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The Growth of Export-oriented Small and Medium Enterprises in Afghanistan, Kyrgyzstan and Tajikistan

Bente Molenaar Neufeld and Jessica Earle



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Abstract

This paper examines how small and medium-sized enterprises (SMEs) can serve as engines for economic growth. Relevant international trends are explored before we home in on the regional experience, focusing on Central Asia. It should be noted that the number of SMEs engaged in trade in the region is relatively limited, making the potential for growth significant. The bulk of the paper will consider findings from the four research papers published by the Institute of Public Policy and Administration at the University of Central Asia (UCA), seeking to put them into a broader context. This synthesis report draws primarily on the following reports:

- Export Driven SMEs in Kyrgyzstan: The Garment Sector (Jenish 2014)
- Informality and Gender: Study on Kyrgyz SME sector (Kapalova 2014)
- Small and Medium Enterprises Development and Regional Trade in Afghanistan (Mashal 2014)
- Dynamics of the SME Sector in Tajikistan (Tilekeyev 2014)

For the purposes of this synthesis paper, we focus on four cross-cutting themes that emerge from the case studies but that are also relevant to the development of the SME sector outside the three countries considered. The four common themes that will be dealt with in more detail are: size of SMEs; the informality of the sector; domestic bottlenecks to trade and women and their engagement in SMEs.

Keywords

Small-and medium sized enterprises (SMEs); Afghanistan; Kyrgyzstan; Tajikistan; trade; non-tariff barriers

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1. Introduction

Trade and development are inexorably linked: trade liberalisation is an effective policy instrument to improve growth and development, but the benefits can only be maximised if there are a sufficient number of domestic firms that can compete and thrive in international markets.

The challenge in Central Asia¹ is not the creation of a more open trade policy regime. This has already largely been achieved. The next step is to promote competitiveness and the capacity to trade so that the countries in the region can benefit more from trade. Small and medium-sized enterprises (SMEs) are an important starting point. The promotion of a robust SME sector requires strategies that demand a range of macro and micro-level interventions. For example, SMEs are generally more successful if there are sound and predictable macro-economic policies in place. Moreover, a micro-economic environment that facilitates understanding of regulatory frameworks, access to credit, reliable infrastructure and a supply of skilled labour also significantly improves the chances of developing a thriving SME sector.² A well-developed domestic SME environment is, in turn, an important building block for promoting export-oriented SMEs. Developing an effective SME strategy is a complicated business that requires both time and effective engagement from all stakeholders. SMEs operating in a supportive environment are the creators of wealth and best positioned to allow the greatest number of citizens to benefit from economic growth. SMEs are also agents of change and have the potential to bring the less empowered, such as women, into the formal economy.

This synthesis paper begins with an analysis of how SMEs can serve as engines for economic growth. Relevant international trends are explored before we home in on the regional experience, focusing on Central Asia. Currently, the Central Asian economies are beginning to turn their attention to SME policy. It should be noted that the number of SMEs engaged in trade in the region is relatively limited, making the potential for growth significant. The bulk of the paper will consider findings from four research papers published by the Institute of Public Policy and Administration at the University of Central Asia (UCA), seeking to put them into a broader context. This synthesis report draws primarily on the following case studies:

- Export Driven SMEs in Kyrgyzstan: The Garment Sector (Jenish, 2014)
- Informality and Gender: Study on the Kyrgyz SME sector (Kapalova, 2014)
- Small and Medium Enterprises Development and Regional Trade in Afghanistan (Mashal, 2014)
- Dynamics of the SME Sector in Tajikistan (Tilekeyev, 2014)³

The above-mentioned reports cover a wide range of issues related to the SME sectors in Afghanistan, Kyrgyzstan and Tajikistan. It should be noted that the papers employ a range

¹ For the purposes of this paper, Afghanistan is considered part of the Central Asian region. As noted by Mogilevskii, from a trade perspective, it is useful to look at Afghanistan in a broader Central Asian context.

² Organisation for Economic Co-operation and Development (OECD), "Promoting SMEs for Development," *Report from 2nd OECD Conference of Ministers Responsible for Small and Medium-Sized Enterprises (SMEs)*. (Paris: OECD, 2004), 5-6. Accessed 27 April 2014. <http://www.oecd.org/cfe/smes/31919278.pdf>.

³ Please see summaries of the case studies in Annex 1

of methodologies and, as indicated by the titles above, cover different ground.⁴ In brief, Mujib Mashal argues regional trade and SMEs will not become Afghanistan's primary drivers of sustainable, long-term growth unless several barriers are addressed. Problems include neighbouring states' distrust of Afghanistan, corruption, customs technology and lack of clear benefits that entice firm owners to enter the formal sector. Kanat Tilekeyev, meanwhile, finds SMEs have untapped economic potential in Tajikistan's agricultural sector and export industry. He believes that several non-trade barriers must be addressed before further development can take place, and recommends studies be conducted on state privatisation, access to land and taxation. Nurbek Jenish expresses concern about the medium-term competitiveness of Kyrgyzstan's garment manufacturing sector, arguing that the industry will likely be negatively affected by the state's recent increase in import tariffs and planned accession to a regional customs union. Altyn Kapalova also looks at SMEs operating in Kyrgyzstan, but focuses instead on communication flows as the defining feature of the sector's state of development, with particular emphasis on barriers facing women entrepreneurs. She concludes that informal communication mechanisms verging on corruption are extremely powerful forces at the SME level and assist entrepreneurs in compensating for lack of business literacy. Kapalova also finds that while the role of women in enterprise development is accepted in Kyrgyzstan's society, female entrepreneurs are restricted by the cultural notion that household and family functions are a woman's most important responsibilities. As has been amply illustrated by these case studies and will be highlighted below, the beginnings of an SME sector are present in Central Asia. In order to grow the sector and ensure its sustainability, however, a coordinated approach to facilitating SME operations is required.

For the purposes of this synthesis paper, we focus on four cross-cutting themes that emerge from the case studies and are also relevant to the development of the SME sector outside the three countries considered. The four common themes that will be dealt with in more detail are:

- Size
- Informality
- Domestic bottlenecks
- Women and SMEs

2. Background and Context

The Place of Central Asian Economies in the Global Context and Trade

Before embarking on a discussion about the importance of SMEs as drivers of growth, it should be noted that no economy exists in isolation and that the economies in Central Asia are in transition and are vulnerable to external macro-economic developments. As an illustration of this interconnectedness, one can look to the financial crisis of 1998 and 1999, which had a deep impact on the region. As Sinitsina has noted, financial crises caused a reduction in trade turnover between Russia and the Central Asian countries, with "goods turnover in

⁴ For a note on methodology, see Annex 2.

1999 declined to just 45.6 percent of the 1996 level.”⁵ The period 2000 to 2010 is described as one of economic recovery by Mogilevskii. He notes that all Central Asian economies demonstrated good financial growth, with “Turkmenistan recording double-digit average annual GDP growth, and in Afghanistan, Kazakhstan and Tajikistan these growth rates exceeded 8 percent.”⁶ The Kyrgyz economy also had a healthy level of growth, with an average annual rate of 4.8 percent between 2000 and 2008⁷ while the Tajik economy saw gross domestic product (GDP) increase an average of 8.3 percent annually between 2000 and 2012.⁸

Although the Central Asian economies weathered the most recent financial crisis better than many other economies, they are still vulnerable to macro-economic development beyond their control, including pricing of imported inputs. Moreover, some Central Asian economies experienced an appreciation of their currencies between 2000 and 2010 against the Chinese *yuan*. As Mogilevskii points out, this led to a reduction in price competitiveness of commodities produced by Central Asian countries on both domestic and export markets.⁹ Afghanistan is a case apart, due to its history of armed conflict. The past decade has recorded impressive growth rates, averaging 10.5 percent annually between 2005 and 2012. As Mashal points out, however, this improvement was in large part fuelled by the international military presence, and as troops withdraw there is an expectation that growth will slow.¹⁰

Russia is an important trading partner for the region, being the second most important destination for exports from the region and the most important source of imports. Energy production and trade in raw materials comprise the majority of trade flows between Russia and Central Asian countries. The trading relationship experienced flux, with the Soviet Union driving economic development in Central Asia before 1991, then economic ties weakening following the disintegration of the Soviet Union. Sinitsina notes that it is really only after 2003 that the re-building and intensification of this trading relationship gathered force.¹¹ The European Union (EU) is also a key trading partner, serving as the main destination of exports and the second most important source of imports. China is the third most important destination of exports and the third most important source of imports. Mogilevskii notes that the official trade statistics do not take into account a large flow of informal imports from China, including textiles and footwear.¹² In fact, the author further asserts that *informal* trade imports from China in fact are larger than formal trade flows.¹³ Informal trade is inherently difficult to measure. The importance of China as a trading partner emerged in recent years

⁵ Irina Sinitsina, “Economic Cooperation between Russia and Central Asian Countries: Trends and Outlook,” *Institute of Public Policy and Administration Working Paper Series No. 5* (Bishkek: University of Central Asia, 2012), 7.

⁶ Roman Mogilevskii, “Trends and Patterns in Foreign Trade of Central Asia Countries,” *Institute of Public Policy and Administration Working Paper Series No. 1* (Bishkek: University of Central Asia, 2012), 7.

⁷ Investment Climate Advisory Services, World Bank Group and International Financial Corporation, *Business Environment in the Kyrgyz Republic as Seen by Small and Medium Enterprises* (Washington: World Bank Group, 2010), 20.

⁸ Kanat Tilekeyev, *Dynamic Business Environment of SME Sector in Tajikistan* (Unpublished draft, 2014.)

⁹ Mogilevskii, 8.

¹⁰ Mujib Mashal, “Small and Medium Enterprises Development and Regional Trade in Afghanistan,” *Institute of Public Policy and Administration Working Paper Series No. 24* (Bishkek: University of Central Asia, 2014), 6-7.

¹¹ Sinitsina, 7.

¹² Mogilevskii, 31, 38.

¹³ *Ibid*, 43.

and will likely continue to play an important role. As Mogilevskii notes in his conclusion, trade performance in the region is sensitive to energy-related infrastructure development. For example, the construction of new gas and oil pipelines and electricity transmission lines in the region resulted in an expansion of energy exports and their reorientation towards China and Afghanistan.¹⁴

It should be noted that Kyrgyzstan has a “persistent trade deficit exceeding 10 percent of GDP.”¹⁵ Tajikistan runs a similar trade deficit. In contrast, Uzbekistan, Kazakhstan and Turkmenistan achieved positive trade balances from 2000 to 2010. Afghanistan’s trade deficit is significant at US\$8.5 billion.¹⁶ Fostering a thriving SME sector is seen as a vehicle of change and growth in the region. Currently, *formal* interregional trade is of relatively limited importance, as it represents only five percent of trade turnover.¹⁷ Trade in services is also of limited significance. There is substantial scope for increasing trade in the region.

In terms of trade linkages, Kazakhstan, Kyrgyzstan, Uzbekistan and Tajikistan are members of the Commonwealth of Independent States (CIS); Kazakhstan is a member of the Customs Union (CU) with Russia and Belarus, while Tajikistan and Kyrgyzstan are members of the World Trade Organization (WTO). Kazakhstan, Uzbekistan and Afghanistan are undergoing accession talks with the intent to become members. Jenish attributes the growth of the garment industry in Kyrgyzstan to, among other things, WTO membership.¹⁸ The process of accession led to significant domestic reforms, including in the areas of permits and licensing, business registration, taxes and restructuring of import and export procedures. All of these are significant in creating a more conducive environment for SMEs.¹⁹ However, it should be noted that if Kyrgyzstan joins the CU, as forecasted, the common external value-based tariff will be applied to imported fabrics and other supplies needed for garment production, which will prove more costly than current weight-based taxes. Since Kyrgyzstan is a net importer of fabrics, this change could substantially increase the cost of apparel production and may result in Kyrgyz products becoming less competitive in CU markets. Jenish sees this as one of the primary risks to the viability of the export-driven garment industry in Kyrgyzstan.²⁰

The SME Landscape

SME development is now considered its own field of study, following two decades of growing realisation that the sector can serve as a major driver of economic growth. In an edited volume dedicated to SMEs, Blackburn and Schaper convincingly argue that “[o]nce regarded as peripheral to the economy, the significance of SMEs and entrepreneurship has now been promoted to one of key importance in the economic and community development strategies

¹⁴ Ibid, 48.

¹⁵ Ibid, 18.

¹⁶ Mashal, 7.

¹⁷ Mogilevskii, 48.

¹⁸ Nurbek Jenish, “Export-Driven SME Development in Kyrgyzstan: The Garment Manufacturing Sector,” *Institute of Public Policy and Administration Working Paper Series No. 26* (Bishkek: University of Central Asia, 2014), 4

¹⁹ Investment Climate Advisory Services et al. (2010), 26

²⁰ Jenish, 5

of many nations [...].”²¹ Griffiths et al. point out that “[t]here is broad agreement on the merits of devising policies to enhance the contribution of SMEs to global trading, since it is widely recognized that SMEs are underrepresented in the global economy. For example, SMEs typically contribute some 50 percent of GDP in the developed economies and 60 percent of total employment, yet SMEs contribute only around 30 percent of exports and even less in terms of flows of international investment.”²² This recognition is a catalyst for public policy development and over the past 30 years, we have witnessed a range of interventions to support SMEs and entrepreneurship. Blackburn and Schaper acknowledge that the scope of interventions is incredibly diverse, reflecting the manifold nature of SMEs.²³ Despite this variety on all levels, governments generally share the view that a robust SME sector plays a role in promoting growth, providing employment and ultimately increasing the welfare of citizens.²⁴ Further growth of SME trade would likely enhance these benefits. While the case studies under analysis consider trade in goods, the trade in services might also play an important role in the years ahead and should not be ignored as an area of policy intervention.

In the Central Asian countries discussed in the four UCA papers, namely Kyrgyzstan, Afghanistan and Tajikistan, the SME sector has undergone dramatic growth. A 2010 report by the World Bank Group estimates that SMEs in the Kyrgyz Republic accounted for 13.8 percent of total employment and 42.8 percent of GDP. The vast majority of SMEs were, in fact, individual entrepreneurs (204,246 registered individuals), while there were 11,988 small and medium-sized companies registered. Farmers also represented a significant number of SMEs.²⁵ The authors note that these statistics represent *registered* SMEs and that significant grey areas still exist, with many SMEs continuing to operate in an informal manner. We will return to considering definitions below.

Jenish focuses on the garment industry, in which a significant number of enterprises are SMEs. Tilekeyev notes that according to the Statistical Agency of Tajikistan, of the 206,300 business entities registered in Tajikistan, 177,000 were identified as individual entrepreneurs.²⁶ A report by the World Bank Group published in 2009 notes the increasing importance of SMEs, and that “[t]he private sector as a whole accounted for 43% of GDP in 2007, with an average growth of 5.3% since 2001.”²⁷ The Afghan SME sector has similarly seen an increase, and SMEs currently make up 85 percent of Afghan businesses.²⁸

²¹ Robert A. Blackburn and Michael T. Schaper, “Introduction” in *Government, SMEs and Entrepreneurship: Policy, Practice and Challenges*, ed. Robert A. Blackburn and Michael T. Schaper (Burlington: Ashgate Publishing Company, 2012), 4.

²² Alan Griffiths, Stuart Wall, Carsten Zimmermann and Ronald Klingebiel, “Doing Business: The Nature of Global Trading” in *Trading Places: SMEs in the Global Economy*, ed. Lester Lloyd-Reason and Leigh Star, 11-39 (Cheltenham: Edward Elgar Publishing Limited, 2007), 11.

²³ Blackburn and Schaper, 5-6.

²⁴ Sharafat Ali, “The Small and Medium Enterprises and Poverty in Pakistan: An Empirical Analysis,” *European Journal of Business and Economics* 8:2 (2013): 25-30.

²⁵ Investment Climate Advisory Services et al. (2010), 22.

²⁶ Tilekeyev (Unpublished draft, 2014), 4.

²⁷ Investment Climate Advisory Services, World Bank Group and International Financial Corporation, *Business Environment in Tajikistan as Seen by Small and Medium Enterprises* (Washington: World Bank Group, 2009), 22.

²⁸ Mashal, 4.

Export-Oriented SMEs

Globalisation²⁹ creates new opportunities for SMEs. Indeed, Nummela and Saarenketo argue that “it will be the lower-income markets in emerging economies that present the true opportunities for and challenges to the international growth of SMEs.”³⁰ An interesting development in this more interconnected world is the proliferation of regional trade agreements, bilateral trade and investment treaties. More liberal trade regimes and preferential terms can help facilitate the internationalisation of SMEs. As Griffiths et al. point out, “SMEs have [...] become important producers of components and other intermediate inputs for larger firms. Indeed multinationals are increasingly outsourcing some of their non-core activities to smaller SMEs, who often become part of the larger company’s global supply chain [...]”³¹ The European experience demonstrates that the larger the size of the SMEs, the more likely the move towards international integration. Other interesting findings include the positive effects of informal SME collaboration and networks in which “small firms can benefit from sharing knowledge and skills and more effectively [implement] new products and process innovations and business practices.”³² In the case studies, there is some evidence of collaboration between SMEs in-country. For example, there are two textile producer associations in Kyrgyzstan, namely Legprom and Souztextil.³³ Building stronger networks between SMEs might be one way of advocating for the needs of the sector, and also sharing knowledge which could help promote growth and potentially more production for export.

Griffiths et al. point out that “[t]here is broad agreement on the merits of devising policies to enhance the contribution of SMEs to global trading, since it is widely recognized that SMEs are under-represented in the global economy.”³⁴ In a recent report from the OECD,³⁵ it is noted that “[m]ost enterprises are not exporters: in all countries, fewer than 10% of firms are exporters.”³⁶ Moreover, the study finds that the propensity to export increases with the enterprise size in the 29 economies studied. In fact, “[a]cross countries, less than 5% of micro-enterprises are exporters while typically half of large enterprises export.”³⁷ The OECD study concludes that policies to enable smaller companies to engage in internationalisation would therefore be useful. The Least Developed Country Report 2013 by the United Nations Conference on Trade and Development (UNCTAD) is also relevant to transition economies and sug-

²⁹ A discussion of globalisation is beyond the scope of this paper. For our purposes we will rely on the following definition: “globalization is seen as a marked increase in movement across boundaries of goods, service, investment and people.” See Griffiths et al.

³⁰ Niina Nummela and Sami Saarenketo, “Drivers of International Growth of SMEs” in *International Growth of Small and Medium Enterprises*, ed. Niina Nummela, 1-11. (New York: Routledge, 2011), 5.

³¹ Griffiths et al., 16.

³² Ibid.

³³ Jenish, 4.

³⁴ Griffiths et al., 11.

³⁵ The report is based on statistical analysis of data from Australia, Austria, Belgium, Brazil, Bulgaria, Canada, the Czech Republic, Denmark, Estonia, Finland, Hungary, Israel, Italy, Korea, Latvia, Lithuania, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Romania, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland and the United States.

³⁶ Organisation for Economic Co-operation and Development (OECD). *Financing SMEs and Entrepreneurs 2012: An OECD Scoreboard* (Paris: OECD, 2013), 38. CFE/SME(2012)12/FINAL. Accessed 26 April 2014. [http://search.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=CFE/SME\(2012\)12/FINAL&docLanguage=En](http://search.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=CFE/SME(2012)12/FINAL&docLanguage=En).

³⁷ OECD (2013) 38

gests that developing countries can base their industrial strategy on two main approaches. The first builds on activities where the economy has a comparative advantage by “fostering backward and forward linkages and technological upgrades in these sectors.”³⁸ These sectors typically include natural resource extraction and agriculture. A second approach aims to attract labour-intensive industry and promote integration into global value chains. SMEs play an important role in both scenarios.

Over the past decade, several donor-supported initiatives in the region aimed to help Central Asia’s SMEs sector realise its potential. This work has directly targeted SMEs, but also contributed more generally to improving the environment for private entrepreneurship by supporting tax reform and improved physical infrastructure.³⁹

Common Theme 1: Is Small Beautiful?

There are varying definitions of what exactly constitutes a small or medium-sized enterprise since firms operate in a wide range of sectors and markets.⁴⁰ Businesses may include farmers exporting onions, women producing and selling handicrafts, or enterprises producing garments for export. The most commonly used variable to classify SMEs is the number of staff engaged, as this is more easily ascertained than, for example, value of sales or assets.

In Tajikistan, SMEs are defined as enterprises with less than 200 employees.⁴¹ Kyrgyzstan uses a similar standard, with the caveat that in the non-production sphere, the cap is 50 staff.⁴² In both cases, individual entrepreneurs and farmers are included and indeed play a very important role. We will return to this later. In Afghanistan, micro-enterprises are those with less than five staff, small enterprises consist of five to nineteen employees and medium-sized enterprises are those with between 20-99 staff. There are additional guidelines in terms of value of production.⁴³ The majority of SMEs in the three case-study countries are in fact very small. In Kyrgyzstan, for example, individual entrepreneurs made up 67 percent of SMEs.⁴⁴ Another example is the agricultural sector in Tajikistan, where a significant portion of production is by household units.⁴⁵

³⁸ United Nations Conference on Trade and Development (UNCTAD), *Economic Development in Africa: Intra-African Trade: Unlocking Private Sector Dynamism*, UNCTAD/ALDC/AFRICA/2013 (Geneva: United Nations, 2013), xi.

³⁹ See for example EU-funded projects: <http://www.casip-smes.eu/en/node/7>; http://www.eeas.europa.eu/delegations/tajikistan/documents/press_corner/2014/20140425_en.pdf; The World Bank Group has undertaken to support the region in, for example, tax reform and improving competitiveness of the private sector: <http://www.worldbank.org/en/country/tajikistan/projects/all> and http://www.worldbank.org/en/country/kyrgyzrepublic/projects/all?qterm=&lang_exact=English&os=40. The World Bank Group actively supports infrastructure development in the region.

⁴⁰ OECD (2004), 10.

⁴¹ Investment Climate Advisory Services et al. (2009), 29.

⁴² Ibid (2010), 22.

⁴³ Ministry of Industry and Commerce, Islamic Republic of Afghanistan, *Homepage*, <http://moci.gov.af/en/page/6024>.

⁴⁴ Investment Climate Advisory Services et al. (2010), 22.

⁴⁵ Tilekeyev (2014), 12.

The European experience mirrors the tendency towards small enterprises with the majority of SMEs employing fewer than 10 people. In a recent report from the OECD,⁴⁶ it is noted that “[i]n all countries most business are micro-enterprises, i.e. firms with [fewer] than ten persons employed; between 70% and 95% of all firms are micro-enterprises.”⁴⁷ In most Least Developed Countries, size distribution is also generally skewed towards the very small, and often informal, enterprises. The international outliers in this respect are Japan, which sets the upper limit of employees in an SME at 300, and the United States where the upper limit is 500.⁴⁸

As Jenish describes in his study of export-driven SMEs in the garment industry in Kyrgyzstan, most entrants into the industry start out with a few sewing machines. He describes small enterprises as those with between five and 15 machines, medium-sized enterprises with between 20-70 machines, and those with more than 70 constituting large enterprises. The small-scale operators generally do not have a regular nor stable client base. Instead they rely on taking any order they can get. The workshops are vulnerable to what one entrepreneur interviewed for the case study referred to as “guest customers;” customers who might pay for a few orders, then vanish without paying for the next larger order.⁴⁹ The smallest enterprises also rely on having larger enterprises “borrow” their workers as they endeavour to fulfill orders. Notably, however, Kyrgyzstani garment businesses struggle to maintain a stable labour force.

Kapalova also considers SMEs in Kyrgyzstan. She notes that businesses across different sectors, employ only one to five people and fail to grow because owner-operators primarily get into business out of “desperation or [in an] attempt to find employment.”⁵⁰ The author conducted a study of a neighbourhood in Bishkek. Her research found that the majority of the 87 SMEs operating in this area had little aspiration to grow or export. The notable exceptions, confirmed by findings in Jenish’s study, were six garment shops that are primarily export-driven. While on first glance micro-scale agricultural production in Tajikistan might appear to be primarily for domestic use, there is in fact some export too.⁵¹

Governments may favour larger companies and state-owned enterprises directly or indirectly. In Tajikistan’s transportation sector, for example, state enterprises are in direct competition with SMEs.⁵² The agricultural sector is similarly affected by state control of the main export crop, cotton. The agricultural sector is a growth industry but is threatened by an unfinished land reform process and the threat of expropriation of land for use for the state-

⁴⁶ The report is based on statistical analysis of data from Australia, Austria, Belgium, Brazil, Bulgaria, Canada, the Czech Republic, Denmark, Estonia, Finland, Hungary, Israel, Italy, Korea, Latvia, Lithuania, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Romania, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland and the United States.

⁴⁷ Organisation for Economic Co-operation and Development, European Union, European Training Foundation and European Bank for Reconstruction and Development, *OECD SME Policy Index: Eastern Partner Countries 2012 Progress in the Implementation of the Small Business Act for Europe* (Paris: OECD, 2012). doi: 10.1787/9789264178847-en.

⁴⁸ OECD (2004), 10.

⁴⁹ Jenish, 9.

⁵⁰ Alтын Kapalova, “Small and Medium Enterprise Development in Kyrgyzstan: Informal Communications and Role of Women,” *Institute of Public Policy and Administration Working Paper Series No. 27* (Bishkek: University of Central Asia, unpublished draft, 2014.)

⁵¹ Tilekeyev, 11.

⁵² Ibid, 29.

owned cotton industry.⁵³ Market distortion created by state involvement stands in the way of SME development in the agricultural and transportation sectors. Indeed, larger firms tend to be found in the more profitable sectors, such as resource extraction. These larger firms face fewer obstacles in terms of access to credit and often have foreign investors. The potential for growth in the resource extraction industries is drawing increasing attention in both Kyrgyzstan and Afghanistan.

While size does not determine whether an SME is able to thrive, the case studies demonstrate that the very smallest enterprises are more vulnerable to domestic bottlenecks, such as access to finance and lack the networking knowledge required to access markets.⁵⁴ As noted elsewhere in the paper, research finds that the very smallest enterprises tend not to engage in exports. An UNCTAD study of regional trade on the African continent notes that it is in fact the *medium*-size companies that hold the greatest potential for promoting economic development.⁵⁵ The Least Developed Country Report 2013 finds that “suboptimal size can be a constraint in itself, since it leads to lower productivity than that of larger firms, which affects profitability and makes it harder for small firms to expand scale of production.”⁵⁶ The question then becomes not only how we can promote individual entrepreneurship, but also what type of policy support is required to encourage the smallest enterprises to grow. It should also be noted that while small enterprises may be more vulnerable, they also possess a degree of resilience and flexibility that allows them to adapt to the circumstances.

Common Theme 2: Informality of SMEs

A common international trend in SME development entails adopting policies that aim to expand the formal SME sector. A 2004 OECD report found that “[i]n low-income countries, especially in least developed economies, the contribution of SMEs to employment and GDP is less than that of the informal sector [...]. In middle-income countries, formal SMEs contribute about 20% more to employment and GDP than the informal enterprises.” The authors demonstrate that bringing informal enterprises into the formal economy can help spur economic growth.⁵⁷ In order to harness the export potential of SMEs, governments must ensure that rules and regulations do not impose undue burdens on SMEs. Informality is not unique to the Central Asian region. In fact, an UNCTAD study estimates that 37.6 percent of the Sub-Saharan economy is informal, while the figure for high-income OECD countries is estimated at 13.4 percent.⁵⁸ Effective formalisation should translate into benefits for SMEs. In countries with a highly regulated SME sector, there are policies that actively support increasing the competitiveness of SMEs by facilitating access to credit and training programmes for entrepreneurs. The three countries under study have all made moves towards creating a more supportive environment for SMEs, but there is some doubt about what still remains to be done and also whether the changes achieved so far can be sustained.

⁵³ Ibid, 10.

⁵⁴ Mashal, 11.

⁵⁵ UNCTAD, 66.

⁵⁶ Ibid, 109.

⁵⁷ OECD (2004), 11.

⁵⁸ UNCTAD, 66.

Mashal notes in his case study that a staggering 70 to 80 percent of SMEs in Afghanistan remain informal and unregistered. There is a perception among business owners that there are few benefits to formalising operations, because of significant fear of corruption and the burden of bureaucracy.⁵⁹ If the regulatory environment is such that it places an undue cost on SMEs, both in terms of actual payments and lack of clarity around procedures and legislation, then companies are less likely to move out of the informal sphere. In fact, in Afghanistan, from the perspective of SME owners, “formal recognition simply meant a tax officer raiding their offices.”⁶⁰ As long as the tax burden is perceived to be too high, business owners may elect to artificially split their business into smaller entities to lower costs.

In her study of Kyrgyzstan, Kapalova finds that there is a high degree of informality, with rules and regulations just emerging. The Kyrgyz economy relies on informal players. She argues that there is “virtually no clear, coherent and focused public policy in the area of SME development.” Government systems for business registration, reporting and monitoring are “inconsistent and contain mutually conflicting provisions.”⁶¹ The sub-group of SMEs that Kapalova termed “peripheral business” demands an informal connection entirely, and entrepreneurs in this group generally operate on the basis of a patent or register as individual entrepreneurs. All transactions in this environment are in cash and business owners generally do not have bank accounts.⁶² The term “biznesman” is often associated with crime and corruption, and Kapalova notes that this negative association may contribute to the lack of entrepreneurship. Kapalova also describes two additional sub-categories of SMEs in Kyrgyzstan: (1) “conscious business,” where the owner starts out small but is able to expand and possesses some knowledge of production and distribution, and (2) “smart business,” characterised by well-educated owners with a strong ability to develop their enterprises. Still, even in these sub-groups there is a significant reliance on informality. For example, as quoted in Jenish’s case study on the garment industry in Kyrgyzstan: “Sewers have a specific mindset: for them every extra *tyyn* matters. If they see another enterprise that pays one *som* more for similar clothing, they will leave you for sure. Yesterday, while you were paying salary to workers, you had 17 sewers, and today there are just two of them left.”⁶³ Kapalova finds that generally, SMEs do not operate with formal agreements; relationships between wholesalers and retail outlets are based on trust, reputation and personal relationships rather than contracts.

Work conditions and labour rights also appear to operate under informal mechanisms, with none of the SMEs studied by Jenish and Kapalova offering paid sick leave or parental benefits.⁶⁴ Informality helps perpetuate informality; when the labour force is unstable and can change from day to day, SMEs are far less capable of creating strategic plans for their future, expanding or exporting in an effective manner.

⁵⁹ Mashal, 10.

⁶⁰ Ibid, 9.

⁶¹ Kapalova, 5.

⁶² Ibid, 11.

⁶³ Jenish, 9.

⁶⁴ Jenish, 10; Kapalova, 35.

Common Theme 3: Domestic Bottlenecks and Barriers to Trade

This section will consider the range of domestic factors that serve as bottlenecks and barriers to establishing a positive environment for the growth of SMEs.

SME Strategies and Government Efforts to Promote SME-led Exports

Some Central Asian economies are actively pursuing an outward-oriented trade policy in which SMEs feature as one of the key drivers of trade expansion. As noted elsewhere, the countries in question have relatively open trade regimes, and for the most part tariffs are not an issue. Non-tariff barriers such as overly restrictive requirements for licences/permits and inspections, as well as weak infrastructure, are more significant challenges and can place export-oriented SMEs at a disadvantage. Some governments have been quicker than others to put in place policies and programmes that support export-driven SMEs. In the case study countries, three of the authors see the need for improving policies on SME development, with Kapalova stressing that Kyrgyzstan's SME sector is "chaotic" due to the lack of a coherent approach to public policy in this area. There are examples from outside the region of a more supportive environment. Jenish points to Belarus, where the government provided subsidised interest payments on loans to the textile industry between 2006 and 2010 to allow for equipment purchases, as well as an exemption of agricultural taxes on natural fibres and an agreement that sees universities and vocational schools produce skilled workers for the textile industry.⁶⁵ Such programmes and support in neighbouring countries represent a threat to the garment industry in countries such as Kyrgyzstan where there is a lack of government support for the industry. Afghanistan has an SME strategy, with implementation starting in 2011. Mashal notes that although the strategy provides a starting point, "[e]xport promotion, in the short term at least, was not considered a key element of the strategy because exports remain limited to traditional items." Indeed, he notes that officials claim that SME development over the past decade was *ad hoc*, and that there was not enough attention paid to value chain development and coordination of economic policy at a higher level.⁶⁶

While Tajikistan and Kyrgyzstan do not have an official SME strategy, they implemented a number of reforms over the past few years that helped the sector develop. The Kyrgyz government, with external donor support, implemented the National Strategy for the Textile Sector, which aimed to increase industry competitiveness.⁶⁷ Beneficial changes were effected in the area of obtaining a patent, as well as with regard to inspections, licences and taxes.⁶⁸ Jenish notes that allowing SMEs engaged in the textile industry to operate under a patent system is proving effective, as it eases the tax burden business owners must bear.⁶⁹ Kapalova, in her study of a sample of SMEs, is more critical, noting that there are significant gaps in government support for SME development and that "[t]here is virtually no clear, coherent and focused public policy in the area of SME development."⁷⁰ Both authors see developments and scope for improvement. Indeed, a report by the Investment Climate Advisory Services,

⁶⁵ Jenish, 16.

⁶⁶ Mashal, 8.

⁶⁷ Jenish, 5.

⁶⁸ Investment Climate Advisory Services et al. (2010), 8.

⁶⁹ Jenish 8

⁷⁰ Kapalova 5

the World Bank Group and the International Financial Corporation (IFC) notes that “many of these reforms have yet to deliver tangible benefits or change for many businesses, in practice. The proportion of businesses subject to certain regulatory procedures remains high, particularly among individual entrepreneurs and small and medium-sized companies, with medium-sized companies, in particular, bearing the greatest burden in terms of compliance.”⁷¹ Sustained work is required in the area of implementation and monitoring of the reforms, as well as on what further action is needed.

In Tajikistan, significant changes have led to better conditions for SMEs. Many reforms came in the context of accession to the WTO (2 March 2013) and donor recommendations. The majority of changes were in the area of business and tax regulations and, on balance, worked in favour of SMEs. For example, regulations for registration of enterprises were streamlined,⁷² value-added tax was decreased by two percent to 18 percent, the tax on profits was decreased from 25 to 15 percent; a new tax code, entered into force in 2013, saw the abolition of retail sales tax and exemption of newly established enterprises from profit taxes for up to five years, depending on the size of the investment. However, despite changes to facilitate SMEs in the context of taxes and registration processes, internal export procedures still represent a major obstacle,⁷³ as does the distorting effect of state involvement in the cotton industry.⁷⁴ () It is estimated that “[l]ess than 3% of small and medium companies, and less than 1% of *dekhkan* farms or individual entrepreneurs, export.”⁷⁵

Within the region, there are export-oriented SMEs. For example, the Kyrgyz garment industry, employs 100,000 people in Kyrgyzstan and is comprised of some 3,000 SMEs, exports more than 90 percent of its products to Kazakhstan and the Russian Federation. The value of exports shot up from \$15 million in 2003 to \$155 million in 2012.⁷⁶ This is significant, but the author cautions that sustaining the sector might not be feasible given the implications of a recent decline in demand from these key markets. The two factors believed to be behind this slump in sales are (1) increases in tariffs on imported Chinese fabrics, which are an important input into the Kyrgyz garment industry, and (2) increased competition from Belarus, where the government has been more pro-active in its support of its clothing industry. Additionally, sales may be negatively impacted by the implications of Kyrgyzstan’s planned accession to the Custom Union of Belarus, Kazakhstan and the Russian Federation.

Access to Financing

Access to credit is a challenge for SMEs globally. The EU established the Eastern Partnership in 2009, and a project report considering Armenia, Azerbaijan, Belarus, Georgia, Republic of Moldova and Ukraine is instructive. Like Afghanistan, Kyrgyzstan and Tajikistan, these countries underwent significant change and saw an expansion of their SME sectors. A key finding of the report is that improved access to financial resources will promote the competitiveness of the SME sector, helping businesses realise the potential for economic growth and engage-

⁷¹ Ibid.

⁷² Investment Climate Advisory Services et al. (2009); Investment Climate Advisory Services et al. (2010).

⁷³ Ibid.

⁷⁴ Tilekeyev, 29.

⁷⁵ Investment Climate Advisory Services et al. (2009), 218.

⁷⁶ Jenish, 4.

ment in trade.⁷⁷ In Tajikistan, although micro-lending institutions and banks are expanding, only 70 percent of SMEs have a relationship with financial institutions. A mere 20 percent of individual entrepreneurs have a loan or line of credit, and just seven percent have a bank account.⁷⁸

Kapalova notes that limited access to financing keeps the SME sector static in Kyrgyzstan, and that borrowing is, in her sample of 87 SMEs, based on informal deals.⁷⁹ In Afghanistan, many of the SMEs, and particularly very small-scale enterprises with women entrepreneurs, are currently supported by the international donor community. While access to credit is a challenge for men and women, women-led businesses face more complex challenges. While there are commercial banks and micro-lending institutions that offer loans, insurance for these products traditionally is dependent on property and land ownership. This is a limiting factor for Afghan women, as properties are historically registered under the name of male household members.⁸⁰ Major donors have helped fill this gap over the past few years, but Mashal questions the sustainability of female-led SMEs as international donors shift their attention away from Afghanistan.

As noted above and illustrated in all four case studies, the majority of SMEs are very small. This is in part a response of business owners to an uncertain business environment, where small-scale entrepreneurs are unable to get credit. There is also unwillingness by business owners to take risks and expand, given the lack of a supportive SME environment. Another limiting factor, at least in the case of Tajikistan, is the weak financial system, where lending is hampered by a lack of a creditor information system.⁸¹ As noted earlier, the smaller the enterprise, the less likely it is to engage in trade. Therefore, growing SMEs so that they can achieve a certain economy of scale will help equip them for export. This is by no means unique to Central Asian economies. A study by UNCTAD on African trade notes that the lack of finance is one of the factors that limit African firms from growing and being competitive.⁸² Domestic markets in Afghanistan, Kyrgyzstan and Tajikistan are relatively small, but the governments in all three states do embrace the need to trade, both implicitly and explicitly.

Crossing Borders: Room for Improvement

Significant changes have been made in Afghanistan, Tajikistan and Kyrgyzstan to make regulatory frameworks and tax regimes more conducive to SMEs. Tilekeyev attributes the reforms as resulting from, in part, accession to the WTO. Both Tajikistan and Kyrgyzstan are members of the WTO. Afghanistan has an ambition of accession to the WTO, and with significant donor support is undergoing regulatory reform. The process is on-going, and although progress is variable, initial steps have been taken.

In Tajikistan, Tilekeyev notes that exporters still face significant challenges in terms of internal export procedures and requirements. For example, custom authorities continue

⁷⁷ OECD et al. (2012), 22.

⁷⁸ Investment Climate Advisory Services et al. (2009), 114.

⁷⁹ Kapalova, 23.

⁸⁰ Mashal, 9.

⁸¹ Investment Climate Advisory Services et al. (2009), 114.

⁸² UNCTAD (2013), 67.

to demand pre-payment of goods before export. Custom rules further demand exporters present certificates of origin and product certification for each shipment, rather than relying on periodic confirmation of compliance.⁸³ This runs contrary to WTO principles of ensuring that movement of goods across borders happens in an efficient and minimally trade restrictive manner. The WTO recently produced *The Agreement on Trade Facilitation*,⁸⁴ which states that “[t]he agreement provides a framework of rights and obligations that should see reform of border procedures around the world, if legitimate requests from developing countries for technical assistance are met.”⁸⁵ As Tajikistan and Kyrgyzstan are members, there might be scope for support to implement their obligations under the agreement.

In large part due to donor funding, Afghanistan has implemented modern customs technology. The Automated System for Customs Data (ASYCUDA) provides communication and information for tracking imports and exports across borders. Mashal notes that, although the system increases transparency, there are still complaints about corruption along trucking routes. Moreover, Afghan officials “complain that the technology they have in place does not help them if their trading partners do not have the same technology.”⁸⁶ The other Central Asian economies do not have such systems in place.

Corruption is a challenge at Afghan customs and taxation offices. In eastern Afghanistan, the Pakistani border is unreliable, with gates closing down primarily as protest over drone strikes. In the north, “the freight capacity to carry goods is limited, with only up to four trains operating weekly. The railway is only used for imports. The trains bringing goods into Afghanistan return empty because Uzbekistan only allows Afghan goods to arrive via ship.”⁸⁷ This, notes the author, leaves room for corruption. For example:

“Last year, over 3,000 tons of dried fruits, largely raisins, were stranded at the border in Hairatan for three months, waiting for a ship to transfer it to Uzbekistan. According to officials, cement and oranges coming from Pakistan were given priority over the Afghan raisins. About 1,700 tons of the stranded dried fruit came from [a business called] Tabasum. This incident affected Tabasum’s relationship throughout the value chain, but especially with the clients in Central Asia and Europe. When the raisins finally made it through months later, the product life span had been shortened.”⁸⁸

As we have seen above, predictability is of key importance for SMEs, whether they are exporters or not. Complicated requirements for export permits, payment schedules and inspections add costs, which hit SMEs disproportionately hard compared to larger firms.

⁸³ Tilekeyev, 29.

⁸⁴ Adopted at the WTO’s 9th Ministerial Conference in Bali, Indonesia, in December 2013.

⁸⁵ World Trade Organisation (WTO), *WTO Trade Facilitation Agreement: A Business Guide for Developing Countries* (Geneva: WTO, 2014), 13. <http://www.intracen.org/uploadedFiles/intracenorg/Content/Publications/C-UsersadeagboDesktopFACILITATIONENGLISHWTO%20.pdf>.

⁸⁶ Mashal, 16.

⁸⁷ Ibid, 17.

⁸⁸ Ibid, 18.

Peace and Security

The development of SMEs capable of effectively engaging in international trade requires a healthy domestic SME operating environment. One of the basic requirements for making the operating environment predictable is peace and security. Insecurity creates trade distortions.

Afghanistan is a post-conflict country and suffers significant challenges related to the transition, including lack of infrastructure and a perception of risk by the private sector.⁸⁹ Indeed Mashal cites the main concern related to security as “uncertainty and unpredictability: rather than physical security.” Most SMEs operating in Afghanistan are based in urban centres, such as Kabul, Herat, Kandahar, and Jalalabad, where physical insecurity has not been a crippling problem. As Mashal points out, “[m]ost urban centres have been largely secure in recent years, though potential attacks are not ruled out.” However, the risk and uncertainty, the author argues, contributes to a climate where entrepreneurs are unwilling to grow their businesses because chaos “is not good for business.”⁹⁰ Central Asian neighbours are reluctant to trade with Afghanistan, and express fears associated with their 2,000 kilometres of shared borders with Afghanistan. Central Asian economies, such as Tajikistan, view imports from Afghanistan with suspicion.⁹¹

There are other security concerns that dampen regional trade, in particular between Central Asian economies and the Russian Federation. There is significant illicit trade in drugs, which in turn supports the illegal economic sector, corruption and organised crime, both in exporting and importing countries. Insecurity and unpredictability related to illegality have adverse impacts on the operations of legitimate business.⁹²

Tensions related to post-conflict and major illicit operations, however, are not the only factors that can create unpredictability. Kapalova’s study documents how erratic visits by various inspectors can have negative effects on SMEs, as articulated by one Kyrgyz business owner: “what makes me particular[ly] bitter is when I have tax inspectors or fire inspectors showing up at my door and starting to zealously search for violations, non-compliance – anything that would force me to offer a bribe [...]”⁹³

Need for Knowledge: Business Knowledge, Skilled Labour and Education

Kapalova’s work on Kyrgyzstan underlines the importance of entrepreneurs having sufficient business knowledge to grow their operations and take measures that increase competitiveness. In her study, informants identified lack of knowledge in business planning, risk analysis and access to credit as reasons for failure to expand. Jenish notes that “about 70 percent of enterprises starting in the apparel industry are owned by people with no specialised education.” He notes that, despite this, the export-driven garment industry has been quite successful, which he attributes in part to the business savvy of entrepreneurs. One of Kapalova’s recommendations is to increase business literacy by creating a public platform for discussion of the issues facing SMEs.⁹⁴ Mashal’s recommendations also recognise a need

⁸⁹ Ibid, 6.

⁹⁰ Ibid, 10.

⁹¹ Ibid, 14.

⁹² Sinitina, 67.

⁹³ Kapalova, 12.

⁹⁴ Kapalova, 37.

for increased human capital, suggesting that “[t]he SME Directorate should work with public and private educational institutions to ensure that educational curricula reflect local economic and business needs.”⁹⁵

With donor support, the Kyrgyz government is taking some steps to promote the export-driven garment industry. One project, funded by the Asian Development Bank (ADB), focused on vocational training and skills development in the garment industry. A competency-based modular sewing course was offered at 25 locations. Additionally, the International Trade Centre offered a series of training programmes and advisory services to support companies making the transition toward producing larger orders and attracting new customers.⁹⁶

Only fragmented figures and statistics are available on SMEs in the region, in part due to the informality of the sector. Solid data are essential to facilitate planning and business development of SMEs engaged domestically and those that produce for export. Tilekeyev illustrates this point by looking at the export of onions from Tajikistan to the Russian Federation and Kazakhstan between 2008 and 2012. Discrepancies in the data meant that “the value and role of agricultural products in trade are seriously underestimated.”⁹⁷ In fact, he notes, undervaluing the importance of agricultural production by SMEs masks the potential of this sector in terms of its role in exports.⁹⁸

Infrastructure

Two of the case studies note that SMEs depend on working infrastructure, both for domestic production and for export. Constraints and lack of access to transportation, communications and water increase the cost of doing business.⁹⁹ Over the past decade, Central Asian countries have made improvements. Mashal notes the importance of the work led by ADB, which links country infrastructure projects in the region with the larger vision of trade facilitation. At the heart of this vision is to connect land transport corridors (rail and road) in order to help increase the capacity and volume of trade between Central Asian economies.¹⁰⁰ Tilekeyev notes that in Tajikistan, SMEs providing services spring up mainly in urban settings, taking advantage of infrastructure that exists there.¹⁰¹ A report by the Investment Climate Advisory Services, World Bank Group, and the International Finance Corporation notes that in Tajikistan “[t]he road network is generally poor and deteriorating, harsh weather prevents transportation to some parts of the country in winter, rail travel is slow and requires transit through Uzbekistan. Poor roads extend the time to market, and they generate secondary costs, such as additional vehicle maintenance and fuel costs.”¹⁰² In Kapalova’s study of 87 SMEs, the majority had access to electricity but no water. She further notes that narrow and congested streets near businesses are not designed to function as transport corridors. The author notes that the less capital the entrepreneur has, the more limited their access to physical infrastructure.¹⁰³

⁹⁵ Mashal, 21.

⁹⁶ Jenish, 5.

⁹⁷ Tilekeyev, 14.

⁹⁸ Ibid, 16.

⁹⁹ UNCTAD, 84.

¹⁰⁰ Mashal, 15.

¹⁰¹ Tilekeyev, 19.

¹⁰² Investment Climate Advisory Services et al. (2009), 220.

¹⁰³ Kapalova 36

To facilitate effective SME development, access to basic infrastructure is required. A study of trade in Africa notes that “poor infrastructure in Africa reduces productivity of companies by 40 percent and per capita output growth by about two percentage points.”¹⁰⁴ To realise trade and economic development potentials of economies, especially in the SME sector, the constraints caused by lack of infrastructure must be removed.

Common Theme 4: Women and SMEs

Kapalova and Jenish both discuss the participation of female business leaders in the SME sector. The majority of workers in the Kyrgyz garment industry are women. The sewers are female, while cutters, ironers and packers tend to be male.¹⁰⁵ Kapalova documents a similar gender dynamic in her study: of the 300 people employed at 87 SMEs under review, 250 were female and 80 percent of enterprise managers were women.¹⁰⁶ In Afghanistan, about 1,600 female-owned businesses are registered. The majority of these, notes Mashal, “are SMEs in the handicrafts or business services sectors, which are currently subsidised by donors, calling into question their long-term sustainability.” In fact, without donor support, women’s engagement in the Afghan economy and SMEs is questionable, in part because public acceptance of women working outside the home is declining.¹⁰⁷ A report by the Investment Climate Advisory Services, World Bank Group, and the International Finance Corporation indicates that in Tajikistan, “[s]urvey results indicate that 42% of the people working as individual entrepreneurs are women. Of the average of two employees per individual entrepreneur, the top manager is a woman in more than 1 in 3 individual entrepreneurs.” Moreover, “[w]omen are the top manager in 16% of small and medium companies, and 29% of a small and medium companies’ employees are female.”¹⁰⁸

The presence of women entrepreneurs is critical to SME development, and their engagement should be supported, particularly because they face additional challenges as a result of being female. Both Kapalova and Mashal found that barriers faced by women are exacerbated by social limitations. Women in both Afghanistan and Kyrgyzstan are more limited than men in their access to finance, in part due to the fact that property is generally registered by male household members.¹⁰⁹ Interestingly, in Kapalova’s study of 87 SMEs in Bishkek, women did not report experiencing any discrimination based on their sex. In fact, many noted the benefits of being a women entrepreneur, such as being treated with more leniency by inspectors and male customers. The author notes this reflects the educational level and awareness of women who have already established businesses, not the struggles of marginalised women who do not have the capacity to overcome obstacles related to opening an enterprise in the first place.¹¹⁰

¹⁰⁴ UNCTAD, 84.

¹⁰⁵ Jenish, 8.

¹⁰⁶ Kapalova, 33.

¹⁰⁷ Mashal, 11, 21.

¹⁰⁸ Investment Climate Advisory Services et al. (2009), 28, 30.

¹⁰⁹ Mashal, 11; Kapalova, 30.

¹¹⁰ Kapalova, 30.

Conclusions

The four case studies reviewed in this synthesis paper are diverse in methodology and focus, but they all make a significant contribution to understanding the current climate for SMEs in Afghanistan, Kyrgyzstan and Tajikistan. SMEs in these countries are overwhelmingly on the smaller side of the business scale, with many operations consisting of individual entrepreneurs. While the individual entrepreneur and the very small SME are important sources of employment because of their remarkable resilience and adaptability, they are disproportionately affected by lack of credit, complicated regulatory environments and external price shocks.

Coordinated government policies are required to ensure the sustainability and competitiveness of SMEs. The country case studies demonstrate that although work on this front is underway, much remains to be done. For example, without more targeted government support for the garment industry in Kyrgyzstan, the sustainability of the sector may be in question. The Central Asian region faces issues around peace and security, challenges with infrastructure and inadequate links between educational programmes and industry. Developing the capacity of SMEs to engage in trade requires fostering skills related to business development and strategy, as well as knowledge of rules and regulations. Although SMEs in the region are engaged in exports, volumes are relatively limited. The main obstacles are non-tariff related because trade regimes are relatively open. The potential for growth is significant, but the SME regulatory and operational environment must be improved so that SMEs can develop the required scale of operation to become competitive internationally.

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ANNEX 1: Summaries of the IPPA Research Papers.

SUMMARY of Export-Driven SME Development in Kyrgyzstan: The Garment Manufacturing Sector by Nurbek Jenish

While Kyrgyzstan boasts a decade of impressive growth in its garment production industry, the sector's competitiveness is under threat in the medium-term future. This paper analyses the factors that contributed to the industry's success, as well as the real and anticipated effects of two recent policy changes – import tariff increases on fabrics and clothing accessories, as well as accession of Kyrgyzstan to the Customs Union (CU) of Belarus, Kazakhstan and Russia. To gain insight into these developments, in-depth interviews were conducted with eight owners of sewing shop enterprises and two wholesale order customers. In addition, a series of discussions were held with garment-sector experts and distributors of Kyrgyz apparel in the Russian Federation. This research suggests the 2013 decrease in demand for Kyrgyz clothing in key markets was likely caused by two factors: 1) import tariff increases, which resulted in decreased imported fabrics and increased production costs; and 2) a shift in preferences for Belarusian apparel, which is perceived as the closest competitor for Kyrgyz clothing. Once Kyrgyzstan enters the CU, the production cost of clothing is projected to increase by 10 to 20 percent. While Kyrgyz products would still be cheaper than their Belarusian counterparts, the price differential is expected to decrease. This shift, combined with enormous state support for the Belarusian clothing sector, may result in Kyrgyz garment producers losing their hold on middle-class customers in the Russian Federation and Kazakhstan.

Kyrgyzstan's Clothing Sector

Economic Performance

Kyrgyzstan's clothing exports rose from around \$15 million in 2003 to \$155 million in 2012. The sector currently contributes an estimated five to 15 percent to gross domestic product (GDP) and employs more than 100,000 people; over four percent of the total labour force. In 2012, garment production constituted more than 80 percent of light industry production, with over 3,000 small and medium-sized enterprises (SMEs) exporting more than 90 percent of their production to the Russian Federation and Kazakhstan.

Industry Profile

Kyrgyz garment output is primarily aimed at middle-class consumers in Russia and Kazakhstan and, to a lesser extent, in Tajikistan and Uzbekistan. The main challenge for young enterprises is securing a stable wholesale customer base. The process of developing a customer list to ensure repeat orders can take several years. Worker turnover is a barrier, with growth in the number of enterprises creating competition for qualified labour. Almost all enterprises function under the juridical status of "individual entrepreneur," which requires business owners to purchase a patent from tax authorities. The patent, introduced by Kyrgyz authorities to bring small businesses out of the shadow economy, charges a reasonable fee in exchange for exemption from value-added and sales tax.

There are three main sizes of clothing enterprises, measured by the number of sewing machines owners possess. Small enterprises or mini-workshops have between five and 15 ma-

chines and are often made up of industry entrants looking to expand. Medium enterprises have between 20 and 70 machines. Most of these enterprises have more than five years' operating experience and rely on regular wholesale customers who provide a stable number of orders. SMEs tend to be more flexible than larger enterprises in taking orders and producing different styles of clothing. They do not usually deal with ordering fabric and accessories or the distribution of the final product, and focus exclusively on sewing. Large enterprises have more than 70 machines. These enterprises design their own clothing and manage the supply of their materials and their product distribution. The apparel production sector is seasonal, with enterprises typically producing eight times the volume of clothing in the summer compared to the winter. Larger enterprises usually outsource some work to small enterprises during high-volume months.

The quality of Kyrgyz clothing is improving, likely because sewers are better trained and more experienced, and wholesale customers are demanding higher quality work. The material used in the production of Kyrgyz apparel, however, is typically lower quality synthetic fabric imported from China. Summer clothing is usually sewn from semi-natural materials, consisting of about 50 percent staple cotton and synthetic fibres, while a small proportion of clothing is produced from more expensive fabrics imported from Korea, Turkey and the United Arab Emirates. The cost of natural fabric is typically prohibitively expensive for wholesale customers.

Factors That Led to Success

Three main factors are associated with Kyrgyzstan's impressive growth in garment manufacturing: the country's accession to the WTO in 1998 and simplified weight-based customs clearance, which allows for relatively cheap acquisition of fabrics; favourable patent-based tax treatment; and the solid entrepreneurial skills of Kyrgyz entrepreneurs. Kyrgyzstan's open trade regime enables imports of low-cost materials from China and, to a lesser extent, Turkey. The patent system helps bring a substantial number of apparel SMEs out of the shadow economy by restricting tax burdens. In addition, the presence of relatively large Kyrgyz diasporas in the Russian Federation and Kazakhstan equips domestic entrepreneurs with market knowledge of the region and regional tastes, facilitating the creation of efficient distribution and sales networks.

Another factor that explains the garment industry's success is the *National Strategy for the Textile Sector*, which was implemented by the government and donors to strengthen industry competitiveness and expand markets of product distribution. The strategy includes employee training programmes and advisory services that assisted companies' transition from small scale production to conveyor-type production systems, allowing firms to pursue larger orders.

Impact of Recent Policy Changes

Two recent policy changes could negatively impact growth in Kyrgyzstan's garment industry. The first is an increase in import tariffs on fabrics and clothing accessories, and the other is Kyrgyzstan's planned accession to the CU of Belarus, Kazakhstan and the Russian Federation.

Change in Import Tariffs

In August 2012, the Kyrgyz government introduced changes to international trade regulations and import tariffs for specific goods. Tariffs for imported fabric increased from \$0.20

to \$0.35 per kilogramme for on-land transportation. Research suggests this change resulted in a 30 percent decline in the volume of Chinese fabric imports for the first 10 months of 2013 relative to the same period in 2012. Industry representatives further claim that the number of Kyrgyz clothing orders significantly decreased in 2013; some by as much as 30 to 40 percent. While increased tariffs are not expected to significantly increase the cost of clothing production, experts believe wholesale customers are cautious about placing large orders because they worry they will not be able to sell apparel at higher prices. Wholesalers are also reportedly decreasing their per-unit payments to sewing companies, which suggests they are offloading some of the burden of increased tariffs to sewers.

Joining the CU

If and when Kyrgyzstan joins the CU, the common external value-based tariff will be applied to imported fabrics and other supplies needed for garment production, which will be more costly than current weight-based taxes. Since Kyrgyzstan is a net importer of fabrics, this change could substantially increase the cost of apparel production and may result in Kyrgyz products becoming less competitive in CU markets.

The decline in competitive value is compounded when standard trade theory is applied. This paradigm holds that when a small market integrates into a much larger one, the larger market dictates the price level of the combined economy. Given the tremendous size difference between markets in Kyrgyzstan and Russia, the overall price level in Russia would likely prevail, raising prices and labour wages in Kyrgyzstan after integration. If we assume aggregate price levels rise by 15 percent when Kyrgyzstan joins the CU, we can add an additional 10 to 20 percent to the production costs of clothing because of increased labour costs. While Kyrgyzstan's garment industry would still produce cheaper products post-integration than its closest competitor, Belarus, the price differential would narrow.

Competition from Belarus

Belarus' clothing industry is the main competitor of Kyrgyz apparel in the Russian and Kazakh markets. Like Kyrgyz garments, Belarusian clothing is aimed at middle-class consumers, whereas Turkish garments cater to Russia's wealthier customers, and Vietnamese, Bangladeshi and Chinese clothes target lower-income populations. Kyrgyzstan garments are currently 30 to 70 percent cheaper than Belarusian garments, which makes them more attractive to lower-middle-class buyers. For example, similar dresses made in Kyrgyzstan and Belarus currently cost \$25 and \$45 respectively. Belarusian garments are gaining popularity in Russia and Kazakhstan, with the absolute value of the country's exports to CU states growing from \$118 to \$438 million between 2002 and 2012. In relative terms, however, Kyrgyzstan far outpaced this growth, recording a ten-fold increase in apparel export volume over the same period.

Despite past trends, Belarusian clothing producers possess several advantages that could make them more competitive than their Kyrgyz counterparts in the medium-term future. Their biggest advantage is that Belarus possesses a mature fabrics industry and is a net exporter of linen, meaning clothing producers are not affected by import tariff hikes for fabrics. An additional competitive advantage is government support of Belarus' apparel industry, as reflected in the *State Programme of Innovative Development of the Republic of Belarus for*

2011-2015. Initiatives include subsidised interest payments for textile businesses investing in re-equipment, certification of Belarusian products under the “Quality” Programme, agriculture tax exemption for producers of natural fabrics, funding of research and development activities, and agreements with universities and vocational schools to produce skilled workers. This assistance is resulting in the modernisation of sewing factories, which will positively impact productivity and decrease production costs and prices. The improved efficiency, combined with Kyrgyzstan’s accession to the CU, will likely shrink the price differential between Kyrgyz and Belarusian clothing. Since there is no way the Kyrgyz government can match the support provided by the Belarusian government to its garment sector, the danger is that Kyrgyzstan could lose its current middle-class market niche in Russia and Kazakhstan and would instead need to sell to less affluent customers.

Other Factors

Another possible reason for the decline in Russian orders for Kyrgyz clothing is a rise in lower-quality counterfeit “Made in Kyrgyzstan” clothing exported from China, which undermines the demand for Kyrgyz products. Decreased demand may also be caused by an increase in income of the Russian middle class, enabling them to purchase more expensive items. Belarus is actively developing a wide range of products and brands to meet this evolving taste, including clothing, fur, leather goods and shoes, knitted products, sportswear and lingerie.

Recommendations

In light of expected developments associated with Kyrgyzstan’s planned accession to the CU and the state’s shortage of financial resources to support its clothing sector, the government should, at a minimum, maintain status quo in tax regulation and retain the amount of tax payments under the patent and social fund contribution.

SUMMARY of Small and Medium Enterprise Development in Kyrgyzstan: Informal Communications and the Role of Women by Altyn Kapalova

The goal of this study is to improve the understanding of small and medium-sized enterprises (SMEs) in Kyrgyzstan. Specifically, there are three objectives: first, to describe social dimensions, strengths and weaknesses of the Kyrgyz SME industry; second, to understand informal communications related to SME operations; and third, to identify the role of women in the sector. Anthropological research was conducted in Bishkek from October 2013 to March 2014, including mapping of more than 150 businesses, analysis of gender composition at 87 SMEs and interviews with 67 business owners, employees and government officials. This paper examines the current state of SME development and uses degrees of informal communication to differentiate three categories of firms within the sector; analyses factors that affect business development and the role of informal communications in SME operations; maps three SME zones in Bishkek; explores barriers facing women entrepreneurs; and offers recommendations to public and private stakeholders. The paper finds informal communication mechanisms verging on corruption are extremely powerful forces in the SME sector, and compensate for lack of business literacy in entrepreneurs. Women already active in SMEs report that they do not experience gender-based discrimination, and that in fact, their gender can grant them some leeway when dealing with officials. However, there are significant barriers to women joining the sector, and While the role of women in enterprise development

is accepted in Kyrgyz society, female entrepreneurs are restricted by the cultural notion that household and family functions are a woman's most important responsibilities.

Current State of SME Development

Government Regulation

Kyrgyzstan's business environment is nascent, with no coherent policy existing in the area of SME development. At times regulations are inconsistent, including definitions of what constitutes a "small" or "medium" enterprise. Government statistics are also limited, especially with regard to the gender dimension of SME development. The business sector is not subject to proper tax regulation or a trade union movement.

Business Community

Kyrgyzstan's culture is highly dependent on informal relationships, including during economic interactions. Analysis of business owners' communication flows revealed three types of SMEs:

Peripheral Business: The use of "peripheral" reflects not only geographic location on the edges of a city or country, but also that the firm exists on the fringes of the economy, contributing minimally to financial development and improved livelihoods. These businesses usually involve one to five people and do not demonstrate growth in sales, income or other performance indicators. Owners are extremely vulnerable because the location of their business is based on accident or advice from relatives or acquaintances. Usually, operations consist of retail shops like grocery stores, shoe repair businesses and small restaurants.

Three main factors explain the lack of growth in peripheral businesses:

- 1. Initial philosophy:** Business owners in this category tend to see their firms as a means of survival instead of enterprises that will grow and expand. A potential reason for this is that they associate the term "*biznesmen*" with people who build enterprises through dishonest labour and criminal means.
- 2. Lack of business knowledge and restricted access to finance:** Respondents who unsuccessfully attempted to expand their operations attribute their failures to inadequate skills like business planning, competition analysis and risk analysis.
- 3. Dependence on informal communications:** Owners in this category tend to rely on back-channel solutions that are frequently rooted in corruption. Informal relations exist with government officials, as well as kinship and other social networks that are not directly related to the business itself. Entrepreneurs could, for example, face pressure to spend work-related funds to help a relative. Risks associated with this dependence increase the more an enterprise grows.

Conscious Business: Enterprises in this category possess dynamic growth patterns, but not always in a positive direction. Conscious business owners typically do extensive analysis of their competition and demand for their goods and services before beginning their operations. These include medium-sized sewing shops, where the owners start with a couple of machines, eventually expanding by taking calculated risks and using loans. These types of businesses can positively impact livelihoods by creating jobs and providing quality goods and services to others.

Smart Business: Owners in this category are extremely cognizant of opportunities in Kyrgyz business. They tend to be well-educated, sometimes at the graduate level, and possess work experience in international or civil society organisations or the private sector. They always have an active civic position. In some cases, conflicts of interest exist because an owner's employment provides access to insider information about the institution's need for products and services.

Internal Dynamics: Factors Affecting Business Development

The following factors drive SME development, though they are not always positive.

Human resources: All working relationships are based on verbal, informal understandings, with no formal labour contracts. Employers usually do not offer permanent work because it can hurt their already low bottom line, but the trade-off is lack of worker loyalty. As a result, employment in Kyrgyzstan tends to be short-term, with garment industry workers paid on a weekly basis and retail workers on a daily basis.

Densely populated market: Entrepreneurs do not need to make significant investments to meet the needs of domestic consumers, but this approach may limit expansion opportunities. Some respondents suggest Kyrgyzstan is slow to implement new technologies and innovations compared to regional powerhouses like Russia.

Education and work experience: Education is a key factor in business development. Research found 61 percent of business owners in Kyrgyzstan have undergraduate degrees, and 17 percent have graduate degrees. The majority of respondents without higher education believe they lack important knowledge, which allows government officials to take advantage of them. In addition to being formally educated, successful entrepreneurs also tend to have extensive and useful work experience in various sectors.

Role of Informal Communications in SME Sector

The degree of reliance on informal communications varies according to the category of SME. In smart businesses, personal contacts are used to secure orders, search for information, establish partnerships, accelerate resolution of individual issues and build relations. Informal rapport in these firms does not go beyond official matters. In contrast, informal relationships in peripheral and conscious businesses involve physical and financial resources and interactions outside of the business environment, such as visits of entrepreneurs and government officials to each other's homes or joint leisure activities. SME owners often believe these types of relationships nullify the need for proper documentation. In conscious businesses, informal relations involve giving jobs to relatives and acquaintances, providing trust-based loans to relatives, operating without contracts that protect the rights of workers and maintaining informal rapport with government inspectors.

Unofficial relationships compensate for gaps in knowledge and help ensure that businesses run smoothly. For example, SME owners try to report to tax inspectorates or Social Fund branches where they have acquaintances who can help them skip the queue, understand regulations or admit reports late in exchange for a fee or an offer of friendship. Some own-

ers forgo formal registration because instead of buying a patent, they can pay half as much in bribes to local inspectors. Interestingly, participants of such relationships do not typically view their actions as corrupt.

There are no formal contracts or official guarantees between wholesalers and retail outlets. Reputation in this environment is backed by informal guarantors, such as common acquaintances, relatives or repeat customers. In order to reduce their risks, entrepreneurs tend to work for repeat customers with proven reliability instead of pursuing new market opportunities.

Role of relatives and kinship in SMEs: SME owners rely on relatives to assist with business needs in a number of ways:

- *Equal players with distinct functions:* One relative may manage operations while another is responsible for marketing, and a third oversees distribution.
- *Patronage:* Relatives may use their status to assist SME owners in exchange for tangible returns like money and goods, or intangible rewards like invitations to homes and a place of honour during special occasions.
- *Investment:* Relatives with capital often prefer to hire family members for SME operations because they believe these individuals will be honest, easier to control and more flexible about timing of payment.

SME Map of Bishkek

Mapping exercises in Bishkek demonstrate that lack of government oversight leads SMEs to erect or occupy chaotic, spontaneous infrastructure. These developments alter city structures in both positive and negative ways, affecting public transportation routes, population density and neighbourhood aesthetics. Since business owners are left to their own devices to set up shop, most SMEs siphon electricity from nearby houses or power poles. Their premises typically have access to electricity but not running water or toilets. They rely on mobile heaters. Vehicles are parked on roadsides, leading to traffic jams. Accumulation of waste is also a challenge. The lower the capital of the business owner, the worse the physical conditions of the operation.

Profile and area of coverage: Business in Bishkek is inward-oriented and static. Firms tend to focus on nearby neighbourhoods, and do not reach out to consumers beyond their immediate area. With the exception of the apparel sector, Kyrgyz entrepreneurs do not often establish export-oriented operations.

Types of formal registration for SMEs: Of the 87 SMEs surveyed, six were registered as limited liability companies (LLC), eight as individual entrepreneurs (IE), 33 operated under a patent, seven had no formal registration.. While micro-businesses tend to prefer patent-based registration, entities with higher sales usually register as both LLCs and IEs. IE registration is less costly, and LLCs registration is better for firms that transact with international organisations or large companies.

Women in Kyrgyz SMEs

Research revealed that the difficulties women entrepreneurs face in Kyrgyzstan are not related to accessibility of financing, lack of education or indifference of the government. Instead, the primary problem stems from traditional social and familial views of a woman's hierarchical responsibilities: she is first and foremost seen as a wife, then a daughter-in-law, mother, daughter and sister-in-law. Only after these roles are fulfilled is a woman viewed as a socially active member of society. Most studies look at the restrictions women entrepreneurs face rather than the barriers that prevent women from starting their own businesses in the first place. More research is needed in the latter area, with emphasis on psychological and social factors.

In-depth interviews with 44 women revealed female-run operations can be successful as long as they do not interfere with household responsibilities. Not a single respondent reported being discriminated against on the basis of gender. In fact, women entrepreneurs believe they receive favourable treatment because male customers and government inspectors tend to give them more leniency. Business mapping further revealed that women are significantly over-represented in SMEs, both as owners and workers. Of the 87 firms employing 300 people in one Bishkek neighbourhood, more than 250 workers were female, and 80 percent of operations were managed by women.

Recommendations

To the Government:

- Streamline SME policy.
- Define medium and long-term development goals.
- Create a system of indicators and mechanisms for implementation and monitoring of objectives.
- Simplify procedures for SME registration, licensing and reporting.
- Tighten control over the activities of government officials and fight corruption in the SME sector.
- Ensure meaningful participation of SMEs in the policy-making process.
- Develop a system of subsidised government loans for women.
- Monitor compliance of SME sector with labour legislation.
- Adopt laws that reduce tax burdens for SMEs that invest in social infrastructure.
- Launch information campaigns that explain the purpose of collecting entrepreneurship-related statistical information.

To the Labour Unions:

- Initiate and encourage development of trade unions in the SME sector.
- Create mechanisms to protect workers' rights.

To SME Owners:

- Establish public associations of SME owners so that members can collectively protect industry interests.
- Coordinate lobbying efforts on important issues.

To the Research and Academic Community:

- Conduct studies that focus on starting conditions for women entrepreneurs.
- Create a platform to discuss academic issues related to SME development.

To Civil Society Organisations:

- Increase business literacy of the population:
 - Create a public platform for discussions of SME-related issues, including an annual conference.
 - Encourage development of business consulting services geared especially toward micro-operations.
 - Inform entrepreneurs of their rights and responsibilities through mass media and handouts.
 - Monitor the quality of services provided by public servants.
 - Disseminate information on labour legislation. Provide workers with free legal advice on gender issues.
 - Support development of trade unions.

To City Administration:

- Develop comprehensive urban infrastructure plans that include physical space for SMEs.
- Include commercial and service provision zones in planning of new neighbourhoods.

To Banks, Microfinance Institutions and International Donors:

- Create instruments that support women entrepreneurs and that contribute to reducing gender barriers facing women who want to start their own businesses.
- Provide subsidised loans.
- Offer free or subsidised classes, including training for entrepreneurs.

To the Mass Media:

- Support broad public discussion of issues related to SMEs.

SUMMARY of Small and Medium Enterprises Development and Regional Trade in Afghanistan by Mujib Mashal

Afghanistan is set to undergo a period of economic transition, prompted by the withdrawal of a decade-long international military presence. As massive international investments tied to the security campaign wind down, focus is shifting to regional trade and development of small and medium-sized enterprises (SMEs) as the primary drivers of sustainable, long-term economic growth. This paper surveys recent economic and trade developments in Afghanistan, as well as forecasts for growth; analyses Afghanistan's relations with neighbouring countries and the status of its trade with these states; explores key barriers to trade; evaluates the role of SMEs in the Afghan economy, government policy on SME development, and the barriers that prevent SMEs from realising their full potential; provides an assessment of the current state of regional trade and SME development in Afghanistan; and offers recommendations. The paper concludes that regional trade and SMEs will not become Afghanistan's primary drivers of economic growth unless several barriers are ad-

dressed. Problems include the distrust of risk-averse neighbouring states; corruption; regionally inconsistent customs technology; and a lack of clear benefits to entice SME owners to enter the formal sector.

Recent Economic and Trade Trends

Massive military spending is credited with helping Afghanistan's real gross domestic product (GDP) average 10.5 percent growth between 2005 and 2012. Most gains were made in the services sector, such as construction and logistics; areas that will contract as troops withdraw, aid dwindles and political uncertainty increases.

Trade in Afghanistan also recorded sound growth over the past decade, though the current account deficit remains large and exports are limited to traditional items like carpets, dried and fresh fruit, and natural herbs. Afghanistan's 2012 trade balance with Central Asia was nearly ten to one, with \$1.5 billion in imports compared to \$17 million in exports. Despite this gap, Afghan firms recorded major increases in the volume of their registered exports, which went from an estimated \$100 million in 2002 to \$470 million in 2012. If unrecorded smuggled goods are considered, the latter figure is estimated at \$2.6 billion. Since 2011, exports have declined steeply, however, with some items dipping by as much as 50 percent. Experts believe this is primarily due to hesitation of regional countries to trade with Afghanistan.

Economic Forecast

The World Bank offers several potential scenarios for Afghanistan's economy during the decade following the withdrawal of foreign forces. The most optimistic forecast predicts the economy will continue to grow at an average rate of seven to eight percent. A second scenario, which is the most likely, projects growth will hover around six percent, assuming sustainable growth in businesses and agricultural industries and a gradual decrease in international aid. Finally, if security radically deteriorates, growth could average less than one percent.

Regional Trade

Afghanistan's Relationship with Central Asian Countries

Official economic relations between Afghanistan and Central Asian countries were close to non-existent during the 1990s, with Central Asia undergoing a decade of recession associated with post-USSR transitions. These economies bounced back in 2001, and continue to demonstrate strong growth 13 years later. Regional trade is dominated by primary products such as hydrocarbons and metals.

Current and Potential Exchange

Afghanistan's main trading partners are Uzbekistan, Pakistan and China, though its exchange with Central Asia as a whole remains extremely low compared to the region's trade with other states. While absolute gains are significant, relative improvements are paltry. Trade with Tajikistan, for example, grew from \$3.2 million in 2001 to \$92.1 million in 2010, but the latter figure accounts for less than one percent of Tajikistan's foreign exchange and is largely dominated by electricity and re-exports.

The flow of goods between Central and South Asian states also remains low, accounting for about 15 percent of total exchange. Some experts believe that given Afghanistan's geographic location, the country could become the pivot for interregional trade between Central and South Asia, as well as between India and Europe via Central Asia. Proponents hold that increased trade would provide security in Afghanistan, with Central Asian countries proving more reliable economic partners than Pakistan. One example of a promising initiative is the Central Asia-South Asia Electricity Transmission and Trade Project (CASA – 1000), which aims to bring hydro-electricity from Tajikistan and Kyrgyzstan to Pakistan via Afghanistan. Another project that is generating optimism is the \$7.6 billion India Natural Gas Pipeline (TAPI), which will run more than 1,700 kilometres through Turkmenistan, Afghanistan, Pakistan and India.

Challenges to Regional Trade

In 2014, the World Bank ranked Afghan business 184th out of 189 economies for cross-border trade. Several barriers stand in the way of turning the country into a regional trading hub, including:

Skepticism of Neighbouring States: Officials in regional countries express concern about corruption and mafia-like networks that export outside of Afghanistan's official channels. For example, the mafia is known to import low-quality dried fruit, mix it with domestic supplies and re-export it, bypassing inspection. These practices negatively impact perceptions about the quality of Afghan goods and decrease demand for Afghan products. Central Asian nations also mistrust goods coming from Afghanistan because of a perception of "drugs and guns." A recent survey of traders showed that, with the exception of Kabul, corruption was a major issue at all entry points into Afghanistan.

Infrastructure and Trade Facilitation: While in-country infrastructure is improving in Afghanistan and Central Asian states, much remains to be done in this area. According to the World Bank's 2012 Logistics Performance Index, Afghanistan ranked 135 out of 155 countries, with many of its neighbours faring only slightly better.

Physical Inspections at Borders: Afghanistan has installed the Automated System for Customs Data (ASYCUDA) to integrate trade and transit and to open standardised lines of communication about goods. However, other Central Asian countries have yet to adopt the technology. This limits trade and increases costs for businesses, with Afghan officials complaining ASYCUDA is of no use if their trading partners do not have the same system. Since other Central Asian states do not possess the same level of international aid as Afghanistan, they are harder pressed to invest in the customs upgrade.

Transportation: On the eastern front, the Pakistani border is frequently closed because of protests over drone strikes. In the north, freight capacity is limited, with a maximum of four trains operating weekly. The railway is used to bring imports into Afghanistan, but trains return empty because Uzbekistan only allows Afghan goods to arrive by ship. Corruption is an issue at both the eastern and northern borders, with Pakistani goods sometimes prioritised over local products. Afghan officials also describe a mafia, with far-reaching ties inside the government.

SMEs in Afghanistan

Profile

Given Afghanistan's unpredictable economic climate, large investments in the region remain limited. This means SMEs have a better chance of driving economic growth. According to the Afghan Ministry of Commerce, "small" enterprises employ between five and 20 people and "medium" enterprises employ between 20 to 100 individuals. SMEs make up 85 percent of Afghan businesses, half of the country's GDP and employ more than one third of the country's labour force. Most operate in urban areas and between 70 and 80 percent of them remain informal, and are not registered with the government.

SMEs face a number of significant challenges that must be addressed before their full economic potential can be realised. In addition to those related to corruption, unreliable borders and customs technology discussed earlier, these include:

- **Disincentive to formalise:** Corruption and excessive red tape keep the majority of SME owners from registering their operations with the government. This leaves some businesses, particularly those with export ambitions, vulnerable to exploitation by so-called commission workers who work as middlemen, collecting goods from small producers and distributing them to registered SMEs that can then export the products. This system negatively impacts Afghanistan's revenues and is not subject to oversight mechanisms.
- **Security concerns:** The main concern expressed by business owners is "uncertainty and unpredictability" of the business environment, rather than physical security.
- **Lack of capacity:** A recent survey indicates SMEs do not possess sufficient capacity in business planning and marketing.
- **Lack of clarity about the involvement of the United States (US):** While the Obama administration pledged to help Afghanistan become the transit hub envisioned in the New Silk Road Initiative, there is no specific budget or team leading this project. Doubts about US commitment are reinforced by the simultaneous American pivot to East Asia.
- **Irrelevant education programmes:** A disconnect exists between labour market needs and Afghanistan's education programmes.
- **Dependence on donor organisations for start-up support**
- **Lack of industrial-level energy**
- **Limited access to credit**
- **Lack of product diversity**

Additional Barriers for Women

For women-led businesses, existing challenges are exacerbated by social limitations. Further barriers faced by female entrepreneurs include:

- Access to credit is more difficult because property documents are often required for loan insurance, and property is typically listed under the husband's name.
- While women's participation in the value chain of the Afghan economy is comparable to that of their male counterparts, their role in leading businesses remains marginal.
- The majority of women-owned businesses are currently subsidised by donors, calling into question their long-term sustainability.

- A recent survey found that Afghan support for women working outside the home fell from 71 to 63 percent between 2006 and 2013.
- The Ministry of Women's Affairs, which is responsible for facilitating women-friendly economic policy, is frequently criticised for incompetence. A survey found 77 percent of Afghan women were unaware of the ministry's activities in their area.
- Women's businesses are often run with an "NGO-like mentality" that does not enable female entrepreneurs to become competitive.

Current SME Policy

Despite the importance of SMEs to the economy, small business development only recently became a priority of the Afghan government. The current SME strategy was finalised in 2009 and policy implementation and oversight began in 2011 with the formation of the SME Directorate under the Ministry of Commerce and Industry. Afghanistan's main goal is to lower the country's massive trade deficit by focusing on target sectors that can develop alternatives to imports. Export promotion, at least in the short term, does not play an important role in the strategy.

There are two main criticisms of Afghanistan's SME policy. First, officials working on development of this sector lament that a clear awareness campaign about the new economic system was never launched and that not enough attention was given to value chain development and coordination of economic policy at a higher level. The result is that SME development has, in recent years, happened on an *ad hoc*, donor-driven basis. Second, the directorate possesses a staff of about 25 which is too small for the scope and complexity of its mandate.

Moving Forward

Assessment of Current Situation

The volume of trade between Afghanistan and Central Asia is unlikely to change dramatically in the near future because of Central Asian skepticism and unresolved "soft issues" such as border clearing and customs technology. SME development is also stalling because a lack of clear benefits and corruption, both real and perceived, are keeping most firms informal and unregistered.

Recommendations

- **Raise awareness of the role of government in business development:** A well-orchestrated campaign is needed to inform SME owners about the government's role in business facilitation under the new economic policy. As the subsidising role of international aid organisations shrinks, entrepreneurs will increasingly turn to the government to invest in their businesses. Entrepreneurs must know when they can and cannot approach the public sector for assistance.
- **Include women:** Female business leaders must be included in policy-making bodies such as the Afghanistan Investment Support Agency and the Afghanistan Chamber of Commerce and Industry. This could facilitate policies that create more enabling environments for women in business.
- **Increase capacity at the SME Directorate:** With a clear SME strategy finally in place, the government needs to increase human resource capacity within the SME Directorate to ensure effective implementation and monitoring of key objectives.

- **Build SME capacity to find and engage new markets:** The Afghan government needs to help SMEs develop marketing and networking strategies to engage long-term foreign clients, and not just rely on immediate sales at trade exhibitions.
- **Link business needs and the education system:** The SME Directorate should work with educational institutions to ensure that curricula and qualifications reflect market needs.
- **Facilitate SME formalisation:** The Afghan government must simplify the licensing process for SMEs as a means of bringing more of firms under its formal supervision.
- **Improve communication with Central Asian countries:** Streamlined channels of communication are needed so that trade barriers, such as transit issues, are addressed promptly.
- **Gain clarity on the New Silk Road Initiative:** The US needs to clarify the framework for this project. This could help Central Asian nations assess the benefits of investing in customs technology and trade facilitation, paving the way for increased trade with Afghanistan.

SUMMARY of Dynamic Business Environment of the SME Sector in Tajikistan by Kanat Tilekeyev

Tajikistan is coming off a decade of strong economic growth, thanks in large part to reforms implemented as part of the World Trade Organisation accession process. Still, the country remains deeply dependent on remittances from migrant workers and continues to suffer from high levels of poverty and undeveloped infrastructure. This paper holds that small and medium-sized enterprises (SMEs) could become major drivers of economic growth in Tajikistan, though certain non-trade barriers must be addressed before the sector can realise its full potential. This paper provides an overview of Tajikistan's recent economic trends, including contributions from the SME sector; surveys the operations of four important or fastest growing sectors: agriculture, trade and services, construction and transportation; assesses recent economic reforms implemented by the government; and analyses the current state of SME development and provides recommended actions.

Economic Trends

Tajikistan's gross domestic product (GDP) averaged an impressive 8.3 percent nominal growth rate between 2000 and 2012, which allowed GDP per capita to expand 3.5 times between 2002 and 2009. This performance came from a boost in three key sectors – trade services (retail, catering and warehouse services), construction, transportation and communications. Collectively, these four industries increased their share of GDP from 19 to 42 percent between 2002 and 2009.

Despite this strong financial record, Tajikistan's private sector is still recovering from the financial and food crises of 2008-2009, which claimed more than 70 percent of firms. In 2012, 206,300 registered business units and 200,000 individual entrepreneurs operated in the country. Entrepreneurs that belong to the latter category can operate under one of three forms: certificate (20 percent of informal workers), private (*dekhkan*) farm (30 percent) or patent (50 percent). Women are under-represented in the private sector, making up only 14

percent of entrepreneurs under certificate and *dekhkan* farm registration and 16 percent of entrepreneurs registered under patents.

While Tajikistan's formalised SMEs are still in their infancy, the sector is showing sound growth. The number of business units doubled from 1,700 to 3,400 between 2005 and 2011, employing an average of 17,000 to 20,000 workers at any given time. Further development in this area is crucial because SMEs have strong potential to absorb unemployment, demonstrate adaptability in a complicated business environment, and are capable of increasing competitiveness of the economy on both a regional and global scale.

Growth Sectors

Agriculture

Agriculture is one of the most important sectors in Tajikistan because of the size of its rural population. While the sector's share of GDP decreased slightly from 22 to 19 percent between 2002 and 2009, its growth in real terms is significant, with farmers increasing volume of production 3.8 times between 2005 and 2009. This achievement is remarkable given constraints facing the sector, including low levels of mechanisation, problems with other technological inputs, ongoing industry reform and migration of workers.

Despite this strong performance, two policy debates are slowing down agricultural development: land reform and management, and regulation of the cotton sector. While distribution of land from collective farms to *dekhkan* farms is increasing, the state maintains considerable control through numerous regulations and institutions. Land ownership is further eroded by the threat of expropriation. Government legislation propose using 70 percent of Tajikistan's land for cotton production. State regulation of the cotton market, in turn, is associated with distortions and corruption.

While state policy led to multiple market failures and distortions that prevented effective development of SMEs in the agricultural sector, a significant portion of production at the micro-level is not controlled by the public sector. Rural households produce most agricultural products in the country, including about 93 percent of livestock and 57 percent of crops. Research indicates Tajik households and some *dekhkan* farms are well-positioned to develop a number of higher-value niche products for exports, such as onions and dried fruit. This potential is tempered, however, by barriers in access to land, which varies considerably across regions.

Commercial Trade and Services

Trade is playing an increasingly important role in Tajikistan's economy, rising from 11 percent of GDP in 2002 to 21 percent in 2009. An estimated 8.9 percent of all employed workers in the country are in this sector, though the prominence of trade and the types of goods exchanged vary extensively by region. Trade in retail is a major driver of internal employment and economic growth, with the industry generating about 70,000 jobs.

Tajikistan's accession to the WTO in 2013, may further support an increased role of SMEs in export trade, especially on the Russian and Kazakh Customs Union market. Tajikistan is also expected to increase its volume of imports from Afghanistan, Iran and China.

The paid services industry is demonstrating higher growth rates compared to trade, with volume increasing 112 percent from 2006 to 2012. State companies, however, continue to increase their share in this sector, rising from 18 percent in 2006 to 31 percent in 2012. The government maintains control over several key infrastructure industries, including transportation, communications, health care and education.

Construction

Construction is playing a bigger role in Tajikistan's economy, thanks in large part to the support of state programmes. The industry's share of GDP increased from two to 10 percent between 2002 and 2009, with physical volume rising 41 percent between 2005 and 2009. While much of this success can be attributed to the government's large investments in fixed capital and the high volume of foreign investment, there are indications some growth is being driven by private capital. Tajikistan's boom in new residential dwellings supports this finding since the vast majority of homes are built by individuals at their own expense. Construction in this sector more than doubled between 2004 and 2012; likely the result of growth in the services sector, remittances of migrants and improvements in financial lending. The upswing in Tajikistan's construction sector is promising because it presents opportunities for the informal sector, such as bricklaying, finishing work and carpentry.

Transportation

Tajikistan's transportation sector consists of two categories: freights and passenger carriage. Road vehicles are the most common form of transportation because of the country's landscape and recent problems with railroad transportation through Uzbek territory. Demand for passenger transportation is rising, with bus passenger volumes growing 3.5 times between 2010 and 2011. The volume of air transportation is also growing, though at a smaller rate. While the private sector is making significant gains in freight services, one concerning trend is the decline of private companies in passenger transportation, with the slump beginning in 2011. State intervention in the industry is likely to blame for this phenomenon causing low transparency of operations, high levels of corruption and practices that create unfair competition with private businesses. High state involvement prevents growth of private capital in a number of potential transportation sectors where SMEs could provide services with better cost efficiency.

Policy Reform

The Tajik government implemented a number of economic reforms in recent years related to agriculture (discussed above) as well as taxes and tariffs. These changes directly affected the SME sector, and were driven by the need to satisfy WTO accession requirements. New tax codes, for example, were implemented in 2008-2009 and 2012-2013, which led to the following changes:

- Simplified regulations for private business registration;
- Moratorium on inspections of SMEs;
- Decrease of value-added tax (VAT) from 20 to 18 percent and profit tax from 25 to 15 percent for production enterprises;
- Eliminated retail sales tax;
- Gradual decrease of the profit tax until 2017;
- Tax breaks for certain types of investments; and
- Unification of land tax and immovable property tax.

Despite these improvements, tax administration is still one of the most constraining barriers preventing development of the SME sector. While it is too early to know the full effects of the new tax code, there are already concerns that some aspects of the regime will harm business interests, such as the decrease in threshold for the patent regime, making patents harder to get, implementation of the new social tax for *dekhkan* farms, and introduction of new restrictions for certain VAT exemptions.

In its work with the WTO, the Tajik government also committed to decreasing customs barriers, reducing internal subsidies and privatising certain state enterprises. While improvements are being made, SMEs continue to struggle with internal customs problems, which include mandatory pre-payment for export items, as well as the requirement of certificates of origin and product certification in all cases instead of periodic confirmation of compliance. Successful development of SMEs necessitates that the Tajik government make further headway in lowering tax burdens, implementing simple and transparent administrative regulations, and providing legal protection of property rights.

Main Findings and Recommendations

This paper finds that SMEs in Tajikistan have untapped economic potential in the agricultural sector and export industry. Household-based rural micro-production is a pillar of growth, but several non-trade barriers must be addressed before further development can take place. The following policy gaps are detected:

- **Urgent reassessment of state privatisation is required:** Public companies are competing with SMEs in sectors such as transportation and paid services, and likely also in construction and retail trade. A study of the private construction market, for example, may reveal ways of developing SMEs in this sector.
- **Regional access-to-land studies is needed:** Detailed information about agricultural practices and barriers in different parts of Tajikistan is required before the government can develop sustainable policies that support SME development in rural areas.
- **Tax burdens are too high:** Excessive taxation prevents economic agents from entering the formal economy. This, combined with the high level of corruption in Tajikistan, may seriously erode future economic growth.
- **Taxation/investment study is needed:** Current land and immovable property taxes prevent private capital from investing in business infrastructure in the country. A deeper analysis of these barriers is required before further development can occur.

ANNEX 2: Methodology

The methodologies employed in the four case studies vary. Mashal uses a two-pronged research methodology, providing a thorough study of existing literature on SME development, as well as primary data collected through extensive interviews with sectoral representatives. His literature review included reports on the Afghan economy, trade, private sector development and diplomatic relations with Central Asian nations. Sources consisted of documents and data from aid organisations working on enterprise development, the World Bank and conference presentations by government officials and independent experts. Key informants were officials from the Afghan Ministry of Commerce and Industry, the Ministry of Finance, business association members, SME owners and business consultants. Mashal's report included two case studies with business owners, analysis of Afghanistan's existing SME policy, and exploration of changes in key economic statistics over time.

Tilekeyev draws inferences from analysis of government legislation, case studies and official statistics across time. Variables he considers include regional distribution of economic performance, number of formal and informal firms, gender, import and export levels, financial growth by sector, production output and shares of public ownership. He also offers a theory about how current and prospective policy reform is impacting SME development.

Jenish's primary research methodology consists of in-depth interviews with key stakeholders of Kyrgyzstan's apparel industry. Informants include eight garment manufacturers, two wholesale order customers and a number of sector experts and distributors in the Russian Federation.

Kapalova uses a number of qualitative research methods, including meta-analysis of existing data, participant observation, stakeholder interviews and mapping of 150 SMEs within areas in Kyrgyzstan's capital city. A total of 67 respondents were interviewed, including business owners, employees and government officials. Analysis of gender composition was conducted at 87 firms. The study omitted businesses associated with illegal activities, as well as Internet-based SMEs.

For the purposes of this paper, additional sources were used to supplement and support the findings from the four case studies. Other papers produced by UCA were consulted during the writing of this paper. While the scope of the project did not allow a comprehensive literature review, a limited desk study was conducted using Google Scholar and Carleton University online library resources. The materials represent a sample of available materials, not a comprehensive review. The search terms employed included "SME and economic development" and "SME and transition economies" and yielded a significant volume of resources. The results were narrowed by excluding materials published before 2000 and illuminating duplication. A scan was then conducted for relevance and 13 documents were retained. The websites of the World Bank, the International Financial Corporation (IFC), the United Nations Conference on Trade and Development (UNCTAD), the World Trade Organisation (WTO), the United Nations Industrial Development Or-

ganisation (UNIDO) and the Organisation for Economic Co-operation and Development (OECD) were also consulted for relevant materials. The desk research was conducted from 14 to 17 April 2014.

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