

Developing SME Policy in Pakistan

SME Issues Paper - for Deliberation by SME Task Force -

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Turn Potential into Profit

Small & Medium Enterprise Development Authority

Ministry of Industries & Production Government of Pakistan

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Table of Contents

Executive Summary	i
Basic Situation of SME and Their Support Structures	1
Current Status of SME	1
Government Socio-economic Strategies and SME	2
Coordination and Institutional Support	3
Short and Medium-Term Issues	5
Business Environment.....	5
Relationships between Government and SME	6
Taxation issues	7
Labour issues.....	8
Delivery of assistance and access to resources	9
Finance	10
Human Resource Development	12
Technology Transfer and Up-gradation.....	12
Market and Industry Information.....	13
Monitoring Developments.....	14
Harmonizing enterprise size categories	14
Measuring our success	15
SME as a Medium-Term Channel for Other Objectives	15
Gender Development	15
Environmental Issues.....	16
Long-Term Issues	17
Literacy	17
Law and Order.....	18
Intellectual Property Rights	18
Infrastructure	19
Annex-I	I
SME Policy Development Process.....	I
Business Support Network in Pakistan.....	II
Annex-II	III
Table of Consolidation of Labour Legislation.....	III
Annex-III	IV
Table of SME Definitions used by various institutions in Pakistan .	IV

EXECUTIVE SUMMARY

Pakistan's economy is an economy of SME. Policies in the past have given a general perspective, direction and defining broad parameters of activity within the macroeconomic framework, but efforts have focused on the large enterprises, neglecting SME which are at the heart of our economy.

Our SME suffer from a variety of weaknesses which have constrained their ability to adjust to the economic liberalization measures introduced and to take full advantage of rapidly expanding markets of the world. But SME importance and contribution in the economic activity suggests that there is a significant potential to enhance their growth through appropriate regulations and promotion.

While SME are being mentioned in some of our socio-economic strategies and policy documents, measures are not sufficiently specified and prioritized for us to be able to speak of any coherent SME policy or approach. The SME Sector Development Program seeks to improve this situation by inviting all concerned stakeholders to draft Pakistan's future SME policy.

SME promotion is an important issue for many government departments and central offices. However, there is an existing lack of coordination and regular information exchange mechanism among institutions which constrains their collective ability to deliver in the SME development process.

The responsibility for facilitating SME policy development lies with SMEDA, attached to the Ministry of Industry and Production. One of the major reasons for the lack of coordination is that SMEDA has not been provided with a mechanism to initiate, coordinate, monitor, and evaluate initiatives of SME development outside of its own scope of activities.

Therefore, cross-departmental and stakeholder consultations, resulting in the preparation of our national SME policy are our key to success. A network of institutions stimulating the growth of SME is also being proposed.

The issues highlighted in this paper give a retrospective view of things while giving a current picture of the SME business environment in Pakistan. There are issues we may only solve in the long term and which therefore are beyond our current scope. And there are issues we may solve in the short to medium term. These issues should become the focus of our SME policy.

Short to medium-term issues revolve around three major topics:

Business environment

Creating a favorable business environment for SME in Pakistan's economy and eliminating unnecessary obstacles which obstruct their development. This concerns the relationship between Government and SME as well as specifically taxation and labor.

Delivery of assistance and access to resources

Improving the delivery mechanisms for assistance and the access to resources for SME in Pakistan, *inter alia* finance, business development services, qualified human resources, and technology, so as to improve their productivity and capacity for employment generation. Market-driven support programs are important to attain sustainability, maximize the potential for cooperation with the private sector, and minimize distortions in the economy. Yet the structures for such a system still need to be mutually agreed and implemented in Pakistan.

Monitoring developments

Harmonizing enterprise size categories for Pakistan of what are to be considered micro, small, medium, and large enterprises. Furthermore, the establishment of a sound mechanism by which their development of the SME sector and the effectiveness of the assistance provided to SME can be monitored. What is at stake is that we forego the benefits of learning from one another in order to continuously improve our support structures to meet the needs of the target group, SME.

There is also ample scope to make use of SME promotion channels to achieve major aims related to equitable and sustainable socio-economic development which we have not yet fully exploited. Cases in point are gender development and environmental issues.

Implementing change requires the formulation of a policy for SME development and assigning specific responsibilities for its implementation and continuous improvement.

A fair number of countries have opted for legislation on SME promotion. The appropriate format of the SME Policy for Pakistan is to be decided by the Task Force.

Background

BASIC SITUATION OF SME AND THEIR SUPPORT STRUCTURES

Current Status of SME

It is fair to say that our economy is an economy of SME. The significant role of SME is clearly indicated by research and statistics. Enterprises employing up to 99 persons constitute about 90 %¹ of all private enterprises in the industrial sector and SME employ some 78 % of non-agriculture labour force.² They contribute over 30 % to GDP, PKR 140 billion to exports, and 25 % of manufacturing export earnings besides sharing 35 % in manufacturing value added.³

Stability of policy is a necessary condition for achieving and sustaining high levels of economic development. The stability in the economy can be ensured by a desirable mix of various other policies. In Pakistan, policies in the past have given a general perspective, direction and defining broad parameters of activity within the macroeconomic framework. However, efforts have remained limited focusing on the large enterprises, neglecting SME which are at the heart of our economy. For example, institutions established to facilitate business activity, like Board of Investment (BOI), Export Promotion Bureau (EPB), Central Board of Revenue (CBR), to name a few, have been concentrating their efforts on large scale industry.

The adverse influences of legal environment affect all economic agents. The evidence suggests small firms are discriminated against relatively large firms⁴. And while large enterprises and established holding structures possess the necessary economic and human resource potential to cope with and overcome these difficulties, SME, due to their size and the resulting peculiarities, are far less capable of adjusting and carrying on successful business.⁵ While spared direct statutory or administrative discrimination, SME remain subject to unequal treatment, which distorts the competitive environment for business. The economic significance of this bias is apparent. Such an environment does not cater well to innovative activities which come from newly founded, small firms, and the new job creation potential of

¹ *Pakistan Country Assistance Strategy*, World Bank Report, Annex II, Page 3

² Census of Establishments-1998

³ Economic Survey of Pakistan 2002-03

⁴ SME policy Note, the World Bank; ILO SMEDA Study 2001 on MSME, LUMS study on SME constraints

⁵ LUMS in its study on "Barriers to SME Growth in Pakistan: An Analysis of Constraints" compared the growth rates of Large vs. Small scale manufacturing and established that during 1970s both were growing at a comparable rate of over 4% whereas in 1990s during the period of economic downturn small scale manufacturing growth dropped to 2.6% against large scale manufacturing growth rate of 3.6%.

the economy is thus constrained while the informal sector tends to grow.⁶

Our SME suffer from a variety of weaknesses which have constrained their ability to adjust to the economic liberalization measures introduced by the Government of Pakistan and to take full advantage of rapidly expanding markets of the world. But SME importance and contribution in the economic activity suggests that there is a significant potential to enhance their growth through appropriate regulations and promotion.

More recently, the importance of SME has been realized, with the Government's efforts focusing on the hitherto neglected informal sector. The reason behind the increased stress on the SME sector is that SME promote entrepreneurial culture, create a wider base for employment generation and are a primary vehicle for poverty eradication.

Government Socio-economic Strategies and SME

SME are a distinct pillar of the economy that needs to be given due attention. It requires specific policy and regulatory space to turn SME into an effective tool for driving the economy and increasingly contribute to economic growth and employment.

The Government of Pakistan has developed a number of strategies for socio-economic development.

- Poverty Reduction Strategy Paper (PRSP)⁷
- Micro Finance Sector Development Program
- SME Sector Development Program
- Education Sector Reforms 2001-05
- Reform of financial sector
- Reforms in Tax Administration

While SME are being mentioned in some of these important socio-economic strategies and policy documents, including even very specific measures for their promotion, these measures are not sufficiently specified and prioritized for us to be able to speak of any coherent SME policy or approach. The SME Sector Development Program seeks to improve this situation by inviting all concerned stakeholders to draft Pakistan's future SME policy.

Although SME policy is a sector-specific policy, it should be noted that the task of formulation is not a simple exercise. SME are a

⁶ Non-Linear Model to estimate underground economy in Pakistan, SBP Research Department

⁷ Under PRSP government is following a five point strategy which includes 1) Macroeconomic stability and Fast growth 2) Investment in Human Resources 3) Government's involvement in particular sectors (including SME) 4) Expansion in social security system and 5) Good Governance.

cornerstone of our economy. Many changes in existing legislation may have direct or indirect effects on SME, e.g. in labour law, financial law, export regulations, banking system regulations, tax regulation etc. SME promotion therefore comes close to a cross-cutting issue.

Furthermore, the environment for SME is constantly changing, in particular with an increased exposure to world markets due to the opening up of the economy. Therefore, SME policy within a socio-economic development strategy cannot be a one-off exercise. Only a process of regular review linked with predictable behavior by all stakeholders will ensure successful outcomes in the long run.

Coordination and Institutional Support

The role of government as a facilitator of business and its interaction with business support institutions is imperative for the establishment of a mutually beneficial relationship for the growth of the sector. SME promotion is an important issue for many government departments and central offices.

For example, the Ministry of Labour plays an important role in shaping the labour market policy of the state. Similarly, in order to gather information on the health of the SME population the role of Federal Bureau of Statistics, the Ministry of Finance, and planning division is pivotal. Other ministries and divisions such as Ministry of Finance, Ministry of Commerce, Planning Division, Ministry of Food, Agriculture and Live Stock, Ministry of Environment, Ministry of Local Government and Rural Development, and the Ministry of Science & Technology also influence the situation of our SME. Provincial and local governments also take their share in responsibility.

However, there is an existing lack of coordination and regular information exchange mechanism among institutions which constrains their collective ability to deliver in the SME development process. As a result of the Governments more recent efforts, two institutions Small and Medium Enterprise Development Authority (SMEDA) and SME Bank were created.

The responsibility for facilitating SME policy development now lies with SMEDA which is attached to the Ministry of Industry and Production (MoIP). SMEDA is responsible for creation and coordination of Government policy for the SME sector. Parliament, naturally, is responsible for monitoring policy and its implementation.

One of the major reasons for the lack of coordination is that SMEDA has not been provided with a formal mechanism to initiate, coordinate, monitor, and evaluate initiatives undertaken for SME development which fall outside of its own scope of activities.

Therefore, cross-departmental and stakeholder consultations, resulting in the preparation of our national SME policy are our key to success.

Regular information exchange mechanism and networking needs to be developed amongst our public and private sector institutions. There is a strong need to devise such an information exchange mechanism and redefine the role of institutions, specifying their functions in order to avoid duplication of efforts and allowing the best-possible usage of resources.

Under the SME Sector Development Program it is expected that SMEDA

- prepares Government documents on policy regarding SME
- drafts relevant laws and regulations

To form a collective view of all stakeholders, the SME Task Force has been established at the MoIP. SMEDA will serve as the secretariat.

A network of institutions stimulating the growth of SME is being proposed (*see Annex-I*). The institutions in this network cover all stakeholders involved in SME promotion: Regional Development Agencies, Business Support Centers, Chambers of Commerce, as well as other organizations which are established as an initiative of local communities, etc.

Issues in SME Development

SHORT AND MEDIUM-TERM ISSUES

This section reflects issues where we feel we may achieve strong impacts in the short and medium-term, i.e. until 2011. They should therefore become major topics of our deliberation and shape the formulation of our SME policy.

Business Environment

The large size of the SME sector limits the ability of Government and business support institutions to achieve complete coverage by support programs. This is a fundamental reality in most countries of the world and it is why policy framework and regulatory measures are of tremendous importance when SME promotion is concerned.

It is agreed that much more can be achieved only by appropriate policy tools and regulations than with support programs. Likewise, SME development is hampered more by inappropriate regulations than compensated by means of appropriate support programs.

Most of the developed nations therefore have mechanisms in place to revert the biases against small firms. For instance, the United Kingdom introduced the "Think Small First" initiative which requires all Government organizations to assess the impact of their actions on small business prior to implementation. Furthermore, participation of small business in government procurement is being facilitated as a matter of routine.

The result of such policies is that (unfortunate) surprises to small firms are less frequent. It is made sure that businesses potentially affected are consulted and informed of any forthcoming policy shifts so as to avoid negative impacts. They are also allowed an adequate grace period for the adjustment of economic activity and there is no retroactivity of new regulations. Besides this, special attention is paid to minimizing the room for bureaucratic discretion while developing policy rules or procedures.

All such mechanisms are missing in present policy or legal environment in Pakistan. The absence of a specialized, uniform legal framework for the development of SME hampers SME operations.⁸

⁸ To this point, the Ten Year Perspective Development Plan 2001-2011 notes that there is a large range of zoning and other regulations imposed by the federal, provincial and local governments and public sector utilities which affect the functioning of SME hence, legislation similar to the US Small Business Regulatory Enforcement Act of 1996, which includes Regional Small Business Ombudsmen, would be considered to ensure the fair and efficient functioning of SME. Whatever the mechanism to enforce it, a "level playing field" is one of the cardinal conditions for SME development.

Relationships between Government and SME

The relationship between Government and SME seems to be fundamentally flawed. In many cases this extends also to other large organizations and their interaction with smaller clients as SME.

Our compulsion of centralized control stems from the fear of the regulator to be misled by the opportunistic profit-seeking entrepreneur. And our administration practice is characterized by rent-seeking bureaucrats who, given the low level of their pay, take advantage of the semi-literate entrepreneur.

Of course, we all know there are also many dedicated and honest professionals on both sides. But the fact of the matter remains that there are severe attitude problems in the relationship between the two sides. The only way to break this discouraging situation is to face the problem squarely and seek solutions in a positive spirit and entertain systematic dialogue between the two sides.

The present divide is, among others, reflected in a language gap. Part of the concern for local business people is the inadequate business facilitation process in the local language which includes laws, regulations and business support material available in the English language only.

As a starting point, we propose to consider the increased usage of Urdu in our written documentation, in our official deliberations and communications. This Issues Paper will be translated to Urdu and circulated so as to enable a debate with all of Pakistan's interested SME. Eventually, we should expect the SME policy we are going to develop to be published in Urdu as well, and to regularly report about the achievements under this policy in Urdu to the policy's clients, our nation's SME.

A second point is how we may increase the share of SME participating in the provision of goods and services to the public sector, as it is common practice in many countries. A typical SME in Pakistan caters to the domestic private sector. It is noted that fewer than 4%⁹ are supplying to the government sector. Some of the issues are related to tough bargaining price (36%) and supplies on credit (34%) and other are related to absence of rules on how the public sector should increase its procurement from SME.

Further points may possibly emerge from the dialogue between Government, stakeholders, and their SME clients.

⁹ World Bank SME policy Note 2001, the results of SMEDA-World Bank Investment Climate Survey 2003 also conforms to the findings.

Taxation issues

High tax rates are one of the major reasons for firms to drift into the informal economy. This holds for countries all over the world, including developed countries. These effects are compounded by high compliance costs for small firms to deal with tax laws and other forms of government regulation. This is a specific size-related disadvantage compared to large scale firms which have not only the necessary accountants, but frequently also in-house tax and legal advisors. Compliance costs have monetary implications (such as paying tax advisor fees or salary payments to personnel dealing with tax issues), time cost implications (in the form of time spent by a taxpayer to handle tax issues), and physiological cost (in terms of anxiety, stress, and apprehensions related to possible mistakes or a possible audit by the tax authorities).

Firms in Pakistan's SME sector, encounter an increasingly complex legal, tax and administrative environment, both in starting up and developing their business. According to research, 67% of enterprises termed tax regulations as most problematic. 56%¹⁰ of businesses report a crunch of taxes, while 28% of businesses felt that taxes in the country are too high.

From SME point of view, the present tax structure and administration generally distort incentives and discriminate against small firms who are harassed by the tax authorities. Smaller firms found tax related issues more restrictive than larger firms, 69% of firms, whose size of assets was less than Rs.1 million faced the greatest of tax related problems. Many small firms claim it is not possible for them to maintain books¹¹ as per law or hire a professional due to cost constraints.

The prevailing system is non-standardized and offers excessive discretion to the tax authorities. There is no consolidation or rationale in current provincial or local tax structure either. Hence, there has been a constant confrontation between tax authorities and the business communities resulting in very slow expansion in tax base¹². Two sectors; retailers and small to medium sized manufacturers have

¹⁰ The 56% figure is an addition of the three tax related responses: High taxes 28%, High Sales tax 16% and high Income Tax Rate 12%

¹¹ In Japan, after the war in 1949, old taxation system was replaced by new system to resolve the problem of incomplete bookkeeping and fear of over-taxation of SME. The new system allowed certain tax merits if a tax return is made with a "certain formula of quick bookkeeping." This system resulted in not only the improvement of financial accounting but also the strengthening of financing systems for SME.

¹² There are 1.05 million active tax filers in Pakistan. In 1999-2000 the number of salaried taxpayers was 440,000 and those filed under old self-assessment scheme were 275,000. Lowering tax rates may well lead to substantial expansion of the tax base in compensation and be neutral for government income. However, without more profound improvements in the relationship between Government and enterprises, hopes should not be raised high for tax rate changes to bring immediate tax base expansion.

already propounded the idea of fixed taxation as remedy to this continuous ailment.

Cognizant of the change required to cater to the SME sector in its policies, there have been reforms in the advance stage of implementation of Pakistan's tax regime. But these reforms are focused on tax administration and management, instead of addressing the aspects that directly affect SME. No incentives are being offered to SME to enter the formal economy.¹³ There has been no consideration as such for reviewing tax law from an ordinary SME or even micro enterprise perspective.

Labour issues

Likewise, the intensity of regulations are the second most important reason for firms to drift into the informal economy all over the world. Labour Laws and regulations in Pakistan¹⁴ are considered to be one of the most complicated areas with which any business enterprise deals. The present set of labour laws was the result of checkered initiative of various governments to create a healthy business environment for labour. Consequently, enterprises have to deal with fifty six (56) labour laws with some of them being industry specific. The existing plethora of labour laws has made compliance impossible for the enterprises due to their inherent inconsistencies. Numerous labour inspections under these laws are yet another impediment that retards the growth of SME.

The Labour market dynamics have changed considerably over the years, a higher degree of adaptability and flexibility along with Labour market security, including protection against arbitrary loss of employment, reductions in income and unhealthy work practices are essential requirements of new environment. Besides, the condition for compliance of international labour standards under the global economic system is another issue.

Taking into account the need of labour market and employers, the Ministry of Labour and Manpower introduced an employment security regime. The new labour policy initiatives is aimed at creating a favourable environment for facilitating industrial promotion and revival along with legislative and structural changes to bring in an

¹³ A taskforce on the reform of tax administration, chaired by Mr. Shahid Hussain, was constituted by the government, which gave detailed recommendations in its report published in May 2001. Based on this document and comments from the IMF and the World Bank a restructuring plan was drawn up by CBR. This restructuring plan is now being made operational with World Bank support.

¹⁴ A committee on Reforms in Regulatory Legal and Policy Environment was established in the Ministry of Industries & Production in 2000 with the purpose to coordinate, review, identify issues of concern and formulate recommendations on various laws effecting businesses. Some of their efforts have resulted in the consolidation of labour laws as announced in the Labour Policy 2002 and proposed amendments in the Factories Act 1934, Drug Act 1976, Boiler Act 1923, and Explosives Act 1884, and as such reviewed 101 commercial and labor laws that effect industrial sector.

environment devoid of restrictive labour practices, but protecting the rights and interests of the workers.

It was proposed that existing labour legislation be simplified and rationalised into six basic laws (*Annex-2*). In addition, for promoting bilateralism among government employer and employees, government established a forum Workers Employers Bilateral Council of Pakistan (WEBCOP). The government is also working on the development of Labour Inspection Policy under the SME Sector Development Program to reduce the interface of government officials with businesses without compromising on the unhealthy work practices.

The only issue highlighted thus far through direct interaction with SME is that of co-ordination. The business and labour community at large has been supporting the reforms.

Delivery of assistance and access to resources

Competitive advantage is determined by the productivity with which a country, region or cluster uses its human, capital and natural resources. Pakistan's international competitiveness markedly declined over past few years.¹⁵ Part of the blame is shared by lower productivity of the workers. The evidence reveals that median labor productivity, as measured by annual value added per worker, is 25 percent lower in Pakistan than in India and 35 percent lower than in China.¹⁶

Trade liberalization at the global and regional levels and the new information and communication technologies have entwined to create rich opportunities as well as formidable challenges to all interdependent countries and enterprises. Competition has become increasingly fierce among the global and regional economies and enterprises. The structure of markets and their demand¹⁷ is increasingly complex.

Despite operating locally, Pakistan's SME need to be increasingly aware of the world market. They cannot escape it even in their local economy. To meet this challenge, there is growing need for information on global technology trends, rules and compliance cost including facilitation services regarding global issues.

¹⁵ World Bank, Development Policy Review 2002 reveals that the annual manufactured exports of Pakistan are barely 12 percent of those of Malaysia, 18 percent of Thailand's, and less than a third of Philippines— countries whose combined manufacturing exports were less than Pakistan's in the mid-1960s

¹⁶ Investment Climate Survey of Pakistan-2003

¹⁷ Consumer preferences and market standards have become more sophisticated and exacting. Competitive advantage is now determined by several non-price parameters such as quality, health and safety, social equity in employment and production and ecological compatibility of products and processes.

An integrated program for improving competitiveness, promoting trade, and developing workforce can help.¹⁸ Training, research and development, labour productivity enhancement, technology transfer and up-gradation and support to business startups through business incubation and various other business support services, including finance, are issues that need to be addressed separately by the SME policy.

What is important is that access to resources and services necessary to compete in this global environment are being provided to SME because their size poses an effective limit on their capacity to assess world market conditions and tap appropriate resources. Old policy tools of protection now require replacement with promotional and facilitation functions. The roles of business development services, hence, become imperative.

The capacity to deliver such services by the public or private sector led institutions is a major topic for debate but also relates to the specifics of the service in question. However, market-driven support programs are a cornerstone in any SME support system which strives for sustainability. This also maximizes the potential for cooperation with private sector organizations and minimizes the distortions in the market economy. Yet the structures for such a system still need to be mutually agreed and implemented in Pakistan. Below we flag the important issues.

Finance

Access to equity and formal debt financing has repeatedly been identified as a recurring constraint to SME growth and development. Commercial banks apply conservative policies in lending to SME. More, importantly the existing structure of financial sector was developed to serve medium to large enterprises which are organized as a formal business. Most banks prefer to hold risk free-income generating assets and lending to SME is unattractive due to a range of objective and subjective factors. These include high transaction costs, inability to do away with tangible collateral requirement, no linkage of financial products with sector needs and the inability to structure/offer and manage risk-prone SME specific medium to long term financing options.

It has been observed that 57% of new investment for Small and Medium Enterprises and 67% of working capital finance come from internal finance or retained earnings; only about 7% of funds for investment or working capital come from banks or other financial institutions. Even suppliers' credit rivals the contribution of the banks

¹⁸ The Ministry of Science & Technology is preparing a National Quality Policy & Plan and another initiative of the government is working on the development of National Productivity Policy.

as a source of working capital (4.5%).¹⁹ Another survey²⁰ concludes that SME are indeed being rationed out of the credit market, rather than merely exhibiting a lower demand for credit.²¹

However, financing SME is one of the key prerequisites for the future development of the national economy and the achievement of economic growth. The Government of Pakistan had originally responded to the growing needs of the sector by introducing a Self Employment Scheme through Small Business Finance Corporation of Pakistan (SBFC) in 1992. SBFC continued to grant loans to small businesses and disbursed 12 billion by June 1998, catering to the needs of 157,162 unemployed persons. Other schemes for SME development or employment generation included the Youth Investment Promotion Society, Provincial Small Industries, Prime Minister's Self Employment Scheme, and Yellow Cab Scheme. But all of these efforts lacked coherence across institutions, and, in the absence of any national policy, resulted in disjointed efforts and even corruption.

Previous efforts have therefore had rather limited results and were highly inefficient because the financial sector accumulated a huge portfolio of non-recoverable loans under these schemes. The SME Bank will need to undergo restructuring for next three years.

Furthermore, severe damage has been done because the financial sector has developed disinterest for any such initiatives in future, and we need to basically start from scratch. The banking industry in general is also not venturing into the areas where new processes and procedures with a view to improve SME's access to credit are required. It is likely that market-led mechanisms will take some time to improve the access of smaller firms to formal credit. In particular, outreach shall remain to be a problem for the due to the limited presence especially in the rural SME market.

The Government is seeking to facilitate the participation of commercial banks in SME lending by training with the assistance of the ADB. The sooner commercial banks obtain the know-how how to successfully engage in cash-flow based lending to small enterprises, the better.

Finally, new prudential regulations increase the likelihood of viability and sustainability in the financial sector. However, the broad

¹⁹ SMEDA – World Bank Investment Climate Assessment survey was conducted between May and November 2002 by SMEDA in collaboration with the World Bank covering a random selection of 965 mainly manufacturing businesses (90% being SME), drawn from 12 largest cities of Pakistan. To date it represents the most comprehensive data set.

²⁰ Faisal Bari, Ali Cheema, & Ehsan-ul-Haque; Barriers to SME Growth in Pakistan: An Analysis of Constraints, June 2003.

²¹ This finding is corroborated by the World Bank (2001) survey, which finds that over 50% of their sample SME who had ever approached a bank reported difficulties in obtaining credit. SMEDA-ILO Study 2001 also reports a similar finding.

definition of SME also bear a risk of upward filtering of the loan portfolio towards the higher-end medium enterprises unless targeted programs for micro and small enterprises exist. The creation of SME credit endowment fund may be one way of mitigating this effect.

Human Resource Development

One of the major challenges that SME have to face is the emergence of the knowledge-based economy. People must continue to innovate, change and upgrade. There is a need to nurture the entrepreneurial spirit and skill development for adopting innovative technologies.

The low-literacy level of our population poses an immense challenge to our competitiveness. Yet, it is a fact of life which we will not overcome in the short run. It is therefore absolutely imperative that we seek intelligent short and medium-term solutions to bridge the literacy gap.

One aspect of the Government's strategy is to strengthen non-formal skills and entrepreneurship development, to better prepare workers for employment and to improve the population's general capacity for self-employment. But are there any other ways by which we may enhance the skills of our workforce in such a way that we need not despair when facing external competition?

The Government has established a number of institutions that impart training and skill development. These institutions, Pakistan Institute of Management Sciences (PIMS), Technical Training and Vocational Authority (TEVTA), Provincial Vocational Training Councils, Government Universities and various other support institutions have, however, remained rather passive regarding the shaping of human resource development for SME.

A frequent complaint is the mismatch of the output of our human resource development institutions with the demand of SME. There are also only limited training options for middle management. Low skills of work force, inadequate vocational training facilities yet remain outside the scope of the reform agenda. Are there any mechanisms by which we may achieve effective consultation between the supply and the demand side of our vocational training system so as to attain a maximum benefit for our economy?

Entrepreneurship does not breed in a vacuum. For a healthy, growing business environment, it is necessary to foster entrepreneurial culture in Pakistan which goes beyond the inclination to trade in goods. This can be boosted by entrepreneurial skill development programs.

Technology Transfer and Up-gradation

Developing SME based on local skills/resources has now been rightly recognized as a means of promoting economic growth and a very effective tool for providing productive employment in any country.

But up to date technology also plays a vital role in the vertical integration of firms, moving them up the economic ladder in terms of firm productivity enhancement.

In our country, growth oriented exporting firms still have problems sourcing quality inputs due to the lack of a network of reliable suppliers. This adds to their transaction costs. Likewise, the SME are not large enough to furnish sufficient demand to be an incentive for a big high quality input supplier.

The Government in its efforts to facilitate technological transfer for indigenous SME initiated a program with the United Nations Development Program (UNDP) to promote Technical Cooperation among Developing Countries (TCDC).²² The scope of Phase I remained narrow and focused on capacity building of various public sector organizations through training programs. The intended final beneficiary, SME, has not yet been able to benefit from the program.

In its other efforts, the Government used to offer cash grants²³ for ISO certification to those enterprises that chose to be growth-oriented internationalized SME. The Government also set up a National Productivity Organization as a resource centre and a research institute to enhance industrial and labour productivity in Pakistan.

Similarly other organizations like Pakistan Council for Scientific Industrial Research (PCSIR), Pakistan Industrial Technical Assistance Centre (PITAC), Ministry of Science and Technology (MOST) etc. established to facilitate industrial growth still need to adopt an active approach to provide their services to SME in a effective manner.

Major technology up-gradation obstacles include:

- Inability to acquire sophisticated testing equipment and R&D facilities. (SME see it as a financial problem.)
- Lack of skills/ experience to operate high-tech machinery
- Insufficient information on technological co-operation opportunities
- lack information on target market quality requirements and lack of knowledge on how to achieve these quality levels
- Absence of appropriate metrology and testing equipment and related infrastructure as common facility centers

Market and Industry Information

Access to market and industry information is one of the keys to develop successful business strategies. Frequently, business and trade

²² A few countries (mainly China, Singapore, Indonesia, Sri Lanka) also shared their experiences and expertise with Pakistan.

²³ Discontinued since June 2003

associations are able to provide their members with such services. By associating with like institutions in foreign countries, they are also able to establish links and obtain information on foreign markets.

Over half of our SME (54%)²⁴ belong to a business or industry association. Their perceived role is limited to lobbying and negotiation with the government. Yet very few SME (12%) perceive their associations to be a source of information on new developments in their fields of business operation. How to increase the service provision by all types of stakeholders will become a fundamental issue when SME support programs will be looking for delivery channels.

Monitoring Developments

Harmonizing enterprise size categories

Pakistan has no across-the-board legal definition of SME. This makes it extremely difficult to monitor the development of our SME economy and to establish benchmarks against other countries in order to devise areas of intervention and support.

Various government departments and public-sector agencies have adopted their own definitions (*Annex-III*). There are, of course, various reasons for them to define SME, and there may even be discussion on just how a strict and reasonable size standard could be defined.

A number of current definitions are based on capital standards since this influences patterns of fund raising in the formal and informal financial market by SME.

Many stakeholders consider enterprises with 100 or more employees as large, and enterprises with less than 5 workers as micro. Yet our statistical system classifies enterprises with more than 10 employees as large, and the State Bank of Pakistan considers those with more than 250 employees as large.

The reference to international practice also suggests differentiation among industrial, whole sale, retail²⁵ and services related enterprises. This view also gets credence from various studies on the issue for Pakistan.²⁶ Again, this consideration is only visible in the SBP definition and missing in all others.

There are also rationales beyond the particular organizational motivations for defining specific size classes, and it will therefore be useful for all stakeholders to review definitions on technical grounds.

²⁴ World Bank SME policy Note 2001

²⁵ The Census for Establishments 1988 reveals that retail constitute 42.5% of total non-agriculture establishments and employs 20% of the labour force.

²⁶ The survey of SME for ADB study on SME Constraints reports observed differences for retails sector. It suggests that the sector is dominated by micro enterprises and there has been considerable organizational, management and technological differences between enterprises employing 10-49 workers and those employing 50 or more workers.

For a national policy, it is extremely important to have a harmonized definition for as it is important for the government to focus assistance as reasonably as possible for maximum efficiency. It is also imperative to adopt a definition to foster the coherence of vision in SME policy development and for the better implementation of related support programs across institutions.

Measuring our success

Public resources are as scarce as private sector resources, and we need to ensure that they are being used in the most efficient way so as to be able to create and maintain sustainable support structures for SME which are able to perform in the long run. At the same time, we, of course, seek a maximum effectiveness of our support programs.²⁷

As things stand, we have no mechanism in place for measuring our success. In fact, we do not even have any criteria established by which we are able to determine our success as a nation in fostering SME development. And we are not able to correctly state what the Government is spending on SME support annually.

Our present "system" of support is incoherent. While division of labor with diverse stakeholders is a necessary condition for obtaining a maximum reach, it is also a perfect ground for duplication of activities and wastage of resources. There is no current overview of activities, and we are compelled to commission specific research if we seek information on the diverse contributions by the various stakeholders.

What is at stake is that we forego the benefits of learning from one another in order to continuously improve our support structures to meet the needs of the target group, SME.

SME as a Medium-Term Channel for Other Objectives

It is common practice in many countries to make use of the SME in order to further specific development objectives as, for example, sustainable or equitable development. After all, SME constitute the overwhelming part of the economy. Currently, we are not making sufficient use of this channel for promoting the development of our country. Two issues which also relate to our competitiveness are flagged in the sections below.

Gender Development

Each of the two genders of any society constitutes roughly half of the population, and Pakistan is no exception. People of both genders embody not only labor force, but also knowledge and creativity which may be mobilized to achieve economic ends. Discarding either of the

²⁷ Reminder: "Efficiency" measures inputs vs. outputs whereas "effectiveness" measures outputs vs. objectives. Programs may be very effective and at the same time inefficient. The goal must be to seek both effectiveness and efficiency at the same time.

genders, therefore, implies foregoing the potential benefits which arise from mobilizing the respective human resources for development.

Pakistani women have been engaged in production process for ages. Their participation in economic activities in the modern society has also progressed beyond agriculture into the local market economy. Women are increasingly migrating to urban areas for employment in a range of cottage industries, such as carpet weaving, textiles and handicrafts. In search for wage employment, women are moving into small business and self-employment ventures thereby creating many formal and informal opportunities for work.

Women entrepreneurship in the formalized sense, however, remains a new concept. Our current strategies also tend to focus on increasing women's participation in the labor force.

The business environment for women in Pakistan reflects a complex interplay of many factors made up of social, cultural, traditional and religious elements. These have taken shape over many centuries; are anchored in the patriarchal system and are clearly manifested in the lower status of women. The form of constitutional structures, policy documents, regulatory arrangements and institutional mechanisms is contemporary rather than traditional, so it is cosmetically impartial.

Yet, the gender bias is rigid and deep-rooted as it draws legitimacy from the perpetuation of a traditional mind-set, established rituals and a firm belief system. It has conclusively been shown that women business owners encounter more obstacles, and face more risks, financially, socially- economically, culturally and legally than male business owners face.

The Government of Pakistan is well aware of the potential of women in our society and the contribution that they can make towards economic development. Women are continuously being encouraged to enter the business stream of our country and are being provided incentives. However, there still is a strong dearth of focused initiatives that need to be taken by existing business facilitation institutions.

Environmental Issues

Environmental issues are most frequently a result of the interaction between human activities of production and the environment. Under fierce competitive pressure in the market economy or as part of a coping strategy when faced with difficulties to cover basic needs, enterprises and individuals are creating environmental issues.

While certainly one of the economic root causes for environmental damages are externalities²⁸ which require appropriate government

²⁸ Reminder: "Externalities" are economic effects resulting from one economic unit and arising at another unit without any commercial transaction between them. For example, by polluting a river, an

intervention, it is frequently overlooked that there are many economic gains which may be achieved from producing in an environmentally friendly manner. Reducing material waste can be one way of reducing input cost. Saving resources such as water and energy does not only generate benefits at the national level but may translate into competitiveness and thus economic gain at the enterprise level.

There is also a direct link between the effectiveness of technology transfer and the stabilization of global climate change and natural resources depletion. Major constraints²⁹ to effectiveness lie in the high transaction costs associated with the development of capacities and capabilities to manage and generate technological change. Developing country enterprises thus tend to ineffectively exploit available technology options, as well as to inefficiently utilize the transferred technologies.

Many OECD countries make use of channels of SME promotion in order to achieve improvements for the environment. For example, special credit lines may be provided in order to encourage the adoption of environmentally friendly technologies. Specific training courses are being offered to SME on waste reduction. ISO 14000 is actively being promoted in the European Union as one way of combining environmental concerns with quality and thus competitiveness. How may we best use our current and future SME support structures in order to achieve positive effects.

LONG-TERM ISSUES

There are issues which are beyond the scope of our current interventions. They are partially rooted in the multiple cultural structures of our society, frequently exacerbated by our geo-political situation. We, nevertheless, recognize their importance and therefore point them out here. However, it is not recommended to attempt to solve these questions by ways of an SME policy initiative.

Literacy

The evidence reveals that SME find it extremely difficult to grow because of their inability to delegate to soundly trained staff. The day, the small businessman feels comfortable to delegate, SME start progressing.

upstream producer may affect the viability of a downstream producer without any economic transactions occurring between them. There is not internalization of cost at source, and the market cannot self-regulate. Government must step in.

²⁹ According to the World Bank's survey for SME Policy Note 2001, a vast number of small entrepreneurs are highly interested (42%) or moderately interested (40%) in acquiring new technology. It further elaborates that SME learn their skills from own family (40%), working for another employer (35%), and educational institutions (25%). On sources of technical know-how it reveals Books and journals (30%), other companies working in the same field (23%), internet (13%), and only 4% from formal institutes as a source of acquiring technical know-how.

The low literacy level also determines the potential of our labor force. Higher literacy rates are essential to enhance the quality of production can be enhanced by multiple factors which is what we need to be able to effectively compete in the international economy which is being extended to our local markets by the effects of opening up and WTO accession.

Law and Order

Law and order situation in Pakistan has always been regarded as worrisome. One survey reports that one in five respondents report that the business was the target of at least one crime during 2002. Another assessment suggests that businesses in NWFP spend 4.5%, Sindh and Punjab 1-2% of their revenue on security. One in four SME consider law and order to be a severe problem.

Law and order problems weaken property rights and as a result weaken the investors' decision to invest. These problems are clearly linked to the manner in which the law enforcement and criminal justice system functions. The high time cost involved in seeking legal recourse together with lack of access to both effective informal and formal enforcement mechanisms, increase the costs associated with contract enforcement.³⁰

Intellectual Property Rights

Intellectual Property Rights (IPR) is a vital issue that needs to be looked into. It has been observed that many developing countries, with the help of a change in their IP systems and laws, are able to attract Foreign Direct Investment (FDI) in the Research and Development (R&D) especially in the industrial and scientific field. Therefore, promotion and protection of intellectual property spurs economic growth, creates new jobs and industries, enhancing the quality and enjoyment of life.

Another benefit for Pakistan in properly adopting IPR culture is that it will protect the indigenous products such as rice, kinno, traditional knowledge, pottery etc. The owner of IPRs has the most valuable assets which can be utilized in commercial transactions, whether IP licenses, joint ventures, manufacturing, purchase or distribution agreements, or mergers and acquisitions. Licenses to use patents, trademarks and copyrights, are often combined with transfer of know how in the form of training and are increasingly an important term in such transactions.

³⁰ Commercial disputes in Pakistan are regulated under the Contract Act (1882) and falls in the jurisdiction of civil courts only. Major problems associated with this forum include time delays and judicial corruption.

Infrastructure

Basic physical infrastructure is a prerequisite to growth and development. Power outages and access to connections are considered an irritant which significantly affects the productivity of firms in Pakistan. It is estimated that a typical business in Pakistan loses 5.6% in annual sales revenue due to just this single factor.

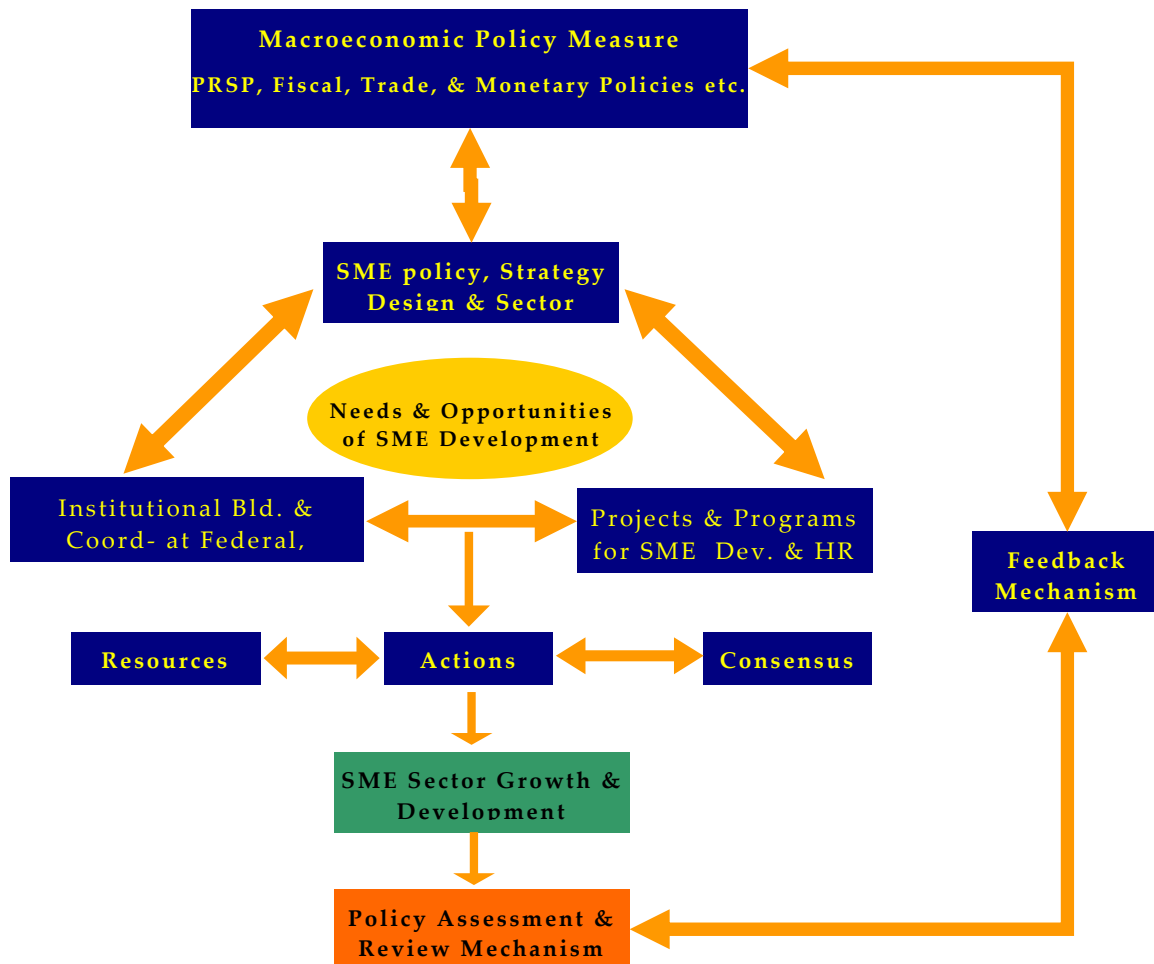
Differences associated with firm size recognize that smaller firms are relatively hard hit in comparison with the larger ones because of inability to arrange alternate power source such as private power generators. High rates of power, the poor quality of delivery and its reliability are the serious concerns of SME.

Similarly, access to telecommunication facilities and transport also serve as a detriment to smooth growth and transition of smaller firms to larger ones. The chief problem in the provision of telecom services is the shortage of new fixed line connections, which currently stand at a mere 0.5–0.6 million a year for the whole country. Pakistan could also save up to 16.5% of the value of exports by improving its trade and transport logistics systems.³¹ Inefficiency in transport alone is estimated to cost the economy Rs. 320 billion a year.

The concentration of power, telecommunication, and transport services, except for road transport, in the public sector has been regarded as the major concern. Evidence suggests that Pakistan's state-controlled and concentrated structure of infrastructure delivery is highly inefficient.

³¹ World Bank, Development Policy Review 2002

SME Policy Development Process



Business Support Network in Pakistan

Agencies & Programs

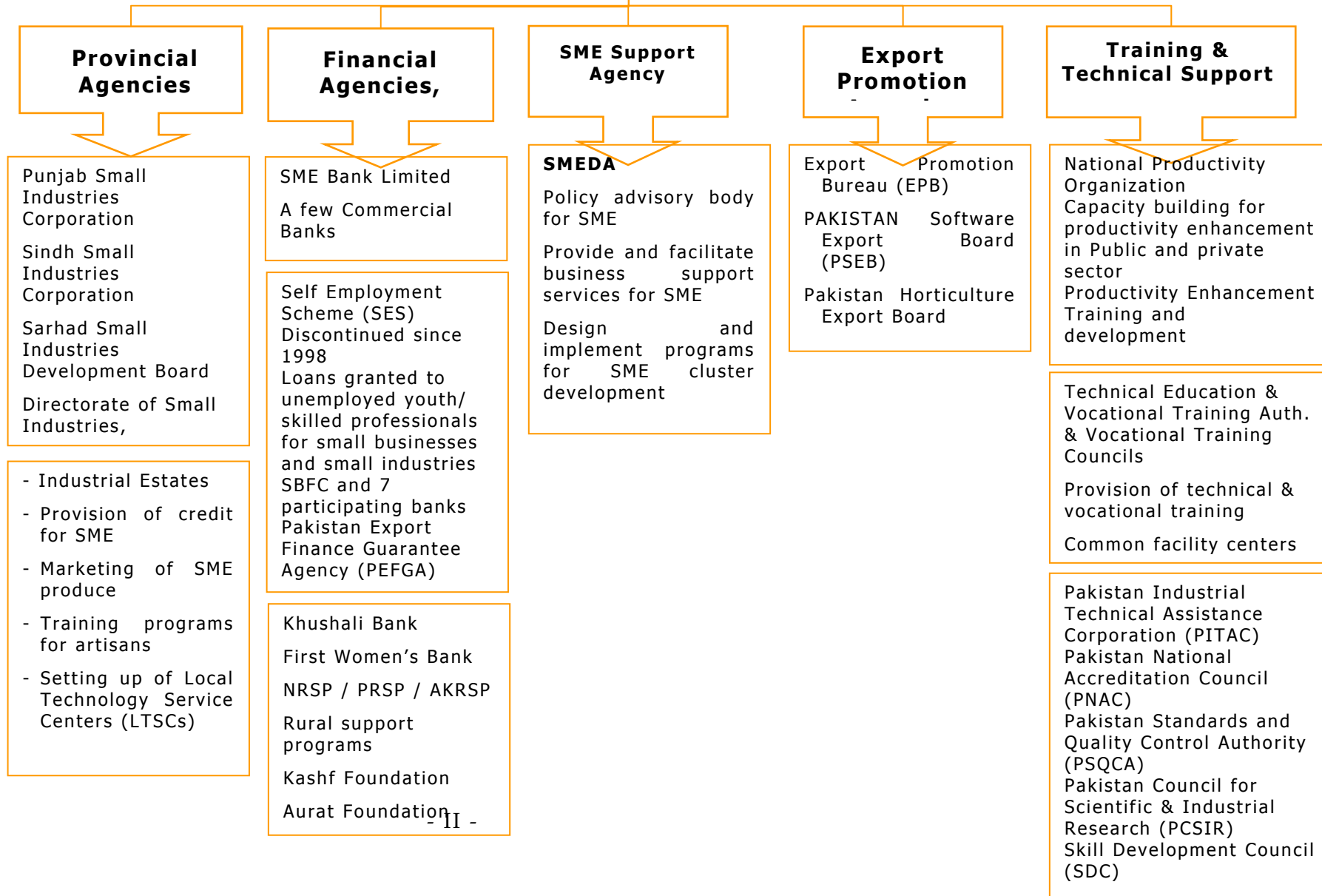


Table of Consolidation of Labour Legislation

The first column of the following table highlights various Ordinances that have either been promulgated or are expected to be promulgated in the near future. The second column delineates the labour laws to be repealed or consolidated as identified in the Labour Policy 2002.

Ordinances	Labour Laws repealed / consolidated
<i>I. Industrial Relation Ordinance, 2002</i>	1. IRO 1969 and 2. Section 27B, Banking Companies Amendment Act, 1997
<i>II. Conditions of Employment Ordinance</i>	3. Employment (Record of Services) Act, 1951 4. Standing Order, 1968 5. Shops & Establishment Ordinance, 1969 6. Disabled Persons Employment & Rehabilitation Ordinance, 1981 7. Employment of Children Act, 1991
<i>III. Payment of Wages Ordinance</i>	8. Payment of Wages Act, 1936 9. Minimum Wages Ordinance, 1961 10. Employees Cost of Living (Relief) Act, 1973
<i>IV. Occupational Safety & Health Ordinance</i>	11. Mines Act, 1923 12. Factories Act, 1934 13. Dock Laborers Act, 1934
<i>V. Human Resources Development & Control of Employment Ordinance</i>	14. Apprenticeship Ordinance, 1962 15. Control of Employment Ordinance, 1965
<i>VI. Labor Welfare & Social Security Ordinance</i>	16. Provincial Employees Social Security Ordinance, 1965 17. Excise Duty on Minerals (Labor Welfare) Act, 1967 18. Workers Welfare Fund Ordinance, 1971 19. Workers Children Education Ordinance, 1972 20. Employees Old Age Benefit Act, 1976

Table of SME Definitions used by various institutions in Pakistan

Institution	Small	Medium
Small and Medium Enterprise Development Authority (SMEDA)	10-35 Employees or Productive assets of Rs 2-20 million	36-99 Employees or Productive assets of Rs. 20-40 million
SME Bank	Total Assets of Rs. 20 million	Total Assets of Rs. 100 million
Federal Bureau of Statistics	Less than 10 employees	N/A
State Bank of Pakistan (SME Prudential Regulations)	<p>An entity , ideally not being a public limited company, which does not employ more than 250 persons (manufacturing) and 50 persons (trade / services)³² and also fulfills one of the following criteria:</p> <p>(i) A trade / services concern with total assets at cost excluding land and buildings up to Rs 50 million.</p> <p>(ii) A manufacturing concern with total assets at cost excluding land and building up to Rs 100 million.</p> <p>Any concern (trade, services or manufacturing) with net sales not exceeding Rs 300 million as per latest financial statements.</p>	
Sindh Industries Department	Entity engaged in handicrafts or manufacturing of consumer or producer goods with fixed capital investment up to Rs.10 million including land & building	
Punjab Industries Department	Fixed assets with Rs. 10 million excluding cost of land	
Punjab Small Industries Corporation	Fixed investment. up to Rs. 20 million excluding land and building	N/A

³² Enterprises exporting up to US\$2.5 Million a year are considered Small by the State Bank of Pakistan