

## Challenges Faced by Startups and Small and Medium Enterprises: A Case Study of Kabul Province

Kardan Journal of Economics  
and Management Sciences

2 (4) 43–54

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Kardan Publications

Kabul, Afghanistan

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### Abstract

*This paper makes an endeavour to evaluate the challenges faced by Startups and Small Medium Enterprises in Kabul Afghanistan during 2017 and 2018. It outlines an approach to learning how startups perceive the impact of input constraints related to market, finance, labor, regulation, technical, etc. on their success. The paper sheds light on the identification of such constraints and challenges from the perspective of managers and entrepreneurs. The study employs inductive approach of thematic analysis to analyze the outcomes of the four sessions of focus group discussions conducted with the managers or founders of startups, SMEs, and government officials. Meanwhile, the paper recommends specific measures suggested by the related authorities from the government and non-government sectors to secure the survival and growth of startups. Prevalence of government regulation, including but not limited to; taxation, bureaucratic licensing, along with complicated procedures are some of the most critical challenges faced by Startups and Small Medium Enterprises in Kabul.*

**Keywords:** *Startups, SMEs, entrepreneurship, private sector, economic growth*

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## Introduction

Small and Medium-sized Enterprises (SMEs) are regarded as the backbone in the developing countries as these constitute a large portion of their economies. SMEs also contribute a significant part to GDP and employment in these countries (Ayyagari, Beck, & Kunt, 2007). For example, according to a report by Switchasia (2017), SMEs in Afghanistan produces more than 50% of the GDP; in addition to that, more than 30% of the labor force is busy in this sector.

Furthermore, startups are not only crucial for economic growth and employment generation but also, for building people's capacities Switchasia (2017). Given that SMEs contribute to GDP and employment in a country, they are also faced with various challenges from the environment. According to Abeh (2017) SME face challenges because of inadequate fund, corruption, political and religious factors, social and cultural factors, infrastructure, and environmental factors. In addition to that, this sector is mostly neglected by governments. For example, as discussed by Naithani (2007) the SMEs are lacking support from the government side in the form of tariff, as the government charges less tariff on foreign goods and let a cut-throat competitive environment between domestic producers and foreigners which results in failure of SMEs, being dumped by foreign competitors, lack of subsidies by government.

In addition to the problems from the state actors, SMEs face problems from the non-state actors as well, for example, according to Mathai (2015) the significant problems toward SMEs are lack of credit from banks, competition from multinational companies, poor infrastructure, unavailability of raw material and other inputs, lack of advanced technology, lack of distribution channels in the markets, lack of training and skill development programs.

However, there are numerous publications on the importance, contribution, and challenges of SMEs in Afghanistan specially focusing on the financial challenges faced by SMEs; there is little written on startups. Startups are the building blocks of SMEs, which currently face numerous problems not only in terms of financial and technical support but also in terms of the government's support and the role of non-state actors, on the one hand, and the challenges. According to Raza et al. (2018), the failure rate of small and medium enterprises is higher in developing states.

Therefore, as it is evident that the challenges faced by startups are different from those faced by more established firms, the current paper will focus on the challenges that are faced by startups in Kabul from both the state and non-state actors. In this paper, the research findings are based on

the responses of the managers or entrepreneurs running startups or small size enterprises in Kabul.

### **1.1 Problems Statement**

The state and non-state actors – for example, competitors and customers – may pay less attention to the development of SMEs, their consideration of small enterprises at their early stages of development is even less. In Afghanistan, small businesses are more fragile than established enterprises due to lack of attention and proper support. This was due to the flow of tremendous aid and money tied to the military presence that distracted the government from focusing on the development of SMEs and facilitating their access to market, which would ensure the sustainability of the economy in the long run (Mashal, 2014). Similarly, Ghosh (2012) states that more than 70% of the startups fail in the first five years, while more than 90% fail in ten years of their business. Afghanistan is no mystery to this; in the past few years a large percentage of the startups and SMEs have never made it to their third year of operation. Therefore, it is necessary to focus on identification of the challenges that lead to the failure of enterprises at their early stages of development. Nevertheless, the fragility of the startups is more severe in developing countries, since they face much more problems than they are prone to in the US and other developed countries.

The failure of SMEs in Afghanistan has long been a challenge for the government. The government has always been criticized for its lack of support to the most significant contributor to the economy and yet the most vulnerable sector of the economy. Therefore, it is crucial to identify the challenges faced by startups and SMEs in Afghanistan to make it easier for the policymakers to address them. However, according to Schoofs (2014) three issues define fragile context for Small Enterprises: high level of political insecurity, lack of security, and personal connections in developing countries. This study will shed light on the details of challenges faced by the startups and SMEs at their early stages of development, from both the state and not-state actors.

## **2. Literature Review**

According to Sudalaimuthu & Kannan (2014) the main problems of SMEs in developing countries are lengthy and complicated procedures & documentation to raise finance from the market, absence of sufficient necessary infrastructure, lack of physical access to markets, and psychological access to consumers, high bureaucratic to utilize the schemes

and subsidies by various bodies and agencies and lack of trained & poor educated labors – especially to non-urban entrepreneurs.

Among the developing countries, according to Muhammad Khaliq, Adel, & Shaari (2011) the main challenges on the path of SMEs growth in Malaysia are a recession, barriers from global sourcing, low productivity, lack of managerial capabilities, and lack of financing, difficulty in accessing management, technology, and onerous regulatory burden. While, according to Hussain (2015) in Pakistan, still following the initiate model of 1960 is considered one of the main issues towards the development of SMEs.

According to Venkatesh & Muthiah (2012) the significant challenges of SMEs are the lack of enough and timely supply of fund, high cost of fund, problem to raise capital from equity market, procurement of material at less competitive cost, storage problem, package issue, lack of linkage to international markets, lack of infrastructure and advanced technologies facilities, less skilled employees, complication of business law and lack of support and mechanism for rehabilitation of sick business entities.

A study by Habibi (2016) revealed that the major drawback of SMEs is high-security requirements to access finance, availability of short-term loans, high capital cost, lack of accounting, and bookkeeping knowledge of staff to maintain proper financial statements and book of accounts and high iteration of loan installment.

According to Chowdhury & Alauddin (2015) the major problem of SMEs are inability to market the products and maintain product's quality, lack of skilled technicians and workers, poor management skills of entrepreneurs, lack of quality assurance, scarcity of resource, high employee turnover ratio, access to market and lack of awareness from marketing tool, high interest rate, lack of commitment to innovation and customer satisfaction and lack of research and development facilities.

As a developing country, various challenges affect the growth and development of SMEs in Afghanistan; for example, according to Schoofs (2014), these five challenges are the most effective in Afghanistan, insecurity, corruption, poor governance, and Finance. Meanwhile, uncertainty of business environment and decreasing market confidence; dependence on donor organizations for startup support, limited productive diversity, limited access to credit, quality control and creativity, lack of industrial energy, and access to markets are the issues SMEs face in Afghanistan according to Mashal (2014).

Similarly, Switchasia (2017) states the challenges faced by SMEs, such as lack of reliable financial records, lack of capacity in business planning, lack

of capacity in marketing, limited product diversity, limited access to markets, and informal status of business.

USAID points the challenges of SMEs, in a report before 2009 by (Charitonenko & Tulchin, 2009), in this report challenges are listed as public corruption, unreliable electricity, vacuum policies, and law, weak capacity of legal structures, absence of proper land registration, adverse taxation, lack of skilled labor and unavailability of proper data.

However, a lot has been written on the challenges faced by SMEs in the rest of the world and Afghanistan; little has been written on the challenges faced by startups in Afghanistan. The current study is aimed to fill the gap in the literature by explaining the challenges faced by startups and SMEs during establishing and growth of the business by pointing out the legal and environmental problems they face.

### **3. Methodology**

The researcher has conducted four sessions of focus group discussions in two rounds. At the same time, each round of focus group interview had two sessions, which continued for 2 hours, and every session had around 25 participants. The first session of every round gathered the founders and managers of startups and SMEs operating in Kabul. The participants of the first session were focused on identification of the challenges their businesses faced. While the second session of each round consisted of a few prominent members from the first session - who could better present the challenges they faced - along with the government authorities to confirm or deny the raised challenges. The identified challenges were shared with the government authorities to suggested ways of addressing the challenges and making sure such challenges were taken to the table of the responsible higher authorities for further investigation. The investigator neglected the challenges that were refuted or addressed by the government authorities; however, this paper reports the challenges that were acknowledged by them.

Additionally, the nature of the questions used for focus group discussions was semi structures. A few of the questions were structured, such as: What problems do you face the government could solve? What challenges have you faced in the market? What legal challenges does your business face? What kind of support could be offered to you? Additionally, some questions were asked during the focus group discussions to clarify answers and reach valid and reliable conclusions. It is worth mentioning that the course of focus group discussions was sound recorded, and the facilitator was taking notes for future references.

The investigators used the inductive approach of thematic analysis to identify some common themes using manual commonality analysis. First of all, the focus group discussions for each of the sessions were transcribed. Then, the keywords and phrases in each session were identified. Later on, from the identified key phrases four themes emerged.

#### **4. Findings**

Here, the first theme focuses on the challenges that emerge before and during the launch of the business. While the second theme focuses on the challenges that are faced by startups during their operation. Furthermore, the third theme focuses on the business environment challenges faced by the startups, and the fourth theme brings to picture the regulatory constraints and challenges faced by businesses.

##### **4.1 Setting up a Business**

It is not easy for investors to decide on setting up a business in Afghanistan, which is associated with various challenges. The challenges appear with the establishing of startups and continue parallel to the growth of the company. However, they will not necessarily disappear with the closing of the enterprise. For example, one of the most common ways of doing business in Afghanistan is copying other business ideas. A new business in the Afghan market means finding a business that is earning good profits and then copying that same idea. In some cases, the formula of product and even the method of production is copied, and therefore competition is hindered. The ground is not leveled for competition.

Instead, donor organizations must work on the generation of new business ideas. Donor organizations have to focus on those startups that bring new ideas, methods, and processes into implementation; however, the government should work on intellectual property rights and their enforcement. The current Intellectual Property Rights Law does not issue patents to chemical formulas, which is a problem for some of the producers. Meanwhile, the existing startups have to be assisted in growing larger; for example, capital should be easily provided, technical assistance has to be available, competition should be fair, and markets should be expanded.

Furthermore, opening new small businesses should not be hindered by bureaucracy, capital requirement, and piles of documents such as tax forms, contracts, bank statements, etc, it should actually be effortless to start small businesses. Startups should be exempt from bureaucratic documentation, capital requirement, taxation and anything else that discourages startups. Instead, they have to be given technical, capital, legal and political support, and tax holidays.

For example, bureaucratic business licensing is a barrier to entry; it still takes a very long time to update business licenses with the ministry of commerce and industries. Sometimes it takes more than a month to renew a license. The process of renewing licenses takes a massive pile of documents and signatures which increases the time and cost of processing licenses; thus, increasing the need for brokers, and facilitating corruption. As a result, investing in the generation of original business ideas and applying e-governance to decrease bureaucratic procedures may prove to be helpful.

#### **4.2 Barriers to Growth**

Once a startup is successfully established despite all the problems mentioned before, other challenges will lead to slow growth and possibly failure of most of the established startups. These challenges range from cultural, political, legal, economic to social factors that hinder the growth of startups and SMEs. Cultural and social factors include the terrible image of Afghan products, unfair competition, and less value to contract enforcement. The label of “Made in Afghanistan” has earned a bad image in the Afghan market, which has encouraged some of the producers in the market to label their products as made-in-Iran and made-in-Pakistan. Because consumers do not trust the Afghan brands; they trust brands of other countries more than Afghanistan.

Meanwhile, competition practices in the Afghan market ignore and surpasses lawful and ethical competition. Competitors use any illegal means to hinder competition; or create barriers to entry. For example, the established producers in the market refuse to trade with startups. Others produce without getting a license. However, some startups have managed to keep up with the demand in the market, but others have suffered and even closed their businesses.

Economic factors include expensive capital, high taxes, the requirement of standard marks, and lower consumer confidence. The interest rate is exceptionally high; it makes only the high return businesses viable in the market. Meanwhile, capital-intensive firms cannot be established with ease. In addition to that, not only tax holidays are not given to startups; they have to pay equal taxes as large industries. There is no difference between the taxes paid by startups and large industries, which may be considered a barrier to entry.

Furthermore, the lack of a proper local online payment system is another issue that has shrunk the market. Especially the youth who has access to internet are interested in online purchases. While online sales are a very lucrative market place for startups, they cannot sell products online,

because of the lack of local online payment systems. Some of the startups, who does sell through Facebook and other platforms, still use cash payment on delivery.

Political factors include weak support for SMEs and startups in the National Unity Government (NUG). Currently, there are no or limited schemes available to support startups, more than 100 newly established companies have been closed in Herat and Kabul in the years 2018 and more than 400 have been closed in 2019.

Additionally, ACCI is currently monopolized, and it serves the interests of only a few large sharks in the market. Afghanistan Chamber of Commerce & Industries (ACCI) does not have any plans or programs to support startups. A separate body should be created to unite the startups and small businesses so that these businesses can help each other in the market by buying each other's goods and services. Once the startups are united, they will be able to crowdfund, enter contracts with each other, support each other, and provide technical assistance to each other.

To conclude, rebranding the Afghan products, fair competition in the market, tax holidays, lower interest rates, better banking practices, countering corruption, and better management practices in Afghanistan Chamber of Commerce & Industries (ACCI) may prove to be useful in the establishment of startups.

### **4.3 Climate for Entrepreneurs**

However, most of the participants are of the view that the climate for entrepreneurs has improved recently, but there are still lots of problems and issues that have to be addressed. These problems range from legal requirements to market access. The government could efficiently address most of the problems, while others are related to entrepreneurs and businesses themselves. For example, one such problem is the troublesome procedure of payments to the contractors by the government. Payment made by the government to the contractors takes a very long time, that is why most of the SMEs are not interested in engaging in contracts with the government, let alone the startups. Since startups have little capital, they cannot afford to wait for months for the payment. Therefore, the startups are excluded from enjoying the benefits of government contracts.

In addition to that, insecurity and uncertainty in the market are the other two factors that complicate the environment of doing business for SMEs. For example, when a market catches fire, or if there is a bomb blast nearby, startups suffer the most. Not only because of the physical damage



to the enterprise, but also because of the slower flow of customers to the market and thus drop in sales.

In conclusion, the business environment could be improved if the government could take measures on, easing the procurement procedures, making payments in time, and securing the markets.

#### **4.4 Rule of Law**

Legal factors hindering the growth of SMEs and startups include the lack of law enforcement, loopholes in the law, and lack of law. For example, some producers in the market that do not have any licenses do not pay taxes and use child labor, which remarkably decreases the cost of production and prices in the market. As a result, it makes competition difficult.

Besides, in order to attract extra customers, some firms make out-of-proportion claims in their advertisement messages, with no regard to the truth or its consequences in the market. Therefore, either the Ministry of Culture and Information should create a mechanism to monitor the details of advertisements messages, or the antitrust law should be able to monitor such details.

Furthermore, the procurement law of Afghanistan discourages small businesses from participating in procurement contracts of the government. The procurement law favors large companies over small; for example, from one side, to win contract companies are required to show similar experience, which startups lack, and on the other side, such contracts require a minimum amount of balance with banks, which is usually more than what a startup may have. Similar legal requirements block startups from getting government procurement contracts.

Furthermore, the write-up and text of the law are not easy to comprehend, which results in a shallow rate of reading and understanding of the law. Text of the available laws in Afghanistan especially those that are intended for the public should be rewritten for better comprehension; otherwise its enforcement rate will stay low.

The consensus is that a new wave of entrepreneurs, who are committed to the rule of law, is spreading over the market. These new entrepreneurs are motivated and committed to the rights of their employees, interest of the public, and government obligations.

On the other hand, it is complicated to start a small business in Afghanistan. The requirement of licenses, contracts of renting an office, having a large amount of money in the bank (One million AFN), and many more requirements by the licensing agency make it difficult for people to license their businesses in the first place. For example, startups are currently

required to fill all the tax forms and report to the taxation agency even if they do not have any activity, which has resulted in extra payments to the brokers who fill the required documents and forms for startups, which increases expenses and thus the prices.

Because of this, there is a black market of unlicensed startups shaping up in the market, which leads to market failure and unfair competition. The existence of unlicensed firms has made business difficult for licensed businesses. The licensed business has to pay taxes, pay brokers, and pay other fees that result in higher prices and low competitiveness. As a result, rewriting and amendment of the law to address the current challenges may prove to be useful.

## **5. Conclusion and Recommendations**

The emerged themes suggest that startups and SMEs are facing challenges on many grounds. The related authorities could immediately address some of the challenges, however, other challenges take time to be addressed. The emerged themes resulted in summarizing the legal, economic, social, and political problems of startups. The most prominent of these problems and concerns on the government side was a less-supportive treatment of startups. In other words, startups were treated the same as established SMEs in terms of taxation, licensing, documentation, and government procurement contracting. Meanwhile, the participants insisted the lack of a supportive policy for startups, which may have included compulsory technical, financial, and market support of the government for such businesses.

For example, the government should create a Standardizing Agency that can accredit the high-quality producers in an attempt to increase consumer trust for the Afghan brands and separate the good from bad quality products and services in the market. However, International standardization agencies and licenses are not easy to get, and sometimes quality goes down after such licenses are achieved. Meanwhile, the government Standardizing Agency should work on creating better image for domestic products that are certified by them, which will not only increase consumer confidence in the afghan products but also ensure quality.

The participants also insist on the establishment of a separate policy in support of startups, small businesses and the cottage industry of the country, where such policy will insist on financial, technical, legal, and political support for such businesses. With a particular focus on financial support, a separate fund or bank can be set up to pool capital in support of small domestic producers. In case of legal support, special licenses should

be produced for startups, which have enough privileges such as low taxes, less documentation, low tariffs on imports, better market access, share in government procurement, and even subsidies for such businesses. In addition to that, the representative of the ministry of commerce and industries insisted that he will raise the concern with his authorities to establish such a policy.

Most of the participants agreed that the government had ignored the cottage industry of the country. However, SMEs created substantial employment opportunities and produced above 80 percent of the GDP; they insisted that government had paid little attention or did not implement policies to support SMEs in Afghanistan. They suggested that government should develop a specific policy to support SMEs, establish sectoral banks such as agriculture banks, investment banks, services bank and export banks in Afghanistan.

Other participants asked the government for technical support to sustainable development and growth of the established SMEs. Such support will enable small businesses to grow larger and be able to compete in the market.

Accordingly, most of the participants who have either had a business or wanted to start one suggested a union of the SMEs. This union would agree on certain privileges to the members, such as charging small fees for services, being a customer to each other, and attract the government's support for startups and SMEs.

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