutions in cases where this support can help increase the utility of informal institutions. The case of *Sar qufli* shows that the Afghan judiciary has the capacity to improve the utility of informal credit transaction through incremental, bottom-up, and demand-led interventions.

### **5.2.2.3. The Users of Informal Institutions Resist Formalization**

Any institutional arrangement produces winners and losers by creating a certain distribution of resources.<sup>1270</sup> An institutional reform, to be successful, must either forcefully overcome the resistance from the invested users of existing institutions or ensure that transition to a new institutional arrangement is beneficial enough to a large enough group of users that a transition becomes possible without considerable coercive power.<sup>1271</sup>

Formalization of informal institutions in Afghanistan poses the same problem. Existing informal institutions have invested users who will resist formalization. This renders any attempt

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<sup>1269</sup> See *supra* Chapter Three.

<sup>1270</sup> See KNIGHT, *supra* note 240, at 14.

<sup>1271</sup> *Id.*

to change informal institutions (whether it be formalizing them or replacing them) difficult.<sup>1272</sup> In this instance, invested users this dissertation refers to financial intermediaries that have developed under informal institutions (most notably *Sarrafs*). The user of financial services of these financial intermediaries, on the other hand, are responsive to the workability and cost of alternative institutional solutions as they are not inextricably linked to the prevailing informal institutions.

Current inclusion strategies focus only on users of informal institutions but not on those who function as maintainers of those institutions (i.e. invested users).<sup>1273</sup> Existing informal institutions have created powerful group of financial intermediaries (e.g. *Sarrafs* and real estate agents) who are invested in the continued existence of current institutional arrangement. What adds to this difficulty, in the context of Afghanistan and other underdeveloped countries, is the limited coercive power and administrative capacity of the Afghan government, coupled with the pervasiveness and entrenchment of informal institutions. According to the World Bank 2016 Governance Index, the Afghan government falls within the lowest percentile consistently ranking one of the worst countries across the recorded measurements which are important for formulation and implementation of policies and regulation.<sup>1274</sup> According to World Bank 2016 Governance Index, Afghanistan's ranking across 5 dimensions of governance is as follows (0 for the weakest and 100 for the strongest): in Political Stability: 0.95; Government Effectiveness: 9.62; Regulatory Quality: 7.21; Rule of Law: 3.86; and Control of Corruption: 3.37.<sup>1275</sup> In addition, according to the Special Reporter for Afghanistan, the Afghan government's control over one-third of the

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<sup>1272</sup> See *supra* Chapter Four.

<sup>1273</sup> See, e.g., MINISTRY OF COMMERCE AND INDUSTRIES STRATEGIC PLAN 2016-2020, *supra* note 9, at 55.

<sup>1274</sup> WORLD BANK, WORLDWIDE GOVERNANCE INDICATORS: AFGHANISTAN FOR THE YEARS 1996 TO 2016, <http://info.worldbank.org/governance/wgi/index.aspx#reports>.

<sup>1275</sup> *Id.*

country's districts is at least contested.<sup>1276</sup> These reports collectively provide strong evidence that the Afghan government has limited coercive power and administrative capacity of Afghan state.

As Thomas has argued the implementation of the institutional reforms formulated in the range of Government Strategic Policies is out of reach for governments like those of Afghanistan.<sup>1277</sup> Concurring with Thomas' argument, Grounded Institutional Reform will reduce the difficulty of formalizing informal institutions by providing incentives to users as well as invested users of existing informal institutions to formalize. Grounded Institutional Reform incorporates the existing informal institutions while altering them. Thus, it offers a mixed package of benefits and costs. It offers invested users of informal institutions the opportunity to increase some of the current benefits they receive by granting them formal legal recognition while imposing costs upon them to curb the negative aspects of the informal institutions. Therefore, depending on the informal institutions and their efficiency, Grounded Institutional Reform will either reduce or eliminate the resistance to the formalization of informal institutions. As a result, it draws on an incentive-based model, instead of a coercive model, to implement institutional reform by inducing compliance and reducing the need to use the state's limited coercive power.

Absorption of informal institutions, under Grounded Institutional Reform, must be coupled with efforts to improve the quality of formal institutions, especially curbing corruption. Invested users and not-invested users of existing informal institutions resist formalization not only to ensure they can continue to engage in illegal activities (e.g. handle illegal funds or evade taxes) but also to protect themselves against predatory behavior of regulators. Formalization makes the users of information institutions visible to the corrupt officials who may misuse their regulatory power to

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<sup>1276</sup> See SPECIAL INSPECTOR GENERAL FOR AFGHANISTAN (2017), *supra* note 391, at 87. It should be noted that Afghan Government disputes this report.

<sup>1277</sup> See Section 4.3.6. and THOMAS, *supra* note 1221, at 202.

extract rent from informal financial intermediaries and users of informal institutions. Therefore, to incentivize those who are involved in informal institutions to join the formal economy and subject themselves to formal institutions, the Afghan government must ensure not only that invested users have an incentive to comply with the formal institutions but also that they are protected against predatory behavior of regulators. Thus, improvement of formal institutions goes hand in hand with Grounded Institutional Reform.

Grounded Institutional Reform focuses on formal institutional design and process of formalization to make them fit for context of Afghanistan. However, *if the government does not seriously fight the corruption in formal institutions, regardless of their content and design, no model of formal institutions and formal institutional design can ensure that formal institutions will gain tractions in Afghanistan.*

### **5.3. What Would Reforms Based on Grounded Institutional Reform Look Like in Afghanistan?**

This section provides a number of possible institutional reforms as illustrative applications of Grounded Institutional Reform in the context of Afghanistan. These examples are drawn from research findings conducted for this dissertation and will show how Grounded Institutional Reform-based solutions differ from Afghan Government's Strategic Policies which reflect the State-Centered Theory-based solutions.<sup>1278</sup>

Government Strategic Policies have a narrow view of Afghanistan's institutional landscape; therefore, they propose solutions that disregard the wealth of working informal institutions. While they most often correctly diagnose the problems of credit transacting in

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<sup>1278</sup> See Section 5.2 for a discussed how a Grounded Institutional Reform-informed regulation of the *Sarrafi* market would be different than the current failed regulation.

Afghanistan, their solutions do not get traction in Afghanistan. While most of the Government Strategic Policies' proposed formal institutions may be necessary institutional outcomes, they are more likely to get traction and work for the Afghan context be if they are built incrementally using existing formal institutions as building blocks, i.e. if they are revised using Grounded Institutional Reform.

Government Strategic Policies do not recognize Afghanistan's existing informal institutions, such as *Gerawee*, *Sar qufli* or short-term working capital loans, as possible building blocks for solutions to the problem of access to credit for Afghan merchants. The only Government Strategic Policies that mention the informal economy and informal institutions is the Commerce Strategy.<sup>1279</sup> This is most likely due to the collaboration between Ministry of Commerce and business associations in Afghanistan which has partially remedied the informational deficiency of institutional reform concerning informal economy. However, the Commerce Strategy only refers to the informal economy and informal institutions in the context of incentivizing inclusion of informal businesses in formal economy. While the Commerce Strategy correctly underscores the need to design incentive-based mechanisms to promoting inclusion in the formal economy, it only discusses the need to reduce the barriers to and increase the benefit of inclusion in the formal economy. The Commerce Strategy does not mention the need for building on and correcting informal institutions as a way of increasing the workability and acceptance of the formal economy and formal institutions. The Commerce Strategy does not mention the need to draw on the existing institutions. Thus, while the Commerce Strategy highlights an important and often missing component of institutional reform in Afghanistan, it does not go far enough to advocate for the use

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<sup>1279</sup> See *supra* Chapter Four.

of informal institutions as building block for devising institutional solutions to the problem of credit transacting in Afghanistan.

Government Strategic Policies underscore the need for property right reforms and creation of an effective titling system to unleash the value trapped in the housing market in Afghanistan cities. However, they do not mention *Gerawee* which currently is helping Afghans raise capital against the value of their houses in the absence of secure tenure and land certification. Instead of building on and correcting these working institutions, Government Strategic Policies again advocate for creation of new formal institutions.

Facilitating the absorption of *Gerawee* by formal institutions, which could be aided by placing *Gerawee* transactions under the jurisdiction of commercial courts, can improve access to long-term financing while the Afghan government reforms formal property rights in the country. Likewise, Government Strategic Policies disregard the potential of the network of local real estate agents in implementing and maintaining an updated and comprehensive system of property titling. However, local real estate agents, who are acting as institutional entrepreneurs to facilitate *Gerawee* and *Sar qufli* transactions despite the current informality of property rights, can be used to partially privatize the creation and maintenance of a comprehensive system of property titling. Local real estate agents have an incentive to obtaining information about the legal status of the properties in their locality. They also have informational advantage due to their continuous interaction with the property users and property owners in their locality as well as their intimate knowledge of property transactions that are occurring. Afghan laws already require the registration of property transactions (e.g. lease and sale) with a registered real estate agent to improve tax collection. The Afghan government can leverage real estate agents' network and information to create and maintain an updated and comprehensive property titling system. Real estate agents offer

a possible way to privatize creation or maintenance of property registration system, at least in major urban centers.

To solve the information problem that banks face in Afghanistan, Government Strategic Policies acknowledge the need to improve access to credit information to enable banks to assess borrowers. However, this idea completely disregards the wealth of credit information *Sarrafs* possess. *Sarrafs* conduct 90% of financial transactions in Afghanistan<sup>1280</sup> and have ongoing financial interactions with Afghan merchants. Providing banks access to this wealth of information can greatly improve banks' ability to assess risks and will reduce their reliance on scarce formal deeds. For example, the Government Strategic Policies could propose the use of *Sarrafs* as guarantors for banks loans. This would encourage banks to outsource creditworthiness assessment and monitoring to *Sarrafs*. Government Strategic Policies, on the other hand, propose creation of new formal institutions like a Credit Bureau. A Credit Bureau would not work for the context of Afghanistan because it relies on information about formal credit practices, which due to the low rate of formal credit use, are scarce in Afghanistan.

To expand Afghanistan's limited export, Government Strategic Policies underline the importance of inducing exports through providing better access to commercial and export financing. However, this disregards the potentials of short-term working capital loans which are already financing import and supply chains. Instead, they propose creation of a new formal institution, namely an export bank. Such a bank may help but it requires resources that the Afghan government does not have and institutional knowledge that Afghan merchants do not possess.

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<sup>1280</sup> See CURBING ILLICIT FINANCIAL FLOWS IN AFGHANISTAN: MONEY LAUNDERING, TERRORIST FINANCING, AND HAWALA, *supra* note 310, at 28; See also AFGHANISTAN—STATE BUILDING, SUSTAINING, GROWTH, AND REDUCING, *supra* note 781, at 6.

Concerning the capital market, Government Strategic Policies stress the need to improve liquidity in Afghanistan's capital market. However, they do not mention *Sar qufli* as a way of commodifying future revenue tied to a place of business. Instead, they focus on creation of new formal institutions like security markets. While a capital market, if successfully created, may improve capital market liquidity in Afghanistan, *Sar qufli* is currently delivering the same result although in significantly limited contexts. Leveraging *Sar qufli*, by supporting its use in other transactions where the value created by use of a property is not easily movable, could have an immediate and positive consequences for liquidity in Afghanistan's capital market.

## CONCLUSIONS AND RECOMMENDATIONS

Credit transactions raise a number of fundamental problems in the context of Afghanistan. Its highly uncertain business climate of Afghanistan increases the borrowing costs and renders adherence to fixed repayment terms challenging. Formal property rights cannot be used to secure credit transactions because formal deeds are scarce, the titling system is a failure, and formal property right system does not reflect the practical needs of the property-rights owners in Afghanistan. Formal contract enforcement institutions cannot reliably enforce credit transactions because underdevelopment of formal property rights and the instability of Afghanistan's business climate have made it difficult to hold the debtors accountable.

Formal institutions have not been able to overcome the fundamental problems of credit transacting in the Afghan context, as such, bank loans are seldom used to finance investment. For example, although banks in Afghanistan hold sufficient reserves, Afghan merchants increasingly find it difficult to obtain bank loans. The stickiness of informal credit institutions cannot explain the low demand for bank loans because, as the case of Balkh shows, the use of formal credit institutions is not inversely correlated with the use of informal credit. The low demand for bank loans is likewise not entirely attributable to Shari'ah-based opposition to interest: interest-friendly (or at least natural) attitudes do not positively correlated with the increased use of bank loans and there is a pervasive use of informal credit institutions that incorporate the time value of money. Similarly, low trust in banks cannot explain the low demand for bank loans because Afghan merchants generally express more confidence in banks compared to *Sarrafs*. Thus, the inability of formal institutions to provide credit in a way that work for the Afghan context is the primary explanation for low demand for bank loans, and consequently, the inability of formal institutions to improve access to credit for Afghan merchants.

Afghans have instead developed a number of informal institutions to facilitate credit transactions. In Afghanistan, market competition animates the supply of trade credit by sellers/creditors who are most often importers. *Sarrafs*' short-term working capital loans help sellers/creditors meet their financial obligations to their foreign suppliers despite unpredictable cash flow from their domestic buyers/debtors. There exists a feedback loop: low barriers to entry increases market competition and animates the supply of trade credit and *Sarrafs*' short-term working capital loans, while the access to trade credit and *Sarrafs*' short-term working capital loans reduces the barriers to entry and ensure the competitiveness of markets. On the demand side, the risk-sharing-enabling feature of trade credit is the primary cause of demand for trade credit. Trade credit arrangements allow buyers/debtors to pass the market risk to sellers/creditors; sellers/creditors are able to engage in these risk-sharing arrangements because they have been able to minimize moral hazard and reduce principal-agent problems through a weekly payment system that consists of regular monitoring and short-term cash extractions. Research conducted for this dissertation shows that the informality of credit institutions has limited exclusionary effects for Afghans. Afghan merchants can rely on a range of social and institutional networks to form credit transactions with other merchants within Afghanistan. However, informal credit institutions put outsiders at a disadvantage hindering the attraction of foreign investment to Afghanistan.

*Sarrafs* provide short-term working capital loans to sellers/creditors to entice customers to utilize their *hawala* and currency exchange business. These short-term loans are often executed in the form of a credit *hawala*, whereby a *Sarrafs* executes a *hawala* paying a merchant-client's foreign suppliers when the client does not have sufficient funds with the *Sarrafs* with the expectation that the merchant-client will reimburse the *Sarrafs* in a short time by collecting on receivable from his domestic debtors. Thus, *Sarrafs*' short-term working capital loans help

sellers/creditors, who are often importers, bridge the gap between Afghanistan's uncertain business climate that operate under risk-sharing arrangements and foreign markets that require adherence to fixed-term payments.

In addition to supply chain financing, informal institutions have been able to provide partial access to investment financing as well. Despite underdeveloped formal private property rights, Afghan merchants are able to raise long-term capital against the value of their real estate using *Gerawee*. Estimated figures suggest that *Gerawee* is an important source of investment financing for Afghan merchants. However, the unwillingness of courts to recognize the lender's security right in the property, and the bilateral nature of the transaction, have limited the financing capacity of *Gerawee*.

To improve liquidity in the capital market, Afghan merchants have adopted *Sar qufli* to commodify future business reputation in cases where reputation is closely tied to a place of business. *Sar qufli* has evolved organically in Afghanistan and other places to curtail the opportunistic behaviors that arise from the problem of asset specificity in commercial lease of immovable property. Afghan courts have recognized the legal validity and Shari'ah-compliance of *Sar qufli*, increasing its popularity. *Sar qufli*, and the judicial jurisprudence that has developed in connection to it, have the capacity to improve liquidity in the capital markets in cases where the use of a property creates additional value that cannot be easily separated from the property.

Another way to raise capital in Afghanistan is equity financing which is facilitated by family businesses. Family businesses are not only very common in Afghanistan but also positively correlate with the success of the business enterprise because they help Afghans pool capital, prevent dilution of capital across generations, and ensure that the business has continued access to a pool of agents whose interests are aligned with the interest of the business.

These informal institutions are good but not great. They have significantly improved access to working capital financing for Afghan merchants while bringing about some improvements in access to investment financing and liquidity of capital market. However, the emergent informal institutions only have limited capacity for pooling savings for investment purposes because they are not capable of scaling up or drawing in funds from savers. Thus, they are not a substitute for effective formal institutions. The Afghan government needs to create better formal institutions.

The Afghan government's current approach aimed at improving access to credit through reforming formal institutions has generally failed. This dissertation argues that this failure is rooted in an unwillingness to use the existing informal institutions as building blocks for creating workable formal institutions. Using the content of the Government's Strategic Policies as evidence, the Afghan Government's approach reflects the policy prescriptions of State-Centered Theory. Thus, the Afghan government strategy has aimed to displace the functioning but inadequate informal institutions with imported, untried (in the Afghan context) formal institutions, rather than incorporating successful informal institutions into new formal institutions that can meet Afghan merchants in the Afghan context. This dissertation makes the case that neither imported formal credit institutions, nor entrepreneur-supplied informal institutions have been able to provide adequate access to investment financing in Afghanistan. The former has failed because formal institutions have not been able to provide credit in a way that work for the Afghan context, or because the Afghan government does not have sufficient coercive power and administrative capacity to overcome resistance from the invested users of the existing informal institutions. The latter has failed because poor infrastructure and limited market expansion opportunities limit the incentive for supply of informal institutions, and improvement of existing informal institutions, to sustain credit transactions in more complex and inclusive way.

Showing that institutions created by both State-Centered Theory and Entrepreneurial Institutional Theory have failed to provide adequate investment financing for Afghan merchants, this dissertation proposes a new approach. It proposes Grounded Institutional Reform as an approach that would enable Afghan government to create workable formal institutions in Afghanistan by absorbing the working informal institutions. By building on and reshaping the working informal institutions, Afghan government can harness the problem-solving abilities of Afghan entrepreneurs to create formal institutions that work for the Afghan context and ensure user-readiness of the formal institutions. By ensuring a continued role, albeit an altered one, for the invested actors in the existing informal institutions, Grounded Institutional Reform will also help the Afghan government induce compliance with the formal rules, reducing the need to rely on the limited coercive power of state.

This dissertation proposes Grounded Institutional Reform based on a critical assessment of Afghanistan's informal institutions. It finds that Afghanistan's informal institutions are popular because they are able to provide credits on terms acceptable to Afghan merchants. Thus, it is the ability of informal institutions to overcome the credit transacting problems that explains their popularity not the fact that they are informal or traditional institutions. This, this dissertation has argued, creates an invaluable opportunity for the Afghan government to harness the potentials of existing informal institutions to create formal institutions that can meet the needs of Afghan merchants in their context, while enabling formalization of Afghanistan's economy. This is the opportunity that Grounded Institutional Reform is trying to seize.

While this dissertation has only applied Grounded Institutional Reform to credit institutions, this approach is scalable and can be applied to institutional reform in other areas both within and outside Afghanistan. Within Afghanistan, for example, Grounded Institutional Reform

can be used to design reform to improve access to justice for Afghans by building upon informal institutions such as *shuras* and *jirgas*. Application of this approach in the area of access to justice would require in-depth studies of the problems of access to justice and informal institutions to identify what is working with the informal institutions and why. Grounded Institutional Reform can also be applied in to reforms in other less-developed countries. This dissertation provides three suitability criteria for application of this approach to economic institutions of other less-developed countries: poor infrastructure, limited market expansion opportunities, and weak but reformist government.

In addition to an assessment of credit institutions, this dissertation also produces interesting findings about dispute resolution institutions in Afghanistan. This research finds that Afghan merchants avoid the use courts not because they are invariably against the use of formal, adversarial dispute resolution institutions, but because formal dispute resolutions are most often ineffective. The high rate of court use for commercial cases where court judgments are both necessary and effective disproves the commonly-held hypothesis that Afghan merchants are invariably opposed to use of formal, adversarial dispute resolution. Informal dispute resolution effectively resolves most common disputes among Afghan merchants, however, they often disregard the formal rules of property rights, the principle of limited liability, and hinder depersonalization of business dealings in Afghanistan.

The available statistics on use of courts suggest that merchants in predominately Pashtun provinces use courts significantly less often than the merchants in ethnically diverse provinces, or predominantly non-Pashtun provinces. This observation is robust even if one controls for the business size. Cultural aversion to the use of signed written documents in the course of business dealings, combined with the cultural salience of *jirga*, which provides a focal point for dispute

resolution, and ethnic homogeneity are responsible for the reduced rate of court use in predominately Pashtun provinces.

The research presented here suggests that jurisdictional rules have important consequences for formalization of informal credit institutions in Afghanistan. Commercial courts, compared to civil courts, are more likely to recognize informally developed financial institutions that are incongruent with the normative stance in the broader society. This divergence of judicial attitude is due to history of commercial law in Afghanistan, the type of actors involved in commercial transactions, and the specialized nature of commercial transactions.

Drawing on the research presented here, this dissertation makes the following specific recommendations for the Afghan government to reform credit and dispute resolution institutions:

The Afghan government needs to reform formal property rights to create clear rules of determining legal ownership, and to create an integrated system of legal, reliable, and up-to-date titling to reduce the cost of transactions in property, the ability to effectively use property for collateralization. The current unsupportive property rights system is a fundamental problem of credit transacting in Afghanistan. Creating an effective system of formal property rights will have enormous positive effects on access to credit and formalization of Afghanistan's economy.

The volatility of Afghanistan's business climate increases the borrowing costs, preventing productive investments with considerable positive externalities from taking place. The Afghan government needs to reduce the borrowing costs to stimulate more investments and job creation. One way the Government can accomplish this goal is by introducing targeted and performance-linked credit guarantee schemes to lower the cost of capital. The high volatility of business climate increases the cost of borrowing in Afghanistan; the government can reduce this cost through partial guarantee of the repayment of business loans. This will incentivize distribution of loans by banks

and increase investment. There has already been a pilot project to test this model in the Northern Afghanistan with positive results.<sup>1281</sup>

Banks in Afghanistan have 3 billion US\$ in excessive reserve;<sup>1282</sup> this figure is almost doubled the Afghan government's developmental budget.<sup>1283</sup> The Afghan governments needs to improve the distribution of these excessive reserve in the form of loans to stimulate economic growth. Afghan merchants do not use bank loans because they cannot satisfy the collateral requirement of banks. Banks require collateral to ensure the creditworthiness of the borrower. One mechanism by which banks can reduce their reliance on collateral is to use alternative measure of creditworthiness. However, the scarcity of credit data hinders the use of alternative measure of creditworthiness in Afghanistan. *Sarrafs* hold rich data on the financial flow and creditworthiness of their clients. *Sarrafs* currently use this information to issue short-term working capital loans to their clients without even use of a written contract. The Afghan government should incentivize *Sarrafs* to share information with banks, and the proposed Credit Bureau, if established. If *Sarrafs* are properly incentivized to share credit information with banks, it will greatly improve the ability of banks to assess risk and creditworthiness, facilitating loan distributions.

In addition to high borrowing costs and demanding collateral requirements, low financial literacy on the side of Afghan merchants, and low professional capacity on the side of banks, are also hindering the distribution of business loans. Afghan the government can increase distribution

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<sup>1281</sup> See OVERCOMING THE ACCESS TO FINANCE PARADOX IN AFGHANISTAN, *supra* note 1138; *see also* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PRIVATE SECTOR DEVELOPMENT POLICY HANDBOOK, IMPROVING ACCESS TO FINANCE FOR SMES IN CENTRAL ASIA THROUGH CREDIT GUARANTEE SCHEMES (2013), <http://www.oecd.org/global-relations/AccessstoFinanceforSMEs.pdf>.

<sup>1282</sup> See *supra* Section 4.2.

<sup>1283</sup> The total of Afghanistan's development budget for the year 2018 is roughly 1.299 billion US\$, See NATIONAL BUDGET FISCAL YEAR 1397 [2018], [http://www.budgetmof.gov.af/images/stories/DGB/BPRD/National%20Budget/1397\\_Budget/Final%201397%20National%20Budget%20-%20approved%20\(Final\).pdf](http://www.budgetmof.gov.af/images/stories/DGB/BPRD/National%20Budget/1397_Budget/Final%201397%20National%20Budget%20-%20approved%20(Final).pdf).

of bank loans by improving the financial literacy of Afghan merchants and improving the professional capacity of banks' loan officers. Thus, the Afghan government should support and implement financial literacy programs for Afghan businesses, as well as training programs for bank staff.

Banks in Afghanistan face problems when it comes to attracting savers as well. After the Kabul Bank corruption scandal, people's trusts in banks has suffered. The Afghan government needs to improve banking regulations to restore people's trust in banks and incentivize savings in banks. Afghans generally do not trust the durability of formal institutions; therefore, banks have a higher burden convincing people to deposit their savings. The Kabul Bank scandal has seriously undermined the trust of Afghans in the banks. However, banks are the most important institution for pooling of savings for investment purposes, as such, the Afghan government must undertake measures to safeguard the integrity of financial institutions and restore the public trust in banks.

In conjunction with reforming the banking system, the Afghan government also needs to improve the non-banking sources of credit. *Sar qufli* has been able to improve liquidity in the capital market by making it easier for developers to recover their capital cost. *Sar qufli* has also helped solve the asset specificity problem by encouraging investment in immovable properties by the renter-businesses. To improve certainty and predictability in the *Sar qufli* market, the Afghan government should enact legislation based on the judicial jurisprudence developed in connection with *Sar qufli*. *Sar qufli* has the capacity to expand to other settings where the use of a property creates additional value that cannot be easily separated from the property. Afghan government needs to enact legislation to unleash the broader potentials application of *Sar qufli*.

Like *Sar qufli*, *Gerawee* too has been effective in alleviating the capital constraints of Afghan merchants. However, unlike *Sar qufli*, development of *Gerawee* is hindered by the

unwillingness of courts to recognize and protect creditor rights in the *Gerawee* transactions. To unleash the value trapped in the housing market, the Afghan government needs to improve the formal protection of financiers in the *Gerawee*. This dissertation argues the Government can achieve this goal by assigning *Gerawee* creditors. This dissertation argues to the jurisdiction of commercial courts in cases where the borrower is a merchant. Commercial courts are more likely to lend formal support to the *Gerawee* transaction, thereby improving the rights of creditors and unleashing the potential trapped in housing market to finance productive activities.

*Sarrafs* play an important role in financing supply chains in Afghanistan. The Afghan government should promulgate regulations, using the Grounded Institutional Reform approach, to facilitate the financing role of *Sarrafs*, especially for exporters. To curb the amount of illegal funds in the *Sarrafi* markets, instead of outlawing deposit-keeping and loan distribution by *Sarrafs*, the Afghan government should enact regulations that facilitate the financing role of *Sarrafs* in exchange for compliance with transparency and reporting requirements. Such regulations not only will have a greater chance of success, thereby curbing illegal funds, but also will improve access to working capital financing by ensuring that *Sarrafs* will continue to provide credit-*hawala* to merchants.

To ensure effective performance of policies and improve contract enforcement, Afghanistan needs to reform commercial procedures and improve court judgment enforcement. Enforcement costs are an important factor in the use of credit transactions. Afghan merchants will not enter into a credit transaction if they are not reasonably sure, *ex ante*, that the transaction will be enforced. Currently, the majority of non-bank credit transactions are enforced by informal institutions. While these informal institutions are effective in most cases, they put outsiders at a disadvantage and do not uphold the principles of limited liability or separation of private property.

Therefore, the Afghan government needs to encourage the use of formal dispute resolution institutions by removing barriers to the use of courts and improving court judgment enforcement. Currently, the two formal institutions in charge of formal dispute resolutions, the Judiciary and the Ministry of Justice, either do not have a strategic policy or do not prioritize judgment enforcement and commercial court procedures reform in their strategic policies. The Afghan government needs to undertake reforms of commercial court procedures and judgment enforcement to improve the comparative competitiveness of formal dispute resolution in relation to informal dispute resolution.

Creating good formal institutions in less-developed countries is an immensely difficult task. Grounded Institutional Reform posits that an effective way to approach this task is to set reasonable expectations and utilize the potential of organically developed institutions. Instead of starting by looking outside to find solutions, Grounded Institutional Reform suggests that the governments of less-developed countries should seriously consider the potential of informally developed institutions because they capture the collective efforts of indigenous economic entrepreneurs over a long period of time to solve their institutional problems.

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APPENDIX I

LIST OF INTERVIEWEES

Province	Name of Company or Individual	Companies' Activities	Sector(s)	# of Employees	Annual Dealings
Balkh	Abdul Qayoom & Sons	Sarrafi and Hawala, Chair of Balkh's Sarrafi Union	Sarrafi		
Balkh	Al-Mubashir Group	Produces cakes, chocolates, and gum	Manufacturing/ Trade	100	
Balkh	Bashir Naweed Group	Imports rods, construction materials, and food items, and produces bricks and washing products	Manufacturing/ Processing/ Trade		
Balkh	Fahim Farzam Group	Imports and produces cooking oil	Manufacturing/ Trade	70	
Balkh	Hamid Sadat Co.	Imports and sells raw materials, produces bottled water	Processing/ Trade	52	
Balkh	Jamshid Rahim Co.	Buys fruits from farmers, processes and exports dried fruit	Processing/ Trade	13 permanent, up to 200/day	
Balkh	Judge Abdullah Muhammadi	Chief Judge of Primary Commercial Court in Balkh	Commercial Court		
Balkh	Kabul Cam Co.	Produces Chocolate	Manufacturing	20	
Balkh	Khaled Tayba Co.	Imports and exports food and wood	Trade	12	
Balkh	Mazar Money Services	Sarrafi and Hawala	Sarrafi		
Balkh	Nasir Ahmad Qasemi	General Manger of Balkh's Chamber of Commerce and Industry	Chamber of Commerce		
Balkh	Navid Munib Tomato Paste Production Co.	Produces tomato paste, distributes food	Processing/ Trade		
Balkh	Roof Bitumen Production Co. of the North East	Imports, sells, and installs roof bitumen, also a board member on Balkh's Union of Manufacturers	Services/ Trade	40	
Balkh	Roshan Zada Group	Produces PVC, imports construction Materials, grains, and exports sesame and Zira; the president	Manufacturing/ Trade	40	

		of Balkh's Union of Manufacturers and president of Balkh's Oil and Gas Union			
Balkh	Sadat Cola Production Co.	Produces non-alcoholic beverages	Manufacturing	200	
Balkh	Sarrafi Sayed Hishmat	Sarrafi and Hawala, and sells phone top-ups	Sarrafi/ Trade		
Balkh	Sayed Jamal Co.	Imports tractors, wheat and flavorings; produces plastic bags, pipes and flavorings; exports animal skins	Manufacturing/ Trade	40 (prior 200, downsized)	
Herat	Bahar Ahmad Marble Factory	Processes marble	Manufacturing/ Processing	17	
Herat	Biranj Co.	Assembles motorcycles and tricycles	Assembly/ Manufacturing	200	
Herat	Fawad Sediqi Group	Imports oil and gas from Central Asia and sells across Afghanistan	Trade		\$20 Mil.
Herat	Haji Abdul Wudud Faizzada	President of the Herat Union of Manufacturers	Union		
Herat	Haji Sa'ad Khatibi	President of Herat Chamber of Commerce and Industry	Chamber of Commerce		
Herat	Herat Marble Processing Co.	Processes Marble	Processing/ Trade		
Herat	Ibrahim Yahya Co.	Manufactures, imports furniture	Manufacturing/ Trade	15	
Herat	Judge Ali Ahmad Ahmadi	Appellate Judge at the Commercial Dewan of the Herat Court of Appeals	Commercial Dewan		
Herat	Judgement Enforcement		Huquq Dept.		
Herat	Mubarak Group	Imports and exports rugs and carpets, produces hygiene products, and owns and operates a printing company	Manufacturing/ Services/ Trade	200	
Herat	Nadem Group	Imports construction materials from Iran and Uzbekistan	Trade	12	\$20 Mil.
Herat	Najm Co.	Imports and distributes tea	Trade		

Herat	Noorzai Group	Produces UPVC, profiles, and electric cable; imports raw materials and sells to other factories; and owns a Sarrafi	Manufacturing/ Sarrafi/ Trade		
Herat	Pamir Group	Assembles motorcycles, produces bottled water and party energy drink	Assembly/ Manufacturing	360	
Herat	Rahimi Sarrafi	Sarrafi and Hawala, Chair of Herat's Sarrafi Union	Sarrafi		
Herat	Sarrafi Arman Masooud	Sarrafi and Hawala	Sarrafi		
Herat	Taha Co. and Shahid Cookie & Cake Factory	Produces cookies and cakes	Manufacturing/ Trade		
Herat	Talash Asia Production Co.	Produces wheel caps of different sizes and models for cars, trucks, motorcycles and tricycles	Manufacturing	40	
Herat	Talaya Co.	Produces tissues, shampoo, and cleaning products	Manufacturing	40	
Herat	Turkani & Sediqi Sarrafi	Sarrafi and Hawala	Sarrafi		
Herat	Yusufi Group	Imports machinery, e.g. generators and construction machines, exports valuable minerals	Trade	210	
Kabul	Abdul Hakeem Sanaee Co.	Provides transportation and custom clearance services	Services		
Kabul	Adeel Co.	Processes marble and natural stones	Processing/ Trade		
Kabul	Afghan Polyethylene Co.	Produces 3D panels used in construction	Manufacturing/ Services		
Kabul	Amirian Group	Imports and distributes cellphones and accessories, produces stoves	Manufacturing/ Trade		
Kabul	Aziz Faizy	Head of Afghanistan Center of Commercial Dispute Resolution	ACCDR		
Kabul	Hekmat Afghan Construction	Construction and logistics company, imports electronics and seed for chicken	Services/ Trade		
Kabul	Judge Sediqi	Chief judge of Kabul primary commercial court	Primary Commercial Court		
Kabul	Khedmat Group	Imports machinery, processes marble and other minerals	Processing/ Trade		
Kabul	Parwiz Wahid Co.	Imports drugs and pharmaceutical products	Trade		

Kabul	Salim Karwan Group	Imports construction materials, owns and operates an oil refinery, owns a construction company	Manufacturing/ Processing/ Services/ Trade		
Kabul	Sarrafi Khosti	Sarrafi and Hawala; former president of Kabul Sarrafi Union	Sarrafi		
Kandahar	Amin Karimi Box Production	Produces boxes and owns and operates a printing company	Manufacturing/ Services		
Kandahar	Brothers Co.	Sarrafi and Hawala	Sarrafi		
Kandahar	Eng. Ab. Baqi Banaee	VP of Kandahar Chamber of Commerce and Industry	Chamber of Commerce		
Kandahar	Erfan Ahmad Co.	Buys fruit from farmers, processes and exports dried fruit	Manufacturing/ Processing/ Trade		
Kandahar	Haji Ghulam Rasul Sarraf	Sarrafi and Hawala	Sarrafi		
Kandahar	Judge Rahim	Chief judge of Kandahar primary commercial court	Primary Commercial Court		
Kandahar	Miami Co.	Distributes cleaning products	Trade		
Kandahar	Milko Co.	Produces dairy products, e.g. yogurt and ice cream	Manufacturing/ Processing	250	
Kandahar	Nazir Ahmad Forwarding	Forwarding and transportation services	Services		
Kandahar	Negah Afghan Co.	Produces bottled water	Manufacturing/ Processing	23	
Kandahar	Noori Afghan Co.	Imports and distributes home appliances	Trade		
Kandahar	Noorzai Group (Kandahar)	Produces UPVC, profiles, and electric cable, imports and sells raw materials, owns and operates a Sarrafi	Manufacturing/ Trade/ Sarrafi		
Kandahar	Sadiq Co.	Produces juice, bottled water and ice; president of Kandahar's Union of Manufacturing	Manufacturing/ Processing		
Kandahar	Sardar Rush Iodine Salt	Produces iodized salt	Manufacturing/ Processing		

Kandahar	Wali Hootak Co.	Owns and operates a large supermarket, furniture store and home appliance store	Trade		
Kandahar	Zmaray Ae'temad Co.	Distributes imported blankets	Trade		
Nangarhar	Admin Officer of Primary Commercial Court	Admin officer of primary commercial court in Nangarhar	Primary Commercial Court		
Nangarhar	Al-Madina Manufacturing Co.	Produces aluminum plates	Manufacturing		\$20,000 Initial Capital
Nangarhar	Bashir Faheem Co.	Imports food	Trade		
Nangarhar	Faqir Wahab Co.	Imports household goods, e.g. dishwashing liquids	Trade	40	
Nangarhar	Getz Pharma - Afghanistan Representative	Imports drugs and pharmaceutical products for Pakistan	Trade		\$2.5 Mil.
Nangarhar	Haji Taj Muhammad	A major importer and distributor of fabrics	Trade		
Nangarhar	Javid Afghan Co.	Imports and produces iron rods	Manufacturing/ Trade	225	
Nangarhar	Judge Munir	Appeal judge at the commercial dewan of Nangarhar's court of appeals	Commercial Dewan		
Nangarhar	Manager at Nangarhar Chamber of Commerce		Chamber of Commerce		
Nangarhar	Muhammad Asif Sarrafi	Sarrafi and Hawala	Sarrafi		
Nangarhar	Muhammad Kamal Sarrafi	Sarrafi and Hawala	Sarrafi		
Nangarhar	Nawi Sediqzai Co.	Imports household necessities, e.g. cooking oil and washing powder	Trade	18	
Nangarhar	Omid Sajid Basit Co.	Imports and distributes drugs from Pakistan	Trade		
Nangarhar	Qasim Ma'raj and Ma'raj Shirak Co.	Imports rugs and carpets from Pakistan	Trade	3	
Nangarhar	Samiullah Fahim Co.	Imports iron rods	Trade		

## APPENDIX II

### POOL OF INTERVIEW QUESTIONS

Name of interviewee:

Name of Interviewee's business:

Number of employees:

A rough estimate of annual dealings:

Ethnicity:

A short description of business:

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#### A) Starting a Business (8 questions)

1. When did you first start your business?
  2. Where did you get the money to start your business?
  3. Did you have family members, relatives or close friends who were involved in the same or similar business when you start your business?
  4. How did you first establish business relations? (e.g. drawing on personal, family relations, or drawing on ethnic or religious connections)
  5. Did you have to conduct your business (buy and sell) in cash when you first start your business?
  6. Did you have a relation with a Sarraf through family, relatives, or friends when you first started your business?
  7. Do you have a relation with a Sarraf(s) now? How old is your relation?
  8. If you answered question number 6 in negative and question number 7 in positive, how did you establish a relation with a Sarraf?
- 

#### B) Business structure (6 questions)

1. Is your business registered? If yes, with what governmental entity?
  2. What is legal form of your business?
  3. How many equity partners do you have?
  4. What kind of relations you and your equity partners had before you became partners?
  5. Are you a member of a business association? Name them?
  6. How you and your employees knew each other before your hired them?
- 

#### C) Preventive Institutions (26 questions)

1. Who are the people you do business with? (E.g. suppliers, customers, Sarraf, government, etc.)
2. Can you estimate, how much your business is done on credit?
3. How do you decide to give someone credit?
4. Do you have to personally know the people you do business with?
5. If you answered the question number 4 in positive, from where do you know the people you do business with?
6. If you answered the question number 4 in negative, do you need to trust the people you do business with?
7. If you answered the question number 6 in positive, what makes you trust a person if you don't know him/her personally?
8. If you answered the question number 6 in negative, how do you make sure that your business partner does not cheat without trust?

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9. Can you estimate, in the last year, how many of your dealings involved a late payment? What was the average length of delay?
10. Do you still do business with the people that delayed their payments? Why?
11. Did you change the conditions of your dealings after the delayed payment? How?
12. In the last year, how many of your dealings involved a late delivery of good/service? What was the average length of delay?
13. Do you still do business with the people that delayed the delivery? Why?
14. Did you change the conditions of your dealings after the delayed delivery? How?
15. In the last year, how many of your dealings resulted in complete non-payment, or complete failure to deliver good/service?
16. Do you still do business with the people who did not pay or did not deliver the good/service? Why?
17. Did you change the conditions of your dealings after non-payment or failure to deliver good/service? How?
18. In the last year, how many of your dealings involved other disagreements as to what each party's obligation was?
19. Do you still do business with the people you had the disagreements with? Why?
20. Did you change the conditions of your dealings after the disagreement? How?

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21. Do you collect evidence (receipt, written contract, etc.) when you enter into a business agreement so you can prove it? What do you collect?
  22. Do you collect evidence on all of your agreements? If answer is no, for what kind of agreements do you collect evidence?
  23. If you answered question number 21 in positive, to whom do you think you need to prove the agreement?
  24. Do you record the conditions of agreements too? How do you record the conditions of agreements?
  25. Do you record the conditions of agreements for all your agreements? If answer is No, for what kind of agreements do you record the conditions of agreement?
  26. If you do record the conditions of agreements, why do you do it? When do you think you will need the record? And for whom?
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D) Dispute Resolution Institutions (48 questions)

1. Can you estimate, over the last year, how many disputes did you have with the people you do business with?
2. With whom do you usually have disputes? (e.g. suppliers, old customers, new customers, Sarrafs)
3. What were the most common disputes?
4. What were the most common sources of disputes?
5. What do you do first when you have a dispute with someone?
6. Do you try to preserve the relationship with the other party?
7. How do you decide if you should try to preserve the relations despite the dispute or you should stop doing business with the other party?
8. Do you compromise so you can still do business with other party? How do you decide if you should compromise?

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9. Do disputes and the need for compromise are an important cost to your business?
10. Can you estimate, over the last year, how much money, roughly, did you lose due to disputes and compromise? (E.g. time, bribe, gifts, forgone profit, etc.)
11. If there was a way so you did not have to compromise (e.g. someone made other party honor the contract without you having to compromise) would that reduce the cost of your business significantly?

12. How would you change the kind of deals you make, the price you charge or any other thing about your business if you did not have to consider the cost of disputes or compromise?

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13. Do you resort to superintendent of your market when you have a dispute?

14. Can you estimate, over the last year, how many times did you resort to superintendent for a dispute?

15. How and when do you decide that you need to involve the superintendent of your market?

16. For what kind of disputes do you involve superintendent more often? Why?

17. Does involving superintendent increase the cost or length of dispute? Why? What are the costs and source of delays?

18. Does involving superintendent help resolve the dispute? How?

19. Do you like to involve the superintendent? Why? Why not?

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20. Can you estimate, over the last year, how many times did you resort to business associations for a dispute?

21. How and when do you decide to involve the business associations in your dispute?

22. For what kind of disputes do you involve associations more often? Why?

23. Does involving the business associations increase the cost or length of dispute? Why? What are the cost and source of delays?

24. Does involving associations help resolve the dispute?

25. Do you like to involve the associations? Why? Why not?

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26. Over the last year, how many times did you go to Huquq for a dispute?

27. How and when do you decide to go to Huquq?

28. For what kind of dispute you involve Huquq more often? Why?

29. Does involving Huquq help resolve the dispute?

30. Does involving the Huquq increase the cost or length of dispute? What are the costs or source of delay?

31. Do you like involving Hququ in a dispute? Why? Why not?

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32. Over the last year, how many times have you resorted to Courts to resolve a dispute?
33. How and when do you decide to go to Courts?
34. For what kind of dispute do you involve Courts more often? Why?
35. Do involving Courts help resolve the dispute?
36. Does involving the Courts increase the cost or length of dispute? What are the costs or source of delay?
37. Do you like involving Courts in a dispute? Why? Why not?

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38. Have you known any businessmen who have resorted to threats to persuade other party to resolve a dispute?
39. When and how do you think businessmen decide that they need to threaten the other party?
40. For what kind of disputes, and against what kind of people, do you think businessmen are more likely to resort to threat?
41. Is threatening the other party has been an effective way to resolve a dispute when it is used by other businessmen? Why? Why not?

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42. Can you estimate, over the last year, how many times did you resort to police station for a commercial dispute?
43. Can you estimate, over the last year, how many disputes do you know of that at one point involved police?
44. Why did you or the disputants that you know resort to the police?
45. What is usually the result when you or the people you know go to the police?

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46. What are other ways you use to resolve a dispute? Describe?
47. How and when do you decide to resort to these methods?
48. Are they effective?

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E) Access to Credit (40 questions)

1. Can you estimate, what percentage of your supply do you acquire on credit?

2. Can you estimate, how many suppliers do you buy have business with?
3. Do you have a credit line with all of them? If No, what determines whether you a have cash or credit relations with a supplier?
4. Do you acquire your cash and credit supply from the same supplier? Why? Why not?
5. Do you have relations with several suppliers to procure the same product?
6. If answer to question number 5 is yes, why do you maintain relations with several suppliers for procuring the same product?
7. Why do you think suppliers give you credit?
8. Do you have personal relations with all of your suppliers?
9. What is your payment schedule to your suppliers? Do you pay them regularly or do you use different schedule for each contract?
10. How much can your increase your credit supply and how fast?
11. What does it take to increase your credit supply? Explain?
12. If someone offered lower price for your supply, what would you do? Do you switch suppliers? Why? Why not?

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13. Do you have a bank loan(s)? If the answer is yes, answer the following questions:
  14. From how many banks? What is the rough estimate of total amount?
  15. What form are the loan(s) in? (loan, murabaha, ijara, etc.)
  16. For what use did you take the loan(s)?
  17. What kind of collateral generally barrowers provide for the loan(s)?
  18. Did you know anyone from the bank personally before you applied for the loan?
  19. What were the factors that you considered when you decided to apply for a loan? (E.g. interest rate, religious doctrines, etc.)
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20. Do you owe Sarraf(s) money? If the answer is yes, answer the following questions:
  21. To how many Sarraf(s) do you owe money? What is the rough total of the debt?
  22. What form are debt(s) in? (loan, murabaha, ijara, etc.)
  23. What are the sources of debt? For what use did you take the money from Sarraf(s)?
  24. What kind of collateral is generally required for the debt, if any?

25. If you did not provide collateral, how do you think Sarraf(s) know they can trust that you will repay the debts?
26. Did you know the Sarrafs personally before you acquired the debt?
27. Can you estimate, how long did you have a relation with the Sarraf before you acquired the debt? How long personally? How long professionally?
28. What are the conditions of a debt?
  - a. Do you pay interest? How much?
  - b. What are your repayment schedules? Are they regular or debt-specific?
29. What were the factors that you considered when you decided to acquire a debt from a Sarraf? (E.g. interest rate, religious doctrines, etc.)
30. Do you prefer Sarrafs to banks? Why?
31. Is there a source of credit that you prefer to Sarrafs? (E.g. family and/or friends, suppliers, banks or etc.) rank them

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32. Over the past year, have you wanted to expand your business? (e.g. open a new store, enter a new line of business, expand your inventory, produce new products) if answer is yes, answer the following questions
  33. Have you been able to expand your business partially or completely as you wanted?
  34. What were the main obstacles for expansions?
  35. Was access to credit one of the main obstacles?
  36. Which one of the following sources of credit have you tried for expansion, and what was the result?
    - a. Family, relatives, and friends:
    - b. Sarrafs and money dealers:
    - c. Banks and moneylenders:
    - d. Suppliers and business partners:
    - e. Starting a partnership with someone:
  37. What were the factors that you used to decide for and against any of the above options?

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38. Over the last year, have you faced cash shortage?

39. Which one of the following sources of credit did you use to solve your liquidity problem, and what was the result?
- a. Family, relatives, and friends:
  - b. Sarrafs and money dealers:
  - c. Banks and moneylenders:
  - d. Suppliers and business partners:
  - e. Starting a partnership with someone:
40. What were the factors that you used to decide for and against any of the above options?
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F) Networks (3 questions)

1. List five suppliers that you do most business with; describe your relationships with them and how you first got to know them.  
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2. List five customers that you do most business with; describe your relationships with them and how you first got to know them.  
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3. List your five source of credit; describe your relationships with them and how you first got to know them.