

## **ESSENTIAL OILS AND NATURAL PERFUMES: A RURAL DEVELOPMENT OPPORTUNITY IN AFGHANISTAN - GULESTAN ARIANA COMPANY**

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Case study prepared for the Enabling Environment Conference

### **I. CONTEXT AND BACKGROUND**

Gulestan<sup>1</sup> Ariana Company **produces essential oils and floral waters for fragrance, personal care and pharmaceutical products.** The company operates a distillery in Jalalabad and supports the development of organic rose plantations in Afghanistan. It has also started wild plant collection<sup>2</sup> in the remote Hisarak district of Nangarhar.

The idea of the company started in 2003 in Kabul, in the context of discussions about potential **economic alternatives to opium poppy production.** The horticultural crops needed for the fragrance, personal care and pharmaceutical industries are high-value, labor-intensive, with excellent export prospects and could therefore be ideal licit substitutes for opium poppy production. It is also the type of industry singled out for attention by the Interim Afghanistan National Development Strategy:

“The ideal type of agricultural activity for Afghanistan is labor-intensive production of high-value horticultural crops that can be processed and packaged into durable high-value, low-volume commodities whose quality and cost would be adequate for sale in Afghan cities or export to regional or world markets.” I-ANDS (chapter 5)

Initial market research was financed by UNDP and carried out by Altai Consulting in Kabul and Paris. The study indicated that a private company would be best able to foster development of this sector. Gulestan Ariana Co. Ltd officially registered as an Afghan company in December 2004.

Private investors, both Afghan and international (French and American), started Gulestan by investing US\$ 88,000 in capital. FKH Group, Barnett R. Rubin, Mathieu Beley and others decided to invest capital in this venture. Gulestan shareholders understood that **restarting an industry from the ground up would be a difficult business, with the initial focus being more on the development contribution of the endeavor rather than on significant economic returns on investment.**

In the long term, the opportunity for Afghanistan is sizeable. Natural raw materials (including but not limited to essential oils) represent US\$ 900 million worldwide. Rose essential oil is a US\$ 20 million market.

The main producers of rose essential oil (Bulgaria, Turkey) and orange flower essential oil (North Africa) are becoming more expensive with the cost of labour in rural areas. Afghanistan may be part of the next wave of producers. These flowers

represent thousands of hectares and rural livelihoods in producing countries.

The main focus to date has been on roses and orange flowers. Gulestan identified a local variety of scented roses (*Rosa Damascena*) and has started reproducing them in nurseries. There are many bitter orange (*naranj*) orchards around Jalalabad. In 2007, Gulestan harvested 1.5 tons of *naranj* flowers and obtained two kilograms of *néroli*, the essential oil of orange blossom. French perfumers in Paris and Grasse tested the 2006 production and would like the company to produce much more of it.

**Worldwide production is more than two tons of essential oils, mostly produced in North Africa, and Afghanistan could ultimately take a decent share of this market.**

But rural capacity building is the issue. It has been very difficult to convince farmers to invest in production of flowers, since it is not yet an established industry.

This case study discusses the **challenges Gulestan has faced thus far in establishing and running its business**. Issues have emerged particularly in the areas of taxation, infrastructure (roads and electricity) and human capacity. It also includes issues that are more specific to this industry, namely working with donors and the civil society on building agricultural capacity.

## II. EXPERIENCES OF GULESTAN TO DATE: KEY ISSUES

Since the start of its operations, Gulestan has been faced with a range of issues that are common to many new enterprises in Afghanistan. This section lays out steps that have worked well and other areas that have been impediments to a smooth start-up of operations.

### Setting up the company

Registering the new company with AISA was very easy. AISA worked very efficiently throughout the registration process. Since starting the company in December 2004, dealing with AISA has been without issue.

### Access to land and utilities

Nangarhar Valley Development Authority (NVDA) operates an olive oil factory in Hadda Farm next to Jalalabad. NVDA management let Gulestan install a distillery within the olive oil factory. Gulestan

used factory space, access to water, a Russian-built steam generator and the help of Russian-trained engineers.

In the fall of 2006, Gulestan was prevented from accessing the olive oil factory for more than two months because it was being used as the elections HQ for Nangarhar. More recently, in the Spring of 2007, Gulestan was not able to use the equipment in the olive oil factory during critical orange blossom season because of a management issue at NVDA (NVDA's Director was jailed on corruption charges, while lower management was afraid of making any decisions).

### Installing the Jalalabad Factory

The distillery equipment was purchased in Turkey in March 2005, half of the cost of which was financed by a U.S. Department of Agriculture matching grant obtained through CNFA's Afghanistan Agricultural Development Program.

When the distillery was imported from Turkey, **bad roads and a lack of capacity at the Islam Qala customs point**, as well as the requirement that all cargo had to be packed and unloaded into Afghan trucks, delayed the arrival of the equipment. As a result, the new company missed the spring season by a few days in 2005. This delayed our work by a full year.

### Taxation

The **tax regime and the process of paying taxes are very burdensome**. Key issues are listed below:

- ◆ **High tax burden for starting businesses:** The fledgling company already had to pay taxes before having made any revenue: a 24,100 Afg (US\$ 480) fee was collected to register the balance sheet from 1383 (2004-2005). This is a fixed amount regardless of the size of a company, thereby imposing a heavy cost on small companies that join the formal sector. With the addition of the AISA registration (US\$ 700), **Gulestan had to spend more than two percent of its initial US\$ 50,000 capital on taxes in the first half year of operations, before production even started.**
- ◆ **Complicated, labor-intensive and non-transparent process of paying taxes:** While the new tax law suggests that meeting tax obligations is easy, actual interactions with the *mustufiat* have been complicated. Despite the fact that the forms were filled out on the basis of a careful reading of the tax law, **it took a Gulestan employee more than two weeks time to complete the tax filing**

**process.** The unwillingness to pay any money that could not be accounted for (by getting a receipt) made it difficult for him to complete this process.

When Gulestan reported this problem to the Ministry of Finance, it was asked to go to the **Large Taxpayer Office (LTO)** and was able to work directly with the LTO's professional advisers, foreign and local alike, who helped make decisions regarding accounting and amortisation regulation.

But Gulestan is still required to pay taxes with the *mustufiat*, and is currently experiencing major problems in paying taxes.

- ◆ **Antiquated tax paying methods:** All taxes must be paid in cash and in person, because of a lack of checking or electronic payment systems. For example, the company has to withhold taxes from its employees' wages every month, and is required to pay in cash and in person every month, which takes two working days. Gulestan would prefer to pay at the end of the quarter instead. Eventually, the company should be able to pay through check or an electronic payment system.
- ◆ **Uncertainty about tax laws and nuisance taxes:** On his first visit to LTO in June 2006, Gulestan's CEO asked advisors how much tax would be charged on its local product sales and was told that two percent BRT would apply, which was consistent with the written tax law. But on a subsequent visit, he was told that an extra 10 percent tax would apply to all sales, including past sales. This tax, *mal e mawad e estehelaqi*, is part of the old tax law; it has been identified as a "nuisance tax" by Ministry of Finance advisers, but Gulestan is still obliged to pay it, although the rate is not yet clear (perhaps six percent rather than 10 percent). **It is a major problem for a fledgling company to not know how much tax it must pay on past and present sales.**

### Skills development

Operations started at the olive oil factory in Jalalabad. The French-based Robertet, a world leader in natural raw materials for perfumery, sent an engineer to help train the team on a pro bono basis. As a result, Gulestan now has a well-trained master distiller.

Beyond the successful training of a master distiller, Gulestan needs to train technicians, farmers and wild plant harvesters. **No expertise from universities or ministries is available to help with training.** (Any knowledge there of organic agriculture or wild plants is not used systematically and takes a lot of research to find.)

**Trained accountants and engineers are very difficult to find**, as these professions are in very high demand. The demand for skilled workers far exceeds the current supply, leading to higher labor costs and therefore higher production costs. All these points add up to make production relatively expensive in Afghanistan.

Employees that have been trained by Gulestan are very happy to work in a new and promising industry. But they are getting offers for much better salaries in United Nations or NGO offices.

### Physical infrastructure

**The lack of infrastructure, roads in particular**, constantly causes delays, bottlenecks and high costs. The very bumpy roads to rural areas of Nangarhar prevent economies of scale by reducing the area that can be covered with a distillery. Flowers have to be brought to the distillery within a few hours of harvest. The journey from Hisarak to Jalalabad would take only a few hours on a good road, but the actual travel time is over eight hours. Hence, the distillery cannot use fresh materials from Hisarak for production in Jalalabad.

### Central government cannot ensure security and rule of law

**Gulestan cannot rely on the Government to provide security, and it cannot rely on the courts to resolve any disputes.** It has no way to operate in Nangarhar or to contact local villagers except through the tribal structure, which is dominated by a few big families. Although this structure has enabled the company to enjoy security and to have access to villages and other properties from which they purchase raw materials, and find space and land to locate their facilities, it makes it more difficult for Gulestan to maintain autonomy.

*This has implications in terms of:*

- ◆ Not being able to maximise the social benefits of operations, as these families monopolise the role of intermediary between the company and the society
- ◆ Running a risk of being drawn into interfamily rivalries that could negatively affect the company
- ◆ Not being able to steer clear of the competing politics of the various clans
- ◆ Having to constantly allocate resources to the balancing act that is required in order to reduce insecurity. This takes energy away from focusing on the company's core operations

### **Working with rural communities: developing agricultural capacity by involving civil society?**

The main flowers on which Gulestan focuses are roses and orange flowers. Unexpectedly, it turned out to be very **difficult to convince orange garden owners to work with the company**. They are afraid of losing their fruit production, even when experts agree that harvesting flowers actually improves fruit production and quality. In other countries, farmers hire harvesters themselves and bring the flowers to the distillery. But in Nangarhar, Gulestan has to pay first (to get access to the gardens) and also carry out the harvesting.

It is difficult to **find farmers who are ready to plant roses**. It will take some time for the roses to produce flowers, thus farmers need public support in order to plant roses. Overall, **agricultural capacity remains an issue as farmers are not able to invest in new crops and market opportunities, and they demand support (usually in cash) before taking any risk**.

It has been **difficult to raise funds for programmes aimed at helping farmers plant flowers**. Gulestan, as a private company, cannot invest in farming capacity. Gulestan invested in a distillery, and provides access to the market. The management is trying to **convince more donor-funded programmes to help farmers invest in this market opportunity**.

A potential solution to this problem might be through working more closely with civil society, by encouraging farmers' groups to own distilleries and produce essential oils. The company is currently trying to build sustainable relationships with groups of farmers.

UNOPS recently provided funding for a *shura* in Nimla Bagh (a mughal garden in Khugyani district of Nangarhar) to plant roses and build a distillery on government land. But with no effective enforcement of contracts, and lack of transparency in the Government, Gulestan is not sure to be able to work efficiently with this community in the long run.

Gulestan has not been able to find support for groups of farmers to plant roses on their private land. Consequently, Gulestan is thinking of starting a non-profit entity that the company would contribute to while looking for other sources of funding which would specifically focus on supporting farmers that want to plant roses.

### **Coordination or competition with public (donor-funded) projects**

As donors get involved in income-generation programmes, there is a risk of creating unfair competition to the private sector, if these programmes are not properly coordinated. For example, German Agro Action (GAA) obtained funding to build a distillery and plant roses that it imports from Bulgaria into Nangarhar, with the objective of producing rose oil for a German company. Today the GAA team is planning to sell their distillery to a new private company that they would create for this purpose. This could create **unfair competition**, since the distillery at stake was started using grant money and NGO personnel.

Gulestan is now working on **fostering consultation with donor-funded programmes in order to develop win-win relationships: donors and NGOs should focus on increasing agricultural capacity, while Gulestan provides distillation expertise and access to markets**. Recently it found two interesting partners who are ready to plant roses and other flowers in nurseries and pilot farms in order to help build agricultural capacity, namely AKDN in Badakhshan and MRRD in Shomali.

### **International standards do not include Afghan products**

Several medicinal and aromatic plants are found only in Afghanistan, and are famous for their uses in the traditional *unani dawakhana* medicine. But there has been **no modern research concerning these plants and their medicinal uses. Many of these plants are not registered as raw materials on important American and European markets, and thus cannot be exported there**.

In addition, traders of neighboring countries have been adulterating the products for a long time. Today, where international standards and market prices for resins (such as galbanum or asafoetida) or their essential oils do exist, they are based on the adulterated product, which makes it difficult for Afghanistan to position itself in the world market.

With high production prices and low bulk prices for essential oils on world markets, Gulestan will need to focus on value-adding segments, such as perfume, naturals and organics, fair trade and direct sales to end consumers.

Certification (for organic agriculture, sustainable use of wild resources) is very costly in Afghanistan, since certification bodies have not yet established operations here. Import regulations on finished products (especially cosmetics) make it difficult to

reach end users in foreign countries without going through importers or traders.

### III. CONCLUSION AND RECOMMENDATIONS

Gulestan has been successful at building processing capacity in Nangarhar. The quality of essential oils obtained so far has been very good, and markets are showing interest. The **main difficulty is to scale up.**

Gulestan's leadership is convinced that **until the Government addresses the obstacles listed above, normal investors will still hesitate before investing in Afghanistan. The I-ANDS and the Afghanistan Compact contain commitments to addressing all these issues. These commitments must be made into realities soon for Afghanistan to extricate itself from poverty and insecurity.**

In addition to the above raised issues, Gulestan believes that the following steps would make sense:

1. Identify agro industries that have potential (e.g. essential oils, juice concentrates, medicinal plants), and invest in expertise to help farmers with these. Expertise can be available close by, in neighboring countries.
2. Help civil society to invest in agricultural and post-harvest capacity to take advantage of market opportunities and create non-farm employment.
3. Help private companies gain access to international markets and add value to Afghan products. For example, public initiatives could help create an Afghan brand or certification, especially when it comes to traditional (organic) agriculture or sustainable exploitation of biodiversity/wild plants.
4. Donors should work with private companies to identify key infrastructural needs (e.g. roads and agricultural capacity) and address them to facilitate access to markets.
5. Aid systems should have one-window shopping for project needs, since the current system wastes an incredible amount of time.
6. Transparent, simple procedures should be available to help law-abiding companies pay taxes smoothly.
7. Industrial parks with subsidised access to power and water should be made available for agro industries.

### IV. DISCUSSION QUESTIONS

1. What measures would help newly starting businesses to get started smoothly and at reasonable costs? Specifically:
  - a) How can the high tax burden for starting businesses, particularly SMEs, be alleviated? Is it possible to reduce costs related to the AISA licence and the registration fee for balance sheets, particularly for SMEs?
  - c) Would a substantial lowering of these costs provide an effective incentive for SMEs to enter the formal economy?
2. How can bureaucratic procedures at customs be streamlined to increase planning security and decrease time lost at customs and associated costs?
3. Gulestan has experienced very burdensome, expensive and unpredictable tax paying obligations. Are the experiences described in the case study representative of SME problems with tax paying authorities? Specifically,
  - a) How could the process of paying taxes be made less labour intensive? For example, are there alternatives to having to pay taxes in person on a monthly basis?
  - b) How could transparency and clarity about tax paying obligations and procedures be improved?
4. Companies that are processing agricultural products in Afghanistan often face a problem of unreliable, low quality supply of raw materials. How can agricultural capacity be strengthened to increase opportunities for processing/value adding activity? Specifically:
  - a) Would the promotion of a more organised rural civil society, for example through strong farmers' associations, facilitate better interface between producers and processors and also provide an effective channel for capacity building measures? How could such organisations be supported by government, civil society and private sector?
  - b) Often, farmers are opposed to the introduction of new crops or methodologies, as they cannot take any risks associated with new products. Are there solutions to this problem? How can the risk for farmers be lowered and information flow on new crops and technologies improved?
  - c) Could international aid be better targeted to support agricultural capacity and thus contribute to an enabling environment for rural, private and non-farm economic activities?

5. What can government do to improve domestic companies' access to international markets? For example, through introducing quality certificates and facilitating/promoting the registration of Afghan products on international markets?

6. The lack of qualified staff is a recurrent theme in many accounts of businesses, and costs related to recruitment and training are particularly high for SMEs. Are there possible short- and medium-term solutions to this problem? Would the introduction of short-cycle, certificate level education in areas such as accounting, bookkeeping, office skills, etc. provide relief to the private sector?

*This case study was prepared by the President of Gulestan Ariana Co. Ltd., Mathieu Beley.*

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<sup>1</sup> Gulestan means "rose garden." Gulestan is also the title of a 13<sup>th</sup> century mystic poetry book by Saadi of Shiraz. Ibn Sina, the famous doctor and philosopher who was born in Balkh in the 10<sup>th</sup> century, invented the refrigerated coil and thus distillation as we know it. In Jalalabad, orange blossoms are celebrated with a Pashto language poetry festival held annually in April. Flowers and perfumes are important topics of sufi poetry.

<sup>2</sup> The biodiversity of wild plants and flowers also offers a huge economic potential for Afghanistan: The biodiversity of wild plants is exceptional, and knowledge of the traditional medicinal uses of local plants has been preserved in *unani dawakhana* (Greek pharmacy). Medicinal plants are a specialty of Afghanistan that can be (re-)developed to tap their economic potential.