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## SMALL AND MEDIUM ENTERPRISE DEVELOPMENT IN FRAGILE CONTEXTS: ANALYZING THE EXPERIENCE OF AFGHANISTAN

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**Abstract:** *The article analyzes small and medium enterprise (SME) development in Afghanistan as one of the fragile contexts as defined by the OECD. State fragility is characterized by the combination of exposure to risk and insufficient coping capacity of the state, system or communities to manage, absorb or mitigate those risks and, as shown in the article, may be an impediment to entrepreneurship. However, private sector and SME development has been prioritized both by the Afghan government and international donors as an important driver of economic growth in the country. In our analysis we apply fragility framework to SME development in Afghanistan to show how state fragility affects Afghan SMEs and whether action taken by the government and donors helps resolve the problems faced by Afghan businesses. The article finds that as Afghanistan is simultaneously fragile across multiple dimensions appropriate policies should be in place to mitigate negative effects of state fragility. Despite that, Afghan government has only recently accelerated business environment reforms, with donor projects yielding only mixed results and failing to account for their sustainability. Our analysis of the problems faced by the Afghan SMEs indicates that action taken by the government and international donors has not been effective. Increasing violence and lack of capacity of governmental institutions to enforce and implement regulation in due form, as well as limited access to resources, remain a source of uncertainty and increased risk for businesses, creating incentives for them to operate informally or adopt risk-averse strategies that do not contribute to economic growth. We argue that there is a need for further reforms to produce better outcomes for Afghan SMEs.*

**Keywords:** SME development, Afghanistan, economy of Afghanistan, state fragility, fragile states.

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According to the Organization for Economic Cooperation and Development (OECD), small and medium enterprises (SMEs) constitute around 99% of businesses globally and account for 60% of total turnover [OECD, 2017(1), p. 36–56]. They are defined as “non-subsidiary, independent firms which employ fewer than a given number of employees” [OECD, 2005]. In Afghanistan the applied definition of SME denotes businesses that have from 5 to 99 employees, with investment in physical capital of less than AFN10 mln for manufacturing sector and less than AFN5 mln for services sector [OECD, 2019, p. 99]<sup>1</sup>.

SMEs are likely to be of greater importance in the developing economies and, particularly, in low-income and fragile states. Their contribution to GDP in low-income countries is on average

<sup>1</sup> We refer to the OECD publication here for technical reasons, as the relevant page at the Ministry of Industry and Commerce of Afghanistan website is unavailable.

lower than in high-income ones (29% of GDP and 45% of total employment), however, taking into account underreporting and informality<sup>2</sup>, their contribution to GDP and employment may be as high as 37% and 48%, respectively [Teima et al., 2010, p. 11].

Up to 24% of the world population lives in fragile states [OECD, 2018, p. 98] which are characterized by the lack of strong governmental institutions and vulnerability to internal and external shocks and crises [Ault, Spicer, 2019, p. 983]. They tend to perform poorly in economic terms and are viewed as a particularly unfriendly environment for investment and business. At the same time private sector and SME development has been viewed as a way forward for these countries and prioritized by the international community, as it could boost economic growth and employment generation and provide additional livelihoods for population, while also establishing a more stable environment [Naudé, 2011, p. 123, 328]. Despite the attention, the progress achieved by the fragile states in SME development has been uneven and demands a thorough research, particularly on a state-based level.

We therefore seek to analyze SME development in Afghanistan as one of the fragile contexts as defined by the OECD. We apply fragility framework to SME development in Afghanistan, noting that there is a distinct connection between fragility and entrepreneurial outcomes in the country. The author argues that the experience of SME development in Afghanistan has been rather discouraging, which stems from inadequate state capacity to promote their development and other problems related to state fragility.

The article primarily relies on a thorough study of existing scientific literature on SME development in fragile states and in Afghanistan, in particular. We also scrutinize available statistical data and data on SME support donor projects in Afghanistan to draw our conclusions, acknowledging that data availability has been a major constraint for this research.

SME development in Afghanistan has not been extensively studied by the researchers, but there are some publications that cover the topic. The literature is primarily concerned with women entrepreneurship [Beath et al., 2013; Ritchie, 2016], noting that gender discrimination in Afghanistan is widespread and women face severe restraints in their pursuit of starting and doing business. Researchers also studied the effects of instability on entrepreneurial outcomes, finding that it has been “institutionalized” and has limited impact on entrepreneurial activity [Ciarli et al., 2015], however, Afghan SMEs tend to remain informal and engage in low-productive low-risk activities that may be viewed as a means of subsistence [Hoffman, Lange, 2016]. Mashal [2014] studies SME development in Afghanistan from historical perspective and analyzes the problems Afghan SMEs face. This article aims to contribute to the existing literature by studying SME development measures in Afghanistan and their implications.

The article covers several topics and is divided into several sections. Firstly, we provide some insights into how fragility affects SME development. Subsequently, we proceed with our analysis of the SME support efforts in Afghanistan after 2001, providing some relevant background information on the economic development of the country. Then, we discuss challenges for SME development in Afghanistan emphasizing their links to state fragility.

## HOW FRAGILITY AFFECTS SME DEVELOPMENT?

The concept of “state fragility” is a transition from previously applied rather categorical concept of “state failure” [Ault, Spicer, 2019, p. 986]. Following OECD, fragility is understood as a continuum of situations, when “the combination of exposure to risk and insufficient coping capacity of the state, system and/or communities to manage, absorb or mitigate those risks”

<sup>2</sup> As suggested by existing research, low per capita income is a significant predictor of the size of the informal sector [Hassan, Schneider, 2016].

may lead to negative outcomes including violence and conflict, humanitarian crises and other emergencies [OECD, 2016, p. 73]. The countries which are faced with these problems are referred to as “fragile states”.

The OECD fragility framework distinguishes five dimensions of fragility (each represented by a number of corresponding indicators), which are presented in a table below (see *Table 1*).

*Table 1.* The OECD fragility framework dimensions of fragility

Dimension	Description
Economic	Vulnerability to risks that stem from weakness in economic foundations and human capital development including macroeconomic shocks, unequal growth and high youth unemployment
Environmental	Vulnerability to environmental, climatic and health risks that affect citizens lives and livelihoods
Political	Vulnerability to risks inherent in political processes, events or decisions including lack of political inclusiveness, lack of transparency, corruption, repression and society’s ability to accommodate change and avoid oppression
Security	Vulnerability of overall security to violence and crime, including both political and social violence
Societal	Vulnerability to risks affecting societal cohesion that stem from both vertical and horizontal inequalities <sup>3</sup>

*Source:* Taken from [OECD, 2016, p. 23].

Fragility framework seems to be suitable to serve as a basis for our analysis, as state fragility as a concept unites under a common umbrella a wide spectrum of potential situations, which may be an impediment for development (and SME development, in particular) [Ault, Spicer, 2019, p. 990].

We now proceed to show how fragility affects SME development by, first, looking at the factors that contribute to SME performance and development by examining a conceptual framework for SME business environment proposed by the OECD, and, then, showing how these factors may be absent in fragile states.

According to the OECD framework, SME performance is dependent on business environment, with its elements being institutional and regulatory framework, access to markets and resources and entrepreneurial culture [OECD, 2017(2), p. 12]. Although the contribution of different factors is context-specific, the elements of the framework should be at least not severely limiting entrepreneurial activity<sup>4</sup>.

We provide a brief review of the impact of state fragility on SME development. We do not cover the impact of all the dimensions of state fragility in detail, but only those most relevant to our analysis – economic, political and security fragility.

Economic fragility affects feasibility of SMEs, as fragile contexts are characterized by abound economic risks for doing business ranging from weak demand and infrastructure bottlenecks [Naudé, 2011, p. 142] to underdeveloped markets and financial institutions [Gorlorwulu, 2011, p. 297], while there also may be insufficient knowledge on how the markets operate and the opportunities doing business presents. Economic fragility thus limits access to resources and markets which we identified as necessary conditions for SME development.

<sup>3</sup>Horizontal inequality is the inequality between different culturally defined or constructed social groups, like gender, ethnic or confessional.

<sup>4</sup>For further discussion of the framework see: [OECD, 2017(2)].

Although political fragility can manifest itself in a number of ways, overall, the governments of the fragile states lack capacity to establish and support institutions and regulation that would promote entrepreneurship. The costs of doing business formally in politically fragile contexts tend to be higher, which together with ineffective regulatory enforcement may create incentives for economic agents to operate informally [Webb et al., 2014, p. 8]. These negative effects may be even more profound, when also considering the impact of societal fragility. All else equal, lower levels of human development, poverty, inequality and lack of social cohesion it entails account for lower entrepreneurial abilities and higher transaction costs as societies tend to be fractured and various groups (for instance, ethnic, religious or tribal) have little mutual trust [OECD, 2018, p. 42].

As for security fragility, Collier and Hoeffler [2004] and Ballentine and Nietzsche [2005, p. 7] argue that a persistent and widespread use of violence leads to the emergence of so-called “conflict entrepreneurs” as actors in the national business ecosystem that profit as a result of specific conditions created by violent conflict. In such an environment it may be difficult to rely even on informal relations to secure investment or access to markets [Hiatt, Sine, 2014], whereas powerful actors can employ violence for business ends and gain an edge over smaller competitors [Desai et al., 2013].

Finally, fragile states are often weak across multiple dimensions [Ault, Spicer, 2019, p. 997]. Multidimensional fragility therefore is likely “to generate multiple institutional hazards that limit the ability of commercial enterprises to capture economic returns when serving the poor in fragile state settings” [Ault, Spicer, 2014, p. 1819]. Generally, that means that states simultaneously fragile across multiple dimensions are likely to exhibit characteristics inconsistent with conditions for SME development we identified in this section.

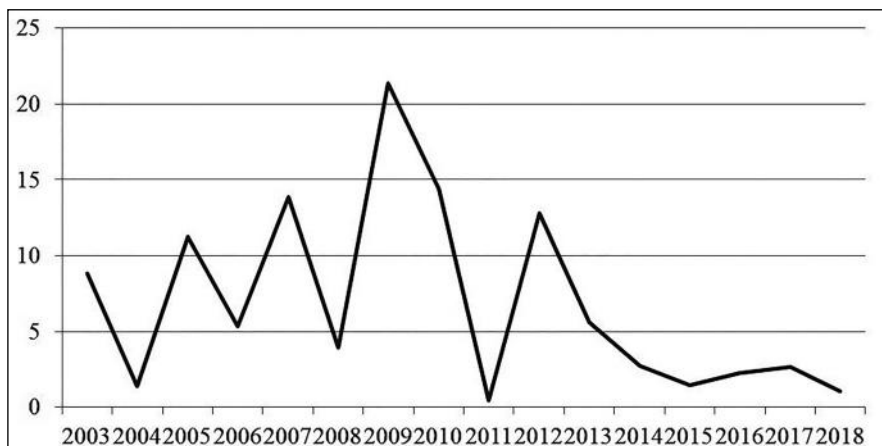
Despite lacking in some key factors favoring SME development, private sector and SME development has been prioritized by both international institutions and national governments and is viewed as a way forward for fragile states. Researchers note that SMEs’ presence in the economies of fragile states is significant, and they may also have some comparative advantages in such settings. SMEs are usually more flexible, less risk-averse, which enables them to provide services in territories outside governments’ reach or control and foster job creation [Naudé, 2011, p. 123, 328; Page, Söderbom, 2012, p. 3]. What is more, they have the potential to contribute to economic growth badly needed in fragile contexts, and their development may even have positive effects on political stability [Miklian, 2019]. With environment being not conducive to their development and growth, a number of micro- and macro-level measures should be applied<sup>5</sup> and substantial donor assistance is required to promote SME growth in fragile contexts to make up for insufficient government capacity, lack of entrepreneurial abilities and enhance access to markets and resources.

## STATE FRAGILITY AND AFGHAN ECONOMY DEVELOPMENT SINCE 2001

In this section we provide some relevant background information on the economy and state fragility of Afghanistan, which could help better understand the relevance of SME development for the country. The article argues that it has a potential to become a factor of economic growth given SMEs’ size in the economy and lack of other factors for growth.

Afghanistan is almost unanimously considered a fragile state [Fund for Peace, 2019, p. 7; The World Bank. *FY20 List of Fragile and Conflict-affected Situations*], being categorized as chronically and extremely fragile by the OECD [2018, p. 26]. We deem Afghanistan as a country fitting this definition for protracted conflict, low institutional capacity and poor economic development are among the country’s major development problems, which create a difficult to break vicious circle [The World Bank, 2018, p. 4]. The state fragility of Afghanistan, though often attributed to a 40 year-long violent conflict, probably predates it for there was no robust state for most of

<sup>5</sup> See: [Datzberger, Denison 2013] for the detailed discussion of these measures.



*Fig. 1. Afghanistan annual GDP growth (%)*

*Source:* calculations based on [The World Bank. World Bank Open Data].

the Afghanistan history, with the government exercising limited control over the whole of its territory [Goodhand, 2004].

Fragility has influenced overall economic development of the country as well as its SMEs. Afghanistan saw high though volatile rates of economic growth in 2000s and its slowdown in 2010s (see *Fig. 1*), with the country being at risk of not bringing about job creation to accommodate increasing labor force [UNCTAD, 2018, p. 9].

There are several explanations for such a change of fortunes, as growth was mostly fuelled by external factors.

Firstly, it was a large-scale presence of international forces (ISAF) in the country which brought about massive spending and favored contracting with local producers of goods and services [NATO, 2010] that boosted economic growth. The withdrawal of foreign troops in 2014 carried negative effects on growth, as ISAF forces had been the single largest spender in the country and could have provided employment for up to 60,000 people [Nasery, 2014, p. 44].

Secondly, economic growth was also boosted by official development assistance (ODA) with Afghanistan being its largest recipient for several years [OECD. States of Fragility]. However, the total amount of military and civilian aid halved over 2009–2014. Despite that, aid still finances a large trade deficit of more than 30% of GDP and more than 60% of government expense [OECD. States of Fragility] indicating lack of domestic revenue sources.

Thirdly, the economic decline was exacerbated by increased state fragility, i.e., increasing violence and political instability. The number of civilian deaths and injuries as a result of conflict is twofold its level of 2009 [UNAMA, 2019], while military casualties increased nearly fourfold over 2009–2018 [Uppsala Conflict Data Program].

These changes point to the need to search for new sources of economic growth. Despite constraints posed by fragility, SMEs have the potential to become one of the drivers of economic growth. They make up nearly 80% of businesses in the country, 50% of GDP and employ  $\frac{1}{3}$  of the labor force [Mashal, 2014, p. 8–9], notwithstanding the fact that their formalization could help increase tax revenue<sup>6</sup>. Yet, according to Afghanistan Center for Business Registration (ACBR) data, number of business registrations has declined after 2014 [World Bank. Doing Business Data], which indicates unfulfilled development potential.

<sup>6</sup>Taxes on income, profits and capital gains contribute only 4% of total revenue [IMF. Government Finance Statistics]

## HOW THE GOVERNMENT AND DONORS ADDRESS SME DEVELOPMENT IN AFGHANISTAN?

In this section the article looks at the measures taken by the Afghan government and international donors to promote SME development in Afghanistan and assesses what results they helped achieve.

Private sector and SME development has been considered one of the development priorities since the beginning of the post-conflict reconstruction in Afghanistan after 2001–2002. The 2004 Constitution reads that the state “shall encourage ... private enterprises in accordance with the provisions of the law and market economy” [Government of Afghanistan, 2004], although the Afghan government has been slow in adopting legislation that would foster SME activity. Moreover, as the market economy was a new system for Afghanistan, there was no campaign to raise awareness about opportunities new system and entrepreneurship presented [Mashal, 2014, p. 8].

Nevertheless, official documents have repeatedly referred to private sector and SME development as development priorities and strategic objectives [Government of Afghanistan, 2008; 2017; 2018] that would help Afghanistan achieve greater self-reliance, private-sector led economic growth and job creation amid the decline in development assistance and economic growth [Government of Afghanistan, 2018, p. 6–7]. Yet, these documents remain rather vague in their wordings of particular measures and often carry no timeframe obligations with regard to implementing them.

It is not surprising therefore that the Afghan government was slow to act and adopted its first what may be called an SME strategy only in 2009, with its implementation starting two years later with the formation of the SME Directorate within the Ministry of Commerce and Industry. The strategy targeted import oriented sectors given large trade deficit and lack of competitive goods to export [Mashal, 2014, p. 8].

We observe some meaningful recent changes in the government’s SME policy. The National Priority Program for Private Sector Development (NPP) of 2018 mentioned some of the objectives directly related to SMEs and promised to work out a detailed SME strategy within 5 years [Government of Afghanistan, 2018, p. 24]. With regard to SME development the NPP sets the following goals:

- promote formalization of businesses;
- strengthen security;
- promote development of new businesses in prioritized sectors, such as agriculture and mining;
- fight corruption and strengthen the rule of law;
- continue with reforms that address land governance, infrastructure bottlenecks, access to markets and finance.

Acknowledging the capacity and resource constraints, the NPP notes that most of the goals are long-term. It therefore aims to limit the impact of state fragility through increased transparency of decision-making and government services, along with strengthening security [Government of Afghanistan, 2018, p. 6–7].

Coinciding with the adoption of the NPP the pace of reforms has since accelerated. The government has reduced fees for business registration down from AFN 32,000 to just AFN 100 for a three-year license and enhanced some of the elements of the legal framework for business, including a new tax administration and law manual with clear rules and guidelines on tax audit<sup>7</sup> and a new insolvency law that streamlines proceedings and promotes reorganization for distressed registered companies [Chaudhuri, 2018].

As a result, the country has advanced through the World Bank Doing Business ranking (see Fig. 2) being the top improver in the 2019 ranking. These improvements do not necessarily reflect

<sup>7</sup> However, electronic tax declarations were introduced for large taxpayers only.

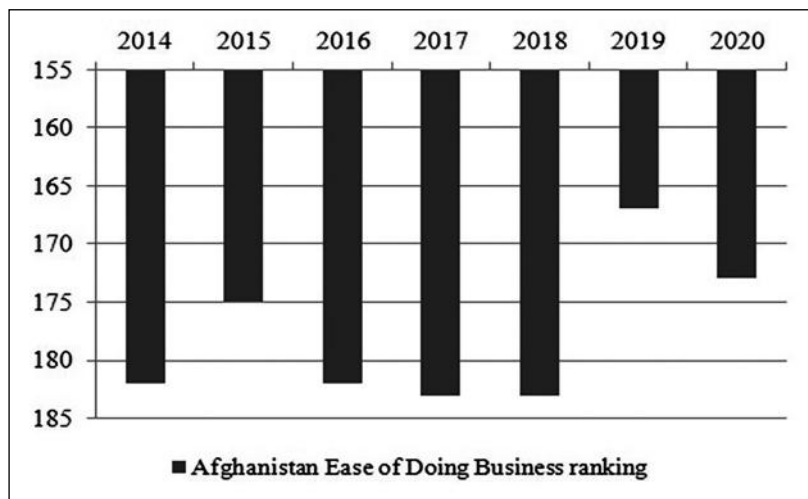


Fig. 2. Afghanistan Ease of Doing Business ranking 2014-2020

Source: taken from [The World Bank. Doing Business Data].

changes in the business environment and should be interpreted as the indicator of regulatory constraints for doing business [Naudé, 2011, p. 129].

As the government lacked capacity and finance, international donors led the way providing resources, expertise and services to promote SME development. The World Bank, the Asian Development Bank (ADB) and the USA (USAID) have been among major contributors to SME development programs in Afghanistan [Ghiassy et al., 2015, p. 52], therefore we focus on open access data that is available through the databases of these organizations. We devote our particular attention to the projects implemented under the supervision of USAID for they are the largest in terms of expense and geographical scope. The relevant projects (along with some information on them) are listed in the *Table 2*<sup>8</sup>.

Table 2. Major SME support donor projects in Afghanistan

Project Title	Supporting agency	Approval and closing date	Status	Estimated project cost (\$ mln)	Actual disbursement (\$ mln)	Outcome rating
<b>Emergency Community Empowerment and Public Works Project</b>	World Bank	June 2002–December 2004	Closed	42	46,05	Satisfactory
<b>AF Rural Enterprise Development Program</b>	World Bank	March 2010–June 2018	Closed	87,2	45,23	Moderately satisfactory

<sup>8</sup>There are also projects aimed at PSD in general not listed in the Table 2, though they may still indirectly cover SME development.

<b>AF ICT Sector Development Project</b>	World Bank	April 2011–December 2017	Closed	50	41,66	Moderately satisfactory
<b>AF New Market Development</b>	World Bank	May 2011–November 2017	Closed	22	17,05	Moderately satisfactory
<b>AF Access to Finance</b>	World Bank	November 2013–June 2021	Active	50	28,35	Satisfactory
<b>Afghan Women's Economic Empowerment</b>	World Bank	March 2017–April 2020	Active	2,74	N/A	Satisfactory
<b>Afghanistan International Bank project</b>	Asian Development Bank	May 2004–September 2014	Closed	2,6	2,6	N/A
<b>Horticulture Value Chain Development Sector Project</b>	Asian Development Bank	November 2018–June 2025	Active	118,66	5,06	N/A
<b>Afghanistan Small and Medium Enterprise Development (ASMED)</b>	USAID	October 2006–March 2012	Closed	N/A	114	Mixed
<b>Assistance in Building Afghanistan by Developing Enterprises (ABADE)</b>	USAID	October 2012–August 2017	Closed	N/A	292	Successful

Source: compiled from [The World Bank. Projects in Afghanistan; *Asian Development Bank. Projects and Tenders*; USAID. Afghanistan Foreign Assistance].

The World Bank as well as the ADB SME support projects in Afghanistan emphasize SMEs' importance as a tool of employment generation and improving income opportunities, particularly in rural areas. The projects focused on providing technical assistance and knowledge, increasing women participation in income-generation opportunities, such as starting their own business, and improving access to credit. There was also specific sectoral support for rural enterprises (an area prioritized by the Afghan government) and ICT sector that was supposed to help establish new SMEs in the sphere and improve connectivity, thus, creating a more business friendly environment through reduced transaction costs. We note that SME support is just a fraction of total World Bank ODA to Afghanistan, with some projects being underfunded or ending up with reduced funding, and much lower than that for enhancing security and social services provision, as total aid committed by the organization stands at \$4,4 bln in grants [World Bank, 2019, p. 4]. The projects are assessed either satisfactory, or moderately satisfactory, indicating that they did not reach all of their objectives.

USAID supervised the implementation of two SME support projects – “Afghanistan Small and Medium Enterprise Development” (ASMED) and “Assistance in Building Afghanistan by



Developing Enterprises” (ABADE), which were largest in terms of total expense (see *Table 2*). However, as these projects heavily relied on public-private alliances (PPAs), not all of the funding was provided by the USAID<sup>9</sup>. We take a closer look at these projects.

ASMED was being implemented on a national scale for 6 years, from 2006 to 2012. The project sought to increase trade, employment, and investment opportunities by strengthening the private sector and particularly SMEs through knowledge and expertise sharing schemes [USAID, 2016, p. 33]. It combined mentorship and internship/apprenticeship approaches to help develop entrepreneurial skills and establish new or strengthen existing SMEs. Despite large investment and reaching its targets of employment generation and strengthening value chains, the project yielded only mixed results [USAID, 2016, p. 81]. The mentoring approach was considered unsuccessful and discontinued early [USAID, 2016, p. 33]; overall performance was hindered by fragility of political institutions and infrastructure deficiencies. Finally, the project failed to keep track of its targets that prevented effectiveness and sustainability evaluation [USAID, 2016, p. 44].

ABADE was organized in three components: developing and implementing PPAs, providing technical assistance and improving the business enabling environment [USAID, 2018(1), p. 4–5]. ABADE reports to have exceeded all its targets in reporting indicators, making a substantial impact on 518 SMEs and helping create 17,000 jobs in Afghanistan [USAID, 2018(1), p. 40]. A final performance evaluation report by USAID, however, does find overall positive impact of the project, but puts into question some of its achievements, noting that it had minimal effect on women empowerment, focused on bigger SMEs that improved the project’s statistical performance. One of the concerns is again the sustainability of the achieved results [USAID, 2018(2), p. 24–25].

Although fragility poses many challenges to SMEs and entrepreneurship, not many of them have been addressed in Afghanistan. Recent measures by the government have removed some regulatory hurdles for doing business formally, but most of them have been adopted only recently, so there are no immediately apparent results. International donors in the meantime implemented a number of SME support projects that, reportedly, had positive economic effects with regard to employment generation, women empowerment, improving access to finance and sharing knowledge and expertise. These projects, however, have not been flawless and often failed to track the results and account for their sustainability as data collection in Afghanistan remains extremely difficult. Moreover, the reported positive effects on job creation may not be substantial given increasing labor force and still rapid population growth.

## WHAT PROBLEMS DO SMES FACE IN AFGHANISTAN?

In this section we analyze the implications of the governmental and donor action to promote SME development in Afghanistan and aim to uncover problems small and medium enterprises currently face.

It has to be noted that the article only analyzed policies and projects aimed at SME development, which are by design incapable to address all factors that affect entrepreneurship in fragile contexts, for instance, increasing violence. At the same time violent conflict and political instability in Afghanistan is a source of uncertainty for economic agents which hinders investment and undermines business confidence. World Bank Enterprise Survey of 2014 and recent survey by the Afghan Chamber of Commerce & Investment (ACCI) show that Afghan SMEs perceive political instability to be the main obstacle for business in the country, with around 25% of respondents mentioning it [The World Bank. *Enterprise Surveys: Afghanistan*, 2014, p. 4; *Afghan Chamber of Commerce & Investment*, 2019, p. 13–14]. SME policies and projects, however, have little tools

<sup>9</sup>For instance, for ABADE USAID contributed only 17% of total investment [USAID, 2018(1), p. 5]

to mitigate such risks, but we speculate that attempts at strengthening security in the country have not been effective.

Among other problems most often mentioned by Afghan firms were those related to access to resources and markets and governmental regulation, though seemingly addressed by policies and projects we discussed. As Afghanistan remains politically fragile and governmental institutions lack capacity to enforce regulation, implementation of the reforms at the local level may be arbitrary.

For instance, despite recent simplification of registration procedures, corruption and bureaucracy result in unpredictability and lack of transparency of requirements and decision-making for Afghans who want to start a business [Chaudhuri, 2018]. The benefits of registering are also uneven, as businesses can expect to pay up to 72% of their revenue in taxes in the second year of operation [The World Bank. Ease of Doing Business in Afghanistan], while competing with informal firms that avoid such costs. Moreover, according to ACCI, nearly half of businesses surveyed view tax system to be not transparent and sophisticated, as firms note that bribes create additional costs [*Afghan Chamber of Commerce & Investment*, 2019, p. 5, 8].

Access to finance also remains limited. The inability of the Afghan government to establish centralized land registration system complicates access to credit as land is often requested as collateral by banks, while financial sector remains weak and fragile: as of 2018 domestic credit to private sector by banks was the lowest in the world standing at 3.263% of GDP [The World Bank. World Bank Open Data]<sup>10</sup>. ACCI survey reflects complaints by firms of high interest rates and excessive collateral requirements [ACCI, 2019, p. 6].

We find that action taken by the government and major donors has not much changed the outcomes for Afghan SMEs, as the conditions for SME development we identified previously are still largely absent in the county. The Afghan government has been slow to adopt regulation necessary for SME development, and we also find evidence that its implementation at the local level may be arbitrary as corruption and lack of transparency of procedures create additional costs for businesses. We point to the need of further reforms as high tax burden registered businesses are subject to may disincentivize formalization as the risks of staying informal are relatively low. All the problems we report in this section are closely related to political and security fragility of the Afghan state, as increasing violence and lack of capacity of governmental institutions to enforce and implement regulation in due form is a major obstacle for Afghan SMEs as reflected by the surveys of Afghan businesses we considered.

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Reduction in development assistance and the withdrawal of foreign troops from Afghanistan emphasize the importance of policies aimed at SME development, as it is viewed as a driver of economic growth. The government has recently removed some administrative hurdles and reduced costs of doing business, while the donors have implemented a number of projects providing funds and sharing knowledge and expertise with potential entrepreneurs. However, the environment is still not very conducive to SME development for reasons rather common in fragile contexts, i.e., risk of violent conflict, political instability, corruption and ineffective institutions.

As private sector has become the government central growth priority, there is a need for further reforms to support SMEs. OECD [2019] suggests that the government should be more active in tackling the problems of formalization, access to finance and quality of public services, and the first step should be a comprehensive and informed SME strategy and improved data collection. Meanwhile, as Afghanistan remains extremely fragile, there is no guaranteeing changes to the better even if appropriate action is taken.

<sup>10</sup> Although there is no data available on Islamic finance or microfinance lending.

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