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# PROPOSING AN ALTERNATIVE MODEL FOR FINANCING MICRO ENTERPRISES IN AFGHANISTAN

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**ABSTRACT**

The advancement of Micro-Enterprises (MEs) holds significant value in a nation such as Afghanistan, where MEs form a substantial portion of the private sector and play a pivotal role in fostering the country's economic development. Notwithstanding the acknowledged significance of MEs, securing adequate financial support for them remains an onerous task. It is evident that MEs in Afghanistan confront formidable financing hurdles, encompassing exorbitant borrowing costs, stringent collateral prerequisites, rigorous documentation mandates, the necessity for comprehensive business blueprints, and the imperative need for robust financial record-keeping. Unfortunately, a considerable portion of these MEs find it difficult to meet these requisites, consequently perpetuating their challenges in procuring external financing. Consequently, this study introduces an innovative model termed the Integrated Qardhul Hasan and Equity-based Micro Enterprise Development (IQEMD) model. The study critically surveys pertinent literature related to the issues MEs encounter when attempting to secure financing, including Qardhul Hasan and equity-based financing, and utilizes these insights to formulate the IQEMD model. This model is designed not only to alleviate the external financing conundrum faced by MEs but also to enhance their overall performance and amplify their contributions to the national economic landscape. The study culminates with a prospective recommendation for further exploration in this domain.

*Keywords: Micro Enterprises, Financing problems, Integrated Qardhul Hasan and Equity-based Micro Enterprise Development (IQEMD) model, Afghanistan*

**ABSTRAK**

Perkembangan Perusahaan Mikro (PM) mempunyai nilai yang signifikan di negara seperti Afghanistan, di mana PM ini membentuk sebahagian besar sektor swasta dan memainkan peranan penting dalam menyemai pembangunan ekonomi negara. Walaupun kepentingan PM ini diakui, namun ia masih lagi menghadapi kesukaran untuk mendapatkan bantuan kewangan yang mencukupi. Ianya adalah jelas PM di Afghanistan menghadapi kesukaran dalam mendapatkan pembiayaan, iaitu melibatkan kos pinjaman yang terlalu tinggi, prasyarat cagaran yang ketat, dokumentasi yang ketat, keperluan dalam pelan tindakan perniagaan yang komprehensif, dan penyimpanan rekod kewangan yang mantap. Malangnya, sebahagian besar daripada PM ini menghadapi kesukaran untuk memenuhi syarat-syarat ini, kesannya mereka berkekalan menghadapi cabaran dalam mendapatkan pembiayaan luaran. Oleh itu, kajian ini memperkenalkan model inovatif yang dikenali sebagai Model Bersepadu Qardhul Hassan dan Ekuiti-

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berdasarkan Pembangunan Perusahaan Mikro (MBQEPM). Kajian ini secara kritis meninjau literatur yang berkaitan dengan isu-isu yang dihadapi oleh PM ketika cuba mendapatkan pembiayaan, termasuk pembiayaan berasaskan Qardhul Hasan dan ekuiti, serta menggunakan dapatan ini untuk menghasilkan model MBQEPM. Model ini direka bukan sahaja untuk mengurangkan masalah mendapatkan pembiayaan luaran yang dihadapi oleh PM tetapi juga untuk meningkatkan prestasi keseluruhan dan meningkatkan sumbangan PM kepada landskap ekonomi negara. Kajian ini diakhiri dengan memberikan cadangan bagaimana penerokaan dalam bidang ini boleh dilanjutkan lagi.

*Kata kunci: Perusahaan Mikro, Model Bersepadu Qardhul Hassan dan Ekuiti-berdasarkan Pembangunan Perusahaan Mikro (MBQEPM), Afghanistan*

## 1. Introduction

Micro-Enterprises (MEs) make substantial and multifaceted contributions to economic advancement, technological innovation, economic rejuvenation, engagement with larger enterprises, and societal amelioration, as evidenced by Manzoor et al. (2021). On a global scale, MEs assume a pivotal role, bolstering their economies by making significant contributions to the Gross Domestic Product (GDP) and elevating the overall well-being of communities. It is essential to underscore that the impact of MEs contributions is felt across a spectrum of sectors and industries, where they often represent a disproportionately substantial portion of the total business establishments in many countries.

Empirical evidence underscores the pivotal role of MEs, revealing that they constitute more than 70% of the entire Small and Medium-sized Enterprise (SME) landscape across the majority of the world's economies. Furthermore, these MEs serve as the catalyst behind the creation of more than 60% of employment opportunities, thus emphasizing their indispensable function in stimulating economic growth and facilitating the generation of jobs.

In Afghanistan, according to a report from Afghanistan's Ministry of Economy in 2012, as referenced by Najafizada (2014), Micro, Small, and Medium-sized Enterprises (MSMEs) within the private sector comprise approximately 80% of local businesses and engage more than one-third of the labor force. Notably, around 90% of such enterprises employ five or fewer workers, categorizing them as MEs (Ghiasy et al., 2015; Najafizada, 2014). These MEs hold a paramount and transformative role in propelling the expansion of the domestic Afghan economy, as emphasized by Najafizada (2014). In the Afghan context, a MEs is defined as a business establishment with a workforce of fewer than five employees. Furthermore, it is worth noting that the criteria for investment in physical capital differ in Afghanistan. For the service sector, this threshold is set at less than AFN 1 million (equivalent to USD 12,987), while for non-service sector enterprises, it stands at less than AFN 2.5 million (equivalent to USD 32,467), in accordance with the World Bank's criteria as of 2022.

Despite their recognized significance and substantial economic contributions, MEs in Afghanistan confront formidable challenges when seeking external financial support. This predicament is well-documented in various studies (Abdullah, 2021; Ghiasy et al., 2015; Hussaini, 2021; Hussein, 2009; Lutfi, 2021; Najafizada, 2014; OECD, 2019). These studies consistently underscore the paucity of accessible financial services from lending institutions and related agencies as a predominant impediment to MEs development. The obstacles that obstruct their access to external financing encompass (i) exorbitant financing costs, (ii) stringent collateral requisites, (iii) rigorous documentation prerequisites, (iv) the need for professionally crafted business plans, and (v) the absence of a financial track record. Moreover, a considerable proportion of financial institutions exhibit reticence in extending credit to MEs due to their perceived lower profitability, elevated default risks, and the associated higher transaction costs. Conversely, while the Afghan government has instituted various financial programs, their efficacious impact remains unrealized, and MEs continue to grapple with these persistent challenges.

Numerous literary works have proposed alternative strategies to tackle these challenges. Among the suggested approaches are the utilization of conventional microfinance institutions (Bateman & Chang, 2012; Watkins, 2018) and Islamic microfinance institutions (Dhaoui, 2015; Hassan, 2014; Heriyanto et al., 2022; Khan & Bedi, 2021; Amirul et al., 2021). Nevertheless, the former approach, involving conventional microfinance institutions, has not proven entirely effective in addressing these issues, particularly concerning high-interest rates, the need for comprehensive business plans, and the costs associated with training and skill development (Hearth, 2018; Hussaini, 2021; Masyita, 2012; Misra, 2019; Nkwabi & Mboya, 2019; Wang, 2016; Watkins, 2018). Conversely, Islamic microfinance institutions face constraints, often necessitating the convergence of their existing procedures with conventional methods. For instance, many Islamic microfinance institutions primarily rely on debt-based financing, resembling the interest-based practices of conventional financing. In certain instances, operations of Islamic microfinance institutions in some Muslim-majority countries tend to be cost-intensive due to the preeminence of Murabahah practices or administrative charges that are intertwined with riba (Asmy et al., 2022; Kassim & Satar, 2019; Kholis, 2012; Saad, 2012; Shah et al., 2014). Furthermore, it is worth noting that while several proposed models are designed to address the needs of MSMEs in a general sense, only a limited number of studies have studied on component based MSMEs, with particular emphasis on MEs.

Hence, the current study endeavors to introduce an innovative and compelling framework, termed the Integrated Qardhul Hasan and Equity-based Micro Enterprise Development (IQEMD) model. This model is envisioned to effectively address the challenge of securing external financing for MEs and, concurrently, to bolster their capacity to make substantial contributions to the national economy while enhancing their productivity.

## 2. A Review of the Proposed Model

In accordance with the existing literature, numerous research studies, such as those conducted by Hussaini (2021), Abdullah (2021), Najafizada (2014), Ghiasy et al. (2015), Lutfi (2021), and Hussein (2009), have collectively shed light on the noteworthy financial challenges encountered by Micro-Enterprises (MEs). These challenges include (i) the substantial cost associated with securing external financing, (ii) the stringent collateral requirements imposed, (iii) the arduous demands for comprehensive documentation, (iv) the imperative need for meticulously crafted professional business plans, and (v) the absence of a discernible financial track record. In response to the formidable financing impediments elucidated in the literature, scholars have proposed various solutions, with a recurring theme being the integration of Qardhul Hasan and Islamic equity-based financing mechanisms for MEs. These scholars have outlined several propositions, which yet remain in need of formal conceptualization into a cohesive model.

This current study, therefore, undertakes the task of synthesizing and elaborating upon these propositions by formulating an innovative model. In terms of financial services, this model is designed to facilitate the deployment of funds in the form of Qardhul Hasan and Islamic equity-based financing. The overarching objective is to establish a consistent and reliable channel for financing availability, catering specifically to the unique financial requirements of MEs.

### 2.1 The Integration of Qardhul Hasan and Islamic Equity-based Financing

Numerous scholarly investigations have placed considerable emphasis on the potential of employing Qardhul Hasan as a viable financing avenue for enterprises, as exemplified in studies by Aderemi and Ishak (2020, 2022), Machfudz and Kamila (2019), and Zauro et al. (2016). These studies collectively underscore that judiciously harnessing the Qardhul Hasan mechanism can furnish Micro-Enterprises (MEs) with a source of capital that is substantial enough to meet their financial requirements. Nevertheless, it is important to note that these studies have thus far refrained from formulating a practical model that can be implemented to address the multifaceted financing challenges faced by MEs.

For instance, Zauro et al. (2016) introduced a conceptual framework designed to assess the viability of Qardhul Hasan financing for MEs. Within this framework, the authors placed particular emphasis on delineating the crucial relationships among variables such as attitudes, knowledge, perceived government support, and perceived benefits associated with the utilization of Qardhul Hasan as a financing source for MEs. The study's primary focus revolved around identifying the factors that enhance the acceptability of Qardhul Hasan as a financing mechanism within their conceptual model. However, it is important to note that the research did not undertake an empirical exploration of a practical model that could be effectively put into action to alleviate the prevailing financing challenges confronting MEs.

In their research, Aderemi and Ishak (2020) introduced an innovative Qardhul Hasan financing model tailored for the advancement of Micro and Small Enterprises (MSEs). This distinctive model seamlessly incorporates crowdfunding as a strategic component to mitigate the financial challenges encountered by MSEs. The study advocated for the adoption of Qardhul Hasan-based crowdfunding as an alternative financing avenue for MSEs, positing that the absence of fixed interest rates could yield more favorable returns for micro and small businesses. Within their work, the authors presented a comprehensive conceptual framework for the seamless integration of Qardhul Hasan-based crowdfunding into the operations of MSEs. It is important to note, however, that the model was not subjected to empirical analysis with a focus on validation, specifically in terms of gauging the intentions of potential investors to utilize the proposed model.

Machfudz and Kamila (2019) investigated the implications of Qardhul Hasan development. Their study was designed to provide insights into Qardhul Hasan financing, its impact on business performance, and the perceptions of MEs regarding Qardhul Hasan loans for their development. The research findings demonstrated that the adoption of Qardhul Hasan financing yields highly favorable results. When directed towards MEs operating within the creative economy sector, this approach fosters a sense of contentment and tranquility, primarily because borrowers are not encumbered by the burden of interest-based loan repayments. Additionally, the study highlighted that Qardhul Hasan financing garnered positive feedback from various economic stakeholders. However, it is noteworthy that the research did not offer a comprehensive mechanism for establishing a sustainable and practical framework for the conceptualization of Qardhul Hasan modeling to promote the development of MEs.

Aderemi and Ishak (2022) presented an innovative Qardhul Hasan-based crowdfunding model, wherein micro-entrepreneurs present their business concepts to the crowdfunding platform. The platform's Shariah advisor assumes the critical role of assessing the proposed projects to ensure their compliance with Sharia principles. A due diligence team is tasked with verifying the qualifications of business owners seeking to avail themselves of this service. Once approved, the platform actively promotes the selected business ideas to a wider audience. In this arrangement, the platform acts as an intermediary, assuming the role of "Wakalah," facilitating interactions between two key parties: funders (investors) and fundraisers (micro-entrepreneurs). Furthermore, the platform has the flexibility to impose a service fee on entrepreneurs, calculated based on a predetermined fixed ratio, irrespective of the amount raised or the loan's maturity.

It is important to note, however, that the proposed model has not undergone empirical testing to assess the willingness of MEs to adopt and utilize this innovative crowdfunding mechanism. Moreover, a substantial body of research underscores the significance of leveraging an Islamic equity-based financing approach for the funding of MEs, as evident in studies conducted by Ishak and Rahman (2021), Lawhaishy and Othman (2022), and Rahman et al. (2020). These investigations collectively emphasize that the effective deployment of the Islamic equity-based financing mechanism as a source of funding plays a pivotal role in guaranteeing that MEs gain access to the requisite financial resources necessary for their sustained operations.

As an example, Rahman et al. (2020) introduced a conceptual framework for Shar'iah-compatible Equity-based Crowdfunding (SEC), comprising three key phases: pre-funding, financing, and post-funding. The model underscores that entrepreneurs seeking to secure capital through SEC must establish an affiliation with a specific operator of an equity-based crowdfunding platform. The proposed contractual arrangements could manifest as Mudarabah or Musharakah. It is pertinent to observe, however, that the model was primarily designed with a focus on entrepreneurial development and did not give due consideration to the distinct needs of MEs. Furthermore, the model exclusively incorporates Islamic equity-based financing mechanisms as the source of funding. This singular approach may not necessarily yield optimal outcomes for disadvantaged MEs.

In their study, Lawhaishy and Othman (2022) put forth a conceptual framework for the structure of a Mudarabah investment fund model rooted in Islamic equity-based financing principles. This framework involves Micro Investors (MIs) who possess certain financial assets contributing funds into the model, functioning as arbab ul-mal. Concurrently, an Islamic microfinance cooperative organization operates as a mudrib, utilizing these invested funds for Sharia-compliant ventures. A noteworthy feature of this approach is that MIs can make relatively modest contributions to the Islamic fund while expecting returns based on predetermined ratios. Furthermore, MIs are given the opportunity to engage in multiple Islamic investment funds, affording them the ability to diversify their investment portfolios. However, it is crucial to acknowledge that this model was designed with a specific focus on MIs who may lack entrepreneurial skills or expertise. Consequently, the model may not be directly applicable to MEs due to its distinct orientation towards the investment behavior of MIs.

Ishak and Rahman (2021) introduced an Islamic equity-based crowdfunding model, which employs Mudharabah contracts as the financing mechanism for enterprises. In this model, the project manager is required to furnish comprehensive information about their project. The crowdfunding platform serves as a agent representing the donors' interests. The platform diligently evaluates the project for its credibility and adherence to Shariah principles. Additionally, the platform may propose certain modifications to the original project concept presented by the project manager. If the project receives approval, the platform proceeds to initiate a funding campaign to raise the necessary capital. However, it is important to note that this model does not specifically cater to the needs of MEs. Furthermore, the model exclusively relies on Mudharabah contracts as a financing mechanism, which may not always be the most suitable choice for businesses in their nascent stages of development.

Building upon the aforementioned discourse, numerous studies have lent support to the potential roles of Qardhul Hasan and Islamic equity-based financing in facilitating the delivery of financial services to MEs. However, it is crucial to note that the majority of these studies have primarily centered on the conceptual and theoretical dimensions of Qardhul Hasan, Islamic equity-based financing, and their relevance to enterprises. A notable void in the literature pertains to the absence of endeavors aimed at translating these theoretical underpinnings into empirically testable frameworks or models. To address this gap, our study endeavors to bridge this theoretical-practical divide by introducing an innovative model, referred to as the Integrated Qardhul Hasan and Equity-based Micro-Enterprise Development (IQEMD) Model. The IQEMD Model presents a collaborative agreement between Islamic Microfinance Institutions (IsMFIs) and MEs. This model comprises two distinct stages: In the first stage, it incorporates a Qardhul Hasan financing arrangement between IsMFIs and disadvantaged MEs, aimed at providing a financial lifeline to these entities. In the second stage, the model integrates an Islamic equity-based financing arrangement between IsMFIs and economically viable MEs. This dual-pronged approach is designed to cater to the diverse financial needs and conditions of MEs, fostering a more comprehensive and adaptable framework for their development. This research contribution is intended to guide practical implementation and empirical examination, thereby enriching the practical applicability of these financing mechanisms for the benefit of MEs.

## 3. A Proposed Integrated Qardhul Hasan and Equity-based Micro Enterprises Development (IQEMD) Model

Figure 1 illustrates the conceptual framework of the Integrated Qardhul Hasan and Equity-based Micro Enterprise Development (IQEMD) model, which serves as an innovative alternative to existing programs and schemes for financing Micro-Enterprises (MEs) in Afghanistan. The key elements of this model are the Donors, Islamic Microfinance Institutions (IsMFIs), and MEs. The proposed IQEMD model involves the following stages:

- The donors (both individual and corporate sector) contribute cash as a donation to the IsMFI to create a perpetual Central Pooled Found (CPF). Individuals or the public sector can contribute cash through sadaqah and waqf. In contrast, the corporate sector can contribute cash (donation) to their Corporate Social Responsibility (CSR). However, apart from the public and corporate sectors, the government should also provide philanthropic donations from baitul maal as a source of funding for the model, contributing to the CPF. The IsMFI becomes a mutawali (manager) of the fund and makes the necessary financing decisions regarding the collected funds (1).
- IsMFI ensures the availability of financing using the CPF (1). The financing can be made to Economically Poor Micro Enterprises (EPMEs) through the provision of Qardhul Hasan financing with the aim of enhancing their productivity and improving their performance for becoming economically viable MEs (2a and 2b), where the IsMFI could be engaged with offering Islamic equity-based financing such as Musharakah Mutanaqisah partnership (4a and 4b)).
- After EPMEs avail financing services, they are supposed to develop from stage one (EPMEs) to Economically Viable Micro Enterprises (EVMEs) (stage two) (3). It is a state where MEs are positioned to enhance gross output, profit, employment and productivity - all of which later contribute to the national income or GDP.

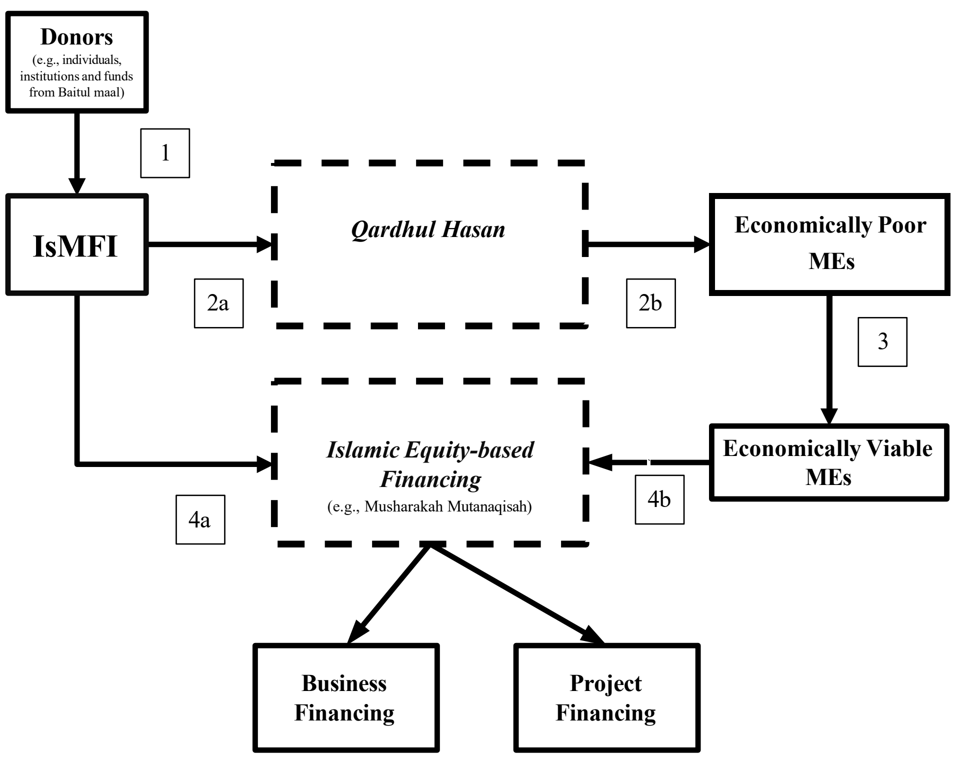


**Figure 1: Conceptual framework of the IQEMD model**

## 4. The Significance of the IQEMD Model

The development of the Integrated Qardhul Hasan and Equity-based Micro Enterprise Development (IQEMD) model highlights a complementary relationship between the Central Pooled Fund (CPF) and

Micro Enterprises (MEs), recognizing that MEs serve as a catalyst for economic growth. In the initial phase of ME development, Islamic Microfinance Institutions (IsMFIs) can extend financial support to Economically Poor Micro Enterprises (EPMEs). Subsequently, in the second phase of ME development, IsMFIs can provide equity-based Islamic financing to Economically Viable Micro Enterprises (EVMEs) by employing the Musharakah Mutanaqisah Partnership (MMP) contract. In this comprehensive framework, it is essential to recognize that the IQEMD model has the potential to yield significant positive impacts not only on IsMFIs and MEs but also on society and economy.

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### 4.1 Impact on Islamic Microfinance Institution (IsMFI)

The Islamic Microfinance Institution (IsMFI) stands to accrue several advantages from the implementation of the proposed model. The establishment of a Central Pooled Fund (CPF) comprised of contributions from Islamic charities, the general public, the corporate sector, and governmental entities, facilitates the creation of the IsMFI as the operational body. The IsMFI is poised to collaborate effectively with community stakeholders to provide financial services and harness expertise for the development of Micro-Enterprises (MEs), aligning with the principles of Islamic philanthropy.

By nurturing economic production and employment generation, the IsMFI can contribute to community development, thereby advancing the broader objectives of Islamic endeavors. Additionally, the IsMFI secures a dependable source of income and sustains cash flow. This approach, moreover, aids in risk diversification and risk-sharing. Furthermore, it serves as a vehicle for fostering adherence to Shariah law and the promotion of Islamic values through its financial activities, ensuring that the principles of Islamic finance are upheld.

### 4.2 Impact on the Micro-Enterprises (MEs)

The core of this model revolves around the establishment of a Central Pooled Fund (CPF) dedicated to advancing the development of Micro-Enterprises (MEs) through various stages of growth. The incorporation of Qardhul Hasan plays a pivotal role in elevating the profile of Economically Poor Micro Enterprises (EPMEs). As EPMEs progress from their initial stages to the subsequent phase (Economically Viable Micro Enterprises or EVMEs), Islamic Microfinance Institutions (IsMFIs) can engage with them by offering equity-based financing options, such as the Musharakah Muthanaqisa Partnership (MMP) contract. This approach empowers MEs by enhancing their ownership rights and promoting their sustainable development.

By focusing on delivering financial services, this model helps financial institutions shift away from perceiving micro businesses as high-risk ventures. Moreover, it has the potential to significantly contribute to the success and growth of MEs, enabling them to transition from small-scale enterprises to medium-sized and even large-scale businesses. The Integrated Qardhul Hasan and Equity-based Micro Enterprise Development (IQEMD) model serves as a holistic framework that supports the expansion and maturation of MEs.

### 4.3 Impact on the Society and Economy

The envisioned impact of the Integrated Qardhul Hasan and Equity-based Micro Enterprise Development (IQEMD) model extends to society and the broader economy, offering several substantial benefits. By placing a strong emphasis on financing and human capital development, the model creates an environment conducive to innovation and creativity. It contributes to the promotion of private ownership and the cultivation of entrepreneurial skills.

The IQEMD model leads to the establishment of more sustainable Micro-Enterprises (MEs), enabling underprivileged individuals to access affordable consumer products and services. This model not only facilitates the growth of MEs but also facilitates their access to external financing opportunities. Furthermore, as it incorporates Islamic donations, it serves as an intermediary, enabling the corporate sector to fulfill its social responsibility by contributing to the Central Pooled Fund (CPF).

Additionally, this model generates employment opportunities and assists disadvantaged micro-entrepreneurs in generating income, thereby contributing to poverty reduction. Simultaneously, it contributes to the accumulation of wealth, increased consumption, and enhanced investment, all of which can drive economic growth. The IQEMD model is poised to have a transformative effect on both the social and economic landscape.

## 5. Conclusion, Limitation of the study and Future Recommendation

Micro Enterprises (MEs) form a significant segment of the Micro, Small, and Medium-sized Enterprises (MSMEs) landscape in Afghanistan. However, MEs face notable challenges in accessing external financing, primarily due to their classification as high-risk ventures. This limitation severely constrains their potential for growth and development. MEs grapple with daunting external financing obstacles, including stringent collateral prerequisites, exorbitant financing costs, onerous documentation requirements, and the imperative need for comprehensive business plans and financial track records. Regrettably, many MEs find it arduous to meet these stringent conditions, which perpetuates their financial difficulties.

To address this pressing issue, the present study introduces the Integrated Qardhul Hasan and Equity-based Micro Enterprise Development (IQEMD) model as an innovative financing source that alleviates the financial constraints confronted by MEs. This model is expected to enhance the productivity and overall contribution of MEs to the economic growth of the country.

There are some potential limitations of the study. First, the study may have focused on a specific context, such as Afghanistan, which could limit the generalizability of the findings to other regions with different economic, cultural, and regulatory conditions. The effectiveness of the proposed model may vary in different contexts. Second, the study might have relied on existing literature and theoretical frameworks, and there may have been limited empirical data available for testing or validating the IQEMD model. This could impact the practical applicability of the model.

It is imperative that future research endeavors are undertaken to refine the IQEMD model through expert interviews and validation via surveys to assess the willingness of MEs to embrace the IQEMD model as a viable financing solution. This iterative process of development and validation will further bolster the model's applicability and effectiveness in empowering MEs within the Afghan economic landscape.

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