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# A Review of Financing and Human Capital Development Issues among Micro Enterprises in Afghanistan

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**ABSTRACT**

This paper's primary objective is to investigate the obstacles related to financing and human capital development that hinder the growth of micro enterprises (MEs) and their contribution to the overall economic progress of Afghanistan. Evidently, MEs in this country are grappling with significant financing challenges, including high financing costs, stringent collateral requirements, rigorous documentation criteria, the need for comprehensive business plans, and the necessity for robust financial records. Moreover, MEs are also confronting issues related to human capital development, such as a lack of administrative and managerial skills, inadequacies in training courses and programs, low levels of education, limited entrepreneurship knowledge, and financial literacy. Despite the Afghan government's efforts to address these financial and human capital development issues, they continue to impede the growth of MEs. Consequently, this study seeks to conduct a comprehensive examination of these challenges through content analysis. By shedding light on these problems, this research aims to offer clear insights and recommendations for addressing the issues related to financing and human capital development in Afghanistan.

*Keywords: Micro Enterprises, Financing, and Human Capital Development issues, Afghanistan.*

**ABSTRAK**

Objektif utama kertas ini adalah untuk menyiasat halangan berkaitan pembiayaan dan Pembangunan modal insan yang menghalang pertumbuhan perusahaan mikro (ME) dan sumbangan mereka kepada kemajuan ekonomi keseluruhan Afghanistan. Jelas sekali, ME di negara ini sedang bergelut dengan cabaran pembiayaan yang ketara, termasuk kos pembiayaan yang tinggi, keperluan cagaran yang ketat, kriteria dokumentasi yang ketat, keperluan untuk rancangan perniagaan yang komprehensif, dan keperluan untuk rekod kewangan yang kukuh. Selain itu, ME juga menghadapi isu berkaitan pembangunan modal insan, seperti kekurangan kemahiran pentadbiran dan pengurusan, ketidakcukupan dalam kursus dan program latihan, tahap pendidikan yang rendah, pengetahuan

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keusahawanan yang terhad, dan celik kewangan. Walaupun usaha kerajaan Afghanistan untuk menangani isu pembangunan kewangan dan modal insan ini, ia terus menghalang pertumbuhan ME. Oleh yang demikian, kajian ini bertujuan untuk menjalankan pemeriksaan menyeluruh terhadap cabaran ini melalui analisis kandungan. Dengan menjelaskan masalah ini, penyelidikan ini bertujuan untuk menawarkan pandangan dan cadangan yang jelas untuk menangani isu berkaitan pembiayaan dan pembangunan modal insan di Afghanistan.

*Kata kunci: Perusahaan Mikro, Pembiayaan dan isu pembangunan modal insan, Afghanistan.*

## 1. Introduction

The MEs contributes significantly to economic development, technical innovation, economic regeneration, sourcing to big enterprises and social improvement (Manzoor et al., 2021). In the worldwide economy, they are assumed as a vital role through their critical commitment to GDP and boost the comfort of societies. MEs play an essential role in economic growth in both developed and developing countries across the globe.

According to a recent World Bank report, MEs account for 95 percent of all enterprises and 60 percent of total employment in developed nations' private sectors (World Bank, 2017). Empirical studies have shown that MEs contribute more than 55% of the GDP in high-income nations (Singh & Venkata, 2017). There are more than 100 million MSMEs in developing countries, including 21 million small and medium-sized businesses and 141 million micro-businesses (IFC, 2017). In the Asian region, MEs account more than 90 percent of all firms, employ 62 percent of the labor force, and contribute an average of 42 percent of the gross domestic product (ADB, 2015; OECD, 2017).

MEs present a large share of the private sector, estimated to be 98.5% of private businesses in Afghanistan, contributing approximately 17.5% of the GDP and employing 19.5% of the labor force (OECD, 2019). About 90 percent of such enterprises employ five or fewer workers (Ghiasy et al., 2015; Najafizada, 2014), and they play a critical dominating role in the expansion of the Afghan domestic economy (Najafizada, 2014). Meanwhile, investment in physical capital is considered less for the service sector with AFN 1 million (USD 12,987) and for the non-service industry to be less than AFN 2.5 million (USD 32,467) (World Bank, 2022).

Even though MEs have tremendous potential in building stable economic growth, the contribution of the Afghan SMEs to the GDP is still lower compared to South Asian countries and other neighboring countries. For example, MEs contribute 30% of GDP in Tajikistan and employ 33% of the labor force. Meanwhile, in Uzbekistan, their contribution to GDP is 54.9%, and they provide 78% of job opportunities (Dildora, 2019; Mirzoev & Sobirzoda, 2019). These scenarios have shed light on why MEs contribute less to GDP despite their substantial presence in the entire business establishments of the Afghan economy. Previous literature and several studies highlighted the excellent performance of MEs in other Asian countries is associated with the availability of financing and human capital development services (Asmy, 2015; Ghosh et al., 1996; Gunatilake, 2016). However, in the case of Afghanistan, it has raised the concerns of the Afghan micro enterprises, in terms of their performance and contribution to the expansion of the Afghan economy.

Financial assistance remains the most common problem for MEs development in Afghanistan, which has been confirmed by several studies (Abdullah, 2021; Ghiasy et al., 2015; Hussaini, 2021; Hussein, 2009; Lutfi, 2021; Najafizada, 2014; OECD, 2019). According to the study by ACCI (2016), around 47 percent of MEs were facing a problem with funding availability. However, there were significant disparities across regions, with most respondents in Kandahar (70 percent), Nangarhar (64 percent), and Balkh (56 percent) indicating that they had difficulty gaining access to external financing. In addition, 52.1% of MEs stated that the high cost of financing and collateral requirements are the primary deterrents to their growth (ACCI, 2016).

On the other hand, MEs in Afghanistan are also hindered in terms of human capital development issues (Freshta, 2016; Ghiasy et al., 2015; Matiullah, 2018; Nazeer Mohammad, 2021; OECD, 2019). For instance, Afghanistan utilized only 40 percent of its human capital potential (World Bank Group, 2020).

Ghiasy et al. (2015) stated that a shortage of skilled labor in Afghanistan has been developed due to improper education and training programs.

Based on the discussion above, the problems of financing and human capital development hindered MEs' growth and development in Afghanistan. Therefore, a thorough study is required to fully explore the hurdles to their access to external financing and human capital development to provide policy recommendations that could help mitigate the issues.

## 2. Overview of Micro-Enterprises in Afghanistan and their Contribution

In Afghanistan, the definition of micro-enterprises is provided by the Ministry of Industry and Commerce, which mainly emphasizes on two criteria namely full-time employees and investment in physical assets. As shown in Table 1, MEs are defined in Afghanistan as established enterprises with fewer than five employees. Meanwhile, investment in physical capital is considered less for the service sector than AFN 1 million (USD 12,987) and for the non-service industry to be less than AFN 2.5 million (USD 32,467). MEs in Afghanistan constitute a large share of micro, small, and medium enterprises (MSMEs). The number of MEs in Afghanistan is 218,226, which is 88.64% of the total business establishments in the country (Ministry of Economics, 2020). Table 2 presents the profile of the total number of each component of MSMEs in Afghanistan.

**Table 1**
**Definition of Micro Enterprises in Afghanistan**

| Type of Enterprises | No of Employees | Investment in Physical Capital (AFN Millions) | |
|---|---|---|---|
| | | Non-Service sector | Services Sector |
| Micro-Enterprise | <5 | <2.5(USD 32,467) | <1 (USD 12,987) |

Source: Ministry of Industry and Commerce, also cited in World Bank (2022)

**Table 2**
**Total Numbers of MSMEs and Each Component of MSMEs (micro, small, and medium enterprises) in Afghanistan**

| Country | Total numbers of MSMEs | Total of Micro-Enterprises | Total of Small Enterprises | Total of Medium Enterprises |
|---|---|---|---|---|
| Afghanistan | 246,189 | 218,226 | 7,776 | 20,187 |

Source: Compilation from Ministry of Economics, Center for Economic Analysis (2020), and Ehsanullah et al. (2022)

MEs play a substantial role in revenue generation for the government of Afghanistan, contributing a total of AFN 7,501,047,326 (equivalent to USD 97,416,199). This contribution by micro enterprises represents approximately 21% of the overall revenue generated (Ehsanullah et al., 2022). Table 3 provides a detailed breakdown of MEs' contribution to revenue generation, with a specific focus on micro enterprises.

**Table 3**
**Micro Enterprises Contribution to Revenue Generation**

| Country | MSMEs' contribution to revenue generation | (%) Micro-enterprises |
|---|---|---|
| Afghanistan | AFN 7,501,047,326 (USD 97,416,199) | 21.% |

Source: Compilation from Ehsanullah et al. (2022)

In terms of employment opportunities, micro enterprises (MEs) have provided jobs for approximately 601,680 workers. This number represents about 43.6% of the total employment opportunities offered by all business establishments combined. It's noteworthy that MEs, on average, employ fewer than three workers per establishment. Table 4 in the study presents a detailed breakdown of the number of employment opportunities created by MEs and their share of employment generation in Afghanistan.

**Table 4**
**Micro enterprises Contribution to Employment Generation**

| Country | Total number of employments provided by MSMEs | (%) Micro-enterprises |
|---|---|---|
| Afghanistan | 1,380,000 | 43.6% |

Source: Compilation from Ministry of Economics, Center for Economic Analysis (2020), and Ehsanullah et al. (2022)

Geographically, micro enterprises (MEs) in Afghanistan are concentrated primarily in the five major provinces: Kabul, Herat, Kandahar, Balkh, and Nangarhar, accounting for approximately 51.5% or 112,356 MEs in total. Among these provinces, Kabul has the highest number of ME establishments, comprising about 35.2% or 76,857 of all MEs. Following Kabul, Herat, which is the second-largest province in terms of MEs, contributes around 5.1% or 11,088 MEs. Kandahar is the third-largest province in terms of ME availability, with a total of 12,469 MEs, out of which 9,749 MEs are established. The specific figures for the number of MEs in these major provinces in Afghanistan can be found in Table 5

**Table 5**
**Profile of Micro Enterprises Based on Major Provinces in Afghanistan**

| Province | Total MSMEs | Micro-Enterprises |
|---|---|---|
| Kabul | 80,965 | 76,857 |
| Herat | 13,697 | 11,088 |
| Kandahar | 12,469 | 9,749 |
| Balkh | 10,668 | 8,636 |
| Nangarhar | 7,444 | 6,026 |

Source: Compilation from Ministry of Economics, Center for Economic Analysis (2020), and Ehsanullah et al. (2022)

**3. The Availability of Financing for Micro-Enterprises**

Several external financing sources are available in Afghanistan for MEs. The standard external financing sources available for MEs are (i) microfinance, (ii) commercial banks, (iii) non-governmental organizations (NGOs), and (iv) money-lenders (Hussein, 2009; Lutfi, 2021).

The microfinance model has been considered a dominant source of financing for MEs. However, the majority of microfinance institutions provide funding facilities to women-owned micro enterprises based on a group-lending mechanism (Jahish, 2017). Some microfinance institutions also offer microcredit products designed for individual-owned micro businesses run by men. However, the loan conditions and requirements are the most important when it comes to the eligibility criteria for granting a loan. The loan has been disbursed to clients who have completed numerous loan cycles. Besides, the guarantor is also required, alongside with title deeds as collateral for loan security. In the microfinance model, microfinance institutions charged high-interest rates with annual interest rates of around 20 to 40 percent (Hussaini, 2021). Regarding collateral requirements, empirical findings indicated that 43 percent of men and 33 percent of women stated that due to the absence of collateral, their loan applications were not approved by the microfinance institutions (Microfinanza, 2019).

In the second source of financing, commercial banks provide funding facilities to MEs. However, in Afghanistan, commercial banks rarely offer financing facilities to micro enterprises. This is because micro enterprises are considered quite risky in terms of being unable to pay back their loans with a high interest rate. Therefore, they demand a high level of collateral with a high-interest rate of up to 25 percent along with a short loan maturity (OECD, 2019). Empirical evidence revealed that 51.1 percent of MEs indicated that commercial banks demand high interest rates and strict collateral (ACCI, 2016). Moreover, according to the Afghanistan Central Bank (as cited in OECD, 2019), the amount required by commercial banks as collateral for backing their loans is 120 percent of the total average amount applied for a loan. Besides, they need a proper business plan and financial documents for loan approval (Mashal, 2014).

In the NGO financing model, certain international financial institutions offer loan facilities and they are registered as non-governmental organizations (NGOs). They are assisting MEs in providing financing to support the establishment of credit unions and Self-Help Group (SHG). These credit unions and SHG provide financial assistance to the owner of micro entrepreneurs. In the NGO financing model, the saving and lending financing facilities are only offered to the owner-member of the union and SHG. The major drawbacks of the NGO financing model are that the loan amount is small, and a 17.5 percent interest rate is charged on loan provision services along with obligatory saving.

The money-lenders model is the traditional financing model available for micro enterprises in Afghanistan that compensate for the absence of financing facilities for MEs. Hawala dealers in this model provide MEs financing services (OECD, 2019). The financing facilities offered by Hawala dealers, compared to other models such as microfinance, commercial banks, and NGO models, are quicker and more convenient. However, the major problems of this model are (i) the loan is granted to micro enterprises based on a high commission rate, (ii) the loan duration is very short, and (iii) it requires a guarantor to secure the loan.

As discussed above, the present financing models cannot provide reliable and sustainable financing services to MEs. Overall, the issues of high-interest rates, strict collateral requirements, strict documentation, short duration of the loan, low amount of financing and the requirement of a business plan are the major financial difficulties that hinder micro enterprise development in Afghanistan.

**4. Availability of Human Capital Development Services for Micro-Enterprises**

Human capital development include programs for developing skills and training activities related to marketing, management, education and building self-confidence that contribute to the growth of businesses (Hossain, 2019). Hearth (2018) emphasised that the availability of non-financial services for MEs, including business development skills, capacity-building programs, education, and income generation techniques determined the sustainability of the businesses.

However, in Afghanistan, a limited number of non-governmental organizations (NGOs) offer several types of training programs to uplift skills needed for MEs development. For instance, organizations such as BRAC (Bangladesh Rural Advancement Committee), FINCA (Foundation for

International Community Assistance) and Women for Women provide education, entrepreneurship training, and business support facilities. Many of these women graduated into the NGO's formal microfinance client (Hussein, 2009). FINCA Afghanistan collaborates with the International Rescue Committee (IRC) to provide financial and human capital development programs. This allows the poor Afghan families to overcome financing and human capital development challenges. IRC provides market-oriented skills, training, and business development assistance to FINCA's new Afghan customers. Meanwhile, BRAC provides training facilities and education for its staff. Currently, 1,104 of the 1,985 BRAC Afghanistan staff members working in the microfinance sector are female, making up about 95 percent of the total staff.

The German Cooperation with Afghanistan (2017) introduced a program to support and provide human capital development services to enhance MEs development in Kabul. In this program, 30 university graduates were recruited and learned how to start and manage their enterprises, particularly in the energy sector. The program provided a training curriculum based on market demand. The participants learned technical training in the program's first phase; in the second phase, they learned entrepreneurial skills. Similarly, Cordaid (2018) introduced a Bright Future Program to provide human capital development services. The program provides entrepreneurial skills through Bright Business Incubator and youth vocational training programs. The program also aimed to facilitate the start and growth of MEs in Kabul.

## 5. Issues of Financing and Human Capital Development among Micro-Enterprises

In Afghanistan, the support from external sources for microenterprises (MEs) primarily relies on microfinance institutions, commercial banks, non-governmental organizations (NGOs), and money lenders. Several studies have conducted empirical investigations into the challenges faced by MEs in accessing external financing (Abdullah, 2021; Ghiasy et al., 2015; Hussaini, 2021; Lutfi, 2021; OECD, 2019). Micro enterprises in their initial stages of development generate limited cash flows, which leads them to depend on external funding sources. However, due to their small and fledgling nature, they often encounter difficulties in securing external financing and frequently face financial constraints (Abdullah, 2021; Hussaini, 2021; Najafizada, 2014; OECD, 2019).

As an illustration, Hussaini (2021) pointed out that microfinance institutions offer loans with annual interest rates that fall within the range of 20% to 40%. Furthermore, Abdullah (2021) noted that despite the substantial credit demand among micro enterprises, numerous barriers impede the efficient provision of credit. For instance, many businesses object to interest-bearing loans due to religious beliefs, which are incompatible with financial products and systems (Hussaini, 2021; Microfinanza, 2019).

Furthermore, field research conducted in 2021 in Kabul, Faryab, and Balkh has substantiated that key concerns for enterprises include high interest rates, protracted regulatory procedures, short maturity terms, inadequate documentation, a lack of financial records, and stringent collateral requirements (Abdullah, 2021). Correspondingly, a report by Microfinanza (2019) provided empirical evidence, indicating that 33% of women and 43% of men reported that the primary reason for microfinance institutions rejecting microcredit applications for their microenterprises was the absence of collateral. Additionally, a report by ACCI (2016) disclosed that approximately 47% of enterprises faced challenges related to the availability of financing, with 52.1% citing high financing costs and onerous collateral requirements as the primary financing difficulties. Furthermore, banks and other financial institutions require a well-structured business plan and associated documents for loan approval (Mashal, 2014).

Habibi (2016) conducted a study in Nangarhar province to investigate the factors influencing financing for enterprises in the region. The study identified several factors that significantly impacted the development of micro, small, and medium-sized enterprises (MSMEs), including the short duration of loans, frequent loan repayment schedules, and a deficiency in managerial skills. In contrast, Mia (2017) reported on the portfolio yield in the South Asian microfinance industry, noting that it has ranged from 16 percent to 42 percent, with Afghanistan having the highest average interest rates. Conversely, the microfinance industry in Bangladesh maintained consistently lower interest rates, ranging from 22% to

26% between 2005 and 2014. Additionally, The World Bank (2018) highlighted that due to the high cost of formal financing, low confidence in banks, a lack of financial literacy, and religious objections to interest-bearing loans, only 2% of enterprises opt for formal financing. Consequently, the majority of MSMEs predominantly rely on informal or family-based funding methods.

According to the empirical findings outlined in the preceding section (Section 5), the challenges related to accessing external financing for microenterprises (MEs) in Afghanistan can be categorized as follows:

- High cost of external financing
- Lack of collateral
- Insufficient information and documentation
- Lack of comprehensive business plans
- No financial track records
- The loan products were not in compliance with Shariah
- The short duration of loans

The existing literature has identified that the primary obstacles impeding the development of human capital in microenterprises (MEs) in Afghanistan include the absence of specific skills, low levels of education, inadequate training programs, and limited access to training opportunities (Freshta, 2016; Murtaza et al., 2019; Nazeer Mohammad, 2021; Nazifa & Muhammad Shahid, 2018; Wasiq & Dahlan, 2019).

Nazeer Mohammad (2021) observed that the prolonged periods of war and insurgencies have had enduring repercussions on the country's human capital. Despite significant advancements and educational achievements among the youth, there persists an educational gap that necessitates substantial improvement to align with workplace requirements and international standards. Mohammad Zahir (2020) also noted that entrepreneurship is regarded as a means of adapting to or imitating innovators because the potential of Afghan entrepreneurs has not been nurtured adequately within educational institutions.
Unfortunately, Afghanistan's higher education system is primarily designed for imparting knowledge rather than promoting innovative thinking. Consequently, it tends to produce individuals seeking traditional employment opportunities rather than fostering job creators. The research suggests that expecting economic growth in the nation solely based on conventional education and training programs is unrealistic.

Additionally, Freshta (2016) emphasized that entrepreneurship training plays a crucial role in enhancing the profitability of enterprises. This can be achieved by implementing an active learning approach, teaching participants how to incorporate innovation and novel features into their products and services and discovering more cost-effective methods for production and service delivery. The study also highlighted that female-owned microenterprises often lack the necessary skills and still need to bridge an educational gap to achieve success.

Similarly, Murtaza et al. (2019) investigated the impact of entrepreneurship education on the choice of entrepreneurship as a career in Afghanistan. The study concluded that entrepreneurship education significantly and positively influences entrepreneurial behavior and attitudes toward entrepreneurship development. As a result, the research recommended that universities should actively promote entrepreneurship education to enhance graduates' entrepreneurial skills.

Nazifa and Muhammad Shahid (2018) conducted a study to identify the factors influencing female entrepreneurs' intentions toward enterprise development in Afghanistan. Their research underscores the need to establish modern entrepreneurship institutions that provide knowledge, skills, and training to enhance the capabilities of entrepreneurs. The study revealed that many businesses in the region face challenges related to a lack of business knowledge and experience.

Similarly, Wasiq and Dahlan (2019) found that entrepreneurship knowledge, skills, and human values play a significant role in shaping enterprise development in Afghanistan. They pointed out that the country's higher education institutions do not effectively bridge the gap between the skills demanded by the market and the development of enterprises.

ACCI (2017) identified a shortage of training facilities and a competent workforce as major obstacles to the growth of micro, small, and medium-sized enterprises (MSMEs). A significant number of respondents in various sectors, such as services, manufacturing, and construction, highlighted the scarcity of skilled workers as a pressing issue. Additionally, the low level of financial literacy among Afghan adults, estimated at only 14% (OECD, 2019), further compounds the challenges faced by businesses.

Mashal (2014) noted that banks often perceived loan applications and business plans from MSMEs as of low quality. He recommended that MSMEs receive assistance in developing high-quality business plans and financial documentation to enable the effective use of credit for productive business operations.

It is evident that the current programs focused on human capital development do not adequately meet the needs of micro enterprises, which are hindered by inadequate training courses and programs (Nazeer Mohammad, 2021; OECD, 2019). Furthermore, NGOs impose specific criteria for selecting micro enterprises to participate in human capital development training programs, including requirements related to business plans, financial records, and related documentation.

Based on the findings presented in the previous section (Section 5), the challenges concerning human capital development in Afghanistan in the context of microenterprise development can be summarized as follows:

- Improper training courses and programs
- Lack of education
- Lack of administration and management skills
- Lack of financial literacy
- Lack of technical skills
- Lack of entrepreneurship knowledge

## 6. Conclusion and Recommendation

The development of microenterprises (MEs) in a country like Afghanistan holds significant importance, as they constitute approximately 80 percent of all business establishments. Consequently, any improvement in their growth and development can substantially contribute to the overall economic growth of Afghanistan. Research and existing literature in this field emphasize that the availability of financing and human capital development services plays a pivotal role in the establishment, growth, and expansion of MEs.

However, in Afghanistan, MEs contribute less to employment generation and economic growth compared not only to South Asian countries but also to neighbouring nations. This discrepancy has raised questions about why micro enterprises in Afghanistan have a relatively lower impact on the GDP despite their substantial presence within the business landscape. In contrast, the remarkable performance of micro enterprises in other Asian countries is closely linked to the availability of financing and human capital development resources.

Multiple studies have underscored the challenges related to financing and human capital development as the primary barriers that impede the growth and development of micro enterprises. Consequently, this study was designed to comprehensively examine the difficulties faced by micro enterprises in Afghanistan in terms of financial access and human capital development.

Previous research and literature reviews on the availability of financing and human capital development have identified significant challenges faced by microenterprises (MEs). The study's recommendations are based on the recognition that the existing financing and human capital development systems or models are unable to adequately meet the demands of MEs in terms of providing consistent access to financing and human capital development services. Additionally, conventional loan products offered by financial institutions do not align with Shariah law, which is a significant consideration in Afghan society. Many MEs are hesitant about interest rates, making them unable to benefit from conventional financing mechanisms.

To address these challenges, the study recommends a shift towards an Islamic approach to financing and human capital development. It suggests developing an alternative model that integrates Islamic financial contracts with Islamic charities. The goal is to provide sustainable financing and human capital development services to MEs, aligning with Islamic principles and addressing the specific needs and sensitivities of the Afghan context.

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