

Business Informality as a Deterrent to Peace and Stability in Afghanistan

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Abstract

Afghanistan's business environment has been challenged by years of war, political uncertainty, inadequate institutional investment, and discrimination against women and minorities. With informal activities constituting up to 80% of the economy, growth is hindered, policymaking is complicated, and public service delivery is affected. The economy's vulnerabilities are magnified by heavy reliance on international aid, limited industrialization, and prevalent nonregulatory activities. This study aims to explore the reasons why most businesses remain in the informal sector and the consequence of this on peace and stability. The reasons for remaining in the informal sector are investigated through surveys, interviews, and focus group discussion with formal and informal businesses. Key informant interviews were also conducted with officials of the Ministry of Commerce and Industries and the Ministry of Finance. Respondents mentioned similar issues, including procedural complexity, educational gaps, complex business registration systems, high taxes, weak institutions, and corruption, while even formal businesses noted some positive aspects of the informal sector. The findings and literature analysis indicate that the government's inability to generate sufficient revenue is mainly due to the fact that the large informal sector does not contribute to state coffers, and that this further exacerbates social grievances and conflicts. Weak public services

decrease the government's legitimacy and fuel the expansion of the informal sector. Based on our analysis, we argue that measures to encourage the formalization of businesses need to be supportive rather than punitive.

1. Introduction

As history has shown, poverty, inequality, and a lack of economic opportunities can lead to conflicts and social unrest, while economic disparities can erode social cohesion and heighten conflicts along racial, religious, or class lines. This has also been true in the case of Afghanistan, where economic vulnerabilities and the government's limited revenue from taxation significantly affect peace and stability in the country. Afghanistan's high crime rate, linked to unemployment and poverty, exemplifies these issues (Shinwari, 2023). These problems have persisted from before 2001, during the peacebuilding phase, and after the Taliban's return in August 2021. The UN's Transitional Engagement Framework (TEF) for 2022 highlighted Afghanistan's significant GDP contraction, rising unemployment, and shift towards informal businesses, which increase risks such as terrorism and trafficking. Furthermore, the COVID-19 pandemic, severe droughts, and ongoing conflicts have exacerbated these challenges, affecting millions and leading to the escalation of unemployment-related crimes as people are pushed towards informal or illicit activities (Shinwari, 2023).

In Afghanistan, informal businesses dominate the economy but contribute little to state revenues. Efforts to enhance revenue through taxation have been undermined by the informal sector's minimal contribution. As the OECD (2019) has highlighted, weak and underfunded state institutions have failed to deliver effective public services, reducing public confidence and impeding state-building and economic growth. A significant trade deficit (over 40% of Afghanistan's GDP as of 2019) and reliance on foreign aid have enhanced consumption and imports while weakening domestic competitiveness and the trading sector. The rise in unemployment, from 11.22% in 2019 to 15.2% in 2022, is partly due to the government's limited revenues and service delivery failures, which has increased public dissatisfaction and distanced people from the government. This situation, along with perceived government corruption, has been linked to youth support for armed opposition and a tendency towards both nonviolent and violent rebellions (Mercy Corps, 2015). The crisis has led to an increase in illicit and informal activities, accounting for 80-90% of the nation's economic activity (World Bank, 2022a). This has a significant impact on both the average income of Afghans and the total GDP of the country.

The prevalence of informal businesses is linked to Afghanistan's economic fragility and its struggle for peace and stability. To improve our understanding of this relationship, this paper focuses on the informal sector and sets out three objectives. The first is to identify why businesses remain informal despite the limitations to their operations. The second is to assess the costs of operating in the formal sector. The third is to explore the relationship

between business informality, the growth of formal businesses, and the overall stability of the country. By discussing these aspects, we aim to show the difficulty of formalizing business and its negative impacts, not only on the economy but also on the peace and stability of the country.

The informal sector, as defined by organizations including the OECD (2019) and ILO (2015), typically consists of small-scale and low production entities. These businesses have little to no division between labor and capital and primarily aim to generate income and employment. They are usually unincorporated, household-owned businesses that may not meet certain employee thresholds or conform to national regulatory or tax legislation. Economists generally view this sector as comprising small, low-productivity activities that do not utilize advanced technology (Deléchat & Medina, 2020). The IMF (2020) defines the informal economy as businesses operating outside formal government systems, which often do not adhere to the laws and regulations that govern formal businesses. Indeed, the informal sector often engages in "underground production" (OECD, 2002), generating income that is not officially recorded or taxed, and thus remaining hidden from public authorities. The OECD (2002) refers to this as "legal yet concealed economic activity" (139), typically aimed at evading taxes, pension contributions, and certain legal and administrative requirements such as minimum wage laws, safety standards, and official paperwork.

Due to their characteristics, informal businesses often face difficulties in transitioning into the formal sector, perpetuating a cycle of informality. We can draw at least eight characteristics of informal businesses based on several studies (Hart, 1973; ILO, 2002; Chen, 2007; Portes & Haller, 2010). First, they are not registered with government authorities and may operate as small-scale enterprises without official documentation. Second, they are often outside the legal protection and do not have access to the same rights and benefits as formal businesses. They may face challenges such as limited property rights, absence of contracts, and inadequate legal recourse. Third, they are usually small in scale and have limited capital. They may operate on a micro or household level, relying on family labor and basic tools or equipment. Fourth, they usually rely on cash transactions rather than formal banking systems. This can make financial management and access to credit more challenging. Fifth, they frequently employ workers in informal employment arrangements, which may lack formal contracts, benefits, and social security provisions. Sixth, they are not subject to the same regulations, licensing requirements, and taxation, as formal businesses. This can result in a loss of potential tax revenue for governments. Seventh, they often operate in vulnerable sectors with low productivity and limited access to resources, training, and market opportunities. The eighth characteristic is in many ways the result of the previous characteristics: they can operate more flexibly than formal businesses. Informal businesses are known for their flexibility and adaptability, and can quickly respond to market demands and modify their goods or services to satisfy people's requirements.

Previous literature on Afghanistan has also extensively discussed the negative impact of the informal economy. However, few studies have explored why many businesses resist formalization. We attempt to fill this research gap by first enquiring what drives businesses to remain in the informal sector in Afghanistan, despite the sector's limitations and underdevelopment. We further investigate the consequences of the businesses' choice to remain in the informal sector from the perspective of peace and stability. Taking into account the challenges of

conducting research under the new Taliban regime which took power in 2021, we designed an empirical study that provided valuable insights. Specifically, we conducted field research involving interviews and focus group discussions, in addition to online surveys. These methods enabled us to access the direct voices of business owners and government officials, as described in more detail below.

The article is structured as follows. Section 2 presents a literature review of the concepts and types of informal businesses, the issue of formalization, and research on these issues in the context of Afghanistan. Section 3 then provides detailed information on the methodology used and sources of data, while Section 4 presents the results of the data analysis. Section 5 discusses the main implications of the findings. Finally, the Section 6 concludes with recommendations to encourage the formalization of businesses and potential themes for further research.

2. Literature Review

In this section, we first review previous studies on the informal economy, including its definition, characteristics, and causes; the relationship between informality and economy; and the challenges of formalization. Then we focus on the literature specifically on the informal economy of Afghanistan.

2.1 Informal businesses and economy

The informal economy is often defined as the market-based legal production of goods and services hidden from public authorities due to financial, regulatory, or institutional reasons. Financial motives for informal businesses include tax evasion and avoiding social security payments; regulatory motives involve bypassing bureaucracy; and institutional reasons are often related to corruption and weak political structures (Schneider et al., 2011; Ulyssea 2020; Roberto, 2022). The relationship between informality and economic progress, especially in emerging economies, has been a longstanding debate. The dualist approach, dating back to Lewis (1954), describes a society with two economic sectors: a capital-intensive 'capitalist' sector and a labor-intensive 'subsistence' sector (often agriculture), with labor movement from subsistence to capitalist sectors driving economic expansion. Informal economies thus encompass legitimate businesses that do not fully comply with tax, labor, or product market regulations, distinguishing them from criminal organizations like drug cartels or prostitution rings. Yet, their existence poses significant challenges to national economic sustainability (Farrell, 2004).

McKinsey Global Institute (MGI)'s analysis highlights the significant cost advantages that informal businesses gain by avoiding taxes and regulations, outweighing their small size and low productivity (Farrell, 2004). This allows ineffective informal players to persist, hindering the growth of more efficient formal companies due to unbalanced competition. Consequently, the long-term negative impact on economic growth and job creation supersedes any short-term employment benefits, trapping these businesses in a cycle of low-scale, ineffective work

(Farrell, 2004). The World Bank (2023) links informality with negative economic outcomes such as greater poverty, lower incomes, reduced financial development, and less growth in output, investment, and productivity. Countries with large informal sectors experience lower tax revenues, ineffective policy institutions, and weak governance, leading to poor public service delivery and human development outcomes, further exacerbated during crises like COVID-19 (Singh et al., 2012; World Bank, 2023).

However, the relationship between economic growth and informality varies across countries due to different levels of pre-existing informality, economic structure, or institutional variables (Chacaltana et al., 2022). Informality can persist even after economic growth due to factors such as businesses' shortage of capital, high costs of formalization, and insufficient demand (Chacaltana et al., 2022).

Informality is multidimensional, encompassing formal and informal workers, businesses, and production methods. Recent research underscores the distinctions and similarities between the determinants of business and labor informality, suggesting that formalizing informal enterprises is a prerequisite for formalizing workers in the informal sector (Díaz et al., 2018). Ulyseas (2018) identifies three perspectives on why informality persists: the legalistic perspective, where high regulatory costs keep entrepreneurs informal; the parasite view, where businesses capable of formal operation choose informality for cost benefits; and the survival view, where low-skilled individuals use informality for subsistence. Expanding this framework, Kanbur categorizes economic actors into four groups, based on their interaction with government regulations: those compliant with and covered by regulation, those covered but non-compliant, those initially covered who modify their behavior to avoid regulation, and those never covered by regulation (Chacaltana et al., 2022). This classification underscores the observation that informality is not homogeneous, with each type having distinct causes and characteristics, highlighting the complexity and varied nature of informal economic activities.

Along with the heterogeneity of informality, scholars have discussed the causes of informality. For example, Loayza (2018) argues that informality results from a combination of factors like low productivity, poor institutional quality, and economic structure. Schneider et al. (2011) linked the growth of informal businesses to economic vulnerability. In their study on the global shadow economy, they argue that the ineffectiveness of government actions such as taxation and regulation contribute to an economy's vulnerability and underdevelopment and thus, balanced policies to encourage growth is required. Similarly, Women in Informal Employment: Globalizing and Organizing (WIEGO)'s research on informality highlights the role of government regulations in the persistence of the informal sector. Tokman (2007) explores the informal economy in Latin America, highlighting issues including wage disparities, overrepresentation of vulnerable groups, and non-existent employment relationships, which perpetuate economic vulnerability in the region. These previous studies suggest the need to explore governmental policies on taxation and business regulations, as well as the social dimensions of employment including the features and conditions of informal sector workers.

Informal employment is a primary source of income for many in developing countries, but it often comes with lower wages, higher risks, and limited access to legal protections and economic opportunities. Informal workers also have a reduced capacity to assert their economic rights and collective voice (ILO, 2002). For instance, they often

lack legal titles to assets and access to the financial system, necessitating legislative changes to unlock the informal economy's potential.

With regard to the role of urban informal economies in peacebuilding, Young (2020) presented three distinct perspectives: contribution to economic development which promotes long-term peace; manifestation of resistance by the poor against the failure of state and formal economic institutions; and structural marginalization involving exploitation and inequality. While the three perspectives do not always reconcile with each other, Young argues that the role of urban informal economies should be given serious consideration in the theory and praxis of peacebuilding.

Formalization is considered a key to economic development, to strengthening the government's ability to provide public services, and to the greater protection of workers. Salazar-Xirinachs and Chacaltana (2018) analyzed formalization in Latin America from 2005 to 2015, identifying a 5 percentage-point decrease in informality attributed to productivity, regulations, incentives, and enforcement, underscored by strong economic growth. Jessen and Kluge (2021) found limited empirical research on diminishing informality, mostly in Latin America. Their study suggests that interventions are more effective in favorable labor markets, with tax incentives, information dissemination, and comprehensive strategies showing positive impacts. Interventions targeting labor formalization are generally more successful than business formalization, with larger programs yielding better and more lasting effects than smaller ones. These insights highlight the need for a coordinated approach in addressing informality, considering its multifaceted impact and the necessity of sustained, integrated treatments for effective formalization.

2.2 Informal businesses in Afghanistan

The OECD (2019) has classified 75 countries, including Afghanistan, as "fragile," with Afghanistan ranked as "severely fragile" across multiple dimensions: economic, environmental, political, security, and societal. This classification calls for targeted engagement and support for initiatives to strengthen governance, grow human capital, and create regulatory frameworks conducive to business (OECD, 2019). Other studies, including studies by the United Nations and the Peace Research Institute Oslo (Strand et al., 2017), highlight key factors affecting the nation's economy and politics. These factors include the impact of ongoing and past conflicts, the country's heavy reliance on international financial aid, a significant illicit and informal economy, and dependency on trade with neighboring countries due to its landlocked status. Key challenges identified include aid dependency, the growth of informal businesses, political and policy instability, and poor coordination and execution of internal policies. This has led to diminished business confidence in the government and an increase in informal sector activities, exacerbating state fragility and corruption. According to the Special Inspector General for Afghanistan Reconstruction (SIGAR) (2018), formalizing the informal sector is critical for Afghanistan's progress.

Afghanistan's unstable political, economic, and security environment also hinders investment, crucial for boosting employment and productivity in the formal sector. Afghanistan Voluntary National Review (VNR) 2021 on Sustainable Development Goals (SDGs) observed a decline in the formal sector and a rise in informal and illicit

activities due to conflict, leading to increased insecurity and corruption. Since August 2021, one in three businesses have ceased operations temporarily, about 700,000 jobs have been lost, employment in the formal economy has dropped by 50%, and the growth of tax-evading informal businesses continues to contribute minimally to the GDP (UNDP, 2022).

In Afghanistan, informal businesses are often intertwined with illicit activities. Both contribute to illegal revenue, power imbalances, and social divides (Fishstein & Wilder, 2012). The insurgency, particularly the Taliban's strategies involving land rights and poppy cultivation, has significantly fueled illicit businesses. The Taliban's manipulation of land grievances and its control over the narcotics trade highlight the complex relationship between informal business, illicit activities, and socio-economic issues in Afghanistan (Fishstein & Wilder, 2012).

Discussing Afghanistan's economy, Jonathan Goodhand (2004) mentions the war economy and breaks it down into three categories: combat economy, shadow economy, and coping economy. While the informal economy, the focus of this study, includes the coping economy, the shadow economy is the most relevant here. The definition given by Goodhand is "economic activities that are conducted outside state-regulated frameworks and are not audited by the state institutions" (p. 157). The informal economy, encompassing activities like opium cultivation, undermines the formal sector by reducing productivity and fueling socioeconomic issues, such as dependency on illicit income and instability, which in turn heighten conflict, violence, and corruption (OECD, 2019). Up to 80% of Afghanistan's economic activity is informal, offering employment but adversely affecting equality, resource distribution, and job quality (OECD, 2019).

The government's limited tax revenue due to informality also weakens its ability to support formal businesses and provide social and legal protections (Elagin, 2020). Insufficient tax revenues have led the government to rely heavily on borrowing, increasing public debt and economic vulnerability. By 2021, Afghanistan's external debt reached \$1,925.71 million (7.7% of GDP), with significant loans from the Asian Development Bank, World Bank, IMF, and Islamic Development Bank. Bilateral creditors such as the Saudi Fund and Kuwait Fund constituted 7% and 2% of the total debt, respectively (IMF, 2020), impacting fiscal flexibility and risk of debt crises. With grants funding about 75% of public expenditure, expanding revenues without rapid economic growth is a significant challenge (IMF, 2020). Limited tax bases contribute to high fiscal deficits, inflation, and unmanageable debt, undermining investor confidence, hindering private sector growth, and compromising economic stability (World Bank, 2022b). The Taliban's return further limited the government's budget, leading the aid-dependent economy into crisis.

While existing studies have extensively examined the adverse impact of informal businesses on Afghanistan's economy, there is a gap in research regarding specific barriers to participation in the formal economy. The current study aims to investigate these barriers and identify discrepancies between government policies for formal and informal sectors and the actual business environment.

3. Methodology

As mentioned in the introduction, this study employed in-depth interviews, focus group discussions, and surveys for primary data collection. The secondary information was obtained through literature, and media and news tracking. The fieldwork in Kabul was conducted in June 2023. For both surveys and interviews, most participants were aged 20-50, which is in line with the working-age population in Afghanistan. Gender distribution showed male dominance in business, with only twelve women participating due to post-August 2021 political changes. Most participants were university graduates, and seven had baccalaureate degrees, indicating that business owners are generally well-educated.

For interviews, purposeful and convenience sampling was used. Semi-structured interviews were conducted with two groups of participants. The first group consisted of eight officials from the Ministry of Commerce and Industries and the Ministry of Finance, focusing on their perspectives on informal sector dominance and its economic effects. Challenges in interviewing arose due to recent staffing changes and discomfort among potential participants in discussing systemic issues. The key informants were afraid of talking about the role and inability of the policymakers in the government to handle informal businesses. Such inability could include a lack of knowledge and expertise to analyze Afghan markets, the economic situation, and the dire need for the public sector's income growth. The second group was 14 business owners, consisting of seven each from formal and informal sectors. These interviews tried to understand the practical challenges the business owners faced. The details of the interviews varied depending on respondents' backgrounds and time constraints. Considering the political sensitivity under current political conditions, the interviews strictly observed research ethics, including informed consent and confidentiality. Only the companies which granted an explicit agreement are named in the results section.

A total of 32 business owners (18 formal and 14 informal) responded to survey questionnaires, developed using Microsoft Office Forms and distributed through the first author's networks. The responses of the businesses to the online surveys were concise but focused. For example, in response to the question of what the benefits of formalization would be, participants mostly mentioned the services they will receive from the government, such as access to legal documents, project offers, and export and import facilities. On the other hand, these participants did not have any concerns about mentioning the systemic problems within the government structures as their names and other information were not requested through the survey. Because of this, they provided more focused information and expressed their concerns, especially on the taxation system, corruption, and regulatory and bureaucracy issues.

In total, survey and interview participants consisted of 27 formal and 19 informal businesses. All formal businesses had bank accounts, were registered with the Ministry of Commerce and Industries, and possessed Tax

Identification Numbers.¹ In contrast, informal business owners typically avoided bank accounts and tax obligations. Regarding accounting practices, most companies, regardless of size, recognized the importance of maintaining accounting records for business growth and operational flow. However, in our survey, informal business owners often neglected standardized record-keeping of expenses and revenues. In contrast, formal business owners adhered to proper accounting systems for daily transactions, as part of the business registration criteria and fiscal year financial reporting.

The data collection phase involved certain challenges because some key informants from ministries and businesses were initially reluctant. It therefore took more time than expected to obtain consent for their contributions. However, some of them agreed after receiving a sufficient explanation of the research purpose. It should be noted that interviewees allowed photographs but not voice recordings. The interview data was triangulated with secondary data, such as national statistics, academic papers, and various reports of international organizations and think tanks.

4. Results

4.1 Survey results

Online survey participants representing formal businesses identified various benefits of registration. These include legal status, conducting licit activities, orderly documentation, potential government support such as land in industrial parks and export-import facilities, banking access, shareholder opportunities, tax incentives, access to state and donor funding, contributing to taxation and competition for quality services, engaging with diverse groups, meeting market needs, contributing to Sustainable Development Goals (SDGs), and accessing various education and training programs.

On the other hand, the challenges they mentioned were a complex tax system, lack of digitalization, limited business knowledge and education, corruption, government bureaucracy, rapidly changing laws, law violations, an unstandardized labor market, insufficient social protection and credit access, poor quality control and productivity, resource scarcity for business promotion, financial instability, government restrictions on women-led NGOs and employment, and limited donor support.

Informal businesses responded that the reasons for avoiding registration were high taxes, weak institutional support, lack of awareness about formalization benefits, and political and economic instability. They prefer the informal sector for its low investment, regular returns, autonomy, and distance from bureaucratic processes. However, they face challenges such as business uncertainty, lack of government support, market access issues,

¹ Legal and natural persons (registered entities and people) pay taxes, while informal entities without registered business licenses and Tax Identification Numbers (TIN) do not contribute to revenue collections as taxpayers.

inability to participate in exhibitions, lack of formal contracts, and unprofessional behavior of public staff. Insufficient legal and tax guidance, gender bias, high office rents, and negative attitudes from officials are hindering their move to formalization.

4.2 Interviews with Business Owners/Managers

Similar explanations about the advantages and challenges of the formal sector were given by the participants of interviews and focus group discussions. Registering businesses offers numerous benefits such as government support, credibility, and market trust. The owner of Bilim, a research and consultancy firm, noted that registration in Afghanistan enhances credibility and access to government projects, invitations through the Chamber of Commerce, and legal protection in disputes. Khaliq Kabir Construction Company, with over 10 years of experience in Afghanistan's construction sector, also acknowledged these advantages, adding that access to industrial parks is also a significant benefit of branding. The owner of Shining Pyramids emphasized that registration helps in forming affiliations with national and international organizations. He aims to showcase his company's capabilities for partnerships with international organizations and UN agencies, and access to training programs by government or international groups. Furthermore, the participants highlighted that the key benefits of being a registered entity are increased credibility and trust, leading to easier access to business opportunities and projects, alongside other advantages like legal dispute protection, enhanced branding, unlimited investment potential, and increased publicity.

However, the formal sector also offers some challenges. The owner of Pyramid Design Company mentioned examples of challenges, such as "complexity and frequent changes in regulations, high administrative burdens in terms of government auditing and paying taxes, and financial implications while paying vast amounts of taxes." Different types of taxes and irregularities in taxes create many challenges for the formal sector.² Additionally, another challenge comes from the informal sector. The formal sector must compete with low-quality but cheaper products produced by unregistered entities without quality control or new technology access.

For informal businesses, their understanding of advantages and challenges mirrors the points discussed by the formal businesses. A car mechanic listed several advantages, including no paperwork or licensing fees, low investment and flexible location, expertise gained in vehicle repair, potential to expand business when financially affordable, the lack of a need for a financial expert or for reporting to the government, and ease of teaching vehicle repair skills to his son. A shopkeeper added, "I don't have any boss, I can work anytime. I don't have the tension of paying taxes or paying for business license renewal."

² The Government sets several taxes which are relevant to businesses: withholding tax on rental service, business receipt tax (BRT), wage withholding tax, withholding tax on contractor services, and income tax. Afghanistan's Minister of Finance approved a VAT implementation plan in November 2011, and the implementation date was set for 2014. Implementation was postponed, first to December 2016, then to December 2020, and finally to December 2021. Because the government collapsed in August 2021, the VAT has not been implemented in Afghanistan.

However, the car mechanic and shopkeeper identified similar challenges of informality: bribes for tax staff, limited registration knowledge, no support for larger business spaces, lack of recognition and support from authorities and international entities, mistreatment by government staff, financial instability, and increased costs in formal setups. A street fruit seller elaborated further:

Sometimes the municipality comes and asks for taxes, and I beg for them to leave me. I do not know if my work needs registration as I do not have a shop or enough money for registration. There is no authority to go and ask for a loan to expand my activities in a permanent area. I have not received any support from any foreign entity, such as foodstuff, tent, or cart to use, instead of staying on the street. As I am on the street, I cannot work longer during the night as I am scared someone might come to loot me.

This highlights the difficulties pertaining to tax demands, lack of knowledge about registration, lack of support for business expansion, and security concerns. A carpet washer also mentioned friction with government officials and the lack of support from the municipality, underlining the risks associated with operating without a license:

In fact, there is no government or NGO support. Misbehavior of government staff sometimes while they come to force us to pay the taxes and register with the environment-related office. I cannot work sometimes during the night as a mosque is nearby, and in case of noise, the district authority comes and seals [closes] my shop as I do not have a license. No support from the municipality in case of any dispute because we have no working licenses... uncertainty to easily leave the business. In the case of bankruptcy, the government will take everything you have.

Considering both the benefits and challenges of informality, one of the interview questions asked about why people decide to stay in the informal sector. A car mechanic cited several reasons for choosing informal work: limited education, prolonged unemployment, insufficient funds to open a formal garage, occasionally earning more than formal jobs, skepticism about government support, the possibility of involving family in the business, and the flexibility to work in any situation (wars or holidays). An informal business owner, previously a kindergarten teacher, also shared his case:

I do not think the government can help me if I register myself with it. I lost my job after the collapse of the previous government; I was a teacher in a kindergarten. The economic crisis happened, and women lost their jobs; no one took their children to kindergarten, and it was closed, and we became jobless.

A shopkeeper, also a former teacher, explained his reason for entering the informal sector:

I lost my job after the collapse of the previous government; I was an army teacher who taught literacy to army people. After losing my job, I had no option but to use my house garage as a shop and sell products. On the other hand, many schools have been closed, and seeking formal jobs has become critical and difficult. Now the benefits I receive as a shopkeeper are better than the salary I received as a teacher; it is now better for me to continue my life with this shop.

In both cases, the choice was made out of necessity, and in the latter case, the shopkeeper earned more than when he did in the formal sector.

A photocopy shop run by four brothers near the Passport Department showcases a unique informal business model. This shop offers diverse services such as photography and document assistance, services beyond the scope of a registered single-activity company. This scenario illustrates that while informality is often a necessity due to financial constraints and bureaucratic challenges, it can occasionally be a strategic choice when the opportunity costs are low. The need for income, hurdles in renting a shop, and registration barriers highlight the struggles of starting a business, emphasizing the need for more supportive policies by the government which enable entrepreneurship and small business development.

In summary, informal business owners often find the income from such ventures preferable to formal employment, despite facing various challenges such as the unprofessional behavior of government agencies and a lack of legal support. This reality reflects a balance between job security and earning potential, forcing individuals to navigate a complex landscape of survival and entrepreneurship.

4.3 Interviews with Ministry Officials

Even for government officials, the picture of the formal and informal sectors remains unclear. Noting the advantages of informality, an official mentioned the number of businesses in formal and informal sectors, "According to Afghanistan Central Business Registration (ACBR) statistics, around 153,000 companies are registered with the Ministry of Industry and Commerce, while the informal sector encompasses about 600,000 entities." However, another official pointed out the lack of information:

No detailed information is available about the exact number of formal and informal businesses... Regarding informal businesses, the ministry intends to obtain accurate figures and information through the relevant agencies, municipalities, and other institutions because most businesses are very small and cannot be easily identified by government authorities.

The government officials seemed aware of the government's shortcomings in supporting business formalization. One participant noted:

The formalization plan was prepared and arranged ten years ago in the Ministry of Industry and Commerce, and submitted to the *Supreme Economic Council*, [but] the Ministry received no responses, and the plan remained a draft and outdated.

One participant also detailed the complex relationship between the informal and formal sectors:

Formal and informal businesses are interlinked, with formal sectors sometimes relying on the informal for low-cost tasks. While formal sectors have access to markets, contracts, and legal connections, the informal sector operates without such advantages, leading to unfair competition due to lower overheads and pricing, often resulting in stricter regulations against it.

The same participant also explained:

The formal sector's skills and productions are recognized, but the informal sector's skills would be degraded [due to neglected conditions], making it impossible to transition into the legal sector. Formal sectors bear different costs, but the informal sector does not have any costs unless the law captures them. The formal sector contributes to revenue collection, income generation, and employment, as all the business aspects would be recorded and reported. Still, the informal sector's role in poverty reduction, livelihood support, and entrepreneurship growth remains unclear due to a lack of evidence on business activities.

Despite these views, there are official efforts to formalize the informal sector. A ministry official mentioned a plan to introduce a new, simplified registration process for small, medium, and large enterprises, aimed at easing formal recognition. Post-registration, all manufacturing factories and entities will be consolidated into a single database for easy access and streamlined operations. The government is developing a comprehensive registration process for all businesses, as explained by another participant:

An application form is available in English, Pashto, and Dari on the Afghanistan Central Business Registration (ACBR) website. Required documents include a *Tazkera* (ID) or passport of the business's President and Vice President, their color passport photographs, and the Article of Incorporation of the business, detailing ownership, shares, and agreements. Changes in this document must be reported and updated with ACBR.

In contrast to measures to facilitate business registration, the formalization strategy also involves punishment. The informal sector faces significant consequences for not transitioning to the formal sector, with the government enforcing various measures. The fourth participant explained,

Informal businesses will face fines for unaccounted revenues and possibly business closure. Registered businesses not paying license fees will be charged for delays in reporting and updating licenses. Additionally, if a registered company doesn't pay taxes, penalties will be imposed, legal properties blocked, and owners will be banned from travel until tax payments are settled.

Two respondents from the Ministry of Commerce and Industries and two from the Ministry of Finance identified several challenges hindering state support for business formalization in Afghanistan. The first three concern international relations: 1) political isolation from the global community which exacerbates economic vulnerabilities; 2) financial sanctions imposed by countries, including the USA, and by the United Nations; and 3) selective financial support from donor agencies. The following four concern the problems related to human resources: 4) a shortage of human resources and policymakers for political, economic, and social strategies; 5) limited staff in public institutions who can conduct business training; 6) a lack of skilled staff to enforce laws; and 7) restrictions on women's activities hindering half the population's productivity. The next two are about government income sources: 8) overreliance on taxation as the primary revenue source without full tax collection; and 9) dependence on foreign financial aid. The tenth challenge is the reliance on agriculture as the sole industry without improvement capabilities. The last challenge is the increase in opium cultivation, leading to hidden power struggles and conflict.

The informal sector's growth in Afghanistan is fueled by the economic crisis and lack of formal employment opportunities. Lack of awareness of regulations and registration procedures, as well as the intention to avoid taxation, are some of the reasons why businesses choose to remain informal. Education gaps, complex registration processes, high business license rates, weak institutions, lack of government support, absence of exit options, corruption, and insecure business environments also discourage formalization.

5. Discussion

The previous section described the informal sector's advantages and challenges from three perspectives, the formal sector, the informal sector, and the government. In this section, we will discuss the reasons why informal businesses do not formalize, and how the situation impacts peace and stability in the country.

The reasons why informal businesses resist formalization are twofold. First, some businesses do not have options due to their limited resources, and the lack of information and governmental support. These informal businesses can be their owners' means of survival. Secondly, other business owners strategically choose to remain in the informal sector to avoid tax payment and cumbersome regulations, and to enjoy flexibility. These reasons resonate with Ulyassee's (2018) discussion of the legal, parasite, and survival views mentioned in the literature review section above. For these reasons, we can identify a vicious cycle, whereby the weak state's failure to provide formalization support further reduces its capacity because of the lost tax income from the informal sector. Revenue

collection is hindered by corruption, ineffective tax administration, and weak governance, leading to increased economic vulnerability, erosion of public trust, discouragement of private investment, and a climate of economic uncertainty (Azizi, 2021).

To exit this vicious cycle, efforts towards formalization need to be enhanced. As mentioned by the government officials, their current strategy has both facilitating and punitive aspects. Making the registration process more friendly addresses one of the problems that hinders business owners from formalizing their businesses. However, heavily punishing businesses that fail to pay tax may have countereffects. Taxes, often enforced through military pressure and without proper consultation with unions or citizens, are contributing to rising poverty and unemployment, potentially leading to the closure of businesses (Vafaie, 2023). The Persian Independent Press reports that tax increases and irregularities in Afghanistan, particularly by the Taliban, have posed significant challenges for the formal sector. As discussed by Young (2020), the state holds the power to coerce the poor to abide by the discipline that the state chooses to enforce. In the state-building process where the state's legitimacy is not established, this can diminish popular trust in the government.

A more effective way to advance business formalization may be to provide incentives for tax payments. For example, the government can remove the guaranty amount required for formal business registration, which is currently set at a fixed ceiling of 500,000 AFN. It would also be effective to temporarily reduce or exempt certain taxes after formalization, such as income tax and withholding taxes on rent and wages of professional employment. Other support, such as providing social security and access to resources such as social services, business consultation, land and infrastructure (electricity and water at affordable costs), and credit finances, would help businesses, and the government can gain their trust in return. This approach is similar to what Goodhand (2004) advocated, saying, "With the right combination of (dis)incentives, wartime entrepreneurs who have historically been labeled profiteers, economic criminals or greedy warlords may perhaps also become builders of a basis of long-term, more legitimate economic success" (p. 166). Furthermore, a Micro, Small, and Medium Enterprises (MSME) institution that offers training, information sharing, and support for public and private entities will be an asset. This would help informal businesses through entrepreneurial training, tax information, and guidance on formalization processes. The institution can serve as an incubator for formal business initiation, focusing on building strong human capital with managerial skills. This approach will attract the informal sector by informing them about formalization, business expansion, and handling business insolvency.

6. Conclusion

This research aimed to deepen our understanding of why businesses remain informal despite inconveniences and challenges, and how this perpetuates aid dependency, economic vulnerability, and peace and

stability in Afghanistan. To answer these questions, various data collection methods were employed, including interviews, focus group discussions, online surveys, and media and news tracking.

The data analysis revealed that businesses remain informal due to the government's inability to foster a stable business environment. Key issues include weak enforcement of business regulations, inadequate resource access, insufficient infrastructure development, lack of business education and awareness, minimal support for small businesses, and poor protection for valuable domestic informal activities. Other factors are a lack of incentives for formalization, investment challenges, complex registration processes, and ineffective measures against corruption. Additionally, the limited human resources in the public sector impede effective policymaking.

Afghanistan's vulnerable economy faces multifaceted challenges, which are exacerbated by the growth of informal businesses not contributing to state revenue. High poverty, income disparities, and limited access to public services fuel economic inequality, sparking conflicts and societal discontent. Political instability, corruption, and weak governance further contribute to internal upheaval. Competition for natural resources like minerals and poppy cultivation intensifies conflicts. The social and economic effects of these conflicts, including destroyed infrastructure, displaced populations, and disrupted economies, require significant recovery resources, hampering economic progress. Conflicts can also exacerbate the growth of the informal economy, which may provide a vital lifeline in violent circumstances but can also fuel violence due to competition for limited resources (Ballentine & Sherman, 2003; Mallet & Slater, 2012; Schoofs, 2015). This situation affects peace and stability; a nation plagued by inequality struggles to achieve positive peace, which is peace based on justice, equity, social well-being, and sustainable development.

Addressing the informal economy's challenges requires tailored interventions for different groups, such as self-employed individuals, enterprises of varying sizes and scales, and workers who either evade or are ill-served by existing regulations. Monitoring the impact of economic and social policies on the informal economy is vital, as these policies can affect it directly or indirectly. The ILO (2021) proposes a theory of change for transitioning informal businesses to formal, which emphasizes the need to address the core causes of informality related to institutional and economic environments, individual or business characteristics, and external shocks like pandemics. Formalization involves bringing businesses under regulation and providing workers with proper labor rights and social security.

Despite the collapse of the democratic government, various actors in the international community, including UN agencies, continue to support Afghanistan. These agencies contribute to poverty alleviation and food security (UNAMA, 2023) and engage in private sector development. For example, UNDP's ABADEI project provides services, jobs, and hope to both formal and informal businesses through micro-financial services, albeit without government coordination. UNITAR offers training for existing and prospective businesses (UNITAR, 2023). Effective coordination between UN agencies and the Afghan government is crucial to better prioritize needs and support business formalization.

This paper identified the rise of informal businesses in Afghanistan and the resulting economic vulnerabilities. For further research, a detailed analysis on effective policy formulation to reduce these

vulnerabilities is necessary. One essential element is research on the values, benefits, and population engagement of Afghanistan's different economic sectors. Understanding the value of each sector requires a perspective beyond Afghanistan's borders, identifying international market opportunities and benefits. By establishing different investment priority clusters in each sector, the government can allocate investment levels based on the sectors' value and benefit generation. This approach would enable the private sector to lead and legally manage these sectors under government oversight. By doing so, the government's capacity will increase while it gains the trust of the business sector.

Another research theme can be the potential of diaspora networks as sources of technical and financial support for businesses in Afghanistan. Through the Chamber of Commerce and Industries, the diaspora can link Afghani products to foreign markets as they have access to international markets and sources. This initiative can improve businesses and encourage formalization in the long run, as informal businesses would not have legal access to these markets unless they were registered.

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