

# **The Role of Small Medium-Sized Enterprises in Economic growth of Afghanistan**

## **Challenges and opportunities**

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## Abstract

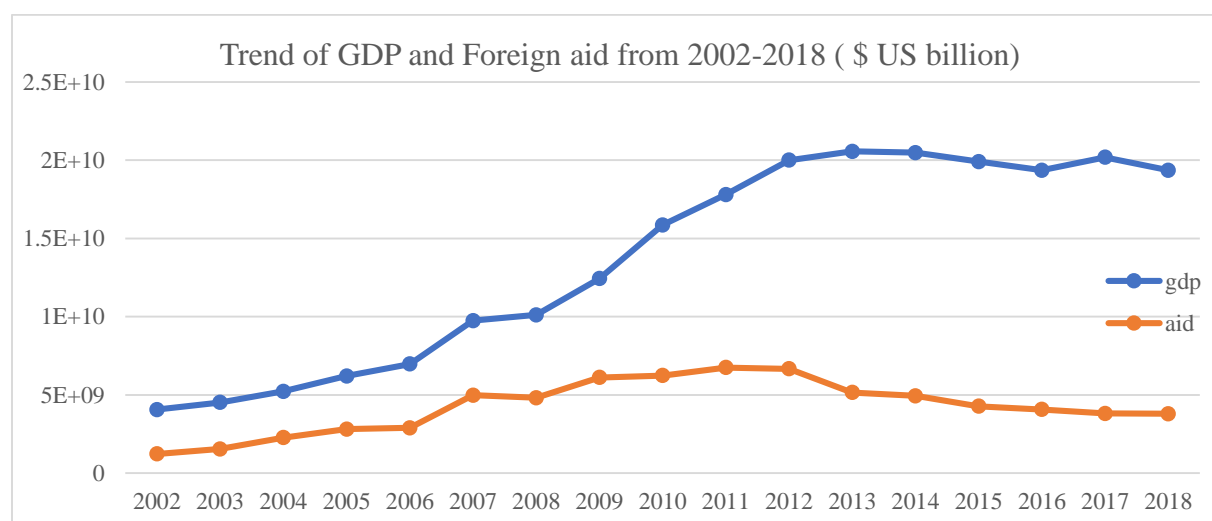
This paper examines the role of Small Medium-sized Enterprises (SMEs) in the economy of Afghanistan. Even though SMEs in Afghanistan, as a least developed country, are an engine of economic growth, they are in a fragile state due to several obstacles, including political instability, insecurity, corruption, informality, and a few others. The private sector is dominated by SMEs, estimated 98.5 percent of the business, and contributes considerably to Afghanistan's economic development (20 percent of gross domestic products per capita). In Afghanistan, informality plagues SMEs, with nearly 70 percent of them operating in the shadow economy. This study highlights the Afghanistan SMEs' strengths, weaknesses, opportunities, and threats. Therefore, this paper recommends that the government should get involved in developing policies to assist SMEs in flourishing in the country's economy.

## Introduction

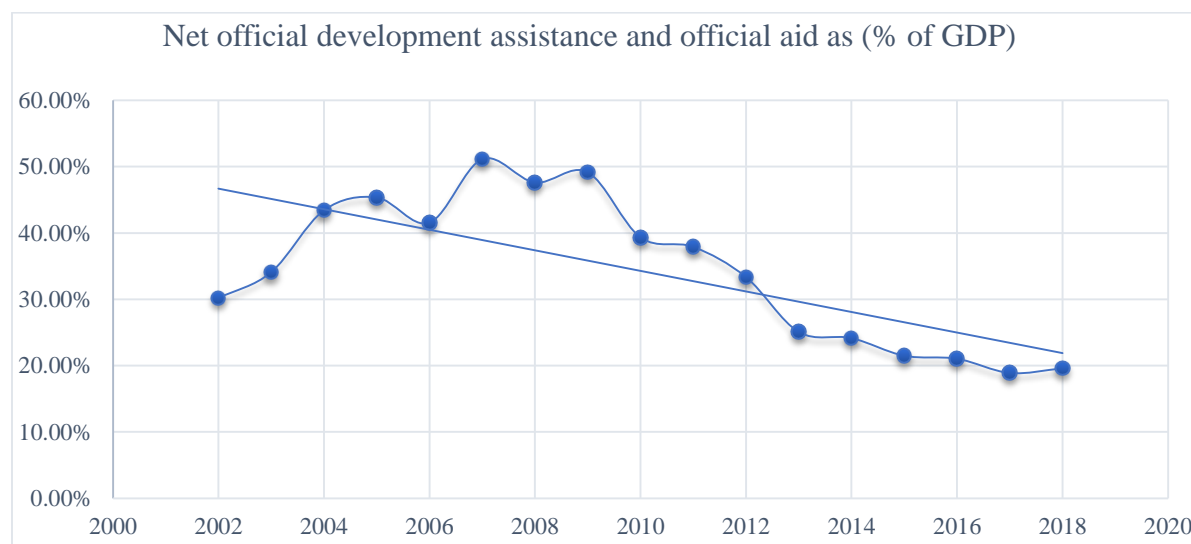
Small Medium-sized Enterprises (SMEs) play a significant role in the economy of developing countries. Afghanistan as an underdeveloped country deals with major issues such as insecurity, corruption, lack of access to finance, and a few others. Given these, the flow of investment in large businesses is less and SMEs are accounted as an engine for economic growth. According to a Business Establishment Survey (BES) in 2015, there are about 700,000 formal businesses in Afghanistan, which have a significant contribution to economic growth, accounts for 20 percent of Gross Domestic Product (GDP), and provides job opportunities for around 1.4 million people (20 percent of the total labor force). However, due to security concerns at the time of data collection, the BES survey excluded two of the thirty-four provinces (Kunduz and Faryab provinces) and failed to account for businesses largely engaged in agriculture, mining, small-scale construction, transportation, and banking insurance (Central Statistics Organisation, 2016). This paper argues that if these two provinces and the mentioned enterprises above are considered, the share of SMEs in GDP and labor force engagement would be greater.

In addition, with a tremendous flow of foreign aid since 2001 that coincides with the invasion of Afghanistan by the US and its allies, the government has been distracted to invest in the development of SMEs. On the contrary, international aid forms a significant share of Afghanistan's GDP which jeopardizes the country's economy and dependent on foreign aids. As it is described in *Figure1* the trend of GDP and foreign aid. Until 2014, the trends were similar, but after that,

Afghanistan's economic growth slowed due to a fall in foreign aid. Similarly, *Figure 2* shows net official aid as a percentage of GDP, indicating a large proportion of GDP and a reliance on grants.



*Figure 1:* Trend of GDP and Foreign aid from 2002-2018(\$ US billion-dollar)(Adapted from the World Bank 2018) (*World Bank, 2018*)



*Figure 2:* Net official development assistance and official aid received (current US\$) as a percentage of GDP: (Adapted from the World Bank 2018)

Currently, the government is focusing on SMEs' growth, which stabilizes the economy and minimizes reliance on foreign aid. Reduced business registration fees, easier access to new ports on the worldwide market, and increased cross-border trade are only a few of the initiatives adopted.

The purpose of this article is to evaluate the importance of SMEs in Afghanistan's economic growth.

### Key Indicators for Afghanistan

Afghanistan, located in South-West Asia, bridges Central Asia with South Asia through the Silk Highway. According to the National Statistics and Information Authority in 2019, Afghanistan's population is estimated at 32.2 million, with a male-to-female ratio of 1.03<sup>1</sup> (Central Statistic Organization, 2019). While the GDP is estimated at around \$19.363 billion (World Bank, 2018), the Statistic Times has ranked Afghanistan among the countries with the lowest GDP (183 out of 192 countries). The average GDP per capita in 2019 was \$520.89 (Statistic Times, 2020). Afghanistan is highly dependent on goods imported from its neighbors, particularly Iran, Pakistan, and Central Asian countries. Imports of goods account for 45.33 percent of the country's total GDP. The percentage of exporting to GDP, on the other hand, is 5.9%, indicating a significant deviation. Afghanistan is currently grappling with bad security, corruption, a lack of infrastructure, and restrictions on business investments, all of which have a detrimental impact on the flow of foreign direct investment, which accounts for only 0.6 percent of GDP (World Bank, 2018). Corruption has been a major problem in Afghanistan, and it is one of the main obstacles to development. Afghanistan is ranked 173 out of 180 countries on Transparency International's Corruption Perception Index (CPI) (Transparency International, 2019). Similarly, Afghanistan is ranked 173rd out of 190 countries, with a score of 44 out of 100, on the Ease of Doing Business index, which measures how easy it is to do business. Ease of doing business is a composite index made up of ten elements (explained in the following table 1). This ranking takes into account not only the overall ranking but also the rankings for each factor. (For further information, see table 1.) (World Bank , 2019).

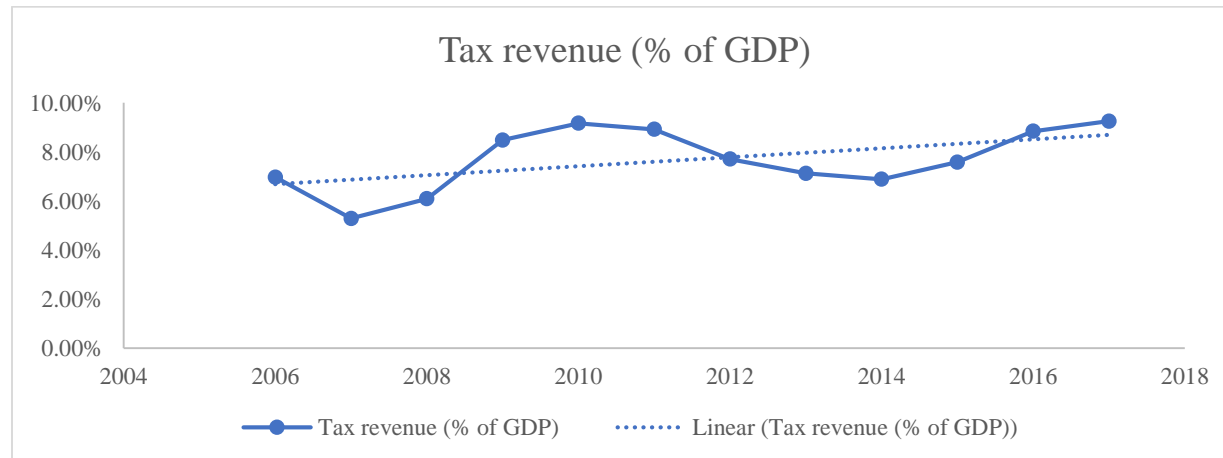
Table 1 Ranking on doing business topics (1-190)-Afghanistan

Factors	starting a business	Dealing with construction permit	Getting electricity	Registering property	Getting credit	Protecting minority investors	Paying tax	Trading across border	Enforcing contract	Resolving insolvency
ranking #/190	52	183	173	186	104	140	178	177	181	76
score#/100	92	34.5	44.2	27.5	50	36	42.2	30.6	31.8	51.9

<sup>1</sup> Male and female in sequence population is 16.4million and 15.8 million.

Afghanistan is well-positioned to establish a business, as indicated in Table 1. This is owing to several measures implemented by the Afghan government in 2019, such as making the registration procedure easier and lowering the registration fee. For instance, the licensing fee for small and medium businesses were \$100 and \$700, respectively. (Khaleeq, 2015), which is reduced to \$1.33. On the other hand, registering property rights in the country is a complicated and non-transparent process. In terms of credit availability, the government has implemented some initiatives, including creating a new insolvency law, protecting minority investors by mandating greater disclosure or transaction with interested parties, developing new tax administration, and streamlining tax revenue collection. Furthermore, the government improved the resolving of insolvency issues reforms in 2019 by adopting the restructuring procedure and providing creditors greater participation in the proceedings, as well as continuing the debtor's business throughout insolvency proceedings (World Bank, 2019).

Taxation is a significant source of revenue for all governments. In Afghanistan, tax revenue accounted for 9.25 percent of total GDP in 2017. That was because, since 2014, tax revenue has increased as the flow of international aid has declined. As it is described in the following *figure 3*.



*Figure 3: Tax revenue (% of GDP) (adopted from the World Bank 2018) (World Bank, 2018)*

### Definition of Small and Medium Enterprises (SMEs)

SME is primarily measured in terms of country contexts since there's no widespread consensus on a single definition. In Afghanistan, micro, small, and medium enterprises (MSMEs) are classified by the number of employees and the amount of capital invested. MSMEs in the services and manufacturing sectors, according to the Organization for Economic Co-operation and

Development (OECD), are companies with less than 100 employees and less than 10 million Afghanis [\$150,000] in investment (OECD, 2019). Table 2 in particular gives a thorough review of each Afghan enterprise's definition.

Table 2: MSMEs in Afghanistan (adopted by the ministry of industry and commerce) (*Ministry of Industry and Commerce, 2018*)

No	Type of enterprise	# of employees	Investment in equipment	
			Manufacturing sector	Service sector
1	Micro	<5	<2.5million AFN	<1 million AFN
2	Small	5-19	2.5-5 million AFN	1-2 million AFG
3	Medium	20-99	5-10 million AFN	2-5 million AFN
4	Large	>100	>10 million AFN	>5 million AFN

Micro-enterprises, as stated in table 2, have fewer than five employees and an initial investment of less than 2.5 million AFN in the manufacturing sector and less than one million AFN in the service sector. Similarly, the number of employees and amount of investment vary for small, medium, and large businesses. For instance, Small businesses (5-19 employees) invest (2.5-5) million AFN in manufacturing and (1-2) million AFN in services. China, on the other hand, classifies SMEs based on the kind of sector, number of employees, total assets, and company revenue, according to Liu Xiangfeng. Companies with fewer than 600 staff, less than 40 million Yuan<sup>2</sup> of initial investment, and less than 30 million Yuan in annual revenue are called small enterprises. However, Medium enterprises are companies with fewer than 3,000 employees, 400 million Yuan in total assets, and 300 million Yuan in annual revenue. (Xiangfeng, 2008). This discrepancy demonstrates that SMEs do not have a unified definition. Figure 4 depicts a comparison of MSMEs classifications across nations in terms of employment criteria.

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<sup>2</sup> Exchange rate between yen and USD dollar (\$1= ¥7.14)

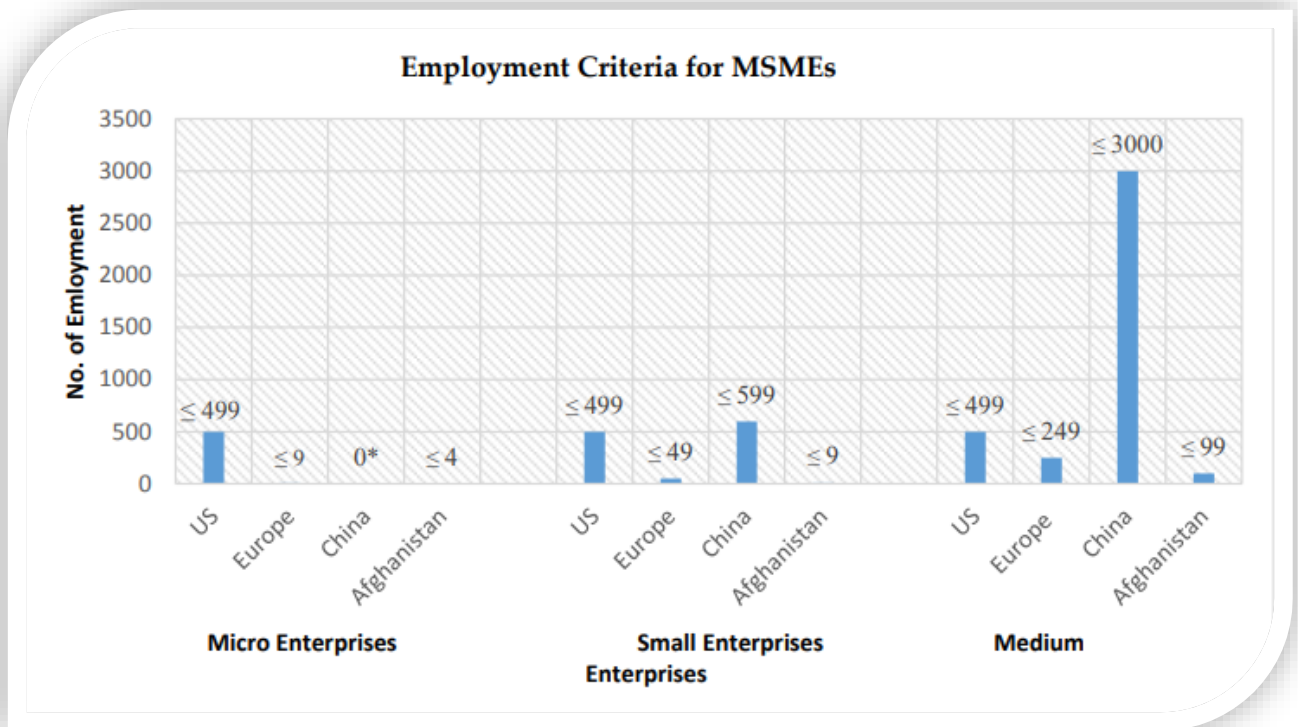
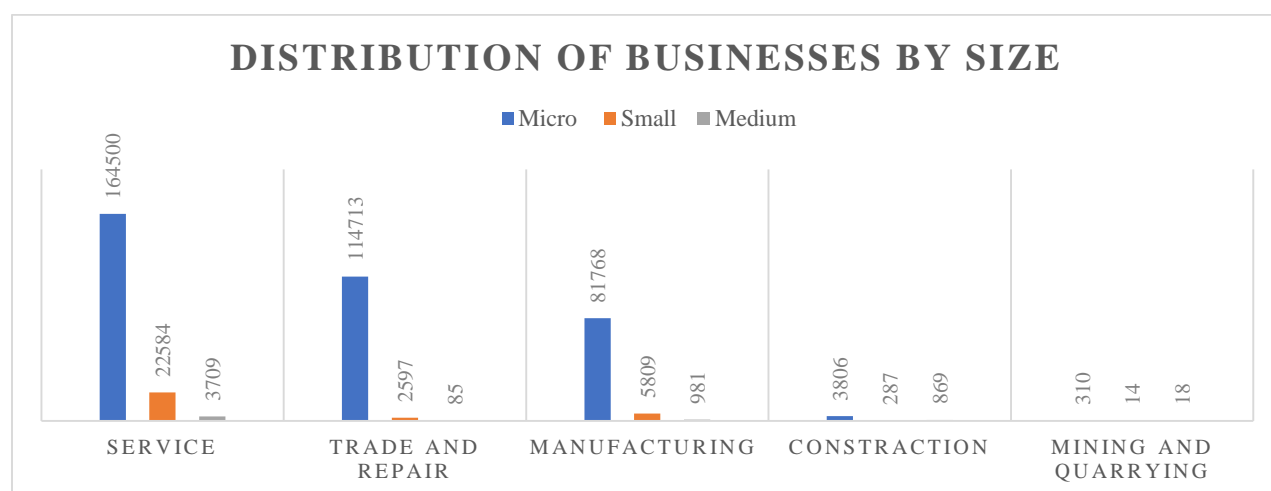


Figure 4: indicates there is no definition available for the country, according to Xiangfeng (2009)

#### SMEs and Economic Growth in Afghanistan

Since 2002, the trajectory of Afghanistan's economic activities has risen. Although there have been some ups and downs in various years (see figure 1), Afghanistan's GDP increased from \$4.5 billion in 2002 to \$19.3 billion in 2018. The economy has performed well in the first decade, with an average annual growth rate of 11% from 2003 to 2013 (Najafizada, 2014). Although agriculture is important to Afghanistan's economy, as Izabela Leao mentioned, 70% of Afghans live in rural regions and agriculture generates 61% of their family income (Leao, 2018), agriculture's contribution to GDP has dropped in recent years. On the contrary, the percentage of industries and services has increased. Agriculture accounts for 25.52 percent of Afghanistan's overall GDP, while industries provide 12.13 percent and services 57.38 percent, according to the National Statistics and Information Authority of Afghanistan (Central Statistic Organization, 2019). Due to the importance of the private sector in in-country growth, the private sector in Afghanistan is dominated by SMEs, which account for 98.5 percent of all businesses (OECD, 2019). Furthermore, micro-enterprises in Afghanistan have an impact on SMEs. According to the Asia Development Bank's Integrated Business Enterprises Survey, roughly 402,044 businesses operating in

Afghanistan's economy in 2009, with over \$8 billion invested in various sectors (See *figure 4* for further details) (Asian Development Bank, 2009).



*Figure 4: Distribution of SMEs by Size (adopted from the Asian Development Bank 2009) (Asian Development Bank, 2009)*

The government of Afghanistan's strategy for SMEs was established in 2009 (Ministry of Commerce and Industry, 2011). The idea behind this strategy was to reduce poverty, enhance job creation, and develop competition among domestic and foreign SMEs. SMEs in Afghanistan create over 50% of GDP and employ more than 75% of the labor force, demonstrating their importance in providing job opportunities. The industries considered for this purpose are Processing wool, carpet weaving, cutting, washing, and trading; Marble quarrying, cutting and polishing; Gemstone mining, cutting and polishing for jewelry; Livestock skins and leather; Construction; Wood, timber and carpentry, and Agri-business (Ministry of Commerce and Industry, 2011).

### SWOT Analysis of Afghanistan's SMEs

Understanding the presence of internal and external elements is an integral part of emerging sectors, paving the way for them to improve their potential and overcome their obstacles. Therefore, the assessment of capability, resources, core competencies, and comparative benefits is taken into account by internal factors. However, by assessing market competitors, the state of the industry, and the general environment, the external environment clarifies market opportunities and threats. The rationale behind SWOT analysis is to apply an organization's understanding of its current situation and formulate its strategic strategy accordingly (Tannya Sammut-Bonnici, 2015)



SMEs in Afghanistan have both their strengths and weaknesses. In addition, the external business environment forges not only opportunities but also threats for SMEs in Afghanistan. This paper provides a SWOT analysis of Afghanistan's SMEs in Table 3 to illustrate the internal and external elements that determine their long-term viability.

Table 3: SWOT Analysis of SMEs in Afghanistan

Factors	Strengths	Weaknesses	Opportunities	Threats
<b>Internal</b>	<ul style="list-style-type: none"> <li>• cheap workforce;</li> <li>• legislative acts and strategies regarding SMEs;</li> <li>• Smooth and sustainable growth of SMEs;</li> <li>• Access to cheap raw materials;</li> <li>• Women's significant role in Afghan industries, such as agriculture, carpets, and handicrafts (embroidery);</li> </ul>	<ul style="list-style-type: none"> <li>• Weak institutions framework;</li> <li>• High, multiple taxes which accompanied by a complex taxation system;</li> <li>• Traditional financial systems, such as recording transactions in a large notepad and journals (poor use of financial software);</li> <li>• Insufficient investment strategy;</li> <li>• Weak marketing strategy;</li> </ul>	<ul style="list-style-type: none"> <li>• Government commitment to develop SMEs;</li> <li>• potential to move up the value chain of industrial production;</li> <li>• competitive advantages in some industries especially carpet;</li> <li>• Lack of human capital and managerial capabilities</li> </ul>	<ul style="list-style-type: none"> <li>• Inadequate research and development;</li> <li>• Inadequate quality of public services for businesses;</li> <li>• The high administrative requirement for SMEs;</li> <li>• lack of modern technology;</li> <li>• Lack of diversification in products and services;</li> </ul>
<b>External</b>	<ul style="list-style-type: none"> <li>• Access to international markets;</li> <li>• Facilities in trading across the border;</li> <li>• Low barriers to entry;</li> <li>• Long-term support of SMEs by the international organization;</li> <li>• Decreased substantially registration fee in 2019</li> <li>• rich in terms of natural resources;</li> </ul>	<ul style="list-style-type: none"> <li>• Insecurity and political instability;</li> <li>• Corruption and weak institutions;</li> <li>• Weak enforcement of regulation/legislation;</li> <li>• Domination of informal firms in the market;</li> <li>• Limited access to capital and credit;</li> <li>• Inability to compete with imported goods market (particularly in terms of price);</li> </ul>	<ul style="list-style-type: none"> <li>• Growth existing market;</li> <li>• Emerging new technologies recently;</li> <li>• Increasing firm's share from local to national markets;</li> <li>• Small enterprises play a major role in the economic growth and development of the country;</li> </ul>	<ul style="list-style-type: none"> <li>• High cost of production due to poor technology;</li> <li>• Political instability affecting the currency &amp; economy;</li> <li>• No business insurance;</li> <li>• Inadequate power supply;</li> <li>• Lack of access to the modern banking system (e.g. electronic transactions);</li> <li>• Lack of interest for new SMEs in the market due to the informal economy;</li> <li>• Lack of local SMEs' trust in the banking system;</li> </ul>

Table 3 demonstrates that in Afghanistan as an unstable state, weaknesses and threats outnumber strengths and possibilities for SMEs. This article examines some of the primary problems impacting SMEs' competitive capabilities, as well as government actions to help them grow in local, national, and international markets, in the following paragraphs.

### **SMEs Challenges in Afghanistan**

Governments are obliged to adopt rules to control bottlenecks and hurdles for enterprises, as these obstacles have an impact on their survival and growth. (Bannock, 2005). Political instability, corruption, access to finance, and informality are all important impediments for Afghan SMEs. The subheadings below highlight some of the most significant obstacles for Afghan SMEs.

#### **Political instability**

Twenty years after foreign intervention in Afghanistan, the country is still beset by a slew of conflicts, political unrest, and insecurity. Although the economy has grown, it is hardly serving the country's interests. The evacuation of international armed forces in 2014 could be one of the triggers. Political instability has a direct impact on security, and a lack of security reduces investment and entrepreneurship. SMEs are no exception, and political instability has a significant impact on them since it contributes to economic volatility. Following the 2014 election, the National Unity Government was formed, however it failed to provide the country with security. The author claims that the fundamental reason for the country's diminishing investment is security. The country's business investment was further harmed by a reduction in foreign aid. Because there is no guarantee for investment and investor safety, the investment stimulus has been reduced. Political instability, according to the Business Monitoring Report, is the primary source of insecurity, which remains a major issue for businesses and industries in Afghanistan (Afghanistan Chamber of Commerce and Industries, 2013). Furthermore, according to the World Bank's enterprise survey report, lack of security and political uncertainty was cited as one of the top concerns by 21% of the 356 entrepreneurs surveyed. (World Bank, 2014). Fortunately, the current government (elected in 2019) has prioritized security, and its efforts to engage in peace dialogues with the Taliban (a powerful anti-government party) offer hope for the future.

#### **Corruption**

Corruption as the abuse/misuse of authorized power for private interest (Transparency International, 2019), remains a major challenge for Afghan businesses. SMEs bribe Afghan officials to make administrative operations such as business registration, license extension, tax

payment, license cancellation, and so on, easier and more convenient. According to the World Bank's enterprise survey report, 17 percent of the 356 businesses surveyed viewed corruption as a serious risk to their progress (World Bank, 2014). Furthermore, corruption is a major factor in market rivalry, which hurts both the domestic and international markets. Mujib Mashal researched in Afghanistan on SMEs and regional trade. His findings reveal that corruption at border crossing points, particularly along Pakistan's southern and eastern borders, makes market competition incredibly challenging. Furthermore, he notes that corruption was recognized as the top challenge by 78 percent of surveyed business owners (Mashal, 2014). As a logical consequence, it's no surprise that Afghanistan is placed 173 out of 180 nations in the Corruption Perception Index.

#### [Access to Credit](#)

Another key stumbling block to SMEs' competitiveness in Afghanistan is a lack of financial resources. Loans and financial assistance are difficult to come by not only in Afghanistan but in all underdeveloped countries. SME development, life, and death, according to Peter Johnson, are all dependent on the availability of financing or the lack thereof (Jahnson, 2007). The finance conditions in Afghanistan do not match the needs of SMEs and startups, according to a 2015 survey by the Afghan Chamber of Commerce and Industries. According to the survey, 43.45 percent of the 290 firm representatives interviewed by phone found access to credit to be a key stumbling block (Afghan Chamber of Commerce and Industries, 2015). Constraints on both the supply and demand sides are included in this survey. The supply-side constraints are the financial system's and market environment's weaknesses, which include a lack of sufficient development of non-bank financial institutions to meet needs due to a lack of bank credit. However, Low financial literacy, poor and inadequate financial statement and bookkeeping maintenance, excessive collateral requirements, and high interest rates are all demand-side limitations (OECD, 2019). In addition, frequent loan repayments and loan disbursement amounts provide a hurdle in SME financing (Habibi, 2016), while banks, financial institutions, and donors currently provide funds for SMEs. Afghan United Bank, Ghazanfar Bank, First Micro Finance Bank, and Afghanistan International Bank are among these private banks. Fighting Poverty with Microfinance and Social Enterprise (FINCA), Mutahid Development Finance Institutions, Afghan Rural Finance Company, and OXUS are among the financial institutions. This initiative is also supported by several non-profit and non-governmental organizations (NGOs), as well as international donors. The US Agency for International Development (USAID), the Deutsche Gesellschaft für Internationale

Zusammenarbeit (GIZ), Hand in Hand Afghanistan, the Afghan Women Council, Hope for Life, and Exchanger Zone, for example, offer finance to SMEs. According to Alimadad Rasoli's research on the financing of SMEs in Afghanistan, the following impediments to financing SMEs exist:

- The Da Afghanistan Bank has no regulations governing SME financing (Afghanistan central bank).
- Young financial institutions/banks and weak private sectors, so the government does not have any supporting policies for these institutes and SMEs.
- The lack of professional business skills and SMEs' conventional management style.
- High-interest rates on loans (Rasoli, 2019).

The MISFA Small Medium Enterprises Program was launched in Afghanistan in October 2006, with financial support from USAID's ARIES<sup>3</sup> Project. Its SME loans are typically between AFN 250,000 and AFN 5,000,000. The MISFA SME program currently has four partners, including a commercial bank and three microfinance institutions. Table 4 provides the most recent MISFA SME lending statistics (MISFA, 2020).

*Table 4: MISFA Afghanistan's portfolio in SME lending through financial institutions*

<b>Key indicators</b>	
Active SME borrowers	1,034
Total number of loans disbursed (cumulative)	36,697
The total value of loans disbursed (cumulative)	AFN 18.02 billion
Loan outstanding	AFN 1.76 billion
<b>SME Loans by Sector</b>	
Trade and Service:	58.7 %
Handicrafts & Manufacturing:	27.2 %
Agriculture and Livestock	13.5 %
Housing Loans and Others	0.6 %

<sup>3</sup> Agriculture, Rural Investment, and Enterprise strengthening (ARIES)

In Afghanistan, the private sector is new and immature, and it requires government participation as well as appropriate policies to improve its competitiveness. Donors also help SMEs through a variety of projects, but this isn't enough. Banks and MFIs should be required to lend to SMEs by the government.

### Informal Businesses

Afghanistan's financial market is dominated by informal industries. They account for 70-80 percent of SMEs which operate under the shadow economy (Mashal, 2014). While informal enterprises reduce government tax revenue, they provide jobs and have a substantial impact on the economy and poverty reduction. Informality, according to Rafael La Porta and Andrei Shleifer, is a fundamental impediment to increased productivity, improved job creation, and more inclusive growth. In addition, the informal economy harms resource allocation, employment quality, and income distribution (La Porta, 2014). In Afghanistan's rural areas, agriculture employs the majority of the population, and the sector contributes significantly to the economy. While agriculture is still practiced in a traditional and non-modernized manner, their economic activities are not recorded and do not go through a formal process. As a consequence, informality has a bearing on rural areas. In addition, compared to other industries, agriculture requires comparatively little fixed capital investment (manufacturing, and services). The key drivers of SMEs' informality in Afghanistan, according to an OECD assessment, are as follows:

- SME formalization in Afghanistan is hampered by weak institutions and burdensome laws.
- The country's complex taxation system, which includes high rates and multiple taxes, has hindered the development and formalization of SMEs.
- The country's low-quality governmental institutions for business services hinder corporate productivity and formalization (OECD, 2019).

Considering SMEs contribute almost 98.5 percent of all enterprises in Afghanistan, and over 80 percent of SMEs are informal, informality is a critical concern.

### Conclusion

Afghanistan's reliance on foreign aid and military presence has decreased as the government views the private sector as a source of economic progress. Internal issues such as poor security, political instability, and low-quality institutions, on the other hand, continue to stymie large-scale investment flows in the country. Small and medium-sized enterprises (SMEs) form the backbone

of Afghanistan's private sector and play a critical role in the country's economic growth, accounting for 20% of gross domestic products. SMEs also employ 20% of the workforce in the country. Political instability, corruption, limited access to finance, and the dominance of the informal sector (SMEs' informality) are the critical issues to strengthening SMEs in Afghanistan.

### Policy recommendations

Policy recommendations for SMEs in Afghanistan are based on the SWOT analysis in table 3. The author realizes that political instability and corruption are the primary drivers of insecurity and economic vulnerability in Afghanistan's government. However, moving forward, the following should be considered to stimulate the economy:

- While ensuring adequate security in Afghanistan is a tough challenge, the government should take the necessary efforts to safeguard the country's SMEs;
  - The government should focus on combating corruption by enacting efficient rules/regulations;
  - The government should adopt an anti-corruption strategy based on the models of surrounding and other developing countries and apply it to the country's specific circumstances;
  - The government should ensure that SMEs have equitable access to a favorable business climate, since it is currently biased and does not include it all;
  - More infrastructure, such as industrial parks, should be developed and built by the government;
  - To improve competition among international and domestic SMEs, the government should install modern technology to secure borders and eliminate corruption;
  - The government needs to raise awareness about the role of government in business development.
  - Subsidies should be provided by the government to new SMEs to help them expand their capacity in local, national, and international markets;
- SMEs in Afghanistan suffers from limited access to finance
- Government should improve the financial literacy of citizens and entrepreneurs
  - The government should establish a relationship between business needs and the educational system;

- To avoid financing gaps for SMEs, the Afghan government should give loans based on Islamic conditions;
  - Improve the definition and coordination of government programs aimed at assisting SMEs in obtaining bank loans;
- The informality of SMEs is one of the crucial issues in the country
- Rather than stifling informality, policymakers should embrace it;
  - SME institutions and regulatory frameworks should be developed by the government, and regulations should also be strictly followed.
  - Developing formalization incentives by focusing on lowering taxes and simplifying the tax system's complexity;
  - The quality of public-sector services should be improved by incentives within industrial parks to address public-sector services, beginning with pilot zones that aggregate services;
  - The government should raise awareness of the benefits of formalization and persuade enterprises to do so;
  - The Afghan government must take considerable steps to register all SMEs and bring them into the legal sector, to avoid the shadow economy and increase state income through taxation;
  - Government controllers should monitor the performance of businesses at least every two years to reduce tax fraud;
  - The government should make registration and other business requirements easier;
  - Providing entrepreneurs with training courses and mentorship opportunities could help them build managerial skills and promote the growth of their businesses;
  - The government should work to strengthen SMEs and make the best possible use of their opportunities. Reduce, if feasible, the vulnerabilities and risks that SMEs face.



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