Article

Role of Venture Capital as a Source of Finance for Small and Medium Enterprises in Afghanistan: An Investigation

Kardan Journal of Economics and Management Sciences
1(4) 1–32

Kabul, Afghanistan
DOI: 10.31841/KJEMS.2021.70
https://kardan.edu.af/Research/CurrentIssue.aspx?j=KJEMS

Aimal Mirza
Fahim Sabah

Abstract

The objectives of the study were to review the types of venture capital financing in Afghanistan, identify the factors that drive the venture capital financing and impact of venture capital on small business development. The study adopted a quantitative methodology in order to investigate the subject. Questionnaires were administered on respondents. The study established that government was the main financer of venture capital financing in Afghanistan. Further, stable economic environment, investor protection and corporate governance and well developed capital markets were found to be main determinants of venture capital financing. The study also established that the role of venture capital financing played an important role in the areas of employment creation, investment, export growth as well as innovation and creativity.

JEL Classification: *M10, M13, M20, M21*

Key words: *venture capital, small and medium enterprises, entrepreneurship, investors.*

Mr. Aimal Mirza, *Thesis coordinator at Kardan University, Kabul, Afghanistan.*
Mr. Fahim Sabah, *MBA Alumni, Kardan University.*

Introduction

In Afghanistan, the micro, small and medium scale enterprises have been seen as important for economic growth beside the agricultural projects and activities, which is one of the strong economic developing portion in the developed and under developed countries in the world. According to United Nations Environment Program Finance Initiative, UNEP FI (2008) "MSMEs employ 63% of the employed people in Zimbabwe with 90% of business coming from them. In Afghanistan SME make up to 80% of businesses, half of the country GDP and employ more the than 1/3 of the labor force (AREU Jan 2014). To have highest impact on economic growth, the economic development strategies should focus on increasing number of oriented SMEs which can be competitive on both international and local market". These strategies require linking SMEs to affordable sources of finance and providing adequate business support. The financing instrument that can be used to attain this goal is venture capital.

Wright (2005) broadly described venture capital as a medium term equity investment or direct equity with a well-defined exit strategy in young privately held companies. Venture capital financing is underpinned by the principle of forging relationships through matching finance to entrepreneurs. This study, therefore, seeks to evaluate the role of venture capital as a financing option for SMEs in Afghanistan.

1.1 Statement of the Problem:

In Afghanistan the venture capital market seems a start-up concept and area to focus on to target large and the small to medium enterprises. Can venture capital be the solution to financing problems for SMEs? Do these SMEs meet the requirements for venture capital finance? This study, therefore, seeks to evaluate the role venture capital financing as a financing option for small to medium enterprises in Afghanistan.

1.1.1 Research objectives:

The objectives of this research are to first of all identify type of venture capital. Secondly, this study aims to examine available type of venture capital in Afghanistan and establish factors that drive venture capital financing. Thirdly this study will attempt to determine the effect of venture capital of SMEs development and finally study will offer a set of recommendation on venture capital financing concept in Afghanistan.

2. Literature Review:

2.1. Definitions of Venture Capital:

International Finance Corporation (IFC) (2009) defines venture capital as commitment of capital by venture capitalist to promote development of new ideas, business, products, services and processes that offer high returns on investment. Venture capital involves other non-monetary tasks which include screening, monitoring, strategic advice, operational assistance and corporate governance (Sorensen, 2007; Ivanov and Xie, 2010). Black and Gilson (1998) define venture capital by explaining the high-growth and high-risk nature of the investments. Venture capitals are equity investments for the purposes of launching, start-up development and expansion of a business (European Venture Capital Association (EVCA), (2012).

Black and Gilson (1998), IFC (2009) and EVCA (2012) agree on the venture capital as form of equity investment with high risk and return. Sorensen (2007), and Ivanov and Xie (2010) include the non-monetary contributions to the entrepreneurs. From the above varied definitions venture capital can be defined as investment both in the form of capital and non-monetary to entrepreneur ideas that have the potential to generate higher returns. Venture capitalists would provide the finance on projects that have the highest potential to maximise the returns. The main features of venture capital include high degree of risk, equity participation, management participation and liquid investment (IFC,2009).

Venture capital also has distinctive types of financing appropriate to each stage of business development. EVCA(2012) argued that venture capital resembles a hybrid type of finance because it resembles the qualities of a stock market investor, a banker and an entrepreneur.

Empirical Literature: In order to fully understand the problem under study, empirical evidence was obtained. Studies done in both developed and developing countries was obtained and is discussed below:

i. Venture capital in U.S:

The successful venture capital industries like Silicon Valley and Route 128 clearly outlines the reasons for their success. Silicon Valley continues to have an edge in high-tech business because of its large numbers of entrepreneurs, engineers and venture capitalists. A lot of high-tech business were founded and established in Silicon Valley and have created many jobs. Such businesses include CISCO Systems, Apple, Oracle, eBay, Yahoo and Google. According to the Joint Venture (2008), there were 1.15 million jobs and 22,000 start-up businesses in Silicon Valley. Zhang, (2007) also added that 2100 high-tech business were created annually on average from 1990 to 2000. Price Waters House Coopers, (2005) reported that $111 billion dollars was invested in Silicon Valley by venture capitalists and that represented about 32% of venture capital investments made in the U.S.

Michel and Mark (2009) concluded that the network of agents in Silicon Valley is the main reason why it can be used as a reference of a successful venture capital industry. They further developed the Etzkowitz triple helixes model into multiple agents' model with 9 parties involved as in.

Table 2.1: Agents in venture capital

Agents	Formal functions	Informal functions

Universities	-nature innovations, accumulate expertise, provide trained workers	-incubate start-ups, socialise agents
Large Firms	-nature innovations, develop innovations, accumulate expertise	-incubate start-ups, acquire start-ups, partner with start-ups, provide trained workers, socialise agents
Law firms	-accumulate legal expertise, handle legal issues	-embed start-ups, network the cluster
Recruiting Agencies	-favour labour market	-network the cluster
Media	-circulate information	-publicise start-ups, sustain an entrepreneurial culture
Consulting groups	-accumulate business expertise, supply expertise to start-ups	-provide trained workers
Certified Public Accountants	-accumulate accounting expertise, handle accounting issues	
Investment Banks	-organise IPO and acquisitions of start-ups	-signal start-ups
Commercial banks	-enable financial transactions	

Agents involved in creating venture capital industry: Michel and Mark, (2009)

Herve (2007) had also identified the pioneering culture, ability of people to take the risk and the exchange of ideas as other critical factors for the development of venture industry. Aoki (2000) pointed out the stability in social and political environments as key the success of entrepreneurial development. The meritocracy in Silicon Valley attracts immigrant talent to engage in entrepreneurial activities. Other factors that led to the successful establishment of Silicon Valley include a large pool of expertise, highly networked suppliers, access to venture capital, and tolerance of failure, enthusiasm for change and new ideas and availability of educational research facilities.

The U.S recognises venture capital as specialised in the promising and upcoming small business development. They concentrate on distinguished sectors with high growth opportunities. Abdul Basit (et al, 2003) stated that there is clear supremacy for venture capital funded businesses over self-funded ones in all aspects with the exception of little difference in case of creating a more efficient labor between the two types of projects. Table 2.2 summarizes the results.

Table 2.2: Comparison of venter capital funded and self-funded projects

Factor	Self-funded	V/C funded
Create a more efficient labour (%)	+59%	+56%
Employment per year (%)	-3%	+25%
R & D expenditures per year (%)	+33%	+67%
Annual investment rate (%)	+9%	+35%
Annual productivity (%)	+5%	+12%

Source: Abdul Basit, Wafa (2003)

The national venture capital association reported that during 1989 to 1993, sales for the venture capital funded projects recorded a 41% increase in annual growth rate versus the 2% for other projects and about 5% for the total economy. Furthermore, 76% of the small and new businesses belong to venture capital institutions against 6% for the founders and the remainder to the general investors. These figures show the strategic role and effectiveness of the venture capital firms in supporting the new and existing projects in the whole economy.

ii. Venture capital India:

The Research and Development Act of 1986 in India saw the birth of the venture capital concept as a new financing strategy. The Industrial Development Bank of India (IDBI) was the first to introduce the venture capital fund as a facility to finance the development of indigenous technologies in 1987. Thereafter a lot of venture capital firms came into effect. They increased from 12 in 1990 to 31 in 1997 and 45 in 2000. Due to the slow growth in the domestic funds, offshore private equity funds started coming into India in substantial amounts since 2001 upon recommendations from the Report of the Working group on structure of Venture capital funds.

World Bank also played a crucial role in the development of venture capital in India where it provided start-up capital and international exposure. They also developed manpower resources and networking among venture capital firms to foster cohesiveness and professionalization of the venture capital firms was the ultimate result.

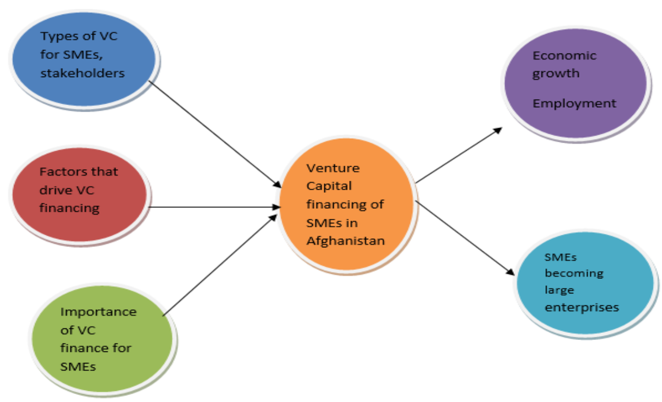
iii. The Afghanistan Case:

The venture capital concept is new concept in most developing countries and their results are very limited due to a number of factors. It finances some sectors and neglects other sectors because of the risk element. In Afghanistan, there is a financing gap created by traditional financiers and other investment institutions to promote the development of small businesses from grass roots level. Introducing venture capital to finance small businesses and brings them to reality will close this financing gap. The venture capital concept is not developed in Afghanistan to promote entrepreneurial projects mainly at the start-up and early stages of development. This is because of the weak financial markets, lack of effective risk control techniques, low levels of investor confidence, lack of transparency and credibility in the information provided on financial conditions and the political and economic instability and also the most important one the unstable security in the country

2.2. Theoretical Basis of the Study:

The study is based on the Principal Agency Theory. Besley and Brigham (2006) stated that principal agency relationship occurs when the principal (owner) engages another person (agent) to perform service. Service performance entails delegation of decision making authority to the agent. In venture capital financing, there exists the principal-agent relationship between the investors and corporate entities, in this case venture capitalist and entrepreneur. Delegation comes with problems such as goal differences and information asymmetry (Gatsi, 2012). Venture capitalists can be tempted to serve own interest or goals than investors who own the funds, hence goal differences resulting in the principal agency problems. This is in the case of pension funds, insurance companies and banks. Also as they are active investors some level of information asymmetry exists in those investors rely on venture capital firms to make selection on viable projects that give high return to investors (Sahlman, 2010). Also the entrepreneur has an incentive to favour her interests over those of the venture capital firm. The choice and timing of exit and entry can be strongly influenced by desire to minimise these agency problems (Cumming and Macintosh, 2009).

Figure 2.1. Conceptual Framework



Based on the Principal-Agency theory, the problem under study would be analyzed as shown in the tentative Conceptual Framework in Figure 2.1. The framework shows the current problems regards venture capital financing of SMEs in Afghanistan and the proposed solutions after the problems had been addressed. With the conceptual framework in place, there is need to define venture capital

3. Research Methods and Design:

3.1. Sampling techniques and Population:

The target population, sampling methods and respondents for the study are discussed below:

3.2. Target Population:

Target population refers to all the members of the real or hypothetical set of people, events or objects to which we want to generalize the results of our research. The population for this research was made up of Afghanistan Investment and Support Agency, Ministry of Commerce, ACCI, and other Financial Institutions. The population (refer to bellow table) was classified into policy makers and financiers. And they were selected as it provides finance and deals directly with SMEs.

Policy makers	Financial Institutions
-Afghanistan Investment and Support Agency	-Commercial banks
-Ministry of Commerce	-Microfinance Institutions -ASMED
-ACCI	-MISFA

3.3 Sampling techniques; a stratified random sample was selected as a suitable sampling method to ensure that the views of different categories of groups with an effect of venture capital financing for SMEs were incorporated into the study. The method was selected based on the roles they play in venture capital financing for SMEs in Afghanistan. Bryman and Bell (2009), a stratified random sample exhibits a proportional representation of the different strata in a population. Accordingly, three groups of policymakers (regulators), financiers were selected. The quota sampling was therefore used to identify target groups of respondents who were in a position to provide necessary and informed opinions which would assist in answering the research questions. The quotas are listed below:

- *Ministry of Commerce*:
- *Afghanistan Investment Support Agency (AISA)*
- *Afghanistan Chamber of Commerce and Industries and*
- *Financial Institutions* including:
    - Afghanistan International Bank
    - OXUS micro finance institution,

Sample Size: Since the most respondents were managers and directors who had busy schedules and dairies had no time to respond fully to the questions being asked by the researcher so a sample size of twenty nine (29) served as the sample of the population. Bellow table summarize the sample size for study.

Target population	Sample Size
Ministry of Commerce	4
AISA	4
Financial Institutions	12
MISFA	6
ACCI	3
Total	**29**

Data collection instruments was Questionnaire. *The* questionnaire is containing 14 questions was designed and distributed to the sampled informants for the purposes of extracting primary data.

***Pretesting*:** The research instrument were pre-tested and evaluated by the researcher before administered on to the field. This was done with 7 respondents and these consisted of respondents from a financiers, and regulators. This was done to fine tune unclear areas on the data collection instruments.

Data analysis process*:* The Microsoft office excel and SPSS application packages were used due to the nature of the statistical data analysis and presentation method. These were the packages only available at the researcher's disposal.

4. Data Analysis and Presentation of Results

4.1 Response Rate analysis:

Questionnaires were used as primary sources in the collection of data. A total of twenty-nine (29) research instruments were administered. The researcher discarded three instruments, due to non-completion and ineligibility, and no response come back from the individual due to his absences and tight scheduled daily time table. An overall response rate of 89.66%. A high response was achieved due to the questionnaires which were directed to the knowledgeable people who did not have any challenges in understanding the problem under study and the questions were short and precise to the problem under study.

4.2 Demographic analysis of respondents

The demographic characteristics of the respondents have an effect on the overall conclusion of the study. The following were the characteristics of the respondents;

***Level of education*:** The level of education has an impact on the understanding and appreciation of venture capital financing to SMEs. The survey results as shown in figure 4.1 indicate that 54% of the respondents are holders of degree or higher with 31% diploma/certificate holders and 15% holders of secondary education.

The majority of the respondents in the study were in possession of degree or higher as the highest level of education. This could be attributed to the entry requirements of the companies under study. Most of the organizations require that the employees be in possession of minimum education qualification. This is so for those working in the venture capital financing section where basic skills and training is a prerequisite. Considerably, respondents would be able to provide solutions related to the problem under study.

4.3. Period dealing with SME financing:

The period of dealing with financing of SMEs at an organization assist in the evaluation of projects and related factors (Brad, 2008). In order to determine the experience and knowledge on the venture capital financing for SMEs response was shown in figure 4.2. The results showed that 46% had been worked dealing with SMEs financing for period of 4 years to 7 years with 31% having worked for more than 7 years and 23% less than 4 years.

The above results show that the majority have had working experience with SMEs financing of 4 years to 7 years. The results clearly indicate that the majority have been dealing with SMEs financing and development for a considerable time which could be attributed to good human resource practices. The respondents in the study would be able to provide answers on the problem under study and offer solutions on the same.

4.4. Types of Venture Capital financing in Afghanistan:

The researcher sought to establish the venture capital financing in Afghanistan which focus on types of venture capital financing and industries for SMEs likely to attract venture capital finance. Availability of venture capital financing promotes the development of SMEs. The responses were as follows:

Available types of venture capital financing in Afghanistan: The respondents were probed on the types or categories of venture capital financing available in Afghanistan. These have different characteristics and are used to finance business at different levels of development. The responses as shown in figure 4.3 were as follows 52% alluded that government venture capital were most likely with 22% sighting independent partnerships, 19% financial venture capital and 7% corporate venture capital.

The majority of the respondents sighted government venture capital which can be attributed to the role played by the government in promoting the development of SMEs. This can also be attributed to the liquidity challenges being faced in the country.

An institution is capable to provide venture capital funds if it has a healthy liquidity position, its risk appetite is high as well as having expertise into the field on venture. Some of the respondents explained that pension funds have a high capacity to enter into venture capital market. Also insurance firms were nominated as a potential investor in the venture capital market. The main reason given by respondents was that the pension funds and insurance firms are highly liquid institutions with high capacity to fund new ventures. Their funds can also be committed for long periods and always seek to invest in funds under management.

Banks do not want to commit their funds in high risk businesses for a long period of time. The research also revealed that any institution with excess liquidity and appetite to invest money for long periods of time have the capacity to offer venture capital.

The Small Business Innovation Research (SBIR), which is the biggest government venture capital program in the U.S, indicated that there was rapid growth to companies backed by SBIR venture capital. Cumming and Maclintosh (2003) argue that investment made by government venture capitals creates less value than other venture capital firms. In Afghanistan there are no venture capital companies in the country such as Afghanistan only the donors and the direct investors and companies from different nationalities. However all these were mainly independent partnerships or private equity funds which closed due to the economic down turn, NATO Force withdrawals.

Industries likely to attract venture capital financing: The study sought to find out the importance of venture capital financing in promoting entrepreneurial development. Respondents were asked to indicate sectors which they think would require venture capital financing and the findings are shown in Table 4.2.

Table 4.2.: Industries likely to attract venture capital financing for SMEs

Industry	Frequency
Agriculture	88%
Mining	73%
Manufacturing	65%
Information Technology	53%

Source: Research Survey, 2015

The findings revealed that agriculture, manufacturing, information technology and telecoms and the mining sectors have the highest potential to attract venture capital financing. The study also revealed that the agricultural sector can become vibrant and active if supported by venture capital to start up operations. This represented by the highest frequency of 88% indicating agriculture followed by frequency of 73% in mining, manufacturing (65%) and information and technology (53%).

The main reason why these sectors got the most respondents could be attributed to that the Afghanistan economy is agricultural based and by making finance available this promotes entrepreneurship and boost the economy. Agriculture and mining are also main earners of foreign currency. The information technology and telecoms industry provides the infrastructure for communication and information sharing since the world is now a global village.

4.6. Drivers of venture capital financing:

In order to fully understand and address the objective of the drivers of venture capital financing in the country, participants were asked to indicate the factors which contribute to the development of small businesses through venture capital financing. It is important to note that these factors do not work in isolation. They have a complementary effect on each other. Respondents were not restricted to any number of drivers. However similar responses were grouped together. The findings are shown in the Table 4.3.

Table 4.3.: Respondents frequency on factors that drive venture capital financing

Driver / Factor	Frequency
Stable economic environment	100%
Overall securities and Corporate governance	92%
Capital markets	84%
Entrepreneurial environment	76%
Human and social environment	61%
Taxation policies	73%
Government policies and programs	65%
Profits and potential for growth	34%

Source: Research Survey, 2015

4.7. Economic, regulatory and capital markets:

The major drivers of venture capital financing identified by respondents included stable economic environment (100%), Overall Securities and corporate governance (92%) and the well-developed capital markets (84%).The least popular driver identified was the profits and potential for growth which was highlighted by frequency of 9 respondents. The pleasing note was that most respondents acknowledged and appreciated the factors that drive venture capital financing and gave significance to three main drivers namely stability in the economic environment, regulatory framework and the capital markets.

The liquidity of the stock market plays an important part. These results concurred with Clarysse (2009) that market capitalisation is one of the critical drivers of venture capital investment. The liquidity of the capital markets makes funds available for venture capital thereby promoting early stage business developments (Schertler, 2003). Investors also advocate for safety of their investments as a contributory factor to the positive establishment of venture capital investments (Desai, 2006).

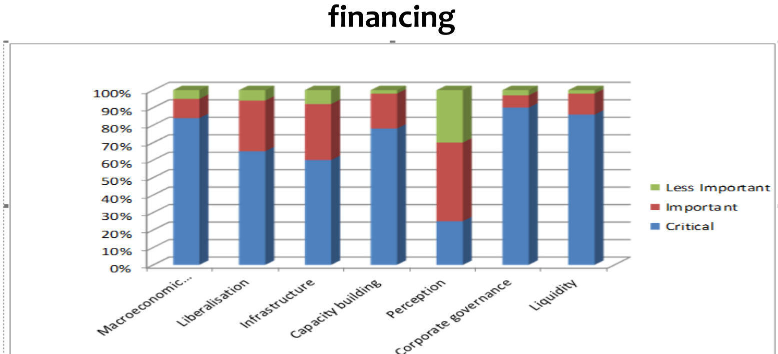
Taxation and government policies:

A significant number of respondents argued that taxation policies (73%) and government policies and programs (65%) actually hinder the development of venture capital financing. Djankov (2008) advised that the tax rates were critical in determining the level in investments, entrepreneurial activity as well as the international investors' perception on start-up businesses. The respondents gave reference to the high tax rates on both business and individual incomes such that they reduce the amount of disposable income for investments.

4.8. Ranking of conditions for a successful venture capital market:

In order to address the objective on the key conditions necessary for the establishment of the venture capital market the research asked the respondents for their views concerning the prescribed conditions. Factors were then ranked by respondents in order of their perceived importance. The findings are shown in Figure 4.1.

Figure 4.1: Ranking of the factors that drive venture capital financing



Macroeconomic Stability: The study established that 84% of the respondents highlighted that macroeconomic stability as a critical factor to the development of venture capital market. The inflation rates, exchange rate, economic growth, together with the consistency in policies help to determining the stability in the economy. Most respondents cited politics as the main factor in affecting the macroeconomic fundamentals. There is a direct and close relationship between the politics and macroeconomic fundamentals. However, 11% of the respondents argued that the macroeconomic stability is important and 5% of the respondents did not find any role played by the macroeconomic stability as important. The macroeconomic stability result in increasing the market size and the market capitalization, factors which attract the investors.

***Capital market liberalization*:** Market liberalization is a process by which the government through its authorities relaxes their managerial control, entry and exit barriers into an economy. Sixty five percent (65%) of the respondents considered the liberalization as a critical factor in the development of entrepreneurship. This is because the venture capital concept has not been developed in Afghanistan yet and hence there are more opportunities for investment.

Once the industry is open then international investors with more experience and expertise in venture capital would get attracted to the country and invest in small businesses. This increases the number of players in the venture capital market hence competition increases. Competition would then result in small businesses coming up with new innovative ideas, more products, improved quality of products and services and hence efficiency and effectiveness in their operations. The study also established that 29% of the respondents considered liberalisation as important to venture capital market development. The 6% of respondents thought that liberalisation would open the market for abuse and would not develop the venture capital market hence less important. However the liberalisation of the venture capital market results in ease access to deeper and more liquid markets.

Infrastructure: The respondents had mixed feelings with regards to the role played by infrastructure in venture capital development. At least 60% of the respondents considered infrastructure as a critical factor in promoting venture capital market. A sizeable percentage (32%) of respondents saw infrastructure as important. Accessibility to market information is critical to the success of a venture capital market. There is need to have a robust information technology systems in the country for easy accessibility to information.
Liquidity: The majority of the respondents considered liquidity to play an important role in the development of venture capital market. Eighty six percent (86%) of the respondents consented that liquidity is critical with 12% saying that it is important. An insignificant percentage of 2% considered liquidity to be less important. A liquid market easily attracts investors and the opposite is true. Since the venture capital market in Afghanistan has not been developed and is having liquidity challenges, the development of venture capital market will increase the level of liquidity in the market and more investors will come and invest into the market.
Capacity Building: The research noted that 78% of the respondents considered capacity building as a critical factor in promoting the development of venture capital financing small businesses. Twenty percent (20%) of the respondents viewed the skill and or education as simply important as they believed that experience would be gained in the process. For a venture capital market to operate successfully there is need to develop the skills and educate the entrepreneurs through the formal training, exchange programs with countries with venture capital expertise and workshops.

The capacity building initiative would involve training in basic business management principles, risk management techniques as well as the venture capital processes. This is because the concept will be a new financing method to new businesses in Afghanistan. It is therefore imperative to ensure that players in the venture capital market have the necessary knowledge and skills to ensure proper development of the venture capital market.

Perception: The perception of a country is depended on the political, economic, regulatory and security environments among other things. It is also difficult to separate these variables. The outright hostility from politicians, the media and the regulators can destroy the potential of a venture capital market. Forty five percent (45%) of the respondents concurred that perception is an important factor in promoting venture capital. The issue of risk associated with venture capital was highlighted by 25% of the respondents who believed that perception is a critical factor. A stable political and economic environment and good international relations with the international bodies like World Bank (WB) and the International Monetary Fund (IMF) automatically deals with the issue of perception. Perception is associated with risk in the eyes of the investors.

Corporate Governance: An economic environment guided by professional business principles and ethics provides a basic conducive environment for the small business development. The study noted that corporate governance plays a critical role in promoting venture capital market. This constitutes 90% of the respondents who accorded that corporate governance is critical and at least 7% of the respondents also cited it as an important factor. An economic environment characterized by high levels of corruption, no business ethics and a poor regulatory framework to regulate the operations discourages both local and international investor. Only 3% of the respondents criticized it as less important in that they believed in an economic environment which is self-regulatory.

4.9 Current regulatory requirements in Afghanistan*:*

A follow up question was asked to respondents to comment on the position of the current regulatory requirements in Afghanistan to successfully support the development of venture capital market.

The research revealed that the majority of the respondents (67%) view the current regulatory requirements as inadequate to support the development of venture capital market. However, 28% of the respondents had a patriotic view whereas 5% could not decide.

The general view was that the Ministry of commerce in conjunction with other relevant authorities must come up with clear, specific and more comprehensive policies and guidelines to promote the financing of small businesses by venture capitalists. The respondents who considered the current regulatory requirements as inadequate had various reasons ranging from the absence of clear cut regulation, structures, systems and policies to stimulate venture capital, pension funds and insurance companies being prohibited from venture capital financing and lack of knowledge and skills.

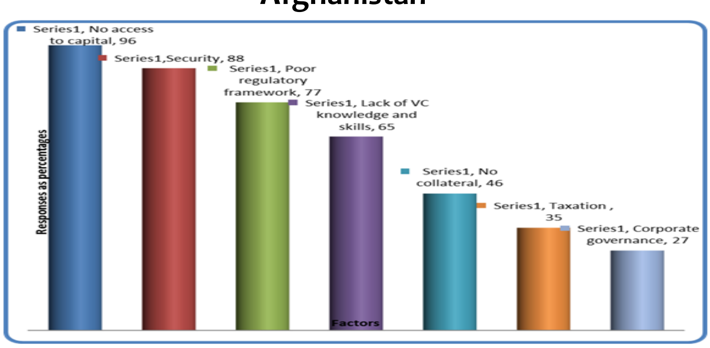
The respondents who were positive about the current regulatory requirements highlighted the issue of risk and the unavailability of capital as only obstacles to venture capital development.

4.10 Current challenges being faced by small business:

Fraunchart et al (2011) summarized these challenges affecting the small business into five (5) constructs as inadequate technical skills, operational capacity, unsupportive business environment, uncompetitive pricing and inadequate experiential knowledge. All these factors act as obstacles to the growth, survival and competitiveness of small business as echoed by respondents in their responses.

The respondents were asked to highlight the current major constraints being faced by SMEs in the country. The findings are summarized by the Figure 4.2.

Figure 4.2: Respondents factors facing small businesses in Afghanistan



Lack of access to capital and liquidity challenges: The majority of the respondents (96%) claimed that the greatest constraint being faced by small businesses was that of lack of access to capital. Capital is the life blood of any business venture such that its absence has detrimental effect to the small business. This is also worsened by the Security challenges represented by 88%. Attached to these two factors is the cost of funds from those with little capacity to finance small business. The funds are so expensive because the demand for money outstrips the supply.

Lack of collateral: Lack of collateral (46%) by entrepreneurs is one other factor restricting small business to access lines of credit from financial institutions like banks. Most of these new businesses do not have any business record that can be used by the financial institution to evaluate the viability of the business before advancing credit. This is in sync with the Commonwealth Secretariat (2002) and Isimbadi (2006) that various requirements have to be met to access working capital from banks which start-up businesses have problems in meeting and that they do not have the necessary collateral and credit history.

Taxation: Some respondents have argued that the taxation (35%) is another impediment to the development of small business. The tax rates are very high such that businesses are left with very little capital for investment and expansion. The regulatory framework governing the management and treatment of tax is said to be rigid. This is because of the punitive measures against companies which fail to pay the tax not because they do not want but because they do not have the money to do so. The respondents who cited taxation as an obstacle vowed that the tax authorities should look at situations because the way they apply their law forces small businesses to shut down operations.

Regulatory framework: Seventy seven percent (77%) of the respondents highlighted that there is poor regulatory framework governing the operations of the small business and policy inconsistencies. This is because of the informal nature of the business.

The challenges start from the registration process where the terms and conditions are punitive especially to start-ups. There are no mechanisms in place to monitor the operations of the entrepreneurs. Such mechanisms would assist the sector to improve on product and service quality, service delivery and general business practices.

The formalization of the industry would also add revenue to the discus. The policy inconsistency in our country is also a major challenge affecting the development of small business. There is no transparency and accountability especially with regards to Indigenization policy. The policies are silent on issues to do with capital to fund all the projects and such issues need clarity if investors are to be attracted. However in order to attract investors Afghanistan must turn these blueprints into strategic and comprehensive documents which are self-explanatory.

Lack of venture capital knowledge: Respondents also placed great emphasis on the lack of venture capital knowledge and skill as one of the challenges being faced by small businesses. This was represented by 65% of the respondents. Very few people are conversant with venture capital operations and this led to low levels of small business development.

This is what one respondent said, “There are not enough structures that will see the SMEs having the right incentives for initial investments allowances and there is need for more public education on this. Most of the people know of the existence of micro-finance organizations but the question remains as to how many really know how venture capital works and the associated benefits attached to it”.

There is need to create awareness and have structures to develop entrepreneurial skills. Such skills will enhance the monitoring and administration of small business to succeed. The respondents also argued in the same line with Deakins and Freel (2009) that entrepreneurs lack the quality of devotion, innovation, management, control and marketing skills which are critical to the growth and survival of new businesses.

4.13. Impact of venture capital financing: The research sought to establish the benefits the economy derives from venture capital financing of small businesses. The respondents were asked to explain the major benefits from an economic perspective. Frequency of responses were summarised as presented in Table 4.4.

Table 4.4: Frequency of responses on benefits of Venture capital financing

Benefit	Frequency
Employment creation	100%
Investment and export growth	100%
Local competitiveness	69%
Innovation and creativity	76%
Increase in the level of liquidity	73%
Reduces load on national budget	61%

Source: Research Survey, 2015

The major benefit of venture capital financing small business identified by respondents includes employment creation (100%), investment and export growth (100%) and innovation and creativity (76%). This shows how the respondents appreciate the importance of venture capital to entrepreneurship development. The opening up of small business means more people getting employment and new products on to the market through innovation. This however confirms the assertion by BVCA (1999) that venture capital backed start-ups contribute to the creation of highly skilled jobs. A supporting view by Van Osnabrugge (1999a) also highlights that about 50% of employment comes from start-up businesses.

According to Pandey et al. (2003), the introduction of a venture capital market act as a catalyst to the development innovative and highly competitive enterprises which is also supported by a frequency of 69% respondents from study.

In the event that the venture capital industry is formalized, it means more revenue through tax. Increase in liquidity and local competition came up as other benefits to the local market cited by frequency of 73%. Venture capital financing increases the level of liquidity in the market due to increased activity and flow of funds. Respondents also highlighted an increase in gross domestic product (GDP) ensuring a speedy recovery of the economy because it leaves the government with room to focus on the strategic areas of the economy. The introduction of venture capital market reduces interest rates by way of reduced demand for the funds from the banks and other financial institutions hence reducing the cost of funds available for investments. Overall, the venture capital financing give benefit financially and socially to the economy. These benefits created by venture capital financing are interlinked and the absence of one of the benefit will have ripple effects on the other benefits.

Policy Initiatives to promote the development of venture capital market: The respondents were asked to come up with appropriate policy measures to promote venture capital financing entrepreneurship in Afghanistan. Their responses as a frequency are presented in Table 4.5.

Table 4.5.: Policy Initiatives by institutions

Policy Initiative	Frequency
Improve international relations	69%
Formalization of SME sector	96%
Regulatory framework	96%
Tax incentives on venture capital firms	73%
Management of Information Systems (MIS)	84%
Skills development	76%

Source: Research Survey, 2015

Formalization of SME sector: The formalization of the SME sector and the improvement of the regulatory framework were the most important measures suggested by respondents in the promotion of venture capital. These were cited by a frequency of 96%. Such initiatives included the reformation of the investment conditions for insurance companies and pension funds, imposition of import licenses on certain products to protect the local market, scraping or relaxation of indigenization laws, creation of markets for small business companies and increasing their visibility by encouraging them to participate at exhibition shows.

Tax incentives: A frequency of 73% of the respondents considered tax incentives for venture capital firms investing in small business start-ups. The Small Tax Office and Medium Tax Office as well as custom office authorities should relax import tariffs on certain raw materials allow for tax exemptions for funding provided to business in their formative stages.

Availability of information : Information about the venture capital, industries with more business opportunities, requirements for business set ups including other players in the industries for reference purposes must be available free of charge. That is the reason why frequency of 84% of respondents advocated for improvements in the MIS.

Skills development: Players in the venture capital market must be exposed to some skills development programs. A frequency of 76% of respondents cited the need for skills enhancement since this concept has not been fully developed in Afghanistan.

Exchange programs as well as attachments to venture capital institutions with expertise and experience at country level, in the form of bilateral agreements would be a positive move towards the development of venture capital market. All these initiatives come to the conclusion that total compliance is a critical factor in the development of venture capital market.

5. Conclusion and Recommendations

5.1 *Conclusions*

The conclusions to the study regards the research objectives and literature review are presented as follows:

- The main type of venture capital financing in Afghanistan is government and the donor agencies. Though they argue that investment made by government venture capital created less value compared with other types of venture capital.

- The major drivers of venture capital financing identified were stable economic environment, investor protection, and corporate governance and well developed capital markets. These results concur with Clarysse (2009) that stable economic environment and well developed capital markets were the critical drivers of venture capital investment.
- The major benefit of venture capital financing to small and medium businesses identified by respondents included employment creation, investment, export growth, innovation and creativity. This confirmed the assertion by BVCA (2009) and Van Osnabrugge (2009a) that the benefits included employment creation.

Overall it can be concluded that venture capital financing can serve as an alternative financing option to SMEs development in Afghanistan.

5.2 ***Recommendations:*** The main players in the study were the AISA, ACCI, & MoC, and financial institutions. The following recommendations were reached.

Government policy: The government's role in promoting venture capital financing to small business development must be of a regulatory in nature as well as policy formulation. Policies should be formulated that encourage venture capital financing. This can be done through looking for finance. In Ghana this Venture capital was formulated through levying roads users over a three year period having levies accumulated. Also policy consistency is needed to attract funding. Any industry can attract venture capital financing as long as the investor finds it potentially viable and able to grow his equity and get a return from their investments.

Conducive macroeconomic policies and political fundamentals are an important element to attract and sustain foreign investors' interest in a country business environment. Weaknesses in the domestic, political climate and domestic financial systems often result in capital flight. This leads to a reduction in the amount of capital available in a country for investments.

Regulatory and legal framework: The country's legal set up is a critical aspect in the venture capital investment process. The rule of law is indispensable and contracts should be enforceable for venture capital market to thrive. This also gives both foreign and local investors' confidence into the market. There are clear, realistic and attainable prospects for achieving a vibrant venture capital market in Afghanistan.

Regulation brings in a balance between the important function played by venture capitalists and the risks borne by the unregulated markets. An active venture capital market promotes self-regulation and improves the organization's internal controls through discipline of market forces. The guarantees by the government also strengthen moral-hazard behavior by venture capitalists.

This research study recommended the formulation of a comprehensive regulatory framework to promote the development of small businesses in Afghanistan. The framework will explicitly protect and attract the investors as well as instilling confidence in the business environment.

Linked to the regulation and licensing of businesses in Afghanistan is the issue of policy inconsistency. International investors are keen to expand economic relations to our country but the policy discord on the part of Afghanistan is affecting investors and their investment decisions. There is need to have clarity of economic policies. There must be transparency and accountability on these policies.

Capital Market development and finance accessing: A vibrant venture capital market is one that is characterized by transparency, responsibility, accountability and fairness. Good corporate governance ensures the growth and sustainable private sector. The private sector is the main driver of a country's economic growth hence it needs to be accountable. Good corporate governance ensures integrity and effectiveness of the private sector and helps the businesses to operate more effectively. The starting point is to propose the code of corporate governance by the MOC, the relevant regulatory bodies, the AISA and other key stakeholders in the economy to build greater understanding of the implications of corporate governance. Corporate governance plays a bigger role reducing business scandals which damage trust in businesses, systems to prevent and deter corruption, deregulation and integration of capital markets, harnessing domestic savings for economic growth and value placed on good corporate governance by institutional investors. There is also need for international linkages to support and facilitate trade with other established markets so as to get access to global markets.

There is also the need to include international players aimed at capacitating the private sector to contribute meaningfully to revive the economy and strengthen the capacity of economic players.

The development of small business is affected by a variety of factors and on top of the list is lack of access to finance. Traditional financiers like banks do not avail credit to start up business because of the risk associated with the business at early stages. Where the credit facility is present, the conditions to get access to the capital are punitive. These businesses are still small they have inadequate or no collateral. Cost of finance from the traditional financiers is also very expensive.

Investor education: Venture capital as a financing concept that has not been developed in Afghanistan in promoting start-up businesses. There is limited understanding of venture capital financing concept but vast knowledge on private equity investments. Such limited knowledge by business leaders act as a hindrance to the development of small businesses in Afghanistan.

The government through the Ministry of Commerce and the ACCI should educate the business community on the benefits of venture capital financing entrepreneurship. The processes involved in setting up a business, the requirements, what type of business to venture into, the policies and regulatory frameworks governing different sectors must be well documented and made available to the public. MoC must offer a one-stop shop for the registration and formalization of businesses. The processes and time to do all this must be shortened so as not to frustrate potential business investors in the country. This must also house offices for the Anti-corruption Commission and the Indigenization and Empowerment Board as these are topical and influential subjects of the moment when investors want to invest in the country.

Entrepreneurship and Skills development: Since the venture capital concept is not developed in Afghanistan, there is need for capacity building in this area. The Government of Afghanistan through AISA/ACCI and Ministry of Commerce should engage its various stakeholders to facilitate career development in promoting entrepreneurship development. This would be done through countrywide training, workshops and exchange programs with various venture capital firms and country level. The authorities can also engage the services of international experts in venture capital for further training. Monitoring and evaluation mechanisms are also developed in the process to improve on service delivery efficiently and effectively.

Other factors which have got an influence on the development of entrepreneurship are security situations, economic, political, social, technological and human factors. These do not work in isolation and can positively or negatively affect the development of small business

Formalization of SME sector: The SME sector needs to be recognized as an important contributor to the national income and the economic growth. Formalizing the sector would regularize all business transactions to go through the formal channels and the operations being monitored closely. These also curb illegal dealings and may even reduce the level of corruption associated with the sector. The players in the sector will be forced to follow rules and regulations which may improve the quality of service delivery in the sector. The government will also increase its revenue base by collecting taxes from the sector, a situation that is not currently happening. The formalizing of the sector results in these small business keeping trading or financial records. These financial statements or records can then be used to apply for capital from financial institutions because the financier can actually evaluate the performance of the business based on those financials.

Improving international relations: The Government of Afghanistan, the MOC and other regulatory bodies should come up with a common goal on improving the chances of accessing international financing. The country's huge debt and budget deficit are obstacles to accessing international financing. Afghanistan is part of the global economy and cannot work in isolation. It needs both local and international partners to do business with. The Afghanistan's relations with the international community have been compromised greatly because of the politics. It is therefore important to separate politics from business economics to deal with the country's international relations. In order to attract domestic and international capital inflows in Afghanistan, there is need to put more emphasis on stabilizing the political environment and to have a sustainable economic along the normal security situations.

Infrastructure development: The development of small businesses comes up with developments in various aspects of the business to improve of efficiency, delivery and quality of the service and product. New processes and procedures to support these developments also come up to support these through innovation. It is therefore recommended that venture capital financing will come up with new developments in electronic trading and management information systems. This will keep the domestic market abreast with the global developments.

5.3 Area of further study:

The venture capital concept is not fully developed and well understood in Afghanistan. It is therefore important to explore deal structuring in venture capital financing. Areas of further research included identification the process and understand the critical role in venture capital deals. This would help in the establishment of a vibrant venture capital market in Afghanistan

References

Adul Basit, W. (2003). Venture Capital institutions and strengthen its role in emerging companies. *Cairo: Dar El-Nahda Al-Arabia.*

Aoki, M. (2000). Information and Governance in the Silicon Valley, working paper. *Department of Economics. Stanford University:* 56.

Arundale, K. (2007). Raising Venture Capital Finance In Europe. *A practical guide for business owners, entrepreneurs and investors. London:* Kogan Page Limited.

Audretsch, D. K. (2002). Entrepreneurship capital and economic performance. *ZEW Discussion Paper* 02-76.

Bank, W. (2008). World Bank Group Entrepreneurship Survey. *World Bank*.

Batta, G. (2008). Improving access to finance for SME: International good experience and lessons for Mongolia. *Mongolia: IDE-JETRO*.

Beck, T. (2007). Barriers to SMS lending around the world. *World Bank*.

Beck, T. (2007). Financing constraints on SMEs in developing countries: Evidence, determinants and solutions. *World Bank, Development research Group*.

Berger AN, G. U. (1998). The economics of small business finance: The roles of private equity and debt markets in financial growth cycle. *Journal of Banking & Finance,* 223-225.

Berger, A. a. (2002). Small Business Credit Availability and Relationship. The Importance of Bank Organisational Structure. *Economic Journal*, 32-55.

Black, B. a. (1999). Does venture capital require an active stock market? *Journal of Applied Corporate Finance* 11(4).

Black, B., & Gilson, R. (1998). Venture capital and the structure of capital markets. *Journal of Financial Economics* 47.

Blanchard, O. (1997). The medium run. *Brookings Papers on Economic Activity*.

Botswana, V. P. (2008). VPB 11 Fund Summary. Gaborone: *Venture Partners Botswana*.

Bottazzi, L. D. (2008). Who are the active investors? Evidence from Venture capital. *Journal of Financial economics* Vol9 No.3, 488-512.

Bottazzi, L. M. (2002). Venture Capital in Europe and the financing of innovative companies. *Economic Policy No. 34*, 229-269.

Bronwyn, A. (1995, July). Venture Capital Funding. *Paper prepared for presentation at the President's conference on Small Business, South Africa*.

Bruce, D. a. (2005). Taxes and entrepreneurial activity: an empirical investigation using longitudinal tax return data*. Working paper for SBA Office of Advocacy*.

Bryman, A. B. (2007). Business Research Methods, 2nd edition. *Oxford University press*.

Bygrave, W. a. (1992). Venture capital at the cross roads. *Harvard Business School Press*.

Clarysse, B. K. (2009). Benchmarking UK venture capital to the US and Israel: what lessons can be learned?

Collins, H. (2010). Creative Research: The Theory and Practice of Research for the Creative Industries. *AVA Publications*.

Cowan, R. J. (2004). Network structure and the diffusion of knowledge. *Journal of Economics, Dynamics and Control*, 1557-1575.

Davila, A. G. (2003). Venture Capital Financing and the growth of start-up firms. Journal of Business Venturing, 61-65.

Davis, E. (1992). Debt, Financial fargilioty and systemic risk. *Oxford University Press*.

Deakins, D. a. (2009). Entrepreneurship and Small Firms. 5th Edition. London: McGraw Hill.

Desai, M. G. (2006). Institutions and entrepreneurial firm dynamics: evidence from Europe. *Harvard NOM Research paper.* 03-59.

Djankov, S. G. (2008). The effect of corporate tax on investments and entrepreneurship. *NBER Working Paper no 13756*.

Djankov, S. L.-d.-S. (2008b). The law and economics of self-dealing. *Journal of Financial Economics*, 88-3, 430-465.

Dushnitsky, G. (2006). Corporate Venture Capital: Past evidence and future directions. Oxford: *Oxford Handbook .*

E.V.C.A. (1996). The economic impact of venture capital in Europe, in collaboration with Coopers & Lybrand Corporate finance . *European Private Equity & Venture Capital Association, Zaventen.*

E.V.C.A. (2001). policy priorities for Private Equity: Fostering long term Economic growth. EVCA White paper.

Engel, D. (2002). The Impact of Venture Capital in firm growth. An Empirical Study, *EW Discussion paper 30*, 30-33.

Etzkowitz, H. L. (2000). The Dynamics of Innovation: From National Systems and "Mode 2" to A Tripple Helix of University-Industry-Government Relations, Res. Policy. 29.

EVCA. (2001). Survey of the economic and social impact of venture capital in Europe. *EVCA Research Paper .*

Fauchart, E. a. (2011). Darwinians, communications, and missionaries: the role of founder identity in entrepreneurship. *Academy of management Journal*, 54 (5), 935-957.

Fellers, C. R. (2001). With company's faulterin, VCs look at redemption Exit. Venture Capital Journal, 34-38.

Forum, W. E. (2008). The Global Information Technology Report 2007-2007. Geneva: World Economic Forum.

Gans, J. a. (2003). When Does Funding Research by Smaller Firms Bear Fruit?:. *Economics of Innovation and New Technology,,* 361-384.