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**| RESEARCH ARTICLE**

## **Catalysts and Constraints: The Role of Small and Medium Enterprises in Afghanistan's Economic Transformation**

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**| ABSTRACT**

Small and medium enterprises (SMEs) are considered among the most important factors of sustainable development and greater employment under the term "motor of growth." In fact, SMEs have a significant impact on a country's economic growth. These companies and the opportunities they create lead to job creation, increased income, higher employment levels, and improved living standards, ultimately bringing positive changes to people's lives in a country. Today, 90% of global economic activities are carried out by SMEs. These businesses produce approximately 85% of Afghanistan's semi-gross domestic products and employ nearly one-third of the country's workforce (Mashal, 1392). If proper attention had been given to enterprises, the country could have achieved sustained economic growth and stability. Afghanistan's current strategy, particularly for SMEs, was finalized in 2009. However, it places more emphasis on the production sector as a key point for substituting imports.

**| KEYWORDS**

Small and Medium Enterprises (SMEs); Afghanistan; Economic Development; SME Policy; Investment Barriers; Informal Economy; Financial Access.

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### **1. Introduction**

Small and medium enterprises (SMEs) are considered critical engines of economic development across the world. They play a key role in meeting societal needs, supporting industrial growth, providing employment opportunities, and contributing to gross domestic product (GDP). In many developing countries, SMEs are viewed as the most practical and effective strategy for achieving national growth and self-reliance. However, in Afghanistan, SMEs have not reached a satisfactory level of development. Their growth has neither kept pace with international markets nor fulfilled the internal demands of Afghan society, leaving the sector in a state of stagnation.

The Afghan economy continues to rely heavily on imports for essential goods and services, which has limited the scope for domestic enterprise expansion. This dependence highlights the urgent need for self-sufficiency through local production. To realize such a goal, it is essential to analyze the factors that influence SME development and to address the challenges that hinder their progress. Several internal and external obstacles—such as lack of energy, limited financial access, insufficient institutional support, security threats, and weak infrastructure—continue to affect the sector. Over time, both national and international researchers have studied the development of SMEs in Afghanistan. These studies have identified key supportive elements such as government backing, internal stability, access to capital, and policy reforms, as well as barriers including corruption, bureaucracy, poor market access, and limited technological capacity. Additional concerns include the lack of tax incentives, unfair competition, and the dominance of informal businesses that operate without regulation or legal protection.

Afghanistan officially adopted a market economy in 2001, with the private sector positioned as a central pillar of growth. Government policies emphasize SME development, yet the implementation has been inconsistent. Many businesses remain informal due to limited incentives for registration and weak government engagement. Despite the establishment of an SME strategy in 2009 and the creation of a dedicated directorate, sectoral progress remains slow, especially with the decline of foreign aid. This study seeks to identify the key factors influencing SME development in Afghanistan, assess the role of government and market structures, and highlight the barriers to growth. By doing so, it aims to contribute to the creation of effective strategies that promote sustainable and inclusive economic development through the empowerment of SMEs.

### **1.1 Problem Statement**

Afghanistan's economy has experienced consistent growth over the past decade. A fundamental driver of this growth has been the expenditures of international forces. However, with the withdrawal of foreign forces, attention turned toward the development and progress of the private sector, which has been defined as the core of Afghanistan's economy. The construction industry and the provision of services were directly tied to the support and spending of foreign forces.

These changes occurred despite the fact that the foundation and structure of a market economy in Afghanistan remain weak and unstable. Afghanistan adopted the market economy system in 2001. Prior to that, the country's economic systems were designed based on socialist models under previous regimes, where citizens expected economic support from the government in the form of subsidies. However, during the past decade, expectations shifted significantly due to an influx of international assistance. On the other hand, investment in Afghanistan has remained unpredictable because the economy is still limited. According to the World Bank, although certain opportunities and funds were available to the country, they were not effectively utilized. Unemployment remains at 41%, and no substantial improvements have been made in the lives of the people. Approximately 42% of the population still lives below the poverty line. Among 189 countries, Afghanistan ranks 164th. This is despite the fact that SMEs are recognized as a critical factor in economic development.

Small and medium enterprises are indeed considered fundamental elements in the economic growth and development of a country. These businesses account for 85% of Afghanistan's semi-gross domestic production and employ one-third of the country's labor force (World Bank, 2011). After Afghanistan adopted the market economy in 2001, approximately 85% of its private sector was formed by SMEs, which were identified as the engine of economic growth. However, due to the extensive foreign aid and large amounts of money spent by international forces, the government was not able to focus adequately on developing SMEs within the framework of a market economy.

Furthermore, during the past decade, the consistent growth of Afghanistan's GDP was mainly driven by foreign military expenditures. Real GDP growth was around 10%, and during the period of 2005–2012, the average contribution of foreign military spending was around 5%. Most of this growth was linked to sectors such as service delivery, particularly logistics, construction, and military and non-military spending. With the withdrawal of foreign forces, it is possible that Afghanistan's economic growth may decline, because the ongoing aid had been a major factor in driving development. As such, the departure of international military forces reduced the country's economic momentum. In addition, Afghanistan's future political situation remains uncertain, which raises concerns that there will be little to no large-scale investment. Consequently, cities that were once active in construction and service provision are now experiencing decline.

### **1.2 Importance of the Research**

Small and medium enterprises are considered among the most important factors for sustainable development and high-quality employment, commonly referred to as the engine of growth. In reality, SMEs play a significant role in the economic development of a country. These small and medium-sized companies and the support that leads to the creation of new jobs result in increased income for the population, higher employment levels, improved standards of living, and ultimately bring about positive changes in the lives of the people of a nation.

Currently, 90% of economic activities around the world are conducted through SMEs. These enterprises are responsible for producing approximately 85% of Afghanistan's semi-gross domestic products and employ nearly one-third of the country's labor force (Mashal, 1392). If enterprises had received the necessary attention, the country would have had the opportunity to achieve sustainable economic growth and stability. The current strategy of the country, especially the strategy regarding small and medium businesses, was finalized in 2009. However, there has been a strong emphasis on the productive sector, which is seen as an active area for import-substitution production. At the same time, these businesses are faced with many problems, and significant questions have arisen regarding competitiveness and skills. Given that Afghanistan has faced a persistent trade deficit, the country nonetheless experienced notable growth and development in trade over the past decade. While the position of Afghanistan's trade was previously weak, it has since improved compared to previous decades.

Reading this report provides the audience with insights into the critical factors necessary for the development of small and medium enterprises. It should also be noted that although many factors influence the growth of SMEs, this research focuses on analyzing some of the most important and influential ones. This study introduces the factors that can revive the growth and development of small and medium enterprises. It takes into account those variables that are directly involved in the growth and expansion of SMEs. An increase in reinvestment and a reduction in unemployment can lead to a rise in domestic production and, ultimately, allow the country to benefit from economic development and prosperity.

### **1.3 Research Questions**

- Which factors play a role in the growth and development of small and medium enterprises?
- What kind of role does the government play in the growth and development of small and medium enterprises?
- What challenges and threats exist that hinder the progress of small and medium enterprises?

### **1.4 Research Variables**

In this study, the variables are defined as follows:

- Independent Variable: Factors contributing to growth and development
- Dependent Variable: Small and medium enterprises

These variables are used to assess how various growth and development factors influence the performance and expansion of SMEs.

### **1.5 Research Methodology**

To achieve the objectives of this study, a specific research method must be utilized. In this research, we employed the cluster sampling method. Based on this method, the relationship between the two variables — namely, the factors influencing the growth and development of small and medium enterprises — is analyzed.

To accomplish the research goals, two primary approaches were used:

1. Fundamental and theoretical research: This involved library-based and literature review studies.
2. Empirical research: This was conducted through questionnaires and interviews.

In this research, sources such as books, academic articles, monographs, journals, and various online websites were consulted and used.

## **2. Literature Review**

Research and studies conducted in this field show varying results. A study carried out by Mashal in 2013 (1392 Solar year) on small and medium enterprises and regional trade in Afghanistan indicated that several factors in recent years have hindered the growth of SMEs. These factors include the withdrawal of U.S. military forces, political and security instability, administrative corruption, lack of policy, the absence of effective strategies for the development and expansion of SMEs, the lack of trade markets for domestic products, and the absence of modern technology.

On the other hand, the factors that have supported the growth and development of SMEs include government support, ensuring internal security, having effective policies, and tax exemptions (Mashal, 2013, p. 33). Another study was conducted by Sadat in 2014, identifying the main factors contributing to SME development. These include internal security, political stability, and increased investment — all considered vital for the growth of SMEs. The study compares the situation before and after September 11, concluding that the arrival of foreign actors after 9/11 created an enabling environment for SME growth. The future development of SMEs must be supported through enforceable laws and policies, the professionalization of investors, improvement in the education levels of workers, technological familiarity, prevention of administrative corruption, and reduction of bureaucracy. These are seen as essential factors for the future success of small and medium enterprises (Sadat, 2014, p. 34).

Mehrzaad also conducted a study regarding the role of taxation in the development of SMEs. This research, covering the period from 2005 to 2013, concluded that the government should apply taxes based on the income levels of different social classes. Those with lower income and smaller businesses should not be pushed out of the market due to excessive taxation. Conversely, higher-income individuals should bear a greater tax burden (Mehrzaad, 2013, p. 60). A study by Rood at the European level, titled "The Impact of Taxes on Enterprises," was conducted across 20 European countries between 1998 and 2003. A follow-up study in 2007 revealed that over the last two decades, there had been a noticeable reduction in tax rates across Europe. It concluded that

lowering tax rates encouraged enterprise investment and simultaneously increased the government's tax revenue (Rood, 2002, p. 95).

### 2.1 Definition of Small and Medium Enterprises

There is no single, universally accepted definition for small and medium enterprises (SMEs) across the world. Different countries define SMEs in various ways depending on their specific economic conditions. In order to define SMEs in a given country, the following characteristics are typically considered: the number of employees, the amount of capital invested, the total assets in use, annual sales volume, and the level of production capacity or output.

One of the most widely accepted and standardized definitions of SMEs in global economics is the one used by the European Investment Bank and the Investment Fund. This definition, last updated in 2003, categorizes enterprises based on three specific criteria: number of employees, volume of transactions, and total value of assets.

According to this definition:

- Enterprises with fewer than 10 employees are considered very small businesses.
- Those with 10 to 50 employees are defined as small businesses.
- Enterprises with 50 to 250 employees are classified as medium-sized businesses.

Similarly, based on annual transaction volume:

- Enterprises with less than €2 million in annual transactions are defined as very small enterprises.
- Enterprises with €2–10 million in transactions per year are considered small enterprises.
- Those with €10–50 million are categorized as medium enterprises.

Regarding asset value:

- Very small enterprises have assets below €2 million,
- Small enterprises have assets between €2 and €10 million,
- Medium enterprises hold assets between €10 and €43 million.

A summarized version of these definitions is presented in the following table:

Table 1: Classification of Enterprises by Size

| Type of Enterprise     | Number of Employees | Annual Transaction Volume (in million euros) | Total Asset Value (in million euros) |
|------------------------|---------------------|--|--------------------------------------|
| Very Small Enterprises | Fewer than 10       | Less than 2                                  | Less than 2                          |
| Small Enterprises      | 10–50               | 2–10   | 2–10                                 |
| Medium Enterprises     | 50–250              | 10–50  | 10–43                                |

(Source: [www.worldBank.org](http://www.worldBank.org))

### 2.2 Definition of SMEs in Other Countries

The definition of small and medium enterprises (SMEs) varies across different countries. Each country sets its own standards, typically based on the number of employees, amount of assets, or annual revenue. The following table illustrates how some countries define SMEs:

Table 2: Definitions of SMEs in Selected Countries

| Country               | SME Definition Criteria                  | Classification  |
|-----------------------|--|---|
| <b>Czech Republic</b> | Number of employees                      | Enterprises with fewer than 500 employees are considered SMEs.<br>- Very small: fewer than 10 employees<br>- Small: 10–100 employees<br>- Medium: 101–500 employees |
| <b>China</b>          | Number of employees                      | Enterprises with fewer than 100 employees are considered SMEs.  |
| <b>Indonesia</b>      | Number of employees                      | Enterprises with up to 100 employees are classified as SMEs.  |
| <b>Japan</b>          | Number of employees or asset value       | Enterprises with fewer than 300 employees or assets less than 10 million yen.   |
| <b>Malaysia</b>       | Capital flow                             | Enterprises with capital flow less than 150 million Malaysian ringgit and fewer than 150 employees.   |
| <b>Philippines</b>    | Number of employees and asset value      | Enterprises with fewer than 200 employees and assets below 40 million pesos.  |
| <b>Singapore</b>      | Fixed asset value or number of employees | - In manufacturing: asset value less than 12 million Singapore dollars<br>- In services: fewer than 100 employees   |
| <b>Thailand</b>       | Number of employees or capital value     | Enterprises with fewer than 300 employees or capital less than 100 million baht.  |

(Source: [www.worldBank.org](http://www.worldBank.org))

These differing definitions reflect the economic structures and policy priorities of each country. The classification systems are tailored to local conditions in order to better support SME development and regulation.

### **2.3 Differences Between Small and Medium Enterprises**

There are several fundamental differences between small and medium enterprises (SMEs), particularly in terms of their economic capacity, structure, and operational scope:

- **Economic Capacity:** Small enterprises are generally unable to adapt quickly to changes in their economic situation, whereas medium-sized enterprises are better equipped to make such adjustments efficiently.
- **Market Access and Service Delivery:** Medium-sized enterprises are typically able to offer services across multiple markets. In contrast, small enterprises often lack the capacity to serve diverse markets and are limited in their outreach.
- **Decision-Making:** In small businesses, critical decisions related to risk, investment, and profitability are usually made directly by the business owner. In medium enterprises, these decisions are typically made by a team of managers or directors.
- **Resource Utilization:** Medium-sized enterprises usually have access to and make use of a broader range of economic resources. Small enterprises may rely only on secondary or limited resources, while larger enterprises predominantly utilize primary resources..

### **2.4 Relationship Between Small and Medium Enterprises**

Small enterprises are often influenced by medium enterprises, and their development is frequently linked. Economic crises tend to have a lesser impact on small enterprises, as they can quickly adapt to changing conditions. The interconnection between small and medium enterprises can be described as follows:

- Supply Chain Linkage: Medium enterprises often provide raw materials or semi-finished goods to small enterprises, which then process or assemble them into finished products.
- Production Support: Small enterprises manufacture specific items that are used by larger businesses in their final products.
- Packaging and Components: Small businesses may produce items such as packaging (e.g., cartons), which are then purchased by larger businesses to support their own production needs.
- Subcontracting: Large enterprises often outsource maintenance and repair work to small businesses.
- Branding and Resale: Small businesses create products under their own operations, while larger firms, benefiting from stronger market positions and financial capabilities, purchase these goods and resell them under their own brand names.

This mutual dependence enhances the overall business ecosystem, strengthens supply chains, and supports broader economic activity through cooperation between enterprise tiers.

### **2.5 Obstacles to the Development of Small and Medium Enterprises**

The growth and progress of small and medium enterprises (SMEs) in Afghanistan face several serious challenges. These obstacles hinder the ability of SMEs to scale, compete, and contribute effectively to national development. The key barriers include:

1. Lack of Electrical Energy: Electricity shortages are a major obstacle to the development of SMEs in Afghanistan.
2. Lack of Financial Resources: Limited access to financial capital is one of the most significant challenges faced by SMEs in the country.
3. Lack of International Training Opportunities: There are insufficient opportunities for training and skill development for SME employees.
4. Marketing Difficulties: There is a lack of suitable and stable markets for SME-produced goods.
5. Absence of Promotional Institutions: There is no supportive institutional framework dedicated to SME promotion.
6. High Tariffs on Raw Materials: Raw materials, particularly those imported from countries like Pakistan, are subject to high tariffs, increasing costs for producers.
7. Inexperienced Workforce: Many employees working in SMEs lack sufficient skills and experience.
8. Lack of Government Attention: The Afghan government has not adequately prioritized or supported SMEs.
9. Limited Investment: Another major issue is the lack of new investments. The private sector struggles with inadequate access to capital, and very few financial institutions are willing or able to provide loans due to multiple constraints.
10. Lack of Market Awareness: Many entrepreneurs lack sufficient knowledge about both domestic and international markets.
11. Transportation Challenges: Poor transportation infrastructure hinders the movement of goods and access to markets.
12. Absence of Strategic Business Planning: Many SMEs operate without proper business planning and management strategies.
13. Lack of Tax Incentives: There are no tax exemptions or fiscal relief measures to encourage SME growth.
14. Insecurity: Widespread insecurity and lack of stable conditions present a significant threat to the survival and expansion of SMEs in Afghanistan.

These problems combined create a difficult environment for small and medium enterprises, stifling their growth and reducing their contribution to the country's economic development.

### **2.6 Factors Contributing to the Development of Small and Medium Enterprises**

In order for small and medium enterprises (SMEs) to grow within the globalizing economy, it is necessary for them to become competitive. Several key factors contribute to the development and competitiveness of these businesses:

- **Reduction in Product Prices:** Lowering the prices of goods makes SMEs more competitive and increases their appeal to consumers, both domestically and internationally.
- **Improvement in Product Quality:** Enhancing the quality of goods strengthens consumer trust and gives SMEs a better chance in the market.
- **Innovation:** The ability to introduce new products, services, or processes is essential for growth. Innovation helps SMEs stand out and adapt to market demands.
- **Modernization of Machinery:** Upgrading equipment and adopting new technologies increases production efficiency, reduces costs, and boosts competitiveness.

Additionally, strengthening the connection between small and medium enterprises plays an important role in mutual development. One effective tool for this is microfinance, which provides financial services to low-income households. Micro-loans can bring significant changes to their lives by enabling them to start small businesses and become self-reliant. These development factors, when effectively applied, can lead to increased productivity, job creation, and broader economic participation, ultimately supporting national economic growth and stability.

### **2.7 Importance of Small and Medium Enterprises**

Small and medium enterprises (SMEs) play a significant role in the global economy in several ways. One such role relates to their operational presence. In the United States, for instance, the role of small businesses was highlighted during the 1980s by small business organizations and a number of political leaders. It was noted that 9 out of every 10 manufacturing units were operated by companies with fewer than 100 employees. In recent years, SMEs have played a substantial role in the creation of new products. The economist Schumpeter introduced a theory in 1911, in German, emphasizing the importance of small and medium enterprises in economic development. A clear understanding of their role can be seen by examining how SMEs function in various economies around the world.

For example, in the European Union — with a population of approximately 300 million people — about 98.8% of economic activity is associated with SMEs. On average, there are 52 enterprises per 1,000 people, and about 66% of the labor force is engaged in this sector. In some European countries, this figure reaches as high as 80%. In Germany alone, there are at least 2 million SMEs employing approximately 20 million people. Around 70% of all employees work in this sector, and SMEs control nearly 50% of the private sector labor force.

Repeated emphasis is placed on the fact that SMEs are particularly effective in creating new job opportunities. In developing countries where there is a surplus of labor and limited capital, SMEs serve as a vital tool for managing these resources. If these resources are not properly managed, the labor surplus could lead to instability. Moreover, without attention to the development of SMEs, unemployment could rise both nationally and internationally. These businesses also contribute significantly to reducing poverty, attracting investment, increasing domestic production, strengthening professional capacities, increasing household income, supporting national planning, generating tax revenue, fostering innovation, and achieving full employment.

In summary, the evaluation and analysis of this sector show that without supporting and developing SMEs, a prosperous future and stable life will not be possible. It is therefore essential to take informed, thoughtful, and practical steps toward addressing future needs. If we observe small, medium, and large businesses properly, we find that the majority of economic activity originates from small and medium enterprises, whereas large businesses exist in smaller numbers due to their capital-intensive nature. In Afghanistan, because private companies lack the financial capacity for large-scale investment and foreign investors consider the risk level too high, few large enterprises exist. This is one of the reasons Afghanistan has been unsuccessful in attracting foreign investment. Given the current situation — including limited capital, minimal investment, high risk, and lack of infrastructure — the focus must shift toward the development of SMEs as a means to generate employment.

## 2.8 Afghanistan and Small and Medium Enterprises

Following the study of the previous chapter and an understanding of the nature and importance of small and medium enterprises (SMEs), it can be concluded that as long as SMEs do not develop in a country, that country will not achieve economic progress — neither in the present nor in the future. Furthermore, this sector also has a significant influence on the cultural landscape of a nation. A government can only become self-reliant if it provides the necessary conditions for the growth and development of SMEs. The development of this sector plays a vital and essential role in the overall progress of a country. It contributes to poverty reduction, lowering unemployment, attracting investment, increasing domestic production, enhancing professional capacity, increasing household income, supporting economic planning, improving tax collection, fostering innovation, and enabling full employment.

In summary, this analysis and evaluation show that unless this sector is supported and developed, we cannot expect a prosperous future or a stable life. It is therefore essential to take scholarly, insightful, and practical steps to fulfill the country's future needs. If we properly observe and assess small, medium, and large businesses, we realize that the majority of enterprises fall into the small and medium categories. Large businesses are fewer in number due to their higher capital requirements, which most private companies in Afghanistan cannot afford. Additionally, foreign investors often avoid investing in large-scale ventures in Afghanistan due to perceived risks. This has been one of the main reasons why Afghanistan has not been successful in attracting substantial foreign investment.

Given the current circumstances — such as limited financial resources, lack of investment, high investment risk, and the absence of infrastructure projects — the country must prioritize the development of small and medium enterprises. This approach aligns with Afghanistan's existing conditions and can lead to significant employment generation and economic participation.

## 2.9 Status of Small and Medium Enterprises in Afghanistan

According to a survey conducted by the World Bank in 2008 focusing on the private sector and financial systems in Afghanistan, small and medium enterprises (SMEs) in the country were categorized across several investment dimensions. The data can be observed in the following classifications:

Table 3: Classification of Enterprises in Afghanistan by Capital Investment and Employment

| Enterprise Type | Number of Employees | Investment in Real Assets (land, buildings, labor) | Investment in Equipment | Investment in Tools & Machinery |
|-----------------|---------------------|--|-------------------------|---------------------------------|
| <b>Micro</b>    | Fewer than 5        | 2.5 million AFN                                    | 1 million AFN           | —                               |
| <b>Small</b>    | 5–19                | 2.5–5 million AFN                                  | 1–2 million AFN         | —                               |
| <b>Medium</b>   | 20–99               | 5–10 million AFN                                   | 2–5 million AFN         | —                               |
| <b>Large</b>    | More than 100       | Over 5 million AFN                                 | Over 5 million AFN      | —                               |

In defining SMEs in Afghanistan, Ahmad Zia Sediqyar, the Director of the Ministry of Industry and Commerce, stated in an official meeting:

- Enterprises with fewer than 5 employees and annual investment of up to 2.5 million Afghanis are considered micro enterprises.
- Those with 5 to 19 employees and annual investment of 2.5 to 5 million Afghanis are categorized as small enterprises.
- Businesses with 20 to 99 employees and investment between 5 to 10 million Afghanis are identified as medium enterprises.

According to Mr. Sediqyar, the total number of such enterprises exceeds one million, but unfortunately, by the end of June 2014, only 39,896 domestic companies had been registered with the Investment Support Directorate. The remaining enterprises continue to operate informally and without proper regulation.

This widespread informal activity in the sector has created several key challenges:



1. Unfair Competition: Informal businesses have triggered unhealthy competition with formal enterprises, causing some of the latter to violate government laws and regulations.
2. Limited Trade Growth: Informality has restricted the expansion and development of trade within the country.
3. Low Product Quality: Domestic products often lack quality and are unable to compete with imported goods in an open market.
4. Lack of Legal Enforcement: Commercial contracts become unreliable, leading to weakened rule of law.
5. Environmental Risks: Unregulated activities may result in increased pollution and environmental degradation.
6. Tax Evasion: The government's ability to collect taxes is significantly compromised by widespread informality.

To understand why informal enterprises do not formalize, interviews were conducted with 50 business owners. Despite the Ministry of Industry and Commerce's focus on supporting nine specific sectors (construction materials, timber, agricultural products, precious stones, marble, leather, carpets, wool, and many informal businesses expressed reluctance to register. They stated that the government has so far provided no tangible benefits, and its only interaction with them is through taxation.

As one respondent noted, "If we register our businesses formally, the harm will outweigh the benefits."

These businesses also face several other problems. Based on the responses from 50 entrepreneurs, the most pressing issues include:

- No access to domestic and international markets
- Lack of government support
- Limited access to necessary technology
- Theft and fraud
- Unhealthy competition
- Unstable currency exchange rates
- Insecurity

However, the primary challenge remains lack of access to financial resources.

Many of those interviewed in Kabul reported having little to no knowledge about available financial resources. Even those who were aware of loan providers found the lending conditions too strict. For example:

- Loan terms are limited to three years, which most small entrepreneurs cannot repay in time.
- They are forced to pay interest rates of 24%.
- The loan approval process takes 3–4 months.
- Most entrepreneurs prefer Islamic financing, but no bank currently provides such services.
- Loan services are centralized in Kabul, while most SMEs operate in rural areas and remain excluded.

These obstacles severely limit the financial inclusion and formal growth of Afghanistan's small and medium enterprises.

## **2.10 Definition of Small and Medium Enterprises in Afghanistan**

Ahmad Zia Sediqqar, Director at the Ministry of Industry and Commerce, provided an official definition of small and medium enterprises (SMEs) in Afghanistan during a government meeting. According to his explanation, SMEs in the country are categorized based on the number of employees and the amount of investment:

- Enterprises with fewer than 5 employees and an annual investment of up to 2.5 million Afghanis are defined as micro enterprises.
- Enterprises with 5 to 19 employees and an annual investment of 2.5 to 5 million Afghanis are classified as small enterprises.
- Enterprises with 20 to 99 employees and annual investment between 5 to 10 million Afghanis are considered medium enterprises.

According to Sediqqar, there are more than one million such enterprises in Afghanistan. However, by the end of June 2014, only 39,896 domestic companies had been officially registered through the Investment Support Directorate. The vast majority continue to operate informally and without regulatory oversight.

The informal operations of these enterprises have created significant barriers to sectoral growth and have negatively affected economic regulation. Among the issues caused by this informality are:

1. Unhealthy competition: Informal businesses initiate unfair competition with formal enterprises, leading some formal businesses to violate government laws and regulations.
2. Stunted trade development: Trade growth within the country remains limited and underdeveloped.
3. Low product quality: Domestic products often lack competitiveness in the open market due to poor quality and inability to match imported goods.
4. Weak contract enforcement: Commercial contracts lack credibility, calling into question the authority and enforcement of law.
5. Environmental degradation: Informal and unregulated business operations may contribute to increased pollution.
6. Tax evasion: Tax avoidance is a major ongoing issue for the Afghan government.

To investigate why many businesses remain informal, interviews were conducted with 50 enterprise owners. Despite efforts by the Ministry of Industry and Commerce to support nine key sectors (construction materials, timber, agricultural products, precious stones, marble, leather, carpets, wool led businesses), these enterprise owners expressed reluctance to formalize.

Many said that government services do not offer any real benefit; rather, the only time they hear from government authorities is when taxes are being collected. As they stated: "If we formalize our businesses, the losses will exceed the gains."

Furthermore, Afghanistan's SMEs face numerous other challenges. According to the same group of 50 entrepreneurs, the most serious obstacles include:

- Lack of access to domestic and international markets
- Absence of government support
- Lack of modern technology
- Incidences of theft and fraud
- Unfair competition
- Fluctuating currency exchange rates

- Security issues

However, the most critical problem, cited by nearly all respondents, is limited access to financial resources.

Those interviewed in Kabul said they had little or no knowledge of financial services available to them. Even those who were aware of loan providers said that the conditions were too restrictive, such as:

- Loan repayment periods limited to 3 years, which is insufficient for business sustainability.
- High interest rates (around 24%) are unaffordable for many small businesses.
- Loan processing takes 3 to 4 months, causing serious delays.
- Most businesses prefer Islamic finance, but unfortunately no bank in Afghanistan currently provides Sharia-compliant loan products.
- Almost all loan services are located in Kabul, while most businesses operate in rural areas, making access even more difficult.

These issues continue to hold back the formalization, expansion, and sustainability of Afghanistan's small and medium enterprises.

### **2.11 Challenges Faced by Small and Medium Enterprises**

Small and medium enterprises (SMEs) in Afghanistan encounter a range of structural and operational challenges that hinder their development and long-term sustainability. These challenges have created significant barriers to growth, productivity, and competitiveness. The primary issues include:

1. **Small Business Size and Scale Limitations:** In areas where production and marketing activities occur, demand-driven locations are essential. The small scale of many enterprises leads to higher production costs and reduced capacity for innovation.
2. **Financial Constraints:** One of the most critical challenges facing SMEs is the lack of access to financial resources. Banks tend to provide loans only to large industries whose products are guaranteed in the market. Financial problems commonly include:
  - High interest rates
  - Lack of access to startup capital
  - Limited knowledge or expertise in accounting and financial systems
3. **Weak Management:** SMEs are typically run by individual owners who are responsible for all managerial functions, including organization, marketing, production, and accounting. In many cases, the lack of professional and experienced managers prevents enterprises from reaching their strategic goals.
4. **Technological Limitations:** Technology plays a crucial role in the success or failure of SMEs. Without modern tools and processes, businesses experience higher costs, lower quality, and reduced competitiveness in the market.
5. **Administrative and Regulatory Burdens:** Government regulations often create additional hurdles for SMEs. In order to resolve even minor issues, businesses must navigate through multiple administrative bodies, which consumes time and resources.
6. **Flawed Government Policies:** Inconsistent or poorly implemented trade policies, including tariffs and taxation, also hinder SME operations. The government has been unable to manage these areas effectively, adding to the burden on small businesses.

These persistent challenges affect the viability of small and medium enterprises, limiting their ability to contribute fully to Afghanistan's economy.

### **2.12 The Government's Fundamental Role in SME Investment and Development**

The government plays a critical role in promoting and enabling investment in small and medium enterprises (SMEs). Its involvement is essential in policymaking, infrastructure development, and creating an environment conducive to sustainable business growth. The key governmental roles include:

1. **Policy Formulation:** The government is responsible for developing national and local policies that support SME investment. Through these policies, it identifies priority sectors for SME growth and addresses their specific needs, especially in financing, capacity building, and infrastructure.
2. **Creating a Supportive Environment:** The government must remove barriers and market inefficiencies that hinder SME investment and development. By doing so, it can create a more competitive and functional business environment.
3. **Promoting Fair Competition:** The government helps establish a fair and open competitive market for SMEs. This encourages producers to innovate and improve product quality, which in turn strengthens their position in both domestic and international markets.
4. **Coordination and Facilitation:** The government also facilitates coordination between various organizations working to promote SME development. It ensures that institutional support is streamlined and aligned with SME priorities, enhancing the effectiveness of development initiatives.

Through these roles, the government can play a transformative part in enabling SMEs to access investment, overcome systemic challenges, and contribute meaningfully to Afghanistan's economic growth.

### **2.13 Characteristics of Small and Medium Enterprises**

In today's global economy, small and medium enterprises (SMEs) play a role as vital as the heart does in the human body — pumping economic life throughout all sectors. Recognizing their importance, governments around the world strive to support the growth and expansion of SMEs.

Some of the key characteristics of SMEs include:

- **Adaptability to Change:** Owing to their size and organizational simplicity, SMEs can quickly adapt to changing market conditions. Their flexibility makes them more responsive to economic fluctuations compared to larger companies.
- **Lower Systemic Risk:** The failure of an SME has minimal impact on the broader economy, whereas the collapse of a large corporation can cause economic instability and damage a nation's reputation in international markets.
- **Enhanced Productivity:** SMEs contribute significantly to productivity and provide a strong foundation for innovation. They allow for the full utilization of employee potential and often increase workforce efficiency.
- **Employment Generation:** SMEs are a powerful tool for reducing unemployment and raising employment levels. For example, in China, SMEs are responsible for 80% of total employment, whereas in Afghanistan, the figure ranges from approximately 35% to 40%.
- **Low Capital Requirement:** These businesses can be started with relatively small amounts of capital, making them more accessible to the general population. The growth of the enterprise is often tied to the mindset and initiative of the owner, including the ability to deliver quality services to customers.
- **Encouragement of Healthy Competition:** SMEs foster a healthy competitive environment in the economy. This competition is based on improving product quality and service delivery, which ultimately benefits consumers.

In summary, SMEs not only drive economic growth and innovation, but they also serve as a stabilizing force in employment and enterprise diversity, contributing significantly to national welfare. (Source: Afghanistan Chamber of Industries and Commerce, 2013).

### **2.14 SME Strategy in Afghanistan**

Until 2009, Afghanistan had no specific strategy for the growth and development of small and medium enterprises (SMEs). This strategy was finalized in 2009 and began implementation in 2011. Within the framework of the Ministry of Industry and

Commerce, a separate directorate for SMEs was established. At the time of its founding, the directorate employed 12 staff members, and within a year, the number of employees doubled. However, even now, the directorate lacks sufficient human resources to meet its increasing workload.

As the country's trade deficit continued to grow, Afghanistan's SME strategy focused — in both short-term and medium-term planning — primarily on sectors involved in import substitution. Specifically, the SME directorate became highly active in providing educational services and information to entrepreneurs. Donor organizations also requested that the government provide support for private and food-related industries, such as edible oils and dairy production. However, the import sector itself was not initially prioritized as a key component of the national strategy.

In response to this gap, the Department for the Development and Regulation of SMEs was created within the structure of the Ministry of Industry and Commerce. The department's development goals include the following:

1. Creating opportunities for SME investment: The aim is to strengthen social protection and support mechanisms across Afghanistan by encouraging new business activities.
2. Expanding employment through SME projects: Approximately 80% of Afghan businesses employ fewer than 100 people. Most rural investment projects also fall into this category.
3. Contributing to national revenue: SMEs are responsible for generating more than 50% of the country's gross national income, employing 75% of the workforce.

Despite these goals, several key officials working in the SME sector have expressed concern. They report that no effective public awareness campaigns have been launched to introduce the new economic system. Furthermore, there is a lack of coordination among responsible agencies in implementing economic policies. As a result, the growth and development of SMEs have progressed slowly and in a fragmented manner. One of the primary reasons is the decreasing level of foreign financial support from donor organizations.

### **3. Conclusion**

Small and medium enterprises (SMEs) play a crucial role in the economic development of both Afghanistan and the global economy. Today, these enterprises are central to the economic environment and bring with them both opportunities and challenges. As a result, businesses must conduct strategic assessments and leverage their internal strengths to support further expansion.

The development of SMEs has the potential to create employment, stimulate domestic production, support national economic growth, and improve standards of living. However, SMEs in Afghanistan face numerous challenges, including limited access to finance, lack of infrastructure, weak institutional support, and insufficient integration of entrepreneurs. For SMEs to thrive and contribute meaningfully to Afghanistan's economy, structural reforms, policy support, and targeted investment are essential. With proper attention and support, SMEs can serve as a sustainable engine for long-term national development.

#### **3.1 Recommendations**

4. Develop Diverse Financing Methods for SMEs  
It is essential to create a range of accessible financing mechanisms tailored specifically for small and medium enterprises.
5. Government Support through Incentive Policies  
Governments should implement policies that provide financial and non-financial incentives to encourage SME growth and formalization.
6. Expand and Improve Data on SMEs  
Reliable, comprehensive data on SMEs should be collected and made available. Research in this field should be expanded to inform policy decisions.
7. Transparent and Inclusive Management  
Strategic plans, goals, and policies related to SMEs should be clearly communicated and shared with employees to ensure alignment and engagement across the organization.

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